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Sunny and Windy—Tax Credits and Renewable Project Finance

James B. Mann and Mark Howe*

The recent unexpected extension of renewable energy tax credits by Congress is expected to spark greater numbers of project finance transactions for these assets. While there is some guidance from the Internal Revenue Service and the Treasury Department regarding these transactions, questions remain. This article details the changes made to taxes related to energy project investments and then analyzes how investors can best take advantage of the available tax benefits using various different financing structures.

Introduction

Renewable energy assets have been the object of targeted federal tax benefits for some time.¹ There has never been a settled statutory tax regime of these benefits, however, and the benefits have varied significantly among the different types of renewable energy assets as well as over time. Needless to say, this lack of continuity has posed challenges for renewable energy developers. An additional obstacle is that the developers and operators of renewable energy assets are rarely in a position to take full advantage of the tax benefits of renewable energy assets.

Since renewable energy assets generate cash flow from the sale of energy, financing their purchase has typically been regarded as a specialized, tax-sensitive form of project finance. The major source of tax complexity in this type of project finance transaction is allocating the tax benefits of these projects to taxpayers that can use them and are willing to pay for them.

Recent Legislative Changes

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”) was enacted as part of a year-end revenue and appropriations

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¹ The 1978 Energy Tax Act, P.L. 95-618, 92 Stat. 3174, contained credits for both individuals and businesses for renewable energy assets.

package.² The PATH Act made a number of changes to renewable energy credits. However, the appropriations bill that became part of the package, the Consolidated Appropriations Act, 2016 (the “Appropriations Act”), also made important changes to the taxation of renewable energy assets.³

There are three basic tax advantages to owning renewable energy assets—the investment tax credit (ITC), the production tax credit (PTC), and depreciation. The two new laws made significant, and favorable, changes to all three in ways that benefit renewable energy project finance.

Although a number of different classes of renewable energy assets can take advantage of these benefits, by far the greatest investments have been made in projects that generate electricity from wind and solar assets.

Solar. As an initial matter, it is helpful to understand where the solar credit fits into the statutory scheme. Section 38 of the Internal Revenue Code provides the list of general business credits. The investment tax credit for ownership of solar assets is based on Section 38(b)(1), which provides as an allowable credit “the investment credit determined under [S]ection 46.”⁴ Section 46, which determines the allowable amount of the various investment credits, includes the amount of “the energy credit.”⁵

Section 48 specifies the energy credits. The general rule is “[f]or purposes of [S]ection 46 . . . the energy credit for any taxable year is the energy percentage of the basis of each energy property placed in service during the taxable year.”⁶ There are different kinds of energy properties, including geothermal equipment, fuel cells, microturbines, and combined heat and power systems.⁷ Solar energy property is defined as “equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purpose of heating a swimming pool.”⁸ The credit for solar energy property was set as 30 percent of the basis of the energy property, and limited to “periods ending before January 1, 2017,” meaning that the solar energy property had to be placed in service on or before December 31, 2016.⁹

² Division Q of P.L. 114-113. For discussion of other elements of the PATH Act, see John R. Lehrer II & Paul M. Schmidt, “PATH Act: Implications for FIRPTA, REIT Spin-offs, and Bonus Depreciation,” in this issue (p. 3).

³ P.L. 114-113.

⁴ IRC § 38(b)(1). Unless otherwise specified, all “Section” references are to the Internal Revenue Code of 1986, as amended (the “IRC”), or to Treasury regulations promulgated thereunder.

⁵ IRC § 46(2).

⁶ IRC § 48(a)(1).

⁷ IRC § 48(a)(3).

⁸ IRC § 48(a)(3)(A)(i). See Rev. Rul. 82-207, 1982-2 CB 29.

⁹ IRC § 48(a)(2)(A)(i)(II).

The Appropriations Act struck “periods ending before January 1, 2017,” in Section 48(a)(2)(A)(i)(II) and inserted “property the construction of which begins before January 1, 2022.”¹⁰ In other words, the solar credit is extended for five years.

However, the Appropriations Act added new Section 48(a)(6) (“Phase-out for solar energy property”).¹¹ For property the construction of which begins before January 1, 2020, the credit remains at 30 percent, so there is an extension of the full credit by three years.

The phaseout starts with solar energy property the construction of which begins during calendar year 2020, and for this property the credit is limited to 26 percent of the property’s basis. For energy property the construction of which begins in calendar year 2021, the credit is 22 percent. However, to qualify for even these reduced rates, the solar asset must be placed in service by December 31, 2023.

For solar assets the construction of which begins before January 1, 2022, and that are placed in service after December 31, 2023, the credit is 10 percent. The credit remains at 10 percent for solar assets the construction of which begins after December 31, 2021. The “permanent” solar tax credit was 10 percent before the Appropriations Act and the amount of this credit was not changed by the Appropriations Act; its onset was simply delayed.¹²

Wind. Owners of wind facilities that produce electricity can qualify for either an investment credit or a production tax credit.

Investment Tax Credit. Under Section 48, wind property is eligible for a 30 percent tax credit if a taxpayer makes an election pursuant to Section 48(a)(5)(C)(iii)(II). The ITC election precludes taking a production tax credit, and can be made only with respect to property that qualifies as a wind facility under Section 45(d)(1).¹³ This credit had been limited to wind facilities the construction of which began before January 1, 2015.¹⁴

However, the PATH Act extended the 30 percent wind investment tax credit for two years to property the construction of which begins before January 1, 2017.¹⁵ After that, there is a phaseout of the credit under new

¹⁰ Appropriations Act § 303(a).

¹¹ Appropriations Act § 303(b).

¹² IRC § 48(a)(2)(A)(ii).

¹³ IRC § 48(A)(5)(C)(i).

¹⁴ IRC § 48(a)(5)(C)(ii) before the passage of the PATH Act and the Appropriations Act.

