UNDERSTANDING THE NEW PROHIBITED FOREIGN ENTITY RULES FOR CLEAN ENERGY TAX CREDITS

Date: 18 September 2025

US Policy and Regulatory Alert

By: Michael W. Evans, David J. Skillman, Marne Marotta, Martha G. Pugh, Vivian K. Bridges

INTRODUCTION

The One Big Beautiful Bill Act[1] (OBBBA) makes major changes to the Internal Revenue Code's (Tax Code) clean energy tax provisions, particularly to the provisions that were extended, expanded, and established as part of the 2022 Inflation Reduction Act (IRA). In some cases, the OBBBA terminates or limits the duration of energy tax incentives. In other cases, it imposes new requirements that must be met in order to claim the remaining incentives. In particular, the OBBBA imposes a series of restrictions that apply when a "prohibited foreign entity" (PFE) participates in the production supply chain for a facility or product for which a taxpayer seeks to claim an energy tax credit.

This alert describes the new PFE rules based on the statutory language of the OBBBA. Pursuant to Executive Order 14315 of 7 July 2025 and Internal Revenue Service (IRS) Notice 2025-42, forthcoming guidance from the US Department of the Treasury (Treasury) is expected that will shed additional light on the implementation of these rules. The discussion starts with some brief background. Then it describes the operation of the rules, including their scope; the key definitions of PFE, specified foreign entity (SFE), and foreign-influenced entity (FIE); and the application of the material assistance test.

These new PFE rules are important. They also are complicated, requiring a cascading series of determinations, which are outlined below.

BACKGROUND

Over the past several years, there has been growing congressional concern about the United States' reliance on companies related to potential foreign adversaries, particularly China, in the supply chain for critical products. This concern has been the subject of investigations and hearings,[2] and it has resulted in the enactment of several laws imposing restrictions on foreign products and components.

The first of the new statutory restrictions was enacted in 2021, as part of the Infrastructure Investment and Jobs Act (IIJA).[3] The IIJA established grant programs for, among other things, battery processing projects, recycling projects, and critical minerals mining projects. In each case, the law prohibited grants from being awarded to projects using material that originates from or is supplied or processed by a foreign entity of concern (FEOC).[4] The definition of a FEOC covers organizations that are designated as threats to national security by various federal agencies.[5]

©2005-2026 K&L Gates LLP. All Rights Reserved.

Several other recent laws imposed similar restrictions, including the 2022 CHIPS and Science Act, which imposed restrictions with respect to semiconductor manufacturing projects;[6] the National Defense Authorization Act (NDAA) for fiscal year 2021, which imposed restrictions associated with Chinese military companies;[7] the Uyghur Sanctions Act, which imposed restrictions on various companies operating in or associated with China's Xinjiang autonomous region;[8] and the NDAA for fiscal year 2024, which imposed restrictions on seven specifically identified Chinese battery production companies.[9]

The 2022 IRA extended, expanded, and established various clean energy tax credits. In one case—the new section 30D tax credit for electric vehicles—the IRA imposed a FEOC restriction, making the credit unavailable for an otherwise eligible clean vehicle if any of the critical minerals contained in the battery "were extracted, processed, or recycled by a foreign entity of concern [as defined in the IIJA]" or if any of the vehicle's battery components "were manufactured or assembled by a foreign entity of concern (as so defined)."[10]

As Congress began work on the bill that became the OBBBA, there was significant interest, among the bill's proponents, in cutting back the IRA clean energy tax provisions, partly for budgetary reasons and partly for other policy reasons.[11] The final version of the OBBBA enacted many provisions along these lines, including provisions terminating or limiting the duration of energy tax incentives and imposing new requirements that must be met in order to claim the remaining incentives.

A key part of this effort was the dramatic expansion of the FEOC restrictions. Under the OBBBA, the FEOC restrictions—now referred to as the PFE restrictions—apply more broadly to many more energy tax provisions than just section 30D; the restrictions also reach more deeply, imposing restrictions that go well beyond those under the FEOC rules. The new PFE rules are, essentially, FEOC on steroids.

We now turn to the operation of the new rules.

