



The American Recovery And Reinvestment Act Of 2009: Payments For Specified Energy Property In Lieu Of Tax Credits For Renewable And Alternative Projects

I. Introduction

The newly enacted American Recovery and Reinvestment Act of 2009 (the “ARRA”) represented a transformative shift in Congress’ policy for encouraging the development and operation of renewable and alternative energy projects in the United States.

Traditionally, because developers and owners of renewable energy assets lacked the tax base necessary to efficiently use the array of tax incentives for renewable energy assets in the form of production tax credits (“PTCs”), investment tax credits (“ITCs”), and accelerated tax depreciation under the Internal Revenue Code of 1986, as amended (the “IRC”), developers and owners received value for them by entering into sale-leaseback (for ITCs) or “flip partnership” (for ITCs or PTCs) financing structures designed to allow tax equity investors, typically large financial institutions, to claim the tax incentives. These financing structures worked well enough as long as there were sufficient tax equity investors with a stable tax base to fill the financing needs of developers.

However, the financial difficulties in the U.S. capital markets reduced both the number of these tax equity investors and the investment capacity of the remaining tax equity investors.

In response, the ARRA included the following provisions:

- allowing the elective conversion of PTCs for a renewable energy project into an ITC under IRC section 48,
- *and most significantly, under Section 1603 of ARRA, making all IRC section 48 ITCs convertible into an equivalent (nontaxable) cash payment (“ITC Direct Payment”) from the Department of the Treasury (“Treasury”).*

The ITC Direct Payment is available for projects that are either (i) placed in service during 2009 or 2010, or (ii) placed in service after 2010 (but before the expiration date for the corresponding ITC) if construction for such projects began during 2009 or 2010. The time for ITC Direct Payment is stated to be during the 60 day period beginning on the later of (1) the date of application of the ITC Direct Payment or (2) the placed-in-service date for the relevant project. The ARRA includes a corresponding appropriation of “such sums as may be necessary to carry out” the ITC Direct Payment program, (*i.e.*, a literally unlimited appropriation of money by Congress).

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The passage of the ITC Direct Payment program was greeted by the renewable/alternative energy industry with a mix of both great anticipation and apprehension concerning how Treasury would implement this program (*i.e.*, what type of documentation would be required by Treasury). This apprehension grew as the time for Treasury to issue preliminary Guidance Document passed the initial 60 day period after which payments could begin to be made under the ITC Direct Payment program and early reports of the Guidance Document being written by Treasury appeared to include some somewhat counterproductive interpretations of ARRA Section 1603.

Finally, on July 9, 2009, Treasury issued the following statement and materials:

The Treasury Department is not accepting applications for [the ITC Direct Payment] program at this time¹.

However, to help facilitate the timely flow of program funds to eligible businesses, we are publishing several key documents in advance in order to give ample time for businesses to prepare applications and expedite implementation of this program. Posted here are the *guidance document*, *terms and conditions*, and a *sample application form*. Please read each of the documents carefully.

A notice, with further instructions, will be posted here when Treasury is ready to begin receiving applications via a web-based application designed to further expedite program implementation.

After reviewing these materials, the consensus generally is that this Guidance Document was generally worth the wait, in that Treasury has crafted a set of reasonable, practicable, and user-friendly rules. As a result, we anticipate that the ITC Direct Payment program will move forward rapidly and transform the way in which U.S. renewable/alternative energy assets are financed over the next few years.

Summaries of the relative availability and terms of the ITC Direct Payment to various renewable and alternative energy facilities are provided in the charts attached to this briefing. The discussion below focuses on some of the more significant parts of the ITC Direct Payment Guidance Document and on how the financing structures that developers or owners of renewable/alternative energy assets and tax equity investors may change in light of that

Guidance Document.

II. ITC Direct Payment Materials from Treasury FAS

A. Guidance Document

General Approach

In general, Section 1603 of the ARRA provided Treasury with the authority to apply rules to an ITC Direct Payment “similar” to the rules of IRC section 50 for the IRC section 48 ITC. Moreover, the legislative history indicates that the ITC Direct Payment program is intended to “mimic” the operation of the IRC section 48 ITC.

Accordingly, based upon this statutory provision and legislative history, Treasury could have adopted the approach that all of the constraints and parameters applicable to the IRC section 48 ITC are to be incorporated into the ITC Direct Payment program, and administered the program in the same manner as an additional tax with all the enforcement powers and liens as the IRS has with respect to a recapture of the ITC (the “strict incorporation approach”).

However, the strict incorporation approach for the rules of IRC section 48 ITC was not adopted for the ITC Direct Payment program. The reasons perhaps include that responsibility for the ITC Direct Payment within Treasury was assigned to the Fiscal Assistant Secretary (“Treasury FAS”), that was less familiar or comfortable with tax than the IRS or the Office of Tax Policy, then acted only in an advisory role. Further, Treasury FAS apparently concluded that the legal authority for it to administer the program in the same manner as a tax was at least doubtful. Finally Treasury FAS, may also have resisted some of the results from this strict approach.

In any event, the result is that the Guidance Document for the ITC Direct Payment program is freely selective as to the circumstances when the ITC Direct Payment program “mimics” the IRC section 48 ITC and when it does not. Fortunately, however, as described with more specificity below, this selectivity was generally used to craft rules that are developer-friendly.

Eligible Applicants

One of the most puzzling aspects of the provisions of the ITC Direct Payment under Section 1603(g) of the ARRA is that it requires complete forfeiture of eligibility for an ITC Direct Payment by any tax partnership with a partner who is any of the following: (a) a federal, state, or local government, including any political subdivision, agency or instrumentality thereof; (b) a tax-exempt organization that is described in IRC section 501(c); (c) any entity that issues “clean renewable energy bonds;” or (d) a

¹ Representatives of Treasury FAS have informally indicated that the “window will open” and Treasury FAS will begin accepting ITC Direct Payment applications on or before August 1, 2009.

tax-exempt cooperative or mutual electric company (each of the foregoing being a “disqualified person”). The addition of this provision made the ITC Direct Payment *more* restrictive than the application of similarly based rules under the IRC section 48 ITC. (For purposes of the IRC section 48 ITC, such credit was lost in proportion to highest possible distributive share of partnership income that such disqualified entities, and other types of entities, could be allocated by the tax partnership.) Moreover, there was concern that ARRA 1603(g) would be interpreted, by virtue of a strict incorporation approach to pick up as additional disqualified persons those persons defined as such under the rules of the IRC section 48 ITC applied (*e.g.*, a taxable C corporation that was owned more than 50% by tax-exempt organizations described in IRC section 501(c)).

The result of this provision was that any developer of a project that was organized as a tax partnership and that had an investment from a private equity fund probably could not qualify for an ITC Direct Payment because invariably the private equity fund had disqualified investors somewhere in its ownership. Consequently, most practitioners questioned the need or wisdom of this provision.

When faced with this provision and requests from industry players for relief, Treasury FAS understandably replied that the statutory language prevented them from providing any general relief. Accordingly, the Guidance Document generally defines a disqualified person by repeating the statutory language of ARRA 1603(g). However, Treasury FAS did address in a helpful manner the concern that the strict incorporation approach would “double up” the definition of disqualified person to include additional persons under the rules of the IRC section 48 ITC by declining to adopt that approach with respect to any taxable C corporation. Accordingly, under the Guidance Document, a taxable corporation, some or all of whose shareholders are disqualified persons is not a disqualified person and such a corporation’s ownership of an interest in a partnership or other pass-through entity will not cause the partnership or other entity to be treated as a disqualified person.

