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Traps for the unwary when purchasing projects before, during, or after construction

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Discussion topics – purchasing projects before, during, and after construction

Purchase model vs. contribution model

Property acquired

- Single project
- Development pipeline
- Tangible and intangible assets
- Alta Wind case

Acquiring projects before, during, and after construction

- When does cost basis ”attach” to the property acquired?

Key terms and concepts

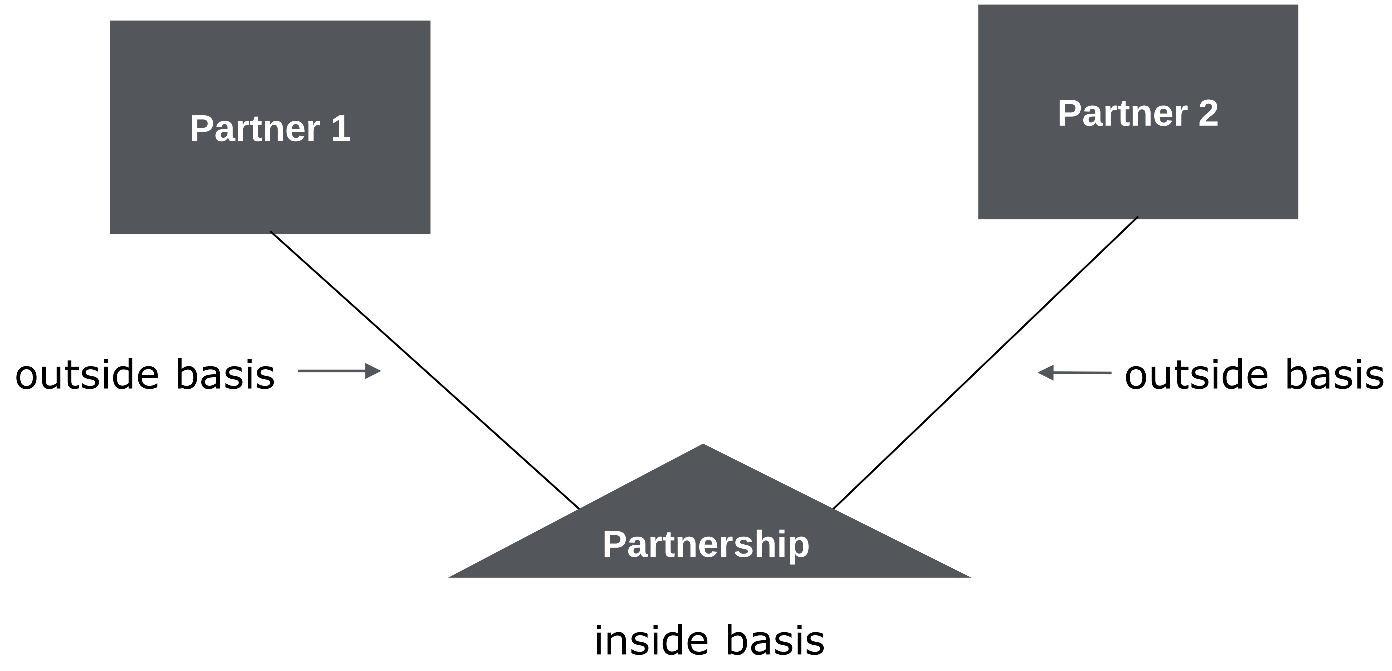
- Cost basis
- Carryover basis
- Step-up
- Development fee
- Bottom-up or Top-down
- Inside basis
- Outside basis
- Disguised sale
- Revenue Ruling 99-5
- IRC section 1060 allocation
- IRC section 743(b) adjustment

The form of the acquisition structuring has tax consequences

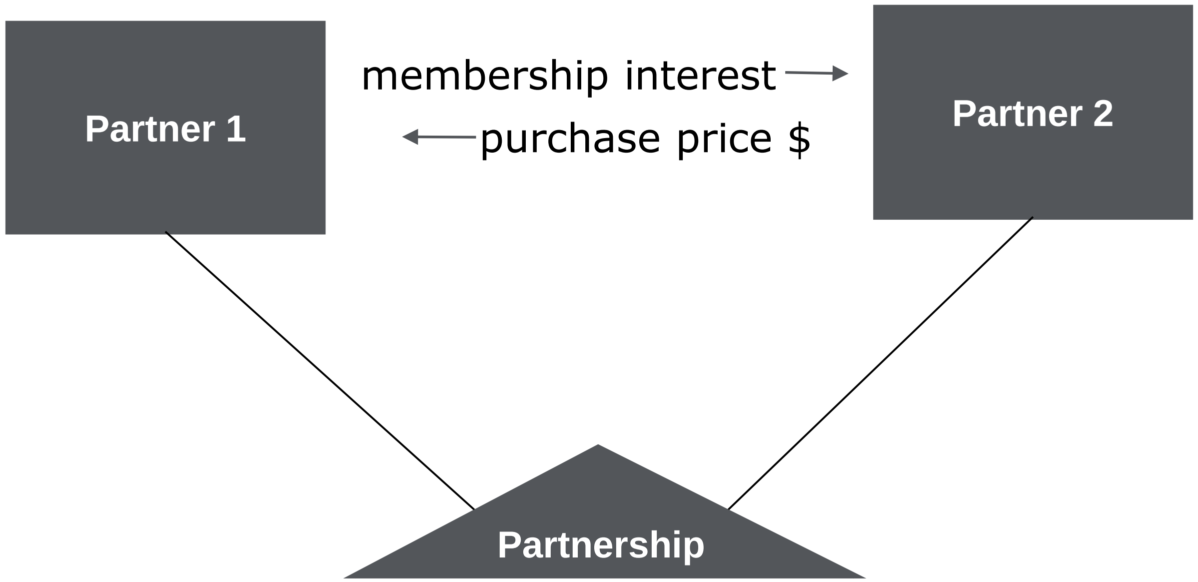
Understand the:

