

March 7, 2024

## MEMORANDUM

TO: Carbon Capture Coalition

FROM: Hunter Johnston  
Lisa Zarlenga  
John Cobb  
Nick Sutter

RE: Direct Pay Final Regulations

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On March 5, 2024, the Department of Treasury and Internal Revenue Service (collectively “Treasury”) issued final regulations to implement the Inflation Reduction Act’s elective payment (“direct pay”) provisions under section 6417 (the “Final Regulations”).<sup>1</sup> Treasury previously published on June 21, 2023, proposed regulations regarding direct pay elections and temporary regulations regarding direct pay registration requirements (the “Proposed Regulations”).<sup>2</sup> The Final Regulations are effective beginning May 10, 2024.

The Carbon Capture Coalition (“CCC”) filed a comment letter regarding the Proposed Regulations on August 14, 2023.<sup>3</sup> This memorandum provides a summary of the Final Regulations. The memorandum includes an analysis of how the Final Regulations address CCC’s comment letter recommendations; if not mentioned, CCC did not comment on the issue.

Along with the Final Regulations, Treasury issued Notice 2024-27 that requests comments on “chaining” where a direct pay election could be made for a clean energy tax credit that was received through a section 6418 transfer election.<sup>4</sup> Treasury also issued a Notice of Proposed Rulemaking (“NPRM”) regarding credit property co-ownership arrangements that could allow partnerships to elect under section 761(a) to not be treated as a partnership that

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<sup>1</sup> TD 9988, Elective Payment of Applicable Credits (“Final Regulations”) available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>2</sup> 88 Fed. Reg. 40,528 (Jun 21, 2023) (Proposed Rule: Section 6417 Elective Payments of Applicable Credits); 88 Fed. Reg. 40,093 (Jun. 21, 2023) (Temporary Rule: § 1. 6417-5T Additional Information and Registration).

<sup>3</sup> IRS-2023-0029-0135, Comment from Carbon Capture Coalition to REG-101607-23 (Section 6417 Elective Payment of Applicable Credits) available at <https://www.regulations.gov/comment/IRS-2023-0029-0135>.

<sup>4</sup> Notice 2024-27 (Mar. 5, 2024) available at <https://www.irs.gov/pub/irs-drop/n-24-27.pdf>.

would otherwise be ineligible to make a direct pay election.<sup>5</sup> Comments on Notice 2024-27 are due December 1, 2024, and comments on the NPRM are due on May 10, 2024.

## I. Final Direct Pay Regulations

### A. §1.6417-1 Elective Payment of Applicable Credits

The Final Regulations affirm that any applicable entity may make a direct pay election for any applicable credit. The Final Regulations adopt the Proposed Regulations and include governments of U.S. territories as well as agencies and instrumentalities of various governments in the definition of an applicable entity.<sup>6</sup> The Final Regulations adopted a broader definition of a tax-exempt organization and clarified that any organization described in sections 501 through 530 of the Internal Revenue Code that meets the requirements to be recognized as exempt from tax under those sections is an applicable entity eligible to make a direct pay election.<sup>7</sup>

The Final Regulations adopt the Proposed Regulations' definitions of applicable credit and applicable credit property for section 45Q. The Final Regulations define applicable credit to include "[s]o much of the credit for carbon oxide sequestration determined under section 45Q(a) of the Code as is attributable to carbon capture equipment that is originally placed in service after December 31, 2022."<sup>8</sup> Applicable credit property is defined "[i]n the case of a section 45Q credit, a component of carbon capture equipment within *a single process train* described in §1.45Q-2(c)(3)."<sup>9</sup>

The Final Regulations adopt the Proposed Regulations' definition of "electing taxpayer" that allows an applicable entity that is not a tax-exempt or government entity, such as a for-profit entity, to elect direct pay for the section 45Q, 45V, and 45X credits.<sup>10</sup>

### B. §1.6417-2 Rules for Making Elective Payment Elections

The Final Regulations adopt the rule in the Proposed Regulations that partnerships and S corporations cannot be applicable entities and elect direct pay except that a partnership or S corporation is eligible to make the direct pay election for the section 45Q, 45V, and 45X credits (assuming all the other requirements to make the election are met).<sup>11</sup> The partners and S

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<sup>5</sup> Notice of Proposed Rulemaking, Election to Exclude Certain Unincorporated Organizations Owned by Applicable Entities from Application of the Rules on Partners and Partnerships, REG-101552-24.

<sup>6</sup> Treas. Reg. § 1.6417-1(c).

<sup>7</sup> Treas. Reg. § 1.6417-1(c)(1)(i); *see also* Final Regulations at 14 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>8</sup> Treas. Reg. § 1.6417-1(d)(3).

<sup>9</sup> Treas. Reg. § 1.6417-1(e)(3).