This indirect disqualified person problem may still remain for many projects and ultimately require a statutory change because many governmental instrumentalities are investors in private equity funds and do not want a taxable C corporation blocker between themselves and the project. Without such a blocker, these indirect governmental partners would still cause a forfeiture of the eligibility of a project.

The Guidance Document provides that neither a REIT, nor a

cooperative organization described in IRC section 1381(a), is a pass-through entity for purposes of indirect disqualified persons. Accordingly, the presence of *any* disqualified person as a shareholder of a REIT or member of a cooperative that is a direct or indirect partner of a developer organized as a tax partnership does not cause complete forfeiture of ITC Direct Payment eligibility for projects of that developer.

However, the Guidance Document follows a strict incorporation approach with respect to the eligibility of REITs to receive an ITC Direct Payment. Thus, the ITC Direct Payment that may be received by a REIT is limited to a pro rata share of its investment, the numerator of which is its taxable income (determined without regard to any deduction for capital gains dividends and by excluding any net capital gain) and the denominator of which is its taxable income computed without regard to the deduction for dividends paid. Consequently, to the extent that a REIT makes distributions to zero out its taxable income (the most common result), such ratio would be zero, and it would not be eligible for the ITC Direct Payment.

The Guidance Document also adopts the strict incorporation approach in the applicant’s favor with respect to the favorable rule for the IRC section 48 ITC that a non-U.S. person or entity, including a foreign governmental entity, may be eligible for an ITC Direct Payment, as long as at least 50% of the income recognized by the non-U.S. person or entity from the project is subject to U.S. income taxation.

Recapture

Under Section 1603(f) of ARRA, Treasury must, in applying rules for the ITC Direct Payment similar to the rules of IRC section 50 for the IRC section 48 ITC, provide for recapture of the ITC Direct Payment if “the project is disposed of, or otherwise ceases to be specified energy property” within the five-year recapture period. Recapture would mean that at least a portion of an ITC Direct Payment received would be required to be paid back to Treasury.

If Treasury FAS had adopted an approach of strictly incorporating the rules of IRC section 48 ITC in the Guidance Document, an ITC Direct Payment per the legislative history, would have been “paid to whichever party would have been entitled to” the corresponding ITC. Thus, an ITC Direct Payment would have been paid to, and any recapture liability would belong to, the taxpayer(s) who would have claimed the corresponding ITC². Moreover, events triggering recapture would then have included

² As the proceeds of an ITC Direct Payment would be required to finance the project, the agreement among the owners and lenders will certainly require the grant proceeds to be contributed to the project company unless such owners already had “fronted” the money to the project.

any disposition of the underlying project, including pursuant to foreclosure, and a disposition by a tax partner of its interest in a tax partnership which owned a relevant project. Finally, the strict incorporation approach would have satisfied lenders to a project because foreclosure upon the project and/or the owners' interest therein could proceed without interference from Treasury and without inheriting any liabilities because the recapture liability would remain with the equity owners, rather than attach to the project in any form. On the other hand, the strict incorporation approach created concern for potential tax equity investors in projects because of such a foreclosure triggering recapture liability to them.

However, under the Guidance Document, Treasury FAS instead has incorporated only some of the rules of IRC section 50 in respect of recapture of the ITC Direct Payment, and rejected outright some of such rules. As an initial matter, the Guidance Document does provide that recapture liability "ratchets down" over a five-year period from the placed-in-service date, in the manner of the IRC section 48 ITC³.

However, the Guidance Document also provides that, in the case of a tax partnership, as long as each direct and indirect partner in the partnership (or other pass-through entity) would be eligible to receive Section 1603 payments, the relevant "Applicant" for an ITC Direct Payment is the tax partnership, and not the ultimate tax partners/taxpayers. This treatment arguably is directly contrary to the prescribed payee of an ITC Direct Payment under the legislative history.

When practitioners first heard of this proposed definition of "Applicant," there was great concern that this approach would interfere with the expectation of lenders that they be able to exercise remedies without bearing any economic cost for recapture of an ITC Direct Payment either directly or indirectly by encumbrance on the project.

Thankfully, the Guidance Document addresses this concern by not following the strict incorporation approach with respect to the events that trigger recapture. Instead, under the Guidance

Document, a project ceases to qualify as "specified energy property" (*i.e.*, eligible for an ITC Direct Payment) if the use of the project changes so that it no longer qualifies as specified energy property. For example, use of a project predominantly outside the United States in a year will result in recapture. Further, permanent cessation of production of electricity by the project will result in recapture. In contrast to the rule for the IRC section 48 ITC, whereby any disposition of the underlying project, including pursuant to foreclosure, and a disposition by a tax partner of its interest in a tax partnership that owned a relevant project, would trigger recapture, the Guidance Document provides that only a transfer to a disqualified person (of any interest in the project or any interest in a partnership or pass-through entity) will trigger recapture. Finally, receipt of an ITC Direct Payment does not create a lien on the project in favor of the United States, and any recapture liability is not considered a tax liability.

Accordingly, selling or otherwise disposing of the project, or an interest in the project company partnership, to an entity other than a disqualified person will not result in recapture, provided the project continues to qualify as a specified energy property. This favorable rule should allow a project lender to foreclose on a project (or a partnership interest in a project company) without incurring any recapture liability. Further, the equity owners of the project, including any tax equity investors, also would not suffer any cost of recapture upon that foreclosure unless and until the project ceased to be specified energy property⁴.

Further, the Guidance Document helpfully provides that temporary cessation of energy production will not result in recapture provided the owner of the project intends to resume production at the time production ceases. Even a permanent cessation of production due to natural disaster will not result in recapture if the project is replaced with a project for which an ITC Direct Payment is allowed. Replacement would be treated as occurring if the applicant uses IRC section 1033 to avoid gain recognition.

Perhaps of all of the provisions in the Guidance Document, this decision not to follow the strict incorporation approach is the most significant and helpful to project developers going forward.

³ Consequently, 100% of an ITC Direct Payment must be repaid if the disqualifying event takes place within one year from the date placed in service; 80% of an ITC Direct Payment must be repaid if the disqualifying event takes place after one year, but before two years, from the date placed in service; 60% of an ITC Direct Payment must be repaid if the disqualifying event takes place after two years, but before three years, from the date placed in service; 40% of an ITC Direct Payment must be repaid if the disqualifying event takes place after three years, but before four years, from the date placed in service; and 20% of an ITC Direct Payment must be repaid if the disqualifying event takes place after four years, but before five years, from the date placed in service.

⁴ For a hydropower project where incremental hydropower production has been licensed by FERC, recapture will not take place if actual incremental increases in energy production do not occur that year due to environmental and/or regulatory factors. Recapture for a hydropower project installed on a nonhydroelectric dam will occur if the FERC license is surrendered or repealed based on significant changes in water surface elevation caused by operation of the project. If the amount of the ITC Direct Payment depends on the percentage of electricity produced from biomass (in the case of closed-loop and open-loop biomass facilities) or the energy efficiency percentage (in the case of combined heat and power system, a project using biomass) and the percentage is reduced, a proportionate percentage of the project ceases to qualify as specified energy property. The applicable percentages will be determined on an annual basis for the year beginning on the date the project is placed in service and for each succeeding year within the recapture period. No additional grant will be allowed in a subsequent year in which the percentage increases.

