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Foreign Investment in U.S. Renewable Energy Projects: Deal Structures, Tax Issues, Accumulating Assets, Capitalization

TUESDAY, MAY 10, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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FOREIGN INVESTMENT IN U.S. RENEWABLE ENERGY PROJECTS

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AGENDA

- Overview of U.S. renewable energy market
- Why are foreign investors attracted to the U.S. renewable energy market?
- Complications of investing in the U.S.
- Overview of U.S. tax subsidies
- Overview of ownership structures
- Accounting Issues
- Tax Issues
- Financing issues

OVERVIEW OF U.S. RENEWABLE ENERGY MARKET

- Wind
  - Offshore getting started
- Solar
  - This is where most of the volume has been and is expected to be
- Biomass
  - Substantially fewer projects
- Fuel cells
  - Even less
- Geothermal
  - See them albeit sporadically
- Other

WHY ARE FOREIGN INVESTORS ATTRACTED TO THE U.S. RENEWABLE ENERGY MARKET?

- Financial returns
  - Projects in the U.S. often offer returns that exceed what many investors are getting on projects in their own country.
- Market size and potential
  - Technologies
  - Developers
- Market stability

COMPLICATIONS OF INVESTING IN THE U.S.

- A substantial portion of project is financed with tax incentives
  - Primarily tax credits
  - And a relevant portion with accelerate depreciation
- Foreign investors typically don't have significant tax liabilities in the U.S.
  - Therefore don't need a lot of tax incentives
- As a result, deal participants need to bifurcate benefits
  - Foreign investors are primarily interested in cash flow benefits
  - There are specific investors in the U.S. that seek tax incentives
- This leads to very careful structuring to make sure deal participants get the benefits they're investing for
  - Next let's look at the primary tax subsidies, then we'll look more closely at the ownership structures

OVERVIEW OF U.S. TAX SUBSIDIES

- Investment Tax Credits (ITCs)
  - 100% is made available the year the facility is placed in service
  - Based on eligible construction costs
    - Solar uses the ITC
    - ITC also available for:
      - Offshore wind
      - Fuel cells
      - Combined heat and power
      - Small wind projects
        - » Wind turbine with a nameplate capacity of 100 kilowatts or less
      - Waste energy recovery property
      - PTC property that elects to instead be treated as ITC property

OVERVIEW OF U.S. TAX SUBSIDIES (CONTINUED)

- The Solar ITC % depends on when the facility commences construction and is placed in service
  - 26% if construction commences this year and placed in service before 2026
  - 30% for projects that began construction prior to 2020 and placed in service before 2026
  - 22% if construction begins after 2022 and placed in service before 2026
  - 10% if construction begins after 2023 or is placed in service after 2025.
  - The renewable energy industry is lobbying the U.S. Government to extend these amounts, which they have been known to do many times

OVERVIEW OF U.S. TAX SUBSIDIES (CONTINUED)

- Production Tax Credits (PTCs)
  - Claimed annually over a 10 year period
  - Credit period begins in the year the facility is placed in service
  - Based on electricity generated and sold to an unrelated taxpayer
    - Technologies that qualify for PTCs include
      - Wind
      - Closed-loop biomass
      - Geothermal
      - Open-loop biomass*
      - Landfill gas*
      - Qualified hydropower*

*The amount of PTCs for these technologies are half of the full amounts (explained next)

OVERVIEW OF U.S. TAX SUBSIDIES (CONTINUED)

- PTCs are calculated on the amount of electricity produced multiplied by a percentage published by the U.S. Government's Internal Revenue Service (IRS)
  - In 2021 the rate was 2.5 cents per kilowatt hour of electricity generated
  - Recently increased to 2.7 cents for electricity generated in 2022
  - Similar to the ITC, the specific PTC rate depends on when construction began
    - For example, if a wind project commenced construction in 2021, the rate is 2.5 cents @ 60%, or 1.5 cents
      - » Other technologies like biomass, geo, landfill gas, etc. are not subject to the above phase downs.
    - However if construction for all PTC technologies didn't commence by 12/31/2021 then the project isn't eligible for PTCs (or the ITC election)

OVERVIEW OF U.S. TAX SUBSIDIES (CONTINUED)

