Tax Alert

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Inflation Reduction Act: Treasury and IRS Release Final Regulations on Credit Transferability

By Steven Lorch, Jonathan Macke, Griffin Baker and Nathan Bunch

On April 25, 2024, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued final regulations with respect to the transfer of certain energy transition tax credits under Section 6418 (the Final Regulations).[1]

Despite receiving a significant number of comments (approximately 80 comment letters), the Final Regulations are generally consistent with the proposed regulations under Section 6418 released in June 2023 (the Proposed Regulations). Treasury and the IRS declined to accept many comments that would have brought more purchasers, and therefore more liquidity, into the credit transfer market. However, at the same time, the Final Regulations' consistency with the Proposed Regulations means that credit transfers in process (either transfers under negotiation or those that have signed and are waiting to fund) should not require material alteration.

The Basics of Tax Credit Transfers

Section 6418 permits eligible taxpayers to transfer all or a portion of an eligible credit to an unrelated[2] transferee taxpayer for cash. An eligible taxpayer generally includes any taxpayer that is not an applicable entity for purposes of the direct pay election under Section 6417.[3]

Eligible credits include the following eleven energy transition tax credits:

- the alternative fuel vehicle refueling property credit under Section 30C;
- the production tax credit under Section 45;
- the carbon sequestration credit under Section 45Q;
- the zero-emission nuclear power production credit under Section 45U;
- the clean hydrogen production credit under Section 45V;
- the advanced manufacturing production credit under Section 45X;

[1] Unless otherwise indicated, "Section" references are intended to refer to sections of the Internal Revenue Code of 1986, as amended (the Code).

[2] One party is determined to be related to another, for purposes of Section 6418, if the parties have greater than 50 percent common ownership in accordance with the principles of Sections 267(b) and 707(b).

[3] Our recent client alert regarding the final regulations under Section 6417 can be found here.

- the clean electricity production credit under Section 45Y;
- the clean fuel production credit under Section 45Z;
- the investment tax credit under Section 48;
- the advanced energy project credit under Section 48C; and
- the clean electricity investment credit under Section 48E.

To transfer all or a portion of an eligible credit, the eligible taxpayer must make an irrevocable election on its tax return for the taxable year in which the credit is generated. An eligible credit (or portion thereof) may be transferred only once. Any amount of cash paid by the transferee taxpayer to the eligible taxpayer in exchange for eligible credits is not included in the transferor's gross income, nor is such amount permitted as a deduction to the transferee taxpayer.

Highlights from the Final Regulations

Despite the high volume of comments, Treasury and the IRS adopted the Proposed Regulations without significant changes. Here are the highlights:

- No relief for individuals seeking to purchase eligible credits.
  - The Final Regulations confirm that eligible credits are subject to the passive activity credit rules under Section 469 (the Passive Credit Rules) in the hands of transferee taxpayers.
  - The Passive Credit Rules generally prevent transferees who are individuals from applying purchased credits to offset tax liability from nonpassive sources. Tax liabilities from nonpassive sources include taxes attributable to an individual's salary, wages, or portfolio income (i.e., dividends, interest, and gain from selling securities).
  - A transferee who is an individual would be permitted to apply purchased credits to offset nonpassive tax liabilities only if he or she "materially participates" in the activities giving rise to the credits.[4] However, material participation would be unlikely unless the transferee is an officer, employee, or owner of the eligible taxpayer selling the credits.
  - The Passive Credit Rules therefore represent a nearly-complete barrier for the typical salary or wage-earning individual to enter the credit transfer market, thereby eliminating a key avenue for additional liquidity.[5]
- Bonus credits may not be sold separately from base credits.
  - The Final Regulations confirm that, in the case of an eligible credit with a bonus amount, the eligible taxpayer is not permitted to transfer the bonus portion of the credit separately from the base amount. Instead, an eligible taxpayer transferring less than 100 percent of such an eligible credit would be deemed to transfer a proportionate amount of the bonus credit and the base credit to any transferee taxpayer.
  - This rule would prevent an eligible taxpayer from separately selling base credits and bonus credits to different transferee taxpayers with differing risk tolerances.

