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Modeling Concepts – Partnership Flip and Sale-Leaseback Structures

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Agenda

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Partnership Tax Concepts

Allocations

<u>Question</u>

- What determines the allocations of tax items (including income, deductions, and credits)?

<u>Answer</u>

- Determined by partnership agreement

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Allocations *(cont.)*

Question

- When will allocations contained in a partnership agreement be respected?

Answer

- When they have “substantial economic effect”
  - If an allocation lacks “substantial economic effect,” the item(s) must be re-allocated in accordance with the partner’s interest in the partnership (PIP)

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Allocations *(cont.)*

<u>Question</u>

- What allocations have “substantial economic effect?”

<u>Answer</u>

- The allocation must have economic effect, and
- The economic effect must be substantial

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Allocations *(cont.)*

<u>Question</u>

- When will allocations of PTCs or ITCs have "substantial economic effect?"

<u>Answer</u>

- Never (this was a trick question)
  - PTCs and ITCs cannot have economic effect because they are not expenditures/receipts that could be reflected in capital accounts
    - Actually, ITCs often affect capital accounts, but indirectly as result of basis adjustments

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Allocations *(cont.)*

Question

- When will allocations of PTCs or ITCs be respected?

Answer

- When they are in accordance with PIP
  - ITCs can satisfy a “deemed” PIP standard
  - PTCs allocated in proportion to valid allocations of the relevant receipts

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Economic Effect

- For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners
- Three bright-line requirements:
  - Capital accounts compliant with regulations
  - Liquidation in accordance with positive capital accounts
  - Deficit restoration obligation (DRO)
    - Limited DRO requires qualified income offset (QIO)

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Capital Accounts & Modeling

- The capital account is the “score card” for the economic benefit or burden of the allocations
  - Cornerstone of economic effect test

- Modeling for partnerships in the energy space generally geared toward
  - Correct book and tax allocations
  - Proper maintenance of capital accounts

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Capital Account Rules

- Capital accounts must reflect
  - FMV of contributions by or distributions to the partner
  - Allocations of partnership income, gain, loss, or deduction
    - Generally including tax-exempt income and non-deductible expenditures
  - ITC basis reductions

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Basic Capital Account Rules *(cont.)*

- Depreciable/Amortizable 704(c) Property
  - Book depreciation or amortization based upon original or revaluation FMV book (and not tax) basis
  - Book recovery schedule dependent upon the 704(c) method elected by the partnership
    - Traditional and Curative – Under General Rule
    - Remedial – Special Rule

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Example – Traditional Method

- Depreciation
  - Tax: $200 contributed basis with 2 years remaining life ($133 recovered in year 1, $67 in year 2 under tail end of 5YR MACRS schedule)
  - Book: $1,200 FMV ($800 recovered in year 1, $400 in year 2)

	TEI - 99%		Developer - 1%	
	Book	**Tax**	**Book**	**Tax**
Year 1 Depreciation	(792)	(133)	(8)	0
Book/Tax Shortfall		**(679)**		
Year 2 Depreciation	(396)	(67)	(4)	0
Book/Tax Shortfall		**(329)**		

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Example – Remedial Method

- Depreciation
  - Tax: $200 contributed basis with 2 years remaining life ($133 recovered in year 1, $67 in year 2 under tail end of 5YR MACRS schedule)
  - Book: $1,200 FMV ($233 recovered in year 1, $387 in year 2) *Note the change in book!*

	TEI - 99%		Developer - 1%	
	Book	**Tax**	**Book**	**Tax**
Year 1 Depreciation	(231)	(133)	(2)	0
Remedial Allocations		**(98)**		**98**
Year 2 Depreciation	(383)	(67)	(4)	0
Remedial Allocations		**(316)**		**316**

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Section 704(d) Loss Limitation

- Losses allocated to a partner are only allowed to the extent of the partner's "outside" tax basis
  - Excess losses are suspended and carried forward until the partner has sufficient tax basis
  - Impacts when tax losses are monetized for after-tax IRR purposes
- Modeling task is correctly computing the 704(d) limitation and carrying forward the running balance of suspended losses

