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Report No. 1475
March 28, 2023

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel
and Deputy Chief Counsel
(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report No. 1475 - Report on the Transferability of Energy Tax Credits Under Section 6418

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1475 of the Tax Section of the New York State Bar Association discussing the transferability of energy tax credits under Section 6418 of the Internal Revenue Code.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Philip Wagman
Chair

Enclosure

Cc:

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New York State Bar Association Tax Section

Report on the Transferability of Energy Tax Credits Under Section 6418

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Report on the Transferability of Energy Tax Credits Under Section 6418

I. Introduction

This Report[1] (the "**Report**") analyzes the transferability of energy tax credits under Section 6418,[2] which was added to the Code as part of the Inflation Reduction Act of 2022 (the "**IRA**"). The IRA included $370 billion of federal funding for clean energy and other energy and climate-related initiatives.[3]

Congress provided a significant share of this support in the form of tax credits.[4] In addition to modifying the existing production tax credits ("**PTCs**")[5] and investment tax credits ("**ITCs**")[6] for renewable energy and extending them through 2024, the IRA added new technology-neutral zero emissions-based tax credits for production[7] and investment,[8] increased credits for solar and wind facilities placed in service in low-income communities,[9] and added a credit for the production of zero-emissions nuclear power.[10]

To make use of these tax credits, developers must have both the incentive and capacity to invest in these various clean energy initiatives. Historically, these types of tax credits generally have had financial value only to investors who owe U.S. federal income tax. In response, a market has developed in "tax equity" for this type of project, in which developers who lack tax capacity enter into arrangements (generally partnerships) with investors who have this capacity, enabling developers to monetize the value of the credits (e.g., by allocating them principally to the

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[1] The principal drafters of this Report were Drew Batkin, Eli Katz, Stuart Rosow, and David Schizer. Helpful comments were received from Andy Braiterman, Robert Cassanos, Peter Connors, Matthew Donnelly, Lucy Farr, Stephen B. Land, Alexander Leff, Jiyeon Lee-Lim, John Lutz, John Narducci, Richard Nugent, Elliot Pisem, Jason Sacks, Michael Schler, Philip Wagman, and Andrew Walker. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] Unless otherwise indicated, all references in this Report to "**Section**" and "**Sections**" are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all references to "**Treas. Reg. §**" are to regulations (or proposed regulations) issued thereunder ("**Regulations**"). References to "**Treasury**" are to the United States Department of the Treasury including, as applicable, the Internal Revenue Service (the "**Service**" or the "**IRS**"). References to the "**Secretary**" are to the Secretary of the Treasury.

[3] White House, Building A Clean Energy Economy: A Guidebook To The Inflation Reduction Act's Investments In Clean Energy and Climate Action 5 (2d version Jan. 2023) (hereinafter "**White House Guidebook**"), https://www.whitehouse.gov/wp-content/uploads/2022/12/Inflation-Reduction-Act-Guidebook.pdf.

[4] *Id*.

[5] Section 45.

[6] Section 48; *see also* White House Guidebook at 5 ("The Inflation Reduction Act modifies and extends the current PTC [production tax credit] and ITC [investment tax credit] through 2023 and 2024, at which point they sunset in favor of technology-neutral, emissions-based credits, the Clean Electricity PTC and Clean Electricity ITC.")

[7] Section 45Y.

[8] Section 48E.

[9] Section 48(e); Section 48E(h).

[10] Section 45U.

investors). Although tax equity structures have been a key source of funding for clean energy, the complexity and costs associated with these structures have limited their appeal and availability for some developers and investors. In response, Congress recognized that more, and more efficient, private financing may be needed to incentivize the rapid development of the green economy.

To broaden the pool of potential investors beyond U.S. taxpayers, the IRA added a "direct pay" feature for the credits described above. "Section 6417 of the Internal Revenue Code extends many of the law's tax incentives to entities that generally do not benefit from income tax credits, such as state, local, and Tribal governments and other tax-exempt entities," The White House Guidebook explained. "Specifically, these entities can elect to receive some of the Inflation Reduction Act's tax credits in the form of direct payments."[11] The Report does not address this provision.

In addition, Congress added Section 6418–the subject of this Report–which allows taxpayers who are not eligible for the benefits of Section 6417 to transfer these credits under specified circumstances.[12] In an effort to provide timely input, this Report addresses a limited number of key issues under Section 6418. The Tax Section may follow up with an additional report on issues that are not addressed here.

Part II of this Report is a summary of our recommendations. Part III surveys competing policy considerations that Treasury needs to balance in its guidance on Section 6418, including the effectiveness of the transfer of tax credits in securing more financing for clean energy projects, the risk that credits will be misused, potential adverse effects on the tax system, and administrative costs.

Part IV discusses issues related to the specific requirements of Section 6418, including the requirement that consideration for tax credits under Section 6418 must be "paid in cash," as well as the limit on transferring credits a second time. The next two Parts consider how Section 6418 interacts with other provisions of the Code. Part V considers the application of investment tax credit recapture and the passive activity credit rules, while Part VI discusses issues under Subchapter K. Part VII briefly identifies a selected number of additional issues that warrant further consideration.

II. Summary of Principal Recommendations

The following are the Report's main recommendations, which address issues about Section 6418 itself and about its interaction with other provisions of the Code:

1. Paid in cash

a. In our view, prepayments of cash should satisfy the "paid in cash" requirement, even though the purchaser is offering the time value of its money as a portion of the consideration.

[11] White House Guidebook at 6.

[12] *Id*.

b. If Treasury determines to impute interest on prepayments, we recommend imputing interest only to the extent that funds are advanced for more than a minimum period of time before the credits become available (e.g., 12 months).

c. A number of administrative and commercial concerns arise if taxpayers have to wait until they file their annual tax return in order to make the transfer election. Instead, we recommend that Treasury should permit elections either quarterly or at the time when credits are generated. If an election is filed after the date the credit was generated, the credit should be deemed to have been transferred as of the date on which it was generated, with the result that the transferee is entitled to claim the benefit of the credit to reduce its estimated taxes and the transferor is not entitled to do so.

d. Treasury should consider offering guidance also about whether the purchaser of a credit must pay cash for rights associated with a credit, but formally distinct from it, including indemnities and rights of first refusal.

2. Limits on a second transfer

a. Guidance is needed on whether the bar on a second transfer should apply to arrangements other than just a transferee's filing of a purported second election under Section 6418 - for example, whether there is a prohibition on having a series of two or more assignments of the contractual right to acquire a credit, as well as transfers of an interest in a partnership that is selling or buying credits. We recommend a limited interpretation of the no-second transfer rule, which does not reach these and similar arrangements, and instead only prevents the transferee from making a second election.

3. ITC recapture

a. Treasury should provide guidance about whether ITC recapture should be imposed on the tax credit seller or the tax credit buyer, as well as which events trigger recapture. In our view, while recapture should apply to ensure that the asset remains in service for five years, there is less reason to police *who* is using it. Now that Congress has authorized the transfer of credits—so a taxpayer no longer needs to own the asset to claim them—sale of the asset no longer seems to be a compelling reason for recapture. In our view, the best argument to continue to police ownership changes after a credit has been transferred is to maintain parity with situations in which the credit has not been transferred (assuming Treasury continues to believe it is appropriate for ownership changes to trigger recapture in the latter context).

b. As a result, the Treasury faces a tradeoff here. On the one hand, unequal application of the ITC recapture rules to transferred and retained ITCs could distort the market. On the other hand, a more relaxed ITC recapture rule for transferred ITCs seems congruent with the purpose of Section 6418, which seeks to expand the pool of applicable tax credit buyers and eliminate the friction costs inherent in the existing tax equity market.

c. We present four options in the Report, which balance these competing considerations in different ways.

4. Passive Activity Credit Rules

a. Timely guidance is urgently needed about whether the passive activity credit rules apply to credits transferred under Section 6418. Without it, there will be uncertainty in the markets which could take years of litigation to resolve.

b. As a matter of statutory interpretation, we believe the better reading is that the passive activity credit rules do apply to a buyer of such credits, although the statute can also be read to support the opposite conclusion.

c. In analyzing this issue, Treasury should be mindful of the competing policy considerations at work here, which are substantial. On the one hand, if the passive activity credit rules do not apply, there is a heightened risk of abuse and of erosion of confidence in the tax system. On the other hand, if the passive activity credit rules do apply to a buyer, Congress's goal of encouraging more investment in clean energy could be undermined. Credits will sell at greater discounts, so a higher percentage of funds that Congress intended for clean energy projects will go to credit buyers instead of clean energy projects. We do not take a position on the question of how to balance these considerations as a matter of policy, since the energy policy issues are beyond our expertise.

d. In our view, although the application of the passive activity credit rules to *purchasers* of credits is a difficult question, the application to *sellers* is straightforward. Our recommendation is that these rules should not limit the quantity of credits that sellers are allowed to transfer.

5. Partnerships

a. Treasury should clarify the treatment of partnerships that sell credits. We recommend interpreting the phrase "held directly" as applying to partnerships that that hold assets through a disregarded entity, and we believe a partner should be treated as directly owning its ratable share of assets held by a partnership that elects out of Subchapter K under Section 761. We also recommend that guidance provide for allocation of tax-exempt income of a partnership from a sale of credits in the same manner as the credits would have been allocated if the partnership had not transferred them. In addition, the ITC recapture rules generally should apply to a partnership that owns a project to the same extent as they apply to other project owners, and the bar on second transfers should not be implicated by changes in the ownership of such a partnership. We also recommend an anti-abuse rule to prevent inappropriate results when a partner (in its individual capacity) buys credits from the partnership.

b. Treasury should clarify the treatment of partnerships that buy credits. In addition to confirming that partnerships are permitted to purchase credits (*e.g.*, by clarifying that these purchases are a valid business purpose), Treasury should clarify how the credits should be allocated among the partners in the purchasing partnership. Treasury also should require corresponding basis and capital account adjustments, so partners cannot claim a loss for amounts contributed to a partnership that are used to acquire credits. In addition, Treasury should ensure that the limits on second transfers and the ITC recapture rules generally apply to partnerships in a manner that is coordinated with the manner in which these limitations apply to direct purchases by a non-transparent buyer.

6. Additional issues

a. Treasury should consider anti-abuse rules to ensure that Section 6418 serves its intended purpose, including disclosures of transfers that are at a significant discount.

b. Treasury should provide specific rules for corporations (whether taxed under subchapter C or subchapter S) that choose to purchase or sell tax credits, including the treatment of such corporations under Sections 382-384.

c. Guidance is needed on the treatment of transferred credits under "Pillar Two" of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting.

d. Guidance would be helpful to confirm that lessees who are treated as owning investment tax credit eligible property pursuant to a lease-passthrough-plus election under Section 50(d)(5) can elect to receive a direct payment under Section 6417 or to transfer the credit under Section 6418.

e. Treasury should clarify that the purchaser of credits may carry them back to offset tax liability from earlier tax years, and should consider providing relief to the purchaser under the statute of limitations if the seller cannot elect to transfer until it files its tax return for the relevant year.

f. Treasury should clarify how it intends to audit transferred credits. Treasury should consider first auditing sellers of the credits, who have superior information about the relevant issues, before assessing the purchasers.

g. Treasury should clarify the treatment of transactions in which credits are transferred with other assets. Guidance would be helpful about the circumstances in which the parties' allocation of purchase price will be respected.