[4] The material participation standard is described in Sections 1.469-5 and 1.469-5T of the Treasury Regulations.

[5] An individual transferee that is not a material participant in the activities giving rise to the eligible credit should be able to utilize the credits to offset tax liability from passive activities. The typical individual, however, does not have significant passive tax liability.

- No flexibility for parties seeking to transact with advanced payments.
  - The Final Regulations confirm that payments for eligible credits may not be made before the eligible taxpayer's taxable year when the credits are generated.
  - Consistent with the Proposed Regulations, the Final Regulations provide that consideration for eligible credits will not be treated as "paid in cash" unless transferred to the eligible taxpayer within the period beginning on the first day of the taxable year when the credits are generated and ending on the due date for completing the transfer election statement.[6]
  - As a result, credit purchasers are not permitted to prepay for production tax credits (PTCs) expected to be generated in future years.[7] However, parties may contractually commit to purchase eligible credits in future years as long as payments for future-year credits do not violate the timing rule described above.
  - The preamble to the Final Regulations (the Preamble) confirms that a loan paid to an eligible taxpayer outside of the timing window described above, either from the transferee taxpayer or a third-party lender, would not be treated as an impermissible advanced payment as long as the loan has arm's length terms and is classified as debt for federal income tax purposes. Notably, however, the Preamble reserves the right to recharacterize such loans as upfront payments based on the specific facts and circumstances.
- No new opportunities for tax credit brokers.
  - The Final Regulations confirm that eligible taxpayers and transferee taxpayers can utilize brokers and syndicators to facilitate eligible credit transfers, provided that the transaction does not cause ownership of the credit to transfer to the broker or syndicator for federal income tax purposes before the transferee taxpayer acquires the credit.
  - However, Treasury and the IRS declined to create an exception to the prohibition against second transfers to accommodate brokers and syndicators, thereby stopping short of creating additional flexibility and opportunities for these particular market participants.
  - Some commenters recommended that contracts for the right to acquire eligible credits be transferable and suggested that the Final Regulations clarify that the purchase and sale of such a contract not give rise to a second transfer of the credits. The purchaser under an executory tax credit transfer agreement might be motivated to transfer the contract for a profit, for example, if per-credit pricing rises after signing. Treasury and the IRS declined to take this recommendation on the grounds that such a transfer would be unlikely to satisfy the technical requirements for a valid credit transfer in the first instance and therefore should not give rise to a second transfer issue.
- Transferee taxpayers continue to bear recapture risk.

[6] The transfer election statement must be completed by the earlier of (1) the filing of the eligible taxpayer's tax return for the taxable year when the eligible credit is generated and (2) the filing of the transferee taxpayer's tax return for the taxable year when the credit is taken into account.

[7] PTCs include the production tax credit under Section 45, the advanced manufacturing production credit under Section 45X, the clean electricity production credit under Section 45Y, and the clean fuels production credit under Section 45Z. Market participants have observed that the inability to prepay for PTCs creates an inconsistency with partnership flip structures, where tax equity investors typically make a substantial portion of their investment upfront.

- The Final Regulations confirm that the transferee taxpayer bears the risk of recapture of investment tax credits (ITCs) under Section 50(a)[8] (unless, in the case of an eligible taxpayer that is a partnership, the recapture event is triggered by a transfer of a partnership interest therein) and recapture on account of previously stored or utilized carbon oxide leaking into the atmosphere under Section 45Q(f)(4).
- Additionally, the Final Regulations confirm that, if an eligible taxpayer transfers a portion of an eligible credit to a transferee taxpayer and retains the balance, recapture liability is borne proportionately by each party. This is different than the ordering rule for disallowed credits in an excessive credit transfer (i.e., eligible credits that are subject to reduction because the amount of the credit, as initially reported, was incorrect), which requires the eligible taxpayer to bear a dollar-for-dollar reduction of the retained credit before the transferee taxpayer's credit is reduced.

