

PROPOSED TREASURY REGULATIONS ISSUED ON DIRECT PAY AND TRANSFERABILITY ELECTIONS FOR TAX CREDITS

INTRODUCTION

Background

The enactment of the Inflation Reduction Act ("IRA") on August 16, 2022, significantly changed the landscape of renewable energy tax credit monetization and tax equity finance in the United States. The IRA introduced two mechanisms that have enhanced taxpayers' ability to monetize tax credits effective for taxable years beginning on or after January 1, 2023. First, certain tax-exempt entities can elect to treat certain tax credits as a tax payment, which effectively allows these entities to receive a tax refund from the United States Treasury even if they otherwise do not have sufficient tax liability to use the credits (the "**direct pay election**"). Second, certain eligible taxpayers can elect to sell some or all of their eligible tax credits for cash consideration, generally to buyers that have sufficient tax liability to avail themselves of the credits (the "**transferability election**").

The Treasury and the Internal Revenue Service ("IRS") were tasked with the implementation of these rules and published Notice 2022-50 in October 2022 to request feedback from stakeholders on potential issues that may require administrative guidance. On June 14, 2023, based on the feedback from comment letters received in the fall of 2022, the Treasury and the IRS released temporary regulations and proposed regulations implementing the direct pay election and the transferability election. The regulations largely address technical points related to the implementation of the direct pay election and the transferability election, which we have not reproduced here. Rather, the discussion below focuses on surprises and key takeaways from these regulatory packages, with additional briefings on other topics to follow.

DIRECT PAY

"Applicable Entities"

The proposed regulations clarify what "applicable entities" are eligible for the direct pay election. Notably, a partnership or an S corporation, even one that is wholly owned by one or more tax-exempt entities, is not treated as an eligible "applicable entity" that can make a direct pay election with respect to most eligible credits—investment tax credits under Section 48, the alternative fuel vehicle refueling property credit under Section 30C, the renewable electricity production credit

under Section 45(a), the zero-emission nuclear power production credit under Section 45U, the credit for qualified commercial vehicles under Section 45W, the clean electricity production credit under Section 45Y, the clean fuel production credit under Section 45Z, the qualifying advanced energy production credit under Section 48C, and the clean electricity investment credit under Section 48E. While a partnership or S corporation is an eligible "electing taxpayer" that can elect direct payment with respect to clean hydrogen production, carbon oxide sequestration, and the advanced manufacturing production credits, the omission of a partnership, in particular, from the definition of "applicable entity" is expected to narrow the circumstances in which tax-exempt investors can make the direct pay election. Most tax-exempt investors generally would want to partner with a developer or other non-applicable entity with expertise in the development, construction, ownership and operation of projects that generate tax credits, as most tax-exempt investors would not be expected to have the experience or resources to develop or operate credit generating projects independently. The proposed regulations specifically provide that a tax-exempt entity that otherwise qualifies as an "applicable entity" for purposes of the direct pay election is able to make a direct pay election with respect to tax credit property held through a tenancy-in-common or pursuant to a joint operating arrangement that has properly elected out of subchapter K under Section 761. In practice, we expect that tax-exempt investors will be eager to explore such structures as a way to partner with developers or others with expertise in developing and operating credit generating projects.

The proposed regulations also provided that an otherwise eligible applicable entity can make a direct pay election with respect to projects that it holds through a "disregarded entity," but no election may be made for property held through a C corporation. Further, a member of a consolidated group can make an election for applicable credits determined with respect to the member.

Determination of Applicable Credit

In order to prevent a "double benefit," the amount of tax credit that is available for the direct pay election will be reduced to the extent that total amount of applicable credit plus any tax-exempt income (i.e. grant or forgivable loan) received for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring an investment-related the credit property exceeds cost of such investment-related credit property.

TRANSFERABILITY

"Paid in Cash"

Consideration for a tax credit must be "paid in cash" to qualify for the transferability election. The proposed regulations clarify that the consideration must be made in United States dollars and can be made by cash, check, cashier's check, money order, wire transfer, automated clearing house (ACH) transfer, or other bank transfer of immediately available funds. The cash consideration must be paid within the period beginning on the first day of the transferor's taxable year during which the portion of the credit to be transferred is determined, and by the earlier of the filing of (i) the transferor's return for the taxable year for which the credit is determined, or (ii) the transferee's tax return for the year in which the transferred credit is taken into account. An amount will be treated as having been

paid in cash if the transferee has a contractual commitment to purchase eligible credits in advance of a credit transfer date if the requirements above are otherwise met.

Mechanics of the Transfer

A partnership or S corporation that holds an eligible credit property may make an election to transfer all or a portion of its eligible credit attributable to that property. In addition, an eligible taxpayer may make an election to transfer a credit for eligible credit property held through a disregarded entity, or for its undivided ownership interest in an eligible credit property held through a tenancy-in-common or through an organization that has made a valid election under Section 761(a) to elect out of the provisions of Subchapter K.