Given the existing constraints faced by developers in today's capital markets in raising project debt and tax equity financing, any interference with the expectation of lenders that they be able to exercise remedies without bearing any economic cost for recapture of an ITC Direct Payment (either directly or indirectly by encumbrance on the project) or possible liability of tax equity investors for ITC Direct Payment upon any such exercise of lender remedies, was absolutely critical. Treasury FAS recognized that, even if the original investor disposes of its interest in the project, if the project continues to generate energy in the statutorily favored manner, the public policy goal of investment in a long-term asset has been achieved and recapture is not appropriate. Treasury FAS is to be commended for its practical approach on this issue.

Perhaps less helpful is the provision within the Guidance Document that the seller of a project must continue as jointly liable with the purchaser for any recapture liability. Recapture would occur in the event the project is resold to a disqualified person or ceases to qualify as a specified energy property. The applicant remains jointly liable to Treasury for the recapture amount even if the applicant no longer has control over the project. (Generally speaking if the applicant is a project company, taxed as a partnership, upon sale of the project, the project company would typically liquidate; it is not clear whether the owners of the project company in that case would be required to assume their pro rata share of the joint recapture liability.)

Applicants will not be required to post a bond as a condition of receiving an ITC Direct Payment. However, any recapture liability will be considered a debt owed to the United States, subject to enforcement and collection by the United States Department of Justice through all available means and against any assets of the applicant.

Eligible Basis

The ITC Direct Payment is calculated as an applicable percentage of the basis of "specified energy property." "Specified energy property" is defined as any qualified property that is part of a "qualified facility" (*i.e.*, those PTC renewable facilities eligible for elective conversion into an ITC under IRC section 48) and other property eligible for the IRC section 48 ITC.

With respect to the tax basis of the property that is the "specified energy property" portion of a project, the Guidance Document closely follows the strict incorporation approach of the rules for the IRC section 48 ITC. The eligible basis of a qualified project does not include the portion of the cost of the project that is attributable to a non-qualifying activity.

Consequently, specified energy property includes only depreciable tangible property that is both used as an integral part of the

activity performed by a qualified project and located at the site of the qualified project. Property is an integral part of a qualified project if the property is used directly in the qualified project, and is essential to the completeness of the activity performed in that project.

Qualified property does not include a building, but may include structural components of a building. Roadways and paved parking areas located at the qualified project and used for transport of material to be processed at the project or equipment to be used in maintaining and operating the project are integral to the activity performed there, but roadways or paved parking lots that provide solely for employee and visitor vehicle traffic are not an integral part a qualified project.

For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items, but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

Generally, a qualified project must be capable of operating as an independent unit even though the property is installed at the site of an existing project. Certain modifications to property installed on an existing project qualify as specified energy property even if the project was placed in service before 2009.

The tax basis of qualified property is determined in accordance with the general rules for determining the basis of property for federal income tax purposes. Thus, the basis of property generally is its cost (IRC section 1012), unreduced by any other adjustment to basis, such as that for depreciation, and includes all items properly included by the taxpayer in the depreciable basis of the property, such as installation costs and the cost for freight incurred in construction of the specified energy property.

Based upon the adoption of the strict incorporation approach in determining qualified tax basis, the foregoing rule should also allow for an arm's length, development fee to be paid to the developer for actual services rendered, recognized by the developer as taxable income and capitalized into qualified tax basis for purposes of an ITC Direct Payment, as it would in calculating the tax basis for purposes of the IRC section 48 ITC.

Costs that will be deducted for federal income tax purposes in the year in which they are paid or incurred are not includible in the basis on which the payment is determined. For example, if the applicant will take the IRC section 179 deduction for all or part of the cost of the property, then no payment is allowed for the

portion of the cost of the property for which the IRC section 179 deduction will be taken.

Placed in Service

In order for otherwise qualified property to be eligible for an ITC Direct Payment, the Guidance Document provides that the original use⁵ of such property must begin with the applicant. In addition, the Guidance Document does incorporate for purposes of the ITC Direct Payment the rule under the IRC section 48 ITC (IRC section 45 PTC) that if the cost of the used parts contained within a facility is not more than 20 percent of the total cost of the facility (whether acquired or self-constructed), an applicant will not fail to be considered the original user of property because the facility contains used parts.

Interestingly, the Guidance Document defines “placed in service,” not simply by reference to being placed in service for federal income tax purposes, but somewhat cryptically as when “the property is ready and available for its specific use.” This definition very generally tracks what it means to be placed in service for federal income tax purposes, but a more specific statement adopting the strict incorporation approach for the IRC section 48 ITC would have provided greater certainty. It is not clear whether Treasury FAS meant for placed in service for purposes of an ITC Direct Payment to be any different (*i.e.*, less restrictive) than the same concept for federal income tax purposes.

Under Section 1603(a) of ARRA, only the cost basis of qualified property placed in service in 2009 or 2010 or, in the case of qualified property placed in service after 2010 for which construction begins in 2009 or 2010, before the termination date for the corresponding IRC section 48 ITC, is eligible for an ITC Direct Payment.

The two primary questions that practitioners had in respect of this provision of the ITC Direct Payment were as follows: (a) What does it mean for “construction to begin,” and (b) how do you determine the scope of a “qualified facility” (*i.e.*, those PTC renewable facilities eligible for elective conversion into an ITC under IRC section 48) which consists of multiple units. For

example, pursuant to the first question, would one “turn of a shovel” at the project site constitute “beginning construction”? Pursuant to the second question, in respect of a wind farm, in the “qualified facility” the entire wind farm or each separate wind turbine generator?

With respect to when construction begins, the Guidance Document generally follows the approach of the existing rules for determining when “construction begins” for purposes of qualifying for so-called “bonus depreciation” under IRC section 168(k). Consequently, “construction begins” when “physical work of a significant nature” begins. The determination of when “physical work of a significant nature begins” depends upon whether the asset is “self-constructed” by the applicant or not.

If an applicant manufactures, constructs, or produces (*i.e.*, “self-constructs”) qualified property for use in its own trade or business, physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. For example, in the case of a facility for the production of electricity from a wind turbine, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for the foundation, the setting of anchor bolts into the ground, or the pouring of the concrete pads of the foundation. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings and foundations), does not constitute the beginning of construction. However, if a facility such as a wind turbine and tower unit is to be assembled on-site from modular units manufactured off-site and delivered to the site, construction begins when physical work of a significant nature commences at the off-site location.

If the qualified property is not self-constructed by the applicant, but instead the property is manufactured, constructed, or produced for the applicant by another person under a written binding contract (as described below) that is entered into prior to the manufacture, construction, or production of the property for use by the applicant, then construction begins for that applicant when

⁵ Interestingly, many practitioners had argued to Treasury FAS that ARRA Section 1630 contained no “original use” requirement, on the premise that the lack of that requirement indicated that a subsequent purchaser of a project did not violate the requirements of the ITC Direct Payment (and thus did not trigger recapture). Treasury FAS has rejected this assertion in the Guidance Document, but as noted above, still has fashioned a very generous recapture rule.

physical work of a significant nature begins under the contract⁶.

As with the same issue for determining property eligible for bonus depreciation, the Guidance Document provides a “safe harbor” for determining when construction begins. Under this safe harbor, an applicant may treat physical work of a significant nature as beginning when the applicant incurs (in the case of an accrual basis applicant) or pays (in the case of a cash basis applicant) more than 5 percent of the total cost of the property, excluding the cost of any land and preliminary activities described above. When property is not self-constructed, this test is measured in respect of amounts paid or incurred by the applicant, not another person⁷.