¹⁵ The PATH Act amended IRC § 48(a)(5)(C)(ii) by striking “January 1, 2015” and adding “January 1, 2017.” PATH Act § 187(b).

Section 48(a)(5)(E).¹⁶ For assets the construction of which begins in calendar year 2017, the credit is reduced to 24 percent. For assets the construction of which begins in calendar year 2018, the credit is reduced to 18 percent. For assets the construction of which begins during calendar year 2019, the credit is reduced to 12 percent.

In contrast to solar, there is no “permanent” wind tax credit. Wind facilities that begin construction after December 31, 2019, will not be eligible for an investment tax credit under Section 48. Table 1 compares the available credit for both wind and solar property over time.

Production Tax Credit. Section 38 also lists “the renewable energy production credit under Section 45(a)” as a current-year business credit.¹⁷ Section 45(a) provides a production tax credit for 10 years with respect to a “qualified facility,” and Section 45(d) defines “qualified facility” as including a facility using wind to produce electricity “the construction of which begins before January 1, 2015.”¹⁸ The credit, which is subject to adjustment for inflation, is currently \$0.023/kWh for electricity generated from wind.¹⁹

The production tax credit had applied to wind assets the construction of which had begun by January 1, 2015, but it has been extended by five years to apply to assets the construction of which begins before January 1, 2020.²⁰ The current full production tax credit may be taken with respect to assets the construction of which begins before January 1, 2017. There is a

Year construction begins	Wind ITC (% of basis)	Solar ITC (% of basis)
2015	30	30
2016	30	30
2017	24	30
2018	18	30
2019	12	30
2020	0	26
2021	0	22
2022 on	0	10

¹⁶ The phaseout of the wind credit was added by the Appropriations Act, not the PATH Act. Appropriations Act § 302.

¹⁷ IRC § 38(b)(8).

¹⁸ IRC § 45(d)(1).

¹⁹ Notice 2015-32, 2015-20 IRB 967.

²⁰ IRC § 45(d)(1), as amended by the Appropriations Act § 301(a)(1).

phaseout after that under new Section 45(b)(5). For assets the construction of which begins during calendar year 2017, there is a reduction in the credit of 20 percent. For assets the construction of which begins during calendar year 2018, the reduction in the credit is 40 percent. For assets the construction of which begins during calendar year 2019, the reduction in the credit is 60 percent. There is no production tax credit for wind assets the construction of which begins on or after January 1, 2020. These reductions in the production tax credit mirror the reductions of the wind investment tax credit, as shown in Table 2.

Other Asset Classes. There were changes to other types of renewable energy provisions relating to credits and deductions, including nonbusiness energy-efficiency improvements, biodiesel fuel, biofuel plants, and energy-efficient commercial building improvements.²¹ The 30 percent credit for individuals for residential solar facility expenditures was extended for five years to “qualified solar electric property expenditures and qualified solar water heater property expenditures” for property placed in service before January 1, 2022.²² The full 30 percent credit is allowable for property placed in service before January 1, 2020, but the credit is reduced to 26 percent for property placed in service during calendar year 2020 and 22 percent for property placed in service during calendar year 2021.²³ There will be no residential solar credit after that time.

The Section 48 ITC for fuel cells, combined heat and power projects, small wind farms, and microturbines was not extended, so these projects must be placed in service by December 31, 2016, in order to qualify for the 30 percent credit.

Year construction begins	Wind PTC (% of credit)
2015	100
2016	100
2017	80
2018	60
2019	40
2020 on	0

²¹ These changes are found in PATH Act §§ 181–193.

²² IRC § 25D(g), as amended by the Appropriations Act § 304.

²³ IRC § 25D(g).

Start of Construction Standard. At one time, the expiration dates for all wind and solar tax credits were determined under a “placed in service” standard (that is, the date on which the facility became available for generating electricity). However, the American Taxpayer Relief Act of 2012 revised the wind production tax credit under Section 45(d) and the wind investment tax credit under Section 48(a)(5) by changing the deadlines for both to a “commencing of construction” standard.²⁴

Several IRS Notices have given guidance as to when construction begins, starting with two tests that the taxpayer could meet, by either (1) starting physical work of a significant nature or (2) meeting a safe harbor test that required paying or incurring more than 5 percent of the total cost of the facility.²⁵ Both methods require that a taxpayer make continuous progress toward completion once construction has begun. The most recent guidance, Notice 2015-25, relates to the requirement in Section 45(d)(1) (before amendment by the Appropriations Act) and Section 48(a)(5) (before amendment by the PATH Act) that construction of a qualified facility must have begun before January 1, 2015.

Notice 2013-60 established a safe harbor for the safe harbor, providing that with respect to the requirement that construction commence before January 1, 2014, the continuous progress safe harbors (as applied to both the physical construction safe harbor and the costs incurred safe harbor) will be deemed to have been satisfied if the facility is placed in service before January 1, 2016.²⁶ More recently, Notice 2015-25, as a result of the extensions of the credits in TIPA, extended the “deemed satisfaction” deadline to facilities placed in service before January 1, 2017.²⁷ Further guidance along the same lines is expected in the wake of the PATH Act and the Appropriations Act.

The “placed in service” standard is fairly clearly defined in Treasury Regulations and has also been the subject of Tax Court litigation.²⁸ Given the

²⁴ IRC § 45(d)(1) was amended by the American Taxpayer Relief Act to define “qualified facility” to mean “any facility owned by the taxpayer which is originally placed in service after December 31, 1993, and the construction of which begins before January 1, 2014.” American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (ATRA). The deadline for wind facilities for the investment tax credit under IRC § 48(a)(5) was also changed to include construction beginning before January 1, 2014. The deadline for construction beginning was extended to January 1, 2015, by the Tax Increase Prevention Act of 2014, P.L. 113-295, 128 Stat. 4010 (TIPA). Most recently, the Appropriations Act extended the IRC § 45(d) deadline to “the construction of which begins before January 1, 2020.” Appropriations Act § 301(a)(1). The PATH Act changed the IRC § 48(a)(5) January 1, 2015, deadline to January 1, 2017. PATH Act § 187(b).

