300
5-24-84 JS(1)

DR-06 82-5

DOE/RA/04934-T34
(DE84008267)

Energy

C
O
N
S
E
R
V
A
T
I
O
N

LEGAL FACTORS AFFECTING THE FINANCING OF
SMALL SCALE HYDROELECTRIC PROJECTS

By
Martin J. Ringo
Nicholas Forgione

September 1983

Work Performed Under Contract No. AC07-78RA04934

Energy Law Institute
Concord, New Hampshire

Technical Information Center
Office of Scientific and Technical Information
United States Department of Energy

DISCLAIMER

This report was prepared as an account of work sponsored by an agency of the United States Government. Neither the United States Government nor any agency Thereof, nor any of their employees, makes any warranty, express or implied, or assumes any legal liability or responsibility for the accuracy, completeness, or usefulness of any information, apparatus, product, or process disclosed, or represents that its use would not infringe privately owned rights. Reference herein to any specific commercial product, process, or service by trade name, trademark, manufacturer, or otherwise does not necessarily constitute or imply its endorsement, recommendation, or favoring by the United States Government or any agency thereof. The views and opinions of authors expressed herein do not necessarily state or reflect those of the United States Government or any agency thereof.

DISCLAIMER

Portions of this document may be illegible in electronic image products. Images are produced from the best available original document.

DISCLAIMER

This report was prepared as an account of work sponsored by an agency of the United States Government. Neither the United States Government nor any agency thereof, nor any of their employees, makes any warranty, express or implied, or assumes any legal liability or responsibility for the accuracy, completeness, or usefulness of any information, apparatus, product, or process disclosed, or represents that its use would not infringe privately owned rights. Reference herein to any specific commercial product, process, or service by trade name, trademark, manufacturer, or otherwise does not necessarily constitute or imply its endorsement, recommendation, or favoring by the United States Government or any agency thereof. The views and opinions of authors expressed herein do not necessarily state or reflect those of the United States Government or any agency thereof.

This report has been reproduced directly from the best available copy.

Available from the National Technical Information Service, U. S. Department of Commerce, Springfield, Virginia 22161.

Price: Printed Copy A09
Microfiche A01

Codes are used for pricing all publications. The code is determined by the number of pages in the publication. Information pertaining to the pricing codes can be found in the current issues of the following publications, which are generally available in most libraries: *Energy Research Abstracts (ERA)*; *Government Reports Announcements and Index (GRA and I)*; *Scientific and Technical Abstract Reports (STAR)*; and publication NTIS-PR-360 available from NTIS at the above address.

DOE/RA/04934-T34
(DE84008267)

Distribution Category UC-97e

LEGAL FACTORS AFFECTING THE FINANCING
OF SMALL SCALE HYDROELECTRIC PROJECTS

Prepared By:
Energy Law Institute
21 Green Street
Concord, New Hampshire 03301
(603) 225-7530
Contract No. DE-AC02-78RA04934

William H. Wilson, Esq., Project Manager
Martin J. Ringo, Ph. D.
Nicholas Forgione

Date: September, 1983

INDEX

- I. Introduction
- II. Business Organizational Options
 - A. Corporations
 - B. Subchapter S Corporation
 - C. Partnerships
 - D. Limited Partnerships
- III. Basic Federal Income Tax Comparisons of Organizational Options
 - A. Basic Principles of Taxation
 - B. Earnings
 - 1. Reinvested Earnings
 - 2. Distributed Earnings
 - C. Capital Gains and Losses
 - D. Operating Expenses
 - E. Fringe Benefits
 - F. Section 1244 Stock
- IV. General Federal Income Tax Provisions Affecting SSH Development
 - A. Business Expenses
 - B. Depreciation
 - 1. Definition and Significance
 - 2. Summary of Pre-ERTA Depreciation
 - 3. Depreciation After ERTA
 - 4. Depreciation After TEFRA
 - 5. Land Preparation Costs
 - C. Federal Tax Credits
 - 1. Introduction
 - 2. Investment Tax Credit
 - 3. Energy Tax Credit
 - 4. Rehabilitation Tax Credit
 - 5. Qualified Progress Expenditures
 - 6. Changes to the Tax Credits after TEFRA
- V. Special Concerns in Federal Income Taxation of SSH Development
 - A. Public Utility Property
 - B. Limitation on Deductions to Amount "At Risk"
 - C. "At Risk" Limitations on Credits
 - D. Availability of Tax Credits when Property is Owned or Leased by Public or Tax Exempt Entities
 - E. Loss of Credit for Use of Subsidized Financing
 - F. Recapture of Depreciation and ACRS Deduction
 - G. Recapture of Tax Credits
 - H. Recapture of Qualified Progress Expenditures
 - I. Date Property Is Placed in Service
 - J. Energy Tax Credit Concerns
 - K. Allocation of Tax Benefits and Cash Flow: Limited Partnerships

- L. Investor - Site Owner/Developer Contracts
 - 1. Joint Ventures
 - 2. Activities not Engaged in for Profit
 - 3. Inadvertant Sales
- M. Capital Expenditures

VI. Structures for Transferring Tax Benefits

- A. Introduction
- B. Partnerships and Limited Partnerships
 - 1. Limited Partnership Agreement
 - 2. The General Partner's Role
 - 3. The Limited Partner's Role
 - 4. Organizational Considerations to Ensure IRS Treatment as a Partnership
 - 5. Valuation of Tax Consequences of Contributors
 - 6. Flow-Through of Tax Benefits
 - 7. The "At Risk" Rules
 - 8. Allocation of ITC and ETC among Partners
 - 9. Sale of Partnership Interests
 - 10. Losses and Loss Carryovers
 - 11. State and Local Tax Aspects
- C. Subchapter S Corporations
 - 1. Introduction
 - 2. Requirement of S Corporation
 - 3. Determining Stockholder's Ratable Share
 - 4. Accounting Period of S Corporation
 - 5. Taxable Income
 - 6. Basis in S Corporation Stock
 - 7. Losses and Loss Carryovers
 - 8. Distribution of Appreciated Property
 - 9. Distributions
 - 10. Allocation of ITC and ETC among Stockholders
- D. Safe Harbor Leasing/Tax Benefit Transfers
 - 1. Introduction
 - 2. TEFRA Changes: Requirements
 - 3. Lessor's Tax Benefits
 - 4. Effective Dates
 - 5. Finance Lease
- E. Leveraged Leasing
 - 1. Introduction
 - 2. IRS Guidelines
 - 3. Impact of Safe Harbor Leasing Rules
 - 4. TEFRA Changes
- F. Note on Securities Law Compliance
 - 1. Private Offering Exemption
 - 2. Small Offering Exemption
 - 3. Intrastate Offering Exemption

VII. Tax Exempt Financing

- A. General Considerations
- B. State Law Considerations
 - 1. Exemption for State and Local Obligations
- C. Industrial Development Bonds: Code § 103(b) Requirements

D. Exemptions

1. The Small Issue Exemption
 - a. The \$1 Million Small Issue
 - b. The \$10 Million Small Issue
2. The Local Furnishing Exemption
3. The Qualified Hydroelectric Generating Facilities Exemption

E. TEFRA Changes

1. Information Reporting Requirement
2. Public Approval Requirements
3. Restrictions on Depreciation Deductions
4. Small Issue Exemption
5. Relationship of Bond Maturity to Asset Life
6. Registration Requirement
7. Multiple Lot IDBs

I. Introduction

In February of 1981 the Energy Law Institute published the first edition of The Financing of Private Small Scale Hydroelectric Projects. At that time, the small scale hydroelectric (SSH) industry was in the early stages of rebirth. Examination of the merits of the resource was initially stimulated by rising fossil fuel prices and large central generating plant siting difficulties.

Several legislative and regulatory initiatives also favorably affected the economics of private SSH development. The Public Utility Regulatory Policies Act of 1978 (PURPA) provided a market for SSH generated electricity by requiring electric utilities to purchase that power at the utilities' incremental or avoided cost. In addition, PURPA exempted qualifying SSH facilities from certain federal and state regulations applicable to public utilities and provided the authority for a loan program to finance feasibility studies, licensing expenses, and construction. The Crude Oil Windfall Profits Tax Act of 1980 (COWPA) extended attractive tax benefits to SSH projects. The licensing process was simplified by the exemptions from federal licensing authorized in the Energy Security Corporation Act of 1980 and by the streamlining initiatives of the Federal Energy Regulatory Commission.

The combination of market, regulatory, and legislative factors stimulated considerable interest in hydroelectric development as a potentially profitable enterprise. However, at that time, few recent models for the successful development of SSH

projects existed. It was thought that this lack of recent development experience created a deficiency of information about factors important to the financing and development of SSH projects. The first edition of this manual was intended to address this problem by providing information on the evaluation, planning, structuring, financial opportunities and limitations and legal factors, particularly federal income tax factors, particularly important to the financing of SSH projects.

Since the first publication of The Financing of Small Scale Hydroelectric Projects, the industry has continued to develop, but many aspects of its environment have changed. Fossil fuel prices have declined somewhat from their highs, the FERC licensing process has been tested by a substantial number of applications, several SSH projects have progressed to operation, and two major revisions of the federal tax laws have occurred. The combination of these changes suggested a need to update and revise the original finance manual. This impetus was translated into the preparation of this second edition.

In the original edition, the chapters discussing federal tax and other legal issues were interwoven with chapters on the other aspects of the financing process. In this edition the tax and legal discussions have been consolidated into a separate volume, Volume II. Volume I of the second edition contains the discussion on non-legal financing issues.

Volume II of the second edition is entitled Legal Factors Affecting the Financing of Small Scale Hydroelectric Projects. The major emphasis of this volume is on the federal income tax

laws. As discussed in the first edition and in Volume I of the second edition, federal income taxation can have a significant influence on the economic viability of a SSH facility. The essential reason for this impact is that Congress has seeded the tax code with a number of economic incentives to encourage business investment in capital improvements generally, and investment in certain types of cogeneration projects in particular. Thus, assuming the use of the resulting benefits at their highest value (i.e., as a complete offset to tax liability from the project or other sources as rapidly as available), the existence of these incentives offers the opportunity for substantial reductions in the effective cost of project capital and hence the total cost of a given SSH project. Thus, a major purpose of Volume II is to provide developers, investors, and lenders with sufficient information about tax opportunities and requirements to facilitate production use of these incentives.

The federal income tax law of primary relevance to an SSH project has been shaped by four major tax acts in the last six years. The Energy Tax Act of 1978 (ETA) originated the energy tax credit (ETC) for certain investments in projects intended to reduce fossil fuel dependency. The Crude Oil Windfall Profits Tax Act of 1978 (COWPTA) expanded the class of projects eligible for the ETC to include certain hydroelectric projects and extended the time limit and credit percentage for many of the existing eligible categories. The Economic Recovery Tax Act of 1981 (ERTA) replaced depreciation with the generally more rapid deductions for capital investments possible under the new Accelerated Cost Recovery

System (ACRS), simultaneously imposed some constraints on tax shelter access to tax credits, and created a streamlined pseudo-lease known as the safe harbor lease, which amounted to the creation of a free market for the sale of tax benefits. Finally, the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA) reduced some of the value of the simultaneous use of ACRS deductions and tax credits, significantly reduced the value of and provided a sunset for safe harbor leasing, and reduced access to tax exempt financing.

Volume II is organized into seven chapters. Following the introduction, Chapter II contains an introduction to the major business organizational options open to SSH projects. Chapter III compares the major federal income tax treatments of these options. In Chapter IV, significant general federal income tax factors affecting SSH projects are reintroduced and explained. Chapter V isolates some of the special federal income tax problem areas in SSH development. Chapter VI discusses tax benefit flow through or transfer mechanisms. Finally, Chapter VII reviews tax exempt financing opportunities for private SSH projects.

The information in Volume II updates and elaborates on the information covered by Chapter III of the first edition. As a result, in addition to providing a legal supplement to Volume I, it may be used in conjunction with the first edition as a replacement for Chapter III and the appendix of the original manual. As in the first edition, the discussion of legal and tax factors presented in Volume II is intended to aid the parties to an SSH development in identifying and understanding certain

federal income tax and other legal issues related to financing deemed significant by the authors. It is not intended to cover all legal aspects of SSH development. In particular, it is not intended to substitute for professional advice. Given the complexity of the tax and other legal issues confronting a typical SSH project, it is recommended that the parties involved in such projects consult with specialized professionals knowledgeable in such areas prior to undertaking significant capital commitments.

II. BUSINESS ORGANIZATIONAL OPTIONS

This chapter endeavors to present a broad overview of the business organizational considerations and tradeoffs that should be examined when making an organizational choice. As noted above, the selection of an appropriate business organization form is a critical element in the business plan of any business venture, including an SSH project. A well informed decision will require a critical review of the unique circumstances and goals of a prospective business, a consideration of the characteristics of the most probable forms, and a careful assessment of the ability of each form to satisfy the circumstances and governing law changes.

The four business forms considered here are corporations, S Corporations, partnerships and limited partnerships. S Corporation characteristics are the same as regular corporate characteristics, unless specifically noted.

A. Corporations

Corporations must comply with state incorporation requirements and in some cases, federal and state securities law must be observed. Compliance with state law typically requires minimum capitalization, drafting and filing of the corporate charter, preparing by-laws, obtaining the necessary authority for issuance of stock, etc. The consequences of failure to comply with state incorporation requirements are such that most individuals obtain legal counsel to assist them in forming a corporation.

A corporation has an existence separate and apart from the stockholders who own it. A corporation has the right to sue and

be sued in its corporate capacity, hold, manage and dispose of property, enter into contracts and otherwise conduct business in a capacity separate and distinct from its stockholders. The liability of a corporate stockholder is limited to his investment in the corporation; he is not personally liable for the corporation's debts and other liabilities. Thus, in most cases, a corporate stockholder's exposure to loss is limited to the value of his investment in the corporation's debts and stock. The corporate form insulates the stockholder's personal assets from a claim against the corporation.

Some individuals feel that the corporation is unsuited to a small business because it is designed for use by large enterprises requiring the accumulation of capital by many investors. In this situation, individuals create what is commonly called a closely held corporation. A closely held corporation is usually a corporation owned by only a few individuals, by members of one family, or even by a single individual. A significant characteristic of the closely held corporation is that the stockholders actively participate in the management of the business. Thus, unlike a large, publicly held corporation, there is a mixture of management and ownership in the closely held corporation, and this unique relationship between the stockholders usually results in efforts to insure direct stockholder control through internal stockholder agreements and restrictions on the transfer of equity securities. Most jurisdictions have no separate closely held corporation statute and require that the closely held corporation be formed and operated under the normal corporation code. A closely held corporation has the same legal

characteristics as a normal corporation, such as limited liability, perpetual existence, and federal income tax treatment. It should be noted that the legal status of the stockholders may change as a result of stockholder agreements contained in the corporate by-laws. For example, the corporate by-laws may state that the stockholders of the closely held corporation have to cosign for corporate purchases. In that case, the cosigning stockholders will not have limited liability but will be subject to unlimited personal liability for the wrongful acts of the corporation.

Corporations may obtain capital by the sale of stock, bonds, and securities. An individual's interest in the corporation is represented by the stock shares he owns. Stock shares are normally readily transferable. However, individuals participating in a closely held corporation usually enter into agreements that prevent the stockholders, or their estates, from divesting their interest without first offering it to the corporation or other stockholders of the corporation.

A corporation's actions are constrained and its management authority is limited in three controlling documents: the state's incorporation law, the corporate charter, and the corporation's by-laws. The state's incorporation law states the requirements that must be met before the corporation is allowed to operate. The corporate charter states the corporation's name, the business it is to conduct and its capital structure, among other things. The by-laws govern the administration and regulation of the affairs of the corporation. Generally, the board of directors is elected by the voting stockholders on a one share equals one vote

basis. As the name implies, non-voting stockholders cannot vote on, or participate in, the affairs of the corporation. Some state laws, corporate charters or by-laws provide for cumulative voting. Cumulative voting entitles each stockholder to cast, for each share held by him, as many votes as there are directors to be elected. Thus, if five directors are to be elected, each share will have five votes, all of which may be cast for a single candidate or distributed among two or more candidates as the holder may desire. This affords minority stockholders a greater opportunity to gain board representation.

The board of directors appoints the corporate officers, who are responsible for the day to day management decisions, under the general guidance of the board. In a closely held corporation, board members may be synonymous with corporate office holders because there are so few individuals involved in the corporation.

A corporation can generally be dissolved only by operation of law. A corporation is not terminated or affected as an organization by the death of a stockholder or by the transfer of an interest in the corporation. This may not be true for a closely held corporation because of the limited number of individuals involved with it.

B. Subchapter S Corporation

A Subchapter S Corporation (S Corporation) is a "small business corporation" which has been defined by Internal Revenue Code (IRC or the Code) § 1361 as a domestic corporation with one class of stock, a maximum of 35 stockholders, no stockholders that are not individuals (e.g. - corporations or partnerships) and no

nonresident alien stockholders. All stockholders of a qualifying small business corporation must elect to have S Corporation tax treatment. The effect of a Subchapter S election is to allocate the corporate income ratably among the stockholders to be included on their individual tax returns.¹ Thus, the separate entity of the corporation is disregarded for federal income tax purposes.

Although the S Corporation is not treated as a separate entity status for federal income tax purposes, it remains a corporation for the purpose of stockholder liability. Stockholders of an S Corporation enjoy the same limited liability as stockholders of a regular corporation.

Stock shares in an S Corporation are normally transferable. However, in certain circumstances the sale of S Corporation stock may render the corporation ineligible for Subchapter S tax treatment. The sale of stock to an ineligible stockholder, such as a partnership, a corporation, an ineligible trust, or a nonresident alien, will render the corporation ineligible for Subchapter S tax treatment.²

Subchapter S status can be terminated by revocation of the election by stockholders owning a majority of the S Corporation stock and by failure of the corporation to continue to satisfy the requirements of a "small business corporation".³ Subchapter S status will also be terminated if the corporation has profits and gross income, more than 25% of which is passive investment income

¹26 U.S.C. §§ 1363, 1366.

²26 U.S.C. § 1362(d)(2).

³26 U.S.C. § 1362(d)(1).

in each of three consecutive years.⁴ Passive income is defined to include gross receipts from rents, royalties, interest, or capital gains.⁵ The Service has been successful in defining rents and royalties to include compensation for the use of property by persons unrelated to the S Corporation unless substantial services were also provided in connection with the property.⁶ The termination of Subchapter S status is effective on the date of the disqualifying event.⁷

⁴26 U.S.C. § 1362(d)(3).

⁵26 U.S.C. § 1362(d)(3)(D).

⁶See Rev. Rul. 81-197, 1981-2 CB 166.

⁷26 U.S.C. § 1362(d).

C. Partnerships

The Uniform Partnership Act (UPA) defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit.⁸ The formation of a partnership essentially involves the drafting and execution of a contract among the co-owners (partners) for an agreed term. There are no formalized filing, registration, or recording requirements for a regular partnership. In fact, a partnership can be constructively formed by two or more persons conducting, as co-owners, a business for profit even though the parties had no intention of forming a partnership. When a partnership is intentionally formed, great care should be taken in drawing up a partnership agreement. This agreement is commonly called the "articles of partnership" and it contains any provisions which the partners wish to govern the internal operations of the partnership. Normally, the partnership agreement contains provisions concerning the transferability of a partner's interest, expansion of partnership membership, and the management of deadlocks.

A partnership does not have separate entity status, as a corporation does, and the individual partners do not have limited liability for its activities. In a partnership, each general partner is individually liable for all obligations of the partnership, including wrongful acts of co-partners committed in

⁸UPA § 6(1).

the course of carrying on the partnership business.⁹ Insurance and indemnity agreements may be utilized to lessen the risk of liability.

The creation of a partnership ordinarily involves the contribution by the participants of property, money, and credit, which will constitute the capital of the business. A partnership may raise new capital by increased contributions from its members, by loans, or by expanding its membership. It should be noted that expanded membership technically dissolves the old partnership unless the partnership agreement contains a provisions allowing expanded membership.

Members of a partnership have equal rights in the firm's management and in the conduct of its operations. However, partnership agreements often delegate certain functions to named or specially skilled partners. Absent contrary provisions in the partnership agreement, the UPA grants special management rights and responsibilities to all general partners. Partnership action is usually dependent upon majority agreement, which may impair the ability of the partnership to function because of a deadlock. However, it is possible to include in the partnership agreement contractual arrangements to prevent deadlocks.

The life of a partnership is generally governed by the partnership agreement. State statutes and case law provide the term of the contract if no formal agreement has been executed. In general, death or withdrawal of a partner can cause dissolution

⁹UPA §§ 13, 14, 15.

and possibly liquidation of the partnership.¹⁰ Since this is so, a carefully structured succession agreement should be prepared and included in the partnership agreement.

Under the UPA, a voluntary transfer of an interest cannot be made by one partner without the consent of all the partners, unless the partnership agreement provides otherwise.¹¹ When a partner transfers his interest, the old partnership is technically dissolved and a new one created with the remaining or new members.

¹⁰U.P.A. § 31.

¹¹U.P.A. § 18(g).

D. Limited Partnerships

In most states, limited partnerships may only be created pursuant to state law. Limited partnerships were created to facilitate commercial investments by those who want a financial interest in a business but do not want all the responsibilities and liabilities of regular partners. The Uniform Limited Partnership Act of 1976 (ULPA) defines a limited partnership as a partnership formed by two or more persons under the laws of a state and having one or more general partners and one or more limited partners.¹² The general partner is a partner who assumes the management responsibilities of the partnership while the limited partner is a partner who makes a contribution to the partnership, thereby obtaining an interest in it, but is not active in the management of the partnership.¹³ State law usually requires a limited partnership to draw up a partnership agreement, "articles of limited partnership," and file the agreement with a public official, usually the secretary of state.

A limited partnership does not have separate entity status, however, the liability of the partners differs. The general partner is personally liable for all obligations of the partnership while the limited partner is liable only to the extent of his capital contribution.¹⁴ However, where a limited partner takes part in the management and control of the partnership, he becomes liable as a general partner.¹⁵

¹²ULPA § 101(7).

¹³ULPA §§ 303, 403.

¹⁴Id.

¹⁵ULPA § 303.

A limited partnership is initially financed in much the same way as a regular partnership. At the creation of the partnership, the participants generally contribute cash, property, or services, which constitute the capital of the business.

Under the ULPA, a partnership interest in a limited partnership is assignable in whole or in part. However, the assignment entitles the assignee to receive only the distribution to which the assignor was entitled to.¹⁶ An assignment of a partnership interest does not entitle the assignee to become a partner, unless the partnership agreement states otherwise.¹⁷

The life of a limited partnership is generally governed by the partnership agreement. Unless otherwise provided in the agreement, the retirement, death, or insanity of a general partner dissolves the partnership.¹⁸ However, the death of a limited partner does not dissolve the partnership. The assignment of a limited partner interest will not dissolve the partnership; however, the assignment of a general partner interest may.¹⁹

¹⁶ULPA § 702.

¹⁷Id.

¹⁸ULPA §§ 402, 801.

¹⁹ULPA §§ 402, 702.

III. BASIC FEDERAL INCOME TAX COMPARISONS OF BUSINESS ORGANIZATIONAL OPTIONS

A. Basic Principles of Federal Income Taxation

Corporations are separate legal entities and as such are separate and distinct from their stockholders for tax purposes. The taxable income generated by a corporation is taxed at the corporate level at the following rates:¹

<u>Taxable Income</u>	<u>Rate</u>
0 - \$25,000	16%
\$25,001 - \$50,000	19%
\$50,001 - \$75,000	30%
\$75,001 - \$100,000	40%
greater than \$100,000	46%

Any dividend distributed by a corporation is included in the stockholder's gross income and is taxed again (hence, the term "double taxation") in the stockholder's income tax return. IRC § 116 provides a maximum \$100 exclusion (\$200 in the case of a joint return) from gross income for dividend income received by an individual.²

There isn't any separate partnership income tax. Nevertheless, the partnership does file an informational return. A partner is taxed on his share of the partnership's income, whether distributed or not. No additional tax is imposed upon the partners when previously undistributed income is distributed. Partnership distributions retain their distinct character on the tax returns of the partners, that is, capital gains and losses and business losses to the partnership are treated as capital gains

¹26 U.S.C. § 11(b).

