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## Using Governmental Incentives to Finance Solar Renewable Energy Projects: Alternative Investments for High-Net-Worth Individuals

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# Using Governmental Incentives to Finance Solar Renewable Energy Projects: Alternative Investments for High-Net-Worth Individuals

*Michael Cole*\*

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Federal and state renewable energy programs have dramatically lowered the cost differential between photovoltaic, or solar, energy production, and available energy provided by third-party utility companies. Solar property installations, such as solar panels, are rapidly rising across the country and increased by 85% between the first quarter of 2011 and 2012.<sup>1</sup> Possible investment opportunities may exist for high-net-worth individuals seeking diversification through properly structured Solar Renewable Energy Projects (hereafter “REP”).<sup>2</sup> Tangible after-tax monetary benefits are available when investing in REPs, as a part of a diversified portfolio. Financial, tax, and legal planning are desperately needed to maximize the available governmental and economic benefits of REPs. Notwithstanding the inherent complexities of structuring REPs, the financial feasibility of solar energy production can be a viable investment option when designed to monetize tax and other governmental incentives. To provide a solar client with the best advice, legal facilitators must understand the following: the stakeholders to the transaction and their goals; how to calculate and evaluate the return on their client’s investment; how to structure the transaction; and the common tax limitations that could pose as roadblocks to unsuspecting investors.

There are two high profile federal programs that enable the recapture of funds expended in solar REPs. These programs are the Tax Credit and Recovery Act Section 1603 Program: Payments for Specified Energy Property in Lieu of Tax Credits, and Federal Section 48: Investment Tax Credit.<sup>3</sup> Each program should be considered when structuring projects to maximize the return on

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1. U.S. Solar Market Insight Report, Q1 2012, SOLAR ENERGY INDUSTRIES ASSOCIATION (June 12, 2012), <http://www.slideshare.net/SEIA/us-solar-market-insight-report-q1-2012>. Solar installations encompass a wide variety of equipment and infrastructure improvements. The end result of an installation is to produce consumable energy through a photovoltaic process. The increase of 85% was determined by reviewing projects that started in the first three months of 2011 and the first three months of 2012. 2012 was 85% greater than the installations in 2011.

2. These transactions are highly complex and individualized. This Comment is not intended to serve as an advertisement or solicitation for any transaction or prospective transaction. This Comment is not intended to be tax advice and anyone entering into these transactions should consult a tax professional and may not rely upon this Comment. Empirical data on the profitability of these transactions could not be discovered. There is an actual risk of loss in many REP transactions and past outcomes do not guarantee future results.

3. I.R.C. § 45 (West Supp. 2010). This Comment does not address the Production Tax Credit. *See* Energy Policy Act of 2005, Pub. L. No. 109-58, 100 Stat. 567 (codified at 1 U.S.C. §§ 900–99).

investment. From far away, the two appear to be similar. Both provide a return of 30% of the asset cost and a reduction in basis equal to 15% of the asset value placed in service for tax depreciation calculations.<sup>4</sup> However, when viewed under a microscope, the programs have significant substantive differences.

Developers, investors, and energy users share the burdens and benefits of a clean energy project in achieving their respective goals. Constructing an accurate model that accounts for the expected energy production, cash flow, and the resulting tax implications is time-consuming and fact-specific. These complexities highlight the importance of breaking down the various tax and legal structures that enable a solar transaction to produce the tangible benefits from the use of capital. A deeper understanding of the economic goals of a client will help legal facilitators provide value-added services in these transactions. This Comment provides a detailed overview of the common considerations for generating models and structuring a solar REP.

### I. STAKEHOLDERS AND INVESTOR GOALS

Working together, developers, investors, and energy users will maximize the available benefits of the transaction. The conflicting yet complimentary goals of each stakeholder make understanding intentions crucial to ensuring that the correct tax structure and programs are employed. Developers are the architects, engineers, or contractors that provide the physical skills and expertise in constructing REP property. Investors receive governmental benefits provided by the project, in exchange for their capital investment. Energy users are the consumers of the energy produced by the REP. The ability to use tax and other governmental benefits, commonly referred to as the “appetite,” varies by investment structure and taxpayer. When the developer and energy user are unable to utilize the benefits of the REP, a high-net-worth individual may find that a reasonable return is available from investing in the project. Consequently, these individuals can act alone or in partnership, when investing in a REP, to assign the appropriate benefits while accounting for the

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4. I.R.C. § 1012 (West Supp. 2010); I.R.C. § 50(c)(3) (2006). The basis of both assets is considered in respect to the calculation of basis under section 1012. However, sections 50(c)(3) and 48(d) mandate that both The Credit and The Grant reduce their basis by one half of the benefit received from their respective programs. Depreciation is then calculated in accordance with section 167. *See infra* Part V(B).

prior tax planning,<sup>5</sup> passive activity, and income restrictions that often limit them.

The developer frequently identifies new REPs by marrying them with previously planned projects such as a new roof or factory expansion. Developers are primarily interested in the fee for assembling the project and use their preexisting expertise in architecture and construction to erect the REP asset infrastructure as an add-on service to another project. Nevertheless, substantiating federal or state benefits requires a high level of documentation; as a result, the developer's role must evolve to satiate the incentive's mandates. Throughout the construction of the REP, the architects and engineers are required to opine on the validity of the structure and its anticipated output.<sup>6</sup> Ultimately, developing a strong working relationship with the developer will better ensure that deadlines are timely communicated and the documentation requirements are satisfied during the life cycle of the project.

The energy user is the consumer of electricity produced by the REP and receives lower energy or construction costs in exchange for the governmental incentives. Green practices, such as placing solar panels on large plant facilities, have become more and more commonplace to minimize energy costs and promote local goodwill.<sup>7</sup> Not all organizations can utilize the beneficial tax attributes generated by REPs.<sup>8</sup> Nonprofits and municipalities are prohibited from taking advantage of many REP oriented governmental incentives.<sup>9</sup> While these operations often have viable

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5. In many instances, the developer or energy user may have the prerequisite appetite to take advantage of the governmental incentives and can operate the transaction without a high-net-worth individual or corporate investor. Many of the same procedures, although slightly augmented, will apply. This article does not discuss those variations. For additional discussion, see *infra* Part V.

6. As discussed below, the requirements for both The Credit and The Grant focus on the calculation of basis under Internal Revenue Code § 1012. *ARRA Energy Co. I v. United States*, 97 Fed. Cl. 12 (Jan. 18, 2011). See also Memorandum from the Office of Fiscal Assistant Secretary in Consultation with the Office of Tax Policy on Evaluating Cost Basis for Solar Photovoltaic Properties 1, available at [http://www.treasury.gov/initiatives/recovery/Documents/N%20Evaluating\\_Cost\\_Basis\\_for\\_Solar\\_PV\\_Properties%20final.pdf](http://www.treasury.gov/initiatives/recovery/Documents/N%20Evaluating_Cost_Basis_for_Solar_PV_Properties%20final.pdf) (last accessed Oct. 3, 2012).

7. See U.S. Solar Market Insight Report, *supra* note 1, at 4. See also U.S. ENERGY INFO. ADMIN., DOE/EIA-0383 (2012), ANNUAL ENERGY OUTLOOK 2012 75 (Jun. 2012), available at [http://www.eia.gov/forecasts/aeo/pdf/0383\(2012\).pdf](http://www.eia.gov/forecasts/aeo/pdf/0383(2012).pdf). (“Solar power is the fastest-growing source of renewable energy in the outlook, with annual growth averaging 11.7%.”).