²⁵ Notice 2013-29, 2013-2 CB 1085; Notice 2013-60, 2013-2 CB 431; Notice 2014-46, 2014-2 CB 520; and Notice 2015-25, 2015-13 IRB 814.

²⁶ Notice 2013-60, *supra* note 25.

²⁷ Notice 2015-25, *supra* note 25.

²⁸ Treas. Reg. §§ 1.167-11(e)(1)(i), 1.46-3. See, e.g., *Piggly Wiggly Southern v. Comm’r*, 84 TC 739 (1985), *aff’d*, 803 F2d 1572 (11th Cir. 1986); *Brown v. Comm’r*, TC Memo. 2013-275.

importance of the “construction of which begins” standard in both the wind and solar investment and production tax credits, and the fact that the credit reduction deadlines will be relevant through 2022, it would be better if at some point the Treasury Department would issue proposed regulations, subject to notice and comment as required by the Administrative Procedure Act, rather than relying on a stream of administrative pronouncements.²⁹ Changing a regulation is a difficult and cumbersome process. In contrast, a new notice can be issued to amend an earlier notice quickly and without warning. It is not difficult to imagine a Treasury Department in a subsequent presidential administration, one that regarded renewable energy credits as wasteful and inefficient, might accordingly issue less sympathetic notices.

Bonus Depreciation. The PATH Act extended bonus depreciation of certain asset classes to qualified property placed in service by the taxpayer before January 1, 2020.³⁰ The bonus depreciation amount is 50 percent of the adjusted basis of qualified property placed in service before January 1, 2018, 40 percent for property placed in service during calendar year 2018, and 30 percent for property placed in service during calendar year 2019.³¹

Most wind and solar facilities are classified as five-year class life property, thus qualifying for bonus depreciation, although there are longer lives for some land improvements and electricity transmission assets.³²

Depreciable basis is reduced by 50 percent of energy credits taken.³³

New Markets Tax Credit. The New Markets Tax Credit is sometimes combined with the energy credits described above in renewable energy projects. The New Markets Tax Credit is available to investors in a “qualified community development entity” (CDE), which is a domestic corporation or partnership the “primary mission [of which] is serving, or providing investment capital for, low-income communities or low-income persons.”³⁴ There are

²⁹ For an interesting discussion of IRS notices and the Administrative Procedure Act, see Kristin Hickman, “IRB Guidance: The No Man’s Land of Tax Code Interpretation,” 2009 Mich. St. L. Rev. 239, 249. The Treasury Guidance “Payments for Specified Property in Lieu of Tax Credits under the ARRA of 2009” (rev. April 2011) was accorded limited deference in *W.E. Partners II, LLC v. U.S.*, 2015-1 USTC (CCH) ¶ 50,144 (Ct. Fed. Cl. 2015).

³⁰ PATH Act § 143(a) extended bonus depreciation retroactively to property placed in service during calendar year 2015, and § 143(b) extended bonus depreciation to property placed in service during calendar years 2016 through 2019.

³¹ PATH Act § 143(b)(5) added a new IRC § 168(k)(6) with a “phase down” schedule. The Appropriations Act uses the term “phaseout.”

³² IRC § 168(e)(3)(B).

³³ IRC § 50(c)(3).

³⁴ IRC § 45D(c)(1).

numerous other requirements including Treasury certification of the qualified CDE. The credit is taken over seven years and is 5 percent of the amount of the taxpayer's investment for the first three years and 6 percent of the investment for the last four years.³⁵ The PATH Act extends the credit at its current level (there is an annual dollar limitation on the available credit of \$3.5 billion) for calendar years 2015 through 2019.³⁶

Project Finance Structures

One of the challenges in financing renewable energy assets is shifting their tax benefits (credits and depreciation) to taxpayers that can use them. Developers of solar assets cannot use the tax benefits in many cases. Tax-exempt entities that are desirable purchasers of renewable energy also cannot use the tax advantages. In addition, there are many other non-taxpaying potential investors. As a result, a number of different structures, discussed below, are used to allocate the tax attributes of renewable energy assets. Investors that receive part of their return on investment in the form of tax benefits are known as "tax equity investors."

Adding to the challenge is the fact that, because of the credit recapture rules, ownership of the renewable energy asset is frozen for at least five years. Under Section 50, an owner is required to recapture all or part of the investment tax credit if it transfers its interest in the partnership or if its interest in the partnership is reduced by more than two-thirds.³⁷

Flip Partnerships. Partnerships (or limited liability companies (LLCs)) are frequently used to give tax ownership of renewable energy assets to investors able to use the tax advantages of the assets. In a flip partnership, the developer creates a partnership to hold the asset, and the tax equity investor contributes capital to the partnership (or purchases a partnership interest). Initially, the tax equity investor receives 99 percent of the taxable income and loss of the partnership, and then at some later point the tax equity investor's share of taxable income and loss "flips" down to 5 percent. At the time of the flip, the developer has an option to purchase the tax equity investor's 5 percent interest.

The flip point may occur after a set period of time (always after the tax credit vesting period), or it may come after a predetermined yield to the tax equity investor has been attained. The developer's call option is typically for fair market value at the time of the exercise of the option. Allocations of

³⁵ IRC § 45D(a).

³⁶ PATH Act § 141, amending IRC § 45D(f)(1)(G).

³⁷ IRC § 50(a); Treas. Reg. § 1.47-6.

distributable cash may also vary over time, and any given partnership may have several inflection points when allocations change.

