Newly Proposed Regulations Provide Much-Needed Guidance on Federal Energy Tax Credit Monetization Provisions

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06 / 21 / 23

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On June 21, 2023, the Treasury Department (Treasury) and Internal Revenue Service (IRS) published proposed regulations (88 FR 40528 and 88 FR 40496) under two key provisions of the Inflation Reduction Act of 2022 (IRA) designed to enable taxpayers and tax-exempt entities to monetize certain energy-related federal tax credits. Section 6417 of the Internal Revenue Code (Code) allows certain tax-exempt and governmental entities to apply to receive direct payments from the government with respect to certain energy-related tax credits. Section 6418 of the Code permits taxpayers to transfer all or a portion of certain energy-related tax credits to unrelated parties for cash. By broadening the universe of organizations that are able to make use of energy-related tax credits through direct pay, and creating a more direct pathway for taxpayers interested in financing energy projects to share credits through transferability, these provisions stand to significantly expand the market for investment in energy projects. Even before the regulations were proposed, these two provisions had begun to generate significant interest in the energy technologies that the credits are designed to support. The issuance of the proposed regulations, which provide guidance on the scope, limitations and mechanics of both provisions — and on which taxpayers are entitled to rely pending issuance of final regulations — is expected to further accelerate the entry of new participants into the market.

Transferability (Section 6418)

By permitting an "eligible taxpayer" — generally, an entity that is not eligible for direct pay — to transfer all or a portion of certain energy-related tax credits to an unrelated party for cash, the transferability provisions are expected to remove barriers to entry for companies interested in financing clean energy projects. These investors previously had to largely rely on relatively complex tax equity structures — partnerships or leases — to invest in projects supported by tax credits. The transferability provisions, although detailed and complex in their own right, allow investors to purchase credits without the use of these structures. Following are some of the noteworthy aspects of the proposed transferability regulations under Section 6418 of the Code.

Transfers of a portion of a credit. In addition to extending the period for which certain energy-related tax credits can be claimed and making new technologies eligible for the credits, the IRA introduced certain "bonus" credit amounts (*e.g.*, for satisfying certain "domestic content" requirements) that increase the base credit rate applicable to qualifying projects. The proposed regulations make clear that an eligible taxpayer can elect to transfer all or a portion of a credit — including by transferring different portions of a credit to multiple transferee taxpayers — while also stating that any portion transferred must represent a proportionate share of the entire credit determined for the property (*i.e.*, any bonus credits cannot be split from the base credit in order to transfer one or the other or transfer them separately). This provision, which purports to prohibit the transfer of horizontal slices of a credit, stands in contrast to an example in the proposed regulations in which a taxpayer has transferred a portion of a credit with respect to a facility and, in a later year when the tax credit is partially disallowed — but the allowed credit exceeds the amount transferred — the disallowance applies only to the retained portion. The example implies that it is possible for a taxpayer, in effect, to transfer the base credit while retaining a bonus credit for a project where the bonus credit, but not the base credit, is at risk of being disallowed.

Transfers by partnerships. The proposed regulations would allow eligible taxpayers that are partnerships to choose to transfer a portion of the credit allocable to one or more partners while retaining the portion allocable to others. In such a case, the partner to whom the transferred credit is allocable would be allocated the tax-exempt income received from

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the transferee, while the other partners would receive their distributable share of the credits. The cash received from the transferee could be distributed as agreed among the partners (*i.e.*, the cash does not necessarily have to follow the allocation of the associated tax-exempt income). In the case of projects with multiple investors, this taxpayer-favorable rule would allow each investor to decide whether its share of the tax credits associated with the project will be transferred, which may support the ability of larger projects that require financing from multiple investors to take advantage of tax credit monetization.

Brokered transfers. In general, a tax credit may only be transferred once under Section 6418. The preamble to the proposed regulations notes, however, that an arrangement using a broker to match transferors and transferees should not violate this rule, assuming the arrangement at no point transfers the federal income tax ownership of a tax credit to the broker or any person other than the ultimate transferee. In addition, the proposed regulations make clear that allocations of a transferred credit by a transferee that is a partnership to its partners do not violate the no-additional-transfer rule.

