ALERT

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Final Regulations Expand Access to "Direct Pay" Elections for Energy Credits

The U.S. Department of the Treasury and the Internal Revenue Service have issued final regulations allowing tax-exempt entities that are partners in clean energy projects to elect to receive energy tax credits in cash.

The Inflation Reduction Act of 2022 allows nonprofits, government agencies, and certain other tax-exempt organizations ("Applicable Entities") to elect direct payment of clean energy credits. By making a direct pay election, Applicable Entities can receive cash payments from the Internal Revenue Service in respect of their renewable energy credits, even if they do not owe any federal income taxes.

Special rules apply to direct pay elections for projects owned by partnerships. If a clean energy project is owned by a partnership (including an LLC treated as a partnership for tax purposes), the partnership is the entity that must make the direct pay election. However, a partnership generally would not qualify as an Applicable Entity under the direct pay regulations, except in limited situations.

Regulations proposed in March 2024 contemplated that certain unincorporated entities, like LLCs, that own clean energy projects and that are owned by Applicable Entities, could elect out of being partnerships for tax purposes. If an Applicable Entity could elect out of partnership status, it would be treated as a co-owner of the clean energy project and could make its own direct pay election. But under the proposed regulations, an unincorporated entity could elect out of partnership status only if organized "exclusively to produce electricity," a limitation that many interpreted to exclude several types of clean energy partnerships.

The final regulations expand the ability of unincorporated entities to elect out of partnership status. Under the final regulations, an unincorporated entity is generally eligible to elect out of partnership status if: (i) it is owned in whole or in part by one or more Applicable Entities that will make a direct pay election; (ii) the owners of the entity enter into a joint operating agreement that meets the requirements of the regulations; and (iii) the entity is organized exclusively to "own and operate" a clean energy project. By electing out of partnership status, the unincorporated entity will enable its owners that are Applicable Entities to make their own direct pay elections.

In addition to the final regulations, Treasury issued proposed regulations that address various ancillary matters. The final regulations apply to taxable years ending on or after March 11, 2024.

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