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Due Diligence and Risk Mitigation

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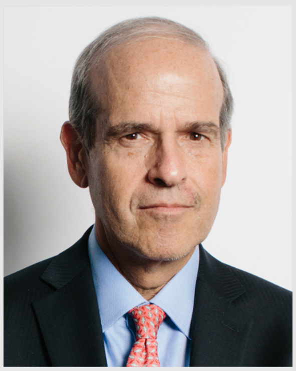

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In this article, Miles and Lee explain due diligence and risk mitigation considerations for purchasers of transferable tax credits in light of the One Big Beautiful Bill Act.

I. Introduction

Section 6418, enacted as part of the Inflation Reduction Act in 2022, created unprecedented opportunities for taxpayers to monetize federal tax credits (eligible credits) by permitting taxpayers to sell them to third parties in exchange for cash payments. By sanctioning the sale of federal tax credits, section 6418 effected a sea change in the way taxpayers may obtain tax benefits. Until section 6418 was enacted, taxpayers seeking tax benefits were generally required to establish a nontax business purpose or some nontax economic substance for the underlying transaction.[1] With the enactment of section 6418, Congress expressly authorized the purchase and sale of tax credits in transactions that have no economic substance other than the purchase of the tax credits for cash.[2]

Since section 6418 became effective, federal energy tax credits have evolved from nontransferable tax attributes into transferable assets that can be monetized through sales. A large market has emerged in which taxpayers purchase tax credits at a discount and apply those credits to satisfy their own tax liabilities.[3]

A taxpayer that buys tax credits must consider the potential tax risks that arise in connection with the purchase. Those potential tax risks increased following the enactment of the One Big Beautiful Bill Act. Purchasers can minimize their potential tax exposure through comprehensive due diligence, robust representations, covenants and indemnities from a creditworthy obligor, and if possible, tax insurance.[4] This article explores due

[1] Before enactment of section 6418, tax credits were often monetized through a partnership "flip" structure. In a typical partnership flip, a tax equity investor contributed capital to the project-owning partnership and was allocated most of the tax credits and depreciation allowances, as well as a small share of project cash flow.

[2] Section 6418 is somewhat analogous to the safe harbor leasing tax regime that was in effect from 1981 through 1986, and which allowed a tax lessor to claim depreciation deductions and the ITC for leased property even though the tax lessor did not have a nontax economic interest in the leased property. By enacting the safe harbor leasing legislation in 1981, Congress also allowed a taxpayer to claim tax benefits for a transaction that lacked nontax economic substance.

[3] The discount would reflect, among other things, the creditworthiness of the seller, the supportability of the taxpayer's tax position, and the quality of documentation supporting the availability of the credit. A comprehensive and strong tax opinion from a reputable firm addressing all material tax issues would likely reduce the discount at which the credits are sold.

[4] Indemnities of a seller are, of course, only as good as the creditworthiness of the seller. Indemnities can be supplemented with guarantees of a seller's parent or, if available, insurance.

diligence and risk mitigation considerations for purchasers.

Several types of investment tax credits and production tax credits (PTCs) are potentially eligible for transfer under section 6418. This article focuses on one type of ITC, the technology-neutral clean electricity ITC under section 48E (the section 48E ITC) and one type of PTC, the clean electricity production tax credit under section 45Y (the section 45Y PTC). This discussion is also generally relevant to other types of tax credits eligible for transfer under section 6418.

II. Overview of Section 6418 and the Transferability Rules

Section 6418(a) authorizes an eligible taxpayer to transfer all or a portion of an eligible credit (determined for that eligible taxpayer) to an unrelated taxpayer (the purchaser). Under section 6418(b), amounts received by an eligible taxpayer in connection with the sale of tax credits are not includable in gross income, and amounts paid by a purchaser are not deductible. A purchaser (1) has no basis in the transferred credit and (2) realizes no income from the purchase of the credit, even if the credit amount exceeds the purchase price.

To be an eligible taxpayer, the transferor must be a taxpayer other than a tax-exempt organization, any state or political subdivision thereof, the Tennessee Valley Authority, any Indian tribal government, any Alaska Native corporation, or any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.[5] In the case of property held directly by a partnership or S corporation, the credit transfer election must be made at the partnership or S corporation level.[6] If a partnership or S corporation makes an election to transfer a credit, any amount received as consideration for the transfer is treated as tax-exempt income for purposes of sections 705 and 1366.[7]

An election to transfer a credit must be made no later than the due date (including extensions of time) for the tax return for the tax year for which the credit is determined. Any such election, once made, is irrevocable.[8]

Before a credit can be transferred, the seller must complete an IRS prefiling registration process through the agency's "Energy Credits Online" portal.[9] The IRS will issue a unique registration number for each eligible facility or credit-generating property.[10] The registration number is required for the transfer election, and it must be included on the parties' tax returns.[11] Without the registration number, the credit is useless to a transferee. But the registration number is simply an identification number, and it does not ensure that the seller is an eligible taxpayer or that the tax credit is valid.

