KPMG report: Analysis and observations of final transferable credit regulations

May 2, 2024

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Contents

Introduction

The U.S. Treasury Department and IRS issued final regulations related to the election to transfer certain tax credits. As introduced in the "Inflation Reduction Act of 2022" (IRA), for tax years beginning after December 31, 2022, certain eligible taxpayers can make an election to transfer all or a portion of an eligible credit to unrelated persons (within the meaning of section 267(b) or 707(b)(1)) solely for cash consideration under section 6418. The unrelated taxpayers are then allowed to claim the transferred credits on their tax return. The cash payments are not included in gross income of the eligible taxpayer and are not deductible by the unrelated taxpayers.

Treasury and the IRS on June 14, 2023, released proposed and temporary regulations on transferability (section 6418) and direct pay (section 6417) for certain IRA energy credits (the "proposed regulations"). Read a KPMG report providing a summary of the rules and observations of the proposed regulations. Final section 6417 regulations were published in the Federal Register on March 11, 2024. Read a KPMG report providing observations and analysis of the final section 6417 regulations.

These final regulations largely adopt the proposed regulations despite various suggested changes from commenters. This report will highlight notable adoptions and departures from the proposed regulations for the election to transfer credits.

Eligible tax credits

Eligible tax credits include the following:

- Alternative fuel vehicle refueling property credit under section 30C, but only the portion that is treated as a general business credit under section 38(b)
- Renewable electricity production credit under section 45
- Carbon oxide sequestration credit under section 45Q
- Zero emission nuclear power production credit under section 45U
- Clean hydrogen production credit under section 45V
- Advanced manufacturing production credit under section 45X
- Clean electricity production credit under section 45Y
- Clean fuel production credit under section 45Z
- Energy credit determined under section 48
- Qualifying advanced energy project credit under section 48C
- Clean electricity investment credit under section 48E

Eligible taxpayers

Eligible taxpayers are any persons subject to internal revenue tax, including, but not limited to an individual, C corporation, S corporation, trust, estate, or partnership. Generally, an eligible taxpayer does mean any taxpayer that is not an "applicable entity" by reason of section 6417.

KPMG observation

Although there are no deviations from the proposed regulations with respect to the definition of an eligible taxpayer, these final rules clarify that a partnership that is wholly or partially owned by applicable entities qualifies as eligible to elect to transfer certain credits so long as the partnership itself has not elected to be an applicable entity for the purposes of section 6417.

Eligible credit property

An eligible taxpayer that is electing to transfer an eligible credit must make the election on its timely filed return with respect to each eligible credit property. In other words, to the extent that an eligible taxpayer is transferring credits for multiple eligible credit properties, a separate election must be made for each credit property.

The final regulations largely adopt the definition of eligible credit property as provided in the proposed regulations. However, in some instances the Treasury and the IRS have clarified or modified this definition.

First, the final regulations note that for purposes of section 48 property, the eligible credit property is the unit of energy property or, as relevant, the "energy project" defined in section 48(a)(9)(A)(ii) and proposed regulations thereunder. Proposed section 48 regulations issued in November describe an energy project as multiple units of energy property that are treated as singe project in certain circumstances. Read *TaxNewsFlash*

Additionally, commenters recommended a revision of the definition of "eligible credit property" for purposes of section 45Q. Specifically that the definition be a *component* of a single process train for the capture, disposal, utilization or injection of qualified carbon oxide rather than a single process train (as drafted in the proposed regulations). Treasury and the IRS agreed that guidance under section 45Q does not require a taxpayer to own every component of a single process train to qualify for the 45Q credit and have thus revised as recommended.

Rules for making transfer elections

The final regulations clarify that an eligible taxpayer must own the underlying eligible credit property *and* conduct the activities giving rise to the credit, except in the case of section 45X in which the taxpayer only needs to conduct the eligible activity, or substantially transform the constituent parts. And the final regulations confirm the proposed regulations by providing that when an election is made to pass the investment tax credit to a lessee under former section 48(d) and when the section 45Q credit is allocated to a disposer or user of carbon oxide under the election in section 45Q(f)(3), the lessee credit claimant and allocatee credit claimant in those situations cannot make an election to transfer the credit.

The proposed regulations provide a specific rule that if an eligible taxpayer is a grantor or owner of a trust, such grantor or owner can make a transfer election for the portion of eligible credit property held by the trust.

Specified credit portion

The proposed regulations defined the term “specified credit portion” to mean a proportionate share (including all) of an eligible credit. This confirms that an eligible taxpayer would not be permitted to sever bonus credit amounts from the base eligible credit and separately transfer any bonus or base credit amount (horizontal credit transfer).

Several commenters raised questions and concerns about the resources required for diligence, finance, and risk tolerance, and the increase in the administrative tax burden required to audit a transferee taxpayer’s portion of a vertical credit transfer.

