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Direct pay election – Final regulations

Tax Alert

Overview

Section 6417 provides that "applicable entities" (or "electing taxpayers" for credits provided in sections 45V, 45Q, or 45X) may elect to treat certain credits ("applicable credits") as a direct payment made against their federal income tax liabilities, thereby allowing such entities a federal tax refund of the amount of the direct payment in excess of any tax liability (the "direct-payment election"). On March 11, 2024, the IRS published in the Federal Register final regulations under section 6417 (T.D. 9988) (the "Final Regulations"). The Final Regulations finalized, with modifications, proposed regulations (REG-101607-23) under section 6417 (the "Proposed Regulations") and removed the temporary regulations (T.D. 9975) setting forth mandatory information and registration requirements for direct-payment elections released on June 14, 2023.

The Final Regulations would generally apply to taxable years ending on or after March 11, 2024. However, taxpayers and other entities may rely on the Final Regulations in taxable years ending before March 11, 2024, provided the Final Regulations are followed in their entirety and in a consistent manner. The IRS also updated the elective payment FAQs based on the Final Regulations.

Description of Provisions

Consistent with the Proposed Regulations, the Final Regulations are divided into six sections:

- Treas. Reg. § 1.6417-1 defines important terms for purposes of the statute and regulations, including, but not limited to, applicable credit, applicable entity and electing taxpayer.
- Treas. Reg. § 1.6417-2 provides rules and procedures for how to make a direct-payment election, rules for determining the amount and timing of the payments, and rules denying double benefits.
- Treas. Reg. § 1.6417-3 contains rules and procedures for direct pay elections made for credits provided in section 45V (clean hydrogen production credit), section 45Q (carbon oxide sequestration credit), and section 45X (advanced manufacturing production credit), by electing taxpayers (i.e., taxpayers that are not applicable entities).

- Treas. Reg. § 1.6417-4 provides rules for direct-payment elections made by electing taxpayers which are partnerships or S corporations with respect to section 45V, 45Q, or 45X credit.
- Treas. Reg. § 1.6417-5 provides pre-filing registration requirements and other information required to make a direct-payment election effective.
- Treas. Reg. § 1.6417-6 provides rules relating to excessive payment penalties, basis adjustments, partnerships electing out of Subchapter K and credit recapture.

Who Can Get a Direct Payment?

Generally, a direct-payment election may be made by any applicable entity. The Final Regulations provide that an "applicable entity" includes, but is not limited to, section 501(a) tax-exempt organizations, governments of any US territory, State, the District of Columbia, Indian tribal governments, or any political subdivision, agency or instrumentality thereof. Agencies and instrumentalities of the United States are not defined as applicable entities. The Final Regulations also provide that nonprofits under State law that do not have federal tax-exempt status are not applicable entities.

The Final Regulations generally follow the definition of "applicable entity" in the Proposed Regulations, with the following changes:

- Include all entities exempt from tax under subchapter F (sections 501 through 530 of the Code), including homeowners associations.
- Include consolidated groups with any applicable entity parent (not just Alaska Native Corporations).
- Include rural electric cooperatives whether or not they are tax-exempt. The preamble to the Final Regulations clarifies that publicly owned utilities and non-profit cooperatives that do not qualify as rural electric cooperatives may still qualify as applicable entities under other definitions, such as agencies or instrumentalities of a state government.
- Clarification on agencies and instrumentalities and political subdivisions of states or territories and subdivisions of Tribes.

Partnerships and S corporations are not "applicable entities," even if some or all of their owners are applicable entities. Furthermore, applicable entities that are partners of partnerships or shareholders of S corporations may not make a direct-payment election with respect to property generating an applicable credit ("applicable credit property") that is owned by the partnership or S corporation. In contrast, applicable entities owning or deemed to own interests in the applicable credit property through (i) a disregarded entity[1], (ii) a tenancy-in-common arrangement, or (iii) an organization which properly elected out of the partnership tax rules under section 761, may make a direct-payment election with respect to the applicable credit property or their share of the applicable credit property.