<sup>10</sup> Treas. Reg. § 1.6417-1(g).

<sup>11</sup> Treas. Reg. § 1.6417-2(a)(1)(iv).

corporation shareholders are prohibited from making the direct pay election with respect to property held by the partnership or S corporation.<sup>12</sup>

The Final Regulations adopt the Proposed Regulations requirements that the direct pay election for the section 45Q credit is made separately for each applicable credit property and that the direct pay election for section 45Q must be made in the taxable year in which the carbon capture equipment is originally placed in service.<sup>13</sup>

## 1. Pre-Filing and Filing Requirements

To make a direct pay election, the Final Regulations adopt the Proposed Regulations and require the taxpayer to complete the pre-filing registration requirements under Treas. Reg. § 1.6417-5 and receive a valid registration number for the applicable credit property.<sup>14</sup>

The Final Regulations also adopt the Proposed Regulations' rule that the taxpayer must make the direct pay election on an original return (including any revisions on a superseding return) along with a completed Form 3800, General Business Credit, and any required completed source credit forms that are filed no later than the due date (including extensions) for the taxable year in which the applicable credit is determined.<sup>15</sup> The preamble to the Final Regulations clarifies that taxpayers can make the direct pay election on the Form 1120, U.S. Corporation Income Tax Return.<sup>16</sup> A direct pay election cannot be made for the first time on an amended return or withdrawn on an amended return.<sup>17</sup> The Final Regulations removed "or revised" from the Proposed Regulations' original return requirements in Prop. Treas. Reg. § 1.6417-2(b)(1)(ii), and the preamble to the Final Regulations states this is intended to address situations in which a taxpayer intended to make a direct pay election but made a reporting error with respect to an element of a valid election.<sup>18</sup>

## 2. Partial Direct Pay Elections

The Final Regulations adopt the Proposed Regulations' requirement that the direct pay election applies to the entire amount of the applicable credit and the direct pay amount will be the entire amount of the applicable credit for a taxable year.<sup>19</sup>

- CCC Comment Letter Recommendation: The Final Regulations do not adopt CCC's recommendation to allow for partial direct pay elections. The preamble to the Final

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<sup>12</sup> Treas. Reg. § 1.6417-2(a)(2)(ii)-(iii).

<sup>13</sup> Treas. Reg. § 1.6417-2(a)(3)(ii).

<sup>14</sup> Treas. Reg. § 1.6417-2(b)(2).

<sup>15</sup> Treas. Reg. § 1.6417-2(b)(1)(i)-(ii).

<sup>16</sup> Final Regulations at 43-44 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>17</sup> Treas. Reg. § 1.6417-2(b)(1)(ii).

<sup>18</sup> Final Regulations at 45 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>19</sup> Treas. Reg. § 1.6417-2(b)(5).

Regulations states that partial elections cannot be made and the direct payment election is made for the applicable credit's full amount.<sup>20</sup>

### 3. Direct Pay Election for Transferred Credits/Chaining

The Final Regulations adopt the Proposed Regulations' limitation on taxpayers making a direct pay election for transferred credits. The applicable entity or electing taxpayer making the direct pay election must own the underlying applicable credit property and conduct the activities giving rise to the credit.<sup>21</sup> The Final Regulations adopt the Proposed Regulations and state a direct pay election cannot be made on a credit acquired by a taxpayer under section 45Q(f)(3).<sup>22</sup>

- CCC Comment Letter Recommendation: The Final Regulations do not distinguish between credits transferred under section 6418's transfer election and under section 45Q(f)(3)(B) and do not adopt CCC's recommendation to allow for direct pay elections for credits attributable under section 45Q(f)(3)(B) that a taxpayer earns by disposing of, utilizing, or injecting qualified carbon oxide. However, see the discussion in Section 2 below on Notice 2024-27.

### 4. Timing of Payments

The Final Regulations adopt the Proposed Regulations and state that the direct payment is treated as made on the later of the date that a return is due or the date on which a return is filed.<sup>23</sup>

- CCC Comment Letter Recommendation: The Final Regulations do not adopt CCC's recommendations to allow taxpayers to claim direct pay against estimated tax payments.

### 5. Section 38 Tax Credit Ordering and General Business Credits

The preamble to the Final Regulations states that Treasury revised Treas. Reg. § 1.6417-2(e) and the examples in the Final Regulations to ensure that taxpayers making a direct pay election will not have to delay using non-applicable section 38 general business credits ("GBC") because of an applicable credit. The Final Regulations allow a taxpayer to benefit from a reduction in tax liability 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.

- CCC Comment Letter Recommendation: The Final Regulations and examples address CCC's recommendation related to the use of GBCs. Under the Final Regulations, an applicable entity or electing taxpayer will calculate the net elective payment amount before applying the ordering rules of section 38(d). These revisions

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<sup>20</sup> Final Regulations at 52-53 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>21</sup> Treas. Reg. § 1.6417-2(c)(4).

