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SECTION 6417 FINAL AND SECTION 761 PROPOSED REGULATIONS

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OUR AGENDA TODAY

- Basics of elective, or direct, pay (Section 6417)
 - What it is
 - Who can use it
 - What you can use it for
 - How it works
 - How to claim it
- Significance to direct pay of proposed changes to Section 761 regulations
 - A work-around to the prohibition on partnerships claiming direct pay
 - Applies to clean electricity projects

BACKGROUND

- The Inflation Reduction Act includes a new mechanism to help fund clean energy projects
- Section 6417, Elective Payment of Applicable Credits (aka, Direct Pay)
- Treasury released direct pay final regulations on March 5
- Treasury also released proposed regulations modifying Section 761 regs to allow certain unincorporated organizations organized exclusively to produce electricity to elect out of partnership rules

WHAT IS DIRECT PAY?

- Direct pay allows tax exempt organizations (TEOs), called “applicable entities”, to receive a “refund” from the IRS of tax credits on eligible projects and property
- Direct pay allows taxable businesses, called “electing entities”, to claim refundable tax credits for 45Q, 45V, and 45X
- Direct pay is generally available for projects and property placed in service in taxable years beginning after December 31, 2022.

WHAT IS DIRECT PAY?

- Direct pay is a new way to help TEOs finance clean energy projects and equipment
- This is an alternative to traditional public-private partnership arrangements where TEOs partner with taxable investors who can use the tax credits, like tax equity structures
- Unlike PPPs, TEOs can receive 100% of the tax credits
- Direct pay is available for 12 types of clean energy tax credits

WHAT IS DIRECT PAY?

- Direct pay is also available to taxable entities for the carbon capture, hydrogen, and advanced manufacturing production tax credits
- These entities can receive the full amount of the tax credit in the year earned even if they don't have sufficient tax liabilities to use the full amount
- These “electing entities” can elect direct pay for up to 5 years
- The Section 6418 transferability of credits is available in lieu of direct pay, and after 5 years

WHO IS AN APPLICABLE ENTITY?

- Organizations exempt from taxes imposed under subtitle A of the Internal Revenue Code
- Any state, DC, or political subdivision thereof
- An Indian Tribal government or subdivision thereof
- Any Alaska Native Corporation
- The Tennessee Valley Authority
- Rural electric cooperatives
- Agencies or instrumentalities of certain applicable entities

WHAT TAX CREDITS CAN YOU USE DIRECT PAY FOR?

