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Tax Credit Sale Frenzy: Don't Create a Prisoner's Dilemma

by Shirley Chin

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Shirley Chin is the head of tax insurance at Willis Towers Watson.

In this article, Chin explains how to align interests when negotiating tax credit transfers, and she identifies some pitfalls that should be avoided.

Under the Inflation Reduction Act of 2022 — along with the rapid adoption of tax insurance — tax credit transfers have turned a bilateral tax controversy process (taxpayer versus the IRS) into a multilateral, multidimensional process (tax credit buyer, seller, insurance and potentially even the tax equity investor, versus the IRS), in which rights and obligations are negotiated upfront during deal closing when the tax insurance is placed, years before an audit commences.

Because those rights are negotiated upfront, it is important for all parties engaging in a tax credit transfer to consider how to structure each other's rights and obligations within the context of an IRS administrative process and an insurance claims process; remember that, if audited, you will be simultaneously managing three processes: aligning taxpayer-side interests; engaging in a chess match with the IRS on both substantive and procedural grounds; and protecting your claim so that you can collect under your tax insurance policy.

To succeed, you should have advisers who can guide you through all three processes. Step 1 requires your tax insurance broker and advisers to understand the long audit process so that they can bake into your insurance policy and transfer agreement contract terms that will align taxpayer-side interests. If an audit commences, you do not want to get trapped in a prisoner's dilemma in which the optimal outcome for all the parties is to cooperate but inadequately considered provisions can lead to suboptimal — or even disastrous — taxpayer outcomes.

Two recent incidents suggest confusion lies in wait. First, a corporate client requested our review of a tax insurance policy placed by another brokerage and a tax transfer agreement that it had been asked to sign. The documents were fraught with heavy-handed obligations to which no corporation should agree. Second, a buy-side tax credit adviser who attended my panel presentation on "IRA Clean Energy Credits and Anticipated Enforcement" at the recent New York University Tax Controversy Forum reached out to ask questions about the audit process out of concern regarding similar obligations for their buyers as well as representations made by other brokerages.

Before joining WTW as its head of tax insurance, I spent a decade at the IRS Office of Chief Counsel (Large Business and International) auditing and litigating tax credit, corporate, and partnership issues. I was appointed to litigate alongside the Department of Justice Tax Division as a special assistant U.S. attorney and twice recognized by the IRS National Office with the Lucite award for litigating cases with significant tax impact. I spent the next eight years as the vice president of tax at a publicly traded solar developer, successfully leading its tax policy and tax controversy efforts (with and without tax insurance in the mix). I offer the following observations with the benefit of that 360-degree perspective of a full tax credit life cycle.

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Aligning Taxpayer-Side Interests

To manage step 1 of the three processes successfully, you need to first understand the trade-offs in aligning taxpayer-side interests. Your tax insurance policy will state clearly that your insurer does not assume any duty to defend the audit and that the insured *shall* defend and contest any tax claim for which coverage is sought; failure will jeopardize your insurance coverage. There are many trade-offs and strategic decisions to make regarding how this audit defense will be conducted, the first being that of audit control.

I have been consulted about the following audit control options: (1) the buyer executes a Form 2848, "Power of Attorney and Declaration of Representative," for the seller; (2) the buyer executes a limited/restricted Form 2848 for the seller; and (3) the buyer pushes the audit to the seller level.

Tax credit buyers should seriously think through the wisdom of agreeing to execute a Form 2848 to the tax credit seller or its advisers. Some sellers are seeking powers of attorney over buyer audits because they perceive it necessary to protect their indemnification obligation, insurance coverage, and their appraisal method. While understandable, tax credit sellers should consider whether negotiating such a broad right — at the expense of buyer autonomy of its audit process — is tactically worth the effort.

Form 2848 broadly authorizes the designated party (that is, tax credit seller) to inspect and receive confidential tax information and to perform all acts (sign agreements, consents, waivers, or other documents) that the tax credit buyer can perform regarding the audit. It also empowers the designated party to represent you before the IRS.

