TAX PLANNING FOR HYDROPOWER

Presented by:

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STOEL RIVES LLP

ATTORNEYS AT LAW

to the

National Hydropower Association
Finance Summit

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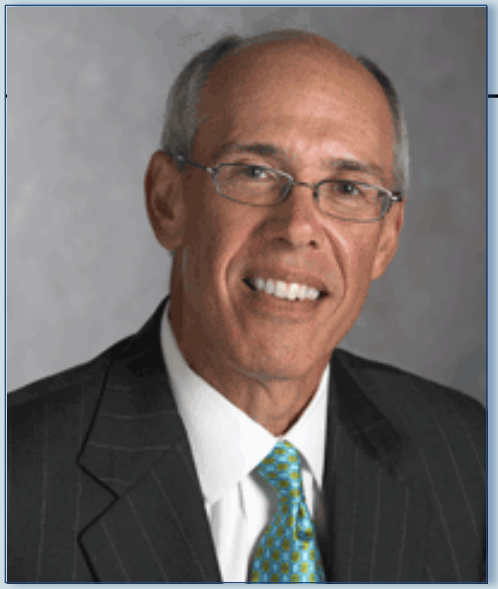

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TOP RANKED
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Stoel Rives is pleased to announce that is has received National rankings for its **Renewables and Alternative Energy practice** from ***Chambers USA***. **Chambers and Partners** annual rankings are a result of extensive independent research conducted among in-house counsel, corporate executives and leading attorneys.

2013
BEST LAW FIRMS
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The firm is also pleased to announce that for the third year in a row it has received a **National First-Tier ranking** for its **Energy Law practice**, an honor achieved by only a select number of law firms in the country.

Overview of Available Incentives

- Production Tax Credit (“PTC”)
- Investment Tax Credit (“ITC”)
- 1603 Grant
- Accelerated Depreciation (“MACRS”)
- Basis and income inclusion issues

Production Tax Credit

- Based on amount of electricity produced
  - from qualified resource
  - sold to unrelated person
  - during each year of credit period
    - Credit rate adjusted for inflation each year
    - Credit rate for 2013 is 2.3¢ per kilowatt hour
- Credit Period – 10-year period beginning with “placed-in-service” date

Production Tax Credit

- Qualified resources include:
  - Wind
  - Geothermal
  - Biomass
  - Hydropower, marine and hydrokinetic
  - Others (small irrigation, landfill gas, trash, refined coal, Indian coal)
- Not solar

Production Tax Credit

- Electricity must be owned and produced by taxpayer seeking to claim the PTC
  - Taxpayer need not own on placed in service date
- Facility must be located in the U.S.
- Construction must begin before January 1, 2014

Production Tax Credit

- Nonrefundable, but can be carried back one year and forward 20 years
- Credit reduced for certain grants, credits and government subsidized financing
- Credit for open-loop biomass, hydro, MSW, landfill gas, marine, etc., reduced by 50%

Beginning Construction

- Two alternative tests:
  - Physical work of a significant nature
  - 5% Safe harbor
- “Binding written contract”
- Continuous program of construction/ efforts
- Multiple vs. single facilities
- Paid vs. incurred (Economic performance)
- Look-through rule

Qualified Hydropower

- Divided into two categories:
  - Incremental
  - Non-incremental (non-hydropower)
- Incremental:
  - Improvements, additions, etc. to an existing hydroelectric dam placed in service before 8/9/2005
  - Credit based on the “incremental hydropower production” for the taxable year (defined as ...)

Qualified Hydropower

- Percentage of annual hydropower production attributable to “efficiency improvements or additions to capacity” PIS after 8/8/2005
- Determined by using the same water flow information used to determine an historic average annual hydropower production baseline facility
- Certified by FERC

Qualified Hydropower

- Non-Incremental (Non-hydropower)
  - Licensed by FERC and ...
  - Meets all other environmental, licensing and regulatory requirements (including fish), and that was ...
  - Placed in service before 8/8/2005, and is
  - Operated for flood control, navigation or water supply purposes,
  - Did not produce hydroelectric power on 8/8/2005, and
  - Is operated so that water surface elevation that would have occurred in the absence of the project is maintained, subject to licensing requirements, etc.

Marine and Hydrokinetic

- Four categories:
  - Waves, tides and currents in oceans, estuaries and tidal areas
  - Free-flowing water in rivers, lakes and streams
  - Free-flowing water in irrigation systems, canals, or other man-made channels
    - Includes non-mechanical structures to accelerate water flow for production of electricity
  - Differentials in ocean temperature

Marine and Hydrokinetic

- Does not include power produced from:
  - Dams
  - Diversionary structures (other than those described previously), or
  - Impoundment
  - Pumped storage
- Must have nameplate capacity of 150 Kw+
- Must be owned by the taxpayer
- Placed in service after 10/3/2008

