

Using Partnership Flips to Finance Renewable Energy Projects: Evaluating Tax Risks, Navigating IRS Safe Harbors

THURSDAY, JULY 28, 2022

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

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Partnership Flips

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Partnership flips are used to raise tax equity in the renewable energy market. They are not the only structure for doing so, but they are the most common, and they are the only way to raise tax equity for wind farms and other projects on which production tax credits will be claimed.

The US government offers two tax benefits for renewable energy: a tax credit and depreciation. They amount to roughly 44¢ per dollar of capital cost for the typical wind or solar project that was under construction in time to qualify for tax credits at the full rate. Few developers can use them efficiently. Therefore, finding value for them is the core financing strategy for many US renewable energy companies.

Tax equity raised through a partnership flip structure accounts for 65% of the capital stack of a typical wind farm, plus or minus 5%, and 35% of a typical solar project, plus or minus 10%.

Two other structures for raising tax equity – sale-leasebacks and inverted leases – raise different amounts of tax equity and have different risk allocations and different deadlines for when the tax equity investor must invest. Lease structures only work for projects on which investment tax credits – as opposed to production tax credits – will be claimed.

Tax equity yields have been falling this year due to increased competition for scarce projects and about \$4.5 to \$5 billion in returning tax equity capacity. The economic outlook will eventually weigh on tax capacity forecasts. Bank of America and JPMorgan said roughly 85% of their tax equity for this year was already committed by the third week in January. Some tax capacity will free up as projects slip.

offtakers

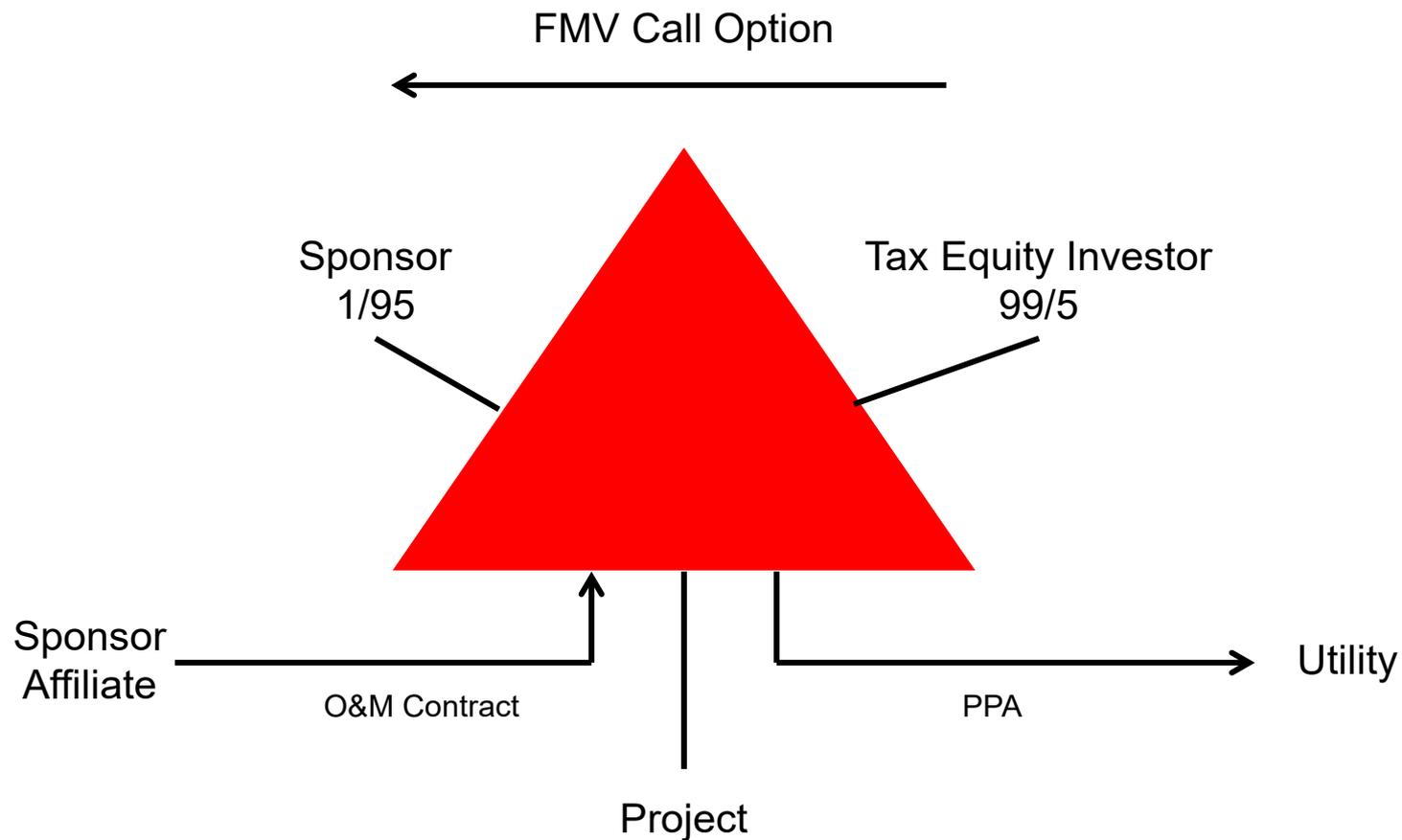
The tax equity last year was split roughly 50-50 between wind and solar. There is concern about the supply of tax equity as carbon capture projects and mammoth offshore wind projects start coming to market.

