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IRS Proposed Rules Explain How Taxpayers Can Buy and Sell Renewable Energy Tax Credits or Receive Cash Refunds

The proposed rules for monetizing tax credits should catalyze energy transition markets and offer an alternative to tax equity transactions.

Key Points:

- Before a tax credit may be sold, the seller must comply with a pre-certification process that the IRS is expected to formalize toward the end of the year.
- Tax credits from one project may be divvied up and sold to multiple buyers.
- When a partnership is a seller, the partnership must make the transfer election. However, each partner in a partnership may direct the partnership to sell its respective allocable share of tax credits without affecting any other partner's entitlement to its share of tax credits.
- Tax credits may be transferred using a broker arrangement without violating the resale rule.
- The buyer of tax credits must make its payments no earlier than the first day of the seller's taxable year and no later than the seller's tax filing date. However, long-term binding commitments to transfer credits are permissible.
- The seller must provide minimum required documentation to the buyer to validate the existence and amount of the tax credit being transferred.
- Tax credit buyers will be subject to the passive loss rules, thereby likely limiting the buyer universe to C corporations.
- The buyer is responsible for ITC recapture resulting from the sale of the project or the project ceasing to be ITC eligible. However, if a developer sells an interest in a partnership that owns the ITC property, that sale will not result in a recapture to the buyer, and instead will result in a recapture to the seller if the seller's interest in ITC property is reduced.

On June 14, 2023, the IRS issued proposed rules for how it intends to administer the tax credit transfer and direct payment programs in the Inflation Reduction Act, or the IRA (the Proposed Rules).

Together, these rules provide both procedural information — the forms and registration processes that will be required to participate in the programs — and the substantive guidelines that will govern the programs, including who is eligible to buy or sell tax credits, how and when payments for tax credits must be made, how tax credit recapture is apportioned among buyers and sellers, and various other detailed rules described in later sections of this Client Alert. For further discussion on the basics of the direct payment and tax credit transfer programs, see this Latham Client Alert.

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Rules for Buying and Selling Tax Credits

The rules for buying and selling tax credits, referred to as "transferability," were established by the IRA and allow certain project owners to sell tax credits to an unrelated third party for cash. The Proposed Rules establish procedures for making the tax credit transfer election under Section 6418[1] (the Transfer Election), requirements to effect a sale, and special rules for partnerships and other pass-through taxpayers who buy or sell tax credits.

Credit Transfer Basics

A taxpayer may sell to an unrelated person some or all of the tax credits generated by a qualifying project including any bonus or adder credits available for projects that include sufficient domestic content or are located in energy communities. The tax credit amount is determined separately for each energy property or facility.

The taxpayer that owns the credit-generating property generally makes the Transfer Election. Credits may be sold only once, and after a credit has been sold, the buyer may not resell the credit. Partnerships that purchase tax credits may, however, allocate the purchased credit to their partners without violating the resale rule. In addition, tax credits may be transferred using a broker arrangement without violating the resale rule, as long as tax ownership of the tax credit is not transferred to the broker. If, as is common in many project financings, the project is owned by a special purpose entity that is treated as a disregarded entity for tax purposes, the taxpayer that owns the disregarded entity will make the Transfer Election.

The buyer may take into account the tax credit in the first taxable year of the buyer ending with, or after, the taxable year of the seller with respect to which the tax credit was determined. A buyer may also take into account a tax credit that it has purchased, or intends to purchase, when calculating its estimated tax payments. However, subject to any negotiated agreement between the buyer and seller, the buyer will remain liable for any additions to tax to the extent the tax credit does not materialize as anticipated and, as a result, the buyer has an underpayment of estimated tax.

Identifying the Credits

Elections must be made on a property-by-property (or facility-by-facility) basis and on a year-by-year basis. Accordingly, if a project owner wishes to sell tax credits generated by multiple wind turbines, it must make a separate election for each turbine and in each year for which it wishes to sell the credits. This could impose a significant compliance burden on taxpayers, especially in the context of large-scale projects with numerous facilities. The preamble to the Proposed Rules notes that the IRS may address grouping rules at a later time.