- Equity Capital Contribution Agreement ("ECCA")
- Membership Interest Purchase Agreement ("MIPA")
- Limited Liability Company Agreement ("LLCA")

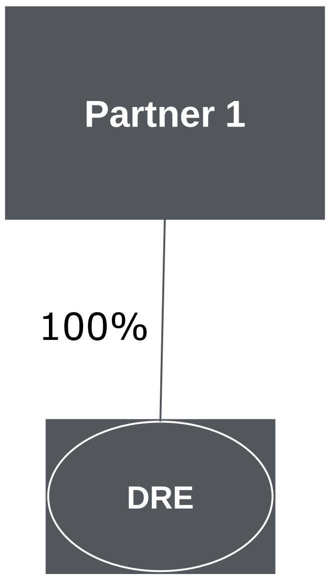
Inside and outside basis

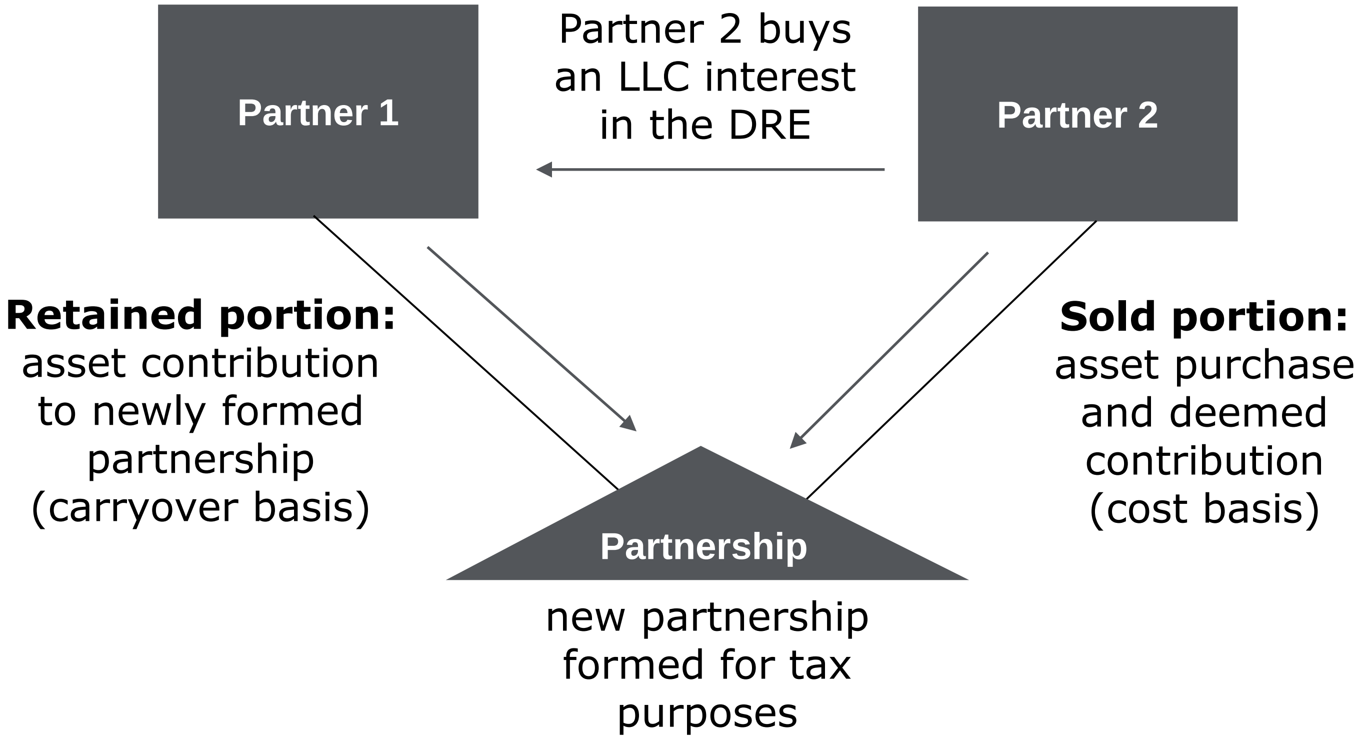


Purchase model – over the top sale

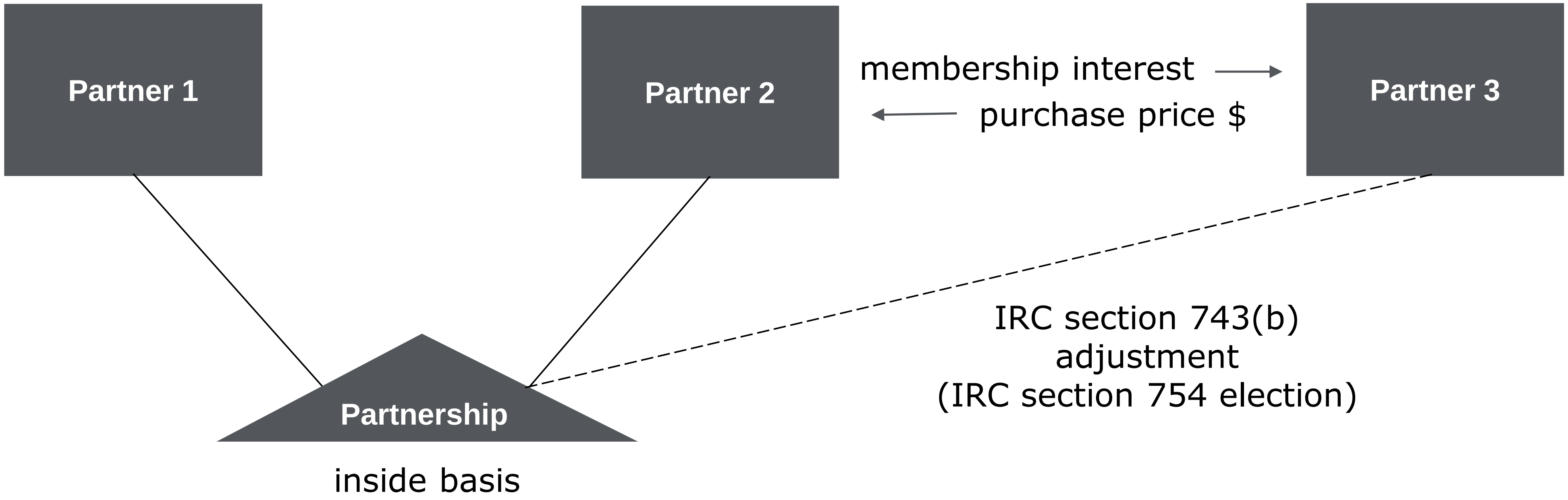