Tax credits eligible for sale are called eligible credits, and they include the following:

- the renewable electricity production credit under section 45(a);
- the credit for carbon oxide sequestration under section 45Q(a);
- the zero-emission nuclear power production credit under section 45U(a);
- the clean hydrogen production credit under section 45V(a);
- the advanced manufacturing production credit under section 45X(a);
- the clean electricity production credit under section 45Y(a);
- the clean fuel production credit under section 45Z(a);
- the energy credit under section 48;
- the qualifying advanced energy project credit under section 48C;
- the clean electricity investment credit under section 48E;
- a portion of the alternative fuel vehicle refueling credit under section 30(c); and
- a portion of the biodiesel fuels credit under section 40A.[12]

An eligible credit does not include any business credit carryforward or business credit

[5] Sections 6417(d)(1)(A) and 6418(f)(2).

[6] Section 6418(c)(2).

[7] Section 6418(c)(1)(A).

[8] Section 6418(e)(1).

[9] Reg. section 1.6418-4(a).

[10] Reg. section 1.6418-4(c)(1).

[11] Reg. section 1.6418-4(a).

[12] Section 6418(f)(1)(A).

carryback under section 39.[13] A credit may only be transferred once in accordance with a transfer election and may not be resold.[14]

It is essential to obtain robust representations from the seller. At a minimum, purchasers should obtain a representation for the transferred tax credits saying that (1) the seller has not agreed or elected to transfer the transferred tax credits to any person other than the purchaser; (2) no portion of the transferred tax credits was transferred to the seller under section 6418; (3) none of the transferred tax credits have been carried forward or back by the seller; (4) the transferred tax credits are eligible credits under section 6418(f); (5) the seller is an eligible taxpayer under section 6418(f); and (6) neither the seller nor any other person has claimed a tax credit under any section of the code for the project that would affect the right or ability of the seller to be eligible to claim the transferred tax credits.

III. Section 48E ITC, Section 45Y PTC, and Bonus Credit Amounts

The section 48E ITC and section 45Y PTC are two principal energy credits. The section 48E ITC is a one-time tax credit equal to a percentage of the amount invested in the project's qualifying property. The section 45Y PTC is a long-term, per-kilowatt-hour credit based on the amount of electricity produced and can be claimed during the first 10 years a facility is operational.

A. Section 48E ITC

For projects placed in service after 2024, the section 48E clean electricity ITC is the technology-neutral ITC. The section 48E ITC is for a "qualified facility" or "energy storage technology." Section 48E(b)(3)(A) defines the term qualified facility for section 48E purposes as a new facility that is used for the generation of electricity and that is placed in service after December 31, 2024, and for which the anticipated greenhouse gas emissions are not greater than zero.

The base section 48E ITC rate for a qualified facility is 6 percent. If the qualified facility also satisfies the prevailing wage and apprenticeship (PWA) requirements, the section 48E ITC rate is increased to 30 percent.[15] If the qualified facility also satisfies the domestic content requirement, the section 48E ITC rate is increased to 40 percent.[16]

If the purchased tax credit is a section 48E ITC, the purchaser should secure a representation from the seller that the underlying project owned by the seller is a qualified facility, within the meaning of section 48E(b)(3)(A), and the seller's qualified investment in the qualified facility, within the meaning of section 48E(b)(1), is no less than the amount set forth in the cost-segregation study and appraisal of the project (which should be secured in connection with the transaction).

B. Section 45Y PTC

Section 45Y(a)(1) provides a PTC for kilowatt hours of electricity produced by the taxpayer at a qualified facility and either (1) sold by the taxpayer to an unrelated party during the tax year, or (2) in the case of a qualified facility equipped with a metering device owned and operated by an unrelated person, sold, consumed, or stored by the taxpayer during the tax year.

Section 45Y(b)(1)(A) generally defines qualified facility for purposes of section 45Y as a new facility owned by the taxpayer that is used for the generation of electricity and that is placed in service after December 31, 2024, and for which the greenhouse gas emission rate is not greater than zero. The PTC period is the 10-year period beginning on the date the facility was originally placed in service.[17]

To avoid the operational risk that the facility fails to generate electricity, the purchaser could buy the credit at the end of the year, when the amount of the credit is known to a significant degree. If the purchaser buys section 45Y PTCs, it should secure a representation from the seller that the underlying project owned by the seller is a qualified facility, within the meaning of section 45Y(b)(1)(A).

[13] Reg. section 1.6418-1(c)(1).

[14] Reg. section 1.6418-2(c)(2).

[15] Section 48E(a)(2)(A)(ii)(III).

[16] Section 48E(a)(3)(B).

[17] Section 45Y(b)(1)(B).

