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Treasury and IRS Provide Guidance on Energy Tax Credit Direct Payment Elections

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The Inflation Reduction Act of 2022 added Section 6417 to the Internal Revenue Code of 1986, as amended (the "Code"). Under this new section, certain taxpayers may elect to receive a direct payment in lieu of certain energy tax credits (such election, a "Direct Payment Election"). Tax-exempt entities, state or local governments, and other specified taxpayers may make a Direct Payment Election for all applicable credits. Other taxpayers are eligible to make a Direct Payment Election with respect to the tax credits available under Sections 45Q (carbon capture credit), 45V (clean hydrogen production credit), and 45X (advanced manufacturing production credit).

On June 14, 2023, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") released a notice of proposed rulemaking and public hearing regarding [the direct payment of tax credits under Code Section 6417](#) (the "Proposed 6417 Regulations") and issued [temporary regulations on pre-filing registration requirements](#) (the "Pre-Filing Registration Requirements") for Direct Payment Elections (the "Temporary Regulations"). This guidance is fairly comprehensive and provides clarity on applicable requirements and procedures to taxpayers seeking to employ this new monetization option.

I. Direct Payment of Applicable Credits: Proposed Section 6417 Regulations

Code Section 6417 and the Proposed 6417 Regulations permit an "applicable entity" (an "Applicable Entity") to make a Direct Payment Election to claim a direct cash payment for the amount of an "applicable credit" in lieu of receiving the credit.

A. Applicable Definitions

1. *Defining an "Applicable Credit"*

Applicable entities may make a Direct Payment Election with respect to the following tax credits:¹

- Alternative fuel vehicle refueling property credit (Section 30C);
- Renewable electricity production tax credit (Section 45) ("PTC");
- Carbon oxide sequestration credit (Section 45Q);
- Zero-emission nuclear power production credit (Section 45U);

- Credit for production of clean hydrogen for facilities that are originally placed in service after December 31, 2012 (Section 45V);
- For tax-exempt entities only, credit for qualified commercial vehicles under Section 45W(d)(2) (Section 45W);
- Advanced manufacturing production credit (Section 45X);
- Clean electricity production credit (Section 45Y);
- Clean fuel production credit (Section 45Z);
- Energy investment tax credit (Section 48) (“ITC”);
- Qualifying advanced energy project credit (Section 48C); and
- Clean electricity investment credit (Section 48E).

2. Defining “Applicable Credit Property”

Under the Proposed 6417 Regulations, an applicable credit is determined with respect to an “applicable credit property,” which is defined generally as the unit of property with respect to which the amount of an applicable credit is determined under the applicable statute. For example this is, in the case of the PTC (Section 45), a “qualified facility,” in the case of the carbon capture credit (Section 45Q), a “single process train,” in the case of the advanced manufacturing production credit (Section 45X), a facility that produces “eligible components,” and in the case of the ITC (Section 48), an “energy property.”

3. Defining “Applicable Entities”

Under Code Section 6417, the following entities are “applicable entities” eligible to make a Direct Payment Election with respect to any applicable credit (“Specified Applicable Entities”):

1. an organization exempt from tax imposed by subtitle A of the U.S. Code, which the Proposed 6417 Regulations clarify includes organizations exempt from tax under Code Section 501(a) and governments of U.S. territories;
2. any state or political subdivision thereof, which the Proposed 6417 Regulations clarify includes the District of Columbia;
3. the Tennessee Valley Authority;
4. an Indian tribal government, which the Proposed 6417 Regulations clarify includes subdivisions thereof;
5. an Alaska Native Corporation (“ANC”), which the Proposed 6417 Regulations clarify includes a non-ANC member of an ANC-parented group; and
6. any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.