8. Treas. Reg. § 1.48-1(j) (amended 1994).

9. *Id.*; see, e.g., *Xerox Corp. v. United States*, 656 F.2d 659, 671 (Ct. Cl. 1981).

solar production property, many cannot afford the REP-related installation expenses without being subsidized. Even so, the inability to lower installation expenses does not prevent governments, hospitals, schools, and other nonprofit organizations from using clean energy incentives to curtail the cost of energy consumption.<sup>10</sup> A power purchase agreement can still enable the energy user to minimize his impact on the environment while lowering their cost of power consumption.<sup>11</sup>

The investor provides capital funding in exchange for the tax benefits and cash flow from operations of the REP. The energy user owes their lower consumption and construction costs to the investor. The investor may be a partnership, individual, or corporation. In many instances, the energy user or developer may be one in the same with the investor. A high-net-worth individual seeking to minimize tax liabilities can often exploit the benefits that energy users cannot. In contemplating the structure of a REP, it is important to review the investor's tax position and current planning. Income, depreciation, and passive activity limitations could restrict the benefits generated by the REP, thereby lowering its value and return for the client.

## II. MODELING & UNDERSTANDING RETURN ON INVESTMENT

Financing REPs with federal and state incentives may produce a return on investment sufficient to entice high-net-worth individuals to diversify portfolios and minimize tax liabilities by investing in REPs. Return on investment calculations for REP projects assess the after-tax discounted cash flow generated from the REPs, and not the reported income on a financial statement. The individual, acting as an investor to the REP, receives a return benefit by monetizing tax incentives or other governmental programs. Modeling for individuals in this scenario requires a very complex and thorough calculation. Valuable models account for the various sources of income derived during the REP. Investor models must include the original and added expenses of investment, the anticipated depreciation, the anticipated taxable income or loss, state and local benefits, cash flow from operations, and federal grants or incentives. Each stakeholder in the transaction must undergo a complete review of its financial and tax history to ensure that the benefits assigned from the REPs are complimentary to each stakeholder's respective tax position.

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10. *Smith v. C.I.R.*, 57 T.C.M. 826, T.C.Memo 1989-318 (1989).

11. I.R.C. § 7701(e) (2006).

Further complications arise when models account for state and local benefits. In many jurisdictions, the state offers a voucher, often called a renewable energy certificate or REC, for each unit of renewable energy generated.<sup>12</sup> Renewable energy certificates may be sold or exchanged for monetary compensation. Renewable energy credit markets can be similar to a secondary securities market because the value of the voucher often fluctuates based on supply and demand forces.<sup>13</sup>

REP structuring often depends on the return on investment that an investor will receive from the outlay of capital. The desired return can be calculated using a wide variety of models created by the financing team. Value can be added in these transactions by fully understanding how the finance group views the various aspects of the transaction. Completing the models early facilitates discussion points in negotiations by providing tangible support for the suggested structure or term. When the facilitator can identify the benefits that actually drive value for the client, the ability to advocate in negotiation is enhanced.<sup>14</sup>

The complexity of a REP model will vary from client to client. Often, an investor will use a personal financing team to review the projections of a REP. The financing team will perform their own calculations to determine if the investment is right for the high-net-worth individual and confirm that the projected return on investment matches their independent calculation. There are several key economic considerations to consider when modeling from the return on investment to internal rate of return. Understanding the basics of each will facilitate discussions between the investor, developer, and financing team.

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12. See, e.g., N.J. STAT. ANN. §§ 48:3–49 (2012).

13. State of New Jersey, Board of Public Utilities, I/M/O the Renewable Energy Portfolio Standards, Alternative Compliance Payments, and Solar Alternative Compliance Payments. Decision Order Doc. No. EOO6100744 (Sep. 12, 2007). For example, New Jersey utility companies must either produce or obtain a certain level of clean energy, and the value of vouchers on the market has a significant influence on the value of the project. An investor often must speculate on the future value of these vouchers when calculating the anticipated return on investment prior to the investment. While an in-depth discussion of individual state benefits and programs is outside the scope of this Comment, it is important to review the laws and programs of each state to determine if the proposed structure is appropriate and what additional benefits, if any, are provided by a particular state or locality. Additional information on many state and local benefits can be found at the United States Department of Energy website. See U.S. Dept. of Energy, Tax Credits, Rebates & Savings, ENERGY.GOV, <http://energy.gov/savings>.

14. See generally ROGER FISHER & WILLIAM URY, GETTING TO YES NEGOTIATING AGREEMENT WITHOUT GIVING IN (3d ed., 2011) (using fact based, rather than positional, negotiation).

Determining the benefit to the investor in the most simplistic form is the traditional return on investment calculation. Return on investment is the income *less* expenses *divided* by the cost of investment.<sup>15</sup> Unfortunately, this simple calculation method ignores the time value of money, termination value, risk, tax benefits, debt service, and other considerations. More advanced financiers tend to prefer a combination of discounted cash flow, net present value, and internal rate of return calculations to provide a broader view of the total impact from the investment. In the end, the model is only as good as the information that is inputted. Discussing the energy generated and costs of development will require active communication with the development team to ensure that the model accurately portrays the actual system that will be built.

Many investors use after-tax discounted cash flows to determine the REP's return on investment. Net present value of the discounted cash flow is the present value of cash from a future period, inclusive of all sources related to the investment that is reduced or "discounted" to the present value using the "discount rate."<sup>16</sup> The discount rate is a calculated constant applied to the calculation that considers many of the ignored factors in the simple return on investment calculation, like the time value of money or risk.<sup>17</sup> Once each period has been reduced to its present value, an investor may then calculate the internal rate of return.<sup>18</sup> If an investor has a set return on investment, the summation of the after-tax discounted cash flows will provide the net present value of the REP that may be used to determine the return on investment using the simple calculation. The underlying principle of these calculations will remain the same from project to project, but the actual application may vary significantly.

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15. FRANK ALLEN, STEWART C. MYERS & RICHARD A. BREALY, *PRINCIPLES OF CORPORATE FINANCE* 17 (9th ed. 2008). The return on investment is equal to the income minus the expense, divided by the capital investment. (Return on Investment = (Income-Expense)/Capital Investment).

16. *Id.* at 35-39.

17. *Id.*; *see also id.* at 14. Net Present Value is the present value of an investment less the required cost of capital. Expected return is the summation of all future cash flows less the investment.

18. JOHN TALAMO, *THE REAL ESTATE DICTIONARY* (Financial Publishing Co., 7th ed., 2001). An internal rate of return is the annually required return on investment to equate another investment to the REP. *Id.* at 109. This is calculated by determining the discount rate that would yield a zero net present value. *Id.* at 65. The mathematical calculations are the same for every transaction, but the financing team may apply the principles in an alternative fashion to best accommodate their business model.