Project owners may sell proportionate shares of any tax credits to one or more buyers, but tax credit adders may not be sold separately from the underlying base credit. Project owners that wish to sell an adder credit will have to sell a proportionate amount of the total credit that corresponds to the value of the adder credit.

Payment for Credits

Tax credits must be purchased with cash. Cash for a tax credit must be paid no earlier than the first day of the seller's tax year during which a credit is determined, and no later than the date on which the buyer or seller files its tax return for the taxable year in which the credit was generated. This means that many developers will have a roughly 18-to-20-month window during which they can be paid for a tax credit, assuming normal extensions of time to file tax returns. While this rule limits the period of time during which cash must be paid from buyer to seller, it does not prohibit advance commitments to

purchase tax credits. For production-based tax credits, such as PTCs and 45Q tax credits, transfer arrangements may be structured on a 100% pay-as-you-go basis. The rule prohibiting tax credit buyers from paying for multiple years of tax credits in advance means that developers that wish to raise capital against future tax credits will prefer traditional tax equity structures or will need to raise bridge capital against a forward tax equity sale commitment from either a tax credit buyer or a separate capital source.

The consideration paid for a tax credit is neither included in the seller's gross income nor deductible by the buyer. A buyer will also not recognize gross income if the buyer purchases a tax credit at a discount. An anti-abuse rule would disallow the sale of credits 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 Section 6418. One example is where a buyer who also receives services or other property from a tax-credit seller pays an above-market price for the tax credit. While this example in the Proposed Rules implies the existence of a determinable "market" price for a given credit, in practice determining a market value for any specific tax credit may be difficult, because each credit represents a unique asset tied to a specific energy property or facility.

Permitted Sellers

For projects held by partnerships, only the partnership is eligible to make a Transfer Election, not the individual partners. An exception to this rule is for owners that hold property through tenant-in-common structures, in which case each owner is permitted to make its own Transfer Election (and its own direct pay election, if applicable). Project owners that seek to maximize tax credit value through different monetization strategies may prefer this holding structure, thanks to the flexibility offered by tenant-in-common structures.

Entities that are eligible for project tax credits that were transferred to them through special tax election procedures — such as a lessee in a lease-passthrough arrangement or, in the case of the 45Q credits, a taxpayer who sequesters or uses captured CO2 — are not eligible to sell tax credits. Prior to the issuance of the Proposed Rules, sponsors had contemplated utilizing a lease-passthrough structure to achieve a step-up on the ITC prior to the sale of the ITC to a buyer. However, under the Proposed Rules, this is no longer permitted.

Transfer Mechanics

Tax credit sellers must include a Transfer Election together with the filing of their original tax return for the year in which the credit is generated no later than the due date for the return (including extensions). The election generally must include a Form 3800 (*General Business Credit*) and schedule showing the amount of the eligible credit transferred for each eligible credit property. It must also include a statement (the Transfer Election Statement) describing the transfer of the tax credit between the buyer and seller. Both the buyer and seller must attach the Transfer Election Statement to their respective tax returns. The Transfer Election Statement must be completed prior to the filing of each of the buyer's and seller's tax return for the applicable year. The Transfer Election Statement must include representations as to the credit sold, the price paid for the credit, the date (or dates) on which the payment was made, and an acknowledgement of the tax credit recapture requirements, among other items. It must also include a statement that the seller has provided the "minimum required documentation" to the buyer. This minimum required documentation includes information that validates the existence and amount of the tax credit being transferred. The buyer must retain this information during the period when its tax returns are open to audit.

