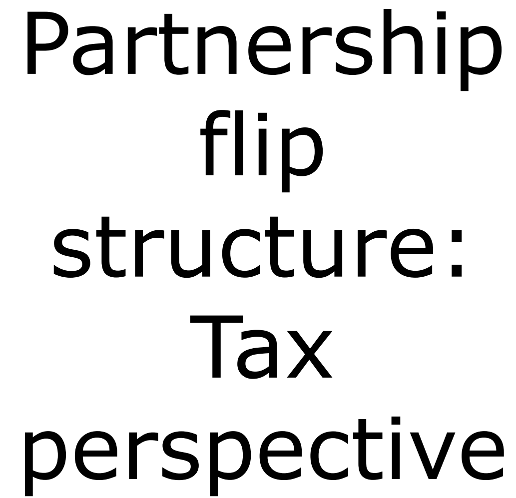
2017 Deloitte Renewable Energy Seminar

Innovating for tomorrow

November 13-15, 2017

Deloitte Center *for* Energy Solutions

Deloitte.



Partnership flip structure: Tax perspective

Michael Kohler, Managing Director, Deloitte Tax LLP
Tom Stevens, Partner, Deloitte Tax LLP

Tax incentives are integral to project economics

- What if I can't monetize the incentives currently?
  - 1-year carryback/20-year carryover period
  - Multiple monetization structures are utilized
    - Partnership flip
    - Sale-leaseback
    - Inverted lease
    - Power prepayment

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip

- IRC Section 45 Production Tax Credit (“PTC”)
  - In order to claim the PTC, taxpayer must be the owner of the assets and the producer of the electricity
  - Leasing structures not available (except biomass)
    - Partnership special allocation rules are utilized to specially allocate the incentives to an investor
  - Safe Harbor for wind PTC flip (Rev. Proc. 2007-65)

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip

Participant	Role
1. **Tax investor**	• Possesses sufficient taxable income to monetize tax benefits (both tax credits and MACRS tax depreciation) • Subject to Passive Activity rules? • Funds a percentage of total project costs • Target IRR earned through allocation of 99% of tax credits and taxable losses/income and distributable cash • Typically exits the project after the flip when the developer/sponsor exercises its FMV purchase option

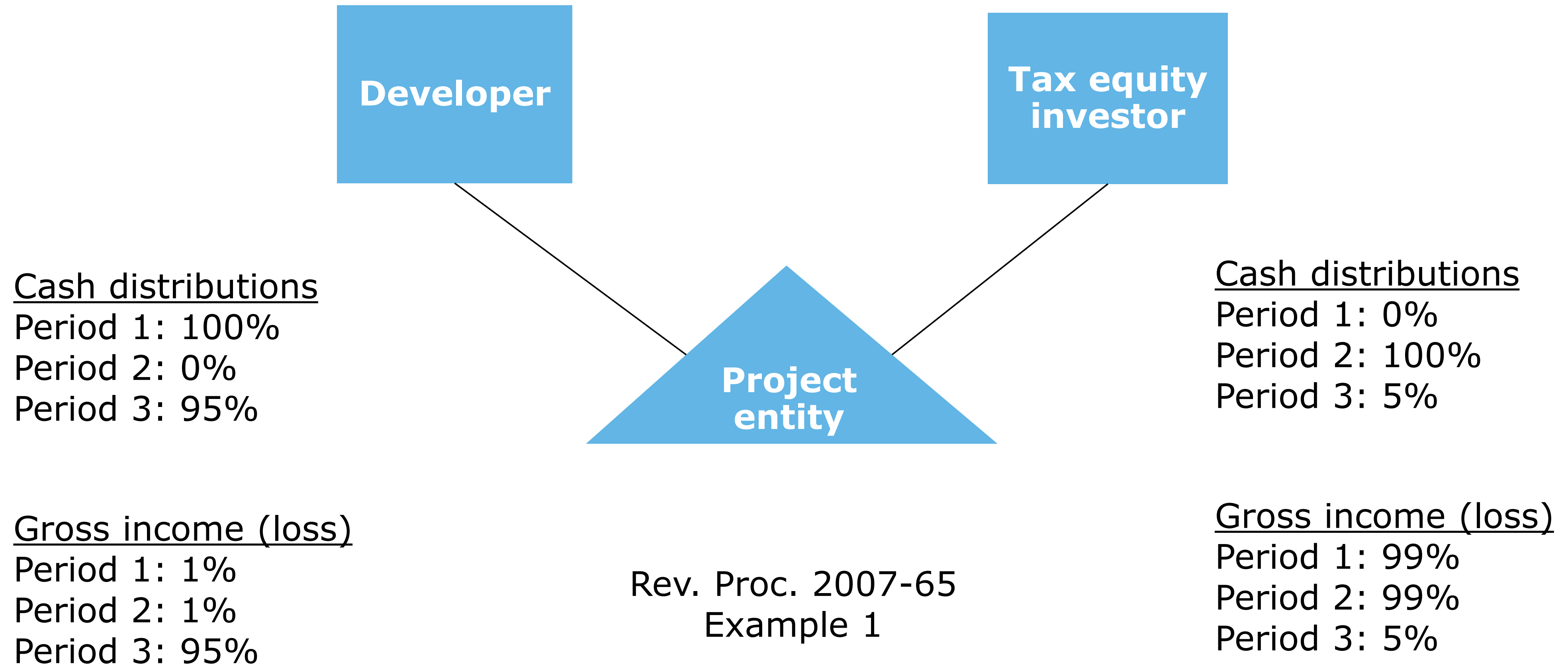
Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip

