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Financing Renewable Energy Projects: Sources of Capital and Current Federal Income Tax Issues

Brought to you by Winston & Strawn LLP's Tax and Energy Practice Groups

Today's eLunch Presenters



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Sources of Capital for Renewable Energy Projects

Types of Financing

- Project-Level Debt
- Tax Equity Investors
- PPA Prepayments
- Cash Grant
- Other
 - Corporate-Level equity and debt
 - Development capital
 - DOE loan guarantee

Debt Tranches

- Turbine/Panel Supply Loan
- Construction Loan
- Equity Bridge Loan
- Cash Grant Loan
- Term Loan

Features

- Timing
 - All project documents in place with creditworthy counterparties
 - All material permits in place
- Security Package
 - Pledge of all assets of project company, including project documents
 - Pledge of all interests in project company
- Grant-specific issues
 - Recapture risk at project level
 - Disqualified Persons
 - Use of Property

Trends

- Additional players have (re-)entered the market
- Spreads are lower
- Tenors are longer – beyond the "mini-perm" but not yet out to 15-17 years

Tax Equity

- Goal to monetize tax benefits inherent in renewable energy projects that may not be efficiently used by developer
 - "Permanent" benefit of the 2.1¢/kwh production tax credits ("PTCs") over first 10-years of operation (e.g., wind, biomass and geothermal)
 - "Permanent" benefit of the 30% investment tax credit ("ITC") (PTC qualified resources and solar)
 - "Permanent" benefit, for construction commencing prior to end of 2010, ability to elect a grant in lieu of ITC
 - "Timing" benefit of accelerated depreciation deferral pattern
 - —5 year– 200% declining balance

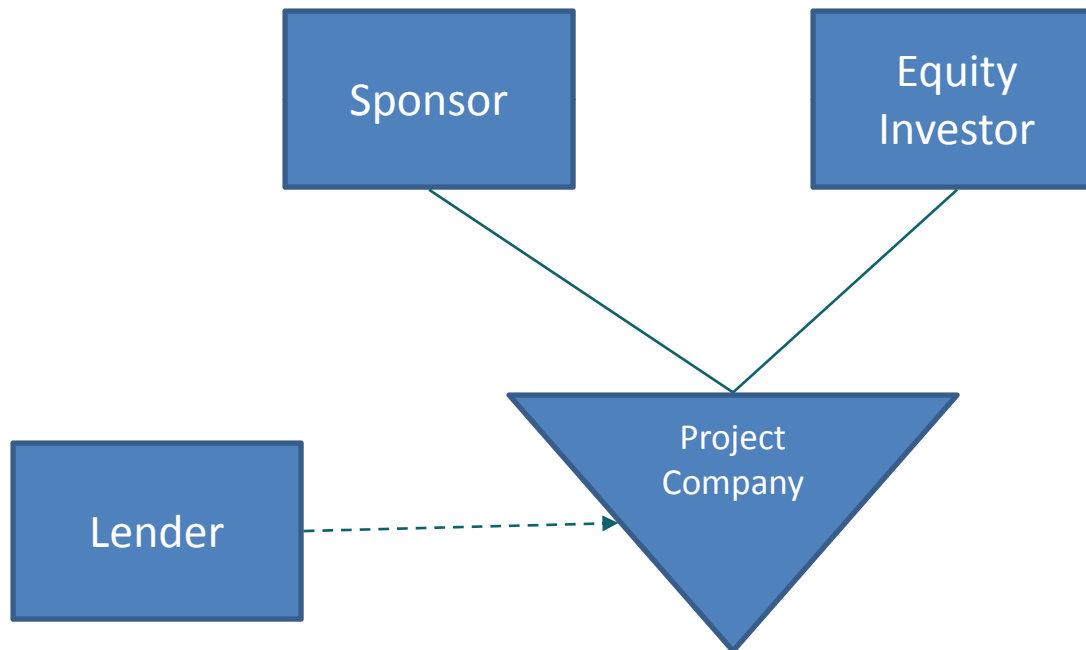
Tax Equity

Dependent on equity investor with tax base

- Current – ITC
- Projected – PTC and depreciation

Transaction Structures

- Partnership Flip (Rev. Proc. 2007-65)

