PRELIMINARY AND SUBJECT TO CHANGE[1]

Significant Features of Proposed Regulations for the Transferability Provisions of Section 6418 as Included in the Inflation Reduction Act of 2022

Background: The Inflation Reduction Act of 2022 (IRA) included a provision (section 6418) that allows an eligible taxpayer[2] to elect to transfer certain energy credits ("eligible credits")[3] to another taxpayer (the "transferee"). On June 14, 2023, Treasury issued proposed regulations under section 6418. Comments on the proposed regulations are due by August 14, 2023, and a public hearing is scheduled for August 23, 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 taxable years beginning after December 31, 2022, and before the date the final regulations are published.

The proposed regulations cover a wide variety of issues and address many of the major concerns raised by taxpayers trying to implement section 6418. Following is a brief description of the more significant issues in the proposed regulations.

Form of election, documentation, and registration requirements. – Treasury has vigorously exercised its authority provided in section 6418(g)(1) to condition the transfer of eligible credits on information reporting and registration requirements. The proposed regulations and contemporaneously issued temporary regulations provide extensive rules requiring eligible taxpayers to register with the IRS with respect to transferred eligible credits, to enter transfer election statements with transferee taxpayers, and to provide transferees with certain documentation. Both the eligible taxpayer and transferee taxpayer(s) are required to include certain information on their respective tax returns. These requirements are quite extensive and because of the high degree of detail are not described herein, except in a few cases below. They reflect concerns expressed by Treasury and the IRS regarding the opportunity for fraud in Notice 2022-50. However, adherence to these procedures is important. The proposed regulations provide that an invalid election negates an eligible credit transfer that cannot be cured by section 301.9100 relief. Any transfer election under section 6418 is irrevocable.

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

[2] An "eligible taxpayer" is any person subject to any internal revenue tax other than those described in section 6417 (the "direct pay" election). For purposes of this discussion, the eligible taxpayer is the transferor of the eligible credit and the terms "eligible taxpayer" and "transferor" are used interchangeably.

[3] Eligible credits generally are those determined under section 30C (alternative fuel vehicle refueling property), section 45 (renewable electricity production), section 45Q (carbon oxide sequestration), section 45U (zero-emission nuclear power production), section 45V (clean hydrogen production), section 45X (advanced manufacturing production), section 45Y (clean electricity production), section 45Z (clean fuel production), section 48 (energy property), section 48C (qualifying advanced energy project), and section 48E (clean electricity investment).

Treatment of transfer payments. – Section 6418(b) provides that amounts received or paid pursuant to a credit transfer are not included in the gross income of the eligible taxpayer or deductible by the transferee taxpayer. The proposed regulations restate these rules and provide an anti-abuse rule (and examples) to address potential situations where an eligible taxpayer manipulates the transfer price of an eligible credit or other services provided to a transferee taxpayer to take advantage of these non-recognition rules. In such cases, the transfer election may be invalidated, and the proper tax treatment applied to the transaction.

The proposed regulations clarify that a transferee taxpayer does not recognize income or gain when it utilizes an eligible credit in an amount in excess of the consideration paid for the credit.

Determining the amount of transferred eligible credit and carryovers. – Eligible credits are only eligible to be transferred if claimed with respect to an originally filed tax return. Thus, eligible credits that originate on an amended return or pursuant to a request of administrative adjustment may not be transferred.

The proposed regulations provide that eligible credits are determined on a property-by-property or facility-by-facility basis, as applicable. "Property" and "facility" generally are determined pursuant to the rules applicable to the eligible credits. Eligible taxpayers can designate any portion of such credits as subject to the transfer election (the "specified portion"). These rules provide significant flexibility to eligible taxpayers.[4]

Further, the eligible taxpayer may allocate and transfer any specified portion of an eligible credit among multiple transferees. In such instance, each transferee essentially receives an undivided interest in the specified portion of the eligible credit. For this purpose, if an eligible credit with respect to a property or facility includes any "bonus credit,"[5] each transferee must share in each component of the credit. That is, the eligible taxpayer cannot transfer the "bonus" credit to one transferee and the base credit to another transferee. This may be less efficient because requirements for the bonus credits generally are more stringent than the base credit and may be more appropriate for those transferees that are less risk averse.

A transferor taxpayer generally is allowed to determine an eligible credit if it owns the underlying property or engages in the applicable activity that gives rise to the credit. However, certain present-law rules allow certain eligible credits to be assigned to another person (e.g., under section 45Q(f)(3)(B), section 50(b), or Treas. reg. sec. 1.48-4). The proposed regulations do not allow such already-transferred credits to be transferred under section 6418.

