CLEAN ENERGY TAX UPDATE: PROPOSED REGULATIONS ISSUED REGARDING DIRECT PAY AND TRANSFERS OF CLEAN ENERGY TAX CREDITS

On June 14, 2023, the Internal Revenue Service (the "**IRS**") and the Department of the Treasury ("**Treasury**") released a package of proposed regulations including Section 6417 Elective Payment of Applicable Credits and Section 6418 Transfer of Certain Credits (the "**proposed regulations**"). The proposed regulations provide guidance regarding the direct pay election and the transfer election (both available for tax years beginning after December 31, 2022) for certain clean energy tax credits as established by the Inflation Reduction Act of 2022 (the "**Inflation Reduction Act**") and designed to facilitate monetization of tax credits by persons that cannot otherwise use the tax credits against their tax liability.

On October 24, 2022, the Treasury Department and the IRS published Notice 2022-50 to, among other things, request feedback from the public on potential issues that may require guidance, and the proposed regulations are based in part on the feedback received.

The proposed regulations are generally proposed to be effective for taxable years ending on or after the date final regulations are published in the Federal Register, although taxpayers may rely on them prior to such time (for tax years beginning in 2023), provided the taxpayers follow the proposed regulations in their entirety and in a consistent manner.

Concurrent with the release of the proposed regulations, IRS and Treasury also released temporary regulations (Pre-Filing Registration Requirements for Certain Tax Credit Elections) regarding the registration processes discussed below with respect to both direct pay elections and transfer elections (the "**temporary regulations**"). The temporary regulations include rules identical to those regarding the registration processes in the proposed regulations. The temporary regulations are effective for taxable years ending on or after June 21, 2023 (the date the regulations were published in the Federal Register) and expire June 12, 2026.

On June 14, Treasury also released FAQs regarding both direct pay and transferability, and several brief publications with information regarding direct pay.

Comments on the proposed regulations are due by August 14, 2023, and a public hearing on the proposed regulations under Section 6417 is scheduled for August 21, and on the proposed regulations under Section 6418 on August 23.

In addition to the proposed regulations, the Treasury and IRS have issued other guidance under the Inflation Reduction Act, including with respect to the prevailing wage and apprenticeship requirements (discussed by us here), the low-income community bonus credit (discussed by us here), the energy community bonus credit (discussed by us here), and the domestic content bonus credit (discussed by us here).

Highlights of Proposed Rules

In General

- ***Registration and Transfer Requirements.*** The proposed regulations condition the transfer and direct pay elections on new information reporting and registration requirements, including extensive rules requiring eligible transferor taxpayers to register the credits with the IRS through an electronic portal, receive a registration number for each credit, and use that registration number in connection with all transfer and direct pay documentation and filings.

- ***Prohibition of Successive Transfers.*** The proposed regulations do not permit successive transfers of the same credit or a direct pay election with respect to a credit that has been transferred. For example, a Section 45Q credit that has been transferred to the taxpayer pursuant to an election under Section 45Q(f)(3)(B), or a credit acquired by a lessee from a lessor by means of an election to pass through the credit to a lessee under former Section 48(d), cannot be the subject of an election under Section 6417 to receive direct pay of the credit or under Section 6418 to make an additional transfer of the credit. And a credit that has been transferred under Section 6418 cannot be the subject of a Section 6417 direct pay election or another Section 6418 transfer.

Direct Pay Elections

- ***No Change to Direct Payment Timing***. Despite requests from commenters, the proposed regulations offer no mechanism for receiving payment from the government pursuant to a direct pay election any earlier than upon return filing and refund payment. Moreover, the credit amount from a direct pay election is deemed to occur only upon the filing of the return, so (unlike a credit transferred under Section 6418) it cannot be used to reduce a taxpayer's quarterly estimated tax payment obligation.

- ***Scope of Government Entities for Direct Pay Election***. The proposed regulations clarify that applicable entities eligible to make the direct pay election include ***any agency or instrumentality*** of any State, the District of Columbia, Indian tribal government, U.S. territory, or political subdivision thereof, thereby including for example, certain universities, hospitals, school and water districts.

- ***Partnership vs. Tenancy-in-Common Ownership***. Partnerships that include both applicable entities and non-applicable entities are not eligible to make a direct pay election. However, an applicable entity that owns credit property through a tenancy-in-common or joint operating arrangement may be considered to own an undivided interest in or share of the underlying property, thereby allowing a direct pay election for its interest or share.

