



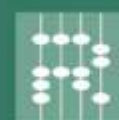
Municipalities/Tax Exempts: How to Utilize Federal Income Tax Credit Funding in Municipal or Tax Exempt Renewable Energy Projects

WHITE PAPER

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**Reznick
Group**

ACCOUNTING · TAX · BUSINESS ADVISORY

This Reznick Group White Paper explains how careful planning with the help of experienced tax credit professionals can help municipalities and tax-exempt organizations get renewable energy and energy efficiency projects financed through the monetization of federal or state tax benefits or both.

Introduction

The economics of financing renewable energy projects can be quite challenging due to high capital costs. In an effort to address this, the U.S. federal (and some state) income tax codes provide a number of incentives for investment in renewable energy projects in the form of tax credits and deductions or income exclusions for renewable energy or efficiency projects. Therefore, with proper tax and legal structuring, the economic benefit of the tax credits and deductions can be “monetized” or allocated to investors who will invest cash in an energy project in exchange for those tax benefits. However, the complexity of the tax code, and the general lack of comprehension of complex federal and state tax law often conspires to leave otherwise viable energy projects on the drawing board, simply because the requisite tax expertise is not consulted and thus an often critical source of equity financing gets overlooked by the decision makers.

Executive Summary

Municipalities and tax exempt entities are avidly pursuing and investing in renewable energy projects, but given the high cost of such projects, federal, state, local and public utility incentives are often required to offset a substantial portion of the cost. Unfortunately, governmental and tax exempt entities do not pay tax, therefore, otherwise critically valuable tax benefits are forever lost and wasted. However, through use of special provisions in the U.S. Tax Code which have been in force since the 1960s, between 40% and 60% of certain renewable energy projects can be paid for without the use of municipal or tax exempt funds or borrowing if special rules are followed.

Governmental and Tax-Exempt Use Rules

Property used by the United States, State or Local Governments, Foreigners, or Tax-Exempt entities generally does not qualify as property eligible for the federal 30% energy investment tax credit.

Rules of similar overall effect apply separately to federal production tax credit projects.

In the case of the federal Energy Credit, property “used” by such entity generally means:

1. Property owned by any such governmental unit or tax exempt entity, or
2. Property leased to any such governmental unit or tax exempt entity.

In sum, this means that many typical renewable energy projects involving governmental or tax exempt entities will not qualify for federal renewable energy tax credits and therefore may be uneconomical and never get built given the high cost of acquisition and construction.

Fortunately, the solution to this problem rests in adopting the correct legal and tax/financial structure of the transaction.

How It Works

In order for governmental or tax exempt entities to receive an advantage from the federal renewable energy income tax benefits in the form of project capital, the transaction must be structured for federal income tax purposes so that the municipality or tax exempt entity is neither the lessee nor the owner of the renewable energy project that is otherwise qualified for tax benefits.

Though there may be some municipal/tax-exempt minority ownership in limited and special cases¹, the majority of the ownership could not be in the hands of the municipality or tax exempt entity and preserve the material value of the tax benefits.

Therefore, instead of ownership or lease, the solution is for the municipality or tax-exempt entity to enter into a “Power Purchase Agreement” (PPA) or an energy services contract, under which it would pay for power or heat or both. The PPA or contract would extend through the tax benefit period and would be carefully structured for tax and legal purposes. An ESPC with an ESCO is not required and often not advised.

At the end of the tax benefit period, the municipality or tax-exempt entity could have the option to “buyout” the non-governmental or tax-exempt owner and take possession or lease of the renewable energy project if it wished, often financed through the issuance of bonds, typically tax-exempt or tax credit bonds (discussed below). In that case, one result is that the utility expense line-item may “permanently” shift from the issuer’s operating budget to the capital budget of the issuer, thereby freeing up the operating budget to that extent.

What Constitutes a Lease for Federal Energy Tax Credit Purposes

When a taxpayer provides equipment to a governmental or tax-exempt entity as part of an integrated package of services and equipment, the question arises whether the taxpayer is primarily providing a service with ancillary equipment or whether the transaction is actually an equipment lease to the tax exempt entity or government which would prohibit claiming tax credits for the property and restrict the tax depreciation deductions available to the lessor.