In addition to the Final Regulations, the IRS and Treasury have issued proposed regulations that, if finalized, would modify the regulations under section 761 to provide certainty for certain entities owned in whole or in part by applicable entities to elect out of subchapter K. These proposed regulations are discussed in a separate Tax Alert.

In addition, consistent with the statute, the Proposed Regulations clarified that for production tax credits (a "PTC") under section 45V (clean hydrogen production credit), 45Q (carbon oxide sequestration credit) and 45X (advanced manufacturing production credit), a taxpayer *other than an applicable entity* may elect to receive direct payments during 5-year periods. Such taxpayers ("electing taxpayers") are deemed for those periods of time to be applicable entities and qualify to receive direct payments. Partnerships and S corporations may be electing taxpayers. If a partnership or S corporation

elects to receive direct payments for credits under section 45V, 45Q, or 45X, it makes the election and receives the direct payments (and not the partners or S corporation shareholders). The Final Regulations are consistent with the Proposed Regulations.

Which Credits Are Eligible for Direct Payments?

Only "applicable credits" are eligible for direct payments. Applicable credits include the following:

Applicable Credits	
Section 30C alternative fuel vehicle refueling property credit	Section 45X advanced manufacturing production credit
Section 45 renewable electricity production tax for qualified facilities originally placed in service after December 31, 2022	Section 45Y electricity production credit
Section 45Q carbon oxide sequestration credit for carbon capture equipment originally placed in service after December 31, 2022	Section 45Z clean fuel production credit
Section 45U zero-emission nuclear power production credit	Section 48 energy investment tax credit
Section 45V clean hydrogen production credit for qualified facilities originally placed in service after December 31, 2012	Section 48C qualifying advanced energy project credit
Section 45W qualified commercial vehicles (tax-exempt entity)	Section 48E clean electricity investment credit

Each direct-payment election is made for an applicable credit property, which is a property-by-property or facility-by-facility election except in the case of energy property described in section 48, where the applicable entity may choose to make the direct-payment election with respect to an energy project. An applicable credit cannot be partially retained and partially elected for a direct payment. Except for credits under section 45V (clean hydrogen production credit), 45Q (carbon oxide sequestration credit), and 45X (advanced manufacturing production credit), any election once made is irrevocable and remains in effect for the entirety of the applicable tax credit period (10-year or 12-year PTC period).

The Final Regulations are consistent with the Proposed Regulations with regard to the election being made on a property-by-property or facility-by-facility basis, but clarify that an election with respect to the section 45Q credit can be made with respect to a component of a single process train if the taxpayer does not own every component of a single process train. The preamble further clarifies that whether an applicable credit property may include a group of assets or facilities is determined under the underlying Code section providing for the applicable credit. The Final Regulations retain the irrevocability rules of the Proposed Regulations.

The Final Regulations provide that any credit with respect to which a direct-payment election is made must have been determined with respect to the applicable entity or electing taxpayer. That is, an applicable entity or electing taxpayer who does not directly determine the applicable credit by owning the underlying eligible credit property and conducting activities giving rise to the underlying applicable credit (e.g., a section 45Q credit allowable to a taxpayer as the result of an election under section 45Q(f)(3)(B), or section 48 credit allowable to an applicable entity or taxpayer because of an election under section 50(d)(5) and Treas. Reg. § 1.48-4) is ineligible for the direct-payment election with respect to that applicable credit. The Final Regulations clarify that in the case of section 45X credits, the applicable entity or electing taxpayer must be considered the taxpayer with respect to which the section 45X credit is determined.

The Final Regulations are consistent with the Proposed Regulations regarding the requirement that a direct-payment election must be made by the taxpayer owning the property or conducting the activities giving rise to the applicable credit. In addition, the Final Regulations retain the rule that no direct-payment election may be made for any credits purchased pursuant to section 6418 ("chaining"). However, the IRS and Treasury have issued a notice (Notice 2024-27) requesting comments for whether chaining should be permitted.