Partnership flips are a simple concept. Tax benefits can only be claimed by the owner of a project. A developer finds an investor who can use the tax benefits. The two of them own the project as partners through a partnership. Partnerships offer flexibility in how economic returns from a project can be shared by the partners.

Yield-Based Flips

The partnership allocates 99% of income, loss and tax credits to the tax equity investor until it reaches a target yield. Cash is shared in a different ratio. After the yield is reached, the investor's share of everything drops to 5%, and the developer has an option to buy the investor's remaining interest.

Basic Yield Flip



In some deals, the investor takes as little as 2.5% of the cash after the flip, but this is uncommon.

The developer retains day-to-day control over the project. A list of “major decisions” requires consent from the tax equity investor. In some deals, the list is shorter after the flip.

Developers like partnership flips because they get back 95% of the project after the flip without having to pay anything for it.

The sponsor call option is usually for fair market value or the higher of fair market value and an expected all-in yield. The IRS allows a fixed price that is a good faith estimate at inception of what the value will be when the option is exercised. Some investors require the developer to pay enough to avoid a book loss on sale. Sometimes the call option can be exercised before the flip, but not before five years have run.

Many investors use HLBV accounting to account for their investments. This requires tracking what the investor would receive at each year end if the partnership liquidated. The difference in amount from one year to the next is added or subtracted from earnings.

The IRS published guidelines in 2007 for partnership flip transactions. Most transactions remain within the guidelines.

**Rev. Proc. 2007-65
Announcement 2009-69**

The guidelines that are most likely to come into play are the tax equity investor must retain at least a 4.95% residual interest after the flip, the flip cannot occur more quickly than five years, any option to buy the investor's interest must be for fair market value or a fixed price that is a good faith estimate of FMV, the investor must make at least 20% of its total investment before the project is put in service, and the investor cannot have a "put."

The guidelines also bar guarantees of production tax credits, and the developer, turbine supplier and electricity offtaker cannot guarantee the output for the investor.

Most investors want to see at least a 2% pre-tax or cash-on-cash yield. Most investors treat tax credits as equivalent to cash for this purpose.

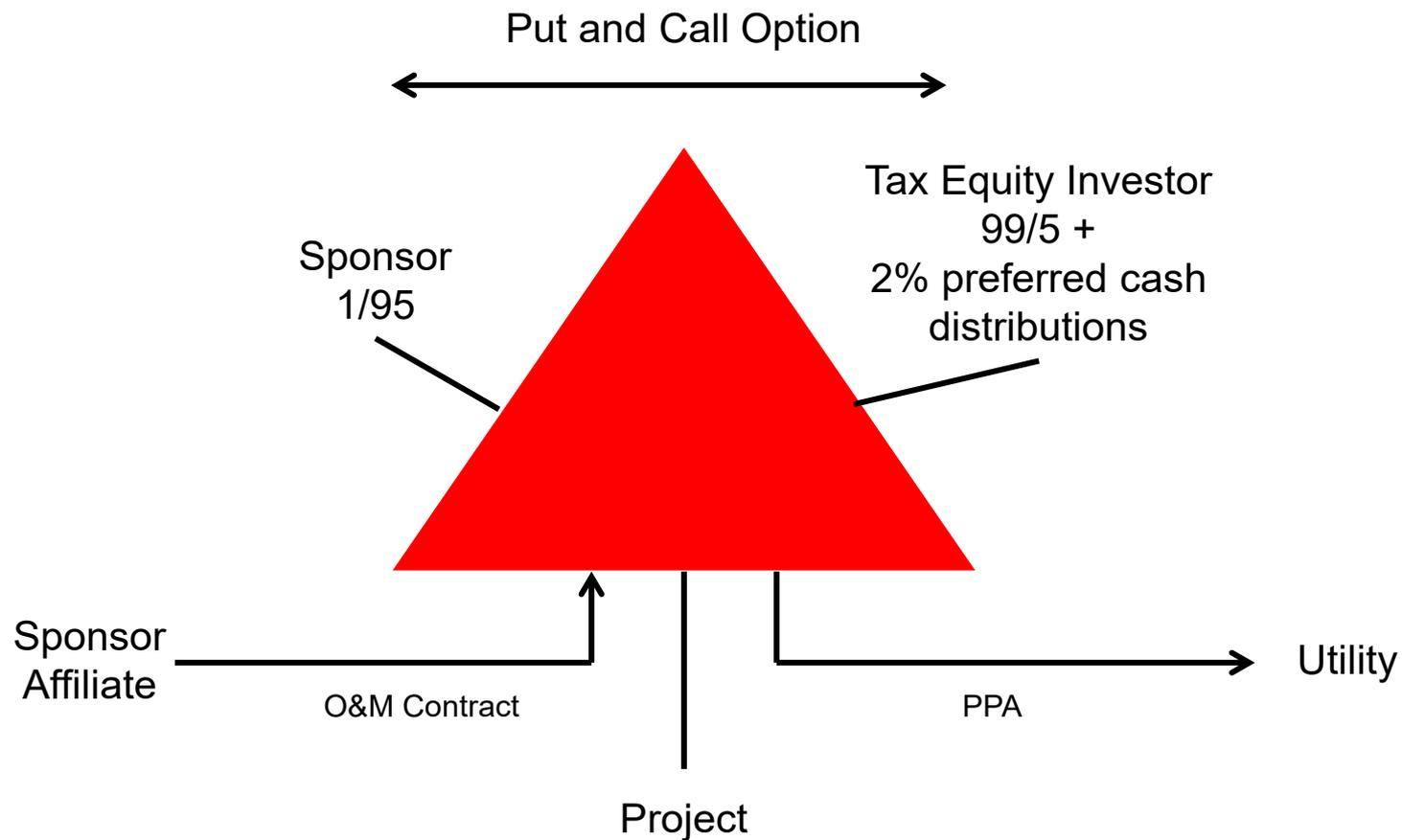
The investor must not walk so close to the line as to be considered a lender or a bare purchaser of tax benefits. A lender advances money for a promise to repay the advance plus a return by a fixed maturity date.

