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2021 Deloitte Renewable Energy Seminar

Resilient, reliable, and recharged

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Partnership flip and lease structures

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Agenda

Background on Flip Structures	3
Partnership Allocations	13
Safe Harbor	18
Use of Leverage	28
Tax Equity – Leasing Structures	36
Treasury Guidance on Inverted Leases	46
Tax Ownership / True Lease Analysis	50
Section 467 Concepts	55

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Background on Flip Structures

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Tax Equity Structures

Two Basic Tax Incentives

There are two basic types of tax incentives that are used by the U.S. federal government to incentivize investment in renewable energy generation (and battery storage in certain cases)

- Credits against income tax liability
- Accelerated depreciation

There are currently two kinds of credits against income tax liability we are concerned with

- Investment tax credit (“ITC”)
- Production tax credit (“PTC”)

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Tax Equity Structures

ITC

ITC under section 48 is a credit based upon a prescribed percentage of a qualified investment

- Must be original user (first person to use the property for its intended function)
- Possible to decouple the owner of qualifying property from the producer of the electricity using pass-through election

Under current law, both the PTC and ITC step down according to differing schedules, effectively modified by IRS "safe harbor" guidance

- For example, the ITC available for qualified solar generation steps down according to statute as follows:
  - 26 percent for projects that begin construction in 2021 and 2022
  - 22 percent for projects that begin construction in 2023
  - After 2023, the residential credit drops to zero while the commercial credit drops to a permanent 10 percent

Example

- A qualifying solar generation project with gross FMV of $110 million, $100 million of which qualifies for the ITC
- The project begins construction in 2021 and reaches COD in 2022
- The ITC is $26 million (26% of $100 million), accruing on the tax "placed in service" (PiS) date to the tax owner

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Tax Equity Structures

Constraints on ITC

Ownership structure and allocations must be respected for federal income tax purposes

- Safe Harbor technically only applies to wind PTC (Rev. Proc. 2007-65)
- Allocated in the same proportion as the general profits or, alternatively, in accordance with the allocation of basis recovery of the relevant property

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

Recapture of ITC during first 5 years

- Vests 20% per year

Potential limitation of ITC (as well as MACRS/bonus depreciation) if tax-exempt direct or indirect equity in capital stack

- Deal by deal consideration and potential impacts of blocker corporations
- Looking up the chain through partnerships
- Certain C Corps can be treated as tax-exempt owners

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Tax Equity Structures

PTC

PTC under section 45 is a credit based upon energy generated using a qualified generation resource and sold to third parties

- PTC is available for 10 years after the date the facility is placed in service for tax purposes
- Inflation adjustments, and different base rates for different generation technologies
- 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)

Under current law, the PTC will expire at the end of 2021 for new wind projects

- At the end of December 2020, Congress extended the PTC for wind at 60% of the full credit amount, or $0.018 per kWh ($18 per mWh), for project that have begun construction by December 31, 2021

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Tax Equity Structures

Constraints on PTC

Ownership structure and allocations must be respected for federal income tax purposes

- Safe Harbor (Rev. Proc. 2007-65)
- Allocated in the same proportion as the electricity sale that generated the PTCs

No recapture provisions or limitations on PTC to tax-exempt or foreign investors

- Must be United States project to qualify for PTC

Depreciation limitations

- MACRS and bonus depreciation may be limited if tax-exempt ownership in structure

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Tax Equity Structures

Value of Credits Against Income Tax Liability

Financing depends heavily on tax incentives

- Tax equity investments in solar generation often price as a multiple of the ITC
- If a deal prices at 1.2x, and tax equity is expected to be allocated an ITC of $30 million, tax equity will invest $36 million (=30 x 1.2)
- The present value of the ITC is, generally speaking, equal to the present value of anticipated decrease in quarterly estimated tax payments attributable to the ITC
  - So, using a discount rate of 4%, the present value of the $30 million ITC is $29.30 million
    - If the tax equity investor does not otherwise have federal income tax liability of at least $40 million (=30 / .75, representing the 75% general business credit limit), the present value of the ITC decreases
- If tax equity believes the NPV of its investment is $4 million (=40 – 36), then approximately 74% (=29.75 / 40) of tax equity's economic return is attributable to the ITC
  - The remaining $10.70 million (=40 – 29.30) is attributable to the present value of pre-tax cash flows and the other anticipated tax benefits / (detriments)

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Tax Equity Structures

Basic Types of Tax Equity Financings

There are four principal forms of financing (excluding debt)

- Partnership flip
- Sale-leaseback
- Inverted lease
- Power prepayment

Certain common variations

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What is a flip partnership?

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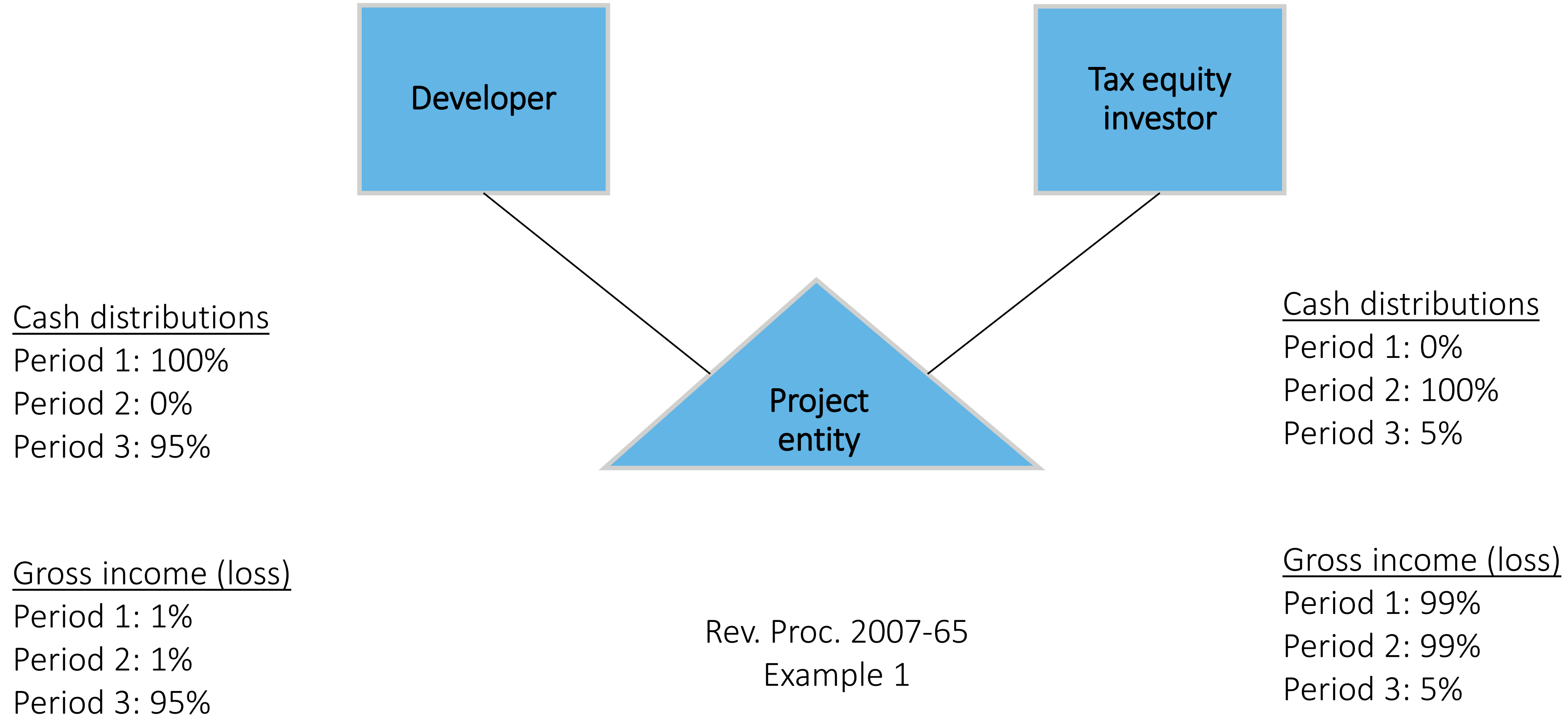
Background on Flip Structures

