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Expert Q&A on the Regulations Governing the Transfer of Clean Energy Tax Credits Under Section 6418 of the Code

by Practical Law Finance

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An Expert Q&A with Carina Federico of Crowell & Moring LLP discussing the final regulations for the transfer of qualifying clean energy credits under Section 6418 of the Internal Revenue Code, which are effective on July 1, 2024. This Expert Q&A addresses key issues, including chaining and the transfer of bonus credits separate from the underlying base credit (horizontal slicing).

On April 25, 2024, the Internal Revenue Service (IRS) and the Department of the Treasury (the Treasury) published final regulations to implement Section 6418 of the Internal Revenue Code, a provision that allows a taxpayer to transfer to unrelated third parties the tax credits and related bonus credits for which certain clean energy projects may qualify (89 Fed. Reg. 34770 (Apr. 30, 2024)). Section 6418 of the Code was established under the Inflation Reduction Act (IRA) (Pub. L. 117-169, 136 Stat. 1818 (2022)) to give project owners another method to monetize these credits, including production tax credits (PTC) and the investment tax credits (ITCs).

Under the IRA, the base credit amount may be increased five-fold if prevailing wage and apprenticeship (PWA) requirements are met or the project is otherwise exempt from these requirements. Qualifying projects may also receive certain bonus credits (or adders) if they:

- Meet certain steel, iron, and manufactured products' domestic content requirements.
- Are in an energy community, including areas with closed coal mines or coal-fired power plants.
- Are in a low-income community.

The final transferability regulations are effective on July 1, 2024, and apply to taxable years ending after this date. For tax years ending before this date, taxpayers may choose to apply the final regulations to those taxable years if the taxpayers apply the rules in their entirety and in a consistent manner.

Practical Law asked Carina Federico, a partner in Crowell & Moring LLP's tax practice, to discuss several issues the final regulations and the accompanying IRS explanations sought to address and clarify, including:

- The differences between the final regulations and the notice of proposed rulemaking and proposed regulations issued in June 2023 (88 Fed. Reg. 40496 (June 21, 2023)).
- How the IRS addressed key concerns raised by commentators, including regarding the sale or transfer of bonus credits separately from the underlying base tax credit and the ability to make a direct pay election under IRC Section 6417 of a credit purchased under Section 6418.
- Steps taxpayers can take to ensure their transfer transactions do not run afoul of the IRS regulations.

For Practical Law resources focused on the tax credit transfer provisions, see Practice Notes:

- Transferability and Direct Pay Provisions for Clean Energy Projects Under the Inflation Reduction Act.
- Buying and Selling Clean Energy Tax Credits: Key Issues and Risk Mitigation Strategies.
- Tax Credit Transfer Agreements: Common Negotiation Points.
- Tax Credit Transfer Bridge Loans: Structuring Issues and Considerations.
- Biden Administration Energy and Climate Change Policies and Regulations: 2024 Tracker.

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The final transferability regulations are substantially similar to the June 2023 proposed regulations, but there were a few areas that the IRS sought to clarify. What were the key points of clarification?

The Treasury and the IRS generally avoided broadening the transferability regulations in the final regulations, repeatedly citing administrability and potential fraud and abuse concerns. The government seems keen to avoid many of the issues in the past with other federal tax incentives.

Specific key points of clarification in the final regulations include:

- The Treasury and the IRS maintained the requirement that if tax credits associated with a project are sold as a portion of the credits received for a project to a buyer, the portion of the credit transferred must include a proportionate amount of the base and any bonus credits. In other words, the base credit cannot be sold separately from any bonus credits.
- The Treasury and the IRS declined to require sellers of tax credits to provide increased documentation to buyers, citing the government's desire not to over-regulate clean energy tax credit sales between two arm's length parties. The Treasury and the IRS seem to be indicating that tax credit buyers will be responsible for ensuring there are adequate protections in tax credit transfer agreements (TCTAs), so that the buyer has what is needed to provide to the IRS during audit.
- The Treasury and the IRS have maintained that the passive activity rules apply to transfers, so that the clean energy tax credits may only be used to offset passive income. Commenters disliked that this limits the ability of most individuals, as well as estates, trusts, and certain corporations, to benefit from the credits.

Some commenters had requested that the IRS allow for chaining of direct pay with tax credit transfers, whereby applicable entities under Section 6417 (tax-exempt entities eligible for direct pay) could buy tax credits on the transfer market and then make an election under Section 6417(a) to receive a refund for those purchased tax credits. In the final transferability regulations, the Treasury and the IRS declined to allow chaining under Section 6418, explaining that chaining fell outside the scope of the Section 6418 regulations and instead would need to be addressed under Section 6417. The IRS issued Notice 2024-27 asking for written comments on several questions, including the potential effect of chaining on the tax credit transfer market. Comments are due on December 1, 2024. However, the IRS is unlikely to change its position since it has stated in Notice 2024-27 that chaining could cause administrability issues and increase the potential for fraud and abuse.