Fixed-Flip and Pay-Go Variations

There are several variations in form of partnership flip transactions. At least one major investor uses a fixed-flip structure. The investor flips to a 5% residual interest on a fixed date after five or five-and-a-half years. The developer has a call option. The investor has a withdrawal right six months to a year later if the call is not exercised.

The investor receives preferred cash distributions each year equal to 2% of its original investment and some percentage of remaining cash. Developers like this structure because it lets them retain as much cash as possible. Developers would rather borrow against future cash flow at a lower debt rate than a tax equity yield.

Fixed Flip



An area of tension in fixed-flip transactions is how quickly the partnership must pay the market value of the investor's interest when it withdraws from the partnership. Most deal documents give the partnership two years. The withdrawal amount is paid out of partnership cash flow.

If the full withdrawal amount is not paid within two years, then the investor can take the project. If there is back-levered debt, the partnership obligation to pay the withdrawal amount leads to intercreditor issues.

Each partner has a “capital account” and an “outside basis.” These are two ways of measuring what the partner put into the partnership and is allowed to take out.

A developer who is distributed most of the cash will end up with a negative capital account. Many tax equity investors now require developers to agree to put cash back into the partnership if the developer still has a negative capital account when the partnership liquidates.

fine print

Another common variation on the standard flip is a pay-go structure used in deals with production tax credits. The investor makes 75% of its investment at inception or as a fixed amount over time, and the other 25% is tied to the production tax credits the investor is allocated each year. The IRS flip guidelines limit the amount of investment that can be contingent on output or tax credits to 25%.

Absorption Issues

Almost all flip transactions have “absorption” problems. The tax equity investor will have paid only a fraction of the cost of the project for an interest in it. Therefore, it will not have a large enough capital account to absorb all the depreciation on the project. Once its capital account hits zero, remaining tax losses shift to the developer.

Once the investor's outside basis hits zero, then any further losses it is allocated end up being suspended. They can be used only against future income the investor is allocated by the partnership. Any cash it is distributed must be reported as capital gain.

This is one of several reasons why it is important to model what is happening in the partnership. The business deal may be to allocate 99% of tax benefits to the investor, but that is not what will happen in fact.

Partnership agreements have a standard clause that shifts losses once a partner has run out of capital account to the other partner. Such a loss shift will drag production tax credits with it. Some tax counsel worry that it may also lead to recapture of any unvested investment tax credits.

There are two ways to deal with an inadequate capital account. One is for the investor to agree to a “deficit restoration obligation” or “DRO.” This is a promise to contribute more money to the partnership at liquidation to cover any negative capital account. On that basis, the IRS will let the investor absorb more losses.

A DRO will let a partner be allocated additional losses, but the partner cannot use them immediately if its outside basis has also hit zero.

DROs had been as high as 50% to 70% of the tax equity investment when wholesale electricity prices were low, but are now back in the single digits. Tax equity investors who agree to DROs usually want to be allocated income as quickly as possible after the flip to reverse the deficit and to be distributed cash to cover the taxes on the additional income.

Such post-flip measures could turn the original 99% allocations to the tax equity investor into “transitory allocations” if they are reversed within five years. The IRS does not allow transitory allocations. Be sure to check the model.

An investor usually places a dollar limit on the DRO to which it will agree. The tax laws allow the allocations to be changed retroactively up to the due date (without extensions) for the tax return for a year. Some investors wait to see how a year went and then increase the DRO after the year ends. In most deals, once the deficit starts to contract, the DRO goes down as well.

Another way to address the absorption problem and to prevent a loss shift is to add project-level debt. This turns part of the depreciation into "nonrecourse deductions" that can be taken by partners even after they run out of capital account. The debt also increases the investor's outside basis.

However, partners taking nonrecourse deductions must be allocated an equivalent amount of income later as the debt is repaid. These later allocations are called “minimum gain chargebacks.”

phantom income

Almost all debt in the market today is back-levered debt behind the tax equity in the capital stack. If there is project-level debt, then the tax equity investor will demand a higher yield and require the lender to enter into a forbearance agreement. In contrast, lenders are not charging any premium to lend on a back-levered basis due to the intense competition among banks to lend.

A tax equity investor might take other steps to make it less likely that its capital account will go negative. These include reducing its share of income and losses in a solar deal from 99% to 67% in the year after the project is placed in service and then moving back to 99% in the year the partnership starts generating taxable income or taking depreciation on the project on a straight-line basis over 12 years.

The IRS will ignore a DRO if there is a “plan to circumvent or avoid” the obligation to contribute more capital. There should be “commercially reasonable provisions for enforcement and collection of the obligation,” and the partner should be required to provide documentation regarding its financial condition. The practical effect is to impose a net worth test on the sponsor to ensure it can satisfy the DRO.

The IRS requires that a third metric called “tax capital” be tracked and reported each year starting with K-1s sent to partners in 2022 for the 2021 tax year. This is a hybrid between capital accounts and outside basis. It is a way for the IRS to identify partners who may have taxable gains to report to the IRS. Negative tax capital is a sign of a potential gain.

