SEPTEMBER 2024
VOL. 24-8

PRATT'S ENERGY LAW REPORT

LexisNexis

Pratt's Energy Law Report

VOLUME 24 **NUMBER 8** **September 2024**

LexisNexis®

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ISBN: 978-1-6328-0836-3 (print)
ISBN: 978-1-6328-0837-0 (ebook)
ISSN: 2374-3395 (print)
ISSN: 2374-3409 (online)

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S ENERGY LAW REPORT [page number] (LexisNexis A.S. Pratt);

Ian Coles, *Rare Earth Elements: Deep Sea Mining and the Law of the Sea*, 14 PRATT'S ENERGY LAW REPORT 4 (LexisNexis A.S. Pratt)

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(2024–Pub.1898)

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Pratt's Energy Law Report is published 10 times a year by Matthew Bender & Company, Inc.

POSTMASTER: Send address changes to *Pratt's Energy Law Report*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

Federal Government Releases Direct Pay Guidance on Clean Energy Tax Credits

By Mary Burke Baker, Michael W. Evans, Martha G. Pugh, Charles H. Purcell, Rebecca J. Kim and France Beard Johnson*

In this article, the authors review recently released federal regulations detailing how certain entities can use a new funding mechanism that allows a direct payment from the Internal Revenue Service for certain clean energy tax credits.

The Department of Treasury (Treasury) and the Internal Revenue Service (IRS) recently released regulations detailing how applicable entities (AEs) and electing entities (EEs) can utilize a new funding mechanism that allows a direct payment from the IRS for certain clean energy tax credits. These rules, enacted in the Inflation Reduction Act (IRA),[1] are intended to encourage and facilitate the use of "direct pay" by tax-exempt and taxable entities developing clean energy infrastructure projects as an alternative to traditional financing structures.

Three sets of regulations were released. These include final regulations for the direct pay election, also known as "elective pay" and informally as "direct pay," under Section 6417 of the US Internal Revenue Code of 1986 (Code), as amended (6417 Final Regulations), and 48D of the Code (48D Final Regulations and together with the 6417 Final Regulations, the Direct Pay Final Regulations).[2]

Simultaneously, the Treasury and IRS also released proposed regulations (761 Proposed Regulations) that modify Section 761 with respect to certain unincorporated organizations, allowing them to opt-out of partnership status.[3] These rules are critical for clean energy project developers advancing projects under the IRA, as parties must understand the impacts on project financing and tax credits.

WHAT IS DIRECT PAY?

The elective pay mechanism is often called direct pay because that aptly describes what it is – a payment directly from the IRS in the full amount of a

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[1] Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818 (August 16, 2022).

[2] All "Section" or "§" references herein are to the Code, unless indicated otherwise.

[3] Prop. Treas. Reg. § 1.761-2, 89 Fed. Reg. 17613 (Mar. 5, 2024).

tax credit on eligible facilities or property owned by an AE (in the case of Section 6417) or an EE (in the case of Sections 6417 and 48D).[4]

AEs are tax-exempt or tax-indifferent organizations, and EEs are taxable businesses.[5] While AEs generally are not required to file an income tax return, the rules provide guidelines for them to file a tax return with the IRS solely for purposes of claiming a tax credit through direct pay. Both AEs and EEs are required to preregister annually with the IRS before claiming the credit.[6]

WHY ARE THESE RULES IMPORTANT?

This set of regulations answers many questions that remained after the release of the corresponding proposed regulations last year. The Direct Pay Final Regulations provide more certainty for AEs and EEs as they consider whether to elect direct pay in lieu of other financing options.

Importantly, the 761 Proposed Regulations provide a useful workaround to the general prohibition in Section 6417 which denies partnerships from making an election for direct pay. This is achieved by allowing AEs to own a clean energy generation facility through an unincorporated organization providing limited liability to owners, like a limited liability company, that has "opted out" of partnership status and allowing these AEs to enter into long-term power sales agreements.[7] Under the prior regulation, the owners of the facility had to hold the facility as co-owners and could not enter into a power sales agreement with a term of more than a year. This arrangement will give AEs, who may not have the internal expertise or experience in launching a clean energy facility, the ability to effectively partner with a taxable investor that does have those skills.

FINAL REGULATIONS ON DIRECT PAY UNDER SECTION 6417

An election to claim direct pay under Section 6417 is a new way to help AEs and EEs finance clean energy projects and equipment. AEs, such as states, local governments, nonprofits, tribal entities, Alaska Native corporations, the Tennessee Valley Authority, rural electric cooperatives, and United States territories (and their political subdivisions), may elect to treat certain tax credits as a payment against U.S. federal income tax, which would potentially turn the applicable tax credit into a cash payment from the government.[8] In other

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[4] See generally I.R.C. § 6417.

