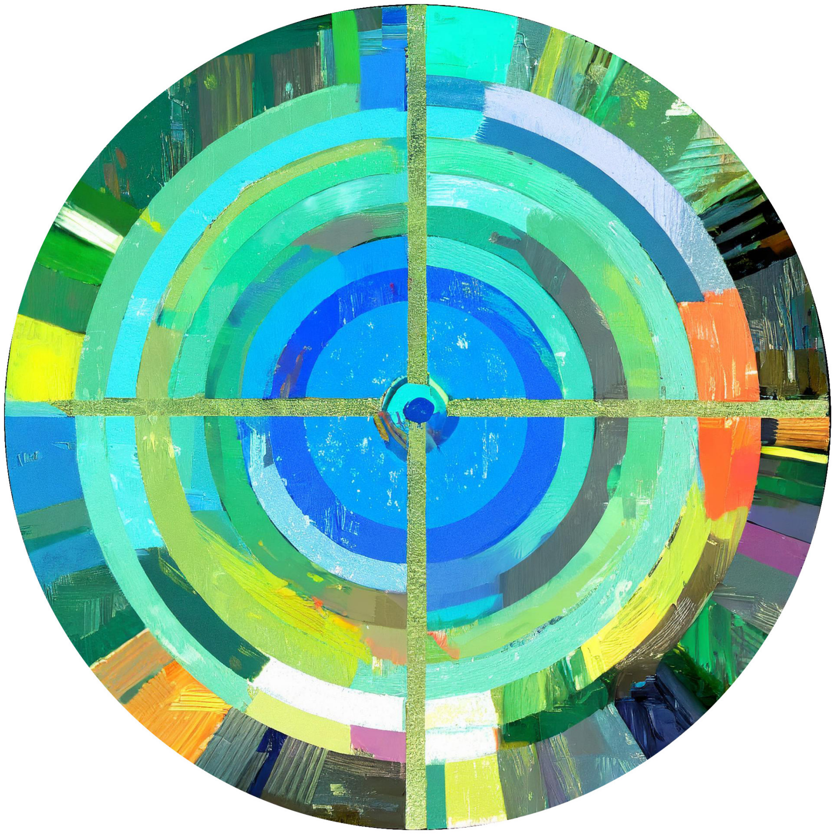


M&A Tax Talk

Exploring tax credit transferability

Introduction

As part of the Inflation Reduction Act of 2022 ("IRA"), Congress provided new mechanisms for monetizing tax credits for taxable years beginning after December 31, 2022, including the transfer of certain credits under Internal Revenue Code ("IRC") section 6418 ("Transferability"). Through this transferability provision, companies (generally non-tax-exempt entities) can elect to transfer all or a portion of an eligible credit to an unrelated taxpayer in exchange for cash. The negotiation, diligence, and execution of tax credit transfers share many of the same processes observed in tax diligence for the broader mergers and acquisitions ("M&A") marketplace. By examining the overlap between Transferability and M&A, we can uncover valuable insights into how the rigorous due diligence and transactional practices of M&A can be applied to the transfer of tax credits under IRC section 6418. This article aims to explore these connections and provide readers a better understanding of the transferability process and its relationship with M&A practices.

IRC section 6418: A brief overview

Transferability of tax credits

IRC section 6418 provides that an eligible taxpayer[1] ("Transferor"), as defined by IRC section 6418(f)(2), may elect to transfer all or any portion of an eligible credit determined with respect to such taxpayer for any taxable year to a taxpayer ("Transferee") which is not related to the Transferor within the meaning of IRC section 267(b) or 707(b)(1).[2] The Transferee will be treated as the taxpayer for purposes of the IRC with respect to the transferred credit.[3]

The term eligible credit includes any of the following credits: (i) IRC section 30C, alternative fuel vehicle refueling property, (ii) IRC section 45, renewable electricity production credit, (iii) IRC section 45Q, carbon oxide sequestration credit, (iv) IRC section 45U, zero-emission nuclear power production credit, (v) IRC section 45V, clean electricity production credit, (vi) IRC section 45X, advanced manufacturing production credit, (vii) IRC section 45Y, clean electricity production credit, (viii) IRC section 45Z, clean fuel production credit, (ix) IRC section 48, energy credit, (x) IRC section 48C, qualifying advanced energy project, and (xi) IRC section 48E, clean electricity investment credit.[4]

