Direct pay and transferable credit proposed regulations

KPMG analysis and observations

June 27, 2023

kpmg.com/us

Contents

- Background 2
  - Inflation Reduction Act 2
  - CHIPS Act 2
  - Proposed and temporary regulations 2
- Section 6418 – Transferable tax credits 2
  - Eligible credits 3
  - Eligible taxpayers 3
  - Eligible credit property 3
  - Solely for cash 4
  - General rules for making transfer election 4
  - Manner and due date for making election 5
  - Application of at-risk and passive activity rules 6
  - No gross income to transferees 6
  - Estimated taxes 6
  - Anti-abuse rule 6
  - Special rules for partnerships and S corporations 6
  - Application of investment credit at-risk rules 9
  - Investment credit recapture 9
  - Excessive credit transfers 10
  - Recapture 10
- Section 6417 – Direct pay 11
  - Applicable entities 11
  - Applicable credits 11
  - Special rules for unincorporated joint ventures 12
  - How to make the direct pay election 13
  - Rules for applicable entities 13
  - Situations when no elective payment election allowed 14
  - Mechanics of direct pay election 14
  - Timing 15
  - Special rules for electing taxpayers 15
  - Special rules for partnership and S corporations 15
  - Excessive payments 16
- Registration requirements 16
- Section 48D credits 17

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Background

Inflation Reduction Act

The Inflation Reduction Act significantly extended and expanded numerous energy-related federal income tax credits and enacted new sections 6417 and 6418, which allow such credits to be sold to unrelated third parties for cash or, in certain circumstances, to be monetized for cash payments from the federal government through a direct pay election.

Under section 6418, for tax years beginning after December 31, 2022, eligible taxpayers can elect to transfer all or a portion of an eligible credit to unrelated taxpayers for cash consideration. The transferee taxpayers are then allowed to claim the transferred credits on their tax returns. The cash payments are excluded from the transferor's gross income and are not deductible by the transferee.

Under section 6417, for tax years beginning after December 31, 2022, governmental and tax-exempt entities and, in certain limited cases, other taxpayers can make a direct pay election with respect to certain credits, effectively treating them as refundable tax credits. So-called "applicable entities" (generally, governmental and tax-exempt entities) are eligible to make direct pay elections with respect to the energy tax credits addressed in the IRA. However, taxpayers that do not meet the definition of an applicable entity may only make direct pay elections with respect to three types of credits. Thus, for most taxpayers, direct pay is not available for most energy tax credits.

The availability of transferable and direct pay credits represents a monumental shift in the operation of these tax credits, and the way credit projects are financed.

CHIPS Act

The CHIPS Act created a new advanced manufacturing investment tax credit under Section 48D for which a direct pay election is also available for all taxpayers eligible to claim the Section 48D credit.

Proposed and temporary regulations

The U.S. Treasury Department and IRS on June 14, 2023, released proposed regulations on transferability and direct pay and proposed and temporary regulations on related procedural aspects. These proposed procedural regulations apply to section 48D, as well as sections 6417 and 6418.

The proposed regulations are generally applicable to tax years ending on or after the date of publication of final rules. However, taxpayers are permitted to rely on the proposed regulations for tax years beginning after December 31, 2022, provided they apply the proposed regulations in their entirety and in a consistent manner. The temporary regulations apply to tax years ending on or after their publication in the Federal Register on June 21, 2023.

This report provides a summary of the operative rules, as well as observations and practical implications.

Section 6418 – Transferable tax credits

For tax years beginning after December 31, 2022, eligible taxpayers may transfer eligible credits to an unrelated person (within the meaning of section 267(b) or 707(b)(1)) solely for cash.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Eligible credits

Eligible 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; and
- Clean electricity investment credit under section 48E.

Eligible taxpayers

Eligible taxpayers are any persons subject to internal revenue tax other than applicable entities as defined described in section 6417. Eligible taxpayers include individuals, C corporations, S corporations, trusts, estates, and partnerships.

Special rules apply to partnerships and S corporations. These rules are discussed below.

Eligible credit property

As outlined below, an eligible taxpayer that is transferring an eligible credit must make an election on its originally 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.

In general, a separate election must be made for each credit property type and each different project location/facility. More specifically:

- Alternative fuel vehicle refueling property – elect on a "property-by-property" basis;
- Renewable electricity production credit – elect on a "facility-by-facility" basis;
- Carbon oxide sequestration credit – elect on a "process train of carbon capture equipment basis"'
- Zero emission nuclear power production credit – elect on a "qualified nuclear power facility basis"
- Clean hydrogen production credit – elect on a "facility by facility basis";
- Advanced manufacturing production credit – elect on a "facility by facility basis";
- Clean electricity production credit – elect on a "facility by facility basis";
- Clean fuel production credit– elect on a "facility by facility basis";
- Energy credit determined – elect on a "property by property" basis;
- Qualifying advanced energy project credit under section 48C of the Code – elect on a "property by property" basis; and
- Clean electricity investment credit – elect on a "facility by facility basis" but a "property by property" basis for energy storage property.