Treasury and the IRS maintain that only vertical credit transfers are permissible for two reasons. First, horizontal credit transfers would add another layer of compliance due to the separate tracking of bonus and base credits with respect to the same property. Second, a bonus credit amount is not itself an eligible credit.

Manner and due date for making election

The final regulations largely adopt the procedures as provided in the proposed regulations but clarify and modify the following important points.

Procedurally, a taxpayer must include a properly completed relevant source credit form containing the registration number, a properly completed Form 3800 (or its successor), a schedule attached to the Form 3800 (or its successor) showing the amount of eligible credit transferred for each eligible credit property, and a transfer election statement to make a valid transfer election as a part of filing an annual tax return.

A notable clarification is that the final regulations permit corrections to numerical errors on an amended return or administrative adjustment request (AAR) only if the change is to a substantive item. For instance, a taxpayer may not correct a blank item or an item that is described as being “available upon request.”

Most notably here, if the amount of the eligible credit is changed, any increases to the credit amount may not be transferred but decreases to the credit must be reflected. Specifically, the amount of the decrease will first decrease the amount of the eligible credit that is retained, if any (and thus not transferred) by the eligible taxpayer. Any portion of such decrease that remains after reducing the eligible credit retained by the eligible taxpayer then reduces the amount reported by the transferee taxpayer. If the eligible credit was transferred to more than one transferee taxpayer, the reduction to each transferee taxpayer’s specified credit portion is on a pro rata basis. The amount of any cash consideration retained by the eligible taxpayer after accounting for any reduction in the amount of the eligible credit transferred to the transferee taxpayer(s) cannot be excluded from gross income.

If an eligible taxpayer has made an adjustment to decrease the credit amount, depending on the facts and circumstances, a transferee taxpayer may be at risk for an excessive credit transfer, should the IRS make such a determination prior to the transferee taxpayer making its own adjustment to correct the specified credit portion through a qualified amended return. The final regulations do not mandate a reporting or notification requirement on the eligible taxpayer or the transferee taxpayer in the event of an adjustment that occurs after a timely and properly filed transfer election. Therefore, it is up to the eligible taxpayer and the transferee taxpayer to contract for such a requirement and mitigate the risk of excessive payments.

As provided in the proposed regulations, no transfer election can be made or revised on an amended return or AAR. Thus, the election must be made on a timely filed return or superseding return as long as it is filed on or before the due date (including extensions). These final regulations modify the proposed regulations

to permit the extension of time to allow for an automatic six-month extension if the eligible taxpayer did not received an extension of time to file a return after the original due date, has timely filed a return, takes corrective action under §301.9100-2(c) within the six-month extension period, and meets the procedural requirements outlined in §301.9100-2(d).

Timing and treatment of transfer payments

Timing

Several commenters asked for clarity on when a transfer is deemed to have occurred. The final regulations clarify that a transfer of a credit portion does not technically occur until an eligible taxpayer satisfies all of the requirements (described in the section above) to make a valid transfer election. However, the technical transfer date does not necessarily control for other purposes of section 6418. For example, under the paid in cash rule, amounts can be paid with respect to the specified credit portion as early as the beginning of the taxable year in which the related eligible credit is determined.

There is no late-election relief available under §§ 301.9100-1 or 301.9100-3 of this chapter for a transfer election that is not timely filed; however, relief under §301.9100-2(b) may apply if the eligible taxpayer has not received an extension of time to file a return after the original due date, has timely filed a return, takes corrective action under §301.9100-2(c) within the six-month extension period, and meets the procedural requirements outlined in §301.9100-2(d).

To clarify, a transfer of a specified credit portion does not technically occur until an eligible taxpayer satisfies all the requirements in §1.6418-2(b) to make a valid transfer election. However, it is important to note that the technical transfer date does not necessarily control for other purposes of section 6418. For example, under the paid in cash rule, amounts can be paid with respect to the specified credit portion as early as the beginning of the taxable year in which the related eligible credit is determined.

Cash payments

Several commenters advocated for the allowance of advanced payments, specifically for future production tax credits (PTCs) to more closely align transferability with traditional tax equity structures. Treasury and the IRS state that allowing advanced payments would raise several complex legal and administrative issues (of which no comment addressed). Accordingly, these final regulations continue to disallow advanced payments. The preamble to the final regulations does, however, clarify that there is no prohibition on loans from a transferee taxpayer to an eligible taxpayer, including in the case where the loan is secured by the credit purchase and sale agreement.

Treatment of excessive payments

Based on requests from commenters, the final regulations revise the proposed for the calculation and treatment of the excessive payment for the eligible taxpayer and transferee taxpayer.

Notably, if an excessive credit transfer occurs, the final regulations provide that the eligible taxpayer must treat the portion of the purchase price related to the excessive credit transfer as taxable income. The transferee taxpayer can deduct the payment, but the nature of the deduction will be based on general income tax principles.

