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Report No. 1480
August 14, 2023

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Re: Report No. 1480 - Report on Proposed Regulations Regarding Transfers of Energy Tax Credits Under Section 6418

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1480 of the Tax Section of the New York State Bar Association, discussing proposed regulations regarding transfers 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

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Report No. 1480

New York State Bar Association Tax Section

Report on Proposed Regulations Regarding Transfers of Energy Tax Credits Under Section 6418

August 14, 2023

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Report on Proposed Regulations Regarding Transfers of Energy Tax Credits Under Section 6418

I. Introduction

The New York State Bar Association Tax Section[1] is submitting this report (the "**Report**") to address selected issues related to the Proposed Regulations under Section 6418 of the Code[2] (the "**Proposed Regulations**")[3] that Treasury released on June 14, 2023.

Section 6418 was enacted as part of the Inflation Reduction Act (the "**IRA**") to expand the market for investment in projects intended to generate renewable energy and reduce greenhouse gas emissions. The provision is designed to facilitate the use of credits[4] arising with respect to such projects, by providing a straightforward mechanism for project developers to monetize the credits by selling them to taxpayers that presumably can use the credits to reduce their tax liability.

On October 24, 2022, Treasury released Notice 2022-50 (the "**Notice**"), which requested public feedback on the transfer election provisions under Section 6418.[5] In response, we previously submitted a report on March 28, 2023 (the "**March Report**") with respect to Section 6418.

In Section 6418, Congress has used the Code to pursue energy policy goals. As we observed in the March Report, considerations of energy policy, a matter outside our expertise, should influence Treasury's development of appropriate regulations for implementing tax credit transfers under Section 6418. As we as we have done in the past when Congress has pursued non-tax policy through the Code, we have made recommendations in a manner that we believe adheres

[1] The principal drafters of this Report were Jason Factor, Robert Friedman, Maureen Linch and Stuart Rosow. Helpful comments were received from Drew Batkin, Kimberly Blanchard, Andrew Braiterman, Robert Cassanos, Peter Connors, David Hardy, Shiukay Hung, Eli Katz, Samuel Kaymans, Jiyeon Lee-Lim, Richard Nugent, LaShawn Oxendine, David Schizer, Michael Schler, Philip Wagman, Andrew Walker and Libin Zhang. Research assistance was received from Rita Halabi, Joseph Roy, Colin Wetmore and Kathy Zhang. 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**," "**Sections**" and "**§**" are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all references to "**Treas. Reg. §**" or "**Prop. Treas. Reg. §**" are to regulations or Proposed Regulations issued thereunder. References to "**Treasury**" are to the United States Department of the Treasury including, as applicable, the Internal Revenue Service (the "**IRS**").

[3] The preamble to the Proposed Regulations (the "**Preamble**") provides that the regulations are to apply for taxable years ending on or after the date final regulations are published in the Federal Register. REG-101610-23, 88 Fed. Reg. 40496, 40510 (June 21, 2023). The Preamble further provides that taxpayers may rely on the Proposed Regulations for taxable years beginning after December 31, 2022, and before the date the final regulations are published in the Federal Register.

[4] These include, among others, investment tax credits under § 38 ("**ITCs**") and production tax credits under § 45 ("**PTCs**").

[5] The Preamble states that Treasury received over 200 comment letters in response to the Notice. 88 Fed. Reg. at 40497.

to tax principles and the statute as written, while at the same time noting instances where Treasury may consider other non-tax policy goals as more essential in implementing the statute. For Section 6418, these non-tax policy goals will likely be best achieved if regulations encourage a robust market providing for sale of credits with the least amount of discount.

This Report comments and provides recommendations on selected issues related to the Proposed Regulations, including credit recapture; the application of passive activity credit rules under Section 469; the interaction of Section 6418 and the allocation of partnership items under Section 704(b); the treatment of credit transfer expenses; the prohibition on "second transfers"; anti-abuse measures; registration procedures; excessive credit transfers; and issues related to REITs. The remainder of this Report is organized into three parts. Part II contains a summary of our principal recommendations. Part III provides a general overview of the Proposed Regulations. Part IV describes our recommendations in detail and identifies certain additional issues.

II. Summary of Principal Recommendations

A. **Recapture Rules:** We commend Treasury on the approach in the Proposed Regulations to transactions involving a partnership or an S corporation, which would generally limit the circumstances under which the recapture burden would fall on the transferee taxpayer. We urge Treasury to consider allocating the risk of recapture to the eligible taxpayer in all cases, as it is the person that has control over the eligible credit property and, thus, has the greatest ability to cause or prevent the recapture event.

B. **Application of Section 469 Passive Activity Rules:** In our March Report, we observed that as a matter of statutory interpretation, although the wording of Section 6418 is not entirely clear, the better reading is that Section 469 applies to purchasers of clean energy credits. However, on the question of whether it was better policy for these rules to apply, we said that Treasury needed to balance tax and energy policy goals, and given our lack of expertise on energy policy, we did not make a recommendation. In the Proposed Regulations, Treasury has decided to apply the Section 469 rules to purchasers, and has asked for comments on potential exceptions. As in our March Report, we recognize that these issues require a balancing of policy goals. Since our expertise is in tax rather than energy policy, our analysis here is grounded in tax policy considerations. In response to Treasury's request for comments, we believe there are limited circumstances in which transferee taxpayers subject to Section 469 should be able to treat purchased credits as active. In particular, if a taxpayer owns an interest in and materially participates in a particular energy project, the taxpayer should be able to purchase credits from other participants in such energy project and treat those purchased credits, along with such taxpayer's allocable share of credits as an owner, as active. Additionally, Treasury should consider permitting taxpayers subject to Section 469 that satisfy the material participation requirement with respect to a specific activity (but do not own an interest in it) to treat purchased credits from that activity as nonpassive.

C. **Interaction with Section 704(b) Rules**: In response to Treasury's request for comments, we generally believe that the current rules under Section 704(b) and Treas. Reg. Section 1.704-1 fit adequately with the guidance provided in the Proposed Regulations regarding how allocations of credits, tax-exempt income and non-deductible expenditures should be made. However, we believe it may be useful to provide in Treas. Reg. Section 1.704-1(b)(3) that the special allocations of tax-exempt income and non-deductible expenses in the manner contemplated by the Proposed Regulations will be treated as having been made in accordance with the partners' interests in the partnership.

D. **Treatment of Expenses**: We believe that Treasury should find the appropriate balance between competing policies involving consistent application of general tax principles, on one hand, and the policy of Section 6418 to encourage investment in clean energy and related projects, on the other. Our comments on this issue are grounded solely in tax policy, as that is where we possess expertise. From a tax policy perspective, all transaction expenses incurred by both the eligible taxpayer and the transferee taxpayer in connection with the transfer transaction should be treated as non-deductible. Additionally, we believe that the approach adopted by Treasury for expenses generally should govern situations in which a transferee taxpayer incurs an economic loss because the purchase price of the credit and the related transaction expenses exceed the amount of credits received from the eligible taxpayer (other than because of an excessive credit transfer).

E. **No Second Transfer Election Rule:** We continue to believe, as set forth in our March Report, that the most straightforward interpretation of Section 6418(e)(2) would be to apply the second transfer rule to prohibit only successive transfers made by the transferee taxpayer specified in the transfer election. However, if Treasury concludes that the no second transfer rule is intended to apply more broadly (i.e., that it is intended to prevent the development of a liquid trading market or derivatives activity by dealers and third parties other than the eligible taxpayers), then Treasury should provide a clear and administrable rule for eligible taxpayers and transferee taxpayers to determine when a transfer (i.e., the one permitted transfer) of a specified credit portion is deemed to occur. We believe that it is not workable to apply normal "benefits and burdens of ownership" principles to transfers of credits, and, instead, we recommend that the rule for determining when a transfer of credits occurs should be based upon the other timing rules provided in the Proposed Regulations.

F. **Anti-Abuse Rule:** The anti-abuse rule provided in Prop. Treas. Reg. Section 1.6418-2(e)(4) should include specific examples demonstrating how the rule applies in contexts beyond allocation of consideration. In addition, the anti-abuse rule should be drafted with recognition of the difficulty taxpayers may face in applying an anti-abuse rule under Section 6418 given the potentially conflicting tax and energy policy goals underlying the statute. The goal of promoting clean energy projects, by fostering a robust market in credits that minimizes purchase price discounts, may argue in favor of respecting transactions that meet the bright-line rules under Section 6418, with those rules being drafted as precisely as possible

even while tax policy goals might counsel an interpretation that is more focused on substance over form. Examples illustrating clearly what constitutes an abuse would, thus, be particularly valuable.

G. **Registration Procedures:** We generally agree with the Proposed Regulations' approach with respect to the pre-filing registration process and believe that the information required serves the policy of efficiently preventing fraud and abuse in the credit transfer market. We recommend that Treasury allow for short-form re-registration each year for PTCs and that the retention period for the minimum documentation be clarified and possibly shortened. We also recommend allowing grouping of facilities, as certain types of property are modular, with many identical "facilities" being placed in a particular area.

H. **Excessive Credit Transfers:** We recommend that income received by an eligible taxpayer in respect of an excessive credit transfer should be taxable as ordinary income recognized in the year of the excessive credit determination, and that any corresponding indemnity payment should be an ordinary deduction except to the extent it represents a reimbursement of penalties paid to the IRS by the transferee taxpayer. With respect to the transferee taxpayer, we recommend that amounts originally paid as consideration by a transferee taxpayer in respect of an excessive credit transfer should be deductible as an ordinary business expense in the year of the excessive credit determination, and that any corresponding indemnity or insurance payment received be included as ordinary income in the year the all events test is met (if the transferee taxpayer uses the accrual method) or in the year of payment (if the transferee taxpayer uses the cash method). In the case of an excessive credit transfer where there are multiple transferees, we recommend a rule allowing an election by an eligible taxpayer to choose the order in which transferred credits will be treated as excessive credit transfers.

I. **REITs:** We believe that the Proposed Regulations would benefit from addressing the treatment of credits that have not yet been transferred by a REIT, for purposes of the asset test. Tax credits are not the usual type of asset that can be easily classified as real estate. Treasury should consider providing that such credits will be disregarded in determining whether the REIT satisfies the asset test.

III. Summary of Proposed Regulations

The Proposed Regulations address many of the issues raised in the March Report, although they leave open certain issues and request guidance on a number of important matters pertaining to the operation of Section 6418, as discussed in Part IV.

A. Prop. Treas. Reg. Section 1.6418-1: General Rule and Relevant Definitions

Prop. Treas. Reg. Section 1.6418-1(a) provides generally that an "eligible taxpayer" may make a "transfer election" under Prop. Treas. Reg. Section 1.6418-2[6] to transfer any "specified credit portion"[7] of an "eligible credit" with respect to "eligible credit property" for any taxable year to a "transferee taxpayer."

An "eligible taxpayer" includes any taxpayer, other than certain tax-exempt entities described in Section 6417.[8] Eligible taxpayers, therefore, include partnerships and S corporations, including partnerships with members that are tax-exempt entities.

"Eligible credit" includes the eleven energy related credits listed under Section 6418(f)(1)(A), but excludes any business credit carryforward or business credit carryback under Section 39.[9] In addition, the Proposed Regulations clarify that the eligible credit is separately determined with respect to each eligible credit property.[10] An eligible credit includes any "bonus"

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[6] A "transfer election" sets forth the eligible taxpayer's agreement to transfer "all (or any specified credit portion in the election)" of an eligible credit. Such election must be made in accordance with the rules and contain the information required in Prop. Treas. Reg. § 1.6418-2 (discussed below).

[7] A "specified credit portion" is the proportionate share (including all) of an entire eligible credit determined with respect to an eligible credit property that is specified to be transferred in a transfer election. Prop. Treas. Reg. § 1.6418-1(h). With respect to "bonus" credits (defined in note 11 below), the Proposed Regulations provide that a specified credit portion of an eligible credit must reflect a proportionate share of each bonus credit amount that is taken into account in calculating the entire amount of the eligible credit determined with respect to a single eligible credit property. The Preamble confirms that, under this rule and the statutory language, it is not possible to transfer bonus credits separately from the "base" eligible credit. *See* 88 Fed. Reg. at 40498.

[8] § 6417 generally applies to an "applicable entity", which includes (i) an organization exempt from the tax imposed under subtitle A, (ii) any State or political divisions thereof; (iii) the Tennessee Valley Authority, (iv) an Indian tribal government (as defined in § 30D(g)(9)); (v) any Alaska Native Corporation (as defined in Section 3 of the Alaska Native Claims Settlement Act (42 U.S.C. 1602(m)); and (vi) any corporation operating on a cooperative basis which is engaged in furnishing electric energy to persons in rural areas. *See* Prop. Treas. Regs. § 1.6417-1(b), 1.6418-1(b).

[9] Prop. Treas. Reg. § 1.6418-(c).

[10] *Id*. The Proposed Regulations also specify the relevant eligible credit property with respect to each of the eleven credits listed under § 6418(f)(1)(A). For example, with respect to a § 48 credit, Proposed Regulations specify that the eligible credit property is an *energy property* described in § 48 (as interpreted by Notice 2018-59, 2018-28 I.R.B. 196). *See* Prop. Treas. Reg. § 1.6418-1(d). (At the taxpayer's election, if other requirements are met, the eligible credit property may be an *energy project* described in § 48(a)(9)(A)(ii).) In addition, as explained further down under the heading "*Manner and due date of making a transfer election*," the Proposed Regulations specify that an eligible credit is determined with respect to a single eligible credit property, which implies that a transfer election is made separately for each eligible credit property. Notably, under Prop. Treas. Reg. § 1.6418-(d), an election to transfer a § 45 credit, § 45V credit or § 45Y is made separately with respect to each facility and for each taxable year during the credit period of the respective credit. We discuss the implications of this rule, including the potential for grouping of facilities when making a transfer election, in Part IV.

credit amounts.[11] An "eligible credit property" is the unit of property (of an eligible taxpayer) in respect of which the eligible credit is determined.[12]

The Proposed Regulations clarify that "paid in cash" means a "payment in United States dollar that is made by cash check, cashier's check, money order, wire transfer, automated clearing house (ACH) transfer, or other bank transfer of immediately available funds."[13] In addition, the Proposed Regulations provide a safe harbor timing rule whereby a cash payment does not violate the "paid in cash" requirement if the cash payment is made within the period beginning on the first day of the eligible taxpayer's taxable year and ending on the due date for completing a "transfer election statement" (discussed below). The Proposed Regulations also confirm that a contractual commitment to purchase eligible credits in advance of the date a specified credit portion is transferred satisfies the "paid in cash" requirement so long as all cash payments are made during the safe harbor period.[14]

B. Prop. Treas. Reg. Section 1.6418-2: Rules for Making Transfer Elections

Prop. Treas. Reg. Section 1.6418-2 describes the general requirements for making a transfer election, including clarifying when a transfer election can be made in certain ownership situations, situations where no transfer election may be made, the manner and due date for the election, limitations related to a transfer election, the determination of an eligible credit, the treatment of payments related to a transfer of eligible credits, and the treatment of a transferred specified credit portion by a transferee taxpayer.