Fortunately, the federal tax code has a special provision which deals with the issue of lease versus service contract. Specifically, the federal tax code provides that in general, a contract that purports to be a service contract is nonetheless treated as a lease for federal income tax

purposes if the arrangement is more properly characterized as a lease, taking into account all relevant factors.

Under the federal income tax code, agreements that otherwise might be deemed as leases under the general provisions are nonetheless honored as service contracts for federal income tax purposes with respect to the following taxpayer activities common to many municipalities:

- The operation of a qualified solid waste disposal facility;
- The sale of electrical or thermal energy to a service recipient that is produced by a cogeneration or alternative energy facility and;
- The operation of a water treatment works facility;

Other Structures – ESCOs Or Sale-Leaseback

ESCOs:

An ESCO, or Energy Service Company, is a business that develops, installs, and finances projects designed to improve the energy efficiency and maintenance costs for facilities, typically over a seven to twenty year time period. ESCOs generally act as project developers for a wide range of tasks and assume the technical and performance risk associated with the project under an Energy Savings Performance Contract or ESPC.

Though ESPCs often prove to be beneficial for municipalities or tax-exempt entities, because they only address the issue of utility cost savings, ESPCs may not address the issue of project finance when the goal is for the governmental or tax-exempt entity to eventually take ownership of the project in a relatively short (typically 5 or 6 year time horizon). This is because in many cases, the ESCO exclusively retains the economic value of the tax benefits associated with its ESPC and does not pass on those economic benefits to the government or tax-exempt entity, often thereby increasing the cost to the beneficiary of the savings.

¹ Under current provisions, the 30% Department of Energy grant in lieu of the investment tax credit is not available in the case where a government or tax exempt holds an interest.

Sale-leaseback:

This type of transaction, in its most basic form, involves the sale of a tax credit eligible project property to an investor who holds title and leases the property back to the former owner.

Thus, a sale-leaseback transaction includes two separate transactions:

1. The sale of property by the seller to the buyer, and
2. The concurrent leaseback of the property from the buyer to the seller.

Sale-leaseback structures are generally not the ideal structure for municipal or tax-exempt tax benefit financing because property owned by a government or tax-exempt, or leased by

another person to any such governmental or tax-exempt unit is generally not eligible for the renewable energy tax credits. Therefore, the sale lease-back structure often would not allow the municipality or tax-exempt to directly or indirectly benefit economically from the otherwise available tax incentives, and therefore, a sale-leaseback is not a desired transaction structure.

CREB Bonds

Tax credit bonds, known as Clean Renewable Energy Bonds (CREBs), may be issued by a governmental entity or other authorized issuer of debt in order to help finance a limited amount of capital expenditures incurred by certain tax-exempt electricity providers to increase their capacity to produce electricity from clean renewable sources. CREBs are tax credit bonds. Therefore, the issuer does not pay interest on the bonds. Instead of interest, the bondholder receives a nonrefundable tax credit. The credit rate is determined by the IRS. Other features apply.

The bonds may be issued by governmental bodies, cooperative electricity companies, or cooperative lenders owned by cooperative electricity companies. These bonds provide a federal subsidy to allow nonprofit electricity providers, including cooperatives and government-owned utilities, to compete more evenly with for-profit companies that can take advantage of the renewable electricity production credit.

To qualify as CREBs, 95% or more of the proceeds of such bonds must be spent on qualified projects within the five-year period that begins on the date of issuance. A qualified facility is generally the same as a qualified facility for purposes of the credit for electricity produced from renewable sources, without reference to placed-in-service dates or Indian coal production facilities. Qualified facilities include facilities producing electricity using:

- wind,
- closed-loop biomass,
- open-loop biomass,
- solar or geothermal,
- small irrigation power,
- landfill gas,
- trash combustion,
- qualified hydropower,
- marine and hydrokinetic, and
- facilities that produce refined coal.

