

**Energy and Climate Solutions White Paper:
Opportunities for Financing Renewable Energy Projects
Using the Direct Pay and Transferability Regimes under
the Inflation Reduction Act of 2022**

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I. Executive Summary

The Inflation Reduction Act of 2022 (the “IRA”) provides two new options for monetizing the Internal Revenue Code’s (the “Code”) energy-related tax credits—a “direct pay” election, and the ability to transfer (sell) credits to third parties for cash, referred as the “transferability” election. Together, these options will give project sponsors more flexibility to finance renewable energy projects and, in some cases, may reduce or eliminate the need for such projects to rely on traditional tax-equity structures for financing. Overall, the cost-benefit equation between traditional tax equity structures and new tax credit sales will come down to various factors, such as the ability to realize depreciation and step-up benefits and general transaction costs, that potentially will make traditional tax equity structures less efficient due to the need to create partnerships and engage in other complex legal structuring and tax matters. To be clear, projects need not definitively choose between one or the other. For example, the full tax credit and depreciation benefits could be monetized by a tax equity partnership in the first year of a project, while in a subsequent year, the partnership sells a portion of the tax credits but retains depreciation.

In this white paper, we consider potential structuring opportunities in light of these two new regimes.

II. Transferability and Direct Pay Overview

Beginning in 2023, taxpayers and certain nontaxpaying entities will be able to use the direct pay regime and the transferability regime to allow energy credits to become fully refundable (under the direct pay regime) and in other cases to sell energy credits to unrelated parties for cash with no unfavorable accounting or tax treatment (under the transferability regime). Before the advent of these regimes, project sponsors commonly sought out tax equity investors—that is, investors like banks or other large companies that predictably generate taxable income and can monetize these benefits by reducing their U.S. federal income tax liability—to finance renewable energy projects.

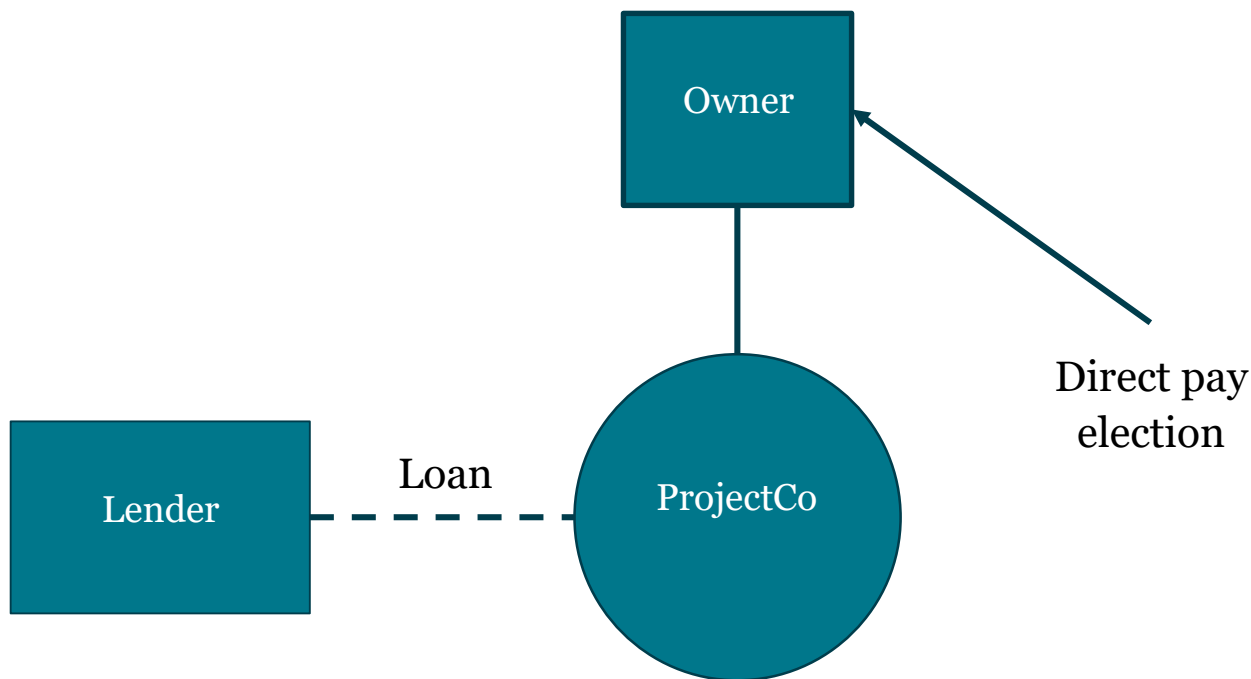
Broadly speaking, the direct pay regime allows an applicable entity (generally, a governmental entity or tax-exempt entity) to elect to have the value of the applicable tax credit paid to them directly by the Internal Revenue Service (“IRS”), even if such entity lacks commensurate (or any) federal tax liability. Congress intended for direct pay to help certain governmental entities and tax-exempt entities monetize these tax credits directly, and further, to bolster specific industries. Certain tax-exempt entities and governmental entities are eligible to elect direct pay for all eligible credits (listed below); for-profit companies and other entities, on the other hand, can only use direct pay in a limited fashion for three credits: Code Section 45Q (carbon sequestration), Code Section 45V (hydrogen production), and Code Section 45X (advanced manufacturing production).

