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IRS AND TREASURY ISSUE PROPOSED REGULATIONS PROVIDING INITIAL GUIDANCE ON DIRECT PAYMENTS FOR CLEAN ENERGY CREDITS

To Our Clients and Friends:

On June 21, 2023, the IRS and Treasury published proposed Treasury regulations (the "Proposed Regulations") that provide eagerly awaited guidance on rules for receiving refund payments in respect of certain credits (more commonly referred to as "direct pay") under the Inflation Reduction Act of 2022 (the "IRA").[1] Taxpayers are permitted to rely on the Proposed Regulations until final regulations are published. The IRS and Treasury also released a temporary regulation (the "Temporary Regulation") that implements a registration system that taxpayers will need to satisfy before any valid direct pay election can be made. (This system is substantially similar to the system that facilitates cash sales of certain credits. We discussed that system in our previous alert, which can be found here.)

This alert begins with some background regarding section 6417 (the statutory provision permitting direct pay) and provides a short summary of some of the most important aspects of the Proposed Regulations and Temporary Regulation,[2] including some observations regarding key implications of the guidance for market participants.

Background

Historically, federal income tax credits associated with the investment in and production of clean energy and carbon capture technologies have been non-refundable,[3] and using non-refundable tax credits has required current tax liability against which the credits could be applied. In our recent client alert on the rules facilitating cash sales of certain credits, we provided background regarding the complicated tax equity arrangements that have been utilized by developers to monetize credits and explained how new rules authorizing the sale of credits could simplify monetization. The "direct pay" rules are expected to serve a similar, albeit more limited, role in reducing the need for complicated tax equity arrangements.

Direct Payment of Credits

The Proposed Regulations and Temporary Regulation provide substantial practical guidance on direct payment of credits, clarifying who may receive direct payments, what a direct payment election covers, how to compute the amount of the direct payment, how (administratively) to elect to receive such payments, how to avoid new excessive payment penalties, and how the rules apply to passthrough entities.[4] The subsections below describe some of the most significant aspects of the guidance on these topics.

Who May Receive Direct Payments

In general, any taxpayer can receive refund payments for the following three credits for five years of the applicable credit period:

- the carbon capture and sequestration credit (section 45Q);
- the clean hydrogen production credit (section 45V); and
- the advanced manufacturing production credit (section 45X).

For the section 45Q and section 45V credits, the election is available for the first five years of the applicable credit period and, for section 45X the election, is available for any consecutive five-year period for which the credit is available, in each case, only for taxable periods that end before January 1, 2033. The Proposed Regulations clarify that, for these three credits, taxpayers are allowed refund payments for only a single five-year period and cannot re-elect to receive refund payments again once the five-year period has expired or the election has been revoked.

Notably, several types of tax-exempt entities are entitled to direct payments for the three credits above for the entire applicable credit period, as well as for eight other energy-related credits (including the production tax credit under section 45 and the investment tax credit under section 48).[5] In response to significant comments from taxpayers, the Proposed Regulations clarify that applicable tax-exempt entities that can receive direct payments include the District of Columbia and agencies and instrumentalities of states, Indian tribal governments, and Alaska Native Corporations.

The Proposed Regulations also clarify that direct payments cannot be received for purchased credits.

Like the rules for cash sales of credits, the Proposed Regulations confirm that, where a disregarded entity owns the property that generates the tax credit, the relevant taxpayer entitled to pursue a refund under the "direct pay" rules is the regarded owner of the disregarded entity. The Proposed Regulations also impose the same ownership requirement as the credit sale rules, denying direct payment to, for example, contractual counterparties that otherwise are allowed the credits under special rules such as section 45Q(f)(3)(B) (election to allow the section 45Q credit to the party that disposes, utilizes, or uses the qualified carbon oxide) or section 50(d)(5) (election to allow lessees to claim the investment tax credit, *i.e.*, inverted leases).

What is Covered by a Direct Pay Election

Similar to the rules for cash sales of credits, the Proposed Regulations provide that an election to benefit from direct payments generally must be made on a property-by-property basis, with an exception for the investment tax credit, which can be elected on a project-wide basis.

Unlike the credit transfer rules, taxpayers cannot elect direct payment for only a portion of a credit. Moreover, unlike a transfer election, which must be made yearly, a direct pay election would apply for entire applicable five-year window (or, for tax-exempt entities, the entire credit period).

How to Compute Direct Payment Amounts

The amounts otherwise determined as eligible for direct payment are subject to several special computation rules.

- *Reduction for Tax-Exempt Financing*. First, all production tax credits (sections 45 and 45Y) and investment tax credits (sections 48 and 48E) are subject to as much as a 15% reduction if the construction of the facility is financed with certain tax-exempt debt, regardless of whether direct payments are sought.

