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IRS Guidance on Transferability Resolves Some Issues, Leaves Others Unanswered

The IRS recently released much-anticipated guidance concerning the transfer of various renewable energy tax credits pursuant to Code Section 6418, which was passed as part of the Inflation Reduction Act in August 2022. The proposed regulations will be subject to a 60-day public comment period (comments must be received by August 14) before final regulations are issued.

While the proposed regulations clarify a number of issues affecting the transferability market, a number of issues remain unanswered.

Use of Passthrough Entities

The proposed regulations clarify that a passthrough entity may be either the transferor or transferee in a credit transfer transaction as long as the transferor and transferee are not related under Code Sections 267(b) or 707(b)(1). The proposed regulations clarify that the passthrough of a transferred credit to the partners in a transferee partnership, or to the shareholders in a transferee S-corporation, is not treated as a "transfer" and thus does not violate the one-transfer limitation. However, the regulations further clarify that upper-tier partnerships that hold a direct or indirect interest in a transferor partnership or a transferee partnership are not eligible taxpayers, and thus cannot make an election under Section 6418 to transfer their allocated share of credits.

At-Risk, Tax-Exempt Use and Passive Loss Limitations

The proposed regulations clarify that an eligible taxpayer may generally only transfer eligible credits determined with respect to the eligible taxpayer. The proposed regulations therefore clarify that all rules which relate to the determination of an eligible credit, including Section 49 (at-risk) and Section 50(b) (tax-exempt use) of the Code are applied to the transferor, and may potentially reduce the amount of eligible credit that can be transferred.

Observation: The proposed regulations do not appear to foreclose the possibility of certain "tax-exempt controlled entities" making an election under Code Section 168(h) to be treated as a taxable corporation. Thus, a partnership with tax-exempt partners may elect to transfer an eligible credit under Code Section 6418 to the extent that the tax-exempt partners make an election under Code Section 168(h)(6) to be treated as taxable.

While the at-risk rules are applied to the transferor partnership, the proposed regulations clarify that the at-risk determination is made only once, at the time the transferor files its tax return for the year

that the eligible credit property is placed in service. Therefore, any increase or decrease in the at-risk amount after the taxable year in which the property is placed in service does not impact the amount of the eligible credit determined, or result in recapture to the transferee. However, a partner or shareholder in a transferor partnership or transferor S-corporation is required to reapply the at-risk rules annually. To the extent that there is an increase in such partner's or shareholder's share of nonqualified nonrecourse financing under Code Section 49, such partner or shareholder is generally required to recognize income in accordance with Code Section 49(b). Alternatively, if there is a decrease in nonqualified nonrecourse financing, any increase in the credit base is taken into account by the partner or shareholder, provided that any resulting credit would not be eligible for transfer under Code Section 6418.

Transferred credits are subject to the passive activity rules applicable under Code Section 469. However, a transferee taxpayer is not considered to have owned an interest in the transferor's business for purposes of determining material participation and similarly cannot change the characterization of a transferred credit based on grouping with its own activities.

With respect to a transferor partnership, the amount of consideration received in connection with the transfer of an eligible credit which is required to be recognized by the partners of the transferor partnership as tax-exempt income under Code Section 6418 is not treated as passive income under Code Section 469.

Observation: Despite the general applicability of the passive loss rules, the explanation attached to the proposed regulations indicates that the IRS is seeking commentary regarding situations in which it may be appropriate for the passive activity rules not to apply with respect to specified transferred credits. It is thus unclear in what circumstances the passive loss rules may be deemed not to apply to a credit transfer transaction.

Treatment of Payments

Amounts paid by a transferee in connection with the transfer of an eligible credit must be paid in cash. Such amounts are not includible in the transferor's gross income and may not be deducted by the transferee. The proposed regulations include an anti-abuse provision which allows the IRS to disallow a transfer, or to recharacterize the tax consequences of such transfer, if the principal purpose of the transaction was to avoid federal tax liability beyond the intent of Code Section 6418. Amounts paid by a transferee will not be considered to be paid in connection with the transfer of a specified credit portion as required under the proposed regulations if a principal purpose of the transaction or series of transactions is to allow an eligible taxpayer to avoid gross income or to increase a taxpayer's federal income tax deduction.