III. Competing Goals

In exercising its authority under Section 6418(h) to "issue such regulations or other guidance as may be necessary to carry out the purposes of this Section," Treasury must consider the various goals Congress presumably was balancing in allowing taxpayers to transfer energy tax credits. This Part surveys these competing goals in order to lay the groundwork for the analysis in Parts IV, V and VI.

A. Assuring Cost-Effective Federal Funding for Clean Energy Initiatives

As stated by the White House Guidebook, a key purpose of the energy credits in the IRA is to "build a new clean energy economy."[13] In this spirit, Congress sought to encourage wider production and use of clean energy and to promote innovations, so that new sources of clean energy are developed and existing sources become more cost-effective.

The Report does not evaluate the merits of these energy policy goals, which are outside the expertise of the Tax Section. Rather, taking these energy policy goals as given, the Report seeks to highlight tradeoffs and synergies with other policy goals that Congress has pursued both in these tax credit provisions and in the U.S. federal income tax system as a whole.

1. Minimizing the Discount

An important measure of the cost-effectiveness of these credits is the extent to which they sell at a discount. All else being equal, Congress should want credits to trade as closely as possible to 100 cents on the dollar.

For example, assume that Developer seeks to build a new solar facility, which is eligible for a $100,000 tax credit. Developer does not have any taxable income, so it is not able to use the credit. Under Section 6418, Developer can sell the credit to Investor.

A key question is how much Investor will pay for it. Since Congress is forgoing $100,000 in tax revenue, Congress presumably wants the Investor to put something close to $100,000 into the project. Either way, Congress is forgoing $100,000 of tax revenue, and presumably it wants as much of this money as possible to go to the clean energy project, not the Investor.

For example, assume that the solar facility in the above example is profitable only if it generates a cash flow of $X, and without a subsidy it will generate $90,000 less than $X. If Developer can't use a $100,000 tax credit itself, this credit will make this project profitable—and thus will increase the volume of clean energy projects—only if Developer can sell the credit for at least $90,000. If the sale price is less than $90,000, Developer presumably will not proceed with the project.

[13] *Id*. at 2.

Even if the project proceeds, the sale of credits at a significant discount is still undesirable from the government's perspective. For example, assume that the project above is profitable—and thus will proceed—with a $60,000 subsidy. A $100,000 credit is more than the project requires. Instead, Congress presumably would rather provide an amount closer to $60,000, while redeploying the balance of the $100,000 to another project. In short, Congress gets more "bang for the buck" from these subsidies when the discount is minimized.

Admittedly, some discount is necessary to induce Investors to buy the credit, instead of simply paying their taxes. For example, Investor may demand a discount to compensate for time value, assuming that Investor pays for the credit now but cannot use it for a period of time. Also, as discussed below, there are frictions for which Investor will want to be compensated. If Investor already has to file a tax return, it is easier just to pay the U.S. government, assuming there is no savings from paying a clean energy developer instead.

Even so, Congress presumably should want to minimize the discount for the reasons noted above. To an extent, the size of the discount is within Congress's control (and, to some extent, that of the Treasury and the Service). How burdensome is it to buy and claim the credit? Are there uncertainties about whether the credit actually can be claimed? The greater the expense, risk, and uncertainty, the larger the discount will be.

Congress also can influence the size of discounts by expanding or limiting the pool of taxpayers permitted to use the credit. Presumably, Congress opted to make these credits transferable because of concerns that there might not be enough "tax equity" capital to invest in clean energy projects. A key goal of Section 6418 is to broaden the pool of investors.

It is not entirely clear how broad Congress intends this pool to be. For example, if the passive activity credit rules of Section 469 apply to purchasers of these credits, individual investors are unlikely to buy them. Restricting the pool of potential investors will tend to increase the price discount when credits are transferred, thereby reducing the amount of the subsidy that is actually provided to renewable projects. There are trade-offs involved in addressing more traditional tax policy concerns as opposed to the goal of subsidizing renewable energy through section 6418.

2. Piggybacking on Informed Decisionmakers with "Skin in the Game"

To avoid the concern about credits selling at a discount, Congress could simply have authorized government agencies to allocate funds directly, so government officials choose which projects to fund. Indeed, some provisions of the IRA follow this model. While a direct subsidy program would not result in the discounts that are inherent in transferable tax credits, direct subsidies impose other costs on the government. For example, resources are required to evaluate and monitor whether (and which) projects should be subsidized.

In contrast, the energy tax credits analyzed in this Report rely on developers and investors to vet projects. Presumably, Congress is more comfortable depending on these private decisionmakers when they have "skin in the game." When developers have equity in their projects, they have an incentive to choose promising ones and run them efficiently. Likewise, when investors buy tax credits, they (or their agents) presumably also evaluate the project, if only to ensure that it is, in fact, eligible for the relevant credit. In authorizing these credits–and, indeed, in allowing them to be transferred–Congress presumably seeks to "piggyback" on these judgments. At least to an extent, Congress presumably is willing to tolerate a discount as compensation for this vetting because it relieves the government of monitoring and administrative costs.

B. Comparing Purchasers of Credits with Tax Equity Investors

In tapping a new source of funding for clean energy projects, Congress presumably did not mean to preclude the traditional method of attracting capital: tax equity. Rather, Congress seems to have authorized the transfer of credits as a supplement, not a replacement, for this financing. In this spirit, Congress presumably did not want to introduce unnecessary disparities in the tax treatment of these funding sources.

This is not to say that every aspect of the treatment should always be the same. On the contrary, the mere fact that credits can be transferred is a notable difference, which will require purchasers of tax credits to be treated differently from tax equity investors in a range of ways. Indeed, Congress presumably enacted Section 6418 in order to attract capital that tax equity deals were not already attracting.

Thus, the goal should be to minimize unnecessary differences in tax treatment. Accordingly, Treasury should focus on potential disparities in the treatment of tax equity investors and tax credit purchasers, making judgments about which differences are justified and which are not.

C. Parity Between Direct and Indirect Investments

As a general matter, the result should be the same whether credits are held directly or through an entity. For example, if the eligible taxpayer is a partnership, the treatment of its partners generally should not change merely because they own the relevant activity through a partnership, instead of owning it outright. Assuming that partnerships are eligible to purchase credits, the same logic should generally apply. There generally should be parity between taxpayers who purchase the credit directly and those who do so through a partnership.

Yet although parity is desirable as a general principle, it should not be required in all circumstances. Sometimes partnerships can achieve a somewhat different result (e.g., with special allocations). Depending on the context, this differential treatment may be appropriate—even desirable—as long as the general rules for partnerships are satisfied.

D. Policing Fraud and Abuse

In authorizing the transfer of credits—and thus seeking to increase the flow of capital to clean energy projects—Congress obviously did not want these credits to be abused. To ensure that this funding is used for clean energy projects, credits should be available only when a qualifying project actually is funded. There also should not be "double dipping": a credit should be claimed only once. However, Congressional efforts to foreclose these abuses are likely to add to the cost of these transactions, and thus could increase the discount when credits are sold (which, unfortunately, also diverts funds from clean energy projects).

Parts IV, V and VI illustrate how the sometimes divergent goals just described are relevant to a series of issues related to Section 6418 on which guidance is needed.

IV. Issues Related to Specific Requirements of Section 6418

This Part focuses on issues related to the specific requirements and limitations of Section 6418—notably, the requirement to purchase credits for cash and the limit on second transfers of the credit—while Part V considers the interaction of Section 6418 with other provisions of the Code.

A. "Paid in Cash"

Section 6418(b)(1) requires that consideration paid by a transferee "shall be required to be paid in cash . . . ." Although this requirement may seem straightforward, it actually presents a number of issues that can materially affect credit transfer transactions and, more generally, renewables development, including (1) what is meant by "cash"; (2) how the timing of a payment, relative to the date when a credit is generated, affects the determination of whether "cash" is paid; (3) whether taxable interest should be imputed for some advance payments of cash for credits generated in the future; and (4) whether other features of credit purchase transactions may require special rules.

1. What is Meant by Cash?

In requiring payments to be made in cash, Congress seems to have been pursuing two policies: first, ensuring that the funds can be invested immediately and, second, avoiding abuse.

In requiring funds to be easy to deploy, Section 6418 resembles Section 45D, which provides for "new markets tax credits" for investments "solely in exchange for cash" [14] made in qualified investments[15] within a 12-month period.[16] Under Section 45D, the rationale for requiring cash seems to be ensuring that the "cash" is invested promptly (as property other than cash is more difficult to invest). A similar concept may be at work in Section 6418. Congress presumably wanted the monetization of tax credits to inject capital promptly into clean energy projects, so the cash requirement might assure immediate liquidity to fund project costs.

In addition, requiring cash consideration may be necessary to prevent abuse. Specifically, if purchasers of tax credits provide property as consideration, instead of cash, they would have an incentive to understate the value of this property. A "low-ball" valuation would enable them to claim a smaller gain or a larger loss on this property. Admittedly, a lower valuation of the consideration they provide means that purchasers are purportedly buying the credit at a larger discount, but there is no tax cost in doing so, assuming they are not taxed on this discount.[17]

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[14] Section 45D(b)(1)(A).

[15] Section 45D(b)(1)(B).

[16] Treas. Reg. 1.45D-1(c)(5)(iv).

[17] It could be asked whether the discount between the price paid for credits and the face amount of credits is taxable. We note that this is an open question and assume that it is not, for a number of reasons. First, taxing this discount

Notably, although purchasers of credits have an incentive to offer a low valuation for property they provide as consideration, sellers of these credits won't necessarily have an offsetting incentive to press for a higher valuation. In theory, sellers might want a higher valuation in order to maximize their tax basis in the property they receive in exchange for the tax credit. But in practice, these taxpayers might not feel strongly about this issue. Presumably, they are in a loss position (or they would not be selling their credits), so the tax benefits of increasing their tax basis might be deferred many years or never realized.[18]

In general, we believe "cash" means physical cash, a wire, a check, or any other form of transfer where the funds are immediately available to the recipient. We generally see no need for Treasury to provide that property other than cash (as just defined) is equivalent to cash for purposes of Section 6418.

2. Implied Interest

Treasury should offer guidance about whether implied interest counts as "cash" for purposes of this requirement. If a developer sells credits months or even years before they will be generated, a portion of the credits ultimately transferred could reasonably be considered interest or compensation for an advance of funds. Thus, the transferee is receiving credits in part for cash and in part for the accreted time value of its payment. Does this mean that some portion of the purported transfer should be disallowed?