- *Reduction for Restricted Tax-Exempt Funding*. Second, in response to taxpayer concerns, the Proposed Regulations helpfully clarify that, for purposes of receiving direct payments for investment-related credits (*i.e.*, credits that are computed by reference to the entity's cost basis), exempt income used to fund investments (*e.g.*, certain grants and forgivable loans) in property eligible for credits is generally included in that property's basis for purposes of computing direct payments, regardless of whether those amounts would have been included in basis under general tax principles. However, this taxpayer-favorable rule comes with a significant exception where the grant, forgivable loan, or other exempt funding was made "for the specific purpose" of purchasing, constructing, reconstructing, erecting, or otherwise acquiring an investment-related credit property. In such a case, if the sum of that restricted exempt funding plus the credit exceeds the cost to acquire or construct the property, then the amount of the credit is reduced so the sum of the credit plus the restricted exempt funding equals the cost of the property.[7]

- *Reduction for Failing to Satisfy Domestic Content Requirements*. Finally, for projects beginning construction in 2024 and after, direct payments for the investment tax credit (sections 48 and 48E) and the production tax credit (sections 45 and 45Y) will be subject to reduction (and will be unavailable entirely beginning in 2026) unless the project also incorporates specified percentages of U.S.-source steel, iron and manufactured components (discussed in our previous client alert, available here).[8]

How (Administratively) to Elect Direct Payments

A direct payment election is made on a taxpayer's "annual tax return."[9] For taxpayers that are already required to file an annual tax return, the due date for making a direct pay election is the due date (including extensions) of the taxpayer's original tax return.[10] For entities that are not otherwise required to file tax returns, the due date is generally the fifteenth day of the fifth month after the end of the entity's taxable year (or, until further guidance is issued, six months following that date pursuant to an automatic paperless extension).[11] Certain tax-exempt entities that do not otherwise file tax returns (*e.g.*, governmental entities) will need to file IRS Form 990-T to receive direct payments.

The process and rules for making a direct pay election are substantially similar to those applicable to credit transfers. Those requirements include completing a pre-filing registration process and obtaining a registration number for each eligible credit property with respect to which a direct payment election is made and including the relevant registration numbers on the taxpayers tax return for the year of the election. See a summary of those rules here. Like credit transfers, no direct payment election may be made or revised on an amended return or via a partnership administrative adjustment request, and no late filing relief would be available.

When Direct Payments Are Made

When a direct pay election is made, the credit is treated as a payment made against tax, and therefore the cash payment is not made until after the "annual tax return" is filed and processed.

Taxpayers that are required to file a tax return (such as a partnership that is claiming a direct payment of a section 45Q credit or certain section 501(c)(3) organizations) would become eligible for direct payments on the later of their tax return due date (without extensions) and the date on which the return is filed. Entities that are not required to file a tax return would become eligible for a direct payment on the later of the fifteenth day of the fifth month after the end of the taxable year and the date on which that entity submits a claim for refund.

How to Avoid Excessive Payment Penalties

Rules similar to those under the transferability rules (discussed here) apply for purposes of avoiding excessive payment penalties.

Additionally, some of the credits that are eligible for direct pay (*e.g.*, the investment tax credit) are subject to recapture upon the occurrence of certain events. Recapture will operate the same way as with taxpayers that claim credits on their tax returns, *i.e.*, if the credit property ceases to be eligible credit property within the recapture period, the taxpayer's tax liability for such taxable year will be increased by the recapture amount. Thus, if an applicable entity received a $100,000 direct pay refund in respect of investment tax credit property, and that property is sold 1.5 years after the property was placed in service, the applicable entity's tax liability will be increased by $80,000 for the year in which the property is sold.

How the Rules Apply to Passthrough Entities

The Proposed Regulations provide additional rules with respect to passthrough entities electing to treat a credit as a payment against tax. The preamble clarifies that passthrough entities can only receive direct payments in respect of credits under sections 45Q, 45V, or 45X. This holds true regardless of how many "applicable entities" are partners in a partnership and even if, for example, all of a partnership's partners are tax-exempt entities that would be entitled to direct payments if they owned their interests in the project directly. As a result, tax-exempt entities that hold projects through partnerships will be required to sell credits in many instances.[12]

Consistent with the proposed rules for credit transfers, only a passthrough entity – not the owners of the entity – are permitted to make the direct payment election. Also, the passive activity credit rules do not limit direct payments available to a passthrough entity, even if all of the passthrough entity's owners otherwise would be subject to the passive activity credit rules in their separate capacity. Direct payments made to a passthrough entity are treated as tax-exempt income and each passthrough entity owner's share of the tax exempt income is equal to its distributive share of the otherwise applicable credit for each taxable year.[13]

Observations

The refund timeline may result in a significant lag (up almost two years) between outlays and receipt of direct payments, which may require sponsors to obtain bridge financing.

