Energy Alert

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Inflation Reduction Act: New Guidance on Direct Payment Election

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On March 5, 2024, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) released the following guidance with respect to the elective payment election (the Direct Payment Election) under Section 6417:[1]

- Final regulations under Section 6417 (the 6417 Final Regulations), which modify and finalize proposed regulations released on June 21, 2023 (the 6417 Proposed Regulations);
- Proposed regulations under Section 761 (the 761 Proposed Regulations), which would expand the election to be excluded from Subchapter K (the Election Out) to apply to certain unincorporated organizations organized exclusively for electricity generation; and
- Notice 2024-27 (the Chaining Notice), which requests comments regarding whether, in certain circumstances, the Direct Payment Election should be available for energy transition tax credits that are purchased by the taxpayer pursuant to Section 6418 (frequently referred to as the "chaining" of tax credits).

The Basics of the Direct Payment Election

Section 6417 permits applicable entities (generally, tax exempts and other entities that do not pay federal income tax) to receive a cash payment for the dollar amount of applicable credits following a valid Direct Payment Election. Applicable credits include the following twelve energy transition tax credits:

- the alternative fuel vehicle refueling property credit under Section 30C (the 30C Refueling Credit);
- the production tax credit under Section 45 (the 45 PTC);
- the carbon sequestration credit under Section 45Q (the 45Q Credit);
- the clean hydrogen production credit under Section 45V (the 45V Clean Hydrogen Credit);
- the advanced manufacturing production credit under Section 45X (the 45X AMPC);
- the clean electricity production credit under Section 45Y (the 45Y CEPC);
- the clean fuel production credit under Section 45Z (the 45Z CFPC);
- the investment tax credit under Section 48 (the 48 ITC);

[1] All "Section" references are intended to refer to sections of the Internal Revenue Code of 1986, as amended.

- the advanced energy project credit under Section 48C;
- the clean electricity investment credit under Section 48E (the 48E CEIC);
- the zero-emission nuclear power production credit under Section 45U (the 45U NPPC); and
- the qualified commercial vehicles credit under Section 45W (the 45W QCVC).

Taxable entities (referred to as electing entities) are permitted to make a Direct Payment Election for a limited menu of energy transaction tax credits – the 45Q Credit, the 45V Clean Hydrogen Credit, and the 45X AMPC – but only for a five-year period.[2]

The Direct Payment Election generally permits an applicable entity or electing entity to treat the dollar amount of an applicable credit, first, as an offset to the entity's federal income tax liability for the taxable year of the election, if any, with any excess amount treated as a refund and payable to the entity as a cash payment from the Treasury.

The applicable entity or electing entity generally must make the Direct Payment Election no later than the due date for the tax return for the taxable year of the election.

Highlights from the 6417 Final Regulations

With limited exceptions, the 6417 Final Regulations adopt the form and substance of the 6417 Proposed Regulations. Here are the highlights:

- No Partial Elections. The 6417 Final Regulations confirm that applicable entities and electing entities are not permitted to make a Direct Payment Election for less than 100 percent of an applicable credit.
- Pass-through Entity Guidance. The 6417 Final Regulations confirm that:
  - Partnerships (and entities and arrangements classified as partnerships for federal income tax purposes) and S corporations are not applicable entities. Partnerships and S corporations therefore are not eligible to make the Direct Payment Election, except with respect to the 45Q Credit, the 45V Clean Hydrogen Credit, and the 45X AMPC.
  - An applicable entity is not permitted to make a Direct Payment Election through an entity or arrangement classified as a partnership, even if some or all of its partners are, themselves, applicable entities.
  - If an applicable entity is a co-owner in an applicable credit property through an unincorporated organization with a valid Election Out, the applicable entity's undivided ownership interest in the applicable credit property will be treated as a separate applicable credit property, and the applicable entity may make a Direct Payment Election with respect to the interest. The 761 Proposed Regulations, if finalized in current form, would expand the Election Out to accommodate renewable generation joint ventures (see discussion below).
- No Chaining Allowed?
  - The 6417 Final Regulations prohibit an applicable entity or electing entity from chaining applicable credits. The term "chaining" refers to a Direct Payment Election for an applicable credit for which the applicable entity or electing entity does not own the related applicable credit property (or, in the case of the 45X AMPC, does not conduct the activities giving rise to the credit). A Direct Payment Election therefore would be prohibited for (1) applicable credits acquired pursuant to a transfer