Credit Transfers

- ***Passive Activity Credit Rules***. The proposed regulations provide that rules that relate to the determination of the amount of a credit apply at the transferor level, while rules that determine the extent to which a taxpayer is entitled to use a credit apply at the transferee level. Under this approach, the passive activity credit rules will generally discourage purchases of credits by individuals and closely-held corporations. However, the IRS has requested comments on this topic.

- ***Recapture.*** The proposed regulations provide that any recapture liability would fall on the transferee of a credit under Section 6418 (e.g., if the transferor of an investment tax credit transfers the relevant energy property during the five-year recapture period). However, in the event of an indirect ownership change of a project (e.g., in the case of a transfer of an interest in a partnership that previously claimed and transferred a credit), the recapture liability would remain with the transferor.

- ***No Separate Transfers of Bonus Credits.*** The rules explain that bonus credits (e.g., the domestic content bonus credit, the bonus credits for projects in low-income communities or energy communities, and the 5x multiplier for compliance with the prevailing wage and apprenticeship requirements) cannot be transferred separately from the base credit amounts.

- ***Sale of Credit Allocable to Specific Partners***. Even though the transfer election must be made at the partnership, and not the partner, level, the proposed rules allow transferor partnerships that are transferring only part of their credits to use special allocations to allocate the sales proceeds to those partners that want to participate in the sale while allocating the remaining credits to partners that do not want to participate in the sale, thereby effectively implementing the transfer on a partner-by-partner basis.

- ***No Gross Income for Discounted Purchase Price***. There is no gross income to a transferee taxpayer if the amount paid for the credit is less than the amount of the credit transferred and claimed.

- ***Reasonable Cause Exception to Penalties***. In order to avoid the penalty for excessive credit transfers, transferees may establish reasonable cause for their credit claim by pointing to extensive diligence inquiries of the transferor, including the transferor's documentation evidencing eligibility for bonus credit amounts.

Applicable Tax Credits

The income tax credits for which the Section 6417 direct pay election and the 6418 transfer election may be made include the following:

- The portion of the credit for alternative fuel vehicle refueling property allowed under Section 30C

- Renewable electricity production credit determined under Section 45(a) (with respect to the Section 6417 direct pay election, limited to facilities that are originally placed in service after December 31, 2022)
- Credit for carbon oxide sequestration determined under Section 45Q(a) (with respect to the Section 6417 direct pay election, limited to carbon capture equipment that is originally placed in service after December 31, 2022)
- Zero-emission nuclear power production credit determined under Section 45U(a)
- Clean hydrogen production credit determined under Section 45V(a) (with respect to the Section 6417 direct pay election, limited to clean hydrogen production facilities that are originally placed in service after December 31, 2012)
- In the case of certain tax-exempt entities, the credit for qualified commercial vehicles determined under Section 45W (not available for the Section 6418 transfer election)
- Advanced manufacturing production credit determined under Section 45X(a)
- Clean electricity production credit determined under Section 45Y(a)
- Clean fuel production credit determined under Section 45Z(a)
- Energy credit determined under Section 48
- Qualifying advanced energy project credit determined under Section 48C
- Clean electricity investment credit determined under Section 48E

Applicable Units of Property

A key question for taxpayers is how to define the applicable unit of property for making the Section 6417 or Section 6418 elections. The proposed regulations provide additional information regarding the appropriate unit of measurement for registrations and the election:

- In the case of most of the credits, the taxpayer is required to register and make an election on a facility-by-facility basis (i.e., a qualified "facility" within the meaning of the applicable Code section).

- For the credits under Section 30C and Section 48C, and credits under Section 48E with respect to energy storage technology, a taxpayer would be required to register and make an election on a property-by-property basis (i.e., a qualified "property" within the meaning of the applicable Code section).

- For the Section 45Q credit, a taxpayer would be required to register and make an election on the basis of a unit of carbon capture equipment—generally, all components that make up an independently functioning process train capable of capturing, processing, and preparing carbon oxide for transport (i.e., a single process train).

- For the Section 48 credit, a taxpayer would generally be required to register and make an election on a property-by-property basis (which in the case of Section 48, generally includes all components of property that are functionally interdependent, unless such equipment is an addition or modification to an energy property). However, a taxpayer would have the option to instead determine the credit for an "energy project" as defined in future guidance.