KPMG observation

Some of these credits are new and what constitutes the relevant "facility" or "property" has not yet been defined.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

For purposes of the renewable electricity production credit for wind energy facilities, there is a definition under applicable guidance. Each separate concrete pad, tower and turbine is a separate facility under those rules. It is not clear whether a wind farm with 20 turbines must file 20 separate elections; this seems overly burdensome.

For purposes of the energy credit, the preamble to the proposed regulations provides that the "property" consists of all components of property that are functionally interdependent if the placing in service of each component is dependent upon the placing in service of each of the other components in order to generate electricity. Functionally interdependent components of property that can be operated and metered together and can begin producing electricity separately from other components of property within a larger energy project will be considered an energy property. The preamble to the proposed regulations cross references to sec. 7.01 of Notice 2018-59 for this purpose.

Sec. 7.01 further provides:

> Generally, energy property is comprised of all components of property necessary to generate electricity up to and including the inverter. This may include PV panels (or other arrangements of solar cells), fiber-optics, fuel cells, turbines, boilers, mounting equipment, support structures, tracking equipment, monitoring equipment, transformers and other power conditioning equipment, and inverters. For rooftop solar energy property, property integral to the generation of electrical energy that is installed on a single rooftop is considered a single unit of property.

It is not clear whether a solar facility with multiple inverter lines must file more than one election; this seems overly burdensome.

Solely for cash

Compensation for the transfer of eligible credits must consist solely of cash. Cash means payments made by cash, check, cashier's check, money order, wire transfer, automated clearing house (ACH) transfer, or other bank transfer of immediately available funds.

Payments made by the credit transferee prior to the transfer of an eligible credit, or prior to the claiming of the credit on an transferee's return, will be treated as made solely for cash, and not as part of a deemed loan, if the payment is made during the period (1) beginning on the first day of the eligible taxpayer's tax year during which an eligible credit is determined and (2) ending on the due date for completing a transfer election statement. See discussion of transfer election statements in the next section.

A contractual commitment to purchase eligible credits in advance of the date an eligible credit is transferred to the transferee complies with this rule as long as the cash transfer satisfied the rules immediately above.

General rules for making transfer election

The proposed regulations provide general rules for making transfer elections in various contexts, including the treatment of disregarded entities and consolidated groups. The proposed regulations also identify circumstances in which no transfer election can be made.

Specifically, the proposed regulations provide that no transfer election can be made:

- With respect to any amount of investment credit allowed for progress expenditures.
- By any lessee of investment credit property that is otherwise allowed to claim the credit pursuant to lease-passthrough election under former section 48(d); or
- By any disposer or user of carbon oxide that is otherwise allowed to claim section 45Q credits pursuant to an election under section 45Q(f)(3).

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

The preamble explains the rationale for this rule and a similar rule under section 6417 by reference to the principle that credits are only determined with respect to taxpayers who own the underlying property or, if ownership is not required, otherwise conduct the activities giving rise to the relevant credit. For purposes of section 45Q, the disposer or utilizer arguably conducts the activities giving rise to the underlying eligible credit. This rule, if finalized, may limit the economic flexibility afforded by the section 45Q(f)(3) election.

Manner and due date for making election

A transfer election must be made on an original return filed no later than the due date (including extensions) for the original return for the tax year in which the credit is determined. As described above, a separate credit transfer election must be made for each credit property. Additionally, a transfer election must be made for each tax year during an applicable credit period (e.g., each taxable for 10 years for the section 45 production tax credit).

A valid transfer election must include the following: (1) source form for the credit (e.g., Form 7207, Advanced Manufacturing Tax Credit for section 45X) for the year the credit is determined; (2) Form 3800 including the registration number received during the pre-filing registration relating the eligible credit property; (3) a schedule attached to the Form 3800 showing the amount of eligible credit transferred for each eligible credit property; (4) a transfer election statement; and (5) any other information specified in guidance.

The transfer election statement must be attached to the returns of both the transferor and the transferee. The transfer election statement can be any document, including a purchase and sale agreement, but must be labeled “Transfer Election Statement.” The transfer election statement should include all relevant information, such as name, address, description of eligible credit, total amount of credit determined, the tax year of the transferor and the first tax year in which the credit will be claimed by the transferee, the amounts paid as cash consideration and when paid, and the registration number. The statement must be signed under penalties of perjury.

A transfer election statement can be completed at any time as long the relevant information is available but must be completed before the earlier of (a) the filing of the transferor’s return for the tax year for which the transferred credit is determined or (b) the filing of the return of the transferee taxpayer for the year in which the credit is claimed.

The proposed rules require the transferor to provide the transferee with a minimum amount of documentation consisting of: (1) information that validates the existence of the eligible credit property (which could be third party provided); (2) documentation substantiating eligibility for bonus credit amounts; (3) evidence of the transferor’s qualifying costs in the case of investment credits, or evidence of the amount of qualifying production activities in the case of production based tax credits.