Are there any common misconceptions that sellers and buyers should understand to avoid running afoul of the IRS?

Yes. One common misconception is that the IRS's pre-filing registration process through its portal means that the IRS has blessed the credits. Tax credit buyers should be prepared to conduct due diligence on any credits purchased, as the IRS may audit the transferred credits later down the line, and the buyer will be the one who is audited.

Are there any key compliance considerations that businesses should focus on to ensure the successful transfer of tax credits while optimizing their tax benefits?

Due diligence in these transactions is key. Buyers should conduct their own due diligence process rather than solely relying on what is provided by the seller. Taxpayers will also need to ensure that they keep all the required documentation to substantiate the clean energy tax credits claimed. Taxpayers should review their recordkeeping policies and make sure they understand what is needed for their tax file regarding the clean energy tax credits to be audit ready. Taxpayers involved in many projects or purchasing from numerous credit sellers can adopt checklists to use to ensure they are consistently creating necessary files and retaining key documents.

So far, the tax credit sale market has been most active for Section 45 PTCs and Section 48 ITCs. What are the biggest hurdles to the development of a market for the other credits?

Some of the other credits, such as the Section 45V hydrogen PTC (IRC § 45V), involve newer technology. If the Section 45V tax credit works as intended to move that industry forward, we could expect to see more hydrogen

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projects under development, which will lead to more hydrogen PTCs being transferred in the market.

Other credits, such as the advanced manufacturing PTC (IRC § 45X) and the carbon capture and sequestration credit (IRC § 45Q), allow for direct pay. For those credits, most qualifying taxpayers are electing to receive any credit above their tax liability in the form of a refund in the full amount of the credit rather than transferring the credits to another taxpayer for a discounted amount.

What best practices have emerged as parties try to maximize these credits?

Both buyers and sellers in transfer credit transactions are consulting outside advisors to assist with maximizing these credits, including to conduct due diligence and carefully review TCTAs. Parties selling credits are using these outside advisors to provide due diligence on their credits before the sale and involving counsel early in the process.

Sellers of credits are also paying close attention to the provisions in their agreements to ensure that they incorporate requirements of the transferability regulations and other IRS guidance. For example, the buyer of the tax credits will be the one entity audited by the IRS. However, that doesn't mean that sellers are off the hook, because if the seller's credits are disallowed during an audit, it may affect the seller's ability to sell future credits to taxpayers and reduce the value of the seller's tax credits. Sellers are therefore including cooperation provisions in their TCTAs to ensure that sellers have a seat at the table should the credits they sold be audited by the IRS. This will allow sellers to defend the credits they are generating during an audit.

Prudent buyers and their advisors are also carefully reviewing the provisions of their TCTAs to ensure that adequate support for the purchased credits will be available if they are audited, including to prove the validity and amount of the base and bonus credits. Some buyers are including specific provisions to ensure that the PWA documentation will be available to provide to the IRS if needed in audit.

Tax credit insurance has become extremely prevalent in transfer credit transactions to protect against some of the risk. Parties should understand the terms of their insurance, including what is covered, and ensure they comply with what is required under the policy.

The IRS confirmed that no horizonal slicing is permitted and that bonus credits (or adders) must be sold proportionately with the tax credit amount being sold. This was not unexpected. Are parties talking full advantage of these adders, and if not, what are the key obstacles to the monetization of these credits?

I am not surprised that the IRS took this position due to its concerns about administrability of the credits and preventing potential fraud and abuse. Commenters noted that projects including adders will require more diligence than those without, which I agree with. I do not think the issues with transferring adders are fully realized yet.

Currently, there are numerous projects that fall within the beginning of construction exception for PWA requirements. Under that exception, a taxpayer that began construction or installation of a facility before January 29, 2023, may be eligible for the increased credit without satisfying the PWA requirements. As we move further away from that date, we are likely to see more projects that must comply with the PWA requirements. If a project is claiming the beginning of construction exception for PWA, the due diligence on the projects shifts away from the PWA requirements to whether the Physical Work Test or Five Percent Safe Harbor has been met for showing beginning of construction before January 29, 2023 (see Notice 2021-41, Notice 2013-29, Notice 2017-04, and Notice 2018-59).

For more information on the PWA, see Increased Credit or Deduction Amounts for Satisfying Certain Prevailing Wage and Registered Apprenticeship Requirements, 88 Fed. Reg. 60018 (Aug. 30, 2023), as amended and clarified by Definition of Energy Property and Rules Applicable to the Energy Credit, 88 Fed. Reg. 82188 (Nov. 22, 2023).

Similarly, project developers have found it difficult to comply with the domestic content requirements. While the elective safe harbor set out in the IRS's recent Notice 2024-21 provides a simpler way to calculate whether the minimum percentage of the costs of the manufactured products and components of manufactured products is met, it may still be difficult

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for project developers to source the required products and components, particularly steel and iron products. Once project developers are better able to find products and components needed to meet the domestic content requirements, we could expect to see more projects claiming the domestic content bonus credit.

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