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TAX CREDIT SPECIALISTS

ALLOCATED TAX CREDIT INVESTMENTS

GAAP Accounting Best Practices:
Utilizing the Deferral Method to Recognize Renewable Energy Tax Credits

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TAX EQUITY BASICS — ALLOCATED TAX CREDITS

A tax credit is a type of tax incentive that can reduce a company's tax liability on a dollar-for-dollar basis. The U.S. government uses tax credits to incentivize certain types of projects that produce social, economic, or environmental benefits. Common tax credit projects include affordable housing, rehabilitation of historic properties, low-income census tract economic development, wind energy, and solar energy. For these projects, the tax credit is a valuable and important part of the project financing capital stack. Many project developers do not have enough tax liability to take advantage of the tax credits themselves, so the developer monetizes the tax credit by attracting a "tax equity" investor.

Tax equity is a term that is used to describe a passive ownership interest in a qualified project, where the investor receives a return based on cash flow from the project, and tax benefits. In such a transaction, a partnership is often formed among the parties to facilitate injection of investment capital and the allocation of tax attributes. The specifics of each partnership vary by project, tax credit type, and transaction structure.

In practice, a tax equity investment utilizes the same dollars that are earmarked to satisfy a company's estimated tax liability payments. Those funds are repurposed and then invested into qualified projects that generate tax credits, such as a solar farm or affordable housing project. The tax benefit attributes (tax credits and depreciation) from the project flow back to the investor, eliminating a corresponding amount of tax liability. The investor typically also receives cash returns from the project for participating, thus earning them a rate of return on the same money that otherwise would have been wired to the government with no expectation for a return.

Returns on tax credit investment can vary widely depending on the program, the counter parties, and all standard risk factors associated with real estate or energy project underwriting. Generally speaking, after- tax returns to investors usually fall between 5% and 12% depending on the credit quality and other project risk

characteristics — e.g., low income housing tax credit (LIHTC) projects tend to fall on the lower end of the yield scale (for various reasons beyond the scope of this paper), while utility-scale renewable energy projects fall in the middle and mid- to small-scale renewable energy projects drive the top of the yield scale.

TAX CREDIT ACCOUNTING BEST PRACTICES & IRS GUIDANCE

IRS guidance with respect to tax credit programs varies significantly, with LIHTCs on one end of the scale and renewable energy tax credits (RETCs) on the other. LIHTC projects have special, clearly defined accounting rules and extensive, precise IRS guidance on all aspects of low-income housing transactions [1]. Unfortunately there is little to no published IRS guidance specific to the renewable energy industry, despite the RETC industry being a $20+ billion per year market, compared to LIHTC's $10 billion per year. Accordingly, there are many questions regarding accounting best practices for RETC projects, which invariably affect the desirability and risk assessment of investment opportunities in the renewable energy market.

This whitepaper strives to uncover and capture the best practices and approaches for investors and third-party accounting firms considering allocated tax credit investment opportunities. Before considering ways to address the issue of accounting best practices, however, a more detailed discussion and understanding of the renewable energy industry generally is essential, including the tax incentives available and tax equity structures utilized for RETC projects.

TAX INCENTIVES FOR RENEWABLE ENERGY INVESTMENTS

Federal tax incentives: Renewable energy projects may qualify for two types of tax credit (ITCs and PTCs) and depreciation incentives at the federal level:

- *Investment Tax Credit* — purchasers can take a tax credit equal to 30% of their basis in a new qualifying energy system. The ITC was enacted to serve as an incentive device to stimulate the purchase or modernization of certain kinds of productive assets by permitting a reduction in tax liability based on the taxpayer's qualified investment in certain kinds of property placed in service during the tax year.

- *Production Tax Credit* — available for certain partnership flip deals (explained in more detail below), the PTC is a per-kilowatt-hour tax credit for electricity generated by qualified energy resources and sold by the taxpayer to an unrelated person during the taxable year. The period of the credit is generally for a 10-year period beginning on the date the facility was originally placed in service. [2]

- *Bonus Depreciation* — under the Inflation Reduction Act (IRA), discussed in greater detail below, large companies that would owe limited annual income due to bonus deprecation, will be subject to a 15% minimum tax regardless of the amount of depreciation deduction available per year.

[1,2] *Internal Revenue Code (IRC) §45. (Unless otherwise noted, all references herein are to the IRC.)*

- *Accelerated MACRS Depreciation* — businesses can depreciate renewable energy systems using a 5-year schedule (even though, e.g., the useful life of a solar system is 30-¬35 years).

