KPMG

EU Green Deal - US Inflation Reduction Act

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EU Green Deal vs. US Inflation Reduction Act

Different types of incentives for innovation, sustainable industrialization and decarbonization in the EU and USA

EU Green Deal - US Inflation Reduction Act - Overview

The appetite in the European Union (EU) and the USA to launch strategic industrial programs has significantly increased in the post-Covid era. The two most important programs are:

The European Green Deal is a comprehensive set of measure launched by the EU in June 2021 to transform the EU into a modern, resource-efficient and competitive economy. It aims at transforming the EU economy toward net zero by 2055, accelerating economic growth and decoupling from non-renewable resource use, while at the same time assuring social coherence.

In the summer of 2022, the USA enacted the Inflation Reduction Act (IRA) with a similar broad focus. The IRA is addressing inflation by reducing the national debt, healthcare costs and energy costs over the next ten years. Key provisions are intended to incentivize, mainly through tax credits on the federal level, a shift by companies and individuals toward investments in products and technologies that utilize clean energy and reduce emissions.

Different types of incentives

The EU Green Deal operates with non-tax incentives. Tax incentives are explicitly not part of the incentive toolbox. However, through the OECD GloBE rules, qualified refundable tax credits (QRTCs) are available, which might be claimed for projects which fit the EU Green Deal program.

The IRA, on the other hand, explicitly focuses on tax incentives in the form of transferable tax credits (TTCs) through the extension and expansion of numerous energy-related federal income tax credits. To a lesser degree there are also grants, research and loan programs available at federal, state and local levels.

For corporates, this means that they have the choice between applying for grants and loans in the EU or for tax credits in the US, depending on their own global growth strategies.

Different types of incentives

Non-tax incentives can take the form of direct grants/cash payments, loans, loan guarantees or the provision of goods and services below market value, etc. There are EU state aid rules and respective WTO rules which limit the use of such subsidies.

Tax incentives include additional tax deductions, accelerated depreciation, tax credits or even tax exemptions. Similar to non-tax incentives, tax incentives are frequently utilized to promote investment for specific activities, such as research and development, renewable energy or development of economically disadvantaged areas.

In the middle ground, there are what are known as qualified refundable tax credits (QRTCs), which are classified as non-tax incentives like grants, since they are also distributed in case of loss-making (within max. four years). In most countries they are administered by the tax authorities.

Another category of incentives is transferable tax credits (TCCs). These are favored by the US Government for the IRA program. There are ongoing discussions between the USA and the OECD on whether marketable TTCs (MTTCs) qualify as non-tax credits and thus to do not lower the ETR below the OECD minimum threshold of 15%.

Non-tax incentives

Tax incentives

Grants, Loans, etc

Qualifying tax credits (QRTC)*

Marketable transferable tax credits (MTTC)

Non-qualifying tax credits

Additional deduction

Patent box

Tax holiday (tax relief)

Granted and administered by authorities other than tax authorities

Granted and administered by tax authorities

Granted and administered by tax authorities

Granted and administered by tax authorities

- Treated as GloBE income (profit-increasing, not tax-reducing)
- No or low impact on GloBE ETR
- QRTCs also distributed in case of loss-making situations
- Limited through state aid rules

- Not profit-increasing but reduction in covered tax
- Significant impact on GloBE ETR
- Generally only effective in profit-making situations
- Ineffective for large companies if tax incentives push GloBE ETR below 15%

Non-tax incentives and tax incentives – pros and cons for governments and corporates

<u>Governments</u>

Large EU countries and the OECD prefer non-tax incentives since they allow for targeted direct support for desirable activities or investments. However, there is significant governmental cash outlay, sponsored by the taxpayers involved. There is also a significant risk of inefficient allocation of funds and for coemption between countries at the level of non-tax incentives.

With the IRA, the US focuses on tax incentives, in particular transferable tax credits, because they are deemed more efficient and business-friendly.
Small countries often favor tax incentives rather than non-tax incentives. Reasons include the limited direct funding capacities of smaller governments and a general distrust of "Big Government" industrial strategies.