With respect to applicable entities, the amount of any applicable credit is determined without regard to certain governmental and tax-exempt use restrictions under sections 50(b)(3) and (b)(4)(A)(i) and by treating any property as used in a trade or business of the applicable entity. This rule allows applicable entities to take advantage of applicable credits outside of the unrelated business taxable income context, apply the capitalization and depreciation rules (such as sections 167, 168, 263, 263A, and 266[2]), and subject general limitations on the use of credits, such as sections 49 (at-risk) and 469 (passive activity) to certain taxpayers subject to these rules. The preamble also states that the rules do not create any presumption that the trade or business is related or unrelated to an exempt organization's exempt purpose.

The Final Regulations are consistent with the Proposed Regulations regarding the exemption from the restrictions under sections 50(b)(3) and (b)(4)(A)(i) and treating the property as used in a trade or business activity of the applicable entity.

Subject to a limited exception, the Final Regulations provide that certain income exempt from federal income tax, including certain grants and forgivable loans 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), is generally included in the basis for purposes of computing the applicable credit amount. However, if such income is received for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring investment-related credit property (the "restricted tax-exempt amount"), the applicable credit amount is reduced to the extent the restricted tax-exempt amount plus the otherwise applicable credit exceeds the cost of the investment-related credit property.

The Final Regulations clarify that the determination of whether certain tax-exempt grants are the restricted tax-exempt amount is generally made at the time the grant is awarded. A tax-exempt grant awarded after the investment-related credit property is purchased, constructed, reconstructed, erected, or otherwise acquired is generally not a restricted tax-exempt amount unless the approval and the amount of the grant was virtually certain at the time of the application. The Final Regulations further clarify that the restricted tax-exempt amount does not include an amount not received for the specific purpose of purchasing, constructing, reconstructing, erecting, or otherwise acquiring investment-related credit property, even though the amount is used for acquiring the investment-related credit property.

How to Elect

A direct-payment election is made on the applicable entity or electing taxpayer's original return (including any revisions on a superseding return) for the taxable year in which the applicable credit is determined but only after a registration number has been obtained pursuant to pre-filing registration requirements (discussed below). This return must be filed not later than the due date (including extensions). For entities not required to file income tax returns, the direct-payment election must be made by the 15th day of the fifth month after the entity's taxable year unless an additional six-month extension of time is granted pursuant to additional guidance that has not yet been

published. The direct-payment election cannot be made on an amended return or by filing an administrative adjustment request under section 6227.

The Final Regulations provide limited relief by providing that no elective payment election may be made for the first time on an amended return, withdrawn on an amended return, or made or withdrawn by filing an administrative adjustment request under section 6227, although a numerical error with respect to a properly claimed elective payment election may be corrected on an amended return or by filing an administrative adjustment request under section 6227 if necessary. The preamble provides that miscalculating the amount of the credit on the original return or making a typographical error relating to a registration number are examples of numerical error. The preamble explains that this would allow taxpayers to correct an excessive payment before determination by the IRS, or to correct an error that leads to larger direct payment than indicated on the original return.

The Final Regulations also provide an automatic six-month extension of time under Treas. Reg. § 301.9100-2(b) from the due date (excluding extensions) to provide relief for entities that file by the original due date of the return. Finally, the preamble to the Final Regulations clarifies that if the elective payment is reduced because of the filing of the superseding return, the taxpayer could be subject to interest and penalties for failure to pay the reduction amount.

Consequences of Election

An applicable entity or electing taxpayer that makes a direct-payment election is treated as making a payment against its federal income tax liability on the later of the date the entity's federal income tax return is due (without regard to extensions) or the date on which it files its return. In the case of an entity that is not required to file income tax returns, the payment is deemed to be made on the date its tax return would have been due if it were required to file a return.

After the direct-payment election is made for an applicable credit, the credit amount is reduced to zero and deemed to have been allowed as a credit to the applicable entity or electing taxpayer making the election for other purposes of the Code (the "denial of double benefit rule"). However, to address commentators' concern that the application of the denial of double benefit rule in the Proposed Regulations may limit the taxpayer's use of other non-applicable general business credits (GBCs), the Final Regulations modify the denial of double benefit rule and provide examples to clarify that taxpayers making a direct-payment election will not have to delay using non-applicable GBCs. The Final Regulations also allow a taxpayer to benefit from a reduction of taxability as of the due date of the return by treating an applicable credit as a credit for purposes of section 38, up to the section 38(c) limitation.