C. The Prevailing Wage Bonus Credit Amount

The code provides for two tiers of tax credits depending on whether the PWA requirements are satisfied. As mentioned above, the section 48E ITC base rate is 6 percent if the PWA requirements are not satisfied, and it increases to 30 percent if they are satisfied. For the section 45Y PTC, the base amount is 0.3 cents per kilowatt-hour of electricity if the PWA requirements are not satisfied and 1.5 cents per kilowatt-hour of electricity if they are.[18] Additional bonuses, such as the domestic content bonus and the energy community bonus, may also be available.[19]

The PWA requirements are modeled on the Davis-Bacon Act. To qualify for the PWA bonus, the taxpayer must ensure that all laborers and mechanics employed by the taxpayer and contractors and subcontractors employed in the construction of the facility are paid at least the prevailing wage rate determined by the U.S. Department of Labor for the applicable type of work and geographic area. Wage determinations are issued by the Labor Department and vary by locality and job classification.

The prevailing wage requirement applies to repairs and alterations as well. For the section 45Y PTC, the requirement applies to repairs and alterations during the 10-year credit period, and in the case of the section 48E ITC, the prevailing wage requirement must be satisfied for the five-year period commencing on the placed-in-service date.[20]

If prevailing wages were not paid, a taxpayer may be able to cure the violation by paying (1) the wage shortfalls to the affected workers and (2) a penalty to the IRS.[21]

Two exceptions apply for the PWA: Projects that began construction before January 29, 2023, are generally not subject to the PWA requirements, and many projects under one megawatt also qualify for the full PWA bonus without having to satisfy the PWA requirements.[22]

A taxpayer generally can establish that construction began before January 29, 2023, by either satisfying a test showing "physical work of a significant nature" began before that date or by incurring 5 percent or more of the total cost of the facility before January 29, 2023.[23]

PWA compliance is a potential risk in these transactions. The purchaser should receive a certificate from the seller showing that construction of the project began before January 29, 2023, if applicable, or a copy of a report from a qualified third-party consultant that audits the seller's compliance with the PWA requirements. For some projects, the seller will have completed a Form 7220, "Prevailing Wage and Apprenticeship (PWA) Verification and Corrections," and if that is the case, the purchaser should review the form, which documents to a limited degree the seller's satisfaction of the PWA requirements with respect to the facility. The purchaser should also secure appropriate representations, covenants, indemnities, and insurance, if applicable, regarding compliance with the PWA requirements.

D. The Apprenticeship Requirement

The apprenticeship requirement includes three components — a labor-hours requirement, a ratio requirement, and a participation requirement.

Under the labor-hours requirement, the taxpayer must ensure that a minimum percentage of the total labor-hours performed for the construction, alteration, or repair of a facility are performed by qualified apprentices from a registered apprenticeship program. The applicable percentage is 10 percent for construction beginning before 2023, 12.5 percent for construction beginning in 2023, and 15 percent for construction beginning in 2024 and thereafter.[24]

Under the ratio requirement, the taxpayer must ensure that the applicable ratios of apprentices to journey workers established by the registered apprenticeship program are met for apprentices working on the facility each day.

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[18] Section 45Y(a)(2)(B).

[19] This article does not discuss the energy community bonus.

[20] *See* sections 45Y(g)(9), 45(b)(7)(A)(ii), 48E(d)(3), and 48(a)(10)(A)(ii).

[21] Sections 45(b)(7)(B) and 48(a)(10)(B).

[22] Reg. sections 1.45-7(a)(2) and 1.48-13(b)(1).

[23] *See, e.g.*, Notice 2022-61, 2022-52 IRB 560.

[24] Section 45(b)(8)(A)(ii).

Under the participation requirement, any taxpayer or contractor that employs four or more individuals during the course of the construction, alteration, or repair of the facility must hire at least one qualified apprentice.[25] Unlike the prevailing wage requirement, there are no apprenticeship requirements for alterations or repairs after a facility is placed in service.

Purchasers should closely focus on PWA compliance because a failure to satisfy these requirements could reduce the credit by 80 percent. Due diligence includes:

- certified payroll reports;
- Labor Department wage determinations;
- apprenticeship agreements;
- apprenticeship labor-hour calculations;
- contractor and subcontractor certifications;
- indemnities from developers and engineering, procurement, and construction contractors;
- opinions or memoranda regarding PWA compliance; and
- documentation regarding cure or penalty payments.

E. Domestic Content Bonus Credit Amount

If the domestic content and PWA requirements are both satisfied, then the section 48E ITC and section 45Y PTC credits could increase by an additional 10 percent. To satisfy the domestic content bonus requirement, a project must satisfy one of two requirements: (1) the steel and iron requirement, or (2) the manufactured products requirement.[26]

To satisfy the steel and iron requirement, a taxpayer must establish that any steel or iron that is a component of an applicable project was produced in the United States. Steel and iron are produced in the United States if all manufacturing processes take place in the United States, except metallurgical processes involving refinement of steel additives.[27]

To satisfy the manufactured products requirement, all "applicable project components" that are manufactured products incorporated into the facility must be produced in the United States or be deemed to be produced in the United States. All applicable project components that are manufactured products are deemed to be produced in the United States if the adjusted percentage rule described in section 3.03(2) of Notice 2023-38, 2023-22 IRB 872, is satisfied.