Participant	Role
2. **Developer/sponsor**	• ROI earned through cash flows, minimum 1% allocation of tax benefits and long-term ownership • FMV purchase option on Tax Investor’s residual interest

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip



Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip structure with PTCs

- Ownership structure and allocations must be respected for federal income tax purposes
  - Safe Harbor technically only applies to wind PTC (Rev. Proc. 2007-65)
- No recapture provisions or limitations on PTC to tax exempt or foreign investors
  - must be US project to qualify for PTC
- Depreciation limitations
  - MACRS and bonus depreciation may be limited if tax exempt ownership in structure

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip with ITC

- In general, the same concepts as PTC flip structures
- Ownership structure and allocations must be respected for federal income tax purposes, however, no safe harbor
- Recapture of ITC during first 5 years
  - Vests 20% per year
  - ARRA 1603 Grant in lieu of tax credits has favorable recapture rules vs. ITC

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership flip with ITC

- Potential limitation of ITC if tax exempt ownership in structure
  - Deal by deal consideration and potential impacts of blocker corporations
- Basis reduction
  - Depreciable (inside) basis must be reduced by 50% of the ITC
  - Outside basis of partnership interest must be reduced by the same amount

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Is the tax investor a valid partner?

- Must assure that the partnership owns the assets and the partners own their interests
- Rev. Proc. 2007-65. IRS released ILM 201524024, 6/12/15, stating Rev. Proc. 2007-65 does not apply to ITC deals.
- *Historic Boardwalk Hall, LLC v. Commissioner*
- Rev. Proc. 2014-12
- Does the Tax Investor have enough upside and downside to be the tax-law owner?

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Is the tax investor a valid partner?

- Burdens and benefits of ownership is key
- No guarantee of credit result
- Documents should not state the credit is being “sold”
- Pre-tax 2-3% cash-on-cash return is a good factor
- Accounting firm needs to maintain independence and ensure projections are realistic
- Court applied substance over form doctrine
- Paygo
- Puts/calls

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Historic rehab. tax credit
Safe harbor

- Revenue Procedure 2014-12
  - Issued on December 30, 2013
  - Safe harbor under which the IRS will not challenge allocations by a partnership to its partners of historic rehabilitation tax credits under IRC section 47
  - Issued in response to the decision in *Historic Boardwalk Hall, LLC v. Commissioner*

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Economic substance

- Is the transaction “real” or just tax motivated?
- Codification of economic substance doctrine in Code section 7701(o)
- Joint Committee explanation FN 344, March 21, 2010. It is not intended that tax credits be disallowed as lacking economic substance if “a taxpayer makes the type of investment or undertakes the type of activity that the credit is intended to encourage.”