<u>Corporates</u>

Tax incentives are generally favored by profitable multinational companies over grants and loans because of their large impact on effective tax rates (ETR) and because they are comparatively easy to apply for. Tax incentives, however, affect the ETR of companies with a global revenue of more than USD 750 million and hence may become ineffective if the ETR is pushed below 15% under the new OECD regulations. Exceptions are non-tax incentives including QRTCs and possibly the US MTCCs.

Non or low-profit-generating companies can benefit from non-tax incentives, however, if they engage in activities which are in line with industrial strategies such as the EU Green Deal or the IRA.

	Non-tax incentives +	Non-tax incentives −	Tax incentives +	Tax incentives −
Government	• Targeted direct support for desirable activities or investments • Do not erode tax base of corporate tax payers • No automatic distribution mechanism	• Increases gov. cash outlay • Significant risk of misuse or inefficient allocation • Risk of market distortion • Requires strict state aid regulations and control • Significant risk of violation of international trade agreements • Complex administration • Race to the top for non-tax incentives between countries	• Efficient administration by tax authorities • Incentivizes profit-generating companies • Little risk of international trade disputes • Does not increase gov. cash outlay	• Lower income tax from corporate tax payers • Application limited by various OECD regulations • Race to the bottom for tax incentives between countries
Corporates	• Not repayable (grants) • Effective, even when not profit-generating • No or low impact on GloBE ETR	• Incentives not automatically received even if conditions are met • Often complex application process with unclear outcome • Strings attached (i.e. requirement for consortium in certain cases)	• Impact on effective tax rate • Generally easily obtainable when requirements are met	• Only efficient if profit-generating • Risk of over-engineering tax planning structures • Effect factually limited or ineffective for large enterprises under the minimum taxation rules

The EU Green Deal

Key features

The EU Green Deal is not one single program but rather an extension of existing EU programs which are complemented by new programs.

To achieve geopolitical, ecological and social goals, the EU is increasingly focusing on research, innovation, and sustainability, such as the expansion of renewable energies.

The funding programs rolled out by the EU are intended to subsidize innovative projects with high investment volumes to maintain Europe's industrial competitiveness and ensure growth and prosperity in the future.

Many of investment projects by multinational companies are potentially eligible for grants and subsidies. However, so far most of the funding potential remains untapped.

01

Focus on non-tax incentives rather than tax credits

02

Support for research, innovation and sustainability, as well as local manufacturing

03

Existing EU programs have been extended and new ones created to implement the EU Green Deal

04

Many programs are available at member state level and regional level in addition to the EU programs

Qualified refundable tax credits (QRTCs) are not explicitly part of the EU Green Deal but are available for activities such as R&D or green transition of supply chains

The EU Green Deal

Funding objectives

The EU Green Deal is the most ambitious program ever launched by the EU. It aims at creating a net-zero green economy by 2050, enhancing manufacturing and digital capacity in crucial industries and sustaining innovation leadership via scientific and technological investment.

Achieving these goals shall be facilitated by an unprecedented high volume of non-tax incentives, including EU funds, national funds and the EU's Covid-specific NextGen Fund (depending on clearance by the European Commission, EC), which can be directly disbursed by member states without requiring EU consent.

- Financing the development of low-carbon industrial manufacturing
- Transition of industrial regions with high carbon emission industries
- Support for lower income EU member states toward climate neutrality
- Focus on Important Projects of Common European Interest (IPCEI)
- Promotion of research and development
- Establishing sustainable infrastructure in low income member states

Overview of programs included in the EU Green Deal (examples)

Horizon Europe

Largest EU research & innovation program to drive systemic changes to ensure green, healthy and resilient EU. 35% of its expenditure will support climate objectives.

Budget of EUR 95.5 bn (2021-2027).

Who can benefit?
Any type of organization with operational and financial capacities to run research activities. Min 3 intl. partners. Swiss companies CAN participate.

InvestEU

Budgetary guarantee for riskier projects that are commercially viable and leverage private investments. Areas: sustainable infrastructure; research, innovation and digitalization; SMEs and social investment skills.