- For the Section 45W credit (with respect to the direct pay election), a taxpayer would be required to register and make an election for each "qualified commercial clean vehicle."

Such units of property are referred to in the proposed regulations as "**applicable credit property**" for purposes of the direct pay rules and as "**eligible credit property**" for purposes of the credit transferability rules.

Direct Payments – Section 6417

Applicable Entities

Under Section 6417, the following are "applicable entities" eligible to make the direct pay election with respect to an "applicable credit property":

- Tax-exempt entities under Section 501(a) (including those in U.S. territories)
- The government of a U.S. territory (or a political subdivision thereof)
- Any State or political subdivision thereof
- The Tennessee Valley Authority
- An Indian Tribal Government
- Any Alaska Native Corporation
- Rural electric cooperatives

The proposed regulations clarify that applicable entities include ***any agency or instrumentality*** of any State, the District of Columbia, Indian tribal government, U.S. territory, or political subdivision thereof. This would include, for example, certain universities, hospitals, water and school districts.

Other Entities Entitled to Elect Into "Applicable Entity" Status

In addition to the entities listed above, certain taxpayers may make an election (the "**taxable entity election**") to be treated as an applicable entity, but only with respect to applicable credit property qualifying under Sections 45Q, 45V, or 45X, and only during the five-year period specified by Section 6417. Unless otherwise specified, references herein to an applicable entity include an entity that has made the taxable entity election.

Special Rules for Disregarded Entities, Corporation, Partnerships and Joint Ownership

The proposed regulations clarify that, if an applicable entity is the regarded owner of a disregarded entity that holds applicable credit property, the regarded owner may make the direct pay election with regard to such property.

The rules clarify that partnerships and S corporations are not "applicable entities," even if some or all of their partners are applicable entities. However, a partnership or S corporation may make the taxable entity election with respect to applicable credit property qualifying under Sections 45Q, 45V, or 45X (and therefore be treated as an applicable entity). Partners and S corporation shareholders may not make a direct pay election with respect to property held by the partnership or S corporation.

Under the rules, if an applicable entity forms a C corporation to carry on applicable credit activity, the separate existence of the taxable C corporation prevents the applicable entity from making the Section 6417 election. (However, an applicable entity for property qualifying under Sections 45Q, 45V, or 45X may include a taxable C corporation that has made the taxable entity election, including a member of a consolidated group.)

The proposed regulations provide that an applicable entity that co-owns applicable credit property through a tenancy-in-common, or joint operating arrangement that has elected out of subchapter K under Section 761, is considered to own an undivided interest in or share of the underlying property. Since any applicable credits are determined separately with respect to each owner, an applicable entity may make a Section 6417 election with respect to its share of the applicable credits. Importantly, this rule would permit an applicable entity to engage with for-profit partners in such an ownership arrangement and make a direct pay election with respect to its share of the applicable credits.

Direct Ownership or Direct Activity Required

Under the proposed regulations, the applicable entity must own the underlying eligible credit property or, if ownership is not required, otherwise conduct the activities giving rise to the underlying credit.

This means that ***no direct pay election may be made for credits purchased pursuant to Section 6418***, transferred pursuant to section 45Q(f)(3), acquired by a lessee from a lessor by means of an election to pass through the credit to a lessee under former section 48(d) (pursuant to section 50(d)(5)), owned by a third party, or otherwise not determined directly with respect to the applicable entity.

Credit Amount

The elective payment amount includes the applicable credits for which an applicable entity makes a direct pay election. It includes both the current year applicable credits allowed under Section 38 and the amount (if any) of unused current year applicable credits which would otherwise be carried back or carried forward under Section 39.

For taxpayers that qualify for bonus credit amounts, both the applicable credit amount and the eligible bonus credit amount (assuming all relevant requirements are met) are eligible for the direct pay election. Importantly, the proposed rules provide that a direct pay election applies to the ***entire amount of the applicable credit***. Thus, a partial election for direct payment would not be allowed.

Partnerships and S Corporations

If an applicable entity is a partnership or an S corporation (i.e., that has made the taxable entity election with respect to credits under Sections 45Q, 45V, or 45X), the direct payment amount is equal to the applicable credit for which the partnership or S corporation makes the direct pay election and results in a payment to such partnership or S corporation equal to the amount of such credit (unless the partnership or S corporation owes a Federal tax liability, in which case the payment may be reduced by such tax liability).