Large multinational corporations, common buyers of tax credits, will have many audit issues unrelated to tax credits. Before agreeing to such a provision, tax credit buyers should think through the implication of granting a tax credit seller such broad rights not only to review audit notices, workpapers, and other confidential tax information on audit issues unrelated to tax credit but also to represent the buyer before the IRS on these unrelated issues. If you work in a siloed business environment, your team running the tax transfer purchase had better check with its legal department regarding this broad power of attorney designation. Agreeing to these provisions now just to get the deal done in time for estimated tax payment benefits — without understanding the full implication of the authorization — needlessly sets the stage for acrimony when parties should work together at the commencement of an audit.

Perhaps realizing the broad scope of a Form 2848, parties are trying to contractually limit the broad rights provided by Form 2848 by calling for a limited or restricted Form 2848. But Form 2848 is part of an IRS administrative process; the parties can contractually negotiate all they want, but the language in box 3 of Form 2848 simply does not contemplate an issue carveout for transferred credits. It allows a carveout by tax matters (income, employment, payroll, excise, estate, gift, whistleblower, practitioner discipline, private letter ruling, Freedom of Information Act, civil penalty, section 4980H shared responsibility payment, etc.). And it allows a carveout by tax form number (1040, 941, 720, etc.), tax year, or tax period, but there is no further limitation. Thus, accepting a limited (or restricted) power of attorney that is delineated by issue (that is, limited to tax credit issue only) is subject to the IRS audit team's discretion and might not provide anything meaningful in practice.

Tax credit buyer claims the tax credits on Form 3800, "General Business Credit."[1] Limiting the Form 2848 to just Form 3800 will still be too broad because that form includes all tax credits, not just the transferred tax credits. The carryforward, carryback, corporate alternative minimum tax, and other waterfall effects of transferred tax credits make it difficult to surgically carve out the tax credit issue in a way that would avoid inadvertent disclosure of confidential buyer tax information to seller. IRS agents are trained to protect the confidentiality of tax returns and tax return information; section 6103 specifically codifies this sacrosanct requirement and prohibits unauthorized disclosure. When I informally asked my former IRS colleagues if they would accept such an issue carveout, they uniformly and

[1] Tax credit seller claims the investment credit on Form 3468, "Investment Credit," but the buyer claims its transferred credit on Form 3800, which is a much broader form.

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unequivocally said no — there is too much risk of section 6103 unauthorized disclosure.

To avoid the power of attorney issue, parties try to negotiate a provision that would have the buyer, if audited, ask the IRS to move the audit to the seller instead. You cannot just tell the IRS to audit the tax credit seller instead of the buyer — there is no procedural mechanism to do so. Apparently, some tax insurance brokers are erroneously advising buyers on that point. Unfortunately, those brokers are likely mistaking the push-out election under section 6226, in which there is a statutorily prescribed process for a partnership to elect to push an audit out to the partner and misapplying that concept in a buyer and seller transfer credit context.[2]

There is no such push-out election in the tax credit transfer context to permit the IRS to audit someone else simply because you asked them to do so. During the comment process immediately after the passage of the IRA, many groups asked Treasury to draft regulations to place the recapture risk on the seller and not the buyer. I spoke with the Senate Finance Committee tax legislative staff who was heavily involved in the drafting of the IRA about the issue; unfortunately, Congress intended the recapture risk to fall on the tax credit buyer, serving a due diligence function. Thus, you don't even have a tax policy argument under the tax credit transfer statute (section 6418). If you ask the IRS to audit the tax credit seller instead, you might end up with two audits, on the buyer and the seller.