1. Transfer Elections in General

The Proposed Regulations clarify that an eligible taxpayer may make multiple transfer elections to transfer one or more specified credit portion(s) to multiple transferee taxpayers, provided that the aggregate amount of specified credit portions transferred with respect to any

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[11] Prop. Treas. Reg. § 1.6418-1(d). The IRA introduced "bonus" credit amounts if certain prevailing wage and registered apprenticeship requirements are met. Moreover, these bonus credits can be incrementally increased if the taxpayer or project meets certain additional requirements. Generally, energy projects under §§ 45, 48, 45Y and 48E that meet "domestic content" requirements and certify that iron steel, iron, and manufactured products used in the project were domestically produced are eligible for additional bonus credits of up to 10% (which 10% increase applies to both the "base" credit and bonus credits). There is also a second incremental increase equal to 10% if the energy project is located in an "energy community" (generally, a brownfield site, an area that has or had certain amounts of direct employment or local tax revenue related to oil, gas or coal activities and has an unemployment tract at or above the national average, or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009). Further incremental increases are available for certain wind and solar projects of 5 megawatts or less where the project (i) receives an allocation of available capacity limitation of 1.8 gigawatts for each of calendar years 2023 and 2024; (ii) qualifies for the ITC; and (iii) is either (A) located in a "low-income community" or on American Indian land or (B) is part of a qualified low-income residential building.

[12] *Id*.

[13] Prop. Treas. Reg. § 1.6418-2(f).

[14] *Id*.

single eligible property does not exceed the amounts of the eligible credit property.[15] In other words, the Proposed Regulations do not limit the number of transfer elections or number of transferee taxpayers with respect to which an eligible taxpayer can make a transfer election, except to the extent the transfer would exceed the amount of the eligible credit that is actually available for transfer.[16]

2. Manner and Due Date of Making a Transfer Election

A transfer election must be made on an original return no later than the due date (including extensions of time) for the original return of the eligible taxpayer for the taxable year for which the eligible credit is determined.[17] In addition, the Proposed Regulations clarify that an eligible taxpayer is required to make a transfer election with respect to each eligible property.[18] The Preamble explains that this approach would provide eligible taxpayers with flexibility in determining the credit to transfer and aligns with the mechanics to determine an excessive credit transfer (as defined in Section 6418(g)(2)(C)).[19] We discuss potential rules to allow for grouping of properties (specifically, grouping of facilities with respect to the credits under Sections 45, 45V and 45Y) when making a transfer election further below in Part IV.

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[15] Prop. Treas. Reg. § 1.6418-2(a)(2).

[16] The Proposed Regulations also address when eligible taxpayers are permitted to make a transfer election in certain ownership situations. Prop. Treas. Reg. § 1.6418-2(a)(3) clarifies that: (i) the eligible taxpayer makes a transfer election for a disregarded entity wholly-owned (directly or indirectly) by the eligible taxpayer; (ii) if eligible credit property is directly owned through an arrangement properly treated as a tenancy-in-common for Federal income tax purposes, or through an organization that has made a valid election under § 761(a), each co-owner's or member's undivided ownership share of the eligible credit property will be treated as a separate eligible credit property owned by the co-owner or member, and each makes a separate transfer election; (iii) with respect to consolidated groups, a member that serves as the agent of the group (under the rules of Treas. Reg. § 1.1502-77) is required to make a transfer election; and (iv) with respect to a partnership or S corporation, the partnership or S corporation (and not the partners or shareholders) makes a transfer election.

[17] The Proposed Regulations clarify that an election must be filed on an original return and may not be made or revised on an amended return or by filing a request for an administrative adjustment under § 6227. Prop. Treas. Reg. § 1.6418-2(a)(1). In addition, under the Proposed Regulations, no relief is available under Treas. Reg. §§ 301.9100-1 through 301.9100-3 for a late transfer election. *Id*.

[18] Prop. Treas. Reg. § 1.6418-2(a)(1).

[19] 88 Fed. Reg. at 40500. The Preamble also notes: "In requiring the election to be made on the basis of a single eligible credit property, Treasury and the IRS request comments on two issues. First, Treasury and the IRS ask whether more specific guidance with respect to any eligible credit property is needed to allow eligible taxpayers to make the election as required. If such guidance is needed, suggestions for further defining the relevant eligible credit property are requested. Second, Treasury and the IRS ask whether to adopt a grouping rule that allows taxpayers to make an election with respect to certain groups of eligible credit properties. If such a rule is recommended, discussion of the eligible credits that such a rule apply to, the appropriate circumstances for grouping, as well as specific rules for determining a group with respect to an eligible credit is requested." *Id*.

Prop. Treas. Reg. Section 1.6418-2(b)(3) provides the manner of making a valid transfer election for eligible taxpayers other than partnerships or S corporations.[20] To make a valid transfer election, an eligible taxpayer must include with its return (including a short year return):

1) A properly completed relevant source credit form for the eligible credit;

2) A properly completed Form 3800 (General Business Credit), including reporting the registration number it received during the required pre-filing registration (as described in Prop. Treas. Reg. Section 1.6418-4 (discussed further below));

3) A schedule attached to the Form 3800 showing the amount of eligible credit transferred for each eligible credit property;

4) A transfer election statement; and

5) Any other information related to the election specified in guidance.[21]

3. Transfer Election Statement

A transfer election statement must be attached to an eligible taxpayer's and transferee taxpayer's respective return and can be any document (such as a purchase and sale agreement),[22] so long as the document is labeled "Transfer Election Statement" and contains certain minimum information, including (i) a description of the eligible credit; (ii) the taxable year of the eligible taxpayer and the first taxable year in which the specified credit portion will be taken into account by the transferee taxpayer; (iii) the amount(s) of cash consideration and date(s) on which it is paid by the transferee taxpayer; (iv) a statement or representation from the eligible taxpayer that it has or will comply with all requirements of Section 6418, the regulations under Section 6418, and the provisions of the Code applicable to the eligible credit; (v) a statement or certification from the eligible taxpayer and transferee taxpayer acknowledging the notification of recapture requirements under Section 6418(g)(3) and the regulations under Section 6418; and (vi) a statement or representation from the eligible taxpayer that it has provided required minimum documentation to the transferee taxpayer.[23]

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[20] The rules for partnerships and S corporations are covered under Prop. Treas. Reg. § 1.6418-3(d).

[21] Prop. Treas. Reg. § 1.6418-2(b)(3)(ii).

[22] Prop. Treas. Reg. § 1.6418-2(b)(5)(i) defines "transfer election statement" generally as a written document that describes the transfer of a specified credit portion between an eligible taxpayer and transferee taxpayer.

[23] The minimum documentation the eligible taxpayer is required to provide to a transferee taxpayer, as set forth in Prop. Treas. Reg. § 1.6418-2(b)(5)(ii), consists of (i) information that validates the existence of the eligible credit property, which could include evidence prepared by a third party (such as a county board or other governmental entity, a utility, or an insurance provider); (ii) if applicable, documentation substantiating that the eligible taxpayer has satisfied the requirements to include any bonus credit amounts (as defined in Prop. Treas. Reg. § 1.6418- 1(c)(3)) in the eligible credit that was part of the transferred specified credit portion; and (iii) evidence of the eligible taxpayer's qualifying costs in the case of a transfer of an eligible credit that is part of the investment credit or the amount of qualifying production activities and sales amounts, as relevant, in the case of a transfer of an eligible credit that is a production credit.

The Proposed Regulations generally allow a transfer election statement to be completed at any time after the eligible taxpayer and transferee taxpayer have sufficient information to prepare the transfer election statement.[24] However, a transfer election statement cannot be completed for any taxable year after the earlier of (i) the filing of the eligible taxpayer's original return for the taxable year for which the specified credit portion is determined with respect to the eligible taxpayer or (ii) the filing of the return of the transferee taxpayer for the year in which the specified credit portion is taken into account.[25] The Preamble explains that the proposed rule "is intended to provide flexibility but places an outer limit on the timing of the transfer election statement because both the eligible taxpayer and the transferee taxpayer would be required to include a transfer election statement as part of filing a return, and therefore, the transfer election statement would need to be completed before a return is filed by either party."[26]

4. Limitations after a Transfer Election is Made: "No Second Transfer" Rule, "Dealers" and "Intermediaries" versus "Brokers"

Consistent with the statutory language, the Proposed Regulations provide that an election to transfer a specified credit portion, once made, is irrevocable.[27] In addition, the Proposed Regulations prohibit a transferee taxpayer from making a second transfer under Section 6418 with respect to any specified credit portion (discussed in greater detail below).[28] In response to inquiries as to whether eligible credits can be transferred through "dealer arrangements," the Preamble comments that "Any arrangement where the Federal income tax ownership of a specified credit portion transfers first, from an eligible taxpayer to a dealer or intermediary and then, ultimately, to a transferee taxpayer is in violation of the no second transfer rule in Section 6418(e)(2)."[29] However, the Preamble explains, "an arrangement using a broker to match eligible taxpayers and transferee taxpayers should not violate the no second transfer rule, assuming the arrangement at no point transfers the Federal income tax ownership of a specified credit portion to the broker or any taxpayer other than the transferee taxpayer."[30]

5. Limitations on the Amount of Eligible Credit that is Transferable

The Proposed Regulations would apply the Section 49 at-risk rules and the Section 50(b) rules (e.g., limiting the availability of credits with respect to property used by a tax-exempt

[24] Prop. Treas. Reg. § 1.6418-2(b)(5)(iii).

[25] *Id*.

[26] 88 Fed. Reg. at 40501.

[27] Prop. Treas. Reg. § 1.6418-2(c)(1).

[28] Prop. Treas. Reg. § 1.6418-2(c)(2).

[29] 88 Fed. Reg. at 40501.

[30] *Id.*

organization) to determine the eligible credit that is transferable with respect to an eligible taxpayer.[31]

6. Treatment of Payments Made in Connection with a Transfer Election

The Proposed Regulations provide that payments made in connection with a transfer election are neither includible in gross income by the eligible taxpayer nor deductible by the transferee taxpayer.[32] Treasury has asked for comments regarding the treatment of credit transfer transaction costs, and regarding whether a transferee taxpayer may deduct a loss if its payment for the credit exceeds the amount of the eligible credit that the transferee taxpayer can ultimately claim.[33] Finally, the Proposed Regulations introduce an anti-abuse rule, which authorizes a disallowance of the transfer election or recharacterization of the tax consequences of the transaction effecting the transfer of credits, if the transaction's principal purpose is avoiding tax liability beyond the intent of Section 6418.[34]

7. Transferee Taxpayer's Treatment of Eligible Credit

The Proposed Regulations treat the transferee taxpayer as the eligible taxpayer with respect to the transferred specified credit portion,[35] and moreover, require the transferee taxpayer to take the specified credit portion into account in its first taxable year ending with or after the eligible taxpayer's taxable year.[36] Importantly, the Proposed Regulations treat the transferred specified credit portion as earned in connection with the conduct of a trade or business and, if applicable to the transferee taxpayer, apply the passive activity limitation rules in Section 469 to such specified credit portion.[37] As a result, a transferee taxpayer that is subject to Section 469 would be required

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[31] Prop. Treas. Reg. § 1.6418-2(d)(1). With respect to ITC eligible credit property that is held directly by eligible taxpayers that are partnerships or S corporations, the Proposed Regulations provide that the amount of the eligible credit that can be transferred is determined taking into account application of the § 49 at-risk rules at the partner or shareholder level as of the close of the taxable year in which the ITC eligible credit property is placed in service. Prop. Treas. Reg. § 1.6418-2(d)(2).

[32] Prop. Treas. Reg. § 1.6418-2(e)(2)-(3). In addition, Prop. Treas. Reg. § 1.6418-2(e)(1) provides that an amount paid by a transferee taxpayer to an eligible taxpayer is consideration for a transfer of a specified credit portion only if it directly relates to the specified credit portion and is not described in Prop. Treas. Reg. § 1.6418-5(a)(3) (describing payments related to an excessive credit transfer).

[33] 88 Fed. Reg. at 40502.

[34] Prop. Treas. Reg. § 1.6418-2(e)(4).

[35] Prop. Treas. Reg. § 1.6418-2(f)(3)(i). Additionally, Prop. Treas. Reg. § 1.6418-2(f)(2) provides that the transferee taxpayer does not have a gross income inclusion if the amount of the eligible credit that it ultimately claims exceeds the purchase price of the eligible credit.

[36] Prop. Treas. Reg. § 1.6418-2(f)(1).

[37] Prop. Treas. Reg. § 1.6418-2(f)(4)(ii). However, Prop. Treas. Reg. § 1.6418-2(f)(4)(ii) clarifies that a transferee taxpayer would not be considered to own an interest in the eligible taxpayer's trade or business at the time the work was done (as required for material participation under Treas. Reg. § 1.469-5(f)(1)).

to treat the amount of the specified credit portion that exceeds its passive tax liability as passive activity credits.[38]

C. Prop. Treas. Reg. Section 1.6418-3: Additional Rules for Partnerships and S Corporations

1. Generally

Prop. Treas. Reg. Section 1.6418-3 provides additional rules related to transfers of eligible credits by eligible taxpayers that are partnerships or S corporations ("**Transferor Partnerships**" and "**Transferor S Corporations**"), as well as purchases of eligible credits by transferee taxpayers that are partnerships or S corporations ("**Transferee Partnerships**" and "**Transferee S Corporations**"). The Proposed Regulations provide that cash received by a Transferor Partnership and Transferor S Corporation in exchange for the transferred specified credit portion would be treated as tax-exempt income for purpose of Sections 705 and 1366.[39] Moreover, the Proposed Regulations provide that if (i) a partner or shareholder of a Transferor Partnership or Transferor S Corporation disposes of its interest in such partnership or S corporation or (ii) there is a change in the at-risk amounts under Section 49 at the level of a partner or shareholder of a Transferor Partnership or Transferor S Corporation, such partner or shareholder may be subject to recapture under Section 6418(g)(3)(B), and the eligible taxpayer would not be required to provide notice to the transferee taxpayer.[40] Thus, Prop. Treas. Reg. Section 1.6418-3 would allocate recapture risk to the partners or shareholders of a Transferor Partnership and Transferor S Corporation to the extent that certain actions of such partners or shareholders trigger a recapture event. The Proposed Regulations provide that a Transferor Partnership or Transferor S Corporation must make a transfer election for a specified credit portion in the same manner as for other eligible taxpayers.[41]

2. Rules Applicable Solely to Partnerships

The Proposed Regulations clarify that a partner's distributive share of tax-exempt income from the receipt of cash by a Transferor Partnership for a transferred specified credit portion would be based on the partner's proportionate distributive share of the eligible credit it would have been allocated if the transfer had not occurred.[42] In addition, if a Transferor Partnership transfers a

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[38] *See* 88 Fed. Reg. at 40504.

[39] Prop. Treas. Reg. § 1.6418-3(a)(2). Such tax-exempt income would be treated as arising from an investment activity, rather than from the conduct of a trade or business for purposes of the passive activity credit limitation rules under § 469(c)(1)(B). Prop. Treas. Reg. § 1.6418-3(a)(5).

[40] Prop. Treas. Reg. § 1.6418-3(a)(6)(i)-(ii).

[41] Prop. Treas. Reg. § 1.6418-3(d)(1). More specifically, Prop. Treas. Reg. § 1.6418-3(d)(2) requires such eligible taxpayers to attach to their partnership or S corporation returns all documents that are required for other eligible taxpayers to make a transfer election. In addition, Prop. Treas. Reg. § 1.6418-3(d)(2) provides that transfer elections by such eligible taxpayers are irrevocable.

[42] Prop. Treas. Reg. § 1.6418-3(b)(1). In addition, Prop. Treas. Reg. § 1.6418-3(b)(1) clarifies that such tax-exempt income would be treated as received or accrued as of the date the specified credit portion is determined with respect to the eligible taxpayer that is a partnership.

specified credit portion of less than all eligible credits determined with respect to an eligible credit property that it holds, such Transferor Partnership would be permitted to allocate the tax-exempt income to those partners that desire to transfer their distributive share of the underlying credits.[43]

Finally, the Proposed Regulations provide that if an upper-tier partnership is a direct or indirect partner of a Transferor Partnership or Transferee Partnership, the upper-tier partnership would not be treated as an eligible taxpayer with respect to (as applicable) a credit that is allocated by the Transferor Partnership to its partners or that is purchased by the Transferee Partnership.[44]

The Proposed Regulations provide generally similar rules for S corporations.[45]

D. Prop. Treas. Reg. Section 1.6418-4: Registration and Election

Prop. Treas. Reg. Section 1.6418-4 requires generally that eligible taxpayers must register before filing the return on which a transfer election is made and provide information related to each eligible credit property for which the eligible taxpayer intends to transfer a specified credit portion.