What is a flip structure?



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Background on Flip Structures

What is a flip structure?

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

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Background on Flip Structures

What is a flip structure?

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

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Partnership Allocations

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Tax Equity Flip Structures

Capital accounts & modeling

There are two kinds of capital accounts that are always maintained for partners

- "Tax capital" account
- "Section 704(b)" capital account

The "tax" capital account is used to ensure compliance with the rules governing recognition of taxable income / (loss)

The "section 704(b)" 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 section 704(b) and tax allocations
- Proper maintenance of capital accounts

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Tax Equity Flip Structures

Capital accounts

Capital accounts are balance sheets

- However, unlike GAAP balance sheets, both the tax and section 704(b) capital accounts are *maintained consistent with tax (and not GAAP) income recognition principles*
  - In consequence, items like accelerated depreciation reduce equity much more quickly than actual "economic" depreciation would reduce equity, typically causing very significant differences between the economic value of a partner's equity interest and their tax or section 704(b) capital account
  - For instance, in the renewable generation industry, it is typical to see negative section 704(b) capital accounts (i.e., negative equity) even though the value of that equity is significantly positive

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Tax Equity Flip Structures

Capital accounts

Tax and section 704(b) capital accounts "balance"

- Project finance models only infrequently show the traditional left side (assets) vs. right side (liabilities and equity) presentation
- Nonetheless, the balance between assets and liabilities and equity is always implicit, as indicated in the illustration below

	Assets			Liabilities and Equity	
	704(b)	Tax		704(b)	Tax
Cash	10	10	Liabilities	90	90
Accounts receivable	10	10			
PP&E	70	30	Partner 1 capital	2	(8)
Goodwill	10	-	Partner 2 capital	8	(32)
Total	100	50	Total	100	50

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Tax and section 704(b) capital accounts "balance" (cont.)

- In the illustration below, the partners have negative tax capital; however, in determining each partner's "outside" basis in its interest in the partnership, each partner is credited with its share of the partnership's liabilities

In this case, each partner has positive outside tax basis even though each has negative tax capital

	Assets	
	704(b)	Tax
Cash	10	10
Accounts receivable	10	10
PP&E	70	30
Goodwill	10	-
Total	100	50

	Liabilities and Equity	
	704(b)	Tax
Liabilities	90	90
Partner 1 capital	2	(8)
Partner 2 capital	8	(32)
Total	100	50
Partner 1 liability share		18
Partner 2 liability share		72
Partner 1 "outside" tax basis		10
Partner 2 "outside" tax basis		40

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Tax Equity Flip Structures

Capital accounts

Tax and section 704(b) capital accounts “balance” (cont.)

- In the illustration below, the partners have negative tax capital; however, in determining each partner’s “outside” basis in its interest in the partnership, each partner is credited with its share of the partnership’s liabilities

	Assets			Liabilities and Equity	
	704(b)	Tax		704(b)	Tax
Cash	10	10	Liabilities	90	90
Accounts receivable	10	10			
PP&E	70	30	Partner 1 capital	2	(8)
Goodwill	10	-	Partner 2 capital	8	(32)
Total	100	50	Total	100	50
			Partner 1 liability share		18
			Partner 2 liability share		72
			Partner 1 "outside" tax basis		10
			Partner 2 "outside" tax basis		40

The sum of the partners’ outside basis will generally equal (subject to some exceptions) the total tax basis the partnership has in its assets

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Tax Equity Flip Structures

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:

- Section 704(b) capital accounts compliant with regulations
- Liquidation in accordance with positive section 704(b) capital accounts
- Deficit restoration obligation (DRO)
  - Obligation must not be a bottom dollar payment obligation that is not recognized or legally enforceable
  - Facts and circumstances indicating a plan to circumvent or avoid an obligation
  - Limited DRO requires qualified income offset (QIO)
  - Special “stop loss” allocations generally intended to prevent negative balances in excess of any limited DRO

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Tax Equity Flip Structures

Basic section 704(b) capital account rules

Section 704(b) 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 under section 50
- Increases to reflect gain, if any, on cash distributions to the partners
  - Special rules apply in certain circumstances

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Tax Equity Flip Structures

Basic tax capital account rules

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 under section 704(d) until the partner has sufficient tax basis
  - Impacts when tax losses are monetized for after- tax IRR purposes
  - Upon the sale of a partner's interest in a partnership, the suspended loss balance does not transfer or give rise to additional losses
- Outside basis generally includes project debt

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Effect of suspended losses on the tax capital balance sheet

- In the illustration below, Partner 2 has a suspended loss

	Assets	
	704(b)	Tax
Cash	2	2
Accounts receivable	2	2
PP&E	56	-
Goodwill	10	-
Total	70	4

	Liabilities and Equity	
	704(b)	Tax
Liabilities	90	90
Partner 1 capital	2	(8)
Partner 2 capital	(22)	(78)
Total	70	4
Partner 1 liability share		18
Partner 2 liability share		72
Partner 1 "outside" tax basis		10
Partner 2 "outside" tax basis		-
Partner 1 "suspended" tax losses		-
Partner 2 "suspended" tax losses		(6)

No partner's outside basis can be negative; therefore, in this case Partner 2 must carry forward a "suspended" loss, which must be taken into account when determining the relationship between the partnership's tax basis in its assets and the aggregate tax basis of the partners