Calculating How Much Tax Equity Can Be Raised

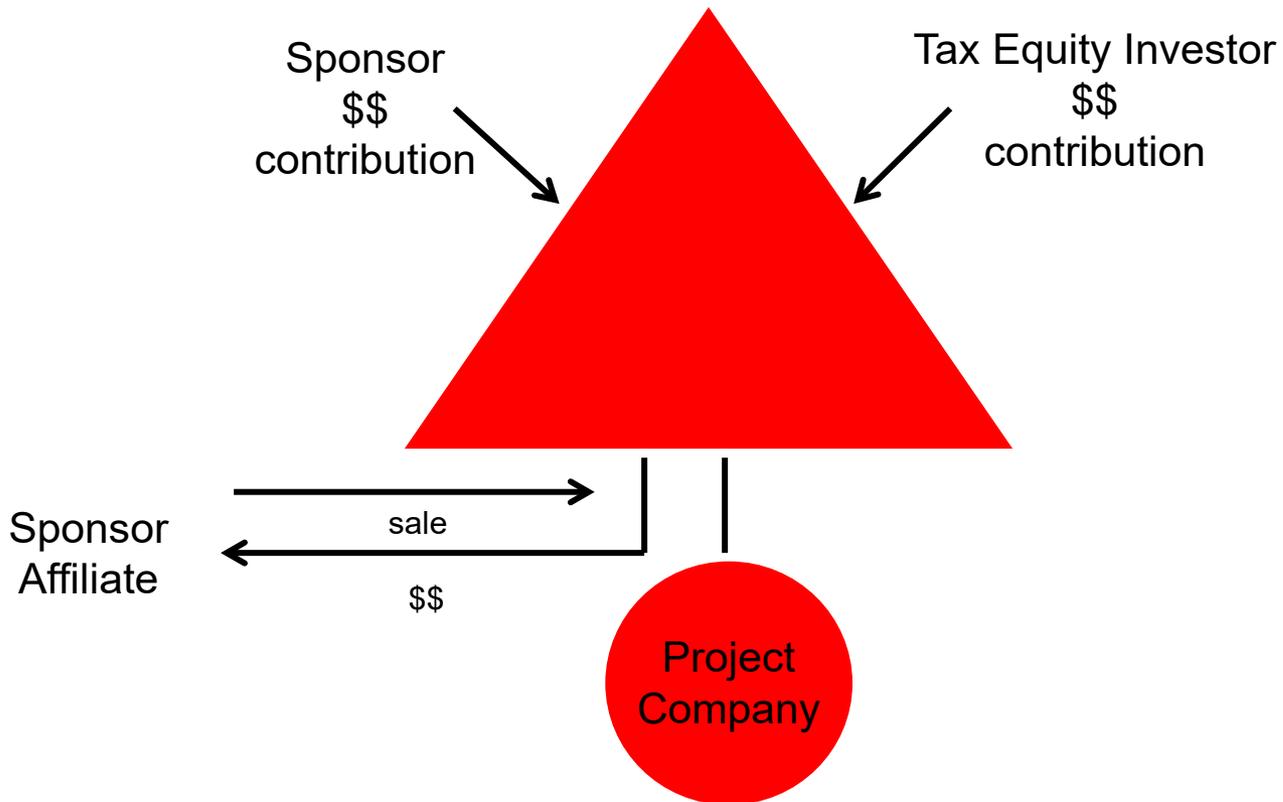
The amount of tax equity that can be raised through a flip transaction is the present value of the discounted net benefits stream to the tax equity investor. The investor receives three benefits: tax credits, cash and tax savings from losses. It suffers one detriment: taxes must be paid on the income it is allocated. It discounts these amounts using its target yield to a present-value number.

Putting the Structure in Place

There are three ways to put a partnership flip transaction in place. The most common approach today is a “project company sale model” where the developer sells the project company near the end of construction to the tax equity partnership. Both the developer and the tax equity investor contribute capital to the partnership to pay the purchase price.