Revenue Ruling 99-5, Situation 1

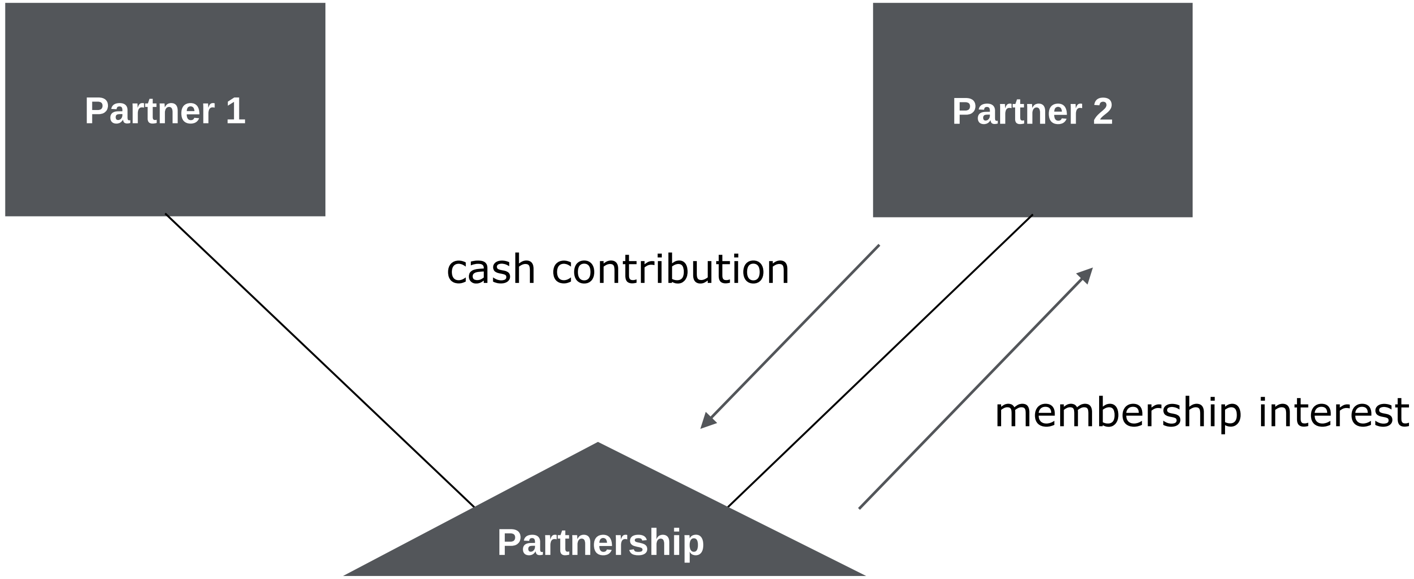




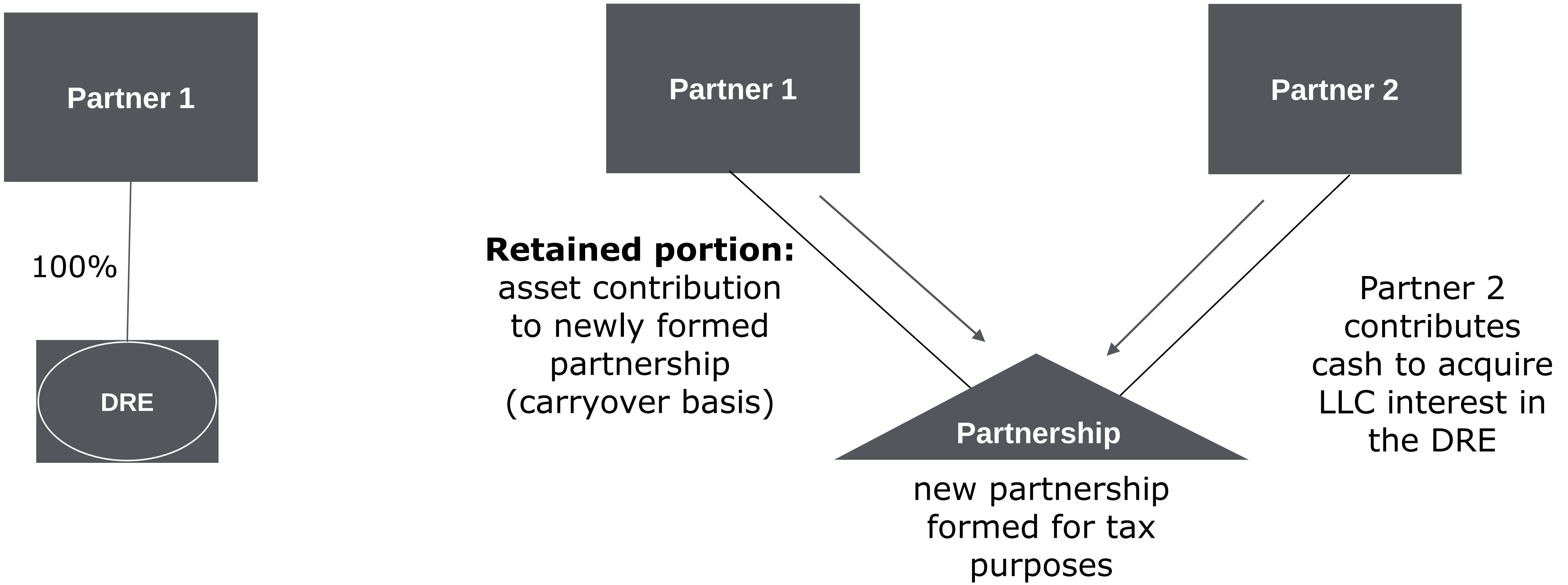
Purchase of membership interest in regarded partnership