The Final Regulations are generally consistent with the Proposed Regulations regarding the consequences and timing of an election. The Final Regulations clarify that a taxpayer that otherwise would not have a filing requirement that is making an initial Form 990-T filing solely to make an election can apply either a calendar or fiscal tax year, provided that adequate books and records are maintained.

Rules for Partnerships and S corporations

The Proposed Regulations provided that if a partnership or S corporation makes an effective direct-payment election, the Service will make a payment to the partnership or S corporation. That payment would be treated as tax-exempt income for the partnership or S corporation for purposes of sections 705 and 1366. A partner's distributive share of tax-exempt income with respect to the direct payment is equal to the partner's distributive share of the otherwise applicable credit (i.e., how the applicable credit would be allocated

to the partner if no direct-payment election were made). This rule also applies to an upper-tier partnership that is a direct or indirect partner of the partnership making the direct-payment election. Similarly, an S corporation shareholder's pro rata share of tax-exempt income with respect to the direct payment is equal to the shareholder's pro rata share (determined on a per-day, pro rata basis under section 1377(a)) of the otherwise applicable credit. Tax-exempt income resulting from a direct-payment election made by a partnership or S corporation is not treated as passive income to any partners or shareholders, who do not materially participate. In addition, the applicable credit amount determined in the hands of the partnership or S corporation is not subject to the limitations of sections 38(b), 38(c), and 469 (because these limitations typically apply at the partner or shareholder level), nor the limitations described in sections 49 and 50 (because partnerships and S corporations cannot make elective payment for investment credits subject to these limitations).

The Final Regulations are generally consistent with the Proposed Regulations with respect to partnerships and S corporations.

Pre-Filing Registration Required

An effective direct-payment election requires obtaining a registration number, on a property-by-property, facility-by-facility, or energy project basis, prior to completing the direct-payment election, and reporting that registration number on the applicable entity or electing taxpayer's annual tax return. Registration numbers can only be obtained through an electronic portal maintained by the IRS. The Temporary Regulations (and the Proposed Regulations) set out in some detail the pre-registration process, and the IRS issued Publication 5884, *User Guide and Instructions for Pre-Filing Registration Tool*, to provide detailed guidance on how to use the electronic portal. Registration is required on a per-member basis for members of consolidated groups. Registration generally requires providing certain information about the electing entity and relevant applicable credit property, including name, TIN or EIN, type of entity, applicable entity or electing taxpayer's taxable year, the credit(s) being elected, and location and type of applicable credit property. Registration numbers are valid only for one taxable year. Therefore, the applicable entity or electing taxpayer must renew the registration for a subsequent taxable year.

The Final Regulations are generally consistent with the Proposed Regulations and clarify that a valid registration number must also be included on any required completed source credit form(s) with respect to applicable credit property.

Excessive Payment Penalties

Direct Payments under section 6417 are potentially subject to a 20% penalty on the amount of an "excessive payment." Excessive payments are defined as the amount of direct payment over the amount of applicable credit that would otherwise be allowable under the Code (without regard to the general business credit limitation under section 38(c)). In the event of an excessive payment, the applicable entity or electing taxpayer not only loses the financial benefit of the excessive payment, but must pay a penalty equal to 20% of excessive payment, unless the applicable entity or electing taxpayer can show the excessive payment resulted from reasonable cause. The Proposed Regulations provided that credit recapture is not treated as an excessive payment.

The Final Regulations are generally consistent with the Proposed Regulations regarding excessive payment penalties.

Footnotes

[1] For purposes of these rules, certain Tribal corporations that are disregarded as separate from the tribe for U.S. federal income tax purposes are treated as disregarded entities.
[2] Section 266 was added by the Final Regulations.

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