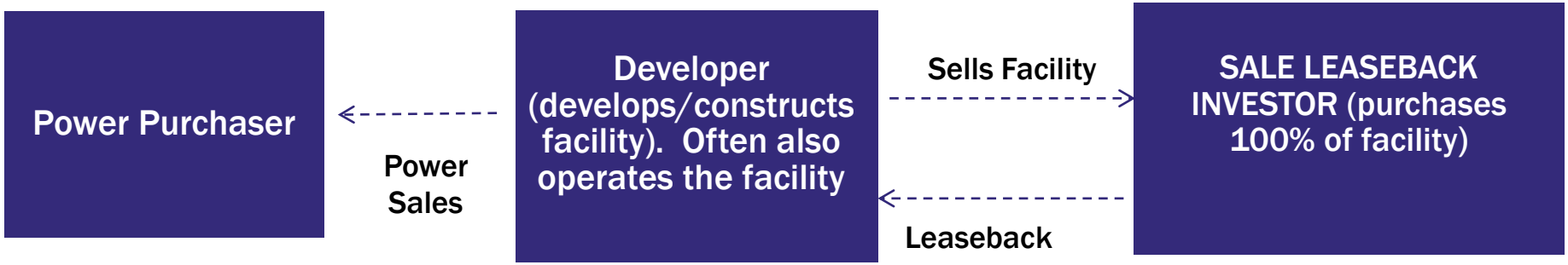
- Tax Depreciation Benefits
  - Equal to the depreciation deduction multiplied by the investor's tax rate (i.e. 21%)
    - Thus, $100,000 of depreciation expenses is worth $21,000.
    - Note that tax credits have a value that's worth dollar for dollar

- Substantially all of most solar, fuel cell and wind projects can be depreciated over 5 years
  - And if placed in service before 2023, can depreciate most of the cost all in year 1.
    - This is called "Bonus" depreciation
    - Bonus phases down 20% per year for facilities placed in service after 2022 and before 2026

OVERVIEW OF U.S. OWNERSHIP STRUCTURES

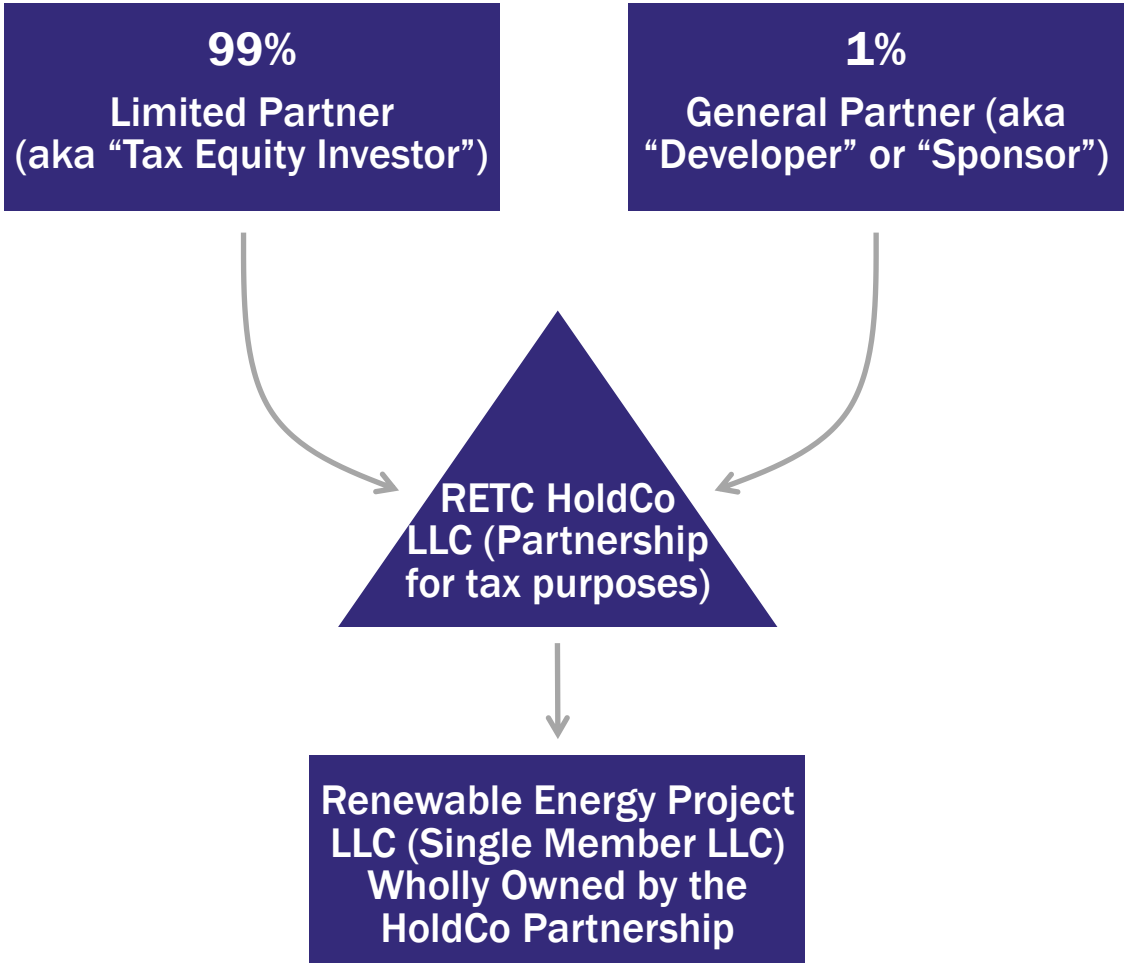
- There are three commonly used ownership structures
  - Sale lease-back structure (generally considered to be the simplest)
    - All benefits go to one owner, thus may not be well suited for foreign investors that do not have enough U.S. tax liability
  - Partnership flip
    - Partnerships are very commonly used in the U.S. to own and operate any type of project that qualifies for a major tax credit
    - Ownership %s are designed to start at one level then flip, often dramatically, once tax credits have been fully "earned"
      - For example, although the IRS allows owners to claim 100% in the year a qualifying facility is PIS, the credits technically get earned 20% per year.
        - » If certain events happy prior to earning all of the ITCs, then some or all can be disqualified.
        - » This is called tax credit recapture
        - » Doesn't apply to PTCs
  - Inverted lease (aka lease pass-through)
    - Also a partnership structure