OTHER RENEWABLE ENERGY INVESTMENT FINANCIAL INCENTIVES

Additional programs are offered at the state, municipal, and utility levels in order to further incentivize local renewable energy investment.

Some states offer an additional tax credit, which usually "stack" with the federal ITC, meaning both state and federal tax credits apply to the full cost of installation. (Some states, utility companies, and municipalities offer cash rebates for solar installations, which may further offset the costs of installation but tend to reduce the return on federal/state ITCs because the rebate is applied first to the array cost before filing, thus they are generally disfavored by tax equity investors.)

Certain states also have performance standards for utilities, requiring power companies to either produce or purchase energy from renewable sources like solar power. In these states, utilities often use solar renewable energy credit (SREC) marketplaces to purchase solar power credits produced by homeowners who generate renewable energy, allowing for the sale of these credits to increase solar system income substantially, thereby reducing the time it takes for the system to offset the cost of installation.

Non-financial benefits to investing in ITC projects:

In an increasingly climate-conscious political and social environment, investing in clean energy can have significant, wide-ranging benefits to a company from a public relations and global perspective.

Most renewable energy generation produces little to no global warming emissions nor emits air and water pollution akin to that associated with traditional energy production — wind, solar, and hydroelectric systems generate electricity with no associated air pollution emissions, and the air pollutants emitted by geothermal and biomass systems are generally much lower than those of coal- and natural gas-fired power plants.

Further, wind and solar energy require essentially no water to operate and thus do not pollute water resources or strain supplies by competing with agriculture, drinking water, or other important water needs, and the water required for cooling at biomass and geothermal power plans would be reduced significantly in a future with high renewables.

Renewable energy sources are also essentially inexhaustible, so while a relatively small fraction of US electricity currently comes from these sources, studies have repeatedly shown that renewable energy can provide a significant share of future electricity needs, even after accounting for potential constraints.

The renewable energy industry also offers employment and other economic benefits. The industry is more labor intensive as compared to fossil fuel technologies, which means overall job creation and potential for technology-

driven higher-skilled, higher-wage opportunities.

Renewable energy can also benefit local governments in form of property and income taxes and other payments from renewable energy project owners and create value for property owners (especially farmers and rural landowners) in the form of lease payments and royalties. Furthermore, while renewable facilities require upfront investments to build, they can then operate at very low cost and thus can help stabilize energy prices in the future.

GAAP ACCOUNTING FOR ALLOCATED TAX CREDITS

If your company has made tax credit investments in the past, you likely need to keep account for new investments using the same methodology that has historically been applied. If you have not, there are two ways a company can account for an allocated tax credit:

- *Flow through/tax reduction method:* the credit is viewed as a selective tax reduction that applies at the time of purchase and the income tax expenses for that period are reduced by the credit. Companies that advocate this method believe the investment creates the credit.

- *Deferral/cost reduction method:* the credit is allocated to the accounting periods over which the asset is depreciated, with the key being the tax credit is taken to offset the related asset, thereby alleviating the amortization expense of the investment. Companies that advocate this method believe the asset creates the credit.

Investment tax credits accounted for by the deferral method: under the deferral method as established in paragraph 740-10-25-46, investment tax credits are viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred investment tax credits may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered. [3]

The flow-through method reflects the tax credits as expenses (non-asset purchases), thereby flowing directly to the income statement in the year of the purchase An ITC can be recognized either by directly reducing income tax expense or by providing an offset to the accounting expense that provided the credit.

Under the deferral method, the tax credit is treated as part of the purchased asset, and thus the credit is amortized over the same accounting periods as the asset is depreciated. Here again, a company has two choices: (i) it can deduct the credit from the asset base and calculate the depreciation expense on the net amount, or (ii) it can defer the credit and amortize it over the asset's serviceable life.

Additional renewable energy-specific accounting considerations and challenges:

- Project structuring and reporting are generally driven by tax considerations.

- Various unique accounting issues facing renewable energy companies such as significant government

[3] *ASC 740-10-25-20 paragraph (f).*

incentives; long term contracts for the sale of electricity; sale-leaseback structures (i.e., requirements to qualify for sale/operating lease treatment); obligations to remove plant and equipment at the end of contract; etc.

- Limited guidance regarding renewable energy deal structures/parameters — e.g., how long partners must retain partnership interests in the transaction entity; acceptable allocation of non-ITC tax assets; etc.