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Allocation of partnership items

- Credits are allocated consistent with:
  - Gross receipts for PTCs
  - General profits in the year of the credit for ITC
- Allocations of MACRS tax depreciation must have substantial economic effect
- IRS views electricity as inventory so special allocations are limited
- TEIs generally require all allocations for five years remain consistent with the credit allocation [generally 99%] to avoid recapture issues

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Allocation of partnership items

- Limitation on allocation tax benefits to Investor
  - Losses are limited to positive capital accounts unless the partner has a “deficit restoration obligation” or “minimum gain”

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax exempt use property

- Results in a reduction in the total depreciation deductions available to a partnership that makes nonqualified allocations to tax exempt entity partners
  - A nonqualified allocation is generally an allocation to a tax exempt entity partner that is not “straight-up” through out the life of the partnership
  - For this purpose, a tax exempt controlled corporation is treated as a tax exempt entity. A tax exempt controlled corporation is any domestic corporation that is owned greater than 50% (by value) by tax exempt entities

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax exempt use property (cont.)

- No ITC if property is owned by or leased to tax-exempt entities
  - Property leased to a partnership is treated as leased proportionately to its partners which could result in a proportionate loss of ITC
  - If allocations vary, the tax rules [IRC section 168(h)(6)(C)] required measurement based on the highest share, so in a flip partnership the proportionate share of the developer can be large (e.g., 95% post-flip share in the Rev. Proc. 2007-65)

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65

Safe harbor for wind partnership flip

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

- General background
  - Directly applies to the wind PTC only
  - No rule policy
  - Requirements under which the IRS will respect the allocation of PTCs by partnerships in accordance with section 704(b)
  - Applies to any partnership (the “project company”) between a project “developer” and one or more “investors,” with the project company owning and operating the qualified wind project

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

- General background (cont.)
  - "Investors" are partners in the project company whose investment return is reasonably anticipated to be derived from both PTCs and participation in operating cash flow

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

- IRS safe harbor
  - Announcement 2009-69 (September 21, 2009)
    - Rev. Proc. 2007-65 safe harbor not intended to provide substantive rules and not intended to be used as audit guidelines
- Recently issued Rev. Proc. 2014-12 reaffirmed the minimum investment requirements in Rev. Proc. 2007-65

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

- Minimum 1 percent interest for developer
  - Throughout the existence of the project company, the developer must have at least 1 percent interest in each material item of partnership income, gain, loss, deduction, and credit
- Minimum 5 percent interest for each investor
  - Each investor must have a minimum interest in each item of partnership income and gain for every year, equal to 5 percent of its largest interest in income and gain for any year (99% x 5% = 4.95%)

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Investor’s minimum investment

- Throughout the duration of the project, the investor must have a minimum investment equal to 20% of the sum of (i) fixed capital contributions plus (ii) its reasonably anticipated contingent capital contributions
- Minimum investment may be reduced by distributions from company operations
- Effective with respect to an investor’s investment as of the later of the date the wind project is placed in service or the date the investor acquires its interest in the project company

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Investor's minimum investment

- The investor must not be protected against loss on any portion of the investor minimum investment

Investor's non-contingent investment

- At least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an investor must be fixed and determinable and cannot be contingent or uncertain

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Investor's non-contingent investment (cont.)