Tax Ownership. The overriding tax issue in flip partnerships is whether the allocation of tax benefits will be respected. Two different (but related) analyses come into play in this context:

1. Determining whether the tax equity investor is actually a partner in the partnership instead of being a creditor to the partnership; and
2. With respect to the partnership tax rules, focusing on whether the transaction complies with the “substantial economic effect” test in Section 704(b) (the tax equity investor could be a partner in the flip partnership but not entitled to the allocations being claimed).

Revenue Procedure 2007-65 Guidance. The initial IRS guidance centered on the second analysis under Section 704(b). The IRS issued guidelines for structuring flip partnerships that hold wind assets in Revenue Procedure 2007-65.³⁸ Since the wind production tax credit requires that the investors must own and operate the asset (as opposed to a lease situation, where the lessee, not the owner, operates the asset), projects claiming the wind production tax credit must use a partnership structure.³⁹ The “safe harbor” described in the guidelines is to “provide guidance to taxpayers establishing or participating in wind energy partnerships in lieu of taxpayers requesting a letter ruling,” but taxpayers are cautioned that the safe harbor requirements “are not intended to provide substantive rules and are not to be used as audit guidelines.”⁴⁰ The tax issue concerned in the safe harbor is whether “the Service will respect the allocation of Section 45 wind energy production tax credits by partnerships in accordance with Section 704(b).”⁴¹

The safe harbor requires that (1) the developer at all times have a minimum 1 percent interest in the partnership and (2) investors at all times have a minimum 5 percent interest in the partnership. For the investor, there is a minimum investment that must be made on or before the later of the date the wind farm is placed in service or the date the investor acquires its interest

³⁸ Rev. Proc. 2007-65, 2007-2 CB 967, revised by Ann. 2007-112, 2007-2 CB 1175, and Ann. 2009-69, 2009-2 CB 475.

³⁹ IRC § 45(d)(1).

⁴⁰ Rev. Proc. 2007-65, *supra* note 38. Announcement 2009-69 withdrew the warning that “the Service will closely scrutinize a Project Company as a partnership or Investors as partners if a Project Company’s partnership agreement does not satisfy each requirement of this revenue procedure.”

⁴¹ Rev. Proc. 2007-65, *supra* note 38.

in the project company of at least 20 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions required to be made by the investor under the partnership agreement. At least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated capital contributions to be made by an investor must be fixed and determinable obligations that are not contingent in amount or certainty of payment. The investor may not have a contractual right to cause any party to purchase its partnership interest. There are also prohibitions on different types of risk shifting. Announcement 2009-69 liberalized the requirements for entering into rights to purchase the asset at a price set in advance.⁴²

Revenue Procedure 2007-65 is useful in providing guidelines for renewable energy financing structures in general. However, it should be noted that the IRS has stated in an Office of Chief Counsel Memorandum that Revenue Procedure 2007-65 does not apply to solar tax credits or other investment tax credits, drawing distinctions regarding the variability of a production tax credit and the fact that an investor “recovers its initial investment much more quickly than an investor receiving a production tax credit.”⁴³

Impact of Historic Boardwalk Hall Decision. However, the Section 704(b) analysis has been overtaken in importance by the threshold issue of whether the tax equity investor was actually a partner in the partnership as a result of a government appellate court victory. In *Historic Boardwalk Hall, LLC v. Commissioner*,⁴⁴ the Third Circuit reversed the Tax Court and concluded that the tax equity investor was a creditor, not a partner in a partnership, and thus was not eligible to take a tax credit.

In *Historic Boardwalk Hall*, a partnership was formed to restore a building and the project qualified for the historic rehabilitation tax credit, an investment credit of “20 [percent] of qualified rehabilitation expenditures with respect to any certified historic structure.”⁴⁵ The investor received a 3 percent “preferred return” on its investment, which had been effectively funded in advance, and the principal elements of risk to the investor had been minimized through the LLC operating agreement and other contractual arrangements.⁴⁶ In addition to “avoidance of all meaningful downside risk,” the transaction resulted in “a dearth of any meaningful upside potential.”⁴⁷

⁴² Supra note 38.

⁴³ ILM 201524024 (Nov. 24, 2014).

⁴⁴ 694 F3d 425 (3d Cir. 2012), *rev'g* 136 TC 1 (2011), *cert. denied*, 133 S. Ct. 2734 (2013).

⁴⁵ IRC § 47(a)(2).

⁴⁶ The arrangements resulted in the “effective elimination of Investment Risk, Audit Risk, and Project Risk.” *Historic Boardwalk Hall*, supra note 44, at 458.

⁴⁷ *Id.* at 459.

While the circuit court concluded that the transaction had economic substance (the IRS had sought to have the arrangement recharacterized as a sham transaction), the opinion chose to look at substance over form to decide that the investor was not an equity participant in the transaction and thus was not entitled to the tax credit. In considering whether a partnership existed or whether the investor had made a loan, the court was guided by the Supreme Court's holding in *Culbertson v. Commissioner*⁴⁸ that

[t]he question is . . . whether, considering all of the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.⁴⁹

The *Historic Boardwalk Hall* court examined how the *Culbertson* test had been applied in other cases examining whether a partner's interest was a true equity participation, accepting the government's contention that the two guidepost cases are *Castle Harbour*⁵⁰ and *Virginia Historic Tax Credit Fund*.⁵¹ In *Castle Harbour* the Second Circuit examined a transaction to make a determination under Section 704(e)(1): "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."⁵² *Castle Harbour* concerned a complex partnership transaction that attempted to shift taxable income away from domestic taxpayers to tax-exempt foreign banks. Using the *Culbertson* approach of examining all the facts and circumstances, the court held that the two foreign banks involved in the transaction were not partners because the banks' interest was "overwhelmingly in the nature of a secured lender's interest."⁵³ The court concluded that "the banks' interest was not a capital interest within the meaning of Section 704(e)(1)

⁴⁸ 337 U.S. 733 (1949).