Private and public loan/equity financing is mobilized for a budget of EUR 26.2 bn and can grow to EUR 372 bn over seven years.

Who can benefit?
Implementing partners (selected financial service parnters)

Modernization Fund

Support 10 lower-income EU countries in their transition to climate neutrality by helping to modernize their energy systems and improve energy efficiency, storage, generation and use of renewable sources

Who can benefit?
Mostly energy companies (production, storage, network, etc.)

The Modernization Fund may amount to EUR 14 bn in 2021-30 (depending on revenues from EU ETS – 2% of total allowances value).

Innovation Fund

Bringing highly innovative low-carbon industrial technologies in need of additional capex and opex support to reach break-even in the next decade.

Who can benefit?
Technology companies on large national flag ship projects

Budget of around EUR 20 bn (2020-2030).

Important Projects of Common European Interest (IPCEI)

Support investments in large innovative projects in which common European objectives are pursued.

Depending on the project several billion euros per project.

Who can benefit?
Technology companies on large flag ship of pan-European relevance

Connecting Europe Facility

Support investments in transport projects, energy sector, and telecom projects.

Budget of over EUR 34 bn for 2021-2027 to be disbursed through the CEF debt instrument and CEF equity instrument.

Who can benefit?
Infrastructure companies in collaboration with national and regional governments.

The only EU funding program entirely dedicated to environmental, climate and energy objectives.

Life programme

Budget of EUR 5.43 bn for 2021-2027.

Who can benefit?

The US Inflation Reduction Act

Key features

The Inflation Reduction Act (IRA) includes USD 369 bn in incentives for energy and climate, mainly as corporate tax credits, valued at USD 270 bn. The act aims to steer private capital towards clean energy, transportation and industry. Many of these tax credits may be transferable or refundable through the direct pay mechanism. These new mechanisms allow for organizations to monetize the benefits regardless of their lack of federal tax liability.

The IRA complements other acts such as the CHIPS Act and the Infrastructure Investment and Jobs Act (“Infrastructure Act”), which aim to improve infrastructure or increase competitiveness and foster innovation.

01

Focus on tax credits rather than non-tax incentives – includes minimum tax of 15%

02

Support for green transformation of value chain, for R&D and for investments in domestic manufacturing

03

Tax credits are monetizable through transferability or direct payment (transferable tax credits, TTCs)

04

The IRA complements other acts, such as the CHIPS Act and the Infrastructure Act

05

There are additional non-tax and tax incentives available at state and local level

Funding objectives

While several different US federal agencies oversee distribution of IRA funds, the main part of IRA funding package is distributed via the U.S. Department of the Treasury (Internal Revenue Service), since the IRA is heavily focused on tax credits.

The IRA involves both modifying and expanding existing tax credits and introducing of new tax credits related to energy production and usage.

The target areas of these credits include renewable energy, advanced manufacturing, transportation, alternative fuels, and carbon capture, etc.

Eligible taxpayers include individuals, C corporations, S corporations, trusts, estates, and partnerships as well as tax exempts, certain state and local organizations and tribal nations.

Transportation

Renewable energy

Carbon capture

Advanced manufacturing

Alternative fuels

Overview of programs included in the IRA program (examples)

Renewable energy

Extensions and modifications to existing credits:

- Production tax credit
- Investment tax credit (wind, solar, geothermal, etc.)
- Energy-efficient commercial buildings deduction

Who can benefit?

- Producer
- Property investor

New credits:

- Zero-emission nuclear power production credit
- Technology neutral clean electricity production and investment tax credits

Advanced manufacturing

Extensions and modifications to existing credits:

- Credit for manufacturing advanced energy property (EV components, fuel cells, electric grids, etc.)

Who can benefit?

- Property investor

New credits:

- Advanced manufacturing production credit for solar and wind components, batteries and critical minerals
- Clean hydrogen production credit

Transportation

Extensions and modifications to existing credits:

- Clean vehicle credit
- Credit for EV charging stations

New credits:

- Qualified commercial clean vehicles
- Previously owned clean vehicle credit

Who can benefit?