The rules for passthrough entities are particularly counter-intuitive because they introduce enormous pitfalls (and sanction planning) in a manner that would otherwise be anathema to the U.S. system of partnership taxation – namely, under these rules, simply interposing a partnership for tax purposes, where there are otherwise no changes to the parties' economic arrangement, can dramatically alter consequences for direct payments. While these rules will facilitate investments by individuals otherwise subject to the passive activity credit rules, the rules may well discourage investment by tax-exempt entities, which will need to be especially careful to avoid creating unintended tax partnerships with their financial counterparties. In the case of certain credits (*e.g.*, the investment tax credit under sections 48 and 48E), the stakes will be even higher because the IRS has left in place rules that can render partnership projects funded by tax-exempt partners wholly ineligible for such credits, notwithstanding that such tax-exempt partners are effectively treated as taxpayers for all other purposes relevant to such credits.

Effective Date

Taxpayers may rely on these Proposed Regulations for taxable years beginning after December 31, 2022 and before the date the final regulations are published. The Temporary Regulation (*i.e.*, the pre-filing registration regime) is effective for any taxable year ending on or after June 21, 2023.

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[1] As was the case with the so-called Tax Cuts and Jobs Act, the Senate's reconciliation rules prevented Senators from changing the Act's name, and the formal name of the IRA is actually "An Act to provide for reconciliation pursuant to title II of S. Con. Res. 14."

[2] Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" or "Prop. Treas. Reg. §" references are to the Treasury regulations or proposed Treasury regulations, respectively, published under the Code.

[3] The investment tax credit for energy property was briefly refundable at its inception (1978-1980) and was effectively payable as a cash grant for projects that began construction in 2009-2011.

[4] For the purposes of this client alert, the term "passthrough" or "passthrough entity" means a partnership or an S corporation, unless otherwise noted.

[5] These entities are (i) any tax-exempt organization exempt from the tax imposed by subtitle A (a) by reason of section 501(a) or (b) because such organization is the government of any U.S. territory or a political subdivision thereof, (ii) any State, the District of Columbia, or political subdivision thereof, (iii)

the Tennessee Valley Authority, (iv) an Indian tribal government or subdivision thereof (as defined in section 30D(g)(9)), (v) any Alaska Native Corporation (as defined in section 3 of the Alaska Native Claims Settlement Act (43 U.S.C. 1602(m)), (vi) any corporation operating on a cooperative basis which is engaged in furnishing electric energy to persons in rural areas, or (vii) any agency or instrumentality of any applicable entity described in (i)(b), (ii), or (iv).

[6] These credits include the alternative fuel vehicle refueling property credit (section 30C), the qualified commercial clean vehicle credit (section 45W), the qualifying advanced energy project credit (section 48C), and the investment tax credit (section 48 and 48E).

[7] For example, if a public charity uses $20,000 of its own funds plus a $60,000 tax-exempt grant that it received "for the specific purpose" of building solar energy property, and the energy property would otherwise be entitled to a 50% investment tax credit ($40,000) under the general direct payment rules, the investment tax credit is reduced to $20,000 under this special rule for restricted exempt funding.

[8] Under these rules, a 10-percent haircut applies to projects beginning construction in 2024, a 15-percent haircut applies to projects beginning construction in 2025, and projects beginning construction in 2026 and after are wholly ineligible for refunds, in each case, unless the IRS makes an exception to the applicable domestic content requirements. The IRA authorizes the IRS to provide exceptions to the phaseout if (i) the inclusion of steel, iron, or manufactured products that are produced in the United States either increases the overall costs of construction of projects by more than 25 percent or (ii) there are either insufficient materials of these types produced in the United States or the materials produced in the United States are not of satisfactory quality.

[9] "Annual tax return" is defined in the Proposed Regulations to mean (i) for any taxpayer normally required to file an annual tax return with the IRS, such annual tax return (*e.g.*, IRS Form 1065 for partnerships or IRS Form 990-T for organizations with unrelated business income tax), (ii) for any taxpayer not normally required to file an annual tax return with the IRS (such as taxpayers located in U.S. territories), the return such taxpayer would be required to file if they were located in the U.S., or, if no such return is required (such as for governmental entities), IRS Form 990-T, and (iii) for short tax year filers, the short year tax return.

[10] This date cannot be earlier than February 13, 2023.

[11] For entities located outside the United States, the due date generally is the due date (including extensions) that would apply if the entity were located in the United States.

[12] As noted, passthrough entities can still receive direct payments for credits under sections 45Q, 45V, or 45X.

[13] The Proposed Regulations would also modify the partnership audit rules to specify that direct payments for credits are subject to the partnership audit regime.

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