



## Direct Pay Election: Proposed and Temporary Regulations Tax Alert

### Overview

The Inflation Reduction Act of 2022 ([P.L. 117-169](#)) (IRA) added a novel “direct pay” provision, section 6417, to the Code. Section 6417 provides that “applicable entities” (or “electing taxpayers” for credits provided in sections 45V, 45Q, or 45X) may elect to treat certain credits (“applicable credits”) as a direct payment made against their federal income tax liabilities, thereby allowing such entities a federal tax refund of the amount of the direct payment in excess of any tax liability (the “direct-payment election”). On June 14, 2023, the IRS and Treasury released proposed regulations ([REG-101607-23](#)) under section 6417 (the “Proposed Regulations”). In addition, the IRS and Treasury issued temporary regulations ([T.D. 9975](#)) setting forth mandatory information and registration requirements for direct-payment 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 elective payments after December 31, 2022, in taxable years ending 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 six sections:

- Prop. Treas. Reg. § 1.6417-1 defines important terms for purposes of the statute and regulations, including, but not limited to, applicable credit, applicable entity and electing taxpayer.
- Prop. Treas. Reg. § 1.6417-2 provides rules and procedures for how to make a direct-payment election, rules for determining the amount and timing of the payments, and rules denying double benefits.

- Prop. Treas. Reg. § 1.6417-3 contains rules and procedures for direct payment elections made for credits provided in section 45V (clean hydrogen production credit), section 45Q (carbon oxide sequestration credit), and section 45X (advanced manufacturing production credit), by electing taxpayers (i.e., taxpayers that are not applicable entities).
- Prop. Treas. Reg. § 1.6417-4 provides rules for direct-payment elections made by electing taxpayers which are partnerships or S corporations with respect to section 45V, 45Q, or 45X credits.
- Prop. Treas. Reg. § 1.6417-5 provides pre-filing registration requirements and other information required to make a direct-payment election effective.
- Prop. Treas. Reg. § 1.6417-6 provides rules relating to excessive payment penalties, basis adjustments, partnerships electing out of Subchapter K and credit recapture.

In addition, the Temporary Regulations set out in more detail and implement the pre-registration process described in Prop. Treas. Reg. § 1.6417-5.

## Who Can Get a Direct Payment?

Generally, a direct-payment election may be made by any applicable entity. The Proposed Regulations provide that an “applicable entity” includes, but is not limited to, section 501(a) tax-exempt organizations, governments of any U.S. territory, State, the District of Columbia, Indian tribal governments, or any political subdivision, agency or instrumentality thereof. Agencies and instrumentalities of the United States are not defined as applicable entities. The Proposed Regulations also provide that nonprofits under State law that do not have federal tax-exempt status are not applicable entities.

Partnerships and S corporations are not “applicable entities,” even if some or all of their owners are applicable entities. Furthermore, applicable entities that are partners of partnerships or shareholders of S corporations may not make a direct-payment election with respect to property generating an applicable credit (“applicable credit property”) that is owned by the partnership or S corporation. In contrast, applicable entities owning or deemed to own interests in the applicable credit property through (i) a disregarded entity, (ii) a tenancy-in-common arrangement, or (iii) an organization which properly elected out of the partnership tax rules under section 761, may make a direct-payment election with respect to the applicable credit property or their share of the applicable credit property.

In addition, the Proposed Regulations clarify how the special rule for direct payments attributable to investments in clean hydrogen, carbon sequestration, and advanced manufacturing will apply. For production tax credits (a “PTC”) under section 45V (clean hydrogen), 45Q (carbon oxide sequestration) and 45X (advanced manufacturing), a taxpayer *other than an applicable entity* may elect to receive direct payments during 5-year periods. Such taxpayers (“electing taxpayers”) are deemed for those periods of time to be applicable entities and qualify to receive direct payments. Partnerships and S corporations may be electing taxpayers. If a partnership or S corporation elects to receive direct payments for credits under sections 45V, 45Q, or 45X, it makes the election and receives the direct payments (and not the partners or S corporation shareholders).

## Which Credits Are Eligible for Direct Payments?

Only “applicable credits” are eligible for direct payments. Applicable credits include the following:

Applicable Credits	
Section 30C alternative fuel vehicle refueling property credit	Section 45X advanced manufacturing production credit
Section 45 renewable electricity production tax for qualified facilities originally placed in service after December 31, 2022	Section 45Y electricity production credit
Section 45Q carbon oxide sequestration credit for carbon capture equipment originally placed in service after December 31, 2022	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 for qualified facilities originally placed in service after December 31, 2012	Section 48C qualifying advanced energy project credit
Section 45W qualified commercial vehicles (tax-exempt entity)	Section 48E clean electricity investment credit

Each direct-payment election is made for an applicable credit property, which is a property-by-property or facility-by-facility election except in the case of energy property described in section 48, where the applicable entity may choose to make the direct-payment election with respect to an energy project. An applicable credit cannot be partially retained and partially elected for a direct payment. Except for credits under section 45V (clean hydrogen production credit), 45Q (carbon oxide sequestration credit), and 45X (advanced manufacturing production credit), any election once made is irrevocable and remains in effect for the entirety of the applicable tax credit period (10-year or 12-year PTC period).