Prop. Treas. Reg. Section 1.6418-4(b) provides the pre-filing registration requirements. First, an eligible taxpayer must complete the pre-filing registration process electronically through an IRS electronic portal in accordance with the instructions, unless otherwise provided in guidance.[46] Second, an eligible taxpayer must satisfy the registration requirements and receive a registration number prior to making a transfer election for a specified credit portion on the eligible taxpayer's return for the taxable year at issue.[47] Third, an eligible taxpayer is required to obtain a

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[43] Prop. Treas. Reg. § 1.6418-3(b)(2).

[44] Prop. Treas. Reg. § 1.6418-3(b)(3), (b)(4)(v).

[45] Prop. Treas. Reg. § 1.6418-3(c)(1) requires a shareholder of a Transferor S Corporation to take into account its pro-rata share of tax-exempt income from payments received by such Transferor S Corporation in exchange for the transfer of a specified credit portion. The tax-exempt income would be treated as received or accrued as of the date the specified credit portion is determined with respect to the Transferor S Corporation. Prop. Treas. Reg. § 1.6418-3(c)(1).

In addition, Prop. Treas. Reg. § 1.6418-3(c)(2)(ii) would treat cash payments made by a Transferee S Corporation in exchange for transferred specified credit portion as § 1367(a)(2)(D) expenditures. Finally, under Prop. Treas. Reg. § 1.6418-3(c)(2)(iii), each shareholder of such Transferee S Corporation is required to take into account its pro-rata share (within the meaning of § 1377(a)) of any transferred specified credit portion.

[46] If the election is by a member of a consolidated group, the member must complete the pre-filing registration process as a condition of, and prior to, making an elective payment election. Prop. Treas. Reg. § 1.6418-4(b)(2).

[47] Prop. Treas. Reg. § 1.6418-4(c) provides rules related to the registration number that is obtained after the IRS has reviewed and approved the eligible taxpayer's submitted information. First, a registration number is valid for an eligible taxpayer only for the taxable year for which it is obtained, and for a transferee taxpayer's taxable year in which the specified credit portion is taken into account. Second, the eligible taxpayer is required to renew the registration with respect to an eligible credit property each year in accordance with guidance, including attesting that all the facts are still correct or updating any facts. Third, if facts change with respect to an eligible credit property for which a registration number has been previously obtained, an eligible taxpayer is required to amend the registration to reflect these new facts. Lastly, an eligible taxpayer is required to include the registration number of the eligible credit property on the eligible taxpayer's return for the taxable year, as provided in Prop. Treas. Reg. § 1.6418-2(b), for an election to be effective with respect to any eligible credit determined with respect to an eligible credit property

registration number for each eligible credit property with respect to which a transfer election of a specified credit portion is made. Finally, an eligible taxpayer must provide certain information about the taxpayer, the eligible credits and the eligible credit property that is intended to allow the IRS to prevent duplication, fraud, improper payments, or excessive transfers under Section 6418.[48]

E. Prop. Treas. Reg. Section 1.6418-5: Special Rules - Excessive Credit Transfers

Prop. Treas. Reg. Section 1.6418-5(a) provides that if any specified credit portion that is transferred through a transfer election is determined to be an "excessive credit transfer," the transferee taxpayer must pay tax equal to the amount of the excessive credit transfer plus an additional 20% of such excessive credit in the year the determination is made. The additional 20% penalty does not apply if the transferee taxpayer demonstrates that the excessive credit transfer result from "reasonable cause."[49] Reasonable cause is determined under the relevant facts and circumstances but includes reliance on third party experts and representations made by the eligible taxpayer. An excessive credit transfer is any amount transferred with respect to an eligible property in a taxable year that is not allowable with respect to the eligible credit property for that year. In the case of multiple transferees, Prop. Treas. Reg. Section 1.6418-5(b) provides that the amount of disallowance first reduces the specified portion, if any, retained and claimed by the eligible taxpayer. Additional disallowed credits are then taxed to the transferee taxpayers, pro-rata based on the proportion of the credit they originally received in the transfer election.[50]

IV. Recommendations and Discussion

A. Recapture Rules

1. Overview of the Recapture Rules

The Proposed Regulations provide rules allocating the consequences of the recapture of eligible credits that have been transferred. Recapture of credits can occur for ITC eligible credit property if, during the recapture period, (i) the ITC property ceases to be eligible for credits with respect to the eligible taxpayer, or (ii) there is a net increase in nonqualified nonrecourse financing

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for which the eligible taxpayer does not include a valid registration number on its return. A transferee taxpayer is also required to report the registration number received from an eligible taxpayer on its return for the taxable year that the transferee taxpayer takes the transferred eligible credit into account.

[48] Prop. Treas. Reg. § 1.6418-4(b)(5); *see* 88 Fed. Reg. at 40507. Prop. Treas. Reg. § 1.6418-4(b)(5)(v) provides a non-exhaustive list of information that the IRS may require with respect to an eligible credit property, including (i) the type of eligible credit property; (ii) the physical location (i.e., the address and coordinates (longitude and latitude) of the eligible credit property); (iii) any supporting documentation relating to the construction or acquisition of the eligible credit property (such as State, Indian Tribal, or local government permits to operate the eligible credit property, certifications, evidence of ownership that ties to a deed, lease, or other documentation of the right to use and access any land or facility upon which the eligible credit property is constructed or housed, and U.S. Coast guard registration numbers for offshore vessels); (iv) the beginning of construction date and placed in service date of the eligible credit property; and (v) any other information that will help the IRS evaluate the registration request.

[49] Prop. Treas. Reg. § 1.6418-5(a)(4).

[50] Prop. Treas. Reg. § 1.6418-5(b)(2).

with respect to the ITC property. Recapture can occur for Section 45Q eligible credit property if qualified carbon oxide ceases to be captured, disposed of, or used as a tertiary injectant in a manner consistent with Section 45Q.[51]

As a default rule, the Proposed Regulations impose liability on the transferee taxpayer for recapture events under Sections 50(a), 49 or 45Q. Of note, the Preamble clarifies that the parties are not prohibited from contracting for indemnification of the transferee taxpayer upon the occurrence of a recapture event.[52] In addition, importantly, the Proposed Regulations introduce special rules that vary from the default rule for Transferor Partnerships and Transferor S Corporations. These rules allocate the recapture liability to the partners or shareholders, rather than the transferee taxpayer, with respect to certain recapture events under Sections 50(a) and 49.

i. Recapture Under Section 50(a)

Section 6418(g)(3)(B) requires that, upon a recapture event under Section 50(a), the eligible taxpayer must notify the transferee taxpayer, which must, in turn, notify the eligible taxpayer of the recapture amount.[53] Therefore, as a result of a recapture event under Section 50(a), the transferee taxpayer is responsible for any amount of tax increase under Section 50(a).[54] The Proposed Regulations provide further guidance on the mechanics of the notification procedures set forth in Section 6418(g)(3). First, the eligible taxpayer is required to provide the transferee taxpayer with notice of the recapture event, containing all information necessary for the transferee taxpayer to correctly compute the recapture amount by the due date on the transferee taxpayer's Federal income tax return (without extensions) for the taxable year in which the recapture event occurs.[55] Then, the transferee taxpayer is required to notify the eligible taxpayer of the recapture amount, in order for the eligible taxpayer to calculate any basis adjustments with respect to the ITC eligible credit property by the due date of the eligible taxpayer's return (without extensions) for the taxable year in which the recapture event occurs.[56] As a result, the transferee taxpayer is responsible for any amount of tax increase under Section 50(a), and the eligible taxpayer must increase its basis in the ITC eligible credit property to reflect the recapture amount.[57]

ii. Recapture Under Section 49

The Proposed Regulations provide generally that the at-risk rules under Section 49 apply to determine the amount of any eligible credit with respect to ITC eligible credit property held

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[51] The Proposed Regulations clarify that recapture events under §§ 45Q(f)(4) or 50(a) would not be treated as excessive credit transfers. Prop. Treas. Reg. § 1.6418-5(a)(5).

[52] 88 Fed. Reg. at 40509.

[53] § 6418(g)(3)(B)(i)-(ii).

[54] Prop. Treas. Reg. § 1.6418-5(d)(3).

[55] Prop. Treas. Reg. § 1.6418-5(d)(2)(i).

[56] Prop. Treas. Reg. § 1.6418-5(d)(2)(ii).

[57] Prop. Treas. Reg. § 1.6418-5(d)(3)(i)-(ii).

directly by an eligible taxpayer.[58] Under the at-risk rules, if there is a net increase of nonqualified nonrecourse financing with respect to the taxpayer's ITC eligible credit property as of the close of the taxable year, the tax for such taxable year is increased by the amount equal to the aggregate decrease in credits allowed under Section 38 for all prior taxable years which would have resulted from reducing the credit base taken into account with respect to such property by the amount of such net increase.[59] The Preamble states that a recapture event under Section 49 that is applicable directly to an eligible taxpayer (e.g., to an individual or a C corporation) results in recapture to the transferee taxpayer under Section 6418(g)(3).[60]

iii. Recapture Under Section 45Q

Section 45Q provides a tax credit for carbon capture and sequestration. While Section 6418(g)(3) does not contain specific rules related to recapture of carbon sequestration under Section 45Q(f)(4), the Proposed Regulations contain guidance under the legislative grant of authority in Section 6418(h) to issue regulations to carry out the purposes of Section 6418.[61] The Proposed Regulations apply rules consistent with Section 6418(g)(3).[62] Specifically, if during any taxable year, there is recapture of any Section 45Q credit allowable with respect to any qualified carbon oxide that ceases to be captured, disposed of, or used as a tertiary injectant in a manner consistent with Section 45Q before the close of the recapture period set forth in Treas. Reg. Section 1.45Q-5(f),[63] the transferee taxpayer is subject to recapture and is responsible for any tax increase under Section 45Q(f)(4).[64] In addition, the Proposed Regulations require the parties to comply with the notification requirements that apply to recapture under Section 50(a), except that the recapture amount would be computed in accordance with Treas. Reg. Section 1.45Q-5(e).[65]

iv. Special Rules Applicable to Partnerships and S Corporations

The Proposed Regulations provide that, with respect to eligible credit property that continues to be held by a Transferor Partnership or Transferor S Corporation,[66] if a partner or shareholder disposes of its interest in such Transferor Partnership or Transferor S Corporation, respectively, the Section 50 recapture rules discussed above would apply to such partner or

[58] Prop. Treas. Reg. § 1.6418-2(d)(1).

[59] § 49(b)(1).

[60] 88 Fed. Reg. at 40505.

[61] 88 Fed. Reg. at 40509.

[62] *Id*.

[63] Prop. Treas. Reg. § 1.6418-5(e)(1).

[64] Prop. Treas. Reg. § 1.6418-5(e)(3).

[65] Prop. Treas. Reg. § 1.6418-5(e)(2).

[66] Prop. Treas. Reg. § 1.6418-3(a)(6)(i)(A).

shareholder and not the eligible taxpayer or the transferee taxpayer.[67] The recapture amount borne by such partner or shareholder would be calculated based on the partner's or shareholder's share of basis in the Section 38 property to which the specified credit portion was determined, in accordance with Treas. Reg. Section 1.46-3(f) and Treas. Reg. Section 1.48-5, respectively.[68]

The Proposed Regulations clarify that, in such case, the eligible taxpayer would not be required to comply with the notification requirements discussed above because the disposition of the partner's or shareholder's interest in the Transferor Partnership or Transferor S Corporation, as applicable, does not result in recapture to the transferee taxpayer, so long as the property remains eligible credit property.[69]

In addition, the Proposed Regulations provide that, with respect to either a disposition or change in financing at the partner or shareholder level after the close of the taxable year in which the ITC eligible credit property is placed in service and the specified credit portion is determined, the Section 49 recapture rules would apply to such partner or shareholder, rather than to the eligible taxpayer or the transferee taxpayer.[70] In case of an increase in nonqualified nonrecourse financing at the partner or shareholder level, a partner's or shareholder's adjustment under Section 49(b) (i.e., the recapture amount under Section 49) is calculated based on such partner's or shareholder's share of basis in the Section 38 property to which the specified credit portion was determined in accordance with Treas. Reg. Section 1.46-3(f) and Treas. Reg. Section 1.48-5, respectively.[71]

Similarly, the Proposed Regulations clarify that the Transferor Partnership or Transferor S Corporation would not be required to comply with the notification requirements discussed above because a change in nonqualified nonrecourse financing at the level of a partner or shareholder of such eligible taxpayer does not result in recapture to the transferee taxpayer.[72]

2. Recommendations

We commend Treasury on the approach in the Proposed Regulations to transactions involving a partnership or an S corporation, which would generally limit the circumstances under which the recapture burden would fall on the transferee taxpayer. We believe that this approach in many situations facilitates efficient transfers of the eligible credits. We urge Treasury to consider allocating the risk of recapture to the eligible taxpayer in all cases, as it is the party that

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[67] Prop. Treas. Reg. § 1.6418-3(a)(6)(i)(B). We note that in the limited circumstances, if a partner in a Transferor Partnership transfers a partnership interest to certain tax-exempt entities, there is possibly a recapture liability that falls upon the transferee taxpayer rather than the transferring partner. *See* § 50(b)(3) and Prop. Treas. Reg. § 1.6418-3(a)(6)(i).

[68] Prop. Treas. Reg. § 1.6418-3(a)(6)(i)(B).

[69] Prop. Treas. Reg. § 1.6418-3(a)(6)(i)(B).

[70] Prop. Treas. Reg. § 1.6418-3(a)(6)(ii)(A)-(B).

[71] Prop. Treas. Reg. § 1.6418-3(a)(6)(ii)(B). In the case of a decrease in nonqualified nonrecourse financing, any increase in the credit base is taken into account by the partner or shareholder, and any resulting credit is not eligible for transfer under § 6418.

[72] Prop. Treas. Reg. § 1.6418-3(a)(6)(ii)(A).

has control over the eligible credit property and, thus, has the greatest ability to cause or prevent the recapture event.

3. Discussion

As we noted in the March Report, the structure of the statute suggests, but does not explicitly provide, that the burden of recapture should be borne by the taxpayer claiming the credit. Section 6418(a) provides that the transferee taxpayer (and not the eligible taxpayer) is generally treated as the taxpayer with respect to the credit. In addition, Section 6418(g)(3) provides for an exchange of notices between the transferee taxpayer and the eligible taxpayer to identify the event causing the recapture and to determine the amount to be recaptured. Taken together, these provisions imply that the taxpayer that claimed the credit should be required to recapture it. However, the statute does not expressly require this. In addition, after the credit is sold, only actions by the eligible taxpayer (or its partners or shareholders) may actually cause recapture, and it is anomalous not to impose the consequences of recapture on the party whose actions caused those consequences.

With respect to transfers of credits by Transferor Partnerships, the Proposed Regulations adopt a bifurcated approach of placing the burden on the transferee taxpayer when the Transferor Partnership causes the recapture and on the partners of the Transferor Partnership when they cause the recapture event. The proposed rules for Transferor S Corporations and their shareholders are similar. This approach for partnerships and S corporations may thus create a disparity with respect to which party is subject to recapture, making this dependent on the tax classification of the eligible taxpayer. Moreover, the sale by all of the partners of their partnership interests in a Transferor Partnership is economically equivalent to the sale by the Transferor Partnership of the underlying asset, especially where the Transferor Partnership is considered to continue under Section 708. In light of this, it appears somewhat arbitrary that under the Proposed Regulations, the recapture burden will fall upon the partners of the Transferor Partnership in the former case, but on the transferee taxpayer in the latter. A similar point applies to a sale of a project by a Transferor S Corporation, as compared to a sale of the Transferor S Corporation's shares.

