Pitfalls Associated with Expansion of Energy Tax Credits

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I. Introduction

The Federal Government uses the tax system to encourage certain behaviors and discourage others. Taxes are not only a way to raise revenue, but also a tool of governance. The Inflation Reduction Act ("IRA")—the Biden administration's catchall bill—puts its hand on this lever by allowing taxpayers to sell tax credits which they earn through engaging in renewable energy investments, mostly wind farms or solar fields.[1] Despite its name, the Act has nothing to do with inflation. Its authors sought to encourage corporate investment in clean energy and to help small businesses.[2] Now, the Treasury Department is considering whether to expand these credits to individual credit purchasers.[3]

The IRS has for years provided tax credits to taxable entities operating clean energy investment projects.[4] However, that system came up for renewal or cancellation every two years,[5] generating uncertainty among energy-investing credit recipients. The tax credits could only be claimed by operators of clean energy projects—meaning one had to invest major funds in a capital-intensive project to benefit from the credit.[6] The IRA tax credit provisions sought to bring certainty to a complex area of law, allow small businesses to benefit where only large ones once did and further incentivize investment in clean energy. This was the *initial* plan. However, the Treasury Department is considering extending the market for energy tax credits to individuals.[7]

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[1] Keith Goldberg, *Clean Energy Tax Credit Transfers Gather Steam—Slowly*, LAW360 (Oct. 26, 2023, 5:49 PM EDT), https://perma.cc/ZE8J-UAK2.

[2] Justin Badlam et al., *The Inflation Reduction Act: Here's What's in it*, MCKINSEY AND CO. (Oct. 24, 2022), https://perma.cc/W853-38QT.

[3] Erin Slowey, *Treasury Floats Allowing Individuals to Buy Energy Tax Credits*, BLOOMBERG TAX (Oct. 16, 2023, 4:09 PM CDT), https://perma.cc/MW3L-YJDT.

[4] *Id.*

[5] Keaton Peters, *Flush With the Promise of Tax Credits, Clean Energy Project are Booming in Texas*, INSIDE CLIMATE NEWS (Aug. 16, 2023), https://perma.cc/8YVE-FRGK.

[6] Press Release, U.S. Department of the Treasury, U.S. Department of the Treasury, IRS Release Guidance on Provisions to Expand Reach of Clean Energy Tax Credit Through President Biden's Investing in America Agenda (Jun. 14, 2023), https://perma.cc/W553-W7K4.

[7] Slowey, *supra* note 3.

This article argues that this proposed change is a bad idea. It will create tremendous inefficiencies as middlemen take much of the available government handout, considerable fraud will occur similar to the Employee Retention Credit ("ERC"), and direct grants to energy investors would more effectively stimulate clean energy investment.

II. ANALYSIS

With certain kinds of energy tax credits, it used to be that if you developed a wind or solar partnership, those credits could be distributed directly to the partners.[8] Partners would receive money in the form of return on investment, with a sweetener on top in the form of tax credits.[9] However, one first needed hundreds of millions of dollars to invest in such a large and complicated venture. This required hiring a large law firm, costing millions in lawyers' fees alone. Thus, only the largest companies benefitted from this tax strategy.

The new Treasury Department guidance allows developers of projects to *sell* these credits, so long as they acquire a registration number from the IRS.[10] For instance, Google no longer has to invest in a clean energy partnership and hire lawyers; instead, it can buy credits from a wind developer in Texas and reduce its tax obligations rising from its profitable search business. This creates efficiency in the process because it allows entities with large tax obligations to purchase from individuals who have the expertise to manage energy projects well, and it prevents Google in our example from diverting significant resources to figuring out how to get into the energy business. Individuals can't use these credits now because of passive loss rules—the IRS doesn't think such a complicated tax incentive and filing structure is well suited to individual taxpayers.[11] Nonetheless, the Treasury is studying whether it should permit individuals to buy and use these credits.

An initial reaction is to view the energy tax credit market as expanding constantly, from energy partnerships to now "the little guy." Along with that expectation comes the thought that bringing these energy tax credits to individuals would (1) reduce tax liabilities for lower-income persons, as opposed to the wealthy who benefit the most from increase in Google's stock price via effective tax strategies,

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[8] Keith Martin, *Solar tax equity structures*, NORTON ROSE FULLBRIGHT (Dec. 14, 2021), https://perma.cc/J4TD-XAKL.

[9] Solar Energy Technologies Office*, Federal Solar Tax Credits for Businesses*, OFF. ENERGY EFFICIENCY & RENEWABLE ENERGY (Aug. 2023), https://perma.cc/BWL5-J9FS.

[10] U.S. Department of the Treasury, supra note 6; Michael Cohn, *IRA lets investors transfer clean energy credits*, ACCOUNTING TODAY (Oct. 04, 2023), https://perma.cc/6SJX-ZUPZ.

[11] *Passive activity loss limitation rules and solar project investment*, BERRYDUNN (Sep. 14, 2020), https://perma.cc/Y3SE-ULA4.

and (2) further incentivize clean energy investment. But there are reasons why such an expansion would not achieve its goals.