- Property investor

Alternative fuels

Extensions and modifications to existing credits:

- Second-generation biofuel credit
- Biodiesel and renewable diesel; biodiesel mixture credit; alternative fuel credit

New credits:

- Sustainable aviation fuel
- Clean fuel production tax credit

Who can benefit?

- Producer
- User

Extensions and modifications to existing credits:

- Credit for carbon oxide sequestration (increased rates)

Carbon capture

Who can benefit?

- Property investor

New credits:

- Advanced manufacturing production credit for solar and wind components, batteries and critical minerals
- Clean hydrogen production credit

What corporates should know

Eligibility

The IRA as well as the EU Green Deal are both programs under development and focus and eligibility may change over time.

Both programs have a large scope and are in essence industrialization and innovation programs with a focus on sustainability.

Therefore corporates with major capex or innovation projects in the US or in the EU should investigate if they are eligible for subsidies related to the EU Green Deal or the IRA.

Additionally, tax exempt entities, certain state and local organizations and tribal nations, among others, should consider US IRA tax credits due to the new direct-pay monetization feature.

Accessibility

In the EU

Accessibility to EU funding is complex. There are different funds available, which are difficult to identify, and application is cumbersome, while the out-come is never clear. For example, additional NextGenerationEU funds allocated to the EU Green Deal is distributed in direct management by the European Commission in Brussels but also via the National Recovery Plan of the member state. Its recent addition of a REPowerEU chapter facilitates in-country distribution.

In the USA

There are certain credit eligibility requirements that must be met before the US IRA credit claim can be made. Many of the credits require a robust multi-disciplinarian analysis from tax, engineering, cost segregation, legal and carbon accounting perspectives.

US IRA grants require competitive applications, which can be time-consuming.

Strings attached

In the EU

Funding under the EU Green Deal almost always comes with strings attached. In many cases collaboration with partners in different EU countries is required

In the USA

Certain documentation requirements need to be met in order to substantiate the US IRA credit claims, including support of the credit adders. If no credit documentation is maintained, the claim may be denied by the Internal Revenue Service.

Certain accounting, reporting, and compliance obligations exist for US IRA grants.

Controversy between the EU and USA

Protective or not?

Although the EU welcomes the contribution of the USA to fighting climate change, the IRA is being criticized for its outright “Buy American” provisions.

Concerns include the risk that EU exports to the US will be hampered, and that EU firms might be enticed to relocate to the US.

In response to the IRA, the EU has relaxed its state aid rules. Also, funding from the NextGen recovery facility will be dedicated to offset the IRA's effects on the EU economy.

Further possible EU responses are currently under discussion.

Equal treatment in tax competition?

Whereas the non-tax incentives provided under the EU Green Deal are treated as income and hence have no or only a low impact on the GloBE ETR, i.e. they do not trigger top-up taxes, the main question is about the GloBE treatment of the various tax credits under the US Inflation Reduction Act. Can companies enjoy the same favorable treatment under the global minimum taxation rules? Currently the OECD takes the view that the credit must be paid in cash or cash equivalents from the jurisdiction providing the credit within four years if not already credited against a tax liability.

The latest administrative guidance by the Inclusive Framework on BEPS of July 2023 provides for a possibility for resolving the dispute (i.e. granting the same favorable treatment for IRA tax credits) by giving clear instruction on when a tax credit can be considered as marketable transferable tax credits (MTTCs) – equal to QRTCs – and when as non-MTTCs. MTTCs are at hand if the tax credits can be transferred at a price that equals or exceeds 80% of the net present value of the tax credit. Also US transferable tax credits related to the IRA may be transferable in the hands of the originator, but not in the hands of the purchaser.

Glossar

QRTC	Qualified Refundable Tax Credit
MTTC	Marketable Transferable Tax Credit
IRA	Inflation Reduction Act
OECD GloBE Rules	OECD’s Global AntiBase Erosion Model Rules

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