REPs require a significant initial cash investment to purchase and install the required equipment. In many models, the cash flow from operations is simply not enough to warrant an investment; therefore, governmental incentives are mandatory in facilitating the REP. A client's financing team will be unable to generate an accurate model if it does not understand all available revenue streams. The most common considerations are gross revenue from operations, operational expenses, debt service, tax benefits, termination value, insurance, and governmental incentives. The calculation of tax benefits is inherently complicated and will vary from transaction to transaction. Important considerations include the appetite for tax credits produced on state and federal levels, the depreciation allowed or allowable, the loss generated, the applicable tax rate, and, when appropriate, the passive activity loss limitations. To enable clients to fully understand the complexity of the structure, it is important to separate each benefit that is driving value and the assumptions used in the model. This enables the financing team to manipulate the variables independently to determine the attributes that provide the largest value and their respective diminishing rate of returns.

### III. MONETIZING BENEFITS—DISTINGUISHING THE CREDIT FROM THE GRANT

There are two principle programs that allow for the recapture of funds expended in solar REPs: Tax Credit and Recovery Act § 1603 Program: Payments for Specified Energy Property in Lieu of Tax Credits (hereafter "The Grant" or "1603 Grant"), and Federal Section 48 Investment Tax Credit (hereafter "The Credit").<sup>19</sup> Each program provides its own unique benefits and burdens. The two largest differences concern the ability to monetize and the timing of the project. Both The Grant and The Credit have a 30% value, but The Grant provides for direct payment of cash at the origination of the project. A project will qualify for the 30% of the value the property so long as it is section 48 or section 45 qualified property. Solar REPs in many instances qualify as section 48 property, but a full review of the assets placed in service is required to ensure compliance.<sup>20</sup> The Grant and The Credit cannot

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19. The Section 45 Production Tax Credit is not discussed here. *See supra* note 3 and accompanying text.

20. *ARRA Energy Co. I v. United States*, 97 Fed. Cl. 12, 21 (2011).

be taken simultaneously; thus, accepting one will forfeit the other.<sup>21</sup>

#### A. The Grant

The Grant is often preferred over The Credit because it provides immediate cash benefit. The Grant provides for the payment of 30% of the applicable basis within sixty days of the application or placed in service date.<sup>22</sup> This enables investors to minimize their capital contributions by using funds from The Grant. Limiting debt financing or immediate cash flow will increase the return on investment and the sixty-day period is often significantly shorter than the return year, thereby giving greater benefit related to the time value of money. Additionally, The Grant is a cash payment issued to the investor directly and therefore no “tax appetite” is required to obtain this benefit.

The terms and application of The Grant will be substantially similar to those of The Credit.<sup>23</sup> Basis is accordingly calculated under the Internal Revenue Code section 1012.<sup>24</sup> The Treasury recently challenged the basis provided in an application for The Grant. In *ARRA Energy Company I v. United States*, ARRA Energy Company I filed twenty-five separate 1603 Grant applications with the Treasury.<sup>25</sup> Each application related to a separate mobile solar production unit.<sup>26</sup> Upon review of the applications, the Treasury requested additional information.<sup>27</sup> In response, ARRA Energy Co. I obtained an independent valuation of the assets to support the basis.<sup>28</sup> The Treasury issued the following response:

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21. See generally The Emergency Economic Stabilization Act of 2008 § 103, 12 U.S.C. 5213 (2012). Unfortunately, The Grant expired at the end of 2011. There is a safe harbor for property of more than \$1 million, but only when the developer has substantially performed work in a binding contract, 5% of the total construction costs are completed by December 31, 2011, and the project is finished by October 1, 2012. The Credit is set to expire on December 31, 2016. Office of Fiscal Assistant Sec’y, Payments for Specified Energy Property in Lieu of Tax Credits Under the American Recovery and Reinvestment Act of 2009 16, U.S. DEP’T OF ENERGY (2011), available at [http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20\(2\)%20clean.pdf](http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20(2)%20clean.pdf).

22. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1603, 123 Stat. 364 (2009).

23. *Id.*; *ARRA Energy Co. v. United States*, 97 Fed. Cl. 12, 21 (2011).

24. Office of Fiscal Assistant Sec’y, *supra* note 21, at 16.

25. 97 Fed. Cl. at 15.

26. *Id.* at 14.

27. *Id.* at 15.

28. *Id.*

Eligible Basis—basis of property is determined in accordance with the general rules for determining the basis of the property for federal income tax purposes. Thus, the basis of property generally is its cost and includes all items properly included by the taxpayer in the depreciable basis of the property. Applicants must submit with their application for a Section 1603 payment documentation to support the cost basis claimed for the property. Although [ARRA Energy Co. I] submitted documentation regarding [the] cost basis, we found the documentation insufficient to support your claimed basis.<sup>29</sup>

The *ARRA* Court found that many of the costs from improving the land and related expenditures are not directly related to production assets and will not be included in the basis of a REP.<sup>30</sup> Thus, it is now common practice to consult with contractors and government officials before finalizing plans, thereby increasing the procedural expense and up-front cash requirements of many projects.

#### *B. The Credit*

The Credit is allocated between the partners in an amount up to 30% of the value of the qualified REP property and is available through December 31, 2016.<sup>31</sup> The Credit is generally available and taken in the year that the asset is placed in service. This Credit reduces basis by half of every credit dollar received, similar to The Grant basis adjustments.<sup>32</sup> The Credit is a section 38 General Business Credit, and therefore limitations may occur with some investors that have previously planned to maximize General Business Credits on Form 3800. General Business Credits, such as the Low Income Housing Credits, are capped at a reduction of 25% of the taxpayer's liability that exceeds \$25,000.<sup>33</sup>

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29. *Id.* at 15–16.

30. *Id.* at 21.

31. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1603, 123 Stat. 364 (2009).

32. *Id.*

33. I.R.C. § 38(c)(1)(B) (2006). The Credit is not limited by the Alternative Minimum Tax and has a one-year carry-back and a twenty year carry-forward. *Id.* at § 38(c)(1)(A) and § 39(a). If the asset is sold within the first five years of its life, The Credit's value is recaptured in full on the next return for any and all previous reductions in tax liabilities. *Id.* at § 50. The Credit is nonrefundable and therefore cannot be used to generate a cash windfall.

## IV. STRUCTURING THE TRANSACTION

There are two common structures used in REP transactions: one is the “sale-leaseback” and the other is the “partnership flip.”<sup>34</sup> While both structures have inherent benefits and limitations, one structure often will produce the better result for a client or better satisfy the wants of the other stakeholders. Due to the intricate nature of each structure, it is critical to understand both the partnership flip and the sale-leaseback to select the appropriate structure for a client’s unique needs, wants, and demands. Explaining the complexities and variations of each structure will help clients generate more accurate models and make accurate comparisons. For instance, in a sale-leaseback structure, the developer or property owner builds and owns the REP.<sup>35</sup> The investor purchases the property and leases it back to the energy user. In a partnership flip structure, the transaction assigns tax benefits without violating the shifting rules through varying the ownership of the organization over its lifetime.<sup>36</sup> Both the sale-leaseback or partnership flip structures must fulfill the requirements of the Economic Substance Doctrine as articulated in section 7701(o).<sup>37</sup>

*A. The Sale-Leaseback*

A sale-leaseback structure enables financing of the REP.<sup>38</sup> Prior to placing the asset in service, the developer will sell the property to an investor in exchange for the construction price of the asset.<sup>39</sup> This provides the developer with 100% financing of construction and transfers the governmental benefits to the investor. The investor will place the asset in service and lease the property to the developer.<sup>40</sup> The developer subsequently sublets the property to the energy consumer or uses a power purchase agreement to sell the electricity at a discounted price.<sup>41</sup>

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34. Rev. Proc. 2007-65, 2007-45 I.R.B. 967; *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). I.R.C. § 38(c).