If applicable, the purchaser should secure representations, covenants, and indemnities from the seller, and if possible, insurance, for compliance with the domestic content bonus requirement. Further, the purchaser should obtain a report from a qualified third-party consultant confirming that the facility qualified for the domestic content bonus.

IV. Tax Risks

There are several additional issues that could potentially deprive a purchaser of the benefit of purchased tax credits.

A. Section 49 Tax Credit At-Risk Limitation

If property that is placed in service during the tax year by a taxpayer described in section 465(a)(1) is used in connection with an activity for which any loss is subject to limitation under section 465, the credit base of the property is reduced by the nonqualified nonrecourse financing for the credit base (as of the close of the tax year in which placed in service).[28] This could be relevant if the seller is an individual, an S corporation, a closely held C corporation described in section 542(a)(2), or a partnership consisting of individuals, S corporations, or closely held C corporations. The purchaser should confirm that the purchased tax credit is not subject to the section 49 tax credit at-risk limitation. If section 49 applies to limit the use of the credit by the seller, the limitation applies to the purchaser as well.[29]

To avoid a reduction in the section 48E ITC base in that case, any nonrecourse financing must constitute "qualified commercial financing,"

[25] Section 45(b)(8)(C).

[26] *See* sections 45Y(g)(11) and 45(b)(9)(B).

[27] Notice 2023-38, 2023-22 IRB 872.

[28] Section 49(a)(1).

[29] *See* reg. section 1.6418-2(d)(1) ("All rules that relate to the determination of the eligible credit, such as the rules in Sections 49 and 50(b) of the Code, apply to the eligible taxpayer and therefore can limit the amount of eligible credit determined with respect to an eligible credit property that can be transferred.").

within the meaning of section 49(a)(1)(D)(ii). To constitute qualified commercial financing, (1) the property must not be acquired from a related person, within the meaning of section 465(b)(3)(C), (2) the amount of the nonrecourse financing must not exceed 80 percent of the credit base of the property, and (3) the financing must originate from a qualified person or represent a loan from a governmental entity (or be guaranteed by such an entity).[30] A qualified person means any person that is actively and regularly engaged in the business of lending money and that is not (1) a person related to the taxpayer, (2) a person from which the taxpayer acquired the property (or a person related to that person), or (3) a person that receives a fee regarding the taxpayer's investment in the property (or a person related to that person).[31]

The purchaser should secure appropriate representations, covenants, and indemnities from the seller regarding the potential limitation of the tax credit under section 49.

B. Section 469 Passive Activity Credit Limitation

The purchaser must also examine its own ability to use purchased credits. Individuals, estates and trusts, and personal service corporations that purchase tax credits will generally be subject to the passive activity rules for any purchased credits. Generally, this means they can only use the credits to offset their passive income tax liability, within the meaning of section 469. Most taxpayers do not have a passive income tax liability, as it generally does not include tax liability arising from most investment or business activities.

Under section 469(e)(2)(A), if a closely held C corporation (other than a personal service corporation) has "net active income," within the meaning of section 469(e)(2)(B), for any tax year, the passive activity credit or loss of the taxpayer for that tax year is allowable as a deduction or a credit against the tax attributable to that income. Net active income means income excluding portfolio income and passive income. Thus, if a closely held C corporation (other than a personal service corporation) purchases tax credits, it should not be prohibited under section 469 from using the credits to offset tax liability attributable to net active income.[32]

C. ITC Recapture

Tax credits are potentially subject to recapture during the five-year period commencing on the placed-in-service date.[33] The section 48E ITC, in effect, vests at a 20 percent rate each year during the initial five-year period. ITC recapture is one of the most significant tax risks arising in connection with tax credit purchases.

Each event described below could trigger section 48E ITC recapture if it occurs during the ITC recapture period:

- a voluntary sale of the facility;
- a casualty event regarding the facility;
- certain weather-related events;
- operational failure; or
- a foreclosure of the mortgage, which triggers a disposition of the underlying property.[34]

Because the purchaser would have no control over these events, it can only mitigate the recapture risk through due diligence, representations, covenants, indemnities, and insurance.

The ITC could also be recaptured if the seller is a partnership and a tax-exempt entity acquires an equity or profits interest in the seller during the ITC recapture period. Under section 50(b)(3), property generally ceases to qualify for the ITC if it is used by a tax-exempt organization (unless the property is used predominantly in an unrelated trade or business).