Investment Tax Credit

- Based on the cost of qualifying equipment
  - Generally 30% of tax basis
  - Credit is claimed entirely in the year in which property is placed in service
- To qualify, property must be “energy property”
- “Energy property” includes solar, geothermal, fuel cells, and certain PTC-eligible property for which an election is made
- Credit reduced to 10% after 2016

Investment Tax Credit

- Facility must be placed in service by taxpayer
  - Exceptions for certain sale/leasebacks and pass-thrus
- Before the applicable credit termination date:
  - January 1, 2013 for wind
  - January 1, 2017 for solar and fuel cells
  - January 1, 2014 for most other types of projects

Investment Tax Credit

- Property must be eligible for depreciation
- For PTC-eligible property, may not be a building or structural improvements and must be an integral part of facility
  - Must be “generation” equipment and not transmission
    - Cut-off previously thought to be step-up transformers
    - Regardless of how far downstream
    - May also include downstream assets (e.g. circuit breakers, switches, etc.) that insulate transformer from damage
  - Cost allocation based on 263A principles

Investment Tax Credit

- Nonrefundable but can be carried back one year and forward 20 years
- Basis of property reduced by 50% of ITC
  - Exception for lease pass-thru
  - Outside basis adjustments for partnerships and S Corps
- Recapture if property or interest disposed of within 5 years
  - Treated as addition to tax
  - Limited to taxpayer disposing of property or interest

Investment Tax Credit

- No cutback for subsidized financing
- Proportionate disallowance for tax-exempt owner
- Specials rules for REITs, RICs and cooperatives
- Another special rule for Puerto Rico
- More value (relatively) for more expensive, lower producing facilities
- No “haircut” as in PTC

Treasury Dept. Grant

- Section 1603 - election to receive cash grant
- Eligibility requirements for the ITC apply (generally)
- Project generally must be:
  - Placed in service in 2009, 2010 or 2011, or
  - Construction must begin before 2012 and project must be placed in service by credit termination date
- Dates not extended in 2013

Treasury Dept. Grant

- Grant generally operates in the same manner as ITC
  - 30% of tax basis of qualifying property (10% for certain projects)
  - Subject to recapture if sold to disqualified person within 5 years
  - Not included in recipient's taxable income
  - Basis reduced by 50% of grant amount

Treasury Dept. Grant

- "Credit termination date"
  - 12/31/2012 for wind; No more grants for wind
  - 12/31/2013 for most other renewables
  - 12/31/2016 for solar
- What is the "facility?"
  - Guidance says turbine by turbine
  - Solar?
  - Batching?
  - Depreciation?

Treasury Dept. Grant

- What does “placed in service” mean?
  - “[P]laced in a condition or state of readiness and availability for a specifically designed function”
  - Facts and circumstances
- Factors that IRS will consider:
  - Approval of required licenses and permits
  - Passage of control from contractor to taxpayer
  - Completion of critical tests
  - Commencement of daily or regular operations
  - Synchronization into the grid

Treasury Dept. Grant

- If not “placed in service” in 2011, must have “begun construction” in 2011
- Treasury Guidance, including 2010 FAQs
- Two alternative ways to qualify:
  - “Physical work of significant nature”
  - 5% safe harbor -- costs “paid or incurred”
- Remarkable amount of confusion!

Treasury Dept. Grant

- Treasury position on “grandfathering” and transfers
  - Developers may “stockpile” components and feed them into projects (provided 5% safe harbor met)
  - Open question on financing companies and funds
- Sales of project companies may be OK (FAQ 24)
  - Sales of assets may lose grandfather (FAQ 23)

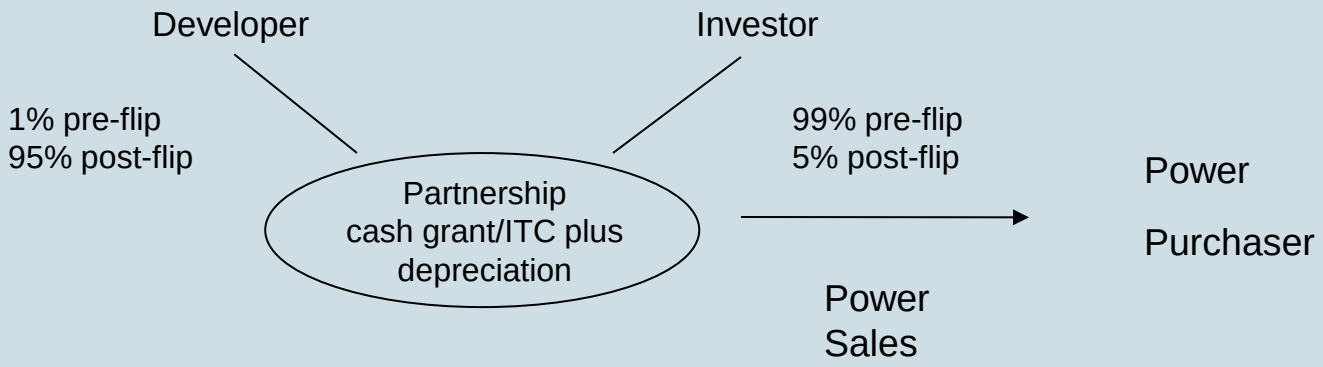
Flip Safe Harbor

- Rev Proc 2007-65
- Applies Only to Wind Farms, but…
- Applies Only For Purposes of PTC, but…
- Creates No Ruling Area

