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Electing out of subchapter K and direct pay - Proposed regulations

Tax Alert

Overview

Section 6417 provides that "applicable entities" (or "electing taxpayers" for credits provided in section 45V, 45Q, or 45X) may elect to treat certain credits ("applicable credits," as defined in section 6417(b) and Treas. Reg. § 1.6417-1(d)) as a direct payment made against their federal income tax liabilities, thereby allowing such entities a federal tax refund of the amount of the direct payment in excess of any tax liability (the "direct-pay election"). On March 5, 2024, the IRS and Treasury released final regulations (T.D. 9988) under section 6417 (the "Final Regulations"). Consistent with the proposed regulations under section 6417 (REG-101607-23), the Final Regulations provide that a partnership, regardless whether it is wholly or partially owned by applicable entities, is not an applicable entity and cannot make a direct-pay election. However, an applicable entity that is a co-owner in an "applicable credit property" (as defined in Treas. Reg. § 1.6417-1(e)) through an organization that has made a valid election under section 761(a) to be excluded from the application of subchapter K of the Code (an "election out of subchapter K") may make a direct-pay election under section 6417 for the applicable credits determined with respect to its undivided interest in the applicable credit property.

On March 5, 2024, the IRS and Treasury released proposed regulations (REG-101552-24) that would modify the current regulations under section 761 to allow certain unincorporated organizations that are organized exclusively to produce electricity from renewable resources to be excluded from the application of partnership tax rules (the "Proposed Regulations"). The Proposed Regulations modify existing requirements to elect out of subchapter K for an "applicable unincorporated organization" (as described below). The general purpose of the Proposed Regulations is to enable applicable entities to make a direct-pay election with respect to their pro-rata share of applicable credits in certain limited situations. The Proposed Regulations are proposed to apply to taxable years ending on or after the date of the publication of the Proposed Regulations in the Federal Register (March 11, 2024).

Election Out of Subchapter K and Reason for Proposed Regulations

Under the current regulations, an unincorporated organization that is availed of for the joint production, extraction, or use of property may make an election out of subchapter K if members in the unincorporated organization:

(i) own the property as co-owners, either in fee or under lease or other form of contract granting exclusive rights (the "co-ownership requirement"),
(ii) reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used (the "separate disposal requirement"), and
(iii) do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year (the "no joint marketing requirement").

According to the preamble, commentors to the proposed regulations under section 6417 expressed concern that the co-ownership requirement would make it more difficult for parties to obtain financing, and that the no joint marketing requirement would put applicable entities at a disadvantage negotiating with utilities and other potential counterparties, which may be averse to negotiating with multiple owners of a single renewable energy project. In addition, the preamble explains that in order "to further the intent of Congress to encourage applicable entities to build, operate, and own renewable energy projects, it is necessary to expand the circumstances in which joint ownership arrangements of applicable credit property can be excluded from the application of subchapter K." Accordingly, the IRS and Treasury released the Proposed Regulations, which modify the co-ownership and no joint marketing requirements to allow certain entities organized exclusively to produce electricity from renewable sources (an "applicable unincorporated organization," as described below) to make an election out of subchapter K.

What is an Applicable Unincorporated Organization?

The Proposed Regulations define an "applicable unincorporated organization" (which may include a limited liability company (LLC)) as an unincorporated organization that meets the following four requirements:

(i) the organization is owned, in part or in whole, by one or more applicable entities,
(ii) the members of the organization enter into a joint operating agreement in which the members reserve the right to separately 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,
(iii) pursuant to the joint operating agreement above, the organization is organized exclusively to produce electricity from its applicable credit property and for which one or more of the renewable electricity production or investment credits (section 45, 45U, 45Y, 48, or 48E credit) is determined. This requirement may be satisfied prior to the applicable credit property being placed in service (if necessary), provided the unincorporated organization is in the process of completing the applicable credit property and will operate the applicable credit property once it is placed in service; and
(iv) one or more of the applicable entity members must make a direct-pay election under section 6417(a) for the applicable credits determined with respect to its share of the applicable credit property.

Specified Exceptions for Applicable Unincorporated Organization

For an organization that is an applicable unincorporated organization and meets the other requirements in Treas. Reg. § 1.761-2(b) and (e):

(i) the co-ownership requirement is modified such that members in an applicable unincorporated organization are permitted to own the applicable credit property through an unincorporated organization, and

(ii) the no joint marketing requirement is modified such that the delegation of authority to sell the member's share of the property produced may allow the delegee to enter into contracts the duration of which may be more than one year (*e.g.*, a multi-year power purchase agreement between the applicable unincorporated organization and an utility off taker), provided that the delegation of authority to act on behalf of the member may not be for a period of time that exceeds the minimum needs of the industry, and in no event for more than one year.

An applicable entity owning an interest in an applicable unincorporated organization that has made an election out of subchapter K may be eligible to make a direct-pay election for the applicable credit determined with respect to the applicable entity's share of the applicable credit property through the applicable unincorporated organization.

An example is also provided to illustrate the application of the specified exceptions for applicable unincorporated organizations.

Request for Comments

The IRS and Treasury request comments regarding the scope and requirements of the Proposed Regulations, including whether similar exceptions are necessary for applicable entities that own applicable credit properties that do not produce electricity. Comments are due by 60 days after the date of the publication of the Proposed Regulations in the Federal Register.