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How Partnerships Can Cash in on Energy Credit Transfers

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In light of recent IRS proposed regulations, Jessica Millett and associates at Hogan Lovells explain how partnerships can best monetize renewable energy tax credits under transferability provisions of the Inflation Reduction Act of 2022.

Many have described the Inflation Reduction Act of 2022 (the ''IRA'') as a game-changer for the renewable energy industry and its efforts to reduce carbon emissions and combat climate change. It is true that the IRA introduced a new sweeping set of tax credits and other incentives, or in some cases updates and revisions to existing incentives, that can make renewable energy the most cost-effective choice for businesses and property owners. However, those tax incentives need to be packaged the right way so that developers and other stakeholders in the renewable energy industry can effectively monetize the benefits.

Prior to the IRA, renewable energy projects were typically financed with ''tax equity'' investors. Historically, this tax equity market has been limited to a select group of investors, since involving a tax credit investor to monetize renewable energy tax credits required complex joint venture or lease structures that would lock the investor into owning a form of equity interest in the underlying project for a period of time. Smaller developers were often not able to attract such investment, or did not have the ability or resources to otherwise fill out the capital stack for their projects to make them economically viable.

Enter the new monetization provisions of the IRA! In addition to the expanded set of tax credits, the IRA also introduced two novel methods to monetize those tax benefits. First, under the direct pay provisions, certain tax-exempt and governmental entities (''Applicable Entities'') can make a direct pay election for a group of specified credits in the IRA, which essentially makes those credits refundable by the IRS. For a small subset of credits in the IRA, even non-Applicable Entities can elect direct pay.

Second, and the focus of this article, under the transferability provisions, all eligible taxpayers (persons other than Applicable Entities) (''Eligible Taxpayers'') can elect to transfer all or a portion of their credits to an unrelated party for cash consideration. This ability to sell tax credits expands the pool of financing options for renewable energy developers and is expected to multiply the tax credit market. Rather than relying on complex tax equity structures, the relative simplicity of the transferability regime should help to bring in a new wave of capital to the renewable energy industry.

Proposed Regulations on Transferability of the Credits

In June 2023, Treasury/IRS released proposed regulations on the direct pay (Prop. Reg. §1.6417-1 through §1.6417-6) and transferability (Prop. Reg. §1.6418-1 through §1.6418-5) regimes. This article focuses on the proposed regulations for transferability, in particular on issues that arise for tax partnerships as buyers and sellers of the investment tax credit (ITC) under §48 of the Internal Revenue Code of 1986, as amended (the ''Code'') and the production tax credit (PTC) under Code §45. Many energy projects are set up through entities treated as partnerships for federal income tax purposes (such as limited liability companies and limited partnerships), and tax partnerships with taxable partners are expected to be part of the new market on the buyer side for tax credits. The proposed regulations offer some helpful flexibility for tax partnerships, but also a few restrictive provisions that may require careful planning to ensure the full amount of the expected credit can be monetized.

The transferability rules permit the sale of a number of additional tax credits, for: alternative fuel vehicle refueling property under §30C; carbon oxide sequestration under §45Q(a); zero-emission nuclear power production under §45U(a); clean hydrogen production under §45V(a); advanced manufacturing production under §45X(a)and §45Y(a); clean fuel production under §45Z(a); qualifying advanced energy project under §48C; and clean electricity investment under §48E. All of these credits are referenced at §6418(f)(1)(A).

Key Concepts in the Transferability Regulations

Before we dive in on issues for tax partnerships, here is a quick summary of certain key provisions in the proposed regulations.

Registration Required. Eligible Taxpayers must go through a mandatory registration process and submit specified documentation to be able to sell their credits.

- The registration process must be completed annually before making a transfer election. Prop. Reg. §1.6418-4(a)
- For the PTC, you need to separately register each energy-producing "facility." Prop. Reg. §1.6418-1(d)(1).
- For the ITC, you need to separately register each "energy property," which generally includes all components of the property that are functionally independent. Prop. Reg. §1.6418-1(d)(9)(i).

Transfer Elections. A credit is transferred by an Eligible Taxpayer that makes a transfer election on an original return (not an amended return) no later than the due date, including extensions, for the tax year in which the credit is determined, according to Prop. Reg. §1.6418-2(b)(4).