With respect to the scope of what is a “qualified facility” for purposes of determining the beginning of construction of property or the date property is placed in service, the Guidance Document begins by generally following the strict incorporation approach for the IRC section 48 ITC, by providing that all the components of a larger property are a single unit of property if the components are functionally interdependent. Components of property that are produced by, or for, the applicant are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. Thus, for example, on a wind farm, each electricity generating wind turbine, along with its tower and supporting pad, which may be separately operated and metered and produce electricity individually, constitutes a single “qualifying facility.”

However, as another example of the Guidance Document varying from the strict incorporation approach in order to provide greater flexibility for project developers, the Guidance Document further provides that an owner of multiple units of property that are located at the same site and that will be operated as a larger unit may elect to treat the units (and any property, such as a computer control system, that serves some or all such units) as a single unit of property for purposes of determining the beginning of construction and the date the property is placed in service. In such a case, the entire cost of such larger unit of property is taken into account in applying the safe harbor.

This election provides a rule of convenience for developers

and tax equity investors in respect to multiple unit projects. For example, for a wind farm consisting of 50 separate wind turbine generators that are placed in service over the course of six months in 2009, the applicant may forego having to apply and separately receive ITC Direct Payments in respect to each wind separate wind turbine generator.

Further, this election will be particular “applicant friendly” in respect to allowing large projects that begin construction by the end of 2010 to qualify for an ITC Direct Payment in their entirety. For example, the applicant/owner of a wind farm begins physical construction of the wind farm for 50 separate wind turbine generators, completing three by the end of 2010 (where each wind turbine generator costs the same amount), and the remaining 47 in 2011. Under this election, the entire 50 wind turbine generators are eligible for an ITC Direct Payment. Moreover, the Guidance Document does not require consistency of this election in cases where it would not be advantageous. For example, in the above example, if the applicant/owner placed in service only 40 of the planned 50 turbines were placed in service by the credit termination date, the applicant still would be eligible for an ITC Direct Payment for the 40 turbines placed in service.

On the other hand, the Guidance Document does not allow an applicant/owner to use this election to “reach back” and include units that were placed in service before January 1, 2009 as part of a larger unit placed in service after December 31, 2008 (eligible for an ITC Direct Payment). Consistent with this approach, the Guidance Document provides that an addition to or expansion made after 2008 to a qualified project placed in service before 2009 may constitute qualified property to the extent of that addition or expansion.

Leasing

With one very large (arguable) exception, discussed below, the Guidance Document closely follows the strict incorporation approach of the rules for the IRC section 48 ITC in providing rules for leasing.

Accordingly, if new qualified property is originally placed in service by a person and is sold to an applicant and leased back

⁶ As is provided under the Treasury Regulations for bonus depreciation, for purposes of the ITC Direct Payment for property that is not self-constructed, a contract is binding only if it is enforceable under state law against the applicant or a predecessor, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. If a contract provides for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding. A contract is binding even if the contract is subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or any term is yet to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the applicant or a predecessor will be treated as binding notwithstanding the fact that certain terms remain to be negotiated by the parties to the contract. An option to either acquire or sell property is not a binding contract. A binding contract does not include a supply, or similar, agreement if the amount and design specifications of the property to be purchased have not been specified.

⁷ For the purpose of determining whether an applicant has incurred more than 5 percent of the total cost of the property, the economic performance standards of IRC section 461(h) apply.

to the person by the applicant within three months after the date the property was originally placed in service by the person, then unless the lessor and lessee elect otherwise, the applicant-lessor is considered the original user of the qualified property for purposes of the ITC Direct Payment and the qualified property is considered to be placed in service not earlier than when it is used under the leaseback.

However, the Guidance Document is surprisingly silent as to whether the sale-leaseback of qualified property by a disqualified person would be eligible for an ITC Direct Payment. Under a strict incorporation approach, the answer would be definitely not. However, as noted throughout this briefing, the Guidance Document for the ITC Direct Payment program is freely selective regarding the circumstances when the ITC Direct Payment program “mimics” the IRC section 48 ITC and when it does not. This selectivity at least leaves open the possibility that an ITC Direct Payment would be available in such circumstances. (In that the Guidance Document states that “[a]pplicant eligibility will be determined as of the time the application is received,” absent any further guidance, presumably Treasury FAS will settle this question upon receipt of the first application with such circumstances.)

As with the IRC section 48 ITC, a lessor is eligible to receive an ITC Direct Payment in connection with qualified property may elect, on a property-by property basis, to pass-through the ITC Direct Payment to a lessee (with the lessee’s consent). In contrast to the silence with respect to the need for lessee qualification in a sale-leaseback, the Guidance Document provides that in order to make this election, both the lessor and the lessee must be persons eligible to receive an ITC Direct Payment. Additionally, this election may not be made by a lessor that is a mutual savings bank or similar financial organization, a regulated investment company, or a REIT.

Such an election will treat the lessee as having acquired the property for an amount equal to the independently assessed fair market value of the property on the date the property is transferred to the lessee, meaning that the ITC Direct Payment may be calculated on the higher purchase price, rather than lessee cost. Otherwise, the Guidance Document states that in such cases the ITC Direct payment will generally follow the rules in the IRC and Treasury regulations governing elections to allow lessees to receive energy tax credits, including that the lessee must agree to include ratably in gross income over the five-year recapture period an amount equal to one-half of the amount of the ITC Direct Payment.

In a sale-leaseback transaction, in order for the seller-lessee to retain and claim the ITC Direct Payment, the lessee must have

originally placed the property in service, and the property must be sold and leased back by the lessee (or if not leased to the seller, must be leased to the lessee), within three months after the date the property was originally placed in service.

Where a lessor elects to pass through the ITC Direct Payment to a lessee, if the lessor sells the project to a disqualified person, the lessee is liable to Treasury for the recapture amount even if the lessee maintains control over the project. If the lease is terminated and possession of the project is transferred by the lessee to the lessor or any other person, the lessee is liable to Treasury for the recapture amount if the use of the project changes during the recapture period to a disqualified use.

Partnership Tax Accounting

The Guidance Document is also somewhat surprisingly silent on how an ITC Direct Payment is to be accounted under the partnership tax accounting rules. The ITC Direct Payment is non-taxable income, so under a strict incorporation approach, such amount would be allocable partnership income for both outside tax basis of the partner’s interests in the partnership and partner’s capital accounts for purposes of determining whether the partnership allocations will be respected for federal income tax purposes.

The adoption by the Guidance Document of the favorable rule that selling or otherwise disposing of an interest in the project company partnership generally will not trigger recapture for that partner (unless sold to a disqualified person) eliminated the relevance of most of the corresponding partnership allocation and tax accounting rules under the IRC section 48 ITC.

It would follow from this rule (and irrelevance of most of the corresponding partnership allocation and tax accounting rules) that the non-taxable income resulting from a tax partnership’s receipt of an ITC Direct Payment generally may be allocated among tax partners in any way that would generally pass muster for an allocation of tax-exempt income. (Perhaps Treasury FAS will confirm this answer in subsequent guidance.)

B. Sample Application Form

General Approach

Another source of apprehension for the renewable energy industry concerning how Treasury would implement the ITC Direct Payment program concerned what documentation Treasury FAS would require in the application. Upon the issuance of the Guidance Document and Sample Application Form, the early consensus on this issue appears to be “it could have been worse.” Given the nature of the ITC Direct Payment program, direct payments with a literally unlimited appropriation of money by Congress, and the legal conclusion of Treasury FAS that it could

not use the enforcement powers and liens that the IRS has in connection with a recapture of an ITC Direct Payment, it is not surprising that Treasury FAS was very concerned about fraud. In light of that concern, it is also not surprising that the Sample Application Form requires that applicants submit a fairly detailed file, including some materials that require verification by third party (directly or as a matter of internal practice).