Flip Safe Harbor (cont)

- Basic Requirements
  - Minimum Partnership Interest
  - Minimum Unconditional Investment
  - Maximum Contingent Consideration
- Purchase and Sale Rights
- Guarantees and Loans
- Passive Loss Issues

Common Flip Structure



- Investor receives 99% of cash grant/credits plus depreciation
- Can depreciation be specially allocated?
- Flip occurs after investor achieves IRR (or after set date)
- Developer has purchase option after flip

Determining Flip Date

- Return-Based Flips
  - Very Complex
  - Modeling Required
  - Fixed Assumptions and Risk Allocation
- Time-Based Flips

Economic Substance

- General Issue – Loan vs. Equity
- Must be Owner to Get Credits and Losses
  - PTCs vs. ITCs
- Economic Substance Legislation
  - (IRC § 7701(o))
- Modeling Required
- Cash-on-Cash Return

Issues Beyond Economic Substance

- Recent Tax Cases
  - Castle Harbor
  - Virginia Historic Tax Credit Fund
  - Historic Boardwalk Hall
  - Consolidated Edison
- Trends and Implications

Structure Comparisons

- Flip vs. Leasing Structures
  - Can't Use Lease Flow-Through for PTC
  - Sale-Leaseback Issues
- Impact of Safe Harbor

IRS Leasing Guidelines: Overview

- Rev. Proc. 2001-28
- Safe harbor for leveraged leases
- Procedural (not substantive)
- Informs IRS view
- Case law differs

IRS Guidelines: Leveraged Leases

- Three parties (Lessor, Lessee, Lender)
- Net leases
- Lease for substantial part of useful life
- Rent covers debt service

IRS Guidelines: 20/20/20 test

- Initial minimum investment = 20% cost
- Maintenance of minimum investment of 20% of cost throughout lease term
- Residual investment = 20% of cost and 20% of original useful life

IRS Guidelines: Options

- Lessee call option
  - IRS view: FMV determined at time of exercise
  - Case law supports fixed price option at FMV determined at inception of lease (w/ appraisal)
- No lessor puts
  - Subsequently acquired puts may be OK
  - Abandonment right = put

IRS Guidelines: Other Requirements

- Generally no lessee improvements
- Generally no lessee loans or guarantees
- Lessor profit
- Limited use property

