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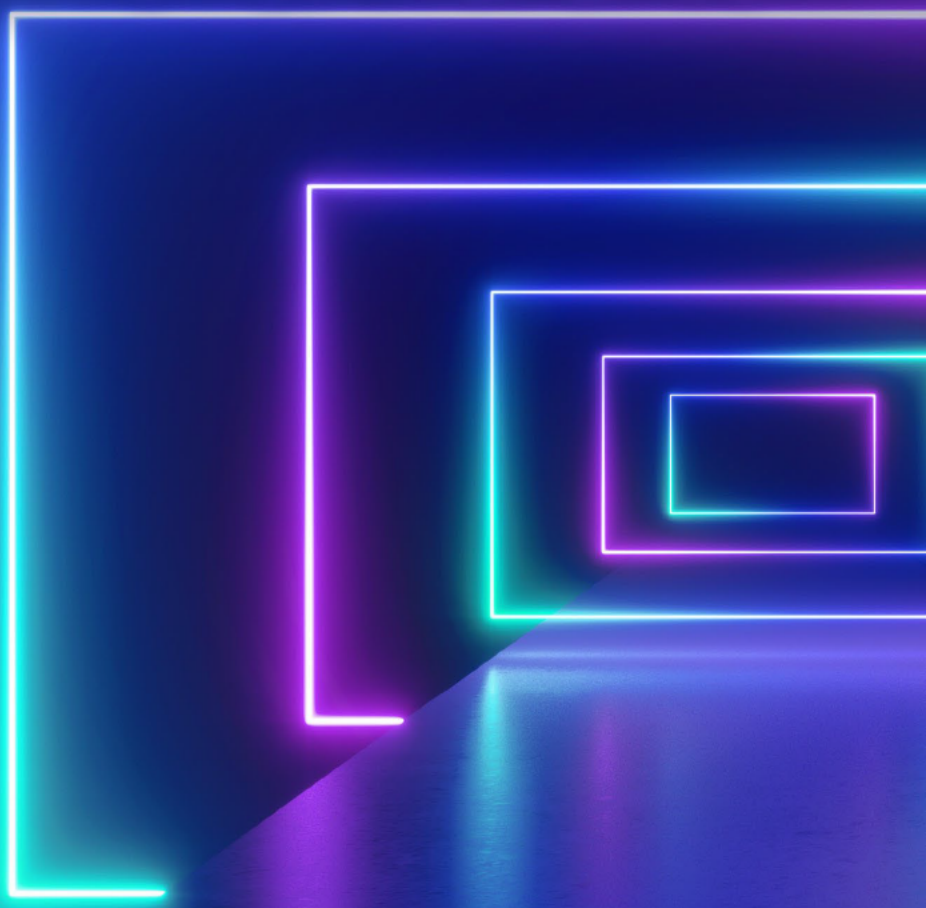
Final regulations on direct pay of certain tax credits under IRA

KPMG observations and analysis



March 13, 2024 (updated March 15)

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Introduction

The U.S. Treasury Department and IRS issued final regulations related to the "direct pay" option (formally known as "elective pay," but more commonly referred to as "direct pay") for monetizing certain tax credits available under the "Inflation Reduction Act of 2022" (IRA). These regulations respond to comments submitted by taxpayers on earlier proposed regulations and describe the rules for the direct pay election; special rules applicable to certain types of entities, basis reductions and recapture, and denial of double benefit; the pre-filing registration process; and penalties for excessive payments.

The final regulations are effective, and prior temporary regulations are removed, beginning May 10, 2024.

Background

The IRA introduced a new monetization mechanism by enacting new section 6417. For tax years beginning after December 31, 2022, applicable entities and, in certain limited cases, other taxpayers can make a direct pay election with respect to certain energy credits that were expanded and introduced in the IRA ("applicable credits") to have the credit amount treated as a payment of tax and refunded if the amount exceeds the entity's tax liability. For some taxpayers this could be the full amount of the credit if no income tax liability exists.