KPMG observation

Taxpayers will have to pay close attention to the timing and documentation requirements required by the proposed regulations to avoid any foot faults around making a good transfer. Furthermore, transferor taxpayers should take care to document every aspect of credit eligibility, including prevailing wage and credit adders, as this documentation will have to be shared with ultimate transferors. It is likely that most parties to a credit transfer transaction will prepare and expect this type of documentation but that it may also be required by regulations emphasizes how important diligent credit documentation will be.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Application of at-risk and passive activity rules

When investment credit property is held by a transferor partnership or S corporation, the proposed regulations provide that the eligible credit amount available to be transferred is determined taking into account the section 49 at-risk rules at the partner or shareholder level. Any transferor partnership or transferor S corporation must determine each partner's or shareholder's amount of nonqualified nonrecourse financing relating to the credit property and the total section 49 limitation must be attached to the partnership's or S corporation's return. Changes to at-risk amounts under section 49 for partners or S corporation shareholders after the year in which the investment credit property is placed in service do not impact the amount of credit transferred. However, such changes do impact the relevant partners or shareholders are discussed below.

The proposed regulations also provide that the passive activity credit rules under section 469 apply to transferees in determining whether they are eligible to claim purchased credits. As a result, transferred credits are treated as passive activity credits to taxpayers subject to the passive activity rules and may only be used to offset passive trade or business income.

KPMG observation

The requirement to take into account section 49 at-risk limitations may prove challenging for partnerships and S corporations that are unable to obtain the required information from indirect owners.

Whether or not the proposed regulations would subject transferred credits to the passive activity credit rules in the hands of transferees was the subject of much speculation, in connection with larger questions about the types of buyers that will constitute the transferee market and, relatedly, the size of the market. The proposed regulations appear to reflect a policy call that the transferee market should not extend to individuals.

No gross income to transferees

The proposed regulations confirm that a transferee does not recognize gross income when claiming a transferred credit where the cash paid for the credit is less than the amount of credit transferred.

Estimated taxes

The preamble to the proposed regulations provides that a transferee taxpayer may take into account credits it has purchased, or intends to purchase, when calculated estimated tax payments.

Anti-abuse rule

The proposed regulations include an anti-abuse rule under which a transfer may be disallowed if the transaction or series of transactions effectuating the transfer are entered into with a principal purpose of avoiding gross income. The proposed regulations include examples illustrating application of the anti-abuse rule in situations where transferors undercharge or overcharge a customer/transferee for services in connection with the transfer of tax credits.

Special rules for partnerships and S corporations

The proposed regulations confirm that partnerships and S corporations may qualify as eligible taxpayers that can elect to transfer eligible credits determined with respect to eligible credit property held directly by such partnerships or S corporations, as well as eligible credit property held indirectly through entities disregarded as separate from such partnerships or S corporations for U.S. federal income tax purposes. In either case, no separate election is permitted to be made by any direct or indirect partner or shareholder.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The proposed regulations also confirm that partnerships and S corporations may qualify as transferee taxpayers that may purchase eligible credits from unrelated eligible taxpayers.

As described below, the rules for partnerships and S corporations generally parallel each other, with additional rules for partnerships required to address their more flexible nature.

Transferor partnerships

Under the proposed regulations, partnerships that directly (or indirectly through disregarded entities) own eligible credit property may elect to transfer all or a portion of any eligible credits determined with respect to such property by filing an election in accordance with the rules described above. No separate election may be made by any partner of a partnership.

Subject to a limited exception described below, if a partnership elects to transfer any amount of an eligible credit, the partnership is required to allocate the tax-exempt income realized from the transfer among its partners based on each partner's proportionate share of the eligible credit that would have been allocated to it absent the transfer. In other words, except as described below, the proposed regulations do not permit any special allocation of tax-exempt income realized by a partnership from the transfer of eligible credits. However, the preamble confirms that the cash proceeds from a credit transfer need not be distributed in the same manner as the tax-exempt income is required to be allocated. Rather, general partnership tax principles will apply.

Significantly, the proposed regulations provide a special taxpayer-friendly rule that allows a partnership that directly holds eligible credit property to transfer only certain partners' shares of the credit. Under this special rule, if a partnership elects to transfer less than all of an eligible credit, the partnership is permitted to allocate the tax-exempt income resulting from the transfer to certain partners, while allocating the remaining portion of the eligible credit among other partners, or a combination thereof. However, no partner may be allocated eligible credits in excess of the partner's eligible credit amount—i.e., the amount of credit the partner would have been allocated absent the transfer election—and each partner must be allocated its proportionate share of tax-exempt income resulting from the transfer. Each partner's proportionate share of such tax-exempt income is determined by multiplying the total tax-exempt income realized from the credit transfer by a fraction, (1) the numerator of which is equal to the partner's eligible credit amount less the amount of eligible credits allocated to the partner, and (2) the denominator of which is amount of eligible credits transferred by the partnership with respect to the eligible credit property for the tax year.

This special rule only applies to partnerships that directly hold the eligible credit property. Upper-tier partnerships are required to allocate their distributive shares of any tax-exempt income realized from a credit transfer by a lower-tier partnership, and their distributive shares of any eligible credits allocated to the upper-tier partnership by a lower-tier partnership, in proportion to the upper-tier partners' distributive shares of the applicable credit, as determined under applicable partnership rules.