SALE LEASEBACK



- Developer often has option to acquire property at end of lease term at 100% of the facility's then fair market value
- Lease must qualify as true lease for tax purpose

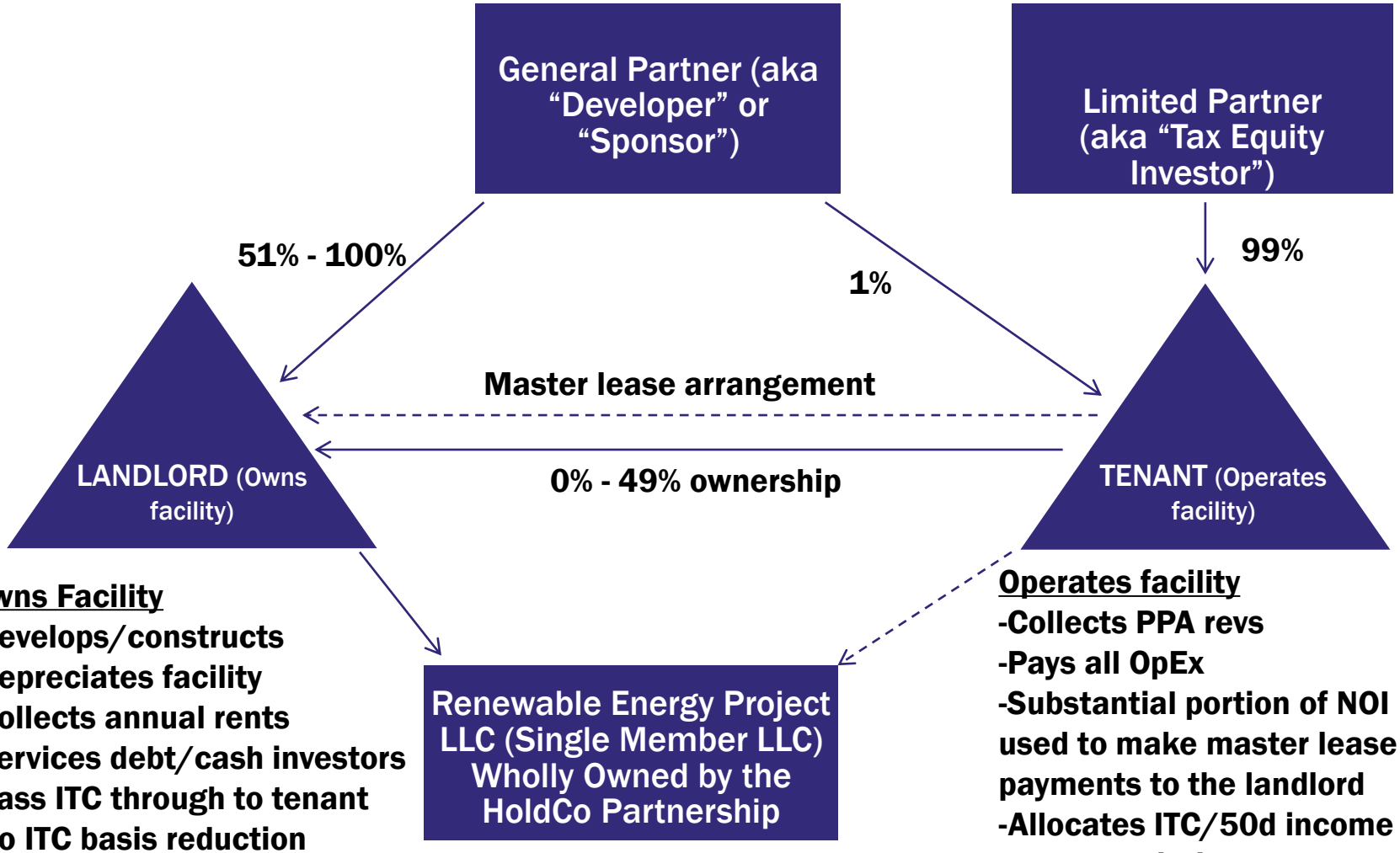
Partnership Flip



Partnership Flip Structures

- Key benefits to developer, investor, lender(s)
  - More common, simpler structure to implement
- Typical allocation
  - Class A 99%, Class B 1%
- Typical depreciation election
  - 5-yr MACRS
- Typical debt
  - Backleverage at Managing Member level
- FMV & ITC determination
  - Alternatives of cost plus margin (via developer fee) and affiliate sale of projects/entities to Partnership at FMV
- Tax accounting
  - Basis reduction - Depreciable basis reduced by 50% of ITC
- Cash vs. tax flip

INVERTED LEASE (a/k/a "Lease Pass-Through")



Owns Facility
- Develops/constructs
- Depreciates facility
- Collects annual rents
- Services debt/cash investors
- Pass ITC through to tenant
- No ITC basis reduction

Operates facility
- Collects PPA revs
- Pays all OpEx
- Substantial portion of NOI used to make master lease payments to the landlord
- Allocates ITC/50d income
- No depreciation

WHICH STRUCTURE IS BEST?

- The answer is that it all depends
- What are the developer's objectives and risk appetite?
- What are the investor's objectives and risk appetite?
- Generally, it can be best to run multiple models when in doubt to determine which is best for you
- If you are the developer, don't focus on the investor's IRR, focus on the benefits you will receive

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ACCOUNTING ISSUES

- U.S. GAAP vs. IFRS and/or other country specific GAAP
  - Converting U.S. GAAP to other accounting frameworks and/or currencies
- Partnerships vs. Corporations, JVs and other types of entities
