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Selling Federal Energy Tax Credits: Who, What, When, and How…and Other Important Points

The U.S. Department of the Treasury recently issued proposed regulations (the Proposed Regulations) providing guidance on the ability of taxpayers to transfer by sale certain federal income tax credits derived from investments in renewable energy projects.

The Proposed Regulations are regulatory sections 1.6418-1 through 1.6418-5, as well as temporary regulation section 1.6418-4T, all of which are intended to carry out the requirements of Section 6418 of the Internal Revenue Code of 1986, as amended (the Code). Section 6418 was added to the Code by the Inflation Reduction Act of 2022 (the IRA) and provides the statutory authority for taxpayers to freely transfer by sale specified federal income tax credits generated by investments in specified renewable energy projects. The Proposed Regulations (including the temporary regulation) are published in the Federal Register dated June 21, 2023. Comments to the Proposed Regulations must be submitted by August 14, 2023.

What follows is an overview of the fundamental requirements and procedures for selling federal renewable energy tax credits, as set forth in Section 6418 and the Proposed Regulations. For simplicity, Section 6418, the Proposed Regulations and the temporary regulation are referred to herein collectively as the “Guidance” and the specified federal renewable energy tax credits that may be bought and sold are the “credits”.

Who Can Sell and Who Can Buy Credits?

Sellers. The Guidance allows any “eligible taxpayer” to sell credits. A “taxpayer” means any person subject to any internal revenue tax. An “eligible taxpayer” is any taxpayer that is not described in Section 6417(d)(1)(A) of the Code. Section 6417(d)(1)(A) defines those entities that are eligible to make a “direct pay” election (i.e., cash refund payment election from the IRS) for investments in specified renewable energy projects. Direct pay eligible entities are, generally, tax-exempt organizations, States, their political subdivisions and instrumentalities, Indian tribal governments, Alaskan native corporations, rural electric cooperatives, and certain governmental affiliated entities such as the Tennessee Valley Authority.

- Thus, under the Guidance, a seller of credits can be any taxpayer other than an entity that is eligible for the direct pay election; namely, for-profit corporations, including S corporations, partnerships, individuals, trusts, and similar taxpayers. An exception to this rule applies to Sections 45V (clean hydrogen production tax credit), 45Q (carbon oxide sequestration tax credit), and 45X (advanced manufacturing production tax credit), which provisions allow certain for-profit entities to elect to receive direct payments for credits for a portion of the applicable tax credit period for those energy projects.

Buyers. A buyer of credits (referred to as the “transferee taxpayer” throughout the Guidance) is any entity with federal income tax liabilities for which credits can be used and which is not related (within the meaning of Code Sections 267(b) and 707) to the seller. Transferee taxpayers can be partnerships, corporations, including S corporations, individuals, trusts, and similar taxpayers.

What Types of Renewable Energy Projects Are Eligible For Credits?

Only credits that are defined as “eligible credits,” that is, derived from specified renewable energy projects, can be sold. No other federal income tax credit can be freely sold.

Eligible credits (and their related Code Sections) are:

- alternative fuel vehicle refueling property (30C)

- renewable electricity production credit (45)
- carbon oxide sequestration credit(45Q)
- zero-emission nuclear power production credit (45U)
- clean hydrogen production credit (45V)
- advanced manufacturing production credit (45X)
- clean electricity production credit (45Y)
- clean fuel production credit (45Z)
- energy credit (e.g., solar, wind, geothermal, etc.) (48).
- qualifying advanced energy project credit (48C)
- clean electricity investment credit (48E).

The above-referenced projects all have their own particular, and complex, requirements.

When Can Credits Be Sold?

Credits can be sold for taxable years beginning after December 31, 2022.

With respect to a specific credit sale, there are various time-sensitive requirements for seller and buyer that are discussed in detail under “How Are Credits Sold?” below.

How Are Credits Sold?

In very general terms, a sale of credits will typically involve a purchase agreement, indemnity or guarantee agreement, insurance coverage for specified recapture events, along with seller provided transactional diligence related to the project generating the credits. Beyond those negotiated items, the “How” in this section pertains specifically to the tax-required mechanics of a credit sale as set forth in the Guidance.