- Financial reporting-related issues: project participants (developers; tax equity investor; etc.) may require GAAP basis financial statements; potential consequences of and/or requirements attendant to particular financial statement/reporting approaches and tax treatment/positions.

BENEFITS OF UTILIZING THE DEFERRAL METHOD OF ACCOUNTING FOR RENEWABLE ENERGY INVESTMENTS

The deferral method presents some advantages that address perceived adverse accounting presentation inherent in renewable equity structures. Using the deferral method means that the recognition of tax credits is reflected as a reduction to the amortization expense of the tax equity investment in a company's income statement.

- Moving ITC investment-related items above the [pre-tax earnings] line means pre-tax earnings are not impacted by any ITC investment accounting adjustments — e.g., renewable energy projects tend to generate losses due to basis reduction, for example, during the initial years after placed in service.

- The flow-through method creates volatility between the pre-tax and post-tax earnings. Pre-tax earnings impact under flow-through method may deter companies from investing in tax credit deals, despite attractive yield compared to alternative investments, because, for example, corporate executive compensation may be tied to pre- tax earnings.

IMPACT OF TAX REFORM ON RETC PROJECTS

The Inflation Reduction Act (IRA) of 2022 is the most recent example of legislation impacting the renewable energy tax credit environment. The bill not only extended the duration of the tax credit programs of existing renewable technologies, but also expanded incentives for those technologies previously supported and for new technologies and formats of tax credit exchange, including:[4]

- 10-year ITC extension – Establishes and extends the ITC at 30% through 2032. It will then step down to 26% in 2033 and 22% in 2034.

- Direct-pay provision. Allows certain tax-exempt entities to receive a direct cash payment in lieu of tax credits. Starting in 2023, entities will be allowed to transfer their tax credits to a third party, effectively allowing them to sell their tax credits for cash to unrelated parties.

- Adder (bonus ITCs) for affordable housing, low-income communities and use of domestic content.

[4]For a comprehensive overview of the 2022 IRA, see IRA related publications in Norton Rose Fulbright website (www.nortonrosefulbright.com).

20% bonus ITC for facilities on eligible federal affordable housing programs and 10% bonus ITC for low-income communities and domestic content.

- Extended carryback and carryforward. Previously, the ITC is permitted for a 1-year carryback and 20-year carryforward. The IRA allows for a 3-year carryback and 22-year carryfoward.

FORECAST: ACCOUNTING FOR RENEWABLE ENERGY INVESTMENTS GOING FORWARD

Clear accounting guidance, rules, and best practices applicable to ITC projects could provide significant benefits to the renewable energy industry.[5] Lobbying efforts directed towards Congress have been successful, for example, in extending the ITC solar project subsidy in 2015 for an additional 5 years as part of a broader budget compromise, which extension was designed to encourage large institutional investors to finance solar development. (The IRS subsequently acted to extend availability of the 30% ITC to solar developers who invested at least 5% of the total expected cost or started significant physical work on the project before the end of 2019, so long as the solar power generators are up and running by 2023.)

Improving the accounting treatment for ITC is of vital importance to ensure the relevant and faithfully representative financial reporting for investments such as those made in not just LIHTC, but all tax credits.

As such, the exposure draft issued in August 22 by the FASB that would allow reporting entities to elect to use the proportional amortization method for all eligible tax equity investments that meet five specific conditions is a positive step forward as it would simplify the accounting treatment for various tax credits.

SAMPLE ACCOUNTING ENTRIES

See Exhibit A to review hypothetical GAAP accounting for a $20 million solar tax equity investment.

Foss & Company

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For more information:
visit: www.fossandco.com
email: IR@fossandco.com
call: (415) 292-9800

[5] *See, e.g., Karam Kang, Policy Influence and Private Returns from Lobbying in the Energy Sector, The Review of Economic Studies vol. 83, iss. 1, pp. 269–305 (Jan. 2016).*

