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IRS guidance offers path for tax-exempts to claim renewable energy tax credits through LLCs

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The Inflation Reduction Act permits state pension plans, tax-exempt organizations and other "applicable entities" that invest in certain renewable energy projects to receive cash payments from the IRS in lieu of tax credits. The IRS proposed regulations last week that would extend entitlement to these payments to clean electricity projects held through an LLC so long as certain conditions are met. The IRS also finalized a broader set of regulations on renewable energy tax credits.

The Inflation Reduction Act of 2022 (IRA) allows so-called "applicable entities" to elect to treat certain renewable energy tax credits as payments of federal income tax, generating a refund payment from the IRS (refundable tax credits or elective payment). Applicable entities generally include tax-exempt organizations, state and local government agencies and instrumentalities (including state pension plans and insurance funds), and certain other entities.

On March 5, 2024, the IRS proposed Treasury regulations (the Proposed Regulations) that would allow an applicable entity to claim these elective tax credit payments with respect to investments in LLCs and limited partnerships that own and operate clean electricity projects so long as the LLC or partnership validly elects for its owners to be taxed as if they directly owned the assets of the LLC or partnership (rather than be taxed under the rules generally applicable to LLCs and partnerships).

The IRS also finalized a broader set of regulations last week governing renewable energy credits (the Final Elective Payment Regulations). Under these final regulations, an applicable entity that owns an interest in a renewable energy project through a partnership is generally not permitted to claim elective payments. As a consequence, an applicable entity that co-invests in a renewable energy project generally cannot monetize the resulting tax credits through the elective payment procedure unless either the co-investors own the credit-producing property as tenants in common or a valid election out of partnership tax treatment is made.[1]

Election out of partnership tax treatment

Existing regulations under Section 761 of the Internal Revenue Code permit an "unincorporated organization" to elect out of partnership tax treatment in limited circumstances. Under these rules, an unincorporated organization that is engaged in the joint production, extraction or use of property (such as natural resources) may elect out of partnership tax treatment if, among other requirements, the property is owned by the organization's participants as co-owners, either in fee or via lease or other contractual interest, such as a joint operating agreement. In other words, the co-investors must own their interests in the property directly rather than through a partnership or LLC.

Under the existing regulations, the co-owners are not permitted to elect out of partnership tax treatment if they jointly sell the property that is produced or extracted. The co-owners may delegate authority to a third party to sell their shares of the produced or extracted property, but not for a period longer than one year (or, if shorter, the minimum needs of the industry).

Whether co-investments in renewable energy projects can be structured as a practical matter to satisfy these existing regulatory standards for electing out of partnership tax treatment is unclear. In particular, the requirement that the co-investors must own their interests in the credit-producing property directly, rather than through a legal entity such as an LLC, presents significant complexity in structuring commercially acceptable financing and other agreements. In addition, electricity produced by these projects is typically sold under contracts that have terms that are significantly longer than one year. To address these concerns, the Proposed Regulations would add a special provision expanding these rules for clean electricity projects.

Proposed expansion of Section 761 regulations

Under the Proposed Regulations, participants in a clean electricity project do not need to hold direct ownership interests in the property or in leases or other contracts relating to the property. Instead, they may hold their interests collectively in a single legal entity such as an LLC or partnership if the following requirements are met:

1. the partnership or LLC must have at least one owner that is an "applicable entity" (that is, the entity may have both applicable entity and taxable members),
2. the members of the partnership or LLC must enter into a joint operating agreement in which they reserve the right to separately take in kind or dispose of their pro rata shares of the electricity produced or associated renewable energy credits,
3. pursuant to a joint operating agreement, the partnership or LLC must be organized exclusively to produce electricity from certain applicable credit property with respect to which credits for renewable or clean electricity or zero-emission nuclear power are determined under Sections 45(a), 45U, 45Y, 48 or 48E, and
4. at least one of the applicable entities will make an elective payment election for refundable tax credits under Section 6417(a) (the refundable credit provision described above).

If the partnership or LLC meets these requirements, the partnership or LLC itself may enter into a long-term contract for sale of the electricity generated by the project. In addition, the owners of the partnership or LLC may delegate authority to negotiate such long-term contracts on their behalf, so long as the delegation of authority does not exceed one year (or, if shorter, the minimum needs of the industry).

The Proposed Regulations therefore would, if finalized, allow governments and other tax-exempt investors to hold interests in a single legal entity (such as a limited partnership or LLC) alongside taxable investors in clean electricity projects, and to enter into long-term power purchase agreements with utilities to sell their respective shares of the electricity produced, so long as the other requirements described above are met.

The Proposed Regulations are proposed to apply to taxable years ending on or after March 11, 2024.

Further guidance and remaining issues

The Treasury Department and the IRS have requested comments regarding the scope and requirements of the rules set forth in the Proposed Regulations, including whether similar exceptions are necessary for property that does not produce electricity. They have also requested comments regarding whether these elections should terminate if any interest in the applicable unincorporated organization is sold or exchanged absent a new election by all resulting members; whether certain "deemed election" rules should apply for these purposes; and whether additional anti-abuse rules are needed.

In addition to requesting comments on the Proposed Regulations, in a separate notice (Notice 2024-27), the IRS requested comments on situations in which an applicable entity may claim an elective payment with respect to a tax credit that it receives through a transfer under the Section 6418 tax credit transfer provisions (also enacted as part of the IRA). This so-called "chaining," which would be another potential path for an applicable entity to monetize renewable energy tax credits, is prohibited under the final regulations under Section 6417. The Treasury Department and the IRS recognize, however, that a robust market for transferred credits is consistent with Congress's intent in enacting the IRA, and they are continuing to consider potential chaining rules that would be consistent with the statutory framework and legislative purpose, while evaluating administrability challenges and potential for fraud.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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[1] Note that under the IRA, elective payments for carbon oxide sequestration under Section 45Q, advanced manufacturing production under Section 45X, and clean hydrogen production under Section 45V are also available to taxpayers that are not applicable entities, including partnerships. The Proposed Regulations do not affect the availability of these tax credits claimed through a partnership.