For purposes of the carbon capture credit (Section 45Q), clean hydrogen production credit (Section 45V), and advanced manufacturing production credit (Section 45X), any taxpayer claiming such credit may make an election to be treated as an Applicable Entity (an “Electing Applicable Entity”).

a. Who Is an Applicable Entity in Certain Ownership Situations

The Proposed 6417 Regulations also provide rules on who may make the Direct Payment Elections (i.e., who is an appropriate Applicable Entity) in certain ownership situations:

- *Disregarded Entities.* If a disregarded entity owned (directly or indirectly) by an Applicable Entity holds an applicable credit property, its regarded owner must make the Direct Payment Election.
- *Taxable C Corporations.* A taxable C corporation owned in whole or in part by a Specified Applicable Entity is not a Specified Applicable Entity. Nevertheless, taxable C corporations may be Electing Applicable Entities.
- *Undivided Ownership Interests.* An Applicable Entity that co-owns an applicable credit property through a tenancy-in-common arrangement or pursuant to a joint operating arrangement that has properly elected out of subchapter K of chapter 1 of the Code under Section 761 may make a Direct Payment Election with respect to the Applicable Entity’s ownership share of the applicable credit property.
- *Consolidated Group.* A member of a consolidated group must make a Direct Payment Election with respect to any applicable credit determined with respect to the member.
- *Partnership and S Corporations.* Partnerships and S corporations are not Specified Applicable Entities, regardless of how many partners or shareholders of such partnership or S corporation individually qualify as Specified Applicable Entities. Nevertheless, eligible partnerships and S corporations may be Electing Applicable Entities.

B. Rules for Making Direct Payment Elections

A Direct Payment Election must be made as provided in the Proposed 6417 Regulations, which provide the specific rules described below.

1. General Rules

An Applicable Entity that properly makes a Direct Payment Election is treated as making a payment against its U.S. federal income taxes for the taxable year with respect to which an applicable credit was determined, in the amount of such credit. For entities that are not required to file a U.S. federal income tax return under Code Section 6011 or 6033(a), this payment is treated as made on the later of (i) the date that a return would be due under Code Section 6033(a) (ignoring any applicable extensions) if the entity were subject to that section or (ii) the date on which the entity submits a claim for credit or refund. For all other entities, this payment is treated as made on the later of (i) the due date of the tax return for the taxable year (ignoring any applicable extensions) or (ii) the date on which that tax return is filed.

In the case of an Electing Applicable Entity that is a partnership or S corporation that has made a Direct Payment Election, the IRS will make a payment to that partnership or S corporation.

2. Time and Manner of Making the Direct Payment Election

The Proposed 6417 Regulations, consistent with Code Section 6417(d)(5), require that, as a condition of, and before, making a Direct Payment Election, a Taxpayer must satisfy the Pre-Filing Registration Requirements (discussed in more detail in Part II, below). If an Applicable Entity does not complete such pre-filing registration and receive a valid registration number with respect to an applicable credit property, any Direct Payment Election will not be effective.

After receiving a valid registration number, an Applicable Entity must make the Direct Payment Election on its annual tax return, along with any required completed source credit form with respect to the applicable credit property, a completed IRS Form 3800, and any additional information required in instructions to the applicable IRS forms. A Direct Payment Election applies to the entire amount of applicable credits determined with respect to each applicable credit property that was registered.

The Direct Payment Election may only be made on an original tax return filed no later than the due date (including applicable extensions) for that original return for the taxable year for which the applicable credit is determined. An Applicable Entity may not make or revise a Direct Payment Election on an amended return or by filing an administrative adjustment request, and there is no late-election relief.

The due date of the Direct Payment Election is as follows:

- An entity that is not required to file a U.S. federal income tax return (such as government entities) must make the Direct Payment Election on or before the due date (including applicable extensions) for the original return that would be due under Code Section 6033 if that section applied to the Applicable Entity.
- A taxpayer that is not generally required to file an annual tax return with the IRS (such as taxpayers located in U.S. territories) must make the Direct Payment Election on or before the due date (including applicable extensions) that would apply if the taxpayer were located in the United States.
- All other Applicable Entities must make the Direct Payment Election on or before the due date (including applicable extensions) for the original return for the taxable year for which the election is made.

Once a Direct Payment Election is made, it is irrevocable. Generally, the election period for the Direct Payment Election is 10 years for the credits under Section 45 (PTC) and 45Y (clean electricity production credit), 12 years for the credit under Section 45Q (carbon capture credit), and to all subsequent taxable years with respect to a facility for the credit under 45V (clean hydrogen production credit). However, for an Electing Applicable Taxpayer, the Direct Payment Election for the credits under Sections 45Q (carbon capture credit), 45V (clean hydrogen production credit), and 45X (advanced manufacturing production credit) is made for a 5-year period, and one revocation of that Direct Payment Election per applicable credit property for each 5-year election period is permitted.