35. See *Frank Lyon Co.*, 435 U.S. 561.

36. Rev. Proc. 2007-65, 2007-45 I.R.B. 967.

37. For additional discussion, see *infra* Part IV.C.

38. Limits may apply to the availability to individuals and certain structures. See I.R.C. § 46 (2006); see also Treas. Reg. § 1.48-1(h)(1)(i) (amended 1994).

39. See I.R.S. Priv. Ltr. Rul. 201214007 (2012) for a discussion of sections 754 and 167(c) as applied to a power purchase agreement and valuing assets in a REP.

40. *Id.*

41. *Id.*

Sale-leaseback structuring is beneficial in 1603 Grant REPs because the cash flow is assigned to the investor as the sole owner. Therefore, the structural burdens of section 704 will not limit the investor's ownership or return. The lease of a REP is similar to traditional leases of long-term assets: the contract must not be structured such that the Internal Revenue Service (hereafter "Service") would determine the transaction to be a conditional sales contract.<sup>42</sup> In the event that the Service disallows the structure, the tax benefits sought for some or all participants will be voided, turning a worthwhile investment into an economic loss.

A leaseholder has the ability to take deductions for necessary expenses that occur in the ordinary course of business.<sup>43</sup> Under I.R.C. section 162(a)(3), the deduction of rental payments for assets used in trade or business is included in the necessary expenses of a business. A developer in a sale-leaseback transaction will record income from the power purchase agreement, but will have an offsetting expense for the cost of rent.<sup>44</sup> The legal owner of the REP is entitled to depreciation by section 167(a), including the total cost basis of the asset, even if subject to a leasehold.<sup>45</sup> A taxpayer that places the asset in service is entitled to the bonus depreciation and either The Credit or The Grant.<sup>46</sup>

The primary concern in a leasing transaction is that the Service will re-characterize the contract as a conditional sale.<sup>47</sup> A conditional sales contract is similar to an installment sale in that gain or loss is recognized overtime in accordance with the payments as though it were transferred under the installment method.<sup>48</sup> The rental payments become principle and interest payments even though there was no change in legal ownership of the property.<sup>49</sup> Gain or loss is triggered and recognized by the legal titleholder and all tax attributes transfer to the leaseholder.<sup>50</sup> The Service does not provide bright-line rules for determining the

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42. See *Swift Dodge v. Comm'r*, 692 F.2d 651 (9th Cir. 1982).

43. See I.R.C. § 162(a) (2006).

44. See *id.* at §§ 61, 162(a)(3).

45. *Id.* at § 167(c)(2).

46. See *id.* at §§ 48(a)(3)(B)(i)–(ii), 168(e)(3)(B)(vi)(1); Office of Fiscal Assistant Sec'y, *supra* note 21, at 15.

47. Buyout provisions are not entirely impermissible. See Treas. Reg. § 1.48-4 (amended 1972) (enables a lessee as a purchaser of section 38 property with restrictions). Limits may apply—see Internal Revenue Code section 46(e)(3) and Treasury Regulation section 1.48-(h)(1)(i). I.R.C. § 46(e)(3) (2006); Treas. Reg. § 1.48-(h)(1)(i).

48. Rev. Rul. 55-540, 1955-2 C.B. 39; *Swift Dodge v. Comm'r*, 692 F.2d 651 (9th Cir. 1982).

49. Rev. Rul. 55-540, 1955-2 C.B. 39; *Swift Dodge*, 692 F.2d at 651.

50. *Swift Dodge*, 692 F.2d at 651. See also Rev. Rul. 55-540, 1955-2 C.B. 39.

proper tax treatment of a contract as a long-term lease or a conditional sales contract.<sup>51</sup>

The distinction between lease and conditional sale is important because the tangible benefits that arise for an investor do not come from the cash flow in operations but from the tax benefits. In *Frank Lyon Company v. United States*, the Supreme Court recognized that the Service may refuse “to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred.”<sup>52</sup> Therefore, if the Service finds the transaction to be a conditional sales contract rather than a lease agreement, the taxable benefits of ownership are transferred from the legal titleholder to the leaseholder.<sup>53</sup> This is devastating for an investor. Instead of receiving depreciation and tax credits, the investor is left with gain or loss from the sale of an asset, likely treated as held for less than a year, as well as interest income. Additionally, the energy user obtains all tax benefits and, depending on the circumstances, those benefits may be unusable to that taxpayer.<sup>54</sup>

Another consideration in structuring arises when the energy user is a nonprofit or governmental organization. Nonprofit and governmental organizations are not eligible to receive the benefits of either The Credit or The Grant.<sup>55</sup> Treasury Regulation section 1.48-1(j) disallows property owned, leased, or used by a nonprofit organization from qualifying for section 38 treatment.<sup>56</sup> The broad definition of use in Treasury Regulation section 1.48-1(j) includes leases, partnerships, and structures through which the property is owned or used by the nonprofit organization.<sup>57</sup> Property used by a nonprofit organization would cause the REP to forfeit all governmental incentives, even if the legal owner has a legitimate business motive.<sup>58</sup>

A power purchase agreement is a service contract that will enable the investor-owner to receive the benefits of the depreciation and The Grant or The Credit while the nontaxable

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51. See Rev. Rul. 55-540, 1955-2 C.B. 39.

52. *Frank Lyon Co. v. United States*, 435 U.S. 561, 572–73 (1978).

53. See Rev. Rul. 55-540, 1955-2 C.B. 39.

54. *Id.*

55. Treas. Reg. § 1.48-1(j)-(k) (as amended in 1994).

56. *Xerox Corp. v. United States*, 656 F.2d 659, 671 (Ct. Cl. 1981); Treas. Reg. § 1.48-1(j) (as amended 1994).

57. Treas. Reg. § 1.48-1(j) (as amended 1994); see also I.R.C. § 470(c) (2010).

58. Treas. Reg. § 1.48-1(j) (as amended 1994).

organization minimizes its energy expenses.<sup>59</sup> The sale of energy to a nonprofit organization is valid under this structure, so long as the terms of the agreement conform to the six requirements of section 7701(e).<sup>60</sup> The terms are considered as a whole to determine if the agreement is a service contract.<sup>61</sup> Structuring a qualifying power purchase agreement will enable the investor-owner to receive the benefits of the depreciation and either The Grant or The Credit while providing the energy to the nonprofit organization.

Alternatively, the specifics of the situation may require a different structure. Straight leases and leveraged leases can also be useful tools in conjunction with the common sale-leaseback. A straight lease is the traditional lease that occurs in all forms of property law, from renting a car to leasing an apartment.<sup>62</sup> Leveraged leases occur by obtaining debt financing to reduce the initial capital investment.<sup>63</sup> The appropriate lease structure will depend on the location of the REP, the parties involved, and the availability of financing.

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59. *Xerox Corp.*, 656 F.2d at 672 (property located on tax exempt or governmental property may qualify for the investment tax credit so long as it is leased to them and the transaction is not a deemed sale).