The proposed regulations provide two other instances where eligible credits cannot be transferred under section 6418: (1) any eligible credit that is determined under the progress

[4] See requests for comments, below, on these issues.

[5] "Bonus credits" are allowed for certain eligible credits if the taxpayer meets certain applicable wage or domestic content requirements or makes investments in certain energy or low-income communities.

expenditure rules, and (2) where the transferor receives any consideration other than cash for the credit.

The election does not apply to eligible credits that are carried forward from a prior taxable year or carried back from a subsequent year. A transferee may carry eligible credits that it acquires back or forward. Note that section 39(a)(4) as added by the IRA allows a special three-year carryback period for eligible credits.

Estimated tax payments. – The preamble to the proposed regulations provides that a transferee may take into account a specified credit portion that it has purchased, or intends to purchase, when calculating its estimated tax payments, though the transferee remains liable for any additions to tax in accordance with sections 6654 and 6655 to the extent the transferee has an underpayment of estimated tax.

"Paid in cash." — Section 6418(b)(1) requires consideration for transfer of an eligible credit to be paid in cash. Under the proposed regulations, for this purpose, "cash" means U.S. dollars and "paid" means by cash, cashier's check, money order, wire transfer, ACH transfer, or other bank transfer of immediately available funds. The proposed regulations include a safe harbor that provides that a payment meets the "paid in cash" requirement if the cash payment is made within the period beginning on the first day of the eligible taxpayer's taxable year during which a specified credit 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 provide that a contractual commitment to purchase eligible credits in advance of the date an eligible credit is transferred satisfies the paid in cash requirement so long as all cash payments are made during this prescribed time period.

Passive loss and other limitations. – In general, under the proposed regulations, present-law limitations that affect the *determination* of an eligible credit apply to the transferor. Present-law limitations that affect the *use* of an eligible credit apply to the transferee. For example, the at-risk rules of section 49 affect the determination of the amount of allowable credits of eligible taxpayers that are partnerships and S corporations. The amount of eligible credits that a partnership or S corporation can transfer is determined after the application of section 49.[6]

Conversely, as another example, the passive activity rules of section 469 affect the use of tax credits. The proposed regulations provide that the passive activity rules would disallow the use of an eligible credit transferred to a taxpayer who is subject to section 469.

Certain ownership structures. – The proposed regulations determine the electing eligible taxpayer under certain ownership structures. In the case of a disregarded entity owned by an eligible taxpayer, the eligible taxpayer makes the election. In the case of an applicable property or facility co-owned by one or more eligible taxpayers, each eligible taxpayer makes its own

[6] The proposed regulations provide more extensive rules on how section 49 applies in such cases and the preamble requests comments regarding these rules.

election for its allocable portion of the eligible credit. In the case of members of a consolidated group of corporations, the member makes the election (subject to consolidated return rules making the parent the agent for the group). Special rules apply to partnerships and S corporations, discussed in detail below.

Partnerships and S corporations. – Section 6418(c) provides that the transfer election must be made at the flow-through entity level. The proposed regulations provide that the election is made by the entity that holds the eligible property (or performs the applicable activity) and cannot be made by any higher tier entity that holds an interest in the flow-through entity that determines the credit.

Further, the proposed regulations provide rules where different partners may have different goals with respect to eligible credits. For example, some partners may have the capacity to use their allocable share of tax credits and would want them to flow through to them. Other partners may want some or all of their allocable credits transferred. The proposed regulations provide this flexibility. The proposed regulations provide that the eligible credits of a partnership are first allocated to the partners pursuant to the partnership agreement and appropriate Treasury regulations. The section 6418 election is then applied separately to each partner to determine the specified portion, if any, of each partner's allocable share of eligible credits. The credits not subject to the election are flowed through to the partners.

The proposed regulations provide how the tax-exempt income attributable to the cash consideration received for the transferred credits are allocated to the partners (essentially based on their respective shares of transferred credits). The proposed regulations clarify that the cash proceeds received from the credit transfers do not have to be distributed in the same manner as the tax-exempt income was allocated. Presumably, partners whose credits were transferred would insist that such cash or other consideration be distributed to them.

The proposed regulations provide allocation rules for tax-exempt income to higher tier partnerships.