3. Determination of Applicable Credit

Rules for Tax-Exempt Organizations and Government Entities. The Proposed 6417 Regulations provide that the applicable credit amount for purposes of the Direct Payment Election will be determined (1) without regard to the restrictions regarding use of property by tax-exempt organizations and government entities and (2) by treating any property with respect to which such credit is determined as used in a trade or business of the applicable entity. In addition, these rules allow tax-exempt and

government entities to apply the capitalization and accelerated depreciation rules (such as Code Sections 167, 168, 263, and 263A) that apply to determining the basis and the depreciation allowance for property used in a trade or business. Furthermore, the Proposed 6417 Regulations require taxpayers to apply general limitations on the use of credits by persons engaged in the conduct of a trade or business, and thus Code Section 49 applies in the context of investment tax credits and Code Section 469 applies in the context of all applicable credits. The preamble to the Proposed 6417 Regulations requests comments on whether additional clarification is required with respect to the application of Code Sections 49 and 469 in this context.

Rules for Investment-Related Credit Property Acquired With Tax-Exempt Income. Any tax-exempt amounts used to purchase, construct, reconstruct, erect, or otherwise acquire investment-related credit property (i.e., applicable credit property described in Sections 30C, 45W, 48, 48C, or 48E) may be included in determining the property's basis for purposes of calculating the applicable credit amount. Notwithstanding that general rule, if an Applicable Entity receives tax-exempt amounts (such as a grant or forgivable loan) for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring an investment credit property plus the applicable credit otherwise determined, exceed the cost of the credit property, then the credit amount will be reduced such that the cost of the investment credit property used to calculate the basis of applicable credit property does not exceed the total amount of the applicable credit plus any such tax-exempt amounts.

Credits Must Be Determined With Respect to the Applicable Entity. Under the Proposed 6417 Regulations, the taxpayer making a Direct Payment Election must own the underlying applicable credit property or, if ownership is not required under the applicable credit rules, otherwise conduct the activities giving rise to the underlying applicable credit. A taxpayer may not make a Direct Payment Election with respect to credits purchased under Code Section 6418, transferred under Code Section 45Q(f)(3), acquired by a lessee from a lessor through a pass-through election under former Code Section 48(d), owned by a third party, or otherwise not determined with respect to the electing taxpayer, although Treasury and the IRS have requested further comment on the issue, particularly with respect to situations in which it may be appropriate to deviate from this rule.

Denial of Double Benefit. The IRS has proposed rules to address the methodology for determining the amount of the Direct Payment Election, reducing the Direct Payment Election amount to zero, and treating the applicable credit as a credit allowed for the taxable year for all other purposes of the Code.

The Proposed 6417 Regulations require that an Applicable Entity (other than a partnership or S corporation) take the following steps:

1. The Applicable Entity computes (a) the amount of its U.S. federal income tax liability (if any) for the taxable year, without regard to the general business credit under Code Section 38 ("GBC"), that it is required to pay on the due date of its tax return (without regard to extensions), and (b) the amount of that liability that may be offset by GBCs under the limitation based on amount of tax under Code Section 38.
2. The Applicable Entity computes (a) the allowed amount of GBC carryforwards carried to the applicable taxable year and (b) the amount of current year GBCs (including applicable credits) allowed for the taxable year (the sum of (a) and (b), the "Taxable Year GBCs").
3. The Applicable Entity applies the Taxable Year GBCs against its tax liability computed in Step 1.

4. The Applicable Entity identifies the amount of any excess or unused current year business credit attributable to current year applicable credits for which the Applicable Entity is making a Direct Payment Election.
5. The Applicable Entity reduces the applicable credits for which it makes a Direct Payment Election by the amount (if any) allowed as a GBC (as provided in Step 3) and by the net direct payment amount (if any) that is treated as a payment against tax (as provided in Step 4), which results in the applicable credits being reduced to zero.