basis step up

Project Company Sale Model

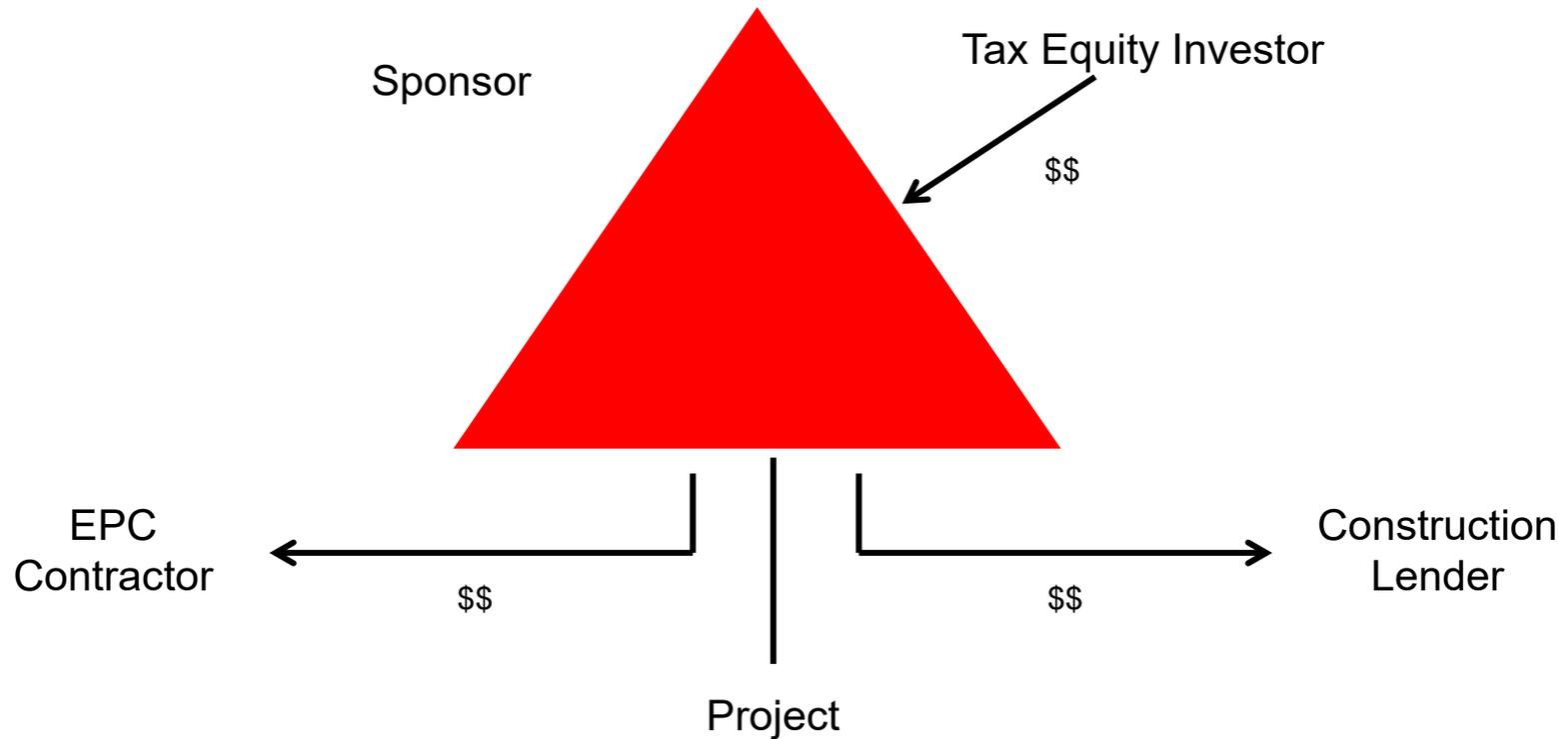


In solar deals, the partnership usually pays 20% of the purchase price at mechanical completion before any part of the project is in service and the other 80% after the entire project is in service. This begs the question what happens if the conditions for the 80% payment are not met.

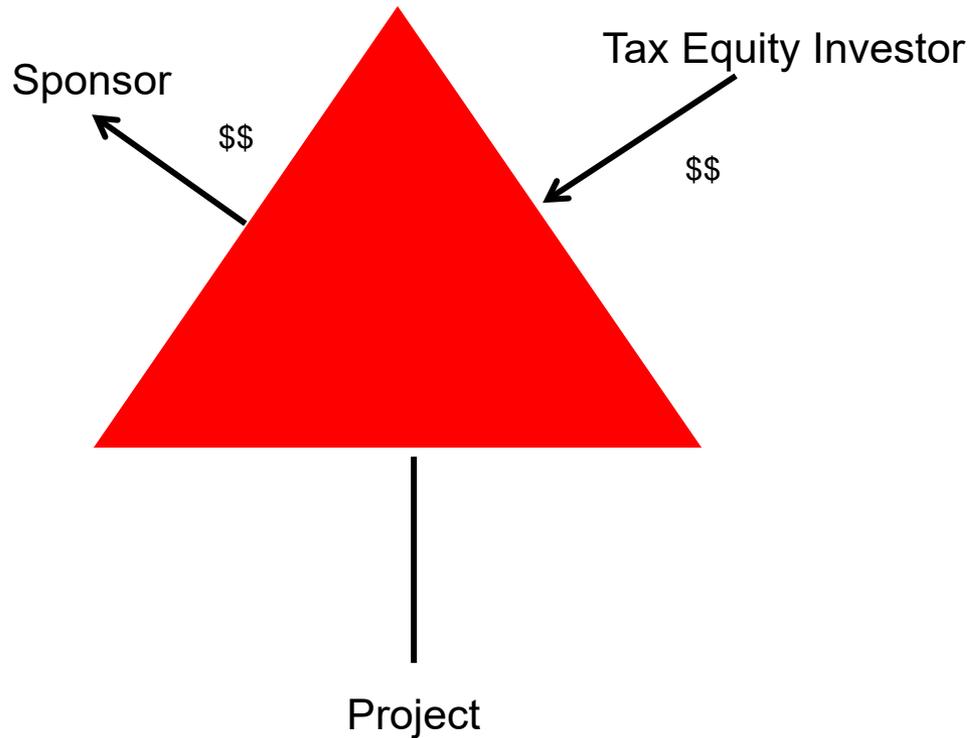
unwind?

Another way to put the structure in place is a “contribution model” where the project is already in the partnership entity, and the tax equity investor makes a capital contribution to the partnership for an interest. The capital contribution may be used by the partnership to pay the EPC contractor or pay off construction debt, or it may be distributed to the developer.