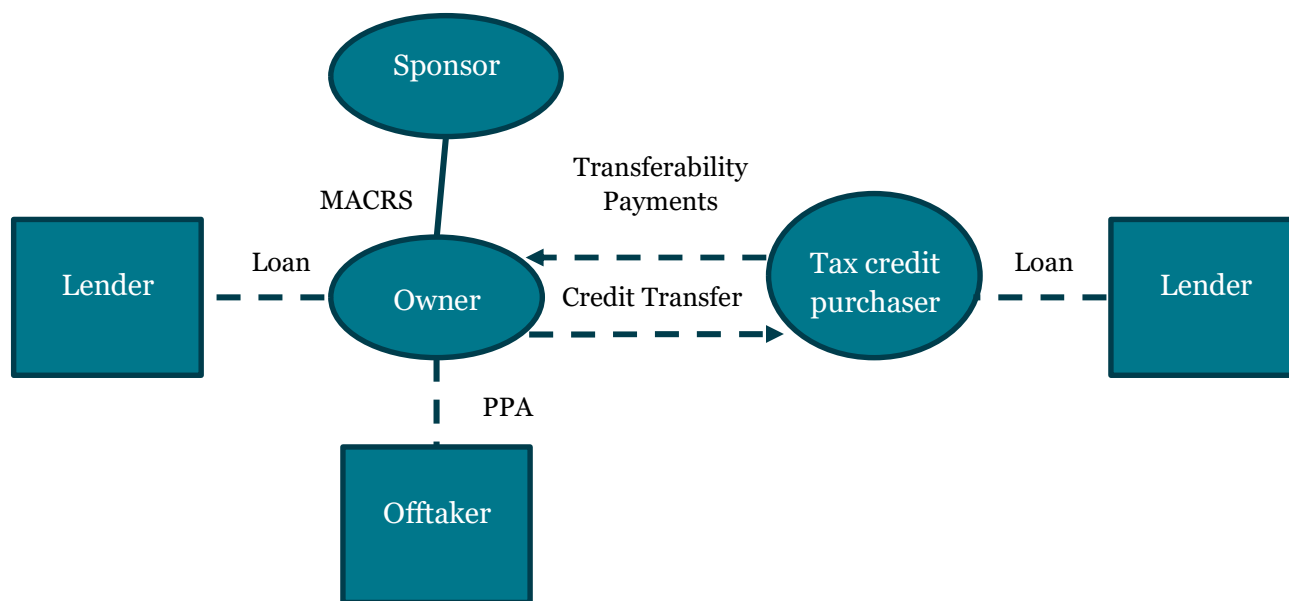
The transferability regime generally allows taxpaying entities to sell credits for cash. Notably, a facility or project owner can transfer tax credits but cannot transfer depreciation benefits in a

transferability transaction. Depreciation benefits are typically coupled with the tax credits for a particular project—a tax credit reduces, dollar-for-dollar, taxes owed, whereas depreciation is a deduction, meaning it reduces a taxpayer’s overall taxable income to which tax credits are applicable. Both the direct pay regime and the transferability regime apply to the following 11 tax credits, with additional restrictions discussed herein, categorized by technology:

- Renewable Energy Generation: Code Sections 45 and 45Y (production tax credit (PTC) and technology-neutral PTC); Code Sections 48 and 48E (investment tax credit (ITC) and technology-neutral ITC); Code Section 45U (nuclear production tax credit)
- Carbon Capture and Sequestration: Code Section 45Q (carbon capture, use, and sequestration tax credit)
- Clean Fuels: Code Section 45V (hydrogen production tax credit); Code Section 45Z (clean fuels production tax credit)
- Manufacturing: Code Section 45X (advanced manufacturing production tax credit); Code Section 48C (advanced energy project tax credit)
- Vehicles: Code Section 30C (alternative fuel vehicle refueling property tax credit)

The structure diagrams below show how project owners can monetize energy tax credits under the direct pay and transferability regimes, respectively.





III. Key Commercial Considerations

Both direct pay and transferability present novel commercial and legal questions that taxpayers must carefully consider before committing to transactions under either regime.

What Buyers Need to Know: The margin that buyers take in a tax credit sale (e.g., buying a tax credit for 90 cents on the dollar) is not treated as income for federal tax purposes. Under proposed regulations issued on June 14, 2023 (the “Proposed Regulations”), a buyer must bear recapture risk (described more below). The recapture rules apply to the ITC, ensuring that if a project is sold or suffers a casualty event within the first five years after the project is placed in service, a portion of the ITC is repaid (100 percent in year 1, 80 percent in year 2, 60 percent in year 3, 40 percent in year 4, and 20 percent in year 5). Additional penalties may apply as well, described further below. Buyers should note further that bonus credits may not be sold separately from the underlying credits. For example, if a utility-scale solar facility claims a 40 percent ITC based on compliance with the prevailing wage and apprenticeship requirements (raising the ITC to 30 percent) and domestic content bonus requirements (additional 10 percent credit), the 10 percent domestic content adder cannot be sold separately as a bonus credit.

