

IRS Issues Final Regulations on Direct Pay

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On March 5, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued [final regulations](#) (Final Regulations) on the elective payment of certain tax credits (direct pay) pursuant to Section 6417 of the Internal Revenue Code of 1986, as amended (Code), which was enacted by the [Inflation Reduction Act](#). Section 6417 allows applicable entities (including tax-exempt, governmental, and certain other entities) to elect to treat certain tax credits, including the Investment Tax Credit (ITC) and the renewable electricity production tax credit (PTC), as a payment against federal income tax liability for the taxable year with respect to which such credit was determined.

The Final Regulations will be effective 60 days after their publication in the *Federal Register* (currently scheduled for March 11, 2024), and will apply to taxable years ending on or after this date. Taxpayers may choose to apply the rules of Treasury Regulation Sections 1.6417-1 through 1.6417-4 and 1.6417 for taxable years ending before that date, if they apply the rules in their entirety and in a consistent manner.

Analysis

The Final Regulations are generally consistent with the proposed regulations and temporary regulations released by Treasury and the IRS on June 14, 2023, which we addressed in our [prior alert](#). Although direct pay is generally available only for tax-exempt entities (except with respect to certain credits), the Final Regulations address items of interest to taxable entities and energy credits more generally, including:

- Partnerships with tax-exempt and taxable owners;
- Relief (or the lack thereof) for late elections;
- The “chaining” of direct pay with tax credit transfers; and
- Procedural details about the pre-filing registration process.

These items are discussed below, together with other noteworthy aspects of the Final Regulations.

- **Territories.** Section 50(b)(1) provides that property used outside the U.S. is not eligible for the ITC. Treasury and the IRS declined to follow the recommendation of commenters that there be an exception to the general rule in Section 50(b)(1) for territorial applicable entities making elections under Section 6417 for investment tax credits.
- **Rural Electric Cooperatives.** The Final Regulations clarify that taxable rural electric cooperatives that furnish electricity are eligible for direct pay. For this purpose, a taxable rural electric cooperative means “any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas as described in Section 1381(a)(2)(C) of the Code.” “Furnishing” electricity includes generating and transmitting electricity. A rural area is defined by reference to Section 1381(a)(2)(C) of the Code and 7 U.S.C. 924(b), which provide that the term “rural area” means any area of the U.S. not included within the boundaries of any incorporated or unincorporated city, village, or borough having a population in excess of 5,000 inhabitants.
- **Partnerships and Joint Ownership Arrangements.** Commenters had numerous questions concerning partnerships and joint ownership arrangements involving applicable entities. The Final Regulations continued the controversial approach of the proposed regulations pursuant to which partnerships are not applicable entities and therefore can make direct pay elections only with respect to Sections 45V, 45Q, and 45X. The Final Regulations also did not adopt a special rule for ERISA plans investing in pooled investment vehicles involving partnerships. The severity of the general approach is mitigated, however, by [proposed regulations](#) under Section 761(a) of the Code issued simultaneously that would allow owners of certain unincorporated organizations (such as limited liability companies) to elect to be excluded from the application of subchapter K, the partnership provisions of the Code. The proposed regulations permit exemption out of partnership treatment if certain organizational and operational conditions are met.
 - The ability to elect out of subchapter K under these circumstances provides a pathway for applicable entities to access direct pay while utilizing partnership structures, which are more commonly used and understood in the renewable energy industry than other joint ownership arrangements such as tenancies in common. The Preamble to the proposed regulations notes that applicable entities have raised concerns that potential offtake agreement counterparties may be averse to negotiating with multiple owners of a single project, particularly owners that lack renewable energy expertise. The proposed regulations provide a more viable commercial option for joint ownership that includes applicable entities.
- **Amended Returns.** Multiple commenters asked that a direct pay election be permitted on an amended return or that a taxpayer be permitted an extension of time under certain relief procedures to make a late election. The Final Regulations did not adopt the broad relief requested, offering only a clarification intended to address situations in which a taxpayer intended to make an elective payment election but made a reporting error with respect to an element of a valid election. Unfortunately, this provision cannot be used to revoke an election or to make an election for the first time on an amended return. However, the Preamble did clarify that a superseding return (a return filed after an originally-filed return but before the due date for filing the return with extensions) could be filed to increase or decrease the amount of the direct pay election.