<sup>22</sup> *Id.*

<sup>23</sup> Treas. Reg. § 1.6417-2(d)(2).

allow an applicable entity or electing taxpayer that has other non-applicable credit GBCs to lower tax liability to the section 38(c) limitation using the non-applicable credit GBCs without impacting applicable credits.

C. §1.6417-3 Special Rules for Electing Taxpayers

1. Direct Pay Election Per Applicable Credit Property

The Final Regulations adopt the Proposed Regulations' requirement that the direct pay election be made separately for each applicable credit property, which for section 45Q is a single process chain, but only if the proper pre-filing requirements are made.<sup>24</sup> An electing taxpayer may only make one election for any specific applicable credit property.<sup>25</sup>

2. Direct Pay Election Period

The Final Regulations adopt the rule in the Proposed Regulations that if a taxpayer makes a direct pay election, the direct pay election period is the year the election is made and each of the four subsequent tax years that end before January 1, 2033.<sup>26</sup> Treas. Reg. § 1.6417-2(a)(3)(ii) requires the taxpayer to make a direct pay election for section 45Q in the year the property is placed in service.

- CCC Comment Letter Recommendation: The Final Regulations do not adopt CCC's recommendations to include an annualization principle to allow taxpayers to elect direct pay for five full years (or 60 months). The Final Regulations require the taxpayer to elect direct pay for the year the carbon capture equipment is placed in service (which may be less than a full taxable year) and four subsequent years. The preamble to the Final Regulations states that Treasury "agree[s] that such a result may seem counterintuitive but note that any other rule would be inconsistent with the statute" because the statute is unambiguous with respect to which taxable years qualify for direct pay.<sup>27</sup>

3. Revocation of Direct Pay Election

The Final Regulations allow the taxpayer to revoke, during a subsequent year, the direct pay election and state that a revocation can only be made once and cannot be subsequently revoked.<sup>28</sup> The preamble to the Final Regulations clarifies that the act of not making an elective payment election during the election period is not itself a revocation.<sup>29</sup>

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<sup>24</sup> Treas. Reg. § 1.6417-3(c), 3(e).

<sup>25</sup> Treas. Reg. § 1.6417-3(e)(2).

<sup>26</sup> Treas. Reg. § 1.6417-3(e)(3)(i).

<sup>27</sup> Final Regulations at 100-01 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

<sup>28</sup> Treas. Reg. § 1.6417-3(e)(3)(i).

<sup>29</sup> Final Regulations at 102 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

#### 4. Transfer Elections During Election Period

The Final Regulations state that a transfer election under section 6418 cannot be made during the direct pay election period, but if the direct pay election period is no longer in effect, the credits for the applicable property can be transferred.<sup>30</sup>

##### D. §1.6417-4 Elective Payment Election for Electing Taxpayers that are Partnerships or S Corporations.

The Final Regulations adopt the Proposed Regulations related to the direct pay elections for partnerships and S corporations for the section 45V, 45Q, or 45X credits. The Final Regulations provide that if a partnership or S corporation makes an effective direct pay election, the IRS will make a payment to the partnership or S corporation.<sup>31</sup> That payment would be treated as tax-exempt income for the partnership or S corporation for purposes of sections 705 and 1366.<sup>32</sup> Tax-exempt income resulting from a direct pay election made by a partnership or S corporation is not treated as passive income to any partners or shareholders who do not materially participate.<sup>33</sup> The Final Regulations also state the applicable credit amount determined for 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 do the limitations in sections 49 and 50 apply because partnerships and S corporations cannot make elective payment for investment credits subject to these limitations.<sup>34</sup>

##### E. §1.6417-5 Additional Information and Registration

The Final Regulations adopt the Proposed Regulations pre-filing registration requirements that require the taxpayer to list all applicable credits it intends to claim and list each applicable credit property on the pre-filing submission.<sup>35</sup> Further, each applicable property must obtain its own registration number.<sup>36</sup> A taxpayer who does not obtain a registration number before filing and does not include the registration number on its annual return is ineligible to claim direct pay.<sup>37</sup> Registration numbers can only be obtained through the IRS electronic portal.<sup>38</sup>

The Final Regulations require the taxpayer to include certain information about the entity electing direct pay and applicable credit property, including name, TIN or EIN, type of entity,

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<sup>30</sup> Treas. Reg. § 1.6417-3(e)(4).

<sup>31</sup> Treas. Reg. § 1.6417-4(c)(1)(i).

<sup>32</sup> Treas. Reg. § 1.6417-4(c)(1)(iii).

<sup>33</sup> Treas. Reg. § 1.6417-4(c)(3).