What Sellers Need to Know: The proceeds of a tax credit purchase and sale will not be treated as income for federal tax purposes, meaning that sellers will not need to pay federal income taxes on the proceeds. Sellers will be required to perform a number of tasks prior to selling credits, including providing documentation attesting to compliance with various requirements such as prevailing wage and apprenticeship and other applicable bonus credits, documentation underpinning operations of the project, registration, and more. Failure to execute these

requirements precisely could jeopardize the transfer of the tax credit. For projects that have been or will be placed into service in 2023, sellers have until October 2024, or the extended tax return filing deadline, to elect to transfer the credit. Due to timing mismatches of when credit sales may take place, sellers may consider investigating short term financial products to bridge any associated gaps.

What Both Sellers and Buyers Need to Know: The diligence process for these transactions is evolving. Understanding core risks and associated indemnities, applicable insurance, and other contractual remedies will be important and can be expected to be negotiated at length as the market becomes established. Many factors will play a role in determining whether transferability or traditional tax equity structures (or a combination of the two) will be preferable, including nascency of technology, relative economics of monetizing depreciation and transaction costs, implications for lenders and borrowers in project debt financing, and more.

IV. Special Considerations

Limitation on Direct Pay for Partnership Structures: The Proposed Regulations provide a broad prohibition on direct pay for partnership structures. Co-ownership alternatives proposed by the IRS, including the ability to elect out of Subchapter K or to own property as tenants in common, are of limited utility. Code Section 761(a) has numerous requirements, including, importantly, that the property in question not be used in an active trade or business and that any co-owner separately contract for the related output, making it unworkable for most projects that would be of use to tax-exempt and governmental entities. Similarly, there are inefficiencies when dealing with undivided interests, including that any offtake arrangements would have to be separately contracted for each such interest.

Limitation on Utilization of Chaining Structures for Tax-Exempts and Governmental Entities: Credits transferred to unrelated parties for cash under Code Section 6418, as well as ITCs passed through by lessors to lessees in Code Section 50(d)(4)/Section 48(d) lease pass-through structures, cannot be paid out using the direct payment election, which removes the ability of tax-exempt and governmental entities to take advantage of direct pay in many cases. With partnership structures also prohibited for direct pay transactions, there are limited avenues (e.g., sale-leaseback) for applicable entities to develop and invest in renewable energy projects. The Proposed Regulations' prohibition on so-called "chaining" of credits applies not just to the three specified instances (former Code Section 48(d), Code Section 45Q(f)(3), and Code Section 6418), but also to any applicable credit "otherwise not determined with respect to the applicable entity or electing taxpayer." This raises the possibility of additional, unmentioned instances of perceived chaining being disallowed as well.

Bonus Credits Not Severable: In certain tax equity financing transactions, parties may wish to allocate the portion of the credit associated with bonus credit amounts to the project sponsor and permit the project sponsor to transfer such portion of the credit for cash. The Proposed Regulations provide that such bonus amounts may not be separately sold but do not preclude a special distribution and/or allocations of the related cash and income within a partnership to

synthetically achieve the same result. Thus, bonus credits may not be severed from the base credit amount for purposes of transferability or direct pay.

Application of Passive Loss Rules: The passive loss rules in Code Section 469 have typically prevented almost all high-net-worth individuals (and funds composed of groups of the same) from investing in tax equity arrangements. Under the Proposed Regulations, Code Section 469 does not prevent transferors from transferring credits, which may open up the tax equity market to investors who were previously hampered by their lack of passive income arising from the conduct of a trade or business. This raises many commercial and tax questions that will need further consideration. However, the Proposed Regulations provide that transferees are fully subject to Code Section 469, which effectively means that an individual, estate, trust, closely held C corporation, or personal service corporation will be unable to purchase eligible credits.

Transferee or Purchaser of Tax Credits Has Recapture and Excessive Credit Transfer Risk and Should Take Associated Precautions: As a practical matter, imposing recapture risk on the transferee, instead of the transferor, generally means that the transferee will seek to be indemnified by the transferor for any recapture liability. Likely, this will favor a transferor with a strong balance sheet, guarantee, and/or insurance. To avoid the 20 percent penalty on an excessive credit transfer, transferees should conduct diligence to confirm the availability and amount of an eligible credit, obtain relevant third-party reports, negotiate robust representations, and review the transferor's financial statements.

V. The Direct Pay Rules

Code Section 6417 provides that, in the case of an applicable entity that makes an elective payment election with respect to any “applicable credit”¹ determined with respect to the applicable entity for the taxable year, the applicable entity is treated as making a payment against the federal income tax for the taxable year with respect to which such credit was determined that is equal to the amount of such credit (elective payment amount).