In our view, the answer is "no." Congress provided for the transfer of credits in order to make funds available to clean energy projects. These projects require cash well before tax credits actually can be claimed. As a result, investors inevitably will make payments in advance—indeed, if they did not do so, Congress's purpose in providing these credits might be frustrated.[19]

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would be a disincentive to buy credits, motivating buyers to demand a larger discount in buying them. In addition, a tax on the discount also would be complicated to enforce, and arguably would imply that the seller should get a loss even though it does not have any basis in the tax credit sold. Also, we note that the credit here is, ultimately, a reduction permitted by the government in the federal income tax otherwise owed by the buyer. Such a reduction in federal income tax liability is not typically an income realization event. One could conclude that the buyer here is not realizing income to a greater extent than any other taxpayer who secures a federal income tax reduction as a result of an election made by another party at the taxpayer's request (for example, a "check the box" election made by an entity at an investor's request, or a Section 338(h)(10) election made jointly by a seller at a buyer's request).

[18] While other rules treat some property as cash equivalents—usually in an effort to determine whether a taxpayer is sufficiently liquid to pay tax—these precedents arguably are not relevant here, since the cash requirement in Section 6418 does not seem to implicate any abuse that could arise as a result of not treating liquid assets as interchangeable with cash. For example, Section 731(a) treats certain "marketable securities" as the equivalent of "money," generally to prevent taxpayers from avoiding recognizing income on partnership distributions that are the equivalent of cash distributions. In addition, Section 965(c)(3)(B) includes in the "cash position" of a specified foreign corporation cash held by such foreign corporation, the net accounts receivable of such foreign corporation, plus the fair market value of the following assets held by such corporation: personal property which is of a type that is actively traded and for which there is an established financial market, commercial paper, certificates of deposit, the securities of the federal government and of any State or foreign government, any foreign currency, any obligation with a term of less than one year and any asset which the Secretary identifies as being economically equivalent to any asset described.

[19] In some circumstances, Treasury might be concerned that the payment for credits comes too early. Specifically, there might be circumstances in which a payment is not made to purchase specific credits, but to inject capital that is more in the form of an equity contribution to some type of joint venture. For example, this payment might be made so

Another reason to treat the use of money as a payment "in cash" is that a rule to the contrary could easily be satisfied with circular cash flows. For example, assume that Developer wishes to sell a $105,000 credit to Investor. Putting tax considerations aside, Investor might pay $100,000 today in exchange for a credit that becomes available in one year (and the $5,000 discount would represent compensation for the use of $100,000 for a year at an implicit interest rate of 5%). If the tax law did not treat this 5% payment as "paid in cash"—so that the buyer was permitted to claim only approximately 95% of the credit—the parties could easily restructure the transaction to include a circular cash flow. Investor would lend $100,000 currently, and Developer would repay this loan with $5,000 in interest a year later, and Investor would then pay $105,000 for the credits. In our view, requiring this circular cash flow merely to satisfy the "paid in cash" rule seems unduly onerous, and would require the Service to police arrangements unnecessarily to evaluate whether to accord significance to otherwise circular cash flows.

3. Imputation of Interest

In addition to confirming that a time value discount does not violate the "paid in cash" requirement, Treasury also should clarify the circumstances (if any) in which interest should be imputed.

If an arrangement qualifies as debt under general tax principles, then interest obviously needs to be imputed. Continuing with the above example, assume that Investor deposits $100,000 upon signing a contract in which Developer is supposed to generate credits in one year, but the credits are never generated. If the contract explicitly requires Developer to return the $100,000 and to make an additional payment that is computed at a specified rate—regardless of whether this amount is called "interest," an "indemnity," a "penalty," "damages," or something else--the deposit presumably qualifies as debt for tax purposes. Investor needs to report this interest as income and Developer can deduct it. [20]

Yet guidance would be helpful on the treatment of prepayments that do not qualify as debt under general principles. Obviously, the influence of time value on the pricing of prepayments is not unique to the transfer of a tax credit. For example, there also is a time-value component in the return earned on prepaid forward contracts, as well as on notional principal contracts with up-front payments. Since this issue is not unique to Section 6418, one option is for Treasury to apply general tax principles to this issue, instead of crafting interest-imputation rules specifically for this context. In other words, prepayment discounts under Section 6418 could be addressed in whatever general analysis is developed over time regarding the proper treatment of the time value in financial instruments, acquisitions, partnership allocations, and the like.

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far in advance that specific projects have not yet been planned, so the credits that nominally are being purchased cannot be identified with any measure of specificity. This circumstance should not necessarily trouble the Treasury--given Congress's evident purpose of ensuring that an adequate flow of capital was supporting the development of clean energy projects—as long as the investment ultimately does support a project that yields credits. But to the extent that Treasury wishes to guard against potential abuses of this sort, general tax principles empower the Treasury to do so, for instance, in asking what a particular payment has purchased.

[20] Otherwise, there would be a significant opportunity for abuse as taxpayers make loans disguised as credit purchases.

Alternatively, Treasury could decide to develop rules specific to Section 6418. A potential justification for a bespoke approach here is that the stakes are different than in the other contexts just referenced. There, the effect of imputing interest is to accelerate the timing of tax (and in some cases to change the character of the income), whereas here the effect is to impose tax on value that otherwise would not be taxed: When a buyer purchases a tax credit at a discount, this spread presumably is not taxed, as noted above.[21] Likewise, when a seller is paid for the credit, this cash is not taxable.[22] In the event that the Treasury comes to this conclusion, this Report suggests below a framework for analyzing the issue.

In the context of Section 6418, the issue can arise in multiple potential scenarios, involving the purchase of either ITCs or PTCs. Credits can be purchased either before they are generated (i.e., for an ITC, before the applicable property is placed in service or for a PTC, before the eligible product is generated and sold, used or disposed of by the taxpayer in secure geological storage), or afterward; and they also can be purchased either before, or after, the transfer election has been made. Varying each of these two variables produces four scenarios, which are considered in turn.

(i) Credits are purchased in advance of being generated and before a transfer election is made.

When a developer sells credits years before they are generated, the case is strongest for imputing interest. Treasury could consider a rule that if funds are advanced more than a minimum amount of time (e.g., twelve months)[23] before credits are generated, such amount is a loan and must start to accrue interest at such twelve month date – with taxable interest computed under the principles of Section 483 and Section 1272.

For example, if a transferee advances funds anticipating credits will be generated within two months but there are unanticipated delays, the arrangement would not be treated as a loan until the twelve-month mark. When the credits are generated, the imputed loan would be settled (with the lender/transferee treated as receiving interest income in the imputed amount and having a principal balance of its principal investment plus such accrued interest, while the borrower/eligible taxpayer would be treated as paying interest and would be deemed to sell the credits for the transferee's initial payment plus the amount of the interest). Although the loan would be repaid with credits, in this case it is unnecessary to have the eligible taxpayer pay cash only to have the transferee immediately return it.

If Treasury wishes to require the imputation of interest in this situation, a further question is what interest rate should be used. If the parties have provided for an interest rate—for instance, in a provision requiring the developer to return an investors funds with interest if the credits do not materialize—then this interest rate, which has been provided by the parties, generally would seem

[21] *See supra* note 17.

[22] Treasury also might consider Section 6418 to be unique for another reason as well: by including the requirement that consideration be "paid in cash," Congress focused on the nature of the payment offered for credits, arguably signaling that Treasury should pay particular attention to the nature and time for payment of the consideration.

[23] Another option, which is draws on Section 1274(c)(1)(B), would be to use six months for this purpose.

to be appropriate, as long as it exceeds the applicable federal rate ("**AFR**") or some other minimum rate.[24]

Alternatively, if no interest rate has been provided, Treasury should consider using the AFR, as is the case in other regimes. Another option would be a rate based on the borrower's usual borrowing cost, as in the contingent debt regulations.[25]

We would caution against a rule that attributes the entire discount to time value, since some of it will derive from other commercial factors. For example, a discount also can arise because there is insufficient demand for credits among investors, as noted above, so that the price must be discounted accordingly. Various risks associated with the credits may also influence the size of the discount, including questions about whether the relevant facility will receive a permit, whether the relevant technology will be effective, how much energy will be produced (in the case of a production credit), and the like.

(ii) Credits are purchased after being generated, but prior to the date a transfer election is made.

In this situation, imputation of interest seems unnecessary. Unlike in situation (i), the credits already exist. Imputing interest is not needed because, in a sense, this is not a prepayment. The credits already have been generated and have economic value at the time they are purchased.

This value is clear from the fact that if the credits are not sold, they can reduce the tax liability of the developer or of tax equity investors: in general, these taxpayers can start claiming an ITC when the associated property is placed in service and a PTC when the relevant production and sale or use occurs. The relevant taxpayer would generally account for such ITC or PTC in calculating its quarterly estimated tax obligations (assuming the taxpayer uses the annualization method of calculating such obligations) for the year the credit arises, consistent with Section 6655 and Treasury Regulations Section 1.6655-2(f)(3)(iii).

Accordingly, if the eligible taxpayer keeps the credits, it can apply them against quarterly estimated taxes (assuming this is consistent with its method for calculating such taxes). A tax equity investor also pays for the credits, to some degree, as soon as they are generated (since the parties calculate an investor's return generally by considering credits available from the date generated and applied from such date consistent with the investor's estimated tax method of accounting).

[24] Admittedly, there is a potential abuse in that, without a clear value for credits, the parties might reduce the nominal interest rate to the minimum allowable rate. A low interest rate means a lower deduction for the qualified taxpayer, but it does not have a significant tax liability, while the purchaser of the credit presumably does. On the other hand, the AFR is used as a reference rate in a variety of contexts under the Code, including in the safe haven interest rate in the Section 482 regulations for a loan from a person not in a lending business, and in the original issue discount rules for an issuance of debt in exchange for illiquid property. *See* Treas. Reg. § 1.482-2(a)(2)(iii); Treas. Reg. § 1.1274-2 and -3.

[25] *See* Treas. Reg. § 1.1275-4(b) (imputing interest, in the case of a contingent payment debt instrument issued for cash, based on the borrower's "comparable yield").

By comparison, when credits are transferred, a transferee cannot start using them until the transfer election is made under Section 6418. However, in our view, this extra step should not motivate Treasury to treat the transferee's payment for the credits as a prepayment, and thus to impute interest. Instead, we urge Treasury to try to make the credit available to the transferee more promptly to reduce its tax liability. Otherwise, if transferees are treated less favorably than tax equity investors, Congress's purpose in allowing transfers—encouraging more capital to flow to clean energy projects—would be undercut.

For example, a credit generated in January 2024 and paid for by a buyer shortly afterward may not be reported on an income tax return until September of 2025. If credits contracted for (let alone paid for) cannot be used to reduce the buyer's tax liability for over twenty months, there is significant economic value lost for the transferee and the eligible taxpayer.

In this situation, once the eligible taxpayer has contracted to sell the credit and has received cash for it, the eligible taxpayer presumably should not use the credit against its estimated taxes, knowing that the credit will not be available to it. Yet although the buyer is the right taxpayer to use it, there is a timing concern if the transfer election has not been filed by the time its annual tax payment is due: even though the transferee has already paid for the credit—and the credit has already been generated and could be used by others—the transferee potentially would have to pay tax and then seek a refund once the election has been filed.

From a more technical perspective, for purposes of Section 461 and the Treasury Regulations thereunder, economic performance has occurred–with solely a ministerial task remaining. In this situation, imputing interest would just make an unfortunate situation worse.

