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Client Alert

Tax

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IRS and Treasury Issue Transferability Proposed Regulations

Developers of renewable energy projects prior to the Inflation Reduction Act of 2022 (the “IRA”) were able to enter into joint ventures and leasing arrangements with other private companies that had a sufficient tax liability in order to monetize tax credits generated by the projects. The joint ventures are commonly called “tax equity” or “flip partnership” deals and are relatively complex and consequently had a limited pool of potential investors.

The IRA changed this dynamic by permitting certain tax credits to be transferred to a taxpayer without the need for a tax equity structure. On June 14, 2023, the Treasury and IRS issued proposed regulations (REG-101610-23) clarifying several key issues relating to “transferability” under new Section 6418 of the Internal Revenue Code of 1986, as amended (the “Code”). In addition, the Treasury and IRS issued temporary regulations on the pre-filing requirements (TD 9975) as well as a series of FAQs, providing additional clarity to taxpayers looking to take advantage of the new opportunity to monetize energy tax credits.

The proposed regulations apply to taxable years on or after the date the final regulations are published in the Federal Register. In the meantime, taxpayers may rely on the proposed regulations, provided the taxpayers follow the proposed regulations in their entirety and in a consistent manner.

OVERVIEW OF SECTION 6418 TRANSFERABILITY

For taxable years beginning after December 31, 2022, certain taxpayers can make an annual election to transfer all or portion of an eligible tax credit to an unrelated transferee taxpayer (within the meaning of Section 267(b) or 707(b)(1) of the Code) in exchange for cash. The election is irrevocable once made.

Transferability is available to a broad class of taxpayers, including individuals, C corporations, trusts and estates. Generally, eligible taxpayers who can make a transfer election are taxpayers other than certain tax-exempt and governmental entities eligible for "direct pay" under Section 6417 of the Code.[1] The cash amount received as consideration for the transfer is not included in the transferor's income and not deductible by the transferee purchasing the tax credit.[2]

Eligible credits include the following:

- Section 30C Credit for Alternative Fuel Refueling Property
- Section 45/45Y Production Tax Credit (PTC)
- Section 45Q Carbon Capture and Sequestration Credit
- Section 45U Nuclear Power Production Credit
- Section 45X Advanced Manufacturing Production Credit
- Section 45V Clean Hydrogen Production Tax Credit
- Section 45Z Clean Fuel Production Credit
- Section 48/48E Investment Tax Credit (ITC)
- Section 48C Advanced Energy Project Credit

The transferee may not transfer again the eligible credit (or portion thereof) previously transferred to it. This is known as the "no-second-transfer rule." The rules for S corporations and partnerships and their equity holders are discussed in more detail below. Tax credits which have been carried back or carried forward may not be transferred. The carryback period for credits is three years and the carry forward period is 22 years.

PROPOSED REGULATIONS ON TRANSFERABILITY

Paid in Cash

Consideration for an eligible credit must be paid in cash. The proposed regulations clarify that cash means payments made by cash, check, cashier's check, money order, wire transfer, automated clearing house (ACH) transfer, or other bank transfer of immediately available funds. A transfer election cannot be made if any consideration is other than cash. This prohibition creates a cliff effect for credits partially paid using cash and non-cash consideration. However, it is not clear from the proposed regulations how the non-cash consideration would be allocated among the transferred credits (or portions) for purposes of determining validity of such transfers. The risk to the transferor and transferee in this case would depend on whether the non-cash portion is allocated to one credit transfer or among multiple transfers.

Payments made by a transferee prior to the credit transfer or prior to claiming the transferred credit on its return will be treated as paid in cash if the payment is made during the period (1) beginning on the first day of the eligible taxpayer's tax year during which an eligible credit is determined and (2) ending on the due date for completing a transfer election statement.

A contractual commitment to purchase eligible credits in advance of the transfer satisfies the "paid in cash" requirement. In tax equity deals it is common for the investors to contribute their investments at or near the start of the deal. In contrast, the transferability rules contemplate a year-by-year sale. To deal with this mismatch, the purchaser of the credits may structure the advance of funds as a loan. This has a number of potential tax and non-tax consequences that will need to be worked out for each potential transaction.

