June 20, 2023

PRELIMINARY AND SUBJECT TO CHANGE[1]

Significant Features of Proposed Regulations for the Direct Pay Provisions of Section 6417 as Included in the Inflation Reduction Act of 2022

Background. – The Inflation Reduction Act of 2022 (IRA) included a provision (section 6417) that allows certain applicable entities and electing taxpayers[2] to elect to receive a direct payment in lieu of certain energy tax credits.[3] On June 14, 2023, Treasury issued proposed regulations under section 6417. Comments on the proposed regulations are due by August 14, 2023, and a public hearing is scheduled for August 21, 2023, for those wishing to testify. Final regulations are intended to apply to taxable years ending on or after the final regulations are published in the Federal Register. Taxpayers may rely on the proposed regulations for direct payments after December 31, 2023, for taxable years ending before the final regulations are published.

Broadly, the regulations clarify several issues (noted below) and provide a framework for determining direct pay amount and making the direct pay election.[4] Notably, the regulations also provide detailed rules on a new electronic pre-filing registration process for applicable entities and electing taxpayers making direct pay elections.

The proposed regulations cover many issues but also does not address several key issues. The below summary highlights some of the more significant of those issues. Treasury also requests comments on specific issues, which are outlined at the end of the document.

Important issues addressed in the proposed regulations. –

Definition of State or political subdivision thereof. – Treasury exercised its authority in section 6417(h) to treat agencies and instrumentalities as applicable entities. Section

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[1] This document does not constitute tax advice and cannot be relied upon as such.

[2] An "applicable entity" is (1) any organization exempt from tax imposed by subtitle A; (2) any State or political subdivision thereof; (3) the Tennessee Valley Authority; (4) an Indian tribal government (as defined by section 30D(g)(9); (5) any Alaska Native Corporation (as defined in section 3 of the Alaska Native Claims Settlement Act; or (6) any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas (rural electric co-ops).

An "electing taxpayer" is any taxpayer that is not an applicable entity but makes a direct pay election for purposes of the section 45Q carbon sequestration credit, 45V hydrogen production credit, or 45X advanced manufacturing production credit. Electing taxpayers may receive direct pay for the first five years following a proper election.

[3] Direct pay is available for "applicable credits," which are generally those determined under (1) section 30C (alternative fuel refueling property), (2) section 45 (renewable energy production), (3) section 45Q (carbon oxide sequestration), (4) section 45U (zero-emission nuclear power production), (5) section 45V (clean hydrogen production), (6) section 45W (qualified commercial vehicles), (7) section 45X (advanced manufacturing production), (8) section 45Y (clean electricity production), (9) section 45Z (clean fuel production), (10) section 48 (energy property), (11) section 48C (qualifying advanced energy project), (12) section 48E (clean energy investment).

"Applicable credit property" is generally the facility or project relating to the applicable credits.

[4] For purposes of this document, the term "direct pay election" has the same meaning as provided in the proposed regulations for the term "elective payment."

6417(d)(A)(ii) defined an applicable entity as "any State or political subdivision thereof," but that language doesn't clearly cover State agencies or instrumentalities. Many government entities provided comments suggesting that instrumentalities should be treated as applicable entities based on section 6417 cross references to sections 50(b)(4)(A)(i) and 168(h)(2)(A)(i), instrumentality income being excluded from tax under section 115, and prior definitions of political subdivision and instrumentality under reg. section 1.103-1(b) and Revenue Ruling 57-128. The analysis of whether an entity is an instrumentality can be complex, and the preamble notes the administrative burden on stakeholders and the government to make those determinations for purposes of direct pay. States also structure government entities differently and there could be inequities on a state-by-state basis if entities were required to make the instrumentality determination. Treasury requests further comments on this issue.

Joint ownership structures. – Historically, applicable entities such as public power utilities and rural electric cooperatives have partnered with other entities to own and operate electricity generation. Joint ownership often allows applicable entities to directly participate in facilities that exceed their demand from the investment and spread risk among the owners. Often these joint ventures will be co-owned as tenants-in-common or through ownership agreements that have elected out of subchapter K through section 761. In such a case each owner is treated as owning an undivided interest in the underlying asset. The proposed regulations respect such arrangements for purposes of direct pay and allow applicable entities to make direct pay elections with respect to its share of the applicable credits.