²26 U.S.C. § 116.

and losses and business losses on the partner's personal income tax return. This phenomenon is often referred to as a "flow through" of the partnership tax consequences.

An S Corporation is treated essentially the same as a partnership for tax purposes. Items of income and loss attributable to an S Corporation are passed through to the stockholders in a manner similar to the way in which like items attributable to a partnership are transferred to the partners. An S Corporation's taxable income is computed in the same manner as that of an individual, except that items which a stockholder must report separately must be computed separately, and certain deductions, such as the deductions for personal exemptions, charitable contributions, and net operating losses, are not allowed to the corporation.³

Each stockholder of an S Corporation is taxed on his proportionate share of the business' income, losses, deductions, and credits.⁴ Thus, each item is treated as if it were realized directly from the source from which it was realized by the S Corporation or incurred in the same manner as incurred by the S Corporation. As described further below, a shareholder's loss deductions are limited to the basis of his stock. If a stockholder cannot utilize his share of losses due to an insufficient basis in his stock, the loss shall be treated as incurred by him from the corporation in its next taxable year.⁵ Thus, if there is sufficient basis to absorb the loss in the year

³26 U.S.C. § 1363.

⁴26 U.S.C. § 1366.

⁵26 U.S.C. § 1366(d)(2).

it was incurred, it will be deductible in full. If not, the loss will be treated as incurred in the next succeeding taxable year and, if still not absorbed, in the next succeeding taxable year, indefinitely, so long as the S corporation election is in effect. The S Corporation pays no tax, except that it does pay a tax on net capital gains in certain circumstances.⁶

It should be noted that an S Corporation must derive no more than 25% of its gross receipts in three consecutive years from passive investment income to preserve its Subchapter S status. In addition, for any year in which the corporation has profits and excess passive income, the excess income attributable to it is taxed at the corporate level at the highest corporate rate.⁷

B. Earnings

A major consideration in the choice of a business organizational form is whether the income will be retained by the business to provide capital for future expansion or whether the funds will be distributed to the owners.

1. Reinvested Earnings

If income is going to be retained or reinvested in the business, the regular corporate business form may be preferred because unlike partnerships and Subchapter S Corporations, some portion of income available for distribution can be retained by the corporation without taxation of its shareholders. Partners and stockholders of partnerships and S Corporations, respectively, are taxed on the taxable income of those entities, whether or not

⁶26 U.S.C. § 1374.

⁷26 U.S.C. § 1362(d)(3).

it is actually distributed.⁸ However, a corporation is subject to an accumulated earnings penalty tax if its accumulated earnings and profits exceed \$250,000 and it cannot show that the excess amount is reasonably needed to run the business.⁹ The rate is 27 1/2% on the first \$100,000 of accumulated taxable income and 38 1/2% on the excess accumulated taxable income for that year.¹⁰ This penalty tax is assessed in addition to the normal corporate tax and promotes the distribution of profits not needed for reinvestment or where earnings and profits are accumulated with a tax avoidance intent (e.g. - delay dividends until a year in which other income could be expected to be reduced).

Corporations are also entitled to exclude 85% of any dividends received from another corporation from their tax calculations.¹¹ However, it is important to avoid having the corporation categorized as a personal holding company. A corporation will be deemed a personal holding company if more than 50% of its outstanding stock is owned by five or fewer individuals during the last half of the taxable year and 60% or more of its adjusted ordinary gross income is passive income, such as interest, dividends, royalties, annuities, compensation paid by stockholders for use of corporate property, and income from

⁸26 U.S.C. §§ 702; 1373(b).

⁹26 U.S.C. §§ 531, 537.

¹⁰26 U.S.C. § 531.

¹¹26 U.S.C. § 243.

personal service contracts.¹² In addition to the normal corporate tax, such an investment corporation would be assessed a 50% penalty tax on its undistributed passive income.¹³

2. Distributed Earnings

If income is not going to be reinvested, then partnership or Subchapter S Corporation status may be preferable because there is only one level of taxation. Note that if income is tax exempt, then the partners have no tax liability because of the flow through phenomenon. However, regular or Subchapter S corporate dividends issued from tax exempt income still result in personal tax liability.¹⁴

C. Capital Gains and Losses

A corporation is not allowed the 60% capital gain deduction authorized for individuals. Instead, a corporation is allowed a special method for computing capital gains.¹⁵ If for any taxable year a corporation has a net capital gain (net long-term capital gain minus net short-term capital loss), then the tax is computed in two ways: the regular method and the alternative method. In the regular method, the tax is computed on taxable income, which includes net capital gains, at the regular corporate tax rate. In the alternative method, tax is computed on taxable income, reduced by the net capital gain, at the regular corporate tax rate, plus a tax of 28% of the net capital gain. The corporation pays the

¹²26 U.S.C. §§ 542, 543.

¹³26 U.S.C. § 541.

¹⁴26 U.S.C. §§ 316, 1366.

¹⁵26 U.S.C. § 1201.

lesser of the tax computed under the two methods. Furthermore, a corporation is not allowed to deduct any excess capital loss over capital gain.¹⁶ However, the excess capital loss may be carried back for three years and carried forward for five years.¹⁷ Such a loss is carried as a short-term capital loss which provides for a dollar for dollar deduction against corporate income. When dividends are issued from capital gain income, the income retains none of its original character for the stockholder.

Each partner treats his respective share of the partnership's capital gains and losses as his own.¹⁸ An individual partner is eligible for the 60% net capital gain deduction. If capital losses attributed to a partner exceed his capital gains, then such losses may offset ordinary income up to \$3,000.¹⁹ The offset is dollar for dollar if the loss is short term. If the loss is long term, \$1 of loss offsets only \$.50 of ordinary income. Any additional net capital loss exceeding \$3,000 can be carried forward according to its original character (i.e. short term or long term), indefinitely, until it is exhausted.²⁰

Since an S Corporation is treated in essentially the same manner as a partnership, items pass through to the stockholders without losing their character. Thus, capital gains and losses of the S Corporation will pass through to the stockholders as capital

¹⁶26 U.S.C. § 1211.

¹⁷26 U.S.C. § 1212.

¹⁸26 U.S.C. § 702.

¹⁹26 U.S.C. § 1211.

²⁰26 U.S.C. § 1212(b).

gains and losses. A stockholder of an S Corporation is eligible for the 60% net capital gain deduction. Capital loss limitation and carry over rules apply as well.

D. Operating Expenses

Operating losses of a corporation are deductible only against earned income. Excess operating losses must be carried back three years and then carried forward 15 years unless the corporation elects to relinquish the carryback period and carry all losses forward.²¹

As observed earlier, partnership and S Corporation losses and income flow through to the partners and stockholders, respectively. However, a partner or S Corporation stockholder may not deduct losses in excess of his basis in the business.²² Operating losses in excess of basis may be carried forward indefinitely and used when the partner or S Corporation stockholder acquires additional basis in the business.

Because dividends are subject to a "double tax", many closed corporation officers and stockholders attempt to extract ordinary income from the corporation utilizing a method that will provide a tax deduction to the corporation. One method of avoiding double taxation in a closed corporation is through payment of salaries to corporate officers and stockholders. However, the Internal Revenue Service (IRS or Service) will scrutinize salaries to determine if they are excessive. Factors considered in determining the reasonableness of these salaries include:

²¹26 U.S.C. § 172.

²²26 U.S.C. §§ 704(d), 1366(d).

(1) individual qualifications, (2) salaries of comparable competitors; (3) the amount and complexity of the work required of the individual; and (4) a review of the salary and dividend history to determine if salaries vary from year to year in order to minimize dividends. It is important that an officer or stockholder be paid a reasonable salary from the beginning of the business, and that he take a note for any amount that the corporation cannot initially afford. This documents the early underpayment to avoid IRS challenges to subsequent and otherwise justified salary increases.²³ An arms-length contract allocating a reasonable percentage of sales to compensation will also protect the salary deduction.

The partnership and S Corporation forms allow the participants to claim all of the regular business deductions available to an operating enterprise. They flow through unchanged like income and losses. The most significant deductions are the allowances for depreciation, accelerated depreciation, and bonus depreciation. Congress has expanded the number of investment tax credits for various kinds of favored development, including hydroelectric development, and a partner or S Corporation stockholder may offset his own tax liability with his share of these credits. A corporation must use any applicable credits against the corporation's tax.

E. Fringe Benefits

The corporate organization offers the greatest number and complexity of alternative compensation options available to key employees of any business enterprise. In addition to salary, the

²³J. L. Klug, The Basic Book of Business, pp. 22-23, (1977).

executive compensation package can include participation in qualified pension or profit sharing retirement plan; group insurance; medical plans; entertainment and travel expenses; and incentive compensation such as stock option plans that provide meaningful financial rewards and employee motivation.

Furthermore, all of these compensation devices are deductible to the corporation; they reduce the corporate taxable income and are also generally not eligible for inclusion in the officer's or stockholder's income tax return. Under the partnership format, the availability of these tax-free fringe benefits is limited to less generous pension or profit sharing retirement plans.²⁴ Under the S Corporation format only those benefits received by employee stockholders owning 2% or less of the S Corporation stock may be deductible by the corporation as a business expense.²⁵

F. Section 1244 Stock

Section 1244 of the Internal Revenue Code provides a tax benefit with respect to losses resulting from the sale of stock or by stock becoming worthless if such stock is still held by the original investor. Up to \$50,000 (or \$100,000 if filing a joint return) of deductions against ordinary income can be taken for such a loss on a "small business corporation's" common stock. A corporation qualifies as a small business corporation after November 6, 1978, if the amount of money and other property

²⁴Id., at 7, 8; J. K. O'Connor, Selection of the Form of Business or Professional Organization: A Need for Clairvoyance Taxes, 891-896 (December, 1978).

²⁵26 U.S.C. § 1372.

received by the corporation as a contribution to capital and as paid-in surplus does not exceed \$1,000,000. This figure is determined at the time the stock is issued and includes amounts received for this stock as well as any other stock that was previously issued. In order to qualify as § 1244 stock:

- 1) The stock must be common stock of a domestic corporation;
- 2) The stock must be issued by a small business corporation;
- 3) The stock must be issued for cash or property, not stock, securities, or services; and
- 4) The corporation must be an operating company and have derived more than 50% of its revenue from other than passive sources.²⁶

The benefit is available to an S Corporation if such corporation is a "small business corporation" as that term is defined in Section 1244. Although both the Subchapter S Corporation provisions and Section 1244 provisions refer to small business corporations, they are entirely independent of each other and have different objectives and requirements for qualification.²⁷

An individual who is a partner in a partnership may also take an ordinary loss deduction for a loss sustained on the sale, exchange or worthlessness of § 1244 stock. To claim a deductible loss on stock issued to the partnership, however, the individual must have been a partner at the time the stock was issued and remain so until the time of the loss. The deduction is limited to the lesser of the partner's distributive share at the time of the

²⁶26 U.S.C. § 1244.

²⁷W.L. Harwell, 33 T.G.M. 669, Dec. 32, 634 (M), T.C. Memo 1974-153.

issuance of the stock or the partner's distributive share at the time the loss is sustained.²⁸ It should be noted that a corporation is not entitled to ordinary loss treatment under Section 1244 regardless of how the stock was acquired.

²⁸26 C.F.R. § 1.1244(a) - 1(b).

IV. GENERAL FEDERAL INCOME TAX PROVISIONS AFFECTING SSH DEVELOPMENT

It should be clear from the preceding discussion of business organizational forms that federal income tax considerations will have a substantial impact on the final decision regarding the appropriate form for an SSH project. Full utilization of the multiple federal tax benefits available to an SSH project will frequently have a decisive impact on the project's rate of return. To make a completely informed decision about the appropriate business form, the SSH developer should have some basic knowledge of the type and extent of the tax opportunities available, the tradeoffs involved, and the major limitations on their use. This section provides some fundamental information on the major federal income tax provisions relevant to an SSH project.

It should be noted that the discussion of tax factors which follows is by no means exhaustive. As noted above in the section on business form selection, this subject matter is extremely complex and hence not readily amenable to summary treatment. Thus, the best use of the information which follows is in assisting the identification of tax considerations which should receive treatment by a knowledgeable and experienced tax professional.

A. Business Expenses

A fundamental policy behind tax law is not to tax the costs of producing income. In tax parlance, the costs of producing income are generally termed business expenses. IRC § 162 allows a taxpayer to deduct from his gross income all ordinary and necessary expenditures connected with or pertaining to his trade or business. Business expenses include the costs of carrying

materials and supplies, salaries, incidental repairs, and rental payments for the use of business property, among other things. Ordinarily, the costs of carrying materials and supplies are deductible only to the extent that they are actually consumed and used in business operations during the year.¹ The costs of incidental repairs are deductible only to the extent that they keep the property in an ordinarily efficient operating condition.² A deduction is not allowed if the value of the property is materially increased or its ordinary life is prolonged by the repairs. Any expenses that can legitimately be characterized as repairs and not improvements will directly reduce the taxpayer's net taxable income. The latter expenditures will be treated as capital contributions to the enterprise and will be disallowed as an ordinary business expense deduction.³ Salaries are deductible to the extent that they are actually paid or incurred and represent a reasonable allowance for personal services actually rendered.⁴ Rent paid by the taxpayer for business property is deductible along with any taxes and interest he is required to pay on behalf of the landlord.⁵

¹26 C.F.R. § 1.162-3.

²26 C.F.R. § 1.162-4.

³Abbott Worsted Mills, Inc. v. Gagne, 30 A.F.T.R. 1726 (1942); Scovill Mfg. Co. v. Commissioner, B.T.A. 265 (1932).

⁴26 C.F.R. § 1.162-7.

⁵26 C.F.R. § 1.162-11.

B. Depreciation

1. Definition and Significance

One of the costs associated with the production of income is the declining value of a business' tangible assets due to wear and use. Consequently, the Internal Revenue Code (hereinafter referred to as the Code) provides for a depreciation deduction from taxable income as a reasonable allowance for exhaustion, wear and tear, and obsolescence, and to defray the cost of purchasing replacement assets.

The Economic Recovery Tax Act of 1981 (ERTA) substituted a new accelerated cost recovery system (ACRS) for the old depreciation system for property placed in service after January 1, 1981. In essence, ACRS offers generally more rapid depreciation deductions than available for depreciable property under prior law. In particular, the relative tax depreciation disadvantage of hydroelectric property relative to other depreciable property was eliminated. The Tax Equity and Financial Responsibility Act of 1982 (TEFRA) provided some changes to this system that partially diminish the value of these improvements. Nonetheless, hydroelectric property now enjoys a considerably more competitive depreciation status than it had prior to ACRS.

The ACRS is applicable only to property installed after the effective date, and hence Code Section 167, governing depreciation before ERTA, is still operative for such property. Because the ACRS did not completely supersede § 167 and certain related Code sections, and because the basic concept of depreciation was not changed by the ACRS, it is useful to briefly consider depreciation before ERTA.

2. Summary of Pre-ERTA Depreciation

Under Code § 167, the allowed depreciation deduction depends on the net salvage value and the useful life of the asset. The net salvage value is the estimated amount to be realized upon the sale of the asset for scrap (less the costs associated with the disposition of the asset), as determined at the time the asset is acquired.⁶ The useful life of the asset is the estimated period for which the asset will be useful, and the Internal Revenue Service (IRS) has established guidelines for the estimation of the useful life of various assets (called Asset Depreciation Range, or ADR). The IRS will not question the taxpayer's choice of a useful life that is within 20 percent of the guideline period (ADR midpoint) established by the IRS.⁷

A taxpayer's annual depreciation deduction is then determined by subtracting the net salvage value from the investor's basis (generally the asset's cost) in the asset and dividing that by the useful life. This method of calculating the depreciation deduction is known as the "Straight Line Method" because it results in the same deduction each year.

The Code also provides for the use of other methods of depreciation. Two common methods are the "Double Declining Balance Method" and the "Sum of the Years Digits Method." Both are known as accelerated depreciation methods because the depreciation deduction available at the beginning of the asset's useful life is greater than that allowed under the Straight Line

⁶26 C.F.R. § 1.167(a)-1(c).

⁷26 C.F.R. § 1.167(a)-11; 26 U.S.C. § 167(m); Rev. Proc. 72-10, 1972-1 C.B. 721.

Method. However, each year the size of the deduction is reduced until, towards the end of the useful life of the asset, it becomes less than the straight line amount. Accelerated depreciation methods effectively give the business a tax break in the early years after the purchase of a depreciable asset while the cash flow generated by its use is small, and results in a smaller tax deduction late in the asset's useful life when the cash flow from its use should be well established.

The Tax Reform Act of 1969 imposed substantial constraints on the availability of accelerated depreciation on investments in real property. In general, Section 1250 property (essentially buildings and structural components), except residential rental property, is not eligible for accelerated depreciation greater than that allowed under the 150% declining balance method. Section 1250 property is defined in the Code as depreciable real property other than property described in Section 1245(a)(3).⁸ Section 1250 property includes all intangible real property, such as leases of land or § 1250 property, buildings and their permanently affixed structural components, and all other tangible real property, such as a radio broadcast tower, a loading area for trucks, or a club swimming pool.⁹ Section 1245 property is defined as tangible personal property and other property, not including a building and its structural components, which, among

⁸26 U.S.C. § 1250(c).

⁹26 C.F.R. § 1.1250-1(e).

other things, is used as an integral part of manufacturing, or producing or furnishing electrical energy.¹⁰ Section 1250 property generally includes buildings and all permanently affixed components. (A component is permanently affixed when movement requires breaking concrete; however, in a 1972 ruling, the IRS found that a "hydroelectric power plant structure" was not a building under Section 48 of the Code but rather "other tangible property used as an integral part of furnishing electricity" and thus qualified for the investment tax credit.)¹¹ In view of the similar language and rationales for Sections 48 and 1245, it seems reasonable to expect that most of the cost of rehabilitating an SSH project would be treated as Section 1245 property.

Prior to ERTA, Code § 179 allowed a taxpayer an additional depreciation deduction for assets with a useful life of over six years, during the first depreciable year of the asset. This bonus depreciation was available only for tangible property and was limited to 20 percent of the cost of the property (not reduced by salvage value), with a maximum deduction of \$2,000.

3. Depreciation after ERTA

ERTA established a new approach to depreciation for most types of property previously depreciable. This approach is called the Accelerated Cost Recovery System (ACRS). New Code § 168

¹⁰26 U.S.C. § 1245(a)(3), 26 C.F.R. § 1-1245-3.

¹¹Rev. Rul. 72-223, 1972-1 C.B. 17.

allows an ACRS deduction for the taxable year with respect to "recovery property." "Recovery property" is defined by § 168 as tangible property of a character subject to the allowance for depreciation which is used in a trade or business or held for the production of income, and placed in service after January 1, 1981.¹² (See the discussion of when property is placed in service in the section on federal tax credits, infra.) To determine the amount of the annual ACRS deduction, the "unadjusted basis" of the property is multiplied by the percentage taken from the tables provided in § 168. The percentage that is applicable depends upon the date the property is placed in service and whether the property is 3-, 5- or 10-year property, 15-year public utility property, or 15-year real property. (See Table 1.)

The "unadjusted basis" is the excess of the basis of the property for the purposes of determining capital gain, over the sum of that portion of the basis which the taxpayer elects to amortize in lieu of depreciation or to expense pursuant to new Code § 179.¹³ New § 179 gives the taxpayer the option to treat the cost of purchasing certain recovery property up to \$5,000 (\$7,500 after 1983 and \$10,000 after 1985) as an expense which may be deducted currently.

Three-year property is defined as § 1245 property with a useful life of four years or less. Five-year property means § 1245 property which is not 3- or 10-year property, or 15-year public utility property. Ten-year property means public utility

¹²26 U.S.C. § 168(c)(e).

¹³26 U.S.C. § 168(d).

TABLE 1

SUMMARY OF DEPRECIATION DEDUCTIONS AVAILABLE UNDER ACRS

If the recovery
year is:

The percentage of the acquisition cost of the property which can
be deducted in that year is:

	3-yr property (expected life of 4 years or less)	5-yr property (property which is not 3-, 10- or 15-year public property)	10-yr property (public utility property with an expected life of 18-25 years and real property with an expected life of 12.5 years or less)	15-yr real pro- perty (real pro- not have an exp- ected life of 12.5 years or less ¹	15-public utility property (public pro- an expected life of more than 25 yr
1	25	15	8	12	5
2	38	22	14	10	10
3	37	21	12	9	9
4		21	10	8	8
5		21	10	7	7
6			10	6	7
7			9	6	6
8			9	6	6
9			9	6	6
10			9	5	6
11				5	6
12				5	6
13				5	6
14				5	6
15					6

Optional 3, 5 or 12 years
straight line
recovery period-
depreciation over:

5, 12 or 25 10, 25 or 35 15, 35 or 45 15, 35 or 45

¹ The percentage of the acquisition cost which can be deducted in each
year is to be determined by regulation. The schedule cited is for non-
low income housing property placed in service in the first month of
the tax year.

property, other than § 1250 property or 3-year property, with a class life of 18 to 25 years, and § 1250 property with a class life of 12.5 years or less. Fifteen-year public utility property is defined as public utility property with a useful life of more than 25 years. Fifteen-year real property is § 1250 property with a class life greater than 12.5 years.¹⁴

Most hydroelectric property will qualify as 5-year property. All recovery property except 15-year real property was made eligible for a percentage declining balance recovery schedule with a half-year convention. For tax years through 1985, such property is eligible for a 150% declining balance recovery schedule.

The half-year convention is built into the ACRS tables specified in § 168 and operates such that property in each class is treated for five years as though it were placed in service for one half of the tax year. For example, if property is placed in service at any time before 1985, 15% of the unadjusted basis is recovered in the first year, 22% in the second year, and 21% in the 3rd, 4th, and 5th years. The taxpayer may no longer elect to use different lives for each separate component of a building such as the plumbing or wiring (component depreciation), but must use a single life for the building and all components (composit depreciation).¹⁵

¹⁴26 U.S.C. § 168(c)(2).

¹⁵26 U.S.C. § 168(f)(1).

4. Depreciation after TEFRA

ERTA also provided for a 175 percent declining balance schedule in 1985 and a 200 percent declining balance schedule in 1986. TEFRA has repealed these highly accelerated 1985 and 1986 depreciation schedules.¹⁶ In addition, property eligible for the investment tax credit will have its depreciable basis reduced by one-half the amount of the investment tax credit claimed.¹⁷

5. Land Preparation Costs

Land preparation costs are generally not considered to be tangible property subject to depreciation. However, where land preparation costs are closely associated with depreciable assets, such costs are also depreciable. The IRS has held that the land preparation costs of a reservoir, including the dam structure, roadway, and clearing, stripping and grading of the reservoir site are depreciable. The Service reasoned that because these costs are so closely related to the construction of the dam itself, a depreciable asset, they should be included contemporaneously with dam construction costs and should be depreciated over the same useful life as the dam.¹⁸

¹⁶Tax Equity and Fiscal Responsibility Act (TEFRA), Pub.L. No. 97-248, § 206.

¹⁷TEFRA § 205.

¹⁸Rev. Rul. 72-96, 1972-1 C.B. 67.

C. Federal Tax Credits

1. Introduction

With the investment tax credits, Congress developed a comprehensive scheme for the stimulation of capital investment. Included in this scheme are several incentives, as modified by ERTA and TEFRA, which would benefit the developer of an SSH project. To be eligible for these credits, the SSH developer must make investments in property which qualifies as "§ 38 property."¹⁹ Section 38 property includes tangible personal property; other tangible property, including real property (exclusive of buildings and their structural components) that is used as an integral part in the furnishing of electricity; and qualified rehabilitated buildings. As a result of ERTA, the property must be recovery property or other property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and which has a useful life of three years or more.²⁰

For tax purposes, a hydroelectric plant structure housing a turbine and generator has been ruled as qualifying tangible property because the structure is so closely interrelated with the turbine and generator in terms of use, function, and design that if any part of the unit ceases to be useful, the remaining components must be abandoned contemporaneously.²¹ Furthermore, the costs of a reservoir, including the access roadway, the dam

¹⁹26 U.S.C. § 46(a)(1).

