SULLIVAN & CROMWELL LLP

Energy Transition
INSIGHTS

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Final Regulations Issued for Clean Energy Tax Credit Transfers

The Inflation Reduction Act of 2022 (the "IRA") introduced a wide range of new and enhanced tax credits across clean energy sectors and created new ways for taxpayers to monetize these credits. In particular, taxpayers can generally elect to "transfer," or sell, all or a portion of tax credits to unrelated parties for cash (a "transfer election").

On April 25, 2024, the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS") released final regulations regarding the transfer of tax credits. The final regulations largely adopt and clarify the proposed regulations that were issued in June 2023 (see S&C Energy Transition Insights memo for more details on the proposed regulations). The final regulations become effective on July 1, 2024.

A. GENERAL RULES AND DEFINITIONS

***Eligible Taxpayer*.** Only an "eligible taxpayer" (generally, any person that is not eligible to make a direct pay election) may elect to transfer its credits to another taxpayer.[1] In the case of a partnership, an election to transfer its credits must be made at the partnership level,[2] and therefore there was a question as to how a transfer election would work when a partnership has partners that are eligible for direct pay (e.g., government entities). The preamble clarifies that a partnership owned by such entities is an eligible taxpayer that can make a transfer election so long as the partnership has not made a direct pay election with respect to the carbon oxide sequestration (Section 45Q), clean hydrogen (Section 45V), or advanced manufacturing production (Section 45X) credit.[3] Also, a partnership with one or more direct pay partners is entitled to transfer the entirety of the eligible credits.[4]

***Paid in Cash*.** Tax credits must be purchased for cash.[5] The transferee taxpayer must make cash payments during the period beginning on the first day of the taxable year of the transferor taxpayer in which the credit is determined and ending on the due date of the filing of the transfer election (i.e., the due date for the

transferor taxpayer's federal income tax return, including extensions).[6] While parties may contractually agree on the sale of credits in advance of the time at which such credits are generated,[7] the final regulations do not allow advanced payments to be made outside of the window provided. However, the preamble notes that there is no prohibition on loans from a transferee taxpayer or a third-party lender to a transferor taxpayer, including loans secured by a purchase and sale agreement for eligible credits, provided that such loans are at arm's length and treated as loans for federal income tax purposes.

Specified Credit Portion. The final regulations provide, consistent with the proposed regulations, that the transfer election applies to both the applicable credit and any eligible bonus credit amounts.[8] Therefore, in the case of a partial sale of eligible credits, the transferor taxpayer must transfer a portion of the entire eligible credit, which would include a proportionate amount of any bonus credit amounts (i.e., a "vertical" slice of the credit). "Severing" bonus credit amounts from the base eligible credit and transferring any bonus credit amount or base eligible credit amount separately is not permitted.

Treatment of Payments Made in Connection with a Transfer Election. Payments received by the transferor taxpayer are not included in their gross income, nor are they deductible by the transferee taxpayer.[9] The final regulations do not provide guidance on the treatment of transaction costs (such as legal and consulting fees, success-based fees, tax insurance and indemnity payments) incurred by transferor and transferee taxpayers in connection with credit transfers, but the preamble states that Treasury and the IRS anticipate issuing further guidance regarding transaction costs.

Passive Activity Loss Rules. Consistent with the proposed regulations, the final regulations do not provide a carve-out for the passive activity loss rules of Section 469 (which generally limit an individual taxpayer's ability to utilize general business credits under Section 38).[10] In other words, taxpayers are still subject to the passive activity loss rules, and if an individual transferee taxpayer does not materially participate in the activity that generated the transferred tax credit, then such transferred credit will be treated as arising in connection with a passive activity and disallowed.

B. PROCEDURE FOR MAKING TRANSFER ELECTIONS

Manner and Due Date for Making a Transfer Election. Consistent with the proposed regulations, the transferor taxpayer must make the transfer election on the original tax return for the taxable year for which the credit is determined, and the election cannot be made on an amended return or by filing an administrative adjustment request ("AAR").[11] However, the final regulations allow a transfer election to be made or revised on an original return that is a superseding return (i.e., a return filed after filing an original return but before the due date of filing such return).[12] The final regulations further confirm that a transfer election cannot be made for the first time on an amended return, withdrawn on an amended return, or made or withdrawn by filing an AAR.[13]

Corrections to numerical errors on an amended return or AAR are permitted so long as the change is to a substantive item that was on the original return.[14] To the extent a correction results in an increase in the amount of the eligible credit, such amount must be reflected in the amended return or AAR.[15] If there is any decrease in the amount of the eligible credit, it will first reduce the amount of eligible credit retained by the transferor taxpayer, if any, and then reduce the amount reported to the transferee taxpayer, which may result in an "excessive credit transfer" (as discussed more below) and resulting tax liability to the transferee taxpayer.[16] The final regulations do not provide a separate rule for reporting or notification in the event of an adjustment that occurs after a transfer election is filed, and the preamble notes that the transferor taxpayer and the transferee taxpayer may freely contract for such a requirement while acknowledging that such adjustment may impact the tax liability of a transferee taxpayer.

Transfer Election Statement. In order to make a valid transfer election, each of the transferor and transferee taxpayer must attach a "transfer election statement" to their return.[17] The final regulations do not require a specific form, but provide a list of the information required to be included on a transfer election statement.[18] The preamble discusses that a written partnership agreement, for example, can serve as a transfer election statement if it contains the required information.