  - Consolidation analysis (i.e. “VIE” analysis)
    - Who controls and is the primary economic beneficiary
- Hypothetical Liquidation at Book Value (HLBV)
  - Noncontrolling interest, “redeemable” noncontrolling interest

TAX ISSUES

- Partnership tax rules offer a lot of flexibility, just a few common issues
  - Capital accounts, special allocations
  - Economic substance
  - Tax exempt use
  - At-Risk and Passive Activities
  - Lease analysis
- Deal participants like the flexibility
- However, the flexibility comes with complex tax rules
- Eligible basis issues for calculating the tax credit
- Valuation issues for determining energy credit basis, especially in lease passthrough structures (i.e. the inverted lease)
- 80/20 analysis on repowering projects
- Commencement of construction analysis for preserving ITC % (to avoid the ITC % step-downs)

FINANCING ISSUES

- Debt
  - Project vs. “back leverage”
  - Recourse vs. nonrecourse
  - Forbearance agreements
- Ownership transfer risk
- Renewable Energy Credits
- State Rebates/Grants
- State Tax Credits
- Property Taxes, PILOT agreements,
- When and where property and sales tax exemptions are in effect
- Transfer Taxes


Questions?

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FOREIGN INVESTMENT IN U.S. RENEWABLE ENERGY PROJECTS: FOREIGN INVESTMENT RESTRICTIONS UNDER THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS)

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AGENDA

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- Why Should I Care About CFIUS?
- Key Terms & Concepts
- Foreign Persons & State-Owned Enterprises ("SOE's")
- Policy Context
- Site Risk
- Critical Infrastructure
- Procedural Overview
- Deal Planning
- Q&A

WHY SHOULD I CARE ABOUT CFIUS?