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Tax Equity Flip Structures

Example – ITC and section 734 adjustments

704(b) Capital Account		Total	2020	2021	2022	2023	2024	2025	2026
Opening Balance	$000s		9,947	10,164	(3,018)	(8,468)	(9,666)	(11,110)	(9,960)
Increase for contributions	$000s	37,527	24,544	-	-	-	-	-	-
Basis adjustment for ITC tax credits	$000s	(13,912)	(10,977)	-	-	-	-	-	-
Increase for 704(b) net income	$000s	8,872	-	-	-	-	-	1,201	4,672
Decrease for 704(b) net loss	$000s	(33,515)	(11,861)	(11,917)	(5,543)	(2,002)	(2,108)	(45)	-
Decrease for distributions	$000s	(11,676)	(1,488)	(1,265)	(1,258)	(1,251)	(1,200)	(1,000)	(993)
734 basis adjustment	$000s	7,923	-	-	1,366	2,203	2,159	1,627	472
734 amortization expense	$000s	(2,312)	-	-	(15)	(148)	(294)	(633)	(696)
Reverse reallocations from Cash Equity in prior periods in tax year	$000s	-							
Reverse reallocations to Cash Equity in prior periods in tax year	$000s	-							
Preliminary 704(b) account	$000s	(7,093)	10,164	(3,018)	(8,468)	(9,666)	(11,110)	(9,960)	(6,505)
Add: DRO	$000s	1,039,602	-	3,018	8,468	9,666	11,110	9,960	6,505
Add: Minimum gain addback	$000s	56	-	-	-	-	-	-	-
Preliminary adjusted 704(b) account	$000s	1,032,564	10,164	(0)	(0)	(0)	(0)	(0)	(0)
Reallocation from Cash Equity	$000s	-	-	-	-	-	-	-	-
Reallocation to Cash Equity	$000s	-	-	-	-	-	-	-	-
Ending adjusted 704(b) account	$000s	1,032,564	10,164	(0)	(0)	(0)	(0)	(0)	(0)
Less: DRO	$000s	(1,039,602)	-	(3,018)	(8,468)	(9,666)	(11,110)	(9,960)	(6,505)
Less: Minimum gain addback	$000s	(56)	-	-	-	-	-	-	-
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Tax Equity Flip Structures

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Reallocation from Cash Equity	$000s	-	-	-	-	-	-	-	-
Reallocation to Cash Equity	$000s	-	-	-	-	-	-	-	-
Ending adjusted 704(b) account	$000s	1,032,564	10,164	(0)	(0)	(0)	(0)	(0)	(0)
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Less: Minimum gain addback	$000s	(56)	-	-	-	-	-	-	-
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Tax Equity Flip Structures

Example – Distributions in excess of tax basis and section 704(d) suspended losses

		Total	2020	2021	2022	2023	2024	2025	2026
Outside Basis									
Beginning Outside Basis	$000s		9,947	10,164	(0)	(0)	(0)	(0)	(0)
Add: Capital Contributions	$000s	37,527	24,544	-	-	-	-	-	-
Add: Taxable income	$000s	6,977	-	-	-	-	-	523	3,976
Add / Less: Increase / (Decrease) in Partner's Share of Liabilities	$000s	6	-	-	-	-	-	-	-
Less: Basis adjustment for ITC tax credits	$000s	(13,912)	(10,977)	-	-	-	-	-	-
TEI Outside Basis Before Cash Distributions	$000s	30,597	23,513	10,164	(0)	(0)	(0)	523	3,976
Less: Cash Distributions	$000s	(11,676)	(1,488)	(1,265)	(1,258)	(1,251)	(1,200)	(1,000)	(993)
TEI Outside Basis After Cash Distributions	$000s	18,921	22,026	8,899	(1,258)	(1,251)	(1,200)	(477)	2,983
Add: Distributions in Excess of Outside Basis	$000s	4,911	-	-	1,258	1,251	1,200	477	-
TEI Outside Basis Before Allocations of Loss	$000s	23,832	22,026	8,899	(0)	(0)	(0)	(0)	2,983
Less: Taxable Loss	$000s	(33,932)	(11,861)	(11,917)	(5,558)	(2,150)	(2,402)	-	-
TEI Outside Basis Before Suspended Losses	$000s	(10,100)	10,164	(3,018)	(5,558)	(2,150)	(2,402)	(0)	2,983
Add: Suspended Losses	$000s	13,131	-	3,018	5,558	2,150	2,402	-	-
Less: Suspended Losses Utilized	$000s	(3,031)	-	-	-	-	-	-	(2,983)
Ending Balance	$000s	(0)	10,164	(0)	(0)	(0)	(0)	(0)	(0)
Taxable Income / (Losses)									
704(b) net income / (losses)	$000s	(26,955)	(11,861)	(11,917)	(5,558)	(2,150)	(2,402)	523	3,976
Adjustment for 704(c) depreciation		-	-	-	-	-	-	-	-
Taxable income / (Losses) before suspended losses	$000s	(26,955)	(11,861)	(11,917)	(5,558)	(2,150)	(2,402)	523	3,976
Suspended losses additions	$000s	13,131	-	3,018	5,558	2,150	2,402	-	-
Suspended losses utilized	$000s	(3,031)	-	-	-	-	-	-	(2,983)
Taxable income / (Losses)	$000s	(16,855)	(11,861)	(8,899)	(0)	0	(0)	523	993
731(a) Gain	$000s	4,911	-	-	1,258	1,251	1,200	477	-
Taxable income / (Losses) + 731(a) Gain	$000s	(11,945)	(11,861)	(8,899)	1,258	1,251	1,200	1,000	993
Interest limitation adjustment	$000s	-	-	-	-	-	-	-	-
Taxable income / (losses) after interest limitation adjustment	$000s	(11,945)	(11,861)	(8,899)	1,258	1,251	1,200	1,000	993

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Tax Equity Flip Structures

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Most partnership or LLC agreements will include reallocation provisions (also called "stop-loss" provisions)

(c) Loss Limitations. Losses allocated pursuant to Section 5.01(a) and any items of loss or deduction allocated pursuant to Sections 5.01, 12.02(a)(iv) and 12.02(a)(v) shall not exceed the maximum amount of Losses and other items of loss or deduction that can be allocated without causing any Member to have an Adjusted Capital Account Deficit at the end of any Allocation Period. In the event some but not all of the Members would have Adjusted Capital Account Deficits as a consequence of an allocation of Losses pursuant to Section 5.01(a) or any items of loss or deduction allocated pursuant to Section 5.01(b)(viii) or 12.02(a)(v), the limitation set forth in this Section 5.01(c) shall be applied on a Member by Member basis and Losses and items of loss or deduction not allocable to any Member as a result of such limitation shall be allocated to the other Members pursuant to Sections 5.01 and 12.02 to the extent such other Members have positive balances in their Capital Accounts so as to allocate the maximum permissible Losses to each Member under Treasury Regulation Section 1.704-1(b)(2)(ii)(d).