60. I.R.C. § 7701(e)(1) (2006) provides:

- (A) the service recipient is in physical possession of the property,
- (B) the service recipient controls the property,
- (C) the service recipient has a significant economic or possessory interest in the property,
- (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
- (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
- (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

61. *Xerox Corp.*, 656 F.2d at 672. A contract will be reclassified if there is a fixed value at the end of the lease for the sale of property. Any discount or preset price will cause structured transactions to be considered service agreements, thereby forfeiting all tax attributes to the power purchase agreement assignee. A purchase price agreement may be valid if the purchase comes at the end of the life of the partnership and is for the fair market value of the asset. There may be considerations built in for lowered costs of avoiding the movement or reinstallation of the property. The IRS has yet to rule on this position but it represents the common belief of tax professionals operating actively in the space. *See* Rev. Proc. 2007-65, 2007-45 I.R.B. 967; *Smith v. Comm'r*, 57 T.C.M. (CCH) 826 (1989).

62. *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978).

63. Rev. Proc. 2001-28, 2001-19 I.R.B. 1156.

Straight leases occur when usage rights are transferred from the legal owner to the tenant without transferring title.<sup>64</sup> The legal owner retains the tax attributes and receives rental payments while the leaseholder pays rent.<sup>65</sup> In leases involving REPs, the rent is provided in exchange for use of the energy property. The amount of electricity produced will vary each month but the cost of electricity to the user will not. A leveraged lease is actually a subset of straight leases and sale-leasebacks.<sup>66</sup> The investor will obtain financing to purchase the REP and minimize capital investment. Commonly referred to as a “net lease,” the lease payments are structured to cover the required payments of the debt service incurred to purchase the asset.<sup>67</sup> This reduces the risk and initial cost of capital required to construct the REP while still allowing the investor to obtain the tax benefits.<sup>68</sup>

### *B. Partnership Flip—Basis & Substantiation Issue*

The partnership flip structure can also facilitate the desires of stakeholders during the REP lifecycle. The partnership flip allows the developer to obtain financing for the project in three ways. First, the investor contributes cash for an interest in the partnership. Second, the contributed capital and value of the assets are used to obtain financing and lower the required capital investments. Third, cash distributions are used during the life cycle of the REP.<sup>69</sup> Both the developer and investor have capital

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64. *Frank Lyon Co.*, 435 U.S. at 572–73.

65. *Id.*

66. Rev. Proc. 2001-28, 2001-19 I.R.B. 1156.

67. *Id.*

68. The interest expense of a leveraged lease reduces the cash value otherwise received by the investor. The financing amount and the interest rate can alter the value of a REP significantly to an investor. In most instances, financing a greater portion of the purchase price will yield an increased return on investment for the investor.

69. The ability to utilize tax benefits is limited to the outside basis that a partner has in the partnership. I.R.C. § 704(d) (2006). Possible basis issues arise when The Credit and depreciation are considered in connection with section 50(c), which causes a corresponding deduction in the partner’s outside basis. *Id.* at § 50(c)(5). As a general rule, credits affect a partner’s basis in the partnership only to the extent that the partnership’s basis in an asset is reduced as a result of taking a credit. *Id.* A similar adjustment will occur to the partner’s basis in the partnership. The adjustment can be reported as a separately stated adjustment in box 20 of the K-1. The Grant, however, provides for income and an increase to basis in the partnership and a corresponding reduction in the basis of the asset and then the partnership. I.R.C. § 48(d)(3)(A)–(B) (2010).



invested in the partnership flip structure.<sup>70</sup> Similar to a leveraged lease, the use of debt financing can improve the return on capital invested by lowering the initial investment required by the investor or developer.<sup>71</sup>

A partnership flip structure uses a partnership, or similarly taxed entity, held by the developer and investor. The energy user holds a power purchase agreement to purchase the energy and makes regular payments to the operating partnership. Traditionally, the partnership flip occurs in three phases to allocate income and cash flow.<sup>72</sup> Each stage is augmented for the particular transaction to maximize the benefits while adhering to the requirements of section 704.<sup>73</sup> The partnership flip allows for significant variations in allocating income, expense, and cash flow. However, the partnership agreement must assign income to comply with the Substantial Economic Effect Test.<sup>74</sup> Transactions that fail to have a true economic purpose are “sham transactions” and the benefits are

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70. Rev. Proc. 2007-65, 2007-45 I.R.B. 967 provides a safe harbor in a flip structure. There are ten prerequisites to qualify for the safe harbor. *Id.*

71. ALLEN, MYERS & BREALY, *supra* note 15, at 17. Lower investment costs in conjunction with minimally increased expenses provides for a net benefit in many return on investment calculations. It would be detrimental to use debt financing when the cost of the debt service exceeds the monetized benefits from the investment.

72. Rev. Proc. 2007-65, 2007-45 I.R.B. 967.

73. Section 704(b) (2006) is vital to determining the proper allocation of partnership attributions. Partnership agreements that fail to comply with the Substantial Economic Effect Test will be assigned by the interest that partner has in the partnership. A partnership interest is determined by taking all circumstances into consideration. Revenue Procedure 2007-65 enables the taxpayer to assign tax credits and income to one partner while assigning the cash to another. 2007-45 I.R.B. 967. This can raise a number of tax issues to the investing partner once the tax benefits are realized. Any subsequent holding of the project may cause unwanted tax burdens to satisfy a deficit restoration obligation, qualified income offset, or basis limitation. When section 704(b) (2006) and Revenue Procedure 2007-65, 2007-45 I.R.B. 967 are read together, a valid structure will provide for the depreciation or other tax attribute to “flip” over a period of time.

74. The term “partnership agreement” is defined by section 761(c) as the agreement in place for the tax year in question including amendments up to the time of filing if the partnership so chooses. Treas. Reg. § 1.671-1 (as amended 1997). The agreement must be signed and any deviations from allocation in accordance with ownership must be disclosed on the return. Section 1.704-1(b)(i) provides that when an agreement is silent to a particular item of income, expense, or cash flow it will be allocated after all facts and circumstances are considered. Treas. Reg. § 1.704-1(b)(i) (as amended 2004). Safe harbors are provided in sections 1.704-1(b)(4) and 1.704-2. Treas. Reg. §§ 1.704-1(b)(4), 1.704 (as amended 2004).

disallowed.<sup>75</sup> The Service issued guidance in Revenue Procedure 2007-65 that included a safe harbor for compliance with the Substantial Economic Effect Test and the rules of section 704.<sup>76</sup> A partnership flip structure that is outside the purview of the safe harbor must otherwise comply with the section 704 rules of economic effect and substantiality.<sup>77</sup>

In the first phase of the partnership flip, the investor is assigned 99% of tax items.<sup>78</sup> Concurrently, the developer is assigned 100% of cash flow and 1% of tax items.<sup>79</sup> The cash flow allocation to the developer is designed to recoup capital previously contributed to the partnership. The investor is monetizing the tax attributes of the partnership by using losses and credits to offset otherwise taxable income.<sup>80</sup> The second period is referred to as the “flip” during which 99% of the income and 100% cash are allocated to the investor.<sup>81</sup> The flip continues either for a specified period of time or until the investor obtains a certain return on investment.<sup>82</sup> Once the temporal or income requirements are satisfied, the partnership interests are reassigned as 95% of cash and tax attributes to the developer and 5% to the investor. The continued operations of the organization provide income to the developer.<sup>83</sup>

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75. *Goldstein v. Comm’r*, 364 F.2d 734 (2d Cir. 1966). The Service determined that a “sham transaction” had occurred when proceeds from otherwise taxable gambling winnings were invested in tax-free bonds offset by an interest on debt and taken as an expense against income. The court found that there was no true debt obligation and labeled these structures as sham transactions. *Id.* at 742.