We believe that the special rules for recapture events caused by owners of Transferor Partnerships and Transferor S Corporations are commercially sensible because those owners are the ultimate taxpayers, and the entities would not be able to control (or, in certain circumstances, even monitor) the actions of their owners in many cases.

However, the dichotomy under the Proposed Regulations will encourage taxpayers to prefer purchases from entities classified as partnerships or S corporations for Federal income tax purposes. In those situations, the owners of the entities may transfer their interests without causing recapture to the transferee taxpayer, while achieving essentially the same tax result as with a sale of the underlying assets.[73] On balance, we believe that a regulatory scheme enabling self-help

[73] Consider a limited liability company with two members. Each member sells its interests in the limited liability company to new purchasers. Under § 708, the limited liability company would be considered to continue as a partnership for Federal income tax purposes, and any recapture would accordingly fall on the members of the limited liability company. Moreover, no notice would need to be given to the transferee taxpayer, under the provisions of the Proposed Regulations.

through creative structuring should be minimized as this kind of structure tends to penalize the less well-advised taxpayer.

The March Report approached the issue in a somewhat different manner. There, we urged that recapture be limited to events involving the property that would have caused the project to cease to qualify for the credit; we recommended that if such a limit was adopted, then in order to achieve parity with the result where credits are retained rather than transferred, the party that claimed the credit (i.e., the transferee) should be subject to recapture. The Proposed Regulations did not adopt that approach. Since the Proposed Regulations have, instead, retained the full range of recapture events, we believe it would be appropriate to extend the approach of allocating the recapture risk to any eligible taxpayer, and not just partners and S corporation shareholders in Transferor Partnerships and Transferor S Corporations. The eligible taxpayer owns the eligible credit property and, therefore, has the greatest ability to control the occurrence of recapture events. We also believe that allocating the recapture risk to the eligible taxpayer would lead to a more efficient contracting process.

We understand that, as the Preamble points out, Treasury believes that the approach under the Proposed Regulations is consistent with the statutory framework under Sections 50, 6418(a) and 6418(g)(3)(B)(ii). We note, however, that there is no statutory provision that expressly allocates recapture risk to the transferee taxpayer, and Section 50 was enacted before it was possible to transfer credits. For this reason, we believe that Treasury was not bound to this statutory framework in the context of recapture events caused by owners of Transferor Partnerships or Transferor S Corporations, and these statutory provisions could be interpreted more narrowly with respect to all eligible taxpayers. Arguably, the transferee taxpayer could be treated as the taxpayer for the limited purpose of complying with the notification requirements under Section 6418(g)(3)(B)(ii), as the transferee is the appropriate party to determine the credit amount required to be recaptured. In the other direction, the eligible taxpayer would need to be notified of the recapture amount, in order to make basis adjustments. Interpreted this way, these statutory provisions would not require allocating the recapture liability to the transferee taxpayer.

If recapture risk was allocated to the eligible taxpayer, then presumably the eligible taxpayer would be required to recapture an amount equal to the credits claimed by the transferee.[74] That consequence may arguably be viewed as harsh, because the eligible taxpayer generally will have received consideration equal only to a discounted value of the credit. However, since the eligible taxpayer generally will have caused, and has the power to prevent this result, requiring the responsible party to repay the government the full credit is not unreasonable.[75] Additionally, the recommended approach is no more harsh than the economic result if the transferee taxpayer was liable for the recapture and was not indemnified by the eligible taxpayer or received indemnification only to the extent of the purchase price paid for the credits.

However, to the extent that Treasury believes that it is bound by the statutory framework treating the transferee as the taxpayer, we recommend that Treasury limit the default rule on the

[74] In this regard, Treasury would be made whole for the amount of excessive credits utilized by the transferee taxpayer.

[75] In the March Report, we suggested that the eligible taxpayer's recapture potentially could be limited to the amount of cash received for the sale of the recaptured credits. *See* March Report at 20-21.

allocation of recapture liability to Section 50(a), as Section 6418(g)(3) explicitly references the rules of Section 50. We believe other items, such as recapture under Section 49 and recapture under Section 45Q, should be solely the responsibility of the eligible taxpayer.

B. Application of the Section 469 Passive Activity Rules

1. The Proposed Regulations' Approach Under Section 469

Both Section 6418 and the Proposed Regulations treat the transferee taxpayer as the taxpayer for purposes of the Code with respect to the transferred specified credit portion. Consequently, whether a taxpayer can claim or use the credit is based on the attributes of the purchasing taxpayer (i.e., the transferee taxpayer). The Proposed Regulations provide that, where applicable to a taxpayer, the limitations in Section 469 apply to purchasers of credits. Under the Proposed Regulations, the eligible credits are treated as earned in connection with the conduct of a trade or business; however, the transferee taxpayer is not considered either to have owned an interest, or to have participated, in the eligible taxpayer's trade or business at the time the of the activity that generated the credit (a key difference from an investor in a tax equity transaction). Accordingly, the transferee taxpayer will not ordinarily satisfy the material participation standard under Treas. Reg. Section 1.469-5T in order to be treated as participating in the activity. In addition, the Proposed Regulations specify that the grouping rules provided in Treas. Reg. Section 1.469-4(c), which would otherwise allow a taxpayer to satisfy the material participation standard for a specific activity by virtue of having materially participated in a separate but related trade or business, do not apply to allow a taxpayer to claim it materially participates in the trade or business that gave rise to the specified credit portion. The effect of these proposed rules is to treat any purchased credit in the hands of the transferee taxpayer under Section 469 as passive (versus active), which in many cases will dissuade individuals, trusts, estates, and closely held or personal service corporations from purchasing eligible credits if they do not have sufficient passive income that can be offset by the purchased credit. This, as we discussed in the March Report, has the potential to reduce the number of participants in the market for credits and, possibly, frustrate the objectives of the IRA.

The Preamble states this approach is "consistent with the result that the transferee taxpayer does not apply rules that relate to the determination of an eligible credit because the transferee taxpayer does not own the underlying eligible credit property to which the credit is determined or conduct the activity directly." The Preamble further explains: "allowing a transferee taxpayer to try to change the characterization of an eligible credit based on grouping with its own activities under Treas. Reg. Section 1.469-4(c) would conflict with the conclusion that the eligible credit has already been determined."[76] Treasury requests comments on whether there are circumstances in which it would be appropriate to not apply the passive loss rules to a transferee taxpayer or to otherwise attribute participation of an eligible taxpayer to a transferee taxpayer.[77]

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[76] 88 Fed. Reg. at 40503

[77] *Id.*

2. Recommendations

We generally support the position that an eligible credit is earned in connection with the conduct of a trade or business, as that reflects how an eligible credit would arise, and also the position that the credit purchaser is not deemed to materially participate in that trade or business if they did not actually do so. In response to Treasury's request for comments as to exceptions to this rule, we believe there are limited circumstances in which taxpayers subject to Section 469 should be able treat purchased credits as active. In particular, if a taxpayer owns an interest in, and materially participates in, a particular energy project, the taxpayer should be able to purchase credits from other participants and treat those purchased credits, along with such taxpayer's allocable share of credits as an owner, as active. Additionally, Treasury should consider permitting taxpayers subject to Section 469 that satisfy the material participation requirement with respect to a specific activity (but do not own an interest in it) to treat purchased credits from that activity as nonpassive.

Although we do not endorse such an approach, Treasury could consider allowing application of the grouping rules provided in Treas. Reg. Section 1.469-4(c) in order to expand the potential purchasers of credits. This approach, which may be supported by the policy of encouraging a robust market for credits, may need to be tempered given the flexibility offered taxpayers in the existing grouping rules.

3. Discussion

In our March Report, we observed that as a matter of statutory interpretation, the better reading was that these rules apply to purchasers of clean energy credits, although the relevant language can be read to come to the contrary conclusion as well. On the question of whether it was better policy for these rules to apply, we noted there are competing considerations of tax and energy policy and did not take a position, as questions of energy policy are outside our expertise.

Treasury has clarified in the Proposed Regulations that Section 469 does, in fact, apply. Treasury indicated in the Preamble, however, that it is continuing to consider the precise application of Section 469, including what exceptions should apply.[78]

As in our March Report, we recognize that these issues require a balancing of tax and energy policy goals, and only the former is within our expertise. As a result, our analysis here is grounded in tax policy considerations.

In that spirit, we note there are situations in which the transferee taxpayer will have materially participated in the activities that give rise to the credit, and the transferee taxpayer should be allowed to purchase the eligible credits under Section 6418 without the limitation in Section 469 applying. For example, a basic case would be a partner of a Transferor Partnership

[78] In the March Report, we offered several different approaches for Treasury to determine whether the use of purchased credits by transferee taxpayers should be subject to Section 469. Because Treasury has concluded in the Proposed Regulations that Section 469 applies to such taxpayers, and because that was one of the approaches we recognized as reasonable in the March Report, we have not addressed that decision in this Report. Rather, have focused on the specific questions raised in the Preamble.

that materially participates in the activities giving rise to an eligible credit purchases credits effectively from another partner in the Transferor Partnership. The purchasing partner should not be denied the ability to utilize the eligible credit purchased through a technical reading of the rules that concludes such purchasing partner does not participate in the activity giving rise to the purchased credit. This result is consistent with the treatment of that partner's share of the credits allocated as an owner of the partnership. There is no provision in the statute that should cause credits from the same project to be treated differently. If the material participation standard is satisfied, it should not matter whether the credits are allocated through the partnership agreement or purchased from other participants.

Treasury should consider allowing the same result for a person that satisfies the material participation standard with respect to the specific activity giving rise to the credit and simply purchases credits but does not own any interest in the activity. The relevant criterion here is satisfaction of the material participation standard with respect to the actual activity giving rise to the credit.[79] To conclude instead that the analysis depends on ownership of an interest in the activity might often lead to arbitrary results, and would tend to favor planning involving small changes in a transaction's structure that would alter the result under Section 469 (e.g., having a Transferee Partnership acquire at least a small interest in a Transferor Partnership).[80]

The question of whether and to what extent the usual grouping rules provided in Treas. Reg. Section 1.469-4(c) should apply is a more difficult one. These grouping rules allow taxpayers considerable flexibility in determining what constitutes a "single activity" for purposes of grouping activities to satisfy the material participation standard for a given activity in which the taxpayer does not materially participate.[81] Treas. Reg. Section 1.469-4(c) allows a taxpayer to use "any reasonable method" to determine whether activities properly constitute a single activity or multiple, separate activities. Moreover, the IRS is limited in its ability to challenge a reasonable grouping of the taxpayer.[82] Given this flexibility accorded to taxpayers, we understand that permitting unlimited use of the grouping rules might lead to questionable results. For instance, although these rules might permit a taxpayer that materially participates in activities that produce

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[79] Satisfaction of the material participation requirement would be determined under the standards set forth in Treas. Reg. §1.469-5T, including the rules that take only certain actions into account.

[80] We recognize our suggested approach would go beyond the usual Section 469 rules, under which the material participation test can be met only for an activity in which the taxpayer owns an interest. However, in the context of a taxpayer buying credits under Section 6418 that are generated by an activity in which the taxpayer materially participates, we believe such a departure from the usual rules may be warranted.

[81] Treas. Reg. § 1.469-4 sets forth the circumstances for grouping tax items to determine what constitutes a single activity. The regulation provides generally that "[o]ne or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." Whether activity constitutes an "appropriate economic unit" depends on the facts and circumstances, with the greatest weight given to five factors: (i) similarities and differences in types of trades and businesses, (ii) the extent of common control, (iii) the extent of common ownership, (iv) geographic location, and (v) interdependencies between or among the activities. Moreover, a taxpayer may use "any reasonable method of the relevant facts and circumstances" to group activities, and not all of the five factors are "necessary for a taxpayer to treat more than one activity as a single activity." Thus, taxpayers have some flexibility in determining what constitutes an appropriate economic unit. *See Hardy v. Commissioner*, T.C. Memo 2017-16.

[82] *See Hardy v. Commissioner*, T.C. Memo 2017-16.

energy from traditional sources to group those activities with the purchase of credits, it is not clear whether such a result would be consistent with the purposes of Section 6418.

The Proposed Regulations do not permit any grouping, even for owners of projects that may wish to purchase credits in similar projects. We are generally supportive of this approach. Nevertheless, Treasury could reasonably conclude that promoting the objectives of the IRA supports a rule that allows limited "grouping" for purposes of Section 6418. Such an approach might be appropriate if Treasury believes that it is important to further the policy of Section 6418 and development of projects by encouraging involvement of individuals active in the field. Under such a view, there are several approaches Treasury could consider. For example, Treasury might consider permitting grouping for an individual that already materially participates in one project and seeks to purchase additional credits from other projects which are similar, where the individual participates in those other activities.[83] Alternatively, Treasury may consider permitting grouping of similar activities even where the individual does not participate in some of them. For example, an individual who materially participates in a wind farm project may be able to "group" his or her ownership in that wind farm with other wind farm investments in which they do not participate. Allowing the grouping rules to apply in such situations may be reasonable as a factual and economic matter, and may incrementally expand the market for eligible credits and create additional liquidity and funding.

C. Interaction with the Section 704(b) Rules

1. Proposed Regulations' Rules on Partnership Elections and Allocations

Prop. Treas. Reg. Section 1.6418-3 contains a number of special rules which address, among other items, the treatment of credits and related items in the partnership context. These include the treatment of payments for the sale of credits by both the Transferor Partnership and the Transferee Partnership, as well as allocations of the credits by each of the Transferor Partnership and Transferee Partnership. For each of these items, the Preamble requests comments on whether additional rules are needed with respect to whether these allocations will be respected under Section 704(b).[84]

The various transactions involved in the transfer of credits impact partnership capital accounts and the Section 704(b) rules in several ways. For the Transferor Partnership, the issues involve the allocation of the tax-exempt income received for the credits, including issues relating to the ability of such eligible taxpayer to transfer less than all of the credits and, moreover, each separate partner's ability to specify whether it is transferring all or a portion of its share of the credits. Prop. Treas. Reg. Section 1.6418-3(b)(2) generally provides considerable freedom for the eligible taxpayer and its partners to specify which partner's share of the credits is being sold. In such a case, the eligible taxpayer is required to allocate the proportionate share of tax-exempt

[83] If Treasury adopts such an approach, it could consider how similar two projects must be, for grouping to apply. For example, one possibility would be to allow grouping only where projects are substantially identical, in order to allow limited grouping without the broad flexibility that the rules under Section 469 normally provide.