[2] The five-year period begins in the year the relevant carbon capture equipment or clean qualified clean hydrogen facility is placed in service or, in the case of the 45X AMPC, any year in which the taxpayer produces eligible components (as defined in Section 45X(c)(1)).

under Section 6418, (2) 45Q Credits acquired pursuant to an election under Section 45Q(f)(3), or (3) applicable credits acquired through a lease pass-through election under Section 50(d)(5).

  - However, in the Chaining Notice, Treasury and the IRS signaled that they are considering whether chaining of transferred credits under Section 6418 could be appropriate in certain circumstances.

- Timing of Direct Payments. Despite the urging of several commenters, Treasury and the IRS declined to specify a timeframe within which the IRS will process the Direct Payment Election and make direct payments.[3]
- Adjustments to the Original Return Requirement.
  - The 6417 Final Regulations confirm that the Direct Payment Election must be made on an original tax return and that revisions can be made on a superseding return (that is, a tax return filed after the original tax return but before the due date, including extensions).
  - The 6417 Final Regulations clarify that applicable entities and electing entities may make corrections for numerical errors on an amended tax return or an administrative adjustment request (AAR) pursuant to Section 6227. The original tax return must contain a substantive error to correct; the amended tax return or AAR cannot seek to correct a blank item or an item that is described as being "available on request."
- Confirmation of the Excess Benefit Rule.
  - With minor clarifications, the 6417 Final Regulations adopt the "no excess benefit" rule included in the 6417 Proposed Regulations. If an applicable entity receives a restricted tax exempt amount (that is, a grant, forgivable loan, or other tax-exempt income) for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring a property eligible for an investment credit (a Specified Purpose),[4] and the sum of the tax exempt amount and the applicable credit exceeds the cost of the property, then the dollar amount of applicable credit is reduced so that the sum of the restricted tax exempt amount and the applicable credit equals the cost of the property.
  - For this purpose, the determination of whether a loan is made for a Specified Purpose, and whether forgiveness of the loan is dependent on satisfying the Specified Purpose, is made at the time the loan is approved. The determination of whether a tax exempt grant is made for a Specified Purpose is made at the time the grant is awarded to the applicable entity. A grant awarded after acquisition of investment credit property is not a restricted tax-exempt amount unless approval of the grant was perfunctory and the amount of the grant was virtually assured at the time of application.
  - The "no excess benefit" rule does not apply if the applicable entity receives tax exempt amounts for a non-Specified Purpose (for example, if the tax exempt amount is from the organization's general funds or if the use of funds is not restricted to a Specified Purpose).
- No Guidance Regarding Payments Against Estimated Tax
  - Consistent with the 6417 Proposed Regulations, the 6417 Final Regulations do not address whether an applicable credit arising during a calendar quarter could be treated as paid against an estimated tax liability for the quarter.

[3] Treasury and the IRS received comments as to whether direct payments above $5 million (and presumably, in the case of entities other than corporations, $2 million) should be subject to Joint Committee of Taxation review pursuant to Section 6405, but noted that this topic was outside of the scope of the 6417 Final Regulations.

[4] For this purpose, investment credits include the 30C Refueling Credit, the 45W QCVC, the 48 ITC, and the 48E CEIC.

- The Preamble to the 6417 Final Regulations explains that taxpayers can adequately determine whether their quarterly estimated payments are sufficient to avoid penalties based on projected taxable income and taking into account the dollar amount of any applicable credit for the year. Accordingly, no special rule was deemed to be necessary.

The 761 Proposed Regulations

Treasury and the IRS received several comments regarding the application of the Election Out to energy transition projects. These comments reflected a general concern that, under current law, the Election Out for the joint production, extraction, or use of property—despite being intended for oil and gas drilling operations and occasionally utilized by public utility partnerships—would not be applicable to the typical non-utility energy transition project.