OPERATION

The new restrictions apply to six tax credits, but the scope of the restriction varies. For three credits—the section 45Q carbon sequestration credit, the section 45U nuclear credit, and the section 45Z clean fuels credit, the scope is relatively limited, simply prohibiting a PFE from qualifying for the credit.[12] For the three other credits—the section 45Y and section 48E clean electricity credits and the section 45X advanced manufacturing credit, the scope is broader, not only prohibiting a PFE from qualifying for the credit but also denying the credit for projects with respect to which a PFE provides material assistance.

We next discuss the definition of a PFE. Then we turn to the rules regarding material assistance.

DEFINITION OF A PFE

New Tax Code section 7701(a)(51) provides, simply, "the term 'prohibited foreign entity' means a specified foreign entity or a foreign influenced entity." (Emphasis added.) So, at the most basic level, a PFE includes both an SFE and an FIE.

The first of these terms, SFE, comprises five categories of entities drawn from the FEOC rules and other existing statutory definitions.[13] The five categories are as follows:

- A FEOC (per the existing statutory definition).[14]

©2005-2026 K&L Gates LLP. All Rights Reserved.

- A Chinese military company (per an existing statutory definition).
- A listed Uyghur sanctions entity (per an existing statutory definition).
- A listed prohibited battery entity (an existing statutory definition).
- A "foreign controlled entity," which is the government of a "covered nation" or an entity that is a citizen of, incorporated in, or controlled by a "covered nation."[15]

There are various details to consider, and some of the relevant lists can be expanded by administrative action.[16] That said, as a general matter, the determination of whether an entity falls into one of these five categories, and hence constitutes an SFE, is relatively mechanical, although facts and circumstances, such as indirect ownership, could be complicating factors.

Then comes the more difficult part. A PFE, again, includes not only an SFE, but also an FIE. With respect to an FIE, the determination requires the application of a series of tests, some complex and subjective.

As a general matter, the determination that an entity is an FIE looks back to whether an SFE is involved. Specifically, an FIE is an entity that is subject to either *formal control* or *effective control* by an SFE.

The test for formal control,[17] in section 7701(a)(51)(D)(i), is mechanical. An entity is an FIE if any one of the following relationships exists:

- An SFE has authority to appoint a covered officer.
- A single SFE owns at least 25% of the stock.
- SFEs, in the aggregate, own at least 40% of the stock.
- SFEs, in the aggregate, hold at least 15% of the debt.

However, testing for formal control is only the first level of analysis. Even if none of these relationships exist, an entity nevertheless is an FIE if it has made a payment to an SFE in exchange for the SFE's right to exercise any one of four forms of "effective control," which are control of a qualified facility; control of energy storage technology; control of the extraction, processing, or recycling of a critical mineral; or control of the production of an eligible component.

This takes us to the meaning of the term "effective control." As a starting point, the statute provides that "effective control" means an agreement providing a SFE counterparty with "specific authority over key aspects of the production of eligible components, energy generation … or energy storage…." The Treasury Secretary then is directed to issue guidance regarding effective control. Until such guidance is issued, the statute further provides that "effective control" means the unrestricted contractual right of an SFE counterparty to control any one of the following: the amount or timing of the production of components; the amount or timing of the production or storage of electricity; the use of components; the purchase or use of output; access to data, a site, or personnel; or maintenance, repair, or operations.

There are special rules for licensing. New Tax Code section 7701(b)(51)(D)(ii)(III) provides that, with respect to agreements for licensing intellectual property (and related agreements), "effective control" means the retention of a contractual right to specify or direct the sources of components, subcomponents, or applicable critical minerals;

©2005-2026 K&L Gates LLP. All Rights Reserved.

the retention of a contractual right to direct operations; the retention of a contractual right to limit the use of the intellectual property; the retention of a contractual right to receive royalties for more than 10 years; the retention of a contractual right to provide services for more than two years; or a limitation on the provision of data, information, or know-how.[18]

Finally, the statute establishes special rules exempting certain publicly traded entities,[19] defining various terms, and establishing rules for determining the beginning of construction (BOC). Notably, BOC rules for PFE purposes differ from BOC standards for other energy credit purposes.[20]

Pulling this together, the definition of a PFE starts with a relatively mechanical definition, of a SFE, then expands to include a FIE, which is an entity that is subject to either formal or effective control by an SFE, with effective control determined by several tests that are subjective and will be fleshed out by forthcoming guidance.