An eligible taxpayer may transfer all or a portion of any applicable credit and may make multiple credit transferability elections to transfer portions of a specified credit to multiple transferees. However, once made, a transferability election with respect to a specified credit portion is irrevocable, and no subsequent transfers of such credit portion are permitted. The prohibition on successive transfers does not prohibit a partnership from allocating purchased tax credits to its investors or a transferor from using a broker or other intermediary to transfer its interest, provided that the tax credit is not transferred to the intermediary.

In the case of a partnership that elects to transfer an applicable credit, the partnership may elect to transfer only a portion of its credits that are allocable to partners who so elect, in which case income from the transfer may be specially allocated to such electing partners, while the remaining (untransferred) portion of the applicable credit is specially allocated to the partners who did not elect to transfer. However, in a tiered partnership structure, an upper-tier partnership must allocate any income from the sale of tax credits by a lower-tier partnership proportionately among its partners.

In connection with transferring an eligible tax credit, the transferor and transferee will need to enter into a separate written agreement ("**Transfer Election Statement**") which must be attached to the tax return for both the transferor and the transferee with respect to any applicable transferred credit or portion thereof.

If the transferee pays an amount for a credit that is less than the value of the credit, the transferee does not have to take into account any deemed income attributable to such discount. However, the proposed regulations do not provide whether a transferee taxpayer is permitted to deduct a loss if the amount paid to purchase a credit exceeds the amount of the eligible credit that the transferee can ultimately claim. The proposed regulations also do not address the U.S. federal income tax treatment of any transaction costs associated with the transferability election.

Recapture and Excessive Credits

In the event that a recapture event occurs with respect to a credit that has been transferred, or it is otherwise determined that an "excessive credit" has been claimed, the transferor is liable for the increased tax cost. As a practical matter, because the transferee will not, in most cases, be involved in determining the amount of the applicable credit, we generally expect that the parties will seek a

contractual indemnity to shift the liability for such risks onto the transferor. The transferor is required under the proposed regulations to notify the transferee of the recapture.

The proposed regulations narrow the circumstances in which a recapture of applicable credits will be triggered to the transferee, providing that a transfer of an interest in a partnership that generates tax credits (an "indirect" disposition) will not trigger a recapture event with respect to a transferee of applicable credits (although the partner who disposes its interest in the transferor partnership generally will still be subject to the recapture provisions).

REQUIREMENTS APPLICABLE TO BOTH THE DIRECT PAY ELECTION AND THE TRANSFERABILITY ELECTION

As a general matter, a direct pay election and a transferability election cannot be made with respect to the same applicable credit or portion thereof, so that a direct pay election could not be made with respect to a credit purchased under a transferability election. However, with respect to credits for clean hydrogen production, carbon oxide sequestration, or the advanced manufacturing production credit (for which the "election period" under a direct pay election generally would include the taxable year for which the election is made and each of the four subsequent taxable years that end before January 1, 2033), once the election period for the property has passed or otherwise is no longer in effect with respect to such property, a transferability election can be made with respect to the property.

To the extent that any partnership makes a transferability election or acts as an "electing taxpayer" and makes a direct pay election with respect to a clean hydrogen production, carbon oxide sequestration, and the advanced manufacturing production credit, tax-exempt income resulting from such election is treated as arising from investment activity and not from the conduct of a trade or business within the meaning of Section 469(c)(1)(A). Accordingly, the tax-exempt income received by the partnership from such election will not be treated as passive income to the partners of the partnership who do not materially participate within the meaning of Section 469 and will not increase any such partner's ability to use passive activity losses.

Pre-Filing Registration System

Temporary regulations effective immediately set forth a mandatory pre-filing registration requirement for taxpayers that intend to make the direct pay election or the transferability election. Before filing their federal income tax return, taxpayers must use an IRS online portal to obtain a registration number for themselves, obtain a registration number for each of their eligible credit properties that have generated the tax credits, and link these properties to their employer identification number ("EIN"). Taxpayers are required to unlink the registration number of an eligible credit property from their EIN when they dispose of the property, and annually update each registration number.

Effective Date and Request for Comments

The temporary regulations that implement the pre-filing registration process for the direct pay election and the transferability election are effective immediately and apply to taxable years beginning on or after January 1, 2023.

The proposed regulations would be made effective for taxable years ending on or after the date on which they are published in final form. However, with respect to the direct pay election, taxpayers are allowed to rely on the proposed regulations for tax credits earned starting January 1, 2023, in taxable years ending before the date on which the applicable regulations are finalized. Similarly, with respect to the transferability election, taxpayers are allowed to rely on the proposed regulations for transfers made in taxable years beginning on or after January 1, 2023, and before the date on which the applicable regulations are finalized. The Treasury and the IRS are seeking public comments with respect to the proposed regulations, which must be submitted by August 14, 2023.

CONTACTS



Alexander Leff
Partner

T +1 212 878 8122
E alexander.leff
@cliffordchance.com



Hannah Richard
Counsel

T +1 212 878 8458
E hannah.richard
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

© Clifford Chance 2023

Clifford Chance US LLP

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.