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Transferability of Credits: Proposed and Temporary Regulations

Tax Alert

Overview

The Inflation Reduction Act of 2022 (P.L. 117-169) (IRA) added a novel "transferable credit" provision, section 6418, to the Code. Section 6418 provides that "eligible taxpayers" may elect to transfer (i.e., sell) certain credits to unrelated taxpayers rather than using the credits against their federal income tax liabilities. On June 14, 2023, the IRS and Treasury released proposed regulations (REG-101610-23) under section 6418 (the "Proposed Regulations"). In addition, the IRS and Treasury issued temporary regulations (T.D. 9975) setting forth mandatory information and registration requirements for transfer elections (the "Temporary Regulations"). The Proposed Regulations would generally apply to taxable years ending on or after the date the final regulations are published in the Federal Register. Taxpayers and other entities may rely on the Proposed Regulations for taxable years beginning after December 31, 2022, and before the date final regulations are published in the Federal Register, provided the Proposed Regulations are followed in their entirety and in a consistent manner. The Temporary Regulations apply to taxable years ending on or after the date they are published in the Federal Register. An IRS FAQ further explaining the Proposed Regulations and Temporary Regulations was also released. The Proposed Regulations and Temporary Regulations are scheduled to be published in the Federal Register on June 21, 2023.

Description of Provisions

The Proposed Regulations are divided into five sections:

- Prop. Treas. Reg. § 1.6418-1 generally provides that an eligible taxpayer may elect to transfer all or a portion of an eligible credit (determined with respect to any eligible credit property of such eligible taxpayer). The remainder of Prop. Treas. Reg. § 1.6418-1 provides definitions for terms used throughout the Proposed Regulations.
- Prop. Treas. Reg. § 1.6418-2 describes the general requirements for making a transfer election.
- Prop. Treas. Reg. § 1.6418-3 provides special rules with respect to transfer elections made by partnerships or S corporations.

- Prop. Treas. Reg. § 1.6418-4 provides pre-filing registration requirements and other information required to make an effective transfer election.
- Prop. Treas. Reg. § 1.6418-5 provides special rules relating to excessive credit transfer penalties, basis reductions, required notifications, recapture determinations with respect to transferred credits, and rules regarding carrybacks and carryforwards.

In addition, the Temporary Regulations set out in more detail and implement the pre-registration process described in Prop. Treas. Reg. § 1.6418-4.

Who Can Sell Credits?

A transfer election must be made by an "eligible taxpayer," which is a taxpayer that is not an "applicable entity" for purposes of making a direct pay election under section 6417. Generally, an eligible taxpayer will be any taxpayer that is not tax-exempt. Partnerships and S corporations are eligible taxpayers, without regard to whether their partners or shareholders are themselves eligible entities.

If an eligible taxpayer (including a partnership or S corporation) makes an election to claim direct payments under section 6417 for a section 45Q credit, section 45V credit, or section 45X credit (an "electing taxpayer"), the eligible taxpayer is deemed to be an applicable entity with respect to that credit and, as a result, is not considered an eligible taxpayer with respect to that credit during the period they have elected be treated as an applicable entity and receive direct payments.

Who Can Purchase Credits?

Eligible taxpayers can only transfer eligible credits to unrelated parties (within the meaning of section 267(b) or 707(b)(1)) in exchange for consideration "paid in cash." As discussed below, the Proposed Regulations describe in detail the paid-in-cash requirement.

Which Credits Can be Transferred?

Only "eligible credits" can be transferred. Eligible credits include the following:

Eligible Credits	
Section 30C alternative fuel vehicle refueling property credit	Section 45X advanced manufacturing production credit
Section 45 renewable electricity production tax credit	Section 45Y electricity production credit
Section 45Q carbon oxide sequestration credit	Section 45Z clean fuel production credit
Section 45U zero-emission nuclear power production credit	Section 48 energy investment tax credit
Section 45V clean hydrogen production credit	Section 48C qualifying advanced energy project credit
	Section 48E clean electricity investment credit

Each transfer election is made on a property-by-property or facility-by-facility basis except in the case of energy property described in section 48, where the eligible taxpayer may choose to make the transfer election with respect to an energy project. An eligible taxpayer may also elect to transfer specified portions of an eligible credit to multiple transferees, but the same credit cannot be sold to different parties or double-counted in any way.

Any credit with respect to which a transfer election is made must have been determined with respect to the eligible taxpayer. That is, an eligible taxpayer who does not directly determine the eligible credit by owning the underlying eligible credit property or conducting activities giving rise to the underlying

eligible credit (e.g., a section 45Q credit or section 48 credit allowable to an eligible taxpayer because of an election made under section 45Q(f)(3)(B), or section 50(d)(5) and Treas. Reg. § 1.48-4, respectively) is ineligible for the transfer election with respect to that eligible credit. In addition, once transferred, credits cannot be transferred again (no second transfer rule). Market participants may not use dealers to facilitate transfers, as dealer arrangements generally violate the no second transfer rule. Market participants may, however, use brokers to facilitate transactions so long as the federal income tax ownership of the credit does not pass to the broker or any taxpayer other than the transferee taxpayer.