²⁰Defined in 26 U.S.C. § 168 and discussed in the section on depreciation, supra.

²¹Rev. Rul. 72-223, 1972-1 C.B. 17.

structure, and the clearing, stripping and grading of the site, have been ruled tangible property subject to depreciation and eligible for a credit.²²

The credits that are allowed include the regular investment credit (ITC), the energy tax credit (ETC), the employee plan investment credit (beyond the scope of this writing), and a credit for qualified rehabilitation expenditures.²³ (See Table 2 for a summary of the tax credits available for investment in SSH property.) The ITC and employee plan investment credit are used to offset tax liability before the ETC may be used.²⁴ The ITC and employee plan credit may be used to offset tax liability dollar for dollar up to \$25,000; above that limit, 85% of the ITC and employee plan credit may be applied to offset tax liability. Any remaining tax liability may be offset dollar for dollar by the ETC.²⁵

Unused credits may be carried back for three years and carried forward for fifteen years.²⁶ The Treasury Regulations provide a special ordering rule which requires ITC carryovers to be applied first, followed by employee plan credit carryovers. Next, the ITC earned in the current year is applied, followed by the current employee plan credit. Finally, ITC carrybacks are applied, followed by employee plan carrybacks. After these credits have been applied, the energy credits are applied to any

²²Rev. Rul. 72-96, 1972-1 C.B. 67.

²³²⁶ U.S.C. § 46(a)(2).

²⁴²⁶ U.S.C. § 46(a)(7).

²⁵²⁶ U.S.C. §§ 46(a)(3), 46(a)(7).

²⁶²⁶ U.S.C. § 46(b).

TABLE 2
SUMMARY OF TAX CREDITS AVAILABLE FOR
INVESTMENT IN SSH PROPERTY

<u>CREDIT</u>	<u>AVAILABLE FOR</u>	<u>PERCENTAGE OF QUALIFIED EXPENDITURES WHICH MAY BE CLAIMED AS A CREDIT</u>	<u>COMMENTS</u>
INVESTMENT TAX CREDIT	a. 3-year recovery property	6% ¹	
	b. All other ² recovery property	10% ¹	
ENERGY TAX CREDIT	a. Hydroelectric Property (equipment used to gener- ate electricity by water; structures for housing turbines and generating equipment, penstocks, and fish passageways; and dam rehabilitation property)	11%	Expires 12/31/85
REHABILITATION TAX CREDIT	a. Rehabilitation of 30-year old buildings	15% ³	
	b. Rehabilitation of 40-year old buildings	20% ³	
	c. Rehabilitation of certified historic structures	25% ¹	

¹ 26 U.S.C. § 46(c) (7); For property placed in service after December 13, 1982 (with specified exceptions), TEFRA requires the taxpayer to reduce the basis of the property by half the amount of the credit claimed. With respect to the investment tax credit, the taxpayer may elect to reduce the amount of the credit claimed by 2% rather than reducing the basis of the property, 26 U.S.C. § 48(q).

² It should be noted that recovery property must qualify as § 38 property.

³ The basis of the property must be reduced by the full amount of the credit claimed.

remaining tax liability.²⁷ If property upon which credits have been claimed is disposed of before the expiration of its useful life, or class life for recovery property, then it will be subject to recapture of a portion of the credits. (See the section on recapture, infra.)²⁸

The project developer who acts as a lessor of qualified property may elect to pass the regular investment tax credit on to his lessee, but only when "new § 38 property" is involved. (See the discussion of "new" and "used" § 38 property, infra.) There are also some limitations on this pass through in the case of a short-term lease and some additional changes made by TEFRA. (See Section 6, infra.)²⁹ A non-corporate lessor of qualified property may claim the credits only by satisfying the Code's "non-corporate lessor" rules. Essentially, this requires limiting the lease term, including unilateral renewal options, to one-half of the estimated useful life of the property and insuring that the lessor take responsibility for annual project costs exclusive of debt service in an amount equal to at least 15 percent of the lease payment. Even if a lessor is unable to claim it himself, he may elect to pass the credit to an eligible lessee.³⁰

²⁷26 U.S.C. § 46(a); 26 C.F.R. §§ 1.46-1(1), 1.46-2(f).

²⁸26 U.S.C. § 47(a)(1)(5).

²⁹26 U.S.C. §§ 48(d)(1), 48(d)(2), 48(e)(3); 26 C.F.R. § 1.46-4(d)(1).

³⁰26 U.S.C. § 46(e)(3).

2. INVESTMENT TAX CREDIT

A taxpayer may claim a credit of 10% of his qualified investment in § 38 property placed in service during the taxable year.³¹ The qualified investment is determined by reference to the useful life of the property, or in the case of property placed in service after January 1, 1981, by reference to whether it is 15-year public utility property or 3-, 5-, or 10-year property as discussed in the preceeding section on depreciation. For instance, if the property was placed in service before January 1, 1981, or if the taxpayer elects to depreciate the property under § 167, the credit will be 10% of 100% of the taxpayer's basis in property with a useful life of 7 years or more. For property with a useful life of 5-7 years, the credit is 10% of 66 2/3% of the basis; for property with a useful life of 3-5 years, the credit is 10% of 33 1/3% of the basis.³²

In the case of property placed in service after January 1, 1981 which the taxpayer elects to depreciate under Code § 168 (recovery property), the taxpayer may claim a credit of 10% of 100% of his basis in 15-year public utility property or 10- or 5-year property, or 10% of 60% of the basis of 3-year property.³³

The Service has held that a fish passageway and fish-related facilities installed at a utility-owned hydroelectric generating facility do not qualify for the ITC as other tangible property because they were not considered an integral part of a facility

³¹26 U.S.C. § 46(e)(3).

³²26 U.S.C. § 46(c)(2).

³³26 U.S.C. § 46(c)(7).

furnishing electrical energy.³⁴ However, the passageways are almost universally required by the FERC (Federal Energy Regulatory Commission) when a license is first granted or when a downstream obstacle to fish migration is removed. Consequently, the Crude Oil Windfall Profit Tax Act of 1980 (COWPTA) specifically designated fish passageways installed on qualified hydroelectric generating property as eligible for the ITC, provided that the fish passageway is eligible for the ETC. Unfortunately, fish passageways at hydroelectric projects which are not eligible for the ETC (generally new dams and facilities over 125 MW) are not eligible for the ITC. However, in expressly extending the ITC to certain fish passageways, Congress did not intend to imply that it approved of the Service's denial of the credit to other fish facilities.³⁵ Thus, it is possible that a developer could successfully challenge the Service's position on these other fish passageways in court.

Qualified property is divided into two classes: "new § 38 property" and "used § 38 property." "New § 38 property" is property constructed, reconstructed, erected, or acquired after December 31, 1961, provided that the original use of the property commenced with the taxpayer after that date.³⁶ "Used § 38

³⁴Rev. Rul. 73-466, 1973-2 C.B. 52.

³⁵Buck L.E., Goodwin L.M., Alternative Energy, The Federal Role, (1982) at 14-5; Staff of Joint Committee on Taxation, General Explanation on the Crude Oil Windfall Profit Tax Act of 1980, at 71 (1981).

³⁶26 U.S.C. § 48(b).

property" is purchased property not qualifying as "new § 38 property." (A more thorough discussion of "used § 38 property" is provided below.)

In meeting the qualification requirements of "new § 38 property," original use means the first use to which the property is put, whether or not such use corresponds to the first use of the property by the taxpayer.³⁷ Thus, a reconditioned generator is not eligible for treatment as "new § 38 property" because it is not being put to original use by the taxpayer. However, if "used § 38 property" is purchased or reconstructed by the taxpayer, the basis of the salvaged parts, the cost of reconstruction materials, and the capitalized cost of reconstruction will be treated as "new § 38 property."³⁸ It should be noted that the question of whether property is reconditioned or rebuilt is a question of fact, and property will not be treated as reconstructed or rebuilt merely because it contains some used parts.

Repair costs and materials used in making repairs are distinguished from reconstruction costs. A repair merely maintains the property in an ordinary efficient operating condition and therefore is deductible as a business expense. Expenditures resulting from a general plan of reconstruction are classified as improvement expenditures. They materially add to

³⁷26 C.F.R. § 1.48-2(b)(7); Rev. Rul. 70-37, 1970-1 C.B. 3; Rev. Rul. 70-114, 1970-1 C.B. 2; Rev. Rul. 70-135, 1970-1 C.B. 10.

³⁸Id.

the value or utility of the property or appreciably prolong its useful life and are thus capitalized.³⁹ Consequently, repair costs are not treated as "new § 38 property."⁴⁰

It is also important to observe that property is constructed, reconstructed, or erected by the taxpayer only if the work is done for him in accordance with his specifications. Property will not be classified as "new § 38 property" if the taxpayer lacks legal and actual control over the property and its construction, reconstruction, or erection.⁴¹

These distinctions between "new" and "used" property may have considerable significance to the redevelopment of an SSH facility. Thus, to ensure the unrestricted availability of the ITC for the maximum amount of capital expenses associated with the redevelopment, a developer should take care that the rebuilding of any used components is accomplished by the taxpayer desiring to take the credit.

A developer can get the ITC for property that is in the process of being constructed. The property must have an estimated construction period of two years or more and must be "new § 38 property" in the hands of the taxpayer when it is placed in service.⁴² The amount eligible reflects the amount charged to the

³⁹26 C.F.R. § 1.162-4.

⁴⁰26 C.F.R. § 1.48-2(b); Rev. Rul. 68-111, 1968-1 C.B. 29; Rev. Rul. 68-111, 1968-1 C.B. 29; Rev. Rul. 67-285, 1967-2. C.B. 7.

⁴¹26 C.F.R. § 1.48-2(b)(1); Public Service Company of New Mexico v. United States, 431 F.2d 980 (10th Cir. 1970); Rev. Rul. 70-135, 1970-1 C.B. 10; Rev. Rul. 68-316, 1968-1 C.B. 30.

⁴²26 U.S.C. § 46(d).

developer's capital account. It does not include any amount borrowed from the person constructing the property.⁴³ The credit taken for this "progress expenditure" property reduces the "new" property eligible for the ITC when the property is finally placed in service. (A more detailed discussion of "qualified progress expenditures" is provided, infra.)

As noted earlier, "used § 38 property" is purchased § 38 property not qualifying as "new § 38 property." Property acquired in tax free exchanges, by inheritance, or devise does not qualify as "used § 38 property."⁴⁴ Furthermore, the credit is not allowed for "used § 38 property" if, after its purchase, it is used either by a person who had used the property before the purchase, or by one related to that person.⁴⁵ Thus, for example, if property is used by a person and is later sold by him under a sale and leaseback arrangement, such property in the hands of the purchaser-lessor is not "used § 38 property" because the property, after its acquisition, is being used by the same person who used it before its acquisition.⁴⁶

The total investment eligible for the consideration as "used § 38 property" cannot exceed \$150,000 (\$125,000 for taxable years beginning in 1981 through 1984) and any excess is not subject to the general carryback/carryover rule.⁴⁷ This means that the

⁴³Id.

⁴⁴26 U.S.C. § 48(c)(3)(A); 26 C.F.R. § 1.179-3(a)(c).

⁴⁵26 U.S.C. § 48(c)(1); 26 C.F.R. § 1.48-3(a)(2).

⁴⁶26 C.F.R. § 1.48-3(a)(2).

⁴⁷26 U.S.C. § 48(c)(2).

taxpayer must carefully select the particular items of "used" property he wishes to claim for the ITC. The cost of "used § 38 property" does not include the remaining adjusted basis of other qualified property traded in during the sale, unless the exchange results in credit recapture. Furthermore the ITC basis of "used § 38 property" never includes the basis of ineligible property involved in the trade.⁴⁸

⁴⁸16 U.S.C. § 48(c); 26 C.F.R. § 1.48-3(b).

3. Energy Tax Credit

The energy tax credit (ETC) is generally available for qualified property that is constructed, reconstructed or acquired by the taxpayer after September 30, 1978, provided that the original use of the property commences with the taxpayer after that date and the property is depreciable with a useful life (determined as of the time the property is placed in service) of three years or more, or which is recovery property.⁴⁹ Code § 48(1) defines the property eligible for the ETC, and specifically notes that, for purposes of determining the ETC, such property is treated as § 38 property. Only "new § 38 property" qualifies for the ETC. Thus, it is important to realize that a developer who acquires reconditioned "used" property (e.g. turbines, generators) will sacrifice the full ETC. As noted above, this consequence can be avoided by acquiring used property and reconditioning it afterward. It should be noted that the special definitions of energy property listed in § 48(1) supersede the definitions in Code § 48(a)(1); consequently some property can qualify for the ETC which does not qualify for the ITC.

Hydroelectric generating property is eligible for an 11 percent energy credit from January 1, 1980 through December 31, 1985.⁵⁰ Qualifying hydroelectric generating property includes:

⁴⁹26 U.S.C. § 48(1).

⁵⁰26 U.S.C. § 46(a)(2)(C).

- 1) All equipment for increased capacity to generate electricity by water, up to, but not including electrical transmissions;
- 2) Structures for housing turbines and generating equipment, penstocks, and fish passageways; and
- 3) Dam rehabilitation property which is the cost associated with strengthening, reconstructing, or rehabilitating the impoundment and existing dam site equipment.⁵¹

The qualified hydroelectric generating property must be located at a qualified hydroelectric site. Code § 48(1)(13)(B) defines such a site as one at which:

- 1) There is a dam the construction of which was completed before October 18, 1979, and which was not significantly enlarged after that date; or
- 2) The electricity will be generated without a dam or other impoundment of water; and
- 3) The net installed capacity of the hydroelectric generating equipment is less than 125 MW.

The qualified hydroelectric site must be located on a natural or manmade water course (such as a river, a water conduit, or an irrigation ditch) at which electricity is generated from flowing or falling water. The credit is not available for property installed in connection with ocean tidal facilities, ocean thermal facilities, or pumped storage projects.⁵² The term "existing dam" includes dams which are currently being used in connection with the generation of electricity, dams which have been used in the generation of electricity in the past, and dams which have never been used in connection with the generation

⁵¹26 U.S.C. § 48(1)(13)(A).

⁵²Buck, L.E., Goodwin, L.M., Alternative Energy, The Federal Role, (1982) at 13-73, citing, HR Rep. No. 817, 96th Cong., 2d Sess. 12.

of electricity. A "dam" includes any barrier built across a watercourse and any other manmade structure for the impoundment of water.⁵³

The full 11 percent ETC is available for qualified hydroelectric generating property installed in connection with projects that have an installed capacity of 25 MW or less. The credit decreases for projects with an installed capacity between 25 and 125 MW.⁵⁴ As stated above, the ETC is available from January 1, 1980 through December 31, 1985. This period is extended to December 31, 1988 in the case of hydroelectric projects for which an application has been docketed with the Federal Energy Regulatory Commission (FERC) before January 1, 1986.⁵⁵ While it is not expressly stated in the Act or the Conference report, it would seem that the acceptance of the application for a preliminary permit, the application for a license, and the application for a license exemption will qualify as "docketed" for the purpose of triggering the extension. However, exactly what event will qualify as "docketing" under this section is not yet clear.

Where qualified hydroelectric property is in whole or in part financed by subsidized energy financing or tax exempt industrial development bonds, the availability of the ETC is restricted. The amount lost is proportional to the amount of the

⁵³HR Rep. No. 817, 96th Cong., 2nd Sess. 127.

⁵⁴26 U.S.C. § 48(1)(13)(c).

⁵⁵26 U.S.C. § 46(a)(2)(1)(c).

project that is financed by either financing device.⁵⁶ Subsidized energy financing means financing provided under a federal, state, or local program the principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.⁵⁷ It includes, but is not limited to, the direct or indirect use of tax-exempt bonds; however, it does not include loan guarantees.⁵⁸ Thus, in the case of a project in which 80 percent of the project cost is supplied by tax-exempt bond proceeds, the developer would only be able to take 20 percent of the ETC otherwise available.

The ETC may not be denied for property owned by or leased to a tax-exempt organization if:

- 1) The organization is a farmer's cooperative; or
- 2) The organization uses the property in a taxable unrelated trade or business.⁵⁹

Finally, it should be noted that unlike most energy property, the fact that qualifying hydroelectric property is used by a public utility will not deny its eligibility for the ETC.⁶⁰

⁵⁶26 U.S.C. § 48(1)(11).

⁵⁷26 U.S.C. § 48(1)(11)(c).

⁵⁸H.R. Rep. No. 817, 96th Cong., 2nd Sess., 136, 137.

⁵⁹26 U.S.C. § 48(a)(4).

⁶⁰26 U.S.C. § 48(1)(17).

4. Rehabilitation Tax Credit

Under certain conditions, some part of the capital cost of a hydroelectric project may qualify for the rehabilitation tax credit. A taxpayer may claim 15 percent of his qualified rehabilitation expenditures with respect to a 30-year qualified rehabilitated building, 20 percent with respect to a 40-year qualified rehabilitated building, and 25 percent with respect to a certified historic structure, as a credit against his tax liability for the year in which that property was placed in service.⁶¹ The investment tax credit and the energy tax credit do not apply to that portion of the basis of any property which is attributable to qualified expenditures for rehabilitation.⁶² However, if qualification can be reasonably achieved, the credit for historical structures is obviously superior to the combined ITC and ETC for qualifying hydroelectric property. In addition, since the rehabilitation is expressly excluded from the Code constraints on property used by public or tax-exempt entities, it may be particularly useful for projects which entail relationships with such entities. In the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures is treated as "new § 38 property."⁶³ Therefore, it is not subject to the \$150,000 "used property" limitation.

⁶¹26 U.S.C. § 46 (a)(2)(F)(i).

⁶²26 U.S.C. § 46 (a)(2)(F)(i).

⁶³26 U.S.C. § 48 (g)(4).

The term "qualified rehabilitated building" means any building and its structural components:

- 1) which has been substantially rehabilitated;
- 2) which was placed in service prior to rehabilitation;
- 3) 75 percent or more of the existing external walls of which are retained in place as external walls after rehabilitation; and
- 4) where at least 30 years have passed between the date the physical work on the rehabilitation began and the date the building was first placed in service.⁶⁴

Rehabilitation includes renovation, restoration, or reconstruction. For a building to be considered rehabilitated, the rehabilitation must be "substantial." In general, to be substantial the rehabilitation must materially extend the useful life of the building, significantly upgrade its usefulness, or preserve it in a manner that significantly improves its condition or enhances its historic value. Cosmetic improvements alone, however, do not qualify as a substantial rehabilitation.⁶⁵

Expenditures attributable to new construction do not qualify as rehabilitation expenditures. In general, in order for expenditures to be considered for rehabilitation and not for new construction, the requirement of retaining 75 percent of the external walls must be met. Any expenditures attributable to an enlargement of a building are considered expenditures for new construction, not for rehabilitation. A building is "enlarged" to the extent that the total volume of the building is increased.⁶⁶

⁶⁴26 U.S.C. § 48(g)(1)(A)(B).

⁶⁵26 C.F.R. § 1.48-11(b)(3).

⁶⁶26 C.F.R. § 1.48-11(b)(4).

Where there is a separate rehabilitation of a major portion of a building, that major portion will be treated as a separate building. In general, a part of a building is considered a "major portion" of a building only if it is composed of contiguous portions of the building and is clearly identifiable (e.g., the first 5 stories of a 7 story building), and it is sufficiently large enough so that it would be reasonable to treat it as a separate building.⁶⁷

The term "certified historic structure" means any building and its structural components which:

- 1) is listed in the National Register; or
- 2) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.⁶⁸

In order for the taxpayer to qualify for the 25 percent rehabilitation credit for rehabilitation of a certified historic structure, the Secretary of the Interior must certify to the Secretary of the Treasury that the rehabilitation is consistent with the historic character of that property or the district in which the property is located.⁶⁹

"Qualified expenditures for rehabilitation" are defined as any amount properly chargeable to a capital account after December 31, 1981 for property, or additions or improvements to property, which has a recovery period (see the discussion of depreciation, supra) of 15 years and made in connection with the

⁶⁷26 C.F.R. § 1.48-11(b)(6).

⁶⁸26 U.S.C. § (g)(3).

⁶⁹26 U.S.C. § (g)(2)(C).

rehabilitation of a qualified rehabilitated building.⁷⁰ Certain expenditures are specifically excluded from the definition of qualified rehabilitation expenditures, the most important being expenditures of lessees. Any expenditure of a lessee of a building will not be a qualified rehabilitation expenditure if, on the date the rehabilitation is completed, the remaining term of the lease (without regard to renewal periods) is less than 15 years.⁷¹ However, both the ITC and the ETC are available in situations in which rehabilitation expenditures also qualify as expenditures for energy property.⁷²

⁷⁰26 U.S.C. § 48(g)(2).

⁷¹26 U.S.C. § 48(g)(2)(B)(1).

⁷²S. Rep. on the Technical Corrections Act of 1979. P.L. No. 96-222.

5. QUALIFIED PROGRESS EXPENDITURES

Ordinarily, the tax credits available to a hydroelectric project cannot be taken until the project enters service. However, the Code provides for the progressive receipt of tax credits for projects with an extended construction period. Thus, a taxpayer may elect to take credits on the aggregate of qualified progress expenditures (QPE) made in the taxable year on qualified "progress expenditure property."⁷³ "Progress expenditure property" is defined as any property being constructed by or for the taxpayer which has a normal construction period of at least two years and for which it is reasonable to believe that it will be "new § 38 property" in the hands of the taxpayer when it is placed in service.⁷⁴ The "normal construction period" is defined as the period reasonably expected to be required for the construction of the property, beginning with the date actual physical work commences until the property is expected to be available to be placed in service.⁷⁵ It should be noted that construction includes reconstruction and erection. Under the proposed regulations, construction is defined to cover building or manufacturing property from materials and component parts. Construction does not include preliminary activities such as planning or designing, securing financing, exploring, researching,

⁷³ 26 U.S.C. § 46(d).

⁷⁴ 26 U.S.C. § 46(d)(2)(A).

⁷⁵ 26 U.S.C. § 46(d)(2)(B).

or developing.⁷⁶ In general, taxpayers should refer to normal industry practice in estimating the normal construction period of particular items.

A taxpayer's "qualified progress expenditures" are the sum of (1) qualified progress expenditures for self-constructed property, and (2) qualified progress expenditures for non-self-constructed property. "Self-constructed property" is defined as property for which it is reasonable to believe that more than half the construction expenditures will be made directly by the taxpayer.⁷⁷ QPE for self-constructed property are defined as the amount properly chargeable to the taxpayer's capital account with respect to such property.⁷⁸ In computing the 50% limitation, only those expenses made directly by the taxpayer are included, and expenses are considered to be made directly only if the taxpayer uses his own employees to construct the property.⁷⁹ Construction expenditures made by a taxpayer to a contractor or manufacturer generally are not included. Thus, the cost of component parts, such as generators and turbines, purchased and merely installed or assembled by the taxpayer are not direct expenditures. Note that items treated as an expense and deducted in the year in which they are incurred, such as the depreciation on the machinery and equipment used in construction, are not included in self-constructed property qualified progress expenditures.

⁷⁶ Prop. Reg. § 1.46-5(c)(2).

⁷⁷ 26 U.S.C. § 46(d)(5)(A).

⁷⁸ 26 U.S.C. § 46(d)(3)(A).

⁷⁹ Prop. Reg. § 1.46-5(d)(3).

