ALERT MEMORANDUM

Final Regulations Under Section 6418

April 30, 2024

On April 25, 2024, the Internal Revenue Service ("IRS") issued final regulations under the renewable energy tax credit transfer provisions in section 6418 of the Internal Revenue Code (the "Code"), introduced by the Inflation Reduction Act of 2022. The Final Regulations update the proposed regulations on this topic that were issued in June 2023.

The final regulations generally follow the approach laid out in the proposed regulations, with some changes to address taxpayer comments. The IRS declined to expand the market for transferable credits in response to taxpayer comments, rejecting suggestions to exempt transferred credits from the passive activity limitations under section 469, to permit "horizontal slicing" of credits into base and bonus amounts, and to relax the rule requiring that credits be transferred only once. The IRS also largely refused taxpayer suggestions that credit transferors should bear increased risk of excessive credit transfers, instead (consistent with the proposed regulations) choosing to place a higher burden on credit transferees.

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Key Changes between the Proposed Regulations and Final Regulations:

— The final regulations include a rule providing that a grantor or owner of a trust can make a transfer election for the portion of an eligible credit determined with respect to eligible credit property held by the trust that the taxpayer is treated as owning under section 671.[1]

— The final regulations clarify that transfer elections must be made for the first time on an original return, but taxpayers can make corrections on amended returns.[2]

- If the amended return reflects an increased credit, the increase cannot then be transferred.[3]
- If the amended return reflects a decreased credit, the decrease first reduces the amount of credit retained by the transferor before reducing the amount transferred (if transferred to multiple transferees, those credits are reduced *pro rata*).[4]
    - Any cash consideration received by the transferor that relates to the amount of decreased credit is not excluded from gross income.[5]

— In response to comments that there might be insufficient publicly available pricing information on credit transfers, the IRS included in the final regulations revised examples illustrating the anti-abuse rule to clarify that the Proposed Regulation's reference to an "average transfer price" was meant to describe an "arm's length price." Additionally, the examples were revised to clarify that the price for the credits should be determined without regard to other commercial relationships between the parties (by replacing a reference to the price in a transaction between "unrelated parties" with a reference to the price determined "without regard to other commercial relationships" between the parties).[6]

— Under the proposed regulations, section 50(a) recapture (*e.g.*, for early disposition, or property ceasing to qualify for credits after ITCs were claimed) was imposed on the transferee. Despite taxpayer comments suggesting that recapture risk be retained by the transferor, the final regulations adopt the approach taken by the proposed regulations (albeit clarifying that if the transferor retains a portion of the credit determined with respect to an eligible property, the transferor and transferees each bear a recapture amount proportionate to their share of the overall credit).[7]

— In response to requests for clarification on the treatment of payments for excessive credit transfers, the final regulations adopt a *pro rata* approach, deeming the amount of payment that "directly relates" to an "excessive credit transfer" to be the portion of total consideration paid in cash for the transferred credit equal to the ratio of the excessive credit transferred to the total amount of credit claimed.[8]

- As a result, a transferor cannot "tranche" the tax exposure related to its sales of credits (with certain transferees taking more risk, and allowing other transferees more certainty). The transferor can, however, provide a degree of protection for transferees by retaining some portion of its credit amount itself.

— The final regulations do not specify the timing and character of income inclusions or deductions relating to indemnity or insurance payments for excessive credit transfers. The preamble to the final regulations says that "[g]eneral income tax principles apply" to these questions.[9]

- To the extent such payments are taxable, indemnities or insurance would need to be

[1] Treasury regulations § 1.6418-2(a)(3)(v).
[2] Treasury regulations § 1.6418-2(b)(4).
[3] Treasury regulations § 1.6418-2(b)(4)(ii)(B).
[4] Treasury regulations § 1.6418-2(b)(4)(ii)(C)(I).
[5] Treasury regulations § 1.6418-2(b)(4)(ii)(D).
[6] Treasury regulations § 1.6418-2(e)(4)(ii) and (iii).
[7] Treasury regulations §1.6418-5(d)(3)(i).
[8] Treasury regulations § 1.6418-5(a)(3).
[9] T.D. 9993 (pdf p.83/163).