Applicable entities—generally, governmental and tax-exempt entities, discussed further later in this report—are eligible to make direct pay elections with respect several applicable credits, including the major investment and production tax credits, as well as credits relating to alternative energy vehicles and refueling property. The ability to make a direct pay election for certain credits begins to phases out, however, if certain domestic content requirements (or the statutory exceptions to these requirements) are not met for projects of 1 megawatt or more beginning construction in 2024 and later. The IRS on December 28, 2023, issued Notice 2024-9 [PDF 128 KB] providing guidance for applicable entities regarding how to meet the exceptions to the domestic content requirements for projects beginning construction in 2024 and requesting comments to inform a future rulemaking relating to the domestic content exceptions more broadly. Read *TaxNewsFlash*

Taxpayers that do not meet the definition of an applicable entity may make a direct pay election only with respect to three specified credits (Sections 45Q, 45V and 45X). These taxpayers are referred to as "electing 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 [PDF 529 KB] providing a summary of the rules and observations of the proposed regulations.

As of the date of this report, the IRS has not issued final regulations under section 6418 relating to transferability.

This report will highlight notable adoptions and departures from the proposed regulations for direct pay.

Applicable entities

Applicable entities include:

- Organizations exempt from federal income tax imposed by subtitle A of the Code
- States, the District of Columbia and their political subdivisions, and instrumentalities and agencies thereof
- U.S. territories and their political subdivisions, and instrumentalities and agencies thereof
- Indian tribal governments and subdivisions, and instrumentalities and agencies thereof
- Alaska Native Corporations
- The Tennessee Valley Authority
- Corporations operating on a cooperative basis that are engaged in furnishing electric energy to persons in rural areas as described in section 1381(a)(2)(C) of the Code

Although commenters requested changes to several aspects of the definition of an "applicable entity", the final regulations largely adopted the proposed regulations, with some revisions.

The final regulations expanded the definition of "applicable entities" to include any organization described in sections 501 through 530 of the Code that meets the requirements to be recognized as exempt from tax under any of those sections. The expanded definition now includes, for example, homeowner's associations described in section 501(c)(28). In addition, the final regulations clarify that taxable cooperatives described in section 1381(a)(2)(C), which are engaged in furnishing electrical energy to rural areas, are included as applicable entities. However, the definition of an applicable entity does not include other cooperatives that are subject to tax under subchapter T.

The preamble to the final regulations notes in response to comments that whether an entity is an agency, instrumentality, or political subdivision (or subdivision in the case of an Indian tribal government), is based on existing law and that additional guidance on this subject is beyond the scope of the regulations. Although not required, the preamble notes that entities may request a private letter ruling from the IRS Office of Chief Counsel, applying the law to the organization's specific set of facts.

Partnerships, tenancies in common (TICs) and valid elections under section 761(a)

The proposed regulations provided that a partnership, even one that has all applicable entities as partners, is not an applicable entity and is therefore not eligible to elect direct pay (except as an electing taxpayer in the case of credits determined under sections 45V, 45Q, and 45X).

Instead of allowing partnerships to elect direct pay, the proposed regulations provided that where an applicable entity and another taxpayer owned applicable credit property through a tenancy-in-common ("TIC") structure or through an organization that has elected out of subchapter K under section 761(a), then an applicable entity could separately elect direct pay for its undivided ownership share of the applicable credit property.

Commenters requested clarifications with respect to TICs, valid section 761(a) elections, and joint ownership under section 6417.

Treasury and the IRS agreed that additional guidance was needed on joint ownership arrangements of applicable credit property that produces electricity. As a result, Treasury and the IRS issued new proposed regulations under section 761(a) ("2024 proposed regulations") concurrently with the section 6417 final regulations. The 2024 proposed regulations expand the circumstances in which joint ownership arrangements of applicable credit property can be excluded from the application of subchapter K to carry out the purposes of section 6417 as intended by Congress.

