

ALLOCATED TAX CREDIT INVESTMENTS

Tax Aspects of Renewable Energy Transactions:
Renewable Investment Incentives, Transaction Structures & Tax Matters



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Intended to promote production of energy from renewable energy resources, renewable energy tax credit programs provide a variety of federal and state subsidies, credits, and incentives to finance the investment and production of renewable energy. These programs provide significant benefits to institutional tax credit investors looking to diversify their tax credit investment portfolios with financially viable and environmentally responsible investments, yet new investors may be deterred by the sometimes-complex tax, accounting, and structuring aspects of these transactions. But by developing a high-level understanding of these transactions—including the incentives, structures, and significant tax issues involved—and, most importantly, utilizing knowledgeable, experienced advisors to help structure and finance the deals, new investors can efficiently optimize the monetization of tax benefits derived from renewable energy projects.

TAX EQUITY BASICS — ALLOCATED TAX CREDITS

A tax credit is a type of tax incentive that can reduce a company's tax liability on a dollar-for-dollar basis. The U.S. government uses tax credits to incentivize certain types of projects that produce social, economic, or environmental benefits. Common tax credit projects include affordable housing, rehabilitation of historic properties, low-income census tract economic development, wind energy, and solar energy. For these projects, the tax credit is a valuable and important part of the project financing capital stack. Many project developers do not have enough tax liability to

take advantage of the tax credits themselves, so the developer monetizes the tax credit by attracting a "tax equity" investor.

Tax equity is a term that is used to describe a passive ownership interest in a qualified project, where the investor receives a return based not only on cash flow from the project, but also on tax benefits. In such a transaction, a partnership is often formed among the parties to facilitate injection of investment capital and the allocation of tax credits. The specifics of each partnership vary by project, tax credit type, and transaction structure.

In practice, a tax equity investment utilizes the same dollars that are earmarked to satisfy a company's estimated tax liability payments. Those funds are repurposed and then invested into qualified projects that generate tax credits, such as a solar farm or affordable housing project. The tax benefit attributes (tax credits and depreciation) from the project flow back to the investor, eliminating a corresponding amount of tax liability. The investor typically also receives cash returns from the project for participating, thus earning them a rate of return on the same money that otherwise would have been wired to the government with no expectation for a return.

Returns on tax credit investment can vary widely depending on the program, the counterparties, and all standard risk factors associated with real estate or energy project underwriting. Generally speaking, after-tax returns to investors usually fall between 5% and 12% depending on the credit quality and other project risk characteristics — e.g., low income housing tax credit (LIHTC) projects tend to fall on the lower end of the yield scale (for various reasons beyond the scope of this paper), while utility-scale renewable energy projects fall in the middle and mid- to small-scale renewable energy projects drive the top of the yield scale.

TAX INCENTIVES FOR RENEWABLE ENERGY INVESTMENTS

Federal tax incentives: renewable energy projects may qualify for two types of tax credit (ITCs and PTCs) and depreciation incentives at the federal level:

Investment Tax Credit — purchasers can take a tax credit equal to 30% of their basis in a new qualifying energy system. The ITC was enacted to serve as an incentive device to stimulate the purchase or modernization of certain kinds of productive assets by permitting a reduction in tax liability based on the taxpayer's qualified investment in certain kinds of property placed in service during the tax year.

Production Tax Credit — available for certain partnership flip deals (explained in more detail below), the PTC is a per-kilowatt-hour tax credit for electricity generated by qualified energy resources and sold by the taxpayer to an unrelated person during the taxable year. The period of the credit is generally for a 10-year period beginning on the date the facility was originally placed in service.¹

Bonus Depreciation — business owners of renewable energy systems put in place before the end of 2017 are eligible to depreciate 50% of their basis in the first year. Under 2017 tax reform, discussed in greater detail below, “qualified property” that is acquired and placed in service after September 27, 2017, and before January 1, 2023 is eligible for 100% bonus depreciation.²

Accelerated MACRS Depreciation — businesses can depreciate renewable energy systems using a 5-year schedule (even though, e.g., the useful life of a solar system is 30–35 years).

¹ Internal Revenue Code (IRC) §45. (Unless otherwise noted, all references herein are to the IRC.)

² §168(k), as modified by the Tax Cuts & Jobs Act of 2017, Pub. L. No. 115-97, § 12001(b)(13), §13201, §13204.

Other renewable energy investment financial incentives:

Additional programs are offered at the state, municipal, and utility levels in order to further incentivize local renewable energy investment.