Pre-filing registration with IRS.

As a crucial first step, the Guidance requires sellers to register with the IRS before selling any credits; specifically, before filing the tax return on which a transfer election (discussed below) with respect to credits to be sold is made and to provide information related to each eligible credit property for which the seller intends to transfer all or a specified portion of credits. The seller must satisfy the pre-filing registration requirements set forth in the Guidance.

After the required pre-filing registration process is successfully completed, the seller will receive a unique registration number (Registration Number) from the IRS for each registered “eligible credit property” for which the seller intends to transfer credits. The Guidance anticipates that this pre-filling registration process will occur through an IRS electronic portal. A seller must obtain a separate Registration Number for each “eligible credit property” and cannot aggregate multiple properties under one Registration Number. Registration Numbers are valid only for the taxable year obtained, but may be renewed via the IRS registration portal.

What constitutes an “eligible credit property” varies based on the specific renewable energy projects described above. For example, for the electricity production tax credit under Code Section 45, an eligible credit property is determined on a “facility by facility” basis. For the investment tax credit under Code Section 48, a credit eligible property is determined on a “property by property” basis, which generally means with respect to the “energy property” determined under that Code Section. The Guidance indicates that a seller may make a transfer election with respect to an “energy project” (which comprises multiple energy properties) based on additional forthcoming guidance. Sellers will need to be especially careful in determining the appropriate unit of measurement for making a transfer election based on the renewable energy property from which the credit is derived.

In connection with any sale of credits, the Registration Number will be reported on both the seller’s and buyer’s tax return for the taxable year of the sale. A seller that does not obtain a Registration Number and report the Registration Number on its tax return with respect to an eligible credit property is ineligible to make a transfer election. As a result, any credit sales without such Registration Number will be invalid.

Tax Credit Transfer Election and Required Documentation.

To make a valid transfer election, a seller, as part of filing a return, generally would be required to include the following-(A) a properly completed relevant source credit tax form for the eligible credit; (B) a properly completed Form 3800, General Business Credit, including reporting the Registration Number received during the required pre-filing registration; (C) a schedule attached to the Form 3800 showing the amount of credit transferred for each eligible credit property; (D) a “transfer election statement” (described below); and (E) any other information related to the election specified in additional guidance.

- A transfer election must be made not later than the due date (including extensions) for the tax return for the taxable year for which the credit is determined.

- The transfer election must be filed on an original return and may not be made or revised on an amended return or by filing a request for an administrative adjustment.

- There is no relief available for a late transfer election.

- Once made, an election to transfer an eligible credit is irrevocable.

A "transfer election statement" is defined as a written document (not a specific IRS tax form) that describes the transfer of credits between seller and buyer. A transfer election statement that is completed by both the seller and buyer would be necessary to allow the buyer the opportunity to file a return without needing to wait for the seller to file. A transfer election statement must include (1) information related to the seller and buyer; (2) a statement that provides the necessary information and amounts to allow the buyer to take into account the credits with respect to the eligible credit property; (3) a statement that the parties are not related (within the meaning of Code Section 267(b) or 707(b)(1)); (4) a representation from the seller that it has complied with all relevant requirements to make a transfer election; (5) a statement from the seller and the buyer acknowledging the notification of recapture requirements (described below) under Code Section 6418(g)(3) and the related Guidance; and (6) a statement or representation from the seller that the seller has provided the required minimum documentation to the buyer. Required minimum documentation is essentially the minimum documentation that the seller must provide to a buyer to validate the existence of the eligible credit property, any bonus credit amounts, and the evidence of credit qualification.

However, a transfer election statement cannot be completed for any taxable year after the earlier of (A) the filing of the seller's tax return for the taxable year for which the credit is determined, or (B) the filing of the tax return of the buyer for the year in which the credit is taken into account. In other words, the transfer election statement needs to be completed before a return is filed by either party.

- A seller may make multiple transfer elections to transfer separate credit portions derived from an eligible credit property to multiple buyers.

- Partnerships and S corporations (and not their partners or shareholders) must make the transfer election in connection with a sale of credits by the partnership or S corporation.