- Paygo
  - After Historic Boardwalk the best practice is to avoid paygo
  - If there are 25% contingent amounts, best practice is to base the contingencies on non-tax business contingencies (rather than the amount of the credit)
  - The IRS, in FAA 20161101F (Dec. 3, 2015), addressed a section 45 refined coal credit transaction involving payments contingent on production and treated them as paygo

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Purchase rights

- Announcement 2009-69 (September 21, 2009)
- Must be negotiated for valid non-tax business reasons at arm's length by parties with material adverse interests
- Must either be:
  - A price that is not less than fair market value determined at the time of exercise or,
  - If determined prior to exercise, a price that the parties reasonably believe, based on all facts and circumstances at the time the price is determined, will not be less than fair market value at the time of exercise
- No purchase right during first 5 years

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

- Sale rights
  - Neither the project company nor the investor can have a contractual right to cause anyone to purchase the facility or their interest in the project company
  - Rev. Proc. 2014-12
    - For rehab credit, allows a put option rather than a call and allows certain sale rights
    - Withdrawal rights?
- Allocation of PTCs
  - Pursuant to Treas. Reg. §1.704-1(b)(4)(ii), PTCs are allocated in the same proportion as the electricity sale that generated the PTCs

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Passive activity

- Separate activity for purposes of Section 469
- Announcement 2009-69 (September 21, 2009)
  - A taxpayer subject to Section 469 may utilize passive activity credits from qualified wind facilities only to the extent of their tax liability allocable to passive activities, whether from qualified wind facilities or other sources

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Rev. Proc. 2007-65 – IRS safe harbor

Guarantees and loans

- No person may guarantee or otherwise insure the investor the right to any allocation of PTCs
- The developer, the turbine supplier, or any power purchaser may not guarantee that a certain level of wind will exist
- The developer and related parties may not lend any investor the funds to acquire its interest in the project company or guarantee any debt incurred in connection with the acquisition of such interest

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Capital accounts

Critical concepts for a partnership flip

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Capital accounts

- Section 704(b) substantial economic effect
- The capital account analysis is the “score card” for the economic benefit or burden of the allocations
- The capital account analysis is based on the following three requirements:
  - Capital account requirement
  - Distribution requirement
  - Deficit makeup requirement

Copyright © 2017 Deloitte Development LLC. All rights reserved.

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; provided each partner maintains a positive “outside” tax basis in its investment

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Capital accounts – Example 1

Partnership capital account ($)	Initial contribution	Year 1	Year 2
Beginning capital balance	100,000,000	100,000,000	75,200,000
Add: additional capital contribution		-	-
Less: cash distributed to partners		(8,800,000)	(9,000,000)
Subtotal (before current year allocations)		91,200,000	66,200,000
Taxable income allocation		(16,000,000)	(31,500,000)
Loss reallocation		-	-
Total taxable income / loss		**(16,000,000)**	**(31,500,000)**
Ending tax capital		**75,200,000**	**34,700,000**
Share of recourse debt		-	-
Share of non-recourse debt		31,400,000	30,500,000
Total debt		**31,400,000**	**30,500,000**
Ending tax basis		**106,600,000**	**65,200,000**

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership tax concepts

Qualified Income Offset (“QIO”)

- Each partner should maintain a positive capital account
- If the capital account of any partner is unexpectedly negative after the initial allocations of cash and taxable income/losses, there may be a reallocation of income between partners, referred to as a “qualified income offset” or “QIO” in an amount necessary to eliminate any negative capital account balances

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership tax concepts

Deficit Restoration Obligation ("DRO")

- A partner with a negative capital account may sign up for a limited DRO so that losses continue to be allocated to the partner even though the partner's capital account goes negative
- A limited DRO may be required in ITC deals to ensure allocation of ITCs to Investor during recapture period

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership tax concepts

Deficit Restoration Obligation ("DRO") (cont.)

- Some tax investors will be willing to sign up for a limited DRO, but they will need to get comfortable that the DRO will reverse out within a desired time frame under a downside scenario (e.g., P95)
- A limited DRO may preserve the desired allocation percentages for tax credits and MACRS tax deprecation, but the allocated losses may be suspended pursuant to Section 704(d)
- New Section 707/752 regulations may limit the ability to phase out the DRO

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Partnership tax concepts

Section 704(d) Loss Limitation

- Losses allocated to a partner are only allowed to the extent of the partner’s “outside” tax basis in its partnership interest
- 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

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Debt financing

- New disguised sale and partnership liability allocation regulations

Changes to debt financed distribution and preformation capex exception

Recourse

- Who bears the economic risk of loss?