How to Elect

A transfer election is made on the electing taxpayer's original return for the taxable year in which the eligible credit is determined but only after a registration number has been obtained pursuant to pre-filing registration requirements (discussed below). This return must be filed not later than the due date (including extensions). The election to transfer cannot be made on an amended return or by filing an administrative adjustment request under section 6227. Additionally, there is no late-election relief available under section 9100. The Proposed Regulations describe the forms required to be filed with the original return as part of the transfer election and the contents of the "transfer election statement," which must be completed and filed by both the transferor and transferee.

No Separating Bonus Amounts from Base Credits

An eligible taxpayer is not permitted to transfer "bonus amounts" related to an eligible credit separately from the "base" credit. Instead, if a portion of an eligible credit is transferred, the portion would include portions of both the "base" credit and any "bonus amount."

Anti-Abuse Rule

The Proposed Regulations provide an anti-abuse rule that would disallow a transfer of an eligible credit where the parties to the transaction have engaged in the transaction or a series of transactions with the principal purpose of avoiding tax liability beyond the intent of section 6418.

Consequences of Election to Transferor

Not Included in Gross Income

The cash consideration received in exchange for the transfer of eligible credits is not included in the eligible taxpayer's gross income.

Rules for Partnerships and S corporations

A transferor partnership or S corporation recognizes tax-exempt income with respect to cash received in exchange for a transferred credit, as of the date the credit is determined for the partnership or S corporation (such as, for investment credit property, the date the property is placed in service). There are no restrictions on how a partnership uses the proceeds of a credit sale, including how it makes distributions to its partners.

The tax-exempt income recognized by a transferor partnership with respect to a credit sale must generally be allocated among the partners based on the partners' distributive shares of otherwise eligible credits (i.e., the amount of credits that would have been allocated to each partner had a transfer election not been made). The Proposed Regulations provide an important elective exception to this general rule, which should allow partnerships the flexibility to sell certain partners' shares of eligible credits and allocate the tax-exempt income from that sale to the "selling" partners, while also allocating any credit

that are retained (i.e., not sold) to the "non-selling" partners. Otherwise stated, if a transferor partnership transfers less than all eligible credits with respect to an eligible credit property, the transferor partnership agreement may specially allocate the tax-exempt income and credits retained among partners, provided the eligible credits allocated to each partner do not exceed that partner's distributive share of eligible credits determined as if no transfer election was made. A partnership that is a partner of the transferor partnership (i.e., an upper-tier partnership) is not eligible for this special allocation rule. In addition, any tax-exempt income received by a transferor partnership or S corporation is not treated as passive income to any partners or shareholders and instead as arising from an investment activity.

The amount of eligible credit determined with respect to investment credit property held directly by a transferor partnership or S corporation is determined by the transferor partnership or S corporation by taking into account the section 49 at-risk rules at the partner or shareholder level. Therefore, if the credit base of the investment credit property is limited to a partner or shareholder by section 49, then the amount of the eligible credit determined by the transferor partnership or S corporation is also limited.

If a partnership makes a transfer election with respect to an investment tax credit, a partner in the transferor partnership is subject to generally applicable recapture rules (sections 49(b) and 50(a)); however, importantly, the Proposed Regulations provide that for purposes of section 6418 only, a disposition of a partner's or S corporation shareholder's interest in a partnership or S corporation, which generally can cause recapture, will not be treated as a recapture event with respect to any transferred credits. Accordingly, if such dispositions occur, the transferor partnership or S corporation is under no obligation to inform the transferee taxpayer (because such disposition cannot affect the transferred credit). If a disposition of a partner's or shareholder's interest triggers a recapture event, the consequences of the recapture are imposed only upon the partner or S corporation shareholder (and not upon the transferee taxpayer).

Consequences of Election to Transferee

When Transferred Credit is Available

Transferee taxpayers account for the credits they purchase in the first taxable year ending with or after the taxable year of the eligible taxpayer with respect to which the transferred credit is determined. For example, if a transferee taxpayer with a June 30 taxable year-end purchases credits determined in 2024 from a calendar-year eligible taxpayer, the transferee taxpayer will account for the purchased credits on its federal tax return ending June 30, 2025. A transferee taxpayer may account for credits it has purchased or intends to purchase when calculating its estimated tax payments. A transferee taxpayer may also carry back purchased credits for up to three years.

Paid-in-Cash Requirement

Amounts transferred to the eligible taxpayer in consideration for eligible credits must be "paid in cash" during a window of time related to when the credit is determined with respect to the eligible taxpayer. The Proposed Regulations provides that "paid in cash" means payment in United States dollars and contemplates payments by cash or similar methods of transferring immediately available funds. Payments must be made no earlier than the first day of the eligible taxpayer's taxable year during which the credit is determined and no later than the due date for completing a transfer election statement (as detailed within the section 6418 regulations). A contractual commitment to purchase eligible credits in advance is allowed, so long as the cash payments are made during the relevant time period.

