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Electing out of subchapter K – Final and 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 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"). Generally, applicable entities include tax-exempt entities and certain other enumerated entities. On March 11, 2024, the IRS and Treasury published final regulations under section 6417 (the "Final 6417 Regulations", T.D. 9988), which provided 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, the Final 6417 Regulations allowed a partnership to be treated as an electing taxpayer. In addition, the Final 6417 Regulations allowed 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") to make a direct-pay election under section 6417 for the applicable credits with respect to its undivided interest in the applicable credit property. Concurrently with the release of the Final 6417 Regulations, the IRS issued proposed regulations (the "March 2024 Proposed Regulations") providing amendments to the election out of subchapter K rules for certain unincorporated organizations.

On November 20, 2024, the IRS published final regulations (T.D. 10012) that largely adopted the March 2024 Proposed Regulations with limited modifications, but expanded the scope of activities to which these regulations would potentially apply (the "Final Regulations"). The Final Regulations would generally apply to taxable years ending on or after March 11, 2024.

Additionally, the IRS and Treasury issued proposed regulations (REG-116017-24) concurrently with the Final Regulations that provide administrative requirements for unincorporated organizations to comply with section 6417 (the "November 2024 Proposed Regulations"). The November 2024 Proposed Regulations are generally proposed to apply to taxable years ending on or after November 20, 2024.

In General: Election Out of Subchapter K

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 one year (the "no joint marketing requirement").

According to the preamble to the March 2024 Proposed Regulations, commentors expressed concern that the co-ownership requirement would make it difficult for parties to obtain financing for applicable credit property, and that the no joint marketing requirement would put applicable entities investing in renewable generation at a disadvantage when negotiating with utilities and other potential counterparties. The March 2024 Proposed Regulations responded to those concerns by proposing modifications to the requirements for electing out of subchapter K, which the Final Regulations largely adopt, but limit the modified election-out option to unincorporated organizations ''organized exclusively to produce electricity from … applicable credit property." Commentators to the March 2024 Proposed Regulations recommended that the election-out option was also needed for organizations organized to own applicable credit property with respect to which any other applicable credit listed in section 6417(b) is determined. In response, the Final Regulations expand the definition of an applicable unincorporated organization, as defined below, to include those organized exclusively to own and operate applicable credit property, not just those that produce electricity.

What is an Applicable Unincorporated Organization?

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

(i) the organization is owned, in whole or in part, 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 any property produced, extracted, or used, and any associated renewable energy credits or similar credits,
(iii) pursuant to the joint operating agreement, the organization is organized exclusively to own and operate applicable credit property,
(iv) one or more of the applicable entity members will make a direct-pay election under section 6417(a) for the applicable credits determined with respect to its share of the applicable credit property,
(v) the members of the organization are able to compute their income without necessity of computing partnership taxable income, and
(vi) the organization is not a syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association.

Specified Modifications for Applicable Unincorporated Organization

The Final Regulations provide two "specified modifications" to the election-out rules 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 (other than an unincorporated organization that is treated as a corporation for US federal income tax purposes), *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 or used may allow the delegee to enter into contracts the duration of which may be more than one year (for example, a long-term power purchase agreement between the applicable unincorporated organization and a 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.

In consequence, 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 owned through the applicable unincorporated organization. The Final Regulations provide a number of examples that illustrate the application of the special rules with respect to co-ownership and delegations that apply to members of an applicable unincorporated organization.

Additional Clarifications

The Final Regulations also provide the following clarifications:

- Partnership flip structures are not eligible under the Final Regulations to make a section 761(a) election;
- According to the preamble, "the existence of a partnership for purposes of these sections does not change the amount of depreciation deductions attributable to each member of an unincorporated organization that has validly made a section 761(a) election;" and
- For purposes of the agent delegation rule, in any given year, an agent may be delegated authority on terms identical to those in a past year, provided that the delegation of authority to act is not for a period of time that exceeds the minimum needs of the industry and each member delegating authority to that agent consents to those terms in writing at least once per year. Delegation arrangements that automatically renew will likely fail the agent delegation rule, as illustrated in a new example.

Additional Rules Proposed in the November 2024 Proposed Regulations (REG-116017-24)

The November 2024 Proposed Regulations generally provide that an election under section 761(a) made by a "specified applicable unincorporated organization" (as described below) will terminate as a result of a "terminating transaction" (as defined below). Such termination will be effective beginning on the first day of the taxable year beginning after the "hypothetical partnership taxable year" (as described below) in which the terminating transaction occurred.

- The November 2024 Proposed Regulations define a "specified applicable unincorporated organization" as an unincorporated organization having a valid section 761(a) election by applying the "specified modifications" provided under the Final Regulations.
- A "terminating transaction" means an acquisition or disposition of an interest in a specified applicable unincorporated organization (including

transfers among members of the organization), other than as the result of a transfer between a disregarded entity (as defined in Treas. Reg. § 1.6417-1(f)) and its owner.
- A "hypothetical partnership taxable year" generally means the taxable year that a specified applicable unincorporated organization would have had, if it had a tax year.

The November 2024 Proposed Regulations also provide an exception to the general termination rule if a specified unincorporated organization meets the requirements to make a new section 761(a) election and makes such an election, together with information about every terminating transaction that occurred in the hypothetical partnership taxable year, no later than the due date that would have been prescribed for filing a partnership return with respect to the hypothetical partnership taxable year (including extensions thereof). Example 4 in the November 2024 Proposed Regulations illustrates the application of the exception to the termination rule.

The November 2024 Proposed Regulations also clarify the procedure for revoking a section 761(a) election to provide that an application to revoke the election must be made by submitting a private letter ruling request that complies with the requirements of Revenue Procedure 2024-1 or successor guidance.