Under section 168(h)(6), if property is owned by a partnership that has both a tax-exempt entity and a taxable entity as partners, and any allocation of partnership income to the tax-exempt entity is not a "qualified allocation," then

[30] Section 49(a)(1)(D)(ii).

[31] Section 49(a)(1)(D)(iv).

[32] In the case of an S corporation, the passive activity loss rules are applied at the shareholder level, so it is unlikely that an S corporation would purchase tax credits.

[33] *See* section 50(a).

[34] In many transactions, debt is incurred at an upper-tier level to reduce the purchaser's potential ITC recapture risk. If debt is incurred at the project level, the debt holders should execute a forbearance agreement, which would preclude them from foreclosing on the mortgage during the five-year ITC recapture period.

a portion of the property held by the partnership will be treated as tax-exempt use property.[35] In many, if not most, cases, an allocation to a tax-exempt entity will not constitute a qualified allocation.

Importantly, even a taxable corporation could be treated as a tax-exempt entity for purposes of section 168(h)(6), and therefore for purposes of section 50(b)(3), if the taxable corporation is a "tax-exempt controlled entity."[36]

Certain purchasers will purchase PTCs rather than ITCs to reduce the potential recapture risk, since PTCs are not subject to section 50 recapture. As a result, PTCs typically trade at a premium to ITCs. This trend will become more pronounced starting in 2028, because section 50(a)(4) provides for a 10-year recapture period and a recapture of the entire amount of the claimed section 48E ITC if (1) the taxpayer claims a section 48E ITC in any tax year beginning after July 4, 2027, and (2) there is a payment to a specified foreign entity (SFE) that provides the SFE with so-called effective control over the facility, energy storage technology, or an eligible component.

To reduce the potential ITC recapture risk, the seller should covenant that "during the ITC recapture period, Seller will not become a 'Disqualified Person.'" A disqualified person should be defined to mean "(i) any tax-exempt entity under Section 168(h) and (ii) any partnership or other passthrough entity (including a single-member disregarded entity) and any partner (or other holder of an equity or profits interest) which is a tax-exempt entity under Section 168(h)."[37]

The seller should also covenant that during the ITC recapture period, the seller shall not take any action or fail to take any action or suffer to exist any event or condition that would reasonably be expected to result in a recapture, loss or a disallowance of the tax credits, or cause the facility to be taken out of service for federal income tax purposes or transfer any interest in the facility in a manner that could reasonably be expected to result in a recapture of the tax credits.

The seller should further covenant that it will notify the purchaser of any ITC recapture event and that it will provide periodic compliance certifications confirming the continued qualified use of the facility and the absence of ownership changes and other ITC recapture events.

Further, the seller should represent that "no portion of the facility is 'tax-exempt use property,'" within the meaning of section 168(h), to the extent that it would reduce the transferred tax credits.[38]

D. Placed in Service

The "placed in service" issue is an important due diligence item for the purchaser because the tax credit is generally allowable in the tax year in which the property is placed in service. If the IRS determines that the facility was not placed in service during the tax year, it could disallow the credit. Courts and the IRS generally consider property to be placed in service when it is ready and available for its specifically assigned function.[39]

The following five factors are particularly relevant regarding the placed-in-service date for an electricity generating facility:

- Is the property physically complete? (If critical components remain uninstalled, the property is generally not placed in service.)
- Is the property operational?
- Has testing been completed?
- Is the property available for regular use in the taxpayer's business?
- Have necessary governmental and contractual approvals been obtained?[40]

Sophisticated purchasers often request the following documents:

[35] A "qualified allocation" means an allocation to a tax-exempt entity that is consistent with that entity's being allocated the same distributive share of each item of income gain, loss, deduction, credit, and basis and that share remains the same during the entire period the entity is a partner in the partnership and that has substantial economic effect. *See* section 168(h)(6)(B).

[36] *See* section 168(h)(6)(F)(iii). In general, under section 168(h)(6)(F)(iii), a "tax-exempt controlled entity" means any corporation if 50 percent or more (in value) of the corporation's stock is held by one or more tax-exempt entities, taking into account certain attribution rules.

[37] Based on the American Clean Power Association, "Form of Tax Credit Transfer Agreement — ITC" (2026).

[38] *Id.*

[39] *See, e.g.*, reg. section 1.46-3(d)(1)(ii).

[40] *See, e.g.*, *Sealy Power Ltd. v. Commissioner*, 46 F.3d 382 (5th Cir. 1995).

- tax opinions addressing the placed-in-service issue;
- independent engineer reports;
- certificates of substantial completion;
- interconnection approvals;
- board resolutions;
- internal placed-in-service analyses; and
- commissioning and testing reports.

The purchaser should secure a representation from the seller that the facility was placed in service in the tax year in which the credit is claimed.