⁴⁹ *Historic Boardwalk Hall*, supra note 44, at 449, quoting *Culbertson*, 337 U.S. at 742.

⁵⁰ TIFD III-E, Inc. v. U.S., 666 F.3d 836, rev'g TIFD III-E, Inc. v. U.S., 660 F.Supp. 2d 367 (D. Conn. 2009), on remand from TIFD III-E v. U.S., 459 F.3d 220 (2d Cir. 2006), rev'g TIFD III-E, Inc. v. U.S., 342 F.Supp. 94 (D. Conn. 2004). This case is usually referred to as *Castle Harbour* because that was the name of the primary LLC involved in the transaction.

⁵¹ *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129 (4th Cir. 2011).

⁵² IRC § 704(e)(1); Treas. Reg. § 1.704-1(e)(1)(v).

⁵³ *Castle Harbour*, supra note 50, at 837.

for essentially the same reasons as supported our earlier conclusion that the banks' interest was not bona fide equity participation."⁵⁴ Even though the *Castle Harbour* court held that there was no different result between the *Culbertson* totality of the circumstances test and the requirements of Section 704(e)(1), it allowed for the theoretical possibility of a different outcome between the two tests.⁵⁵

Drawing on the reasoning in *Castle Harbour*, the *Historic Boardwalk Hall* court focused on whether the investment was more like debt or equity, and thus whether the investor was a partner or not: "The *Castle Harbour* court observed that consider[ing] whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation."⁵⁶ This is the link between the determination of whether an investor is a partner and debt-equity analysis: if the investor's interest is more like debt than equity, the investor is not entitled to the tax credit.⁵⁷

Revenue Procedure 2014-12 provides a safe harbor under which the IRS will not challenge partnership allocations of Section 47 (historic rehabilitation) tax credits in the wake of *Historic Boardwalk Hall*.⁵⁸ Its scope is limited to Section 47 credits and to the issue of "allocations of validly claimed Section 47 credits." The ambit of Revenue Procedure 2014-12 is further limited by statements that

[t]he Treasury Department and the Service do not view the Safe Harbor as determinative of whether an Investor is a partner or acting in its capacity as a partner in an arrangement or transaction that is outside the scope of this revenue procedure. The Treasury Department and the Service do not intend the inclusion of any particular criterion in the Safe Harbor to be an indication either of our views of the significance of that criterion with respect to any other federal or state tax credit transactions, or of whether a Partnership has the requisite benefits and burdens of ownership of a Building.⁵⁹

⁵⁴ Id. at 838.

⁵⁵ Id. at 847 n.8.

⁵⁶ *Historic Boardwalk Hall*, supra note 44, at 450 (internal quotation marks omitted). The *Historic Boardwalk Hall* opinion refers to the first Second Circuit opinion in *Castle Harbour* in 2006, as the second appellate decision had not yet appeared.

⁵⁷ Neither *Castle Harbour* nor *Historic Boardwalk Hall* was decided on "sham transaction" grounds, although the IRS asserted the argument in both cases. Neither of those transactions was a sham. There were real investments made; it is just that they were loans rather than equity investments in a partnership.

⁵⁸ 2014-1 CB 415.

⁵⁹ Id. at 416.

While Revenue Procedure 2014-12 is similar to Revenue Procedure 2007-65 in both structure and substantive requirements, there are several significant differences, including differences regarding minimum investment (now labeled “minimum unconditional contribution”) and purchase and sale rights.⁶⁰ There are also some indications, albeit not very clear ones, of additional requirements to meet the safe harbor:

The Investor’s partnership interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the Investor’s overall percentage interest in the Partnership, separate from any federal, state and local tax deductions, allowances, credits, and other tax attributes to be allocated by the Partnership to the Investor.”⁶¹

Since the investor in a typical historic tax credit rehabilitation would not invest but for the tax advantages (which is obviously the point of creating the tax credit), it is difficult to understand how the value of the Investor’s partnership interest absent the tax advantages is relevant to a determination of the allocation of a Section 47 tax credit.

Practice Point: The differences between Revenue Procedure 2014-12 and Revenue Procedure 2007-65 are due, in large part, to the government’s victory in *Historic Boardwalk Hall*. There is a shift in emphasis away from Section 704(b) analysis to the true equity partner analysis. The argument that the taxpayer is not a bona fide partner and thus is not entitled to the partnership’s allocation of the credit will be asserted more frequently. It is important to note that this argument, from the IRS point of view, has the advantage of being much simpler than trying to prove that there is no economic substance to a transaction.

Of course, Revenue Procedure 2014-12, *Castle Harbour*, and the *Historic Boardwalk Hall* decision all have one thing in common—they are not concerned with financing renewable energy projects. In the absence of directly relevant authorities, however, they are important foundations for reasoning by analogy in the tax analysis of renewable energy transactions.

Other Tax Issues. There are several other tax issues that arise in connection with renewable energy flip partnerships that warrant mention. One obvious issue is the classification of various components of the tax basis of a renewable energy asset. There is an incentive to increase the basis as much as possible in order to maximize the investment credit and depreciable basis. Sometimes, expenses may be capitalized, and thus put into basis, that are better treated as currently deductible expenses.

⁶⁰ One significant change is that the investor must contribute at least 20 percent of its equity before the project is complete. *Id.*

⁶¹ *Id.*

Questions may also be raised regarding the development fee and other fees that become part of the tax basis of the renewable energy asset, particularly with regard to fees paid between affiliated parties. Such fees may be payable only over time and as profits allow, and at some point the fees may be challenged as inappropriate.