- The absence of late election relief for the direct pay election means that it is absolutely essential to monitor the filing process for tax returns for which direct pay elections will be made.
- *No Excess Benefit Rule.* The Final Regulations adopt the “no excess benefit” rule from the proposed regulations, pursuant to which the credit will be reduced to the extent the cost of the credit property is exceeded by the sum of the credit and grants or forgivable loans obtained for the specific purpose of constructing or acquiring an investment credit property (restricted tax exempt amounts). The Final Regulations clarify that the determination of whether a grant is a restricted tax exempt amount is generally made when the grant is awarded. A grant awarded after acquisition of the property is a restricted tax-exempt amount only if approval of the grant was perfunctory and the amount of the grant was virtually assured at the time of application. Similarly, whether a loan is a restricted tax exempt amount (including whether the loan is intended to be forgiven) is generally determined when the loan is approved.
- *Chaining and the “Determined With Respect to” Requirement.* The Final Regulations follow the proposed regulations under both Section 6417 and 6418 (the tax credit transfer provision) in requiring that a direct pay election can be made only with respect to a credit that has been “determined with respect to” the applicable entity or electing taxpayer, meaning that the applicable entity or electing taxpayer must own the underlying eligible credit property or, in the case of Section 45X, conduct the activities giving rise to the underlying eligible credit. This rule prohibits direct pay elections for credits transferred pursuant to Section 6418, transferred pursuant to Section 45Q(f)(3), acquired by a lessee from a lessor pursuant to a “lease pass-through” election, owned by a third party, or otherwise not determined directly with respect to the applicable entity or electing taxpayer (“chaining”). The Preamble clarified that the owner-lessor in a sale-leaseback can make a direct pay election.
 - Treasury and the IRS also released [Notice 2024-27](#), requesting comments on situations in which a direct pay election could be made for a credit that was purchased in a tax credit transfer, reflecting the competing interests of preventing fraud and duplication, and allowing for the development of a robust transfer market.
- *Section 38 Limitation and Ordering Rules.* The Final Regulations address some highly technical issues involving the utilization of current year credits eligible for direct pay, current year credits not eligible for direct pay, and credit carryforwards.
- *Timing and Payment.* Several comments addressed the timing of receipt of direct pay. Treasury and the IRS declined (i) to specify a particular time within which a direct pay election will be processed, (ii) to provide for a payment before the applicable return is filed, or (iii) to have the applicable credits considered to be estimated tax payments or to waive estimated tax penalties. The Preamble clarifies that a taxpayer would receive one payment per taxable year.
- *Five-Year Election Period for Sections 45Q, 45V, and 45X.* The Final Regulations declined to adopt the

comments that (i) taxpayers could make consecutive five-year direct pay elections for the same applicable credit property and (ii) the five-year period should start on the date equipment is placed in service and run for 60 months. Instead, the election can be made for at most five taxable years, meaning that a project placed in service on the last day of a taxable year will have only four taxable years of direct pay remaining after that day. The Preamble reiterated that the direct pay election is elective, clarifying that a taxpayer can make a direct pay election for the first five years of the applicable credit period and then make a Section 6418 transfer election for the remaining years in the applicable credit period (or can make a Section 6418 transfer election for all years).

- *Pre-filing Registration.* The Preamble addressed several issues concerning the pre-filing registration process.
 - *Timing.* Commenters were concerned about the possibility that a registration number might not be received before the due date of the applicable return. The Final Regulations provided no relief on this concern.
 - *Denial.* The Preamble clarified that appeal rights for a denial of a registration are severely limited, stating: “once the IRS determines that a registration number should not be given, the registrant may not appeal the denial unless the IRS and Appeals agree that such review is available and the IRS provides the time and manner for such review.”
 - *Grouping.* The Final Regulations rejected the request of multiple commenters that taxpayers be able to group multiple qualified facilities as a “single project” that would obtain a single registration number, or that consolidated filings be available for multiple facilities (e.g., multiturbine wind farms). However, the Final Regulations reiterate that applicable credit property information can be uploaded by way of a spreadsheet file (bulk upload).
 - This approach seems unnecessarily difficult, creating administrative burdens for both the IRS and taxpayers. The Preamble does a poor job of justifying the position of Treasury and the IRS.
 - *Documentation.* The Preamble clarifies that an applicable entity may use a certificate, permit, or evidence of ownership, rather than all three, during pre-filing registration.
 - *Authorized Representative.* The Preamble clarifies that an authorized representative may apply for a registration number on behalf of the taxpayer.
- *Excessive Payments.* The Final Regulations, following the proposed regulations, do not adopt special “reasonable cause” standards for purposes of avoiding the excessive payment tax. Instead, the general authority on “reasonable cause” will apply.

Conclusion

There are very few surprises in the Final Regulations, which closely follow the proposed regulations, and may be an indication that the rapid release of final IRA guidance is a high priority for Treasury. Interestingly, the Preamble

takes great care to address comments that were in the scope of the Final Regulations and dismiss comments that were outside the scope. Undoubtedly, this is to position the Final Regulations to withstand political, or potentially legal, challenges going forward. We can certainly expect a similar approach in the coming months as Treasury and the IRS issue further regulations under the IRA.

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