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Top 10 Things to Know: Proposed Regs for Renewable Energy Direct Pay & Direct Transfer

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On Wednesday, June 14, 2023, the Internal Revenue Service (IRS) and U.S. Department of Treasury (Treasury) issued proposed Treasury Regulations on the elective payment of certain tax credits (also known as direct pay) under Section 6417 of the Internal Revenue Code (the Code) and on the transfer of certain tax credits (also known as direct transfer) under Section 6418 of the Code. Both direct pay and direct transfer are generally aimed at bringing additional capital to renewable energy projects by allowing tax credits to be monetized, even if the owners of such projects do not themselves have tax liability to use the credits. The IRS and Treasury also issued temporary regulations on mandatory pre-filing registration requirements for taxpayers electing direct pay or direct transfer, indicating that the online system for registering will be available in the Fall.

Some highlights from the proposed regulations include:

1. **Pre-registration process:** Any taxpayer that intends to elect direct pay or direct transfer must register electronically with, and receive a registration number from, the IRS before making the election on their tax return. It is unclear how much review the IRS will conduct before issuing a registration number (and how much time such review will take).
2. **Original tax return:** Taxpayers must elect direct pay or direct transfer on their original tax return. Elections on amended returns are not permitted. No late relief is permitted.
3. **No “chaining” of tax credits:** Taxpayers cannot elect direct pay with respect to credits that they receive via direct transfer under Section 6418, via a transfer to the sequestering party under Section 45Q, or through investment credit leasing transactions. Similarly, credits transferred through investment credit leasing transactions, and to the sequestering party under Section 45Q, are not eligible to be transferred under Section 6418.
4. **Transferee taxpayers – and taxpayers (other than partnerships and S corporations) electing direct pay for Sections 45Q, 45V and 45X of the Code – are subject to Section 469:** Transferred tax credits are treated as earned in connection with the conduct of a trade or business and, if a transferee taxpayer is subject to them, are subject to the passive activity limitation rules in Section 469 of the Code.
5. **Transferor taxpayers are subject to Section 469:** When

partnerships or S corporations transfer tax credits, the payments received in exchange are tax-exempt income that is treated as investment income to their partners and shareholders, making those payments ineligible for treatment as passive income under Section 469 of the Code.

6. **Transferee taxpayers are subject to recapture:** If any tax credits that are transferred are subsequently subject to recapture by the IRS, the transferee taxpayer will be responsible for making the recapture payments to the IRS (though transferor taxpayers may agree to indemnify transferees for any such recapture). However, this does not apply to recapture resulting from transfers by a partner or shareholder of an interest in a transferor partnership or S corporation.
7. **Recapture does not trigger an “excessive payment”:** Recapture of tax credits will not be treated as causing an “excessive payment” of a direct payment or a transferred credit.
8. **Partnerships and S corporations generally cannot elect direct pay:** Except with respect to tax credits under Sections 45Q, 45V and 45X of the Code (for which there is a special rule allowing all taxpayers to elect direct pay for a period of time), partnerships and S corporations cannot elect direct pay, even if all of their partners and shareholders are tax-exempt or government organizations that would be eligible for direct pay if they owned the credit-generating property directly. However, co-tenancy and arrangements that elect out of tax partnership treatment are eligible.
9. **Agencies and instrumentalities eligible for direct pay:** Agencies and instrumentalities of the States and their political subdivisions, Indian Tribal governments, and U.S. territories and their political subdivisions are eligible for direct pay.
10. **Direct pay and direct transfer available with respect to property owned through a disregarded entity:** Eligible taxpayers that own credit-generating property through one or more entities that are disregarded as separate from the taxpayer for U.S. federal income tax purposes may elect direct pay or direct transfer.

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