Observation: The examples in the proposed regulations indicate that the IRS will closely scrutinize transactions in which the cash consideration received is greater or less than fair market value, especially in situations where there is a simultaneous exchange of other goods or services between the transferor and the transferee.

No Transfer Allowed for Lease Passthrough Structures

The transfer election is not available in lease passthrough transactions because the lessee does not own the eligible credit property, and the credit is only available as a result of an election by another taxpayer (i.e., the lessor). In contrast, a sale-leaseback transaction may utilize the transfer election because the purchaser/lessor is the owner of the eligible credit property to which the credit was determined.

Observation: Projects seeking to utilize the transfer election will not have the benefit of utilizing the project's fair market value to calculate the amount of the investment tax credit, which has traditionally been viewed as an advantage of utilizing the lease passthrough structure over a traditional partnership flip.

Special Recapture Rules for Passthrough Entities

Certain tax credits (such as the Section 48 energy credit) are recaptured if there is a disposition of the project at any time during the five-year compliance period described in Code Section 50(a). The amount of credits subject to recapture burns off ratably over the five-year period. The proposed regulations generally confirm that the risk of recapture with respect to a transferred credit will be borne by the transferor.

In the case of a passthrough entity, tax credits claimed by the partners or shareholders are subject to recapture to the extent that there is any disposition of more than one third of such partner's interest in the general profits in the partnership or such shareholder's proportionate stock interest in the corporation. This general rule created significant concern amongst investors that a disposition by a partner in a transferor partnership or a shareholder in a transferor S-corporation could result in recapture of credits to the transferee, despite the transferee having little or no control over the partner's or shareholder's ability to dispose of its interest. However, the proposed regulations provide an exception to the general rule in the case of a disposition by a partner in a transferor partnership or shareholder in a transferor S-corporation by providing that recapture resulting from such disposition is borne by the transferee partner or shareholder, rather than the transferor.

Tax Exempt Income/Allocations

Tax-exempt income resulting from a transferor partnership's receipt of consideration in connection with a transfer election must generally be allocated in the same manner that the eligible credit would have been allocated had the transfer election not been made (i.e., in accordance with general profits interests). In the event that the transferor partnership elects to transfer less than the full amount of the eligible credit determined, the proposed regulations generally allow the partners to determine each partner's eligible credit amount to be transferred, and the amount of eligible credit to be retained and allocated to such partner. The transferor partnership may allocate to each partner its agreed-upon share of eligible credits and/or tax-exempt income resulting from receipt of consideration for the portion of credits transferred, provided that: (i) the amount of eligible credits retained by, and allocated to, a partner may not exceed such partner's distributive share of eligible credits (as determined in accordance with Treasury Regulation Sections 1.46-3(f) and 1.704-1(b)(4)(ii)); and (ii) the amount of tax-exempt income allocated to each partner is equal to such partner's "proportionate share" of tax-exempt income, which is equal to the transferor partnership's total amount of credits being transferred, multiplied by a fraction, (a) the numerator of which is equal to the partner's distributive share of eligible credits, less the amount of credits which are being retained by, and allocated to such partner, and (b) the denominator of which is the transferor partnership's total amount of credits being transferred.

Observation: The proposed regulations provide flexibility in allowing the partners to decide what portion (if any) of such partner's allocable share of credits are to be transferred or retained and allocated to such partner. This presents significant planning opportunities for partners and partnerships in determining which partners will be allocated tax-exempt income resulting from the receipt of consideration received

by the partnership as a result of a transfer election. However, it is unclear whether and to what extent the IRS may seek to challenge or set aside a partnership's agreed-upon allocation of eligible credits and/or tax-exempt income, for example, to the extent that the IRS were to view such agreement to be abusive, or to produce a result that is inconsistent with Code Section 6418. While the proposed regulations provide flexibility by permitting the allocation of tax-exempt income to the partners who desire to transfer their share of eligible credits, as noted above, a partner's share of tax-exempt income is required to match such partner's allocable share of eligible credits pursuant to Treasury Regulation Sections 1.46-3(f) and 1.704-1(b)(4)(ii). Thus, a transferor partnership may not specially allocate tax-exempt income in excess of a partner's allocable share of eligible credits.