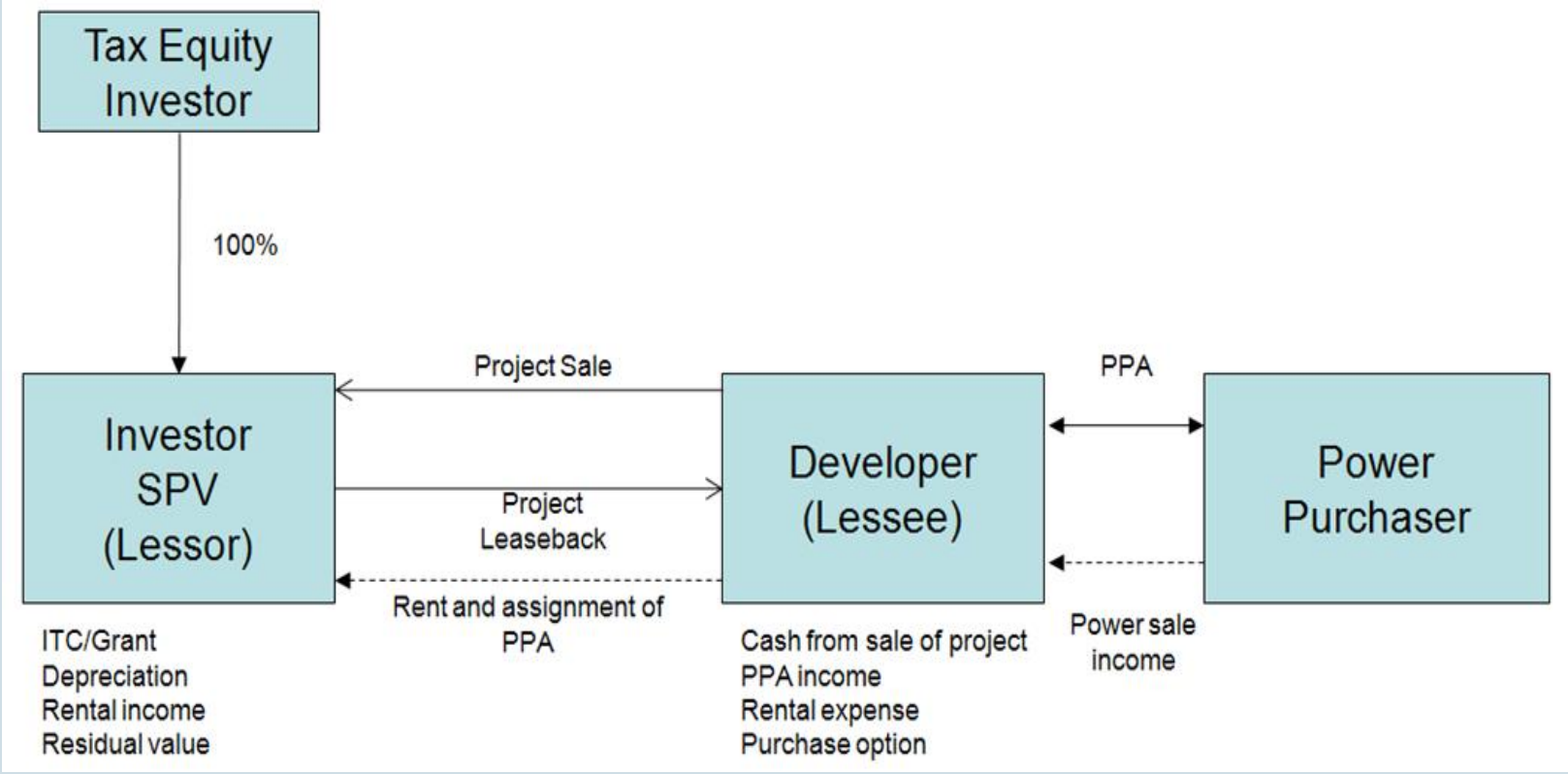
Section 467

- Section 467 applies to leases with either:
  - Increasing or decreasing rents; or
  - Prepaid or deferred rents
- If lease lacks adequate interest, must recognize “proportional rental amount”
- Deemed loan balance and interest