Instead, we recommend that Treasury should allow eligible taxpayers to file transfer elections more promptly. Ideally, they would be permitted to take this step either at the time when the credit is generated or, alternatively, in connection with the filing of quarterly estimated taxes. Enabling transferees to start applying the credit immediately against their next quarterly estimated tax payment obviously would make the credit more valuable, advancing Congress's purpose of encouraging capital to flow more promptly (and at a lower discount) to clean energy projects.

To ensure that this approach is administrable, we recommend that the taxpayer of record with respect to a credit (i.e., the taxpayer that after elections are made and returns are filed is eligible to use the credits) should be the only taxpayer that can use the credits to reduce its estimated tax payments; this retroactive application removes the Service from any complications of determining which taxpayer was eligible to use the credits, and makes the purchaser and seller of credits responsible for contractually allocating the estimated tax benefit of the credit between themselves and then enforcing the contract.

To illustrate the approach we recommend, assume that an ITC eligible project is placed in service in January of 2024 and in February of 2024 the ITCs from such project are sold pursuant to a binding written contract by the transferor to a transferee that uses the calendar year as its taxable year. We recommend allowing the transferee to use these ITCs against its quarterly estimated payments for the first quarter of 2024, since it expects the credits to be transferred to it. However, if the transferee applies the credits against its quarterly estimated taxes and the transferor ultimately fails to properly elect to transfer the credits to the transferee, the transferee will have underpaid its estimated taxes.[26]

(iii) Credits are purchased after being generated and approximately at the time a transfer election is made.

Situation (iii) is a straightforward payment for cash.

As a less clear cut variation of this scenario, what if a transferee contracts to purchase credits, but does not actually make payment until the election is made? Based on the analysis of situation (ii) above, Treasury might consider confirming that the contractual commitment entitles the transferee to apply the credits against estimated taxes, even before payment is made. Again, this issue would be mostly mitigated—and transferees will be motivated to pay earlier--if transfer elections can be made on an as generated or quarterly basis, rather than only when the annual tax return is filed.

(iv) Cash is not paid until after the credit was generated and the election was made.

In situation (iv), our view is that cash was not paid for the credit. The credit was transferred before a payment was made and thus the payment was made in consideration for the transferee's obligation, not cash. Notwithstanding that, allowing a short period for the transferee to ensure that the election was made before paying should be permitted.

4. **Other Factors That May Require Special Rules**

Treasury should consider offering guidance also about whether the purchaser of a credit must pay cash for rights associated with a credit, but formally distinct from it. For example, transferees often receive attendant contractual arrangements intended to ensure that the credit transferred actually materializes, including representations, warranties, covenants and indemnities related to the transfer of credits. Treasury can further consider whether rights of first offer (whereby a transferee can have the right to make the first bidding price to acquire credits from an eligible taxpayer and the eligible taxpayer cannot accept a proposal that is at a lower price) or exclusivity rights to future credits should affect the treatment as paid for in cash.[27]

In our view, when transferees contract for commercial protections against the risk that tax credits will be disallowed or recaptured, or when transferees enter into agreements to purchase credits at a market rate in the future, these contractual terms generally should not be considered as separate arrangements. Rather, typical commercial protections are attendant to the transfer of credits and merely protect that exchange; it is likely that transfers will not happen or will happen at significant discounts without contractual protections and indemnities. Additional rights, such as

[26] The estimated tax regime has its own mechanisms to police abuses, so we think it is unlikely that taxpayers will enter into contracts to transfer credits, and then breach these contracts, as a way to game the estimated tax regime. Transferring credits entails significant transaction costs. If the eligible taxpayer never makes the election it has contracted to make, the transferee owes taxes and interest on its underpayment.

[27] Other issues concerning the allocation of purchase price are noted below in Part VII.G.

rights of first offer, afford a transferee some commercial protections by ensuring that its efforts with respect to a developer can continue to bear fruit, but would not allow a transferee to acquire future credits from an eligible investor at a discount not otherwise available. It should not be necessary to separately allocate part of the buyer's cash payment to these ancillary contractual terms; nor should the buyer's right or obligation to buy additional credits in the future (for cash) be viewed as itself constituting a form of non-cash consideration.

B. Limit on a Second Transfer

Section 6418(e)(2), with the heading "[n]o additional transfers," provides that "[n]o election may be made under subsection (a) by a transferee taxpayer with respect to any portion of an eligible credit which has been previously transferred to such taxpayer pursuant to this section."

The scope of this prohibition is unclear. A threshold question is what goal Congress was pursuing in barring a second election. On the one hand, Congress might have been seeking to make Section 6418 more administrable. Obviously, Congress would not have wanted more than one taxpayer to claim the same credit. If it was possible to make multiple elections, then to prevent abuse, the government would need to track the credit through a daisy chain of elections as it was transferred from one taxpayer to another. In prohibiting a second election, Congress might have been seeking to avoid this monitoring challenge. This is the interpretation we recommend. On the other hand, Congress might simply have wanted to block a secondary market in tax credits.

If Treasury views the restriction as purely one designed to ensure administrability and prevent double benefits (as we do), then guidance under Section 6418(e)(2) might be as simple as a clarification that no election to transfer may be filed by a transferee. In other words, once an eligible taxpayer has filed an election with the Service to transfer a credit, this election is irrevocable and the transferee taxpayer is the only taxpayer entitled to the credit.

Under this approach, parties could freely transfer and assign the **right** to the credit before a formal election is filed with the Service. This is a straightforward interpretation of the statute and likely the most administrable. If this approach is adopted, rules should be provided prescribing when and how the eligible taxpayer must be notified of such transfers and assignments, so that the eligible taxpayer names the right transferee in the transfer election filed with the IRS.

However, if Treasury views the double-transfer prohibition as restricting multiple transfers of the right to the same credit—regardless of whether a second election is needed to effect this transfer of such right—then Treasury should clarify this point. For example, Treasury could define the first transfer or election date as occurring earlier than the date on which the seller formally files an election with the Service. Treasury also could explicitly expand the scope of the no-second-transfer rule to include economically equivalent transactions, such as entering into a contract to sell or otherwise transfer the economic benefit of a credit.

Accordingly, we believe Treasury should clarify its interpretation of Section 6418(e)(2). Consider the following example that illustrates the application of the two alternative approaches just described: Tax credit buyer enters into a binding commitment with a seller obligating the buyer to purchase, and the seller to sell, certain credits at a fixed price on a future date.

If Treasury chooses to define a transfer of credits under Section 6418 as occurring at the time a binding commitment is executed, then both the selling and purchasing taxpayers in the above example would no longer be able to elect to transfer the credit to another taxpayer.

Alternatively, Treasury may choose to define the transfer in the above example as occurring when the eligible taxpayer files an election with the IRS to transfer the credits. Under this interpretation, the buyer (and transferees from the buyer) would be permitted to assign the contract to purchase the credits, with the eligible taxpayer entering the name of the taxpayer that ultimately ends up holding such right on the election form filed with the IRS and with no further assignments being possible after that point.

As a general matter, we recommend the narrower interpretation of the no-second-transfer rule, which views it as one designed to ensure administrability. This interpretation fits more comfortably within the statutory language, which prohibits a second "election" by a transferee taxpayer. [28]

To implement this interpretation, we recommend that Treasury should expressly limit the no-second-transfer rule, so it applies only to a transferee taxpayer who has received a transfer of the same tax credit from the original eligible taxpayer pursuant to an election that has been properly filed. The no-second-transfer rule, therefore, would be a bar on a second election made by the transferee taxpayer, but not on intermediary transactions or arrangements so long as there is only one election between one transferor taxpayer and one transferee taxpayer.

Additionally, as discussed in Part IV.A.3 of this Report, we recommend that Treasury should clarify the process for making a tax credit transfer election. We recommend permitting taxpayers to make this election on a date that is earlier than (and separate from) the date on which it files its annual federal income tax returns.

V. Interaction with Investment Tax Credit Recapture and the Passive Activity Credit Rules

This Part considers the interaction of Section 6418 with the rules for recapturing investment tax credits, as well as with the passive activity credit rules.

A. Investment Tax Credit Recapture

ITCs are likely to comprise a significant share of the tax credits transferred under Section 6418. A number of asset types are limited to the ITC, such as energy storage and qualifying biogas property. In addition, an ITC will be more economical than a PTC for many projects.[29] Congress's decision to offer most projects a choice between the PTC and ITC, as well as to allow ITCs to be

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[28] *See* Section 6418(e)(2).

[29] The ITC is based on a qualified property's tax basis while the PTC is based on the volume or quantity of production from a qualified property. Project owners generally choose the ITC for projects that are expensive to build and have lower projected production (which is often the case for newer technologies) and choose the PTC when the converse is true.

transferred under Section 6418, suggests that Treasury and the Service should apply the ITC recapture rules in a way that minimizes imbalances and friction costs.

As a general matter, the ITC is claimed entirely in the year in which the credit-generating asset is placed into service. The credit, however, vests annually in equal 20 percent increments over a five-year period. If the credit-generating property ceases to qualify for the ITC during the vesting period, the unvested portion of the credit is recaptured and must be repaid. The five-year vesting period is referred to as the recapture period.

The circumstances that give rise to an ITC recapture can generally be divided into two broad categories, each with significant exceptions set forth in Treasury Regulations Section 1.47-1 through -6. The first category includes events where the credit-qualifying property itself fails to maintain its original qualifying status. For instance, the property might suffer a casualty event that destroys it or renders it inoperable.

The second category encompasses situations where the tax status of the taxpayer changes (e.g., the taxpayer becomes tax-exempt) or the equity ownership in the project changes hands, such that the taxpayer who originally claimed the credit has entirely or in part transferred its ownership to another taxpayer. In this connection, if a partner transfers a significant part (more than one-third) of its interest in a partnership that owns a project, such transfer is generally an owner-level recapture event that triggers a recapture by such partner of ITCs that have been allocated to the partner.[30]

For ease of reference, we can call the first category "property recapture events" and the second category "owner recapture events."

Notably, now that Congress has authorized the transfer of credits, the rationale for property recapture events remains clear, but the rationale for owner recapture events is less obvious. It still matters whether the asset remains in service for the full five years; otherwise, Congress would not "get its money's worth" in providing a credit for an asset that is not actually being used. But it seems to matter less *who* is using it. A taxpayer no longer has to own the asset in order to claim the credit, so it is unclear why a sale of this asset is relevant (again, as long as the asset remains in use).

Since the property recapture events remain relevant, it is not surprising that Section 6418(c)(3) provides that the ITC recapture provisions continue to apply to any ITC that is transferred under Section 6418. Section 6418 also contains a set of reciprocal notices that must be provided between the transferor and the transferee in the event of a recapture event, although the form and manner of such notice is left to Treasury's discretion.

Thus, although it seems clear that Congress wanted ITC recapture provisions to continue to apply to a Section 6418 transfer, it is unclear whether all the historical recapture events should apply to a transferred credit, or a more limited subset of these events. It also is not clear whether

[30] *See* Treas. Reg. § 1.47-6(a)(2).

the ITC recapture should be imposed on the tax credit seller (the eligible taxpayer) or the tax credit buyer (the transferee).

