Tax Flip and Cash Flip

In partnership flip transactions, the partners in a limited liability corporation (LLC) change their ownership sharing positions in a renewable project one or more times during the expected term of the agreement. The details of these changes are specifically described in the formation documents of the LLC, and vary according to the negotiations of the partners. The cash flip and tax flip are two common types of changes in cash sharing and taxable income sharing, respectively.

The partners in the partnership flip transaction are called the investor and the sponsor. The investor, also called the tax equity partner, is well positioned to efficiently use the depreciation and tax credit incentives offered by the tax code to promote investment in renewable energy. The sponsor, or cash equity partner, typically cannot take fully advantage of tax deductions and credits. This partner often has an interest in building, operating, and eventually owning the renewable project.

Guidelines issued by the IRS in Revenue Procedure 2007-65 provide some assurance that partnership ownership changes will be respected for tax purposes as long as they follow a set of specific safe harbor provisions, such as minimum partnership interest. A typical minimum interest is 5%. Other provisions are unconditional capital investment and credit allocation consistent with the allocation of taxable income.

The tax flip occurs when the investor has achieved a minimum required internal rate of return (IRR). On this date, the investor's share of taxable income typically steps down from 99% to 5%. At this point, the tax incentives of ownership—depreciation and tax credits—have likely been depleted and the investor retains a minimum interest to continue to share in the risks of the project's operations.

Partnership tax law identifies ownership sharing of the partnership with the allocation of taxable income to each partner. Cash distributions, aside from the maintenance of capital accounts, are afforded more flexibility because changes in their sharing do not trigger an ownership change from the point of view of the IRS. It is common, therefore, that the cash sharing changes more frequently than the allocation of taxable income. The cash flip, also called a cash sweep, is a particular change in cash sharing that occurs towards the beginning of a partnership flip transaction.

In the initial years of a transaction, the LLC agreement gives as much cash as possible (often 100%) to the sponsor while providing the investor its economic return in the form of tax deductions and credits. Once the sponsor has received enough cash to reduce its capital account to zero, the cash distributions switch entirely to the investor until the tax flip date. During the time after the cash flip date and up until the tax flip date, the investor partner might be receiving 100% of the cash flows and 99% of the taxable income allocations of the partnership. Once the tax flip is triggered, the investor's share of both cash and taxable income would then drop to the minimum of 5%.

The purpose of a cash flip is to provide more accelerated cash to the sponsor partner to aid them in their operations. Although cash is also important to the investor partner, it is willing to delay its cash needs while it is allocated tax benefits. A convenient side-effect of the cash flip is that equity position of the investor does not erode as quickly as it would if it was receiving cash immediately. This helps prolong its investment so that their IRR is less likely to be achieved before then end of the 10-year term

associated with production tax credits. For this reason, cash flip features are normally found in wind energy projects rather than solar energy projects.

LLC agreements can introduce additional changes in cash and tax sharing beyond the cash and tax flip. Common reason to do so are to achieve the investor's IRR through the tax flip date, to manage the pattern of either partner's capital account balance, or to reach a minimum full-term IRR of pre-tax cash flows.

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