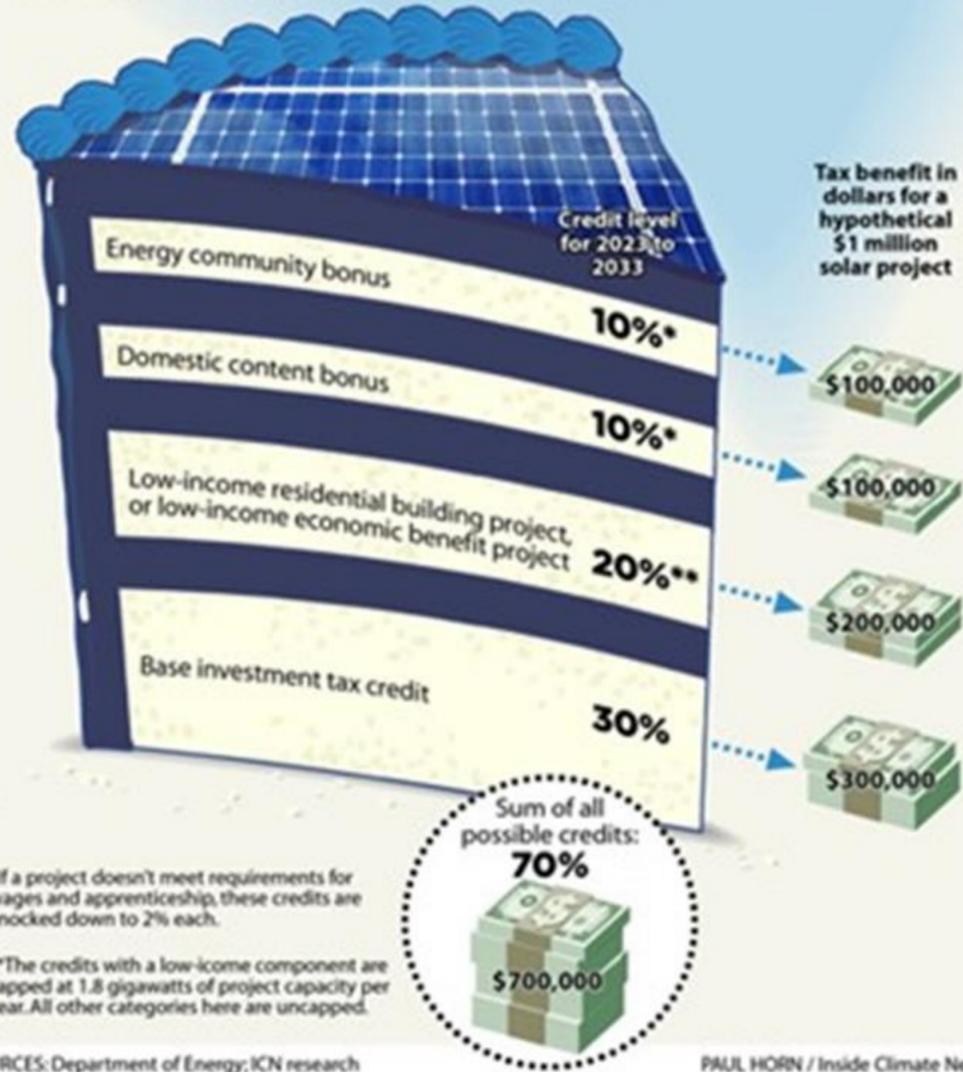
- 30C ITC (alternative fuel refueling property)
- 45 PTC (clean electricity)
- **45Q PTC (carbon capture)**
- 45U PTC (nuclear)
- **45V PTC (hydrogen)**
- 45W ITC (commercial clean vehicles)
- **45X PTC (advanced manufacturing)**
- 45Y PTC (zero emissions electricity)
- 45Z PTC (sustainable aviation fuel)
- 48 ITC (clean energy property, includes energy storage)
- 48C ITC (advanced energy project)
- 48E ITC (zero emissions electricity, includes energy storage)

DIRECT PAY IS AVAILABLE FOR BONUS CREDITS, TOO

- With bonus credits, available in certain circumstances, up to 70% of a project could be paid for with tax credits
 - Domestic content 10%
 - 100% steel
 - 40% components
 - Energy communities 10%
 - Brownfields
 - High unemployment or reduced tax revenues where fossil fuel jobs were lost
 - Where coal mines or coal-fired facilities were closed
 - Low income communities 10% or 20%
 - Indian land
 - Low-income residential

The Clean Energy Layer Cake

The Inflation Reduction Act extends and expands the investment tax credit to cover various types of clean energy projects. But the 30% ITC is just the base layer of a larger set of tax credits if a project can meet qualifications designed to encourage high wages and U.S.-based manufacturing, among other priorities.



SOURCES: Department of Energy; ICN research

PAUL HORN / Inside Climate News

The Clean Energy Layer Cake

WHAT DO I HAVE TO DO TO CLAIM DIRECT PAY?

- Have an eligible project or property
- Pre-register with the IRS
 - You *must* have a registration number for each eligible property or project
 - You must pre-register *after* the project or property is placed in service
 - You must pre-register annually
 - You must notify the IRS if anything changes about the registration
 - The registration number must be reported on the tax return claiming the credit – no number, no credit

WHAT DO I HAVE TO DO TO CLAIM DIRECT PAY?