The 2024 proposed regulations amend the regulations under section 761(a) to allow an unincorporated organization meeting the following four requirements to elect out of subchapter K:

- The unincorporated organization is owned, in part or in full, by one or more applicable entities.
- The unincorporated organization's members entered into a joint operating agreement with respect to the applicable credit property in which the members reserve the right separately to take in kind or dispose of their pro rata shares of the electricity produced, extracted, or used, or any associated renewable energy credits or similar credits.
- The unincorporated organization is, pursuant to a joint operating agreement, organized exclusively to produce electricity from its applicable credit property, with respect to which one or more of the applicable credits is determined.
- At least one of the applicable entities will make a direct pay election under section 6417(a) for the applicable credits determined with respect to its share of the applicable credit property.

The 2024 proposed regulations also modify the joint marketing requirement in the existing section 761(a) regulation, allowing a participant's delegee to enter into contracts, such as power purchase agreements, that bind a participant to sell its share of the electricity generated from applicable credit property, provided that the participant is not bound to the agency relationship with the delegee for longer than one year.

Taxpayers may rely on these 2024 proposed regulations for tax years ending after March 11, 2024.

KPMG observation

Although the IRS did not change its position to allow partnerships to make the direct pay election, these 2024 proposed regulations provide an avenue for co-ownership of credit property by applicable entities, allowing them to elect out of subchapter K so that the applicable entities can make direct pay elections with respect to the applicable credits determined with respect to their undivided shares of the applicable credit property.

No excess benefit rule

The proposed regulations provided that, in the case of an applicable entity, the amount of an investment tax credit and certain other credits ("investment-related tax credits") could be limited if the entity received certain grants, forgivable loans, or similar tax-exempt income specifically for the acquisition of credit property ("restricted tax-exempt amounts"). Treasury and the IRS recognized that the typical rule for taxpayers that excludes from the basis of credit property expenditures made with tax-exempt income would for many applicable entities, whose income is generally exempt from tax, eliminate the entire credit amount and undermine the intent of Congress in providing the direct pay option. Therefore, the proposed regulations provided that applicable entities, unlike taxable entities, may generally *include* expenditures made with tax-exempt income in the basis of credit property. However, the proposed regulations also provided that, for direct pay purposes, the credit amount would be reduced if the sum of the restricted tax-exempt amounts received, and the otherwise available investment-related tax credit exceeded the cost of the credit property. In such case, the credit would be reduced until there was no such excess, potentially to zero.

The final regulations generally follow the proposed regulations but make revisions and add examples to clarify the application of the rules. For example, the final regulations clarify that the determination of whether a tax-exempt grant is made for the specific purpose of acquiring an investment-related credit property is made at the time the grant is awarded to the applicable entity. The final regulations further provide that tax-exempt grants awarded after the investment-related credit property is acquired are generally not restricted tax-exempt amounts unless approval of the grant was perfunctory and the amount of the grant was virtually assured at the time of application. Further, the final regulations state that the rule reducing the direct pay credit amount does not apply to tax-exempt amounts that were not received for the specific purpose of acquiring a property eligible for an investment-related credit – for example, if the tax-exempt amount is from an organization's general fund.

Treasury and the IRS acknowledged but rejected requests from commenters that only federal grants be considered in applying the no-excess-benefit rule, asserting that all tax-exempt amounts should be treated the same way. Additionally, Treasury and the IRS clarified that loans that must be repaid are not tax-exempt amounts and, thus, are not restricted tax-exempt amounts and would not impact the calculation of an applicable entity's credit amount under this rule.

Special rules for tax-exempt organizations and government entities

The proposed regulations allowed applicable entities to apply certain capitalization and depreciation rules (such as sections 167, 168, 263 and 263A of the Code) for the purposes of determining the basis of an applicable credit. In response to a specific comment received, the final regulations adopt the proposed regulation and also add section 266 to the list of capitalization rules that applicable entities can use.