The proposed regulations confirm that a transferee does not have gross income when claiming a transferred credit even if the amount of cash paid to the eligible taxpayer was less than the amount of the transferred credit to the transferee. For example, if a transferee paid $9 for $10 worth of an eligible credit and claimed the transferred credit on its tax return, the proposed regulations clarify that the $1 difference is not included in the transferee's gross income.

Transfer of Eligible Credit

Eligible taxpayers can transfer a portion of an eligible tax credit instead of the full credit. The proposed regulations clarify that eligible taxpayers can make multiple elections to transfer one or more portions of an eligible credit to multiple transferees. However, any bonus credit amount (e.g., domestic content or energy community bonus) cannot be transferred separately from the "base" amount. In other words, a specified portion of an eligible credit must reflect a proportionate share of each bonus credit amount taken into account in calculating the entire amount of the eligible credit.

The proposed regulations clarify that a credit is determined on a property-by-property basis. This means taxpayers can choose to transfer credits with respect to one property and not another, even if the properties are of the same class. This is very beneficial and differs from the bonus depreciation rules which generally require such conformity.

If a partnership or S corporation owns (including indirectly through a disregarded entity) a facility or property for which an eligible credit is determined (an "eligible credit property"), the partnership or S corporation, and not the partners or shareholders, must make any transfer election. If the partnership or S corporation does not make the transfer election, the eligible credit would flow through to the partners or shareholders who will then claim the credits on their tax returns. In such case, the partners or shareholders cannot separately elect to transfer the credits flowing through to them from the partnership or S corporation.

A number of special rules apply to partnerships and S corporations. If the partnership or S corporation makes a transfer election, any amount received as consideration for the transfer is treated as tax-exempt income to the transferor partnership or transferor S corporation for purposes of Section 705 or Section 1366. Any tax-exempt income realized by such partnership or S corporation is treated as arising from an investment activity and not from the conduct of a trade or business, and thus will not be treated as passive income to any partner or shareholder that does not materially participate in the business for purposes of the passive activity rules applicable to individuals and closely held C corporations. In the case of partnerships, tax-exempt income from the credit transfer must be allocated to the partners based on each partner's distributive share of the otherwise eligible credit for each taxable year, and special allocation is not permitted. Cash proceeds from the transfer, however, need not be distributed in the same manner as tax-exempt income is required to be allocated.[3]

Significantly, the proposed regulations allow a partnership that directly holds (including through a disregarded entity) an eligible credit property to transfer only certain partners' shares of the eligible credit. Thus, if a partnership elects to transfer less than all of an eligible credit, the partnership is permitted to allocate tax-exempt income resulting from the transfer to certain partners, while allocating the remaining portion of the eligible credit among other partners, or a combination of both, provided that no partner is allocated eligible credits in excess of the amount of credit the partner would have been allocated absent the transfer election. Each partner's proportionate share of such tax-exempt income is determined by multiplying the total tax-exempt income realized from the credit transfer by a fraction, (A) the numerator of which is equal to the partner's eligible credit amount less the amount of eligible credits allocated to the partner, and (B) the denominator of which is amount of eligible credits transferred by the partnership with respect to the eligible credit property.

In the case of transferee partnerships or S corporations, the proposed regulations clarify that allocations of transferred credits by a transferee partnership or S corporation to its direct or indirect owners do not violate the no-second-transfer rule. Any cash payments paid for a transferred eligible credit are treated as Section 705(a)(2)(B) nondeductible expenditures and allocated among the partners based on their distributive shares of the nondeductible expenditures used to fund the purchase of the credit, as determined by the transferee partnership's partnership agreement (or if the partnership agreement is silent, then based on the transferee partnership's general allocation of nondeductible expenses).

Transferability is not available for two common tax credit arrangements. The investment tax credit ("ITC") permits lessors to transfer the ITC to lessees in certain circumstances. Section 45Q also permits the taxpayer to transfer the credit to the sequestering party. The recipient of the tax credit under either scenario may not subsequently transfer the credits under Section 6418.

The regulations permit the use of brokers but not dealers. The regulatory preamble addressed whether credits could be transferred through a dealer or broker. Use of a dealer or other intermediary where they act as an intermediary buyer violates the no second transfer rule. However, using a broker to match eligible taxpayers and transferees should not violate the no second transfer rule provided the credit is transferred directly from the taxpayer to the transferee.