Transfers of transferee partnership interests. To prevent taxpayers from avoiding the rule against multiple transfers by transferring a tax credit to a partnership and subsequently transferring the partnership interests, the proposed regulations provide that a tax credit purchased by a partnership is treated as an extraordinary item under Treasury Regulations Section 1.706-4(e) that may not be prorated. The preamble to the proposed regulations states that the Treasury and IRS continue to study whether additional rules are required to prevent avoidance of the rule against multiple transfers through transfers of interests in transferee partnerships.

'Paid-in-cash' requirement. Transferability is not allowed under Section 6418 if the transferor receives any consideration other than cash. The proposed regulations state that a payment is considered "paid in cash" if it is made during the period beginning on the first day of the transferor's taxable year during which the transferred credit is determined and ending on the due date for completing a transfer election statement (described below). The proposed regulations do not address the question of whether a transferee could provide a deposit — over which the transferee retains control for tax purposes — at an earlier date.

For sponsors seeking financing for investment tax credit (ITC) projects, this timing aligns with what they could expect in a tax equity financing transaction, where the tax equity investor would generally make their investment in the year in which the relevant property is placed in service. For production tax credit (PTC) projects, however, the requirement in the proposed regulations that the cash consideration for transferred PTCs not be paid earlier than the year in which the PTCs are generated means sponsors would not be able to fully fund projects up front by transferring credits, in contrast to typical tax equity financing transactions where funds provided by tax equity investors are used to pay off construction debt. This may lead to an increased market for debt financing — including potentially for debt that amortizes over the period during which PTCs will be claimed — as sponsors of PTC projects seek alternative financing sources to replace construction debt.

Discount credit purchases. The proposed regulations specify that a transferee does not have gross income as a result of claiming a transferred credit, even if the amount of cash paid by the transferee to the transferor was less than the amount of the transferred credit. For example, a transferee that pays $9x for a tax credit of $10x is not required to include the $1x difference in its gross income.

Limitations in determining credit and credit eligibility. Several provisions of the Code limit the amount of tax credit that may be claimed or limit a party's eligibility to utilize a tax credit. In general, the proposed regulations provide that "rules necessary to determine the amount of an eligible credit," such as the Section 49 at-risk rules, are applied by the transferor and not reapplied by the transferee. By contrast, rules concerning the amount of tax credit "allowed to be claimed in the taxable year by the transferee," such as the Section 38 general business credit limitation, are applied by the transferee and not by the transferor.

Under this approach, the tax credit available to a transferee may be limited by the Section 469 passive activity rules. The proposed regulations specifically provide that, for purposes of applying Section 469 to a transferee of a credit, the credit is treated as determined in connection with the conduct of a trade or business, and the transferee is not considered to own an interest in the transferor's trade or business at the time the work was done. In many cases, this rule will foreclose the possibility of transferring tax credits to individuals, estates, trusts and certain closely held or personal service corporations.

Consistent with this approach, the proposed regulations also specify that a taxpayer may only transfer tax credits that are determined with respect to such taxpayer. Thus, for example, a carbon dioxide offtaker that is only eligible for a Section 45Q carbon capture and sequestration PTC due to an election by another taxpayer under Section 45Q(f)(3)(B) may not transfer such credit under Section 6418. Similarly, a lessee of property that is eligible for a Section 48 ITC due to an election under Treasury Regulations Section 1.48 4 may not transfer such credit under Section 6418.

Carryback and carryforward of transferred credits. In general, taxpayers may carry forward and carry back unused tax credits for the tax periods specified in Section 39. The IRA added a new Section 39(a)(4), which provides for extended carryback periods

for certain energy-related credits. For certain credits, the extended carryback period applies only for projects placed in service after December 31, 2022, notwithstanding that credits from projects placed in service on or before December 31, 2022, may also be transferred under Section 6418. Accordingly, although the proposed regulations confirm that a transferee may carry forward or carry back a transferred credit, not all tax credits that are transferable may be carried back for three years by a transferee. For instance, a transferee of Section 45 PTCs may carry back the PTCs over the extended period described in Section 39(a)(4) only to the extent the PTCs are attributable to facilities originally placed in service after December 31, 2022, as specified in Section 6417(b)(2).