[84] Fed. Reg. 88 at 40505.

income resulting from the transfer to its partners based upon their specific participation in the transfer.[85]

Under the Section 704(b) regulations, the allocation of tax-exempt income will increase a partner's capital account. An allocation of a credit, however, will not increase or reduce a partner's capital account. Thus, it is possible that the partners' respective capital account will become disproportionate, depending on whether a partner elects to sell a credit. For example, consider a Transferor Partnership with two partners that intend to share all items of income and loss equally. If only one partner elects to sell its share of the credits, that partner's capital account will be increased by the amount received for the credit (which is likely less than the amount of the credit), while the other partner's capital account would be unchanged (even though it will receive the benefit of the credit through a reduction in its tax liability outside the Transferor Partnership). The potential divergence may be further complicated by the treatment of distributions of the consideration received by the Transferor Partnership from the sale of the credits. As the Preamble makes clear, the Proposed Regulations do not impose any limitation on the distribution of the cash proceeds arising from the sale of credits, even if that distribution is not proportionate to the allocation of the tax-exempt income.[86]

Similar issues may arise for a Transferee Partnership. Prop. Treas. Reg. Section 1.6418-3(b)(4)(ii) specifies that the cash payment made by such Transferee Partnership is treated as a non-deductible expenditure described in Section 705(a)(2)(B). Under Prop. Treas. Reg. Section 1.6418-3(b)(4)(iii) each partner's share of the purchased credit is based on such partner's distributive share of the non-deductible expenditures used to fund the purchase. That share is determined under the terms set forth in the partnership agreement; if the agreement does not specify a share, then it is based upon the general allocation of non-deductible expenditures.[87] Under Prop. Treas. Reg. Section 1.6418-2(f)(2), the profit on the purchase of credits is not considered to be gross income to the transferee taxpayer.

These rules, combined with the ability of partnerships to purchase credits for different prices, may result in similar disparities in the partners' capital accounts. Consider, for example, a two-person investment partnership with each partner generally sharing equally in all items of income or loss, making equal capital contributions, and being entitled to equal distributions. Suppose the partnership agreement permits each of the partners to designate whether they wish to have a portion of their capital used to purchase credits and assume one partner agrees to purchase credits for $0.80 per $1.00 of credit and the other agrees to purchase them for $0.85 per $1.00 of

[85] Prop. Treas. Reg. § 1.6418-3(b)(2)(B). These rules require a proportionate allocation based upon the portion of credit sold by a particular partner over the total amount of credits sold by the partnership.

In a case where different partners agree to sell credits at different prices during a taxable year, it is unclear whether the Proposed Regulations permit the proportionate allocation rule to be applied separately to each sale of credits, so that each partner receives an allocation corresponding to the particular sale price(s) to which that partner has agreed. Treasury may wish to add an example addressing this situation.

[86] Fed. Reg. 88 at 40505.

[87] This rule is tempered by the provision that treats the purchase of the credit as an extraordinary item for purposes of Section 706. See Prop. Treas. Reg. § 1.6418-3(b)(4)(iv).

credit. Because the Section 705(a)(2)(B) expenditures reduce the partners' respective capital account, these purchases will result in capital accounts that are not equal.[88]

2. Recommendations

In response to Treasury's request for comments, we believe that the current rules under Section 704 and Treas. Reg. Section 1.704-1 fit adequately with the guidance provided in the Proposed Regulations regarding how allocations of credits, tax-exempt income and non-deductible expenditures should be made. The capital accounts of the partners that otherwise have the same economic rights may diverge, depending on whether each partner in a Transferor Partnership sells its share of credits, or each partner in the Transferee Partnership contributes cash to enable the partnership to buy credit, but that is generally an appropriate result. We believe it may be useful to provide in Treas. Reg. Section 1.704-1(b)(3) that the special allocation of tax-exempt income and non-deductible expense in the manner contemplated by the Proposed Regulations will be treated as having been made in accordance with the partners' interests in the partnership.

3. Discussion

For the Transferor Partnership, the divergence in capital accounts may arise due to the allocation of tax-exempt income resulting from a sale of credits by some, but not all of the partners. Those partners selling credits will have a larger capital account than other partners that have not sold. Such larger capital account will result in larger distributions to the partner. Alternatively, the partnership agreement may eliminate the disparity by allocating additional income to other partners or by allocating additional deductions to the partner selling the credits.

These results are in accordance with the substance of the economic arrangement among the partners. The Transferor Partnership has received cash for the credits. To the extent that the cash has been or will be distributed, the selling partner has enjoyed the benefit of the sale and borne the detriment of, in all likelihood, realizing an economic profit that is less than the value of the credit. Alternatively, if the cash is not distributed and is utilized by the Transferor Partnership, the Transferor Partnership has retained a partner's share of income. Depending on the terms of the partnership agreement, the retention of income may result in the allocation of additional deductions to that partner. Again, that result properly addresses the arrangement among the partners without modification of the existing Section 704(b) rules.

An allocation of tax-exempt income to some partners in a Transferor Partnership, which is offset by an allocation of taxable income to other partners, might be seen under the normal substantial economic effect principles of Treas. Reg. Section 1.704-1(b)(2)(iii) as lacking in substantiality and thus as deserving not to be respected. However, respecting these special allocations appears consistent with the basic policy of Section 6418 of giving each taxpayer a choice between selling and retaining credits, and the policy choice made in the partnership rules in the Proposed Regulations to respect the allocation of tax-exempt income to the partners selling their share of credits. In this regard, the rules under Section 704(b) could be coordinated with the provisions in the Proposed Regulations by clarifying that such an allocation of tax-exempt income

[88] A similar consequence would result if only one partner contributed capital for the purchase of credits.

will be viewed as having been made in accordance with the partners' interests in the partnership under Treas. Reg. Section 1.704-1(b)(3).

Conceptually, this treatment could be compared to the result if each of the partners in the Transferor Partnership had received its share of a credit outside the Transferor Partnership, and some of the partners then sold their shares of the credit and contributed the proceeds to the partnership. However, while this seems like a reasonable construct as a conceptual matter, we note that to actually adopt such a characterization (involving a deemed capital contribution) would likely require consideration of other rules such as book adjustments under Section 704(b) and allocations governed by Section 704(c). This would introduce complexity we believe is unnecessary. Instead, we believe it should be sufficient to confirm that a special allocation of tax-exempt income from the sale of some partners' share of credits is deemed to be in accordance with the partners' interests in the partnership.

We believe that there is a similar analysis for a Transferee Partnership. In such a case, the partners' capital accounts are reduced by the non-deductible expenditures incurred to purchase the credits. To the extent such expenditures are allocated disproportionately, there may be future allocations or distributions to correct or offset such disparities. These future allocations or distributions would also generally be consistent with the economic arrangement. A partner with a larger capital account because it has purchased a disproportionately small portion of the credit will be entitled to either a greater distribution in the future or larger allocations of deductions. Similar to our observations above, it appears appropriate to confirm these results will be treated as in accordance with the partners' interests in the partnership.

Finally, we do not believe that there is a need to address the implicit gain attributable to the purchase of the credits at less than their face value. We believe that such gain should be considered realized outside of the Transferee Partnership, just as the credit is ultimately utilized outside of the Transferee Partnership. The alternative of treating the gain as being recognized by the Transferee Partnership and allocated to the relevant partners would create an uneconomic distortion among the partners.

D. Treatment of Expenses

1. Questions Under the Proposed Regulations

Section 6418(b) excludes from gross income "any amount paid by a transferee taxpayer to an eligible taxpayer as consideration for a transfer" of an eligible credit.[89] In addition, such amounts paid by a transferee taxpayer to an eligible taxpayer in connection with a transfer of eligible credits are not deductible by the transferee taxpayer.[90] Further, with respect to Transferor Partnerships and Transferor S Corporations, Section 6418(c) refers to the transfer consideration paid or received as tax-exempt income. Finally, for all transferee taxpayers, any profit resulting

[89] § 6418(b)(2).

[90] § 6418(b)(3).

from the use of credits purchased at a discount is also excluded from income under the statutory scheme.[91] The Proposed Regulations mirror this approach.[92]

The Proposed Regulations do not address the treatment of transaction costs for either the eligible taxpayer or the transferee taxpayer. In addition, the Proposed Regulations do not address whether a transferee taxpayer may deduct a loss if the amount paid to an eligible taxpayer exceeds the amount of the eligible credit the transferee taxpayer can ultimately claim.[93] This may occur, for instance, when the aggregate amount of the cost for the eligible credit (i.e., the price of the eligible credits and the transaction costs) exceeds the amount of the credit.[94] Treasury has requested comments on the treatment of expenses.[95] In making this request, the Preamble points out that, as a well-established principle of statutory interpretation, a tax law should not be interpreted to allow a double benefit without clear Congressional intent; the Preamble asks whether this principle applies with respect to the treatment of transaction expenses.[96] The Preamble also requests comments on whether a loss should be allowed to a transferee taxpayer in the situation in which the amount paid for the credit, together with the transactions costs, exceeds the amount of the credit.

2. Recommendations

We believe that Treasury should find the appropriate balance between competing policies involving, on the one hand, consistent application of general tax principles such as the "no double benefit" principle referenced in the Preamble and, on the other hand, the policy of Section 6418 to encourage investment in clean energy and related projects. Our comments on this issue are grounded solely in tax policy, since that is where we possess expertise.

From a tax policy perspective, in our view, all transaction expenses incurred by both the eligible taxpayer and the transferee taxpayer in connection with the transfer transaction should be treated as non-deductible.

Additionally, we believe that the approach to the treatment of expenses chosen by Treasury should also govern situations in which a transferee incurs an economic loss because the purchase price of the credit and the related transaction expenses exceed the amount of credit received from the eligible taxpayer (other than because of an excessive credit transfer). To the extent that

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[91] § 6418(a) states that the transferee taxpayer is "treated as the taxpayer for purposes of this title with respect to such credit," suggesting that (similar to taxpayers generally) the transferee does not have income as a result of utilizing the credits.

[92] Prop. Treas. Reg. § 1.6418-2(e)(1)-(3).

[93] 88 Fed. Reg. at 40502.

[94] This could occur, for example, if a transferee taxpayer purchases $100,000 of ITCs from a project for $0.80 for each $1.00 of credit and incurs $25,000 of legal fees in connection with the transaction. If the project, despite projections, yields only $100,000 of credits, the taxpayer will have a loss of $5,000.

[95] 88 Fed. Reg. at 40502.

[96] *Id.*; *see U.S. v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969).

expenses are not deductible, no deductible loss should be allowed. If expenses are generally deductible, any loss would also be deductible.

3. Discussion

Turning first to the eligible taxpayer, the no double benefit principle supports denial of a deduction for its expenses incurred to enter into or facilitate a transfer of eligible credits. Since the payment received by the eligible taxpayer from a sale of credits is excluded from gross income under Section 6418(b)(2), the eligible taxpayer would have a double advantage if it could offset its expenses directly attributable to producing the excluded payment, against other gross income that is subject to tax. That result would run counter to the common law principle described above and would seem to contradict the letter and spirit of Section 265(a)(1). The statute denies a deduction in the case of expenses that are allocable to amounts of income (other than interest income) that are excluded from gross income under subtitle A or are exempted by any provision of the Code from a tax imposed by subtitle A.[97] The exclusion in Section 6418(b)(2) is not explicitly within subtitle A; however, there does not appear to be a reason to ascribe significance as a policy matter to that fact. In addition, it would seem reasonable to conclude that Section 6418(b)(2) is a provision that, in effect, exempts income of the eligible taxpayer from tax under Sections 1 and 11. Thus, Treasury could consider issuing guidance, under Section 265 and/or Section 6418, to deny a deduction.[98]

In addition, while Section 6418 reflects a policy of incentivizing investment in clean energy projects, it is not clear whether denying the eligible taxpayer a deduction for expenses incurred to transfer credits would substantially undermine that policy. More specifically, it is unclear how significant an impact there would be on the pricing of credit transfers (and thus, how significant an impact there would be on the efficiency of the subsidy provided by Section 6418 to developers of clean energy projects), if the eligible taxpayer cannot deduct such expenses.

It might be argued that, to the extent that the expenditures incurred are part of the eligible taxpayer's overall activity on the project, the tax treatment of the expenditures should be governed by the nature of the overall activity, which is a trade or business involving energy property that generally produces operating income. On balance, we believe this to be as much a practical as a substantive argument. To the extent specific expenses can be identified that are incurred to transfer or facilitate the transfer of credits, the policy of avoiding a double benefit seems to us to be the logical one to follow notwithstanding the general nature of the activity, as these expenses are entirely attributable to a transaction (the sale of credits) that produces only exempt income.

[97] Treas. Reg. § 1.265-1(b)(1). *See* Notice 2020-32, obsoleted by Rev. Rul. 2021-2, denying a deduction for expenses reimbursed with PPP loans that have been forgiven.

[98] The same basic points apply to Transferor Partnerships and Transferor S Corporations, notwithstanding that § 6418(c) characterizes their receipt of consideration for credits as exempt income rather than excluded income.

The Preamble does not raise any questions about whether any expenses incurred by an eligible taxpayer in connection with generating transferred credits should be deductible or disallowed as incurred to produce tax-exempt income, beyond possibly disallowing expenses incurred in connection with the process of transferring such credits. Nor is this Part IV.D intended to address any questions beyond deductibility of such transaction costs..

However, it would be useful for Treasury to provide clear guidance on the methodology for separating out expenses attributable to the transfer from the overall costs of the project.[99]

In the case of the transferee taxpayer, the analysis is similar, though not identical. The transferee taxpayer does not receive an obvious form of tax-exempt income (or, as in the case of the eligible taxpayer, a cash payment that is excluded from gross income). It does, however, derive a precisely measurable economic benefit when it uses the credit, and it is not obligated to pay any tax on its receipt of that benefit, as recognized in the Proposed Regulations.[100] The tax policy against double benefits thus would seem to apply to the transferee taxpayer as well, to deny it a deduction for the expenses it incurs to purchase the credit.

If the transferee taxpayer's expenses of purchasing credits are treated as nondeductible, taxpayers in arguably economically similar transactions may be disadvantaged by Section 6418 transfers in comparison to tax equity transactions. However, it does not appear to us that purchasers of credits are in a similar position to participants in tax equity transactions, even if the goal in both is essentially the purchase of tax credits. Tax equity structures differ, as the parties, including the passive investors, are actually engaged in the trade or business and have benefits and burdens associated with the overall project, including the recognition of taxable income and loss associated with the project. The credit transfers permitted by Section 6418 are entirely a financial transaction, for which the payments are expressly excluded from gross income.

From the perspective of promoting clean energy projects, there appears to be a stronger argument in favor of allowing a deduction for the transferee taxpayer's expenses, than in the case of the eligible taxpayer. To the extent the transferee taxpayer is denied a deduction, that may impact pricing of credit transfer transactions more directly than non-deductibility for the eligible taxpayer, leading to less efficient results under Section 6418. Treasury can consider the appropriate balance to strike here between energy and general tax policy.

While we would expect situations resulting in the transferee taxpayer having losses (apart from those involving excessive credit transfers) to be rare, we believe the question of whether to allow a deduction for the loss is appropriately addressed by extending the principles just described. Such a loss should only arise in transactions where it was reasonable to anticipate that an economic profit would be made (i.e., the purchase price of the credit and related transaction expenses are less than the anticipated eligible credit purchased). If expectations are met, then as noted the transferee taxpayer would not have taxable income on account of its economic profit. Conversely, to the extent that expectations are not met and the aggregate costs of the eligible credits (including the price of the eligible credits and transaction costs) exceed the amount of the eligible credit that the transferee taxpayer can ultimately claim, an economic loss will have been sustained. It would be symmetrical with the treatment of profits, and consistent with non-deductible treatment for the transferee taxpayer's transaction costs, to deny the transferee taxpayer a tax deduction for its loss.

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[99] *Cf.* Treas. Reg. § 1.263(a)-5.

[100] *See* Prop. Treas. Reg. § 1.6418-2(f)(2) (providing that when the transferee taxpayer claims credits in excess of the price it paid the transferor, the excess is not included in gross income).