The proposed regulations also provide rules for partnerships and S corporations that are transferee taxpayers. Such flow-through entities cannot make a section 6418 election with respect to such eligible credits. The proposed regulations also provide that consideration paid for the transferred credits is treated as a nondeductible expenditure under section 705(a)(2)(B) and the acquired eligible credits are allocated to the partners in the same manner as the section 705(a)(2)(B) amount is allocated under the partnership agreement.

Section 6418(e)(2) provides that eligible credits may only be transferred once. The proposed regulations provide one-transfer rules in the case of the transfer of partnership interests of a partnership that acquired transferred credits. In these instances, the acquired credits are treated as extraordinary items under Treas. reg. sec. 1.706-4(e), which requires such items not be prorated.

Similar rules apply to S corporations and their shareholders.

Recapture. – The proposed regulations generally provide that the transferee is subject to the addition to tax if a recapture event occurs with respect to property that generated the transferred credit. Section 6418(g)(3) and the proposed regulations provide that the eligible taxpayer must inform the transferee that the recapture event occurred (so the transferee can determine the addition to tax) and the transferee must inform the eligible taxpayer of the amount of recapture (so the transferor can increase its adjusted basis in the property).

Special rules apply to recapture as a result of shifts in the ownership interests of partnerships and S corporations. Under current Treasury regulations, recapture occurs if there is a sufficient shift in the ownership interests of a partnership or S corporation during the recapture period. The proposed regulations provide that, in these cases, recapture will apply to the applicable partners or S shareholders of the transferor entity rather than any transferee.

The proposed regulations provide special rules for recapture with respect to section 45Q credits.

Redetermined tax credits and excessive payments. – Section 6418(g)(2) provides that, if the Secretary determines that there has been an excessive credit transfer, the transferee is subject to an addition of tax for such amount plus 20% of the excessive credit transfer. The 20% penalty can be waived with a showing of reasonable cause. The proposed regulations clarify the operation of these rules.

First, if the IRS redetermines the amount of an eligible credit, the reduction is first applied to the amount of any credit retained by the transferor. Any excess reduction is then applied as an excessive credit transfer to the credits transferred. In the case of an eligible credit transferred to multiple transferees, the reduction is applied pro rata among the transferees.

Second, the addition to tax for excessive credit transfers applies to transferees in the taxable year an eligible credit is redetermined, not the year that the credit was originally determined or claimed.

Third, the proposed regulations provide that reasonable cause would be determined based on the relevant facts and circumstances of a transaction. Generally, the most important factor is the extent of the transferee's efforts to determine that the amount of credit transferred by the eligible taxpayer to the transferee is not more than the amount of the eligible credit determined with respect to the eligible credit property for the taxable year in which the eligible credit was determined and has not been transferred to any other taxpayer. Circumstances that may indicate reasonable cause can include, but are not limited to, review of the eligible taxpayer's records with respect to the determination of the eligible credit (including documentation evidencing eligibility for bonus credit amounts), reasonable reliance on third party expert reports, reasonable reliance on representations from the eligible taxpayer that the total specified credit portion transferred (including portions transferred to other transferees when an

eligible taxpayer makes multiple transfer elections with respect to a single credit property) does not exceed the total eligible credit determined with respect to the eligible credit property for the taxable year, and review of audited financial statements provided to the Securities and Exchange Commission (and underlying information), if applicable.

Finally, the proposed regulations clarify that the excessive credit transfer rules do not apply to tax credit recapture (discussed above) or when there has been an ineffective election to transfer eligible credits. In the case of an ineffective election, there has been no credit transfer.

Requests for comments. – The preamble to the proposed regulations requests specific comments on a variety of topics, including:

- whether more guidance is needed on the definition of eligible credit property and whether a grouping rule for such property is appropriate,
- whether information reporting rules and clarifications on the operation of the at-risk rules of section 49 are needed for transferors that are partnerships or S corporations,
- the treatment of transaction costs associated with tax credit transfers considering the tax-exempt income and non-deductibility rules,
- whether a transferee is permitted to deduct a loss if the amount paid to an eligible taxpayer exceeds the amount of the eligible credit that the transferee can ultimately claim,
- the application of the section 469 passive activity rules,
- the indirect disposition recapture rules applicable to ownership shifts of partnerships and S corporations,
- the application of the at-risk recapture rules of sections 49(a)(2) and 49(b) applicable to partners and S shareholders,
- whether additional rules are required for the allocations of tax-exempt income, eligible credits, and specified portions of eligible credits of partnerships,
- whether additional rules or clarifications are needed 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 an eligible taxpayer, and
- whether additional guidance is needed for the application of these rules for REITs.