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Tax Equity Flip Structures

Example - Reallocation

704(b) Capital Account		Total	2020	2021	2022	2023	2024	2025	2026
Opening Balance	$000s		9,947	10,164	(0)	(0)	(0)	(0)	1,150
Increase for contributions	$000s	37,527	24,544	-	-	-	-	-	-
Basis adjustment for ITC tax credits	$000s	(13,912)	(10,977)	-	-	-	-	-	-
Increase for 704(b) net income	$000s	12,491	-	-	-	-	-	1,201	4,672
Decrease for 704(b) net loss	$000s	(33,515)	(11,861)	(11,917)	(5,543)	(2,002)	(2,108)	(45)	-
Decrease for distributions	$000s	(12,281)	(1,488)	(1,265)	(1,258)	(1,251)	(1,200)	(1,000)	(993)
734 basis adjustment	$000s	13,173	-	-	1,366	2,203	2,159	1,627	472
734 amortization expense	$000s	(6,709)	-	-	(15)	(148)	(294)	(633)	(696)
Reverse reallocations from Cash Equity in prior periods in tax year	$000s	-							
Reverse reallocations to Cash Equity in prior periods in tax year	$000s	(10,757)							
Preliminary 704(b) account	$000s	(13,984)	10,164	(3,018)	(5,450)	(1,198)	(1,443)	1,150	4,605
Add: DRO	$000s	-	-	-	-	-	-	-	-
Add: Minimum gain addback	$000s	-	-	-	-	-	-	-	-
Preliminary adjusted 704(b) account	$000s	(13,984)	10,164	(3,018)	(5,450)	(1,198)	(1,443)	1,150	4,605
Reallocation from Cash Equity	$000s	-	-	-	-	-	-	-	-
Reallocation to Cash Equity	$000s	21,867	-	3,018	5,450	1,198	1,443	-	-
Ending adjusted 704(b) account	$000s	7,883	10,164	(0)	(0)	(0)	(0)	1,150	4,605
Less: DRO	$000s	-	-	-	-	-	-	-	-
Less: Minimum gain addback	$000s	-	-	-	-	-	-	-	-
Ending 704(b) account	$000s	7,883	10,164	(0)	(0)	(0)	(0)	1,150	4,605

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Tax Equity Flip Structures

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Add: Minimum gain addback	$000s	-	-	-	-	-	-	-	-
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Less: DRO	$000s	-	-	-	-	-	-	-	-
Less: Minimum gain addback	$000s	-	-	-	-	-	-	-	-
Ending 704(b) account	$000s	7,883	10,164	(0)	(0)	(0)	(0)	1,150	4,605

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Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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

Recall flip partnership background

- "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

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

IRS safe harbor

- Announcement 2009-69
  - Rev. Proc. 2007-65 safe harbor not intended to provide substantive rules and not intended to be used as audit guidelines
- Rev. Proc. 2014-12 reaffirmed the minimum investment requirements in Rev. Proc. 2007-65

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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%)

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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

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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

Paygo considerations

- If there are contingent contributions that approach 25% of the investor’s total projected capital contributions, risk is increased because what is “reasonably anticipated” may be challenged
- The IRS, in FAA 20161101F, addressed a section 45 refined coal credit transaction involving payments contingent on production and treated them as paygo

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

Purchase rights

- Announcement 2009-69
- 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

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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; see also section 45(e)(3)

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

Passive activity

- Separate activity for purposes of Section 469
- Announcement 2009-69
  - 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

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Safe Harbors

Rev. Proc. 2007-65: Safe Harbor for Wind Partnership Flip

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

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Use of Leverage

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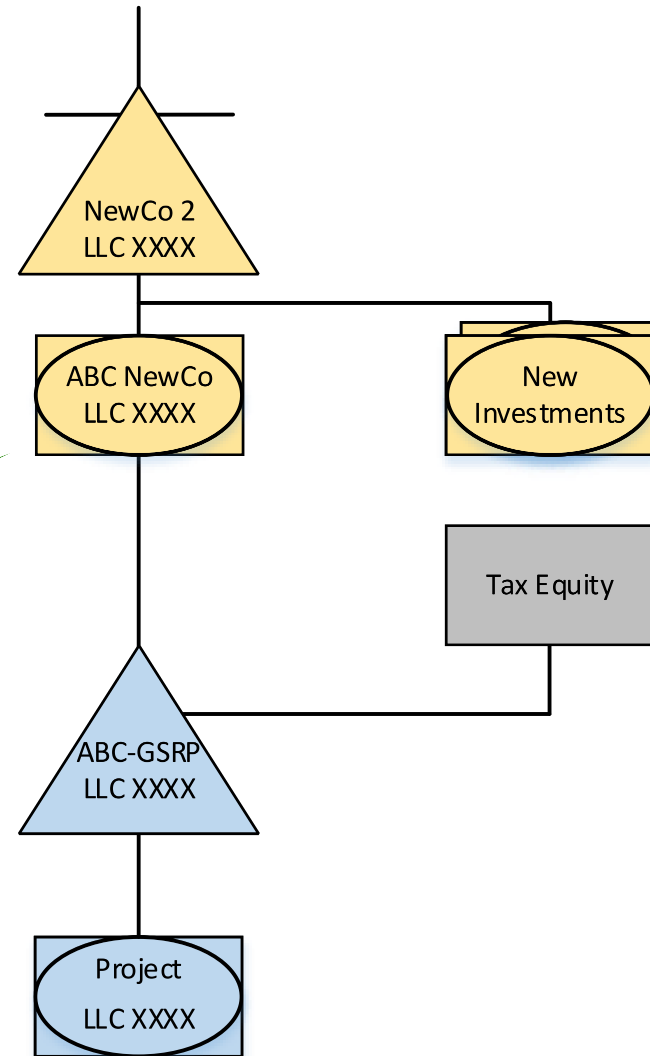
Use of Leverage

Disregarded entities

Entity classification for tax purposes

- There is a set of rules that govern when legal entities (and sometimes mere contractual agreements) are treated as corporations, partnerships, trusts, more specialized tax classifications, or entirely disregarded

By convention, entities that are disregarded are depicted by tax practitioners as ovals within boxes (and tax partnerships are triangles, and corporations are rectangles)