Contribution Model



Contribution Model w/ Distribution Out

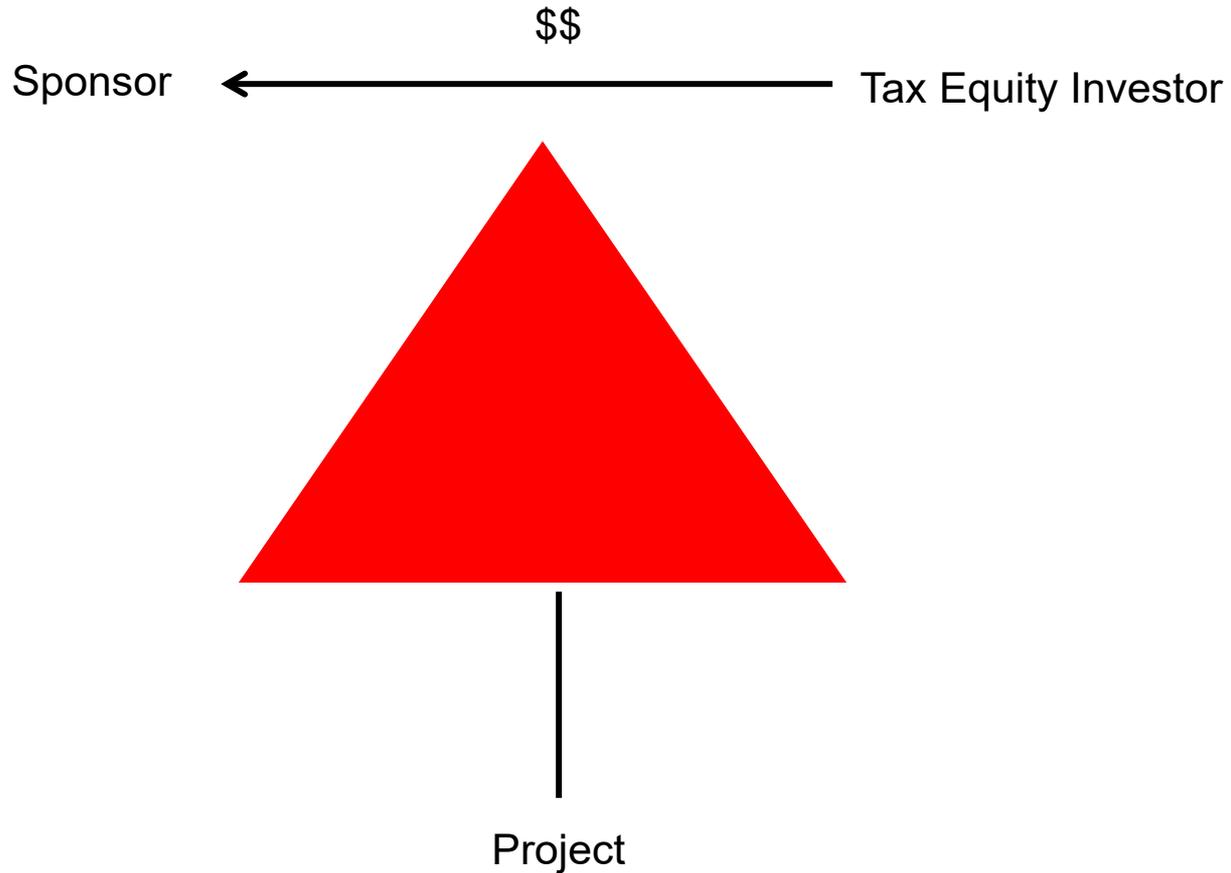


The developer may be able to pull out the tax equity raised as a tax-free return of capital. The key is to avoid having the distribution out labelled a “disguised sale” of the project to the partnership. It must fit in a “pre-formation expenditure” safe harbor that lets the developer be reimbursed for its capital spending on the project over the last two years.

The project cannot be worth more than 120% of the tax basis the developer has in the project when the partnership is formed to make full use of this safe harbor. If there is debt on the project when the partnership is formed, then it will complicate the calculations to determine whether the safe harbor applies.

A third way to put the tax equity partnership in place is a “purchase model” where the investor pays the developer directly for an interest.