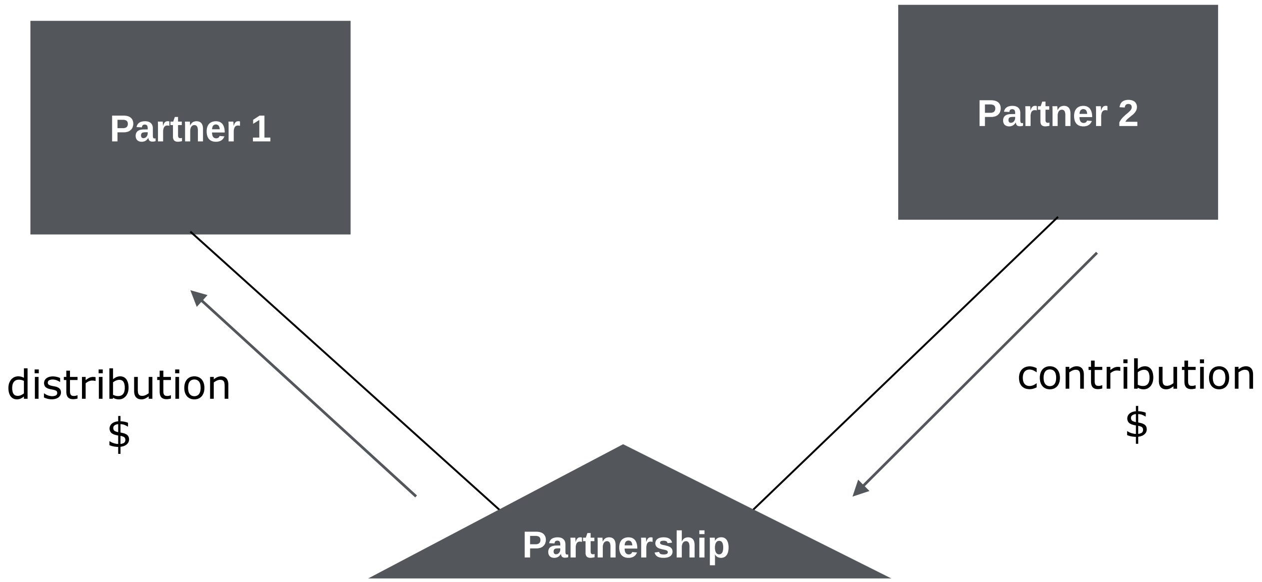
Contribution model – contribution in exchange for equity interest



Revenue Ruling 99-5, Situation 2



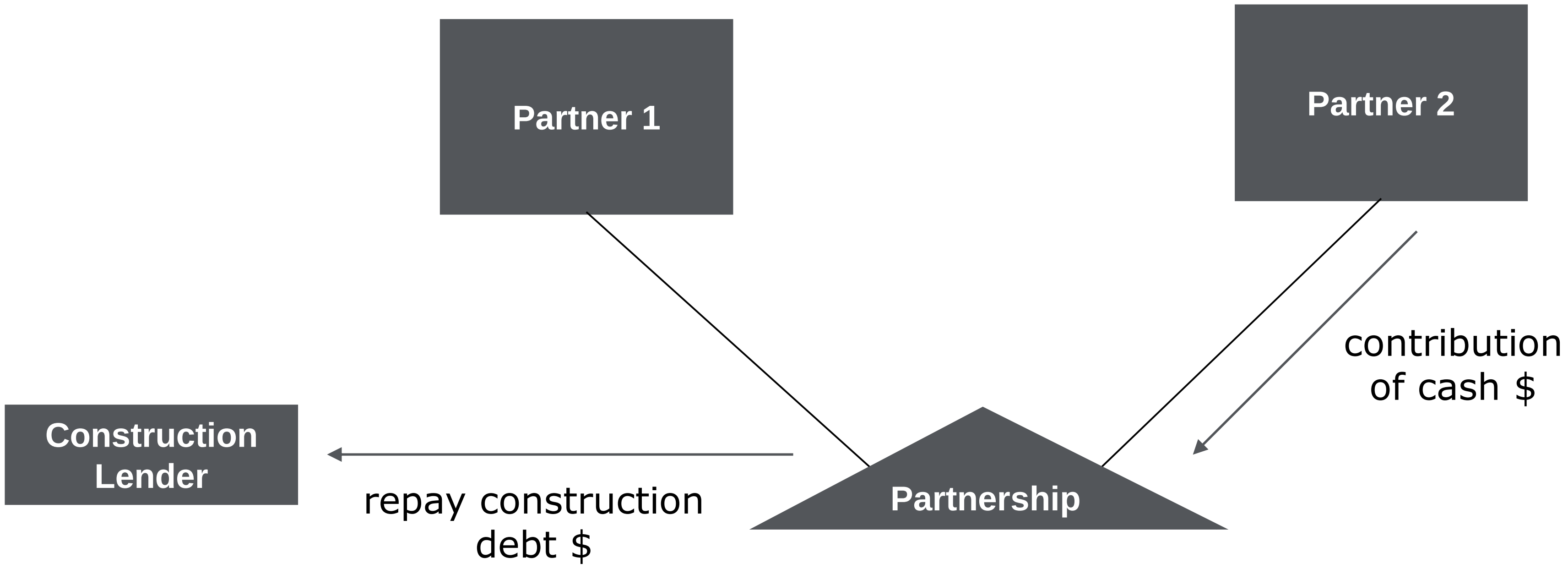
Contribution and distribution



Disguised Sale?

