



SEIA Webinar: The Top Fifteen Tax Mistakes in a Solar Transaction October 1, 2009

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The Solar ITC Basics

- Two main tax benefits:
 - 30% investment tax credit/Treasury grant
 - 5-year depreciation
- The ITC is generated and claimed in the year the project is placed in service
- The grant is available 60 days after the project is placed in service
- Two main “monetization” structures:
 - Sale-leaseback
 - Partnership “flip” structure

Number 15 Mistake: Failing to Account for 50% ITC Basis Reduction in Economic Models

- Solar ITC accrues before depreciation is taken into account
- Depreciable basis is reduced by 50% of the amount of the ITC/grant determined for the solar energy property
- Reduction is equal to 50% of ITC/grant (i.e., 15% of eligible basis of solar energy property (50% of 30%) and not 50% of eligible basis
 - Exception for lessee pass-thru election
- If 50% ITC/grant haircut is not taken into account, estimated depreciation allowances will be overestimated in economic models or erroneously claimed on returns

Number 14 Mistake: Forgetting about Bonus Depreciation

- The Recovery Act extended bonus depreciation for certain property
- Four main requirements (with additional special rules):
 - MACRS property with recovery period of less than 20 years
 - Original use of the property commences with the taxpayer after 12/31/07
 - Taxpayer must purchase the property after 12/31/07 and before 1/1/10
 - Property must be placed in service after 12/31/07 and before 1/1/10

Number 13 Mistake: Not Reducing Basis by Amount of Non-Taxable Grant

- Taxable incentives do not reduce ITC/Grant basis
- Non-taxable incentives for the construction of a project reduce ITC/Grant basis
- What are examples of incentives that are always taxable?
 - General Rule: Assume that all cash payment incentives are taxable
- What are examples of incentives that are always non-taxable?
 - General Rule: Only non-taxable if there is a specific exclusion from income under the Internal Revenue Code. Examples:
 - Section 118 – Contributions in aid of construction (CIAC)
 - Section 136 – Energy conservation subsidies provided by public utilities
 - Treasury grant
 - Note that the Treasury grant may be taxable for state tax purposes or included in Federal minimum taxes

Number 12 Mistake: Claiming ITC/Grant on Ineligible Property

- Definition of eligible property is the same for ITC and grant
- Does not include electricity used to heat a swimming pool
- Does not include cost of attic fan, golf carts, truck, etc. just because a solar panel is mounted on the property
- Does not include property used to transmit or distribute electricity
 - Transformers, substations do not qualify
- Parking structures may not fully qualify for the ITC/grant
- Batteries or storage devices qualify if they store electricity from the solar system, but not if they store electricity drawn from the grid
- Does not include purchase price of other assets which are acquired in addition to a solar system
 - Power contracts, leases with customers, etc.

Number 11 Mistake: Forgetting Dual Use Property Rules

- Should not be an issue for PV projects
- However, solar projects that also utilize an additional energy source other than solar may be affected.
- “Solar energy property”
 - Does not include equipment that use a source of power other than solar or wind energy to provide usable energy (auxiliary equipment)
 - Does include equipment used by both auxiliary equipment and solar energy equipment (dual use equipment) only:
 - If energy from other sources is 25% or less in an annual measuring period
 - To the extent that solar or wind energy is used in such period
- Applicable to Treasury grant program?

Number 10 Mistake: Used Equipment and Original Use Requirement

- Solar energy property includes only:
 - Self-constructed property, or
 - Property that is acquired by the taxpayer, the original use of which commences with the taxpayer
- Cost of used equipment will be excluded from ITC/grant basis
 - 80/20 exception
- Definition of the term “solar energy property”
 - Generally up to (but not including) electricity transmission or distribution stage
 - Includes electricity-generation equipment, solar cells and collectors, storage tanks, rockbeds, heat exchangers, power conditioning equipment, etc.
- Special 3-month sale-leaseback rule also applies to the “original use” requirement—original use is deemed to commence with the purchaser/lessor

Number 9 Mistake: Multiple Facility Pitfall

- Placed-in-service date rules are applied on a facility-by-facility basis
- In the context of wind projects, the IRS has ruled that each wind turbine on a wind farm is treated as a separate facility
- It is assumed that the same rule would apply to solar energy property
- Once solar energy property reaches the point of independent operations, there is a risk that the IRS would treat other similar property which is added later as separate facilities
 - Special election in the Treasury grant program for placed in service and beginning of construction
- Significant issue under the special 3-month rule for sale-leasebacks and identification of taxpayer entitled to credit

Number 8 Mistake: Ignoring Special Partnership ITC Allocation Rules

- Solar ITC will generally be allocated among partners according to their interests in the general profits of the partnership on the placed-in-service date
- Allocations of general profits and ITCs must match up
- Special allocation rules may apply in certain circumstances
- Allocations of general profits must be respected under section 704(b) substantial economic effect rules
- Tax investor partners must have sufficient tax basis to absorb accelerated 5-year depreciation allowances
- Allocation of Treasury grant

Number 7 Mistake: Shifting too Many Burdens and/or Benefits to A Lessee or Service Recipient