Applicable Entity

Code Section 6417(d)(1) defines “applicable entity” as certain tax-exempt organizations, state and local governments, Indian tribal governments, Alaska Native Corporations, the Tennessee Valley Authority, and rural electric cooperatives. Under the Proposed Regulations, any organization exempt from tax under Code Section 501(a), governmental entities whose income is exempt from tax under Code Section 115, and government “instrumentalities” are also treated as applicable entities.

If an applicable entity or “electing taxpayer” (as defined further below) is the owner (directly or indirectly) of a disregarded entity that directly holds an applicable credit property, the applicable entity may make an elective payment election for applicable credits determined with respect to the applicable credit property held by the disregarded entity.

The Proposed Regulations provide that a C corporation that is not itself an applicable entity cannot make an elective payment election, because a taxable C corporation is an entity separate from its owner. However, an electing taxpayer (discussed below) may include a taxable C corporation (including a member of a consolidated group).

The Proposed Regulations provide that, if an applicable entity is a co-owner of a property through an ownership arrangement treated as a tenancy-in-common or pursuant to a joint operating arrangement that has properly elected out of subchapter K under Code Section 761, then each owner is considered to own an undivided interest in or share of the underlying applicable credit property and thus, any applicable credits are determined separately with respect to each owner. As a result, an applicable entity may make an elective payment election with respect to its share of the applicable credits determined with respect to its undivided ownership interest in or share of the underlying applicable credit property. We note however that an ownership arrangement may qualify only in limited circumstances as a tenancy in common or as eligible for a Code Section 761 election.

Importantly, partnerships and S corporations are not applicable entities, regardless of how many (or even if all) of the partners or shareholders are applicable entities. However, an electing taxpayer may include a partnership or S corporation. Separately, an applicable entity may engage with other entities, including with for-profit partners, in an ownership arrangement that has properly elected out of subchapter K and make an elective payment election with respect to its share of the applicable credits determined based on its share of the underlying applicable credit property.

Finally, Code Section 6417(d)(1)(B), (C) and (D) provides that a taxpayer that is not an applicable entity but that, with respect to any taxable year, places in service applicable property that qualifies for the Code Section 45V credit for clean hydrogen production or the Code Section 45Q credit for carbon sequestration, or, with respect to any taxable year after December 31, 2022, in which such taxpayer has produced eligible advanced manufacturing components under Code Section 45X, respectively, may elect to be treated as an applicable entity for purposes of Code Section 6417 for such taxable year, but only with respect to the applicable credit property and only with respect to the credits provided under Code Section 45V(a), 45Q(a) or 45X(a), respectively. The Proposed Regulations define such a taxpayer as an “electing taxpayer.”

Applicable Credit

Any applicable credit is determined without regard to the restrictions regarding use of property by tax-exempt organizations and government entities found in Code Sections 50(b)(3) and (4)(A)(i). Further, the applicable credit would be determined by treating any property with respect to which such credit is determined as used in a trade or business of the applicable entity.

The Proposed Regulations provide that any tax-exempt amounts used to purchase, construct, reconstruct, erect, or otherwise acquire an applicable credit property described in Code Sections 30C, 45W, 48, 48C or 48E (investment-related credit property) are included in basis for

purposes of computing the applicable credit amount determined with respect to the investment-related credit property, regardless of whether basis is required to be reduced (in whole or in part) by such amounts under other provisions of the Code. However, to prevent an excessive benefit, if an applicable entity receives tax-exempt amounts for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring an investment credit property (restricted tax-exempt amount), and the restricted tax-exempt amount plus the applicable credit otherwise determined with respect to that investment-related credit property exceeds the cost of the investment-related credit property, then the amount of the applicable credit is reduced so that the total amount of applicable credit plus the amount of any restricted tax-exempt amount equals the cost of investment credit property.

Further, any credits for which an election is made must have been determined with respect to the applicable entity or electing taxpayer, meaning that the applicable entity or electing taxpayer must own the underlying eligible credit property or, if ownership is not required, otherwise conducts the activities giving rise to the underlying eligible credit. Importantly, this would mean that no Code Section 6417 election may be made for credits purchased pursuant to Code Section 6418, transferred pursuant to Code Section 45Q(f)(3), acquired by a lessee from a lessor by means of an election to pass through the credit to a lessee pursuant to Code Section 50(d)(5), owned by a third party or otherwise not determined directly with respect to the applicable entity or electing taxpayer.

Elective Payment Election

The Proposed Regulations provide that an applicable entity or electing taxpayer shall make an elective payment election on the applicable entity's or electing taxpayer's annual tax return, in the manner prescribed by the IRS in guidance, along with any required completed source credit forms with respect to the applicable credit property, a completed Form 3800 (General Business Credit), and any additional information, including supporting calculations, required in instructions to the relevant forms. For purposes of the Code Section 6417 regulations, the "annual tax return" would mean: 1) for any taxpayer normally required to file an annual tax return with the IRS, such annual return (including Form 1065 for partnerships and Form 990-T for tax-exempt organizations with unrelated business income tax or a proxy tax); 2) for any taxpayer that is not normally required to file an annual tax return with the IRS, the return they would be required to file if they were located in the United States, or, if no such return is required, Form 990-T; and 3) for short tax year filers, the short year tax return.