- Potential exceptions:
    - Preformation CapEx
    - Qualified Liabilities

Contribution and repayment of construction debt



Illustrative Example 1

Original Developer

Developer 2 buys pre-developed project for $45m

Developer 2

Spends $20m on developing the project (pre-construction)

Allocates purchase price as follows:
- $12m PPA
- $8m Land Leases
- $15m Engineering/Permitting
- $10m Interconnection Agreement
- $45m Total

Additional costs incurred by Developer 2 to build facility
- $10m Utility Owned Upgrades
- $125m Buildout Cost
- $135m Total

Total Developer 2 Spend = $180m

Fair Market Valuation to Third Party Buyer

Cost Approach
- Total Developer 2 Spend = $180m
- Capitalized Interest = $5m
- 10% Entrepreneurial Incentive = $18.5m

Cost Approach $203.5m
Income Approach $206.5m
Concluded FMV $205m

Illustrative Example 1 (cont.)

Original Developer ← **Developer 2**

Developer 2 Total Spend = $180m
- Purchase price to Original Developer = $45m
- Additional Spend = $135m

Bottom-up approach ($180m)
- $12m PPA amortized over 15 years
- $8m land leases amortized over the life of the lease
- $10m interconnection agreement amortized over 15 years
- $10m utility owned upgrades amortized over 20 years
- $140m of other costs (cost segregation)
  - 5-Year MACRS
  - 15-Year MACRS
  - 39-Year SL

Development fee?

Sale by Developer 2 to a third party buyer

Purchase Price = $205m
- $0m FMV for at-market land leases
- $5m FMV for PPA (above market)
- $0m FMV for utility owned upgrades
- $11m FMV for interconnection agreement

Top-down purchase price allocation ($205m)
- $0m land leases
- $5m PPA agreement
- $0m utility owned upgrades
- $11m interconnection agreement
- $189m of other costs (cost segregation)
  - 5-Year MACRS
  - 15-Year MACRS
  - 39-Year

Impact of Alta Wind case?
- Does IRC section 1060 apply?
- Above market project specific PPA?

Illustrative Example 2 – Recovery of development costs upon partnership flip formation

- Sometimes a developer holds the project in a disregarded entity (DRE) and seeks to recover its development costs upon the partnership formation with as little taxable gain as possible

- On a sale of an interest in a DRE, the seller recognizes gain under Rev. Rul. 99-5, Situation 1 as though it sold a proportionate share of the assets of the DRE

- The seller must calculate its gain using a proportionate amount of its basis in the assets

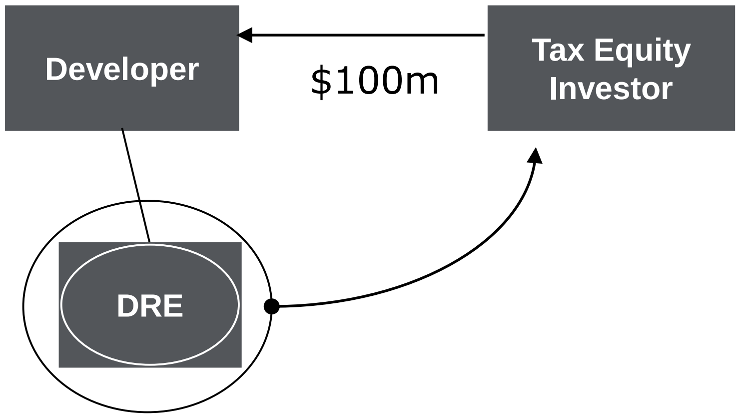
Alternative to actual sale is a disguised sale

- Sponsor contributes property to partnership and Tax Equity Investor contributes money that is distributed by the partnership to the Sponsor

- Treas. Reg. § 1.707-4(d) generally provides that a partnership is allowed to reimburse preformation capital expenditures without the contributing partner being treated as selling property to the partnership if the expenditures were incurred during the two years preceding the contribution

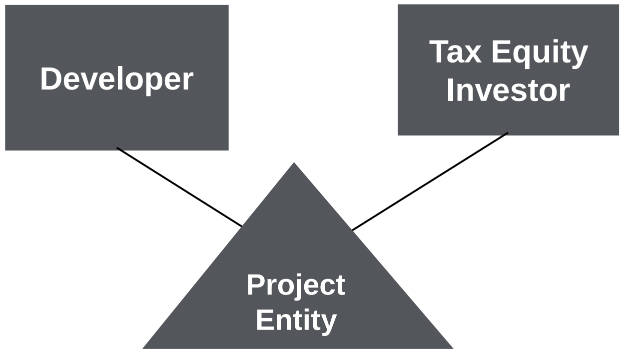
Illustrative Example 2 – Revenue Ruling 99-5 Situation 1

Before Structure



FMV $120m
Basis $100m
(costs incurred within the last 2 years)