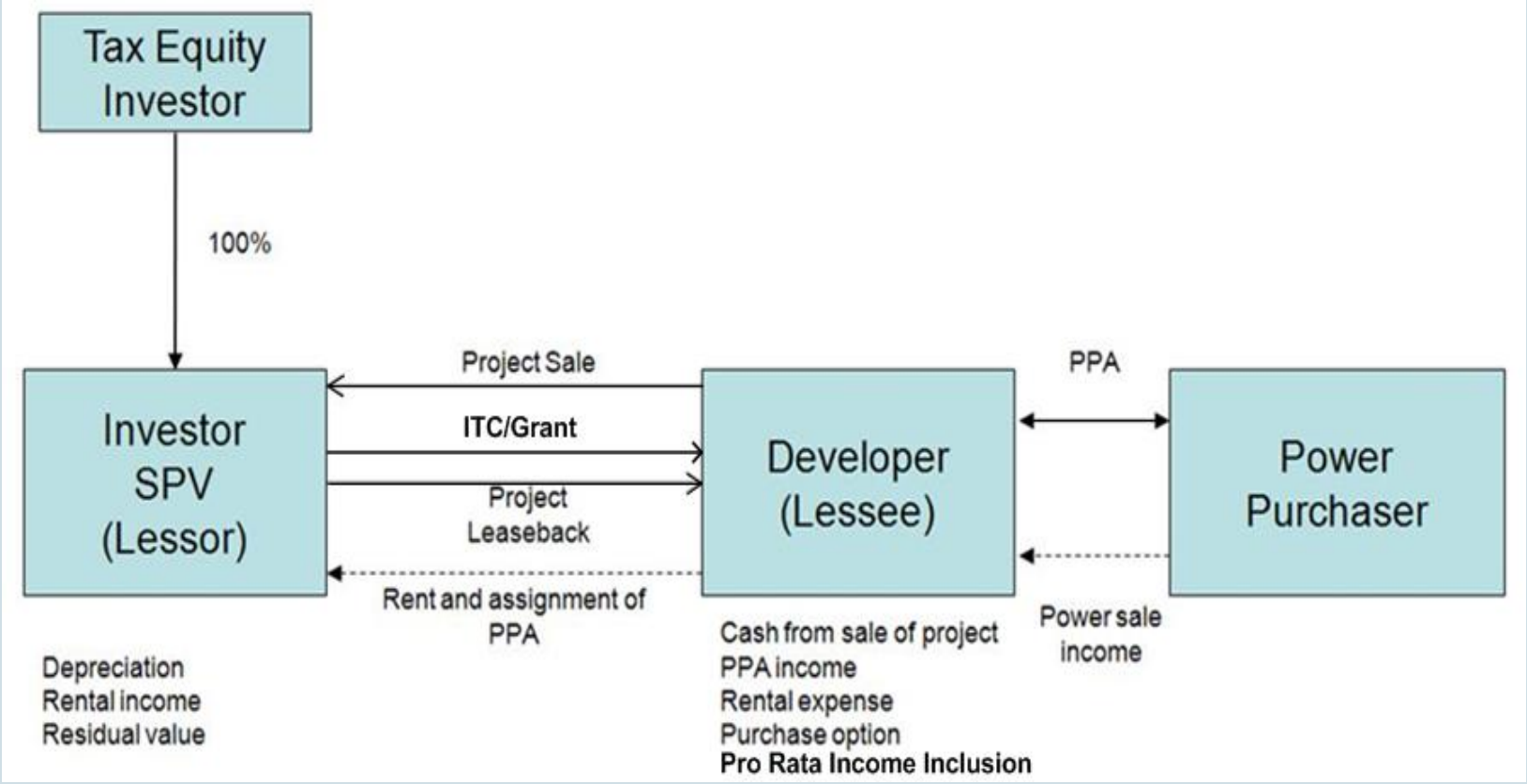
Leasing Structures

- Sale-leaseback
  - Lessor gets ITC/grant and depreciation
- Inverted lease
  - Lessor or Lessee gets ITC/grant
  - Lessor gets depreciation (w/o basis reduction)
  - Basis reduction/ratable income inclusion
  - Lessor and Lessee cannot be tax-exempt

