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Locke Lord QuickStudy: IRS Releases Final Direct Pay Energy Tax Credit Regulations

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On March 5, 2024, the Internal Revenue Service and the Treasury Department issued final Treasury Regulations (the “Final Regulations”) updating and finalizing previously published proposed Treasury Regulations relating to the elective payment election (the “Direct Pay Election”) under Section 6417 of the Internal Revenue Code (the “Code”), as well as a notice of proposed rulemaking (the “Proposed Regulations”) under Code Section 761 to carry out the purposes of the Direct Pay Election. The Final Regulations are generally effective (replacing existing temporary regulations) beginning May 10, 2024, applicable to taxable years ending on or after March 11, 2024. Taxpayers may, in certain circumstances, apply the provisions of the Final Regulations to taxable years ending before March 11, 2024.

The Inflation Reduction Act of 2022 (the “IRA”) created two credit monetization provisions: the “transferability” provision under Code Section 6418, whereby eligible taxpayers can freely transfer certain federal tax credits to third parties for cash (if all applicable requirements are met), and the Direct Pay Election under Code Section 6417. Generally, pursuant to Code Section 6417, for taxable years beginning after December 31, 2022, specified tax-exempt entities (and certain other entities) can elect to have certain energy credits treated as refundable credits rather than their ordinary treatment as nonrefundable offsets to taxpayers’ tax liabilities. In effect, this allows these tax-exempt organizations to have the value of an applicable tax credit paid directly to them by the Internal Revenue Service, despite not having any (or having very limited) taxable income.

Eligible entities that may make the Direct Pay Election (referred to hereinafter as “applicable entities”) include tax-exempt entities under Code Section 501(a), including nonprofit organizations under Code Section 501(c)(3), states and their political subdivisions, the Tennessee Valley Authority, Alaska Native Corporations, and Indian tribal governments. Notable credits for which the Direct Pay Election applies include the Code Section 45 production tax credit and the Code Section 48 investment tax credit, as well as their respective technology neutral successors under Code Sections 45Y and 48E, respectively, for which solar, wind, landfill gas, hydroelectric, geothermal, and standalone battery storage projects may be eligible if all applicable requirements are met. In addition, the Direct Pay Election is also available for several other credits, including, the Code Section 45X advanced manufacturing production credit, the Code Section 45Q carbon sequestration credit, the Code Section 45V clean hydrogen production credit, and, for certain applicable entities, the Code Section 45W clean vehicle credit. For-profit companies and certain other entities that are not applicable entities have a limited ability to make a Direct Pay Election strictly with respect to credits generated pursuant to Code Sections 45Q (carbon sequestration), 45V

(clean hydrogen production), or 45X (advanced manufacturing) (the “Specified Credits”).

Under both the prior proposed regulations and the Final Regulations, partnership entities are generally treated as ineligible for the Direct Pay Election (although partnerships may still make a Direct Pay Election with respect to the three Specified Credits discussed above), even if its partners are applicable entities. Nevertheless, both the prior proposed regulations and the Final Regulations provide that if an applicable entity is a co-owner in a direct pay eligible project through a tenancy-in-common (commonly referred to as a TIC) relationship or an organization that has made a valid election under Code Section 761 to be excluded from the application of Subchapter K, then the applicable entity can make a Direct Pay Election with respect to its share of the applicable tax credits. The Proposed Regulations expand this exception by permitting a full or partial election out of Subchapter K if four requirements are satisfied: (1) the entity must be owned, in part or in whole, by one or more applicable entities; (2) the members must enter into an agreement under which the members reserve the right to take in kind or dispose of their pro rata shares in the electricity produced, extracted, or used, or any associated renewable energy credits; (3) pursuant to the operating agreement, the entity must be organized exclusively to jointly produce electricity from its direct pay eligible projects; and (4) one or more of the applicable entity members make the Direct Pay Election with respect to its share of the direct pay eligible projects. Taxpayers may rely on the Proposed Regulations’ provisions regarding elections under Section 761(a) for exclusion from Subchapter K treatment for taxable years ending on or after March 11, 2024.

The Final Regulations also clarify several items that were left ambiguous under Code Section 6417, including:

- Applicable entities include the District of Columbia and its political subdivisions, as well as United States territories and their political subdivisions. However, while the Direct Pay Election is generally available with respect to projects located in the District of Columbia, it is generally not available with respect to projects located in United States territories.
- The Direct Pay Election is available to applicable entities that hold applicable credit property generating the applicable credit in an entity that is disregarded as separate from its owner for federal income tax purposes.
- The Direct Pay Election must be made on a timely (including extensions), originally-filed income tax return. The election cannot be either made or withdrawn on an amended return, though numerical errors with respect to properly claimed elections can be corrected on amended returns. No late election relief is available.
- A Direct Pay Election is nonrevocable, and with respect to credits under Code Section 45 (production tax credit), 45Y (clean energy production credit), 45Q (carbon sequestration), and 45V (hydrogen production), applies to all taxable years for which the credit is available.
- A Direct Pay Election is only available with respect to credits for which the applicable entity owns the applicable credit property generating the credit (or conducts the activity giving rise to the credit, in the case of Code Section 45X). This precludes the possibility of an applicable entity making an elective payment election with respect to a credit that was transferred to it pursuant to new Code Section 6148.
- In the event that an applicable entity claims a larger credit than it is allowed, the entity will incur a tax (regardless of any tax-exempt status) equal to the excess payment as well as, absent a showing of reasonable cause for such excess payment, a penalty equal to 20% of such excess.

Each renewable energy project for which the Direct Pay Election may apply, as indicated herein, would need to be closely evaluated to determine if it is eligible for any applicable credits and the Direct Pay Election. The statutes and regulations regarding energy credits, and the rules regarding the Direct Pay Election, are complex and nuanced. For additional information and context, please contact one of the authors.?

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