EXHIBIT A - ILLUSTRATIVE GAAP PRESENTATION FOR SAMPLE $20 MILLION SOLAR TAX EQUITY INVESTMENT

GAAP Entries (Deferral Method)	2019	2020	2021	2022	2023	2024
Dr. Partnership Investment	20,000,000	-	-	-	-	-
Cr. Cash	20,000,000	-	-	-	-	-
Dr. Income Tax Payable	16,949,153	-	-	-	-	-
Cr. Partnership Investment	16,949,153	-	-	-	-	-
Dr. Cash	239,407	478,814	478,814	478,814	478,814	399,012
Cr. Partnership Investment	239,407	478,814	478,814	478,814	478,814	399,012
Dr. Income Tax Payable	1,008,972	1,142,371	-	-	-	-
Cr. Income Tax Expense	1,008,972	1,142,371	-	-	-	-
Dr. Income Tax Expense	-	-	70,653	70,653	70,653	296,640
Cr. Income Tax Payable	-	-	70,653	70,653	70,653	296,640
Dr. Deferred Tax Asset/Liability	770,689	-	70,653	70,653	70,653	159,725
Cr. Deferred Tax Expense	770,689	-	70,653	70,653	70,653	159,725
Dr. Deferred Tax Expense	-	1,142,371	-	-	-	-
Cr. Deferred Tax Asset/Liability	-	1,142,371	-	-	-	-
Dr. Cash	-	-	-	-	-	1,149,153
Cr. GAAP write off investment	-	-	-	-	-	497,175
Cr. GAAP Pre-tax earnings	-	-	-	-	-	651,978

Income Statement (Deferral Method)	2019	2020	2021	2022	2023	2024
General Overhead						
Gain/(Loss) on Exit	-	-	-	-	-	651,978
Pretax Earnings "Above the Line"	-	-	-	-	-	651,978
Income Tax Provision						
Federal Current Tax Benefit (Expense)	1,008,972	1,142,371	(70,653)	(70,653)	(70,653)	(296,640)
Federal Deferred Tax Benefit (Expense)	770,689	(1,142,371)	70,653	70,653	70,653	159,725
Total Tax Benefits (Expenses) "Below the Line"	1,779,661	-	-	-	-	(136,915)
Net Income (Loss)	1,779,661	-	-	-	-	515,063

EXHIBIT A - ILLUSTRATIVE GAAP PRESENTATION FOR SAMPLE $20 MILLION SOLAR TAX EQUITY INVESTMENT (CONT'D)

Tax Capital Account	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Beginning Balance	-	6,481,388	562,712	420,339	277,966	135,593
Contributions	20,000,000	-	-	-	-	-
ITC Basis Reduction	(8,474,576)	-	-	-	-	-
Cash Distributions	(239,407)	(478,814)	(478,814)	(478,814)	(478,814)	(1,548,164)
Income/(Loss)	(4,804,629)	(5,439,863)	336,441	336,441	336,441	1,412,571
Ending Balance	6,481,388	562,712	420,339	277,966	135,593	(0)

GAAP Investment Account	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Beginning Balance	-	2,811,441	2,332,627	1,853,814	1,375,000	896,186
Contributions	20,000,000	-	-	-	-	-
ITC Offset	(16,949,153)	-	-	-	-	-
Cash Distributions	(239,407)	(478,814)	(478,814)	(478,814)	(478,814)	(1,548,164)
Distributions Recognized as Income	-	-	-	-	-	651,978
Ending Balance	2,811,441	2,332,627	1,853,814	1,375,000	896,186	-

DTA / DTL Calculation on Partnership Investment	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Tax Capital Account	6,481,388	562,712	420,339	277,966	135,593	(0)
GAAP Investment Account	2,811,441	2,332,627	1,853,814	1,375,000	896,186	-
Excess (deficit)	3,669,947	(1,769,915)	(1,433,475)	(1,097,034)	(760,593)	(0)
Effective Tax Rate	21%	21%	21%	21%	21%	21%
DTA (DTL)	770,689	(371,682)	(301,030)	(230,377)	(159,725)	(0)
Current year increase (decrease)	770,689	(1,142,371)	70,653	70,653	70,653	159,725

EXHIBIT A - ILLUSTRATIVE GAAP PRESENTATION FOR SAMPLE $20 MILLION SOLAR TAX EQUITY INVESTMENT (CONT'D)

Check: Running Balance	Current Year	Cumulativre
Contributions	(20,000,000)	(20,000,000)
ITC	16,949,153	(3,050,847)
YR 1 Cash	239,407	(2,811,441)
YR 2 Cash	478,814	(2,332,627)
YR 3 Cash	478,814	(1,853,814)
YR 4 Cash	478,814	(1,375,000)
YR 5 Cash	478,814	(896,186)
YR 6 Cash	399,012	(497,175)
Exit Cash	1,149,153	651,978

GAAP PRE-TAX EARNINGS IN EXIT YEAR