For all property which is not self-constructed property, called "non-self-constructed property,"⁸⁰ qualified progress expenditures are defined as the lesser of the amount paid by the taxpayer during the taxable year to any other person for the construction of the property or the amount which represents that portion of the overall cost to the taxpayer of the construction by such person which is attributable to that portion of the construction which is completed during that taxable year.⁸¹ Stated another way, they represent amounts paid to the manufacturer, but only to the extent progress is made in construction. Qualified progress expenditures do not include any amount paid if the amount paid is borrowed directly or indirectly from the payee or if there is a financing agreement which has the effect of making the payee a surety.⁸² Consequently, payments made on equipment financed by certain loan agreements through a manufacturer of hydroelectric equipment may not be considered as qualified progress expenditures.

Property such as a generator or turbine which are component parts of, or are otherwise to be included in, any progress expenditure property shall be taken into account no earlier than the time at which they become irrevocably devoted to use in the progress expenditure property and as if, at that time, the taxpayer had expended an amount equal to that portion of his cost for the component which is properly chargeable during the taxable

⁸⁰26 U.S.C. § 46(d)(5)(B).

⁸¹26 U.S.C. § 46(d)(3)(B).

⁸²Prop. Reg. § 1.46-5(d)(3).

year to the capital account for the property.⁸³ No credit for qualified progress expenditures may be claimed in the year in which property is placed in service.⁸⁴ The lessor of progress expenditure property may not elect to treat a lessee as having qualified progress expenditures (i.e., there is no pass-through of the credits to a lessee).⁸⁵

6. CHANGES TO THE TAX CREDITS AFTER TEFRA

TEFRA made several changes to the tax credit scheme. Most important is the requirement that the taxpayer reduce the basis of the property for purposes of depreciation under ACRS for which a tax credit is claimed. Under Code Section 48(q) the ACRS recovery basis for property entering service after 1982 is reduced by one-half of the total of the tax credits claimed. With respect to the ITC, the taxpayer may elect to claim a credit that is 2% less than that otherwise allowed (e.g., 8% for property other than 3-year property), in which case no adjustment in ACRS recovery basis is required.⁸⁶ Note that this reduction to basis applies to all credits claimed, but prior law, which required a reduction in basis by the full amount of any credit claimed for qualified expenditures for the rehabilitation of 30- and 40-year buildings, remains unchanged.

⁸³26 U.S.C. § 46(d)(4)(A).

⁸⁴26 U.S.C. § 46(d)(4)(F).

⁸⁵Prop. Reg. § 1.46-5(f).

⁸⁶26 U.S.C. § 48 (q).

The TEFRA reduction in basis provisions do not apply to the pass-through of the ITC to the lessee of qualified property under Code Section 48(d). Instead, lessees must include in their income ratably over the ACRS recovery period of the property an amount equal to 50% of the credit allowed. However, they may elect to claim a credit that is 2% less than that otherwise allowed, in lieu of an adjustment to their income.⁸⁷

A further important change in the treatment of tax credits reduced the amount of income tax liability in excess of \$25,000 that may be offset by the ITC from 90 percent to 85 percent.⁸⁸ This change is effective for taxable years beginning after December 31, 1982. TEFRA also provides for a deduction of 50 percent of any credits which, at the end of the 15-year carryover period, remain unused when a 50 percent reduction in the basis of the property was made with respect to those credits. If the unused credits were taken for rehabilitation of 30- or 40-year-old buildings, which require a 100 percent reduction in basis, a 100 percent deduction may be taken.

⁸⁷26 U.S.C. § 48 (d)(4).

⁸⁸26 U.S.C. § 46 (a)(3).

V. SPECIAL CONCERNS IN TAX CREDITS AND DEPRECIATION

A. Public Utility Property

If the property involved in an SSH project is considered to be "public utility property," as defined in the Code, it does not qualify for the maximum tax benefits otherwise available to such a project. Public utility property is not eligible for the full investment tax credit,¹ does not qualify for the unrestricted accelerated depreciation available to "non-recovery" property,² and, even if it is "recovery property," does not qualify for a five-year ACRS schedule unless its ADR midpoint life is less than 18 years.³ Note, however, while "public utility property" does not qualify under most categories for an energy tax credit, it does qualify under the qualified hydroelectric generating equipment category.⁴ For all of these purposes, public utility property is defined to include property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission.⁵ The regulations pertaining to regular and ACRS depreciation⁶ define "established or approved" to include

¹26 U.S.C. § 46(f).

²26 U.S.C. § 167(1).

³26 U.S.C. § 168(c)(2).

⁴26 U.S.C. § 48(1)(17).

⁵26 U.S.C. §§ 46(c)(3)(B), 168(1)(3)(A), 46(f)(5).

⁶See 26 U.S.C. §§ 167(1), 168(e)(3)(A).

a required filing of a rate schedule with an agency with authority to set rates.⁷ For purposes of the availability of tax credits, the regulations provide a more elaborate definition of public utility property. In this context, public utility property is defined as property predominantly used in an activity where the goods and services are furnished or sold at regulated rates.⁸ A taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis; that is, the rates cover the taxpayer's costs of providing goods or services, including a fair return on the taxpayer's costs of providing goods or services, where the taxpayer's costs and investments are determined by the use of a uniform system of accounts prescribed by a regulatory body.⁹ A taxpayer's rates are not regulated if they are established or approved on the basis of charging reasonable rates within the industry.¹⁰

The Public Utility Regulatory Policies Act of 1978 (PURPA) specifically relieves small power production facilities from traditional rate-of-return public utility regulation. Qualifying "small power production" facilities include hydroelectric facilities not exceeding 80 MW and not more than 50 percent of which is owned by persons primarily engaged in the electric utility business.¹¹ Under Section 210 of PURPA, such facilities

⁷26 C.F.R. § 1.167(1).

⁸26 C.F.R. § 1.46-3(g)(2)(ii).

⁹26 C.F.R. § 1.46-3(g)(2)(iii).

¹⁰Id.

¹¹18 C.F.R. § 292.201-206.

can require electric utilities to purchase their output at prices equal to the utilities' avoided cost of obtaining the electricity elsewhere. The avoided cost for regulated utilities is established by state regulatory commissions under regulations promulgated by the FERC. Qualifying facilities may also negotiate power purchasing arrangements directly with regulated utilities.¹² The terms and conditions of these contracts are typically reviewed by state commissions to qualify the costs of such power purchases for inclusion in the regulated utilities' rates. In each of these cases, the sale price for the energy produced by the qualifying facility is based on the costs incurred by the purchasing utility, and not on the costs incurred by the qualifying facility. Thus, it would seem clear that the sale of energy from a qualifying facility is not subject to rate-of-return regulation within the meaning of Section 1.43-3(g)(2)(iii).

The Service adopted this reasoning in ruling that qualifying facilities will not be considered public utilities for the purpose of eligibility for the ETC.¹³ Thus, it seems clear that qualifying hydroelectric property will not be subject to the ITC constraints of § 46(f).

Despite the slightly different language in the definition of Code Section 167(1), it also seems that qualifying facility property will be free from public utility property depreciation treatment. The Service took such a position in a private letter

¹²18 C.F.R. § 292.301.

¹³Rev. Rul. 82-109, 1982-1 C.B. 7; See also Private Ruling 8234039.

ruling on a coal gasification project selling electricity under contract to a public utility.¹⁴ After first finding that the facility qualified as energy property, since the price for its electric sales was not set on a rate-of-return basis, the Service indicated that rate-of-return regulation was as central to the definition of public utility property under Section 167(1)(3)(A) of the Code as to the definition of such property under Section 46(F)(5), and hence, the facility should also not be treated as public utility property for purposes of depreciation. It should be noted that while this private ruling is not necessarily definitive on the issue, the Treasury recently determined not to classify qualifying facility property as public utility property in its forthcoming ACRS regulations. In addition, the Conference Report for COWPTA contained language clearly expressing the intent that hydroelectric property should not be subject to public utility depreciation limitations:

"... qualifying hydroelectric generating property will ... not generally be classified as public utility property which is subject to the Code § 167(1) limitations on the use of accelerated methods of depreciation."¹⁵

As a result, it seems reasonable to assume that hydroelectric projects which do not have their rates established on a rate-of-return basis will be able to qualify as 5-year recovery property under the ACRS.

¹⁴Private Ruling 8221119.

¹⁵HR Rep. No. 817, 96th Cong., 2nd Sess. 128.

B. Limitation on Deductions to Amount "At Risk"

A significant part of the total return available to an investor in an SSH project is derived from the use of the tax benefits from the project (largely resulting from tax credits, ACRS and other deductions) to offset tax liability on income from other sources. However, the Code places constraints on the availability of tax credits and deductions by individual but not corporate, investors in projects financed in whole or in part by loans for which there is no personal liability. Section 465 of the Internal Revenue Code limits the deductions (for credits, see the following section) an individual, or a personal holding company (essentially a corporation with 50 percent of their shares owned by 5 or fewer individuals) can take with respect to certain activities to their amount "at risk" in those activities.¹⁶ Covered individuals include general and limited partners and S Corporation stockholders. The at risk rules extend to all activities undertaken for profit, except the holding of real estate.

The Code and Proposed Regulations offer little guidance on the parameters of the "holding real property" exclusion. It is conceivable that under certain circumstances, some of the activities undertaken by an SSH limited partnership may qualify, but this would seem to be a matter for an advance IRS ruling. If only part of the partnership's activities qualify for exclusion, then the partnership must allocate the deductions available for the exclusion, probably in proportion to the income received from or attributable to the "holding real property" activity.

¹⁶26 U.S.C. § 465.

A taxpayer's amount at risk with respect to an activity is essentially his exposure to real economic loss. Thus, amount "at risk" is defined to include cash contributions invested by the taxpayer, the adjusted basis of property contributed by the taxpayer, and any borrowed amount for which the taxpayer is personally liable or for which property (other than property used in the same activity) has been pledged as security.¹⁷ In this latter case, the property pledged must be clearly viewed as the actual security for the loan. A taxpayer is not considered "at risk" to the extent he is protected against loss through nonrecourse financing, guarantees, or stop loss arrangements.¹⁸ The Proposed Regulations state that protection against loss includes a partner's right of contribution from other partners as well as contractual indemnification provisions. Insurance against liabilities and casualties does not constitute loss protection for this purpose.

Taxpayers are also not considered to be at risk for amounts which have been borrowed on a recourse or a nonrecourse basis from a related party or from a lender who has an interest in the activity other than as a creditor.¹⁹

The determination of a taxpayer's amount "at risk" can be difficult in certain cases. However, it seems that where the ultimate liability of the taxpayer is uncertain, the obligation will not be included in the taxpayer's amount at risk. For

¹⁷26 U.S.C. §§ 465(b)(1); 465(b)(2).

¹⁸26 U.S.C. § 465(b)(4).

¹⁹26 U.S.C. § 465 (b)(3).

example, a partner's contribution to a partnership is not included in the basis of his partnership interest until the contribution is made.²⁰ Similarly, despite some internal inconsistency, the Proposed Regulations for Section 465 indicate that a loan guarantee will not increase an amount "at risk" unless the taxpayer has paid on the guarantee and exhausted his legal recourse against the primary borrower.²¹ Similarly, the extent to which contingent liabilities will increase a taxpayer's amount "at risk" is difficult to gauge accurately but it seems that this will only be the result where it can be shown that the occurrence of the contingent event is highly probable.²² However, Proposed Regulation Section 1.465-24(a)(2) declares that when a partnership incurs a liability and, under state law, members of the partnership may be personally liable for its repayment, each partner's amount "at risk" is increased to the extent the partner is not protected against loss.

From the examples in the Proposed Regulations, it would appear that a taxpayer may be "at risk" only where he is first or ultimately in line to bear any potential loss. This may mean that a limited partner may increase his basis by cosigning on any loan to the partnership. However, the exact types of liability which will be sufficient to increase an amount "at risk", and by how

²⁰26 U.S.C. §§ 722, 465(b).

²¹Prop. Reg. § 1.465-b(d).

²²Prop. Reg. § 1.465-b(d).

much, are difficult to predict. Clearly, the less immediate and less probable the borrower's risk of loss, the more likely the liability will not be credited as an increase in the partner's "at risk" basis.

If a taxpayer is involved with farming, or leasing Section 1245 property, oil and gas property, or geothermal property, his amount at risk is separately determined with respect to the activity in each one of these classes. Partnerships and S Corporations must treat all activities in a given class as one activity. With respect to other activities engaged in for profit, a taxpayer will not be able to aggregate separate activities unless the taxpayer or persons taking 65 percent of the losses participate in management.

A taxpayer's amount at risk is adjusted annually. In general, a taxpayer's amount "at risk" in an activity is increased by his pro rata share of undistributed income from the activity and reduced by his allocated share of losses and distributions.²³ Any change in liabilities which eliminates or reduces the taxpayer's personal liability will also reduce his amount at risk. Correspondingly, an increase in personal liability with respect to the activity increases a taxpayer's amount at risk. When the taxpayer's "at risk" amount in the activity is reduced below zero, previously claimed losses are recaptured and taxed as ordinary

²³Prop. Reg. § 1.465-22.

income as necessary to restore the taxpayer's year end "at risk" amount to zero.²⁴ Recaptured losses are carried forward but may only be used against income or gain from the activity.²⁵

The "at risk" rules place substantial restrictions on the ability to combine nonrecourse financing and noncorporate equity contributions to fund projects such as SSH projects. The one slightly positive impact of these provisions is to enable a taxpayer to use the carryover of suspended losses rules to defer losses (e.g., by substitution of nonrecourse for recourse liability) from a year in which they have limited value (i.e., reduced marginal tax rate) to a later year in which the losses are more valuable.

²⁴26 U.S.C. § 465(e).

²⁵26 U.S.C. § 465(a)(2).

C. "At Risk" Limitation on Credits

ERTA extended the "at risk" limitation on losses concept to tax credits. The Code now provides that the same taxpayers subject to the Section 465 restrictions are not allowed credits on their investment in qualifying property beyond their amounts "at risk."²⁶ Essentially this means that such taxpayers, including individual investors in SSH projects, may only take any otherwise available ITC or ETC on the amount of qualifying property for which they are considered to be "at risk."

In general, a taxpayer's amount "at risk" for this purpose is determined under the same exposure to real economic loss tests as used for Section 465's limitations on losses.²⁷ However, a taxpayer's amount "at risk" for credit purposes is determined without regard to any losses taken with respect to the property.²⁸ In addition, an exception permits taxpayers to be considered "at risk" to the extent of nonrecourse loans borrowed from or guaranteed by an agency of any federal, state, or local government, so long as the taxpayer maintains an "at risk" investment (determined without regard to the nonrecourse loan) of no less than 20 percent of the basis of the qualifying property.²⁹ Qualified lenders include regulated banks, savings and loan associations, credit unions, insurance companies, qualified pension trusts, and other persons regularly in the business

²⁶26 U.S.C. § 46 (c)(8).

²⁷26 U.S.C. § 46 (c)(8)(B).

²⁸26 U.S.C. §§ 46 (c)(8)(B)(i); 46 (c)(8)(F)(ii)(III).

²⁹26 U.S.C. § 46 (c)(8)(B)(ii).

of lending money.³⁰ The lender cannot have received a fee based on the taxpayer's investment in the property, sold the property to the taxpayer, or be related to either of the above or to the taxpayer.³¹

A special exception is also provided for energy property, including property used in SSH projects. Any property qualifying for an energy tax credit is not subject to the "at risk" limitation on credits so long as two requirements are met. First, the taxpayer must maintain an "at risk" investment in the property (determined under Section 465 of the Code) equal to at least 25 percent of the unadjusted basis of the property.³² Furthermore, a nonrecourse loan which fails to satisfy the nonrecourse financing criteria discussed above (i.e., 20 percent investor exposure and made by a qualified lender) must have a level debt service.³³

In addition to the problems associated with determining "at risk" amounts discussed earlier with respect to Section 465 of the Code, the new credit "at risk" rules create some doubt as to how sums committed to an activity involving qualified property can be allocated to the property. The legislative history of ERTA makes it clear that only amounts directly attributable to the property and not operating expenses of the activity will qualify for "at risk" purposes. The law provides no guidance on how to allocate

³⁰26 U.S.C. § 46 (c)(3)(D).

³¹Id.

³²26 U.S.C. § 46 (c)(8)(F).

³³26 U.S.C. § 46 (c)(8)(F)(ii).

sums from multiple sources between property and other business expenses. This leaves the possibility that the IRS may allocate the proceeds of a covered taxpayer's investment of both "at risk" and "not at risk" proceeds in the same manner, which would have the result that the smallest amount of property would qualify for the credit. For example, assume that an individual uses \$300,000 in "at risk" proceeds and \$700,000 in "not at risk" proceeds to develop a hydroelectric project. Also assume that of the \$1,000,000 total, \$800,000 is used for qualifying ITC or ETC property and \$200,000 is used for non-qualifying costs. If the "at risk" and "not at risk" proceeds were allocated pro rata between the qualifying and non-qualifying costs, the taxpayer would be sufficiently "at-risk" ($240,000/660,000$) to be eligible for a total credit of \$168,000. Should the IRS apply the "at risk" proceeds to the non-qualifying property first (here, \$200,000), the taxpayer would not be sufficiently "at risk" to qualify for the full credit because he would only have a 14% "at risk" investment in the qualifying property ($\$100,000/\$700,000$). Thus, the taxpayer's total available credit would be limited to \$21,000 because his basis in qualifying property is now \$100,000, and Code Section 46(c)(8)(A) limits the amount "at risk" to the taxpayer's basis in qualifying property. Until further guidance is provided by the Internal Revenue Service, it would be prudent for developers to consider this possibility when structuring their financial arrangements.

D. Availability of Tax Credits When Property is Owned or Leased by Public or Tax-Exempt Entities

Special rules have been established which affect the availability of tax credits to a private project developer when the project is used by the United States or the states, their subdivisions and agencies, or other tax-exempt entities. The Code and the Regulations provide that tax credits are generally not available for otherwise qualifying property if the property is owned by or leased to a governmental unit or tax-exempt entity. Determining if a governmental unit or tax-exempt entity owns the property does not usually present a significant problem but determining if a governmental unit or tax-exempt entity is leasing the property is often problematic.

When a "leasing" problem arises, the question of whether a private entity can use the credits on property which provides some benefit to a governmental or tax-exempt entity turns on whether the relationship between the private developer and the governmental or tax exempt entity is a "lease" or a "service contract".

The "service contract" exception originated with Rev. Rul. 68-109, where the IRS found, in effect, that a phone company could claim the tax credits on switchboards placed on the premises of governmental units.³⁴ The IRS relied on the fact that the taxpayer retained ownership and control over the equipment to find that the equipment was not leased to the governmental units, but instead, was supplied as part of a complete service contract to provide "communication service" to the governmental unit.

³⁴Rev. Rul. 68-109, 1968-1 C.B. 10.

However, in Rev. Rul. 71-397,³⁵ the IRS denied credits to Xerox Corporation on copying machines provided to U.S. Government agencies based on its assessment that Xerox was "leasing" the equipment, since the users were essentially using the equipment to provide services for themselves.

Rev. Rul. 68-109 and 71-397 set the basis for subsequent IRS efforts to distinguish between "service contracts" and "leases." The IRS has denied the credits to a company providing full service vehicles to the Postal Service,³⁶ and to a taxpayer who bussed school children for a public school district under conditions strictly controlled by the school officials.³⁷ The IRS has permitted the credit to be taken by a taxpayer who placed television sets in public hospitals for patient use,³⁸ a taxpayer who provided, maintained, and operated satellite equipment for several agencies of the U.S. Government,³⁹ and a taxpayer who owned and operated a pipeline to transport natural gas to a municipal electric utility power plant.⁴⁰ While the facts in these cases suggest some degree of internal contradiction in the IRS positions taken, it seems clear that the IRS will focus on two general areas in determining whether an agreement is a "service contract" or a "lease." First, the IRS must be satisfied

³⁵Rev. Rul. 71-397, 1971-2 C.B. 63.

³⁶Rev. Rul. 72-407, 1972-2 C.B. 10.

³⁷Private Ruling 8104001 (1980).

³⁸Private Ruling 7829006 (1968).

³⁹Private Ruling 7847075 (1978).

⁴⁰Private Ruling 7913003 (1978).

that the taxpayer desiring to take the credits retains a sufficient possessory interest in the property on which they are claimed. Second, the IRS is more inclined to allow the credit where the property is provided to the governmental unit as part of an integrated operation in which the taxpayer has significant other responsibilities.

Xerox appealed the IRS ruling (Rev. Rul. 71-397), and in Xerox v. U.S., 656 F.2d 659 (Ct. Cl. 1981), the U.S. Court of Claims reviewed and summarized what it considered to be the relevant criteria under each of these categories. After recognizing the need for case by case analysis and recounting the IRS position reflected by the rulings noted above, the Court stated that the possessory factors necessary to satisfy the IRS that a service contract exists appear to include: (1) retention of a property interest by the taxpayer; (2) retention of possession and control by the taxpayer; (3) retention of risk of loss by the taxpayer; and (4) reservation by the taxpayer of the right to substitute comparable property. In determining whether the property is part of an integrated service, the Court found that the IRS distinguishes between the placement of property which is inherent in the nature of the sale of a service and that which is not.⁴¹

In applying these tests to the Xerox agreements, the Court found that Xerox met its possessory burden by retaining ownership, maintaining exclusive control over maintenance, retaining the right to replace or modify the machines, and accepting full risk

⁴¹Xerox v. U.S., 656 F.2d 659 (Ct. Cl. 1981).

for any factors bearing on the value of the machines. In finding the requisite integration of service, the Court noted that the fees, which could have been charged separately for training, insurance, maintenance, and equipment upgrading, were relatively significant in relation to the total cost of the agreement with the governmental entities and that the purchasing agents indicated that the full service accorded by Xerox was a primary factor in selection the machines.

In many cases, the leasing of a public site to a private hydro developer can be structured to avoid much risk that the project property will be found to be "used by" the public entity. However, the risk rises dramatically where the private entity has obtained a FERC license in competition with other license applicants by reasons of a municipal preference under Section 7 of the Federal Power Act. In its memorable decision in the City of Fayetteville,⁴² the FERC stated that municipal preference would not be available to municipal applicants who were shown not to have the requisite property interest in all necessary project property. While the precise dimensions of this requisite property interest have not yet been identified by the FERC, it has been indicated that it may be necessary for the public entity to evidence many of the same indicia of possession and control that would result in IRS characterization of the project property as "leased to" the public entity. The FERC also requires license holders to hold a sufficient property interest in all necessary project property. Since the FERC also must approve license transfers, a municipality which obtained its license with a

⁴²16 FERC ¶ 61,209.

municipal preference might find itself unable to proceed with a private sector partner without going through relicensing or, where possible, obtaining an exemption. It has even been suggested that the FERC might deny license transfers from public to private parties prior to project construction for uncontested projects, on the theory that the public entity had effectively obtained the benefit of municipal preference by discouraging other potentially interested municipal applicants.

The Xerox case and other IRS decisions suggest that it is possible to structure relationships between private alternative energy developers and governmental and tax exempt entities which would permit the private developer to take full advantage of the tax credits available to such projects. Where possible, it is desirable to avoid the need to establish an agreement which must satisfy the FERC, as well as the IRS. Thus, it is best to anticipate the problem prior to finalizing FERC licensing activity. In any event, the problem is sufficiently complex to suggest that care should be taken to insure that the relationship is structured by persons familiar with the constraints.