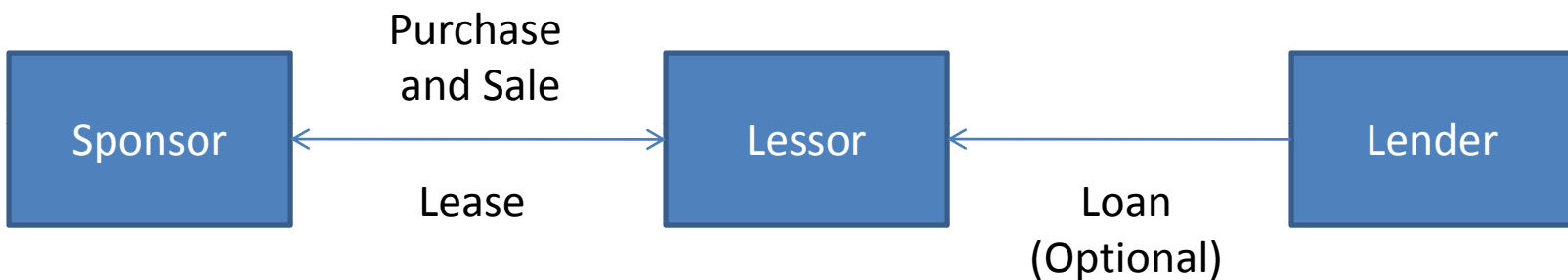


Transaction Structures – Partnership Flip

- Partnership tax items allocated up to 99% to equity investor until negotiated return achieved (the "flip"). Flip may be based on pre-tax or after-tax return
- After the flip, partnership items allocated up to 95% to sponsor
- Sponsor has right to purchase "tail" interest at fair market value or fixed price (determined at closing)
- Equity Investor takes "structural" tax risk (often including lack of "pure" expected pre-tax profit for tax investor)
- Some transactions include the ability of the equity investor to "put" its interest back to the sponsor at a date certain for a fixed price determined at closing

Transaction Structures (cont.)

■ Sale/Leaseback



Bottlenecks

- Intercreditor issues
- Full residual value buyout (fixed price option helps)
- Lack of transparency on pricing
- New structure / new documents
- "Credit" v. "Project" Lease

Benefits

- Unconditional rent payments
- Accounting treatment
- Lower pre-tax cost to Sponsor than pre-tax flip structure