With the foregoing in mind, in the 761 Proposed Regulations, Treasury and the IRS would extend the Election Out for the joint production, extraction, or use of property to unincorporated renewable generation projects that satisfy the following requirements:

- The project must be owned, either in whole or in part, by one or more applicable entities;
- The participants, members, or owners of the project must reserve the right separately to take in kind or dispose of their pro rata shares of the electricity produced, extracted, or used, or the relevant applicable credits, with respect to the project;
- The organization operating the project, pursuant to a joint operating agreement, must be formed exclusively to produce electricity from renewable sources eligible for the 45 PTC, the 45Y CEPC, the 48 ITC, the 48E CEIC, or the 45W NPPC; and
- One or more applicable entities must make a Direct Payment Election with respect to the relevant applicable credits.

In addition, the 761 Proposed Regulations would relax two key requirements for the Election Out that otherwise would apply to a renewable generation joint venture.

First, participants would be permitted to own renewable generation projects indirectly through juridical entities classified as partnerships for federal income tax purposes. By contrast, participants in oil and gas drilling joint ventures are required to have direct co-ownership of the project assets in order to make the Election Out. This change is responsive to concerns that renewable generation project owners would have difficulty obtaining financing and negotiating contracts through direct co-ownership structures, and that the partnership joint venture already is well understood in the energy transition industry.

Second, the 761 Proposed Regulations would amend the joint marketing exception to be better suited for renewable generation. As a general rule, participants in an oil and gas or electricity joint venture are not eligible to make the Election Out if they jointly sell the oil, gas, or electricity they produce. However, under the joint marketing exception, each participant may delegate (typically, to another participant or its affiliate) authority to sell its share of production, but not for a period of time in excess of the minimum needs of the industry and in no event for more than one year.

The 761 Proposed Regulations would amend the joint marketing exception to permit an agent, on behalf of the participants in a renewable generation joint venture, to enter into a power purchase agreement (PPA) or other long-term contract pursuant to which the participants sell their respective shares of electricity without the one year limitation described above.[5] This change recognizes that independent

[5] The 761 Proposed Regulations would limit the delegation of authority to act on behalf of a participant (including to negotiate a PPA) to a period of time that does not exceed the minimum needs of the industry, and in no event for more than one year.

power producers often sell renewable electricity under long-term PPAs, and that buyers of renewable electricity, particularly utilities, often are unwilling to negotiate PPAs directly with multiple project owners.

Key Takeaways

The 6417 Final Regulations do not contain any surprises or significant departures from the 6417 Proposed Regulations. In light of this, the 6417 Final Regulations should provide clarity and certainty to applicable entities and electing entities seeking to incorporate direct payment into their financing structures.

The 761 Proposed Regulations broaden the ability of an applicable entity, as party to a joint venture, to leverage the Direct Payment Election in connection with renewable generation projects. Otherwise, applicable entities would not be permitted to make the Election Out for renewable generation projects owned through entities or arrangements classified as partnerships and, as a result, would not be able to make the Direct Payment Election with respect to their ownership interests in these projects. If not for the 761 Proposed Regulations, applicable entities would not have meaningful opportunities to make the Direct Pay Election other than for wholly-owned renewable generation projects, which would limit the utility of the election.

Interestingly, the expanded Election Out is available for renewable generation but not for other project types, including hydrogen (45V Clean Hydrogen Credit) and renewable fuels (45Z CFPC) production. Query whether the existing Election Out for the production, extraction, or use of property is sufficiently broad to accommodate hydrogen and fuels joint ventures. Even if it were, the existing Election Out still would not permit applicable entities to make the Direct Pay Election for an interest in a molecules joint venture held through a juridical entity, which could put these projects at a commercial disadvantage (e.g., when seeking financing). The 761 Proposed Regulations request comments as to whether the Election Out should be extended to applicable credit properties that do not produce electricity, which indicates that Treasury and the IRS are considering these questions.

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If you have questions concerning the contents of this alert, or would like more information about Weil's Tax practice group, please speak to your regular contact at Weil or to the authors:

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