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Investing in Renewable Energy Tax Credits Without Recaptures

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Investing in Renewable Energy Tax Credits Without Recaptures

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Foss & Company

Renewable energy tax credits can provide a significant reduction in tax liability with practically no risk of recapture due to a §50 disqualifying event during a project's five-year compliance period — with exercise of proper investment due diligence and asset management, Bryen Alperin and Sophie Gunderson of Foss & Company advise.

While the risk of recapture of tax credits in the renewable energy market is a major concern to many investors, it is highly manageable.

Many clients have asked us about the prevalence of recapture, where an investor's credit claim is invalidated due to an early disposition under I.R.C. §50 or is deemed partially or fully invalid retroactively due to the project not qualifying for the amount claimed or for the credit at all. Foss & Company, a tax credit syndicator for 40 years and counting, has analyzed investment tax credit (ITC) recapture data from the IRS and other important sources, and developed effective mitigation techniques.

The low historical prevalence of §50 recaptures (which we will discuss below) speaks not only to the inherent soundness of ITC provisions but also to the effectiveness of mitigation techniques, whoever might be employing them. Many investors have entered the market since the 2022 passage of the Inflation Reduction Act, which introduced a slate of renewable energy tax credits — and we are determined to keep rates low and mitigation high.

That said, "[t]he federal renewable energy tax credit program has a proven track record, serving as a vital driver of the energy transition," to quote the American Council on Renewable Energy (ACORE).

Incentivizing Renewable Energy Investment

Over the past two decades, federal tax incentives have mobilized more than $695 billion in private investment toward the development of solar, wind, and other renewable energy projects in the United States, according to ACORE (*id.*). Investors receive the benefit of reduced tax liability.

Long-standing incentives include, among others, the Credit for Producing Oil and Gas From Marginal Wells under §45I (added to the Internal Revenue Code in 2004), the New Energy Efficient Home Credit under §45L (2005); and the New Qualified Plug-In Electric Drive Motor Vehicles (later renamed the Clean Vehicle Credit) under §30D (2008).

Activity in the renewable energy space has intensified since the advent of the Inflation Reduction Act of 2022 (see Bloomberg Tax roadmap of the IRA), which amended and updated some of the above I.R.C. sections and added others. New provisions include, among others, the §45V Credit for Production of Clean Hydrogen, the §45Y Clean Electricity Production Credit, and the §45Z Clean Fuel Production Credit.

The industry now supports more than 3 million clean energy jobs, accounting for more than 40% of total energy jobs in 2022 and contributing significantly to local economies, according to a Department of Energy report.

In 2023, renewable sources accounted for 22% of U.S. power generation, or 874 billion kWh, the U.S. Energy Information Administration reported, predicting that solar and wind will continue to lead growth.

How Recaptures Happen — and Don't Happen

The term "recapture" in renewable energy often refers to one of two types of situations. The first type, the focus of this article, is a "true recapture" under §50 due to a disqualifying event during the project's first five years — that is, during its compliance period. Such events include the project's removal from service, ownership change, casualty loss, sale to a third party, or other disposition under §50. The second type of recapture is "disallowance" of the claim as the result of an IRS audit determining that the project did not qualify for the credit or for the amount claimed. Credits that qualify as investment credits (using IRS Form 3468) are subject to recapture under these scenarios.

To mitigate the risk, tax equity deals increasingly are featuring tax credit insurance, sponsor guarantees, and indemnities. In transferability deals, where investors and owners may bypass complex ownership structures found in traditional tax equity, the presence of such tax insurance may be even more important. While insurance provides a layer of protection for investors, protection may not be ensured.

The most effective way to mitigate recapture risk is to conduct a thorough investment analysis of the project — knowing what to look for — and continuing asset management throughout the compliance period.

Foss's renewable energy & sustainable technology group works on behalf of our investors to source projects which meet investment criteria and have appropriately mitigated risks. For example, we negotiate forbearance agreements with lenders whereby they agree not to exercise their rights of foreclosure in case of ownership change during the compliance period. We underwrite the natural catastrophe risk level of the region and the equipment's ability to withstand storm risk, and review the insurance policies to ensure sufficient property and casualty coverage. Throughout the investment cycle, we review reporting items such as operational reports, tax returns, and financial statements, monitor ongoing compliance factors such as prevailing wage and apprenticeship reports, and conduct periodic site visits to facilities to identify potential issues such as damaged equipment.

Consequences of a Recapture

A §50 recapture primarily occurs if the property ceases to be an eligible renewable energy property during the compliance period, as could be the case if the property was destroyed by a natural catastrophe and did not have sufficient insurance in place to rebuild. The ITC vests 20% per year after the property is placed in service. Under this scenario, the taxpayer's tax bill will increase equal to the unvested ITC that is recaptured and no interest or penalties will apply. As illustrated in the below table (based on a §50(a)(1)(B) illustrative table), if this scenario occurred in Year 3, the corporation's tax in Year 3 would be increased by $60, which is the total ITC claimed multiplied by the recapture percentage based on how long the ITC property was held.

Illustrative Recapture Example

Year	Recapture Percentage	Total Credit Taken (ITC)	Recaptured Credit
1	100%	$100	$100
2	80%	$100	$80
3	60%	$100	$60
4	40%	$100	$40
5	20%	$100	$20
6	0%	$100	$0

Alternatively, true recapture could be caused by a change of ownership that occurs within the compliance period, as could be the case if a bank with a security interest in the project took ownership through a debt foreclosure. If the ownership changes such that the project would not be eligible for the ITC in the amount originally claimed, the credit is recomputed and the unvested ITC is recaptured to the extent the total is less than originally claimed.