Key features of transferability

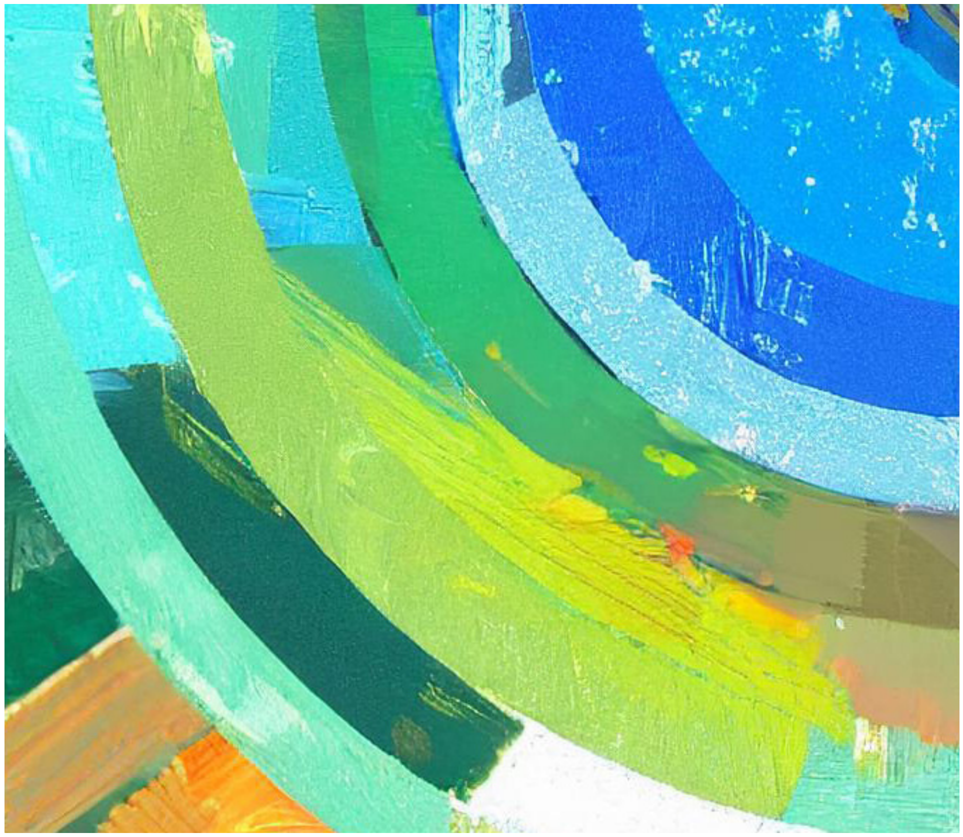
The Transferability provision under IRC section 6418 includes several key features.

- **Eligibility:** Only certain types of tax credits are eligible for transfer and any amount paid by the Transferee to the Transferor shall: (i) be paid in cash, (ii) not be included in the U.S federal gross income of the Transferor, and (iii) not be deductible for the Transferee.[5] An eligible credit can only be transferred by a transfer election under IRC section 6418 one time. Therefore, no election may be made by a Transferee with respect to any portion of an eligible credit which has been previously transferred to such taxpayer (e.g., no lease passthrough election).[6] Nevertheless, Transferor can elect to transfer any portion of the eligible credit and transfer different portions of the credit to multiple Transferees.

  A transfer election must be made by a Transferor that is not an "applicable entity" for purposes of making a direct pay election under IRC section 6417. Generally, a Transferor may be any taxpayer that is not tax-exempt. If a Transferor makes an election to claim direct payments under IRC section 6417 for a IRC section 45Q credit, IRC section 45V credit, or IRC section 45X credit (an "electing taxpayer"), the Transferor is deemed to be an applicable entity with respect to that credit and, as a result, is not considered an eligible Transferor with respect to that credit during the period they have elected to be treated as an applicable entity and receive direct payments.