KPMG observation

This is welcome news for taxpayers who are looking to capitalize more costs (including indirect costs and carrying charges) to the basis of the assets which are ITC eligible, as allows applicable entities to increase the credit amounts for which they qualify.

The final regulations also provide that an applicable entity that has not filed annual tax returns previously may elect to use either a calendar or fiscal tax year when it files its first Form 990-T to elect direct pay, provided that the entity maintains adequate books and records to support its choice.

KPMG observation

Because the direct pay election is only effective for tax years beginning after 2022, entities on a fiscal tax year can only claim credits with a direct pay election for credit properties placed in service in 2023 after the beginning of their fiscal tax year. Entities on a calendar tax year can make a direct pay election for credit property placed in service at any time in 2023.

Electing taxpayers

Partnerships and S corporations

For electing taxpayers that are partnerships or S corporations, the proposed regulations provided that the direct pay election could be made only at the partnership level. Although commentors requested changes

to the proposed regulations, the guidance retains the rule that only a partnership or S corporation (not the members thereof) is eligible to make a direct pay election regarding a section 45V credit, section 45Q credit, or section 45X credit.

Further, the final regulations follow the proposed regulations to provide that if a partnership or S corporation makes a direct pay election, any amount received is treated as tax-exempt income and each partner's share of that tax-exempt income is equal to the partner's share of the credit it would have otherwise received if the direct pay election was not made. Further, tax-exempt income is treated as received or accrued, including for purposes of sections 705 and 1366, as of the date the credit is determined.

Considerations for taxpayers allowed credits under section 45Q(f)(3)(B) and section 50(d)(5)

Taxpayers claiming the section 45Q credit are, generally, electing taxpayers.

Generally, the taxpayer who owns the carbon capture equipment is the eligible credit claimant for the 45Q credit. However, Section 45Q(f)(3)(B) provides an election to allow the person that enters into a contract with the electing taxpayer to dispose of the qualified carbon oxide (disposer), utilize the qualified carbon oxide (utilizer), or use the qualified carbon oxide as a tertiary injectant (injector) to claim the credit (credit claimant). In essence, this election allows the credit claimant to assign the credit to the offtaker.

Consistent with the proposed regulations, Treasury and the IRS have concluded that when a section 45Q(f)(3)(B) election is made, the offtaker cannot make a direct pay election.

Additionally, consistent with the proposed regulations, the final regulations clarify that there is a distinction between sale-leaseback transactions under section 50(d)(4) and lease-passthrough elections under former section 48 (pursuant to section 50(d)(5)). The final regulations provide that an applicable entity, or electing taxpayer, is prohibited from making an election under section 6417 for credits acquired by a lessee from a lessor by means of an election to pass through the credit to a lessee under former section 48(d) (pursuant to section (50(d)(5)). This prohibits the lessor in an inverted leasing arrangement from electing the direct pay option.

Rules applicable to both applicable entities and electing taxpayers

Rules for making direct pay elections

The proposed regulations provided general rules for an applicable entity or electing taxpayer to make a direct pay election. The final regulations largely adopt the rules as proposed.

The proposed regulations provide that a direct pay election must be made on an originally filed return (including extensions). The final regulations follow the proposed regulations by providing that no direct pay election may be initially made on or withdrawn on an amended return or by filing an administrative adjustment request (AAR). A direct pay election may, however, be made (or withdrawn) on a superseding return – one filed after at least one return has already been filed, but before the due date.

On the other hand, the final regulations clarify that the amount of a credit may be adjusted on an amended return or an AAR.

This clarification is intended to address situations in which a taxpayer actually made a direct pay election on a timely filed return but made a reporting error with respect to an element of the valid election (for example, miscalculating the amount of the credit on the original return or making a typographical error in the process of inputting a registration number). This would allow the taxpayer to correct errors or to correct an excessive payment before an excessive payment determination is made by the IRS. Additionally, it is permissible for taxpayers to correct errors that would increase the amount claimed as long as the larger amount claimed on the amended return or AAR is accurate.