- A separate transfer election must be made for each separately registered credit property, and for each applicable tax year. For example, under Prop. Reg. §1.6418-2(b)(2)(i)–(ii), if an Eligible Taxpayer wanted to transfer a PTC for each of the 10 years in which the PTC is generated, transfer elections would need to be made in each of the 10 years.
- The proposed regulations outline the requirements for a transfer election statement, which would need to be attached to the tax returns of both the Eligible Taxpayer seller and the credit buyer. Prop. Reg. §1.6418-2(b)(5).
- No transfer is allowed in situations where the taxpayer does not own the property and is only able to claim the credit as a result of an election by another taxpayer (e.g., tax credits passed through to a lessee in a "synthetic lease" structure).

Paid in Cash. Under §6418(b)(1), payment for the credits by the buyer must be paid in cash.

- For this purpose, a cash payment includes a payment in US dollars that is made by cash, check, cashier's check, money order, wire transfer, ACH transfer or other bank transfer of immediately available funds, under Prop. Reg. §1.6418-1(f)(1).
- Eligible Taxpayers can enter into a contract to sell the credits in advance of the actual credit transfer, as long as the corresponding cash payment is made within a specified safe harbor period: (i) beginning on the first day of the Eligible Taxpayer's taxable year during which an eligible credit is determined and (ii) ending on the due date for completing a transfer election statement (which is the due date, including extensions, for the Eligible Taxpayer's original tax return for the tax year in which the credit is determined). For example, if a calendar year corporation places energy property into service in September 2023 and claims the ITC, a buyer could make a cash payment for all or a part of the ITC between January 1, 2023 and October 15, 2024, assuming the corporation files an extension for its 2023 tax return. Prop. Reg. §1.6418-1(f)(1).

Multiple Buyers Are Okay. Under Prop. Reg. §1.6418-2(a)(2), an Eligible Taxpayer may make multiple transfer elections to transfer one or more specified portions of a credit to multiple transferee taxpayers, as long as the transfers do not exceed the total amount of the credit. For example, 50% of a credit may be sold to Buyer #1 and the other 50% of that credit may be sold to Buyer #2. A credit, or portion of a credit, may only be transferred once, however. So neither Buyer #1 or Buyer #2 may subsequently transfer the credit.

No Separate Transfer of Bonus Credits. Although Eligible Taxpayers can transfer credits to multiple buyers, it is not possible to separately transfer the bonus portion of a credit, according to IRS guidance (88 Fed. Reg. 40,496 at 40,499). For example, if an Eligible Taxpayer were entitled to a 30% ITC plus a 10% bonus amount as a result of the domestic content rules, a buyer of the credit has to buy all, or a "vertical slice," of the 40% credit amount.

Brokers are Okay Too. Brokers can be used to match Eligible Taxpayer sellers and credit buyers, as long as ownership of the credit is not transferred to the broker or any party other than the credit buyer. *Id.* at 40,501.

Tax Consequences of Transfer. As provided in the Code, the cash consideration to the Eligible Taxpayer as seller of the credit is not includible in the Eligible Taxpayer's income, and cannot be taken as a deduction by the credit buyer. Prop. Reg. §1.6418-2(e)(2)–(3).

No Tax on the Discount. If the cash amount paid by the credit buyer is less than the amount of the transferred credit, the proposed regulations confirm that the buyer does not have gross income as a result of that discount. Prop. Reg. §1.6418-2(f)(2).

Carryforwards and Carrybacks. The credit buyer can carry the credit forward and back. Prop. Reg.

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§1.6418-5(g) allows the credit buyer to apply the rules of §39(a)(4), which provides a three-year carryback. The default rule of §39(a)(1) allowing a 20-year carryforward is not amended.

Estimated Tax Payments. The credit buyer can take the credit into account for its estimated tax purposes, but will be responsible for any penalties on an underpayment if they do not ultimately acquire the credit. Prop. Reg. §1.6418-2(f)(1).

Recapture Risk. In general, the credit buyer is on the hook for recapture risk of the ITC and other credits subject to recapture, and for any adjustment of a tax credit amount resulting from an IRS audit (such as eligibility for bonus credits or satisfying the wage and apprenticeship rules). Prop. Reg. §1.6418-5(d)(3).