A disallowance could arise because the IRS, on conducting an audit of the project, challenges costs that contributed to the total ITC amount claimed. Under disallowance, the ITC claimant must pay back that amount plus interest and penalties retroactively to the year the ITC was claimed. The aforementioned vesting schedule does not apply.

In the context of renewable energy, recapture is an inherent risk for investment tax credits but not production tax credits, except for carbon sequestration PTCs under §45Q, which allows a three-year recapture period. The Inflation Reduction Act heralded significant investments into the renewable tax credit market with the extension of tax credits for wind and solar and the introduction of transferability of credits.

Transferability now permits renewable energy project developers to sell specified federal income tax credits directly to taxpayers, forgoing the need for a partnership structure that accompanies traditional tax equity. As with traditional tax equity, investment tax credits sold via transferability are subject to recapture during the five-year compliance period. Liability for most recapture events will go to the transferee, Treasury and the IRS said in recently released T.D. 9993, finalizing regulations on this and other tax credit transfer matters.

Industry Recapture Analysis

IRS SOI Publication 16 provides statistics on the quantity of general business credits claimed annually by corporations and the recapture of investment credits. The general business credit (IRS Form 3800) serves as an "umbrella" credit for corporations to report claimed tax credits and consists of more than 30 individual credits, of which the IRS prescribes a certain order of application. Each of the credits is computed separately but reported together for the purpose of applying the maximum tax liability rules and the carryback and carryforward rules. The investment credit (IRS Form 3468) falls under the general business credit and is to be applied first by

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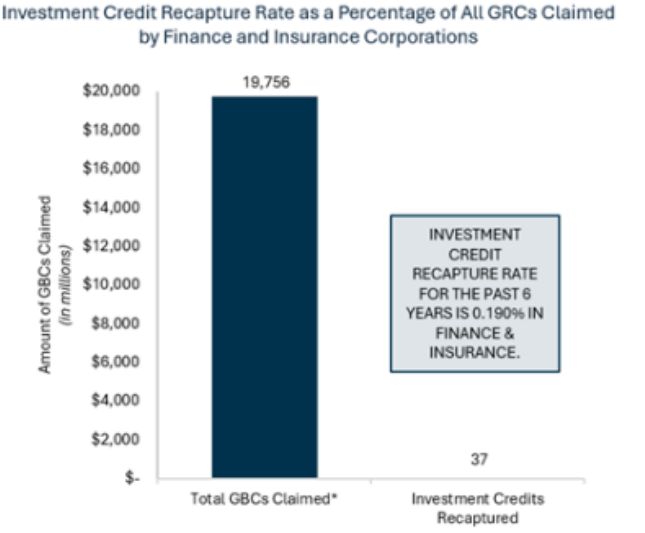
corporations. Under the IRS definition, ITCs include credits pertaining to rehabilitation, renewable energy, and qualifying advanced coal projects, as well as qualifying gasification and qualifying advanced energy projects. It is reasonable to assume that the investment credit accounts for a large portion of the total general business credits.

During 2014–2020 (the latest timeframe for which data are available), corporations claimed $290 billion in general business credits across sectors and there was $315 million of investment tax credit recapture (0.108%). Of that total, $110 million involved utilities, and this was almost entirely from a large $105 million recapture in 2015. This recapture event may skew the results to be greater than customary and does not necessarily apply to renewable energy investments, of which investors prior to the IRA were primarily financial institutions.

Among finance and insurance companies, who likely represent the majority of tax equity investors in renewable energy, there was $37 million in reported recapture across those seven years (0.190%). These recapture rates are extremely low given the double-digit returns that tax equity investors are often able to target. By contrast, a Moody's Analytics survey of infrastructure assets in 2020 found an average default rate of 6.18% for loans on power generation and transmission projects based on a review of 3,881 such projects. Therefore, while earning similar returns to the debt on power projects, tax equity enjoys a much lower default rate.



Presumably, the majority of the investment credit recapture is related to renewable energy projects due to the scale of the renewables market. During 2020–2022, the U.S. renewable energy industry attracted $18–20 billion in tax equity investment annually, according to Norton Rose Fulbright. The tax equity market has remained at this level after nearly doubling from $10 billion in 2017 to $18 billion in 2020. These figures do not reflect the total *credits* claimed on a one-to-one basis but do provide a rough idea of the size and growth of the tax equity market historically. Tax equity investments typically range from $10-300 million in size, depending on the project and investor. Provided the historical scale of the market and the typical size of investment, the total investment credit recapture during 2014–2020 for finance and insurance companies could be a result of just one or two projects.

The introduction of transferability post-IRA is expected to supplement the traditional $20 billion tax equity market and attract nearly $10 billion in 2024 and growing annually, according to ACORE (*id.*). This will expand the renewable energy investment pool outside of primarily large corporations or financial institutions and draw in more taxpayers. Despite the presence of seasoned developers and syndicators in the market who understand how to mitigate recapture risk, there are many new entrants with the passage of the IRA and the accelerating energy transition. In the absence of thorough project due diligence and asset management throughout the compliance period, credits may fall subject to increasing rates of recapture.

Conclusion

Recapture risk continues to be a prevalent concern amongst new and seasoned investors in the renewable energy tax equity market. While the historical rate recapture of investment credits in the pre-IRA was extremely low, investors in the IRA era must continue to maintain risk mitigation techniques via investment due diligence, tax credit insurance, indemnities and asset management throughout the compliance period.

Foss has deployed more than $8 billion in tax credit financing, including tax equity investments for hundreds of renewable energy projects, with no recaptures or disallowances.

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