Pass-Through Entities

The Proposed Rules address a number of unique considerations when a partnership or S corporation (a pass-through entity) is either a buyer or seller of tax credits. When the pass-through entity is a seller, cash received for the credit gives rise to tax exempt income, which is allocated to the partners based on their share of the underlying credits. Each partner in a partnership may direct the partnership to sell its respective allocable share of tax credits without affecting any other partner's entitlement to its share of tax credits. Cash received by a partnership from the sale of a tax credit may be distributed to the partners in any ratio agreed by the partners.

Recapture

When an investment tax credit is sold, the buyer remains liable for certain tax credit recapture throughout the five-year recapture period. Tax credit recapture for which the buyer is liable is limited to when the project is transferred or if the project ceases to otherwise be ITC-eligible (e.g., as a result of a casualty). However, a sale by a tax credit seller of an interest in a partnership that owns the ITC property will not result in a recapture to the buyer, and instead will result in a recapture to the selling partner if the partner's interest in ITC property is reduced.

This bifurcation of recapture liability is intended to address a concern noted by many commentators that using a flip partnership would allow a developer to sell a cash equity stake in a project after it is placed in service without recapture of the tax equity investor's tax credits. Absent this bifurcation, a similar transaction by the developer following a tax credit transfer would result in full recapture of the tax credits. Notwithstanding this allocation of recapture risk, the Proposed Rules clarify that there is no prohibition on the parties contracting for the seller to indemnify the buyer for recapture. Sellers who do not intend to retain their equity positions in an ITC-eligible project through the full recapture period should consider structural solutions, such as retaining a tax equity like interest in a project, to mitigate the impact of a recapture event.

If there is a recapture, the seller must notify the buyer. This notification must include all information necessary for the buyer to calculate the recapture and be provided to the buyer with enough time to calculate the recapture amount by the due date of the buyer's tax return (without extensions). Otherwise, so long as the notification does not conflict with the Proposed Rules, the parties are free to contract regarding the form and timing of the notice. The buyer must then provide notice of the calculated recapture amount to the seller with enough time for the seller to increase its basis in the property by the recapture amount before the return's due date (without extensions).

Limitations

Both the passive loss rules of Section 469 and the at-risk rules of Section 49 restrict the available tax credits. The amount of the credit available to be sold by a partnership or S corporation is limited to the amount that would otherwise be available to that entity after application of the Section 49 at-risk rules. Accordingly, if the amount of the credit available is limited by Section 49, then the amount that is available to be transferred to a buyer is correspondingly limited. Moreover, the passive loss rules of Section 469 also apply to buyers, and buyers are not permitted to use the seller's activities toward the active threshold. This rule may limit the amount of credits available to be sold, and could also have the effect of narrowing the universe of buyers to C corporations.

Excessive Credit Transfer

An excessive credit transfer occurs when the amount of tax credits sold exceeds the amount of credits that would have otherwise been allowed to the seller. If there is an excessive credit transfer to multiple buyers for a single eligible credit property, the amount of the excessive credit transfer is apportioned among the buyers based on their applicable portion of the total amount of the credit transferred for such property.

If the IRS determines that there has been an excessive credit transfer, the buyer must repay the excess tax credit plus a penalty equal to 20% of the excessive credit claimed. The 20% penalty is waived if the buyer can demonstrate to the IRS's satisfaction that it had reasonable cause to claim the excessive credit based on its efforts to determine the accuracy of the amount of tax credits purchased. Factors that may indicate reasonable cause include: (i) review of the seller's records with respect to the determination of the tax credit amount, (ii) reasonable reliance on third party expert reports, (iii) reasonable reliance on representations from the seller, and (iv) review of audited financial statements provided to the Securities and Exchange Commission, if applicable.

New Direct Pay Rules

The direct payment program generally allows certain project owners to receive cash payments from the IRS instead of receiving their tax credits. The Proposed Rules provide procedures for making the election under Section 6417 (the Direct Pay Election), a new framework for determining the amount and timing of those payments, and special rules for partnerships and other pass-through taxpayers who will receive the payments.