We would recommend that potential applicants take advantage of the current hiatus from being able to actually file an application to put these materials and file in order, including retaining necessary third party experts.

Under the Sample Application Form, applicants must agree to the terms and conditions applicable to the ITC Direct Payment program. Applications may be submitted on-line by going to www.treasury.gov/recovery after the qualified property is placed in service, or is under construction. A completed application will include the signed and complete application form; supporting documentation; signed Terms and Conditions; and complete payment information. The application form requests, among other identifying data elements, the applicant's Data Universal Numbering System (DUNS) number from Dun and Bradstreet. If the applicant does not already have a DUNS number, it may request one at no cost by calling the dedicated toll-free DUNS Number request line at 1-866-705-5711. Applicants must also register with the Central Contractor Registration (CCR) at www.ccr.gov/staJ1registration.aspx before an ITC Direct Payment can be made.

For property not yet placed in service at the time of the application, Treasury will review such applications and notify the applicant if all eligibility requirements that can be determined prior to the property being placed in service have been met. If so notified, applicants must then submit, within 90 days after the date the property is placed in service, supplemental information sufficient for Treasury to make a final determination.

If an applicant is applying for Section 1603 payments for multiple units of property that are treated as a single, larger unit of property, all such units may be included in a single application.

Treasury FAS will send a notice to the applicant if its application is approved. In cases where an applicant has not submitted sufficient information upon which a determination can be based, the applicant will be so notified and given 21 days from the date of the notice to submit additional information. If Treasury FAS

determines that the application does not qualify for payment, the applicant will be so notified, including the reasons for the determination, as the final agency action on the application (*i.e.*, there are no administrative appeals).

Eligible Property

The applicant must provide the following documentation to demonstrate that the property is eligible for an ITC Direct Payment:

Design plans -- Final engineering design documents, stamped by a licensed professional engineer.

Nameplate Capacity -- Documentation demonstrating that the property is designed to have a nameplate capacity that meets required minimums or maximums⁸. This documentation can be included within the required design plans or commissioning report, or with the original equipment manufacturer (OEM)/equipment vendor specification sheets.

(There are other documents that must be submitted, unique to particular renewable energy resources described in the attached charts.)

Eligible Basis

Applicants must submit with their application for an ITC Direct Payment documentation to support the cost basis claimed for the property, including a detailed breakdown of all costs included in the basis. Other supporting documentation, such as contracts, copies of invoices, and proof of payment, must be retained by the applicant and made available to Treasury upon request.

For properties that have a cost basis in excess of \$500,000, applicants must submit an independent accountant's certification attesting to the accuracy of all costs claimed as part of the basis of the property.

The standard that the independent accountant must apply in making this certification is an unanswered question that has raised concern among developers. Possible standards mentioned include the standard required of a public audit (very onerous), the standard required to sign a federal income tax return and signing under penalties of perjury. Given the potential for this certification to delay the filing of applications, further guidance from Treasury FAS on this issue would be very helpful.

⁸ This requirement applies for open-loop biomass facility (livestock waste nutrients), marine and hydrokinetic renewable energy facility, fuel cell property, microturbine property, combined heat and power system property, and small wind energy property only.

Placed in Service

Applicants must provide the following documentation to demonstrate that the property is placed in service:

Commissioning report from the project engineer, or the equipment vendor, or an independent third party that certifies that the equipment has been installed, tested, and is ready and capable of being used for its intended purpose.

Interconnection agreement (for properties placed in service that are interconnected with a utility) between the applicant and the local utility that establishes the terms and conditions under which the utility agrees to interconnect with the applicant's system, along with any subsequent documentation to demonstrate that the interconnection agreement has been placed in effect.

If a qualified property is under construction and not yet placed in service at the time of application, the applicant must include the following documentation to demonstrate that construction has begun on the property: (a) Paid invoices and/or other financial documents demonstrating that physical work of a significant nature has begun on the property, and if beginning of construction is based on the safe harbor, these documents must demonstrate that more than five percent of the total relevant costs of the property has been incurred or paid by the applicant, and (b) the binding contract (if the qualified property is not self-constructed).

III. Relevant Financing Structures with the ITC Direct Payment

At least until the ARRA, it was economically necessary to employ a financing structure investment from a tax equity investor for renewable energy projects to access the substantial value inherent in PTCs and ITCs and the accelerated tax depreciation associated with renewable energy projects.

The new options added by ARRA Section 1603, allowing the conversion of IRC section 45 PTCs to an IRC section 48 ITC, and the further option of converting the ITC into a cash ITC Direct Payment, in a sense "wipe the slate clean" as to what financing structure developers and institutional investors may find most efficient and desirable.

The first question that has come to the minds of many developers and investors in renewable energy is whether in light of the availability of the ITC Direct Payment there continues to be any

need for any investment financing structures (with their expense and complications) *at all*. Instead of depending on a tax equity investor to provide capital, the thought is that the developer could simply collect an amount equivalent to the ITC from Treasury under the ITC Direct Payment program and otherwise finance projects through more traditional, non-tax oriented sources (the "*go-it-alone strategy*"). In general, this go-it-alone strategy has become the "default" or worst case financing scenario for developers in making the decision to build a renewable energy project.

The forthcoming months will determine the answer to that fundamental question, and give a better sense of how the market will use the ITC Direct Payment program.

A. "Go-it-Alone" Strategy

To determine the net present value to a developer from the go-it-alone strategy is a function of: (a) reducing the net equity required from the developer to build the project after collecting the ITC Direct Payment, and (b) calculating the expected discounted after-tax cash flows from the project, after servicing any term debt. In calculating those after-tax cash flows, generally the tax losses generated from taking accelerated tax depreciation are assumed to be used only against the future taxable income from the project.

Obviously as a grant (and ignoring potential recapture), the ITC Direct Payment is a source of equity funds that requires no return on, or of, investment. Thus, in the go-it-alone strategy, the ITC Direct Payment creates significant leverage for the pre-tax and after-tax return to the project developer from a project.

To the extent that a project is "merchant" (including if it lacks a power purchase agreement of a sufficient term or with a counterparty without sufficient credit) or faces significant curtailment risk, generally tax equity investment would be particularly difficult to find for such a project. Long-term term debt financing may also be challenging for such a project in today's current environment. Consequently, for any such project, the go-it-alone strategy may be the likely option. However, for projects with at least a sufficient power purchase agreement, tax equity investment, through a "flip" partnership, sale/leaseback, or "inverted" lease, may still allow developers of projects to increase their net present values.

B. "Flip" Partnership

Although there are a number of different variations, the flip partnership is traditionally thought of as a financing structure that

complies with the safe harbor provided by Revenue Procedure 2007-65, I.R.B. 2007-50⁹. For at least the last six years, the flip partnership financing structure had been the predominant financing structure used by developers and tax equity investors to own and operate renewable energy projects eligible for PTCs and even for ITCs. The primary reason for this market predominance was that IRC section 45 PTCs could not be moved through a lease structure because the project owner for tax purposes also had to own the electrical production.