Allocation of risk for recapture. One aspect of transferability that investors had been keenly focused on pending the release of guidance is the allocation of recapture risk as between the eligible taxpayer (transferor) and the transferee. The proposed regulations include rules for the treatment of recapture events under Sections 50, 49 and 45Q(f)(4) (*i.e.*, events that occur following the placed-in-service date and during the recapture period), while clarifying that an excessive credit transfer (*i.e.*, a transfer of credits for which a project was not eligible as of the time it was placed in service) is not considered a recapture event.

In general, the proposed regulations contemplate two potential scenarios where recapture could apply. In the first scenario, where the property is no longer credit-eligible property with respect to the eligible taxpayer (*e.g.*, because the eligible taxpayer disposes of the property), the transferee would be responsible for the associated amount of tax increase. In the second scenario, where the transferor is a partnership or an S corporation and the recapture event results from a disposition of a partnership interest or S corporation stock, the partner or S corporation shareholder that transferred its equity would be responsible for the resulting tax increase. A third potential scenario, which is not directly addressed in the proposed regulations, would be where a partner or S corporation shareholder transfers its interest to a disqualified transferee (*e.g.*, a tax-exempt organization), resulting in a portion of the property no longer being credit-eligible in the hands of the partnership or S corporation.

In all three of these scenarios, we expect that transferees would request an indemnity for recapture from the transferor. The proposed regulations acknowledge as much, noting that "there is no prohibition under section 6418 for [a transferor] taxpayer and a transferee taxpayer to contract between themselves for indemnification of the transferee taxpayer in the event of a recapture event."

The proposed regulations indicate that, upon the occurrence of recapture that is borne by a transferee, the transferee must "provide notice of the recapture amount (as defined in section 50(c)(2))" to the transferor, and the transferor is permitted to increase its basis in the property with respect to which an ITC was claimed "by an amount equal to the recapture amount provided ... by the transferee taxpayer." Presumably, in the case of Sections 48 or 48E, the transferor would only increase its basis in the property by 50% of the recapture amount, as provided in Section 50(c)(3), but the proposed regulations are not clear on this point.

Anti-abuse rule. Amounts paid by a transferee to a transferor in connection with a Section 6418 transfer election are excluded from the transferor's gross income and not deductible to the transferee. The proposed regulations include an anti-abuse rule that applies to parties who have engaged in a transaction or series of transactions "with the principal purpose of avoiding any Federal tax liability beyond the intent of section 6418," such as transactions intended to decrease the transferor's taxable income or increase the transferee's deductions. As illustrated by examples in the anti-abuse rule, transactions where a taxpayer undercharges or overcharges a customer that is also purchasing tax credits from the taxpayer may fall within the scope of this rule. Also, it should be noted that the text of the proposed anti-abuse rule is not consistent regarding whether it applies based on "the" principal purpose or "a" principal purpose, which have decidedly different meanings in other contexts.

Direct Pay (Section 6417)

Section 6417 permits "applicable entities," including certain tax-exempt and governmental entities, to use certain tax credits as an offset to any taxes owed, with any excess received as a direct payment from the government. In addition, Section 6417 permits all taxpayers to claim a direct payment for credits under Section 45Q (carbon capture and sequestration), Section 45V (clean hydrogen) and Section 45X (advanced manufacturing production), subject to certain limitations. Following are some of the noteworthy aspects of the proposed regulations under Section 6417.

Application to partnerships. The proposed regulations provide that a partnership or an S corporation cannot be an "applicable entity," even in the case of a partnership that has one or more tax-exempt entities as a partner. Accordingly, a partnership or an S corporation may only make a direct-pay election under Section 6417 with respect to Section 45Q, Section 45V and Section 45X tax credits.

Estimated tax. In calculating whether a taxpayer has underpaid estimated tax under Sections 6654 and 6655, the taxpayer is deemed to have received the full amount of any credits with respect to which the taxpayer makes a direct payment election under Section 6417. As a result, taxpayers are able to reduce their estimated tax payments to account for a tax credit that will be received via direct pay.

Interaction with Section 6418. The proposed regulations provide that no direct-pay election under Section 6417 may be made with respect to a credit purchased pursuant to Section 6418.