Other Special Rules

The proposed regulations provide certain special rules for determination of the applicable credit.

- For tax-exempt organizations and government entities, the amount of any applicable credit is determined without regard to certain restrictions on property use by tax-exempt organizations and government entities and by treating applicable credit property as used in a trade or business. Additionally, such entities may treat the property as if there is an allowance for depreciation.

- Since taxable entities are generally required to reduce the basis by any tax-exempt amounts used to fund the property, the proposed regulations include special rules for tax-exempt and government entities (which often fund projects with tax-exempt funds, and thus without special rules, would have little or no basis upon which to determine the amount of the credit).

- The proposed regulations also include rules to ensure the denial of any double benefit (e.g., rules to ensure that no person claims a tax credit with respect to an amount subject to the direct pay election).

Rules for Making Direct Pay Elections

Direct Pay Election Mechanics

The proposed regulations include rules on how a taxpayer makes the direct pay election. The election must be made separately for each applicable credit property, and it generally must be made in the year the property is first placed in service or produced, as applicable.

The proposed regulations require that taxpayers make the direct pay election on their annual tax return in the manner prescribed by IRS guidance. The election may only be made on a timely filed (including extensions), original return for the taxable year for which the credit is determined. The direct pay election cannot be made on an amended return.

For entities for which no Federal income tax return is required under Sections 6011 or 6033(a), the direct pay election must be made no later than the due date (including extensions) for the original return as though one were required to file an annual return for a tax-exempt entity under Section 6033(a). Similarly, for entities that are not normally required to file a return with the IRS (such as those in U.S. territories), the direct pay election must be made no later than the due date (including extensions) that would apply to such entity if they were located in the United States.

Taxpayers are also required to make a pre-filing registration and obtain a valid registration number for the applicable credit property. This requirement is discussed in more detail below.

Elections Generally Irrevocable

Once made, a direct pay election under Section 6417 generally is irrevocable and applies to the taxable year in which the election is made. But for certain applicable credits, the election period applies to the entire period prescribed by the applicable credit. For example, for the Section 45 or

Section 45Y credit, the direct pay election applies to the 10-year period following the date the facility was originally placed in service.

For entities that made the taxable entity election with respect to credits under Sections 45Q, 45V or 45X, the direct pay election period applies to the taxable year the election is properly made and the four subsequent tax years. However, a taxpayer who has made a direct pay election may revoke such election in a subsequent tax year.

Partnerships and S Corporations

As stated above, the proposed regulations clarify that partnerships and S corporations are not applicable entities for the purpose of making a direct pay election. Therefore, a partnership or S corporation can only make a direct pay election by making the taxable entity election and only with respect to the credits provided under Sections 45V, 45Q, and 45X.

Generally, income from a direct pay election is tax-exempt income to a partnership or S corporation for purposes of determining the tax basis of the owners in their interests in the entity. The proposed regulations clarify that any tax-exempt income generated from applicable credits would be treated as investment income and not as passive income to any partners or shareholders who do not materially participate in the activities of the partnership.

The proposed regulations make clear that there are no restrictions on how a partnership or S corporation may utilize a cash payment received, including making distributions to partners or shareholders.

The proposed rules include conforming changes to the partnership audit rules, including the treatment of direct pay elections as a special enforcement item that is outside the general audit procedure rules.

Additional Special Rules

Excessive Payments

In the event the IRS determines that the amount of a payment received constitutes an excessive payment (generally defined as the excess of the amount treated as a direct payment with respect to a facility or property, over the amount of the credit that, without application of Section 6417, would be otherwise allowable with respect to such facility or property), the amount of tax imposed on the taxpayer would be increased by the excessive payment amount plus an additional 20 percent of the excessive payment amount. This is imposed even if the entity is not otherwise subject to income tax. This 20 percent additional tax can be avoided after a showing of reasonable cause.

Basis Reduction and Recapture

The proposed regulations clarify that any reporting of a recapture event is made on the taxpayer's return in accordance with future guidance. For entities that do not normally file tax returns, the current proposed regulations do not directly address how they should report a recapture event. Importantly, a recapture event will not be considered an excessive payment and thus will not be subject to the 20-percent additional excessive payment amount.