[5] Treas. Reg. § 1.6417-1(d); Treas. Reg. § 1.6417-1(g).

[6] See Treas. Reg. §1.6417-5; Treas. Reg. §1.48D-6(b).

[7] See generally Prop. Treas. Reg. § 1.761-2, 89 Fed. Reg. 17613 (Mar. 5, 2024).

[8] Treas. Reg. § 1.6417-1(c).

words, this election makes the applicable tax credits "refundable."[9] AEs may take direct pay in the year the property is placed in service for investment tax credits (ITCs) and for the full duration of the production tax credits. The eligible tax credits for AEs under Section 6417 include:

- Section 30C (alternative fuel vehicle refueling property credit);
- Section 45 (renewable electricity production tax credit);
- Section 45Q (credit for carbon oxide sequestration);
- Section 45U (zero-emission nuclear power production credit);
- Section 45V (credit for production of clean hydrogen);
- Section 45W (credit for commercial clean vehicle);
- Section 45X (advanced manufacturing production credit);
- Section 45Y (clean electricity production credit);
- Section 45Z (clean fuel production credit);
- Section 48 (energy ITC);
- Section 48C (qualifying advanced energy project credit); and
- Section 48E (clean electricity investment credit).[10]

Meanwhile, EEs are taxpayers, who are not AEs, who may elect direct pay for tax credits under Sections 45Q, 45V, and 45X for the first five years of production.[11] EEs can elect to transfer the credits under Section 6418 in later years when the five-year direct pay election is not in effect.[12]

As previously mentioned, the 6417 Final Regulations clarified and answered many technical and procedural questions that remained after the release of proposed regulations last year. For instance:

- *AEs and EEs must preregister their facilities or property with the IRS*.[13] Taxpayers are encouraged to pre-register at least 120 days prior to filing a tax return to claim direct pay, but they may not preregister until the facility or property is placed in service. Upon registering, entities will receive a registration number that must be reported on the tax return. Receiving a registration number does not ensure that the property is

[9] See generally I.R.C. § 6417.

[10] Treas. Reg. § 1.6417-1(d).

[11] Id. § 1.6417-3(e)(3).

[12] Id. § 1.6417-3(e)(4).

[13] See Treas. Reg. § 1.6417-5.

eligible for the tax credit being claimed and filers are still subject to potential examination by the IRS. The 6417 Final Regulation refers to Publication 5884, Inflation Reduction Act (IRA) and CHIPS Act of 2022 (CHIPS) Pre-Filing Registration Tool User Guide and Instructions for more information regarding the preregistration process.

- *"Chaining" is not allowed*. Chaining involves the transfer or sale of tax credits under Section 6418 to an AE or EE, which then would make a direct pay election. The proposed regulations on direct pay[14] explicitly indicated that chaining would be challenging to monitor and administer, and could be prone to fraud. As chaining has been a topic of debate since the IRA was passed, the preamble to the 6417 Final Regulations states that the Treasury will continue to evaluate whether chaining should be permitted only in limited circumstances.
- *The AE or the EE must own the underlying credit property and conduct the activities giving rise to the credit*.[15] However, the 6417 Final Regulations clarify that for purposes of the advanced manufacturing production tax credit under Section 45X the party eligible to claim the credit is the party allowed to claim direct pay. In the case of a contract manufacturing situation, this may be the contract manufacturer unless there is an agreement that the contracting party may claim the credit.
- *No excess-benefit rule*. When AEs receive grants, forgivable loans, and similar financial aid for developing or acquiring properties eligible under various ITC provisions, these financial amounts are incorporated into the property's basis for calculating the tax credit.[16] However, when these funding sources, combined with the tax credit, exceed the cost of the investment-related credit property, the allowable credit is reduced so total incentives do not exceed the total cost of the property.[17]
- *If the direct payment is larger than it should be, AEs and EEs must repay the excessive payment, plus 20%*.[18] The excessive payment will not apply to an AE or EE if the entity demonstrates to the satisfaction of the IRS that the excessive payment resulted from reasonable cause.[19]
- *No double benefit rule*. For EEs, the net direct pay credit amount is the

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[14] See Prop. Treas. Reg. § 1.6417–2(c)(4), 89 Fed. Reg. 17613 (Mar. 5, 2024).

[15] Treas. Reg. § 1.6417-2(c)(4).

[16] Id. § 1.6417-2(c)(3)(i).

[17] Id. § 1.6417-2(c)(3)(ii).

[18] Treas Reg. § 1.6417-6(a)(1).