E. '80-20 Rule' and 'Repowering Exception'

To constitute a qualified facility under both sections 48E and 45Y, the project must be placed in service after December 31, 2024. Further, for section 48E ITC purposes, the taxpayer's qualified investment generally only includes new property, not used property.[41]

Developers may attempt to take advantage of the so-called repowering exception or the 80-20 rule, under which a facility will be treated as newly placed in service if it is substantially rebuilt, the value of used components is no more than 20 percent of the total value of the facility, and at least 80 percent of the total value of the facility consists of new property.[42]

The purchaser should determine whether the 80-20 rule applies and whether the facility was placed in service after December 31, 2024. If the value of used components exceeds the 20 percent threshold, the facility would not be treated as newly placed in service under the 80-20 rule, in which case the credit would not be available. Further, if (1) the 80-20 rule is satisfied, and (2) the facility is still considered placed in service after December 31, 2024, the value of used components would not be includable in the taxpayer's qualified investment for section 48E ITC purposes because, as noted above, the section 48E ITC is generally unavailable for used property.[43]

F. Excessive Credit Transfer

The purchaser should determine whether there has been an excessive credit transfer within the meaning of section 6418(g)(2). An excessive credit transfer occurs if the amount of the eligible credit claimed by the purchaser regarding the facility exceeds the amount of the credit that would otherwise be allowable regarding the facility had the credit sale not occurred. The purchaser is potentially subject to a 20 percent penalty if (1) there has been an excessive credit transfer, and (2) it fails to demonstrate that the excessive credit transfer resulted from reasonable cause.[44]

Upon completion of construction of the facility, the fair market value of a facility may be higher than its development cost. In certain cases, a developer may sell the facility to an affiliate before the placed-in-service date, which could enable the developer to sell the underlying tax credits based on the FMV of the facility and not its development cost.

The purchaser should ascertain whether the step-up in tax basis and the allocation of the step-up to section 48E ITC-qualifying property will be respected for tax purposes. The purchase price paid by the affiliate should not exceed the FMV of the facility. The purchaser should review independent appraisal reports, engineering reports, third-party financing materials, and tax opinions. The purchaser should obtain an appraisal and cost-segregation study confirming the seller's tax basis in the facility and the portion of tax basis for which credits can be claimed, together with a reliance letter allowing the purchaser to rely on those reports as if addressed to it.

Further, the seller should represent that the purchaser's tax basis attributable to the section 48E ITC-eligible property will be no less than the amount set forth in the appraisal and cost-segregation study.

[41] *See* section 48E(b)(2)(C)(ii).

[42] *See*, *e.g.*, reg. section 1.48E-4(c)(1).

[43] Reg. section 1.48E-4(c)(2).

[44] *See* section 6418(g)(2).

G. Effect of Foreign Entity of Concern on Credit Eligibility

The OBBBA expands on the foreign-entity-of-concern restrictions introduced by the Inflation Reduction Act. Under sections 48E(d)(6) and 45Y(g)(13), section 48E and section 45Y tax credits cannot be claimed by an SFE or a foreign-influenced entity (an FIE).[45] The terms SFE and FIE are defined below. Thus, for a credit to be transferable, neither the seller nor the purchaser can be classified as an SFE or an FIE.

Broadly speaking, an SFE or FIE is an entity with an impermissible connection to China, Russia, Iran, or North Korea. These limitations were intended primarily to reduce China's access to U.S. tax subsidies, supply chains, and strategic industries, but Russia, Iran, and North Korea were included together with China as covered nations, which are targeted by the tax restrictions.

An entity is an SFE if, on the last day of the tax year, it is either (1) included on various lists under national security laws, including organizations that are designated threats to national security, or (2) a foreign-controlled entity.[46]

A foreign-controlled entity includes:

- a government of a covered nation (China, Russia, North Korea, and Iran);
- a citizen or national of a covered nation (excluding U.S. citizens and lawful permanent residents);
- an entity or a qualified business unit incorporated or organized under the laws of a covered nation or having its principal place of business in a covered nation; or
- any entity controlled by an entity described above.[47]

"Control" means, in the case of a corporation, ownership of more than 50 percent of the stock in that corporation, and in the case of a partnership, ownership of more than 50 percent of the profits interests, or capital interests in the partnership.[48]

Attribution rules apply in making this determination.[49]

For purposes of sections 48E(d)(6) and 45Y(g)(13), an FIE is an entity for which, during the tax year:

- an SFE has direct authority to appoint a covered officer of that FIE (such as a member of the board, or an executive-level officer, including the president, chief executive officer, chief operating officer, chief financial officer, general counsel, or senior vice president);
- a single SFE owns at least 25 percent of that FIE;
- one or more SFEs own, in the aggregate, at least 40 percent of that FIE; or
- at least 15 percent of the debt of that FIE has been issued, in the aggregate, to one or more SFEs.[50]

Thus, determining whether a particular entity constitutes an FIE requires, among other things, an assessment of whether 15 percent or more of its debt was issued to one or more SFEs, and this could be a difficult exercise in certain cases.