Some states offer an additional tax credit, which usually “stack” with the federal ITC, meaning both state and federal tax credits apply to the full cost of installation. (Some states, utility companies, and municipalities offer cash rebates for solar installations, which may further offset the costs of installation but tend to reduce the return on federal/state ITCs because the rebate is applied first to the array cost before filing.)

Certain states also have performance standards for utilities, requiring power companies to either produce or purchase energy from renewable sources like solar power. In these states, utilities often use solar renewable energy credit (SREC) marketplaces to purchase solar power credits produced by homeowners who generate renewable energy, allowing for the sale of these credits to increase solar system income substantially, thereby reducing the time it takes for the system to offset the cost of installation.

Non-financial benefits to investing in ITC projects:

In an increasingly climate-conscious political and social environment, investing in clean energy can have significant, wide-ranging benefits to a company from a public relations and global perspective.

Most renewable energy generation produces little to no global warming emissions nor emits air and water pollution akin to that associated with traditional energy production — wind, solar, and hydroelectric systems generate electricity with no associated air pollution emissions, and the air pollutants emitted by geothermal and biomass systems are generally much lower than those of coal- and natural gas-fired power plants. Further, wind and solar energy require essentially no water to operate and thus do not pollute water resources or strain supplies by competing with agriculture, drinking water, or other important water needs, and the water required for cooling at biomass and geothermal power plans would be reduced significantly in a future with high renewables.

Renewable energy sources are also essentially inexhaustible, so while a relatively small fraction of US electricity currently comes from these sources, studies have repeatedly shown that renewable energy can provide a significant share of future electricity needs, even after accounting for potential constraints.³

The renewable energy industry also offers employment and other economic benefits. The industry is more labor intensive as compared to fossil fuel technologies, which means overall job creation and potential for technology-driven higher-skilled, higher-wage opportunities. Renewable energy can also benefit local governments in form of property and income taxes and other payments from renewable energy project owners, and create value for property owners (especially farmers and rural land owners) in the form of lease payments and

³ U.S. Department of Energy, National Renewable Energy Laboratory, *Renewable Electricity Futures Study (2012)*.

royalties. Furthermore, while renewable facilities require upfront investments to build, they can then operate at very low cost and thus can help stabilize energy prices in the future.

RENEWABLE ENERGY TRANSACTION STRUCTURES

In order to fully utilize the various federal tax incentives available for renewable energy projects and thus achieve a low cost of capital necessary for competitiveness in the energy industry, developers partner with tax equity investors via various financing structures.⁴ Multiple monetization structures are employed to finance renewable energy projects: sale-leasebacks, partnership flips, and lease pass-throughs (also referred to as inverted leases) are the primary financing arrangements, as detailed below.

1) *Partnership Flip (most common):*

Tax equity investor funds percentage of total project costs and receives a pro rata percentage (or other specified allocation) of cash and tax benefits, including the ITCs, prior to a designated flip in allocation.

- Investor must possess sufficient taxable income to utilize tax benefits (both tax credits and accelerated MACRS tax depreciation equity).
- Investor typically allocated 99% of tax credits and a share (usually disproportionate) of taxable losses/income and distributable cash.
- Developer/sponsor: ROI earned through cash flows, minimum 1% allocation of tax benefits and long-term ownership.

Flip timing: under a 5-year “time-contingent” partnership flip (also known as a fixed flip), the flip occurs at the end of year 5 regardless of investor return; under a 10-year “yield-contingent flip,” the flip is not fixed on a given year, but rather occurs when the tax equity investor has achieved a predetermined target internal rate of return (IRR).

- Investor typically exits the project after the flip when the Developer/Sponsor exercises FMV purchase option on Tax Investor’s residual interest.
- The 10-year time period in the yield-contingent partnership flip is used to determine the investor’s equity contribution; the equity amount is set such that the present value of cash flows will yield the target IRR over 10 years.
- In some ITC-based structures utilizing the fixed flip mechanism, the tax equity investor’s equity contribution is a multiple of their tax credit size, known as the “syndication rate.”

Discrepancy between equity injection and cash flow split: in a typical partnership flip model employed in the industry, the tax equity investor invests approximately half (or more) of the initial equity, but this contribution does not match the cash flow distribution:

- In a 5-year fixed flip scenario, the investor typically retains a 2% “preferred yield,” or the yield on the upfront investment vehicle which the investor receives each year, drawn from the initial stream of cash flows.
- In the case of a 10-year contingent flip, the investor

³ U.S. Department of Energy, National Renewable Energy Laboratory, *Renewable Electricity Futures Study* (2012).