We acknowledge, however, that it could be argued that allowing a deduction for the transferee's economic loss would provide a similar result to an investor in a tax-exempt bond that sells such bond at a loss.[101] It also could be argued that such an approach should help produce a robust market for Section 6418 transfers and achieve the goals of the IRA. On balance, if Treasury opts to deny a deduction to the transferee taxpayer for transaction expenses, we believe a similar result would be appropriate for the transferee taxpayer's economic loss (if any) on the transaction.[102]

E. No Second Transfer Election Rule

1. Overview and Purpose of the Rule

Consistent with Section 6418(e)(2), Prop. Treas. Reg. Section 1.6418-2(c)(2) provides that a specified credit portion may be transferred pursuant to a transfer election only once.[103] Thus, once an eligible taxpayer elects to transfer a specified credit portion to a transferee taxpayer, the transferee taxpayer may not then make an election to transfer any of the specified credit portion to any other taxpayer.[104] An essential element to enforcing this rule is to identify when a transfer of a credit (i.e., the one permitted transfer) is deemed to occur. However, the Code and Proposed Regulations do not provide guidance on this issue, and the Preamble suggests the use of general tax principles relating to benefits and burdens of ownership. Moreover, neither the Code nor the Proposed Regulations offer guidance on the purpose of the no second transfer rule that might inform the inquiry as to the factors that should be relevant to that determination.

As discussed in the March Report and reiterated here, Treasury should clarify its interpretation of Section 6418(e)(2) with a rule that establishes when a transfer of a specified credit is deemed to occur. In so doing, Treasury must first determine what, if any, goal Congress sought to achieve in barring a second election, in addition to the goal of preventing multiple taxpayers from claiming the same credit. Under one view, Congress may have simply wanted to make Section 6418 more administrable, while ensuring that only one party claims the credit and making this easier to track. Such an approach, which is arguably consistent with the statutory language's focus on prohibiting successive *elections* rather than successive transfers, would permit a

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[101] In making such an argument, however, one must disregard (or acknowledge the asymmetry concerning) the consequence to a tax-exempt bond investor that sells such bond at a gain, as the investor will include that gain in taxable income. Under Section 6418, a transferee taxpayer that purchases an eligible credit at a discount and then gets the benefit of the full credit purchased, will not recognize gain.

[102] Additional considerations apply, when determining the appropriate treatment of a transferee in a case where an excessive credit transfer has occurred. Excessive credit transfers are discussed in Part IV.H below.

[103] Additionally, the Preamble states that Prop. Treas. Reg. § 1.6418-3(b)(4)(iv), which provides that a transferred specified credit purchased by a Transferee Partnership is treated as an extraordinary item, is intended to prevent avoidance of no second transfer rule provided in Prop. Treas. Reg. § 1.6418-2(c)(2). *See* 88 Fed. Reg. at 40506.

[104] In the case of a Transferee Partnership, the Proposed Regulations provide that an allocation of a transferred specified credit portion to a direct or indirect owner of a Transferee Partnership is not considered a transfer under § 6418 and, therefore, does not violate the no second transfer rule. Prop. Treas. Reg. §§ 1.6418-3(b)(4), -3(c)(2); *see* 88 Fed. Reg. at 40501.

simplified rule, as we suggested in the March Report, that the transferee taxpayer is the taxpayer specified on the transfer election.

On the other hand, one can also read the statutory prohibition more broadly and conclude that Congress wanted to inhibit the development of a secondary or derivative market in tax credits. From the Preamble, it appears Treasury may have concluded that Congress' goal was broader than merely ensuring greater ease of tracking which party can claim the credit to prevent "double dipping." The Preamble states "[any] arrangement where the Federal income tax ownership of a specified credit portion transfers first, from an eligible taxpayer to a dealer or intermediary and then, ultimately, to a transferee taxpayer is in violation of the no second transfer rule in Section 6418(e)(2). In contrast, an arrangement using a broker to match eligible taxpayers and transferee taxpayers should not violate the no second transfer rule, assuming the arrangement at no point transfers the Federal income tax ownership of a specified credit portion to the broker or any taxpayer other than the transferee taxpayer."[105] However, the Preamble does not explain what it is that makes such an intermediary that takes transitory "ownership" more objectionable from a policy standpoint than an intermediary that intermediates without actually taking ownership of the credits. For example, an intermediary that agrees to identify transferee taxpayers could also agree to purchase unsold credits from the eligible taxpayer, but only in the event and to the extent third party transferees are not identified (i.e., to backstop the sales). Is such an arrangement objectionable given the perceived purpose of the rule? It is difficult to answer such questions without clearer guidance on the intended purpose of the no second transfer rule.

The Preamble suggests that taxpayers should rely upon general tax principles to determine when the transfer of benefits and burdens of ownership occurs.[106] However, we do not believe those tax principles as used in other contexts offer a workable test in the case of a transfer of tax credits. Credits are a mere right or legislative grace to reduce one's taxes. The primary commercially relevant attribute is the right to claim and use the credit to reduce one's taxes. That right to claim and use the credit depends entirely on whatever "ownership" test is adopted by the statute and regulations and not on extrinsic commercial realities. Section 6418 divorces the use of a credit from the conduct of the productive activity which gives rise to it. Credits are not like a good or a customary item of property, the ownership of which involves a typical risk of investment loss or opportunity for upside gain. Nor are factors such as which party has the legal right and ability to manage or dispose of the credit helpful, given the absence of carrying costs, lack of any need for active investment management and prohibition on successive transfers. Indeed, under the recapture rules, actions of the eligible taxpayer after a valid election is made may (lawfully)

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[105] *See* 88 Fed. Reg. at 40501. Additionally, the Preamble requests comments on whether additional rules or clarifications are needed in the example where a partner contributes capital to a Transferee Partnership for the purpose of purchasing eligible credits and then subsequently transfers its partnership interest in the Transferee Partnership prior to the Transferee Partnership having made any cash payments to the eligible taxpayer. *Id.*

[106] Generally, the factors used to determine when benefits and burdens of ownership of property have transferred include: (i) the right to possession; (ii) an obligation to pay taxes, assessments and charges against the property; (iii) the responsibility for insuring the property; (iv) a duty to maintain the property; (v) the right to improve the property without the seller's consent; (vi) the risk of loss; and (vii) the passage of legal title. *See Keith v. Commissioner*, 115 T.C. 605, 611 (2000).

preclude use of the credit by the transferee taxpayer, which is a peculiar situation not contemplated under typical ownership principles.

2. Recommendation

We continue to believe, as set forth in our March Report, that the simpler approach would be to interpret Section 6418(e)(2) literally and limit the second transfer rule to prohibit only successive transfers made by the transferee taxpayer specified in the transfer election. We recognize, however, that such a rule does permit various contractual transactions with respect to credits until the transfer election is filed. Treasury could reasonably conclude that the rule is intended to prevent the development of a liquid trading market or derivatives activity by dealers and third parties other than the eligible taxpayers. In that case, we recommend Treasury provide a clear and administrable rule for eligible taxpayers and transferee taxpayers to determine when a transfer of a specified credit portion is deemed to occur. Because we believe normal "benefits and burdens of ownership" principles are not workable in this context, we recommend that such a rule should be based upon the other timing rules provided in the Proposed Regulations.

3. Discussion

The Proposed Regulations provide multiple timing rules that affect, among other things, when eligible credit property may be registered, when a transfer election may be filed, when an eligible taxpayer takes the transfer into account, and when a transferee taxpayer takes the credit into account. The "paid in cash" requirement requires payment to be made no earlier than the first day of the eligible taxpayer's taxable year during which a specified credit portion is determined and no later than the due date for completing a transfer election statement (as provided in Prop. Treas. Reg. Section 1.6418-2(b)(5)(iii)).[107] A transfer election must be made on or with the original Federal income tax return no later than the due date (including extensions of time) for the original return of the eligible taxpayer for the taxable year for which the eligible credit is determined.[108] We note that the transfer election statement may be filed early. The default rule under Prop. Treas. Reg. Section 1.6418-2(f)(1) is the transferee taxpayer takes the specified credit portion into account in the transferee taxpayer's first taxable year ending with or after the taxable year of the eligible taxpayer for which the eligible credit was determined.

Each of these proposed rules provides a significant window of time for completing the transfer, including up to the extended due date of the tax return for the taxable year of the eligible taxpayer to which the credit relates. To the extent Treasury believes there is a broader purpose to the no second transfer rule, we recommend Treasury set forth clear guidance to enable taxpayers to determine when the initial transfer of the credit has been made. From that point, no direct or indirect transfer of the right to claim the credit would be permitted. However, before such date is fixed, transfers of rights to the credit would be permitted.

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[107] Cash payment is a significant requirement for transferring a credit. Prop. Treas. Reg. § 1.6418-2(a)(4)(ii). No transfer election is allowed when an eligible taxpayer receives any consideration other than cash (as defined in Prop. Treas. Reg. § 1.6418-1(f)) in connection with the transfer of a specified credit portion.

[108] Prop. Treas. Reg. § 1.6418-2(b)(4).

One approach would be to choose among the different requirements to effectuate a transfer in order to fix a date. For example, Treasury could adopt a rule that once the amount of the credit has been determined, the specified credit portion is considered to have been transferred on the earliest date on which payment for credit has been made, the last day of the eligible taxpayer's taxable year, or (if earlier) the date the transfer election statement has been filed.

Application of this rule is illustrated by the following.

> **Example 1**. Eligible taxpayer (A) and transferee taxpayer (B) are each a calendar year taxpayer. On January 31, 2024, A places ITC property in service determining the amount of the credits available to be transferred. In addition, on January 31, 2024, A and B enter into a binding contract for the transfer of a specified credit portion with respect to the 2024 taxable year, and B makes full cash payment to A on that date. A and B each include a transfer election statement with their tax return filed on March 15, 2025. The transfer will be deemed to occur on January 31, 2024. If instead of making the payment on January 31, 2024, B makes the payment on June 1, 2024, the specified credit would be considered transferred on June 1, 2024.

> **Example 2**. Same facts as Example 1, except B makes a 20% refundable cash deposit to A on January 1, 2024, and pays the remaining amounts, in cash, to A on February 1, 2025. The transfer will be deemed to occur on December 31, 2024. The "paid in cash" requirement would not have been satisfied until the second payment has been made, which is after the end of the taxable year for which the credit has been determined. Accordingly, the transfer would be considered to have occurred on the last day of the taxable year.

We understand that under this approach, a limited secondary market may arise with respect to binding commitments for the purchase of credits; in general, we believe that such a such secondary market is consistent with brokerage activity in which the binding commitment serves as a backstop. On balance, we believe such an approach, which focuses on satisfaction of critical requirements for a transfer, will provide administrative ease for the IRS and for taxpayers. It would also eliminate the need to create special rules for Transferee Partnerships, as only the partners in the Transferee Partnership at the time of the transfer would be entitled to the credit and any indirect secondary market resulting under this rule is likely to be more limited than one that may evolve under a rule stating that the transfer occurs on the filing date of the transfer election.[109]

[109] We note that under generally applicable S corporation rules, credits are allocated based on the number of days an S corporation shareholder owns stock in the S corporation. Consider the following examples. A broker forms an S corporation that purchases tax credits on January 1, 2024. A third party purchases 100% of the S corporation's stock on July 1, 2024, and receives an allocation of 50% of the 2024 credits from the S corporation. Alternatively, the third party purchases 100% of the S corporation's stock on January 2, 2024, one day after the S corporation is formed, and is allocated most of the 2024 credits from the S corporation. Treasury may wish to consider whether this is acceptable under Section 6418 or a change in the applicable rule is needed based upon its overall evaluation of the purpose of the no second transfer rule.

F. Anti-Abuse Rule

1. Overview

Prop. Treas. Reg. Section 1.6418-2(e)(4) sets forth an anti-abuse rule that applies to transactions the principal purpose of which is avoiding any Federal income tax liability beyond the intent of Section 6418. The examples in the anti-abuse rule describe two transactions in which a seller's and buyer's agreed allocation of consideration paid for the credit and other property or services is recharacterized, in order to reflect the average price of the credit in transfers between third parties and the price usually charged for the other property or services. This recharacterization is, at least arguably, no more than an application of generally understood tax principles to any situation involving a single transfer of multiple items for undifferentiated consideration. We believe anti-abuse examples should be specific to Section 6418.

2. Recommendations

The anti-abuse rule provided in Prop. Treas. Reg. Section 1.6418-2(e)(4) should include specific examples demonstrating its application in contexts specific to Section 6418. In addition, the anti-abuse rule should be drafted with recognition of the difficulty taxpayers may face in applying an anti-abuse rule under Section 6418, given the potentially conflicting tax and energy policy goals underlying the statute. The goal of promoting clean energy projects, by fostering a robust market in credits that minimizes purchase price discounts, may argue in favor of respecting transactions that meet the bright-line rules under Section 6418, with those rules being drafted as precisely as possible, even while tax policy goals might counsel an interpretation that is more focused on substance over form. Examples illustrating clearly what constitutes an abuse would, thus, be particularly valuable.[110]

3. Discussion

Neither the wording of the anti-abuse rule nor the examples address attempts to avoid the rules and limitations under Section 6418. We believe an anti-abuse rule that describes such attempts should be included. The ability to sell or transfer tax attributes among taxpayers is relatively uncommon and the tax consequences are novel. It is difficult to anticipate how taxpayers and their advisors will interpret these rules, and a rule that acknowledges some of the unique considerations here and identifies abusive behavior in this context would be useful. As noted, the rule should be illustrated with examples.

For instance, if Treasury concludes that the second transfer limitation prohibits transactions involving direct or indirect sales of credits by intermediaries, Treasury could consider the following as an anti-abuse example:

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[110] We note that the economic substance doctrine under §7701(o)(5)(A) does not apply when a transaction results in tax benefits clearly intended by Congress. The IRS is not precluded from employing common law doctrines to attack potential abuses of Section 6418; however, we believe specific illustrations of abusive transactions contrary to the intent of the statute would be helpful.

Example 3. Assume that Transferee Partnership ABC enters into a binding commitment in 2024 to purchase credits from DEF, an eligible taxpayer, anticipated to be determined in 2025.[111] The agreement provides for the ability of ABC to compel DEF to deliver a transfer election showing ABC as the transferee taxpayer. Partner A holds a 90% interest in ABC and has agreed to fund 90% of the amount necessary to purchase the credit. To secure ABC's obligation to make payment in cash in 2025, ABC provides a letter of credit to DEF. In January 2025, the amount of the credit is determined and, thereafter, in February, Partner A sells its interest to a new partner, which assumes Partner A's obligation to make a capital contribution. The new partner and partners B and C make their capital contributions in June to pay for the credits.

Under these facts, depending on the perceived purpose for the no second transfer rule, Treasury might conclude that the transfer in February is an impermissible second transfer. Given the agreement and the letter of credit, the credit arguably should have been considered transferred in January when the amount of the credit was determined.

With respect to the "paid in cash" requirement, Treasury could consider the following anti-abuse example:

Example 4. Assume that Transferee Taxpayer ("TT") enters into a binding commitment in 2024 to purchase future credits from G, an eligible taxpayer, anticipated to be determined in 2026. Also assume that a wholly-owned subsidiary of TT lends money to G in 2024 on a non-recourse basis, secured by TT's commitment to purchase the credits.

Treasury could reasonably conclude that this arrangement violates the "paid in cash" requirement in Treas. Reg. Section 1.6418-1(f)(2).

G. Registration Procedures

1. Overview

The Proposed Regulations require a series of procedural steps for eligible credit transfers to be effective.[112] Eligible taxpayers must complete the pre-filing registration process and receive a registration number prior to making a transfer election. Each eligible credit property must have its own registration number.[113] In the pre-filing registration process, the eligible taxpayer must provide general information with respect to the taxpayer, including (i) its name; (ii) address; (iii) Taxpayer Identification Number; (iv) legal entity type; and (v) the type of annual returns, if any,

[111] This example also applies in context of a transferee taxpayer that is not a Transferee Partnership. On balance, however, we believe there is greater potential for abuse when the transferee taxpayer is a partnership for Federal income tax purposes. For example, the no second transfer rule may potentially be circumvented by the transfer of partnership interests in addition to the transfer of the contract.