Special rules apply in the case of publicly traded entities. While a detailed description of the publicly traded entity rules is beyond the scope of this article, publicly traded entities are largely exempt from being considered SFEs unless their stock is traded on a market in a covered nation.[51] A publicly traded entity can be classified as an FIE, however, if (1) an SFE has the authority to appoint a board member or an executive officer, (2) a single SFE that is required to report beneficial ownership under SEC Rule 13d-3 owns at least 25 percent of the entity, (3) multiple SFEs that are each beneficial owners under SEC Rule 13d-3 collectively own at least 40 percent of the entity, or (4) more than 15 percent of the entity's publicly traded debt was originally issued to SFEs.[52]

An entity is generally also classified as an FIE if, during the previous tax year, it made a payment to an SFE under a contract, agreement, or other arrangement that entitled that SFE (or an

[45] *See* sections 48E(d)(6) and 45Y(g)(13).

[46] Section 7701(a)(51)(B).

[47] Section 7701(a)(51)(C).

[48] Section 7701(a)(51)(G).

[49] Section 7701(a)(51)(H).

[50] Section 7701(a)(51)(D)(i)(I).

[51] *See* section 7701(a)(51)(E)(i).

[52] *See* section 7701(a)(51)(E)(iii).

entity related to that SFE) to exercise effective control over the qualified facility, any eligible components produced by the entity, or its energy storage technology, within the meaning of section 7701(a)(51)(D).[53] Effective control refers to any contractual or licensing arrangement that gives an SFE authority over key aspects of a project, such as the authority to:

- determine the amount or timing of activities related to the production or storage of electricity;
- determine which entity may purchase or use the output of a qualified facility of the taxpayer;
- maintain, repair, or operate any plant or equipment that is necessary to the production of electricity or eligible components; or
- restrict access to data critical to the production or storage of energy.[54]

While the statute refers to a dozen acts of effective control, it then broadly includes a reference to any licensing agreement with an SFE that was executed or amended on or after the date of the OBBBA's enactment, that is, July 4, 2025.[55] Notice 2026-15, 2026-11 IRB 658, confirms that there is a serious risk effective control would automatically be triggered if a licensing agreement with an SFE is executed or amended on or after July 4, 2025.

The purchaser should secure tax representations, covenants, and indemnities, backed up by tax insurance, if applicable, and confirm through comprehensive due diligence that the seller does not constitute an SFE or an FIE. In addition, the purchaser should, among other things, review the seller's ownership structure, bylaws, and indebtedness and determine whether an SFE can appoint an individual to an executive or board position at the seller. The purchaser should also confirm that it is not itself an SFE or an FIE.

Section 48E ITCs are subject to a special recapture rule in connection with certain payments to SFEs. If a taxpayer claims the section 48E ITC in any tax year beginning after July 4, 2027, and if within the 10-year period commencing on the placed-in-service date of the property any "applicable payment" is made to an SFE regarding the property, the entire amount of the section 48E ITC is subject to recapture.[56] An applicable payment is a payment that would give an SFE (or certain persons related to an SFE) effective control over the qualified facility, eligible components produced by the taxpayer, or its energy storage technology, as described above.[57] Thus, the section 48E ITC recapture period here would be extended to 10 years, from the regular five-year period, and, upon occurrence of the disqualifying event, the entire amount of the section 48E ITC would be recaptured.

To avoid a potential disallowance or recapture of the section 48E ITC, the purchaser should (1) monitor licensing and other contractual agreements that were executed with an SFE counterparty, and (2) secure representations, covenants, and indemnities to ensure that no applicable payment is made regarding the facility.

H. Material Assistance From an SFE or FIE

In the case of facilities whose construction commenced after 2025, the OBBBA limits a developer's ability to claim section 45Y and 48E credits if it receives material assistance from a "prohibited foreign entity" (a PFE).[58] A PFE is an SFE or an FIE.[59]

A facility will be deemed to receive material assistance from PFEs if PFEs produced too much of the facility. Whether a facility satisfies the material assistance rules is determined by reference to a "material assistance cost ratio" (MACR), which escalates each year.[60] MACR is the percentage of the total cost of a qualified facility not attributable to PFEs. To qualify for tax credits under sections 48E and 45Y, the MACR threshold percentage must equal or exceed 40 percent for projects that commenced construction in 2026, 45 percent for projects that commence construction

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[53] Section 7701(a)(51)(D)(i)(II).

[54] Section 7701(a)(51)(D)(ii)(II).

[55] Section 7701(a)(51)(D)(ii)(III)(aa)(GG).

[56] *See* section 50(a)(4).

[57] Section 7701(a)(51)(D)(i)(II).

[58] *See* sections 45Y(b)(1)(E) and 48E(b)(6).

[59] Section 7701(a)(51)(A).