There is a national clean renewable energy bond limitation of \$1.2 billion. Of that amount, the maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is \$750 million. The authority to issue CREBs expires December 31, 2009.

In most cases, there is an insufficient allocation of CREB bonds to be useful.

New CREBs

There is another category of qualified tax credit bonds call New Clean Renewable Energy Bonds (“New CREBs”). These bonds are separate and distinct from the CREB bonds described immediately above.

The bonds may be issued by public power providers, cooperative electric companies, government bodies, not-for-profit electric utilities that have received a loan or loan guarantee under the Rural Electrification Act of 1936, and clean renewable energy bond lenders.

To qualify as new CREBs, 100% of the issue's available project proceeds are to be used for capital expenditures incurred by government bodies, public power providers, or cooperative electric companies for one or more qualified renewable energy facilities. Qualified renewable energy facilities are qualified facilities owned by a government body, a public power provider, or a cooperative electric company. A qualified facility is generally the same as a qualified facility for purposes of the credit for electricity produced from renewable sources, other than Indian coal production or refined coal production facilities, without reference to placed-in-service dates. Qualified facilities include facilities producing electricity using:

- wind,
- closed-loop biomass,
- open-loop biomass,
- geothermal or solar energy,
- small irrigation power,
- landfill gas,
- trash combustion,
- qualified hydropower, and
- marine and hydrokinetic.

There is a national new clean renewable energy bond limitation of \$2.4 billion.

Depreciation

The federal income tax code has special, often less than beneficial rules as it relates to how depreciation deductions are handled when the depreciable property is owned by or leased to tax-exempt entities.

One such provision suspends the deduction of losses related to "tax-exempt use property" in excess of the income or gain from that property. "Tax-exempt use property" includes property that is leased to a tax-exempt entity. Importantly, however, as a result of the application of this rule,

tax-exempt use property also includes property (whether or not leased) owned by a partnership that:

1. Has as partners both taxable and tax-exempt entities (including foreign persons), and
2. Makes allocations to the tax-exempt partners that are "non-qualified."

As a result, a partnership that has a combination of taxable and tax-exempt (including foreign) partners, and that makes nonqualified allocations, may be subject to the rule.

In the event that the municipality is using a government-sponsored pension fund to finance the project, another complex set of tax rules applies because they are subject to the Unrelated Business Taxable Income (UBTI) rules.

Careful planning and transaction structuring must be done.

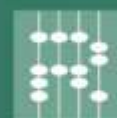
Bankability

There are certain considerations that lenders give high importance to when determining whether to lend on a project. One such consideration is a reasonable expectation of timely payment on their debt. When you have an arrangement where an owner of renewable energy property is required to repay the debt, in the normal course there is often a time lag between when the property owner's invoice is submitted and when the property owner receives payment on the invoice by the municipality. This lag can obviously and negatively affect cash flow of the energy system owner and thus, will impact whether a lender will approve the loan on the project. Thus, to avoid this issue, arrangements between a utility company and a governmental entity often must require that payments for power and services be received by the system owner on a date certain. Again, without a certain payment date by the municipality, lenders will often not lend to finance the project because of this concern.

Conclusion

It is beyond the scope of this white paper to discuss all the nuances and rules that pertain to tax equity monetization, and the financing renewable energy and energy efficiency and savings programs is inherently complex. Given the economic pressures peculiar to such projects, often projects of interest to governmental or tax exempt entities go unfunded and remain because there is inadequate capital. Fortunately, there is an alternative source of funding, the monetized federal and state tax benefits. However, careful planning and structuring must be done in order to achieve success. Part of any successful project is careful legal and tax planning provided by experts in the field of tax benefit monetization. Failure to seek the expertise of those familiar with the intricacies of tax benefit monetization exposes the energy project sponsors to a whole slate of

federal and state tax issues which may cause negative tax and financial results. When experienced tax experts in the area of tax credit monetization are brought in at the very beginning of project structuring, such issues and obstacles can be overcome, and your project can succeed.



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