The tax-exempt income arising from a credit transfer will be treated as received or accrued by a partnership transferor, including for purposes of adjusting a partner's tax basis in its partnership interest, as of the date the transferred credit is determined with respect to the eligible property (e.g., the placed-in-service date of investment credit property). Any tax-exempt income realized by a partnership from a credit transfer is treated as arising from an investment activity and not from the conduct of a trade or business, and thus will not be treated as passive income to any direct or indirect partner that does not materially participate in the business for purposes of the passive activity rules applicable to individuals and closely held C corporations.

Transferor S corporations

Under the proposed regulations, S corporations that directly (or indirectly through disregarded entities) own eligible credit property may elect to transfer all or a portion of any eligible credits determined with respect to such property by filing an election in accordance with the rules described above. No separate election may be made by any shareholder of an S corporation.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

If an S corporation elects to transfer any amount of an eligible credit, the S corporation is required to allocate the tax-exempt income realized from the transfer among its shareholders on a pro rata basis, consistent with the single class of stock requirement for S corporations. Thus, no special allocations are permitted where only some shareholders desire to transfer their share of the eligible credit.

Similar to partnerships, the tax-exempt income arising from a credit transfer will be treated as received or accrued by an S corporation transferor, including for purposes of adjusting a shareholder's tax basis in its stock in the S corporation, as of the date the transferred credit is determined with respect to the eligible property, and is treated as investment income for purposes of the passive activity rules.

Transferee partnerships

Partnerships may qualify as transferee taxpayers and may purchase eligible credits from unrelated eligible taxpayers. An allocation of a transferred credit by a transferee partnership to its direct and indirect shareholders is not considered an impermissible second transfer of the credit.

Cash payments made by a partnership in exchange for eligible credits are treated as nondeductible expenditures that reduce a partner's capital account and tax basis in its partnership interest. Consistent with existing partnership allocation rules, transferred credits are required to be allocated in the same manner as the nondeductible expense incurred in connection with the credit transfer. The proposed regulations state that each partner's share of the nondeductible expense attributable to a credit transfer may be specified in the partnership agreement, or if not specified, will be determined based on the partnership's general allocation of nondeductible expenses.

The proposed regulations treat a transferred credit as an extraordinary item for purposes of the rules governing the allocation of partnership items where the partners' interests in the transferee partnership vary during a tax year. Under the proposed regulations, a transferred credit is allocable to the partners in the transferee partnership as of the transfer date of the credit. For this purpose, the transfer date of a credit would depend on whether the transferor and transferee partnership have the same tax year. If they have the same tax year, the transfer date of the credit is deemed to be the first date the transferee partnership makes a cash payment to the transferor taxpayer as consideration for the credit. If the transferor taxpayer and transferee partnership have different tax years, the transfer date is deemed to be the later of (1) the first date of tax year of the transferee partnership in which the credit would be taken into account or (2) the first date the transferee makes a cash payment as consideration for the credit.

The same allocation rules apply to upper-tier partnerships that directly or indirectly hold interests in the transferee partnership.

KPMG observation

The proposed regulations do not address whether an entity formed solely to purchase credits qualifies as a partnership for federal income tax purposes. While an example describes a fact pattern in which partners contribute cash to a partnership to purchase credits, the example does not indicate whether the partnership conducts any other activity. Clarity around this issue will be important for credit syndications. However, given the nature of the issues involved, additional guidance may be more likely to be issued in the form of a revenue ruling safe harbor, similar to the safe harbors for tax equity partnerships.

Further clarification is also needed regarding the allocation of the nondeductible expenses incurred by a partnership to purchase credits. The proposed regulations suggest that the expenses may be specially allocated among the partners by agreement, but do not indicate whether or how the allocation should be analyzed under the section 704(b) rules.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Transferee S corporations

S corporations may qualify as transferee taxpayers and may purchase eligible credits from unrelated eligible taxpayers. An allocation of a transferred credit by a transferee S corporation to its direct and indirect shareholders is not considered an impermissible second transfer of the credit.

Each shareholder's pro rata share of a transferred credit is determined under the same rules that apply to other tax items of an S corporation. Under these rules, an equal portion of the transferred credit will be allocated to each day of the S corporation's tax year and then divided pro rata among the shares of stock outstanding on that day. If the transferor taxpayer and the transferee S corporation have the same tax year, the transferred credit will be taken into account in the S corporation's tax year in which the S corporation first makes a cash payment as consideration for the transferred credit. If the transferor taxpayer and the transferee S corporation have different tax years, the transferred credit will be taken into account in the S corporation's first tax year ending with or after the tax year of the transferor taxpayer in which the credit arose.

Similar to partnerships, cash payments made an S corporation in exchange for eligible credits are treated as nondeductible expenditures that reduce a shareholder's tax basis in its S corporation stock.

Application of investment credit at-risk rules

As described above, the amount of eligible credit determined with respect to eligible investment credit property held by a transferor partnership or S corporation is required to be determined taking into account the application of the at-risk rules at the partner or shareholder level as of the close of the tax year in which the investment credit property is placed in service. This requirement may result in a limitation on the amount of eligible credit that may be transferred by the partnership or S corporation.

