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Kirkland Alert

Treasury and IRS Issue Guidance on Direct Pay and Transferability for Energy Tax Credits

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On June 14, 2023, the IRS and the Department of the Treasury published proposed regulations under the Inflation Reduction Act (“IRA”) addressing (1) the ability of certain tax-exempt, taxable and government entities to obtain cash from the federal government in lieu of tax credits (“direct pay”) and (2) rules related to transferring energy tax credits to unrelated parties in exchange for cash (“transferability”). The proposed regulations provide important guidance for private equity, sponsors and other financing parties seeking certainty as they monetize tax credits under the new regimes. Key items in the proposed regulations are outlined below. Taxpayers may rely on the proposed regulations currently, provided they apply all provisions consistently.

Direct Pay

The direct pay election allows eligible taxpayers to claim credits that offset their federal income tax liability and receive the excess remaining credit (if any) as a cash refund.

Tax-Exempt Owners and Investors

- Tax-exempt entities that own an applicable property that is eligible to claim the tax credits (directly, through a tenancy in common, or through an entity that is either a disregarded entity or a partnership that has elected out of Subchapter K) could make the direct pay election and receive cash for tax credits.
- Parties must annually register with the IRS, which can be renewed, with respect to each property, and provide the registration number when making a direct pay

election.

Partnerships and S Corporations

- Partnerships (including most private equity, energy and infrastructure funds) and S corporations are generally ineligible for direct pay even if all partners or shareholders themselves are individually eligible, except in the case of the following tax credits: Sections 45Q (carbon oxide sequestration), 45V (clean hydrogen production) and 45X (advanced manufacturing production), which are available to all taxpayers.
- If a partnership is partially owned by tax-exempt entities, it is ineligible for the direct pay election, but is eligible for transferability for available tax credits of the partnership (as discussed below)
 - Alternatively, if the asset is owned as a tenancy in common (“TIC”), then the tax-exempt investor may make a direct pay election with respect to its direct ownership interest under the TIC arrangement, while the non-tax-exempt party may transfer its share of the credits; however, the tenancy in common structure presents governance complexities and may preclude many common commercial arrangements.

Excess Payment Penalty

- If the IRS determines that a direct payment was made in excess of the amount of credits that would have been allowed absent the direct pay election, the IRS will impose a penalty equal to 20% of the excessive direct payment, unless there is reasonable cause for the excessive direct payment.

Transferability

The transferability election allows eligible taxpayers to transfer any eligible tax credit to a third-party transferee for cash, and the third-party will be treated as the taxpayer with respect to such credit.

General Clarifications and Limitations

- Both partnerships (including most private equity, energy and infrastructure funds) and S corporations can qualify as a transferor and can make transfer elections.
- The passive loss rules apply to the transferee. Therefore, individual retail investors generally cannot purchase tax credits and personally benefit from the transferability election, unless they have certain specified passive income that can be offset with the credits.
- Credits may only be transferred once; however, a transferee can be set up as a partnership and allocate credits among its partners, which will not be treated as an additional transfer. When utilizing a structure that allows tax credits to pass through to another taxpayer, such as a lease pass-through structure, a further transfer is not permitted.
- Transfer elections are also subject to anti-abuse rules, which may disallow or recharacterize a transfer if it is determined that the relevant parties engaged in the transaction with the principal purpose of avoiding federal tax liability beyond the intent of Section 6418.
- Tax-exempt income will be allocated the way the tax credits would have been allocated, irrespective of how the money is distributed; however, if there are multiple partners and only some of the partners sell their tax credits, then the partnership can specially allocate tax-exempt income to partners that want to sell their distributive share of the tax credits enabling a one-to-one match of cash and tax-exempt income.

Recapture

- Transferees are subject to recapture risk from the disposition or cessation of use of investment credit property (i.e., property eligible for a tax credit listed under Section 46 of the Code) at the transferor level (excluding recapture resulting from a disposition by partners in the transferor) or leakage from carbon sequestration during specified time periods, with the transferor required to provide notice of the recapture event to the transferee. A disposition of investment credit property by partners in the transferor may result in a recapture at the partner level.

Procedural and Timing Rules

- Prior to transferring credits, an eligible taxpayer must complete a pre-filing registration process electronically through an IRS electronic portal. Transferors must make a separate election with respect to each applicable property that is eligible to

claim the tax credits. There is no late-election relief available. A transfer election with respect to a specified credit portion is irrevocable.

- The transfer election must be made by the due date of the tax return for the taxable year in which the credit was determined.

Bonus Credit Amounts

- Bonus credit amounts (i.e., domestic content and energy community additions to the base credit, if certain requirements are met) cannot be transferred separately from the base credit. The base credit and bonus credit must be transferred proportionately to a transferee.

Excessive Payment Penalty

- If the IRS determines that a transfer election results in a transfer of credits in excess of the amount of credits that would be allowed to the relevant transferor, the IRS will impose a penalty equal to twenty percent of the excessive transfer amount, unless there is reasonable cause for the excessive transfer.

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