November 27, 2024

Re: Chaining of Direct Pay and Transfer of Credits

Notice 2024-27

I am writing on behalf of Taxpayers for Common Sense, a nonpartisan organization dedicated to ensuring taxpayer dollars are spent responsibly and efficiently. We appreciate the opportunity to provide comments on Notice 2024-27: Request for Comments on Situations in Which a Section 6417(a) Election Could Be Made for Credits Purchased in Transfers Under Section 6418(a).

Introduction

Taxpayers for Common Sense (TCS) is a national nonpartisan budget watchdog that has been advocating fiscal responsibility on behalf of taxpayers since 1995. Our mission is to promote a federal government that operates within its means and serves the public interest rather than special interests. We focus our efforts on eliminating programs and policies that are both wasteful and harmful, subsidies to polluting industries, weapons systems that do not work, and perverse incentives that increase taxpayer and environmental risks. As a multi-issue budget watchdog, we bring a perspective informed by both breadth and depth on issues ranging from agriculture, natural resource management, infrastructure, and national security.

Elections Under Sections 45V, 45Q, and 45X

Direct pay allows eligible entities to receive the full value of certain tax credits as cash payments from the government, rather than as a reduction in tax liability. Transferability permits the sale of tax credits to unrelated taxpayers. The Inflation Reduction Act of 2022 (IRA) generally excludes corporations from direct pay, except in three specific cases:

1. Advanced Manufacturing Production Credit (Section 45X)
2. Clean Hydrogen Production Credit (Section 45V)
3. Carbon Oxide Sequestration Credit (Section 45Q)

The IRS' final rule on direct pay specifies that any taxpayer—not just tax-exempt entities—may treat credits under Sections 45V, 45Q, and 45X as refundable payments for a five-year period. For Sections 45V and 45Q, the election applies to the first five years after a facility is placed in service, while for Section 45X, it is available for any consecutive five-year period while the credit is in place. Outside this election period, taxpayers can elect to transfer their credits.

This exception for corporations is significant, as it broadens the availability of direct pay to entities beyond those initially intended. “Chaining” refers to the potential practice of combining direct pay and transferability in sequence. In this scenario, a corporation could acquire tax credits through a transfer and then subsequently receive direct payment for those credits. If corporations purchase 45Q, 45V, and 45X credits through transfer of credit are allowed to elect to receive them as direct payment, it could create a level of market complexity that exceeds the IRS’ capacity to effectively oversee and monitor. This would have significant consequences for taxpayers.

Recognizing these challenges, the IRS released final rules on direct pay in March 2024, prohibiting the chaining of direct pay and credit transfers. Under these rules, eligible taxpayers cannot elect to receive direct payment for transferred credits. In the final rule, the IRS cited concerns about the administrability of chaining.[1]

Administrative Challenges

Chaining will create practical and administrative challenges.

Prohibiting chaining and treating direct pay and transferability as distinct and separate provisions will enable the IRS to administer tax credits more accurately. By contrast, creating a limited exception tailored to specific situations or types of taxpayers—and limiting the prohibition of chaining to potentially abusive scenarios—would be complex and administratively burdensome.

In addition, the pre-filing registration process and portal—a key anti-fraud and abuse feature authorized under Sections 6417 (direct pay) and Section 6418 (transfer of credits)—may not effectively distinguish relationships between eligible parties in cases involving chaining. This limitation could necessitate case-by-case assessments. In the final rule, the IRS acknowledged that it lacks the capability to ensure that “proposed distinctions or criteria could be sufficiently verified in an administratively reasonable manner during the pre-filing registration process.”

Furthermore, allowing chaining would require additional rules to address the operational and administrative differences between the two provisions. For example, transfer elections under section 6418 for credits such as Sections 45, 45Q, 45X, 45V, and 45Y are made annually, whereas direct pay elections under section 6417 are made for a multi-year period and are irrevocable. Additionally, transfer elections under section 6418 can be made for a portion of eligible credits, whereas direct pay elections under section 6417 do not permit partial elections.

Potential Risks of Fraud and Abuse

Allowing corporations to chain direct pay and transferability could also create several avenues for fraud and abuse:

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[1] https://www.federalregister.gov/documents/2024/03/11/2024-04604/elective-payment-of-applicable-credits-elective-payment-of-advanced-manufacturing-investment-credit

1. **Credit Inflation Schemes**: Corporations could potentially inflate the value of transferred credits while also claiming excessive payments through direct pay.