- File a tax return with the IRS
 - For an electing entity, the normal tax return
 - For a TEO, generally Form 990-T
 - Cities may elect a fiscal year or taxable year
- Must claim on a timely filed tax return, with extensions
- Can tweak information and figures on an amended return or through an administrative adjustment request, but you can't add additional projects or property or completely new numbers

OTHER IMPORTANT INFORMATION

- Obtaining a registration number does not “bless” the credit; it’s still subject to IRS audit
- The IRS has made no commitment as to the turn-around time to receive a registration number or to process the claim for credit
- <https://www.irs.gov/credits-deductions/register-for-elective-payment-or-transfer-of-credits>

QUESTIONS THE REGS ANSWERED OR CLARIFIED

- “Chaining” is *not* allowed. This is the practice of transferring, or selling, a tax credit to an applicable or electing entity who would then use direct pay to claim the credit.
- Partnerships and S corporations *cannot* use direct pay, unless they are taxable entities using direct pay for 45Q, 45V, and 45X.
- In those cases, direct pay is elected at the partnership or S corp level

QUESTIONS THE REGS ANSWERED OR CLARIFIED

- If an AE or EE is the common parent of a consolidated group, any member of the group that is an EE may use direct pay
- If an AE is a co-owner in credit property through a tenancy-in-common (TIC) or by a Section 761 election opting out of partnership rules, the AE's undivided ownership share is treated as a separate applicable credit property and the AE can use direct pay for its share of the credit (more on this later)

QUESTIONS THE REGS ANSWERED OR CLARIFIED

- An AE or EE that owns a disregarded entity can use direct pay to claim a credit earned by the DRE
- In the case of Sections 45, 45Q, 45V, and 45Y, direct pay applies to each qualified facility
- The AE or the EE must *own* the credit property and *conduct the activities* giving rise to the credit
- For 45X, direct pay is allowed to the party eligible to claim the credit (may be a contract manufacturer)

QUESTIONS THE REGS ANSWERED OR CLARIFIED

- The direct pay election is generally irrevocable. Electing entities can revoke the election, and the revocation is irrevocable.
- The direct pay election applies to the entire amount of the credit. You can't break it up like you can under 6418.
- For AEs, grants, forgivable loans, etc., used to build or acquire ITC property are added to the basis for purposes of computing the credit

QUESTIONS THE REGS ANSWERED OR CLARIFIED

- If the sum of grants, etc., plus the tax credit exceeds the AE's basis in the property, the credit is reduced by the amount of the excess
- If the direct payment is too much, AEs and EEs must repay the excess payment, plus 20% (can be waived for reasonable cause)
- General basis reduction and credit recapture rules apply, when applicable
- Direct pay will be made in one payment, not installments

QUESTIONS THE REGS ANSWERED OR CLARIFIED

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

PLANNING AN ELECTRICITY PROJECT?

- Treasury just released proposed rules to make it easier for TEOs to partner with experienced energy companies or investors – taxable entities -- and still be able to use direct pay
- A “loophole” providing a work-around to the prohibition on partnerships claiming direct pay
- The work-around is to opt-out of partnership status

PLANNING AN ELECTRICITY PROJECT?

- Applies *only* to entities organized *exclusively* to produce electricity
- Impacted credits include Section 45, 45Y, 48, 48E, and 45U (electricity PTC, ITC, and nuclear)

OWNERSHIP OF RENEWABLE FACILITIES ELIGIBLE FOR DIRECT PAY

- Generation facilities and other renewable energy related assets owned by tax-exempt organizations (“TEOs”) are eligible for Direct Pay. These include facilities owned directly and through disregarded entities.
 - While TEOs that own and use these facilities themselves may feel comfortable owning them directly, some may want to hold them in limited liability entities such as LLCs.
 - Also, building and operating these facilities is complex and most TEOs don’t have the expertise to do so. Large facilities may require significant capital which most municipalities would not have access to.
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JOINT INVESTMENT ENTITIES UNDER THE 6417 REGULATIONS

- Note also that single member entities wholly owned by a governmental entity will be treated as corporations.
 - Unless such entities are treated as instrumentalities of a state, they would not be applicable entities eligible for direct pay.
 - Generally, it may be hard to get absolute assurance on whether an entity constitutes an instrumentality.
 - In other similar situations, many state entities use partnerships with a third party to hold assets to avoid this issue.
 - Thus, there is demand for multi-investor funds as vehicles for TEOs to invest in these facilities.
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JOINT INVESTMENT ENTITIES UNDER THE 6417 REGULATIONS

