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September 2009

IRS Modifies Guidance on Safe Harbor for Wind Energy Partnerships

BY MICHAEL D. HAUN, KEVIN YOUNG, AND SEAN C. HONEYWILL

On September 21, 2009, the IRS issued Announcement 2009-69 (the "2009 Announcement") to revise portions of a 2007 IRS pronouncement concerning the production tax credit (the "PTC") under Section 45 of the Internal Revenue Code of 1986 (as amended) (the "Code"). The earlier guidance provided a safe harbor for a partnership's allocation of PTCs earned for generating electricity from wind resources. After providing a brief overview of the PTC, our alert details the changes effected by the 2009 Announcement.

PTC Overview

Section 45 of the Code provides a 10-year, inflation-adjusted PTC for each kilowatt-hour ("kWh") of electricity generated and supplied by an eligible facility. Eligible facilities include, but are not limited to, those generating electricity from wind resources. For such projects, the current PTC amount is 2.1 cents per kWh. Pursuant to extensions provided in the American Recovery and Reinvestment Act of 2009, wind projects placed in service before the end of 2012 are PTC-eligible. In a manner detailed below, most entities that generate PTCs from wind resources are organized as partnerships (including limited liability companies electing to be taxed as partnerships for federal tax purposes) ("Wind Partnerships").

The 2009 Announcement modifies earlier guidance, issued under Rev. Proc. 2007-65[1] (the "2007 Guidance"), that established a safe harbor for Wind Partnerships' allocations of the PTC. A typical Wind Partnership includes (but is not limited to) a project developer that controls the general partner and at least one tax equity investor. Since the tax equity investor's return is drawn largely from the PTC, oftentimes partnerships allocate PTCs and losses to the investor until it receives an agreed-upon return. At that point, the structure "flips" so that the bulk of future profits, losses, deductions, or credits are allocated to the general partner.

The 2007 Guidance

The 2007 Guidance set forth a safe harbor under which the IRS will not challenge allocations of the PTC (the "Safe Harbor"). As originally provided in the 2007 Guidance, for the Safe Harbor to apply the following requirements must be met:

1. *Minimum Partnership Interest*. The project developer must have at least a 1 percent interest in each "material item" of partnership income gain, loss, deduction, and credit at all times during

the Wind Partnership's existence. This effectively places a 99 percent cap on allocations of tax items to the tax equity investor.

Additionally, at all times during the period in which an investor owns an interest in the Wind Partnership, the investor must have a minimum interest in each "material item" of partnership income and gain equal to 5 percent of its interest in partnership income and gain for the taxable year for which its percentage share of these items will be largest (as adjusted for sales, redemptions, or dilution of its interest). By way of example, a 30 percent pre-flip tax equity investor must, at all times during which it owns a partnership interest, have at least a 1.5 percent interest (5 percent of 30 percent) in the above-mentioned items.

2. *Investor's Minimum Unconditional Investment*. On or before the later of (i) the date the project is placed in service or (ii) the date the investor acquires its interest in the Wind Partnership, the investor must make a "minimum unconditional investment" in the partnership. The investment must equal at least 20 percent of the sum of fixed capital contributions plus reasonably anticipated contingent capital contributions required of the investor under the instant partnership agreement. The investor must maintain this investment throughout its ownership of the interest (except that the minimum may be reduced due to distributions of operating cash flow from the partnership or in connection with Item 4 below). Also, the minimum investment does not include future contributions until they are made.

   Additionally, the investor must not be protected against loss of any portion of its minimum investment through any arrangement, directly or indirectly, with the project developer, any other investor, the project's turbine supplier or power purchaser, or any party related to the aforementioned parties. However, an insurance arrangement with a third party not involved in the project may be permissible.

3. *Contingent Consideration*. At least 75 percent of the sum of fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an investor with respect to an interest in the Wind Partnership must be fixed and determinable obligations that are not contingent with regard to amount or certainty of payment. This addresses arrangements under which an investor's capital contribution obligations do not arise unless and until tax benefits are generated and realized.