Partnerships. – Partnerships with applicable entity owners may not make direct pay elections under the theory that if the partnership owns the assets giving rise to the credits, then the partnership must make the election under section 6417(c); partnerships are not applicable entities under section 6417(d)(1). Further, the preamble notes administrative complexity, particularly in tiered structures, if partnerships could make direct pay elections for a portion of the applicable credit property owned by applicable entity partners. Arguably, this denial is contrary to Congress' intent of allowing the direct pay election for partnerships whose members are tax-exempt entities under section 6417(c). Finally, the transferability proposed regulations (issued on the same day) provide flexibility with respect to partnership arrangements where some partners want their credits transferred and others do not. Perhaps Treasury can be persuaded to provide a similar rule in the final direct pay regulations. Treasury has requested comments regarding the treatment of partnerships.

Pre-filing registration. – To address concerns about fraud, abuse, and administrability of the direct pay program, Treasury and the IRS established a mandatory pre-filing registration process that must be completed before making a valid direct pay election. The taxpayer must both receive a registration number from the pre-filing registration process for each applicable credit property and report it on its tax return to be eligible to make the direct pay election. The pre-filing registration generally requires the applicable entity or electing taxpayer to register and identify itself, list all the applicable credits it intends to claim, and list all applicable credit property attributable to the credits. Receipt of a pre-filing registration number does not mean that the applicable entity or electing taxpayer is eligible to receive a direct payment.

The IRS will establish an electronic portal for completing the pre-filing registration process. The regulations provide a list of information required to complete the process. Some notable items include: information about the taxpayer's exempt or governmental status, the type of tax return normally filed, type of applicable credits the taxpayer is intending to make a direct pay election, the applicable credit property for each applicable credit, physical location and other information about the construction or acquisition of the applicable credit property, the beginning of construction date for the applicable credit property, source of funds used to acquire the property, a contact person, and a perjury statement.

Once the IRS issues a registration number to an applicable entity or electing taxpayer who completed the pre-filing registration process, the number is only valid for the taxable year for which it was obtained. If the registration number won't be used for the initial taxable year, the taxpayer may renew the registration for the subsequent taxable year. If facts change before the registration number is used, the taxpayer must amend its pre-filing registration.

Determination of applicable credit for applicable entities. – Applicable entities making direct pay elections do not apply the rules of section 50(b)(3) (limitation on tax-exempt organizations) or section 50(b)(4)(A)(i) (limitation on credit property used by government entities). Applicable credit property will be treated as used in a trade or business, which allows applicable entities to calculate the credit's basis, treat the property as one with allowable depreciation, apply the at-risk and passive activity loss rules, and does not create a presumption that the trade or business is related to a tax-exempt entity's exempt purpose.

Treatment of grants and forgivable loans. – The proposed regulations provide a special rule with examples for how applicable entities treat the receipt of grants or forgivable loans used for building a project qualifying for an investment tax credit. Generally, if an applicable entity receives a non-taxable grant or forgivable loan and uses the proceeds to purchase, construct, reconstruct, erect, or otherwise acquire an applicable credit property, those amounts are included in the basis for purposes of determining the applicable credit amount. If an applicable entity receives a non-taxable grant or forgivable loan for the specific purpose of building or acquiring applicable credit property, and the Restricted Tax Exempt Amount plus the applicable credit otherwise determined exceeds the cost of the property, the applicable credit is reduced so the total amount of applicable credit plus the amount of Restricted Tax Exempt Amount equals the cost of the credit property.

Chaining. – Some stakeholders requested the ability to transfer credits to an applicable entity that can then make a direct pay election for the value of the transferred credits. The proposed regulations do not allow a direct pay election for credits purchased under section 6418, transferred under carbon oxide sequestration rules (section 45Q(f)(3)), acquired by a lessee, owned by a third party, or otherwise not determined with respect to the applicable entity or electing taxpayer. The general rule is that the applicable entity or electing taxpayer must own the applicable credit property or otherwise conduct the activities giving rise to the credits.

Timing of payment. – For applicable entities for which no return is required, the direct payment is treated as made on the later of the date that a return would be due under section 6033(a) or the date on which the taxpayer submits a direct pay election. For electing taxpayers, the elective

payment will be treated as made on the later of the due date (determined without regard to extensions) of the tax return or the date the return is filed. The proposed regulations do not address how quickly the IRS will process claims for refunds resulting from the direct pay rules.