An elective payment election may only be made on an original return filed not later than the due date (including extensions) for the original return for the taxable year for which the applicable credit is determined and may not be made or revised on an amended return or by filing an administrative adjustment request. No relief is available for an elective payment election that is not timely filed.

Pre-filing registration is a condition of any amount being treated as a payment that is made by an applicable entity under Code Section 6417(a). An elective payment election will not be

effective unless the applicable entity or electing taxpayer receives a valid registration number for the applicable credit property and provides the registration number for each applicable credit property on its Form 3800 attached to the tax return in accordance with guidance. The Proposed Regulations provide that any election, once made, is irrevocable and applies with respect to any applicable credit for the taxable year for which the election is made.

An elective payment election applies to the entire amount of applicable credits determined with respect to each applicable credit property that was properly registered for the taxable year, resulting in an elective payment amount that is the entire amount of applicable credits determined with respect to the applicable entity or electing taxpayer for a taxable year.

Under Code Section 6417, the election period applies for an applicable period of years with respect to certain applicable credits. Specifically, for the Code Section 45 PTC or Code Section 45Y credit for clean energy production, the election applies to the 10-year period beginning on the date the facility was originally placed in service. For the Code Section 45Q carbon sequestration credit, the election applies to the 12-year period beginning on the date the carbon capture equipment was originally placed in service. For the Code Section 45V clean hydrogen production credit, the election applies to all subsequent taxable years with respect to the facility. For purposes of Code Sections 45Q, 45V, and 45X, electing taxpayers can make the election for one 5-year period per applicable credit property, and are allowed one revocation per applicable credit property.

The election would be made separately for each applicable credit property, which is, respectively, a qualified clean hydrogen production facility placed in service for which a Code Section 45V credit is determined, a single process train placed in service at a qualified facility for which a Code Section 45Q credit is determined, or a facility in which eligible components are produced for which a Code Section 45X credit is determined. Only one election may be made with respect to any specific applicable credit property.

Pre-Filing Registration

Temporary Treasury Regulations, which are immediately effective, provide the mandatory pre-filing registration process that applicable entities and electing taxpayers must complete before making the direct pay election. An applicable entity or electing taxpayer must complete the pre-filing registration process electronically through an IRS electronic portal in accordance with the instructions provided therein, unless otherwise provided in guidance. An applicable entity or electing taxpayer is required to obtain a registration number for each applicable credit property with respect to which an applicable credit will be determined and for which the applicable entity or electing taxpayer intends to make an elective payment election. A registration number is valid only for the taxable year for which it is obtained but can be renewed in subsequent years by providing updated information or an attestation that the information has not changed. Certain specified events (e.g., if the property undergoes a change in ownership) will require that the applicant amend its registration or in some cases, submit a new registration.

Elective Payment Amount

The Proposed Regulations provide that the “elective payment amount” means, with respect to an applicable entity or an electing taxpayer that is not a partnership or an S corporation, the applicable credits for which an applicable entity or electing taxpayer makes an elective payment election to be treated as making a payment against the federal income tax for the taxable year, which would be equal to the sum of 1) the amount (if any) of the current year applicable credits allowed as a general business credit under Code Section 38 for the taxable year, and 2) the amount (if any) of unused current year applicable credits which would otherwise be carried back or carried forward from the unused credit year under Code Section 39 and that are treated as a payment against tax.

With respect to an electing taxpayer that is a partnership or an S corporation, the “elective payment amount” would mean the sum of the applicable credits for which the partnership or S corporation makes an elective payment election and results in a payment to such partnership or S corporation equal to the amount of such credits (unless the partnership or S corporation owes a federal tax liability, in which case the payment may be reduced by such tax liability). The Proposed Regulations provide that, before determining any partner’s distributive share or shareholder’s pro rata share of such credit, such credit is reduced to zero and is, for any other purposes under the Code, deemed to have been allowed solely to such entity (and not allocated by such entity to any partner or shareholder) for such taxable year.

Excessive Payments

An excessive payment is the excess of the amount treated as a payment to an applicable entity or electing taxpayer over the amount of the allowable credit, without application of Code Section 6417, that would otherwise be allowable. The Proposed Regulations provide that other rules pertaining to tax credit utilization, including Code Sections 38, 49, and 469, fully apply to the determination of an excessive payment.

For purposes of determining basis reduction and recapture, the Proposed Regulations provide that rules similar to those in Code Section 50 will apply. However, the rules clarify that any recapture event, including recapture events under Code Section 45Q(f)(4) or 50(a), does not itself result in an excessive payment. Examples in the regulations clarify the application of basis reduction and recapture rules to projects held by applicable entities.

VI. The Transferability Rules

Code Section 6418 provides that, in the case of an eligible taxpayer that elects to transfer to an unrelated transferee taxpayer all (or any portion specified in the election) of an eligible credit determined with respect to the eligible taxpayer for any taxable year, the transferee taxpayer specified in such election (and not the eligible taxpayer) is treated as the taxpayer for purposes of the Code with respect to such credit (or such portion thereof).

