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Here Comes the Sun: New Solar Tax Credit Rules Benefit Rental Property Owners

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On Aug. 16, 2022, P.L. 117-169 (commonly known as the Inflation Reduction Act) was signed into law. Among other things, the Act drastically expanded the scope of green energy tax credits and other tax incentives, many of which could benefit rental property owners. In addition, last June, the Treasury Department released proposed regulations that have the potential to allow even taxpayers with no income tax liability to more easily monetize some of these tax credits.

Prior to 2022, the Internal Revenue Code allowed an investment tax credit for certain energy property, including solar panels, generally equal to 30% of the cost of such property. However, the credit for solar panels was being phased out and was set to expire completely for projects for which construction began in 2024 or later. In addition, the credits were nonrefundable, so if a taxpayer had little or no income tax liability, it would obtain little benefit from the credits.

The law prior to 2022 did not permit a taxpayer to directly “sell” any type of federal income tax credits to any person. As a workaround, taxpayers who were expected to generate large amounts of tax credits would sometimes enter into partnership or lease structures designed to allocate credits to a bank or other person with a large income tax liability. However, the structures were very complicated and would typically involve significant legal fees to implement. For a taxpayer with a relatively small amount of credits, such as the owner of a rental building who installed solar panels on the rooftop, the costs of monetizing the credits might not have been worth it.

The Inflation Reduction Act made two important changes that could make energy tax credits far more valuable. First, the Act significantly expanded many energy-related tax credits. For example, the investment tax credit for solar panels was extended so that it now applies if construction of the solar panels begins before 2025. The credit is generally 30% of the cost of the solar panels, but is increased to 40% if the solar panels comply with certain domestic content requirements. The 30% and 40% credits are reduced to 6% and 8%, respectively, if the project does not comply with certain prevailing wage and apprenticeship requirements. However, compliance with the prevailing wage and apprenticeship requirements is not required for projects with a maximum net output of less than 1 megawatt of electricity.

Second, although most energy tax credits are technically nonrefundable, the Act added Section 6418 to the Internal Revenue Code, which starting in 2023 permits taxpayers to directly sell certain energy credits, including the investment tax credit for solar panels, to others. The recently issued proposed regulations provide significant clarity as to how such credit sales would work in practice.

To effect a sale of any eligible tax credits, the seller must complete an online registration process with the IRS, which is expected to become available in early 2024. The buyer and seller must then sign and file an election statement no later than the due date of the tax return for the year in which the eligible credits are claimed. The buyer must pay the seller entirely in cash, which must be received prior to the due date of the election statement. The seller does not recognize taxable income as a result of the sale of the credits. Similarly, the buyer does not receive a tax deduction as a result of any payment for the credits.

A taxpayer is permitted to sell all or any portion of any eligible tax credits. In addition, if the taxpayer is a partnership, the proposed regulations provide a mechanism for the partnership to sell a portion of its credits and distribute the sale proceeds to certain partners, and then allocate its remaining credits to the partners who did not receive the credit sale proceeds. This can provide a significant benefit for partnerships whose partners have differing tax situations.

Even if an eligible credit is sold, there are still several things a seller can do after the sale that could cause the buyer's tax credits to be disallowed. For example, if investment tax credits for solar panels are sold, and then the solar panels are sold or removed within five years of being placed in service, all or a portion of the buyer's credits may be recaptured. Thus, buyers of credits will want to negotiate contractual protections in the purchase and sale agreements to ensure that sellers' future actions will not result in unexpected tax consequences for the buyers.

In sum, the changes made by the Inflation Reduction Act are a significant benefit to property owners installing solar panels and other energy property resulting in tax credits. The rules permitting direct sales of credits should provide a relatively simple means of monetizing tax credits compared to prior law. Nevertheless, most energy credits are still not actually refundable, and so taxpayers wishing to monetize credits will need to locate buyers and negotiate pricing and other contractual provisions.

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