Double benefit rule. – When a taxpayer or applicable entity makes a direct pay election, the corresponding credit is reduced to zero and deemed to have been allowed as a credit. The proposed regulations outline a methodology to calculate the credit reduction:

1) Compute the amount of Federal tax liability for the taxable year without regard to the general business credit (GBC) that is payable on the due date of the return and the amount of Federal income tax liability that may be offset by GBCs pursuant to limitations under section 38;
2) Compute the allowed amount of GBC carryforwards carried to the taxable year plus the amount of current year GBCs (carrybacks not considered);
3) Apply GBCs allowed for the taxable year (as calculated in step 2) against the tax liability computed in step 1;
4) Identify the amount of excess or unused current year GBC, as defined in section 39, attributable to current year applicable credits for which the taxpayer makes a direct pay election using the ordering rules of section 38(d) (if applicable). This is the net elective payment amount;
5) Reduce the applicable credits for which a direct pay election is made by the amount allowed as a GBC under section 38 for the taxable year and by the net elective payment amount.

The proposed regulations include examples outlining the steps above.

Use of applicable credit for other purposes. – The amount of applicable credit for which a direct pay election is made is deemed to have been allowed for other purposes of the Code, such as the calculation of estimated tax under sections 6654 and 6655 and the basis reduction and recapture rules imposed by section 50.

Election requirements. – Applicable entities that make a direct pay election will be treated as making a payment against Federal income taxes for the taxable year with respect to which the applicable credit is determined. If the applicable entity is the owner (directly or indirectly) of a disregarded entity that holds applicable credit property, the applicable entity may make the election. An applicable entity that is a co-owner in applicable credit property through a tenancy-in-common or an organization that has made a valid section 761(a) election to be excluded from subchapter K, then the applicable entity's undivided share of the applicable credit property will be treated as a separate applicable credit property owned by such applicable entity and the applicable entity can make the election. Partnerships and S corporations are not applicable entities and cannot make a direct pay election, regardless how many of the partners are applicable entities.

Election requirements for electing taxpayers. – Electing taxpayers other than partnerships or S corporations will be treated as making a payment against Federal income taxes imposed by subtitle A for the taxable year with respect to which the applicable credit is determined. For

electing taxpayers that are partnerships or S corporations, the IRS will make a payment to the partnership or S corporation in the amount determined. Partners and S corporation shareholders are prohibited from making elective payment elections. Similar rules apply to electing taxpayers owning disregarded entities and undivided ownership interests as those applying to applicable entities. Members of a consolidated group may make an election.

Election made separately for each facility or project. – The election must be made separately for each facility or project for the taxable year such applicable credit property is placed in service. The election applies for the entire term of the production tax credit.

Manner of election. – The direct pay election is made on the annual tax return filed not later than the extended due date for the original return for the taxable year for which the applicable credit is determined. No election may be made or revised on an amended return or by filing an administrative adjustment request under section 6227.

Pre-filing registration (described above) is required for making a direct pay election. Each applicable credit property must be provided a registration number to make a valid election.

The election must be made no later than: (1) in the case of a taxpayer for which no Federal income tax return is required under sections 6011 or 6033(a), the due date (including an extension of time) for the original return that would be required under section 6033(a) if such applicable entity were described in that section. If an automatic six-month extension would be allowed if applicable entity were subject to sections 6011 or 6033(a), the automatic six-month extension is deemed to be allowed; (2) in the case of a taxpayer that is not normally required to file an annual tax return with the IRS (such as taxpayers located in U.S. territories), the due date (including extensions) that would apply if the taxpayer were located in the United States; (3) in any other case, the due date (including extensions) the return for taxable year for which the election is made.

The election applies to the entire amount of applicable credit for each applicable credit property that was registered and for which an applicable entity or electing taxpayer made an election. The election applies to all bonus credits (such as domestic content and energy communities) for each applicable credit property.

Electing taxpayers. – Taxpayers other than applicable entities may elect direct pay with respect to carbon oxide sequestration (section 45Q), hydrogen production (section 45V), and advanced manufacturing production (section 45X) credits. The same general rules applying to applicable entities also apply to electing taxpayers.

The direct pay election for electing taxpayers applies to the year the election is made and the four subsequent years. Taxpayers may revoke the election during a subsequent year and may not revoke the initial revocation. Only one election is allowed for each applicable credit property.

Partnerships and S corporations may be electing taxpayers and direct payments are made to the partnership or S corporation. The double benefit rule applies. Credits and payments are allowed solely to the partnership. The direct payment is treated as tax-exempt income under section 705

or 1366. A partner's distributive share of the tax-exempt income is equal to the partner's distributive share of the credit. Upper tier partnerships must follow similar rules. Tax-exempt income arising from a direct payment is treated as arising from an investment activity, and therefore not treated as passive income to any partners or shareholders who did not materially participate under section 469.