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The President of the United States has plenary, non-reviewable authority to block or force the divestment of foreign investment transactions on the basis of national security, and if this happens to your client, they will have no recourse.

KEY TERMS AND CONCEPTS

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- CFIUS or "the committee" – Committee on Foreign Investment in the United States
  - Section 721 of the Defense Production Act of 1950 (as amended)
  - 31 C.F.R. Parts 800 and 802
- Investments in renewable energy projects could qualify as any one of the three types of transactions CFIUS has jurisdiction to review:
  - "covered control transaction" – a "foreign person" acquires "control" over a "U.S. business"
  - "covered investment" in a "TID U.S. business" – a "foreign person" making a non-controlling minority investment acquires certain rights related to a "U.S. business" engaged in critical technology, critical infrastructure or sensitive personal data ("TID")
  - "covered real estate transaction" – a "foreign person" acquires certain real property rights related to "covered real estate" located near sensitive U.S. government facilities

"FOREIGN PERSONS" & SOE'S

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- Extremely low threshold for defining "foreign person" – any US entity with foreign "control" could be a "foreign person"
- CFIUS regulations reveal the committee's specific concern with foreign investment by parties affiliated with foreign states
- Foreign government affiliation is especially prevalent with Chinese parties, even if an investor is not technically a State-Owned Enterprise
  - *Ralls Corp. v. Comm. on Foreign Inv.*, 758 F.3d 296 (D.C. Cir. 2014) made clear that the President has the right to block and unwind transactions on the basis of national security.
- "Excepted investors" from Australia, Canada and the UK are exempt from certain mandatory filings related to TID U.S. businesses and ALL real estate filings, but excepted status is not always easy to establish

POLICY CONTEXT

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- "National Security" applies to more than nuclear weapons and military hardware – today's biggest concern is really unfriendly access to information (about people, about the government, about technology)
- CFIUS review remains grounded in "national security" – not intended to encompass political or economic concerns
- Latest regulations address foreign investment in personal data, critical infrastructure and real estate
- Energy infrastructure – to what extent does it implicate "national security"?
- Utility scale renewable energy projects could present national security considerations on their own, if they are large enough to qualify as "critical infrastructure", but the more common risk associated with renewables projects is site risk

SITE RISK

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- CFIUS Real Estate Regulations codified the “proximity issue” – applies to acquisition of “U.S. businesses” and acquisitions of “covered real estate”
- Identification of “covered ports” and list of facilities in Appendix A to 31 C.F.R. Part 802 make clear what’s in / what’s out:
  - “close proximity” – within 1 mile of facilities listed in Part 1 of the Appendix
  - “extended range” – within 100 miles of facilities listed I Part 2 of the Appendix
  - counties and parts of counties with ballistic missile silos listed in Part 3 of the Appendix
  - anywhere within the territorial sea surrounding offshore ranges listed in Part 4 of the Appendix
- CFIUS Part 802 Geographic Reference Tool - https://mtgis-portal.geo.census.gov/arcgis/apps/webappviewer/index.html?id=0bb1d5751d76498181b4b531987ce263

CRITICAL INFRASTRUCTURE

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- "Critical infrastructure" for purposes of "covered control transactions" means "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security"
- "Covered investments" in renewable energy projects involving the bulk-power system (including industrial control systems) or that provide power to military installations listed in the Appendix to 31 C.F.R. Part 802

PROCEDURAL OVERVIEW

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- Jurisdictional thresholds
  - No monetary threshold in U.S.; any size investment may be subject to CFIUS review
  - No shareholding threshold – any percentage of interest can be inferred to impart "control"
- Timelines
  - Voluntary notice – pre-filing feedback (1-2 weeks), 45-day review, 45-day investigation, 15-day presidential referral
  - Voluntary or mandatory declaration – 30-day review
- Consequences
  - Mitigation / Sanctions
  - Increasing screening of non-notified transactions

DEAL PLANNING

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- CFIUS filings add considerably to the transaction timeline, increasing the importance of early planning and understanding the political climate
- Investing in a sensitive sector or location? Anticipate heightened scrutiny and allocate risk accordingly
- Allocating risk between parties affects deal flow – e.g., costs, satisfaction of conditions precedent, and reps and warranties (touches various issues) etc.

QUESTIONS? THANKS!

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