4. *Purchase Rights*. The Safe Harbor requires that neither the project developer, any investor, nor any related parties have an option to purchase project assets or an interest in the Wind Partnership at a price less than fair market value ("FMV"), as determined at the time the option is exercised. (As described below, the 2009 Announcement modifies this requirement.) Also, the project developer (or any related party) may not have an option to purchase the wind facility or an interest in the Wind Partnership earlier than 5 years after the facility is first placed in service.

5. *Puts*. The Wind Partnership may not have a right to cause any party to purchase the wind facility or any property included therein (excluding electricity) from the Wind Partnership. Also, investors may not have a right to put their partnership interests in the Wind Partnership to any party.

6. *Guarantees*. Under the Safe Harbor, no person may guarantee or otherwise insure the investor the right to any allocation of PTCs. In that regard, the Wind Partnership must bear the risk that the available wind resource is not as great as anticipated; the project developer, turbine

supplier, or power purchaser may not guarantee otherwise. However, a guarantee regarding wind resource availability may be provided by a third party if the Wind Partnership or an investor directly pays the cost of, or premium for, the guarantee. A long-term power purchase agreement between the Wind Partnership and an unrelated party is not prohibited; however, a "take or pay" contract between related parties would constitute a guarantee and is impermissible.

7. *Loans*. The project developer (or any related party) may not lend an investor funds to acquire any part of the investor's interest in the Wind Partnership or guarantee any debt incurred or created in connection with the acquisition of such investor's interest in the partnership.

In addition to these requirements, the 2007 Guidance explained that, for purposes of the Code's passive loss rules under Section 469, each qualified facility would be treated as a separate activity and could only be grouped with other wind facilities. Thus, only entities not subject to Section 469 (and not individuals) would be able to offset non-project income with PTCs received as a passive investor. Additionally, the 2007 Guidance provided that the IRS would closely scrutinize a project if the requirements of the Safe Harbor were not satisfied. As discussed below, these provisions are revised with the 2009 Announcement.

The 2009 Announcement

The 2009 Announcement makes four primary changes to the 2007 Guidance. First, the 2009 Announcement strikes the language providing that the IRS will "closely scrutinize" a taxpayer that does not satisfy the requirements of the Safe Harbor. Instead, the 2009 Announcement simply provides that "[r]eturns claiming wind energy [PTCs] are subject to examination by the Service."

Second, the 2009 Announcement loosens the limitation regarding fixed price options (Item 4 above) to allow the purchase price to be set prospectively. As modified, a project developer, investor, or related party may have the option to purchase project assets or partnership interests if: (i) the option is negotiated for valid non-tax business reasons at arm's length by parties with material adverse interests; and (ii) the price meets one of two functions of FMV of the property. As to the latter requirement, the exercise price must be either: (i) not less than FMV, as determined at the time of exercise; or (ii) a price that the parties reasonably believe will not be less than FMV at the time of exercise. Note that the restriction prohibiting a project developer from having an option exercisable within 5 years of the placed-in-service date remains intact.

Third, the 2009 Announcement returns to the issue of how the Code's passive loss rules apply to the PTC. In the case of individuals, S corporations, and closely held C corporations, the 2009 Announcement provides that passive activity credits from wind facilities may be used to the extent of tax liability allocable to passive activities, whether from qualified wind facilities or other sources. Thus, in these cases the PTC may be used to offset certain non-project tax liability.

Fourth, the 2009 Announcement modifies an example provided in the 2007 Guidance to clarify that the 2007 Guidance exists only to provide the Safe Harbor's requirements. That is, the Safe Harbor does not provide substantive rules outside of this context.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Michael D. Haun
404-815-2279
michaelhaun@paulhastings.com

Kevin Young
404-815-2261
kevinyoung@paulhastings.com

Sean C. Honeywill
404-815-2286
seanhoneywill@paulhastings.com

[1] 2007-45 I.R.B.