⁴ Even if they cannot be monetized currently, tax incentives can be valuable by utilizing the applicable 1-year carryback/20-year carryover period.

typically retains 35.75% of the initial stream of cash flows for years 1–5.

- Discrepancies between equity contribution and cash-flow allocation are common in other types of structures as well, which is partially justified by the fact that ITC/PTCs, MACRs incentives, and loss allocations are also part of the benefit calculation, and cash-flow allocations often switch midway through the project lifetime.

Debt: 5-year fixed partnership flips are typically leveraged at the project level, while 10-year contingent flips are typically back-leveraged.

Partnership flip tax issues/considerations:

Partnership flip with PTC: in order to claim the §45 PTC, taxpayer must be the owner of the assets and the producer of the electricity; leasing structures not available (except for biomass), but partnership can be both owner and producer — partnership special allocation rules are utilized to specially allocate the incentives to an investor.

- Must assure that the partnership owns the assets and the partners own their interests for tax investor to be deemed valid partner.⁵ Ownership structure and allocations must be respected for federal income tax purposes — no applicable safe harbor.⁶
- No recapture provisions or limitations on PTC to tax exempt or foreign investors (must be US project to qualify for PTC).

- Depreciation limitations — MACRS may be limited if tax exempt ownership in structure.

Partnership flip with ITC: in general, the same basic concepts apply as PTC flip structures — partnering prior to commercial operation date is required; ownership structure and allocations must be respected for federal income tax purposes, but no safe harbors apply.

- Recapture of ITC during first 5 years: vests 20% per year; grant in lieu of ITC has favorable recapture rules; partnership 1/3, 2/3 rules.
- Potential limitation of ITC if tax exempt ownership in structure: although relatively infrequent, deal by deal consideration and potential impacts of blocker corporations.
- Basis reduction: depreciable (inside) basis must be reduced by 50% of the ITC benefit; outside basis of partnership interest must be reduced by the same amount.

2) Sale-Leaseback:

As its name implies, the sale-leaseback structure involves the developer of a project selling it to a tax equity investor, who simultaneously leases it back to the developer. The tax equity investor's basis for tax credit and depreciation purposes is the purchase price paid to acquire the project (often allowing for 15%-20% step-up in basis over the construction cost of the project).

⁵ See Rev. Proc. 2007-65 (safe harbor applicable to wind PTC partnership flips); see also *Historic Boardwalk Hall, LLC v. Commissioner*, Rev. Proc. 2014-12 (tax investor must have enough upside and downside to be the tax-law owner; cash-on-cash return issues).

⁶ IRS released ILM 201524024 (June 12, 2015), stating Rev. Proc. 2007-65 does not apply to ITC deals.

- This is the only transaction structure in which the tax equity investor does not need to be in the deal when the project goes online. There is a special rule that permits the tax equity investor to still claim the tax benefits if the sale-leaseback transaction happens within 90 days of the project being placed in service.

In a relatively rarely utilized variation of the sale-leaseback, known as a leveraged lease, construction is funded by sponsor equity and a construction loan and, once constructed, the sponsor sells the project to a partnership formed by the investors and immediately leases it back.

- The developer repays the construction loan from the sale proceeds, and the trust is financed with cash equity and a non-recourse term debt.
- Lease payments are then likely to be assigned to a lender (for tax purposes, a minimum of 20% equity is usually required), and leasing generates “time value of money” cost saving achieved by deferring tax payments and improves cash flow.

Sale-leaseback tax issues/considerations:

- Tax ownership, i.e., characterization as a true lease versus a financing structure (e.g., a loan or a partnership), which involves considerations of substance and form.
- Requirement that the lessor execute the lease within 90 days of the system being in place; tax credit recapture (i.e., all/part of previously claimed credit must be added to tax liability if the property/asset that generated the credit is no longer used by the taxpayer in a qualifying manner).

- IRS rules requiring the business to reduce its basis in the equipment by 50% of the ITC.
- Tax-exempt use property restrictions, which create the potential for a proportionate loss of ITC if a partnership makes nonqualified allocations to tax exempt entity partners —bifurcated ownership means lessee enters into power purchase agreement (PPA) with the tax-exempt entity; ITC can be preserved by putting a blocker entity (C corporation making a §168(h)(6)(F) election) between the tax-exempt entity and the partnership owning the property, although use of an intermediary does complicate the financial and tax deal structure.