Treasury and the IRS are seeking comments on whether additional guidance should expand or clarify this methodology.

In addition, the Proposed 6417 Regulations provide that the full amount of the applicable credits for which an Applicable Entity makes a Direct Payment Election is deemed to have been allowed for all other purposes of the Code, including the basis reduction and recapture rules under Code Section 50 and calculation of any underpayment of estimated tax under Code Sections 6654 and 6655.

C. Special Rules for Electing Applicable Entities

Electing Applicable Entities may make a Direct Payment Election with respect to the carbon capture credit (Section 45Q), clean hydrogen production credit (Section 45V), and advanced manufacturing production credit (Section 45X). With respect to the credit under Section 45V, an Electing Applicable Taxpayer that elects to treat qualified property that is part of a specified clean hydrogen production facility as energy property under Code Section 48 may not make a Direct Payment Election with respect to that facility.

1. Special Rules for Partnerships & S Corporations

With respect to applicable credit property held by a partnership or S corporation, the partnership or S corporation, and not its partners or shareholders, must make the Direct Payment Election.

Partnership or S Corporation, and Not Partners or Shareholders, Receive the Payment. The IRS will make the direct payment to the partnership or S corporation equal to the amount of the applicable credit. The Proposed 6417 Regulations do not impose restrictions on how the partnership or S corporation that receives such a payment may use that payment in its operations (including on when or if it makes distributions to its partners or shareholders). Before determining a partner's or shareholder's pro rata share of the credit, the credit is reduced to zero and is for all other purposes under the Code deemed to have been allowed solely to the partnership or S corporation.

Tax Treatment and Character of Direct Payment Election Amounts. Any amount with respect to which the Direct Payment Election is made is treated as tax exempt income for purposes of Code Sections 705 and 1366. A partner's distributive share of that tax exempt income is equal to such partner's distributive share of the otherwise applicable credit for each taxable year as determined under Treasury Regulations promulgated under Code Section 704, and an S corporation shareholder's pro rata share of that tax exempt income is equal to such shareholder's pro rata share of the otherwise applicable credit for each taxable year. The partnership or S corporation must take the tax-exempt income into account at the same time as the applicable credit would have been taken into account. In addition, this tax-exempt income is treated as arising from an investment activity and not from the conduct of a trade or business, and thus the tax-exempt income is not treated as passive income to any partners or shareholders that do not materially participate in the trade or business.

Determining the Amount of the Credit. To determine the amount of an applicable credit that will result in a direct payment, a partnership or S corporation must calculate the amount of the applicable credit allowable as if a Direct Payment Election were not made. This amount is not subject to limitations in Code Sections 38(b), 38(c), or 469.

Modifications to Centralized Partnership Audit Regime. The Proposed 6417 Regulations add to and modify the Treasury Regulations promulgated under the centralized partnership audit regime statutes to address Direct Payment Elections made by partnerships.

D. Excessive Payments

If any payment made under Code Section 6417 is determined to be an “excessive payment,” the tax imposed on the Applicable Entity for the taxable year in which the excessive payment is determined will be increased by 120% of the amount of the excessive payment. An “excessive payment” is defined as, with respect to an applicable credit property for which a Direct Payment Election is made for any taxable year, an amount equal to the excess of (i) the amount treated as a payment made with respect to the applicable credit property for that taxable year, over (ii) the amount of the credit that, absent the Direct Payment Election, would otherwise have been allowed with respect to that applicable credit property for that taxable year.

The Applicable Entity’s tax will only be increased by 100% (and not 120%) of the amount of the excessive payment if the Applicable Entity demonstrates to the satisfaction of the IRS that the excessive payment resulted from reasonable cause. The Proposed 6417 Regulations do not provide guidance on the facts and circumstances that may show reasonable cause in this context.

E. Basis Reduction & Recapture

Code Section 6417 and the Proposed 6417 Regulations provide that recapture rules similar to the rules under Code Section 50 (without regard to Code Section 50(b)(3) and (4)(A)(i)) apply with respect to Direct Payment Elections. An Applicable Entity must report any such recapture in the manner prescribed by the IRS, along with any supplemental forms (such as IRS Form 4255, Recapture of Investment Credit).