[19] Id. § 1.6417-6(a)(2).

lesser of the sum of all credits eligible for direct pay or the excess of the eligible direct pay credits remaining after taking direct pay-eligible credits into account for purposes of the general business credit under Section 38, i.e., no double benefit is allowed.[20] The 6417 Final Regulations specify that the applicable credits must be reduced to zero as provided under Section 6417(e).[21]

- *Partnerships and S corporations cannot use direct pay, unless they are taxable entities using direct pay for Sections 45Q, 45V, and 45X.*[22]
- *The direct pay election is generally irrevocable. However, EEs can revoke the election and the revocation is irrevocable.*[23]
- *The direct pay election applies to the entire amount of the credit.*[24] As opposed to the transferability rules under Section 6418(a), which allows an eligible taxpayer to elect to transfer all (or any portion specified in the election) of an eligible credit, the direct pay election does not provide the flexibility to make an election equal to a portion of the applicable credit.
- *Direct pay will be made in one payment, not installments.*[25]
- *An AE or EE that owns a disregarded entity can use direct pay to claim a credit earned by the disregarded entity.*[26]
- *General basis reduction and credit recapture rules apply, when applicable.*[27]
- *AEs and EEs have an opportunity to correct errors on their original returns.*[28] Entities will be allowed to revise their direct pay claims, both reducing and increasing the amount of the claim. This allows corrections to errors that would result in a disallowance of the election or to prevent an excessive payment before an excessive payment determination is made by the IRS. Corrections must be to information already substantively reported and cannot be used to revoke or make a new direct pay claim.

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[20] Treas. Reg. § 1.6417-2(e).

[21] Id. § 1.6417-2(e)(1).

[22] Treas. Reg. § 1.6417-2(a)(1)(iv).

[23] Treas. Reg. § 1.6417-2(b)(4).

[24] Treas. Reg. § 1.6417-2(b)(5).

[25] Preamble to 6417 Final Regulations.

[26] Treas. Reg. § 1.6417-4(a).

[27] Treas. Reg. § 1.6417-6(b).

[28] Treas. Reg. § 1.6417-2(b)(1)(ii).

- *There is no restriction on how the proceeds of direct pay may be used.*

The 6417 Final Regulations are effective as of May 10, 2024, and apply to taxable years ending on or after March 11, 2024. Taxpayers may choose to apply the 6417 Final Regulations to earlier years so long as they adhere to the rules in their entirety.

FINAL REGULATIONS ON DIRECT PAY UNDER SECTION 48D

The 48D Final Regulations refine and clarify certain aspects of the proposed regulations implementing direct pay for the advanced manufacturing investment credit.[29] As described below, while the 48D Final Regulations are similar to the 6417 Final Regulations in many respects, they include some notable differences. The Section 48D direct pay is available only for taxable entities.

Unlike the 6417 Final Regulations, the 48D Final Regulations require taxpayers to include a statement on their original return, under the penalties of perjury, attesting that they are not a foreign entity of concern.[30]

Addressing challenges associated with partnership agreements, the final regulations have adopted an interim rule for the purposes of Section 48D. This rule allows for the determination of a partner's distributive share of tax-exempt income based on basic partnership income allocation principles under Section 704. This is a departure from traditional credit rules by allowing a partner's distributive share of tax-exempt income from a partnership receiving an elective payment to be determined according to the general income allocations of Section 704, rather than being tied direct to the partner's share of the Section 48D credit for each taxable year." According to this rule: (1) if a written binding partnership agreement was entered into after December 31, 2021, and before June 22, 2023, and (2) if the partnership was formed specifically for the purpose of owning and operating an advanced manufacturing facility or qualified property, then a partner's distributive share of tax-exempt income can be determined in accordance with the partnership income allocations.[31]

The 48D Final Regulations require taxpayers to obtain a registration number for each qualified investment and project in an advanced manufacturing facility.[32] This may entail an advanced manufacturing facility, or single and multiple properties within the facility. A taxpayer must be the owner of an advanced manufacturing facility to register the facility. A taxpayer that does not

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[29] E.g., Treas. Reg. § 1.48D-6(e).

[30] Treas. Reg. § 1.48D-6(c)(iv).

[31] Treas. Reg. § 1.48D-6(d)(2)(iv)(B).

[32] Treas. Reg. § 1.48D-6(b)(5).

own the facility but places in service qualified property that is part of an advanced manufacturing facility must register such qualified property.[33]

Common features between the 48D Final Regulations and the 6417 Final Regulations include imposition of the double benefit[34] and excessive payment rules,[35] the irrevocability of the Section 48D direct pay election,[36] the ability to correct errors through an amended tax return or request for administrative adjustment,[37] and the application of general basis reduction and credit recapture rules.[38] Like the 6417 Final Regulations, the Final 48D Regulations do not provide for partial credit payments or installment credit payments, and do not impose restrictions on the use of the refunded credit amount.