Pre-IRA partnership audits are fundamentally different from post-IRA transfer audits. In the pre-IRA world, sponsors and investors are contractually bound by partnership agreements, which trigger the application of an entire body of tax administrative law — be it the Tax Equity and Fiscal Responsibility Act or the Bipartisan Budget Act — on the partnership. Thus, the sponsor is typically designated as the tax matter partner or partnership representative for the partnership, and IRS scrutiny on one entity easily can lead to IRS scrutiny on the other.

[2]Section 6226 is a statutory procedure for a partnership to push out the responsibility for an underpayment to individual partners to ensure that former partners pay their share of an underpayment if they owned an interest in the partnership for an issue that arose during the reviewed year.

From that vantage point, it makes sense for the sponsor, who is already acting as the tax matter partner (or partnership representative), to seek greater visibility and control of the audit process before the IRS to protect its appraisal method for its entire portfolio energy projects because it is already pregnant with the risk of IRS scrutiny.

In a post-IRA transfer world, buyers and sellers are unrelated parties that are not bound by any partnership agreement nor governed by TEFRA or BBA. IRS audits on the buyer need not lead to an audit on the seller. Instead of negotiating for seller control of a buyer audit or tempting the IRS to expand the audit scope to both the buyer and the seller, the seller should consider whether there are any strategic advantages in providing buyer support in the background, without formal visibility with the IRS.

Strategically speaking, it is not in all parties' interest to have the seller in front of the IRS in a buyer audit for several reasons. First, seller participation opens the door for more vigorous IRS inquiries in the buyer audit. You can hardly take advantage of the procedural tactic of limiting seller knowledge from tainting the buyer's audit if the seller is representing the buyer. Second, more vigorous IRS inquiries may trigger red flags (rightly or wrongly) that causes the IRS to open an audit on the seller, potentially creating cascading issues for the seller with flow through impact to its tax equity partners (which may further raise seller disclosures or reserve issues).

Lastly, seller knowledge and action can invalidate buyer insurance coverage. For example, seller fraud, seller filing of inconsistent tax position, and seller misconduct are almost always exclusions under a tax insurance policy. Tax credit buyers simply do not have as much relevant knowledge to cause insurance coverage exclusions. So much more can be uncovered through seller participation and interaction with the IRS than a limited buyer audit; the seller should avoid strong-arming its way into the worst possible prisoner's dilemma outcome.

As you can see, there are many trade-offs — as well as additional IRS processes and forms to consider — beyond the scope of this article. There is no one-size-fits-all solution. But parties at least need to understand the audit terrain on which it is

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situated so that it can correctly balance the trade-offs and select the right IRS procedural tools.

Conclusion

Success in tax controversy requires expertise in substance and process; to prevail you need a technical understanding of the tax statute at issue as well as the IRS administrative process (and as the audit moves into litigation, the court administrative process). Whatever the audit outcome, your tax insurance policy should be there to soften the downside. It can be a long process; we have discussed only the first step. But the procedural moves you make along the way determine the eventual audit or litigation outcome and your ability to collect under your policy.

The time to think through these trade-offs is when the contracts are baking in rights and obligations so that you are not internally arguing about what forms you need to file to fulfill your audit defense obligations under your tax insurance policy because you had negotiated a form that the IRS will not accept or you unintentionally forfeited rights under the contract.

My personal philosophy when working with the IRS has always been to help them help my client close out the audit with no change. I have had much success working through many tax audits guided by that philosophy. We are entering a brave new post-IRA audit world, with multiple interested parties, new substantive and procedural tax rules, and greatly expanded IRS enforcement budget.

Your tax insurance broker should be one of your first points of outside contact when you receive an IRS audit notice because your broker will guide you through the claims process, help you manage your obligations with your insurer (or insurers), and provide market insights on other audit challenges. Your tax insurance broker should be more than a go-between with the insurer; your broker should have substantive renewable energy tax knowledge, procedural audit expertise, and practical experience in multiparty insurance audits, so that we can contribute in the process to help you and your advisers help the IRS close out all tax credit transfer audits with no change or to collect under your tax insurance policy. ■

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