Credit Transfers – Section 6418

Eligible Parties

Under Section 6418 and the proposed regulations, an "eligible taxpayer" (described below) may make a transfer election to transfer any specified portion of an "eligible credit" (including the credits listed above and including bonus credit amounts) determined with respect to any "eligible credit property" of such eligible taxpayer for any taxable year to a transferee taxpayer.

An "eligible taxpayer" that may make an election is generally defined as any taxpayer other than those eligible for direct pay under Section 6417 (e.g., tax-exempt entities and governmental organizations). An eligible "transferee taxpayer" is any taxpayer that is not related (within the meaning of Section 267(b) or Section 707(b)(1)) to the eligible taxpayer making the transfer election. An eligible taxpayer who has made a Section 6418 election is referred to herein as a "transferor taxpayer."

The proposed regulations include special rules for certain ownership situations:

- Similar to the rules described above for the direct pay election (i) if a disregarded entity is owned by an eligible taxpayer, the eligible taxpayer makes the transfer election and (ii) in the case of undivided ownership interests such as a tenancy-in-common or an organization that has made a valid election under Section 761(a), each co-owner's or member's undivided ownership share of the eligible credit property is treated as a separate eligible credit property owned by such person.

- For members of a consolidated group, the member is required to make a transfer election.

- For a partnership or S corporation, with respect to any eligible credit property held directly by such partnership or S corporation, the partnership or S corporation makes a transfer election—not the partners or shareholders.

Transfers of Pro Rata Portions of an Eligible Credit

Under the rules, an eligible taxpayer may make multiple transfer elections to transfer one or more credit portions to multiple transferee taxpayers, provided that the aggregate amount of credit portions transferred does not exceed the amount of the credit determined with respect to the eligible credit property. A taxpayer may transfer only a portion of a credit and retain the rest.

Payment in "Cash"

Under the Code, consideration for a credit transfer must be paid in cash, and the proposed regulations clarify this includes payments by cash, check, cashier's check, money order, wire transfer, ACH transfer, or other bank transfer of immediately available funds. The proposed regulations would include an anti-abuse provision intended to disallow the election and transfer 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 Section 6418 (for example, a transaction where a transferor taxpayer undercharges or overcharges for services to a customer

who is also purchasing credits from the transferor taxpayer as a transferee taxpayer may violate the anti-abuse rule).

The proposed regulations include a safe harbor that provides that a payment meets the "paid in cash" requirement if the cash payment is made anytime within the period beginning on the first day of the transferor taxpayer's taxable year during which a specified credit portion is determined and ending on the due date for completing a transfer (generally, the earlier of the due dates of the transferor's or transferee's tax return). The proposed regulations also provide that a contractual commitment to purchase credits in advance of the date a credit is transferred satisfies the paid in cash requirement (as long as all cash payments are made during the prescribed time period). The proposed regulations do not prohibit transfers of such a commitment to purchase credits.

Credit Amount Transferred

An electing transferor is not permitted to divide a credit into the portion from the qualified activity or investment credit property (i.e., the base credit) and one or more bonus amounts of the eligible credit (e.g., the domestic content bonus credit, the bonus credits for projects in low-income communities or energy communities, and the 5x multiplier for compliance with the prevailing wage and apprenticeship requirements). Instead, a taxpayer would be permitted to transfer the entire eligible credit (or portion thereof, which would include a proportionate amount of any component part of the entire credit) determined with respect to a single eligible credit property. However, as discussed above, an electing transferor can elect to transfer pro rata portions of the entire credit to various transferees. Therefore, even though credit transferees will have varying levels of risk tolerance, transferors would not be able to carve up the components of a total credit to better match buyers with a purchase that most closely fits their risk tolerance.

The transfer election may not be made with respect to any amount of an eligible credit determined based on progress expenditures.

Election Mechanics

In general

Under the proposed regulations, the transfer election must be made on the basis of a ***single eligible credit property (i.e., the units of property discussed above)***—a transferor taxpayer that determines credits with respect to two eligible credit properties would need to make a separate transfer election with respect to each eligible credit property. The IRS and Treasury have requested comments on whether to adopt a grouping rule that allows taxpayers to make an election with respect to certain groups of eligible credit properties.

Once made, an election to transfer an eligible credit is irrevocable.

For the applicable credits based on production (Sections 45, 45Q, 45V and 45Y), the rules would provide that a transfer election would be required to be made for each taxable year the taxpayer elects to make a transfer during the 10-year period (or 12-year period, in the case of a Section 45Q credit) beginning on the date such eligible credit property was originally placed in service. In this manner the proposed regulations clarify that, for these specified credits, a taxpayer would be able to transfer them in some years and retain them in other years.