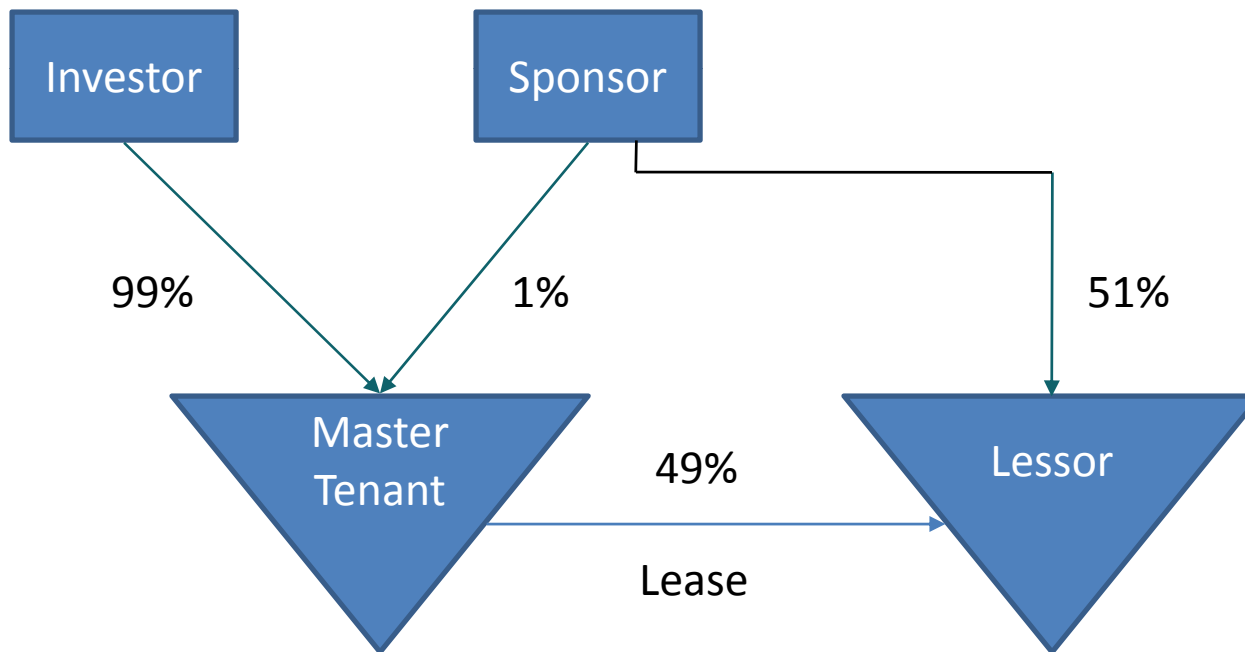


Transaction Structures – Sale/Leaseback

- Unconditional rent payments owed to Lessor
- Full residual buyout at date certain at fixed price determined at closing
- Difficult for Sponsors to compare lease pricing to partnership flip pricing
- New structure/new documents
- Intercreditor issues

Transaction Structures (cont.)

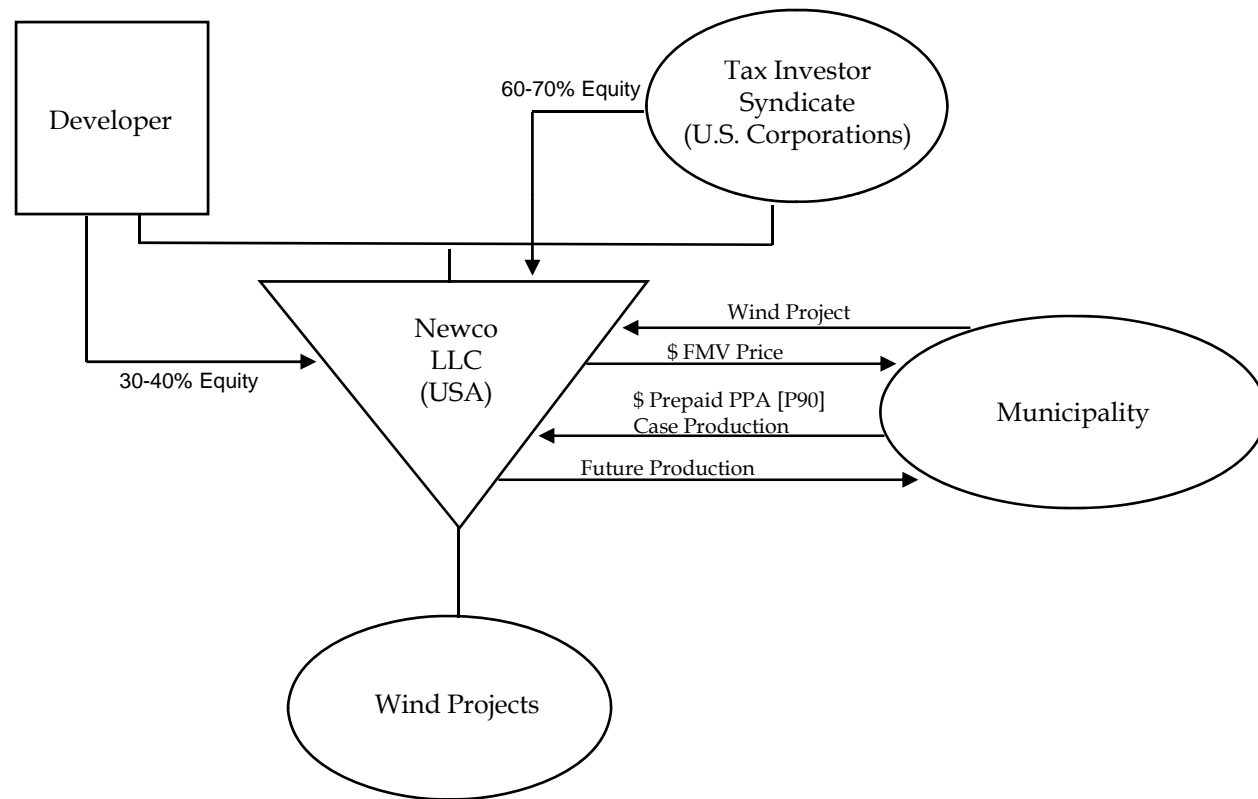
- Inverted Lease Flip Structure



Transaction Structures – Inverted Lease

- Election made to pass ITC/Grant to Lessee
- Equity Investor entitled to annual preferred cash distribution
- Beyond preferred cash distribution, all available cash is for Sponsor
- Investor holds put right after 5 years at greater of (a) FMV or (b) fixed percent of investment
- Sponsor has call at FMV