Pre-Filing Registration Requirements

Before a transfer of an eligible credit (or portion thereof) can be made, the transferor is required to complete the pre-filing registration requirements on the IRS' website and obtain a registration number that must be filed with the transferor's and transferee's tax returns. To the extent that there are multiple projects to which the eligible credits relate, the transferor must obtain a separate registration number for each project.

Observation: The proposed regulations do not clarify the length of time necessary for the IRS to review the transferor's submitted information and issue the required registration number. However, because the proposed regulations specify that a transfer election is not valid without a properly issued registration number, such process may potentially delay the project's ability to monetize tax credits.

Excessive Credit Transfers

Section 6418 enables the IRS to collect a penalty equal to 120% of the amount of any "excessive credit transfer" claimed by a transferee in the event that the transferred credit is subsequently disallowed. The taxpayer can avoid 20% of the penalty to the extent that such taxpayer is able to demonstrate "reasonable cause." The proposed regulations provide that the most important factor in determining whether the transferee had reasonable cause is the length at which the transferee went to verify that the transferred credit was not in excess of the amount of eligible credit to which the transferor was otherwise entitled, and was not previously transferred to another taxpayer. For this purpose, the IRS will consider review of the eligible taxpayer's records with respect to determination of the eligible credit amount (including documentation evidencing eligibility for any adders), reasonable reliance on third party reports and representations from the transferor that the total amount of transferred credits does not exceed the total eligible credit determined with respect to the transferor, and review of audited financial statements provided to the Securities and Exchange Commission (if applicable).

The proposed regulations specify that the amount of any disallowance is first applied against any portion of the eligible credit retained by the transferor. For example, a transferor believes that it is entitled to $100 of tax credits. It elects to transfer $50 of tax credits and retains $50 of tax credits for itself. If the IRS subsequently disallows $50 of tax credits, there is no excessive credit transfer with respect to the transferee because the amount of credits claimed by the transferee is equal to the amount that would otherwise be allowable to the transferor (i.e., $50).

On the other hand, if instead the taxpayer chose to retain $20 of credits and transfer $80 of credits, there is a $30 excessive credit transfer because the amount of credits claimed by the transferee exceeds the

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amount of credits otherwise allowable to the transferor ($50). The transferee would owe $36 (120% of $30), unless it can show reasonable cause, in which case the transferee's liability would be reduced to $30. The transferor is disallowed the $20 of credits claimed, and the amount of consideration paid by the transferee would be taxable to the transferor.

Where there are transfers to multiple transferees, the proposed regulations treat such transferees as a single transferee for purposes of applying the excessive credit transfer rules. Thus, using the example above, if instead the transferor had transferred $45 of eligible credits to A and $35 of eligible credits to B, the excessive credit transfer amount ($30) would be apportioned between A and B based upon the amount of total credits transferred, such that A's share of the excessive credit transfer would be $16.88 ($45/$80 * $30 = $16.88) and B's share of the excessive credit transfer would be $13.12 ($35/$80 * $30 = $13.12).

Conclusion

The transferability guidance answers a number of issues affecting the transfer market and should provide more comfort to previously sidelined market participants and resulting in increased deal activity over the second half of the year. It should be noted that a number of transactions dry closed or paused in anticipation of the release of the proposed regulations. Those transactions may need to be restructured or renegotiated in order to account for the newly released guidance. Although the proposed regulations included some unexpected limitations (e.g., prohibition on lease pass-through structures), the guidance was positive overall and should facilitate greater certainty to transferees and transferors.

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