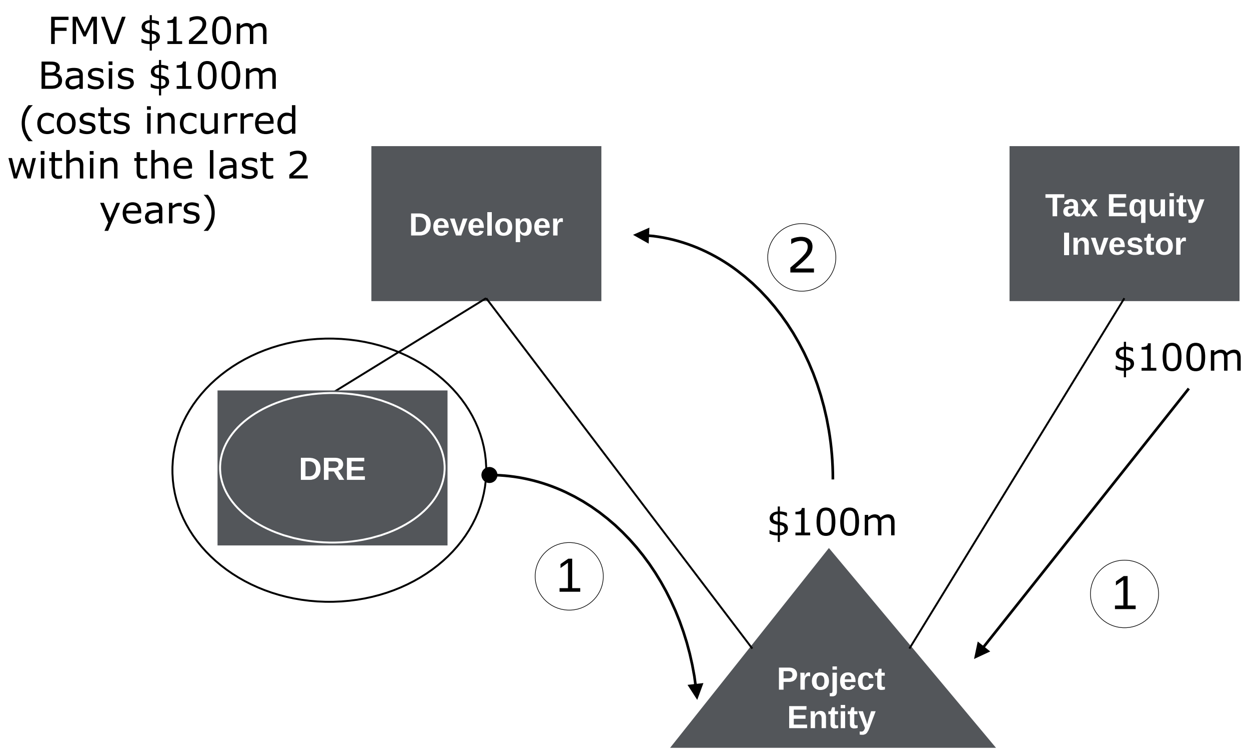
After Structure



FMV $120m
Basis $116.7m
(costs incurred within the last 2 years)

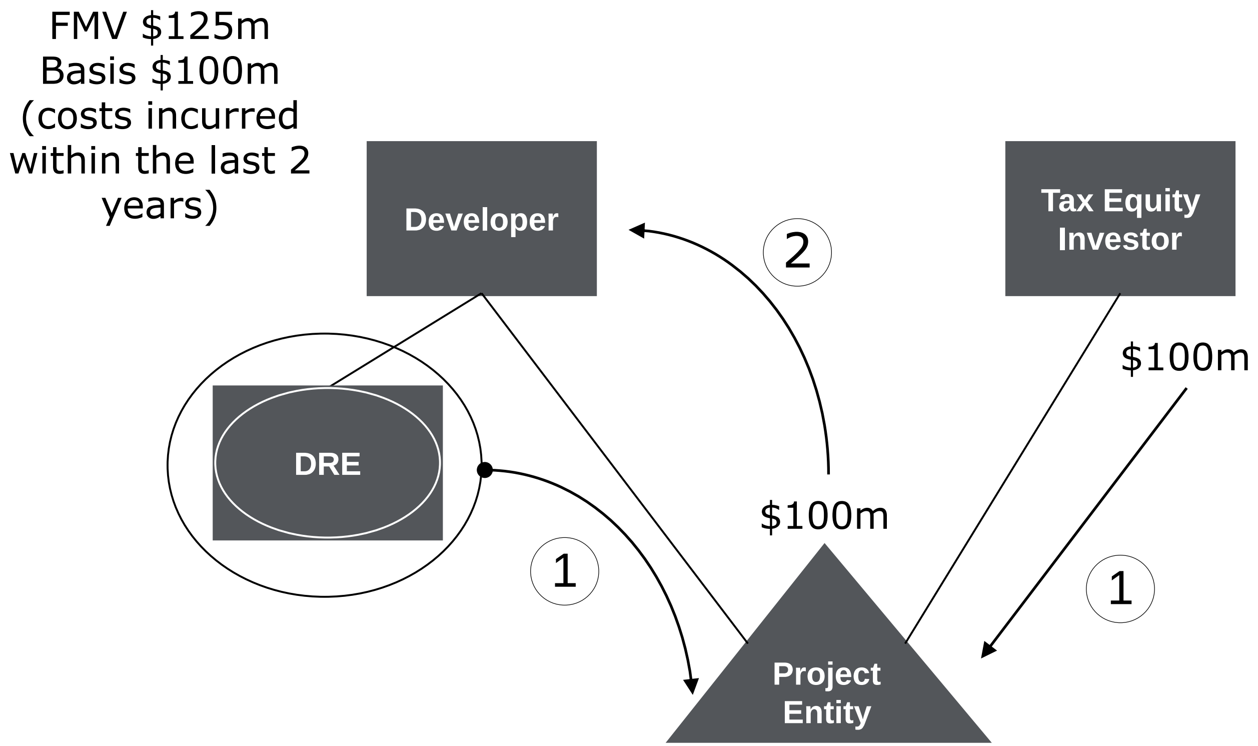
- Tax Equity Investor purchases $100m of Developer's interest in DRE
- Basic Rev. Rul. 99-5, Situation 1 – *No disguised sale analysis*
- Treated for tax purposes as though Tax Equity Investor purchased an interest in $100m of DRE assets and then both parties contributed their assets to a new partnership
- Developer can only use $83.3m of its basis because it is treated as selling a proportionate share of the DRE assets, so it recognizes $16.7m of gain for tax purposes