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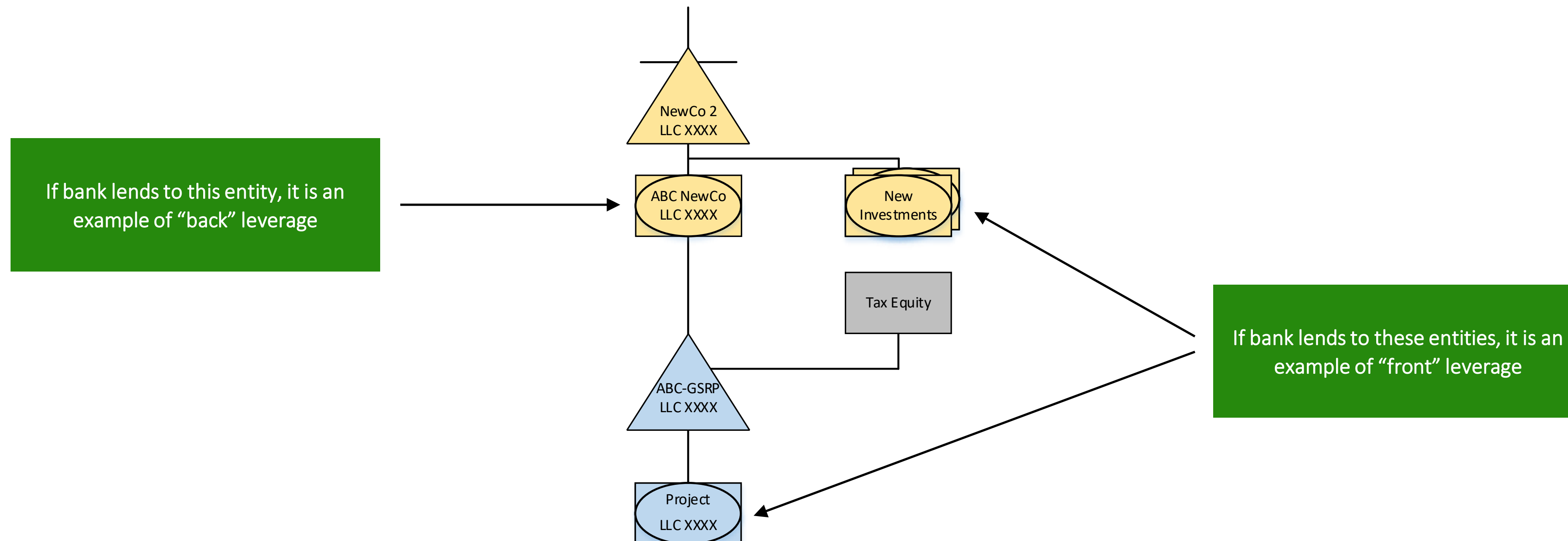
Use of Leverage

Back leverage vs. front leverage

Leverage that finances a partner's equity investment in a partnership is generally referred to as "back" leverage

- Often but not always, back leverage is secured solely by the equity of the relevant partnership or LLC

Leverage that finances a partnership's investment in an asset is generally referred to as "project-level" or "front" leverage



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Use of Leverage

Important considerations

Project-level or "front" leverage generally implicates the "nonrecourse deduction" and "minimum gain" rules

Allocation of nonrecourse deductions

- Cannot have "economic effect"
- Generally must be allocated in manner consistent with a safe harbor that allows these allocations to be "deemed" to have economic effect, which requires
  - Capital accounts compliant with regulations
  - Allocation in manner reasonably consistent with allocations having substantial economic effect
  - Minimum gain chargeback
  - All other allocations respected

Minimum gain chargebacks

- Models must track annual minimum gain balances to determine if chargebacks will apply

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Use of Leverage

Section 163(j)

New section 163(j) limits a taxpayer's ability to claim a deduction for business interest expense

- Limitation is generally equal to the amount of business interest income plus 30% of the taxpayers "adjusted taxable income" (ATI) (50% for taxable years beginning in 2020)
- ATI is, basically, EBITDA (in tax sense) before 2022 and EBIT thereafter
- Applied at the partnership level and at the partner level

Notwithstanding a limitation under section 163(j) affecting the amount of business interest expense that partners can deduct, each partner's share of interest expense is reflected in reductions to both capital accounts as well as "outside" basis in the partnership

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Use of Leverage

Section 163(j)

Final regulations generally

- The final regulations are generally effective and applicable to taxable years beginning on or after 60 days after publication
- Section 163(j) is applied at the partnership level and at the partner level

Proposed regulations provide rules for

- Tiered partnerships
- Self-charged interest
- Debt financed distributions
- Basis adjustments

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Use of Leverage

Section 163(j)

Partnership rules under the final regulations

- ATI is calculated at the partnership level, taking into account section 734 adjustments
- A partnership cannot have both excess taxable income (ETI) and excess business interest expense (EBIE) in the same taxable year
- Partnerships must use an 11-step process for allocating deductible business interest expense and section 163(j) excess items
- ATI of a partner generally is determined without regard to its distributive share of partnership income, but takes into account ETI, remedial items under section 704(c), and adjustments under section 743 and section 704(c)(1)(C)
  - Prohibition of double counting of business interest income and interest income taken into account by the partnership

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Use of Leverage

Section 163(j)

Final regulations – election to be an excepted regulated utility trade or business

- Section 163(j) applies to deductions for business interest expense, which generally means any interest paid or accrued on indebtedness properly allocable to a non-excepted trade or business. Interest paid or accrued on indebtedness properly allocable to an exempted trade or business is not subject to section 163(j).
  - An excepted trade or business includes an excepted regulated utility trade or business
  - Under the final regulations, a trade or business that furnishes or sells electrical energy is eligible to elect to be an excepted regulated utility trade or business to the extent that the rates for furnishing or selling electrical energy have been established or approved by an agency of the United States or by a public service or public utility commission or similar body
  - Consider whether obtaining market-based rate authority from the Federal Energy Regulatory Commission (FERC) enables a taxpayer to elect to be an excepted regulated utility trade or business.

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Use of Leverage

Section 163(j)

Newly proposed regulations

- Tiered partnerships – If a lower-tier partnership (“LTP”) allocates EBIE to an upper-tier partnership (“UTP”), UTP reduces its basis in its LTP interest by the EBIE, but the UTP partners do not reduce their bases in their UTP interests until UTP treats the LTP EBIE as paid or accrued nor is EBIE information with respect to LTP reported to UTP partners
  - The EBIE carried forward by UTP (“UTP EBIE”) has a basis component and a carryforward component.
- Self-charged interest – A lending partner is allocated EBIE from a borrowing partnership and has interest income
  - The lending partner treats the interest income as an allocation of EBII from the borrowing partnership to the extent of the EBIE allocated in that taxable year
  - The interest income recharacterized as EBII is included in the lending partner’s own section 163(j) calculation
- Rules for allocating interest expense when debt proceeds are distributed to partners similar to Notice 89-35
- Basis adjustments to partnership property for excess business interest expense upon disposition of a partnership interest

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Use of Leverage

Section 163(j)

Modeling considerations

- Models must reflect the potentially complex rules that will control the application of the business interest expense limitation
- In general, models have not fully reflected section 163(j)
- New models will need to take into account recently finalized regulations (and recently proposed regulations), and some existing models will require updates to reflect the final regulations
  - "11 step" process for allocating deductible business interest expense and section 163(j) excess items should be reflected
  - Certain "short-cut" computations may no longer be accurate. For example, some models compute taxable income allocations net of section 704(c) remedial allocations, but do not calculate the remedial items on an asset-by-asset basis. Under the final regulations, it will be necessary to actually calculate remedial items (which are taken into account at the partner level, not the partnership level, for section 163(j) purposes), not just final allocations of taxable income net of the remedial allocations.
  - Even partnerships that do not use leverage should reflect some section 163(j) computations to determine the excess items that partners may include in their own ATI calculation.