Accurately valuing and administering tax credits is challenging, particularly for complex or novel projects like hydrogen production or carbon capture and storage. These challenges are exacerbated when tax credits lack robust oversight safeguards. For instance, significant oversight gaps persist for 45Q credits, making them vulnerable to fraud and abuse.

A corporation could potentially collude with a credit seller to artificially inflate the credit's value and then claim this inflated amount through direct pay. This would result in the government paying out more than the actual value of the credit. Under current 45Q rules, the IRS primarily relies on carbon tonnage data reported to the EPA by facility operators, without conducting any physical verification of captured, sequestered, or utilized carbon. At Enhanced Oil Recovery (EOR) sites, companies compliant with EPA Subpart RR regulations are allowed to self-certify reported volumes, with a company official attesting to the accuracy of the figures reported to the IRS. Alternatively, EOR operators may use a different international carbon reporting standard, supplementing it with a statement from an independent engineer or geologist affirming the accuracy of the reported volumes.

Given the lack of on-site verification by either the IRS or the EPA, scenarios of abuse become plausible. For example, Company A could develop a CCS project generating $10 million in tax credits. Through a chaining system, Company B, in collusion with Company A, might "purchase" these credits for a purported value of $12 million. Company B would then claim $12 million in direct pay from the government, resulting in a $2 million overpayment. Currently, few mechanisms exist to prevent such collusion, where credit sellers and buyers could overstate sequestration volumes and 45Q credit amounts.

2. **Shell Company Proliferation**: Allowing the chaining of direct pay and transferability could incentivize the creation of shell companies solely to facilitate credit transfers and direct pay claims.

Corporations might set up multiple shell entities to exploit the direct pay and transfer systems repeatedly using the same underlying credit. For example, Corporation X could create Subsidiaries A, B, and C. Portions of credits could then be transferred from Corporation X to each subsidiary, with the value of the credits potentially inflated at each step. This process could maximize the total credit payout while minimizing the corporation’s overall tax liability.

3. **Exploitation of Recapture Provisions**: Chaining could complicate the enforcement of recapture provisions, potentially allowing corporations to avoid repaying credits that should be recaptured.

If a project ceases to qualify for credits after they have been transferred and claimed through direct pay, it may become challenging to enforce recapture provisions. For example, CCS Facility A qualifies for 45Q credits, which are fully transferred to Company B and claimed via direct pay. If the carbon stored by Facility A were later found to have leaked into the atmosphere, the IRS final rule on transferability states

that the transferee taxpayer, in this case Company B, would be responsible for repaying the credit. However, if Company B is a shell entity created solely to collect direct payment for transferred credit, it could dissolve after collecting the tax benefits, leaving the IRS with no responsible parties from which to recover the improperly claimed credit.

Chaining Will Result in Revenue Loss and Cost Taxpayers
Making energy credits refundable could lead to considerable federal revenue losses. Allowing corporations to claim refundable tax credits imposes additional costs on federal taxpayers. While refundable tax credits are a valuable tool for providing income support via the tax code, they have historically been reserved for households. Extending these income-support incentives to businesses—especially when many companies benefiting from programs like 45Q, 45V, and 45X already enjoy very low effective tax rates—raises serious concerns.

Conclusion
The ability to chain direct pay and transferability for clean energy tax credits could increase the flexibility and attractiveness of these incentives, but it also introduces significant risks of fraud and abuse. The complexity of the clean energy sector, coupled with substantial financial incentives, creates a landscape vulnerable to exploitation by sophisticated actors. Implementing and overseeing such a system poses considerable challenges.

To effectively monitor and enforce compliance, the IRS would need to significantly bolster its capabilities in data analysis, industry expertise, and cross-agency coordination. The potential for abuse must be carefully weighed against the benefits of increased clean energy investment and development. As the Treasury Department and IRS consider allowing chaining, they must develop robust safeguards, including clear regulatory guidelines, enhanced reporting requirements, advanced analytics to detect anomalies, and strengthened enforcement measures.

The decision to allow chaining will require a careful balance between accelerating clean energy adoption and protecting the integrity of the tax system while ensuring responsible use of public funds. Any implementation of chaining should include a comprehensive risk mitigation strategy and a commitment to continuous monitoring and adjustment as needed.

Tax incentives play a critical role in driving investment and innovation in the energy sector, but their effectiveness and sustainability hinge on maintaining public trust and ensuring proper use. Expanding these mechanisms through chaining should be approached with caution, rigorous planning, and strong safeguards to prevent misuse and uphold the public's confidence in the system.

Thank you for considering our comments. We look forward to continued engagement on this important issue.

Sincerely,

President, Taxpayers for Common Sense