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Section 704(d) Loss Limitation *(cont.)*

- 704(d) Ordering Principles
  - Distributions generally exhaust available basis before the 704(d) loss limitation applies
  - Example
    - TEI has outside basis of 21 at the start of the year, receives a distribution of 5, and is allocated net bottom-line loss of 20
    - The distribution does not give rise to capital gain, but 4 (=20-16) of the bottom-line loss is suspended. See Rev. Rul. 66-94

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Debt Basis

- Each partner's "outside" tax basis is generally the sum of its tax capital account balance plus its allocable share of partnership debt
- If the project has debt, a partner's tax capital account may go negative without immediate gain recognition or 704(d) suspended losses, provided each partner maintains a positive "outside" tax basis
  - Negative tax capital often coincides with a negative capital account. Does this compromise economic effect?

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DROs, QIOs, "Stop-Loss" Allocations

- Deficit Restoration Obligations (DROs)
  - Required for economic effect, but may be limited
- Qualified Income Offset (QIO)
  - Required for economic effect if no or limited DRO
- "Stop-Loss" Reallocations
  - Special allocations generally intended to prevent negative balances in excess of any limited DRO

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Inventories and Cost of Goods Sold

- IRS Guidance
  - In TAM 9527003, IRS took position that taxpayer that produced and sold electricity had inventories
- In partnership that generates and sells electricity, most but not all expense items would be cost of good sold if inventories applies
  - Depreciation and amortization
  - Interest?
  - Hedge gain/loss?
- Modeling issue: Which items can be separately allocated if inventories applies?

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Other Important Modeling Concepts

- Allocation of Nonrecourse Deductions
  - Not controlled by general profit/loss allocation in partnership agreement, but as special allocation
- Minimum Gain Chargebacks
  - Models must track annual minimum gain balances to determine if chargebacks will apply
- Exits and gross-ups
- PTC – indexed for inflation
- Tax rate used to monetize tax benefits
- Section 731(a) gain and section 734(b) step-up

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Partnership Flip Examples

For Discussion Purposes Only

– The examples discussed in this presentation are intended to facilitate a discussion related to selected tax concepts relevant to partnership flip project models. The examples are not intended to illustrate a project that complies or does not comply with the tax rules. In some cases, the examples deliberately deviate from the tax rules to illustrate the concept for discussion purposes. Please consult your tax advisor when modeling the tax concepts discussed throughout the deck. The rules are very complex and each project's facts and circumstances are unique.

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Leasing Tax Concepts

Tax Basics – Sale / Leaseback

- Tax Ownership – True lease vs. financing characterization
- Section 467 Rental Agreements
  - Uneven Rent Test (“90 / 110” Test)
- 90-Day Rule
- Tax Credit Recapture
- 50% Basis Reduction
- Tax-Exempt Use Property

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Tax Basics – Inverted Lease

- Tax Ownership – True lease vs. financing characterization
- Section 467 Rental Agreements
  - Uneven Rent Test ("90 / 110" Test)
- Lease Pass-Through Election
- Tax Credit Recapture
- Income from Basis Reduction
- Partnership Allocations
- Tax-Exempt Use Property

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General 467 Concepts

Section 467 Rent Concepts

- In certain cases where there are prepaid or deferred rents, section 467 may require prepaid or deferred amount to be treated as an interest bearing loan
- Application of the section 467 accrual rules may require Lessors and Lessees to recognize interest and impute a "new" rental amount differing from the amount specified in the lease
  - Section 467 does not change the total amount deductible over the term of the lease, it merely changes the timing of the "net" deduction

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Section 467 Rent Concepts

- Under certain circumstances, the section 467 rental accrual may call for an unfavorable "constant rental accrual"
  - Constant rental accrual method is used only when the IRS treats a lease agreement as being a disqualified leaseback or long term agreement that is for the principal purpose of tax avoidance
  - Constant rental accrual may be avoided if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than +/- 10% (110/90 Safe Harbor)

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467 Examples

Questions?

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