- No streamlining or simplification of the pre-filing registration process.
  - The Final Regulations generally adopted the pre-filing registration process set forth in the Proposed Regulations and the accompanying temporary regulations, without any changes to make the process more streamlined or efficient.
  - In the Preamble, Treasury and the IRS committed to monitor the pre-filing registration process and seek opportunities to make the process more efficient for taxpayers.

The Final Regulations also provide the following taxpayer-friendly clarifications:

- Taxpayers may continue to reduce estimated payments before purchasing eligible credits.
  - The Preamble confirms that a transferee taxpayer is permitted to take into account an eligible credit (or portion thereof) that it has purchased, *or intends to purchase*, to calculate its estimated tax payments.
  - As a result, taxpayers generally are permitted to reduce their estimated tax payments for the taxable year even before they have purchased, or contractually committed to purchase, eligible credits, provided that they have the requisite intent to purchase sufficient credits with respect to the same taxable year. As a result, with proper planning, taxpayers may be able to receive the benefit of purchasing eligible credits before making the corresponding cash payment, thereby creating a significant timing benefit. [9]
  - The Final Regulations do not provide specific rules regarding how a transferee taxpayer should take into account transferred credits for purposes of determining estimated tax payments. The Preamble provides gloss on the phrase "intends to purchase," which is intended to capture a situation in which the taxpayer plans to complete a valid tax credit acquisition but has not yet done so.
- No changes to the scope of minimum required documentation.
  - The Final Regulations do not change the scope of the required minimum documentation described in the Proposed Regulations.[10]

[8] ITCs include the investment tax credit under Section 48, the advanced energy project credit under Section 48C, and the clean electricity investment credit under Section 48E.

[9] The transferee taxpayer would remain liable for any additions to tax in accordance with Sections 6654 and 6655; if, and to the extent, the taxpayer's credit acquisitions ultimately are insufficient to sustain the reduced estimated tax payments.

[10] The minimum required documentation includes (1) information that validates the existence of the underlying eligible credit property, (2) if applicable, documentation substantiating that the eligible taxpayer has satisfied the requirements to include any bonus credits,

- The Preamble explains that the minimum documentation requirement is intended to be a non-burdensome baseline for information sharing among eligible taxpayers and transferee taxpayers. Prospective transferee taxpayers are, of course, free to request or require additional information with respect to a particular transaction.

- Discounts on purchased eligible credits are not included in gross income of the transferee taxpayer.
  - The Final Regulations confirm that a transferee taxpayer generally does not have gross income upon purchasing an eligible credit (or portion thereof) at a discount.
  - The Preamble observes that the foregoing rule does not preclude the IRS from recharacterizing all or a portion of the discount as attributable to other value conveyed by the eligible taxpayer to the transferee taxpayer, including under the anti-abuse rule under Section 1.6418-2(e) of the Final Regulations.[11]
- Clarification regarding duplicate recapture.
  - The Final Regulations clarify that, if and to extent an amount of an ITC has been recaptured with respect to a partner in a transferor partnership, either on account of the partner's transfer of a partnership interest or the application of the at-risk rules under Section 49(b), the amount of potential recapture liability remaining to the transferee taxpayer should be reduced.
- Clarification regarding revisions to transfer elections.
  - The Final Regulations confirm that a transfer election can be made or revised on a superseding tax return (i.e., a tax return filed after the original tax return but before the due date, including extensions). However, a transfer election cannot be made or withdrawn by an amended tax return or by filing an administrative adjustment request (AAR) pursuant to Section 6227. An amended tax return or AAR may correct a numerical error. The original tax return must contain a substantive error to correct. The amended tax return or AAR cannot seek to correct a blank item or an item that is described as being "available on request."[12]
  - In addition, the Final Regulations clarify that an eligible taxpayer may, after making a valid transfer election, file an amended tax return or AAR, if applicable, to adjust the amount of the eligible credit if it was incorrectly reported on the original tax return. In the event of an upward adjustment, the eligible taxpayer generally can claim the increased amount but cannot transfer this amount to the transferee taxpayer. A downward adjustment generally reduces the eligible credit (if any) retained by the eligible taxpayer first and, thereafter, reduces the eligible credit reported to the transferee taxpayer, which may result in an excessive credit transfer from the transferee's perspective.[13]
- Normalization accounting rules do not apply to purchased investment tax credits.
  - The Preamble confirms that the normalization rules in Section 50(d)(2) do not apply to purchased ITCs – a topic that the Proposed Regulations did not address.[14]

