EXCERPT

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No Mention of IRC Section 50(d) Income in IRA Language Adds Complexity to Transactions

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The Inflation Reduction Act (IRA) of 2022, signed into law Aug. 16, 2022, added Section 6418 to the Internal Revenue Code (IRC), which provides that, beginning in 2023, certain tax credits (eligible credits), including the energy tax credit under IRC Section 48, may be transferred by a taxable person or entity holding the property giving rise to the credit (the eligible taxpayer) to an unrelated person (the transferee taxpayer) in exchange for cash, such that the transferee taxpayer and not the eligible taxpayer is entitled to claim the credit.

The IRC Section 48 energy credit is a component of the investment tax credit under Section 46 and provides for a credit equal to a percentage of the taxpayer's basis in certain "energy property." The credit may be claimed in one of two ways. In the single-tier structure, the taxpayer that acquired or constructed the energy property and placed it in service claims the credit. By contrast, in the pass-through structure, where the taxpayer that acquired or constructed the energy property (here, the lessor) is leasing the property to a lessee, and the lessor and lessee make a joint election under Treasury Regulations (Treas. Reg.) Section 1.48-4 to treat the lessee as having acquired the energy property for fair market value from the lessor, the lessee is entitled to claim the credit based on the deemed purchase price (i.e., the fair market value) of the energy property.

In the single-tier structure, IRC Section 50(c) provides that the taxpayer must reduce the basis of the energy property by 50% of the amount of the credit claimed. In the pass-through structure, where the lessor is the owner of the energy property, but the lessee claims the credit, there is no basis reduction. Instead, under IRC Section 50(d)(5), which refers to rules formerly in effect under former IRC Section 48(d), the lessee must take into account income equal to 50% of the credit ratably over the shortest recovery period applicable to the property under IRC Section 168. This income is commonly referred to as 50(d) income. For instance, if $100,000 of energy property with a 30% applicable percentage and a five-year recovery period were placed in service by a taxpayer, under the single-tier structure, the taxpayer would claim a $30,000 credit and reduce its basis in the energy property by $15,000. In the pass-through structure, the lessor would not reduce its basis in the property, but the lessee (which claimed the $30,000 credit) would include $3,000 in each of the five years beginning with the year in which the property was placed in service (i.e., $15,000 over five years). Thus, under either structure, 50% of the credit is in a sense taxable to the party receiving the benefit.

New IRC Section 6418 provides that upon transfer of an eligible credit from an eligible taxpayer to a transferee taxpayer, the cash paid is not included in the eligible taxpayer's gross income nor is the transferee taxpayer entitled to a deduction for the payment. IRC Section 6418 also provides that in the case of the transfer of energy credits, IRC Section 50(c)'s basis reduction requirement "shall apply to [energy property] as if [the energy credit] was allowed to the eligible taxpayer." In other words, in a single-tier structure, the eligible taxpayer bears the tax burden of the credit despite the credit being claimed by the transferee taxpayer. The basis reduction is based on the amount of the credit claimed, not the amount of consideration received by the eligible taxpayer and thus an eligible taxpayer selling a $100,000 credit for $80,000 must reduce its basis in the energy property by half of $100,000, not half of $80,000.

While IRC Section 6418 decouples the tax burden of the credit from the benefit of the credit, it at least provides a clear rule for sale of energy credits in the single-tier structure. IRC Section 6418, however, is silent on the treatment of 50(d) income, thus raising questions of (i) whether a transfer of credits in a pass-through structure is permissible, and (ii) which party must include the 50(d) income.