Eligible Taxpayer

The Proposed Regulations define the term “eligible taxpayer” to mean any taxpayer (as defined in Code Section 7701(a)(14)), other than any applicable entity described in Code Section 6417(d)(1)(A). The term “taxpayer” in Code Section 7701(a)(14) means “any person subject to any internal revenue tax” and generally, includes entities that have a U.S. employment tax or excise tax obligation even if they do not have a U.S. income tax obligation.

For a disregarded entity wholly owned (directly or indirectly) by an eligible taxpayer, the eligible taxpayer makes a transfer election.

If eligible credit property is directly owned through an arrangement properly treated as a tenancy-in-common for U.S. federal income tax purposes, or through an organization that has made a valid election under Code Section 761(a), each co-owner’s or member’s undivided ownership share of the eligible credit property will be treated for purposes of Code Section 6418 as a separate eligible credit property owned by such co-owner or member, and each must make a separate transfer election.

For members of a consolidated group, an individual member that owns the eligible credit property is required to make a transfer election.

For any eligible credit property held directly by a partnership or S corporation, the partnership or S corporation makes a transfer election, not the partners or shareholders.

Eligible Credit

The Proposed Regulations define the term “eligible credit” consistent with Code Section 6418(f)(1)(A) and include all 11 of the credits listed in that section. Further, the definition would include a rule that an eligible credit does not include any business credit carryforward or business credit carryback determined under Code Section 39, which is consistent with Code Section 6418(f)(1)(C). The entire amount of any eligible credit is separately determined with respect to each single eligible credit property of the eligible taxpayer and include any bonus credit amounts determined with respect to that single eligible credit property.

Eligible Credit Property

The term “eligible credit property” generally means the unit of property of an eligible taxpayer with respect to which the amount of an eligible credit is determined. Specifically, the appropriate unit of measurement for each of the 11 eligible credits is as follows:

1. For the Code Section 30C credit, a taxpayer would be required to pre-register and make an election on a property-by-property basis. For this purpose, a property means a “qualified alternative fuel vehicle refueling property” as defined in Code Section 30C(c).

2. For the Code Section 45 PTC, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a “qualified facility” as defined in Code Section 45(d).
3. For the Code Section 45Q credit, a taxpayer would be required to pre-register and make an election for a unit of carbon capture equipment. The rules under Treas. Reg. § 1.45Q-2(c)(3) state that all components that make up an independently functioning process train capable of capturing, processing, and preparing carbon oxide for transport (single process train) will be treated as a single “unit of carbon capture equipment.”
4. For the Code Section 45U credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a “qualified nuclear power facility” as defined in Code Section 45U(b)(1).
5. For the Code Section 45V credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a “qualified clean hydrogen production facility” as defined in Code Section 45V(c)(3).
6. For the Code Section 45X credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a facility that produces eligible components, as described in guidance under Code Sections 48C and 45X.
7. For the Code Section 45Y clean energy production credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a “qualified facility” as defined in Code Section 45Y(b)(1).
8. For the Code Section 45Z clean fuel production credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis. For this purpose, a facility means a “qualified facility” as defined in Code Section 45Z(d)(4).
9. For the Code Section 48 ITC, a taxpayer would be required to pre-register and make an election on a property-by-property basis. For this purpose, property means energy property, which generally includes all components of property that are functionally interdependent (unless such equipment is an addition or modification to an energy property).
10. For the Code Section 48C qualifying advanced energy project credit, a taxpayer would be required to pre-register and make an election on a property-by-property basis. For this purpose, property means an “eligible property” as defined in Code Section 48C(c)(2).
11. For the Code Section 48E clean electricity investment credit, a taxpayer would be required to pre-register and make an election on a facility-by-facility basis if the credit relates to a qualified investment with respect to a qualified facility. For this purpose, a

facility means a “qualified facility” as defined in Code Section 48E(b)(3). However, a taxpayer would be required to pre-register and make an election with respect to the Code Section 48E credit on a property-by-property basis if the credit relates to a qualified investment with respect to energy storage technology. For this purpose, property means a unit of “energy storage technology” as defined in Code Section 48E(c)(2).

Transferable Amount of an Eligible Credit

Any rules that relate to the determination of an eligible credit, such as the rules in Code Sections 49 and 50, would apply to the eligible taxpayer and therefore can limit the amount of transferrable eligible credits determined with respect to a single eligible credit property owned by the eligible taxpayer.

For example, the Proposed Regulations provide rules for the application of Code Section 49 to a partnership or S corporation that is an eligible taxpayer and elects under Code Section 6418 to transfer an eligible credit. The Proposed Regulations provide that any amount of eligible credit determined with respect to investment credit property held directly by a transferor partnership or S corporation is determined by the transferor by taking into account the Code Section 49 at-risk rules at the partner or shareholder level as of the close of the taxable year in which the investment credit property is placed in service. Thus, if the credit base of the investment credit property is limited to a partner or shareholder by Code Section 49, then the amount of the eligible credit determined by the transferor partnership or S corporation is also limited. However, even if the partners of the transferor partnership are subject to the passive credit rules, such rules do not limit the amount of credits that may be transferred.