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and (3) evidence of the eligible taxpayer's qualifying costs in the case of an ITC transfer or the amount of qualifying production activities and sales in the case of a transfer of a PTC transfer.

[11] The Final Regulations generally adopt the anti-abuse rule from the Proposed Regulations, with minor clarifications.

[12] This guidance is consistent with the parallel rule in the final regulations under Section 6417.

[13] Cash consideration retained by the eligible taxpayer after accounting for any reduction in the amount of the eligible credit transferred to a transferee taxpayer generally cannot be excluded from gross income.

[14] Section 50(d)(2) cross references Section 46(f) as in effect before November 5, 1990 (the day of the enactment of the Revenue Reconciliation Act of 1990).

- Normalization generally requires public utilities, for rate-making purposes, to amortize the ITC and depreciation deductions with respect to public utility property on a straight-line basis over the property's useful life as determined for regulatory purposes. The normalization rules generally disincentivize utilities from holding ITC-eligible property on balance sheet unless the project is not considered to be public utility property (e.g., because electricity is sold at negotiated rates rather than on a rate-of-return basis).
- Utilities were optimistic that Treasury and the IRS eventually would confirm this result. As a result of this clarification, utilities may transfer ITCs generated by public utility property held on balance sheet and therefore avoid the obligation to normalize the ITCs (accelerated depreciation nonetheless would be subject to normalization).[15]

Finally, the Final Regulations leave open the tax treatment of transaction costs, including legal and consulting fees, success-based fees, tax credit insurance premiums, and indemnification payments under tax credit purchase agreements. In the Preamble, Treasury and the IRS explained that the treatment of these costs was beyond the scope of the Final Regulations and that the treatment of these costs already is governed by other provisions of the Code and federal income tax principles, although Treasury and the IRS anticipate issuing further guidance on this topic.

Key Takeaways

Treasury and the IRS generally resisted comments seeking to bring more participants and liquidity to the credit transfer market. For instance, the continued application of the Passive Credit Rules will keep most salary-earning individuals on the sidelines. Without the ability to detach and transfer bonus credits, project owners may find it difficult to sell bonus credits that are perceived to have greater risk than the corresponding base credit. Flexibility to transfer bonus credits separately might have led to a bonus credit market where buyers with more risk tolerance could purchase riskier bonus credits, thereby allowing project owners to sell bonus credits with less of a discount. Similarly, allocating recapture risk to the eligible taxpayer likely would have brought more buyers into the ITC transfer market and reduced the need for extensive due diligence, ITC recapture insurance, and, as a result, overall transaction costs.

On the other hand, market participants have transacted in reliance on the Proposed Regulations since they were released last June and, from this perspective, any material changes in the Final Regulations could have been disruptive. If nothing else, the Final Regulations should not significantly impact the credit transfer market as it currently exists nor disrupt any transactions either under negotiation or that have signed but not yet funded.

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[15] Section 50(d)(2) already has an exception, added by the Inflation Reduction Act, to the normalization rules for energy storage projects with maximum capacity of at least 500 kilowatt hours.

If you have questions concerning the contents of this alert, or would like more information about Weil's Tax practice, please speak to your regular contact at Weil, or to:

Steven Lorch	View Bio	steven.lorch@weil.com	+1 212 310 8060
Jonathan Macke	View Bio	jonathan.Macke@weil.com	+1 214 746 8194
Griffin Baker	View Bio	griffin.baker@weil.com	+1 214 746 7735
Nathan Bunch	View Bio	nathan.bunch@weil.com	+1 212 310 8299