In light of the new option of converting the IRC section 45 PTCs to an IRC section 48 ITC, and the option of further converting that IRC section 48 ITC into a cash ITC Direct Payment, the first question in determining the optimal finance structure for an IRC section 45 PTC project is whether the available ITC Direct Payment is of equivalent net present value to that expected from a PTC tax-equity financing. This determination will vary by renewable energy type and even within a renewable energy type, project by project. In general, the higher the project capacity (*i.e.*, the greater the expected future energy production), the more valuable the PTCs will be relative to the ITC Direct Payment. The greater the project cost (*i.e.*, the greater the base relative to which the ITC Direct Payment is calculated), the more valuable the ITC Direct Payment will be relative to the PTCs. In addition, the presence of significant possible curtailment for a project (*i.e.*, the possibility of lower electricity sales), results in a higher discount applied in determining the net present value benefit of a PTC tax equity financing, making it less valuable relative to the ITC Direct Payment¹⁰. Finally, for many renewable energy projects with long-term construction periods (*e.g.*, biomass or large utility scale solar projects), a possible PTC tax-equity financing will not be

feasible for purposes of planning because tax equity investors will not commit to funding a project whose horizon for completion of development was beyond a year.

However, perhaps the greatest factor in the current market is the scarcity of investors that have an expectation of a long-term corporate tax base. The events in the credit markets over the last nine months have called into serious question whether investing on the basis of being fully taxable for the next 10 years is one that almost any institution is willing to make. Moreover, even those remaining institutions that have current tax basis and are comfortable investing on that long-term basis realize that such situation is a valuable asset, and thus are very conservatively rationing the use of their tax base asset by investing based upon PTCs¹¹.

If it is determined that the ITC Direct Payment creates a greater net present value benefit to the project developer from a project than monetizing PTCs through an investment by a tax equity investor, obviously there would be no need for a tax equity investor to invest in a project to obtain the value of the ITC Direct Payment. The tax benefit that is left for the tax equity investor to take advantage of is the “stranded” value of the accelerated tax depreciation (including so-called “bonus” depreciation for projects placed in service before the end of 2009).

Using a flip partnership to try and unlock this depreciation benefit, 99% of the accelerated tax depreciation (available to be allocated to the tax equity investor, as part of taxable income or loss) is first used to offset 99% of the project operating income, eliminating any tax drag from this allocation. Second, this tax depreciation

⁹ Generally, in a flip partnership structure, the project developer and the tax equity investors are owners of a project company, organized as a limited partnership or LLC, but taxed as a partnership for federal income tax purposes. Upon completion of the development of the renewable energy project, the tax equity investors contribute to and/or purchase equity interests in the project company (with the tax equity investors generally ending up with the majority of invested capital). The project company generally allocates 99% of its taxable income or loss to the tax equity investors to cause an allocation of 99% of the associated PTCs or ITCs to them. Cash generally is distributed to the partners in a ratio different than the allocation of taxable income or loss. This flexibility often allows the developer to recover all or most of its equity investment through cash distributions early in the life of the project, during which time the tax equity investor is also recovering its investment with tax benefits. After a requisite period (generally the period for which the PTC is available or the period necessary to avoid recapture of the ITC,) the interests of the members often “flip” into so-called “straight” allocations, *i.e.*, each member’s allocation of income and loss is equal to its share of cash distributions. Further, post-flip, the developer usually receives a significantly larger allocation of income and corresponding percentage of cash distributions (generally not to exceed 95.05%).

¹⁰ For example, potential new wind projects in Texas there have been curtailed by the lack of transmission capacity could elect to an ITC instead of PTCs to realize tax benefits pending the development of new transmission lines.

¹¹ An exception to this conclusion would perhaps be in a situation where the offtaker for the project is a public utility that can use the PTCs and accelerated tax depreciation and that, if given the choice, would choose to purchase the project, but is willing to allow the developer to retain an equity stake. Public utilities generally have a bias toward owning projects so that they can include them in the rate base on which they can earn a return. Moreover, public utilities generally have a steady stream of taxable income with which to take advantage of the tax incentives. Utilities are generally willing to take price and operational risk. Accordingly, in some sense, public utilities are the most natural tax equity investors in a flip partnership, but they were unable to be both the offtaker and source of institutional equity because of the provision contained in IRC section 45 that, to qualify for the PTC, the output could not be sold to a “related party.” By virtue of being a tax equity investor, the utility/offtaker was usually considered such a “related party.” Fortunately, last year, the IRS issued Notice 2008-60, I.R.B. 2008-30, which provides that electricity will be treated as sold to an unrelated person for purposes of IRC section 45 if the ultimate purchaser of the electricity is not related to the person that produces it. Thus, a utility that purchases the project’s output and markets the electricity production to its customers may now be the institutional investor in a renewable/alternative energy project without jeopardizing the benefit from the IRC section 45 PTCs. It should be noted that there are unique issues and complications, both tax and otherwise, that arise in connection with each special allocations partnership transaction, including any where the offtaker is also a tax equity investor or developer of the project. A thorough vetting of these issues, including through intensive modeling of the anticipated results, is recommended prior to choosing the flip partnership financing structure.

provides tax shelter to the tax equity investors up to the amount of the capital invested by the tax equity investor, returning \$0.35 (the current, highest marginal rate of 35%) for every \$1 of depreciation deduction unless and until the tax equity investor sells its interest, in which case that \$0.35 is recaptured for every \$1 of cash received. Because the expectation is that the tax equity investor will receive less upon this sale than its initial investment, not all of this benefit is expected to be recaptured¹². Finally, this tax depreciation provides additional tax shelter to the tax equity investor, if there is any debt at the project level, up to the amount of that debt, which returns a benefit equal to the present value of the tax deferral until the depreciation is recaptured (when the tax equity investor sells its interest or as the debt is otherwise paid back).

The remaining value necessary to reach the negotiated after-tax return to the tax equity investor in order to “flip” is made up by after-tax cash distributions to the tax equity investor. Historically, the PTCs, rather than cash, were used as the primary means to create value for the tax equity investor, with the result that the pre-tax return to the tax equity investor was deeply negative. This negative pre-tax return to the tax equity investor created significant leverage for the (pre-tax) return to the project developer on its investment. The safe harbor exacted a cost for this leverage by requiring that the post-flip, pre-tax allocation of cash to the tax equity investors be not less than 4.95%. In a partnership flip transaction without the PTC, a significantly greater portion of the tax equity investor’s return is made through cash distributions, and any leveraging of the developer’s return is greatly diminished. (Another way to think of it is that there is not nearly as much “tax” in “tax equity investing” through a flip partnership as there used to be.)¹³

This need to shift after-tax cash flows to the tax equity investor to make up its return is ameliorated by the ITC Direct Payment, which again reduces the amount of funds required from the tax equity investor, essentially buying down the tax equity investor’s investment. Consequently, although the tax equity investor needs more cash to reach its required return, that return is calculated on a much smaller investment.

C. Sale-Leaseback

In the typical sale-leaseback transaction, the lessor obtains tax

ownership of the leased asset either shortly before or shortly after (but not later than 90 days after) the asset is originally placed in service and leases the asset back to the developer for a term that is meaningfully shorter than the useful life of the asset¹⁴. Much as with the partnership flip structure, the ITC Direct Payment may reduce the initial investment of the tax equity investor/lessor, in a sale/leaseback, lowering the investment base upon which to generate the necessary return for the tax equity investor/lessor.

Although historically, sale/leasebacks have provided 100% financing for the leased asset, to the extent that price or other economic constraints limit the amount of financing that a tax equity investor/lessor is willing to provide (even after taking into account the ITC Direct Payment), the difference may be provided by the developer/lessee in the form of a “rent prepayment.” However, this amount generally is limited by tax constraints to initially not more than 10% of the project value, growing to not more than 20% over the term of the lease.