Illustrative Example 2 – Rev. Rul. 99-5, Situation 2 and disguised sale combined



- Developer contributes DRE and Tax Equity Investor contributes $100m to Project Entity
- Immediately or within 2 years, Project Entity distributes $100m to Developer
- Under section 1.707-4(d), Project Entity is allowed to reimburse all preformation capital expenditures incurred within the last two years
- The limitation on preformation capital expenditure reimbursement does not apply because the value of DRE assets does not exceed 120% of the Developer’s basis in the assets at the time of the contribution
- There is no gain on the transaction done in this way

Illustrative Example 2 – Rev. Rul. 99-5, Situation 2 and disguised sale combined



- Because the value of DRE assets exceed 120% of the Developer’s basis in DRE assets at the time of the contribution, reimbursement of preformation expenditures is limited under section 1.707-4(d)(ii) to 20% of the value DRE assets

- $25m of the distribution is reimbursement (20% of $125m)

- The excess distribution of $75m is a disguised sale that triggers $15m of gain (disguised sale of 60% of $125m of value, so allowable basis is $60m), leaving $40m of outside basis

- Then the $25m reimbursement reduces outside basis to $15m

Alta Wind

1603 Grant Case

Alta Wind 1603 Grant Case

- Basis issue from sale of wind projects via sale leaseback
- Cash grant requested based on 30% of purchase price allocated to eligible property
- Treasury reduced grant award to 30% of Alta’s cost to build wind projects
- Court awarded $206 million in damages
- 20 plaintiffs, 8 complaints
- Service’s expert witness testimony dismissed
- Appealed to Federal Circuit: Government brief filed in April; Response brief filed in June; Reply to response brief filed in July; Hearing in the case expected in November/December 2017, or early 2018

Alta Wind 1603 Grant Case (cont.)

Court rejected government's arguments holding:

- Section 1060 does <u>not</u> apply
- No goodwill or going concern value could attach
- PPAs not separate intangible assets with value independent of tangible property
- Wind projects had "Turn-Key Value"

Alta Wind 1603 Grant Case (cont.)

No “peculiar circumstances” indicating inflated purchase prices such as:

- Unduly manipulating purchase price
- Entering into separate agreements
- Causing purchase price to be highly inflated
- Sale-leaseback NOT per se peculiar circumstances

Pro-rata allocations are reasonable

Acquiring project before, during, and after construction

When, how, and to what does cost basis attach?

Projects acquired before construction

- Only predevelopment rights established (e.g., PPA, interconnection, land rights)
- Premium paid for turn-key value expected to be realized at project completion (”hypothetical CWIP”)
- Must be allocated to identifiable assets existing on the acquisition date
  - Intangible property, goodwill, going concern value?
  - 1060 residual method vs. 1012 specific asset allocation

Projects acquired during construction

- Predevelopment rights established (e.g., PPA, interconnection, land rights)
- Tangible property and CWIP established
- Premium paid for turn-key value expected to be realized at project completion (“hypothetical CWIP”)
- Must be allocated to identifiable assets existing on the acquisition date
  - Tangible property (“CWIP”), intangible property, goodwill, going concern value?
  - 1060 residual method vs. 1012 specific asset allocation

When, how, and to what does cost basis attach? (cont'd)

Projects acquired after construction and COD

- Predevelopment rights established (e.g., PPA, interconnection, land rights)
- Tangible property and going concern established
- Premium paid for value established and demonstrated from operations
- Must be allocated to identifiable assets existing on acquisition date
  - 1060 residual method
  - Tangible property, intangible property, goodwill and going concern value