Issues may also arise in connection with the ability of the tax equity investor to take full advantage of the tax benefits due to the front-loaded nature of the credits and depreciation.⁶²

Sale-Leasebacks. In a sale-leaseback transaction, the tax equity investor purchases the asset for fair market value from the developer and immediately leases it back to the developer or an affiliate under a long-term lease that is treated as a “true lease” for tax purposes.⁶³ The tax equity investor is the owner for all tax purposes of the project and benefits from applicable credits and depreciation. The tax equity investor, as a result of receiving the tax benefits, reduces the developer’s lease payments.

The asset is typically financed with an equity investment by the tax equity investor of 15-20 percent of the fair market value of the asset (which may be partially funded by lease prepayments from the lessee), with the balance generally funded by non-recourse debt from third-party lenders.⁶⁴ The lessee either operates the asset or subleases it to an operator. Lease payments are usually funded through payments under a power purchase agreement with the off-taker of the power produced by the asset. The lessee/developer usually has an option to purchase the asset at the end of the lease term for fair market value, or during or at the end of the lease for a fixed price which is anticipated to be above the then fair market value of the asset.

Many of the significant tax issues of sale-leasebacks have been resolved, since the structure is similar to arrangements for financing numerous other long-lived asset classes (e.g., rail cars). In Revenue Procedure 2001-28, the Internal Revenue Service provided guidelines for advance ruling purposes on the issue of whether a transaction is a lease (as opposed to a sale) for federal

⁶² Treas. Reg. § 1.704-1(b)(2)(ii)(b) generally requires that if a partner has a deficit balance in its capital account after the liquidation of its interest in the partnership, as determined after making capital account adjustments in the year of liquidation, the partner is obligated to restore the amount of the deficit balance to the partnership. This deficit restoration obligation (DRO) is agreed to by some tax equity investors in order to be able to use partnership losses currently.

⁶³ The sale-leaseback structure cannot be used in connection with the wind production tax credit, since that credit may be taken only with respect to electricity produced by the taxpayer. IRC § 45(d)(1).

⁶⁴ The lease pre-payment can be treated as a loan under IRC § 467.

income tax purposes.⁶⁵ For example, the Revenue Procedure requires that the lessor must maintain a minimum investment that is unconditionally at risk of at least 20 percent of the cost of the asset at the beginning of the transaction, and maintain that investment throughout the term of the lease. In addition, the lessor must demonstrate that an amount equal to at least 20 percent of the original cost of the asset is a reasonable estimate of what the fair market value of the asset will be at the end of the lease term and that the term of the lease is for not more than 80 percent of the useful economic life of the asset.

However, since Revenue Procedure 2001-28 only gives requirements for obtaining an advance ruling on the tax issue of whether a transaction is a true lease or sale, taxpayers are free to structure sale-leasebacks that do not meet these criteria but still should be treated as true leases for the purpose of federal tax law.⁶⁶

Inverted Lease. In an inverted lease, the roles of the developer and the tax equity investor are inverted relative to a sale-leaseback transaction: the developer acts as the lessor and the tax equity investor is the lessee. This structure is also known as a “lease pass-through” because the developer/lessor elects to pass through the tax credit to the tax equity investor/lessee.⁶⁷ The tax equity investor typically agrees to make a large upfront rental payment to the developer and then pays periodic rental payments under the lease as the project generates free cash flow (which is revenue to the lessee). The developer/lessor assumes ownership of the asset at the end of the lease without any cost.

While the tax credit is passed through with the election, the depreciation deductions remain with the lessor, who is considered the owner for all other tax purposes. The election to pass through the credit is found in Treasury Regulation Section 1.48-4 (“election to treat lessee as purchaser”), and the amount of “qualified investment” that is eligible for the credit is “[t]he fair market value of such property on the date possession is transferred to the lessee.”⁶⁸ The lessee taking the credit must take into income 50 percent of the

⁶⁵ Rev. Proc. 2001-28, 2001-1 CB 1156. Rev. Proc. 2001-29, 2001-1 CB 1160, provides the information and representations that must be provided in order to receive an advance ruling on leveraged lease transactions.

⁶⁶ There are many cases considering the “true lease” versus sale issue. See, e.g., *Torres v. Comm’r*, 88 TC 702 (1987); *Grodt & McKay Realty, Inc. v. Comm’r*, 77 TC 1221 (1981).

⁶⁷ Inverted lease structures are discussed in the context of historic rehab tax credit transactions in Rev. Proc. 2014-12, *supra* note 58, §§ 3, 4.01, 5 (Ex. 2).

⁶⁸ Treas. Reg. § 1.48-4(c)(2)(i). The election to treat the lessee as a purchaser of the property for its fair market value (for purposes of transferring the credit) was originally in IRC § 48(d) as in effect immediately prior to the enactment of the Revenue Reconciliation Act of 1990, P.L. 101-508, 104 Stat. 1388, and is now codified in IRC § 50(d)(5).

amount of the credit spread over the five years of the investment tax credit vesting period.⁶⁹

Since the developer/lessor is constructing the asset and then leasing it to the lessee/tax equity investor, the tax basis of the asset (on which the tax credit and depreciation are based) is not derived from cost, but rather from an appraisal made on behalf of the developer/lessor to determine the “fair market value” referred to in the statute and regulations.

