ENERGY LAW360

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IRS Guidance For Flip Structures In Wind Deals

Wednesday, Oct 24, 2007 --- On October 19, 2007, the IRS issued much anticipated guidance that provides clarity for investor transactions in wind energy projects that qualify for the section 45 tax credit for renewable energy production.

The Internal Revenue Code currently provides a tax credit of $20 per megawatt for electricity generated by wind projects that are placed in service before the end of 2008.

In order to finance wind projects, developers seek investors that can take advantage of the available tax credits. The predominant structure used with investors is the so-called “partnership flip.”

Although there are many variations, in a typical partnership flip transaction, the tax investor purchases a partnership interest that receives 99% of the income and tax credits generated by the project until the investor earns an agreed after-tax return on its investment, which usually is modeled to occur around the end of the 10-year credit period.

On the flip date, the investor’s percentage interest is reduced to 5 or 10 percent and the developer’s interest in the partnership is correspondingly increased.

Revenue Procedure 2007-65 establishes a “safe harbor” for these flip structures for partners and partnerships that own and produce electricity from qualified wind energy facilities.

If the partners and partnerships satisfy the requirements set forth in the Revenue Procedure, the IRS will not challenge the allocation of tax credits by the partnership.

The IRS states that the safe harbor is intended to simplify the application of the tax credit to partners and partnerships that own and produce electricity from qualified wind projects. The clarification and certainty provided by the safe harbor is sure to be welcomed in the burgeoning wind industry.

The Revenue Procedure indicates that the safe harbor applies to any partnership (the “Project Company”) between a project developer (the “Developer”) and one or more investors (the “Investors”), with the Project Company owning and operating the project containing the wind facilities (the “Wind Farm”).

In order to qualify for the safe harbor, the partners and the partnership must

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satisfy the following twelve requirements:

(1) The Investor's investment return must be reasonably anticipated to be derived from both section 45 credits and participation in operating cash flow.

(2) The Developer must have a minimum 1% interest in all partnerships items, including section 45 credits.

(3) The Investor must have a minimum interest in partnership income and gain equal to 5% of its largest share of such items during its ownership of an interest in the partnership.

(4) The Investor must make and maintain at least a 20% minimum investment (not protected against loss) in the Project Company, but reduced for distributions of cash flow.

(5) At least 75% of the Investor's capital contributions must be fixed and determinable and not contingent in amount or certainty of payment.

(6) Neither the Developer, the Investors nor any related parties may have a purchase option at a price less than fair market value determined at the time of exercise.

(7) The Developer (or party related to the Developer) may not have a purchase option exercisable earlier than 5 years after the wind facility is first placed into service.

(8) Neither the Project Company nor the Investors may have a put option with respect to the Wind Farm, property included in the Wind Farm, or interest in the Project Company.

(9) No person may guarantee or otherwise insure the Investor the right to any allocation of the section 45 credit.

(10) The Project Company must bear the risk of wind availability (no guarantees except from third parties if the Project Company or an Investor directly pays the cost of or premium for such guarantee or insurance).

(11) The Developer (or a party related to the Developer) may not lend any Investor the funds or guarantee any indebtedness with respect to acquisition of its interest.

(12) Section 45 credits must be allocated in accordance with the general partnership rules (e.g., in the same manner as receipts from the sale of electricity produced at the Wind Farm are allocated).

The Revenue Procedure provides two illustrations of the safe harbor rules. The first example is a valid wind energy partnership that satisfies each of the requirements of the safe harbor.

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In the example, the Project Company is a limited liability company that has been formed to develop, own and manage a wind energy project. Investor is a corporation that invests in renewable energy projects primarily to benefit from section 45 tax credits.

The Project Company has entered into a number a contracts or agreements relating to the development of the Project.

Construction of the Project will be financed with $100x of construction financing.

When construction of the Project is substantially complete, the Developer will contribute $15x to Project Company, and (2) Investor will acquire newly issued membership interests in exchange for an upfront cash capital contribution in the amount of $10x which is 20% of Investor's total agreed capital contributions of $50x.

There is no guarantee regarding the level of the available wind resource at the Project or the amount of section 45 tax credits.

The allocations of partnership items and distribution of available cash are divided into three periods. During Period 1, 99% of the Project Company's gross income or loss and the section 45 credits will be allocated to Investor, and 100% of Project Company's cash flows will be distributed to Developer.

Period 1 will continue until the earlier of (i) such time that Developer has received aggregate cash distributions in an amount equal to the aggregate contributions made by Developer (i.e., $15x) and (ii) a fixed outside date.

During Period 2, 99% of Project Company's gross income or loss and the section 45 tax credits will be allocated to, and 100% of Project Company's cash flows will be distributed to Investor.

Period 2 will continue until Investor has achieved an agreed after-tax internal rate of return (the "Flip Point"). Although the Flip Point might occur sooner, it is expected that the Flip Point will not occur until after the end of year 10 of the Project, at which time section 45 tax credits will no longer be available for the production and sale of electricity from the Project.

Following the Flip Point, the Investor will receive 5% of the Project Company's gross income or loss and 5% of Project Company's cash flows, and the Developer will receive 95% of Project Company's gross income or loss and 95% of Project Company's cash flows through the remaining life of the Project.

In the second example, the partnership fails the safe harbor test. In the second example, the Investor is initially allocated 99.5% of the Project Company's gross income or loss and section 45 credits.

The Revenue Procedure indicates that this partnership will not satisfy the

safe harbor requirements (which requires the Developer to have at least a 1% interest in such items) and states that the Project Company's classification as a valid partnership would be closely scrutinized by the IRS.

Thus, it appears that in certain circumstances the IRS may use the Revenue Procedure to challenge transactions that fail to meet its requirements.

The Revenue Procedure states that it applies only to partners or partnerships with section 45 tax credits from renewable resources from wind and does not apply to any other tax credits.

Based on this statement, it is not clear that the IRS will apply the safe harbor in the context of other section 45 tax credits or other tax credit investments.

Nevertheless, investors and tax counsel are likely to apply the rules found in the Revenue Procedure in structuring other types of tax credit transactions, especially those involving other types of section 45 tax credit transactions, such as electricity production from open-loop biomass, geothermal and landfill gas.

Most of the requirements of the safe harbor were anticipated by the industry, such as the range of the approved flip from 99% to 5%.

Other requirements, such as the requirement that any contingent payments not exceed 25% of the total purchase price or required contributions or that the investor maintain a 20% investment in the project may not have been anticipated.

Nevertheless, those requirements are reasonable and should not be difficult to meet in most transactions.

On balance, the wind energy industry should view the Revenue Procedure favorably. It provides clear guidelines for structuring transactions and provides certainty to both the developers and investors in those transactions.

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