E. Limitation on Energy Tax Credit and Depreciation Deduction When Property is Financed by Subsidized Energy Financing or Industrial Development Bonds

The Code contains what are generally called "anti-double dipping" provisions to limit the extent to which the energy tax credit and depreciation deduction can be combined with other forms of subsidized financing. Subsidized financing includes subsidized energy financing and industrial development bonds. "Subsidized energy financing" means financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce

energy.⁴³ Industrial development bonds (IDBs) are defined as tax-exempt bonds within the meaning of Code § 103(b)(2) and, in general, are state or local government obligations which are issued to provide tax-exempt financing for the benefit of private rather than public entities.⁴⁴

Beginning in tax year 1983, qualifying energy property, including hydroelectric property, is ineligible for an energy tax credit on that portion of the qualifying investment financed with subsidized financing or industrial development bonds.⁴⁵ The Code provides that the energy credit available for such projects shall be determined by reducing the basis of the qualified property by a fraction consisting of subsidized or IDB proceeds attributable to the qualifying property divided by the total cost of the qualifying property. Under the proposed regulations for this section, any subsidized financing used for the project is considered to have been used first to purchase qualifying property, then to purchase non-qualifying property.⁴⁶ For example, if a \$1,000,000 project containing \$800,000 of qualifying property obtains \$500,000 of subsidized financing, only \$300,000 of the project would qualify for an energy credit. However, IDB proceeds are considered to have been used on a pro rata basis to purchase qualifying and non-qualifying property.⁴⁷ Thus, in the

⁴³26 U.S.C. § 48(1)(11)(C).

⁴⁴26 U.S.C. § 103(b); See, Tax-Exempt Financing, infra.

⁴⁵26 U.S.C. § 48(1)(11) as amended by P.L. 96-223, Sec. 223(c)(1).

⁴⁶Prop. Treas. Reg. § 1.48-9(o)(5). ⁴⁷ Fed Reg. 3559, 3561 (Jan. 26, 1982).

⁴⁷Id.

example above if the \$500,000 had been provided with an industrial development bond, the qualified investment eligible for the ETC would be \$400,000.

TEFRA added a provision to reduce the depreciation deduction available on property using IDB financing. Thus, a taxpayer is precluded from claiming the maximum deduction under ACRS otherwise available for property placed in service after 1982 which is financed by tax-exempt industrial development bonds issued after June 30, 1982. Instead, the taxpayer must recover his investment using the straight line method with a half year convention over the following recovery periods:

1)	Three-year property	3 years
2)	Five-year property	5 years
3)	Ten-year property	10 years
4)	Fifteen-year property	15 years

If an election is made under Code § 168(b)(3) to depreciate the property under the straight line method over a period which is longer than the above specified period, the prescribed shorter period of § 168(b)(3) does not apply.⁴⁸ For example, if five-year property is financed by the use of industrial development bonds, the taxpayer may not recover the cost under ACRS. Instead, the taxpayer must recover his cost under the straight line method over five years or, if he so elects, depreciate under Code § 168(b)(3) over a life of either 12 years or 25 years.

⁴⁸ 26 U.S.C. § 168(f)(12)(E).

F. Recapture of Depreciation and ACRS Deduction

The Code places constraints on the possibility of using depreciation deductions to convert ordinary income into long-term taxable gain upon the sale of depreciable property. Consequently, any gain on the disposition of Section 1245 "recovery" property is taxable as ordinary income ("recaptured") to the extent of ACRS deductions and § 179 expense deductions.⁴⁹ The gain on the sale of Section 1245 property which is not "recovery" property is "recaptured" to the extent of depreciation and amortization claimed.⁵⁰ As noted above, § 1245 property is depreciable personal property or tangible property (excluding buildings and their structural components) used as an integral part of manufacturing, or production or furnishing of electricity, and certain other activities.⁵¹ Section 1245 "recovery" property is essentially "recovery" property other than certain 15-year real property. Most of the cost of an SSH project would fall within this class.

G. Recapture of Tax Credits

If property ceases to qualify for the ITC or the ETC, either because of an early disposition of the property by the taxpayer or because it ceases to be § 38 property, prior to the expiration of the period on which the credits were based, a portion of the credits may have to be recaptured by the taxpayer.⁵² The amount

⁴⁹26 U.S.C. § 1245(a)(2)(E).

⁵⁰26 U.S.C. § 1245(a)(2).

⁵¹26 U.S.C. § 1245(a)(3).

⁵²26 U.S.C. § 47(a)(1).

of the recaptured credit must be added to the taxpayer's tax liability for the taxable year in which the recapture is deemed to occur.⁵³

The amount subject to recapture depends on whether the property is recovery property or non-recovery property. If the property is recovery property, the taxpayer must recapture a specified percentage of the ITC and ETC. As discussed elsewhere in the manual, most, if not all, of the property involved in an SSH project will be 5-year property. The percentages for 5-year property are as follows:

- 1) If the property ceases to be § 38 property within one full year after it is placed in service, the percentage is 100 percent;
- 2) Within 2 full years the percentage is 80 percent;
- 3) Within 3 full years the percentage is 60 percent;
- 4) Within 4 full years the percentage is 40 percent; and
- 5) Within 5 full years the percentage is 20 percent.⁵⁴

Code § 47 (a)(5)(B) lists applicable percentages for the other categories of § 38 recovery property (e.g., 15-year property, 10-year property, and 3-year property).

For property that is non-recovery property, the taxpayer must recompute the tax credits that would have been allowed with respect to property based on the actual period during which the property qualified for the credits. The taxpayer must then recapture the difference between the credits taken and the recomputed credits.⁵⁵

⁵³Id.

⁵⁴26 U.S.C. § 47(a)(5)(B).

⁵⁵26 U.S.C. § 47(a)(1).

With respect to both recovery and non-recovery property, credits are recaptured only to the extent that they actually reduced tax liability.⁵⁶ Thus, if the credits were not used because the taxpayer had insufficient tax liability, the credits would not have to be recaptured. However, credits that were carried forward or carried back and were used to reduce tax liability are subject to recapture.⁵⁷ Unused carryforwards and carrybacks must also be reduced to reflect the recaptured credits.⁵⁸ Finally, it should be noted that the tax imposed as a result of the recapture may not be offset by other tax credits allowable to the taxpayer.⁵⁹

H. Recapture of Qualified Progress Expenditures

The recapture provisions also apply to qualified progress expenditures. If, during the taxable year, recovery or non-recovery property ceases to be new qualifying property (by reason of sale or other disposition, cancellation or abandonment of contract, or otherwise) or, in the case of recovery property, changes recovery categories, the qualified progress expenditures may have to be wholly or partially recaptured.⁶⁰ The amount that has to be recaptured is 100 percent of the amount that was taken as a credit under Code § 47(d).

I. Date Property Is Placed in Service

As noted in the section on depreciation, supra, an ACRS depreciation deduction is allowed for recovery property placed in

⁵⁶26 U.S.C §§ 47(a)(1), 47(5)(D), 26 C.F.R. § 1.47-1(a).

⁵⁷26 C.F.R. § 1.47-1(a).

⁵⁸Id.

⁵⁹26 U.S.C. § 47(c).

⁶⁰26 U.S.C. § 47(a)(3).

service after December 31, 1980. Also, as noted in the section on federal tax credits, supra, a taxpayer may claim credits for his qualified investment in property placed in service during the taxable year. The meaning of the term "placed in service," and consequently the timing of these tax benefits (a consideration crucial to the economic viability of some projects), is subject to some uncertainty. The Regulations to the Code provide that the ITC is available in the taxable year in which the taxpayer's depreciation, with respect to the property, begins or when the property is placed in a condition or state of readiness and available for a specifically assigned function.⁶¹ In the case of electric generating equipment, IRS decisions indicate that the equipment is not considered to be in a condition or state of readiness until it is capable of being synchronized with the electric grid into which it is to be interconnected.⁶²

J. Energy Tax Credit Concerns

The requirements for the availability of the ETC (see section on energy tax credit) are not definitive of all situations. The promulgation of Treasury Regulations will be necessary to clear up a number of ambiguities. First, qualifying hydroelectric generating property does not include property

⁶¹26 C.F.R. §1.46-3(d)(2).

⁶²Private Ruling 8218009; Private Ruling 8244075; See also Private Ruling 7309261030A.

installed in connection with a significant enlargement of an existing dam.⁶³ The legislative history suggests that enlargement for this purpose will be determined in terms of changes in water level or impoundment area.⁶⁴

Enlargement does not include the reconstruction or rehabilitation of an existing dam to restore the impoundment to its original or designed level if the repairs or reconstruction were undertaken to strengthen the dam or eliminate leakage.⁶⁵ The Conference Report states that the costs attributable to increasing dam height for the purpose of increasing the water level (presumably beyond its historical crest) would not qualify for the ETC. This would seem to indicate that the costs of projects with enlarged impoundments that are not attributable to the expansion would qualify. However, the Conference Report language does not cover significant enlargements and hence, the Service may argue that more than a minor increase in impoundment size will disqualify the entire project. Also uncertain is whether seasonal flashboards will be considered within the category of dam enlargements.

A second question concerns whether dams which are relocated in connection with project development will be considered existing dams and hence eligible for the energy credit. The Conference Report specifies that dam rehabilitation property includes reconstruction of breached sections and, in the case of

⁶³26 U.S.C. § 48(1)(13)(B).

⁶⁴HR Rep. No. 817, 96th Cong., 2nd Sess. 127.

⁶⁵Id., at 126, 127.

impoundments which do not have federal or state requirements, the cost of replacement. However, it is not clear whether a replacement which is located at a point different from the original site to achieve greater generating capacity or lower costs would qualify. Informal discussions with IRS personnel suggest relocations within a reasonable proximity of the original site may be acceptable but the limit on relocation distance is still uncertain. While it is far from clear, relocating to satisfy federal or state requirements may be more favorably regarded. It should be noted that a relocation may also increase impoundment area, even if the new dam is limited to the height of the former structure. Literally, this change would not seem within the Code's disqualifying language but may make a relocation less likely to qualify as an existing dam.

Finally, there is some question as to the type of new project which can qualify for the credit under the Code language: "a site at which ... electricity is generated without a dam or other impoundment." According to the Conference Report this includes new natural or man-made water flows such as rivers, conduits, and irrigation ditches. Since the term impoundment covers any retainage of water behind a barrier, the Code language would seem to suggest that a new project with a structure completely spanning a water course would not qualify. However, diversion structures also "impound water," thus, it is uncertain at what point a diversion structure which did not span a water course would also disqualify a new hydroproject for the credit. Of possible aid is the fact that the Energy Security Act created an exemption from licensing for "natural water features" with similar language. Given the similarity of legislative purposes

between hydro provisions of COWPTA and the Energy Security Act, it would seem reasonable to define this project class to be consistent with the FERC definition of dam and "natural water feature" for purposes of implementing the natural water feature exemption. In drafting its natural water feature exemption regulations, the FERC found it appropriate to interpret language in the Energy Security Act in light of a Congressional intent to promote small diversion structure hydropower projects. As a result, the FERC found that to offer any meaningful encouragement to such projects, dams would have to be construed as water barriers designed to impound water primarily to artificially increase hydraulic head. Thus, under the FERC regulations projects qualifying for a natural water feature exemption include new projects which do not 1) exceed 10 feet in height, 2) impound more than 2 acre feet of water, or 3) increase natural hydraulic head by more than 5 percent. Needless to say, the IRS is bound to use the FERC interpretation of natural water feature to determine whether a project involves the use of a dam or impoundments, so the precise definition of this class remains uncertain.

K. Allocation of Tax Benefits and Cash Flow

An important consideration in the formation of a limited partnership is the ability to allocate profits, losses, and specific items of income in the partnership agreement in a ratio different than that reflecting each partner's capital contribution. Generally, each partner's distributive share of income, losses, deductions, gains, and credits conforms to the business arrangements struck in drawing up the partnership

agreement.⁶⁶ The IRS permits partners to make special allocation with respect to property contributed by a particular partner to account for the difference between the basis of property to the partnership and its fair market value at the time of contribution.⁶⁷ Other special allocations in the partnership agreement will be respected so long as the allocation has a substantial economic effect.⁶⁸ In essence, this means that partners cannot specifically allocate primarily for tax mitigation purposes.

In brief, "substantial economic effect" is defined as "whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences."⁶⁹ It appears from the case law that an examination of how an allocation is treated in the partner's capital account for financial accounting purposes will be at least the starting point in determining whether the allocation has a substantial economic effect; if the allocation causes a change in the capital account such that the partner's ultimate share of partnership income is affected, in many cases it will be considered to have met the test.⁷⁰

⁶⁶26 U.S.C. § 704(b).

⁶⁷26 U.S.C. § 704(b)(2).

⁶⁸26 U.S.C. § 704(c)(2).

⁶⁹26 C.F.R. § 1.704-1(b)(2).

⁷⁰See the regulations under Code § 704; Orrisch v. Commissioner, 55 T.C. 395 (1970); Magaziner v. Commissioner, T.C. Memo 1978-205, 37 T.C.M. 873; Harris v. Commissioner, 61 T.C. 770 (1974).

In determining whether the principal purpose of a partnership allocation agreement is avoidance or evasion of taxation, the agreement must be considered in light of all surrounding facts and circumstances. Relevant circumstances specified in the Treasury Regulations include

- 1) whether the partnership or an individual partner has a business purpose for the allocation;
- 2) whether the allocation may actually affect the distribution of income and loss other than for tax purposes;
- 3) whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation;
- 4) whether the allocation was made without recognition of normal business factors and only after the amount of the allocated item could be established;
- 5) the duration of the allocation; and
- 6) the overall tax consequences of the allocation.⁷¹

If the Internal Revenue Service sets aside the allocation agreement, a partner's share of income and losses will be determined in accordance with his interest in the partnership, as determined from all the facts and circumstances.⁷²

The more any particular allocation conforms to the agreement for distribution of profits and losses, the more likely it is to be upheld, but it is possible to justify special allocations in terms of different risks or foregone opportunities. The Service generally restricts the allocation of credits to the ratio in which the partners divide the general profits of the

⁷¹26 C.F.R. § 1.704-1(b)(2).

⁷²Id.

partnership, but an allocation of credits consistent with an allocation of all other items of gain, income, loss, and deduction which is recognized under Regulation § 1.704-1 will be acceptable. The complexity here would seem to suggest the need for an advance Private Ruling for cases involving any special allocation of credits, deductions, or other tax benefits. Unfortunately, the IRS will not issue such rulings.⁷³

A related item, suggesting the flexibility and utility of the partnership entity, is the fact that an election to take a tax credit for a qualified progress expenditure (discussed in the section on federal tax credits, supra) must be made by each partner on an individual tax return. Thus, one partner may make this election due to his particular tax status in the taxable year without affecting the other partners' ability to receive the credit when the property is placed in service.⁷⁴

⁷³Rev. Proc. 81-10, 1981-13 I.R.B. 14, § 301.

⁷⁴Prop. Reg. § 1.46-5(g)(1).

L. Investor - Site Owner/Developer Contracts

Hydro site owners or developers desiring to derive maximum economic benefits from a hydropower project will frequently find it necessary to share certain aspects of project development with outside investors capable of completely utilizing the project's tax benefits as they occur. The site owner or developer's interest is generally in maximizing his cash receipts and retaining some immediate or future control over the project. The investor's interest is in obtaining a sufficient combination of project tax benefits, cash, and project control to offer a competitive investment opportunity. The separate interests of these parties may be pursued by structuring the development of the project as a tax flow-through vehicle, such as a limited partnership, an S Corporation, or a lease. In this case, the division of project benefits to meet the parties' objectives will be constrained by certain federal income tax provisions affecting these structures discussed above. For limited partnerships and S Corporations, the primary focus will be on the deductibility of payments to the developer partner or stockholder and the allocation of tax benefits to the investors. For leases, the question will be one of insuring the tax treatment of the agreement as a lease, particularly with respect to ultimate dispositions of project property. Alternatively, the site owner or developer may find it appropriate to completely transfer ownership of the project to an outside investor in a sale or royalty arrangement. The investors would seek tax ownership of the project improvements prior to initiation of operation and the deductibility of payments made to the site owner or developer. While this basic arrangement may have many permutations, it may be

expected that the relationship between the parties may entail a lease of the site and transfer of necessary development and operation rights and a development and/or operations management contract. While this approach avoids the problems associated with the allocation of tax benefits, it is subject to its own set of federal tax constraints. Here, the issues will principally concern whether the arrangement between the parties is a joint venture, whether the investor(s) are engaged in an activity for profit, and whether the tax ownership of project property is prematurely transferred to the site owner/developer.

1) Designation of a Site Lease as a Joint Venture

A site owner or developer's ability to benefit from a transfer of a site to an outside investor is directly related to the total net after-tax benefits available to the investor at any given point. Thus, it is important that the site owner participate in project benefits in a manner which does not increase project costs without a corresponding decrease in taxable income from the project.

If the site owner or developer is paid a fixed amount in compensation for his efforts in bringing the project on line, it may be possible to attribute all or a substantial amount of that payment to project costs eligible for tax credits and ACRS deductions. The extent to which such a payment can be so allocated will be determined in accordance with the principals for the tax treatment of capital expenditures discussed above.

It is likely, however, that it will be necessary or desirable to compensate the site owner/developer on a continuing basis for the use of the site and attendant rights. In this case

the payment to the site owner or developer will take the form of a royalty or rental payment. Since presumably the site owner will desire to capture as much as possible of the value from project operation, it is likely that the royalty will be determined under a formula linked to the gross or net revenues of the project. At face value, this would seem to offer an efficient method for the project investors to compensate site owners. However, this arrangement could be viewed as a form of profit sharing which could result in the designation of the relationship between the parties as a joint venture. A joint venture is treated for tax purposes as a partnership. Profit distributions to partners are not deductible and hence, joint venture designation would reduce the net project benefits available for sharing. Thus, it would seem desirable for the parties to avoid agreements which would be likely to result in characterization of the relationship as a joint venture.

The Supreme Court has held that an agreement will be treated as a joint venture or partnership where the surrounding facts and circumstances show that the parties intended to "join together ... for the purpose of carrying on a ... business and where there is a community of interest in the profits and losses."⁷⁵ Such an intention is a question of fact determined by examining the agreement and conduct of the parties. While it has been held that no single factor is conclusive,⁷⁶ the primary focus has been on whether: (1) there has been a sharing of profits and losses, and

⁷⁵Commissioner v. Tower, 327 U.S. 280, 286 (1946).

⁷⁶See e.g., Hubert M. Luna, 42 T.C. 1067 (1964).

(2) joint control is exercised over the venture.⁷⁷ While the courts have frequently declined to distinguish between net and gross profit sharing,⁷⁸ it does seem clear that a joint venture is unlikely to be found in the absence of a sharing of losses.⁷⁹ In addition, the cases suggest that the finding of joint venture status will also require evidence of some joint control over the activity subject to the agreement.⁸⁰

While the law in this area would seem to give the parties considerable latitude to structure a site owner or developer participation in project benefits, it is clear that some provisions would carry more risk than others. The least risk of joint venture status would probably result from compensating the site owner in a manner unrelated to project revenues. Royalty payments based on percentages of gross or net revenues would, respectively, offer slightly more risk, but would still seem acceptable so long as the site owner does not share in the project's risk of loss or in the decisions affecting the management and control of the project.

2) Limit on Losses for Activities Not Engaged in for Profit

The ability of a site owner to derive from a lease of the site to outside investors financial benefit comparable to that available under its own development of the project,

⁷⁷See Bryant v. Commission 399 F.2d 800 (5th Cir. 1968); Commission v. Culbertson 337 U.S. 733 (1949); Lucia Chase Erving, 20 T.C. 216 (1953).

⁷⁸See, e.g., Bryant v. Commissioner, 399 F.2d 800 (3th Cir. 1968).

⁷⁹Paul J. Kelly, 29 T.C.M. 1090 (1970).

⁸⁰Herzbey v. U.S., 176 F. Supp. 440 (S.D. Ind. 1959); Rupe v. U.S. 68-1 U.S.T.C. ¶ 9179 (D. Nev. 1968).

depends upon whether the cash cost of capital for the investor(s)' project is equal to or less than the cash cost of capital for a site-owner financed project.⁸¹ For this to occur, the investor's project will have to be financed with a debt/equity ratio that permits the investors to derive a competitive return from the project's tax benefits alone. In addition, the site owner will have to insure that the royalty structure captures a significant portion of project's cash, the net of operating and debt service expenses. Ideally, this could be accomplished by establishing a debt/equity ratio for the project which provided investors an acceptable after-tax return on equity without any cash payment and paying all net cash to the site owner. Unfortunately, the Internal Revenue Code contains provisions which limit the loss deductions of parties engaged in transactions which have no prospect of profit apart from the anticipated tax benefits.

Section 183 of the Code effectively limits the deductions from activities "not engaged in for profit" to "non-business related deductions" (e.g., interest and taxes).⁸² Code Section 167 provides that depreciation deductions are only available for property used in a trade or business or held for the production of income.⁸³ As interpreted by the courts, this also requires that

⁸¹As discussed in Chapter , the cash cost of capital for a project is equal to the annual cost of all cash payments made to the sources of project capital (debt and equity) divided by total project costs and expressed as a percentage. For example, a project costing \$1,000,000 that is financed with a loan requiring annual payments of \$114,000 and annual payments to equity of \$10,000 would have a cash cost of capital of 12.4%.

⁸²26 U.S.C. § 183.

⁸³26 U.S.C. 167(a), 162(a).

the property be used in an activity entered into with a good faith intent to realize a profit, i.e., taxable income.⁸⁴ Where, as is frequently the case for substantially tax motivated transactions, the activity is conducted by a partnership, this finding is made at the partnership level.⁸⁵ The partnership need not have a reasonable expectation of profit but, if challenged, the burden is on the taxpayer to show that the partnership had the intent or objective of making a profit.⁸⁶ In making this determination, the Courts have generally applied nine factors which are listed in the Regulations under Section 183. These factors relate to whether the activity was conducted by responsible parties in a businesslike manner and whether the activity had a reasonable prospect of producing income or asset appreciation.⁸⁷ As this test has been applied by the Courts, it seems clear that the mere fact that a given activity is unlikely to yield a profit will not result in the disqualification of taxable losses.⁸⁸ Even a highly speculative prospect of profit will suffice where the magnitude of the speculative return is significant.⁸⁹ By the same token, it is also clear that the courts will find a lack of profit motive where

⁸⁴Hush v. Commissioner 315 F.2d 731 (9th Cir. 1963).

⁸⁵Brannen v. Commissioner 78 T.C. 471 (1982).

⁸⁶Id.

⁸⁷26 C.F.R. § 1.183-2(b).

⁸⁸See, e.g., Siegel v. Commissioner 78 T.C. 659 (1982).

⁸⁹King v. U.S. 545 F.2d 700 (10th Cir. 1976).

the total circumstances of the transaction show that to produce a profit the activity would have to "generate revenues far in excess of what it could feasibly produce."⁹⁰

The IRS has taken a more aggressive position on this issue, as evidenced by the guidelines for abusive tax shelters in its Tax Shelters Examination Handbook. The Handbook declares that transactions that fail to produce a return relative to the risk involved are strong candidates for designation as Class III abusive shelters (i.e., transactions not entered into for profit.)⁹¹ In making this finding, the Handbook states that the cash return from the investment should compare favorably with the going rate.⁹²

For the purpose of site owners' agreements with investors, it seems clear that the royalty or savings schedule will have to be carefully designed to permit optimal benefit to the site owner. It also seems clear that the site owner will not be able to capture all net cash from the project. Third party counsel may be expected to argue that investors will have to have a good prospect for an annualized cash return on equity in excess of that available for less risky ventures. However, it would seem that a royalty or price savings formula would survive an IRS challenge so long as it offered a plausible opportunity for some cash return over the life of the project, particularly if accompanied by an opportunity for significant speculative gain.

⁹⁰Brannen v. Commission 78 T.C. 471 (1982).

⁹¹IRS Tax Shelter Examination Handbook, Chapter 351.

⁹²Id., Chapter 364 and Exhibit 300-1.

3) Characterization of the Agreement as a Sale of Project Property to the Site Owner: Lease Purchase Options

If the transaction between the site owner and the investors is characterized as a sale of the project property to the site owner/developer, the investors will not be regarded as the tax owners of the hydroelectric property and hence, not entitled to the tax benefits so critical to the economics of the transaction. Successful IRS characterization of the transaction as a sale of the project property to the site is most likely to result from provisions of the contract which effectively shift the benefits and burdens of ownership from the investors to the site owner. Extremely short site lease terms (i.e., leases which are for a term significantly less than the expected useful life of the equipment), installation of equipment at the site which precludes economic removal of the equipment and, in particular, bargain purchase options may cause such a result.