Overly aggressive appraisals may be subject to challenge by the tax authorities.⁷⁰ In the context of the temporary renewable energy Treasury grant program under Section 1603 of the American Recovery and Reinvestment Act,⁷¹ several large solar companies have been challenged by the Internal Revenue Service and the Department of Justice. (Irregularities in Treasury grant programs are subject to investigation by the Civil Division of the Department of Justice, not the Internal Revenue Service.)⁷²

YieldCos. A YieldCo is a dividend-paying growth-oriented public company, generally created by and spun off from a parent company, which owns and operates renewable and conventional long-term operating assets subject to long-term power purchase agreements, leases, or similar arrangements. The parent company typically retains voting control of the YieldCo while most of the cash available for distribution is given to the YieldCo shareholders. The first YieldCo was launched by NRG Energy Inc., in July 2013.⁷³ There have been a number of issuances of YieldCo stocks since then.⁷⁴

⁶⁹ IRC § 48(d)(5) as in effect immediately prior to the enactment of the Revenue Reconciliation Act of 1990, and now made applicable by IRC § 50(d)(5). If the lessee is a partnership and the income inclusion is treated as a partnership item, there may be an IRC § 705 outside basis increase that could negate the income inclusion because the basis increase could lead to a subsequent loss on the disposition of partnership interests. The Internal Revenue Service regards this as an unintended consequence, and a regulation project has been announced to address the issue. Highlights and Documents, May 4, 2015, 3155; Department of the Treasury 2015-2016 Priority Guidance Plan (Oct. 23, 2015), available at https://www.irs.gov/pub/irs-utl/2015-2016_pgp_1st_quarter_update.pdf.

⁷⁰ Molly Podolefsky, “Tax Evasion and Subsidy Pass-Through Under the Solar Investment Tax Credit,” Working Paper No. 13-05, University of Colorado at Boulder (Nov. 2013), available at <http://www.colorado.edu/econ/papers/Wps-13/wp13-05/wp13-05.pdf>.

⁷¹ American Recovery and Reinvestment Act, P.L. 111-5, 123 Stat. 115.

⁷² For example, a recent SolarCity SEC filing discusses the investigation of the company by the Treasury Department’s Office of the Inspector General and the U.S. Department of Justice Civil Division. SolarCity 10-Q filed October 30, 2015 (for the quarter ended Sept. 30, 2015), at 51, available at <http://investors.solarcity.com/secfiling.cfm?filingID=1564590-15-8928&CIK=1408356>.

⁷³ NRG Yield, Inc.

⁷⁴ YieldCos include TransAlta Renewables, Pattern Energy Group, Abengoa Yield plc, NextEra Energy Partners, LP, TerraForm Power, Inc., Brookfield Renewable Energy Partners L.P., 8point3 Energy Partners LP, and TerraForm Global Inc. There are under a dozen YieldCos, in other words, and plans for issuing others are currently on hold.

While YieldCos vary in their asset mix and relationships with their sponsors, they are similar from a tax perspective. Most YieldCos are organized as LLCs but elect to be taxed as corporations. A distribution of a YieldCo is thus taxable income to the shareholder to the extent the distribution is a dividend.⁷⁵ For federal tax purposes, a dividend is defined as a corporate distribution from current and accumulated earnings and profits, and depreciation reduces earnings and profits.⁷⁶ Because renewable energy assets are subject to accelerated depreciation, the distributions of YieldCos are typically in excess of earnings and profits (and thus not dividends) and so are taxed as a return of capital that reduces the adjusted basis of the shareholder's stock.⁷⁷

As a result, many YieldCo offerings suggest that “[b]ased on our current portfolio of assets that we expect will benefit from an accelerated depreciation schedule, . . . we do not anticipate paying significant United States federal income taxes for a period of approximately ten years.”⁷⁸ For example, 8point3 Energy Partners LP made a cash distribution of \$0.217 per share to its Common A shareholders on January 14, 2016, and the accompanying Form 8397 (Report of Organizational Actions Affecting Basis of Securities) states that the entire amount was a “nondividend distribution” that was “calculated as the amount of cash distributions in excess of 8point3 Energy Partners LP’s current and accumulated earnings and profits for the tax year ended December 31, 2015.”⁷⁹ Obviously, having a cash distribution that is not taxed currently as a dividend is a benefit to YieldCo shareholders, although the price will be paid when the shares ultimately are sold with a reduced basis.

The issue that arises with using depreciation as a tax shield is that it runs out—in the case of most renewable energy assets, in five years. Even if net operating losses are carried forward, in order to maintain depreciation deductions at any given level, at some point new depreciable assets must be acquired. This is one of the challenges faced by YieldCos and may be one of the reasons that stock prices of YieldCos have declined recently.

In terms of financing their projects, YieldCos have a choice of using the three basic structures discussed above:

- *Conventional Sale-Leasebacks*: In general, conventional sale-leasebacks are disfavored by YieldCos. In a sale-leaseback, the tax equity

⁷⁵ IRC § 301(c).

⁷⁶ IRC §§ 316(a) (earnings and profits), 312(k) (depreciation).

⁷⁷ IRC § 301(c)(2).

⁷⁸ TerraForm Power Inc., Amendment No. 4 to Form S-1 Registration Statement (July 8, 2014), available at <https://www.sec.gov/Archives/edgar/data/1599947/000119312514262438/d672387ds1a.htm>.

⁷⁹ 8point3energypartners.com, Investor FAQs (Where can I find a copy of Tax Form 8397?), available at <file:///C:/Users/emj/Downloads/2015%208.3%20Form%20837%20Q4%202015%20Distribution.pdf>.

owner is the lessor, the YieldCo is the lessee, and much of the cash generated by the renewable energy asset is paid to the lessor. This structure is inconsistent with the YieldCo's need to make continuing cash distributions to its shareholders.

- *Flip Partnerships:* Flip partnerships are more amenable to use by YieldCos. In this case, the YieldCo begins with owning 1 percent of the partnership while the outside tax equity investor owns 99 percent. Ultimately, the partnership allocations shift in favor of the YieldCo. In order to accommodate the YieldCo's need for cash, the allocations of cash may need to be changed to allow a larger share of the cash from the projects to be paid to the YieldCo rather than the tax equity investor. Obviously, these allocations would need to pass muster under the same standards as any other partnership allocations.
- *Inverted Leases:* Inverted leases are commonly used by YieldCos. The tax equity investor is the lessee and makes lease payments to the lessor (i.e., the YieldCo) that provide stable cash flows. The lessee, making an upfront payment, takes the tax credit while the YieldCo retains the depreciation from the asset. If desired, the tax equity investor can be a partner in the lessor entity and benefit from some portion of the depreciation.