76. Revenue Procedure 2007-65 relates to wind energy projects and section 45 tax credits. Rev. Proc. 2007-65, 2007-45 I.R.B. 967. The guidance provided by this memorandum is commonly relied upon in other flip structure projects. See Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 709, 769 (2012).

77. Rev. Proc. 2007-65, 2007-45 I.R.B. 967.

78. *Id.*

79. *Id.*

80. The income offset must be passive unless the investor is able to fulfill the grouping requirements under section 469 and the associated regulations. See, e.g., I.R.S. Pub. 925 (2011); Treas. Reg. § 1.469-4(c) (1995). See also *infra* Part V.C.

81. Rev. Proc. 2007-65, Example 1, 2007-45 I.R.B. 967

82. *Id.*

83. At the initiation of the third phase, the developer may purchase the REP for the fair market value (hereafter “FMV”) of the asset. The sales price is referred to as the termination value, and investors should include its estimated value discounted to the current period when determining the return on investment. The investor should be aware that the basis of the asset may have reached zero, and therefore gain may be recognized. Similar to the cash benefit, the future tax on the gain should be included. Rev. Proc. 2007-65, 2007-45 I.R.B. 967.

The Economic Effect Test of Treasury Regulation section 1.704-1(b) is a three-part review of any partnership structure.<sup>84</sup> First, the capital accounts must be kept under section 1.704-1(b)(2)(iv).<sup>85</sup> This Regulation requires that capital accounts are increased by taxable income, tax exempt income, and contributions of capital.<sup>86</sup> A capital account will be decreased by distributions at fair market value, partnership losses, and nondeductible expenses.<sup>87</sup> Second, a partner must have a “deficit restoration obligation” through which a negative capital account must be restored within ninety days of dissolution or the end of the tax year, whichever is later.<sup>88</sup> The Regulations also allow structures when a partnership requires a “qualified income offset.” A qualified income offset occurs when a negative capital account is assigned gross income to restore the deficit to zero.<sup>89</sup> This will create the taxable income to a partner even in a loss year and generate a larger loss to all other partners.<sup>90</sup> Third, distributions at the conclusion of the partnership will be made in accordance with capital accounts after paying creditors.<sup>91</sup>

The Substantiality Test reviews a partnership structure to ensure that the timing of a tax allocation does not provide a cash tax benefit to a partner without impacting the capital account.<sup>92</sup> The Substantiality Test looks to the cash tax burden of all taxpayers impacted by an allocation as detailed in *Orrisch v. Commissioner*.<sup>93</sup> The review occurs in the year of the transaction and each subsequent year.<sup>94</sup> However, the Internal Revenue Code

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84. Treas. Reg. § 1.704-1(b) (amended 2004).

85. *Id.* at § 1.704-1(b)(2)(ii)(B)(1).

86. *Id.* at § 1.704-1(b)(2)(iv).

87. *Id.*

88. Treas. Reg. § 1.704-1(b)(2)(ii)(C) (as amended 2004). There is an alternative to the second test when the DRO is limited.

89. *Id.* at § 1.704-1(b)(2)(ii)(d) (as amended 2004).

90. Rev. Rul. 97-38, 1997-2 C.B. 69

91. Treas. Reg. § 1.704-1(b)(2)(ii)(B)(3) (as amended 2004).

92. *Id.* at § 1.704-1(b)(2)(iii) (as amended 2004).

93. *Orrisch v. Comm’r*, 55 T.C. 395 (U.S. Tax Ct.1970). The U.S. Tax Court held that the allocation of a depreciation deduction to one partner was not allowed because it created both a shifting and transitory tax benefit between the parties. One partner was a real estate developer who could not use the depreciation due to benefits from other investments. Even though there was an allocation assignment in the event of a gain, the lack of DRO removed the substantive economic effect from the transaction. The depreciation was assigned to another partner who needed the benefit. The court reallocated all tax attributes and assessed penalties and interest on all related under payments. The court focused on the ability of the IRS to review the real impact on taxes paid and not just the business purpose of the deal.

94. Treas. Reg. § 1.704-1(b)(2)(iii)(A) (as amended 2004).

section 1.704(b)(2)(iii)(C) establishes a five-year safe harbor provision and an allocation that will resolve the capital account burden after a period of more than five years will be respected.<sup>95</sup> Accordingly, structuring a tax allocation could be substantial, so long as the reversing adjustment is more than five years later.<sup>96</sup>

### C. Economic Substance Doctrine

The Economic Substance Doctrine<sup>97</sup> was originally a common law principle that was later codified in I.R.C. § 7701(o).<sup>98</sup> The Economic Substance Doctrine provides an overarching requirement that a transaction must have an economic benefit and business purpose without regard to the tax benefits.<sup>99</sup> The doctrine applies to all transactions and structures, not only REPs.<sup>100</sup> However, both partnership allocations and sale-leasebacks are frequently reviewed in the courts.<sup>101</sup>

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95. See *id.* at §1.704-(b)(2)(iii)(C) (as amended 2004); Rev. Proc. 2007-65, 2007-45, I.R.B. 967.

96. See Treas. Reg. § 1.704-1(b)(2)(iii)(C) (as amended 2004); Rev. Proc. 2007-65, 2007-45, I.R.B. 967.

97. Recently, the Third Circuit Court of Appeals took an alternative approach to the application of the Economic Substance Doctrine. In *Historic Boardwalk, LLC v. C.I.R.*, the Court reviewed the partnership structure and overturned the decision of the Tax Court stating that the Economic Substance Doctrine should only be reviewed after the partnership has been validated. No. 11-1832, 2012 WL 3641769 (3d Cir. Aug. 27, 2012). The Court determined that a structure similar to Rev. Proc. 2007-65 was not valid because there was not a substantial risk of loss by the investor. *Id.* at 15. The court reviewed the partnership agreement and related transactional documents to determine that the investor was not in fact a partner and therefore the economic substance review was not required. *Id.* at 19–21. Accordingly, based on this recent case, it would appear that transactions related to the use of a tax credit require that an independent review of the partnership is performed prior to determining if the allocations violate the Economic Substance Doctrine. Practitioners reviewing or structuring these transactions should be cognizant of this recent case and all subsequent developments as the printing of this publication may render some or all of the information related to this section stale.

98. *Sacks v. C.I.R.*, 69 F.3d 982, 986 (9th Cir. 1995) (citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (“It has long been the law that a transaction with no economic effects, in which the underlying documents are a device to conceal its true purpose, does not control the incidence of taxes.”) See also I.R.C. § 7701(o)(5)(A) (West Supp. 2010); *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

99. *Sacks*, 69 F.3d at 986.

100. *Goldstein v. Comm’r*, 364 F.2d 734 (2d Cir. 1966).

101. *Frank Lyon Co.*, 435 U.S. at 561 (upholding a sale-leaseback transaction); *Sacks*, 69 F.3d at 982.