Tax Return Requirements

To make a valid transfer election, the transferor taxpayer would be required to include the following with its tax return: (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 showing the amount of credit transferred for each eligible credit property; (iv) a transfer election statement (i.e., a statement executed under penalties of perjury by both the transferor and transferee with information specified in the proposed regulations); and (v) any other information related to the election specified in guidance.

Under the proposed regulations, a "**transfer election statement**" would be required to generally include (1) information related to the transferee taxpayer and the transferor taxpayer; (2) a statement that provides the necessary information and amounts to allow the transferee taxpayer to take into account the specified credit portion with respect to the eligible credit property; (3) a statement that the parties are not related; (4) a representation from the transferor taxpayer that it has complied with all relevant requirements to make the election; (5) a statement from the transferor and transferee acknowledging the notification of recapture requirements; and (6) a statement or representation from the transferor taxpayer that it has provided certain specified required minimum documentation to the transferee taxpayer.

The required minimum documentation includes: (i) documentation that validates the existence of the eligible credit property (could include evidence from a third party); (ii) if applicable, information substantiating that the transferor taxpayer has satisfied the requirements to include any bonus credit amounts; and (iii) evidence of the transferor taxpayer's qualifying costs in the case of a transfer of an investment tax credit, or qualifying production activities in the case of a transferred production tax credit.

An election to transfer any specified credit portion would need to be made not later than the due date (including extensions) for the tax return for the taxable year for which the eligible credit is determined. The proposed regulations would also clarify that an election would need to be filed on an original return and may not be made or revised on an amended return or by filing a request for an administrative adjustment.

In order for a transferee taxpayer to take into account a transferred credit, the transferee taxpayer must include in its tax return (i) a properly completed Form 3800, General Business Credit, taking into account a transferred eligible credit as a current general business credit, including all registration numbers related to the transferred credit; (ii) a transfer election statement completed by the transferor; and (iii) any other information related to the transfer election specified in guidance.

Estimated Taxes

The preamble to the proposed regulations under Section 6418 states that a transferee may take into account credits it purchases or expects to purchase in determining its liability to make payments of estimated tax.

Direct Ownership or Direct Activity Required

Similar to the rules under Section 6417, no election is allowed when eligible credits are not determined with respect to a transferor taxpayer—the transferor taxpayer must own the underlying eligible credit property or, if ownership is not required, otherwise conduct the activities giving rise to the underlying eligible credit (so, for example, (i) a Section 45Q credit claimant under Section 45Q(f)(3) and (ii) a claimant that is a lessee eligible to claim under the inverted lease rules in Treasury Regulations § 1.48-4, may not make the transfer election).

No Second Transfer

Consistent with section 6418(e)(2), the proposed regulations would prohibit a transferee taxpayer of any specified credit portion from making a second transfer under 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 transferee taxpayer does not violate this rule, though as discussed below there are limits on those allocations to prevent indirect transfers of credits through transfers of partnership interests.

The preamble clarifies that an arrangement using a broker to match transferor taxpayers and transferee taxpayers should not violate this rule, assuming the arrangement at no point transfers the Federal income tax ownership of a credit to the broker or any person other than the transferee taxpayer.

Tax Treatment

Treatment of payments and expenses

The proposed regulations clarify that amounts paid in connection with a transfer election by a transferee taxpayer are not includible in the gross income of a transferor taxpayer and are not deductible by the transferee taxpayer.

The Treasury Department and the IRS are currently developing rules and seek comments on (i) the tax treatment of transaction costs and (ii) whether a transferee taxpayer is permitted to deduct a loss if the amount paid to a transferor taxpayer exceeds the amount of the credit that the transferee taxpayer can ultimately claim.

Transferee taxpayer's treatment of a transferred credit

If a valid transfer election is made by for any taxable year, the transferee taxpayer specified in such election (and not the transferor taxpayer) is treated as the taxpayer for purposes of the Code with respect to the credit.

Section 6418 provides that a transferred credit is taken into account by the transferee in the first taxable year of the transferee taxpayer ending with, or after, the taxable year of the transferor taxpayer with respect to which the credit was determined. The preamble clarifies that, consistent with this rule, the transferee taxpayer may claim a transferred credit on an amended return or, if applicable, a request for administrative adjustment.