On the first question, there does not seem to be any rule stating that energy credits in a pass-through structure cannot be transferred. The pass-through election under Treas. Reg. Section 1.48-4 provides for a deemed transfer of investment credit property, not a transfer of credits, so it does not seem that the spirit of IRC Section 6418's one-time transfer rule is violated by virtue of the pass-through election itself. There does not appear to be any policy reason for permitting the transfer of energy credits in a single-tier structure but not in a pass-through structure, and most importantly, there is nothing in the text of IRC Section 6418 stating or implying that transfer of pass-through energy credits is not permitted other than the absence of a provision specifically addressing 50(d) income. Thus, assuming transfer of energy credits in a pass-through structure is permissible, the question is which party–the eligible taxpayer or the transferee taxpayer–bears the burden of the 50(d) income.

Before 2016, there was uncertainty in the investment tax credit industry about the treatment of 50(d) income. While it was clear that the lessee (as opposed to the lessor) must include the 50(d) income, in the context of a lessee that was a partnership, practitioners disagreed as to whether the 50(d) income was a partnership item that was received by the partnership and allocated to the partners in the lessee (in which case the partners would increase their outside bases in the lessee by the amount of income allocated to them) or whether the 50(d) income was received outside of the partnership, i.e., at the partner level (in which case the partners would not be entitled to a basis increase). The question of whether 50(d) income was a partnership or a partner item was relevant both to the question of the amount of a partner's basis in its partnership interest in lessee and thus the amount of gain or loss on sale of that partnership interest and to the question of how to account for unamortized 50(d) income on sale of the partnership interest.

In regulations first proposed in 2016 (TD 9776) and then finalized in 2019 (TD 9872) (the IRC Section 50(d) regulations), Treasury answered both of these questions, stating that the 50(d) income was a partner item and not a partnership item and that the income thus stayed with the partner regardless of whether it remained a partner in the lessee. The logic of this treatment was that it was the investment credit property itself and not the investment credit that was allocated to partners in a partnership under Treas. Reg. Sections 1.704-1(b)(4)(ii) and 1.46-3(f).

The IRC Section 50(d) regulations refer to the "ultimate credit claimant," requiring that in the partnership and S corporation context, the 50(d) income be recognized by the taxpayer that ultimately claimed the credits. In introducing this concept, the preamble to the 2016 proposed regulations states that "[t]he Treasury Department and the IRS believe that the burden of income inclusion should match the benefits of the allowable credit." Applying this matching principle to the transfer of energy credits under IRC Section 6418 would seem to require that the transferee taxpayer (i.e., the party receiving the benefit of the allowable credit) bear the burden of the 50(d) income. However, this matching principle is in contrast to IRC Section 6418's clear treatment of the IRC Section 50(c) basis reduction that is applicable in the single-tier structure, which requires that the basis reduction burden be borne by the eligible taxpayer even though the credits are claimed by the transferee taxpayer.

IRC Section 6418 applies to several credits, each of which has its own particular mechanics. Accordingly, some of IRC Section 6418's general provisions do not appear to match neatly with the investment credit structure, particularly following the IRC Section 50(d) regulations. For instance, IRC Section 6418(c)(2) provides for an election to sell credits at the partnership level where property is held by a partnership. This provision seems at the very least inapplicable to the investment credit structures where each partner is treated as holding its share of investment credit property directly (and thus is entitled to the credits with respect to that property). While one hopes that future regulations will resolve ambiguities such as these, it is understandable that a broad provision such as IRC Section 6418 would not address every nuance applicable to every eligible credit. In that vein, if neither the IRC Section 50(c) basis reduction nor the IRC Section 50(d) income inclusion were addressed in the statutory text of IRC Section 6418, that would not seem unusual. However, the IRA's failure to mention 50(d) income coupled with its inclusion of a specific provision on the treatment of the Section 50(c) basis reduction and the fact that this treatment arguably runs contrary to the principles of matching burdens and benefits contained in Sections 50(c) and 50(d) and articulated in the preamble to the IRC Section 50(d) regulations introduces uncertainty into the treatment of 50(d) income in the context of IRC Section 6418. Until this uncertainty is resolved, it will be difficult for parties to price the sale of energy credits in a pass-through structure. ❖

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