PPA Prepayments



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Other

- Department of Energy Loan Guarantee Program
 - Timing
 - National Environmental Protection Act requirements
 - Lenders are applicants (FIPP)

- Corporate-level equity or debt
 - IPOs
 - Private placements

- Development Capital

Current Federal Income Tax Issues for Renewable Power Projects

Grant-Related Issues

- Risk of grant availability and amount
 - Borne by investor or sponsor
- Accrual of tax-exempt income
 - Treasury follow-up shows application not ministerial
- Upstream ownership
 - Due diligence v. representations for comfort
- Allocation of tax-exempt income
 - Special allocation to Investor

Grant-Related Issues

- Grant recapture liability
 - Generally borne by Sponsor with Investor liable for own acts
- Capitalization of development fees
 - Outside of cash grant — Treasury recognizes reasonable development fee as included in credit eligible basis
 - Treasury (NREL) scrutiny for cash grant
 - Factual support: appraised FMV, arm's-length fee, services rendered

Issues for 2010

- ARRA Technical Corrections Bill
 - Grant not included in taxable income for AMT purposes
 - Grant recapture liability is treated as a tax liability (subject to IRS audit and collection procedures)
 - Tax exempt investor permitted if grant is with respect to unrelated trade or business property

Issues for 2010 (cont.)

- Beginning of construction requirement
 - Facilities completed after 2010 can receive a cash grant only if construction began in 2009 or 2010
 - Such facilities must be placed in service prior to their credit termination date
 - January 1, 2013 for wind
 - January 1, 2017 for solar

Issues for 2010 (cont.)

- Beginning of construction
 - Construction begins when "physical work of a significant nature" begins
 - For self-constructed property, physical work of a significant nature begins when such work commences at the site
 - For property constructed under a contract, physical work of a significant nature begins when such work begins under a written binding contract

Issues for 2010 (cont.)

- Beginning of construction – safe harbor
 - Applicant may treat physical work of a significant nature as beginning when the applicant incurs or pays more than five percent of the total costs of the property (excluding the cost of any land and preliminary activities)

Issues for 2010 (cont.)

- Beginning of construction – safe harbor
 - When property is self-constructed, costs are treated as paid or incurred when paid or incurred by the applicant
 - Developers should closely record activities conducted and costs incurred in 2010, which will likely be the subject of due diligence and a representation
 - When property is constructed under a contract, costs are paid or incurred either (i) when the property is provided to the applicant, or (ii) when costs are paid or incurred by the contractor
 - Expect Developers to seek certification from contractor that five percent of costs have been incurred under contract

Issues for 2010 (cont.)

- Beginning of construction – open issues
 - Treasury rejected five percent non-refundable down payment safe harbor
 - Treasury reasoned purpose of ARRA was to encourage actual economic activity during 2010
 - Can same result be achieved by causing contractor to pay five percent of costs to subcontractors / component manufacturers in 2010?
 - Contractor will have to have incurred these costs under Section 461 and may be required to trace the costs to particular units of property ultimately delivered to the taxpayer
 - Contractor certifications should confirm costs attributable to actual units of property in fact incurred
 - Raises difficult issues for contractors producing large numbers of generally identical property (e.g., solar panel manufacturers)
 - Treasury has not clarified when property will be treated as produced under contract versus self-constructed
 - Analogous authorities hold that property must be highly customized to taxpayer's specifications to be treated as self-constructed if manufactured under a contract



Issues for 2010 (cont.)

- Economic substance codification (Healthcare and Education Reconciliation Act of 2010)
 - Two-part test: (A) transaction "changes in a meaningful way" (apart from tax) the taxpayer's economic position, and (B) taxpayer has "a substantial purpose" (apart from tax) for entering into such transaction
 - Potential for profit can satisfy (A) and (B) only if the "present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits"
 - No indication of what satisfies the "substantial" threshold



Issues for 2010 (cont.)