For three energy tax credits, the determination of whether an entity is an PFE is the end of the matter: Under sections 45Q, 45U, and 45Z, if the taxpayer itself is a PFE, it is not eligible for the credit; if the taxpayer itself is *not* a PFE, no limitations apply.

Not so for three other energy tax credits: Under sections 45Y, 45X, and 48E, even if the taxpayer *itself* is not an PFE, it is prohibited from claiming the credit for a facility that receives *material assistance* from a PFE.

The key provision is OBBBA section 70512(b), which amends Tax Code section 45Y(b)(1) to add new subparagraph (E), which provides, "[t]he term 'qualified facility' shall not include any facility for which construction begins after December 31, 2025, if the construction of such facility includes any material assistance from a PFE (as defined in section 7701(a)(52))." Sections 45X and 48E contain similar limitations.[21]

We now turn to the definition of material assistance.

MATERIAL ASSISTANCE

The OBBBA establishes a new overarching definition under paragraph (52) of Tax Code section 7701(a). It provides, in subparagraph (A), that the term "material assistance from a prohibited foreign entity" means:

- With respect to any qualified facility or energy storage technology, a material assistance cost ratio which is less than the threshold percentage applicable under subparagraph (B), or
- With respect to any facility which produces eligible components, a material assistance cost ratio which is less than the threshold percentage applicable under subparagraph (C).

Paragraph (52) then goes on, in subparagraphs (B) through (G)—which stretch over more than a dozen pages of statutory text—to elaborate: defining the material assistance cost ratio (MACR), establishing threshold percentages, establishing a system for providing safe harbors, and establishing certification requirements.

The general rule establishes that material assistance is provided if the MACR is less than the relevant "threshold percentage." Put simply, the MACR measures the percentage of applicable direct costs attributable to non-PFE sources. Determining the MACR is, on its face, relatively straightforward. Under section 7701(a)(52)(E), the MACR is the quotient of the amount of total applicable direct costs attributable to the qualified facility, energy storage technology, or production of eligible components, less the applicable direct costs attributable to products, components, or energy storage technology that are mined, produced, or manufactured by a PFE, divided by the

©2005-2026 K&L Gates LLP. All Rights Reserved.

total applicable direct costs. In other words, the MACR is the ratio of *total* applicable direct costs minus applicable direct costs attributable to an PFE compared to the total applicable direct costs. For example, if the total applicable direct costs of constructing a qualified facility are US$100, and the applicable direct costs attributable to an PFE are US$20, the MACR is 100-20/100, or 80%. For qualified facilities and energy storage technology, applicable direct costs include labor and materials. For eligible components, the applicable direct costs are materials.

So far, so good. The MACR then is applied against a "threshold percentage," which varies by product and over time. With respect to products, there are separate percentages for qualified facilities, for energy storage technology, and for components—with components broken down into solar components, wind components, inverters, battery components, and critical minerals. With respect to the time period, in each case, the threshold percentage increases (that is, becomes more stringent) by year. For example, for inverters, the threshold percentage rises by increments of 5 percentage points a year from 2026 to 2030—that is, from 50% in 2026 to 70% in 2030, effectively reducing the percentage of applicable direct costs that can be PFE-related.

In an implicit acknowledgement of the complexity of the MACR system, the Treasury Secretary is directed to establish "safe harbor tables" and other appropriate guidance to identify the total direct costs (of manufactured products and components) attributable to a PFE and to "provide all rules necessary to determine the amount of a taxpayer's material assistance from a prohibited foreign entity." The statutory deadline for the safe harbor tables and other guidelines is 31 December 2026.