Making the Direct Pay Election

Generally, the only entities for which the Direct Pay Election is available include certain tax-exempt organizations, any Indian tribal governments, Alaska Native Corporations, the Tennessee Valley Authority, certain co-ops, and any agencies or instrumentalities of certain of these entities. The exception to this rule allows direct payments for other types of entities that are claiming carbon capture tax credits, clean hydrogen PTCs, or advanced manufacturing PTCs. These entities generally must own the applicable tax credit-generating property directly (or through disregarded entities), which means that lessees cannot claim direct payments. In addition, parties that sequester CO2 and receive tax credits pursuant to an election under Section 45Q cannot claim direct payments.

The Direct Pay Election is generally made with the tax return for the taxable year in which the applicable credit is determined (or if no tax return is required to be filed, the date one would have been required to be filed). Pre-registration (discussed below) is a condition to receipt of payments. The election is irrevocable, and applies to each year that the credit in respect of the applicable property is available (e.g., the election applies for 10 years for the PTC under Section 45). In general, the Direct Pay Election applies separately for each applicable project or facility.

Special Rules for Carbon Capture, Clean Hydrogen PTCs, and Advanced Manufacturing PTCs

Any taxpayer (regardless of classification) may claim direct payments for carbon capture tax credits, clean hydrogen PTCs, or advanced manufacturing PTCs for the first taxable year for such property and each of the four subsequent taxable years that end before January 1, 2033. In certain circumstances, these entities may revoke their election. If a taxpayer claiming one of these three tax credits is a partnership or an S corporation, the IRS will make the payment directly to the partnership or S corporation.

Excessive Payments

Any direct payment made in respect of an applicable credit property for any taxable year that exceeds the amount of credit that would have otherwise been allowable is treated as an excess payment. Excess payments result in an increase in tax imposed on the entity claiming the direct payment (the penalty does not apply if the entity demonstrates to the satisfaction of the IRS that the excess payment resulted from reasonable cause using existing standards of reasonable cause).

Pre-Filing Registration

The Proposed Rules establish a pre-filing registration process for both tax credit sales and direct payments that is intended to be an efficient way for the IRS to avoid duplication, fraud, improper or excessive payments, and untimely elections while administering the tax credit sale and direct payment programs. Guidance on the pre-filing registration process for tax credit sales and direct payments was provided in the form of temporary regulations that were made immediately effective in order to allow taxpayers to sell or receive cash payments of 2023 tax credits (the Pre-Filing Registration Requirements).

Under the Pre-Filing Registration Requirements, sellers must register before they file the return on which a Transfer Election is made or before any payment would be made to a taxpayer claiming direct payments. The pre-filing registration will be processed through an IRS electronic portal pursuant to any additional instructions on the portal, which is intended to be established during the third quarter of 2023. Registration will require a taxpayer to provide information related to each credit property for which the taxpayer intends to sell tax credits or receive direct payments, including information about the taxpayer, the credits being sold or for which direct payments will be claimed, the location of the credit properties, supporting documentation regarding the construction or acquisition of the property (including the source of funds for investment-related credit property), the beginning-of-construction and placed-in-service dates, and any other information that the taxpayer believes will help the IRS evaluate the registration request.

Upon the successful completion of the pre-filing registration process, the seller will receive a unique registration number (one must be obtained for each credit property for which the taxpayer intends to sell tax credits or receive direct payments). The number must be reported on both the buyer’s and seller’s tax returns. Successful completion of the Pre-Filing Registration Requirements and receipt of a registration number, while necessary to be eligible for direct payments, does not guarantee the validity of any tax credit sale or claim for a direct payment.

For production-based credits, the seller’s registration must be renewed on an annual basis for each credit property and include either an attestation that the facts are all still correct or an amendment by the taxpayer to the registration to correct or update any facts. In addition, registrations must be updated (or a taxpayer may need to submit a new registration) if certain changes occur between registration and when a credit is claimed on a tax return.

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Endnotes

[1] All references to "Section" are to the Internal Revenue Code of 1986, as amended.