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Direct Payment Option for Renewable Energy

Legal Alert

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As noted in a previous Legal Alert, the United States Department of the Treasury and the Internal Revenue Service issued guidance in June pertaining to the "Direct Payment Option" available for tax credits under the Inflation Reduction Act of 2022 (IRA). The purpose of the Direct Payment Option is to provide financial incentives for the benefit of organizations that are otherwise tax exempt so that they can establish renewable energy programs. It allows these organizations to receive a check from the Treasury Department in the amount of the tax credit that otherwise would have been available to the organization had the organization been obligated to pay taxes.

Clearly, the target audience for this program are municipalities, municipal agencies (e.g. transit agencies, water departments, airports, etc.) that otherwise would not have a way to own a financially-viable renewable energy project without the tax incentives. For airports, it allows them to construct and own the systems themselves without contracting with a third party developer. Of course, there still is good reason to engage a third party with experience and credibility, but the Direct Payment Option adds another structure that might be useful.

The guidance was contained in two Notices of Proposed Rulemaking that involve Sections 6417 of the Internal Revenue Code (IRC) (elective payment of applicable credits) and Section 6418 of the IRC (transferability of tax credits). Under Section 6418, eligible taxpayers may make a yearly election to transfer some or all of the eligible credit to an unrelated taxpayer provided the eligible taxpayer receives cash consideration.

Regarding the Direct Payment Option:

1. The Direct Payment Option generally applies to the clean hydrogen program under Section 45V, the carbon capture sequestration program under Section 45Q and the advanced manufacturing program under Section 45X. A separate election must be made for each applicable credit property. The election is valid for the taxable year in which the election is made and each of the next four taxable years, ending January 1, 2033. This election can be revoked for any applicable credit property, but once revoked it cannot be reinstated.
2. For deal structuring purposes, the election is made at the entity level. Thus a partnership which has partners who themselves are applicable entities is not considered an applicable entity and cannot elect direct payment.
3. "Applicable Entities" eligible to utilize this option include tax exempt organizations, states, political subdivisions and instrumentalities of such state, local, tribal, and federal governments. This should include the sponsors of most if not all Part 139 Airports and many other airports that are part of the NPIAS.

4. Any entity seeking a direct payment must file an IRS Form 990-T (Exempt Organization Business Income Tax Return). This includes organizations like state and local governments that normally do not file this form. If they want to take advantage of this program, they must. This is in addition to other forms required to claim the relevant tax credit (e.g. the Form 3800).
5. All payments are to be made only if the return from the entity is filed timely – meaning generally the tax return for the applicable tax year is filed by the due date. For most tax-exempt and governmental entities, that is generally May 15 for calendar year taxpayers.
6. The entity must complete the necessary pre-filing through the IRS electronic portal, which currently is under development.
7. Once properly registered, the entity is given an IRS Registration Number. Receipt of that number does NOT mean the IRS has approved the registrant or the credit, but that number must be included on its filings.
8. Direct Payment is separate from the transferability of credits. Entities that elect Direct Payment cannot then transfer such payments.

The Direct Payment Option increases the flexibility that airports and other municipal entities have in structuring clean energy projects. It also can enable structures that are more politically feasible for the municipality. Airports that are interested should examine the provisions and talk to qualified counsel to structure these deals, which can be very important as airports try to transition away from fossil fuels. For information on how this impacts airports, please contact Daniel Markind. For information on how the tax credits impact other facilities, please contact any member of our firm’s Tax Department.

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ATTORNEYS MENTIONED

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