- If a project is owned by a disregarded entity, then the disregarded entity's sole ultimate owner must make the transfer election.

- Lessees that receive credits under a lease pass-through election under Code Section 50(d)(5) and Treas. Reg. Section 1.48-4 cannot make a transfer election (and therefore cannot sell credits once received via the pass-through election). However, purchasers/lessors of energy property under a sale-leaseback can make a transfer election with respect to eligible credits.

- Sellers owning projects for which credits are available over a multi-year period, such as the 10-year credit period for the electricity production tax credit under Code Section 45, must make a transfer election for each year of such period for which the seller intends to sell credits.

Other Sale Considerations; Tax Impact; Limitations on Utilization

All credit sales must be paid in cash. Cash means specifically U.S. dollars, and no cash equivalents or any other consideration is permitted, not even a de minimis amount. Other critical points are as follows:

- Credits cannot be sold for progress expenditures.

- Credits can only be sold one time.

- Credits must include all bonus credit amounts. In other words, increases to the applicable percentage for calculating the credit amount, such as for energy communities and domestic content requirements, cannot be sold separately from the base energy credit amount. Therefore, multiple transfers of credits from a single credit eligible property must include a proportionate share of any bonus credit amounts.

- Buyers are subject to passive activity limitations on the use of purchased credits. Therefore, buyers that are subject to the passive activity rules are not treated as materially participating in the seller's trade or business. As a result, the credits would be treated as passive activity credits to the buyer.

- Buyers can use credits against estimated income tax.

- Buyers can use credits via a 3-year carryback or a 22-year carryforward of unused credits. However, credits cannot be sold if they are in carryforward or carryback status.

- Buyers purchasing credits at a discount to the credit value (e.g., $0.90 cents per $1.00 of credit) do not include the discount in gross income for tax purposes.

- Proceeds from the sale of credits are not includable in gross income of the seller for tax purposes and payments for credits are not deductible for any reason to the buyer.

Buyer and Seller Partnerships

Any amount received by a selling partnership or S corporation as consideration for the transfer of credits is treated as tax-exempt income for purposes of Code Sections 705 and 1366. Specifically, the income is treated as arising from an investment activity rather than a trade or business (and as a result, it is not treated as passive income with respect to the selling entity's partners or shareholders).

The Guidance provides that a partner's distributive share of tax-exempt income from a sale of credits is based on such partner's distributive share of the otherwise eligible credit for each taxable year. In other words, tax-exempt income resulting from the receipt of cash by a selling partnership in exchange for credits should be allocated to the same partners and in the same proportionate amount as the specified credit portion would have been allocated if not transferred. Where a selling partnership transfers only a portion of credits to a buyer while retaining other credits to be allocated through to partners, the Guidance allows that tax-exempt income be specially allocated to those partners that desired to transfer their distributive share of the underlying credits, while other credits may be allocated to those partners that did not desire to sell their distributive share of credits. However, the amount of eligible credits allocated to each partner may not exceed such partner's eligible credit amount and the amount of tax exempt income allocated to each partner must equal such partner's proportionate share of tax exempt income resulting from the transfer.

Note that the Guidance imposes no special limitations on the manner in which the cash itself from the sale of credits may be distributed.

With respect to buyer partnerships, an allocation of a transferred credit amount by a buyer partnership to its partners would not be considered a transfer under the Guidance. As a result, an allocation of credits to an owner of a pass-through buyer does not violate the no-second-transfer rule in Code Section 6418(e)(2).

Additionally, buyer partnerships must treated the cash paid to the seller as a nondeductible Section 705(a)(2)(B) expenditure.

Additional rules also apply to tiered partnerships and to S corporations.

Recapture

The Guidance clarifies that buyers are liable for recapture of credits. Recapture is applicable to credits that are considered to be investment tax credits. However, note that recapture does not apply to production tax credits (with the except of carbon sequestration credits under Section 45Q which provides for a 3-year recapture period).

Very generally, a recapture of credits occurs if the seller disposes of the project during the applicable recapture period (typically five years from the date the project is placed in service). In that circumstance, the buyer is liable for the recapture amount.