<sup>34</sup> Treas. Reg. § 1.6417-4(d).

<sup>35</sup> Treas. Reg. § 1.6417-5(a).

<sup>36</sup> Treas. Reg. § 1.6417-5(b)(4).

<sup>37</sup> Treas. Reg. § 1.6417-5(a).

<sup>38</sup> Treas. Reg. § 1.6417-5(b)(1).

applicable entity or electing taxpayer's taxable year, the credit(s) being elected, and physical location, supporting documentation, and type of applicable credit property.<sup>39</sup>

Direct pay registration numbers are valid only for one taxable year and the Final Regulations adopt the Proposed Regulations' requirement that the taxpayer must renew the registration for a subsequent taxable year, including attesting that all the facts previously provided are still correct or updating any facts.<sup>40</sup>

F. §1.6417-6 Special Rules/Excessive Payment

The Final Regulations adopt the rule in the Proposed Regulations that a 20-percent penalty is imposed on an applicable entity or electing taxpayer if the amount of direct payment is excessive.<sup>41</sup> This penalty does not apply if the taxpayer demonstrates that the excessive payment was due to reasonable cause.<sup>42</sup>

G. Tax-Exempt Bonds

CCC's Comment Letter recommended that the Final Regulations clarify that the amount of the section 45Q credit is not reduced by tax-exempt bonds used to finance transportation and storage equipment that is not owned by the taxpayer.

The preamble to the Final Regulations notes that multiple commenters raised this issue, but that this issue is outside of the scope of the Final Regulations because the use of proceeds of tax-exempt bonds under section 103 may impact the amount of a particular applicable credit in the underlying Code sections (such as sections 45 and 48), and such reduction in the credit amount occurs before the application of section 6417 and independently from the application of section 6417.<sup>43</sup>

II. Notice 2024-27

As noted above, the Final Regulations address "chaining" and limit a taxpayer from making a direct pay election for transferred credits, including section 45Q credits transferred under section 45Q(f)(3). However, Treasury issued Notice 2024-27 that requests additional comments on situations where a direct pay election could be made for a credit that was purchased in a transfer election under section 6418. Treasury stated that the market for transferred credits is nascent and allowing chaining could increase demand in the market, consistent with the intent of the IRA. The Notice requests comments on several issues related to chaining, including the impact on credit transfer markets, administrability challenges, and potential rules for chaining related to section 45Q. The comment deadline is December 1, 2024.

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<sup>39</sup> See Treas. Reg. § 1.6417-5(b)(5).

<sup>40</sup> Treas. Reg. § 1.6417-5(c)(2).

<sup>41</sup> Treas. Reg. § 1.6417-6(a)(1).

<sup>42</sup> Treas. Reg. § 1.6417-6(a)(2).

<sup>43</sup> Final Regulations at 123-26 available at <https://public-inspection.federalregister.gov/2024-04604.pdf>.

- Steptoe Recommendation: We recommend that CCC file comments that reiterate CCC's direct pay comment letter recommendations to allow chaining for credits transferred under section 45Q(f)(3). CCC's comments could distinguish between credits transferred under section 6418 and section 45Q(f)(3) and also address Treasury's questions regarding administrability and preventing abuse.

### III. NPRM on Partnerships and Co-Property Ownership

To make a direct pay election for credits other than the section 45X, 45V, or 45Q credits, the applicable entity making the direct pay election must be a non-profit or governmental entity. As discussed above, the Final Regulations do not allow partnerships to elect direct pay except for the section 45X, 45V, and 45Q credits, even if one or more of the partners is an applicable tax-exempt or governmental entity.

The Final Regulations adopted the Proposed Regulations on how partnerships could elect out of partnership status to make a direct pay election.<sup>44</sup> However, commenters on the Proposed Regulations requested additional guidance for the types of credit property co-ownership arrangements that could elect under section 761(a) to elect out of partnership status to make a direct pay election.

In response, Treasury issued an NRPM that would provide exceptions to the Final Regulations for partnerships that co-own eligible credit property to make a direct pay election. Comments on the NPRM are due on May 10, 2024. Under the NPRM, applicable entities must meet four requirements to make the direct pay election<sup>45</sup>:

- The unincorporated organization must be owned, in part or in whole, by one or more applicable entities.
- The unincorporated organization's members must enter into a joint operating agreement in which the members reserve 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 unincorporated organization must be organized exclusively to produce electricity from its applicable credit property and with respect to one or more applicable credits listed in section 6417.
- One or more of the applicable entities must make an elective payment election under section 6417(a) for the applicable credits.

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<sup>44</sup> Treas. Reg. § 1.6417-2(a)(1)(iii).

<sup>45</sup> Prop. Treas. Reg. § 1.761-2(a)(4)(ii)(A)-(D).