Historically (and particularly with respect to IRC section 48 ITC transactions), sale-leaseback financing structures were the most used investment vehicles for separating tax depreciation, which follows the tax ownership of a project, from ownership and sale of production from the project. This separation is particularly useful in allocating the operational and technology risk of a project to the lessee/developer and thereby insulating the tax equity investor from such risks.

If we compare the ability of a sale-leaseback to unlock the value of tax depreciation benefit for tax equity investor (and thus project developer) in comparison to a flip partnership, we find that the initial sale to the lessor/tax equity investor moves 100% (rather than 99%) of the associated accelerated tax depreciation to the tax equity investor, but without requiring the tax equity investor to also recognize the 99% allocation of operating income (as does the flip partnership structure). Instead, this accelerated tax depreciation first offsets the recognition of taxable income from the rental stream, which generally should be dramatically lower than the 99% allocation of all operating income required under the flip partnership. Thus, more of the accelerated tax depreciation is available to create a deferral benefit. Further, as in the flip partnership, the accelerated tax depreciation provides tax shelter to the lessor/tax equity investor up to the amount of its

¹² The expected sale generally occurs on the later of (a) the flip date or (b) the date any underlying project debt is repaid.

¹³ One tax issue in respect of doing a flip partnership based upon tax depreciation may be whether the safe harbor for flip partnerships provided by Revenue Procedure 2007-65, I.R.B. 2007-50 still applies. Although this safe harbor only explicitly covers the production of alternative energy from wind, the general view in the market is that it should apply by analogy to other renewable/alternative energy assets for which PTCs or an ITC are available. However, with the ITC Direct Payment, transactions will have neither PTCs nor ITCs.

¹⁴ The lessor typically finances the purchase with a combination of equity and nonrecourse debt and, in addition to the tax benefits arising from the investment, looks to cash rent payments and proceeds from the sale or release of the asset after expiration of the lease term to earn its return. The lessee is also often granted a fixed price purchase option to reacquire the leased asset. The purchase option price is set at the outset of the transaction at a premium to the expected fair market value of the project on the purchase option date.

invested capital. As in the flip partnership, this tax shelter returns \$0.35 (the current, highest marginal rate of 35%) for every \$1 of depreciation deduction unless and until the tax equity investor sells its interest, in which case that \$0.35 is recaptured for every \$1 of cash received. Finally, if there is debt at the project level (which is typical), the accelerated tax depreciation provides additional tax shelter to the lessor/tax equity investor up to the amount of that debt, which returns a benefit equal to the present value of the tax deferral until the depreciation is recaptured (when the tax equity investor sells its interest or as the debt is otherwise paid back). Thus, it would appear that the sale-leaseback is generally more efficient than the flip partnership in obtaining value for the tax shelter provided by accelerated tax depreciation.

However, in order for the sale-leaseback to be somewhat comparable (and thus competitive) with the flip partnership, the lessor/tax equity investor must grant the lessee/developer a fixed price “early buyout option” (“EBO”). The use of an EBO in a sale-leaseback eliminates the need to share any residual value with the lessor/tax equity investor after it receives its negotiated after-tax return, unless that is the optimal decision on the EBO date. Without the EBO (or other end-of-term fixed price purchase option), the tax equity investor would receive the benefit of 100% of the residual value in the project. By contrast, in the flip partnership, the safe harbor requires the tax equity investor share in the project residual value by no less than 4.95% (through a post-flip pre-tax cash allocation to the tax equity investor). The grant of an EBO in a sale-leaseback has traditionally been the norm in sale/leaseback transactions.

The potential EBO date is typically and optimally set at the point that preserves the expected economic benefits of the lessor/tax equity investor (*i.e.*, avoids a loss for purposes of its financial accounting), satisfies certain tax constraints to be a “true lease¹⁵,” and minimizes the measured cost to the lessee/developer. The value of the tax deferral from the accelerated tax depreciation is combined with scheduled cash rental payments and, potentially an assumed residual value at the end of the lease term in an iterative process to obtain the requisite returns to the lessor/tax equity investor and to the project lender at a minimum cost to the developer/lessee. Except for the residual value, these after-tax cash flows are fixed, which adds greater certainty as to the

timing of the return of the tax equity investor, compared to the flip partnership. This optimization of the lease economics typically involves appraisal conclusions relating to the objective facts of the project to be leased and pricing constraints intended to demonstrate compliance with tax rules. This optimization is typically done using a standard lease pricing model (the most commonly used being Warren and Selbert’s ABC).

Based on our past experience, we would expect this pricing process would generally result in the lease having a stated term being the shorter of eighty percent of the useful life of the project and the term of any underlying power purchase agreement. We would also expect the cash rents be limited to the expected net operating revenue available under a highly secure production case for the project (*i.e.*, a “P95” or “P99” case)¹⁶. The ITC Direct Payment will reduce the initial investment of the tax equity investor/lessor, lowering the investment base upon which the cash rents, tax benefits, and potential residual value would generate a return for the tax equity investor/lessor. The developer/lessee may measure minimum cost in several ways, the most common being the cost of rents through and including an assumed exercise of the optimized EBO. After that, the developer owns the project as though debt financing had been used all along.

One of the potential disadvantages of a sale/leaseback, compared to the flip partnership, may be that the tax constraints for leasing historically required some amount of expected pre-tax profit to the tax equity investor/lessor at least equal to or greater than inflation¹⁷. The lack of the requisite expected pre-tax profit could lead to the sale/leaseback being characterized as a “sham transaction,” and, consequently, to the tax equity investor/lessor losing the accelerated tax depreciation¹⁸.

One possible way to avoid this issue is through a “single investor lease,” (*i.e.*, a lease for which there is no project leverage, but instead the tax equity investor/lessor essentially provides both term debt and lessor equity proceeds through the sale). In that case, the implicit pre-tax return on the “debt” portion of the equity investment by the tax equity investor/lessor generally is sufficient to cause the entire lease to meet the requisite pre-tax profit.

Finally, we also understand that current financial accounting

¹⁵ Sale-leaseback financing structures are not covered by the IRS safe harbor for wind flip partnerships under Revenue Procedure 2007-65, I.R.B. 2007-50, but are instead covered by their own set of IRS safe harbor guidelines under Revenue Procedure 2001-28, 2001-1 C.B. 1156. A purported lease that follows these guidelines will be respected as a “true lease” for tax purposes. A true lease determination is necessary for the tax ownership of the relevant renewable energy project (and thus accelerated tax depreciation) to be moved to the lessor.

¹⁶ The application of IRC section 467 will also maximize tax deferral for the lessor/tax equity investor from rent schedules with front-loaded cash rental payments.

¹⁷ The IRS safe harbor for wind flip partnerships (and to all flip partnerships by extension from the market for these transactions) has been read by the market as blessing the absence of any expected pre-tax cash profit to the tax equity investor from the transaction (apart from the value of anticipated tax benefits).

¹⁸ The ITC Direct Payment should count as cash for purposes of the expected pre-tax profit analysis. However, in that such amount generally buys down the investment of the tax equity investor/lessor, rather than provide a return on investment, it limits the ability of the ITC Direct Payment to convert a sale-leaseback transaction from one that does not satisfy the requisite pre-tax profit to one that does.

rules for leases may be desirable because those rules produce a favorable pattern of financial accounting earnings for lessors/tax equity investors and do not require the lessor to consolidate the nonrecourse debt on its balance sheet. We understand that to the extent the project has term debt of at least 50% of initial project value, “leveraged lease” financial accounting may be available which is particularly desirable. However, we also understand that in a single investor lease (without project debt), as long as there are multiple tax equity investors/lessor, no one of which owns more than 50% of the lease, then still favorable “equity method” financial accounting treatment may be available. Because of this potential financial accounting treatment, the market for potential leveraged lease investors has been significantly larger than the market for tax equity investors in flip partnerships and is generally expected to remain so¹⁹.