Transferee Taxpayer

The Proposed Regulations define the term “transferee taxpayer” as any taxpayer that is not related (within the meaning of Code Section 267(b) or 707(b)(1)) to the eligible taxpayer making the election to transfer a specified credit portion of an eligible credit.

Application of Passive Loss Rules to the Transferee

Code Section 469, which contains the passive loss and credit rules, currently applies in full force to the transferee of an eligible credit. Specifically: 1) the transferred credit is treated as determined in connection with the conduct of a trade or business and 2) the transferee is not considered to own an interest in the transferor’s trade or business at the time the project work was completed (as would be required to satisfy the “material participation” exception to the passive loss rules) and thus cannot change the characterization of the transferee’s participation (or lack thereof) in the transferor’s trade or business by grouping multiple activities under Treas. Reg. § 1.469-4(c).

Transfer Election

The Proposed Regulations define the term “transfer election” as an election under Code Section 6418(a) to transfer to a transferee taxpayer a specified portion of an eligible credit determined with respect to an eligible credit property in accordance with the Code Section 6418 regulations. The Proposed Regulations define a “specified credit portion” to mean a proportionate share of an entire eligible credit determined with respect to an eligible credit property of the eligible taxpayer that is specified in a transfer election. A specified credit portion of an eligible credit would be required to reflect a proportionate share of each bonus credit amount that is taken into account in calculating the entire amount of the eligible credit determined with respect to a single eligible credit property.

The Proposed Regulations provide that an eligible taxpayer may make multiple transfer elections to transfer one or more specified credit portions to multiple transferee taxpayers, provided that the aggregate amount of specified credit portions transferred with respect to a single eligible credit property does not exceed the amount of the eligible credit determined with respect to the eligible credit property. In other words, Code Section 6418 does not, and therefore these proposed regulations would not, limit the number of transfer elections or number of transferee taxpayers for which an eligible taxpayer can make a transfer election, unless the transfer of a specified credit portion would exceed the available eligible credit to be transferred. Further, it is not possible to transfer a credit separate from adders for domestic content, energy communities and low-income communities or vice versa.

Any amounts paid by a transferee taxpayer in connection with the transfer of a specified credit portion be paid in cash. “Paid in cash” means a payment made in United States dollars by cash, check, cashier’s check, money order, wire transfer, automated clearing house transfer, or other bank transfer of immediately available funds. Such payment must be made no later than the due date for completing a “transfer election statement” (discussed below).

The Proposed Regulations describe three circumstances where no transfer election can be made. First, the Proposed Regulations preclude any election with respect to any amount of an eligible credit determined based on progress expenditures that are allowed pursuant to rules similar to the rules of Code Section 46(c)(4) and (d) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990). Second, the Proposed Regulations preclude a transfer election when an eligible taxpayer receives any amount not paid in cash as consideration in connection with the transfer of a specified credit portion. Code Section 6418(b)(1) requires that “any” consideration paid in connection with a transfer must be paid in cash. Thus, if any consideration is other than cash, the transfer election is disallowed. Third, no election is allowed when eligible credits are not determined with respect to an eligible taxpayer. An eligible credit is determined with respect to an eligible taxpayer in cases where the eligible taxpayer owns the underlying eligible credit property or, if ownership is not required, otherwise conducts the activities giving rise to the underlying eligible credit. It is possible that a credit is allowable to an eligible taxpayer, but the eligible taxpayer is not permitted to transfer the credit under Code Section 6418 (such as, for example, a partner in a partnership that is allocated credits).

A transfer election must be made for each taxable year an eligible taxpayer elects to transfer a specified credit portion with respect to such eligible credit property during the 10-year period beginning on the date such eligible credit property was originally placed in service (or, in the case of a Code Section 45Q credit, for each taxable year during the 12-year period beginning on the date the eligible credit property was originally placed in service).

An eligible taxpayer generally would be required to include the following as part of filing a return: 1) a properly completed relevant source credit form for the eligible credit, 2) a properly completed Form 3800 (General Business Credit), including reporting the registration number received during the required pre-filing registration, 3) a schedule attached to the Form 3800 showing the amount of eligible credit transferred for each eligible credit property, 4) a transfer election statement, and 5) any other information related to the election specified in guidance. The election statement must contain a certification that the transferor has provided certain minimum documentation to the transferee regarding the existence of the eligible credit property, documentation of qualification for any ITC or PTC bonus amounts or enhancements, and evidence of qualifying costs or production activities.

A transfer election may only be made on an original return filed not later than the due date for the original return for the taxable year for which the applicable credit is determined and may not be made or revised on an amended return or by filing an administrative adjustment request. No relief is available for a transfer election that is not timely filed, including Section 9100 relief.

As a condition of, and prior to, making an election to transfer a specified credit portion, an eligible taxpayer must satisfy the pre-filing registration process (discussed below). Failure to properly pre-register precludes any transfer of an eligible credit by an eligible taxpayer. A transfer election, once made, is irrevocable.