[112] Prop. Treas. Regs. §§ 1.6418-2 and 1.6418-4.

[113] Prop. Treas. Reg. § 1.6418-4.

it is required to file. The eligible taxpayer must also include information with respect to the credit being sought, such as the type of credits for which the eligible taxpayer intends to make transfer elections and information relating to the relevant eligible credit property. This information includes (i) the type of eligible credit property; (ii) its physical location; (iii) supporting information relating to its construction or acquisition; (iv) the beginning of the construction date of the property; (v) the placed in-service date of the property; and (vi) any additional information that the eligible taxpayer believes will help the IRS evaluate the registration request.

Once the pre-filing registration process is complete, the IRS will review the information and will issue a separate registration number for each eligible credit property for which sufficient verifiable information has been provided.[114] This registration number is valid for only the taxable year in which the credit is determined, as well as for the taxable year in which the eligible credit is taken into account for the transferee taxpayer. Renewals of the registration number may occur after its expiration and would require the eligible taxpayer to attest that all the facts previously provided are still correct or updating them.

2. Recommendations

We generally agree with the Proposed Regulations' approach with respect to the pre-filing registration process and believe that the information required serves the policy of efficiently preventing fraud and abuse in the credit transfer market. Still, we recommend that Treasury allow for short-form re-registration each year for PTCs. In addition, we believe that the retention period for the minimum documentation could be clarified and, possibly, shortened. With respect to the grouping of facilities when making a transfer election, we recommend allowing grouping of facilities, as certain types of property are modular, with many identical "facilities" being placed in a particular area. We would not require grouping, however, and instead recommend allowing taxpayers flexibility, given that different facilities subject to the same credit may carry different risks related to recapture and excessive credit transfers that taxpayers may wish to diversify.

3. Discussion

We generally agree with the Proposed Regulations about the pre-filing registration process and believe that the information required serves the policy of efficiently preventing fraud and abuse in the credit transfer market. We recommend that Treasury allow for short-form re-registration each year for PTCs. The information is unlikely to change significantly from year to year during the PTC period and allowing short-form re-registration would advance the goals of minimizing differences between the ITC, which does not require annual re-registration, and the PTC, and of minimizing differences between transferring credits and tax equity, which does not require registration at all.

The Proposed Regulations also provide that additional information with respect to the transfer is required to be memorialized in a transfer election statement.[115] Both the eligible taxpayer and the transferee taxpayer must attach a transfer election statement to their respective

[114] Prop. Treas. Reg. § 1.6418–2(b)(5).

[115] Prop. Treas. Reg. § 1.6148-2.

return. It may be an existing document between the parties, such as a purchase and sale agreement, but must meet certain requirements. It must be labeled, "Transfer Election Statement."

Additionally, the eligible taxpayer must make a statement that it has provided "minimum documentation" to the transferee taxpayer. Minimum documentation includes (i) information that validates the existence of the eligible credit property; (ii) substantiation for bonus credits claimed; (iii) evidence of qualifying costs for ITCs; and (iv) evidence of qualifying production activities and sales amounts for PTCs. The transferee taxpayer must retain the required minimum documentation provided by the eligible taxpayer as long as the contents thereof "may become material in the administration of any internal revenue law."[116]

We recommend that the retention period for the minimum documentation be clarified and, possibly, shortened. Although the general statute of limitations is three years, the statute of limitations can be tolled indefinitely for fraud and abuse. This means the contents of the minimum documentation could "become material in the administration of any internal revenue law" for an indefinite amount of time. Rather than requiring the transferee taxpayer to keep the minimum documentation indefinitely, we recommend a rule that the transferee taxpayer be required to keep the documentation for: (i) in the case of ITCs, the duration of recapture (5 years), or in the case of PTCs, the duration of the PTCs (which can be 5, 10 or 12 years depending on the specific credit) plus (ii) an additional 3 years from the filing date of the last relevant tax return for the standard statute of limitations. This would limit the maximum length of time the transferee taxpayer would need to maintain the documents to 15 years.

Alternatively, or in addition, the IRS could require the eligible taxpayer to file the minimum documentation with the IRS during the transfer election process, such that the IRS could maintain the documentation for as long as it deems it may be relevant to the administration of any internal revenue law. We believe that these recommendations further the policy goals of keeping the transfer election process in line with tax equity investments by keeping the process streamlined and allowing the IRS to efficiently police fraud and abuse.

Treasury also requested comments regarding whether to allow grouping of facilities when making the transfer election. We believe that grouping should be permitted but not required. Certain types of property are modular, with many essentially identical "facilities" being placed in a particular area. Allowing these facilities to be grouped together could lower the administrative burden of registration for taxpayers. We would restrict the grouping, however, to facilities of the same type and function, generally segregated by the specific Code subsection that describes the facility. As discussed in the March Report, one of the primary goals of the IRA is to deploy as many renewable projects as possible, and the lowering the administrative hurdle of registering for credits would help facilitate faster investment and development in renewable projects. Allowing for a grouping election would also advance the policy goal of minimizing the differences between transferring tax credits and tax equity investments, where one tax equity partnership can allocate credits from multiple eligible facilities.

Different facilities, subject to the same credit, may have different risks related to recapture and excessive credit transfers. Purchasers of credits will want to be able to diversify the risks of

[116] Prop. Treas. Reg. § 1.6148-2(b)(5)(v).

recapture and excessive credit transfers, and the credit transfer market should allow for this diversification. Thus, we believe grouping should be elective and not mandatory.

H. Excessive Credit Transfers

1. Questions Arising Under Section 6418(g)(2) and the Proposed Regulations

Under Section 6418(g)(2)(A), any portion of a transferred credit that is determined to be an "excessive credit transfer" results in additional tax for the transferee taxpayer in the year of such determination, in an amount equal to the sum of (i) the amount of the excessive credit transfer plus (ii) an additional 20% of the excessive credit transfer (a penalty amount). The additional 20% amount does not apply if the transferee taxpayer can demonstrate that the excessive credit transfer resulted from "reasonable cause."[117] An excessive credit transfer is defined as an amount, with respect to an eligible credit property for which a transfer election is made, equal to the excess of (i) the amount of the transferred specified credit portion claimed by the transferee taxpayer with respect to the eligible credit property for the taxable year, over (ii) the amount of the eligible credit that, without the application of Section 6418, would otherwise be an allowable credit under the Code with respect to such eligible credit property.[118]

As discussed above, Section 6418(b) generally excludes from gross income and disallows deductions for "any amount paid by a transferee taxpayer to an eligible taxpayer as consideration for a transfer" of an eligible credit. The Proposed Regulations limit the application of the gross income exclusion and non-deductibility rules to amounts paid by a transferee taxpayer to an eligible taxpayer that are (i) paid in cash; (ii) relate directly to a specified credit portion; and (iii) are not excessive credit transfers.[119]

Although the Proposed Regulations make clear that payments made by a transferee taxpayer to an eligible taxpayer that directly relate to an excessive credit transfer are not subject to the income exclusion rule of Section 6418(b)(2), they leave open a number of questions relating to the tax treatment of such payments.[120] For one, although the Proposed Regulations state that such payments are not excluded from the income of the eligible taxpayer, they do not explicitly state that the payments are includable in income. The Proposed Regulations also do not address the discount paid by the transferee taxpayer in the event of an excessive transfer or the treatment of indemnification payments received by a transferee taxpayer in respect of excessive credit transfers. We believe regulations should more explicitly address the timing and character of the payments made between an eligible taxpayer and a transferee taxpayer in cases of excessive credit transfers.

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[117] § 6418(g)(2)(B).

[118] § 6418(g)(2)(C); Prop. Treas. Reg. § 1.6418-5(b).

[119] Prop. Treas. Reg. § 1.6418-2(e).

[120] Prop. Treas. Reg. § 1.6418-5(a)(3).

The following examples illustrate the questions left unresolved by the Proposed Regulations:

> **Example 5. *Excessive Credit Transfer with No Risk Protection***. In Year 1, Taxpayer A takes the position that is has placed into service a qualified solar facility eligible for ITCs at a 50% rate under Section 48. Taxpayer A believes the project has generated $50 of ITCs and enters into an agreement with Taxpayer B to transfer all $50 of the ITCs to Taxpayer B in exchange for $45. The parties do not contract for, or otherwise obtain, risk protection for the unavailability of ITCs or the potential penalties.
>
> In Year 3, the IRS determines that the project was not placed in service in Year 1, so no Year 1 credits were available for the project. The IRS characterizes the full $50 as an excessive credit transfer and assesses a penalty of $10 on Taxpayer B. Taxpayer B pays $60 to the IRS in Year 3.
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> **Example 6. *Excessive Credit Transfer with Indemnification***. Same facts as Example 5, except Taxpayer A agrees to indemnify Taxpayer B for all losses associated with the unavailability of ITCs with respect to the project, including interest and penalties arising from recapture and excessive credit transfers. In Year 3, Taxpayer A pays $60 to Taxpayer B in indemnification payments, consisting of $50 for the excessive credit transfer and $10 in penalties.
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> **Example 7. *Excessive Credit Transfer with Insurance***. Same facts as Example 5, but Taxpayer A purchases a $5 insurance policy that protects Taxpayer B from losses related to the unavailability of the ITCs, including interest and penalties arising from recapture and excessive credit transfers. In Year 3, Taxpayer B receives $60 in insurance proceeds in respect of its ITC losses.

The examples raise a number of questions with respect to both Taxpayer A and Taxpayer B.

Taxpayer A:

- How should Taxpayer A treat the amount it originally received from Taxpayer B for the later-disallowed credits? Should Taxpayer A realize taxable income equal to the amount of the original payment made by Taxpayer B? If so, what should the timing and character of that income be?
- How should Taxpayer A treat any indemnification payment it makes to Taxpayer B? If Taxpayer A makes an indemnification payment to Taxpayer B that exceeds the amount it originally received for the ITCs, should the two payments be netted against each other so that Taxpayer A has a loss? Or should Taxpayer A be treated as repaying a loan made to it by Taxpayer B?
- How should Taxpayer A treat the insurance premiums?

Taxpayer B:

- How should Taxpayer B treat the amount originally paid to Taxpayer A? Should Taxpayer B treat the amount originally paid to Taxpayer A as a non-capital, non-deductible expense, even though the payment was made for an excessive credit transfer? If not, should the payment be a deductible expense, a capital loss, a capitalized expense, or something else?
- How should Taxpayer B treat the indemnification payment received from Taxpayer A?
- How should Taxpayer B treat the insurance proceeds?

We believe Treasury should include rules addressing these questions. In conducting the analysis and making the recommendations that follow, we are guided by the following principles: (i) eligible taxpayers and transferee taxpayers should be afforded reciprocal treatment wherever possible; (ii) the tax treatment should follow the economic reality of the transaction; (iii) where possible, the rules should avoid unnecessary distortion to the tax credit market and minimize the discount on transferred credits; (iv) the rules should be administratively efficient for both taxpayers and the IRS; (v) the rules should seek to apply generally applicable tax principles rather than create special exceptions; and (vi) opportunities for fraud and abuse should be minimized.

2. Recommendations

We recommend that income received by an eligible taxpayer in respect of an excessive credit transfer should be taxable as ordinary income recognized in the year of the excessive credit determination, and that any corresponding indemnity payment should be an ordinary deduction except to the extent it represents a reimbursement of penalties paid to the IRS by the transferee taxpayer.

With respect to the transferee taxpayer, we recommend that amounts originally paid as consideration by a transferee in respect of an excessive credit transfer should be deductible as an ordinary business expense in the year of the excessive credit determination, and that any corresponding indemnity or insurance payment received be included as ordinary income in the year the "all events" test is satisfied (if the transferee taxpayer uses the accrual method) or in the year of payment (if the transferee taxpayer uses the cash method).[121]

In the case of an excessive credit transferee taxpayer where there are multiple transferees, we generally agree with the approach taken in the Proposed Regulations, which would disallow the portion of a credit retained by the eligible taxpayer and treat all transferees as a single taxpayer for purposes of determining the amount of the excessive transfer, because it encourages informed decisionmakers with "skin in the game" to diligence projects and allows the IRS to piggyback on those judgments. Such an approach advances the policy goal of efficiently policing potential fraud and abuse that we discussed in the March Report.[122] However, we recommend a rule allowing an election by an eligible taxpayer to choose the order in which transferred credits will be treated as excessive credit transfers.

[121] Treas. Reg. § 1.451-1(a).

[122] March Report at Part III.A.2.

3. Discussion

i. Treatment of the Eligible Taxpayer

We recommend that Treasury adopt a rule stating payments received by an eligible taxpayer that are related to an excessive credit transfer be included in the eligible taxpayer's gross income because this treatment most closely follows the economic reality of the transaction. In the absence of the income exclusion rule under Section 6418(b)(2), cash consideration received in exchange for credits would be an "undeniable accession to wealth, clearly realized" and includable as gross income under Section 61.[123] When an excessive credit transfer determination is made, those payments are no longer eligible for the income exclusion rule and should thus once again be includible in gross income.

In Example 5, Taxpayer A in Year 1 received $45 of consideration excluded from income in exchange for transferring $50 of ITCs. In Year 3, when the credits are determined not to exist, the economic reality of the situation is then that Taxpayer A had received $45 not related to a transfer of credits. Taxpayer A should be required to include the $45 in its gross income.

If payments related to excessive credit transfers are treated as income, the next question is whether the income should be recognized in the year of the transfer (Year 1 in the examples above) or in the year of determination of excessive credit transfer (Year 3 in the examples above).

We recommend a rule requiring any income from an excessive credit transfer to be recognized in the year the excessive credit determination is made, rather than in the year the credit is transferred. This approach has several benefits. First, it mirrors the statutory treatment of the transferee taxpayer. The tax imposed on the transferee taxpayer with respect to the excessive credit transfer is imposed in the year of such determination. In Example 5, Taxpayer B should have paid $50 to the IRS in taxes in Year 1, but instead paid Taxpayer A $45. In Year 3, when the excessive credit transfer was determined, Taxpayer B paid an amount representing its $50 Year 1 tax liability plus an additional $10 penalty. The same timing considerations should apply to Taxpayer A, which received the $45 in Year 1 for transferring excessive credits and should be required to include the $45 in income when the excessive credit transfer was determined. Conceptually, the two tax events, the tax on the transferee taxpayer and the income inclusion for the eligible taxpayer, stem from the same underlying event, the transfer of excessive credits. For this reason, we believe that the income recognition should occur in the same taxable year. By statute, the tax on the transferee taxpayer is imposed in the year of determination, so the eligible taxpayer should have reciprocal treatment.

Additionally, requiring income recognition in the year of an excessive credit determination is easier to administer than the alternative, for both the IRS and taxpayers, because it does not require eligible taxpayers to file amended returns or hold open the statute of limitations until a final determination about credit availability can be made. In practice, it is also likely that causing eligible taxpayers to file amended returns often would not result in taxable income in the year excessive credit transfers occur. Many credits are earned by developers that do not have significant

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[123] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

taxable income. If they did, they would use their tax credits against their income rather than transferring them under Section 6418.

We acknowledge this approach would separate the year in which an eligible taxpayer recognizes income from the year in which it received the corresponding economic benefit, especially if the eligible taxpayer is not under a contractual obligation to indemnify the transferee taxpayer. We also recognize this amounts to a timing benefit in favor of the eligible taxpayer, which has use of the payment in the year of the credit transfer but no corresponding income until the year of the excessive credit transfer determination. Because interest on underpayment of taxes begins to accrue when the tax is due under Section 6601, this timing benefit would also mean that interest on excessive transfers would begin to accrue in the year of excessive credit determination, rather than the year of transfer. However, we believe that the additional 20% penalty imposed on excessive credit transfers is an administratively easier way to deter fraud and abuse than requiring amended returns and interest on underpayment of tax, and this potential drawback is outweighed by the advantages discussed above.