Election Mechanics and Reporting for Transferability and Direct Pay

Pre-filing registration. As a pre-condition to making a direct-pay election under Section 6417 or a transferability election under Section 6418, the electing party must complete an electronic pre-filing registration process. The pre-filing registration requirements are described in proposed regulations and have also been promulgated as temporary regulations (88 FR 40086) effective for taxable years ending on or after June 21, 2023.

The temporary and proposed regulations list several pieces of information that an electing party must provide as part of the electronic pre-filing registration process, including information and documentation regarding the relevant properties with respect to which tax credits will be claimed. The IRS will review the information provided and issue a registration number for each unit of property for which sufficient verifiable information was provided. This registration number must be included on filings made by a transferor, transferee or direct pay recipient. The Treasury and IRS have requested comments on whether to adopt a grouping rule that allows taxpayers to make a single transfer election with respect to certain groups of eligible credit properties. Under the temporary regulations now in force, a separate registration number will be required for each eligible credit property (*e.g.*, each wind turbine) for each taxable year in which credits will be transferred.

In effect, the pre-filing registration requirements establish a potential advance-vetting process for tax credits for which direct pay is claimed under Section 6417 or that are transferred under Section 6418. It remains to be seen whether the IRS will use the pre-filing registration process as an opportunity to conduct the equivalent of a scaled-down audit prior to issuing a registration number, or whether the issuance of a registration number will be essentially automatic (with potential credit-eligibility issues to be addressed in future audits).

Election deadline. A direct-pay recipient making a Section 6417 election or a transferor making a Section 6418 election must do so on an original return no later than the due date (including extensions). A Section 6417 or Section 6418 election may not be made on an amended return or by filing an administrative adjustment request, and no relief under the Section 9100 regulations can be obtained for an untimely Section 6417 or Section 6418 election. Accordingly, a foot-fault by the direct-pay recipient or credit transferor may not be curable on an amended return or through administrative relief — parties making these elections should therefore exercise caution to avoid inadvertent errors. A transferee, on the other hand, may claim a transferred tax credit on an amended return or, if applicable, through an administrative adjustment request.

Transferability election statement and documentation. Prior to making a Section 6418 election, the transferor and transferee must together complete a transfer-election statement that includes certain specified information and attestations. The statement must be completed after the transferor and transferee have sufficient information to include the required items, but may not be completed after either the transferor or transferee has filed a tax return for the applicable taxable year. A purchase and sale agreement can serve as a transfer election statement if it includes the required information and is signed under penalties of perjury by the transferor.

A transferor must provide a transferee with certain "required minimum documentation," including:

- Information that validates the existence of the property with respect to which the tax credit is claimed.
- If applicable, documentation substantiating that the transferor has satisfied the requirements for any bonus tax credit amounts (*e.g.*, for satisfying certain "domestic content" requirements).
- Evidence of the transferor's qualifying costs (in the case of an ITC) or qualifying production activities and/or sales amounts (in the case of a PTC).

Transaction Costs

Neither the Section 6418- nor Section 6417-proposed regulations address the tax treatment of transaction costs of a transferor, transferee or direct-pay recipient. The preamble to the proposed Section 6418 regulations specifically requests comments on the extent to which the transaction costs of a transferor or transferee must be capitalized or instead allowed as a deductible expense. In the transferee's case, such costs, if capitalized into the basis of the credit purchased, would generally not be recoverable absent a determination that the transferee had overpaid for the credit and could claim a loss — a point on which the proposed regulations also request comments. In the transferor's case, such costs — if capitalized into the basis of the credit sold — would generally not be recoverable, as the transferor does not recognize gain from the sale of the credit that could be offset by increased basis.

The preamble to the proposed Section 6417 regulations, on the other hand, is silent on the issue of transaction costs. Absent additional guidance, one possible approach would be to treat the costs of making a Section 6417 election as a deductible tax return preparation expense.

Reliance on Proposed Regulations

A taxpayer may rely on the proposed Section 6418 regulations for taxable years beginning after December 31, 2022, and before the date that final regulations are published, provided the taxpayer follows the proposed regulations in their entirety and in a consistent manner. Similarly, an entity may rely on the proposed Section 6417 regulations for direct payments after December 31, 2022, in taxable years ending before the date that final regulations are published, provided the entity follows the proposed regulations in their entirety and in a consistent manner with respect to all elections made under Section 6417.

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