- Special recapture rules apply to Eligible Taxpayers that are partnerships, as discussed below.. Prop. Reg. §1.6418-3(a)(6).
- There is no prohibition on an Eligible Taxpayer and a credit buyer contracting between themselves for indemnification. 88 Fed. Reg. 40,496 at 40,509).

Excessive Credit Penalties. If a credit transfer exceeds the allowable amount), the buyer is liable for the excess plus a 20% penalty, except with a showing of reasonable cause based on facts and circumstances, according to Prop. Reg. §1.6418-5(a)(1). When a credit is sold to multiple buyers, each buyer shares proportionately in an excessive credit penalty. Prop. Reg. §1.6418-5(a)(2).

Partnerships as Eligible Credit Transferors

As noted above, many energy projects are developed and financed through tax partnerships. The proposed transferability regulations acknowledge this and provide some welcome flexibility to Eligible Taxpayers that are partnerships. However, the proposed regulations are clear that existing tax rules which relate to whether, and how much of, a credit is generated in the first place apply to partnerships that want to take advantage of transferability.

Understand the Limitations on the Transferable Amount

Importantly, the credit amount eligible for transfer by a tax partnership is calculated after the application of the at-risk rules in §49 and tax-exempt ownership rules in §50(b) (and, by reference, §168(h)) at the transferor tax partnership level. Prop. Reg. §1.6418-2(d)(2). For example, and very generally, if a tax partnership generates a $100 credit and is comprised of two 50% partners, one of which is tax-exempt, the tax partnership can only transfer $50 of the credit.

One frustrating result is that a tax partnership comprised of exclusively tax-exempt partners may be ineligible to claim or transfer a credit, even though the direct-pay election created under §6417 was put in place specifically to allow tax-exempt entities to benefit from these tax credits. Partnerships with tax-exempt partners may have to consider using corporations to hold the relevant energy property, which can impact the overall efficiency of the structure.

Welcome Flexibility on Partial Transfers

As a general matter, the election(s) to transfer a credit (or a portion of a credit) must be made by the tax partnership that owns the eligible credit property, according to Prop. Reg. §1.6418-2(a)(3)(iv). *See also* Prop. Reg. §1.6418-3(a)(1). However, if only a portion of a credit is transferred, the remaining credit can be allocated to one or more partners, so long as the sum of the credit allocated to a partner and their distributive share of the tax-exempt income does not exceed their proportionate distributive share of the eligible credit that would otherwise have been allocated to such partner absent the transfer of the specified credit portion. Prop. Reg. §1.6418-3(b)(1), (2).

While tax-exempt income must be allocated to partners in accordance with their proportionate distributive share of the eligible credit that would otherwise have been allocated to such partner absent the transfer of the specified credit portion, cash proceeds from the transfer of a credit can be used or distributed by the tax partnership irrespective of such allocations, according to the Preamble to Prop. Reg. §1.6418-3.

Be Mindful of Partner-Level Recapture Events

Relatedly, while recapture events under §50 (such as a disposition of the credit property) generally recapture the credit with respect to the transferee, a partner in a transferor tax partnership may have a recapture event post-transfer if, within the recapture period, such partner sells its interest in, or otherwise reduces its interest in, the profits of the transferor partnership by more than a specified percentage, or if there is an increase of nonqualified nonrecourse financing with respect to such partner. Prop. Reg. §1.6418-3(a)(6). To avoid future recapture risk in cases where allocations may shift or partnership ownership is expected to be dynamic, partners may choose to set up separate ownership structures (such as ownership through a C corporation) with respect to the credit property before it is placed in service.

Partnerships as Buyers (Credit Transferees)

Tax partnerships can purchase tax credits under the transferability regime and pass those credits through to their partners. However, the proposed regulations are clear that partners still need to comply with existing tax rules which relate to whether a credit can be used to offset taxable income.

How to Allocate Purchased Credits Among Partners

Transferred credits are allocated to the transferee partnership's partners under general credit allocation

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rules, according to Prop. Reg. §1.6418-3(b)(4)(iii). Although the payment made for the credit is nondeductible, those nondeductible expenditures reduce a partner's capital account and tax basis in its partnership interest. The purchased credits are then allocated in the same manner as the nondeductible expense incurred in connection with the credit transfer, either as specified in the partnership agreement, or if not specified, determined based on the partnership's general allocation of nondeductible expenses. Prop. Reg. §1.6418-3(b)(4)(iii). The same allocation rules apply to upper-tier partnerships that directly or indirectly hold interests in the transferee partnership. Prop. Reg. §1.6418-3(b)(4)(v).