While the transactions are not directly analogous, the tax law which will govern this question will probably be taken from the area of leveraged leasing. There the issue has frequently been whether the terms in a lease of property, including for example, a purchase option clause, were such as to result in an unintended sale of the property to the lessee. The IRS position, reflected in its former guidelines for advance approval of such transactions as leases, would preclude any purchase option exercisable at a price other than fair market value as of the date of exercise.⁹³ The Courts have been more flexible and have

⁹³Rev. Procedure 75-21. The guidelines were suspended after the enactment of the safe harbor leasing provisions of TEFRA but still represent the Service position on leveraged leases.

declined to find that a fixed price purchase option transfers tax ownership so long as the price bears some reasonable relation to expected fair market value.⁹⁴ The Courts have consistently stated that the proper point at which to make that judgment is at the time the agreement is made⁹⁵ and in some cases have given relatively little attention to the actual price so long as the lessee was not required to exercise the option.⁹⁶

Notwithstanding the IRS position on lease transactions, the site owner should be able to include a provision establishing the price at which it could acquire the hydroelectric property from the investors at the end of the site lease without jeopardizing the tax effect of the transaction. By the same token, the fact that an owner may acquire the hydropower property prior to the end of its useful life should also not in itself be fatal to the investors' tax benefits. However, it is also fair to say that any prearranged transfer of project property to the site owner is best related to a price based on some plausible projection of the remaining project value. Additionally, it may be helpful to give the option of equipment removal to the investors, upon condition that the project site be restored to its previous state.

⁹⁴See, e.g., LTV Corp. v. Commissioner 63 T.C. 39 (1974).

⁹⁵Clarence R. Daniel 37 T.C.M. (CCH) 1180 (1978).

⁹⁶Northwest Acceptance Corp. v. Commissioner 58 T.C. 836 (1972).

M. Capital Expenditures

The deductibility of expenses under Code § 162 is qualified by Code § 263 which provides that no deduction is allowed for any amount expended for new buildings, permanent improvements or betterments made to increase the value of the property, or for amounts expended in restoring property or in making good the exhaustion thereof for which a depreciation, amortization, or depletion allowance has been made.⁹⁷ Code § 263 prohibits any deduction for the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year or for amounts paid or incurred to add to the value, or substantially prolong the useful life, of the property or to adapt the property to a new or different use.⁹⁸

The purpose of Code § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current expenses. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, depreciation, etc., to later tax years when the capital asset becomes income producing.⁹⁹ The effect of Code § 263 is that the capital expenditure constitutes, or is added to, the basis of the acquired or improved property. It is then either: (1) amortized or depreciated over the property's useful life, or (2) if the property is not subject to amortization or depreciation,

⁹⁷ 26 U.S.C. §§ 263(a)(1), 263(a)(2); 26 C.F.R. § 1.263(a)-1(a)(2).

⁹⁸ 26 C.F.R. §§ 1.263(a)-2(a), 1.263(a)-1(b).

⁹⁹ CIR v. Idaho Power Co., 418 U.S. 1 (1974).

held in abeyance until the property is sold or otherwise disposed of, at which time the cost is deducted from the amount realized in computing gain or loss on the disposition. Thus, the basic difference in effect between business expenses and capital expenditures is that expenses are deducted in the taxable year in which they are paid or incurred, while capital expenditures are written off over the useful life of the property or on the disposition of the property.

A majority of the costs associated with an SSH project will be capital expenditures subject to the depreciation allowance and the federal tax credits.¹⁰⁰ These costs include construction costs for the hydroelectric plant and dam, cost for the equipment, (e.g., turbine and generator), and costs for grading and clearing the reservoir. In addition, costs associated with the acquisition or construction of capital assets (e.g., legal fees, architect fees, engineering studies) can generally be made part of the depreciable basis of the capital asset.¹⁰¹ If appropriately related to the development of the project, they will be capital expenditures which qualify for both the depreciation allowance and the federal tax credits. Also, reasonable management/development fees attributable to the supervision of the construction or development of a capital asset have usually been treated as part of the cost of the capital asset and thus subject to the depreciation allowance and the federal tax credits.¹⁰²

¹⁰⁰See, Depreciation and Federal Tax Credits, infra.

¹⁰¹W.P. Brown & Sons Lumber Co. v. CIR, 2b B.T.A. 1192 (1932).

¹⁰²Rev. Rul 81-150, 1981-1 C.B. 119 (1981); ACER Realty Co. v. CIR 45 B.T.A. 333 (1941).

Some of the costs incurred in the development of an SSH project may be considered to be incurred in connection with intangible assets and subject to different treatment. Intangible assets for such purposes may include licenses, permits, leases, easements, power contracts, and the related legal fees and other fees associated with their acquisition or completion. Generally, intangible assets are not subject to the depreciation allowances and the federal tax credits because they are not considered exhaustable through wear and tear and because they may have an indeterminable useful life. However, if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period the length of which can be estimated with reasonable accuracy, then the intangible asset may be subject to a depreciation allowance.¹⁰³ In connection with an SSH project, the cost of reservoir easements and transmission line easements may be considered costs of intangible assets and depreciable over a useful life equal to or coterminous with the life of the dam or line, respectively.¹⁰⁴ However, it should be noted that the costs of intangibles are not eligible for accelerated methods of

¹⁰³26 C.F.R. §1.167(a)-3.

¹⁰⁴Rev. Rul. 71-121, 1971-1 C.B. 81 (1971); Rev. Rul. 72-403, 1972-2 C.B. 102 (1972).

depreciation (i.e., ACRS) or the federal tax credits.¹⁰⁵ Instead, they must be amortized over the asset's useful life. Similarly, costs ascribed to licensing and power contracts, including legal fees and management/development fees, would seem to be amortizable over the term of the license or contract.¹⁰⁶

¹⁰⁵Id.

¹⁰⁶Tube Bar, Inc. v. CIR, 15 T.C. 922 (1950); Pasadena City Lines, Inc. v. CIR, 23 T.C. 34 (1954); Private Letter Ruling 8221003.

VI. Structures For Transferring Tax Benefits

A. Introduction

In order for the significant federal tax benefits potentially available to an SSH project to have the maximum impact in reducing the effective cost of project development, the ultimate recipient of the tax benefits must be able to fully absorb the amounts of any tax credits and deductions generated by the project. The credits available to an SSH project may frequently exceed the project's or even the developer's federal income tax liability for several years, perhaps even beyond the carryover and carryback terms. Similarly, because of the graduated nature of the income tax, the project's tax credits and deductions (most importantly the depreciation deduction) could not be fully utilized unless the project's tax owner is in the highest federal income tax bracket.

There are multiple strategies available to provide for the transfer of federal income tax benefits from a party who cannot take full advantage of them to one who can. A complete review of these devices is beyond the scope of this document. However, it is useful here to discuss some of the salient features of mechanisms which may enable SSH developers to accomplish the desired flow-through of tax benefits.

B. Partnerships and Limited Partnerships

A partnership is a legal, financial, and personal relationship between two or more owners of a business. As a form of business, it resembles the sole proprietorship in its relative ease of formation, in its tax characteristics, and in the personal liability of the partners. The partnership does not share the corporation's limited personal liability, hierarchical and

organizational structure, and lack of flow-through of business tax consequences. The partnership itself is not taxed on the income from the business; rather, the partners are taxed individually on their proportionate share of the partnership's business income, whether distributed to them or not.

There are two types of partnerships - the limited partnership and the regular partnership. Of these types, the limited partnership is the form most likely to be utilized to transfer tax benefits of investment in qualified hydroelectric generating equipment because of the limited liability associated with the limited partner role. It should be noted that with a few notable exceptions the law of regular partnerships pertain equally to limited partnerships.

The limited partnership is generally more complex than a regular partnership. A limited partnership consists of one or more limited partners, whose liability for partnership activity is limited to their investment, and one or more general partners who are personally exposed to all partnership liabilities. The general partner(s) run the day to day operations of the business as "joint proprietor(s)." They are in control of the firm and manage the use of its assets. The limited partners are passive investors who participate in the partnership's gains or losses, but may not interfere in the general partners' everyday business without sacrificing their limited liability.

Generally, the limited partnership is a device used to structure an undertaking between an individual and/or a company (the general partner) and a group of investors (the limited partners). The limited partnership agreement usually provides compensation to the general partner(s) in the form of a management

fee or profit participation and allows the limited partner(s) the tax benefits and a cash flow sufficient to provide them a desired return on their invested capital. The tax and cash flow benefits (tax credits, depreciation allowances, business profits and losses) accrue to the limited partner(s) according to a prearranged formula designed to compensate each participant for his respective contribution.

1. Limited Partnership Agreement

Apart from any statute of frauds problem (agreements not performable within one year and agreements to transfer the ownership of land or property over a certain value are not enforceable unless evidenced in writing), a written agreement is not necessary to establish or continue a partnership. An oral contract is not even necessary since a partnership relationship may be inferred from the conduct of the persons involved.

The operation and structure of a regular partnership and limited partnership and, hence, the impact of various business consequences on the various partners, may be largely established by the partners themselves. Relations among partners will generally be subject to statutory (e.g., the Uniform Limited Partnership Act) and common law rules; however, these rules may usually be overridden or modified by the partners.

It is therefore most important that a clear agreement be drawn up which embodies the partners' wishes and plans for various contingencies to ensure a smooth operation of the business. This is best done with the advice of competent legal counsel. To

ensure that a limited partnership will provide the desired optimal flow-through of tax consequences, it is also critical that the agreement be drafted or reviewed by a knowledgeable and experienced tax counsel.

Among the many issues likely to be addressed in the limited partnership agreement are:

- 1) a clear identification of the parties and the business purpose and terms;
- 2) the partnership's capital structure;
- 3) financial and accounting matters (allocation and distribution of shares, other compensation, and indemnification);
- 4) method of partnership property ownership;
- 5) management and operational rights (including when unanimity of action is required); and
- 6) procedures to be followed upon termination, retirement, or changes in the composition of the partnership (an understanding of the rights to continue and the procedures for accounting and winding up of the business).¹

2. The General Partner's Role

The principal activities of the general partner include:

- 1) full, exclusive, and complete discretion in the management and control of the partnership's affairs;
- 2) keeping the partnership's books; and
- 3) executing or issuing all necessary documents, negotiable instruments, and agreements. This includes reporting and/or distributing any partnership profits, losses, and other tax benefits.

The general partner normally assumes full personal responsibility for the debts of the partnership. Thus, if there are losses, the general partner is responsible to the extent of

¹J.A. Crane and A.R. Bromberg, Law of Partnerships, 597-615 (1968).

his joint and individual resources. Joint liability of general partners is considered one of the most significant characteristics of a partnership. Even a silent general partner (existence undisclosed) is jointly liable. A new general partner is also jointly liable with the other general partners for all debts of the partnership, whether they were incurred before or after his admission to the partnership. This result cannot be avoided by an agreement to the contrary among the general partners. Liability for prior debts with respect to the new partner, however, can be satisfied only out of the partnership's assets.

The general partners are also jointly and severally liable for torts and breaches of trust injuring third persons. Thus, if an SSH partnership failed to properly maintain its dam and flooding ensued with resultant damage to neighboring property, the general partners would be liable.

3. The Limited Partner's Role

The limited partner's primary function is to provide a share of equity for the capitalization of the partnership. In return, he obtains an interest in the partnership similar to that of a stockholder in a corporation. The limited partner usually receives periodic progress reports and a share in the profit or loss of the business. However, the limited partner is a passive member of the firm. He cannot be active in the day to day management and control of the partnership's activities nor can he be paid any salary or interest on his capital contribution.

As a general rule, no limited partner is personally liable for any of the debts of the partnership, or its losses in excess of his capital contribution and share of the partnership's assets. However, where a limited partner takes part in the day to day

management or control of the business, or holds himself out as having authority or power to bind the partnership, he becomes liable as a general partner.

The limited partner has a right of access to the partnership books, to an accounting of the business, and to a dissolution by a court.² A limited partner may also assign or transfer his interest in the partnership without dissolving the firm.³ The scope of these rights should be specified and detailed in the limited partnership agreement.

4. Organizational Considerations to Ensure IRS Treatment as a Partnership

The flow-through of benefits of a limited partnership is sacrificed where the IRS finds that an entity purporting to be a limited partnership, for tax purposes, is an "association taxable as a corporation." Because of this possibility, it may be desirable to request an advance ruling from the Service to remove the risk of the purposes of a limited partnership being defeated by a subsequent IRS finding.

In general, a business will be taxed as a corporation if it more nearly resembles a pure corporation than any other form of organization (e.g., partnership or trust). The IRS has identified certain distinguishing characteristics of a corporation, drawing most from the tests set out in Morrissey v. Commissioner, 296 U.S. 344 (1935). These characteristics are listed in the Treasury Regulations as:

- 1) associates;

²ULPA § 305.

³ULPA § 702.

- 2) an objective to carry on business and divide the gains;
- 3) continuity of life;
- 4) centralization of management;
- 5) liability for corporate debts limited to corporate property; and
- 6) free transferability of interests.⁴

Since the presence of associates and an objective to carry on business and divide gains is common to both partnerships and corporations, the test is practically reduced to the remaining four elements.

Death, insanity, bankruptcy, retirement, resignation, or expulsion of a general partner will cause the dissolution of the limited partnership as a matter of law; therefore, there is no continuity of life under a limited partnership arrangement. This is true even though there may be an agreement by the remaining members to continue in the business as a new limited partnership.⁵

A limited partnership is generally considered to have centralized management only if substantially all of the interests in the partnership are owned by the limited partners.⁶ If that is the case, then one person or group of persons (the general partners) may be deemed to have such exclusive authority to make the management decisions that they resemble directors of a corporation.

⁴26 C.F.R. § 301.7701-2(a)(1).

⁵26 C.F.R. § 301.7701-2(b).

⁶26 C.F.R. § 301.7701-2(c).

In the case of a limited partnership, personal liability does not exist, for purposes of the association test, with respect to a general partner when he has no substantial assets which could be reached by creditors of the organization and when he is merely a "dummy" acting as the agent of the limited partners.⁷ However, personal liability does exist with respect to a general partner when he is not merely a "dummy" acting as an agent of the limited partners, even though he has no substantial assets in the organization. In addition, when the limited partners act as principals of the general partner, personal liability will exist with respect to such limited partners.⁸ It should be noted that when a general partner has substantial assets in the organization, personal liability exists.

If a partnership organization allows members who own substantially all of the interests in the organization the power to substitute other persons for themselves without consulting other partners, then there is free transferability of interests.⁹

In the event a limited partnership should be classified as an "association taxable as a corporation," the limited partners of the association would be treated as stockholders of a corporation with the result inter alia, that:

- 1) Income, gains, deductions, losses, and credits of the partnership would not "flow through" to the limited partners to be accounted for on their individual federal income tax forms;

⁷26 C.F.R. § 301.7701-2(d)(2).

⁸Id.

⁹26 C.F.R. § 301.7701-2(e)(2).

- 2) Distributions would be treated as corporate distributions to the limited partners; and
- 3) The taxable income of the partnership would be subject to the federal income tax imposed on corporations.

5. Valuation of Tax Consequences of Contributors

An initial question in the formation of a partnership has to do with the contributions to the partnership. Contributions may be of two types: contribution of services and contribution of equity (cash or property).

Contributions of cash to the partnership have no immediate tax consequences. However, when a partner contributes property, there are questions related to the valuation of the property and, in the case of property that has appreciated in value, the recognition and taxation of that gain in value.

In general, no gain or loss need be recognized by the partnership upon the contribution of property in exchange for a capital interest in the partnership.¹⁰ The basis of the property is the adjusted basis of the property to the contributing partner.¹¹ If the contributing partner recognizes no gain, the property in the hands of the partnership has the same basis as it did in the hands of the contributing partner and no taxes need be paid.

There are few restrictions on the valuation of contributed property by the partnership. Generally, the restrictions are those imposed by the practicalities of assigning the contributor an interest in the partnership and the fact that the partnership

¹⁰26 U.S.C. § 721(a).

¹¹26 U.S.C. § 722.

will be required to recognize gain or loss upon ultimate disposition of the asset. For the most part, the partnership will value contributed property at some value between its fair market value and the adjusted basis of the property.

More difficult problems are presented by the compensation of a service (general) partner with either a capital interest or profits interest in the partnership. The service partner who receives a capital interest has received property as compensation for his services, thereby incurring income tax liability.¹² A service partner receiving the right to a capital interest at some time in the future will recognize income in an amount equal to the estimated value of the capital interest that is transferred.¹³

The tax treatment of a service partner's receipt of an interest in the profits of the partnership has been the subject of considerable controversy, much of which is beyond the scope of this document. Suffice it to say that there is case law to the effect that such a transfer may expose the service partner to immediate tax liability.¹⁴ However, recent developments indicate that the IRS does not actively enforce this policy¹⁵ and have suggested that there may be ways to affirmatively avoid immediate income recognition in such a situation.¹⁶

¹²26 U.S.C. § 61.

¹³26 U.S.C. § 61; Frazell v. U.S., 213 F. Supp. (W.D. La. 1963) rev'd 335 F. 2d 487 (5th Cir. 1964).

¹⁴Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd 492 F. 2d 286 (7th Cir. 1974).

¹⁵Wheeler v. Commissioner, T.C. Memo 1978-208, 37 T.C.M. 883.

¹⁶See, e.g., 26 U.S.C. § 83; Stafford v. U.S., 611 F. 2d 990 (5th Cir. 1980).

6. Flow-through of Tax Benefits

The limited partnership is a direct participation investment. This means that all the results (profits, losses, tax credits) of the investment flow through the partnership entity directly to the participants.

The real economics of a limited partnership, that is, the potential for business profits and capital appreciation, are important in ensuring full utilization of the tax benefits. The IRS may attack schemes that do not offer a reasonable hope of commercial gain.

The tax consequences will ordinarily be the limited partner's primary point of interest. A deep partnership tax shelter generally involves a tax shelter agreement with a "flow-through" of heavy losses to the partners. In limited situations, these losses can be in excess of the contributions made by the partnership members.

The limited partnership form can be used to provide shelter, cash flow, and "flow-through" tax benefits which:

- 1) Shelter other personal income of the limited partner by passing through the partnership's business losses. The limited partner then deducts these losses from his other income sources;
- 2) Avoid tax payment by passing through the business tax credits to the limited partners; and
- 3) Reduce taxation via conversion of ordinary income to capital gains income.

The limited partnership is a very common vehicle for structuring tax shelters and offers substantial benefits in the SSH area. The limited partnership allows participants to take advantage of the "flow-through" variables (expenses and credits)

to the extent they are "at risk," while simultaneously limiting the possibility of personal liability through the choice of the partnership business form.

7. Limitation on Partner's Loss Deductions To Amount "At Risk"

The extent to which the losses of a hydropower project partnership may be deducted by a partner in any given year is restricted to that partner's amount at risk in the partnership at that time. A partner is considered "at risk" to the extent of his:

- 1) cash contributions;
- 2) adjusted basis of property contributed; and
- 3) borrowings with respect to the activity, to the extent that he is personally liable for the repayment or has pledged personal assets as security for the borrowed amount.¹⁷

As for adjustments to partnership basis, a partner's amount "at risk" is increased by his distributive share of partnership income and indebtedness for which he is personally liable and is reduced by his distributive share of partnership losses and the amount of any current distributions.¹⁸

Since personal liability is considered in a partner's amount at risk, these rules are likely to present problems only for limited partnerships and projects using non-recourse financing. Since it may be desirable to organize a hydropower project as a limited partnership and utilize some degree of non-recourse financing, the "at risk" rules are discussed in more detail in the section on selected federal tax concerns, supra.

¹⁷26 U.S.C. § 465(b).

¹⁸Prop. Reg. §§ 1.465-22, 23, 24, 25.

8. Allocation of ITC and ETC among Partners

Each partner of a partnership is entitled to take an ITC and ETC for his share of the basis of qualifying property owned by the partnership.¹⁹ Whether property is qualifying property is based on the character of the property in the hands of the partnership. Similarly, the useful life of the property will be its estimated useful life in the hands of the partnership.²⁰

In general, each partner's share of the basis or cost of qualifying property is determined in accordance with the ratio in which the partners divide the general or taxable income of the partnership, whether the partnership actually has a profit in that year or not.²¹

If the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the property is placed in service applies.

The ITC and ETC are subject to the general constraints on partnership allocation discussed in Section K of Special Concerns, above.²² However, an exception to the general allocation rule makes it possible to exclude certain partners from being allowed a share of the basis of qualifying property. The requirements of this exception are:

- 1) The partner's interest in the general profits of the partnership during the taxable year is 5% or less;

¹⁹26 C.F.R. § 1.46-3(f)(1); Qualifying property is § 38 property that meets the requirements for application of the ITC or ETC.

²⁰Id.

²¹26 C.F.R. § 1.46-3(f)(2); See also § 702(a)(9).

²²26 C.F.R. § 1.46-3(f)(1).

- 2) Under the partnership agreement, the partner must retire from the partnership during the taxable year or within 7 years after the end of that year; and
- 3) The partnership agreement provides that the basis of the qualifying property placed in service by the partnership during the taxable year must not be taken into account by that partner.²³

Any basis in qualifying property which is not taken into account by the partner must be shared among the remaining partners according to the general allocation rule.²⁴

9. Sale of Partnership Interests

Since one of the tax benefit opportunities available to a tax shelter partnership may be the potential to convert ordinary income into more favorably taxed long-term capital gain, a developer contemplating an SSH limited partnership should completely explore the tax effects of a sale of partnership interests. In general, the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset.²⁵ Thus, a selling partner will recognize long- or short-term capital gain, depending on how long he held the asset, on the difference between the amount realized and the adjusted basis of the asset. The adjusted basis of the partner's interest is governed by Code § 705. It should be noted that the extent to which the selling partner is relieved of liabilities is added to the purchase price of his interest.²⁶ For example, if a partner sells his interest

²³26 C.F.R. § 1.46-3(f)(2)(iii).

²⁴Id.

²⁵26 U.S.C. § 741.

²⁶26 U.S.C. § 752.

in a partnership for \$750 cash and at the same time transfers to the purchaser his share of partnership liabilities amounting to \$250, the amount realized by the seller on the transaction is \$1,000.²⁷

Not all of the gain recognized on a sale of partnership interests will qualify for capital gain treatment. For example, some or all of the depreciation taken on partnership property is ordinary income according to the provisions of Code §§ 1245 and 1250.²⁸ In addition, any gain attributable to the value of a partner's share of "unrealized receivables" will be treated as ordinary income.²⁹ "Unrealized receivables" include any rights to payment for the sale of non-capital goods delivered or to be delivered, or services rendered or to be rendered.³⁰ While the interpretation of this provision has proved to be somewhat elusive, some of the holdings in past cases suggest that an SSH project's long-term purchase power contract may qualify as an "unrealized receivable."³¹ If this is true, then a selling partner will have to allocate some value to any purchase power contract in effect at the time of the sale of his interest and recognize any gain attributable to that property as ordinary income. It should be noted that a selling partner may have

²⁷26 C.F.R. § 1.752-1(a).

²⁸26 U.S.C. §§ 741, 751.

²⁹26 U.S.C. § 751(a).

³⁰26 U.S.C. § 751(c).

³¹U.S. v. Woolsey, 326 F.2d 287 (5th Cir. 1963); Roth v. Commissioner, 321 F.2d 607 (9th Cir. 1963).

substantial latitude in any such allocations since the true economic value of a long-term contract may be difficult to establish definitively.

10. Losses and Loss Carryover

Separate and apart from the "at risk" limitation on losses discussed above, a partner's share of a partnership loss will be allowed only to the extent of the current adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the taxable year in which the loss occurred.³² If a partner whose loss exceeds the basis of his other partnership interest repays the excess to the partnership, the excess is allowed as a deduction at the end of the taxable year in which it is paid.³³ The repayment, of course, increases the partner's basis of his interest. Therefore, in no event would the deduction of the loss decrease the partner's basis below zero.³⁴

The regulations provide that a partner's share of loss in excess of his adjusted basis at the end of the taxable year will not be allowed for that year. However, any excess loss is allowed as a deduction in the next taxable year, or any subsequent taxable year, in which the partner has sufficient basis in the partnership to accommodate such loss.³⁵

³²26 U.S.C. § 704(d).