In the meantime (that is, before the safe harbor issues are promulgated), a taxpayer may rely on two sets of materials, so long as the taxpayer does not know or have reason to know to the contrary: on the tables included in IRS Notice 2025-08[22] (to establish the total direct cost of any listed component or manufactured product) and on a supplier's certification (to establish that the product or component was not produced or manufactured by a PFE and to establish total direct costs).

Having thus laid out the system for calculating the MACR, the section 7701(a)(52) definition of "material assistance" then briefly concludes with some "housekeeping" provisions: defining various terms, providing regulatory authority, and establishing rules for the treatment of existing contracts, to prevent circumvention, for determining BOC[23] and for determining ownership. The OBBBA also extends the statute of limitations and establishes significant penalties in the case of errors and understatements associated with the MACR.

FORTHCOMING GUIDANCE

The provision of regulatory authority, in paragraph (52)(G), comes with a post-enactment twist. Three days after signing the OBBBA, President Trump issued an executive order, entitled "Ending Market Distorting Subsidies For Unreliable, Foreign Controlled Energy Sources,"[24] directing the administration to implement the OBBBA clean energy tax provisions consistently with the intent of the OBBBA, which the executive order describes as including the "end [of] taxpayer support for unaffordable and unreliable 'green' energy sources and supply chains built in, and controlled by, foreign adversaries." As part of this implementation effort, the executive order specifically directs the Treasury Secretary to "take prompt action as the Secretary of the Treasury deems appropriate and consistent with applicable law to implement the enhanced Foreign Entity of Concern restrictions in the [OBBBA]." Given this direction, we expect the administration, in issuing guidance interpreting the PFE provisions, to lean into a stringent interpretation that will provide further clarity on the implementation of the PFE rules. Members of

©2005-2026 K&L Gates LLP. All Rights Reserved.

Congress continue to retain a close interest in these developments as well. Several senators, including Sen. Chuck Grassley (R-IA), Sen. John Curtis (R-UT), and Sen. Thom Tillis (R-NC) have placed holds on certain Treasury nominees as they evaluate Treasury's guidance.[25]

Please contact any of the authors of this alert representing the firm's team under our Public Policy and Law; Tax; and Power practice groups for assistance in understanding and implementing these complex new rules or to provide input to Treasury and the IRS as guidance is being developed.

FOOTNOTES

[1] Pub. L. No. 119-21 (2025).

[2] *See Strengthening Domestic Manufacturing and Our Health Care Supply Chain: Hearing before the Subcomm. on Health of the H. Comm. on Energy and Comm.,* 119th Cong. (2025); *Mapping America's Supply Chains: Solutions to Unleash Innovation, Boost Economic Resilience, and Beat China: Hearing before the Subcomm. on Innovation, Data, and Comm. of the H. Comm. on Energy and Comm.,* 118th Cong. (2023); *Examining Ways to Enhance Our Critical Mineral Supply Chains: Hearing before the Subcomm. on Oversight and Investigations of the H. Comm. On Energy and Comm.,* 119th Cong. (2025); *Trade in Critical Supply Chains: Hearing before the S. Comm. on Finance,* 119th Cong. (2025).

[3] Pub. L. No. 117-58 (2021).

[4] *Id*. §§ 40207, 40210 (these provisions are codified at 42 U.S.C. §§ 18741, 18743).

[5] *See id*.

[6] Pub. L. No. 117-167 (2022).

[7] Pub. L. No. 116-283, § 1260H (2021).

[8] Pub. L. No. 117-78 (2021).

[9] Pub. L. No. 118-31, § 154 (2023).

[10] Pub. L. No. 117-169, §13401(e)(2), adding IRC § 30D(d)(7).

[11] With respect to budgetary policy, the Joint Committee on Taxation estimated that the OBBBA provisions curtailing clean energy tax incentives will increase federal revenue by about US$500 billion over 10 years. With respect to nonbudgetary policy, President Donald Trump's recent executive order (see footnote 24) decried “taxpayer support for unaffordable and unreliable 'green' energy sources and supply chains built in, and controlled by, foreign adversaries.”

[12] Specifically, a taxpayer is ineligible for the tax credits if the taxpayer either is an SPE or is an FIE under the formal control test (but not under the effective control test). See Tax Code § 45Q(f)(10).