The proposed regulations provide that changes in a partner or shareholder's at-risk amount following the close of the tax year the investment credit property is placed in service do not impact a transferee taxpayer. However, any such changes will impact the partner or shareholder as follows:

- If there is a net increase in the amount of any nonqualified nonrecourse financing with respect to a partner or shareholder, the partner or shareholder's is required to increase their tax for the year by an amount equal to the aggregate decrease in investment credits allowed for all prior tax years, including transferred credits, that would have resulted from reducing the credit base by the amount of the increase.
- If there is a net decrease in the amount of any nonqualified nonrecourse financing with respect to a partner or shareholder, any increase in credit base is taken into account by the partner or shareholder and additional investment credit resulting from such increase can only be claimed by the partner or shareholder and may not be transferred.

Investment credit recapture

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. Exceptions to recapture exist for certain nonrecognition transfers, provided certain requirements are met.

Investment credit property held by a partnership or S corporation is subject to additional rules that require recapture of a partner or shareholder's distributive share of the investment credit in the event the interest of the partner or shareholder in the partnership or S corporation is disposed of or reduced (e.g., by partial disposition or dilution) below certain thresholds relative to their interest on the date the investment credit property is placed in service.

The proposed regulations provide that the disposition or reduction in the interest of a partner or shareholder of a transferor partnership or S corporation is disregarded for purposes of the transferability rules. Thus, so

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

long as the transferor partnership or S corporation continues to own the property, and the property remains eligible credit property in the hands of the partnership or S corporation, any such disposition does not result in recapture to the transferee taxpayer.

However, the proposed regulations further provide that the disposing partner or shareholder is subject to recapture in the event its interest in a transferor partnership or S corporation is disposed of or reduced below the applicable thresholds. In such event, the amount subject to recapture is determined based on the partner or shareholder's share of the basis of the investment credit property that gave rise to the investment credit—not the amount of tax-exempt income allocated to the partner or shareholder from the transfer of the credit.

KPMG observation

The proposed regulations confirm that a transferee taxpayer bears the risk of recapture of any purchased investment credit and includes a favorable rule that changes in ownership of a transferor taxpayer do not cause recapture to the transferee taxpayer. However, as changes in the direct or indirect ownership of a partnership or S corporation may impact the property's credit eligibility (e.g., a transfer to a tax-exempt organization), transferees will still need protection in that regard.

The rule imposing recapture on a partner/shareholder that disposes of their interest in a transferor partnership/S corporation following a sale of credits merits further consideration. While the government appears concerned with tax credit churning transactions, the tax benefit to the partner/shareholder is the exclusion of the credit sale proceeds from income and not the tax benefit of the credit claimed by the transferee. The proposed regulations do not address the impact of a sell-side recapture event on any future buy-side recapture event or related basis adjustments.

Excessive credit transfers

The transfer election rules provide that in the case where an amount of transferred credit is determined to constitute an excessive credit transfer, it will result in an increase in tax to the transferee by the amount of the excessive credit transfer plus 20% of such amount. The 20% penalty does not apply if the excessive credit transfer is due to reasonable cause. Unlike the direct pay rules discussed below, the proposed regulations do provide guidance on the reasonable cause exception for excessive credit transfers. Specifically, the proposed regulations provide that reasonable cause may be evidenced by the transferee's review of the transferor's records relating to the credit (including documentation evidencing eligibility for bonus credit amounts), reasonable reliance on third party expert reports, and reasonable reliance on representations from the eligible taxpayer that the total specified credit portion transferred does not exceed the total eligible credit determined with respect to the eligible credit property for the tax year.

Recapture

The proposed regulations confirm that in the event of investment credit recapture, the recapture amount is calculated and taken into account by the transferee. Likewise, although section 6418 is silent on recapture of section 45Q credits, the proposed regulations similarly provide that section 45Q recapture is taken into account by the transferee. The proposed regulations provide that in the case of recapture, the transferor is required to provide notification of a recapture event to the transferee.

KPMG observation

The proposed regulations follow the relevant statutory authority as it relates to recapture. The preamble specifically states, however, the parties to a transfer transaction are not prohibited from agreeing to indemnify the transferee taxpayer in the event of recapture. The extent and amount of

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

recapture indemnification have been and will continue to be an important point of negotiation in these transactions.

Section 6417 – Direct pay

Applicable entities

For tax years beginning after December 31, 2022, applicable entities may elect to receive direct payments from the federal government equal to the applicable credits determined with respect to the entity for applicable credit property.

Applicable entities include:

- Organizations exempt from federal income under section 501(a) of the Code;
- U.S. territories and political subdivisions, instrumentalities, and agencies thereof;
- States, the District of Columbia, and political subdivisions, instrumentalities, and agencies thereof;
- Indian tribal governments and political subdivisions, instrumentalities, and agencies thereof;
- Alaska Native Corporations
- The Tennessee Valley Authority; and
- Corporations operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.