³³Id.

³⁴26 U.S.C. § 705(a)(2).

³⁵26 C.F.R. § 704-1(d)(1).

The basis of a partner's interest in the partnership includes the amount of money and the adjusted basis of any property (essentially the cost of the property less any depreciation taken) that the partner has contributed to the partnership.³⁶ The Code also provides that any increase in a partner's share of the liabilities of a partnership or any increase in a partner's individual liabilities by reason of the assumption by the partner of further partnership liabilities, shall be considered a contribution of money to the partnership, thereby increasing the basis of the partner's interest in the partnership.³⁷ A partner's basis is also increased by his distributive share of partnership income and reduced by his distributive share of partnership loss, distributions, and liabilities.³⁸ Essentially then, the amount of partnership loss that is deductible on a partner's individual return is limited to his current financial stake in the partnership.

If a partner's basis is not sufficient to fully utilize the loss, he may consider increasing his basis by a contribution of additional capital to the partnership, by a loan to the partnership, or by an increase in the liabilities of the partnership. It should be noted that all three avenues for increasing basis should be covered in the partnership agreement. Also, the Internal Revenue Service may challenge the transaction as a sham especially if the contribution, loan, or assumption of a liability does not have a bona fide business purpose.

³⁶ 26 U.S.C. § 722.

³⁷ 26 U.S.C. § 752(a).

³⁸ 26 U.S.C. § 705.

11. State and Local Tax Aspects

With respect to the existence, amount, and manner of taxation at the state and local levels, each individual interested in an SSH limited partnership should consult competent local tax counsel on these matters. However, the following general considerations are offered as a point of departure for an investigation into local tax liability.

- 1) Does the SSH limited partnership operate in a state which imposes a tax on each limited partner's share of the income derived from the partnership's activities in that state?
- 2) To the extent that an SSH partnership may operate in certain jurisdictions, estate or inheritance taxes may be payable upon the death of a limited partner. Therefore, a limited partner may be subjected to income tax, estate, and inheritance taxes in states in which business is conducted, as well as in his own state of domicile.
- 3) The location of the limited partnership or its property and applicable state and local law may preclude the availability of deductions for stated and local purposes irrespective of their availability for federal income tax purposes.
- 4) The treatment of particular items under state and local income tax laws may vary materially from the federal income tax treatment.
- 5) The assessment of local property taxes may vary materially from jurisdiction to jurisdiction.

The preceding discussion of partnership federal income tax considerations is by no means exhaustive. There are a number of additional federal income tax considerations that any developer desiring to structure an SSH limited partnership should fully address. Similarly, the problems noted in the sections on amount "at risk", and allocation and sale of partnership interests are

merely intended to expose some of the major issues an SSH limited partnership may confront in those areas. Any developer desiring to fully utilize this business form should acquire the services of a skilled and experienced professional tax advisor. While this can be expensive, such costs may be offset by the effective increase in the project's rate of return on equity made possible through taking full advantage of this business form.

C. Subchapter S Corporation

1. Introduction

An S Corporation, or "tax option" corporation, offers another vehicle for passing the tax benefits of an activity directly on to the individual investors. An S Corporation is as much of a tax conduit as a partnership; the corporation passes through all items of income, loss, deduction, or credit to the stockholders. Each stockholder of the corporation takes into account his pro rata share of the corporation's items of income (including tax exempt income), loss, deduction, or credit, and all other income or loss.³⁹ The character of any item included in the stockholder's pro rata share will generally be determined at the corporate level rather than at the stockholder level.⁴⁰

2. S Corporation Requirements

In order for a corporation to be treated as an S Corporation for tax purposes, certain requirements have to be met and an election has to be made. The requirements for S Corporation tax treatment are discussed in the section on Business Organization. One of these requirements, the limitation to one class of stock, is more complex than it would appear. An S Corporation can have voting and non-voting common stock; however, it cannot have both common and preferred stock.⁴¹ Corporate liabilities, so long as they constitute "straight debt," are not treated as a second class

³⁹26 U.S.C. § 1366(a)(1).

⁴⁰26 U.S.C. § 1366(b).

⁴¹26 U.S.C. § 1361(c)(4).

of stock.⁴² "Straight debt" is defined as any written unconditional promise to pay a sum certain in money on demand or on a specified date if:

- 1) The interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors;
- 2) There is no convertibility either directly or indirectly into stock; and
- 3) The creditor is an individual (other than a nonresident alien), an estate, or specially defined trusts.⁴³

3. Determining Stockholder's Ratable Share

Each stockholder's portion of corporate items that must be separately stated and passed through to him is computed on a daily basis according to the number of shares of stock held by him on each day during the taxable year of the corporation.⁴⁴ A stockholder's pro rata share is generally determined by:

- 1) Assigning an equal portion of each item to each day of the corporation's taxable year (e.g., 1/365);
- 2) Allocating that daily portion pro rata among the shares outstanding on each such day (i.e., applying to the daily loss the ratio that the stock owned by the stockholder on that day bears to the total stock outstanding on that day); and
- 3) Totaling the stockholder's daily portions of the item as determined under (1) and (2).⁴⁵

4. Accounting Period for an S Corporation

An S Corporation can only use a calendar year accounting period unless it establishes to the satisfaction of the

⁴²26 U.S.C. § 1361(c)(5)(A).

⁴³26 U.S.C. § 1361(c)(5)(B); See Code § 1361(c)(2) for specially defined trusts.

⁴⁴26 U.S.C. § 1377(a).

⁴⁵Id.

Commissioner that a business purpose exists for using a fiscal year.⁴⁶ What constitutes a valid business purpose for changing accounting periods is unclear. However, it appears from the Conference Report that Congress intends that the Service will apply rules similar to the rules applicable to partnerships in changes of accounting periods.⁴⁷ Among the factors that the Service considers in determining whether a valid "business purpose" exists for such a change are

- 1) the tax consequences of using a fiscal year;
- 2) the affect of a fiscal year on the annual cycle of business activity; and
- 3) whether or not a substantial distortion of income would result.⁴⁸

Examples of a "substantial distortion of income" include

- 1) deferral of a substantial portion of an S Corporation stockholder's income, or shifting of a substantial portion of deductions, from one year to another so as to reduce substantially the stockholder's tax liability; and
- 2) creating a short period in which there is either (a) a substantial net operating loss, or (b) a substantial portion of amounts treated as long-term capital gain.⁴⁹

5. Taxable Income

An S Corporation's taxable income is computed under the same rules applicable for computing a partnership's taxable income.⁵⁰

⁴⁶26 U.S.C. § 1378.

⁴⁷Conf. Rept. No. 97-986; p. 22.

⁴⁸26 C.F.R. § 1.442(b)(1).

⁴⁹Id.

⁵⁰Senate Report 97-649, p. 15. See Code § 703 for determination of partnership's taxable income.

Thus, an S Corporation's income is computed in the same manner as an individual's taxable income except that:

- 1) items of income, loss, deduction, and credit will have to be separately stated if their separate treatment by a stockholder could affect his tax liability; and
- 2) the S Corporation may not take deductions for items listed in Code § 703(a)(2) that individuals are allowed to deduct.⁵¹

6. Basis in S Corporation Stock

A stockholder's basis in an S Corporation's stock is used to determine gain or loss on the stock in a taxable sale or exchange, and to limit the stockholder's share of the corporation's losses and deductions in a given taxable year.

A stockholder's basis in S Corporation stock is increased by his portion of the following items:

- 1) all income items of the corporation (including tax exempt income) that are separately stated and passed through to the stockholders;
- 2) the income of the corporation that is not separately computed; and
- 3) the excess of the corporation's deduction for depletion over the basis of the property subject to depletion.⁵²

A stockholder's basis will be decreased by his portion of:

- 1) nontaxable return-of-capital distributions by the corporation;
- 2) all loss and deduction items of the corporation that are separately stated and passed through to the stockholders;
- 3) the nonseparately computed loss of the corporation; and

⁵¹26 U.S.C. § 1363(b).

⁵²26 U.S.C. § 1367(a)(1).

- 4) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to its capital account.⁵³

Effectively, basis would be increased or decreased in the same way as the taxable income of S Corporation shareholders is determined. In the event that the basis reduction applicable to a share of stock exceeds the basis of such share, the excess is applied pro rata in reduction of the basis of all other shares owned by the stockholder.⁵⁴ In effect, the amount of gain or loss on the disposal of stock during the taxable year of an S Corporation will not be able to be determined until adjustments in the basis of that stock are determined.

If in any taxable year of an S Corporation, the total of the amount of items (other than distributions) which reduces a stockholder's basis in stock exceeds the amount that would reduce the stock's basis to zero, the balance will be applied to reduce the basis (but not below zero) of any indebtedness of the S Corporation.⁵⁵ In other words, losses can be deducted to the extent of the total of the basis in the stock and debt of the corporation; however, basis in debt is not taken into account in determining whether distributions are tax free or treated as payment in exchange for stock. If the stockholder owns more than one debt obligation of the corporation, the excess of items reducing basis is applied to reduce the basis of each obligation on a pro rata basis.⁵⁶

⁵³26 U.S.C. § 1367(a)(2).

⁵⁴26 C.F.R. § 1.1376-2(a)(2).

⁵⁵26 U.S.C. § 1367(b)(2)(A).

⁵⁶26 U.S.C. § 1367(b)(2)(B).

If the basis in debt in any taxable year is reduced below a stockholder's original basis in that debt, that basis has to be increased to (but not above) its original amount before the stockholder's basis in stock may be increased.⁵⁷ In other words, to the extent that in any taxable year, the total amount of items that increase basis exceed the total amount of items that would decrease basis, the net increase would be applied first to increase the basis of debt to its original level before increasing the basis of stock. It would seem that if a stockholder owns more than one debt obligation of a corporation whose basis has previously been reduced, the basis of each obligation should be increased in proportion to the amount of reduction previously taken.

7. Losses and Loss Carryovers

A stockholder may deduct his pro rata share of an S Corporation's losses and deductions only to the extent of the total of his adjusted basis in the S Corporation's stock and his adjusted basis in any indebtedness of the S Corporation to him.⁵⁸ As long as the corporation remains an S Corporation, any loss or deduction in excess of basis can be carried over indefinitely, to be used whenever the stockholder has basis enough to be applied against all or any part of the amount carried over.⁵⁹

⁵⁷26 U.S.C. § 1367(b)(2)(B).

⁵⁸26 U.S.C. § 1366(d)(1).

⁵⁹26 U.S.C. § 1366(d)(2); Senate Report 97-640, p. 8.

Since the loss is treated as incurred by the corporation in the succeeding taxable year with respect to the stockholder, it would seem that the carried over loss is personal to the stockholder who owned the stock and does not attach to the stock. In other words, if a stockholder sells his stock before obtaining enough basis to apply against the loss, no part of the loss can be deducted by the new stockholder.

8. Distributions of Appreciated Property

An S Corporation always recognizes gain on the distribution of appreciated property regardless of what any other rule in the Code may provide.⁶⁰ Gain will be recognized in the same manner as if the S Corporation had sold the property at its fair market value.⁶¹

9. Distributions

S Corporation distributions equal the amount of cash distributed plus the fair market value of any other property distributed.⁶² Corporate distributions are taxed as dividends only to the extent of the corporation's current earnings and profit (CEP) or accumulated earnings and profits (AEP).⁶³ An S Corporation has no CEP for any taxable years beginning after 1982 for which the Subchapter S election was in effect.⁶⁴ An S Corporation can have AEP from:

⁶⁰26 U.S.C. § 1363(d); Senate Report 97-640, p. 20.

⁶¹Id.

⁶²26 U.S.C. § 1368(a).

⁶³26 U.S.C. § 316(a).

⁶⁴26 U.S.C. § 1368.

- 1) pre-election taxable years;
- 2) taxable years beginning before January 1, 1983 for which a Subchapter S election was in effect; and
- 3) A corporate acquisition which results in a carryover of earnings and profits under Code § 381.

As a general rule, there will be no adjustments in the amount of a corporation's earnings and profits during the period it was an S Corporation for taxable years beginning after 1982.⁶⁵ In other words, the amount of an S Corporation's earnings and profits is frozen as of December 31, 1982.

If an S Corporation has no AEP, the amount of a distribution to a stockholder with respect to the stockholder's stock reduces the stockholders' basis in that stock (return of capital). If the amount distributed exceeds the basis, the excess is treated as payment in exchange for stock (capital gain).⁶⁶

If an S Corporation has AEP (because of the reasons stated above), a distribution will be a dividend to a stockholder to the extent that it is treated as paid out of AEP. Certain distributions made out of previously taxed but undistributed taxable income from taxable years beginning before 1983 and in which the Subchapter S election was in effect will not be treated as dividends.⁶⁷

For purposes of determining the tax consequences of distributions to stockholders, distributions are deemed made out of the following sources in this priority:

⁶⁵26 U.S.C. § 1371(c)(1).

⁶⁶26 U.S.C. § 1368(b).

⁶⁷26 U.S.C. § 1368(c).

- 1) the accumulated adjustments account (AAA), i.e., the corporation's taxable income during post 1982 taxable years that it is an S Corporation less distributions previously made out of that income;
- 2) accumulated earnings and profits; and
- 3) other sources (e.g., post 1982 tax-exempt income).⁶⁸

These distributions have the following tax consequences to the stockholder:

- 1) To the extent a distribution is deemed made out of the AAA, it reduces the stockholder's basis in his stock (return of capital), and any excess is treated as payment in exchange for stock (capital gain);
- 2) To the extent the distribution is made out of AEP, it is a dividend to the receiving stockholder; and
- 3) To the extent the distribution is made out of other sources, it reduces the remaining basis of the stockholder's stock (return of capital), if any, and any excess is treated as payment in exchange for stock (capital gain).⁶⁹

For example, assume that an SSH project is organized as an S Corporation. SSH has AEP of \$10,000, AAA of \$50,000, and makes a distribution of \$100,000. The distribution is made to a stockholder that has an adjusted basis in her stock of \$70,000. The application of Code § 1368(c) will result in this breakdown:

1)	Return of Capital from AAA	\$ 50,000
2)	Dividend from AEP	10,000
3)	Return of Capital from Remaining Basis in the Stock	20,000
4)	Capital Gain from Excess Basis of Stock	10,000

⁶⁸Id.

⁶⁹Id.

The AAA equals the amount of the S Corporation's taxable income for post-1982 taxable years for which the Subchapter S Corporation election was in effect, less the amount of that income that was already distributed.⁷⁰ It should be noted that the stockholders of an S Corporation can elect to have the distribution treated as a dividend to the extent of AEP.⁷¹

10. Allocation of ITC and ETC among Stockholders

Like items of income, loss, and deduction, the ITC and ETC, if any, are allocated pro rata among the stockholders of an S Corporation. This means that the basis of "new § 38 property" and the cost of "used § 38 property" placed in service during the taxable year is apportioned pro rata among the stockholders who are stockholders of the S Corporation on the last day of the corporation's taxable year.⁷² The Treasury Regulations provide detailed rules with respect to how the allocation should be made. These rules are

- 1) The basis of all new § 38 property falling within a particular useful life category are aggregated;
- 2) The cost of all used § 38 property falling within a particular useful life category are aggregated also;
- 3) The total basis of new § 38 property and the total cost of used § 38 property within each useful life category is apportioned separately; and
- 4) Each stockholder is apportioned his pro rata share of the total basis of new § 38 property and the total cost of used § 38 property within each useful life category.⁷³

⁷⁰26 U.S.C. § 1368(e).

⁷¹26 U.S.C. § 1368(e)(3)(A).

⁷²26 C.F.R. § 1.48-5(a)(1).

⁷³Id.

It would appear that under the ACRS system, property would be aggregated and apportioned to the stockholders according to its recovery class.

The limitation on used § 38 property applies both to the S Corporation and to the stockholders.⁷⁴ The above allocations are taken into account in determining the stockholders' ITC and ETC for the taxable year in which the taxable year of the S Corporation ends.

⁷⁴26 C.F.R. § 1.48-5(a)(2).

D. Safe Harbor Leasing/Tax Benefit Transfers

1. Introduction

In an effort to relax the technical restrictions on lease transactions which the IRS has developed over the years, the Economic Recovery Tax Act of 1981 (ERTA) created what is essentially a new type of tax benefit transfer vehicle. ERTA added Code § 168(f)(8) which creates a safe harbor election that guarantees that a transaction will be treated as a lease, rather than a finance arrangement, even though the transaction does not comply with existing IRS guidelines for obtaining an advance ruling, and even though the transaction would not otherwise be a lease.⁷⁵ As stated in the Senate Committee Report, the purpose of the safe harbor provisions is to allow taxpayers who do not have sufficient tax liability to completely use their ACRS deductions and investment tax credits to transfer these credits to taxpayers who can use them.⁷⁶

The effect of the safe harbor leasing provisions is to enable taxpayers to transfer some or all of the tax benefits associated with the purchase of property to a corporate lessor in return for a cash payment approximately equal to the present value of those tax benefits to the lessor. The purchaser/lessor gives the seller/lessee a cash payment and a note equal to the total cost of the property. The lessee typically pays rent to the lessor equal to the debt service on the note and receives payment

⁷⁵These IRS guidelines are found in Rev. Proc. 75-21, 1975-1 C.B. 715, Rev. Proc. 75-28, 1975-1 C.B. 752, Rev. Proc. 76-30, 1976-2 C.B. 647, as amended by Rev. Proc. 81-71, 1981-2 C.B. 731.

⁷⁶S. Rept. No. 97-494, 97th Cong. 2d Sess., p. 134.

for interest and principal on the note. The rent and interest payment receive the usual tax treatment and the parties can elect in advance to dispose of the property at the end of the lease term without any impact on the tax treatment of the transfer. Thus, the safe harbor provisions guarantee that, for federal income tax purposes, qualifying transactions will be treated as leases, and that the purchaser/lessor will be treated as the owner of the property, even though the seller/lessee is in substance the owner of the property and the transaction otherwise would not have been considered a lease.⁷⁷ Since the purchaser/lessor in such a transaction usually does not acquire legal title, special care must be taken in assessing the impact of state law and the effect on the lessee of the bankruptcy of the lessor.

The safe harbor leasing provisions were restructured by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA); therefore, the requirements for safe harbor leasing will be discussed under those provisions.

2. TEFRA Changes: Requirements

Reflecting a Congressional concern that the safe harbor leases had made the sale of tax benefits so easy as to result in a serious revenue loss, TEFRA imposed changes which significantly reduce the opportunity and incentive for their use. Under TEFRA, the following requirements must be satisfied in order for the safe harbor leasing provisions to apply:

⁷⁷Id.

- 1) All parties to the arrangement must enter into a written agreement and elect safe harbor status;⁷⁸
- 2) The lessor ultimately taking the tax benefits from the property must in effect be a regular corporation;⁷⁹
- 3) The lessor must maintain a minimum "at risk" investment of at least 10% of the adjusted basis of the property at all times during the lease term;⁸⁰
- 4) The term of the lease, including extensions, cannot exceed the greater of 120% of the ADR midpoint life of the leased property or the extended recovery period over which ACRS deductions are allowed for the leased property (see, below)⁸¹; and
- 5) Only recovery property that is "new § 38 property" (and § 103(b)(9) Commuting Vehicles) leased within three months of purchase can be leased.⁸²

The IRS has made it clear in temporary regulations implementing the safe harbor provisions that to the extent the "at risk" rules would have limited deductions of the seller/lessee, the same restrictions will apply to the purchaser/lessor.⁸³

3. Lessor's Tax Benefits

The tax benefits derived by a lessor from a safe harbor leasing arrangement have been limited under the rules adopted by TEFRA. Under TEFRA, a lessor may not reduce its tax liability (including the corporate minimum tax) by more than 50% through the use of safe harbor leasing.⁸⁴ Thus, a lessor's tax liability is

⁷⁸26 U.S.C. § 168(f)(8)(A).

⁷⁹26 U.S.C. § 168(f)(8)(B)(i)(I).

⁸⁰26 U.S.C. § 168(f)(8)(B)(ii).

⁸¹26 U.S.C. § 168(f)(8)(B)(iii).

⁸²26 U.S.C. § 168(f)(8)(D)(i).

⁸³Temporary Reg. § 15f.168(f)(8)-1, question 8.

⁸⁴26 U.S.C. § 168(i)(1).

the greater of its actual tax liability (including safe harbor tax benefits), or 50% of its liability computed without regard to any rental income, interest deduction (if paid or incurred to the lessee), ACRS deduction, and investment credit allowed for the tax year under the safe harbor lease.⁸⁵

The most direct reduction in the value of safe harbor leases results from the reductions in investment tax credit and ACRS deductions. Under TEFRA, safe harbor lease property credits can only be taken ratably over five years.⁸⁶ Thus, only 20% of the credit may be claimed in the tax year that the property is deemed placed in service and 20% of the credit can be claimed in each of the four succeeding taxable years. In addition, ACRS deductions can only be taken under revised ACRS periods extending 3-, 5- and 10-year recovery property to 5-, 8- and 15-year recovery periods, respectively.⁸⁷

A further restriction limits the amount of a lessee's property placed in service in a given year through safe harbor leasing to 45% of the cost of the property.⁸⁸

4. Effective Dates

In general, the changes in the safe harbor rules are effective for leases entered into or property placed in service

⁸⁵S. Rep. No. 97-494, 97th Cong., 2d Sess., p. 142.

⁸⁶26 U.S.C. § 168(i)(3).

⁸⁷26 U.S.C. § 168(i)(2).

⁸⁸26 U.S.C. § 168(f)(8)(D)(ii).

after July 1, 1982. However, the TEFRA rules do not apply for property placed in service before January 1, 1983, if, after December 31, 1980 and before July 2, 1982, either:

- 1) The property was acquired by the lessee or construction of the property was commenced by or for the lessee, or
- 2) A binding contract to acquire or construct the property was entered into by the lessee.⁸⁹

According to the Committee Report, a contract is considered to be binding only where the lessee's failure to perform would subject it to liability for damages exceeding at least 5% of the cost of the property.⁹⁰

Finally, TEFRA repealed the safe harbor lease provisions for leases (other than leases covered by transitional rules) entered into after December 31, 1983.⁹¹

5. Finance Lease

Beginning in 1984, a new category of leases, called "finance leases" will replace safe harbor leasing.⁹² In essence, the finance lease will retain most of the pre-TEFRA safe harbor lease requirements, but provide for some flexibility in setting post-lease purchase prices and dealing with limited use property. Thus finance leases may contain a fixed price purchase option for as little as 10% of the property's value and the limited use property restrictions will not apply.⁹³ However, the lessor must have a

⁸⁹Joint Committee on Taxation Report, P.L. 97-248, p. 60.

⁹⁰Id.

⁹¹Id., p. 62.

⁹²26 U.S.C. § 168(f)(8), effective after December 31, 1983.

⁹³26 U.S.C. § 168(f)(8)(A).

non-tax economic motivation, and the lessee may not have investments in the property or otherwise violate the Service guidelines defining conditional sales.

Finance leases will retain many previous and modified safe harbor lease requirements. Thus, the lessor must be a corporation, or trust or partnership composed of corporations.⁹⁴ Lessors will also be subject to the 50% maximum tax reduction rule.⁹⁵ Until September 30, 1985, lessees will be subject to a 40% annual finance lease property cap.⁹⁶ Significantly, the tax credits on finance lease property will also have to be taken evenly over 5 years.⁹⁷ There will, however, be no special ACRS limitations.

E) Leveraged Leases

1. Introduction

A leveraged lease is not really a structure for transferring the tax benefits of an SSH project. However, it does allow the maximization of the tax benefits and therefore reduces the financing costs to the project developer. The term "leverage" refers to the use of borrowed capital; in a typical leveraged lease arrangement, the lessor borrows between 60 and 80 percent of the purchase price of an asset.