No Second Transfer. Under Section 6418, an eligible credit may only be transferred once pursuant to a transfer election, and the transferee taxpayer cannot elect to resell or further transfer the tax credit to another party.[19] The preamble to the proposed regulations previously provided that dealer arrangements (i.e., any arrangement where the tax ownership of a credit portion transfers first from a transferor taxpayer to a dealer or intermediary and then, ultimately, to a transferee taxpayer) were in violation of this "no second transfer" rule; however, an arrangement using a broker to match transferor taxpayers and transferee taxpayers would not violate the "no second transfer" rule, assuming the arrangement at no point transfers the tax ownership of the credit to the broker or any taxpayer other than the transferee taxpayer. The final regulations do not deviate from the proposed regulations in this regard.

C. RISKS ASSOCIATED WITH TRANSFER ELECTIONS

Anti-abuse Rule. The proposed regulations included an anti-abuse provision that disallowed a credit where the parties engaged in a transfer election with *the* principal purpose of avoiding tax liability beyond the intent of the transferability rules. The final regulations clarify that the credit is disallowed where the parties engage in a transfer with "a" principal purpose (rather than "the" principal purpose) of avoiding tax liability.[20]

Excessive Credit Transfer. If it is determined that there has been an "excessive credit transfer" (meaning the amount of credit claimed by the transferee taxpayer is greater than what was available for the transferor taxpayer), the transferee taxpayer is subject to a penalty in the amount of 20% of the excessive transfer, unless the transferee taxpayer demonstrates to the satisfaction of the IRS that the excessive credit transfer resulted from reasonable cause.[21] Under the final regulations, if a transferor taxpayer receives a payment in respect of an excessive credit transfer, the amount of such payment is not excluded from the transferor

taxpayer's gross income, nor is it precluded as a deduction to the transferee taxpayer.[22] However, the final regulations do not address the timing and character of any gross income or deduction, or the impact of insurance or indemnity payments, and instead defer to general income tax principles. Moreover, if there are multiple transferee taxpayers, their respective tax credit is reduced on a pro rata basis, subject to the ordering rule that any disallowed credit first reduces the credit retained by the transferor taxpayer before applying to any transferee taxpayer.

Recapture. Unlike excessive credit transfers, recapture generally occurs when the original amount of the Section 48 investment tax credits ("ITCs") that were transferred and reported accurately is later affected by a subsequent event (a "recapture event") resulting in a change to the allowed credit amount.[23] Generally, the ITCs are subject to recapture if (i) the credit property is disposed of, (ii) the property ceases to be eligible property in whole or in part during the five-year period following the date on which the property is originally placed in service, or (iii) a partner in a partnership or shareholder in an S corporation disposes of their interest or has their interest significantly reduced in the partnership or S corporation that owned the credit-generating property.[24] The final regulations adopt the proposed regulations that generally imposed recapture risk primarily on the transferee taxpayer except for a recapture event under (iii) above, in which case which the disposing partner or shareholder is liable for any recaptured amount. In the case that the recapture risk falls on the transferee taxpayer, the final regulations clarify that recapture liability applies proportionately to any transferee taxpayers and the transferor taxpayer to the extent the transferor taxpayer has retained any eligible credits.[25] Moreover, to the extent a partner in a transferor partnership or a shareholder in a transferor S corporation causes a recapture event under (iii) above (i.e., by selling and thereby reducing its interest in such partnership or S corporation during the recapture period), the recaptured amount that is borne by the disposing partner or shareholder reduces the total potential credits that are subject to recapture for any future recapture event for which a transferee taxpayer may be liable.[26]

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ENDNOTES

1 Section 6418(a). Entities permitted to make a "direct pay election" generally include tax-exempt entities, such as tax-exempt organizations, state and local government entities, the Tennessee Valley Authority, Indian Tribal governments, and Alaska Native Corporations. Section 6417(d)(1)(A); Treas. Regs. Section 1.6417-1(c).

2 Section 6418(c).

3 Certain taxpayers, in addition to entities who are permitted to make a "direct pay election," may also elect for direct pay with regard to these credits. Section 6417(d)(1)(B), (C), (D); Treas. Regs. Sections 1.6417-3(b), (c), (d).

4 The preamble also notes, however, that Section 50(b)(3) and (4) (providing that no credit is allowed with respect to any property used by a tax-exempt organization, governmental unit or foreign person) may limit the amount of eligible investment tax credits determined with respect to any tax-exempt or government entity partner.

5 Treas. Regs. Section 1.6418-1(f)(1).

6 Treas. Regs. Section 1.6418-2(b)(4)(i).

7 Treas. Regs. Section 1.6418-1(f)(3).

8 Treas. Regs. Section 1.6418-1(h).

9 Section 6418(b); Treas. Regs. Section 1.6418-2(e)(2), (3).

10 Treas. Regs. Section 1.6418-2(f)(3).

11 Treas. Regs. Section 1.6418-2(b)(4)(i).

12 *Id.* An administrative adjustment request ("AAR") is an amended return used for correcting errors related to partnership-related items as provided by Section 6227.

13 Treas. Regs. Section 1.6418-2(b)(4)(i).

14 *Id.*

15 Treas. Regs. Section 1.6418-2(b)(4)(ii)(B).

16 *Id.*

17 Treas. Regs. Section 1.6418-2(b)(5)(i).

18 Treas. Regs. Section 1.6418-2(b)(5)(ii).

19 Section 6418(e)(2); Treas. Regs. Section 1.6418-2(c)(2).

20 Treas. Regs. Section 1.6418-2(e)(4).

21 Treas. Regs. Section 1.6418-5(a)(4).

22 Treas. Regs. Section 1.6418-5(a)(1), (3).

23 Treas. Regs. Section 1.6418-5(a)(5).

24 Treas. Regs. Section 1.6418-5(d).

25 Treas. Regs. Sections 1.6418-5(d), (e).

26 Treas. Regs. Section 1.6418-5(d).

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