KPMG observation

The section 6417 statutory language did not clearly include certain tax exempt and governmental entities, including government instrumentalities in the definition of applicable entities. This raised concerns that such entities—which can include public universities and hospitals—may not be eligible for direct pay. The proposed regulations provide a welcome clarification in including instrumentalities and other tax exempt and governmental entities in the definition of applicable entities.

In addition, taxpayers other than applicable entities may elect direct pay with respect to certain credits—specifically, credits under sections 45Q, 45V, and 45X. Taxpayers making these elections are referred to as electing taxpayers.

Applicable credits

The following table summarizes (1) the type of applicable credit, (2) the relevant applicable credit property, and (3) the entities who are eligible to make direct payment election with respect to the applicable credit.

Applicable credit	Applicable credit property	Eligible entities
Section 30C credit for alternative fuel vehicle refueling property	Qualified alternative fuel vehicle refueling property	Applicable entities
Section 45 credit for qualified facilities placed in service after December 31, 2022	Qualified facility	Applicable entities
Section 45Q credit for carbon capture and sequestration	Single process train	Applicable entities and electing taxpayers

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Applicable credit	Applicable credit property	Eligible entities
equipment placed in service after December 31, 2022		
Section 45U credit for zero-emission nuclear power facilities	Qualified nuclear power facility	Applicable entities
Section 45V credit for qualified clean hydrogen production facilities placed in service after December 31, 2012	Qualified clean hydrogen production facility	Applicable entities and electing taxpayers
Section 45W credit for qualified commercial vehicles	Qualified commercial clean vehicle	Applicable entities*
Section 45X advanced manufacturing production credit	Facility that produces eligible components	Applicable entities and electing taxpayers
Section 45Y clean energy production credit that goes into effect in 2025	Qualified facility	Applicable entities
Section 45Z clean fuel production credit	Qualified facility	Applicable entities
Section 48 energy credit	Energy property	Applicable entities
Section 48C qualifying advanced energy project credit	Eligible property	Applicable entities
Section 48E clean electricity investment credit that goes into effect in 2025	Qualified facility or energy storage technology	Applicable entities

***Note that there remains ambiguity as to whether some applicable entities are able to elect direct pay for the section 45W credit.**

Special rules for unincorporated joint ventures

As described above, partnerships are not applicable entities per se, but may be treated as applicable entities for purposes of sections 45Q, 45V, and 45X if a direct pay election is made.

For other applicable credits, the proposed regulations provide a favorable rule when (1) the applicable credit property is owned by the taxpayers as tenancies in common, (2) the arrangement would otherwise be classified as a partnership for federal income tax purposes, and (3) a valid election is made under section 761 to treat the arrangement as a co-ownership arrangement, and not a partnership, for purposes of Subchapter K of the Code. In such case, an applicable entity's share of the property is treated as separate applicable credit property owned by the applicable entity for which the applicable entity is permitted to make a direct pay election.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

These provisions appropriately address the practical application of section 6417 to co-ownership structures historically used by utilities and other taxpayers that own power producing facilities and other property, where each co-owner takes its share of the output of the property in-kind for separate exploitation by each co-owner.

How to make the direct pay election

A direct pay election must be made on an original tax return, filed no later than the due date (including extensions) for the original return for the tax year in which the election is made. Pre-filing registration is required for any direct pay election to be effective. For taxpayers for which no tax return is required, the due date is that date on which an original return would be due (including extensions) if a return was required.

The proposed regulations provide that for electing taxpayers making an election for purposes of sections 45Q, 45V, and 45X, the election applies for one five-year period per credit property.

KPMG observation

Prior to the issuance of the proposed regulations, there was uncertainty whether electing taxpayers could make an additional direct pay election after the expiration of the initial five-year period. The proposed regulations clarify that no additional direct pay election is allowed.

Rules for applicable entities

The proposed regulations provide that in the case of an applicable entity making a direct pay election, the applicable credit is determined by treating the applicable credit property as property used in a trade or business. The proposed regulations further provide that such treatment allows an applicable entity to take advantage of applicable credits outside the unrelated business taxable income context by meeting the business property requirements in various credit provisions and allows the entity to apply the capitalization and accelerated depreciation rules that generally apply to determining the basis and depreciation allowance for business property.

Further, as it relates to applicable entities, the proposed regulations impose a special rule for investment-related credit property (*i.e.*, property eligible for investment-related credits under sections 30C, 45W, 48, 48C and 48E) acquired with certain tax exempt income, including grants and forgivable loans that are received specifically for the purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring an investment-related credit property ("Restricted Tax-Exempt Amount"). More specifically, the proposed regulations provide that although the Restricted Tax-Exempt Amount is included in the credit eligible basis, if such amount plus the applicable credit otherwise determined with respect to such property exceeds the cost of the investment-related credit property, then the amount of the applicable credit is reduced so that the amount of the applicable credit plus the Restricted Tax-Exempt Amount equals the cost of the investment-related credit property.

