Effective Structuring and Modeling

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<th>Agenda</th>
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<td>1. Getting Started – Project Economics</td>
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<td>2. Project Finance Structures</td>
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<td>3. Contribution vs. Sale – Section 704(c)</td>
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<td>4. Capital Accounts</td>
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<td>5. Partnership “Flip” – IRS Safe Harbor</td>
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<td>6. Debt Financing</td>
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Getting Started – Project Economics

• Projected construction costs
  – Hard costs (e.g., turbines, balance of plant)
  – Soft costs (e.g., financing costs, develop. fee)
• Projected operations
  – Nameplate capacity, capacity factor, etc.
  – Operating costs
  – Other sources of revenue (e.g., RECs)
  – Debt service
  – Tax cost segregation
Tax Cost Segregation

- 5-year MACRS
- 7-year MACRS
- 15-year MACRS
- 20-year MACRS
- 20-year straight-line
- 39-year MACRS
Getting Started – Project Economics

Capital Expenditures → Project

- Tax Credits
  - Tax Savings
- Cash Receipts
  - OpEx and Reserves
    - Distributable Cash Flow
- Taxable Receipts
  - Tax Deductions (MACRS)
    - Tax Savings (Liabilities)
Project Finance Structures

• Partnership “flip”
  – All equity
  – Back-leverage
  – Project level debt
  – Pay-go
• Sale-leaseback
• Power prepayment
• Portfolio financing
Partnership “Flip”

Cash distributions
Period 1: 100%
Period 2: 0%
Period 3: 95%

Gross income (loss)
Period 1: 1%
Period 2: 1%
Period 3: 95%

Rev. Proc. 2007-65 Example 1

Cash distributions
Period 1: 0%
Period 2: 100%
Period 3: 5%

Gross income (loss)
Period 1: 99%
Period 2: 99%
Period 3: 5%
Sale-Leaseback

Tax Equity (Project Owner)

- Tax Credits
- Distributable Cash Flow
- Tax Savings (Liabilities) [MACRS]

Developer (Project Operator)

- Distributable Cash Flow
- Tax Savings (Liabilities) [Lease Expense]

Sale-Leaseback

Sale

Leaseback

Lessor

Lessee
Solar

• Sale-Leaseback
  – Original use: 90-day exception
  – Valid sale: benefits and burdens of ownership
  – Potential IRS challenge: financing transaction
  – Section 467 rent

• Partnership “flip”
  – 5-year ITC recapture period
  – Capital account impact of ITC basis reduction
Contribution vs. Sale – Section 704(c)

Assumptions:
- cost to construct = $75
- project total FMV = $100

Developers contribute $40 of cash and construct $75 worth of assets, for a total of $100 worth of contributions. The project total FMV is $100.

- Holdco LLC acquires 100% of Project LLC for $100, resulting in no deferred gain.
- Tax Equity Investor contributes $60 in cash.

Taxable gain: $100 – $75 = $25

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<th>D</th>
<th>TE</th>
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</thead>
<tbody>
<tr>
<td>FMV: 704(b)</td>
<td>$40</td>
<td>$60</td>
</tr>
<tr>
<td>tax basis</td>
<td>$40</td>
<td>$60</td>
</tr>
</tbody>
</table>
Contribution vs. Sale – Section 704(c)

Deferred gain: $25
Disguised sale? Reg. §1.707-5

Assumption: cost to construct = $75
project total FMV = $100

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<thead>
<tr>
<th></th>
<th>D</th>
<th>TE</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV: 704(b)</td>
<td>$40</td>
<td>$60</td>
</tr>
<tr>
<td>tax basis</td>
<td>$15</td>
<td>$60</td>
</tr>
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</table>
Section 704(c) Methods

- Traditional
  - Ceiling rule
- Traditional with curative allocations
- Remedial
Capital Accounts

- Section 704(b) substantial economic effect
- The capital account analysis is the “score card” for the economic benefit or burden of the allocations
- The capital account analysis is based on the following three requirements:
  - Capital Account Requirement
  - Distribution Requirement
  - Deficit Makeup Requirement
## Capital Accounts Example

<table>
<thead>
<tr>
<th></th>
<th>Investor</th>
<th>Sponsor</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Contribution %</td>
<td>60.00%</td>
<td>40.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>P/L %</td>
<td>99.00%</td>
<td>1.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Contributions (+)</td>
<td>60,000,000</td>
<td>40,000,000</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Distributions (-)</td>
<td>-</td>
<td>(10,000,000)</td>
<td>(10,000,000)</td>
</tr>
<tr>
<td>Taxable Income/(Loss) (+/-)</td>
<td>(12,500,000)</td>
<td>(125,000)</td>
<td>(12,625,000)</td>
</tr>
<tr>
<td>December 31, XX08</td>
<td>47,500,000</td>
<td>29,875,000</td>
<td>77,375,000</td>
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</table>
Debt Basis

- Each partner’s “outside” tax basis is the sum of its tax capital account balance plus its allocable share of partnership debt.
- If the project has debt, a partner’s tax capital account may go negative; provided each partner maintains a positive “outside” tax basis in its investment.
Qualified Income Offset ("QIO")

- Each partner should maintain a positive capital account
- If the capital account of any partner is negative after the initial allocations of cash and taxable income/losses, there may be a reallocation of income between partners, referred to as a "qualified income offset" or "QIO" in an amount necessary to eliminate any negative capital account balances
Deficit Restoration Obligation ("DRO")