[13] Pub. L. No. 119-21 § 7701(a)(51)(B).

[14] Pub. L. No. 119-21 § 7701(a)(51)(B)(i). The underlying FEOC definition, in 15 U.S.C. § 4651, consists of five subparagraphs, (A) through (E). Section 7701(a)(51)(B)(i) incorporates four of the five, subparagraphs (A), (B), (D), and (E), but not subparagraph (C), which includes a list of “covered nations” that is identical to the list of

©2005-2026 K&L Gates LLP. All Rights Reserved.

covered nations incorporated elsewhere in this OBBBA provision and hence would be redundant.

[15] Under present law, a "covered nation" is China, Russia, North Korea, or Iran. See Pub. L. No. 116-283 § 9901(8).

[16] Under subparagraph (D) of the fiscal 2021 NDAA FEOC provision, an entity is a FEOC if it is "alleged," by the US Attorney General, "to have been involved in activities for which a conviction was obtained" under various national security laws. Under subparagraph (E), an entity is a FEOC if the Treasury Secretary determines that the entity is "engaged in unauthorized conduct that is detrimental to the national security or foreign policy of the United States."

[17] Tax Code § 7701(a)(51)(D)(i). "Formal control" is not the term used in the statute itself; rather, it is a term we use here for convenient reference.

[18] There is an exception for the bona fide purchase or sale of intellectual property. Tax Code § 7701(b)(51)(D)(ii)(III)(bb).

[19] The rules with respect to publicly traded entities are particularly complex. As a starting point, the definition of a PFE excludes an entity that is traded on a national securities exchange regulated by the Securities and Exchange Commission (SEC) or on any other exchange or market that the Treasury Secretary determines has sufficient rules in place (unless the exchange is incorporated, organized, or has its principal place of business in a covered nation (currently China, Russia, North Korea, or Iran)), or either the entity's securities are traded in a similar manner or at least 80% of the securities are held by an entity whose securities are traded on a national exchange regulated by the SEC. However, the exclusion does not apply if the entity is required to report under certain beneficial ownership rules or if a SFE either has the authority to appoint a covered officer or holds more than 15% of the debt. 26 U.S.C.

[20] *See* footnote 3 of IRS Notice 2025-42, noting "Section 70512 of the OBBBA added . . . new restrictions regarding certain foreign entities in order to qualify for the § 45Y credit and the § 48E credit, among others, and included separate beginning of construction rules for those new provisions." The IRS Notice further indicates the IRS and Treasury are drafting responsive guidance to implement those restrictions.

[21] Tax Code §§ 45X(c)(1)(C) (with respect only to eligible components), 48E(b)(3)(C)(6), 48E(c)(3).

[22] Notice 2025-18 provides an elective safe harbor for calculating the domestic content amounts for manufactured products and components under the various domestic content requirements of the IRA.

[23] For a detailed discussion of BOC rules, see this K&L Gates alert: Budget Reconciliation Law Puts Beginning of Construction in the Spotlight.

[24] Exec. Order No. 14315, 90 FR 30821 (2025).

[25] Amelia Davidson, *Republican senators continue nominee holds over renewables*, POLITICO PRO (Sept. 5, 2025).

©2005-2026 K&L Gates LLP. All Rights Reserved.

KEY CONTACTS



MICHAEL W. EVANS
PARTNER

WASHINGTON, DC
+1.202.778.4378
MIKE.EVANS@KLGATES.COM



MARNE MAROTTA
PARTNER

WASHINGTON, DC
+1.202.778.9202
MARNE.MAROTTA@KLGATES.COM



VIVIAN K. BRIDGES
ASSOCIATE

WASHINGTON, DC
+1.202.778.9227
VIVIAN.BRIDGES@KLGATES.COM



DAVID J. SKILLMAN
PARTNER

WASHINGTON, DC
+1.202.778.9236
DAVID.SKILLMAN@KLGATES.COM



MARTHA G. PUGH
PARTNER

WASHINGTON, DC
+1.202.778.9033
MARTY.PUGH@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.