- **Valuation and timing:** The value of the transferred credits is negotiated between the parties, making pricing a critical aspect of the process. For timing purposes, cash payment for the eligible credit may be paid no earlier than the first day of the Transferor's taxable year in which the credit is determined and no later than the extended due date for the tax return for the taxable year for which the credit is determined. In any case, a transfer election under IRC section 6418 is irrevocable.

  The Transferee must take the eligible credit into account in the Transferee's first taxable year ending with or ending after the taxable year of the eligible taxpayer with respect to which the eligible credit was determined.[7] For example, if a transferee taxpayer with a June 30th taxable year-end purchases credits determined in 2024 from a calendar-year eligible taxpayer, the transferee taxpayer will account for the purchased credits on its federal tax return ending June 30, 2025. A transferee taxpayer may account for credits it has purchased or intends to purchase when calculating its estimated tax payments but may not, depending upon the circumstances, receive penalty protection.



- **Partnerships and S Corporations:** In cases where the eligible credit is determined with respect to any facility or property held directly by a Partnership or an S Corporation, the transfer election must be made by the Partnership or S Corporation and not by any of the partners or shareholders.[8] In cases where a Partnership or an S Corporation elects to transfer an eligible credit, the amount paid by the Transferee to the Transferor (Partnership or S Corporation) is treated as tax exempt income and the partner's distributive share of such tax-exempt income is based on such partner's distributive share of the otherwise eligible credit.[9]

- **Registration & compliance:** To be eligible to transfer tax credits, the Transferor must satisfy certain pre-filing registration requirements.[10] For purposes of satisfying the pre-filing registration requirements, each eligible credit property must have its own registration number. An eligible taxpayer must obtain a registration number for each eligible credit property with respect to which a transfer election of a specified credit portion is made.

  To effectuate the transfer of the eligible credit, both the Transferor and the Transferee must report the transfer appropriately in their tax returns. A transfer election statement[11] shall be included in the Transferor's originally filed tax return no later than the extended due date for the tax return for the taxable year for which the credit is determined. Additionally, the Transferee must file (i) a properly completed Form 3800 to account for the transferred specified credit portion as a current general business credit (including all registration number(s) related to the transferred credits) and (ii) any other information related to the transfer election specified in guidance.[12]

Connecting IRC section 6418 with M&A processes

Overlap and difference in tax due diligence

Tax due diligence is critical in both traditional M&A and Transferability transactions to identify tax related risks and potential tax exposures. However, the focus of due diligence differs between these transaction profiles. In M&A, tax due diligence is typically just one of various due diligence focus areas, looking at the target company's tax compliance, potential outstanding tax liabilities, and overall valuation. This process aims to understand the financial health of the target, providing insights so that the acquirer makes an informed decision.

In contrast, tax due diligence is the primary focus of the Transferability diligence process. Transferability due diligence aims to substantiate the amount of the credits, identify potential tax risks or exposures (such as recapture, prevailing wage and apprenticeship requirements, placement into service verification, etc.), and certify the creditworthiness of Transferor (in case of a seller indemnity), Transferee (to afford the payment for the tax credits), or Transferor / Transferee guarantors (in case of a guarantee). Specifically, Transferability due diligence focuses heavily on the tax positions that the seller has taken with respect to the credit to be transferred. Since the value of the credit is entirely dependent on these tax positions, careful analysis of these positions is critical.

Legal diligence[13] and review are important in both M&A and Transferability due diligence. Legal reviews for M&A are expected to be more exhaustive, including but not limited to examining documents, legal status of entities, contracts, and compliance with regulations. For Transferability, the emphasis is on validating the amount and eligibility of the credits for transfer, driving compliance with the procedural requirements for a valid tax credit transfer and reviewing the terms of contractual agreements between Transferor and Transferee. Risk management in traditional M&A involves identifying and mitigating various risks associated with the acquisition, many of which are not tax related. For that reason, tax-specific insurance policies occasionally exist but are not as common in M&A. On the other hand, in Transferability, seller indemnities and / or tax insurance products are central to supporting the economic value to the Transferee. Most Transferees will not purchase tax credits without a seller indemnity or an insurance policy, and many require both.