[60] *See* section 7701(a)(52)(B).

in 2027, 50 percent for projects that commence construction in 2028, 55 percent for projects that commence construction in 2029, and 60 percent for projects that commence construction after 2029.[61]

Manufacturers and suppliers must issue certifications regarding their PFE status and cost allocations to enable parties to determine whether the MACR percentage threshold requirement is satisfied.[62] Manufacturer and supplier certifications should be supported by the seller's representations, indemnities, and insurance, if possible. Moreover, the purchaser's due diligence should independently confirm that the MACR percentage threshold requirement was satisfied. Thus, the purchaser should, among other things, map the seller's supply chain to determine whether any entity in the chain is a PFE.

If the seller takes the position that construction of the facility began before 2026, and therefore the material assistance restrictions are inapplicable, the seller should provide a specific representation to that effect, which should be supported by an indemnity and insurance, if possible. Moreover, the purchaser's due diligence should independently confirm the factual basis for the seller's position.

Importantly, MACR-related tax deficiencies are subject to a six-year statute of limitations, rather than the standard three-year statute of limitations.[63]

Further, MACR-related tax deficiencies are subject to enhanced application of the 20 percent substantial understatement penalty. The substantial understatement penalty generally applies only if the understatement exceeds 10 percent of the tax required to be shown on the return. In the case of an MACR-related tax deficiency, the substantial understatement penalty can apply if the tax understatement exceeds 1 percent of the tax required to be shown on the return.[64]

V. Additional Responses to Risks

A. Tax Indemnity

In addition to obtaining the seller representations and conducting the due diligence described above, the purchaser should secure a broad structural tax indemnity from the seller and an agreement by the seller to cooperate with any tax audit. A sample tax indemnity that the purchaser could use is:

> Seller shall indemnify Purchaser in respect of, and defend and hold harmless, from and against any and all Losses suffered, incurred or sustained by Purchaser or any of its Affiliates resulting from or arising out of any Credit Loss, except to the extent such Losses are attributable to (i) any fraud, gross negligence, or willful misconduct of Purchaser; (ii) the inaccuracy, breach or failure of any representation, warranty, or covenant of Purchaser hereunder, unless to the extent resulting from a breach by Seller hereunder; (iii) any tax position taken by Purchaser that is inconsistent with the Tax Credit Transfer Agreement or the Transfer Election Statement; (iv) the inability of Purchaser to use the Transferred Tax Credits due to lack of tax capacity or application of Section 38(c) of the Code, the passive loss rules, the book minimum tax, or the base erosion and antiabuse tax; or (v) the failure of Purchaser to timely file its Tax Return and properly attach the duly executed Transfer Election Statement to the extent timely delivered by Seller hereunder to its Tax Return.[65]

Losses should be defined to mean "any and all liabilities, losses, taxes, penalties, interest, damages, costs, and expenses, including reasonable and documented attorneys' fees, court

[61] Section 7701(a)(52)(B).

[62] Section 7701(a)(52)(D)(iii)(IV). If a supplier provides an inaccurate certification, it could be subject to a penalty equal to the greater of 10 percent of the amount of the resulting tax underpayment or $5,000. Section 6695B. The penalty may be assessed within six years after the tax return or refund claim for which it was assessed was filed. Section 6696(d)(1). The penalty may be avoided if the supplier establishes that the false certification was because of reasonable cause and not willful neglect. Section 6695B(c).

[63] *See* section 6501(o)

[64] *See* section 6662(m).

[65] Based on the American Clean Power Association form of tax credit transfer agreement, *supra* note 37.

costs, and other costs of suit including Credit Losses."[66]

"Credit loss" should be defined to mean "any loss of, reduction of, recapture (under Sections 50(a)(1) or (b) of the Code) of or disallowance of the Tax Credits, any associated interest or penalties, including amounts due under Section 6418(g)(2)(A) of the Code, imposed on Purchaser in respect thereof, including as a result of a determination (within the meaning of Section 1313(a) of the Code) that the transfer of such Transferred Tax Credits resulted in an 'excessive credit transfer,' within the meaning of Section 6418(g)(2) of the Code."[67]

B. Tax Audit

In the event of an IRS tax audit, the purchaser will be required to substantiate its entitlement to the tax credit. While Treasury regulations require sellers of tax credits to provide certain information to their purchasers, more information may be needed for the purchaser to successfully weather an audit. The purchaser should therefore secure broad audit cooperation covenants from the seller.

The purchaser should not wait for a tax audit to commence before preparing for it, as the seller might become unavailable despite covenants requiring cooperation. The purchaser should therefore compile the documentation necessary to substantiate its entitlement to the purchased credits at the time of closing.

VI. Conclusion

The transferability of federal tax credits, including credits under sections 45Y and 48E, has created important new opportunities for taxpayers, but with those opportunities come risks. As we have described above, there are steps that purchasers should take to successfully manage those risks. ■

[66] *Id.*

[67] *Id.*