- Economic substance codification (Healthcare and Education Reconciliation Act of 2010)
 - Underpayment penalty applies without reasonable cause exception
 - Penalty increased to 40% if transaction is not adequately disclosed

Issues for 2010 (cont.)

- Economic substance codification (Healthcare and Education Reconciliation Act of 2010)
 - Statute purports not to change the circumstances in which the economic substance doctrine applies
 - Joint Committee on Taxation explains in a footnote that doctrine is not intended to apply if the tax benefits are "consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate"
 - "Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage." Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10 at 152 fn. 344 (March 21, 2010).

What Comes Next?

- **Schumer’s “Buy American” Bill (S. 3069)**
 - **Requires all iron, steel, and manufactured goods used in the project to be produced in the United States**
 - Exceptions apply if the Federal department or agency involved determines (A) such restrictions are inconsistent with the public interest, (B) sufficient amounts are not produced in the United States, or (C) use of United States produced goods would increase the overall cost of the project by more than 25 percent
 - **Requires Treasury to analyze each potential grant recipient for domestic job preservation and creation related to (A) production of equipment, (B) installation of equipment, and (C) operation of the equipment**
 - Such analysis must be submitted to Senate Finance Committee and House Ways and Means Committee within 30 days after application for a grant



What Comes Next? (cont.)

- Renewable Energy Expansion Act of 2010 (H.R. 4599)
 - Replaces grant with "Refundable ITC"
 - At election of the taxpayer, will be treated as making a payment against tax equal to the applicable percentage of the basis of specified energy property
 - Applicable percentage conforms to ITC percentage (generally, 30 percent)
 - Election is available for property (A) originally placed in service before January 1, 2013, or (B) placed in service before credit termination date, but only if the construction of such property began before January 1, 2013
 - Does not extend credit termination dates
 - Extends group of "disqualified persons" to include pension and profit-sharing plans in addition to those under the grant program
 - Exclusion does not apply to tax-exempt entities if substantially all income from such property is unrelated business taxable income
 - Only pro rata portion of payment, equal to percentage interest in entity owned by a disqualified person, is disallowed



What Comes Next? (cont.)

- Renewable Energy Expansion Act of 2010 (H.R. 4599)
 - Election is made at entity level in case of partnerships and S corporations
 - Partnership is treated as making a tax payment only to the extent of the proportionate share of the partnership that is owned by persons who would be treated as making such payment if energy property was placed in service by such persons
 - Rules similar to those under Section 168(h)(6) that prohibit disproportionate allocations where partnerships have tax exempt partners apply
 - Limitations on REITs do not apply
 - Normalization is not required if utility is required to sell a minimum amount of electricity from renewable sources
 - Any credit or refund is excluded from gross income and alternative minimum taxable income



What Comes Next? (cont.)

- Renewable Energy Expansion Act of 2010 (H.R. 4599)
 - **Materially changes timing of cash flows**
 - Because treated as a payment of tax, refund cannot be claimed until filing of tax return in comparison to 60-day payment period for grant
 - Bill provides that payment shall be treated as made on the later of the due date of the tax return or the date on which the tax return is filed (so no earlier than April 15 for calendar year partnership)
 - **Unclear whether refunded amount increases tax basis**
 - Bill provides that any credit or refund shall not be included in gross income or alternative minimum taxable income
 - Unclear whether refund constitutes tax-exempt income that can be specially allocated to tax investor or simply a tax refund

What Comes Next? (cont.)

- Renewable Energy Expansion Act of 2010 (H.R. 4599)
 - Unclear whether recapture applies at entity or partner level
 - Bill provides that rules similar to rules under Section 50 shall apply
 - However, partnership makes the election to claim the refundable credit and partnership's information return is treated as a tax return for this purpose
 - Unclear whether credit amount will be evaluated in advance of payment
 - Bill requires the provision of such information as the Secretary may require for purposes of "verifying the proper amount to be treated as a payment"

What Comes Next? (cont.)

- Renewable Energy Incentive Act (S. 2899)
 - Extends cash grant program through 2012 and facilities for which construction begins prior to December 31, 2012
 - Expands eligibility to include State-owned utilities

Winston & Strawn LLP has prepared these materials for information purposes only. These materials do not constitute legal advice and cannot be relied upon by any taxpayer for the purpose of avoiding penalties imposed under the Internal Revenue Code.



Questions?



Thank You.

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