Regarding additional carryback and carryforward years, the proposed regulations provide that a transferee taxpayer can use Section 39(a)(4)—which generally allows a 3-year carryback period—to the extent an eligible credit is also listed in Section 6417(b).

Commenters had asked whether there are any income tax consequences to a transferee taxpayer if the amount paid for an eligible credit is less than the amount of the eligible credit transferred and claimed. The proposed regulations clarify this issue by providing that there is no gross income to a transferee taxpayer when claiming a transferred credit if the amount paid for the credit is less than the amount of the credit transferred and claimed.

Since the credit is determined by reference to the transferor taxpayer, a transferee taxpayer does not also apply rules that relate to the determination of credit, such as rules in Section 49 or Section 50(b). However, a transferee taxpayer would apply rules that relate to the amount of a credit that is allowed to be claimed in the taxable year based on a transferee's particular circumstances, such as the rules in Section 38 or Section 469. The Treasury Department and the IRS have requested comments on whether there are circumstances in which it would be appropriate to not apply the passive activity rules under Section 469 to a transferee taxpayer or to attribute the participation of a transferor taxpayer to a transferee taxpayer.

Partnerships and S corporations

The proposed regulations provide general rules related to transfers of eligible credits by transferor partnerships and transferor S corporations and purchases of eligible credits by transferee partnerships and transferee S corporations.

Transferor Partnerships

Under Section 6418, any amount received as consideration for a transfer of eligible credits by a transferor partnership is treated as tax-exempt income for purposes of Section 705, and a partner's distributive share of such income is based on such partner's distributive share of the otherwise eligible credit for each taxable year.

The proposed regulations clarify that any tax-exempt income resulting from the receipt of consideration for a transfer by a partnership or S corporation is treated as arising from an investment activity and not from the conduct of a trade or business within the meaning of Section 469(c)(1)(A). As a result, such tax-exempt income is not treated as passive income to any partners or shareholders who do not materially participate within the meaning of section 469(c)(1)(B).

A special rule permits the tax-exempt income to be specially allocated to those partners that desired to sell their share of available credits (i.e., in the case where the partnership elects to transfer less than all of the available credits). The transferor partnership may determine, either in a manner described in the partnership agreement or as the partners may agree, the portion of each partner's eligible credit amount to be transferred and the portion of each partner's eligible credit amount to be retained and allocated to such partner. The proposed regulations provide examples of this rule.

The preamble confirms that cash received may be distributed in any manner, including in a manner that is different from the partners' distributive shares of the tax-exempt income resulting from the receipt of the cash payment.

Any rules that relate to the determination of an eligible credit, such as rules in Sections 49 and 50(b), apply to the transferor taxpayer and therefore can limit the amount of transferable eligible credits. Since the Section 49 at-risk rules are applied at the partner or shareholder level, a transferor partnership or S corporation would be required to request certain information from the partners or shareholders necessary to determine the applicable limitations and attach such information to the tax return. Treasury and the IRS have requested comments regarding these rules.

Transferee Partnerships

A transferee partnership may allocate a transferred credit to its partners without violating the rule preventing additional credit transfers. Each partner's distributive share of any transferred credit is based on such partner's distributive share of the Section 705(a)(2)(B) expenditures used to fund the purchase.

A transferred credit is treated as an extraordinary item under Section 706 rules that must be allocated to partners at the time of the transfer. The proposed regulations include additional rules for determining the deemed date of the transfer depending on the taxable years of the parties and the date of the cash payment.

The Treasury Department and the IRS request comments on (i) whether additional guidance is needed regarding when allocations will be respected under Section 704(b) and (ii) with respect to transfers of partnership interests that are made after the transferring partner has contributed capital to a transferee partnership for the purpose of purchasing eligible credits, but before the transferee partnership has made any cash payments to the transferor taxpayer.

The proposed regulations also include special rules applicable to transferor and transferee S corporations and their shareholders.

Excessive Credit Transfers

Similar to the excessive payment rules under Section 6417, Section 6418 imposes a 20 percent tax on an "excessive credit transfer" to a transferee taxpayer (generally defined as the excess of the amount of the specified credit portion claimed with respect to the eligible credit property, over the amount of the credit that, without application of Section 6418, would be otherwise allowable for such eligible credit property).