Pre-Filing Registration

The Proposed Regulations provide the mandatory pre-filing registration process. The Department of the Treasury and the IRS intend for this pre-filing registration process to occur through an IRS electronic portal. After the required pre-filing registration process is successfully completed, an eligible taxpayer will receive a registration number from the IRS for each registered eligible credit property for which the eligible taxpayer intends to transfer a specified credit portion. The registration number must be reported on the eligible taxpayer's return. However, completion of the pre-filing registration requirements and receipt of a registration number does not, by itself, mean the eligible taxpayer is eligible to transfer any specified credit portion determined with respect to the eligible credit property. A transferee taxpayer is also required to report the registration number received from an eligible taxpayer on its return for the taxable year that the transferee taxpayer takes the transferred eligible credit into account.

Re-transferability

A transferee taxpayer of any specified credit portion cannot make a second transfer under Code Section 6418 with respect to any amount of such transferred credit. An allocation of a transferred specified credit portion to a direct or indirect owner of a passthrough entity would not be considered a transfer under Code Section 6418. Therefore, such allocation does not violate the no-second-transfer rule.

An arrangement where the federal income tax ownership of a specified credit portion transfers first from an eligible taxpayer to a dealer or intermediary and then to a transferee taxpayer is in violation of the no-second-transfer rule. In contrast, an arrangement using a broker to match eligible taxpayers and transferee taxpayers does not violate the no-second-transfer rule, assuming the arrangement at no point transfers the federal income tax ownership of a specified credit portion to the broker or any taxpayer other than the transferee taxpayer.

Treatment of Payment for the Transfer

Any amount received as consideration for a transfer of eligible credits by a transferor partnership is treated as tax-exempt income for purposes of Code Section 705, and any such amount received by a transferor S corporation is treated as tax-exempt income for purposes of Code Section 1366.

The Proposed Regulations clarify that amounts paid in cash in connection with a transfer election by a transferee taxpayer are not includible in the gross income of an eligible taxpayer and are not deductible by the transferee taxpayer. Any payments made or received outside the requirements described in the Proposed Regulations would be governed by general tax rules.

The Proposed Regulations include an anti-abuse provision to disallow the election and transfer of an eligible credit under Code Section 6418 or otherwise recharacterize a transaction's income tax consequences in circumstances where the parties to the transaction have engaged in the transaction or a series of transactions with the principal purpose of avoiding tax liability beyond the intent of Code Section 6418.

As of the date of this white paper, no guidance addresses the federal income tax treatment of transaction costs, either for the eligible taxpayer or the transferee taxpayer, and whether a transferee taxpayer is permitted to deduct a loss if the amount paid to an eligible taxpayer exceeds the amount of the eligible credit that the transferee taxpayer can ultimately claim.

Excess Credit Transfers

The Proposed Regulations define the term "excessive credit transfer" to mean, with respect to an eligible credit property for which an election is made for any taxable year, an amount equal to the excess of i) the amount of the specified credit portion claimed by the transferee taxpayer with respect to such eligible credit property for such taxable year, over ii) the amount of the eligible credit that, without the application of Code Section 6418, would be otherwise allowable under the Code with respect to such eligible credit property for such taxable year.

In the case of any transferred specified credit portion that the IRS determines constitutes an excess credit transfer, the tax imposed on the transferee taxpayer for the taxable year in which such determination is made will be increased by an amount equal to the sum of the amount of such excess credit transfer plus a 20 percent penalty. The 20 percent penalty does not apply if the transferee taxpayer demonstrates to the satisfaction of the IRS that the excessive credit transfer results from reasonable cause.

The Proposed Regulations include a rule that the recapture amount (as defined in Code Section 50(c)(2)) is calculated and taken into account by the transferee taxpayer. However, there is no prohibition under Code Section 6418 for an eligible taxpayer and a transferee taxpayer to contract between themselves for indemnification of the transferee taxpayer in the event of a recapture event.

However, transferees of credits are not subject to recapture risk if a partner sells its interest in a transferor taxpayer that would otherwise cause recapture, however the partner is responsible economically as if the sold credit were recaptured.

VII. Conclusion

As described in this white paper, there are many considerations for developers of energy projects, potential buyers of tax credits, financial brokers and intermediaries, and others that must be taken into account in designing effective tax credit monetization transactions under the IRA. Nevertheless, the new direct pay and transferability provisions offer inviting alternatives to traditional tax equity that may broaden the universe of interested investors in renewable energy projects going forward.

¹ The applicable credits eligible for direct pay under Code Section 6417 are the following: (1) Code Section 30C alternative fuel vehicle refueling property credit; (2) Code Section 45 renewable electricity production credit; (3) Code Section 45Q carbon sequestration credit; (4) Code Section 45U zero-emission nuclear power production credit; (5) Code Section 45V clean hydrogen production credit; (6) Code Section 45W qualified commercial vehicles credit (for certain tax-exempt entities described in Code Section 168(h)(2) only); (7) Code Section 45X advanced manufacturing production credit; (8) Code Section 45Y clean electricity production credit; (9) Code Section 45Z clean fuel production credit; (10) Code Section 48 investment credit; (11) Code Section 48C qualifying advanced energy project credit; (12) Code Section 48E clean electricity investment credit.