The statutory language in Section 6418 offers some indication of Congressional intent with respect to these questions. Section 6418(a) provides that "…the transferee taxpayer specified in such election (and not the eligible taxpayer) shall be treated as the taxpayer for purposes of this title with respect to such credit (or such portion thereof)." Read literally, this language would suggest that only the transferee, rather than the eligible taxpayer, remains liable for ITC recapture. Section 6418(g)(3) provides that the eligible taxpayer must provide notice to the transferee if the applicable investment credit property is disposed of, or otherwise ceases to be investment tax credit property, and that the transferee must provide the eligible taxpayer with notice of the recapture amount. This rule strongly suggests that property recapture events (property ceasing to be investment tax credit property) and, at least to some extent, owner recapture events pertaining to the tax credit seller (disposition of investment tax credit property) give rise to ITC recapture of a transferred investment tax credit. Moreover, imposing recapture liability on the transferee – the taxpayer that claimed the tax credit that is being recaptured – appears to be the most logical and intuitive way to apply these rules.

We believe that clear guidance on the application of the ITC recapture rules to tax credit transfers will be important to the development and success of the ITC transfer markets. We expect that friction costs associated with the risks of ITC recapture may significantly slow the pace at which market participants enter into agreements for ITC transfers, increase the discount rate demanded by buyers of ITCs, and limit the universe of ITC sellers to those taxpayers with the financial ability to provide strong guarantees and indemnities to protect buyers against the risk of recapture.

As a result, much like with other issues associated with Section 6418, the ITC recapture rules involve carefully balancing of the competing policy objectives summarized in Part III. The tensions among these policy objectives can be seen more clearly by examining the likely outcomes if the rules were implemented at either end of the extremes.

At one end of the spectrum would be the adoption of rules that make the transferee liable for all ITC recapture events, whether such events apply to the eligible taxpayer or to the transferee. In this regime, ITC recapture events would include all property recapture events and would include owner recapture events at both the eligible taxpayer who continues to hold the ITC property and the transferee taxpayer who claimed the ITC.

This choice has two disadvantages. First, as noted above, it is not clear why ownership events should still matter once the credit has been transferred. This is particularly so in a case where the buyer of the ITC is an entity and ownership interests in the buyer are transferred; the buyer does not own the credit-generating asset and presumably cannot transfer the credit itself once it has been claimed on the buyer's federal income tax return.[31] Second, this approach could undermine Congress's goal of encouraging more investment in clean energy. This broad application of the recapture rules would be the most restrictive to the ITC transfer market and

[31] In Part VI.B of the Report, we discuss certain issues that may be relevant to a partnership that undergoes a change at the partner level after purchasing a tax credit.

would consequently increase the discount factor and limit the pool of viable ITC sellers to those who could insulate buyers from recapture risks. Additionally, the liquidity restrictions applicable to the transferee would further diminish the pool of ITC buyers.

The other end of the spectrum would limit ITC recapture liability to the tax credit seller and narrow the ITC recapture rules to only property recapture events on the theory, again, that once the ITC is separated from the underlying property, there should be no further policy objective in imposing restrictions on the ownership or transfers of the underlying qualifying property so long as it remains operational through the recapture period. This choice would eliminate the friction between ITC sellers and buyers because once the ITC is transferred, the actions or circumstances pertaining to any one of them would no longer affect the other.

Yet this approach also has a disadvantage. It would mark a departure from the historic ITC recapture rules and create meaningful differences among taxpayers that claim ITCs on property they own and those that choose to sell or buy ITCs. Taxpayers could be incentivized to sell the ITCs associated with their property for the sole purpose of gaining ITC recapture rules that are more relaxed.

This leads to a tradeoff. On the one hand, there would be a differential in the application of the ITC recapture rules to transferred and retained ITCs.[32] On the other hand, a more relaxed ITC recapture rule in the context of transferred ITCs seems congruent with the purpose of Section 6418 which seeks to expand the pool of applicable tax credit buyers and eliminate the friction costs inherent in the existing tax equity market.[33]

We present four alternative approaches for Treasury to balance these competing concerns.

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[32] Notably, it is not unprecedented to treat recapture differently, depending on whether taxpayers hold an asset or monetize the credit. Treasury has already taken this step in guidance on the cash grant in lieu of credit under Section 1603 of the American Reinvestment and Recovery Act of 2009, which limits recapture upon transfer of a project to circumstances where the transferee of the project would have been ineligible to claim the cash grant. *See* https://home.treasury.gov/system/files/216/GUIDANCE.pdf.

Such a differential can be justified by the fact that there is an inherent advantage in using the credit, instead of selling it: a credit will always be sold at a discount. As a result, someone who wants the credit—but not the project—is better off selling the project, instead of the credit. This way, they get the full face-value of the credit (instead of the discounted amount they would receive in selling it). This means there is a greater churning incentive—and thus a justification for tougher recapture rules—for those who invest directly in the project.

For example, assume that a project has a basis of $100, its owner can claim a $30 credit, and the credit can be sold separately for $25. The project has a fair market value of $100 without the credit and $125 with the credit. If the recapture rules did not apply, the sponsor could keep the credit and sell the project, realizing $130 of value. Alternatively, if the sponsor sold both the credit and the project together, it would recognize only $125 of value. If it sold them separately, it would realize the same $125. As a result, there is no incentive to sell the credit separate from the project. However, for project owners that claim the credit themselves, there is a $5 arbitrage: they would be incentivized to buy the project, take the credit, and sell the project.

[33] We note that the expansive ITC recapture events contained in Treas. Reg. Section 1.47 were largely created through the promulgation of Treasury regulations written many decades ago. Accordingly, if Treasury chooses to relax the ITC recapture rules in the context of transferred ITCs, it might also choose to revisit and synthesize the existing ITC recapture rules for tax credits that are not transferred.

First, as an intermediate position between the two extremes outlined above, Treasury could assign liability for recapture to the transferee, but could limit recapture events to property recapture events and owner recapture events that would apply solely to ownership transfers at the tax credit seller, such as those involving a direct and voluntary transfer of the ITC property.

This puts the transferee on equal footing with any other taxpayer who claims an ITC by allowing it the benefit of claiming the ITC in full in the property's first year in service in exchange for the "promise" to maintain the property's qualification throughout the five-year vesting period. We would expect an efficient market to more highly value assets that are well constructed, operated and maintained, a clear policy objective of the IRA. This approach also has the benefit of not permitting tax credit sellers to gain significant asset liquidity advantages over buy and hold taxpayers.

Second, another way to operationalize this intermediate position is to use the recapture provisions that applied to the 1603 Cash Grant Program,[34] so that recapture generally is limited to the following events: (i) selling the project to a person that would not have been eligible to claim the credit or Section 6417 direct pay; (ii) removing the project from service; (iii) converting the project to non- eligible (e.g., converting for personal use or changing the technology so it does not qualify); or (iv) in the case of a casualty during the recapture period, rebuilding credit eligible property.

Implementing this latter approach would require a departure from the current regulations, which treat a "disposition" as a recapture event and define "disposition" broadly. For example, under this approach, the transfer of a partnership interest would not trigger recapture.

This approach is supported by the observation that the policies advanced by ITC recapture do not seem to be implicated when a taxpayer sells a credit-generating asset after the associated credit has already been transferred to another taxpayer. In this case, there is no risk that a taxpayer would buy the property simply to gain access to the credit. Once the credit is transferable, taxpayers no longer need to buy the underlying asset in order to gain access to the benefits of tax credits. As a result, there seems to be no need to further police whether the same taxpayer continues to hold an asset throughout the recapture period.[35]

Third, another potential approach would be for Treasury to apply the full range of owner recapture events that exists under current law (rather than limiting owner recapture events for purposes of Section 6418 as described above). As previously noted, this approach suffers from a number of drawbacks and is likely to cause the most friction between buyers and sellers of investment tax credit.

Fourth, Treasury could consider imposing a "recapture" of sorts on the transferor of ITCs (e.g., after a change in ownership of the transferor, assuming Treasury still wants changes in ownership to trigger recapture). Since the transferor actually has not used the credit, the remedy cannot be a simple reversal of this benefit. As an alternative, Treasury can consider increasing the

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[34] Section 1603 of the American Recovery and Reinvestment Act of 2009, P.L. 111-5 (February 7, 2009).

[35] *See supra* note 33, suggesting that Treasury may wish to revisit some of the historical ITC recapture events in light of the new tax credit transfer regime.

transferor's federal income tax liability by the amount of the cash the transferor received in exchange for the tax credit. This approach recognizes the reality that credits are likely to sell at a discount, so that a full recapture—of the face amount of the credit, rather than the cash received—seems somewhat punitive (although, admittedly, recapturing only the sale proceeds does not make the government whole for the tax it has forgiven). Likewise, if a partnership is the transferor and an event related to a particular partner is an owner recapture event, that partner would be required to "recapture" its distributive share of the partnership's tax-exempt proceeds from selling the credit). This approach arguably would place the burden of recapture on the person that has caused, and that has the most information about, the owner recapture event.

B. Passive Activity Credit Rules

Like ITC recapture, the passive activity credit rules of Section 469 also can have significant implications for Section 6418. If these rules apply to a buyer of credits, individuals will be largely or entirely foreclosed from buying credits under Section 6418. Yet despite this issue's importance, there is little indication that Congress decided (or even considered) whether Section 469 should apply.

This Section considers three issues. First, as a matter of statutory interpretation, we consider whether the passive activity credit rules apply to purchasers of clean energy credits. On balance, we believe the better reading is that the rules do apply, although the relevant language can be read to come to the contrary conclusion as well.

Second, we highlight competing issues concerning whether it is advisable, as a matter of policy, for these restrictions to apply. As Part III explained, there are good reasons to expand the scope of potential transferees (and thus the market value of transferable credits), on the one hand, and to guard against fraud and protect the integrity of the tax system, on the other hand. We do not take a position on the question of how these considerations should be balanced, as a matter of policy, since the energy policy issues at stake are beyond the scope of our expertise.

Third, we consider whether the passive activity credit rules limit the amount of credits an eligible taxpayer can transfer. In our view, these rules do not limit a seller's ability to transfer credits.

Regardless of how Treasury comes out on these issues, clear and prompt guidance is critical. Without it, taxpayers must interpret for themselves whether and how the rules apply. Some taxpayers will take the position that the passive activity credit rules do not apply and will purchase credits. If Treasury and the Service subsequently determine that the passive activity credit rules do in fact apply, the Service would need to audit and assess those taxpayers and may also need to litigate the issue. In the interim, there would be confusion in the market, as some taxpayers (and their advisors) take the position that the passive activity credit rules do not apply to transferred tax credits, while others take the opposite position. As Treasury and the Service will surely need to address this issue at some point, it would be beneficial to provide guidance as soon as possible.

1. Application of the Passive Activity Credit Rules to Purchasers of Tax Credits: The Statutory Provisions

The passive activity loss rules are designed to block uneconomic tax shelters that generate upfront losses for taxpayers.[36] Very generally, the passive activity loss and credit rules limit the ability of individuals, estates, trusts, closely held corporations, and personal service corporations ("**affected taxpayers**") to use losses and credits from a trade or business in which they do not materially participate.[37] Section 469 and Treasury Regulations use a schedular approach, allowing losses and credits from this "passive" activity to shelter only passive activity income.

