By David Burton and Joe Sebik

Taking Some of the Mystery Out of Alternative Energy Flip Partnership Structures

SOPHISTICATED INVESTORS have been investing in what are known as "tax equity flip partnership structures" for many years, predominately at first for wind farm investments. This article will explain in high-level terms the structure of the investment and the tax rules for such structures.

Tax Background

Congress has historically provided tax incentives for targeted investments. To encourage investment in wind and other renewable energy technologies, Congress created the production tax credit (PTC). The PTC is a tax credit that is based on the production of electricity calculated on a rate per kilowatt hour produced and is available to the *producer* of the electricity for 10 years from the date a facility is originally placed in service. Alternatively, the owner may elect to claim an energy tax credit (ETC) (also referred to as an investment tax credit or ITC) equal to 30% of the eligible alternative energy asset cost.

The American Taxpayer Relief Act of 2012 has established a final end date for new PTCs, which will only be available for facilities that commence construction during 2013. The IRS recently published Notice 2013-29 addressing this requirement. Unless renewed, after 2013 the PTCs and ETCs will no longer be available for newly constructed wind farms. Solar is eligible for a 30% ETC for facilities placed in service by the end of 2016. After that, solar facilities are eligible for a 10% ETC, which is a permanent provision in the tax law.

Often a developer does not have sufficient tax liability to use the credits. Due to the high cost of wind farms and the large tax benefits created, developers often are unable to utilize the tax benefits efficiently and, accordingly, need to implement a flip partnership.

A flip partnership transaction starts with the formation of a limited liability company (LLC) that for federal income tax purposes is taxed as a partnership. The LLC does not owe tax, rather the tax benefits and tax liabilities "flow through" to the partners. There are typically two classes of partners: the developer who acts as the managing member and makes day-to-day decisions and the tax equity investors who are relatively passive.

Flip partnerships are subject to technical partnership tax regulations and a safe harbor promulgated by the IRS for wind farms in Revenue Procedure 2007-65.

In a nutshell, tax regulations allow for cash distributions, taxable income and loss and tax credits to be allocated in a manner that is different from the ownership percentages. The partnership agreement is written so that the partnership initially allocates free cash, PTCs or ETCs and early year tax losses to the tax equity investors. Under partnership tax rules, a partner's tax basis is increased or decreased by taxable income or losses allocated to it and decreased by cash distributions, but not affected by allocations of PTCs, while allocation of the ETC results in a reduction equal to 50% of the ETC.

The Flip

The partnership is called a "flip" because the allocation of cash and tax benefits changes over time upon the occurrence of certain events; in effect, it "flips" between the developer and the tax equity investors. For instance, upon the tax equity investors achieving a targeted after-tax internal rate of return (AT IRR), the allocation of cash, tax credits and taxable income or loss will change from 99% to the tax equity investors to only 5%.

Generally the flip is expected to occur (1) in five years in the case of an ETC transaction, as that is when the ETC has fully vested, or (2) after the 10-year period for which PTCs are available.

Here is an example:

PHASE 1—The funding contributed by the tax equity investors often pays down some of the construction debt balance remaining and repays the developer some of its investment. Once the facility is placed in service, the developer distributed a substantial portion of free cash to start recouping its

		DEVELOPER		TAX EQUITY INVESTORS	
Phase	Phase Description	Free Cash	Tax Benefits	Free Cash	Tax Benefits
1	Initial tax equity period	100%	1%	0%	99%
2	Tax equity earning period	0%	1%	100%	99%
3	Post-flip period	95%	95%	5%	5%

investment while up to 99% of tax benefits are allocated to the tax equity investors.

PHASE 2—After the developer has taken out the agreed-upon cash, the partnership makes its first flip and generally the partnership agreement provides that 100% of the free cash is distributed to the tax equity investors. The tax equity investors continue to be allocated 99% of the tax benefits.

PHASE 3—If the transaction is a PTC transaction, the partnership is usually structured so that the tax equity investors achieve a targeted AT IRR around the time the PTCs expire. If the transaction is an ETC transaction, the targeted AT IRR occurs around the fifth year, after the ETC has vested. Once the targeted AT IRR is achieved, the developer is commonly provided an option to buy out the tax equity investors.

INVESTMENT ANALYSIS—The tax equity investor is receiving the majority of tax credits and tax losses and whatever estimated free cash is needed to achieve the AT IRR through the second flip point. The combination of cash distributions and tax losses (but not tax credits) acts to reduce the tax equity investors' tax basis in the partnership.

The components of the tax equity investors' return can be illustrated in the following example which has been *substantially simplified* for illustrative purposes:

Investment

Project cost	$100.00 million
Developer investment	$ 50.00 million
Tax equity investors' investment	$50.00 million

Sources of Return of and on Tax Equity Investors' Capital

Energy tax credit ($30M x 99%)	$29.70 million
After-tax effect of tax depreciation allocated (($100 – 15% basis reduction due to ETC) x 99% x 35% tax rate)	$29.45 million
Cash distributions $25 – 35% tax ($8.75)	$16.25 million
Total payback of investment plus "yield"	$75.40 million

In the interest of simplicity, income tax from income allocated to the tax equity investors from the sale of electricity is omitted from this example. Thus, the tax equity investors have received $29.70 million from the tax credit, $29.45 million from the allocated tax depreciation deductions and the balance from after-tax free-cash distributions. This is a very simplified approach to looking at the economics, but the fact is that it is not so far from a typical structure. A PTC deal would have slightly different numbers.

To ensure that the tax equity investors are able to claim the anticipated PTCs and depreciation, it is critical to comply with the "capital account" tax regulations. Those regulations are beyond the scope of this article, but careful attention is required regarding the deal model and the drafting of the partnership agreement is required to ensure compliance.

Typically, at the end of the PTC period or the ETC recapture period, the developer has a right to buy out the investment of the tax equity investors. The buyout price is usually defined as the greater of the fair market value of tax equity investors' partnership interests and the value needed to ensure that the tax equity investors achieve their targeted AT IRR.

We hope this article is a useful primer on tax equity flip partnership structures, so that readers can take the first step toward deciding if it is an investment option that is a fit for their organizations. While the flip partnership structure itself is not going away, absent an extension, the PTC and 30% ETC will expire in coming years. Companies may want to consider investing now to capture premium returns from the tax credits. ■

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