- **However, facilities owned by partnerships are not eligible for the Direct Payment.**
 - Treasury may have been concerned about the complexity that would be entailed with the use of partnerships.
 - **Treasury did permit the use of structures involving organizations that elect to be excluded from the application of Subchapter K under Section 761 (Section 761 entities).**
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SECTION 761

- Section 761 has been in the Code since 1954. Regulations were issued more than 50 years ago (amended about 30 years ago).
 - The provision has primarily been used in the energy production context by utilities that jointly operate production facilities. It allows taxpayers to make inconsistent elections with respect to cost recovery and other deductions relating to the property and has also been used to facilitate like-kind exchanges.
 - The ability to elect out under Section 761 is generally fairly strictly limited under current law.
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CURRENT SECTION 761 REGULATIONS

- Under the current rules, exclusion from Subchapter K may be elected where the participants in the joint production, extraction, or use of property:
 - (i) Own the property as co-owners, either in fee or under lease or other form of contract granting operating rights, and
 - (ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and
 - (iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year.
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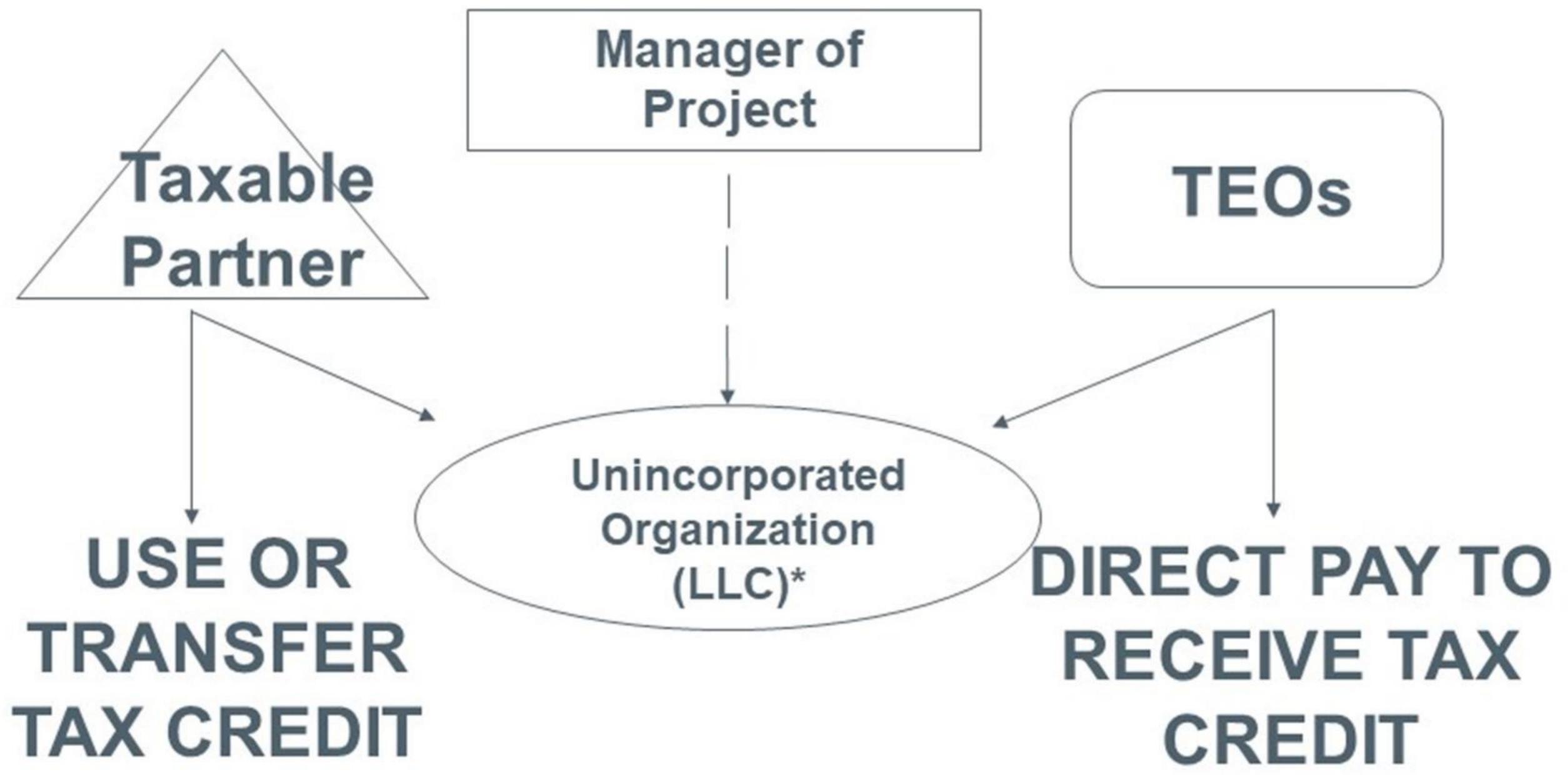
SECTION 761 PROPOSED REGULATIONS