For this purpose, the amount of tax attributable to passive activity income is determined by comparing (i) the amount that the taxpayer would pay with regard to all taxable income with (ii) the amount that the taxpayer would pay with regard to taxable income other than net income from passive activities (disregarding, in both cases, the effect of credits).[38] The passive activity credit rules apply to subpart D of part IV of subchapter A,[39] which includes all the credits eligible to be transferred under Section 6418.[40]

The passive activity loss and credit rules (along with the at-risk rules of Section 465 and Section 49, which limit the availability of losses and credits based on the amounts they are deemed to have "at risk" under those provisions) have largely prevented individuals that are not actively engaged in the renewables development business from participating in the tax equity market.[41]

Whether Congress meant to apply these regimes to purchasers of energy tax credits under Section 6418 is unclear. Section 6418(a) provides:

> In the case of an eligible taxpayer which elects to transfer all (or any portion specified in the election) of an eligible credit determined with respect to such taxpayer for any taxable year to a taxpayer (referred to in this Section as the "transferee taxpayer") which is not related (within the meaning of Section 267(b) or 707(b)(1)) to the eligible taxpayer, the transferee taxpayer specified in such election (and not the eligible taxpayer) **<u>shall be treated as the taxpayer for</u>**

[36] *See generally* Marvin A. Chirelstein & Lawrence A. Zelenak, Tax Shelters and the Search for a Silver Bullet, 105 COLUM. L. REV. 1939 (2005).

[37] *See* Section 469(c)(1).

[38] The legislative history provides a helpful example: if a taxpayer would owe $50,000 of tax disregarding net passive income, and $80,000 of tax considering both net passive and other taxable income (in both cases, disregarding the effect of credits), then the amount of tax attributable to passive income is $30,000. In the absence of net passive income for a taxable year, no tax is attributable to passive income, and passive credits generally are not allowable for the year. COMREP ¶4691.03 Limitations on losses and credits from passive activities. ('86 TRA, PL 99-514, 10/22/86).

[39] Section 469(d)(2)(A)(i).

[40] Subpart B credits (other than §27 (foreign tax credit)) of Part IV of subchapter A (§27–§30D)) are also subject to the passive credit rules.

[41] We note that when evaluating the applicability of Section 49 with respect to credits transferred under Section 6418, the policy issues and the interpretive issues under Section 6418 appear similar to us to the ones discussed below in the text in the context of Section 469.

purposes of this title with respect to such credit (or such portion thereof) (*emphasis added)*.

One reading of this language suggests that the passive activity credit rules apply, while another supports the contrary conclusion.

On the one hand, the reference to "for purposes of this title"—that is, the Internal Revenue Code—can be read to suggest that the passive activity credit rules (and all other rules in the Code) do apply here. Under this reading, being "treated as the taxpayer for purposes of this title with respect to such credit" means that the transferee is both entitled to the credit and is subject to all of the rules and limitations thereon.

By analogy, there is no indication that other limitations and related rules do not apply, including some version of the recapture rules under Section 50,[42] limitations on use under Section 38(c), and the carryback and carryforward rules under Section 39.[43] For example, for purposes of the Section 38(c) limits on using credits to offset income, a transferee of credits should not be permitted to offset more of its tax liability with transferred credits than it could with generated credits. In these respects, Congress presumably did not mean to be more generous to transferees than to tax equity investors.

Under this reading, Section 469 should also apply: the credit eligible project or property was produced in a trade or business and the transferee generally will not have materially participated in that trade or business.[44]

On the other hand, there are two other ways to interpret Section 6418—and, in particular, the language that the transferee is "treated as the taxpayer for purposes of this title with respect to such credit"—to conclude that the passive activity credit rules actually do not apply to limit a purchaser's ability to use transferred credits.

The first argument interprets "treated as the taxpayer" very broadly. Under this reading, this language means that the purchaser steps into the seller's shoes--not just in being able to claim the credit, but also in being treated as materially participating in the activity that generates it.[45] In

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[42] *See supra* Part V.A for a discussion of ITC recapture.

[43] Section 39(a)(4) provides that "applicable credits" defined under Section 6417 (most transferrable credits), are eligible for more generous carryback rules. We note that some commenters have asked for clarification on carryback and carryforward issues for transferred credits. *See* Stellantis, Submission of Comments in Response to IRS Notice 2022-50, IRS 2022-0024-0054, November 3, 2022 ("To eliminate the confusion, it would be very helpful if the Proposed Guidance were to specify how IRC Sec. 39 applies to any acquired IRC Sec. 6418 tax credits"); Hyundai Motor Group, Hyundai Motor Group Comments to U.S. Department of Treasury Request for Comments on Elective Payment of Applicable Credits and Transfer of Certain Credits (Notice 2022-50); IRS-2022-0054-0092, November 4, 2022 ("Treasury should clarify through its guidance whether the credit transferred can be carried forward or carried backward if it meets the requirements under § 39").

[44] Under Section 6418(a), the transferee must be unrelated to the qualified taxpayer under Section 267(b) and 707(b)(1), which does not mean that the transferee did not/does not own a minority interest in, work on the development of or participate in the operation and maintenance of the specific credit eligible property. As a result, the statement in the text is a generalization that conceivably may not apply to a particular set of facts.

[45] One could read Section 6418(g)(2)(C) as being consistent with this type of step in the shoes approach, focusing on the transferor of the credit. Section 6418(g)(2)(C) requires recapture of credits and, potentially, a penalty in the case

other words, this directive is construed to impute the activities generating the credit to the transferee.[46]

Alternatively, the second interpretation is that this language imputes much less to the purchaser: specifically. the purchaser steps into the seller's shoes *only to use the credit*, but not in any other way. According to this reading, the transferee is not treated as engaging (actively or passively) in the underlying activity that generates the credit. It is just buying a credit, which is not itself a trade or business (and thus is not an activity that can be subject to the passive activity credit rules). This interpretation emphasizes the statutory phrase "with respect to such credit": the transferee is "treated as the taxpayer for purposes of this title *with respect to such credit*"-- that is, *only* with respect to the credit, but not otherwise.[47] As a result, the transferred credit is not derived from a trade or business, and thus is not a passive activity credit.

Under each of these two readings, Section 469 would not apply to a purchaser of credits under Section 6418. As a result, affected taxpayers would not be prevented from buying and using credits.

As noted above, on balance, we believe the most natural reading of the relevant language is that the passive activity credit rules do apply to transferees under Section 6418, although there are ways to read the language in support of the contrary conclusion. Given these ambiguities—and the uncertainties they are creating in the market—it is important for Treasury to issue guidance on this issue.[48] In analyzing it, Treasury should be mindful of the competing policy considerations at work here.

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of an "excessive credit transfer," which is defined as the amount of the credit actually claimed over "the amount of such credit which, without application of this section, would be otherwise allowable under this title with respect to such facility or property for such taxable year."

[46] To rebut this argument, one might argue that if this was what Congress intended, the law would have been more explicit on this point. Indeed, it may be that Treasury determines that no characteristics about a credit are imputed to the transferee so that a transferee can never be deemed to materially participate in the activity relevant to the generation of the credit. Under this reading, a person actively participating in a solar trade or business would not be a material participant with respect to ITCs or PTCs purchased from a solar project, even one it works on directly. Such treatment would in effect foreclose affected taxpayers from being transferees.

[47] In response, one might argue that the credit should not be analyzed in isolation, but rather as a product of the trade or business that created it. Under this reading, even if the transferee is just buying a credit, as argued above, the credit still came from a trade or business, and the transferee did not actively participate in that trade or business. According to this interpretation, the fact that the transferee never invested in this business is not relevant.

[48] *See* Section 6418(h) ("The Secretary shall issue such regulations or other guidance as may be necessary to carry out the purposes of this Section . . . ."). Additionally, Section 469(l)(1) authorizes Treasury to "specify what constitutes an activity" for purposes of the passive activity rules, and thus, if there is ambiguity about how to apply the Section 6418 rules, Treasury might apply its authority under Section 469 to resolve the issues.

2. Application of the Passive Activity Credit Rules to Purchasers of Tax Credits: Competing Policy Considerations

As discussed in Part III, the competing interests are substantial. To summarize, those in favor of applying the passive activity credit rules to transferred credits include:

- If the rules do not apply, transferees could acquire benefits they could not acquire by directly investing in the underlying activity;
- There is greater potential for fraud and abuse:
  - Individuals (and other "affected taxpayers") may be poorly positioned to verify whether credits were properly generated, whether an underlying project or property is eligible, whether purported qualified transferors are legitimate, *etc*.;
  - The increased volume of transactions will make it more challenging for the IRS to effectively audit and police them; and
- The ability of affected taxpayers to reduce their tax liabilities substantially by purchasing credits could undermine confidence in the tax system.

In contrast, the case for not applying the passive activity credit rules rests on the desirability of expanding the scope of credit transferees:

- In authorizing the transfer of credits, Congress concluded that the existing pool of tax equity investors was not sufficient to fund the IRA's clean energy goals.
- Relatedly, there may not be enough large corporate taxpayers to absorb the credits that will be available. The sizable production credits under Section 45Q (carbon capture), Section 45V (hydrogen production) and, to an extent 45X (qualified manufacturing),[49] offshore wind, stand-alone storage, nuclear, and continued growth of wind and solar projects may cause a glut of credits that either cannot be efficiently absorbed or will drive down the price of credits;
- If credits cannot be absorbed or the price per credit drops, Congress's efforts in the IRA to encourage clean energy will be less successful, and the tax system will be undermined as credit transferees reduce their tax liabilities for a payment of cents on the dollar; and
- Facilitating transfers of credits to individuals will allow developers of smaller projects that are not large enough to attract large corporate transferees – including

[49] These credits are eligible for direct pay for a portion of their respective credit periods and the project owners may need to transfer the credits to monetize them.

smaller energy projects in low-income communities[50] or energy communities[51]--to find willing transferees that are trying to offset smaller absolute tax liabilities.

We recommend that Treasury address in guidance whether and how the passive activity credit rules apply to transferred credits. We do not make a recommendation about whether it would be advisable for the passive activity credit rules to apply, as a matter of policy, since the energy policy issues at stake are beyond the scope of our expertise.

Furthermore, we recommend that for administrative ease and consistency, Treasury should decide that the passive activity credit rules in their current form generally either do apply (so that transferred credits are passive activity credits in the hands of an affected taxpayer), or do not apply (so that transferred credits are not passive activity credits in the hands of an affected taxpayer), so that Treasury does not create bespoke rules solely for Section 6418.

3. Application of the Passive Activity Credit Rules to Sellers of Tax Credits

An easier question is how the passive activity credit rules apply to sellers of tax credits. Specifically, do these rules limit the amount of credits an affected taxpayer can transfer?[52] Do they limit the amount a partnership can transfer if one or more of its partners are affected taxpayers? In our view, the answer is "no."

Regarding partnerships, Section 6418(c)(1) provides for a partnership (not partner) level election to transfer credits (i.e., it treats the partnership as an entity rather than an aggregate). Furthermore, it would not be administrable for a partnership to be charged with knowing whether its partners would be subject to passive activity credit limitation (or the at-risk rules), and to what extent. In general, these rules apply at the partner level.