Negotiation and structuring

The negotiation and structuring phase in both M&A and Transferability involve crafting a transaction structure that aligns with the strategic objectives and financial expectations of the parties involved. Both transaction types often include term sheets or LOIs that outline the key terms and conditions of the deal prior to formalization and execution of legal agreements (e.g., tax credit purchase agreement).

M&A negotiations often involve lengthy discussions to agree on the deal's terms, including price, payment structure, and post-closing arrangements. The tax structuring negotiations and process in M&A can take months and are often significant value drivers for the transaction. Payment terms in M&A may include cash payments, stock swaps, earn-outs, or other complicated structures. In Transferability, payment terms and the transaction structure have to be in compliance with the IRC and Treasury Regulations, which limit flexibility and, therefore, the need for lengthy negotiation. For Transferability, this phase involves negotiating the transfer price, payment terms (which may be complex for long-term purchase agreements), indemnification, and the terms of the purchase agreement.

Contractual agreements in both processes detail the sale terms, representations, warranties, indemnities, post-closing obligations, and other terms ensuring that all aspects of the deal are clearly defined and agreed upon. Notably for Transferability, the tax contest rights and procedures in the event of an IRS examination are negotiated within the agreement.

Valuation

Valuation in M&A is a critical component that is often performed using methods like Discounted Cash Flow, comparable company analysis, and precedent transactions. For Transferability, the price of the transferred credits is often set based on the market value of the credits, perceived tax credit risks, expected cash tax benefits, and financial impact on both parties. This value may differ or be influenced by a range of factors, such as market conditions (including available supply and demand), project characteristics (e.g., satisfaction of prevailing wage and apprenticeship requirements, beginning of construction exception, domestic content requirements, etc.), the type and volume of the credit, and whether tax insurance, a seller indemnity, or a third-party tax opinion is provided. The value will also depend on Transferee's ability to efficiently utilize the credit amount being purchased, with tax analysis required to determine that amount.

Execution and compliance

Executing the transaction and ensuring compliance are imperative in both M&A and Transferability processes. In M&A, closing the deal involves the transfer of ownership, execution of final agreements, and payment settlement. Similarly, in Transferability, the process involves the formal transfer of credits, updating IRS records, and meeting all legal and regulatory requirements. Tax compliance for M&A will depend entirely on the details of the transaction, while in Transferability, strict adherence to IRC section 6418 guidelines is necessary, including proper reporting to the IRS by both parties. It is worth noting that specific facts and circumstances of particular tax credits (e.g., emissions calculations, technical requirements for IRC sections 45Q or 45V, among others) will necessitate special tax compliance requirements. Comprehensive documentation is required in both processes, and all legal agreements, financial records, and regulatory filings should be properly recorded, filed, and maintained.

Conclusion

The similarities of Transferability and other M&A processes highlight the importance of thorough tax due diligence. Both processes require a deep understanding of the tax aspects so transactions are structured with adherence to relevant tax laws and regulations. In the context of Transferability, applying M&A practices can help in accurately valuing the credits, negotiating favorable terms, and being in compliance with the law and IRS guidance. This comprehensive approach not only facilitates the successful transfer of tax credits but also provides valuable insights into enhancing financial strategies and achieving broader business objectives.

End notes

1. IRC section 6418(f)(2).
2. IRC section 6418(a).
3. IRC section 6418(a) and Treas. Reg. § 1.6418-2(f)(3)
4. IRC section 6418(f)(1)(A)(i)-(xi) and Treas. Reg. § 1.6418-1(c)(2).
5. IRC section 6418(b).
6. IRC section 6418(e)(2) and Treas. Reg. § 1.6418-2(c)(2).
7. Treas. Reg. § 1.6418-2(F)(1).
8. IRC section 6418(c)(2).
9. IRC section 6418(c)(1).
10. Treas. Reg. § 1.6418-4
11. Treas. Reg. § 1.6418-2 through 1.6418-3
12. Treas. Reg. § 1.6418-(2)(F)(4).
13. The Deloitte US firms do not practice law or provide legal advice.

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