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Tax Equity – Leasing Structures

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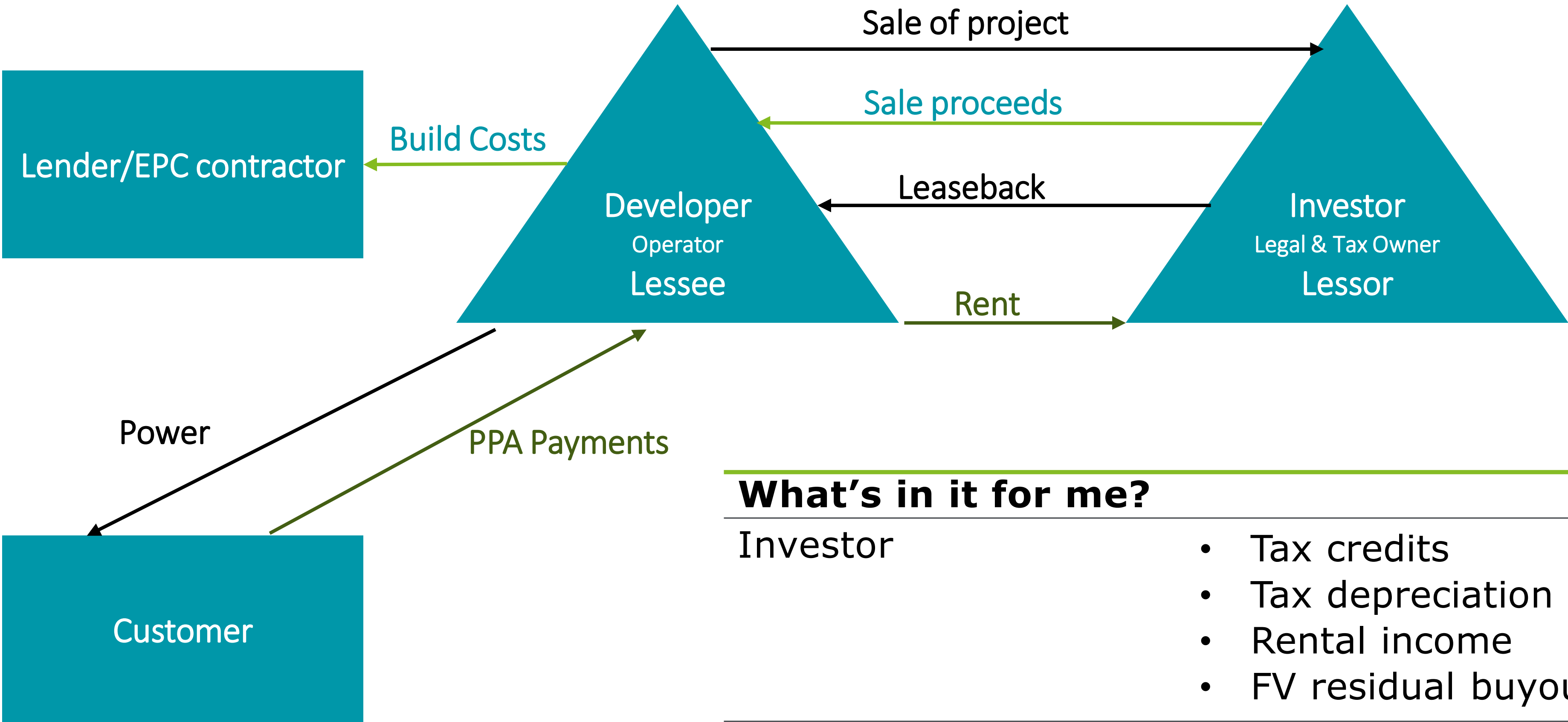
Tax equity leasing structures

Sale-leaseback - Structure



What's in it for me?	
Investor	• Tax credits • Tax depreciation • Rental income • FV residual buyout or renewal
Developer	• 100% project finance • Rental expense • O&M expense • Income from PPAs and REC sales> rent

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Tax equity leasing structures

Sale-leaseback – Economic Overview

Time Period	Developer / Operator (Lessee)	Tax Equity Investor (Lessor)
Construction Period / Placed in Service	(Project Development Costs)	
Sale of Project (90-Day Rule) / Lease Term	FMV Purchase Price (Project Development Costs) Gain on Sale to Lessor	FMV Purchase Price * ITC Rate (26%) Investment Tax Credit
Operations During Lease Term	PPA Revenue (Rent Expense) (Operating Costs)	Rent Income (Depreciation) (Debt Service)
Exit	(Call Option @ FMV – minimum 20% residual value)	Call Option @ FMV

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Tax equity leasing structures

Sale-leaseback – Advantages and disadvantages

- Advantages
  - 100% financing secured by PPA
  - Tax structure risk low
  - Tax equity insulated from technology and operations risk
- Disadvantages
  - Higher exit costs
  - Relatively expensive source of capital ("black box")
  - Depreciation benefits not generally valued by tax equity
  - Basis reduction = 87% of eligible cost basis depreciated (assuming 26% ITC)

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Tax equity leasing structures

Sale-leaseback – Tax issues

- Tax Ownership
  - Lease vs. loan
  - Substance vs. form
- Three-month rule
- Tax-credit recapture
- Basis reduction = 50% of credit
- Tax-exempt use property limitations