A. Safe Harbor Leasing and Tax Credits Given to Individuals

This is not the first time Congress has attempted to give complicated tax credits to the American people. The last time this occurred was when the Economic Recovery Tax Act of 1981 ("ERTA") enacted Ronald Reagan's massive tax cuts. The program was a disaster, and signs point to the same occurrence in the near future if the Treasury Department were to extend energy tax credits to individuals.

ERTA allowed for taxpayers who could not use their newfound depreciation tax credits to sell those credits to other taxpayers with outstanding tax liabilities, mostly large companies.[12] Known as safe harbor leasing, this was intended to stimulate investment in capital assets by making depreciation tax credits incurred against those assets salable.[13] However, Congress repealed safe harbor leasing just one year later.[14] This occurred because the complexity of buying and selling tax credits with detailed requirements that determined their validity incurred significant transaction costs, so much so that in some cases twenty to thirty percent of the value of the tax credits went to the lawyers and bankers facilitating the transaction. Tax credits, while politically popular, often create inefficiencies when the government is less inclined to directly stimulate industry with grants. The goal of the IRA is not to benefit intermediaries in the financial system, and tax credits remain a poor choice to stimulate energy investment. The following section addresses why salable credits aimed at *individuals* are also a poor policy choice.

B. The Employee Retention Credit

Giving complex tax credits to individual taxpayers creates a disproportionate amount of fraud.[15] The government, to further encourage the development of renewable energy, including wind and solar, wants to let individuals buy and use these credits.[16] However, in doing so, considerable illegal tax avoidance will occur, at rates disproportionate to large corporations with expert tax counsel. The country just witnessed this with the ERC.

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12 Marie Sapirie, *Will the IRA Tax Credit Transfers Meet The Same Fate as Safe Harbor Leasing?*, FORBES (Jun. 8, 2023, 2:02 PM EDT), https://perma.cc/D498-8DNB.

13 Richard J. Bronstein & Alan S. Waldenberg, *The Short Life and Lingering Death of Safe Harbor Leasing*, 69 A.B.A. J. 1844 (1983).

14 Sapirie, *supra* note 12.

15 News Release, Internal Revenue Service, To protect taxpayers from scams, IRS orders immediate stop to new Employee Retention Credit processing amid surge of questionable claims; concerns from tax pros (Sep. 14, 2023), https://perma.cc/84V9-A8Z4.

16 Sapirie, *supra* note 12.

During COVID, Build Back Better gave tax credit for every employee retained, i.e. not fired, during the pandemic.[17] The problem with this program was that the average American small business owner and employer is less well-equipped to understand the IRC's structure, and the reasons behind the incentive programs it creates, than expert tax counsel. You may have seen the ads on TV in the past two years: "the government is giving out tax credits. Pay this fee and we can save you money."[18] The problem is that these ads don't seem like outright scams. There's usually a grain of truth, some kind of tax reduction program. But the IRS estimates that billions of dollars in fraud occurred; reducing barriers to committing tax fraud put people who are traditionally held in check by the rigidity of the tax code in a position to be easily swayed into overreporting employees for purposes of reducing taxes.[19] The IRS is trying to figure out how many billions of dollars in fraud took place, and it is attempting to shut down these operations.[20]

When you create a large market for small buyers of tax credits, the ability of the individual to reduce or eliminate their taxes through fraud becomes considerable. Something similar would probably happen following an expansion of energy tax credits to individuals. The lack of policing of the cottage tax credit industry means the IRS will lose out on significant revenue and will then spend further millions trying to recoup. A further danger of allowing individuals to buy credits is that the seller of the credit might manufacture the credits and sell them fraudulently, thus making taxpayers unknowingly underpay their taxes. The Treasury Department has declared that the buyer retains all responsibility for the validity of the credit.[21] The government currently limits this to large corporations to police its legitimacy. Is it better to have a larger market for these sources?

The more money people spend on credits, the more money will flow into wind farms and like projects. However, there's no reason that that money couldn't come from more direct sources. The U.S. has identified semiconductor chips as a crucial component of American industry, and it has invested tens of billions directly into the industry via grants.[22] Similarly, money can be invested directly into the

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[17] Liz Farmer, *Biden's 'Build Back Better' Could Nix a Tax Credit That Helps Small Businesses Still Recovering From Shutdowns*, FORBES (Oct. 26, 2021) https://perma.cc/8A2Y-YCPF.

[18] *See Employee Retention Credit*, IRS (Oct. 24, 2023), https://perma.cc/3ZAD-XRNT (noting that significant fraud took place under the ERC program).

[19] Martha Waggoner, *'Tsunami' of ERC claims required IRS action to halt fraud, experts say*, J. ACCOUNTANCY (Sept. 19, 2023), https://perma.cc/2XVV-C327.

[20] *Id.*

[21] Scott Hodge, *"Monetizing" Clean Energy Tax Credit Creates a Sham Market for Bad Policy*, TAX FOUNDATION (Jul. 18, 2023), https://perma.cc/NA94-UFHE.