Nonrecourse

- Even though partners do not bear the economic risk of loss for nonrecourse liabilities, they bear the corresponding tax burden related to relief from those liabilities in their amount realized upon the disposition of property encumbered by the debt

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Debt financing

Partnership minimum gain

- The calculation of partnership minimum gain comes into play when the partnership uses nonrecourse debt to fund a portion of the capital costs of the project

Nonrecourse deductions

- Increases partnership minimum gain

Minimum gain chargeback

- Decreases partnership minimum

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Debt financing

Minimum gain chargeback

- If there is a net decrease in partnership minimum gain for the taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of income and gain for the year equal to the partner's share of net decrease in partnership minimum gain
- A partner's share is based on the nonrecourse deductions previously allocated to that partner
- Pay close attention if the term of nonrecourse debt exceeds the taxable income/loss flip date (e.g., from 99/1 to 5/95)

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Capital accounts – Example 2

	Investor	Sponsor	Total	
December 31, 2009	15,000,000	2,500,000	17,500,000	A
Contributions	-	-	-	B
Distributions	-	(241,000)	(241,000)	C
1st 99%/1% loss until investor zero	(15,000,000)	(151,515)	(15,151,515)	D
Subtotal	-	2,107,485	2,107,485	
2nd 0%/100% loss until sponsor zero*	-	(2,107,485)	(2,107,485)	E
Subtotal	-	-	-	
3rd 99%/1% loss (based on minimum gain)	(733,590)	(7,410)	(741,000)	F
Taxable income/(loss) (D+E+F=)	(15,733,590)	(2,266,410)	(18,000,000)	
Current year effective P/L %	87.4%	12.6%	100%	
December 31, 2010 (A+B+C+D+E+F=)	(733,590)	(7,410)	(741,000)	

* Assumes no investor deficit restoration obligation ("DRO")

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax scenario analysis – PTC

- PTC: indexed for inflation
  - Rounded to nearest 0.1 cent
- Tax rate used to monetize tax benefits
- Tax depreciation and ITC / 1603 Grant basis
  - MACRS (5 year) vs. ADS (12 year) Life
  - Cost segregation
  - Bonus depreciation
  - Basis reduction for 50% of ITC / 1603 Grant
  - Remedial Section 704(c) allocations
  - Tax depreciation and cost of good sold
- Section 731(a) gain and Section 734(b) step-up

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax scenario analysis – ITC

Recapture provisions

- Disposition is with respect to the "taxpayer"
  - Corporate scenario
    - Sale of stock is NOT a disposition
    - Sale of asset by corporation is a disposition subject to recapture
  - Partnership scenario
    - Sale of the partnership interests may be a disposition subject to recapture
    - 66-2/3 percent and 33-1/3 percent partnership interest reduction rule

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax scenario analysis – ITC

Recapture provisions

- Partnership scenario (cont.)
  - Sale of assets by partnership is a disposition subject to ITC recapture
  - Shifting allocations

Note: ARRA (The American Recovery and Reinvestment Act) 1603 Grant has much more favorable recapture provisions

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Current events

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Tax reform – House bill

- PTC inflation factor changes
- Begun construction – continuous program of construction
- Expensing provision
- Interest expense limitation
- Elimination of technical termination rule
- Pass-through income 25% rate
- Change in law provisions – tax risk

Copyright © 2017 Deloitte Development LLC. All rights reserved.

Flip point issues

- PTC deals flipping too quickly
  - Amendment of flip point from yield based to date certain
  - How is sponsor compensated for the change
  - Potential disguised sale issues

Copyright © 2017 Deloitte Development LLC. All rights reserved.

This publication contains general information only and is based on the experiences and research of Deloitte practitioners. Deloitte is not, by means of this publication, rendering business, financial, investment, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2017 Deloitte Development LLC. All rights reserved.