KPMG observation

The Restricted Tax-Exempt Amount rule appears intended to prohibit duplicative government funding for projects. However, the proposed rule goes beyond government grants and includes restricted funding from any source. Further, the proposed rule appears to operate independently from the rules in various credit provisions that reduce the relevant credit for projects that are financed with tax exempt bonds. These provisions may present challenges in practice, both for the computation and documentation of credit amounts, as well as for the overall financing of the project.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Situations when no direct payment election allowed

Similar to the transferability rules described above, the proposed regulations prohibit taxpayers from making direct pay elections with respect to applicable credits passed through from the owners of the underlying credit eligible property. Specifically, the proposed regulations provide that no direct pay election can be made:

- By any lessee of investment credit property that is otherwise allowed to claim the credit pursuant to lease-passthrough election under former section 48(d); or
- By any disposer or user of carbon oxide that is otherwise allowed to claim section 45Q credits pursuant to an election under section 45Q(f)(3).

Mechanics of direct pay election

The proposed regulations provide that in cases where applicable entities or electing taxpayers have taxable income, they first compute their taxable income and then compute the amount of taxable income that can be offset by general business credits (generally, 75%). The proposed regulations then require taxpayers to apply the general business credit (GBC) ordering rules in using GBCs to offset their taxable income, including applicable credits for which direct pay elections have been made.

The following abbreviated version of the example provided in the proposed regulations illustrates these mechanics:

> Taxpayer W is a business taxpayer eligible for the section 45X credit. W's 2024 federal income tax before GBCs is $125,000 and its limitation on GBCs under section 38(c) (simplified) is $100,000. W claims a section 45X credit of $50,000 and a work opportunity tax credit (WOTC) of $50,000. W also has GBC carryforwards of $25,000. Applying the ordering rules in sections 38(d), W is allowed $25,000 of the GBC carryforwards, $50,000 of WOTC, plus only $25,000 of its section 45X credit against its net income tax, leaving $25,000 of tax liability. The $25,000 of unused section 45X credits is eligible for the direct pay election, resulting in a deemed $25,000 payment against tax by W. On its return, W reports a net tax liability of $25,000 ($125,000 - $100,000 allowed GBCs) and the net direct pay election of $25,000, which W applies to its net tax liability, resulting in zero tax owed on the return.

KPMG observation

The mechanics of the direct pay election in the proposed regulations are potentially different than what some anticipated for electing taxpayers with some tax liability. In those cases, the proposed regulations treat the applicable credit for which the direct pay election is made as a GBC for purposes of offsetting tax and only treat the net credit amount as a payment of tax, rather than treating the entire amount as a payment of tax. This may not make a practical difference for many taxpayers making direct pay elections. However, taxpayers should pay attention to the GBC credit ordering rules because it may be the case that a taxpayer could have GBCs in excess of taxable income but receive no refund as a result of the direct pay election (see further discussion on section 48D below).

Additionally, for taxpayers subject to the Base-Erosion Anti-Abuse Tax ("BEAT"), treatment of the credit as a GBC to the extent of 75% of tax liability will negatively impact their ability to fully realize the benefit of the credit, as opposed to if the credit were treated were as a payment of tax for all purposes. This may cause BEAT taxpayers who are eligible to make direct pay elections to opt to transfer the credits instead of making a direct pay election.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Timing

The proposed regulations do not include any special rules that would allow taxpayers making a direct pay election to receive the payment any earlier than after the return for the relevant tax year is filed and the refund is processed and paid.

Special rules for electing taxpayers

As described above, taxpayers that are not applicable entities may elect direct pay with respect to certain applicable credits—specifically, credits under sections 45Q, 45V, and 45X. In general, this election must be made during the tax year the property is placed in service, except as noted below for clean hydrogen production facilities placed in service before 2023 and advanced manufacturing facilities. As discussed below, taxpayers must complete the pre-filing registration requirements prior to making the election.

For clean hydrogen production facilities placed in service before 2023, a direct pay election must be made by August 16, 2023. If an election is made to treat the facility as energy property under section 48, then no direct payment election can be made.

For advanced manufacturing facilities that produce eligible components after 2022 during the tax year, an election may be made for such tax year.

If a direct payment election is made, it applies to the tax year in which the election is made and to each of the four subsequent tax years that end before 2033. An election may be revoked after the initial tax year of the election, but taxpayers may not then subsequently revoke that revocation. No transfer election may be made while a direct pay election is in effect.

Special rules for partnerships and S corporations

As described above, taxpayers that are not applicable entities may make a direct pay election with respect to certain applicable credits. Electing taxpayers that are partnerships or S corporations are subject to additional rules that address the pass-through nature of these entities.

Under the proposed regulations, any direct pay election permitted with respect to applicable credit property held directly (or indirectly through disregarded entities) by a partnership or S corporation must be made by the partnership or S corporation. No separate election is permitted to be made by any direct or indirect partner or shareholder of the electing partnership or S corporation.

If a partnership or S corporation makes a direct pay election, the IRS will make a payment equal to the amount of the applicable credit to the partnership or S corporation, unless the partnership or S corporation owes a federal tax liability (including any non-income tax liability), in which case the payment may be reduced by the amount of such liability.