For a REP to have economic substance, it must satisfy both parts of a two-part test.<sup>102</sup> First, the REP must have an expected positive economic impact on the investor without consideration of the tax benefits.<sup>103</sup> Second, the REP must have a legitimate business purpose without regard to its tax implications.<sup>104</sup> Failing to meet the requirements of the Economic Substance Doctrine can have dire consequences to an investor. The Service may impose on an investor an accuracy-related penalty from underpayment tax should the transaction fail.<sup>105</sup> Despite codification, the Service will continue to apply the Economic Substance Doctrine in accordance with past precedent and developing case law.<sup>106</sup>

#### V. COMMON TAX LIMITATIONS AND CONSIDERATIONS IN STRUCTURING

The return on investment for a high-net-worth individual is based upon the after-tax consequences of the investment. Failure to accurately identify the client's future earnings may frustrate an otherwise accurate model; therefore, establishing the client's tax return history is a vital first step before entering into a REP. It is impossible to identify all considerations that a client may encounter during the modeling phase. However, there are three considerations that appear frequently for these individuals.

The first consideration is the income tax bracket and income volatility of the investor. The second consideration is depreciation and related asset expenses. The Code allows for deductions against income for expenses related to assets placed in service under section 167 accelerated depreciation and section 179 expense. The third consideration is passive income and groupings.<sup>107</sup> The

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102. I.R.C. § 7701(o) (West Supp. 2010).

103. *Id.* at § 7701(o)(1)(A). State benefits are also not considered in determining economic benefit. *Id.* at § 7701(o)(3).

104. *Id.* at § 7701(o)(1)(B).

105. *Id.* at § 6662(b)(6). A substantial understatement penalty of 20% is imposed if the understatement of tax is the greater of 10% of the annual tax or \$5,000 under the Internal Revenue Code sections 6662(a) and 6662(d)(1). An additional penalty may arise if the transaction or series of transactions is not disclosed in accordance with section 6662(i). Failure to adequately disclose will generate a 40% instead of 20% accuracy related penalty. This is often accomplished by filing Form 8275. For additional discussion, see I.R.S. Notice 2010-62, 2010 I.R.B. 411 and the Regulations of 6011. Treas. Reg § 1.6011-4 (amended 2010).

106. I.R.S. Not. 2010-62, 2010-40 I.R.B. 411.

107. I.R.C. § 469 (2005). Tax loss benefits may be restricted if an individual does not have sufficient passive income to offset his taxable income or is otherwise limited by the Passive Activity Loss rules. Generally speaking,

structuring of REPs as leaseholds, partnerships, or other methods requires that the practitioner be aware of each participant's appetite for the various tax attributes.

#### A. Tax Brackets & Income Volatility

Creating an accurate model for a specific investor provides some certainty to the implications of their investment and future returns. Tax brackets and income volatility are significant factors when determining whether a high-net-worth individual is an appropriate investor in a REP. The value of a deduction to an investor is equal to the tax bracket that the dollar would have otherwise been taxed. Models should account for anticipated variances in business and lifestyles, as any unused loss generated by a REP loses value for each year in accordance with the time value of money. An accurate model will account for the losses from REPs that generate a deduction for periods in which the investor anticipates having income that may be offset.

The Bush-Obama tax cuts have been in service since 2003, providing nine years of relatively constant federal tax rates.<sup>108</sup> This prolonged period of constant rates facilitates the generation of accurate tax models. Unfortunately, in 2012 politicians face a significant tax impasse that could result in significant changes to both the tax rates and overall tax structure.<sup>109</sup> The United States has a progressive tax structure and deductions that would lower the investor's bracket accordingly and yield diminished returns. Currently the highest tax rate for ordinary income is 35%; however, that rate will sunset at the end of the current calendar year.<sup>110</sup> Many high-net-worth individuals have taken other tax planning steps to ensure that their effective tax rate is considerably lower than the highest bracket. The assumption that the individual has an effective rate equal to the highest marginal rate can lead to

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passive activity losses and income may only offset passive activity losses. Corporate investors, on the other hand, are generally better situated to use tax credits and losses because the scheduled separation of passive and active income is not considered in the calculation of corporate tax liabilities.

108. John Snow, 'Taxmageddon' is a Real Threat, WALL STREET JOURNAL, May 14, 2012, at A15, available at <http://online.wsj.com/article/SB10001424052702304743704577382371561326132.html>.

109. See *id.*

110. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296 (2010). Amending Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-1, 115 Stat. 37 (2001). See also *id.* at § 1(i).

an overstatement of benefit or burden during the life cycle of the REP.

### *B. Depreciation*

Accelerated depreciation, allowed under the Internal Revenue Code, offsets income from operations, thereby yielding net loss to an investor.<sup>111</sup> The tax relief driven by depreciation may lower the investor's total tax liability by reducing his taxable income. Similar to real estate investments, ensuring that the project is income tax negative but cash flow positive is the key to success. There are three depreciation benefits available under the current tax laws. First, Internal Revenue Code section 168 allows for the accelerated depreciation of assets for taxation.<sup>112</sup> Currently, property that qualifies under section 48(a)(3) may be depreciated as five-year property.<sup>113</sup> Second, bonus depreciation is allowed for qualified property.<sup>114</sup> Section 48 solar property will qualify for 100% bonus depreciation if placed in service in 2011 and 50% bonus depreciation is available for assets placed in service before the end of 2012.<sup>115</sup> Finally, a section 179 expense is allowed for tangible personal property to which section 168 applies.<sup>116</sup> Qualified solar property is entitled to an immediate expense against the value of the asset. Careful planning is required to monetize the depreciation benefits assigned by the REP because limitations may prohibit their usage.

An expense that matches a reduction in an asset's basis is allowed under section 179(a) for assets that qualify as section 168 tangible property.<sup>117</sup> Expensing business assets is limited under section 179 because of asset value limitations. The section 179 deduction for 2012 is limited to \$125,000 in depreciation and \$500,000 of assets placed in service.<sup>118</sup> The availability of the deduction will be reduced, dollar for dollar, by the value that the

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111. See I.R.C. § 167(a) (2006).

112. Rev. Proc. 2011-26, 2011-16 I.R.B. 664 (2011).

113. I.R.C. § 168(e)(3)(B)(vi)(1) (West Supp. 2010).

114. *Id.* at § 168(k)(5).

115. See *id.* at § 168(k)(1). See also *id.* at § 168(k)(5).

116. *Id.* at § 179(d)(1)(A)(i).

117. *Id.* Section 179(d)(9) reduces the amount of the credit dollar for dollar by the amount taken under section 179(a). See also Rev. Proc. 86-46, 1986-2 C.B. 739 (1986).

118. To be clear, any asset valued at more than \$625,000 will be eligible for zero benefit under section 179.

assets placed in service exceed \$500,000.<sup>119</sup> Treasury Regulation section 1.179-2(b)(3) provides that each company will have separate eligibility for section 179 but the use of any credit will generate a reduction on the “upper tier” for each partner.<sup>120</sup> This creates a multiple tier review process to determine if an investor can apply the section 179 depreciation against a current year liability.

In the review process to determine eligibility under section 179, the investor must first look at the entity level to ensure that the entity is not limited. Next the investors will combine the section 179 expense from the solar REP with all other section 179 expenses allocated to them.<sup>121</sup> Finally, the taxpayer will determine if there is sufficient income to utilize the expense. According to IRS Publication 925, unused losses or section 179 expense which were previously unavailable losses become available in the year of a substantial disposition of interest.<sup>122</sup>

Unused section 179 expense assigned to an investor will carry forward until the next available year. While it will be available to the taxpayer eventually, many high-net-worth individuals have already maximized this expense through other sources. Those who have not done so will receive a maximum benefit of 35% for each dollar. Further limiting the availability of the expense is Treasury Regulation section 1.179-2(c)(6)(ii) that states: “In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business.”<sup>123</sup> Furthermore, mere knowledge of operations is not enough.<sup>124</sup> Real operational control must be exerted to receive the benefit.<sup>125</sup> Accordingly, assets used in a trade or

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119. The 2011 limit is \$500,000 of expense and \$2 million of assets placed in service.