The amount of the applicable credit determined by a partnership or S corporation is not subject to limitations in section 38(b) and (c) and section 469.

The regulations provide an example outlining some of the above determinations.

Important issues not addressed in the proposed regulations. –

Reduction for tax-exempt bonds. – The IRA modified the reduction in credit value rules for projects and facilities that are financed with tax-exempt bonds. Under the IRA revision, the credits, and subsequent direct payment, will be reduced by up to 15 percent if tax-exempt bonds are used. There are differing views on whether the 15 percent reduction applies to the entire applicable credit project if any tax-exempt financing is used, or whether the reduction only applies to the portion financed with tax-exempt bonds. Similarly, in the case of joint ownership in which there is a mix of applicable entity and non-taxable entity owners, there is a question regarding whether the applicable entity's use of tax-exempt financing will cause a reduction in credits for all owners or just the applicable entity using tax-exempt financing.

Domestic content. – For applicable credits determined by property beginning construction after 2023, applicable entities must show that each project meets the domestic content requirements to receive the full value of the credit as a direct payment. Beginning in 2026, the full value of the credit is reduced to zero if the domestic content rules are not met. The statutory domestic content rules for direct pay purposes are generally the same as for the bonus credit with two key distinctions: (1) an exception if the inclusion of steel, iron, or manufactured products produced in the United States would increase the overall costs of construction of the facility or project by 25 percent and (2) an exception if relevant steel, iron, or manufactured products are not produced in the United States in sufficient and reasonably available quantities or of a satisfactory quality.

In April 2023, Treasury and the IRS released a notice of intent to issue proposed regulations on the domestic content bonus credit but did not address the two exceptions described above.[5] Neither those proposed regulations nor the direct pay proposed regulations address the two exceptions. Applicable entities will seek clarity on those rules before they are effective in 2024.

Also, applicable entities will likely seek safe harbors providing certainty as they begin constructing projects to reduce the level of risk associated with not meeting the domestic content requirements and losing the credit.

Request for comments. – The preamble of the proposed regulations requests specific comments on a variety of topics. Below is a comprehensive list of such items:

[5] Notice 2023-23.

- Whether the definition of any organization exempt from the tax imposed by subtitle A should include the United States, Federal agencies, or other organizations beyond the proposed rules;
- Whether additional clarification is needed for the definition of "any State or political subdivision thereof";
- Whether additional clarification is needed for the definition of Indian tribal government or a subdivision thereof;
- Whether definitions relating to Indian tribal governments encompass the entity structures they employ in activities that would give rise to elective payments, including entities with partial Indian tribal government ownership;
- Whether the definition of Alaska Native Corporations needs additional clarification or changes and whether additional guidance is necessary regarding consolidated groups with ANC common parents;
- Whether the definition of rural electrical co-ops needs further clarification;
- Whether additional guidance is necessary to address any uncertainty that may exist regarding the application of section 6417 in the context of a consolidated group with members that are cooperatives subject to the rules of subchapter T;
- Whether additional guidance is needed regarding the approach to defining applicable entities as including agencies and instrumentalities;
- The application of section 6417 to consolidated groups with electing taxpayers;
- Whether additional rules are needed for purposes of partnerships with applicable entity and for-profit partners that have elected out of subchapter K;
- Whether to allow applicable entities organized as partnerships to make a direct pay election;
- Whether additional clarity is needed regarding the application of the at-risk and passive activity loss rules to applicable entities or electing taxpayers;
- Whether applicable entities should be able to make a direct pay election for credits purchased through a transferability transaction and whether there should be exceptions to the general rule prohibiting such transactions[6];
- Whether the rules relating to the methodology that an applicable entity follows to compute the amount of the elective payment should be clarified or expanded and whether there are other Code sections to consider;
- Whether additional guidance on excessive payments is needed;
- The impact of the regulations on small entities and the number of entities affected; and
- Whether there are less burdensome alternatives to the requirements in the regulations that do not increase the risk of duplication, fraud, improper payments, or excessive payments.

[6] The preamble suggests that stakeholders should consider limitations on any exceptions to chaining transactions, such as: (1) the type of applicable entity that may be allowed to make a direct pay election with respect to transferred credits, (2) the involvement of the transferee taxpayer in the project's development, (3) the level of due diligence conducted by the transferee taxpayer regarding whether the project qualifies for the applicable credit and any bonus credits and whether the amount of transferred credits was properly determined with respect to the transferor, (4) what minimum percentage of the face value of the credit should be required, or (5) there are no other special financial arrangements between the parties.