The amount of applicable credit eligible for a direct payment is determined at the partnership or S corporation level, without regard to any partner or shareholder level limitations that would apply to an allocation of the credit. For all other purposes of the Code, the credit is treated as allowed solely to the partnership or S corporation and each partner or shareholder’s share of such credit is deemed to be zero. The payment received by the partnership or S corporation is treated as tax exempt income that is received or accrued at the time the credit arises, including for purposes of adjusting the basis of partners and shareholders in their partnership interest or S corporation stock.

Partnerships are required to allocate the tax-exempt income based on the partners’ distributive shares of the credit for each tax year in which payment is received, as determined under general partnership allocation rules. The same rule applies to any upper-tier partnership that is a direct or indirect partner in the partnership making the election. S corporations must allocate the tax-exempt income pro rata to their shareholders.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The proposed regulations would amend the partnership audit rules to allow the IRS to adjust any direct pay election outside of the process and procedures generally applicable to partnerships and make partner level determinations relating to the payment and any partnership-related item relevant to adjusting the election of payment amounts.

Excessive payments

The proposed regulations essentially restate the statutory rules regarding excessive payments. Section 6417 generally provides that in any case where an amount is determined to constitute an excessive payment, it will result in an increase in tax by the amount of the excessive payment, plus 20% of such excessive payment. The 20% penalty does not apply if the excessive payment is due to reasonable cause. The preamble to the proposed regulations indicates that existing standards of reasonable cause will inform the IRS's determination of whether reasonable cause has been demonstrated.

Registration requirements

For property placed in service after December 31, 2022, and during a tax year ending on or after June 21, 2023, the temporary and proposed regulations require the completion of a pre-filing registration process prior to making a direct pay or transfer election.

The pre-filing registration process will be completed electronically through the IRS electronic portal. The pre-filing registration requirements must be completed, and a registration number received, **prior to** making a direct pay or transfer election on the tax return for the tax year. A registration number must be obtained for each qualified investment or each applicable credit property for which the taxpayer intends to make an election.

The following information must be provided as part of the pre-filing registration process:

- Taxpayer's general information, including name, address, taxpayer identification number, and type of entity;
- Taxpayer's tax year;
- Type of annual return(s) normally filed or that the entity does not normally file an annual tax return;
- Type of applicable credit(s) (for §§ 6417 and 6418);
- List of each qualified investment or credit property;
- Name of a contact person;
- A penalties of perjury statement; and
- Any additional information required by the IRS, such as information regarding the taxpayer's exempt status, type of credit property, location of the property, supporting documentation relating to the construction, beginning of construction and placed in service date, source of funds to acquire the property, etc.

A registration number is only valid for one year and may be renewed. In addition, if specified changes occur after a registration number has been obtained, such as a change in ownership, a taxpayer must amend the registration.

A taxpayer must include the registration number on its return for the tax year the specified credit was determined. A transferee must also report the registration number on its return for the tax year that the transferee taxpayer takes the transferred credit into account. Note that the completion of the pre-filing registration requirements and receipt of a registration number does not mean that the taxpayer is eligible to receive a direct payment or credit.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Section 48D credits

The section 48D proposed regulations largely incorporate the rules provided in the direct pay proposed regulations and temporary and proposed regulations discussed in more detail above.

KPMG observation

The proposed regulations state that each qualified investment must have its own registration number. It may be the case that taxpayers will have multiple qualified investments relating to the same advanced manufacturing facility, so care should be taken to ensure registration rules are satisfied for all qualified investments.

When making a direct pay election, taxpayers will have to include a statement attesting under penalties of perjury that the taxpayer is not a foreign entity of concern and has not made an applicable transaction during the year the qualified investment is placed in service. The applicable transaction rules in the proposed section 48D regulations are complicated and potentially broad and taxpayers will have to make sure to undertake any necessary analysis before making the direct pay election.

The mechanics of the election are the same as described above for section 6417. Because the section 48D credit will be treated first as a GBC, there may be cases when a taxpayer could have GBCs in excess of taxable income but receive no refund from the elective payment credit. Under the GBC ordering rules in section 38(d), investment tax credits (including section 48D) are used first, including before the research credit under section 41.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Contact us

For more information, contact a tax professional with KPMG Washington National Tax:

Hannah Hawkins
T: +1 202 533 3800
E: hhawkins@kpmg.com

Julie Marion
T: +1 312 665 1990
E: juliemarion@kpmg.com

Katherine Breaks
T: +1 202 533 4578
E: kbreaks@kpmg.com

Julie Chapel
T: +1 405 552 2544
E: jchapel@kpmg.com

www.kpmg.com
kpmg.com/socialmedia

The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG LLP is the U.S. firm of the KPMG global organization of independent professional services firms providing Audit, Tax and Advisory services. The KPMG global organization operates in 146 countries and territories and in FY20 had close to 227,000 people working in member firms around the world. Each KPMG firm is a legally distinct and separate entity and describes itself as such. KPMG International Limited is a private English company limited by guarantee. KPMG International Limited and its related entities do not provide services to clients.

© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization. NDPPS 811721