3) Lease Passthrough:

- Unlike the partnership flip and sale leaseback structures, where the owner of the equipment is entitled to the tax benefits, a special rule for lease passthroughs allows the lessor to pass some or all of the tax benefits on to the lessee.
- In an ITC lease passthrough structure, the tax credit is sized based on 30% of the Fair Market Value (FMV) of the project, as opposed to 30% of the project’s cost. In practice, this often allows the tax credit amount to be increased by 15-20% as a “free” event, in the sense that entering a lease is not a taxable event to the developer. In a partnership flip or sale leaseback transaction, a similar step-up in the ITC amount can be achieved, but it would create a taxable event for the developer.
- Instead of reducing the depreciable basis of the project by half of the investment tax credit as you

would in a partnership flip structure, Section 50(d) requires the lessee to recognize income (sometimes called “reverse depreciation”) equal to half the tax credit amount ratably over five years.

- There are two types of lease passthroughs: 1) a basic structure in which the developer is the lessor and leases the project to a tax equity investor, and 2) a shared ownership structure in which the tax equity investor is a minority (typically up to 49 percent) owner of the lessor.
- The lessee typically enters into PPA to sell electricity generated by the project and makes annual lease payments to the owner to cover the project’s debt service.

Lease passthrough tax issues/considerations:

- Tax issues associated with a lease passthrough structure are similar to those associated with sale-leaseback transactions (see above).
- Tax ownership (true lease vs. financing characterization); lease pass-through election; eligible basis (valuation issues); income basis adjustment; partnership allocations; tax credit recapture; and tax-exempt use property limitations.

In sum, each of the various forms of tax equity structure offer certain benefits and disadvantages, thus the respective financial, tax, and accounting positions of the parties in a given deal will dictate the most advantageous structure for the project. All of these structures present some common challenges to renewable energy investing, however, including: a high bar to entry for tax credit investors (high transactional costs, significant expertise

required, niche field); a more limited degree of comfort/certainty that a particular tax structure will be respected by the IRS (as compared to, e.g., LIHTC transactions, which benefit from special rules/clear guidance from the IRS); and, most significantly for the purposes of this paper, potential adverse accounting effects without clear guidance on best practices.

FUNDAMENTAL TAX CONSIDERATIONS/CONSEQUENCES OF RENEWABLE ENERGY INVESTING

When structuring renewable energy transactions, investors and their advisors must address many tax-focused aspects of the deal, e.g., arm’s-length transaction requirements for related/affiliated entities; minimum capital requirements and basis requirements; bargain purchase options not being part of the lease/flip terms; etc. In addition, there are also a handful of particular issues that must be considered when arranging project financing and evaluating transaction risk, as detailed below.

Lack of Accounting Guidance

There is no authoritative accounting treatment under US generally accepted accounting principles (GAAP) regarding how incentives received from the government should be characterized in a company’s financial statements (e.g., revenue vs. reduction to cost basis of project vs. reduction to expense vs. income tax benefit.

- For a detailed discussion of the accounting issues particular to renewable energy investments, see the companion paper in this *Allocated Tax Credit Investments Whitepaper Series* — *GAAP Accounting Best Practices: Utilizing the Deferral Method to Recognize Renewable Energy Tax Credits*.

In 2016, the Financial Accounting Standards board (FASB) issued new GAAP that significantly impact accounting for revenues and for leases, which may impact renewable energy projects (see below).

True Leases

Renewable energy projects typically have at least two significant lease accounting matters to address. One is related to the energy sale agreements and the other is related to the land leases that are usually in place as the project assets are often installed on leased land. The reporting for land leases by a renewable energy project will require the same technical analysis that would be required by any operating company. Having these leases respected as true leases is vital for tax ownership purposes, as discussed below.

Long-Term Contracts for the Sale of Electricity

Most renewable energy projects involve the sale of electricity to an offtaker—in most cases, a public utility—under power purchase agreement (PPA), a long-term contract (usually 15+ years in duration) at a fixed or scheduled price. Whether PPAs are deemed executory contracts or leases significantly impacts their accounting treatment—if considered an executory contract, the payments received from the customers are classified as revenue; whereas if considered a lease, the payments received are classified as rental income and if the company is not in the business of renting property, then the payments are not revenue.

Sale-Leaseback Transactions

Often developers/operators of renewable modules will sell the project, once constructed, to a financial buyer and then lease the asset back for operation. The IRS scrutinizes such lease structures to determine whether it is a “true lease” or if there has been a disguised sale.

- Economic substance and benefits and burdens tests⁸
- Some courts have enumerated lists of “tax ownership” characteristics.⁹
- Facts and circumstances.¹⁰
- Rev. Proc. 2001-28: no Limited Use Property; no lessee loans or guarantees; purchases and sale rights; minimum investment “at risk”; pre-tax profit.