120. Treas. Reg. § 1.179-2(b)(3) (as amended 2004).

121. Should the cumulative amount of all pass-through expenses exceed \$125,000, the investor is limited to \$125,000.

122. For example, consider an investor who owns four partnerships. During the course of the taxable year, each partnership places assets that would otherwise qualify to be expensed under section 179. Investor may receive section 179 deductions from each partnership, but he is personally limited to a total of \$500,000 of bonus in 2011. Accordingly, if each partnership provides \$350,000 of section 179 expense, assuming he may use the full amount, he will still be limited to his personal limit of \$500,000. Any unused amount will be carried forward to the next available year.

123. Treas. Reg. § 1.179-2(c)(6)(ii) (as amended 2004).

124. *Id.*

125. *Id.* See also *e.g.*, Tax Practice Management, Inc. v. C.I.R., T.C. Memo. 2010-266 (Dec. 10, 2010).



business will qualify for section 179 and may offset other passive income. Without material participation in the operations of the business an investor cannot offset other active income with the expense.

### *C. Passive Activity*

Passive activity loss rules may limit the ability of an investor to offset income from active income streams with the passive investment losses of the REP.<sup>126</sup> Generally, passive losses may offset other passive income but may not offset active income.<sup>127</sup> A passive investment is one in which the investor does not materially participate in operations.<sup>128</sup> Failure to produce passive income from other sources impacts the return on investment of the investor because any unused losses are not applied against the investor's tax liability. Loss used in a future year is reduced in value in accordance with the time value of money and therefore lowers the return.<sup>129</sup>

While passive losses may carry forward indefinitely, every year that the loss goes unutilized reduces the time value of money benefit for the investor.<sup>130</sup> An investor may prove that the cumulative participation in an otherwise passive group of investments should count as active participation in an economic unit.<sup>131</sup> Losses generated through passive investments will not offset active income unless material participation is established.<sup>132</sup>

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126. I.R.C. § 469(a)(1) (2006). The limitation is calculated on Form 8582. An exemption of \$25,000 may allow a passive investment in rental real estate against active income. However, limitations of income and participation may prohibit a high-net-worth individual from utilizing this exception. I.R.C. § 469(i)(1) (2006). The amount phases out at 50% for each dollar that AGI is above \$100,000. I.R.C. § 469(i)(3)(A) (2006).

127. *See* I.R.C. § 469(a) (2006).

128. *Id.* at § 469(c)(1) (2006). There are several tests, including a 500 annual hour requirement or a 100 annual hour requirement, and no other person participates above that level. *See* Temp. Treas. Reg. § 1.469-5T (as amended 1996). Merely placing a partner on the power purchase agreement will not in and of itself substantiate any of the requirements. *Id.* at § 1.469-T(a). A license agreement will not likely qualify as a contract for personal services. *Id.* at § 1.469-1T(d). Law, engineering, health, architecture, and accounting are personal services. *Id.* at § 1.469-5T(d)(1).

129. The loss of the time value of money will appear in the NPV calculation of the asset as the discount rate will apply for additional periods. Any unused loss should eventually be available under section 469(b) at the disposition of the interest in the passive activity.

130. *See* I.R.C. § 469(b) (2006).

131. Treas. Reg. § 1.469-4 (as amended 1995).

132. I.R.C. §§ 469(f), 469(h) (2006).

In some instances, a group of otherwise passive investments have such a strong economic correlation to one another that the investor can elect to treat them as an Economic Unit.<sup>133</sup> If the investor materially participates in the Economic Unit, then that group may become active income.<sup>134</sup>

Grouping under section 1.469-4 limits the ability to lump passive investments to only those that function as an Economic Unit.<sup>135</sup> However, Temporary Treasury Regulation section 1.469-5T(f)(2)(ii)(A) provides that “[w]ork done by an individual in the individual’s capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.” Further, section 469(h)(2) prevents a limited partner from being considered an active member in a trade or business unless the individual is the managing member of an LLC and actively participates in the daily operations of that organization.<sup>136</sup> Groupings must be substantiated by a combination of the following factors: similarities of business activities, extent of common control, extent of common ownership, geographic location, and business interdependencies.<sup>137</sup>

## VI. CONCLUSION

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133. Treas. Reg. § 1.469-4 (as amended 1995).

134. *Id.*

135. Recent regulations require taxpayers to disclose their groups. A taxpayer may not change a grouping without a change in circumstance and notification to the Internal Revenue Service. I.R.S. Pub. 925 (2011).

136. L.E. Newell v. Comm’r, TC Memo. 2010-23 (Feb. 16, 2010); *see also* Temp. Treas. Reg. 1.469-5T(e) (as amended 1996).

137. Treas. Reg. § 1.469-4(c) (as amended 1995). The IRS Commissioner has the ability to identify certain transactions and income groups that may generate tax avoidance and limit their grouping to other assets of similar nature. Treasury Regulation section 1.469-4 provides that no one aspect is determinative, but rather the groups look to conformity as a whole. The Commissioner identified renewable energy projects as an area of tax law which may be used for tax avoidance and noted that the Service would apply heavy scrutiny to any grouping of section 48 eligible property. The loss from investment tax credit partnerships could therefore only offset income from similar renewable energy projects. Internal Revenue Bulletin 2009-69 removed the phrase “closely scrutinize” from Revenue Procedure 2007-65 and several other smaller changes. The lack of guidance in the area still leaves a number of issues unresolved related to the structure for solar projects and the applicability of grouping an offsetting income. The complexity and fact specific nature of each investor’s return means that there can be no “one size fits all” approach to structuring a transaction if material participation in a group is sought to enable the passive losses to offset active income.

High-net-worth individuals may capitalize on the opportunity to minimize their tax burdens by investing in clean renewable energy. The opportunities to monetize tax and other government incentives have made solar REPs viable investment options. Working together, developers, investors, and energy users can maximize the available benefits of the transaction. However, structuring footfalls may quickly turn a worthwhile investment into a money pit. Employing the various financial, tax, and legal planning tools set forth in this Comment will help to provide clients with the guidance necessary to maximize available returns while remaining cognizant of possible limitations and risks.

To provide a client with the best advice, professionals must understand the stakeholders to the transaction and their goals, how to calculate and evaluate the return on investment, how to structure the transaction, and the common tax limitations that impact investors. The two common structures used by high-net-worth individuals are the partnership flip and sale-leaseback. These structures provide financing and investing conduits through which an investor may successfully maximize the available governmental benefits. However, the complexity of each transaction means that financial, tax, and legal planning is required.

Investment in clean energy is no longer just for environmentalists and major corporations. A diversified portfolio can include renewable clean energy projects that provide reasonable returns on investment. The ascertainable benefits provided by Tax Credit and Recovery Act section 1603 can be maximized by competent and methodical facilitators. Knowing the key financial calculations provides facilitators the ability to ensure that financial models account for all available revenue streams. This value added service will help to facilitators in negotiating terms to a REP and avoiding the many obstacles inherent to these transactions.