- The Proposed Regulations address the problems with the current regs as follows:
 - An “applicable unincorporated organization” or “AUO” owning an electrical generation facility may
 - Own applicable credit property through an entity (as opposed to having the members own the property as co-owners)
 - The members of the AUO may delegate the right to sell the electricity produced by the facility to a third party who may negotiate long term (more than 1 year) power sales agreements or PPAs as long as the delegation of authority itself is for not more than 1 year
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APPLICABLE UNINCORPORATED ORGANIZATION

- The revised rules apply to unincorporated organizations that meet four requirements:
 - The AUO must be owned, in part or in full, by one or more applicable entities (members)
 - The AUO's members must enter in a joint operating agreement where each member reserves the right separately to take in-kind or dispose of their pro rata shares of the electricity produced, extracted, or used, or any associated renewable energy credits or similar credits.
 - The UO must be organized exclusively to jointly produce electricity that may qualify for the 45, 45X, 45U, 45Y, or 48E tax credits.
 - One or more of the applicable entities will elect direct pay for their share of the tax credit.
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SIMPLE EXAMPLE



* The LLC “opts-out” of partnership status, making TEOs eligible for direct pay

OBSERVATIONS

- The Treasury's concerns about complexity have led us to the Section 761 structure
 - Note that a Section 761 entity must effectively allocate income gain and loss proportionately
 - Groups of AEs are permitted to hold electrical generation facilities through limited liability entities. However, it appears that the AEs may be required to be personally obligated on the PPA with the offtaker
 - Note that an AUO must be organized **exclusively** to produce electricity. What if a battery is made part of the generation facility? A fair reading would probably be that a battery that facilitates the production of salable electricity would be permitted (as long as sales of storage does not occur), but it is not certain.
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MORE OBSERVATIONS

- Note that, in the case of investment tax credit property, once the Direct Payment has vested (that is, it cannot be recaptured under rules like the Section 50 rules) presumably the terms of the Applicable Unincorporated Organization may be modified so that it does not have to qualify as a Section 761 entity. If the rules on vesting are the same as Section 50, the credit will vest after 5 years.
 - Note that for property where the Direct Payment is based on the production tax credit, the Section 761 entity would be needed for a longer period.
 - One question is what mechanisms can be inserted in the agreement among the members to force the entity into a more normal LLC structure after 5 years.
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YET MORE OBSERVATIONS

- The regulations indicate that the sale of electricity must be *by the members*, not by the Applicable Unincorporated Organization. Presumably then, a long term PPA in respect of the electricity produced by the Applicable Unincorporated Organization will be a multiparty agreement with all of the members of the Applicable Unincorporated Organization, the Applicable Unincorporated Organization itself and the offtaker. This will likely be a bit burdensome.
 - What would the delegation look like? If the agreement with the delegate provides that services other than sales services will be provided for more than 1 years but the right to enter into a long term sales agreement is limited to one year, will that delegation qualify under the new rules?
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QUESTIONS

- Are investors in an AUO required to be personally liable on sales contracts?
 - Does a facility with a battery component qualify as a facility “exclusively” for the production of electricity?
 - Will these requirements lapse after 5 years for investment tax credit property?
 - What will the delegation agreements look like?
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THANK YOU!

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