Recapture and Excessive Credit Transfer

Property where the taxpayer claimed the ITC ("ITC property") is subject to recapture if it is disposed of or ceases to be eligible property during the five-year period following the date on which such ITC property is originally placed in service. The transferee bears the recapture risk and must calculate and pay the recapture amount to the Treasury and IRS. The transferor must increase the basis of the ITC property by the recapture amount. Although statutory language is silent on recapture of the carbon capture credits under Section 45Q, the proposed regulations provide that Section 45Q recapture is taken into account by the transferee.

If a recapture event occurs, the transferor is required to provide notice of the recapture event to the transferee, and the transferee is required to provide notice of recapture amount to the transferor. The proposed regulations provide that an eligible taxpayer and a transferee are free to contract for indemnification in the event of a recapture event.

Importantly, if a transferor is a partnership or S corporation, any recapture liability of a partner or shareholder resulting from a reduction in the percentage ownership of such partner or shareholder in the transferor partnership or S corporation will be borne by the disposing partner or shareholder, and not the transferee.

If there is an excessive credit transfer to a transferee, the tax imposed on the transferee is increased by the amount of the excessive credit transfer plus 20 percent of the excessive credit transfer as a penalty, unless the transferee could demonstrate reasonable cause. In the case of multiple transferees, the proposed regulations provide that all transferees will be treated as one transferee for the purpose of calculating whether there was an excessive transfer and the amount of excessive transfer.

Time and Manner of Making a Transfer Election

Eligible taxpayers must register their transferred credits under the rules provided by the temporary regulations discussed below. Once registered, a transfer election must be filed annually on an original return not later than the due date (including extensions) for the taxable year for which the eligible credit is determined. A separate election must be made with respect to each eligible credit property. A transfer election may not be made or revised on an amended return or by filing a request for an administrative adjustment under Section 6227 of the Code.

Eligible taxpayers generally are required to include the following:

(i) a properly completed relevant source credit form for the eligible credit;

(ii) a properly completed Form 3800, General Business Credit (or its successor), including reporting the registration number received during the required pre-filing registration;

(iii) a schedule attached to the Form 3800 (or its successor) showing the amount of eligible credit transferred for each eligible credit property;

(iv) a transfer election statement (containing certain information relating to the eligible taxpayer and transferee and certain representations from the eligible taxpayer); and

(v) any other information related to the election specified in guidance.

TEMPORARY REGULATIONS ON PRE-FILING REGISTRATION

Eligible taxpayers must complete the pre-filing registration process electronically through an IRS electronic portal and receive a registration number from the IRS prior to making a transfer election on the eligible taxpayer's return. Each eligible credit property must have its own registration number, which is valid for one tax year. Unless modified in future guidance, the temporary regulations establish the definitive list of required identifying information:

(i) The eligible taxpayer's general information (including its name, address, taxpayer identification number, and type of legal entity);

(ii) Any additional information required by the IRS electronic portal;

(iii) The taxpayer's taxable year;

(iv) The type of annual tax return(s) normally filed by the eligible taxpayer, or normal non-filing status;

(v) The type of eligible credit(s) being transferred;

(vi) Details about each eligible credit property such as (a) the type of eligible credit property, (b) physical location, (c) any supporting documentation relating to the construction or acquisition of the eligible credit property, (d) the beginning of construction date and placed in service date, and (e) the source of funds used to acquire the property;

(vii) Name of the contact person for the eligible taxpayer;

(viii) A penalties of perjury statement; and

(ix) Any other information the IRS deems necessary for purposes of preventing fraud, improper payments, or excess payments.

The pre-registration process is expected to be introduced before the end of 2023.

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[1] Direct pay, which is a companion provision to transferability, allows certain tax-exempt and governmental entities to receive cash refund instead of claiming tax credits. The IRS issued proposed regulations for direct pay (REG-101607-23) on the same day it issued the transferability proposed regulations.

[2] The proposed regulations do not say whether consideration paid to the transferor can be capitalized. Similarly, the proposed regulations do not say whether the transferor and the transferee can deduct or capitalize transaction costs. The Treasury and IRS are currently developing rules on these general issues and are seeking comments as part of that process.

[3] In the case of S corporations, the proposed regulations provide that tax-exempt income must be allocated pro rata to the shareholders.