Asset Retirement Obligations

Asset retirement obligations may be implicated when there are requirements to remove a plant and/or equipment at the end of a contract. Asset retirement costs must be capitalized as part of the related property, plant, or equipment when a liability for an asset retirement obligation is initially recognized.

- Changes to the asset retirement obligation resulting from revisions to the timing or the amount of the original estimates shall be recognized as an increase or decrease to: the carrying amount of the asset retirement obligation; and the related asset retirement cost capitalized as part of the related property, plant, or equipment.
- Only asset retirement obligations that are considered a legal obligation shall be afforded this accounting treatment.

IMPACT OF TAX REFORM ON RETC PROJECTS

The 2017 Tax Cuts & Jobs Act (TCJA) contained several important provisions affecting RETC investments, as outlined below.¹¹ The ITC for wind and solar projects is unaffected by the new bill, and the PTC retains its current phase-out period for wind projects that begin construction by the end of 2019, and current IRS guidelines that outline the requirements for starting construction remain in effect. Solar tax credits remain at 30% for projects under construction by the end of 2019 with a gradual phase-down to 10% for projects that begin construction in 2020, 2021, or 2022. Grandfathering rules for projects started prior to the stepdown can extend these timelines.

1) *Corporate tax rate* — reduced from 35% to 21% starting in 2018.

2) *100% bonus depreciation* — as noted above, almost all investment property is eligible for a 100% bonus depreciation under the 2017 TCJA.

- Current law allows for a 50% bonus depreciation deduction for investment property placed in service in 2017; a 40% bonus depreciation deduction for 2018 property; and a 30% bonus depreciation deduction for 2019 property.

3) *BEAT* — the BEAT tax is a new minimum tax designed to limit large multinational companies from reducing their US tax liability by claiming deductions for

payments made to foreign affiliates, and while not aimed at the renewable energy industry or renewable energy tax credits, the BEAT tax may affect the value of tax credits to multinational banks and other corporations that invest in renewable energy projects if the investor is unable to offset its BEAT tax liability with renewable energy tax credits.

- Only 80% of the value of renewable energy tax credits may be used against the BEAT tax in each year through 2025. After 2025, none of the renewable energy tax credits may be used against a taxpayer's BEAT tax liability. It should be noted that this was a relatively favorable outcome for the RETC, as many other types of tax credits may not be used against the BEAT tax at all.

4) *Limitations on interest deductions* — starting in 2018, the TCJA limits the amount of interest that can be deducted in any year to 30% of a borrower's taxable income, increased for depreciation and amortization deductions for tax years that end before 2022.

- After 2022, depreciation and amortization deductions are required to be considered, which will reduce taxable income and increase the likelihood that the limitation will apply.
- Any interest that cannot be deducted on account of this limitation may be carried forward indefinitely to future taxable years.

⁸ See *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

⁹ See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981).

¹⁰ See, e.g., *Larsen v. Commissioner*, 89 T.C. 1229 (1987); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985).

¹¹ For a comprehensive overview of the 2017 TCJA's impact on the tax credit market generally, see *A Post-Tax Reform Primer on U.S. Tax Credits*, a 2018 Bloomberg Tax/Foss whitepaper collaboration.

5) *NOLs* — net operating losses (NOLs) may now be carried forward indefinitely to future tax years, but may no longer be carried back to previous tax years.

- Disallowance of NOL carrybacks could have an appreciable effect on certain sponsors—e.g., the significant gain generated in an earlier partnership flip deal cannot be offset by NOLs generated by a subsequent lease passthrough deal.

6) *Repeal of partnership technical terminations* — the TCJA would repeal the existing rule that treats a partnership as “terminating” when 50% or more of the capital and profits interest of a partnership are sold or exchanged within a 12-month period.¹²

- The repeal of the partnership termination rules coupled with the new 100% bonus depreciation rules applicable to new and used property may give rise to new structures that seek to optimize the tax benefits in renewable and energy projects.

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FORECAST: TAX-ADVANTAGED RENEWABLE ENERGY INVESTMENT GOING FORWARD

Investors, developers, accountants, and their respective counsel are utilizing various different strategies to maximize the beneficial TCJA changes on the renewable energy market, and in turn employing new and innovative approaches to deal with the previously-existing and newly-enacted challenges to the industry.

¹² For a comprehensive overview of the 2017 TCJA’s impact on the tax credit market generally, see *A Post-Tax Reform Primer on U.S. Tax Credits*, a 2018 Bloomberg Tax/Foss whitepaper collaboration.