We believe income recognized in respect of an excessive credit transfer should be ordinary in character. In most cases, the underlying eligible property would not be a capital asset to the eligible taxpayer under Section 1221(a)(2), which excludes depreciable property used in its trade or business from the definition of capital asset. Such income recognized with respect to non-capital property should not be capital in nature.

We understand that there may be arguments in favor of treating any income recognized as capital in the case of excessive ITC transfers. However, for purposes of the ITC, qualified property includes depreciable tangible personal property and certain other types of tangible property, substantially all of which would be Section 1231 property. Only in certain limited circumstances is gain recognized on the disposition of such property capital, subject first to any recapture of depreciation deductions. Additionally, in the unusual cases where qualified property is a capital asset, ITCs taken reduce the basis of the property by 50% of the amount of ITC taken, and adjustments to the basis of capital assets are capital in nature.[124]

These arguments do not hold for PTCs. PTCs are not calculated based on the basis in a capital asset, but rather as a fixed amount per kilowatt hour of energy or per unit of manufactured item produced or sold. Income from the sale of electricity is ordinary income, as is income from the sale of photovoltaic cells or battery modules.

We believe that PTCs and ITCs should receive the same treatment in this context. Historically, PTCs and ITCs were subject to different rules and eligibility requirements, but many of the changes the IRA made to Sections 45 and 48 were designed to bring these two types of credits into greater parity.[125] In addition, treating income in respect of excessive ITCs as capital and in respect of excessive PTCs as ordinary could influence the choice between energy projects, a result unintended by the IRA.

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[124] § 50(c)(3)(A).

[125] One example of this is the reinstatement of the solar PTC under § 45(c)(1)(E).

We also believe that if, for the reasons discussed in Part IV.D above, Taxpayer A was denied a deduction for expenses it incurred to transfer excessive credits in Year 1, then Taxpayer A should be entitled to deduct those expenses in Year 3 under Section 162(a), to the extent the requirements of that provision are met. The timing of the deduction should match the timing of Taxpayer A's $45 income inclusion.

Indemnification payments made by an eligible taxpayer to a transferee taxpayer in respect of excessive credit transfers are not payments made "as consideration for a transfer," and are, therefore, not subject to the rules of non-deductibility.[126] We recommend that Treasury adopt a rule allowing an indemnification payment made with respect to the amount of excessive credit transfer to be deductible as an ordinary business expenses under Section 162(a), in the year that the liability to make the payment is taken into account under Section 461 (assuming the eligible taxpayer uses the accrual method). This treatment accords with general tax principles and tracks the economic reality of the payments.

In Example 6, Taxpayer A made an indemnification payment of $60 to Taxpayer B in Year 3. Economically, Taxpayer A received $45 from Taxpayer B in Year 1 and paid $60 to Taxpayer B in Year 3, for a net outflow of $15. If, as discussed above, Taxpayer A recognizes $45 of ordinary income in Year 3, and Taxpayer A deducts $50 (the excessive credit) as an ordinary expense, then Taxpayer A will be left with a net deduction of $5. Allowing a deduction for the payment to offset the $45 in income mirrors the cash outlays made by Taxpayer A.

The next question is the treatment of the $10 indemnification payment made with respect to the 20% penalty. Penalties are not generally deductible under Section 162(f), and we do not believe they should be deductible in this context. Although an indemnification payment from an eligible taxpayer to a transferee taxpayer is not a direct penalty payment under Section 6418, it is a stand-in for this penalty.[127] Allowing the indemnification payment to be deductible would also mean that the 20% excess payment effectively would be a 15.8% penalty for corporate eligible taxpayers, and even lower for individual eligible taxpayers.[128] This would defeat or reduce the deterrence effect of the 20% penalty.

There is an argument that in Example 6, Taxpayer B advanced Taxpayer A $45 in Year 1 and was repaid $60 in Year 3, and the appropriate characterization of this transaction is a loan. We do not believe it would be appropriate to treat a payment by a transferee taxpayer to an eligible taxpayer followed by a later payment by the eligible taxpayer to the transferee taxpayer as a loan, even though the transferee taxpayer would be advancing amounts to the eligible taxpayer that are later returned with an additional amount. The main reason for this is that there is no certainty that repayment will occur; repayment would happen only upon an excessive credit transfer pursuant to which the parties agreed to an indemnification obligation. Loan treatment

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[126] § 6418(b).

[127] *See Central Coat, Apron & Linen Serv., Inc. v. U.S.*, 298 F. Supp. 1201 (S.D.N.Y. 1969) (disallowing on public policy grounds a corporation's business deduction for an indemnification payment made to an officer in respect of an antitrust fine).

[128] (1 – 21%) x 20%.

would also be administratively burdensome, given that the transactions would by their nature involve original issue discount and contingent payments.

ii. Treatment of the Transferee Taxpayer

In general, amounts paid by the transferee taxpayer "in connection with a transfer election with respect to a specific credit portion" are not deductible to the transferee taxpayer.[129] However, because payments related to an excessive credit transfer are not considered to be made "in connection with a transfer election with respect to a specified credit portion," such payments do not fall under the general non-deductibility rule.[130] It is not entirely clear how these payments should be treated under general tax principles because they are not clearly an "ordinary and necessary" business expense under Section 162, nor are they clearly a loss under Section 165.

Section 6418(h) grants Treasury the broad authority to "issue such regulations or other guidance as may be necessary to carry out the purposes of this section." It will be necessary to determine how payments made with respect to excessive credit transfers will be treated to the transferee taxpayer. We recommend that Treasury exercise its regulatory authority granted by the statute to explicitly allow amounts paid by transferee taxpayers for credits that are later determined to be excessive credit transfers to be deductible as an ordinary business expense under Section 162 in the year that the excessive credit transfer determination is made.

Ordinary deduction treatment in the year of an excessive credit transfer determination accords with the policy goal of reciprocal tax treatment for eligible taxpayers and transferee taxpayers that are parties to the same transaction. If, as described above, the eligible taxpayer would include the amount of the excessive transfer payment as ordinary income, the same amount should be allowed to the transferee taxpayer as a deduction in the same year as the income inclusion. In Example 5, Taxpayer B paid $45 to Taxpayer A in exchange for $50 of tax credits in Year 1. In Year 3, an excessive credit transfer is determined, and Taxpayer B must pay $50 and an additional $10 penalty to the IRS. Taxpayer B has paid $45 dollars for disallowed tax credits, and the payment is included in the gross income of Taxpayer A in Year 3. Taxpayer B should be allowed to take a deduction for that same amount in Year 3 to match the income inclusion.

Allowing a deduction would also further the policy goal of minimizing the discount on the transferred credits, which promotes the legislative intent of encouraging investment in clean energy projects.

In addition, if Taxpayer B incurred expenses to acquire excessive credits and was denied a deduction for those expenses in Year 1 for the reasons discussed in Part IV.D above, then Taxpayer B should be entitled to deduct those expenses in Year 3 under Section 162(a) to the extent the requirements of that provision are met.

As discussed above, indemnification payments made to a transferee taxpayer by an eligible taxpayer in respect of excessive credit transfers are not payments made "in connection with a

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[129] Prop. Treas. Reg. § 1.6418-2(e)(3).

[130] Prop. Treas. Reg. § 1.6418-2(e)(1).

transfer election," and are therefore not subject to the rule of exclusion from income.[131] We recommend that the treatment of indemnification and insurance payments be governed by general income tax principles. In general, business expenses cannot be deducted under Section 162(a) where the taxpayer pays the expense but has a right to reimbursement from another person for that expense. In accord with general Federal income tax principles, the payments made by the transferee taxpayer with respect to excessive credit transfers should be deductible only to the extent they exceed the amount for which there is a claim of reimbursement with a reasonable prospect of recovery.[132] If the eligible taxpayer deducts the payment as an expense but in a subsequent taxable year receives reimbursement for the expense, then the eligible taxpayer should include the amount of the reimbursement in income for the taxable year in which it was received.[133] Any amount of indemnification or insurance reimbursement that exceeds the payment with respect of excessive credit transfer should be included in income.

Offsetting the indemnification or insurance payment against the amount of payment and including the excess in income follows the economic substance of the transactions. In Example 6, Taxpayer B paid $45 in Year 1 to Taxpayer A, $50 of taxes to the IRS in Year 3, and $10 of penalty to the IRS in Year 3, for a total payment of $105. Taxpayer B then received $60 from Taxpayer A in Year 3. Disregarding the $10 penalty and the $50 of taxes Taxpayer B already would have been obligated to pay in Year 1 in the absence of the credit transfer, Taxpayer B's net cash inflow was the difference between $60 and $45, or $15. If the $45 original payment that would have been allowed as an ordinary deduction is offset against the $60 indemnification payment, and the remaining $15 by which the indemnification payment exceeds the deduction is included as ordinary income, then Taxpayer B would have $15 of net income, matching the $15 of net cash it received.

Additionally, if the indemnification payments are allowed to the eligible taxpayer as an ordinary deduction, inclusion in income of the transferee taxpayer would match the treatment for the eligible taxpayer. Where the eligible taxpayer in Example 6 has a deduction of $5 (with $10 of deduction disallowed as a penalty), the transferee taxpayer has a corresponding $15 of income.

Assuming our recommendation in Part IV.D is accepted, the treatment of insurance premium payments should generally mirror that of other expenses incurred in connection with a transfer of credits. Thus, prior to the determination that an excessive credit transfer has occurred, the premiums ought to be treated as nondeductible expenses in the year the premiums are paid. When an excessive credit transfer has been determined, the premiums that have previously been paid by the eligible taxpayer or transferee taxpayer should reduce any income that is recognized by that taxpayer in respect of the excessive credit transfer in the year the determination is made. In addition, if our recommendations in this Part IV.H are accepted, then insurance proceeds received, like indemnification payments, should be treated as ordinary income.

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[131] *Id.*

[132] *See* Treas. Reg. § 1.165-1(d)(2).

[133] *Id.*

iii. Excessive Credit Transfers: Multiple Transferees

Section 6418 allows an eligible taxpayer to separate the credits generated by a single property into multiple portions and transfer the portions to different transferee taxpayers.[134] As discussed above, an excessive credit transfer occurs if an eligible taxpayer transfers more credit portions than are available for a particular property. When an excessive credit transfer occurs in the context of a credit that has been separated into multiple portions, a question arises as to which portions represent the amount of excessive credit transfer and which do not. The Proposed Regulations address this question by first disallowing the portion of a credit retained by the eligible transferee and then treating all transferees as a single taxpayer for purposes of determining the amount of the excessive transfer.[135] Excessive credit transfers are allocated to each transferee taxpayer based on its relative proportion of the transferred credits, for each eligible credit property.

The following examples illustrate the rules in the Proposed Regulations:

> **Example 8. *No Excessive Transfer***. In Year 1, Taxpayer A placed into service a qualified solar facility eligible for the 30% ITC. Taxpayer A had a $100 basis in eligible property, which afforded Taxpayer A $30 of ITCs. Taxpayer A had the choice to split the $30 of ITCs into multiple portions to retain or transfer to different taxpayers under Section 6418(a). Taxpayer A transferred $10 of ITCs to Taxpayer B, $10 of ITCs to Taxpayer C, and kept $10 of ITCs to offset its own tax liability.
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> If, in Year 3, the IRS determined that Taxpayer A's solar facility was eligible for only $20 of ITCs, either because its basis was only $67 or because the project failed to meet all of the requirements to achieve the 30% energy percentage under Section 48, no excessive transfer would have occurred under the Proposed Regulations because the amount of available ITCs for the project was equal to the amount of ITCs Taxpayer A transferred, which was $20 to Taxpayer B and Taxpayer C.
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> **Example 9. *Excessive Transfer to Multiple Transferees***. As in Example 8, Taxpayer A retained $10 of ITCs and transferred $10 of ITCs to each of Taxpayer B and Taxpayer C, but the IRS later determined that the solar facility had generated only $10 of ITCs. As a result, an excessive transfer of $5 would have occurred with respect to each of Taxpayer B and Taxpayer C.[136]

We generally agree with the approach taken in the Proposed Regulations because it encourages informed decisionmakers with "skin in the game" to diligence projects and allows the IRS to piggyback on those judgments, which advances the policy goal of efficiently policing potential fraud and abuse that we discussed in the March Report.[137] But we recommend a rule

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[134] § 6418(a); Prop. Treas. Reg. § 1.6418-2(a)(2).

[135] Prop. Treas. Reg. § 1.6418-5(b).

[136] See Prop. Treas. Reg. § 1.6418-5(b)(3), Ex. 1 – 3.

[137] March Report at Section III.A.2.

allowing an election by an eligible taxpayer to choose the order in which transferred credits will be treated as excessive credit transfers.

Under our proposed rule, in Example 8 above, Taxpayer A could make an election to treat all of Taxpayer B's $10 of transferred ITCs as being treated as excessive credit transfers first, prior to any of Taxpayer C's being considered as excessive credit transfers. This would allow Taxpayer A to seek a higher price for the ITCs transferred to Taxpayer C than the credits transferred to Taxpayer B because it would also allow Taxpayer C increased comfort about the likelihood of its credits being respected. It would also potentially ease the burden of negotiating indemnity arrangements with transferees because certain transferees may be willing to accept the risk of excess credit transfers more than others.

Giving eligible taxpayers and their transferee taxpayers the choice to determine the order in which excess credits will be treated as excessive credit transfers would allow for a greater diversity in the risk profiles of transferable credits, which in turn would allow a broader pool of investors with more diverse risk tolerances to enter into the market for tax credits. Drawing a broader pool of investors would create more liquidity in the tax credit market, thus furthering the policy goals described above and minimizing the discount on credit transfers.

Allowing this flexibility to eligible taxpayers and their transferees also would further the policy goal of achieving greater parity between the choice to transfer credits or pursue the traditional route of tax equity. Traditional tax equity investments are made through partnerships, which allow significant flexibility for allocating credits and addressing the unexpected unavailability of credits. An excessive credit transfer ordering election like the one described above would bring the credit transfer regime more in line with the flexibility of allocations of credits in tax equity partnerships. It would also potentially facilitate a sale of all or substantially all of the credits, rather than incentivizing the eligible taxpayer to retain a certain amount of credits as "cushion" to avoid the sale of excessive credits. From the perspective of Taxpayers B and C in the example, having Taxpayer A retain some credits may make it more likely that they avoid an excessive credit situation. An election to have Taxpayer B be the first transferor exposed to such risk would put Taxpayer C into a similar position.

I. REIT Issues

The Preamble notes that the Proposed Regulations do not specifically address whether credits which have not yet been transferred qualify as a REIT asset.[138] Instead, the Preamble notes that with the "paid in cash" requirement and timing of sale requirements in the Proposed Regulations, REITs should be able to manage issues with respect to the asset test. Nevertheless, the Preamble requests comments on whether the Proposed Regulations provide sufficient guidance.

We believe that the Proposed Regulations would benefit from addressing the treatment of credits for purposes of the REIT asset test. Tax credits are not the usual type of asset that can be easily classified as real estate. Rather, in essence, such "assets" are effectively a government subsidy to encourage taxpayers to engage in a specific activity. In that regard, the energy credits

[138] 88 Fed. Reg. at 40509.

are essentially the same as the state tax credits addressed in PLR 200916014, which held that the rights to the credits were disregarded for the purposes of the REIT asset test. That PLR involved state credits offered to encourage development of environmentally contaminated real estate. We believe that a similar approach is applicable to those energy credits that are related to real estate assets. Accordingly, we believe that Treasury should consider explicitly stating that such credits will be disregarded in determining whether a REIT satisfies the asset test.