II. Pre-Filing Registration

As described above, an Applicable Entity making a Direct Payment Election must complete the Pre-Filing Registration Requirements described in the Temporary Regulations and obtain a registration number for each applicable credit property. To make a valid Direct Payment Election, the Applicable Entity must report the registration number of the applicable credit property on its U.S. federal income tax return on which the Direct Payment Election is reported.

The Temporary Regulations apply to Direct Payment Elections made in taxable years ending on or after June 21, 2023.

A. General Requirements

The Temporary Regulations provide the following Pre-Filing Registration Requirements with respect to applicable credit property:

1. The Applicable Entity must complete a registration process electronically through the IRS portal and in accordance with the instructions provided in the portal (unless otherwise provided in

future guidance). If the election is made by a member of a consolidated group, the member must complete this process.

2. The Applicable Entity must satisfy the pre-filing registration requirements and receive a registration number prior to making a Direct Payment Election on its tax return for the taxable year at issue.
3. The Applicable Entity must obtain a registration number for each applicable credit property with respect to which it intends to make a Direct Payment Election; and
4. The Applicable Entity must provide the specific information required to be provided as part of the registration process, which includes the following:
 - a. The Applicable Entity's general information;
 - b. Any additional information required by the IRS electronic portal;
 - c. The Applicable Entity's taxable year;
 - d. The type of tax return normally filed by the Applicable Entity;
 - e. The type of applicable credit for which the Applicable Entity intends to make a Direct Payment Election;
 - f. Each applicable credit property that the Applicable Entity intends to use to determine the credit for which the Applicable Entity intends to make a Direct Payment Election;
 - g. For each applicable credit property, any further information required by the IRS electronic portal, such as (i) the type of applicable credit property, (ii) its physical location, (iii) supporting documentation relating to the construction or acquisition of the applicable credit property, (iv) the beginning-of-construction and placed-in-service dates of the applicable credit property, and (v) any other information that the Applicable Entity believes will help the IRS evaluate the registration request;
 - h. The name of a contact person for the Applicable Entity, whom the IRS may contact if there is an issue with the registration;
 - i. A penalties of perjury statement signed by a person with personal knowledge of the relevant facts; and
 - j. Any other information the IRS deems necessary for purposes of preventing duplication, fraud, improper payments, or excessive payments as provided in future guidance.

B. Registration Number

The IRS will issue a separate registration number for each applicable credit property. That registration number is valid only for the applying Applicable Entity and only for the taxable year for which it is obtained. If a Direct Payment Election will be made with respect to an applicable credit property for a taxable year after a registration number has been obtained, the Applicable Entity must renew the registration. Renewals will also be required in the event of an applicable credit property being placed in service in a year later than the initial registration being obtained, whether planned or as a result of

unforeseen delays. The Temporary Regulations also provide that if facts change with respect to an applicable credit property for which a registration number has been issued, the Applicable Entity must amend the registration to reflect these new facts.

III. Next Steps: Comment Period, Public Hearing & Future Guidance

Treasury and the IRS have encouraged taxpayers and other interested parties to submit comments on the Proposed 6417 Regulations. Comments must be received by August 14, 2023, and a public hearing on the Proposed 6417 Regulations is scheduled to be held on August 21, 2023 at 10 a.m. ET. Those who wish to speak or who wish that certain topics be discussed at the public hearing must submit requests to speak and outlines of topics to be discussed by August 14, 2023, and requests to attend the hearing must be received by August 17, 2023 at 5 p.m. ET.

After the comment period closes and taxpayers have been given an opportunity to be heard at the public hearing, Treasury and the IRS will consider the input they receive and whether revisions to the Proposed 6417 Regulations are warranted. In the meantime, these proposed regulations are a positive development for the renewable energy industry and should provide more comfort to Applicable Entities desiring to make a Direct Payment Election.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Los Angeles lawyers:

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¹ The base amount and any bonus credits under Code Sections 30C, 45(a), 45Q(a), 45U(a), 45V(a), 45W, 45Y, 45Z, 48, 48C, and 48E are included in the applicable credit.

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