- As a consequence, credit sales will customarily require indemnities between seller and buyer for indemnification of buyer in the event of a recapture. Such indemnities should be funded through insurance coverage for recapture events applicable to the buyer. The scope of such coverage may vary but will ordinarily involve the buyer as loss payee and should include penalties and interest.

The Guidance provides that a buyer is not liable for recapture resulting from an indirect disposition event; that is, a recapture event that arises as a result of an owner of the seller (e.g., a partner in the selling partnership or a shareholder in an S corporation) disposing of all or a portion of its interest in the seller (and, thus, its indirect interest in the energy property assets) below a certain percentage threshold (typically below 66.66% of its interest). Similarly, if a partner or shareholder of seller reduces its at-risk amount below a certain threshold during the recapture period, triggering a reduction in the credit base for such partner or shareholder, such partner or shareholder will remain liable for recapture, and not the buyer.

Thus, in the case of a disposition of an interest in seller, the disposing partner, not the buyer, remains liable for recapture with respect to the amount to be recaptured.

In the event of a recapture event, the seller is required to provide notice to the buyer of such recapture event, and the buyer is, in turn, required to provide notice to the seller of the amount of any recapture (collectively, the recapture notices). The recapture notices must be exchanged with sufficient time before the due date for both seller's and buyer's federal income tax returns (without extension) to allow the buyer to calculate the recapture amount and the seller to calculate any increase in tax basis resulting from the recapture.

Excessive Credit Transfer

In addition to recapture, the Guidance requires buyer to be liable for any excessive credit transfer. That is, where a buyer claims more credits than are otherwise allowable to the seller with respect to the eligible credit property, the buyer will be liable for tax equal to the excess amount of credit claimed, plus 20% of the excess amount. A buyer may be excused from the 20% penalty if the buyer can show reasonable cause for an excessive credit transfer. The Guidance clarifies that a recapture event is not an excessive credit transfer and that the excessive credit transfer rules operate separately from the recapture rules. More specifically, the Guidance explains as follows:

“The excessive credit transfer rules apply where the credit amount reported on the original credit source form by the eligible taxpayer [seller] and transferred to a transferee taxpayer [buyer] was excessive. Recapture of a tax credit occurs when the original tax credit reported would have been correct without the occurrence of a subsequent recapture event. Thus, a recapture event does not create an excessive credit transfer.”

Anti-Abuse

In addition to recapture and excessive credit transfer rules, the Guidance includes an anti-abuse provision, which provides authority to the IRS to disallow the transfer of an eligible credit, or to recharacterize a transaction’s income tax consequences, in circumstances where the parties to the transaction have engaged one or more transactions with the principal purpose of avoiding tax liability beyond the intent of Code Section 6418. For example, a transaction where a seller undercharges or overcharges for services to a customer who is also purchasing credits from the seller as a buyer may violate the anti-abuse rule.

The proposed regulations include two examples to illustrate application of the anti-abuse rule. Example 2 describes the following circumstances where a seller attempts to decrease its gross income with respect to a sale of property simultaneous with the sale of credits, while also increasing a buyer’s ability to take an offsetting deduction.

- Taxpayer C, an eligible taxpayer, generates $100 of an eligible credit with respect to an eligible credit property in the course of its trade or business. Taxpayer C also sells property to customers. Taxpayer C offers Customer D, a transferee taxpayer that can deduct the purchase of property, the opportunity to receive the $100 of eligible credit for $20 while purchasing Taxpayer C’s property for $80. Taxpayer C normally charges $20 for the same property without the transfer of the eligible credit, and the average transfer price of the eligible credit between unrelated parties is $80 paid in cash for $100 of the eligible credit. Taxpayer C is willing to accept the higher price for the property because Taxpayer C has a net operating loss carryover to offset any taxable income from the transaction. This transaction is subject to recharacterization under the anti-abuse rule under paragraph (e)(4) of this section, and Taxpayer C will be treated as selling the property for $20 and transferring $100 of the eligible credit for $80, and Customer D will have a $20 deduction related to the purchase of the property instead of $80.

Thus, sellers and buyers should be mindful of clearly separating the economic considerations of credit transfers from other income generating activities between the parties.

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