[22] Press Release, The White House, Fact Sheet: One Year after the CHIPS and Science Act, Biden-Harris Administration Marks Historic Progress in Bringing Semiconductor Supply

energy economy without resorting to roundabout tax incentives that (because of political pressure) must then be expanded to a tax base not well-suited to unnecessarily convoluted tax credit plans.

What's more, the IRS has to police this new market for tax credits. That means more audits, and more creative tax shelters to litigate against. The ERC created billions of dollars of tax fraud. Marketers sold credits, telling employers that five hundred dollars of credits would save the business owner sixty thousand dollars of taxes. Creating a market in energy tax credits will do the same thing. It will allow manipulative advisors to mislead individuals, convincing them to buy tax credits not within their interests, or overclaim deductions, or even buy credits that don't exist. All of these potential schemes present more difficulties for the already-underfunded IRS. Thus the complexity of this system is not well-suited to further expansion to smaller taxpaying entities, both due to the increased enforcement costs and smaller taxpayers' propensity for being misled.

C. An Alternative Recommendation

As a nation, the U.S. has decided it wants oil independence, and less fracking and global warning.[23] Unless it builds nuclear power plants, it needs solar and wind farms. But coal, gas, and oil are much cheaper. This is why Chevron is buying Hess and Exxon bought Pioneer. These companies think the future will be in oil and gas. The relative expense of solar and wind means that for corporate investment in these technologies and their continued advancement to occur, the government has to inject significant capital into the industry. Other tools are available besides this credit expansion that would more effectively support clean energy absent the potential for fraud. Direct national investment removes the likelihood of a similar outcome to the ERC program.

Further, it's not just that Congress says it's going to give out credits for renewable energy sources and then the right things will happen. The windmills might not actually be turning. Companies could misstate their energy output or make their energy seem more environmentally-friendly than it is. It's unclear why one would think that indirect allocation is more efficient than direct outlays to energy companies. Slower energy investment might be preferable, since government financing in amounts determined by negotiations between parties hardly defines the optimal outlay of capital. Also, over-investment concentrated around tax credits incentivizes the creation of sub-optimal energy generation facilities. What if the windmill money goes to countries that oppose our interests? Giving tax breaks to

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Chains Home, Supporting Innovation, and Protecting National Security (Aug. 9, 2023), https://perma.cc/KX8M-ATQU.

[23] Hiroko Tabuchi, *Nations That Vowed to Halt Warming Are Expanding Fossil Fuels*, Report Finds, N. Y. TIMES (Nov. 8, 2023) https://perma.cc/9WT8-L776.

sovereign wealth funds that invest in the U.S. minimizes returns to American consumers.

The Treasury Department has progressively expanded the energy tax credit program. The program began with having to be an investor in a windmill directly to get the credit.[24] Then, with salability, large companies could buy the credits.[25] Smaller companies may soon follow—that's what the Treasury hopes.[26] Now that the credits can be bought, transaction costs decrease. The next step is whether it should be expanded to people who pay high taxes—doctors, lawyers, car dealers, etc. The same division between corporations able to take advantage of the program occurs between taxpayers able to take advantage of the program. Rich taxpayers are best prepared to have the kind of advisors who can help them effectively buy and use these credits. This program will make the marginal tax system more regressive. To benefit low-income taxpayers, the money is better spent directly on industry, perhaps with hiring requirements.

The final piece is the IRS. The IRS will have to audit these complex sales and tax structures. In the coming years, the IRS is due for billions of dollars in new federal funding, to modernize the agency and hire more agents.[27] Such a tax program is better suited to deployment after a strengthened IRS is capable of enforcing a program prone to manipulation.

III. CONCLUSION

The IRA seeks to encourage energy investment by expanding tax credits to smaller businesses. While the plan is going well so far, the next step the government is eyeing is to expand this tax credit to individuals. However, because individual tax payments are more prone to misuse both by individuals and their advisors, a better strategy would be to encourage the energy industry through direct payments similar to the CHIPS act,[28] and lower tax rates on individuals through more direct means, rather than energy-focused tax credits.

The use of complicated tax structures by individuals incentivizes bad actors to manipulate taxpayers into tax fraud, creating crimes where none need to occur. It also costs taxpayers in time and money. Wealthier taxpayers are more likely to itemize. One might think that individual deductions will benefit all people equally, or

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[24] Cohn, *supra* note 10.

[25] *Id.*

[26] Press release, *supra* note 6.

[27] Charles W. Shewbridge, *Comments on IRS Funding*, 52 TAX EXECUTIVE 243 (2000).

[28] H.R. 4346, 117th Cong.

be targeted at low-income taxpayers, but due to the complexity of tax credits, wealthy taxpayers will benefit the most from individualized credits.

The considered expansion shows signs of following the disastrous path of safe harbor leasing and the ERC, with an unnecessarily complicated incentive structure placed on parties less likely to understand, take advantage of, and be effectively influenced by tax credits. Energy tax credits are more effective when left to big companies that can optimally plan how to move their capital into the clean energy investment market, while smaller taxpayers are better served by lowering marginal rates.