With respect to affected taxpayers (as well as partnerships with partners who are affected taxpayers) that transfer credits, it is consistent with the evident purposes of the IRA to permit developers to optimize the use of credits to incentivize further development of clean energy. Allowing affected taxpayers to transfer credits advances this purpose in two ways: first, it allows project developers to efficiently use credits; and, second, it allows affected taxpayers to invest in renewable and green projects (i.e., if an affected taxpayer cannot efficiently use credits, it will be at a competitive disadvantage to other investors with respect to credit eligible projects). In an analogous circumstance, the IRS privately ruled that a lessor that was composed of affected taxpayers could pass through[53] historic rehabilitation credits without limitation to a lessee S corporation, whose owners materially participated in the relevant business.[54] In short, guidance

[50] Including those for which additional incentives are available under Section 48(e).

[51] Including those for which additional incentives are available under Section 45(b)(11) and Section 48(a)(14).

[52] We note it is unlikely that an affected taxpayer would be a qualified taxpayer that does not materially participate in the relevant activity but is nonetheless eligible for credits – the circumstance where a partnership (or S corporation) has affected taxpayers as partners (or shareholders) is more likely.

[53] Former Section 48(d) (currently Section 50(d)(5)) permits a lessor to pass through certain credits to a lessee.

[54] *See* Private Letter Ruling 8951072.

clarifying that the passive activity credit rules do not limit the ability of affected transferees to transfer credits is consistent with the text of the IRA, the purposes of the IRA, and existing guidance.

VI. Issues Under Subchapter K

Guidance from Treasury also is needed on the application of Section 6418 to partnerships. This Part identifies two sets of issues. The first set arises when a partnership sells credits, and the second set arises when it purchases credits. In each context, Treasury will need to balance the competing considerations discussed above in Part III. [55]

A. Partnerships as Transferors

Proposed regulations should address the following issues in connection with a partnership as the transferor of credits: (1) what it means for a facility or property to be held "directly"; (2) how to allocate tax exempt income derived from the sale of credits; (3) the consequences of sales of partnership interests, including the application of the recapture rules; and (4) potential anti-abuse rules.

1. Held "Directly"

When a partnership transfers a credit, Section 6418(c) provides that the tax-exempt proceeds should be allocated to each partner "based on such partner's distributive share of the otherwise eligible credit." This rule applies to "any facility or property held directly by a partnership or S corporation."

Regulations or other guidance should clarify the meaning of "held directly." Specifically, what if the facility is held through a disregarded entity? What if multiple owners hold it as tenants in common or through state-law entities that are entitled to elect out of partnership status under Section 761(a)?[56]

On the one hand, there is an administrability advantage in interpreting "directly" to require a partnership to hold the entire property either in its own name or through a wholly owned disregarded entity: there is a single owner, which can ensure compliance with the statute's recapture, excess credit, and other rules.

[55] Our comments are addressed to the treatment of partnerships specifically, although some similar issues are present for S corporations.

[56] This situation could arise, for example, where a syndicate owns the facility, but it is leased to an operator that conducts the business. In such case, the syndicate would be regarded as holding the property for investment purposes.

On the other hand, a broader reading of "directly" has a different administrability advantage, which we believe is more appropriate: Section 6418 would be interpreted using existing law and authority applicable to partnerships, including under Section 761(a).[57]

2. Allocation of Tax-Exempt Income

When a partnership sells a credit, Section 6418(c) treats the payment for the credit in the same manner as if partnership had actually accrued the credit. Thus, Section 6418(c)(1)(A) provides that the payment will be treated as tax-exempt income and Section 6418(c)(1)(B) provides that a partner's distributive share of that tax-exempt income shall be "based on such partner's distributive share of the otherwise eligible credit." Treasury should provide guidance about how this determination should be made. Presumably, this provision means that credits (and therefore the income) should be allocated consistent with how the credits would be have been allocated among the partners had the partnership not transferred the credit, consistent with existing law, regulations, and other guidance.[58]

3. Consequences of Sales of Partnership Interests

Regulations or other guidance also should address whether the sale of interests in the transferor partnership should trigger ITC recapture. As noted above, under current law, ITC recapture can be triggered by changes in ownership of the underlying project, and also as a result of transfers or changes in partnership interests in the partnership owning the project. This Report has addressed above the issues and considerations involved in determining which ownership changes should trigger recapture. The rules for partnerships that sell credits generally should be consistent with the rules for other sellers.

Thus, if Treasury believes that recapture is not warranted when the ownership of a project changes, a similar rule should be adopted for partnerships. Under this approach partners should be free to transfer their interests in the partnership that has sold the credits without causing any recapture.[59] As discussed in Part V.A, intermediate approaches are also possible under which certain types of transfers of direct ownership of a project would trigger recapture, but changes in ownership of a partnership that in turn owns a project would not do so.

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[57] This interpretive issue arises principally with respect to tenancy-in-common arrangements, and entities that elect out of partnership treatment. Treasury should consider whether for such arrangements to be respected it is required that each owner have the right to sell its share of the credits separately.

[58] This would mean that if a partnership sells only a portion of the credits for the year with respect to a particular project, the tax-exempt income and the retained credits should be allocated in the same manner. Treas. Reg. §1.704-1(b)(4)(ii) offers some flexibility for taxpayers by generally allocating credits (other than ITCs) based upon the expenditures giving rise to the credit. Such expenditures could include, for example, either the costs of capital equipment or operating expenses. Treas. Reg. §1.704-1(b)(4)(ii) provides for allocation of ITCs generally by reference to the ratio in which the partners divide the general profits of the partnership (although if there is a special allocation of all income from the property for which the ITC is being claimed, the allocation of the ITC follows that allocation).

[59] If this approach is adopted, Treasury should consider whether changes to the current rules imposing recapture should also be made to put partners in the same tax position with respect to partnerships that have sold credits and those that have not.

By comparison, Treasury believes that the full range of existing recapture rules should apply in the case of project as to which the ITCs are transferred under Section 6418, then guidance should confirm the existing rules addressing transfers of partnership interests apply with respect to a partnership that transfers credits.

We note that it does not appear that transfers of interests in a partnership that sells credits should generally implicate the prohibition in Section 6418(e)(2) on second transfers of those credits. Transfers of such interests appear to be outside this provision's intended reach because such transactions are not the transfer of a right to the credits in isolation, but rather a transfer of an interest in the entire project including its potential to generate credits.

4. Anti-Abuse Rules

Anti-abuse rules may also be needed to address attempts by taxpayers to circumvent the limitations set forth in the statute. For example, concerns may arise when a taxpayer (or related party), who is a partner in the selling partnership, purchases credits from the partnership. Suppose that a taxpayer owns 49% of a partnership, whose activities generate a transferable energy tax credit. What if the partner (in its individual capacity) buys the credit from the partnership, and then receives a distribution from the partnership of a disproportionate share of the sale proceeds? The taxpayer in such a case could end up with the economic result of claiming a share of the credit which exceeds the distributive share that would be permitted to be allocated to the taxpayer under Section 704(b), without having truly purchased the credit for cash.

B. Partnership as Purchaser

Although Section 6418(c) expressly provides for a partnership to be a transferor of the credits, the statute is silent as to whether a partnership may be a purchaser of credits. Section 6418(a) does not define "transferee taxpayer" other than to require that the transferee be unrelated to the transferor within the meaning of Section 267(b) or Section 707(b)(1).[60]

Permitting partnerships to serve as the purchaser of credits seems consistent with the policy of Section 6418, which is to broaden the pool of investors in clean energy projects. Intermediaries could market such investments to groups of investors, including smaller investors. Bringing more potential investors into this market would increase competition and reduce pricing discounts, assuring more "bang for the buck" for these credits, as discussed in Part III above.

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[60] The use of the term "taxpayer" might be interpreted to exclude partnerships, which are not obligated to pay tax (other than as withholding agents) on their income. However, a partnership can reasonably be seen to be a "taxpayer" as the term is defined in Section 7701(a)(14) ("any person subject to any internal revenue tax"), since a partnership is a "person" (as defined in Section 7701(a)(1)) and is obligated under the Code to pay employment and certain other non-income taxes.

In addition, the Sections 702 and 704 and the regulations implementing them indicate a credit is a partnership item, which the partnership then allocates among its partners. These rules are consistent with the approach of treating a partnership as an appropriate type of transferee owner of credits under Section 6418, and allocating those credits appropriately among its partners as described below.

If Treasury determines that Section 6418 permits partnerships to purchase credits, guidance should be issued recognizing that a partnership formed for the purpose of purchasing credit is formed for a valid investment purpose and not for a tax avoidance purpose.[61]

In addition, Treasury should consider issuing other guidance, including on the following four issues: (1) allocations of the credits among partners; (2) adjustments to the tax basis of partners' interests in the partnership in order to prevent indirect deductions for the cost of purchasing credits; (3) rules limiting transfer of partnership interests to avoid second sales of credits; and (4) recapture rules. In addition, Treasury should consider potential anti-abuse rules to address circumvention of the rules.

1. Allocations of Credits among the Partners

Treasury should provide guidance about how the credit should be allocated among the partners. Treasury could consider applying the general rules in Treas. Reg. § 1.704-1(b)(4)(ii). Alternatively, because the credit is solely attributable to a cash expenditure by the purchasing partnership, the credit presumably should be allocated in proportion to how the partners funded this cash purchase. For this purpose, a partner may be considered to have funded the partnership's purchase either through capital contributions, retained income or a share of debt.[62]

Treasury also should consider adopting the rule that for purposes of Section 706, credits to be claimed in a year are considered "purchased" at the time during the taxable year that the purchaser makes a payment for the credit. Under this approach, the credits would be allocated to the partners at the time of the purchase as if such purchase constituted the end of a taxable period.[63] This approach would simplify the allocation rules and contribute to limiting the ability of partners and partnerships to circumvent the second transfer rule.

2. Adjustments to Basis to Prevent Deductions

Proposed regulations should also address the treatment of the purchase and receipt of credits for tax basis and capital account purposes. In general, the purchase of the credit should be considered a non-deductible expense. Accordingly, the amount paid for credits should be considered a reduction both in the partner's capital account as well as the partner's tax basis in the

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[61] Such partnership may be viewed as engaged in an activity under Section 212 to the extent relevant for potential individual investors.

[62] A situation for consideration in order to prevent potential abuse involves the purchase of credits by a partnership, to which one partner has contributed cash and another appreciated property. If an allocation of the credit to the property-contributing partner is permitted, such allocation would be economically akin to a disguised sale of the property. By comparison, an allocation of the credit solely to the partner that contributes cash would not raise this issue.

[63] Section 704(c) principles should apply to govern situations in which the purchaser actually pays for the credits in a year before the credits are entitled to be claimed by the purchaser. Thus, if a partner at the time of the purchase is also a partner at the time the credit may be claimed, then the partnership would be required to allocate the credit to that partner by reference to the partner's economic interest in the credit as of the time of the purchase. The allocation of the credit to a partner purchasing the original partner's interest would follow the normal Section 704(c) rules, provided that such a purchase of a partnership is permitted under guidance implementing Section 6418(e)(2).

partnership interest.[64] This approach should avoid the possibility that a partner could claim a loss for amounts contributed to a partnership that are then used to acquire credits.