- Solar ITC/Treasury grant and depreciation deductions may only be claimed by the tax owner of the solar energy property
 - Exception for lessee pass-thru election
- Shifting too many burdens and/or benefits of ownership to another party may result in that party being treated as the tax owner (e.g., lessee or service recipient)
 - Lease or power contract should not run for entire useful life and value of the equipment – See below
 - Customer/lessee should not have nominal purchase option or continuous purchase options
- Sale-leasebacks must be genuine and leases treated as “true leases”
 - IRS leasing guidelines should be followed: At least a 20% residual useful life and 20% residual economic value
 - Section 467 rent rules must be considered
- Economic substance doctrine must be considered

Number 6 Mistake: Bringing in Tax Investors After the Placed-in-Service Date

- Solar ITC accrues on the date that the solar energy property is actually or deemed to be placed in service
- In partnership investments, tax investors need to be partners at the placed-in-service date
- In sale-leaseback investments, tax investors must either:
 - own the facility on the placed-in-service date; or
 - satisfy the special 3-month rule for sale-leasebacks
- Placed-in-service date does not equate with “commercial operation date” in all cases
 - IRS follows 5-factor test for determining the placed-in-service date
- Assignments and syndications after sale-leaseback will trigger recapture even if effected within 3-month period after placed-in-service date
- Treasury grant program – More flexible recapture rules

Number 5 Mistake: Foot-Faulting the Recapture Rules

- ITC - A bundle of possible mistakes:
 - Selling solar energy property or significant partnership interest within 5-year recapture period
 - Using a “flip” partnership structure within 5-year recapture period
 - Changes in allocations of general profits of the partnership within 5-year recapture period (33 1/3%, 66 2/3%, and 100% thresholds)
 - One taxable entity placing facility in service, a different taxable entity selling and leasing back facility under 3-month special sale-leaseback rule
 - Conversion of facility from solar energy property to a different type of property
 - Section 708(b)(1)(B) deemed terminations will affect all partners
- Change-of-form transactions may avoid recapture
- 5 year period to fully vest the ITC and avoid recapture
- Treasury grant program – More flexible recapture rules

Number 4 Mistake: Using Partnership “Flip” Structure that is Outside Rev. Proc. 2007-65 Safe Harbor

- In October 2007, the IRS issued Rev. Proc. 2007-65 which provides a “safe harbor” for partnership “flip” structures
- In September 2009, the IRS revised the Rev. Proc.
- Sets forth various requirements to qualify for the safe harbor, including:
 - Developer must have a minimum 1% investment
 - Investor must have a minimum 5% investment (of its largest share)
 - No purchase option at less than FMV, but can be fixed in advance
 - No put options
 - Others
- Only applicable to wind, but....

Number 3 Mistake: Letting Tax-Exempt Entities Reduce or Eliminate ITC

- Solar ITC is disallowed for solar energy property treated as “tax-exempt use property” under the depreciation rules.
- “Tax-exempt use property” refers to property used by a “tax-exempt entity,” which include:
 - Tax-Exempt organizations not subject to UBTI
 - Governmental entities and Indian tribes
 - Foreign persons not subject to U.S. tax (ECI)
 - A “tax-exempt controlled entity”
- Partnerships with tax-exempt partners may also result in proportional or total reduction
 - Beware of “flip” partnerships with tax-exempt partners
- Depreciation is decelerated; section 470 loss deferral rules may also apply

Number 2 Mistake: Letting Ineligible Entities Prevent Receipt of Grant

- Certain persons are not eligible to receive Treasury grants:
 - Federal, state or local governments
 - Section 501(c) entities that are tax-exempt
 - Clean renewable energy bond lender
 - Cooperative electric company
 - State, territory, possession of the United States, District of Columbia, Indian tribal government, and any political subdivision thereof, or
 - Partnership (or other pass-thru entity) that has one of the above as a partner
- Exception if the entity above owns its interest in the pass-thru entity through a taxable C corporation
 - Note that use of a “blocker corporation” will still affect depreciation
- Foreign entity/person may be eligible if more than 50% of gross income is subject to US tax.

Number 1 ½ Mistake: Individuals and Small Corporate Investors

- Passive activity loss rules apply to both the tax credits and the depreciation deductions
- In order for such rules to be inapplicable, an individual must materially participate in the activity which generates the tax benefits
- Can only use tax benefits against income from other passive solar investments
- At-risk rules must also be considered for individuals and closely-held corporations

Number 1 Mistake: Forgetting About the Service Contract Rules

- PPAs must be respected as service contracts under section 7701(e) of the Code
- Special safe harbor for “alternative energy property”
 - Four “foot faults”: (1) operator foot fault; (2) significant financial burden foot fault; (3) significant financial benefit foot fault; and (4) purchase option foot fault
 - Related party rules: Beware of municipalities and operators that can trace roots to the state
 - “Higher of” purchase options: Higher of FMV or termination value may not satisfy purchase option foot fault
 - Force majeure events and events beyond service provider’s reasonable control
- Directly applicable if tax-exempt service recipients but also applicable to taxable service recipients

Questions?

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