• In lieu of a qualified income offset, a partner with a negative capital account may sign up for a DRO (typically a limited DRO) so that losses continue to be allocated to the partner even though its capital account is negative
Section 704(d) Loss Limitation

• Losses allocated to a partner are only allowed to the extent of the partner’s “outside” tax basis in its partnership interest

• Excess losses are suspended and carried forward until the partner has sufficient tax basis
IRS Safe Harbor Requirements

- Revenue Procedure 2007-65
- Directly applies to the wind PTC only
- Requirements under which the IRS will respect the allocation of PTCs by partnerships in accordance with section 704(b)
IRS Safe Harbor Requirements

• Applies to any partnership (the “Project Company”) between a project “Developer” and one or more “Investors,” with the Project Company owning and operating the qualified wind project

• “Investors” are partners in the Project Company whose investment return is reasonably anticipated to be derived from both PTCs and participation in operating cash flow
IRS Safe Harbor Requirements

- Safe Harbor for audit purposes
- No rule policy
- If a transaction falls outside of the Safe Harbor, the Revenue Procedure provides that the IRS will “closely scrutinize” the transaction based on all facts and circumstances under general tax law principles
IRS Safe Harbor Requirements

• Minimum 1 percent interest for Developer
  – Throughout the existence of the Project Company, the Developer must have at least 1 percent interest in each material item of partnership income, gain, loss, deduction, and credit

• Minimum 5 percent interest for each Investor
  – Each Investor must have a minimum interest in each item of partnership income and gain for every year, equal to 5 percent of its largest interest in income and gain for any year
IRS Safe Harbor Requirements

• Investor’s minimum investment
  – Throughout the duration of the project, the Investor must have a minimum investment equal to 20% of the sum of (i) fixed capital contributions plus (ii) its reasonably anticipated contingent capital contributions
  – Minimum investment may be reduced by distributions from company operations
IRS Safe Harbor Requirements

- Investor’s minimum investment
  - Effective with respect to an Investor’s investment as of the later of the date the wind project is placed in service or the date the investor acquires its interest in the Project Company
  - The Investor must not be protected against loss on any portion of the Investor minimum investment
IRS Safe Harbor Requirements

- Investor’s non-contingent investment
  - At least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an investor must be fixed and determinable and cannot be contingent or uncertain

- Separate Activity for Purposes of §469
IRS Safe Harbor Requirements

• Purchase rights
  – Must be at FMV when exercised
  – No purchase right during first 5 years

• Sale rights
  – Neither the Project Company nor the Investor can have a contractual right to cause anyone to purchase the facility or their interest in the Project Company
IRS Safe Harbor Requirements

• Guarantees and loans
  – No person may guarantee or otherwise insure the Investor the right to any allocation of PTCs
  – The Developer, the turbine supplier, or any power purchaser may not guarantee that a certain level of wind will exist
  – The Developer and related parties may not lend any Investor the funds to acquire its interest in the project company or guarantee any debt incurred in connection with the acquisition of such interest
IRS Safe Harbor Requirements

• Allocation of PTCs
  – Pursuant to Treas. Reg. §1.704-1(b)(4)(ii), PTCs are allocated in the same proportion as the electricity sale that generated the PTCs
Debt Financing

• Recourse
  – Who bears the economic risk of loss?

• Nonrecourse
  – Even though partners do not bear the economic risk of loss for nonrecourse liabilities, they bear the corresponding tax burden related to relief from those liabilities in their amount realized upon the disposition of property encumbered by the debt
Debt Financing

- Partnership minimum gain
  - The calculation of partnership minimum gain comes into play when the partnership uses nonrecourse debt to fund a portion of the capital costs of the project
- Nonrecourse deductions
  - Partnership minimum gain goes up for the year
- Minimum gain chargeback
  - Partnership minimum gain goes down for the year
Debt Financing

• Minimum gain chargeback
  – If there is a net decrease in partnership minimum gain for the taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of income and gain for the year equal to the partner’s share of net decrease in partnership minimum gain
  – A partner’s share is based on the nonrecourse deductions previously allocated to that partner
### Example – Taxable Income Allocations

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, XX07</td>
<td>15,135,169</td>
<td>2,530,582</td>
<td>17,665,751</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Distributions</td>
<td>-</td>
<td>(241,452)</td>
<td>(241,452)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st 99%/1% until Investor zero</td>
<td>(15,135,169)</td>
<td>(152,880)</td>
<td>(15,288,049)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td>-</td>
<td></td>
<td>2,136,250</td>
<td>2,136,250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd 0%/100% until Sponsor zero*</td>
<td>-</td>
<td>(2,136,250)</td>
<td>(2,136,250)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd 99%/1% (based on minimum gain)</td>
<td>(460,882)</td>
<td>(4,655)</td>
<td>(465,538)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income/(loss)</td>
<td>(15,596,051)</td>
<td>(2,293,786)</td>
<td>(17,889,837)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>December 31, XX08 (A+B+C+D+E+F=)</td>
<td>(460,882)</td>
<td>(4,655)</td>
<td>(465,538)</td>
<td></td>
<td></td>
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<tr>
<td>Current year effective P/L %</td>
<td>87.1783%</td>
<td>12.8217%</td>
<td>100.0000%</td>
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<td></td>
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</tbody>
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* Assumes no Investor deficit restoration obligation (“DRO”)