Additionally, the Proposed Regulations make clear that transferee taxpayers do not recognize gross income attributable to the difference between the amount transferee taxpayers pay for credits and the amount of credits transferred to and claimed by the transferee taxpayer.

Transferred Credits Subject to Passive Activity Rules

The Proposed Regulations provide that a transferee taxpayer subject to section 469 would be required to treat the eligible credits as passive activity credits (as defined in section 469(d)(2)) to the extent the portion exceeds passive tax liability. No grouping would be allowed to recharacterize the taxpayer's participation. In effect, this proposed rule will significantly decrease the potential for individuals to purchase credits under section 6418.

Recapture

Certain eligible credits (e.g., the energy credit under section 48, qualifying advanced energy project credit under section 48C, the clean electricity investment credit under section 48E (collectively, "the investment credit"), and the credit for carbon oxide sequestration under section 45Q(a)) are subject to potential recapture. Under the Proposed Regulations, a recapture event triggers reciprocal notice requirements as between the eligible taxpayer and the transferee taxpayer. The eligible taxpayer must notify the transferee taxpayer of the recapture event and provide the information necessary for the transferee taxpayer to calculate the recapture amount. The transferee taxpayer must then provide notice to the eligible taxpayer of the recapture amount in order for the eligible taxpayer to calculate any basis adjustments determined with respect to the investment credit property as relating to the recapture amount.

Effect of Recapture on the Transferee Taxpayer

If a recapture event occurs, the transferee taxpayer loses all or a portion of the benefit of the transferred credit and must adjust its federal tax liability upwards to reflect the recaptured portion of the transferred credit.

The Proposed Regulations do not address the contractual remedies, insurance arrangements, or other ways in which transferee taxpayers are expected to protect themselves against the risk posed by potential recapture; however, the Proposed Regulations do provide that the reciprocal recapture notice requirements can be elaborated by contract, provided that the contractual arrangement does not conflict with the notice requirements set out in the Proposed Regulations.

Effect of Recapture on the Transferor Eligible Taxpayer

After informing the transferee taxpayer of the recapture event and receiving notice of the recapture amount, the eligible taxpayer increases the adjusted tax basis of any investment credit property in accordance with section 50.

Pre-Filing Registration Required

An effective transfer election requires obtaining a registration number, on a property-by-property, facility-by-facility, or energy project basis, prior to completing the transfer election statement, which enables a transferee taxpayer to claim the benefit of the transferred credit. Registration numbers can only be obtained through an electronic portal to be maintained by the Service (but which is not yet publicly accessible). The Temporary Regulations set out in some detail the pre-registration process; however, many important elements of the pre-registration process will likely be clarified only after the electronic portal is made available to the public. Registration is required on a per-member basis for members of consolidated groups. Registration generally requires providing certain information about the electing taxpayer and relevant eligible property, including name, TIN or EIN, type of entity, taxable year, the

credit(s) being elected, and location and type of credit property. Registration numbers are valid only for one taxable year. A transferee taxpayer is also required to report the registration number received from an eligible taxpayer on its return for the taxable year that the transferee taxpayer takes the transferred eligible credit into account.

Excessive Credit Transfer Penalties

Credit transfers under section 6418 are potentially subject to a 20% penalty on the amount of an "excessive credit transfer." Excessive credit transfers are defined as the excess of the transferred credit claimed by the transferee taxpayer over the amount of the eligible credit that would otherwise be allowable under the Code. In the event of an excessive credit transfer, the transferee taxpayer not only loses the financial benefit of the excessive credit transfer amount, but also must pay a penalty equal to 20% of the excessive credit transfer amount unless the transferee taxpayer can show the excessive credit transfer resulted from reasonable cause. The Proposed Regulations provide that credit recapture is not treated as an excessive credit transfer. The Proposed Regulations also list non-exhaustive factors for determining the existence of reasonable cause.

Circumstances that may indicate reasonable cause include: (1) review of the eligible taxpayer's records with respect to the determination of the eligible credit (including documentation evidencing eligibility for bonus credit amounts), (2) reasonable reliance on third party expert reports, (3) reasonable reliance on representations from the eligible taxpayer that the total specified credit portion transferred does not exceed the total eligible credit determined with respect to the eligible credit property for the taxable year, and (4) review of audited financial statements provided to the Securities and Exchange Commission, if applicable.

Lastly, the Proposed Regulations treat multiple transferees as one for purposes of calculating whether there was an excessive credit transfer and the amount of any such excess credit transfer penalty. That means each transferee taxpayer shares proportionally with respect to the risk that the IRS may impose a penalty based on a redetermination of the eligible credit amount, but only to the extent of each transferee taxpayer's share of the transferred credit.

Request for Comments

The IRS and Treasury request comments in many areas with respect to section 6418. Comments are due by August 14, 2023.