The amount of the deduction is calculated based on the cash paid by the transferee taxpayer for the specified credit portion. This is multiplied by the ratio of the excessive credit transfer amount to the total specified credit portion claimed by the transferee taxpayer.

KPMG observation

The final regulations do not address when a deduction should be taken or how it should be classified but, rather, that this should be determined based on general income tax principles. This will create a timing question for taxpayers, should an excessive payment arise.

Treatment of transaction costs

Commenters recommended that the final regulations clarify the treatment of transaction costs such as legal and consulting fees, success-based fees, tax insurance, and indemnity payments. This is a live issue that many taxpayers are facing as they plan for the upcoming filing of their 2023 federal tax returns.

The final regulations explicitly do not address the treatment of these costs, stating that these costs are beyond the scope of the transfer regulations and are generally governed by other Code sections and federal income tax principles. However, the Treasury and the IRS may consider these specific comments in developing rules outside of these final regulations.

Anti-abuse rule

The intent of the anti-abuse rule is to allow recharacterization if the price paid is not economically supportable and is unreasonable based on the facts and circumstances of the transaction. Many commenters requested clarification on this rule, specifically questioning whether a transfer of a credit for cash consideration could ever be fully respected in cases in which the cash consideration for the credit is greater or less than the average transfer price of the eligible credit between parties.

The IRS adopted suggestions to revise the examples and use the term "arm's length price of the eligible credit without regard to other commercial relationships" instead of the average transfer price. However, the Treasury and the IRS emphasized that the facts and circumstances of each case would dictate whether the anti-abuse rule applies.

Treasury and the IRS concluded that it is premature to adopt any safe harbor or a list of abuse examples in the final regulations but will continue to study transactions between eligible taxpayers and transferee taxpayers to determine if it is appropriate to adopt an objective safe harbor or clarify other examples of abusive practices.

Passive credit rules under section 469

The proposed regulations provided that section 469 applies to a transferee taxpayer. This proposed rule provided that a specified credit portion transferred to a transferee taxpayer is treated as determined in connection with the conduct of a trade or business and, if applicable, the transferred portion is subject to the rules in section 469 (passive credit rules).

Some commenters questioned whether the passive credit rules (which limit the use of tax credits based on how active a taxpayer is in the business) should apply to transferee taxpayers. It was noted inapplicability of those rules could increase participation in the market, which could strengthen the market and support renewable energy and job creation goals. While other argued that applying the rules would help prevent fraud and abuse.

The final regulations confirm that the passive credit rules should apply to transferee taxpayers, just as they apply to other taxpayers earning credits through a trade or business.

The final regulations do provide a clarification that in the limited circumstance where a transferee taxpayer directly owns an interest in an eligible taxpayer's trade or business and materially participates in the credit generating activity, the transferee taxpayer is permitted to treat those credit as not arising on connection with a passive activity.

Recapture events

Investment credits are subject to recapture (in declining annual 20% increments) if the investment credit property is disposed of or ceases to be eligible property (in whole or in part) during the five-year period following the date on which the property is originally placed in service.

Commenters recommended that the final regulations allocate the risk of recapture to the eligible taxpayer for several reasons, including that the eligible taxpayer would have the greatest ability to cause or prevent a recapture event. The final regulations reject these recommendations and maintain that the burden will shift to the transferee.

Additionally, the final regulations clarify that recapture liability applies proportionately to an eligible taxpayer and any transferee taxpayers to the extent an eligible taxpayer has retained any amount of an eligible credit determined. Specifically, this clarifies instances for which an eligible taxpayer has retained any amount of an eligible credit determine with respect to a component of carbon capture equipment owned by the eligible taxpayer within a single process train.

REIT treatment

Although the proposed regulations touched on the treatment of transferred tax credits for the purposes of calculating REIT qualification, there was still room for clarity. Treasury and the IRS recognize that REITs may be continuously earning and selling eligible credits and, therefore, need certainty with respect to this REIT qualification issue. Accordingly, the final regulations provide that eligible credits that have not yet been transferred pursuant to section 6418 are disregarded for purposes of the REIT Asset Test.

Treasury and the IRS agree that participation in the transfer of eligible credits under section 6418 should not burden all of a REIT's sales of real property. Accordingly, these final regulations provide that the transfer of a specified credit portion pursuant to a valid section 6418 election is not a sale of property for purposes of section 857(b)(6)(C)(iii) and section 857(b)(6)(D)(iv) and, thus, does not count as one of the seven sales described in those provisions.

This is favorable news to REITs who are participating in the transfer of eligible credits.

Conclusion

Although Treasury and the IRS received and considered many comments in response to the proposed regulations, the final regulations generally follow the proposed regulations with only a handful of changes and clarifications. The credit transfer market has been operating relatively effectively under the proposed regulations since their issuance in June, as a result, these final regulations are unlikely to have a significant impact on deal activity or structures.

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