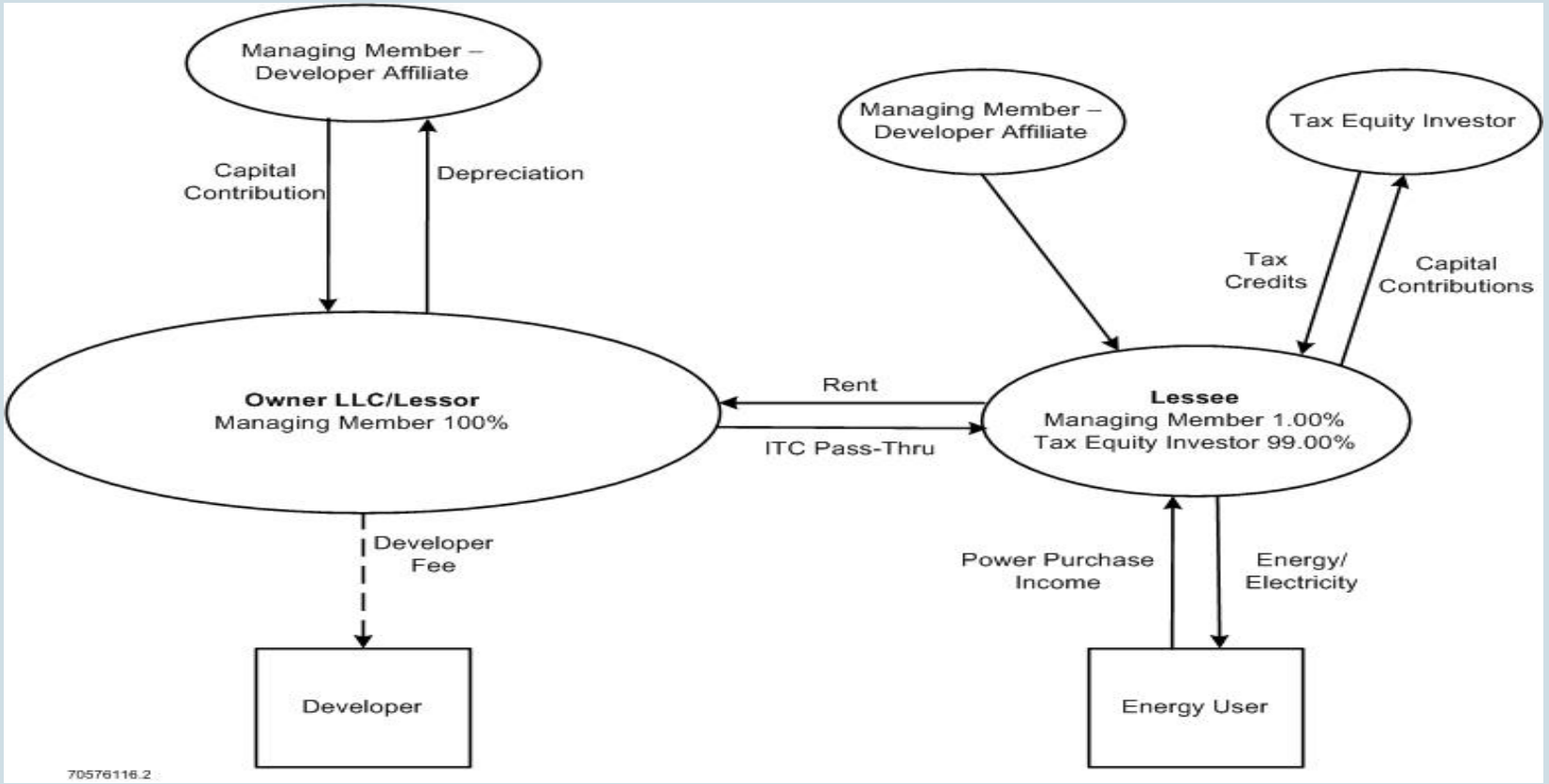
Traditional Sale - Leaseback



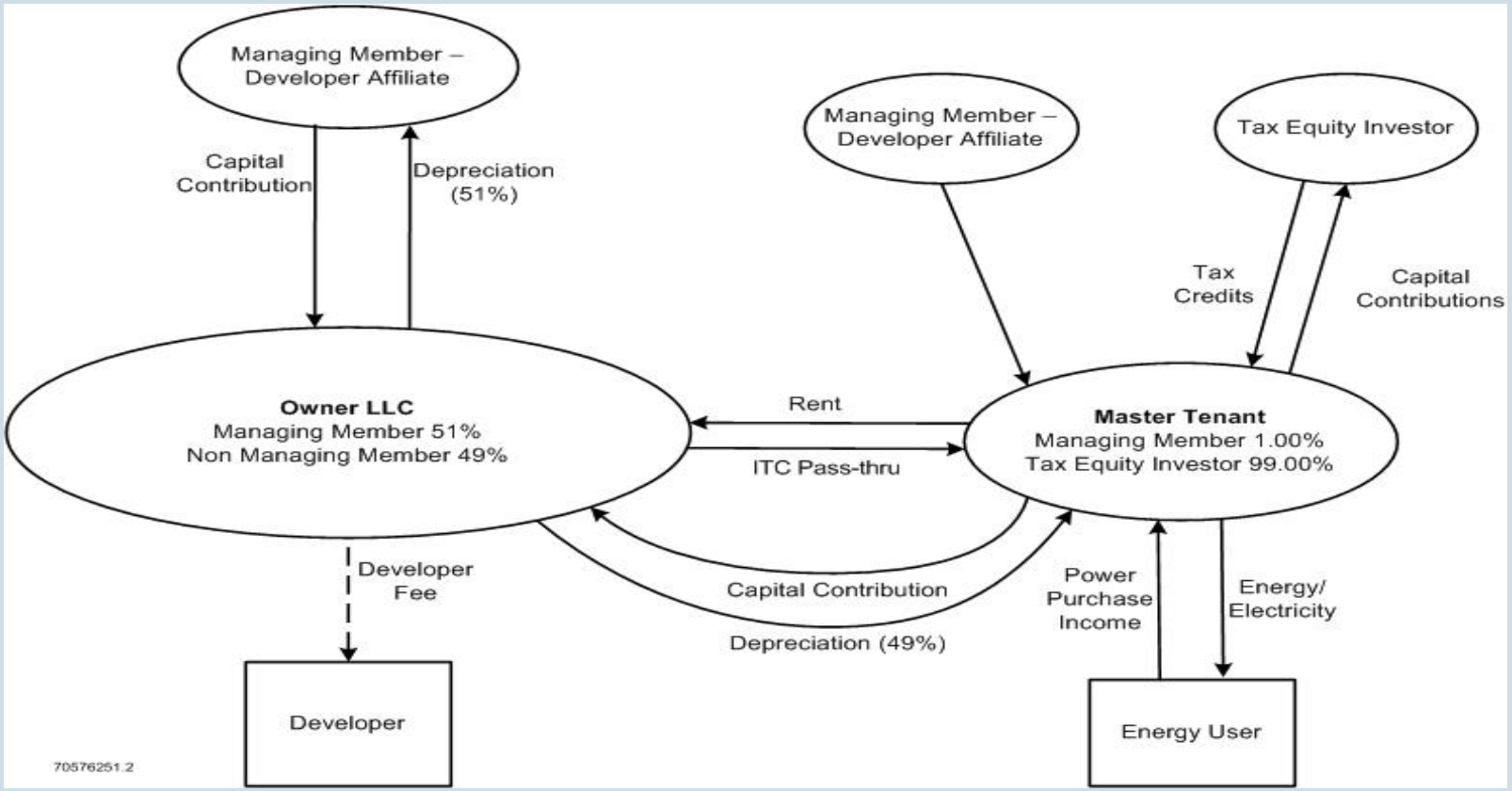
Sale-Leaseback with Credit Pass-thru



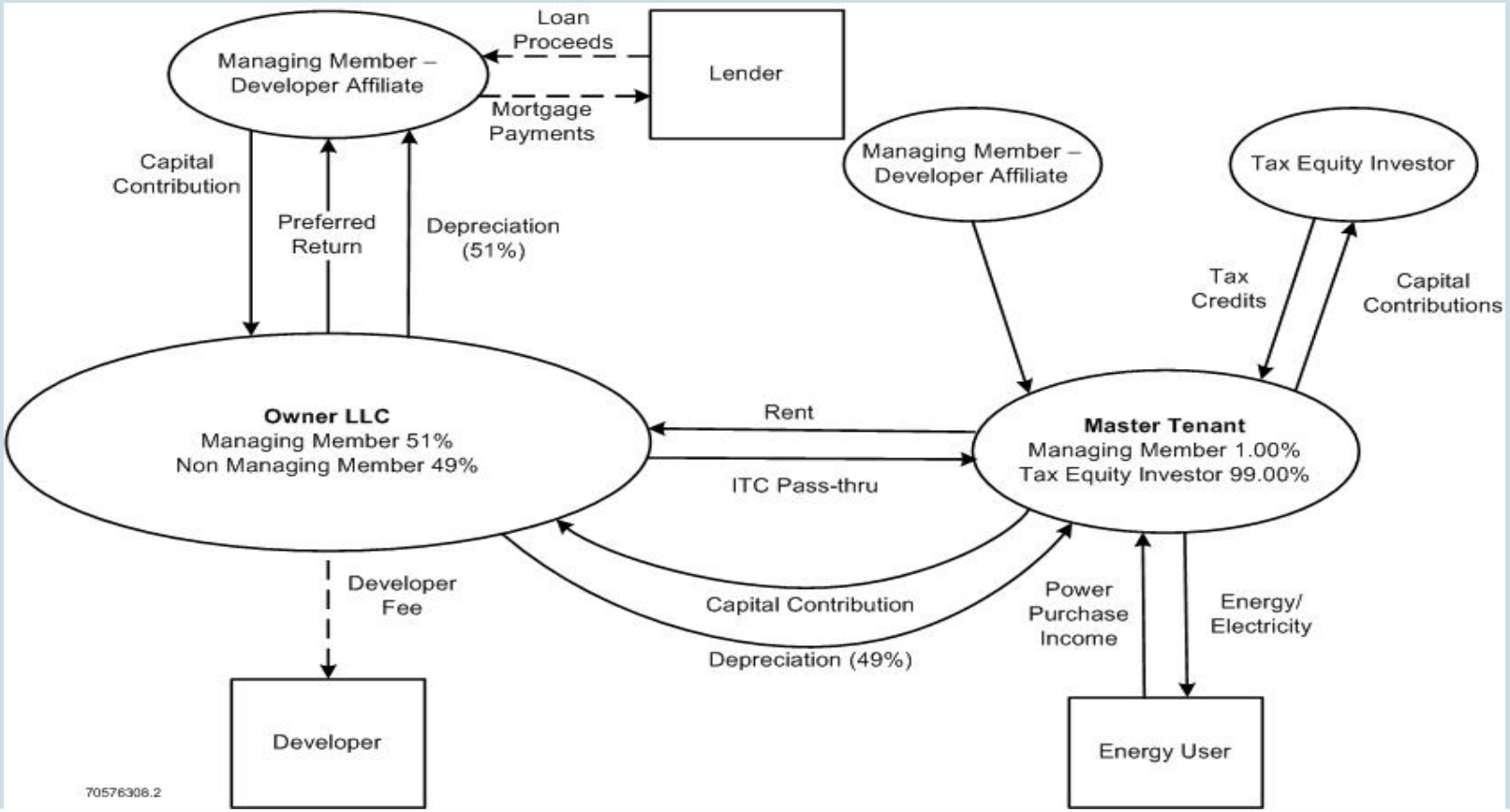
Inverted Lease with Credit Pass-thru



Inverted Lease with Sharing of Depreciation



Inverted Lease with Backlever



Publicly-traded partnerships (MLPs)

- S. 795 (Coons and others)
  - Expands definition of qualified income
  - Does not address technical partnership issues
- Does not work well with tax equity, especially ITC
  - Recapture
  - Passive loss and At-Risk rules
- Trojan horse?

Tax Exempts and Governments

- Tax incentives don't help if you don't pay taxes
- Tax exempt entity leasing ("Pickle") rules make it impossible for tax exempts and governments to effectively "monetize" available incentives
- Enter the pre-paid service contract
- Allows "Exempts" to benefit from tax subsidies

Pre-Paid Service Contracts

- Confluence of three tax issues:
  - Service contracts
  - Tax exempt financing
  - Deferral of tax
- Allows “Exempts” to derive benefits from tax incentives otherwise unavailable

Prepaid Service Contracts (con't)

- Advantages for "Exempts:"
  - Closely approximates ownership
  - Discounts in pricing of electricity
  - Cheaper borrowing costs
- Advantages for Developers:
  - Fills gaps in financing structure
    - Tax equity
    - Debt
    - Real equity
  - Pre-payment serves as "soft equity"
    - Treated as a liability
    - Less stringent defaults

What is a Service Contract?