For example, in a straight 50/50 partnership, if each partner funded 50% of the cost of the purchased credit, then each partner is allocated 50% of the credit. If one partner is itself a partnership, that upper-tier partnership would allocate its 50% share of the credit to its partners under the same methodology.

Importantly, the allocation of the credit by the transferee partnership to its partners does not violate the no-second-transfer rule. Prop. Reg. §1.6418-3(b)(4)(i).

When Partners Can Use the Credit

Under §6418(d), a tax credit buyer takes the eligible credit into account in the first taxable year of the buyer ending with, or after, the taxable year of the selling Eligible Taxpayer with respect to which the credit was determined. So for an ITC resulting from energy property placed in service in 2023 by a calendar year Eligible Taxpayer, a calendar year tax credit buyer takes the credit into account in 2023, and a June 30 fiscal year taxpayer credit buyer takes the credit into account in its taxable year ending June 30, 2024.

However, tax partnerships may have shifting ownership over the course of a tax year. The proposed regulations have a framework to determine the appropriate ''transfer date'' of a credit purchased by a transferee partnership. If the transferor and transferee partnership have the same taxable year, the transferred credit is allocable to the partners in the transferee partnership on the first date that the transferee partnership makes a cash payment as consideration for the credit. Prop. Reg. §1.6418-3(b)(4)(iv).

Alternatively, if the transferor and transferee partnership have different tax years, the transfer date is deemed to be the later of (x) the first date of the tax year of the transferee partnership in which the credit would be taken into account, or (y) the first date the transferee makes a cash payment as consideration for the credit. *Id*. If a calendar year Eligible Taxpayer transfers a 2023 credit to a June 30 fiscal year taxpayer that is a partnership in exchange for a cash payment on or before June 30, 2023, then the credit is taken into account by the transferee partnership on July 1, 2023. If the transferee partnership makes its first cash payment during July 1, 2023 through December 31, 2023, then the credit is taken into account by the transferee partnership on the cash payment date, according to the Preamble to Prop. Reg. §1.6418-3.

Newly Admitted Partners and Allocating Credits

A partner in a transferee credit buying partnership must be in the partnership by the transfer date for the credit. Subsequent transfers or new issuances of partnership interests will not permit those new partners to share in the purchased credit. These rules are intended to prevent a taxpayer from circumventing the ''one transfer'' limitation by having partners come in and out of a partnership.

The proposed regulations do not specifically bless ''syndication partnerships'' that are formed solely to purchase tax credits, so additional guidance from Treasury would be helpful on this point.

The Passive Activity Loss Rules May Limit Use of the Credits for Some Partners

The proposed regulations clarify that the passive activity loss rules of §469 apply to transferees. Prop. Reg. §1.6418-2(f)(3)(ii). Under §469(a), certain taxpayers (individuals, estates, trusts, closely held C corporations and personal service corporations) are limited from using ''passive losses'' (which can include tax credits) to shelter income from non-passive sources.

Transferred credits are treated as passive activity credits and, for taxpayers subject to the passive activity loss rules, may only offset passive income, under Prop. Reg. §1.6418-2(f)(3)(ii) and Code §469(a)(1)(A), (d)(1). For transferee partnerships that purchase credits, any partners subject to the passive activity loss rules may be limited in their ability to utilize transferred credits.

This is an unfortunate outcome of the proposed regulations, although it was widely speculated that the rules would be applied in this manner. For now, the universe of possible credit buyers is likely to be limited to exclude individuals and other taxpayers subject to the passive activity loss rules, as well as partnerships with those partners.

Next Steps

Public comments on the proposed regulations were due by August 14, 2023. Treasury and the IRS consider stakeholder input before finalizing proposed regulations, and changes are not uncommon. The rules are not effective until the publication of final regulations, but in the meantime, the proposed regulations can be relied upon, provided that taxpayers apply them in their entirety and in a consistent manner.

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