The 48D Final Regulations are effective as of May 10, 2024, and are applicable to taxable years ending on or after March 11, 2024.

PROPOSED REGULATIONS UNDER SECTION 761

In addition to the Direct Pay Final Regulations, Treasury and the IRS have issued 761 Proposed Regulations, which allow certain unincorporated organizations that are organized exclusively for producing electricity to be excluded from the application of partnership tax rules.

The revised rules allow a workaround from the general direct pay rules that prohibit a partnership from using direct pay.

The "old" Section 761 rules offered an opt-out provision for unincorporated organizations, enabling them to avoid the computation of partnership taxable income under certain conditions.[39] Eligibility for this opt out was contingent upon the organization's purpose, which had to include:

(1) Being formed for investment purposes only, not for the active conduct of a business

(2) Being established for the joint production, extraction, or use of property, without the intent to sell services or the property produced; and

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[33] Id.

[34] Treas. Reg. § 1.48D-6(e).

[35] Treas. Reg. § 1.48D-6(f).

[36] Treas. Reg. §1.48D-6(a)(3).

[37] Treas. Reg. § 1.48D-6(c)(2).

[38] Treas. Reg. §1.48D-6(g).

[39] I.R.C. § 761(a); see also Treas. Reg. § 1.761-2(a)(1).

(3) Functioning as dealers in securities under specific conditions for limited durations.[40]

Furthermore, participants had to:

(1) Directly own the property as co-owners;

(2) Retain the right to individually manage or dispose of their shares of the property; and

(3) Refrain from making joint sales of services or the produced property.[41]

However, the rules allowed each participant to delegate the authority to sell his or her share of the property produced or extracted, but limited the delegation to no more than one year.[42]

The "new" rules under the 761 Proposed Regulations aim to align better with the practices of the electricity industry and support projects undertaken by AEs. These revised regulations extend the opt-out eligibility to unincorporated organizations that meet four specific criteria:

(1) Ownership, either partial or full, by one or more AEs;

(2) The members' entry into a joint operating agreement that allows for separate management of shares;

(3) Exclusive organization for the joint production of electricity eligible for the Section 45, 45X, 45U, 45Y, or 48E tax credits; and

(4) An election by one or more entities for the direct pay of their share of the tax credit.[43]

Notably, the 761 Proposed Regulations exclude any entity classified as a syndicate, group, pool, or joint venture that is considered an association.[44] However, it should be noted that the ability of taxable entities that participate in transactions with AEs to claim credits may be limited.[45]

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[40] Id.

[41] Treas. Reg. § 1.761-2(a)(3).

[42] Id. § 1.761-2(a)(3)(iii).

[43] Prop. Treas. Reg. § 1.761-2(a)(4)(ii), 89 Fed. Reg. 17613 (Mar. 5, 2024).

[44] Id. § 1.761-2(a)(1).

[45] A footnote to the preamble of the Proposed Treasury Regulations under Section 761 states: "The Treasury Department and the IRS acknowledge that section 6418 does not contain a provision parallel to section 6417(d)(2) providing that section 50(b)(3) and (4)(A)(i) do not apply to limit the determination of a credit in section 6417. Thus, section 50(b)(3) and (4)(A)(i) may limit eligible ITC determined with respect to a partnership or S corporation with AE partners or shareholders for purposes of section 6418."

If the above requirements are met, ownership in an entity opting out of subchapter K can now be held through a noncorporate entity or partnership without necessitating direct ownership.[46] Furthermore, participants can now delegate authority to sell their share of the property produced under agreements exceeding one year, provided that the delegation itself does not exceed one year.[47] This adjustment facilitates the entry into long-term power purchase agreements while adhering to the one-year delegation limit.[48] The election process involves submitting a statement with the Form 1065 tax return, including details about each member and a collective opt-out election, which remains irrevocable unless the IRS approves a revocation.[49]

These 761 Proposed Regulations are applicable to elections for taxable years that end on or after March 11, 2024.

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[46] Prop. Treas. Reg. § 1.761-2(a)(4), 89 Fed. Reg. 17613 (Mar. 5, 2024).

[47] Id. § 1.761-2(a)(4)(iii)(B).

[48] See generally id.

[49] Prop. Treas. Reg. § 1.761-2(b)(2)(i), 89 Fed. Reg. 17613 (Mar. 5, 2024).