Partnership flip structures:

A technical overview & modeling concepts

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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)
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
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)

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<th>Developer - 1%</th>
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<td>Year 1 Depreciation</td>
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Example – Remedial Method

Depreciation

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

• Book: $1,200 FMV ($233 recovered in year 1, $387 in year 2)  *Note the change in book!*

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Section 704(d) Loss Limitation

Losses allocated to a partner are only allowed to the extent of the partner’s “outside” tax basis

• Excess losses are suspended and carried forward until the partner has sufficient tax basis
• Impacts when tax losses are monetized for after-tax IRR purposes

Modeling task is correctly computing the 704(d) limitation and carrying forward the running balance of suspended losses
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?
Interest Expense Limitation

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 taxpayer’s “adjusted taxable income”

• Adjusted taxable income is, basically, business EBIDTA before 2022 and business EBIT thereafter
  – Under the proposed regulations, depreciation deducted as COGS is not added back to taxable income to determine adjusted taxable income

• Applied at the partnership level

• Expecting final regulations

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 both their capital accounts as well as their “outside” basis in the partnership

• Models must reflect the potentially complex rules that will control the application of the business interest expense limitation
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 Background
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
    ◦ Section 38(c)(1) limit upon the use of specified credits
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
## Partnership flip

<table>
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<th>Participant</th>
<th>Role</th>
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| **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 |

## Partnership flip

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<td><strong>2. Developer / sponsor</strong></td>
<td>• ROI earned through cash flows, minimum 1% allocation of tax benefits and long-term ownership</td>
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<td>• FMV purchase option on Tax Investor’s residual interest</td>
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Partnership flip

**Cash distributions**
- Period 1: 100%
- Period 2: 0%
- Period 3: 95%

**Gross income (loss)**
- Period 1: 1%
- Period 2: 1%
- Period 3: 95%

**Project entity**

- Rev. Proc. 2007-65
- Example 1

**Developer**

**Tax equity investor**

**Cash distributions**
- Period 1: 0%
- Period 2: 100%
- Period 3: 5%

**Gross income (loss)**
- Period 1: 99%
- Period 2: 99%
- Period 3: 5%
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
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
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
Is the tax investor a valid partner?

• Must assure that the partnership owns the assets and the partners own their interests


• 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?
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
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
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.”
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
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”
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
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)
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

• 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.

• 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

• 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%)

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

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

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
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

• 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
    ◦ 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
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

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
Partnership Flip Examples
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.