ALERT MEMORANDUM

New U.S. Tax Guidance on Prohibited Foreign Entity Rules for Tax Credits

February 17, 2026

Last week, the IRS and Treasury issued provisional guidance on the supply chain components of the prohibited foreign entity rules enacted in July 2025 as part of the law known as the One Big Beautiful Bill. IRS Notice 2026-15, released on February 12, 2026 describes forthcoming proposed regulations to help taxpayers claiming renewable energy tax credits determine whether they have received material assistance from prohibited foreign entities. The notice answers several supply chain questions the industry has raised and provides safe harbors taxpayers can use until final regulations are issued. But a number of key questions remain, particularly about the impact of entering into contracts with, or issuing debt to, companies with ties to the covered nations of China, North Korea, Russia, or Iran.

Background

The prohibited foreign entity rules prevent prohibited foreign entities ("**PFEs**") and taxpayers who receive material assistance from PFEs from accessing most renewable energy tax credits. PFEs are taxpayers with contractual, governance, equity-related, or debt-related ties to covered nations. To claim credits, taxpayers must ensure the cost of the components and materials they use in their projects or products stay below certain limits, based on a formula called the "material assistance cost ratio" ("**MACR**"). The MACR compares the total costs of a project or product to the costs attributable to materials that were mined, produced, or manufactured by PFEs.

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The Notice

The notice addresses some of the questions the industry has asked about calculating the MACR, and includes safe harbors taxpayers can use until regulations are issued. But several key questions remain.

— *Questions Answered by the Notice*

- Whose Tax Year Matters: The notice identifies which tax year matters for purposes of determining which costs are attributable to a PFE – the purchaser's or the supplier's. For a direct sale, it is based on the tax year of the direct supplier rather than the customer. For a resale, it is based on the tax year of the entity that mined, produced, or manufactured the product or component.
- Which Tax Year Matters: The statute provides the determination of whether an entity is a PFE is made as of the last day of the year, but the statute does not explain which tax year matters – the year the materials are purchased or the year the credits are claimed. The notice clarifies that the relevant year is the one in which the taxpayer claiming a credit incurs the costs under its method of accounting. For example, if X Co, an accrual method taxpayer with a calendar year, incurs costs in 2026 for materials it incorporates into Section 45X eligible components that it sells in 2027, the costs of the materials would be PFE costs if the supplier of the materials is a PFE as of December 31, 2026.
- Entities Without U.S. Taxable Years: If a foreign supplier does not have a U.S. tax year, its PFE status is based on the calendar year.
- Direct Material Costs: The notice gives a number of details about determining direct material costs. In general, it provides that taxpayers should follow the existing guidance under Sections 461 and 263A to determine direct material costs, including Treasury Regulations Section 1.471-3. It confirms that freight-in and tariffs paid or incurred by the taxpayer generally are treated as direct material costs. And it allows taxpayers to apply an averaging convention for constituent materials of the same type (averaged over an elected "specified period of time") to determine the material costs for a particular product or project. Rules are provided for direct material costs incurred in a Section 45X contract manufacturing arrangement.
- Resellers: If a direct supplier is merely a reseller, the PFE test is applied to the entity that mined, produced, or manufactured the material. For example, if X Co buys a material from Y Co who merely resells the material it buys from Z Co, the producer of the material, then X Co must determine whether the material is PFE-sourced based on the PFE status of Z Co, not Y Co. The notice does not provide a definition of the term reseller, but it is possible that the definition of the term under IRS guidance in the context of Section 263A could apply.
- Intellectual Property Contracts: If a taxpayer makes a payment to a "specified foreign entity" (one of the two main categories of PFEs) under an IP licensing agreement entered into or modified on or after July 4, 2025, the specified foreign entity is treated as having effective control over the taxpayer's facility. This makes the taxpayer a foreign-influenced entity.

— *Interim Safe Harbors*: The notice includes several interim safe harbors taxpayers may rely on in calculating the MACR until proposed regulations are issued. Taxpayers may choose between actual cost tracking or using one or more of three safe harbors depending on their particular situation.

— *Questions Not Answered by the Notice*

- Definition of PFE: The notice does not provide any color on the definitions of "specified foreign entity" and "foreign-influenced entity," the two main categories of PFEs. For example, the notice does not address the many questions U.S. public companies are asking about

whether they can issue debt in worldwide public offerings without inadvertently becoming foreign-influenced entities.

- Effective Control Test: Guidance on the effective control test is very limited. The notice provides only one example in which a taxpayer becomes a foreign influenced entity by making a payment under a contract that grants effective control to a specified foreign entity.

Public Comments and Hearing

The Treasury and IRS are accepting public comments until March 30, 2026.

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