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Modeling partnership flip structures

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Partnership tax concepts

Allocations

Question

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

Answer

Determined by partnership agreement

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).

Allocations (cont.)

Question

What allocations have “substantial economic effect”?

Answer

The allocation must have economic effect; and,

The economic effect must be substantial.

Allocations (cont.)

Question

When will allocations of PTCs or ITCs have “substantial economic effect”?

Answer

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.

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

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)

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

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

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

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)		

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

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.

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.

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?

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

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?

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

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.