Alert | Energy Project Finance & Development

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Proposed Regulations under Section 6418 Transferability of Clean Energy Tax Credits

On June 14, 2023, the IRS released proposed and temporary regulations and additional guidance describing rules for eligible taxpayers to benefit from clean energy projects through selling any of the 11 eligible U.S. federal income tax credits to an unrelated taxpayer in exchange for cash. The proposed and temporary regulations were published to the Federal Register on June 21, 2023.

Section 6418 of the Internal Revenue Code (the Code) allows certain taxpayers to elect to transfer all (or any portion specified in the election) of an eligible credit to an unrelated transferee taxpayer; the transferee taxpayer then is able to utilize the transferred tax credit (or such portion thereof) against its own taxable income. Tax-exempt entities, governments, tribes, and other taxpayers eligible for direct pay under Section 6417 of the Code are not eligible.[1] Eligible taxpayers include all other taxpayers and entities classified as partnerships for U.S. federal income tax purposes subject to Subchapter K. The transferability of tax credits is intended to broaden the pool of potential investors able to benefit from renewable energy tax credits and offer an alternative to the traditional tax equity investment structures.

As summarized below, the proposed and temporary regulations clarify several key issues in the statutory language.

[1] See GT Alert, Proposed Regulations under Section 6417 Direct Pay for Clean Energy Tax Credits.

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Key Issues

Recapture: The proposed regulations clarify that, in the event of an investment tax credit or carbon sequestration tax credit recapture event, the transferee of the eligible tax credit is responsible for any tax increase. However, if the transferor is a partnership, the reduction of a partner's partnership interest in such transferor partnership does not alone trigger recapture to the transferee taxpayer.

No Separation of Credit Adders: An eligible transferor can transfer all or a portion of an eligible credit, and there is no limitation on the number of transfer elections or transferees. However, credit adders (i.e., domestic content, energy community, and low-income communities adder) cannot be transferred separately from the base credit. In the case of multiple transferees, the base credit and any credit adders are transferred proportionately. Therefore, the risk of an excessive credit transfer arising out of qualification for a bonus credit is shared among transferees.

Limitation On Additional Transfers: The transferee taxpayer is prohibited from making a second transfer of any portion of a transferred credit. In addition, an eligible taxpayer must either own the underlying eligible credit property or, if ownership is not required, otherwise conduct the activities giving rise to the underlying eligible credit. The proposed regulations, however, specify that the following arrangements are permissible: (i) an arrangement using a broker to match eligible transferor taxpayers and transferee taxpayers, where at no point does the broker take ownership of the specified credit, (ii) an allocation of a transferred credit by a transferee taxpayer to a direct or indirect owner of a passthrough entity, and (iii) sale by the owner-lessor in a sale-leaseback arrangement.

Partnership Impacts: A partnership, not the partners, may elect to transfer any portion of the eligible credits. The tax-exempt income received in exchange for the credits will be allocated to the transferor partners in the same manner the tax credit would have been allocated. If only a portion of the partnership's credits are transferred, partners may be allocated credits, tax-exempt income from the transfer, or a combination thereof, up to their respective shares of the credit. Effectively, if there are multiple partners and some but not all want to sell their credits, then the tax-exempt income can be allocated to the partners that opted to sell their credits. However, an eligible transferor partnership that receives a cash payment is not restricted on how the partnership uses the cash payment. The partnership can distribute the cash to its partners in accordance with their partnership agreement, and the cash distributions do not need to mirror the allocations of the tax-exempt income. This maintains partnerships' flexibility with their economic and income tax arrangements.

Passive Activity Loss Rules: While the passive activity loss rules under Section 469 of the Code do not impact the amount of credit eligible for transfer, the passive activity loss rules apply to the transferee taxpayer. The proposed regulations prevent the transferee from changing the characterization of the transferee taxpayer's participation (or lack thereof) in the transferor's trade or business. Accordingly, transferees subject to the passive activity loss rules (e.g., individuals, estates, trusts, closely held C corporations, and personal service corporations) should carefully consider their ability to utilize credits before purchasing them.

Paid in Cash: The paid in cash requirements dictate that U.S. dollars paid in connection with a transfer election must be paid with cash, check, cashier's check, money order, wire transfer, ACH transfer, or other bank transfer of immediately available funds. Credit transfers cannot be used to satisfy liabilities. The use of any non-cash consideration invalidates the transfer. Cash payments can be made beginning on the first day of the eligible taxpayer's taxable year during which the credit is determined.

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<u>Advanced Commitment</u>: The proposed regulations permit advanced commitments to purchase eligible credits so long as all cash payments are made during the required time period. A transferee taxpayer may make a contractual commitment to purchase eligible credits in advance of the date such specified credit portion exists if all payments related to the specified credit portion are made during the period starting the first of the year the credit is generated until the transfer election statement is due. Practically, this allows for advanced contracts for the purchase of PTCs.

<u>Anti-Abuse</u>: The amount paid is tax exempt. However, the proposed regulations specifically note that such consideration can be recharacterized if the parties have engaged in the transaction or a series of transactions to avoid tax despite technically being considered "unrelated" for purposes of Section 6418 of the Code.

<u>Excessive Credit Transfer Tax</u>: Absent reasonable cause, the transferee is subject to tax and penalty in aggregate equal to 120% of the amount of the excessive credit. Further, the income of the transfer or of such excessive credit is not tax-exempt. If there are multiple transferees, all transferees share the risk. The proposed regulations make clear that recapture events are not excessive credit transfers.

<u>Registration and Election Process</u>: Taxpayers seeking to transfer credits must complete a pre-filing registration through an online portal with the IRS. The registration process includes providing information under penalties of perjury regarding the taxpayer, which tax credits the taxpayer intends to earn, and which projects the taxpayer intends to qualify for the tax credits. Upon completion of the registration process, taxpayers will receive a unique registration number from the IRS for each registered eligible credit property for which the taxpayer intends to transfer a credit. The registration numbers are used when filing annual tax returns. After receiving a registration number, transfer election statements may be prepared and must be filed on a timely (including extensions) original tax return for the taxable year for which the eligible credit is determined. A taxpayer that does not obtain a registration number and report the registration number on its return with respect to an eligible credit property is not eligible to make a transfer election.

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