- Pickle rules are triggered by ownership or lease (use)
- Arrangement that looks like a lease can be structured as a “service contract:”
  - Exception applies to “alternative energy facilities”
  - Four deadly sins (to be avoided):
    - Offtaker cannot operate the facility
    - Offtaker cannot bear significant risk for non-performance
    - Service recipient cannot benefit from cost savings
    - No fixed price purchase option other than at FMV

Tax Exempt Financing

- "Private use" regulations permit tax exempt financing for purchases of electricity
  - Made by or for government-owned utilities
  - At least 90% of electricity used:
    - To furnish retail electric customers of issuing utility who are located in service area; or
    - By a government-owned utility to which the electricity was sold and furnished to its retail customers located in service area

Tax Exempt Financing (con't)

- Actually purchasing electricity
  - Not project financing
  - No credit enhancement may be needed

Tax Deferral

- Normal rule is cash is taxable on receipt
- Possible exception to the rule for “advance payment for ‘goods’”
  - Not later than when included in gross receipts for financial accounting and shareholder reporting purposes (i.e. books must match tax)
  - Electricity treated as a “good” for this purpose

Tax Deferral (con't)

- For "inventoriable" goods, two year limit on deferral if two conditions apply:
  - Advanced payment = "substantial advanced payment"
  - Producer has inventory on hand or available
- What is "substantial advanced payment?"
  - Equals or exceeds expected cost to supply electricity
  - Includes depreciation of generating property
  - Comparison of prepayment to costs of production

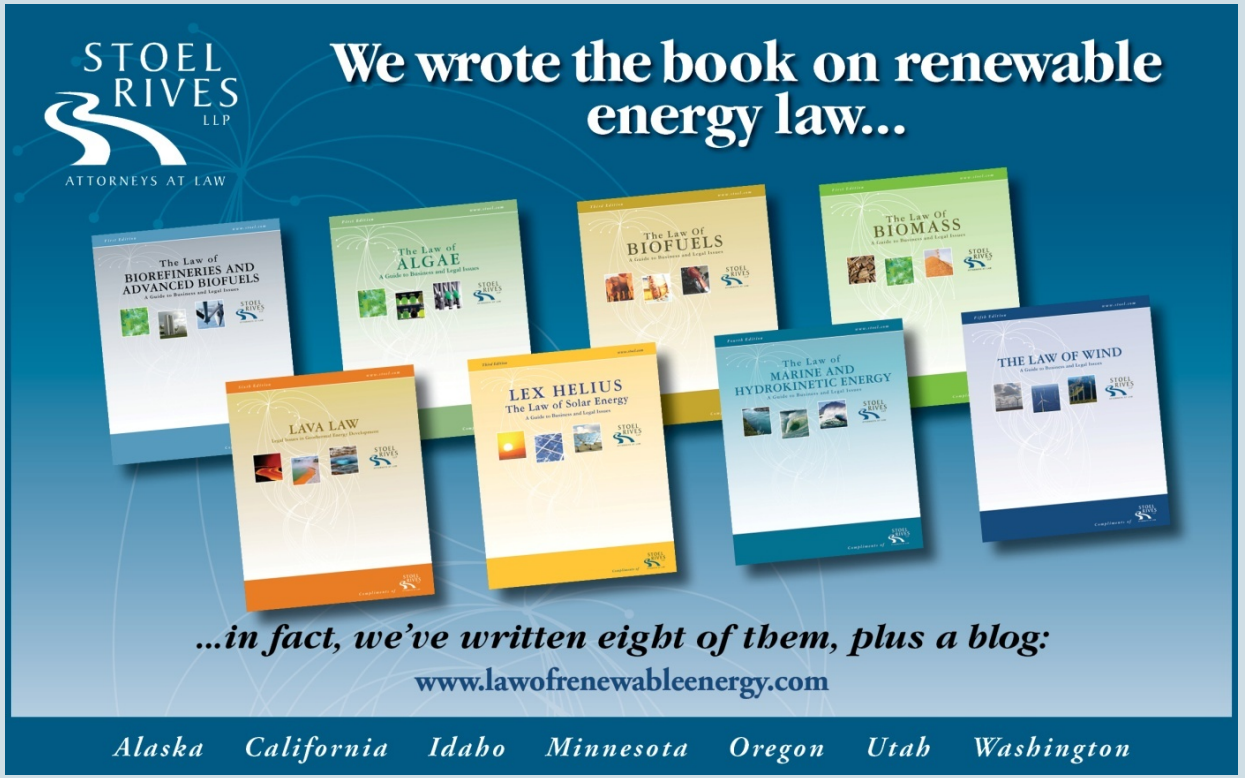
Tax Deferral (con't)

- Inventory on hand or available
  - Intended to prevent abuses
  - Electricity contracts different
    - Electricity cannot be stored
    - Must be available or on hand "to satisfy the agreement" – not sufficient to "pre-supply" electricity
- Can only apply to electricity

Putting All Three Together

- The “Exempt” has lower borrowing costs
- By “prepaying,” lower capital costs for developer
- Developer is able to use that lower-cost capital, together with tax incentives, to provide the “Exempt” with cheaper electricity
- Developer can spread the income tax cost over the period to which the prepayment applies
- Prepayment is added to partners’ outside basis

To order any of these books please contact Carlene Richardson at (503) 294-9104 or cvrichardson@stoel.com



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