In addition, the preamble noted that the taxpayer's original return, which must be signed under penalties of perjury, must contain all of the information required to make the election, including a registration number. To properly correct an error on an amended return or AAR, a taxpayer must have made an error in the information included on the original return such that there is a substantive item to correct. For instance, the regulations provide that a taxpayer cannot correct a blank item or an item that is described as being "available upon request."

For taxpayers that failed to make a timely direct pay election on their originally filed return (filed by the due date, without extensions), the final regulations also modify the proposed regulations to permit a six-month extension of time from the due date of the return (excluding extensions) to make the election, provided the taxpayer follows the procedures in Treas. Reg. 301.9100-2.

Partial elections

The proposed regulations provided that a direct pay election applies to the entire amount of applicable credit(s) determined with respect to *each applicable credit property* properly registered for the tax year. Thus, the direct pay amount is the entire amount of applicable credit(s) determined with respect to the applicable entity or electing taxpayer for a tax year. The final regulations follow the proposed regulations.

Treasury and the IRS noted in the preamble to the final regulations that the statute and guidance to date already provide considerable flexibility because taxpayers can register none, some, or all of their applicable credit properties.

Prohibition of chaining

The proposed regulations provided that an applicable entity could not buy an applicable credit from an unrelated party and then make a direct pay election.

The final regulations follow proposed regulations. Treasury and the IRS explained that sections 6417 and 6418, when read together, are two separate, mutually exclusive regimes. They stated that, while the statute does not expressly prohibit chaining, Treasury and the IRS believe that not permitting chaining allows for a more straightforward application of the statute as a whole. Additionally, Treasury and the IRS are concerned about the administrative burden that tracking chaining would create in order to prevent fraud and abuse.

The IRS also issued Notice 2024-27 [PDF 118 KB] that requests comments to inform future rulemaking for situations in which a direct pay election should be allowed to be made for a transferred credit.

Ownership

To help clarify any confusion around ownership and who is eligible as the credit claimant, the final regulations specify that the applicable entity or electing taxpayer must both own the underlying applicable credit property and conduct the activities giving rise to the applicable credit. The only exception is with respect to the section 45X credit, which requires that the taxpayer substantially transform the constituent

elements to be eligible to claim the credit. That is, with respect to all of the applicable credits, with the exception of the section 45X credit, ownership of qualified property is required.

Estimated taxes and other general business credit applications

The proposed regulations provided that if a taxpayer intends to make a direct pay election, that credit cannot be included in estimating the taxpayer's quarterly estimated tax payments.

The final regulations provide that taxpayer may include credits that are eligible for the direct pay election in their estimated tax payments, but only to the extent that the amount of those credits does not exceed their general business credit (GBC) limitation.

One commenter urged that the final regulations treat the entire direct pay amount as a payment against tax for purposes of determining base erosion minimum tax (known as the base erosion anti-abuse tax or BEAT). The final regulations rejected that request.

Additionally, in response to the proposed regulations commenters had raised concerns about the proposed treatment of direct pay credits first as general business credits (GBCs) applied against tax pursuant to the GBC ordering rules. The concern raised in these comments related to scenarios in which taxpayers would have to apply direct pay credits ahead of other nonrefundable GBCs later in the ordering rules, resulting in no net direct pay amount. The final regulations changed the proposed regulations such that taxpayers will calculate the net direct pay amount prior to applying the ordering rules of section 38(d).

Timing of payment

One question weighing on the minds of commenters was the timeframe in which entities will receive the direct pay amount. Unfortunately, Treasury and the IRS declined to specify a particular time within which a direct pay election will be processed, stating several factors that they anticipate will affect processing time. Additionally, commenters asked for a process whereby taxpayers could receive their refunds in the form of a prepayment, or on a quarterly basis to assist in the funding of the energy properties. Treasury and the IRS declined to provide such a rule.