Securitizations. "Securitization" is the process of pooling revenue-generating assets for issuance and sale into the capital markets as rated securities. The American securitization market includes both mortgage-backed securities (MBS) and asset-backed securities (ABS). Renewable energy assets produce predictable cash flows and thus can be used in ABS transactions. In a typical securitization, the originator of the assets sells or contributes the assets to a depositor entity, which then sells or contributes the assets to another single-purpose bankruptcy-remote entity (the "issuer"), ordinarily a Delaware trust or a Delaware LLC. The issuer issues the asset-backed securities, usually in the form of notes, to the public. There are outside managers of the operating assets and managers of the financial aspects of the securitization (for example, collecting and distributing cash flows).

There have been a number of securitizations of solar assets (beginning in 2013). The sponsors of these securitizations to date have all been developers of solar assets. For example, SolarCity, a developer of residential solar systems, has issued five securitizations—the most recent is SolarCity FTE Series 1, LLC, a January 2016 issuance of \$185 million in A and B notes. The transaction is secured by a pool of 11,583 solar loans made by SolarCity to install residential rooftop systems in a number of states, with most of the

systems in California, Colorado, and Arizona. The loans are 30-year loans to homeowners with outstanding credit ratings, while the notes issued have an expected repayment date of March 2022. Other securitizations by SolarCity have included assignments of the solar installations, power purchase agreements, leases, permits, manufacturers' warranties, and cash flows related to ownership of the assets.⁸⁰

The first securitization from another solar developer, SunRun, pooled 7,893 residential installations and related contracts. Power purchase agreements constituted 68 percent of the contracts and leases were the remaining 32 percent.⁸¹ As with the SolarCity securitizations, the issuer is a subsidiary of SunRun.

Several of the renewable energy securitizations have also involved outside tax equity investors, using both partnership flip and inverted lease structures. There are several significant challenges to using flip partnerships in securitizations, however. One obstacle is that in the event of a successful IRS challenge to the valuation of the systems (and thus the tax credits and depreciation associated with them), the return to the tax equity investor would be lessened and the date for the partnership flip possibly extended. Such an extension would be disruptive of the cash flows necessary for the securitization.

The SunRun securitization used an inverted lease structure for tax equity funding of the assets involved. The lessee was the tax equity investor while the lessor retained legal title to the assets and was therefore able to use them in the securitization. Other securitizations have also used inverted leases.

The National Renewable Energy Laboratory (NREL) sponsors a Working Group on Solar Access to Public Capital. A recent paper describing the Working Group's Mock Securitization Project recommended the use of the inverted lease structure for solar securitizations, explaining that

[a]t the time of the securitization, the lessor will assign all of its interests in the solar assets (including its rights as lessor under the lease) to the special purpose vehicle issuer of the securitization notes, a wholly owned subsidiary of the lessor entity. Thus the assets being securitized are the lessor's interests in the solar assets and the lease payments under

⁸⁰ AES, a large utility, has also had a \$100 million securitization based on 1,548 solar residential, commercial, industrial, and small utility power plants in six states and the U.S. Virgin Islands. Kroll Bond Rating Agency, "Kroll Bond Rating Agency Assigns Preliminary Ratings to Aurora Master Funding, LLC, Series 2015-1" (Sept. 25, 2015), available at <http://www.pymnts.com/businesswire-feed/kroll-bond-rating-agency-assigns-preliminary-ratings-to-aurora-master-funding-llc-series-2015-1/>.

⁸¹ SunRun Callisto Issuer 2015-1, LLC. Kroll Bond Rating Agency, "Kroll Bond Rating Agency Assigns Preliminary Ratings to SunRun Callisto Issuer 2015-1, LLC, Series 2015-1" (June 23, 2015), available at <https://www.krollbonratings.com/announcements/pdf/1422>.

the lease obligation (which are, in turn, being funded from power purchase agreement payments).⁸²

The advantages of the structure are:

(i) avoid having the tax equity and the developer-sponsor invest in the same entity, and thus remove the control of tax equity over decisions of the lessor, which in turn owns the issuer; and (ii) avoid the risk of recapture resulting from the pledge and potential foreclosure of the solar assets, because there will be no recapture for tax equity as long as the lease remains in force. Any entity buying the pledged assets in a foreclosure sale will be obligated to take title to the lease as long as the lessee is still performing its obligations under the lease.⁸³

Conclusion

The recent extensions of significant tax credits for renewable energy assets demonstrate continued public (or at least legislative) support for building new renewable energy projects. The current Administration enthusiastically supports the development of renewable energy, and the President has secured commitments from many corporate leaders to expand the use of renewable energy.⁸⁴ Furthermore, it is easy to ascertain whether a given renewable energy project qualifies for relevant credits; the determination that a wind turbine or solar array is producing electricity is straightforward. Deciding the appropriate tax basis for calculating the credit, while an important issue, is secondary to the fact that the project exists and qualifies for some amount of credit.

In light of the significant extensions of renewable energy tax credits, it is reasonable to believe that there will be sustained growth in renewable energy transactions and that those transactions will be financed by a growing base of tax equity investors willing to master the complexities of renewable energy project finance.

⁸² National Renewable Energy Laboratory, "The Solar Access to Public Capital Mock Securitization Project," Technical Report NREL/TP-6A20-6437 (Dec. 2015), at 23, available at <http://www.nrel.gov/docs/fy16osti/64347.pdf>.

⁸³ *Id.* at 23–24.

⁸⁴ Vin Gurrieri, "WalMart, Apple, Google Join Obama's Clean Energy Push" (Law 360, May 9, 2014), available at <http://www.law360.com/articles/536340/wal-mart-apple-google-join-obama-s-clean-energy-push>.