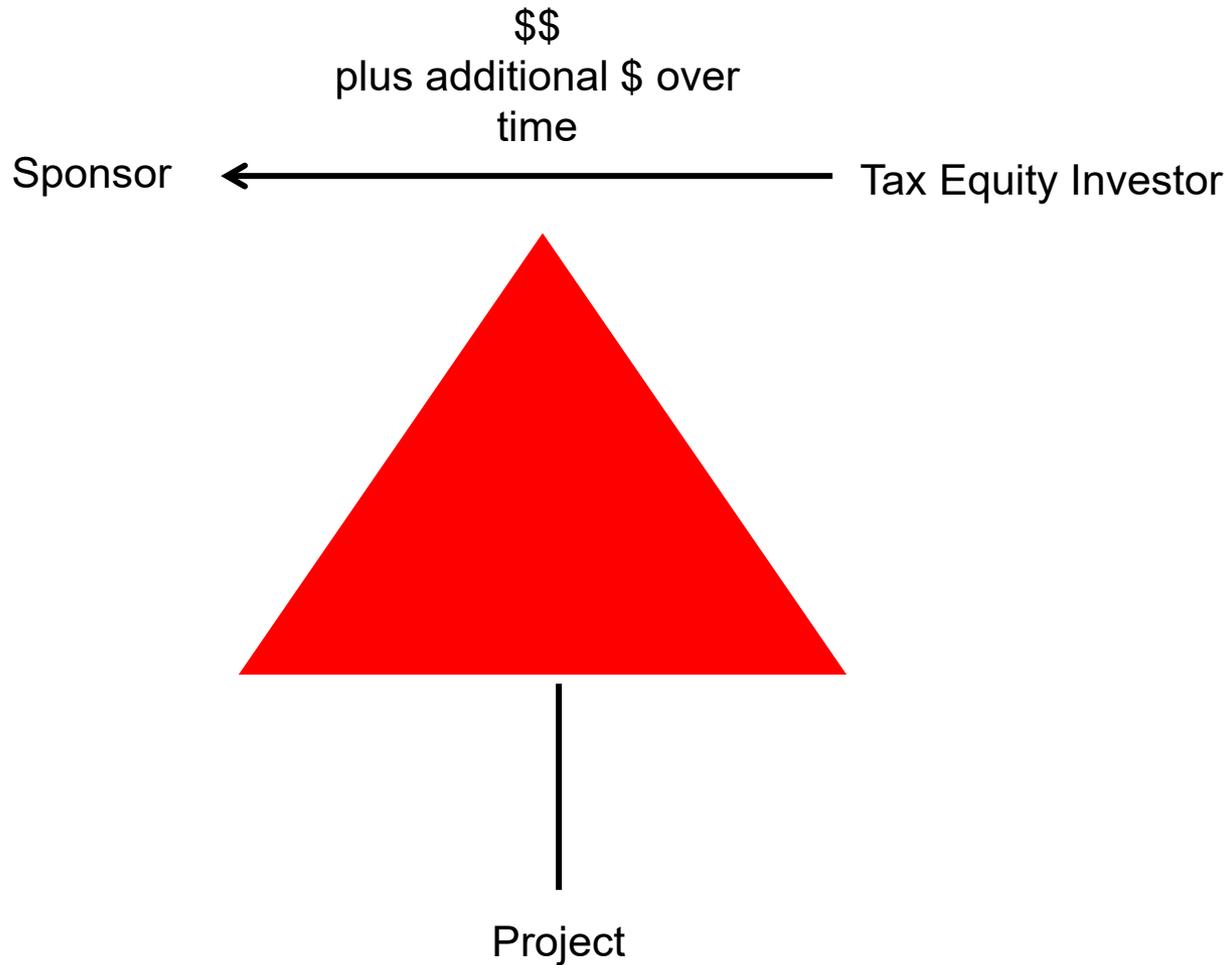
Purchase Model



The purchase model is used when the tax equity investor payment will end up going to the developer. The developer is usually treated for income tax purposes as selling a share of the project assets to the investor. It will have to pay income taxes on its gain from the sale of that share of the project.

In a pay-go variation on these structures, the tax equity investor pays an amount at the start to buy an interest in the project and makes additional payments over time that are a function of the output or tax credits. The contingent amounts cannot be more than 25% of the total investment.

Pay-Go Structure



Current Issues in Deals

Construction delays are creating issues. Some projects that started construction under the 5% test are falling short due to spiraling construction costs. The American Clean Power Association asked the Treasury several weeks ago to reduce the 5% to a 2.5% test.

Some projects are worth less at the end of construction than they cost to build. The ITC on the “built-in loss” can go to the tax equity investor, the IRS said. Some sponsors are asking tax equity investors to pay more if a PPA price increase can be negotiated before the final funding.

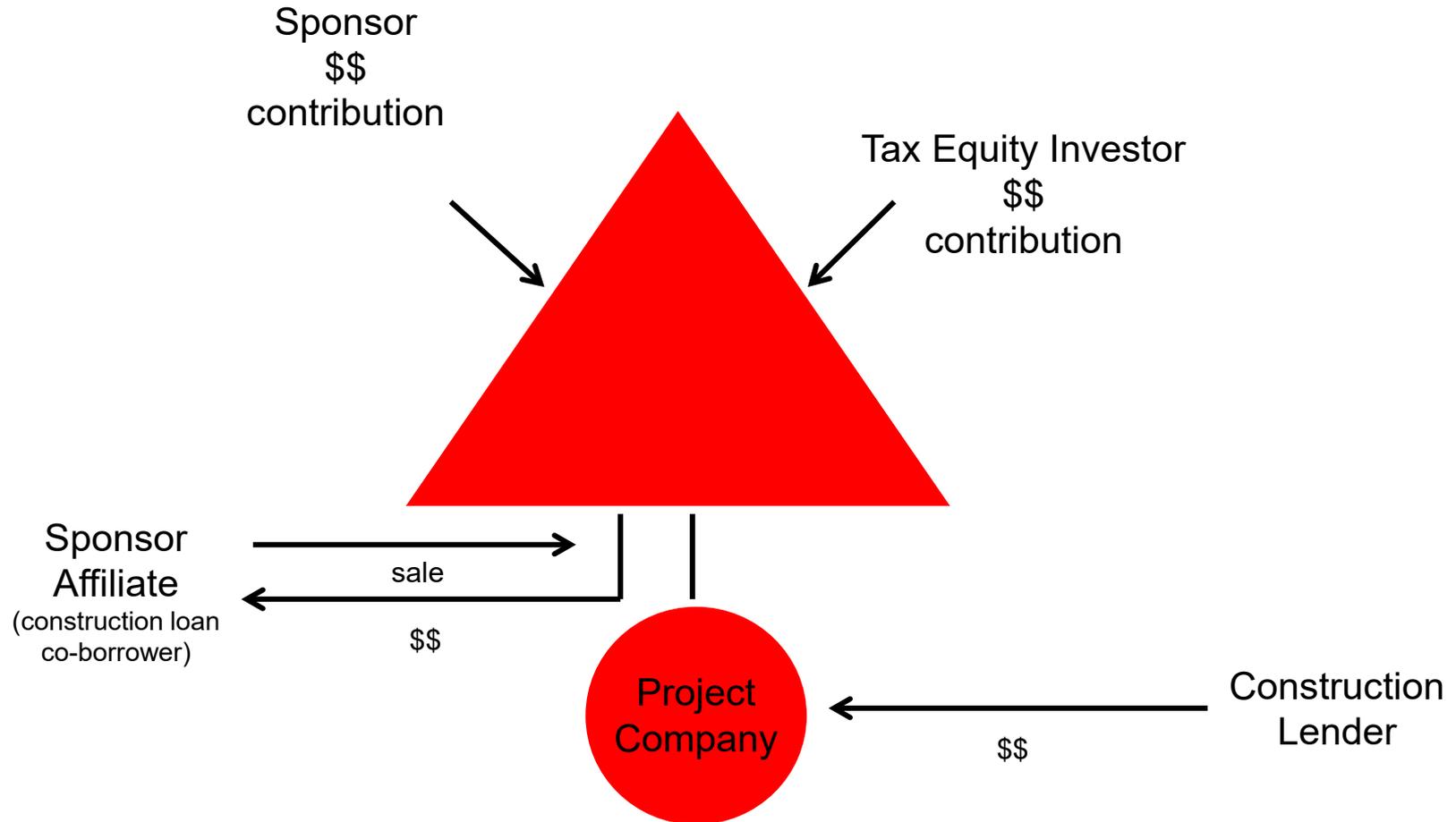
Two of the big four accounting firms are requiring sponsors to establish reserves in cases where the tax basis for calculating tax benefits was stepped up. They do not like circled cash and “one and done” sellers. This, and some IRS audit activity, are causing developers to be more careful about separating the “right” and “left” sides of the structure for purposes of the security on construction debt.