The proposed regulations include special rules for determining an excessive credit transfer and distinguishing such from a recapture event that is not subject to the additional tax. An excessive credit transfer might involve, for example, a determination by the IRS that the basis of the property subject to an investment tax credit was overstated. A recapture event, for example, as a result of the property no longer qualifying as investment credit property, would not be considered an excessive credit transfer. The additional tax for excessive credit transfers can be abated after a showing of reasonable cause.

Because transferee taxpayers have more limited access to information about the credits, the proposed regulations describe what reasonable cause includes in this context. The proposed regulations provide that circumstances that may indicate reasonable cause can include, but are not limited to, review of the transferor's records with respect to the determination of the credit, reasonable reliance on third party expert reports, reasonable reliance on representations from the transferor that the total credit does not exceed the total available credit for the taxable year, and review of transferor's audited financial statements.

Recapture of Transferred Credits

The proposed regulations provide that any credit recapture amount is calculated and taken into account by the ***transferee taxpayer***. The preamble confirms there is no prohibition against the transferor and transferee contracting between themselves for indemnification of the transferee in the event of a recapture event.

However, the proposed rules clarify that, in the case of a recapture event as a result of an indirect disposition (i.e., if an S corporation shareholder's interest in an S corporation, or a partner's interest in the general profits of a partnership, is reduced by a certain amount as a result of certain events during the recapture period), the recapture liability remains with the shareholder or partner rather than the credit transferee.

The proposed regulations provide guidance on the notifications that are required by the transferor taxpayer and the transferee taxpayer after a recapture event. Parties can contract as to the form the notice must take and to any additional time periods for providing the notice, provided the terms of the contract do not otherwise conflict with the terms of the proposed regulations. The proposed regulations contain similar requirements as to the notification required by the transferee taxpayer to the transferor taxpayer (e.g., of the recapture amount).

Section 6418 does not specifically address recapture under Section 45Q(f)(4) (related to release of sequestered carbon oxide), but the proposed regulations clarify that the rules apply to such recapture as well (and the required notifications must include applicable additional information for computing the tax owed, such as the amount of leaked qualified carbon oxide).

Registration Requirements for Section 6417 and Section 6418

Under Section 6417 and Section 6418, the Treasury Secretary may impose a registration requirement in order to prevent duplication, fraud, improper payments, or excessive payments. The proposed and temporary regulations provide rules requiring that taxpayers register before filing the return on which a direct pay or a transfer election is made and provide information related to each applicable or eligible credit property intended to be subject to an election. As a condition of, and prior to, making either a direct pay or a transfer election, the taxpayer must satisfy certain pre-filing registration requirements, after which the taxpayer will receive a unique registration number from the IRS for each registered credit property for which the taxpayer intends to make an election.

It is anticipated that an IRS electronic portal will be established for completion of this pre-filling registration process. The rules clarify that completion of the pre-filing registration requirements and receipt of a registration number does not guarantee eligibility for the applicable election.

The rules provide the following pre-filing registration requirements:

- First, the taxpayer must complete a pre-filing registration process electronically through an IRS electronic portal.

- Second, the taxpayer must satisfy the registration requirements and receive a registration number prior to making a direct pay election or transfer election for a specified credit portion on the taxpayer's return for the taxable year at issue.

- Third, the taxpayer is required to obtain a registration number for ***each credit property*** with respect to which a claim is made.

- Finally, the taxpayer must provide the specific information required to be provided as part of the pre-filing registration process (including information about the taxpayer, about the claimed credits, and about the credit property, such as location and date placed in service).

A registration number is valid for an electing taxpayer only for the taxable year for which it is obtained, and for a credit transferee taxpayer, the taxable year in which the credit is taken into account. A registration may be renewed each year, but if relevant facts change, the taxpayer must amend the registration.

The taxpayer is required to include the registration number of the credit property on the transfer election statement and the taxpayer's return for the taxable year. With respect to transfer elections under Section 6418, the electing taxpayer must provide the registration number to the transferee taxpayer, who must report the registration number on the Form 3800, General Business Credit, as part of the return for the taxable year that the transferee taxpayer takes the transferred credit into account. The credit will be disallowed to the transferee taxpayer if the registration number is not included on the return.

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We will continue to monitor the Inflation Reduction Act guidance initiatives from the IRS and Treasury and will provide further updates as guidance is released. In the meantime, Baker Botts would be pleased to assist you in your analysis of the Inflation Reduction Act and other clean energy tax incentive matters.