"grossed up" to fully cover the transferee on an after-tax basis.

— The proposed regulations provided that recapture events under section 45Q(f)(4) and 50(a) are not excessive credit transfers. The final regulations clarify that in addition to recapture under section 45Q(f)(4) and section 50(a), a recapture event under section 49(b) relating to increases in nonqualified nonrecourse financing is also not an excessive credit transfer.[10]

— In response to comments that there might be duplicate recapture of the same ITC in the case of a partner transferring an interest in a transferor partnership, the final regulations clarify that to the extent an ITC is recaptured by a partner in a transferor partnership, that amount of recaptured ITC reduces the remaining amount of ITC subject to recapture by a transferee taxpayer for a recapture event caused directly by the transferor partnership.[11]

The preamble to the final regulations provides answers to some interpretive questions that commenters had asked, without changing the relevant language from the proposed regulations.

Some of these confirmatory answers include:

— Commenters suggested that the "paid in cash" requirement be relaxed to accommodate advanced payments for credits to be transferred in the future. Although Treasury and the IRS declined to do so, they noted that "there is no prohibition on either a transferee taxpayer or another third-party loaning funds to an eligible taxpayer, including loans secured by an eligible credit purchase and sale agreement, provided such loans are at arms length and treated as loans for Federal tax purposes."[12]

- As a result, loans secured by an eligible credit purchase and sale agreement could become a useful way for sponsors to fund capital-intensive projects without relying on traditional tax equity to bridge the timing gap between capital deployment and credit determination. The preamble warns, however, that "whether such loans are treated as upfront payments for eligible credits or otherwise recharacterized" is a facts and circumstances test not addressed by the regulations.[13]

— Consistent with the proposed regulations, the owner or lessor in a lease passthrough election, and not the lessee, may claim and transfer the credit.

— For purposes of the rule that credits can be transferred only once, the preamble to the proposed regulations had described applying "Federal income tax ownership" principles such as the "benefits and burdens of ownership" test, though the proposed regulations did not themselves refer to such principles.[14] In response to taxpayer comments that such a test would be unworkable, the IRS agreed that "it is unnecessary to apply benefits and burdens of ownership principles to transfers of eligible credits under section 6418," and that a valid transfer occurs only once all the requirements for making transfer elections in Treasury regulations § 1.6418-2(b) have been met.

— The preamble confirmed that transferee taxpayers do not have gross income upon claiming the transferred credit, even if they receive a "discount" in which the amount of cash consideration paid is less than the amount of the transferred credit.

— The preamble confirmed that section 469 passive activity rules apply to a transferee taxpayers' ability to apply transferred tax credits against their income tax liability. However, in what the preamble calls the "limited circumstance" of a transferee taxpayer who materially participates in an eligible credit generating activity within the

[10] Treasury regulations §1.6418-5(a)(5).
[11] Treasury regulations §1.6418-3(a)(6).
[12] T.D. 9993 (pdf p.13/163).
[13] T.D. 9993 (pdf p.13/163).
[14] T.D. 9993 (pdf p.33/163); 88 FR at 40501.

meaning of section 469(h) in which the transferee owns an interest at the time the work is done, the final regulations do allow such a transferee taxpayer to treat those credits as not arising in connection with a passive activity for section 469 purposes.[15]

The IRS noted several areas for which additional future guidance is expected, including:

— whether separate taxpayers to which section 45Q or section 45Z credits are determined with respect to the same qualified facility may each make separate transfer elections under section 6418; and

— the treatment of transaction costs relating to credit transfers, such as legal and consulting fees, success-based fees, tax insurance, and indemnity payments.

Additional special rules apply to transferees and transferors that are partnerships or S-corporations, or REITs.

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[15] Treasury regulations § 1.6418-2 (f)(3)(ii).