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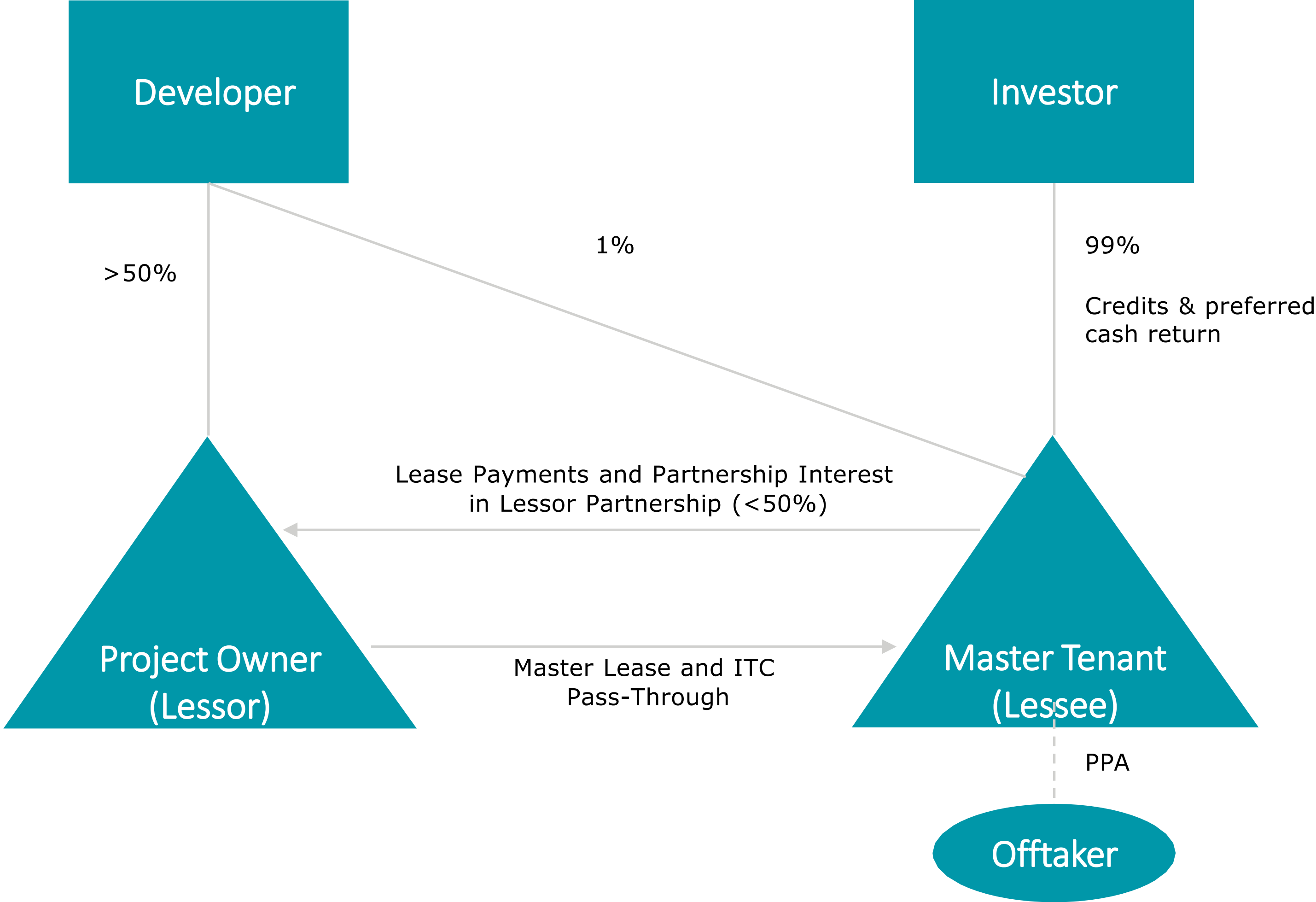
Tax equity leasing structures

Inverted lease - Structure



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Tax equity leasing structures

Inverted Lease – Economic Overview

Time Period	Developer / Operator (Lessor)	Tax Equity Investor (Lessee)
Construction Period / Placed in Service	(Project Development Costs)	
Transfer Possession under Lease / Section 48(d) Election	No gain on pass-through of ITC to Lessee	"Deemed" FMV Purchase Price * ITC Rate (26%) Investment Tax Credit
Operations During Lease Term	Rent Income (Depreciation) (Debt Service)	PPA Revenue 50(d) income (Rent Expense) (Operating Costs)
Exit	(Put or Call Option)	Put or Call Option

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Tax equity leasing structures

Inverted lease – Advantages and disadvantages

- Advantages
  - ITC equals 26% of FMV (rather than cost basis) of ITC-eligible property
  - Lower exit cost (sponsor retains property at end of lease)
  - Can be more efficient use of depreciation benefits
  - No basis reduction = 100% of eligible cost basis depreciated (rather than 87%)
- Disadvantages
  - Tax structure risk can be higher (but see Rev. Proc. 2014-12)
  - Tax equity NOT insulated from technology and operations risk
  - Annual income inclusion = 2.6% of FMV of ITC-eligible property for 5 years (in lieu of 13% basis adjustment)

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Tax equity leasing structure

Inverted lease – Tax issues

- Tax ownership
  - Lease vs. loan
  - Substance vs. form
- Valuation of energy property
- Lease pass-through election
- Income from basis adjustment (section 50(d))
- Partnership allocations
- Tax-credit recapture
- Tax-exempt use property limitations

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Tax equity leasing structures

Sale-leaseback vs. inverted lease

	Sale-leaseback	Inverted Lease
Financing	• Investor provides 100% financing (secured by PPA)	• Investor provides approximately 30-40% financing (secured by PPA)
Exit Cost	• Higher exit costs = 20% of expected FMV to purchase project at end of lease term (or FMV rent)	• Lower exit costs = put/call price at the end of the tax credit period
Operations risk	• Insulates investor from operations risk by separating ownership from operations	• Investor takes on a share of operations risk but will seek to transfer this risk contractually to Developer through O&M agreement
Technology risk	• Insulates investor from technology risk since financing closed after placed in service date	• Investor has technology risk since financing must be closed prior to place in service date
Basis adjustment	• Investor's depreciation benefit reduced by 50% of the ITC amount	• Owner entity depreciates 100% of cost basis • Investor recognizes 50(d) income equal to 13% of ITC-eligible property (i.e., 50% of 26% ITC)

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Treasury Guidance on Inverted Leases (“50(d) Regs”)

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IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1

Inverted “pass-through lease” structure

- Treasury Department and IRS released final regulations (Treasury Decision 9872) concerning the income inclusion rules under IRC Section 50(d)(5) that apply to a lessee of investment credit property when a lessor of that property elects to treat the lessee as having acquired the property and thereby eligible to claim an Investment Tax Credit (“ITC”) – so-called inverted or pass-through lease structures
- Generally, if an owner of investment credit property claims the ITC, the owner must reduce the basis in such property by an amount of the ITC
  - 50% for energy property
- However, when a lessor of investment credit property elects to pass through the credit to a lessee under Treas. Reg. Section 1.48-4, the lessee is deemed as acquiring the property for fair market value
- In lieu of a basis adjustment, the lessee is required to include in gross income, over the shortest recovery period, 50% of the amount of the energy credit

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IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1

Inverted "pass-through lease" structure

- As noted in the preamble, some partnerships and S corporations have taken the position that this income is includible by the partnership or S corporation and that their partners or S corporation shareholders are entitled to increase their bases in their partnership interests or S corporation stock as a result of the income inclusion
- IRS and Treasury provide that such basis increases are "inconsistent with congressional intent," which would "thwart the purpose of the income inclusion" and "confer an unintended benefit" that is not available to any other credit claimant
- Final regulations provide that any gross income required to be ratably included is not an item of partnership income for purposes of Subchapter K or an item of S corporation income for purposes of Subchapter S
- Each partner or S corporation shareholder that is an "ultimate credit claimant" is treated as the lessee for purposes of the income inclusion rules
- An "ultimate credit claimant" is defined as any partner or S corporation shareholder that files a Form 3468 with its income tax return

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IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1

Inverted “pass-through lease” structure

- Thus, each partner or S corporation shareholder that is an “ultimate credit claimant” must include in gross income the credit amount required under the regulations in proportion to its credit amount claimed
- The final regulations also provide that if after the recapture period, but prior to the expiration of the recovery period, there is a lease termination or the lessee disposes of the lease, the lessee may make an irrevocable election in such tax year to include in gross income any remaining income required to be taken into account (or if an ultimate credit claimant, in the tax year when that claimant no longer owns its entire direct or indirect interest in the lessee partnership or S corporation)
- Effective for projects placed in service on or after September 19, 2016
- Notice provides that it should not create any inference about proper interpretation of IRC section 50(d) prior to its issuance

