

Direct Pay: Tackling Clean Energy's Tax Equity Troubles



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Introduction

Congress first enacted a clean-energy tax credit in 1978 to incentivize the development of energy resources other than oil and gas. Since then, clean energy tax credits have expanded in size and scope, helping deploy a diverse set of low-carbon technologies and supporting some of the fastest-growing sources of job growth in the economy.

The success of these policies has hinged on something called tax equity financing, a mechanism that has worked great in the past, but is much less effective when earnings are down and investors are paying fewer taxes. With reduced corporate tax rates and a COVID-induced recession weighing down the economy, clean energy developers have less access to support at a time when they need it most.

Congress can fix this problem with measures like “direct pay”, which would help developers make better use of their tax credits, access the capital needed to move their projects forward, and put more Americans back to work. With millions of jobs and the nation’s climate goals on the line, lawmakers must seize on this opportunity to get the clean energy industry up and running at full speed again.

Key Terms

Tax Equity: A transaction wherein an investor provides capital to a developer in exchange for tax credits.

Tax Liability: The amount an investor or developer must pay in taxes based on their amount of taxable income, derived from total income minus applicable tax deductions and/or credits.

Depreciation: A developer’s long-term assets like property, buildings, and machinery (also called plant, property, and equipment or PPE) decline in value as they age and are used in the course of business operations. Businesses deduct the amount of depreciated value each year from their taxable income in order to reduce their tax liability.

Monetization: The method by which investors or developers convert tax credits into cash.

Refundability: Non-refundable tax credits can only be monetized (or converted to cash) if an investor or developer has sufficient tax liability. Refundable tax credits allow the recipient to monetize the credit regardless of how much they owe in taxes. Think of this as a payment rather than a deduction in amount owed.

How Tax Equity Financing Works

Clean energy tax credits are designed to help developers finance their projects. But many developers don’t actually have enough revenue (and therefore a large enough tax bill) to take full advantage of the tax credits themselves. In these cases, developers partner with a third-party investor using “tax equity financing.”

Under this agreement, investors like banks and other large companies that have more taxable income essentially provide initial capital for project development, and in return, utilize clean energy tax credits to reduce the amount of taxes they owe. The credits are more valuable to tax equity investors than to small companies because they have more taxable income.

Clean energy developers often use a combination of debt and equity to finance their projects. If, for instance, a developer is unable to secure a loan (debt) large enough to cover the cost of bringing its project online, it can raise additional capital through a tax equity arrangement.

There are two common types of clean energy tax credits: investment and production. Investment tax credits provide a one-time credit, allowing investors to deduct from their tax liability a

percentage of their capital expenditures in clean energy projects. Production tax credits are received over a period of time, as energy is produced, and are generally structured in one of the following three ways:

1. **Sale-leasebacks:** An investor fully owns the project, receives all of the tax benefits directly, and uses them to reduce its tax liability. The investor leases the project to a developer, who builds and operates the project and keeps all revenues that come in from customers.
2. **Partnership flips:** An investor and developer form a joint venture that initially operates like a sale-leaseback, but ownership of the project is converted from the investor to the developer within 5-10 years, mitigating the risks associated with long-term ownership for the investor.
3. **Inverted leases:** An investor leases a project from a developer and receives production tax credits in addition to customer payments. The developer owns the project and receives depreciation tax benefits. Once the lease expires (usually after 12 years), customer payments go to the developer.

Current Challenges

Tax equity financing relies on a pool of investors with an appetite to reduce their tax liabilities through various clean energy tax credits. While this arrangement has spurred growth among clean energy sectors, the ongoing economic drag from COVID-19 shifts the landscape. The pandemic-induced downturn has reduced the projected earnings of many large companies and therefore reduced the amount of taxes they project to owe, known as their tax liability. This comes on the heels of the Trump Administration's 2017 corporate tax cuts, which had already made tax liability scarcer. The smaller pool of investors looking to finance clean energy projects in exchange for tax assets could stall growth in these vital industries.

While some sectors have begun to slowly recover, large companies remain precariously positioned. Earnings among S&P 500 companies declined sharply in 2020 across most sectors, including the sector most actively involved in the tax equity market – financial services.¹ In a recent PwC survey of over 300 CFOs across a range of industries, half projected revenue declines of 10% or more this year and plan to defer or cancel planned capital expenditures.²

These studies portend a broad reduction in earnings and therefore tax liability. Without market demand for tax liability reduction, clean energy developers face a dearth of financing options moving forward. A recent BloombergNEF study estimated that 59% of solar projects and 67% of wind projects scheduled to start construction in 2020-2021 were still in need of tax equity financing.³ One of the largest solar developers in the U.S. referred to tax equity markets recently as “somewhat frozen,” explaining that banks are hesitant to commit to projects while their profits, and therefore tax liabilities, are uncertain.⁴ Small and mid-sized developers without sufficient scale or existing banking relationships face even greater challenges obtaining requisite financing.

How “Direct Pay” Solves the Problem

The good news is that we have a template for how to overcome challenges in tax equity markets that are likely to persist long after the pandemic is brought under control.

During the financial crisis in 2009, Congress created a grant program that allowed a variety of clean energy project developers to receive cash payments in lieu of investment tax credits. Often called “Section 1603”, the program sent payments directly from the Treasury for 30% of the project cost, the same amount offered through the Investment Tax Credit (ITC). This helped them access the value of the credit without relying on tax equity financing. By the time it expired in 2011, Section 1603 had funded 105,000 projects and attracted \$90 billion dollars in total investment. ⁵

Despite the previous success of cash grants, many clean energy advocates have coalesced around “direct pay” as a more effective policy solution for today’s tax equity troubles. Direct pay allows developers to treat tax credits like the ITC and Production Tax Credit (PTC) as an overpayment of taxes and monetize these credits as cash refunds from the Treasury after filing their annual tax returns. ⁶ Like the 1603 cash grants, direct pay would send developers payments directly from the Treasury Department, avoiding the need for third-party tax equity investors. But instead of relying on Congress to authorize a grant program and then getting lawmakers to appropriate money toward it, the direct pay option simply changes how the existing tax credits are monetized. **This likely makes direct pay a much more “reconciliation-friendly” option, too.**

Direct pay is a helpful solution when tax equity financing is hard to come by—but it’s also a more efficient way of delivering support to clean energy developers because it allows them to benefit directly from tax credits rather than pay a premium to tax investors. ⁷ These investors essentially act as middle-men, providing capital in exchange for a return on their investment. By allowing developers to monetize energy tax credits directly, they realize their full value without paying a portion of it to investors and at no additional cost to the government.

Recommendations for Congress

In December 2020, Congress passed clean energy tax credit extensions for a range of technologies including wind, solar, carbon capture, biofuels and alternative fuels, fuel cells and energy efficiency. ⁸ The legislation provided necessary support to the clean energy industry but did not include direct pay provisions, such as those found in the newly introduced GREEN Act (H.R. 848) ⁹, or those focused on the 45Q carbon sequestration tax credit (S. 4966, H.R. 8858) introduced at the end of last year.

As Congress considers new relief and stimulus measures to help accelerate economic recovery, it must include a direct pay mechanism to maximize the efficiency and effectiveness of clean energy tax credits. This one additional step would help the U.S. get more economic and climate impact from its tax policy at no discernable cost to taxpayers. *Why wouldn’t we take it?*

ENDNOTES

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9. H.R. 848 allows for an 85% direct payment of the full credit value.