In summary, we believe that the sale-leaseback structure has some significant advantages over the flip partnership with respect to obtaining value for the “stranded” accelerated tax depreciation, so as to make it a viable alternative to the flip partnership or go-it-alone strategy.

On the other hand, the initial reaction of a number of market participants is not as certain. The leasing industry generally has been subject to a great deal of scrutiny and attack by Congress and the IRS over the last decade over the use of so-called “LILO” and “SILO” transactions in which the amount of “true funding” proceeds, (*i.e.*, the portion of the sale proceeds pocketed by the lessee, compared to those proceeds required to be deposited into various “defeasance” accounts,) was typically insubstantial. Although the use of leasing in connection with renewable energy projects would constitute a return to “true funding” leasing, the controversy over leasing apparently has made some potential tax equity investors somewhat reluctant to switch their focus and resources from the flip partnership to sale/leasebacks. Further, the “hell or high water” obligation of the developer/lessee to pay lease rents, regardless of the amount of revenue generated by the underlying project, presents more of a default risk to project developers. As a companion issue, tax equity investors/lessors

must be comfortable with their underlying credit for the lease, (*i.e.*, the offtaker under the power purchase agreement²⁰). Finally, the advantages of leasing generally (and over the flip partnership) increase as the tenor of available project debt lengthens. Although there are signs of recovery, the credit crisis has made this type of debt tenor scarce.

Whether and the extent to which the apparently inherent advantages of the sale/leaseback will cause it to replace the flip partnership as the market structure to bring in investment from tax equity investors will be one of the more interesting market developments to watch.

D. Separating the ITC Direct Payment from Accelerated Depreciation Deductions (the “Inverted Lease”)

One of the general disadvantages from receipt of an ITC Direct Payment is the requirement that the tax basis of the project be reduced by one-half of the ITC Direct Payment, reducing the available tax depreciation benefit. However, as noted above, this basis reduction does not occur where a lessor who is eligible to receive an ITC Direct Payment with respect to a qualified property elects to pass-through the ITC Direct Payment to the lessee. In such case, the lessee must agree to include ratably in gross income over the five-year recapture period an amount equal to one-half of the amount of the ITC Direct Payment. Consequently, the election to pass through the ITC Direct Payment from lessor to lessee maximizes the available accelerated tax depreciation tax benefit.

The IRC section 47 historic rehabilitation tax credit may similarly be passed through from lessor to lessee, and in the IRC section 47 credit market, a fairly common structure used is the so-called “inverted lease.” Recently, we have seen an effort to adapt this structure for the ITC Direct Payment.

Under this structure, the tax equity investor actually owns all or most of the lessee “master tenant” flow-through entity for tax

¹⁹ We understand that, historically, most investors in flip partnerships have used the hypothetical liquidation at book value (“HLBV”) accounting approach to reflect the earnings or losses from such partnerships in the reported financial results of the partners. Under HLBV, each partner calculates, at each balance sheet date, the amount it would receive, or be obligated to pay, if the partnership had liquidated all of its assets at recorded GAAP amounts and distributed the resulting cash to its creditors and investors in accordance with their respective priorities. The amount each partner receives, or is obligated to pay, is that partner’s claim on the partnership’s book value. The difference between this amount at the end of the period and the partner’s claim at the beginning of the period represents the partner’s share of the partnership’s earnings or losses for the period. We understand that, under International Financial Reporting Standards (“IFRS”), as an alternative to HLBV, at least for transactions involving PTCs, the contribution of the tax equity investor is bifurcated into a minority cash investment and a loan that is based upon the expected PTCs and tax savings from accelerated depreciation. Thus, the tax equity investor records the receipt of distributions in relation to his minority cash investment, and the repayment of his loan through the allocation of the PTCs and accelerated depreciation each year. Since we are not accountants, nothing in the discussion contained herein should be relied upon as accounting advice; our discussion of accounting issues is meant solely to identify financial accounting treatment of a proposed transaction as an issue relevant to the participants. Potential investors are encouraged to contact their financial accounting advisors for Guidance Document regarding the proper accounting for a potential transaction.

²⁰ Finally, some projects may raise a “limited use” issue with respect to whether the lease is respected as “true lease” (which, again, is necessary to move tax ownership of the leased project, and the associated tax incentives). For example, a qualifying solar energy project includes equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure. On its face, such a project would appear to raise limited use concerns to the extent a lessor/tax equity investor purchases and leases back only the solar energy a project and not the structure into which it is installed. The flip partnership may overcome this issue more easily than the sale-leaseback.

under a lease without a purchase option. The lessor entity on the lease is another flow-through entity for tax initially owned by the developer, which elects to pass through the ITC Direct Payment to the master tenant lessee. The developer also may have a very small interest in the master tenant lessee entity.

At completion of development, the master tenant lessee purchases part of the flow-through lessor entity for an amount that exceeds more than \$1 per \$1 of ITC Direct Payment. This incremental amount over \$1 of ITC Direct Payment (which the tax equity investor recovers almost immediately) reflects the present value of the accelerated depreciation tax benefit acquired through its acquisition of an interest in the lessor pass-through entity. Generally, the cash flow from operations are used by the master tenant lessee to pay debt service and various fees to the developer (in order to minimize any amount left over for the master tenant lessee). Any remaining cash flow net of debt service and fees would be retained by the master tenant lessee (and distributed to the tax equity investor) to fund a small, but priority return. After that priority return, any remaining cash flow may be paid as supplement rent back to the lessor.

At the end of the lease term (generally from six to 15 years), the lessor takes back the project. At that time, there is a put/call between the tax equity investor and the developer in respect of the tax equity investor's interest in the lessor (held through the master tenant) at then determined fair market value. At this time, the master tenant's interest in the lessor has "flipped down" to around 5% (as in a flip partnership)²¹.

This structure is welcome as yet another way for developers and tax equity investors to come to an agreed financing. Presumably, developers will not take the risk of the structure (just as they will not take the risk of the flip partnership or sale/leaseback structures). Accordingly, their view as to the inverted lease generally will be based upon the potential economics it presents to them. On the other hand, tax equity investors and their tax counsel will need to work through the various tax issues that may arise in respect of this structure to determine whether it generally has the same conservative tax profile as the flip partnership and sale/leaseback²².

²¹ Although there is no opportunity for an ITC Direct Payment, this structure presumably could be adopted with respect to the IRC section 48A ITC for advanced coal electricity generation projects, the IRC section 48B ITC for coal gasification projects, the IRC section 48C ITC for advanced energy manufacturing projects, and the IRC section 45 PTCs for modified closed-loop biomass and open-loop biomass facilities because all these credits may be passed through to either a lessee or operator of the relevant project.

²² For example, tax counsel will need to evaluate the risk of the lease between the master tenant and lessor being collapsed because of the "lessee investment" by the master tenant lessee in the lessor and the master tenant's general lack of upside from operations as the result of payment of fees and supplemental rents. Further, the structure is collapsed into a partnership for federal income tax purposes between the tax equity investor and the developer, there will be a need to examine whether the intended allocation of 99% of tax depreciation to the tax equity investor would be respected.

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