The Proposed Regulations provide that any credit with respect to which a direct-payment election is made must have been determined with respect to the applicable entity or electing taxpayer. That is, an applicable entity or electing taxpayer who does not directly determine the applicable credit by owning the underlying eligible credit property or conducting activities giving rise to the underlying applicable credit (e.g., a section 45Q credit allowable to a taxpayer as the result of an election under section 45Q(f)(3)(B), or section 48 credit allowable to an applicable entity or taxpayer because of an election under section 50(d)(5) and Treas. Reg. § 1.48-4) is ineligible for the direct-payment election with respect to that applicable credit. In addition, the Proposed Regulations provide that no direct-payment election may be made for any credits purchased pursuant to section 6418.

With respect to applicable entities, the amount of any applicable credit is determined without regard to certain governmental and tax-exempt use restrictions under sections 50(b)(3) and (b)(4)(A)(i) and by treating any property as used in a trade or business of the applicable entity. This rule allows applicable entities to take advantage of applicable credits outside of the unrelated business taxable income context, apply the capitalization and depreciation rules, and subject general limitations on the use of credits, such as sections 49 (at-risk) and 469 (passive activity) to certain taxpayers subject to these rules. The preamble also states that the rules do not create any presumption that the trade or business is related or unrelated to an exempt organization's exempt purpose.

Subject to a limited exception, the Proposed Regulations provide that certain income exempt from federal income tax, including certain grants and forgivable loans used to purchase, construct, reconstruct, erect, or otherwise acquire investment-related credit property (i.e., applicable credit property described in sections 30C, 45W, 48, 48C or 48E), is generally included in the basis for purposes of computing the applicable credit amount. However, if such income is received for the specific purpose of purchasing, constructing,



reconstructing, erecting, or otherwise acquiring investment-related credit property, the applicable credit amount is reduced to the extent the income exempt from federal income tax plus the applicable credit exceeds the cost of the investment-related credit property.

## How to Elect

A direct-payment election is made on the applicable entity or electing taxpayer's original return for the taxable year in which the applicable 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). For entities not required to file income tax returns, the direct-payment election must be made by the 15<sup>th</sup> day of the fifth month after the entity's taxable year unless an additional six-month extension of time is granted pursuant to additional guidance that has not yet been published. The direct-payment election cannot be made on an amended return or by filing an administrative adjustment request under section 6227. There is no late-election relief available under section 9100.

## Consequences of Election

An applicable entity that makes a direct-payment election is treated as making a payment against its federal income tax liability on the later of the date the entity's federal income tax return is due (without regard to extensions) or the date on which it files its return. In the case of an entity that is not required to file income tax returns, the payment is deemed to be made on the date its tax return would have been due if it were required to file a return.

Subject to limited exceptions, a direct-payment election once made by an applicable entity is irrevocable and applies with respect to any applicable credit for the taxable year in which the election is made. For electing taxpayers, a direct-payment election may be revoked once per applicable credit property but generally applies for one five-year period per applicable credit property. Further, no transfer election under section 6418(a) may be made by an electing taxpayer, during the election period for that applicable credit property.

### Rules for Partnerships and S corporations

The Proposed Regulations provide that if a partnership or S corporation makes an effective direct-payment election, the Service will make a payment to the partnership or S corporation. That payment would be treated as tax-exempt income for the partnership or S corporation for purposes of sections 705 and 1366. A partner's distributive share of tax-exempt income with respect to the direct payment is equal to the partner's distributive share of the otherwise applicable credit (i.e., how the applicable credit would be allocated to the partner if no direct-payment election were made). This rule also applies to an upper-tier partnership that is a direct or indirect partner of the partnership making the direct-payment election. Similarly, an S corporation shareholder's pro rata share of tax-exempt income with respect to the direct payment is equal to the shareholder's pro rata share (determined on a per-day, pro rata basis under section 1377(a)) of the otherwise applicable credit. Tax-exempt income resulting from a direct-payment election made by a partnership or S corporation is not treated as passive income to any partners or shareholders, who do not materially participate. In addition, the applicable credit amount determined in the hands of the partnership or S corporation is not subject to the limitations of sections 38(b), 38(c), and 469 (because these limitations typically apply at the partner or shareholder level), nor the limitations described in sections 49 and 50 (because partnerships and S corporations

cannot make elective payment for investment credits subject to these limitations).

## Pre-Filing Registration Required

An effective direct-payment election requires obtaining a registration number, on a property-by-property, facility-by-facility, or energy project basis, prior to completing the direct-payment election, and reporting that registration number on the applicable entity or electing taxpayer's annual tax return. 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 entity and relevant applicable credit property, including name, TIN or EIN, type of entity, applicable entity or electing taxpayer's taxable year, the credit(s) being elected, and location and type of applicable credit property. Registration numbers are valid only for one taxable year. Therefore, the applicable entity or electing taxpayer must renew the registration for a subsequent taxable year.

## Excessive Payment Penalties

Direct Payments under section 6417 are potentially subject to a 20% penalty on the amount of an "excessive payment." Excessive payments are defined as the amount of direct payment over the amount of applicable credit that would otherwise be allowable under the Code (without regard to the general business credit limitation under section 38(c)). In the event of an excessive payment, the applicable entity or electing taxpayer not only loses the financial benefit of the excessive payment, but must pay a penalty equal to 20% of excessive payment, unless the applicable entity or electing taxpayer can show the excessive payment resulted from reasonable cause. The Proposed Regulations provide that credit recapture is not treated as an excessive payment.

## Request for Comments

The IRS and Treasury request comments in many areas with respect to section 6417. Comments are due by August 14, 2023.



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