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Tax Ownership / True Lease Analysis

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Tax ownership/True lease analysis

In general

- Lease structures are viewed by the IRS as a potential vehicle by which taxpayers may transfer tax benefits through disguised sales
- Benefits and burdens of ownership
  - *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)
  - *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981)
  - *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985)
  - *Torres v. Commissioner*, 88 T.C. 702 (1987)

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Tax ownership/True lease analysis

Benefits and burdens

- Benefits and burdens of ownership factors:
  - Whether legal title passes to the transferee
  - How the parties treat the transaction
  - Whether the transferee acquires an equity interest in the property
  - Whether the agreement imposes a present obligation on the transferor to execute and deliver a deed and a present obligation on the transferee to make payments
  - Whether the transferee is vested with the right of possession
  - Whether the transferee pays income and property taxes on the property
  - Whether the transferee bears the risk of economic loss or physical damage to the property
  - Whether the transferee receives the profits from the operation, retention, and sale of the property
- Facts and circumstances analysis (no one factor is determinative)

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Tax ownership/True lease analysis

Rev. Proc. 2001-28

Pre-tax profit

- The lessor must expect, without taking into account tax benefits, including credits:
  - Overall profit – Lessee payments plus value of the residual should exceed lessor's aggregate disbursements and lessor equity, including financing fees
  - Positive cash flow – aggregate amount to be paid to lessor over the lease exceeds by a reasonable amount lessor's aggregate disbursements over the lease
- Cash on cash return
  - General rule of thumb is 3%
  - Because alternative energy transactions are cash poor, the rule of thumb is often modified by reducing 3% to 2% and treating the tax credit (but not depreciation) either as cash or a reduction in investment

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Tax ownership/True lease analysis

Rev. Proc. 2001-28

- Lessor must maintain minimum “at risk” amount
  - Requires Lessor to always have 20% “at risk” investment in property
  - Limits extent to which nonrecourse financing can be used
  - Limits the prepayments that can be received from Lessee
- Residual value and life
  - Guidelines require 20%; courts have approved less
  - Effect of renewals
- Purchase options
  - Options vs. Puts
  - Fair Market Value vs. Fixed Price
- Limited use property
  - Commercially feasible to sell or re-lease

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Section 467 Concepts

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Section 467 lease concepts

In general

- Required method of tax accounting for rent under certain leases
- Puts certain lessors and lessees on an accrual basis to avoid timing mismatches (e.g., between cash and accrual basis taxpayers)
- When is Section 467 applicable?
  - Agreement (written or oral)
  - True lease for federal income tax purposes
  - Provides for use of tangible property
  - Aggregate rents exceed $250,000, and
  - Either:
    - Increasing or decreasing rents, or
    - Prepaid or deferred rents
- Section 467 Rent
  - Fixed rent for any rental period
  - Contingent rent that accrues during the tax year

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Section 467 lease concepts

Methods of accounting

- Rental Agreement Accrual
  - Lease is disqualified leaseback or long-term agreement and
  - Either –
    - Lease has no deferred or prepaid rent or
    - Lease has deferred or prepaid rent and provides adequate interest
  - Section 467 rent is allocated rent
- Proportional Rental Accrual
  - Lease is not disqualified leaseback or long-term agreement and
  - Lease has deferred or prepaid rent, but does not provide adequate interest
  - Section 467 rent is set fraction of allocated rent
- Constant Rental Accrual
  - Lease has increasing or decreasing rent and
  - Lease is disqualified leaseback or long-term agreement
  - Section 467 rent is level amount for each rental period

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Section 467 lease concepts

Disqualified leaseback or long-term agreement

- A leaseback or long-term agreement is disqualified only if:
  - A principal purpose for providing increasing or decreasing rent is tax avoidance, and
  - IRS determines that because of tax avoidance purpose, rental agreement should be treated as disqualified
- Tax avoidance:
  - IRS will closely scrutinize a lease agreement between parties where a significant difference between the marginal tax rates is reasonably expected during lease term
  - Significant difference = more than 10% during any rental period to which the rental agreement allocates annualized fixed rent that is less than (or greater than) the average rent allocated to all calendar years
  - Safe-harbor – Uneven rent test (90%/110%)
    - Rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than 10%

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Section 467 lease concepts

Deferred or prepaid rent

- Deferred rent
  - Cumulative rent allocated to all periods as of the close of any calendar year exceeds the cumulative rent payable as of the close of the succeeding calendar year
- Prepaid rent
  - Cumulative rent payable as of the close of any calendar year exceeds the cumulative rent allocated to all periods as of the close of the succeeding calendar year

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Section 467 lease concepts

Deferred Rent

Year	Allocated rent	Rent payments	(A) Cumulative rent allocated	(B) Cumulative rent payable	Deferred rent if A > B thru next year	Prepaid rent if B > A thru next year
1	100	0	100	0	YES	NO
2	100	0	200	0	YES	NO
3	100	0	300	0	YES	NO
4	100	250	400	250	NO	NO
5	100	250	500	250	NO	NO

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Section 467 lease concepts

Prepaid Rent

Year	Allocated rent	Rent payments	(A) Cumulative rent allocated	(B) Cumulative rent payable	Deferred rent if A > B thru next year	Prepaid rent if B > A thru next year
1	100	300	100	300	NO	YES
2	100	50	200	350	NO	YES
3	100	50	300	400	NO	NO
4	100	50	400	450	NO	NO
5	100	50	500	500	NO	NO

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Polling question #1

How familiar are you with partnership flip and lease structures?

- Very familiar
- Somewhat familiar
- I have heard of them
- Not at all familiar with them
- Don’t know/Not applicable

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Polling question #2

Which of these tax credits is NOT a significant factor in flip structures?

- Investment Tax Credit
- Production Tax Credit
- Earned Income Tax Credit
- None of the above
- Don’t know/Not applicable

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Polling question #3

Which of the following are NOT reflected in capital accounts:

- Contributions
- Distributions
- Unrealized appreciation
- Items of income, gain, loss, or deduction
- Don’t know/Not applicable

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Polling question #4

To meet the safe harbor in Revenue Procedure 2007-65, the **developer** must be allocated at least how much of each material item of partnership income, gain, loss, deduction, and credit?

- 5 percent
- 1 percent
- 0.1 percent
- None
- Don’t know/Not applicable

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Polling question #5

Which of the following is true of allocations of nonrecourse deductions?

- They exempt from the need to be allocated
- They always have substantial economic effect
- They can be deemed to have economic effect under a safe harbor if certain requirements are met, including the use of a minimum gain chargeback
- Don’t know/Not applicable

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Polling question #6

Which of the following is an advantage of an inverted lease structure?

- Lower tax structure risk
- Tax equity is insulated from technology and operations risk
- Can be more efficient use of depreciation benefits
- Don’t know/Not applicable

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