However, as the preamble to the proposed regulations stated, the prefiling registration is intended to allow the IRS to verify certain information about a taxpayer in a timely manner while mitigating the risk of fraud or improper payments and then process the annual tax return with minimal delays. Therefore, the registration process is meant as an aid to speed up the processing time for payments after filing.

IRS audits

Another commenter stated that it would be helpful to specify what, if any, audit process would apply to tax-exempt or governmental entities that do not normally file tax returns or pay taxes. This commenter stated that the pre-registration certification process will go a long way toward preventing fraud associated with these projects and thus recommended that Treasury and the IRS identify a category of smaller projects that could be excluded from, or subjected to, a simplified audit process. Treasury and the IRS stated that they expect that tax-exempt or governmental entities that do not ordinarily file tax returns or pay tax would be subject to the same examination process and procedures as other entities that have historically had a filing obligation.

KPMG observation

Although this was anticipated, it is likely that a number of applicable entities do not presently have sufficient internal resources to respond to audit requests, should their credits be challenged by the IRS. Therefore, it is important for applicable entities to work with tax advisors to ensure that they have collected proper documentation to substantiate the credits claimed.

Direct pay timing

An election under section 6417(a), once made, is irrevocable after the filing due date has passed and applies with respect to any applicable credit for the tax year for which the election is made.

Under section 6417, the election applies for a period of years with respect to certain applicable credits. Specifically, for a section 45 credit or section 45Y credit, the election applies to the 10-year period beginning on the date the facility was originally placed in service.

For applicable entities, a section 45Q credit election applies to the 12-year period beginning on the date the equipment was originally placed in service. For electing taxpayers, elections under sections 45Q and 45V apply only for five years and are allowed one revocation per applicable credit property. A few commenters requested that the final regulations clarify whether it is possible to make a second five-year direct pay election for the same applicable credit property. Treasury and the IRS have determined that it is more consistent with the statute to allow only one election per specific applicable credit property; thus, the final regulations continue to unambiguously provide that it is not possible to make an direct pay election for the same applicable credit property for a second five-year period.

Pre-filing registration expectations

As stated in the proposed regulations, the final regulations concur that a direct pay election is not effective unless the applicable entity or electing taxpayer receives a valid registration number and includes the registration number for each applicable property on its federal tax return.

Multiple commenters asked how long the pre-filing registration process is expected to take and what a taxpayer should do if the IRS does not timely issue a registration number. Treasury and the IRS stated that because the timeframe and procedures of the pre-filing registration process may be modified over time as both the IRS and taxpayers gain experience with it, the final regulations do not contain any timeframe.

Multiple commenters asked that the final regulations allow the option to group multiple qualified facilities as a "single project" that would obtain a single registration number, or that consolidated filings be available for multiple small projects.

Treasury and the IRS stated in the preamble to the final regulations that the definition of applicable credit property in section 6417 is based on the relevant rules for the underlying applicable credit, and changes to the definition of particular properties under the underlying Code sections is outside the scope of the rulemaking. They further stated that if the underlying Code section allows grouping to determine a qualified property, then grouping for purposes of a registration number is permitted. If the respective credit does not allow grouping, then each applicable credit property must be registered separately; however, for some applicable credits, the pre-filing registration portal allows applicable credit property information to be uploaded by way of a spreadsheet file (bulk upload).

KPMG observation

Publication 5884 [PDF 6.7 MB] the "Pre-Filing Registration Tool User Guide and Instructions," is a useful tool for all pre-filing registration questions, including documentation requirements by credit, and other various nuances that direct pay registrants may encounter. The final regulations reference this publication in response to commenter requests for clarity.

Conclusion

Treasury and the IRS took careful and thorough consideration of numerous comments in the drafting of the final regulations. Nonetheless, apart from the specific modifications outlined in this report, the regulations largely adopt the proposed regulations issued in June.

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