Partnership Flip Transactions

Since the mid-2000s, many renewable energy projects have been financed through a combination of "tax equity" contributed by investors and "sponsor equity" contributed by developers, pooled together within a limited liability corporation (LLC). These arrangements, commonly referred to as "partnership flip transactions", arose as a method for allowing investors to take advantage of production tax credits (PTCs) available in the tax code for wind energy projects. While passive investors may not use PTCs, investors in a partnership transaction have a direct stake in the operations of a project and are considered active participants in the investment. They experience the same risks as the owner-operator of a project, so they can use the PTCs.

Generally, investors in partnership flip transactions do not intend to maintain a sizable investment in the LLC for the life of the facility. Similarly, developers prefer to eventually reclaim project ownership once the need for outside equity has passed. To address these compatible interests, many projects "flip" on a prescribed date. Ownership sharing of the project cash flows and taxable income drops significantly for the tax investor after the flip date so that they only maintain a small residual interest in the operations going forward. The timing of the flip is determined by a required minimum Internal Rate of Return (IRR) for the investor that was negotiated at the time of LLC formation. Because revenues and expenses of the project operations in the future are uncertain, the exact date of the flip may shift. The actual date of the flip depends on how well the project performs.

Following the introduction and growing popularity of partnership flip transactions in wind energy projects, the IRS published Revenue Procedure 2007-65, which provided direct guidance for wind energy partnerships. Subsequently, companies gradually became more comfortable with these investment vehicles and started financing solar projects using partnership flips. Although similar to wind, solar projects have some significant differences that must be considered when structuring the LLC, including: the use of investment tax credits (ITCs) instead of PTCs, which are not available for solar energy projects; allocation of basis reduction in the capital accounts; the recapture of the ITC resulting from significant ownership changes due to reallocation; and large investor capital account deficits during the early years of the investment. Also, unlike wind, solar projects vary considerably in size: from residential installations to commercial distributed generation to utility scale. Because partnership flip transactions are complex and time-consuming to execute, smaller installations in residential and commercial projects are typically grouped together into a fund which is owned by a single LLC.

Unlike other traditional large-scale investment structures, partnership flip transactions require a high level of ongoing management during the life of the LLC. Tracking the differences between expected forecasts and actual results, adjusting the period of investment to address new forecasts, and verifying the accuracy of operation reports and tax returns are all important considerations for investors in partnership flip transactions. Additionally, investors must determine how to properly account for the earnings of these investments in their financial statements. Because Partnership Flips experience disproportionate sharing over time, the standard equity method of accounting for partnership investments is typically not favored for representing an investor's position in the partnership. An alternative method that is commonly employed is the hypothetical liquidated book value (HLBV) method of accounting. Despite its relative suitability, HLBV has never been officially adopted as GAAP. FASB has not issued any guidelines to assist in the application of this method.

A further consideration for these investments is the level of risk that investors are willing to adopt in forming the LLC. In some recent rulings, the IRS has taken a dim view on clauses in an LLC structure that minimize the exposure of the tax equity investor. Disallowed structures have therefore nullified the economic benefits to the investor. In the *Historic Boardwalk Hall, LLC v. Commissioner* historic tax credit case, the tax courts determined that a level of preferred cash flow guaranteed to the investor and a tax indemnification clause related to possible tax audits constituted an unacceptable level of risk abatement. Since that ruling, the IRS has provided further guidance in Revenue Procedure 2014-12 to signal an intention to interpret common investor protections as being inconsistent with an acceptable level of risk.

The partnership flip has become a widely used financing structure for wind and solar projects. Over the years, its flexibility to accommodate PTCs, ITCs, and changing allocations has been attractive to tax equity investors while satisfying the needs of developers.

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