



Transferable Tax Credits

Understanding the Current Impediments and Outlook for Renewable Energy Companies



What you should know about transferable tax credits

When Congress passed the Inflation Reduction Act (IRA) in the summer of 2022, it was expected to jumpstart a legion of innovative energy solutions and accelerate the country's move toward renewable energy. Today, more than a year post-passage, things haven't progressed as speedily as hoped. What's responsible for the delays and when will transactions pick up?

First, the background. The IRA granted billions of dollars, in the form of transferable and sometimes refundable investment tax credits and production tax credits, to companies investing in renewable energy—solar, wind, geothermal, hydrogen, nuclear power, battery storage and other renewable energy sources. These transferable tax credits can be a very significant source of funding for a given project; and companies can sell them to buyers that will use them to reduce their own tax liabilities. In theory, it's a win-win: the seller raises capital, and the buyer lowers its tax bill. Though a confluence of real-world factors has added some complications to this seemingly simple concept, companies are able to move forward and find various ways to monetize these credits.

To understand how, let's recognize that building an electric car factory, a small nuclear plant, a carbon sequestration facility or a wind farm is an astonishingly complex undertaking. These projects can cost up to multiple billions of dollars, and they can take a decade or more to complete. Land must be leased or acquired; hard assets must be constructed; individual components—a turbine, a giant fan blade, a prototype heat capture system—must be ordered and fabricated; systems installed; and government regulations, subject to change, followed at every step.



Current impediments

When real-world events interfere with the renewable energy construction process outlined above, it's natural for the market in transferable tax credits to be affected as well. We see four key factors constraining wider usage at present:



The process: Just like building the projects themselves, the administration of all of the new incentives is difficult. There are requirements for regulations and other guidance from Treasury and the IRS and a portal for registration that became available at the end of 2023. The technical nature of the additional guidance is a heavy burden for the government, but the guidance is needed for taxpayers to move with certainty on some of these large-scale new technology projects.



Inflation and interest rates: Since passage of the Inflation Reduction Act, we've had a rise in inflation and a series of interest rate hikes attempting to contain it. Together, they have raised the cost of borrowing as well as the cost of labor and materials. In some cases, costs have soared 40% or more above original estimate, causing projects to be postponed and even cancelled.



The bottleneck: Virtually all credit-eligible projects require various federal, state and other regulatory (ie. Federal Energy Regulatory Commission, Bureau of Ocean Management, State Utility Commissions etc.) approvals for construction and operation. As a result, many permitting authorities are dealing with an influx of permit applications with limited resources. Policy makers continue to debate how best to streamline project development. Some Federal and State agencies have taken administrative actions to improve the process, and while some legislative permit reforms have been enacted, more comprehensive permit reforms continue to be considered by Congress.



Supply chain issues: The residual effects of COVID still linger in global supplies. While everyone wants to build renewable energy projects and take advantage of the tax credits, there simply aren't enough batteries, blades or turbines being built. At present, for example, there are a limited number of offshore barges capable of building offshore wind projects. And while Chinese-built solar panels are out of favor, few US panels exist. This ongoing supply shortage lengthens project completion times and drives up materials costs.

These current conditions are, of course, not permanent. There has been a significant amount of guidance issued and more is expected from Treasury and the IRS; inflation is leveling; the backlog of permit applications is being cleared; and, as demand rises and more manufacturing capacity comes online to address the supply chain issues, the pace of fabricating specialized equipment will accelerate. Still, other issues complicate the process.

Speed bumps

One major concern can be timing. While a project developer may be fairly certain that it will be entitled to credits, the credits themselves are generated only after the project is complete and can be monetized only during a specified time frame that begins in the year that the project is placed in service. Companies eligible for the tax credits typically need to raise funds for their projects, so they want to sell their credits as quickly as possible. Buyers, of course, want to delay the transfer of cash to better match when they would have had to make payments to the government or even later.

Another point critical to understanding the transferable credit market is how much a credit might be discounted and why. Generally, discounts are priced as a function of the type and quality of the credit, the timing of the cash payment, and the indemnification and creditworthiness of the seller. It's critical for buyers and sellers to ensure that proper documentation is presented during the transaction and that the transaction is appropriately accounted for in the financial statements. There are many technical issues that surround the validity of the credit and after the credit is purchased, the buyer needs to analyze whether the credit meets the "more likely than not" standard for recognition on their financial statements. Technical requirements, such as the applicability of the prevailing wage and apprenticeship requirements, the qualification of any "adders" such as the domestic content used in the project, as examples, require an in-depth analysis. These and similar conditions illustrate why sellers must document all elements of a credit—and why purchasers must have a robust review process before purchasing the credit, reporting the benefit on their financial statements, and claiming a specific amount on a tax return.

Finally, risk identification and risk mitigation are key considerations. Indemnification and insurance are often required because of the technical risks and inherent uncertainty. If challenged and there are determined to be haircuts to the credit, the purchaser will not be required to repay the government for the credit claimed. As part of this transaction, the purchaser is looking to the seller to indemnify them for any risk associated with that scenario. Purchasers are also weighing the risk of future legal costs

needed to recover the indemnity or insurance proceeds with the benefit of purchasing the credits and looking for a rate of return on the purchase. And as companies consider selling tax credits from an internal rate of return perspective, how are they weighing the sale inclusive of the discount as they think about financing their planned project? If they monetize the credit, can they use the deductions that are generated by the projects in the early years? These questions and the many others that surround every transaction are why it is so important to seek the advice of knowledgeable professionals before making any decisions.

Next steps

The different areas of the IRA present multiple opportunities to take advantage of transferable tax credits. To help identify the most appropriate ones for you, seek out advisors who know the renewable energy industry and have strong experience in both the renewables sector and the nuances of tax credit transfers.

Today's conditions, as we noted above, need not be tomorrow's. We believe the money pumped into the economy by the IRA, and the use of tax credits to promote "made in America" businesses, are already beginning to melt the ice dam holding back a reservoir of capital. The economy appears to be gliding to a soft landing. With the Fed predicting three rate cuts in 2024, investors are again returning to the market.

Another brightening reality is that new deals in the renewable energy space are being executed more frequently. From manufacturers of components to generators of electricity and new technologies for hydrogen and sustainable fuels, there are many companies moving this industry forward. They have spent years progressing from prototypes to commercial viability, and they will now help accelerate the drive to the future.

While investment and production tax credits are not new, the vast expansion of these credits and the transferability of them is new and providing both opportunity and potential traps for the unwary. If your company is a cash taxpayer or if you are in the business of renewable energy production or any of its adjacent businesses and may be looking to monetize credits generated, we encourage you to find an advisor and explore your opportunities.

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