Most audit activity in the solar market has been around the tax bases claimed in tax equity deals. Many tax equity investors limit the markup they are willing to allow above construction cost to 15% to 20%, although these limits are hard to enforce in practice. The IRS tends to focus on where the final basis per watt lands in relation to what it sees generally in the market.

Some tax equity investors are requiring tax insurance to cover basis risk in the residential rooftop market. Premiums on tax insurance generally run 2.5% to 3.5% of the potential payout.

Another issue in deals is how the construction debt converts into back-levered term debt. If the project company and the sponsor partner are co-borrowers under the construction loan and the partnership buys the project company subject to the construction loan, the partnership may not be able to include the loan in tax basis if the sponsor partner remains liable for the debt.

Project Company Sale Model



Some tax counsel prefer that the seller of the project company remain liable for construction cost overruns as a way to help justify the basis step up. The project company will remain obligated when it is sold to the tax equity partnership to pay the remaining EPC contract price, but not any cost overruns. The seller must pay them.

Cash sweeps to pay indemnities are another source of tension in deals. Sponsors want to retain enough cash to cover debt service on back-levered debt. Many investors agree to limit sweeps to 50% to 75% of cash or, in some cases, to prevent the sweep from reaching cash needed for scheduled principal and interest on the debt.

National banks that invest directly in flip transactions as the deposit-taking institution must give notice to the US Comptroller of the Currency and provide a risk analysis. The OCC imposed nine other conditions on such transactions in regulations in 2021.

Deal papers also address what happens if there is a change in tax law. The tax equity investor does not have to fund unless any proposed adverse tax law change is reflected in pricing. If the change is not ultimately enacted, the investor may have to make an additional capital contribution. In some deals, the investor has a cash sweep to get back on track if an adverse tax law change delays the projected flip date by more than X period.

Partnerships that generate and sell electricity must use the “inventory method of accounting.” This means they can only allocate net income or net loss. They cannot disaggregate the elements that go into the calculation of net income and loss and allocate them differently.

lease depreciation

In some deals, the tax equity investor receives cumulative preferred cash distributions that assure it of at least 75% or 80% of its projected cash distributions in the base case model. This limits the downside risk that is part of the analysis whether the investor is really a partner.

Taxpayers cannot claim losses on sales to related parties. This means that a partnership cannot claim net losses in years when electricity is sold to a partner. In some partnerships owning merchant power projects, the developer must put a floor under the electricity price. Any contract with the developer should be a swap rather than a power purchase agreement, at least during the first few years before the partnership turns tax positive.

Investment tax credits must be shared by partners in the same ratio they share in “profits” in the year a project is put in service. The tax credits will be recaptured if a partner suffers more than a one-third reduction in its share of profits during the first five years. Investors who reduce their share of losses to 67% after year one to put less stress on capital accounts should be sure to restore the percentage to 99% once the partnership turns tax positive.

Many investors insist on holding the 99% income share for at least one full year -- and sometimes for two years -- of meaningful income lest the IRS say the first-year 99% allocation used to send the ITC to the investor was illusory because it changed by the time there were profits.

Some developers approach inappropriate parties as tax equity investors. Passive loss rules make it hard for individuals, S corporations and closely-held C corporations to use tax benefits on renewable energy projects.

The IRS started making back tax assessments at the partnership level in the 2018 tax year. In many deals, a “push-out election” is made to push out any such liability to persons who were partners during the year under audit. However, partners will have to pay 2% extra interest on the back taxes if this is done.

Property taxes are an ever-present issue in transactions involving solar equipment in California. Any change in ownership of solar equipment after initial installation will trigger a property tax reassessment.

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