Of course, if a partner invests more than the cost of the credit (e.g., because the partnership also is engaged in other unrelated activities), losses on this excess presumably are still appropriate, and this approach generally preserves this loss. Consider the following example. Partner A funds \$10 for a 10% interest in Credit Purchasing Partnership. The Partnership spends \$80 to purchase \$90 of credits (at a \$10 discount), and also spends \$20 on unrelated activities. Partner A is allocated 10% of these credits (which cost \$8 and can reduce tax by \$9). Partner A's capital account and tax basis are reduced by \$8 (the amount paid for Partner A's share of the credits), leaving a potential loss or deduction of \$2 (attributable to the other \$20 of unrelated activities). This approach is consistent with the treatment of purchasers of credits outside the partnership context in that the cost of the credit is considered a non-deductible expense.[65]

If Treasury concludes that transfers of interests in the purchasing partnership are permitted under Section 6418(e)(2), then additional rules may be needed to clarify the result when partners in partnerships that have acquired credits transfer their interests before the credit is available to be claimed. One approach would be to treat the right to the credit as an item of built-in deduction or loss and to require appropriate adjustments under Section 743. Such adjustments would require an allocation of a portion of the purchase price for the partnership interest to the built-in deduction and a corresponding reduction in basis when the credit is claimed and allocated to the purchasing partner. (We discuss further certain issues related to allocation of purchase price in a transaction involving a purchase of credits together with other assets below in Part VII.G.)

Proposed regulations or other guidance should consider whether other expenditures of the partnership should also be considered non-deductible expenditures and treated in the same manner as amounts paid for the credit. Whether to embark on this approach may depend upon the treatment of the "profit" in the tax credit transaction: the excess of the amount of the credit over its cost. If such "profit" is not taxable, other expenditures should be considered expenses incurred in order to produce tax exempt income, so that no deduction should be allowed for such expenditures and adjustments to the capital account and tax basis should be made. If such gain is taxable, then this treatment may not be warranted.[66]

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[64] We would expect that the current rules relating to distributions in excess of basis under Section 731 as well as rules relating to minimum gain chargebacks and qualified income offsets would apply to the adjustments to basis and capital accounts.

[65] *See* Section 6418(b)(3). Treasury should also consider comparable rules addressing the situation in which the amount of the credit received is less than the amount paid, such as in the case of a fixed price purchase of all production credits for a year. In that case, either (i) there should be a gain to the seller and corresponding loss to the purchaser; or (ii) there should be no gain to the seller and no loss to the purchaser, and Treasury should adopt rules in the partnership context to ensure that the same result applies, including preventing an indirect loss through the disposition of a partnership interest.

[66] In such a case, there may be a need to consider whether the expenditure should be capitalized and recovered as the credit is earned.

3. Rules Limiting a Second Transfer

Section 6418(e)(2) provides that no election may be made by a transferee taxpayer with respect to any credit that transferee has purchased. Part IV.B. has already discussed the considerations that should influence the scope of that rule. For a partnership purchaser, Treasury should adopt rules which are consistent with the general approach adopted for second transfers.

These rules should address specifically indirect transfers in the credit through changes in partnership interests. Consider the situation in which a partnership has agreed to purchase credits that have not yet been paid for. If Treasury adopts rules that a sale of the rights under that agreement constitute a prohibited second transfer, Treasury would need to adopt rules providing that changes in partnership interests which have the same effect would also constitute a prohibited second transfer. Such rules should encompass situations in which a partner transfers its interests in the partnership, a new partner is admitted and would be entitled to a portion of the credit, or there is a change in allocation.[67]

In contrast, if Treasury adopts rules generally permitting transfers of contracts to purchase credits (or other arrangements permitting second transfers), guidance should be issued addressing indirect transfers in the partnership context. For example, such guidance should address situations in which a partnership holds a right to purchase credits and admits partners whose capital contributions are used to pay the purchase price. Under this approach, guidance should make clear that allocation of that credit to the newly admitted partners is permissible.[68]

It should be recognized that adopting the latter rule could lead to a robust market in credits. If Treasury permits parties to enter into a contract to make a future purchase of credits, it can be anticipated that brokers and intermediaries will be incentivized to enter into contracts to acquire credits and then market those contracts through syndications of partnership interests. A broader market for such credits would likely increase the price to be paid for credits and ensure that more of the tax payments forgone by the government are used in constructing energy projects. This broader market would also likely result in a portion of any discount being earned by intermediaries rather than investors, and might present opportunities for development of tax avoidance transactions absent development of clear rules of the type described above for the allocation of credits among the partners in a purchasing partnership.

4. Recapture Rule

As discussed above, Section 6418(g)(3) provides for recapture of the credits in some cases, as well as notice requirements about recapture. Depending on how Treasury decides to treat the other issues discussed above, further guidance may be needed on the way partners in a partnership that has purchased credits should treat the sale of their partnership interests.

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[67] If Treasury adopts our suggested approach to allocations of the credit and treating credits that have been paid for as section 704(c) items, the situations in which a new partner is admitted or there is a change in allocations would not offer the opportunity to transfer the credit, although this position should be made clear in guidance.

[68] This approach would be consistent with our suggestion for allocation of the credit under section 706, as a specific item allocated to partners for the period in which the partnership has paid for the credit.

VII. Additional Considerations

As noted in the introductory part of this Report, we wish to highlight a number of other issues that may merit further consideration by Treasury as it prepares guidance on Section 6418. Many of these issues involve balancing the competing goals that we outlined in Part III. If helpful to Treasury, we would be pleased to address these issues in more detail in a subsequent report.

A. Anti-Abuse Rules

In light of the magnitude and scope of Section 6418, and the broad mandate to issue implementing guidance given by Congress to Treasury in Section 6418(h), we recommend that Treasury consider a series of anti-abuse rules to help ensure that Section 6418 serves its intended purpose. For example, Treasury may deem it appropriate to require specific disclosures or filings for transactions that involve transfers of tax credits at a significant discount. An unusually large discount may indicate that the transferred tax credits are speculative or involve tax positions that may warrant further scrutiny from the Service. As noted in Part III, large discounts may also raise other concerns about the cost-effectiveness of credits, which Treasury and Congress may wish to address.

B. Issues Applicable to Corporate Buyers of Tax Credits

Section 6418 does not provide specific rules for corporations (whether taxed under subchapter C or subchapter S) that choose to purchase or sell tax credits. For example, if a corporation purchases tax credits and subsequently undergoes a change of control, should the limitations in Section 382-384 apply to the purchased tax credits? Applying tax attribute limitation rules to purchased tax credits may result in corporate buyers discounting tax credits that they are uncertain to fully use in their current tax year. On the other hand, permitting the full benefit of the tax credits to a subsequent buyer of corporate stock arguably implicates the no second transfer rule discussed above.

C. Pillar Two

Guidance would be helpful regarding the treatment of the IRA's transferable energy tax credits for purposes of the second of the two "pillars" of international tax rules ("**Pillar Two**") under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (the "**Inclusive Framework**"). If an energy tax credit acquired by a large multinational corporate group under Section 6418 brings the group's income derived in the United States below the minimum level of tax required under Pillar Two, then the global minimum tax would apply to such income and would generally eliminate part or all of the tax benefit otherwise provided by the acquired credit.

On February 2, 2023, the Inclusive Framework issued generally favorable administrative guidance on a related issue: tax equity structures in which a tax credit is a key component of an investor's return.[69] This guidance does not address a credit that has been transferred under Section 6418. However, it would seem consistent with such guidance for the Inclusive Framework to

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[69] OECD/G20 Inclusive Framework on BEPS, Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) 6 (Feb. 2023).

provide additional guidance specifying that an acquisition of transferable credits does not have a negative effect on the ability of a U.S. corporation to satisfy the Pillar Two minimum rate test. Treasury can work with the other governments participating in the Inclusive Framework to provide further guidance addressing the interaction of Section 6418 with Pillar Two.

D. Lease-Passthrough Plus Election

Under Section 50(d)(5) (former Section 48(d)), a lessor can elect to treat a lessee of investment tax credit eligible property as having acquired the property at its fair market value and, accordingly, the lessee is eligible to take the investment tax credit based on the property's fair market value (and not the lessor's cost basis). Regulations under Treasury Regulation Section 1.48-4 address the procedures and applicable rules for a passthrough of credits. Although Sections 6417 and 6418 do not suggest otherwise, it would be helpful for Treasury to release explicit guidance affirming that Section 50(d)(5) applies and would not prevent the lessee from electing to receive a direct payment under Section 6417 or from transferring the credit under Section 6418.

E. Carrybacks of Transferred Credits

Under Section 39(a)(4), "applicable credits" as defined in Section 6417(b) —a definition that largely overlaps with credits that are transferrable under Section 6418—are eligible to be carried back for three taxable years and carried forward for twenty-three taxable years. While Section 6418 is clear that a taxpayer cannot elect to transfer carried back and carried forward credits,[70] Section 39(a)(4) suggests that a transferee may carry back credits it has purchased. For example, if a transferee purchases credits generated with respect to its 2025 taxable year, the transferee can carry such credits back to offset tax liability from its 2022 taxable year. Some clarification of the application of carrybacks would be helpful. This issue has timing implications, assuming carryback elections are valid. A transferee may run into statute of limitation issues if it is trying to carry back a credit for 3 years and the eligible taxpayer cannot elect to transfer until it files its tax return for the relevant year.

F. Tax Contests

Eligible taxpayers and transferees will be concerned with who the Service chooses to audit with respect to transferred credits. Presumably, the eligible taxpayer has the information relevant to determining whether the relevant credit was truly available (e.g., the prevailing wage and apprenticeship requirements were satisfied, the emissions were below a certain level, the production volumes were satisfied, etc.). In contrast, transferees do not have the same access to this information.

Imposing this burden on transferees would slow transactions and impede the market for transferees. In response, transferees would need to (i) determine what information and proof they needed to obtain and retain, (ii) understand the technology and verify the eligible taxpayers' data and representations, and (iii) participate in audits and contests that are far outside their areas of expertise. If these steps are required, the transfer of credits would end up facing a problem that

[70] *See* Section 6418(f)(1)(C).

already hinders tax equity transactions: many potential sources of capital do not have the sophistication to own electricity generating or other green energy assets.

Treasury should consider how it intends to audit transferred credits. For example, in determining whether the transferred credits are valid, Treasury could consider auditing the eligible taxpayer before the transferee. This is broadly analogous to the rules under Sections 6221 et seq., where the Service generally must first audit and assess a partnership with respect to partnership items, before potentially seeking to recover from the partners.

G. Allocation of Purchase Price

In some transactions, a transferee will acquire both credits and other assets from the same transferor. In this situation, guidance from Treasury would be helpful about the circumstances in which the parties' allocation will be respected when they allocate a particular amount of consideration to the credits or, for that matter, when there is a mix of cash and other consideration and the cash is specifically allocated to the credits.