Generally, the project developer, after determining what equipment is needed for the project, will enter into an agreement

⁹⁴26 U.S.C. § 168(f)(3)(c)(i).

⁹⁵26 U.S.C. § 168(i)(1)(A).

⁹⁶26 U.S.C. § 168(f)(3)(B)(ii).

⁹⁷26 U.S.C. § 168 (i) (2).

whereby a leasing company will purchase that equipment and lease it to the developer. The investor(s), supply 20-40 percent of the equity needed to purchase the equipment, and the leasing company enters into a non-recourse loan agreement for the remainder of the purchase price. The loan will be secured by a lien on the equipment purchased by the leasing company and by assignment of the lease agreement and rental payments to the lender. The rental payments are sufficient to pay the principal and interest on the amount borrowed by the leasing company plus a nominal amount of cash return on the equity investment by the investor(s). In this type of arrangement, it is clear that the better the credit rating of the lessee, the lower the cost of the loan.

In this manner, the lessee enjoys the use of the equipment, pays only operating and maintenance expenses (fully deductible), and makes rental payments from his sales revenues, the rental payments being fully tax deductible. The leasing company receives ordinary income in the form of rental payments, but is able to entirely offset it by deducting the cost of the financing arrangement and the debt service on the loan. At the same time, the investor(s), in exchange for the non-risk 20-40 percent equity investment, receive(s) 100 percent of the investment tax credits, depreciation and other deductions, any pre-operation losses, and a nominal cash flow return on the equity invested. Because all parties have been able to take advantage of every possible tax benefit, the rental payments can be lower than those which a lessee would make under a normal lease agreement.

This overview does not disclose the complexities and variations of leveraged leasing which make the structuring of such an agreement an expensive proposition. Because of this expense,

it may be that leveraged leases are of little use to small SSH projects. However, for those projects which involve large investments and correspondingly large tax credits and other tax benefits, such leases can provide significant cost savings.

2. IRS Guidelines

In order to insure that the lessor obtains the desired tax benefits the arrangement must be structured so as not to transfer tax ownership in the facility to the lessee. Revenue Ruling 55-540 set forth a number of conditions that, in the absence of factors compelling a contrary indication, would warrant treating a leveraged lease financing agreement as a conditional sales contract rather than a lease.⁹⁸ Since that ruling, the IRS has issued a series of revenue procedures which set forth guidelines for leveraged lease transactions.⁹⁹ The guidelines indicate the conditions which should be satisfied to avoid tax treatment of a leveraged lease as a sale.

To satisfy IRS guidelines, a lease must have the following characteristics:

- 1) The lessor must maintain a minimum at risk investment in the property and demonstrate an expected value of the property at lease expiration of at least 20% of the original cost;
- 2) The lessor must demonstrate an expected profit from the transaction, exclusive of tax benefits;
- 3) The lessee may not have the right to purchase the property for less than its fair market value;
- 4) The lessee may not invest in the lease or loan any part of the purchase price to the lessor;

⁹⁸Rev. Rul. 55-540, 1955-2 C.B. 39.

⁹⁹Rev. Proc. 72-21, 1975-1 C.B. 715, Rev. Proc. 76-30, 1976-2 C.B. 647, as amended by Rev. Proc. 79-48, 1972-2 C.B. 529.

- 5) Any annual rental payments should not be more than 10% above or below a level schedule;
- 6) The lessor must establish that the property is commercially usable at the end of the lease by someone other than the lessee.

3. Impact of Safe Harbor Leasing Rules

As discussed earlier, ERTA created a special safe harbor that guarantees a transaction will be treated as a lease for the purpose of allowing tax credits and cost recovery allowances to the lessor.¹⁰⁰ So long as the simplified requirements of Section 168(f)(8) are satisfied,¹⁰¹ the parties in a leasing transaction may disregard the IRS guidelines discussed above. In addition to establishing the new hybrid tax lease or "tax benefit" transfer discussed earlier, this means that parties have much greater latitude to structure a leasing agreement which satisfies their special interests. For example, a lease under the safe harbor rules may include a provision permitting or even requiring the lessee to purchase the property at the end of the lease for any value considered appropriate. In addition the property leased can now be a type which would only have value to the lessee at the end of the term. Freedom from the other IRS guidelines representing lessor profit incentive, lessee/lessor loans, and value at the end of the lease offer similar value flexibility in lease transactions.

4. TEFRA Changes

As discussed above, the TEFRA has substantially revised the rules for safe harbor leasing. Quite naturally, these changes

¹⁰⁰26 U.S.C. § 168(f)(8).

¹⁰¹Summarized in the section on safe harbor leasing, supra.

will reduce the opportunities for using hybrid leveraged leases as well. Of particular note are the 5-year tax credit amortization, lengthened ACRS recovery periods, and lessee financing restrictions which will, in most cases, offset the value of the expanded flexibility possible for hybrid leveraged leases under prior safe harbor rules. Much the same can be said for the post 1983 finance leases which retain the 5-year credit amortization requirement.

F. A Note on Securities Law Compliance

The Securities Act of 1933¹⁰² (The Act) was passed to regulate the initial distribution of securities. The Act was designed to prevent fraud by requiring full and fair disclosure of the character of the securities sold. The essence of the Act is its provision for registration, which creates a mechanism to assure that the public has full information concerning the company whose securities are being offered for sale.

For purposes of the Act, a security includes all stocks, bonds, debentures, evidences of indebtedness, and investment contracts.¹⁰³ The basic test of whether a transaction is viewed as involving securities is whether the scheme in question "involves an investment in money in a common enterprise with profits to come solely from the efforts of others."¹⁰⁴

All of the so called tax flow-through devices entail more or less passive investment. Even where tax saving is not a primary motivation for the organizational form it is quite likely that a hydroelectric project development will involve investments which fall within the SEC definition of a security.

If the issue qualifies as a security, then the project sponsors will have to comply with complex and costly SEC registration requirements. However, there are several exemptions

¹⁰²15 U.S.C.S. §§ 77a et. seq.

¹⁰³15 U.S.C.S. § 77b (1).

¹⁰⁴SEC v. W.J. Howley Co., 328 U.S. 293 (1946).

from the registration requirements. The most likely exemptions available to an SSH project are the private offering,¹⁰⁵ the small offering,¹⁰⁶ and the intrastate offering.¹⁰⁷

1. The Private Offering Exemption

Section 4(2)¹⁰⁸ of the Securities Act provides that the registration requirements¹⁰⁹ of the Act will not apply to "transactions by an issuer not involving any public offering." The SEC and the Courts have taken the position that whether a transaction qualifies for the private offering exemption is essentially a question of fact and necessitates consideration of all surrounding circumstances, including:

- 1) the number of offerees and their relationship to each other and to the issuer;
- 2) the number of units of securities offered;
- 3) the size of the offering; and
- 4) the manner of the offering.¹¹⁰

The primary general consideration in determining whether a security offering qualifies for the private offering exemption is

¹⁰⁵15 U.S.C.S. § 77d (2).

¹⁰⁶15 U.S.C.S. § 77c (b).

¹⁰⁷15 U.S.C.S. § 77c (a)(11).

¹⁰⁸15 U.S.C.S. § 77d(2).

¹⁰⁹15 U.S.C.S. § 77e (Section 5 of the Act).

¹¹⁰Hill York Corp. v. American Int. Franchises, Inc., 448 F. 2d 680 (1971); Doran v. Petroleum Management Corp., 545 F. 2d 893 (5th Cir. 1977); SEC v. Murphy. CCH Fed. Sec. L. Rep. ¶ 97,588 at page 98, 119 (decided July 23, 1980).

whether the investors need the protection of the Securities Act, i.e., whether the investors are deemed capable of fending for themselves.¹¹¹

In 1982, the Securities and Exchange Commission adopted Regulation D¹¹² which eases the burdens of making a private exempt offering under Section 4(2) of the Act. Regulation D, which replaces the existing regulations¹¹³ affecting private exempt offerings, is a series of six rules, designated Rules 501-506.¹¹⁴ Rules 501 and 502 define common terms and set forth general conditions which apply to all offers and sales made pursuant to Regulation D. Rule 503 provides for a uniform notice of sales form, designated Form D, and contains specific filing requirements. Rules 504-506 contain the specific exemptions from the registration provisions of the Act. Under Rule 504 the aggregate offering price for an offering of securities cannot exceed \$500,000; under Rule 505 the aggregate offering price cannot exceed \$5,000,000; and under Rule 506 there is no limit.

The information required to be furnished to investors depends upon under which Rule the offer and sale is being made and whether the purchaser is an accredited investor. Generally speaking, an accredited investor is a person or entity of sufficient financial means and with sufficient knowledge and experience in financial and business matters to be capable of

¹¹¹SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

¹¹²Release No. 33-6389.

¹¹³17 C.F.R. §§ 230.146, 230.240, 230.242.

¹¹⁴17 C.F.R. §§ 230.501-230.506.

evaluating the merits and risks of the prospective investment.¹¹⁵ If the offer and sale is made pursuant to Rule 504 then no information is required to be furnished to any investor, whether accredited or not. The SEC will rely on state regulation in this situation. If the offer and sale is made pursuant to either Rule 505 or Rule 506, and only accredited investors are involved, then no information is required to be furnished to the purchasers. However, if non-accredited investors are involved in offers and sales made pursuant to Rules 505 or 506 then all purchasers must be furnished with the required information. In general this requires sufficient information about the issuer, its business, and the securities being offered to permit a reasonably informed purchase decision.¹¹⁶

2. The Small Offering Exemption

Section 3(b)¹¹⁷ of the Securities Act provides for a small offering exemption. Like the private offering exemption, the small offering exemption is governed by a series of rules, designated Regulation A, which must be complied with in order for the issue to be exempt from the registration provisions of the Act.¹¹⁸ However, Regulation A does require that the issuer file an offering statement with the Regional Office of the SEC for the region in which its principal business operations are conducted (See, below).

¹¹⁵C.F.R. § 230.502(b).

¹¹⁶17 C.F.R. § 230.502(b).

¹¹⁷15 U.S.C.S. § 77c(b).

¹¹⁸See, Regulation A, 17 C.F.R. §§ 230.251-230.263.

The small offering exemption generally applies to offers not in excess of \$1,500,000.¹¹⁹ The issuer is required to file an offering statement with the Regional Office of the SEC at least ten days prior to the date on which the initial offering or sale of the securities is to be made.¹²⁰ The Regional Office reviews the statement, makes comments, and returns it to the issuer. The issuer must amend (by counsel) the statement so that it complies with the Regional Office's comments before the offering can be made. In addition, an offering circular must be provided to all purchasers to whom the securities are expected to be sold.¹²¹ This too must be reviewed by the Regional office before the offering can be made.

3. The Intrastate Offering Exemption

Section 3(a)(11)¹²² of the Securities Act provides for an intrastate offering exemption. This exemption is governed by Rule 146.¹²³

The intrastate exemption applies only if the securities are both offered and sold exclusively to domiciliaries (not merely residents)¹²⁴ of the state in which the issuer is organized and doing business, and if the proceeds of the offering are going to

¹¹⁹17 C.F.R. § 230.254.

¹²⁰17 C.F.R. § 230.255.

¹²¹17 C.F.R. § 230.256.

¹²²15 U.S.C.S. § 77c(a)(11).

¹²³17 C.F.R. § 230.147.

¹²⁴SEC Release No. 33-4434 (Dec. 6, 1961).

be used exclusively for local purposes within the state.¹²⁵ The issuer is deemed a resident of the state in which:

- 1) it is incorporated or organized; and
- 2) its principal office is located.¹²⁶

The issuer is deemed doing business within the state if:

- 1) at least 80% of its gross revenues (including subsidiaries) for specified periods (depending on when the first offer is made) was derived from the operation of business or property located in, or from the rendering of services within, the state;
- 2) at least 80% of the net proceeds from sales pursuant to the exemption is used in connection with the operation of a business or property, the purchase of property located in, or the rendering of services within the state;
- 3) at least 80% of the assets (including subsidiaries) is located within the state; and
- 4) the issuer's principal office is located within the state.¹²⁷

Also, during the offering period and for nine months from the last sale by the issuer, resales by any person can be made only to persons who are residents within the state.¹²⁸

Finally, it should be noted that one offer to one nondomiciliary of the state destroys the entire exemption.¹²⁹ This applies to resales also.¹³⁰

¹²⁵17 C.F.R. § 230.147.

¹²⁶17 C.F.R. § 230.147(c)(1).

¹²⁷17 C.F.R. § 230.147(c)(2).

¹²⁸17 C.F.R. § 230.147(f).

¹²⁹Armstrong Jones & Co. v. SEC, 421 F. 2d 359 (6th Cir. 1970).

¹³⁰SEC Release No. 33-4434 (Dec. 6, 1961).

VII. Tax-Exempt Financing

A. General Considerations

Tax-exempt financing refers to financing provided with funds borrowed by state or local governments. Under § 103 of the Internal Revenue Code, interest on obligations issued by a state or political subdivision is generally exempt from federal income tax. Because of this exemption, lenders, the purchasers of state and municipal bonds, are willing to lend money to state and local governments at a reduced rate of interest. For example, to many high income bracket taxpayers, tax-exempt bonds paying 8% interest are as attractive an investment as other taxable bonds paying 16% interest because the interest on the tax-exempt bonds will not be includable in their gross income. This spread of interest rates provides a developer utilizing tax-exempt bonds a substantial savings in capital costs over comparable financing through taxable debt. Depending on the size of the facility, the difference may amount to millions of dollars over the life of the project. Thus, the potential savings in capital costs by use of tax-exempt financing might well determine the feasibility of a particular hydroelectric project.

There are few restrictions on the use of tax-exempt financing for most government projects which are financed and operated by governmental units. However, the interest on bonds issued to finance privately developed SSH facilities will only be tax-exempt if the requirements of § 103 of the Code are satisfied.

Tax-exempt bonds are usually issued through state or local Industrial Development Authorities (IDA), or their equivalents. These bonds are usually referred to as Industrial Development

Bonds (IDB). It should be noted that the mere fact that an SSH project is able to qualify for tax-exempt financing through an IDA does not mean that source of financing should be elected. For example, the 11% Energy Tax Credit is not available to that portion of the project which is financed by tax-exempt debt.¹ In addition, property financed by use of tax-exempt industrial development bonds must use straight-line depreciation over its ACRS recovery period rather than its ACRS schedule.² Also, the investment tax credit may not be available under the financing structure required by some state statutes. Of course, the developer should consider the extent to which the tax benefits accruing to his project can actually be utilized either internally or by a flow-through to individuals in an appropriate federal income tax bracket. Thus, once a developer determines that his project is eligible for tax-exempt debt, he should compute alternative cash flow analyses to determine the relative merits of the combination of tax-exempt financing with restricted energy tax credits and modified ACRS schedule and the use of taxable debt with full availability of the regular investment tax credit, the special energy tax credits, and the depreciation deduction using the appropriate ACRS schedule (discounted, of course, by an inability to fully utilize these tax benefits).³

¹See, Special Concerns: Limitation of Energy Tax Credit and Depreciation Deduction, supra; 26 U.S.C. § 48(l)(11)(C).

²Id.; 26 U.S.C. § 168(f)(12).

³See, The Financing of Private Small Scale Hydroelectric Projects, p. 87 to 90 for general assistance in this analysis, supra.

The fact that a project can legally qualify for tax-exempt financing through an IDA does not guarantee that it can be financed in this way. Many of the industrial projects which are financed with tax-exempt bonds are additionally secured with the general credit of the private company (it is not uncommon for such projects to be undertaken by well-established, highly solvent concerns) and a lien on the property being financed. An SSH facility may not be able to provide such security. This may mean that it will be difficult to finance SSH projects without generous debt coverage ratios or strong additional security via this method.

B. State Law Considerations

In order for a private developer of a hydroelectric facility to be able to obtain access to tax-exempt financing, there must be an authorized governmental entity with the interest and specific authority to enter into such an arrangement. Most states have established such authorities by statute. They may be a state Industrial Development Authority and/or similar authorities of the various political subdivisions of the state (e.g., Municipal Development Corporations). A variety of such industrial development authorities exists from state to state (or even within one state) and each authority's ability to enter into an IDB financing arrangement is limited by the state enabling legislation and the respective state constitution.

Generally, the legislation creating Industrial Development Authorities was enacted for the purpose of actively promoting, attracting, encouraging, and developing economically sound commerce and industry to prevent unemployment and economic

deterioration. These IDAs are public corporations vested with the power to acquire real property by purchase, gift, grant, lease, or condemnation and also to enter into contracts to borrow money and issue bonds to assist ventures falling within the statutory definition of a "qualifying project." Because bonds issued by an IDA are issued on behalf of a particular subdivision, they may qualify for tax-exempt treatment, provided that all IRS requirements for such status are met. These requirements will be discussed at length later in this section.

Depending on the particular jurisdiction, an IDA, as a government entity, will not be subject to property taxation or assessments on the real estate it owns. However, some jurisdictions require that the facility pay the respective state, municipality, or subdivision a percentage of its revenues after a specified grace period. Some financing structures may enable private developers to take advantage of this exemption and avoid the costs of property taxation for the financing period.

Typically there are three parties involved in the IDB transaction: the private developer who wants to develop or retrofit a hydroelectric facility; a bank or lending institution willing to provide the necessary funds; and the Industrial Development Authority that will issue the tax exempt Industrial Development Bonds to finance the project. In many cases, the IDA may first acquire title to the property of the development site. The IDA then issues bonds to finance the project to be constructed at the site. The Industrial Development Bonds (tax exempt if they meet certain requirements under Code § 103 (b)) issued by the IDA are purchased by a bank or lending institution. Frequently, the lender holds a mortgage on the developed property. Proceeds from

the bond issue are then disbursed to construct the facility. The IDA and the developer would then enter into a lease agreement, the term of which coincides with the length of the bond issue. Rental payments made by the developer (derived, for example, from the sale of the power generated at the facility) are for an amount necessary to amortize the bonds and pay interest. These rental payments are used by the IDA to retire the bonds. Upon retirement of the bonds at the end of the lease, the developer may acquire title to the facility for a nominal consideration. For the developer, the entire transaction is similar to an installment purchase of the facility.

The above scenario is only descriptive of one arrangement. Many variations may be possible or necessary depending upon the constitutional and statutory environment surrounding the involved IDA. Developers and associated counsel should thoroughly investigate the controlling laws.

Constitutional roadblocks may also arise. For example, some state constitutions have debt limits for public entities, including IDAs. Others may forbid any government expenditure or activity which has the direct (or maybe even indirect) effect of conferring benefits upon private persons.

The enabling legislation for the IDA may also pose problems. Generally, state statutes only permit the use of IDA financing for specific projects; the development of hydroelectric facilities may not qualify. Lease arrangements with conveyance of title for nominal consideration at the end of the lease term may not be permitted under the enabling legislation. In this instance, the avoidance of property tax assessment may be impossible. Property tax avoidance may also be rendered impossible by statutes which

treat IDA lessees as property owners for local tax purposes. In addition, the financing scheme must be carefully crafted to comply with the requirements of Code § 103(b) in order to insure tax-exempt status for bonds issued to finance the project.

C. Federal Income Tax Law Requirements For Tax-Exempt Issues In General

Internal Revenue Code § 103(a) generally provides that interest paid on the obligations of a state, territory, a possession of the United States, or a political subdivision of these governments is exempt from federal income tax. Obligations issued by or on behalf of a governmental unit (i.e., a state, territory, or political subdivision) by a constituted authority empowered to issue the obligations are considered to be the obligations of the governmental unit and thus, interest paid on these obligations will be tax exempt also. However, tax-exempt status is not available if the obligations are classified as Industrial Development Bonds.⁴

A political subdivision is defined as any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign powers of the unit.⁵ Thus, in order to qualify as a political subdivision, an entity which is not a municipal corporation must have been delegated the right to exercise sovereign powers. Sovereign powers are generally considered the power to tax, the power to condemn and take by eminent domain, and

⁴26 U.S.C. § 103(b).

⁵26 C.F.R. § 1.103-1(b).

the police power. The determination of whether an entity's delegated powers are substantially sufficient is a question of fact which is decided by the IRS on a case-by-case basis examining the following factors:

- 1) the presence or absence of the specific sovereign powers;
- 2) the public purpose of the entity; and
- 3) the extent to which it is controlled by a governmental unit.⁶

Because of the case-by-case approach used by the IRS, project developers should be careful to confirm that the entity with which they are dealing qualifies as a political subdivision.

2. Industrial Development Bonds: Code § 103(b) Definitions

Although some municipal development may be financed by government obligations which are per se tax exempt, most private development financed by Industrial Development Authorities will be considered Industrial Development Bonds (IDBs) by the Internal Revenue Service, and hence, not tax exempt unless the requirements of an exemption under Code § 103(b) are satisfied. State or municipal bonds will be considered IDBs if:

- 1) either all or a major portion (more than 25%) of the proceeds are to be used directly or indirectly in any trade or business of a non-exempt private person; and
- 2) the payment of the bond principal and interest is, in whole or in part (more than 25%):
 - a) secured by an interest in property used in a trade or business of a non-exempt person;

⁶Rev. Rul. 77-165, 1977-1 C.B. 21; Rev. Rul. 77-164, 1977-1 C.B. 20; Rev. Rul. 73-563, 1973-2 C.B. 24.

- b) secured by any interest in the payments of property used in the trade or business of a non-exempt person, or;
- c) derived from the payments of property used in the trade or business of a non-exempt person.⁷

The Treasury Regulations state that the use of more than 25% of the proceeds of a bond issue in the trade or business of a non-exempt person constitutes the use of a major portion of the proceeds in such manner.⁸ This is referred to as the "trade or business" test. If more than 25% of the proceeds of a bond issue is used in the trade or business of a non-exempt person, the trade or business test is satisfied.

The Regulations also prescribe a "security interest" test. Under this test, if more than 25% of the payment of the bond principal and interest are secured by an interest in or derived from payments of property used in the trade or business of a non-exempt person the bond is considered secured by a non-exempt person. The nature of the security interest and the source of the payment for an obligation may be determined from the terms of the bond indenture itself, or on the basis of any underlying legal or practical arrangement. The property or money which is the security or the source of payments for the obligation need not have been acquired from the proceeds of the bond issue. The fact

⁷26 U.S.C. § 103(b)(2); 26 C.F.R. § 1.103-7(b)(1).

⁸26 C.F.R. § 1.103-7(b)(3).

that the bond issue may also be secured by the full faith and credit of a government unit does not prevent a bond from being classified as an IDB.⁹

A non-exempt person is any person or business entity, such as a private corporation or an investor-owned utility. A state or local government unit is an exempt person. It should be noted that the federal government is a non-exempt person with respect to obligations issued or authorized after 1972.¹⁰

Both tests must be satisfied in order for the bonds to be classified as IDBs. In the typical private SSH development scenario, both the security interest and trade or business tests will be satisfied. The developer will be a non-exempt person, the proceeds of the issuance will be used to develop a facility used in the developer's business of selling electrical power, and the bond repayment will be derived from revenues received from the developer's hydroelectric generating facility. Thus, the bonds issued by the IDA to finance the facility would be considered IDBs.

D. Section 103(b) Exemptions

As stated previously, the general rule under Code § 103 states that interest on IDBs is not exempt from federal income tax unless the bonds fall within the scope of certain narrowly defined exceptions.¹¹ There are three exemptions potentially available for the private developer of an SSH facility and one of interest to public developers. These exemptions are:

⁹26 C.F.R. § 1.103-7(b)(4).

¹⁰26 C.F.R. § 1.103-7(b)(3).

¹¹26 U.S.C. § 103(b)(1).

- 1) The small issue exemption;¹²
- 2) The local furnishing of electricity exemption;¹³ and
- 3) The qualified hydroelectric generating facilities exemption.¹⁴

It should be noted here that, under each exemption, tax-exempt status will be lost for the period of time that the bonds are held by a substantial user of the SSH facility or by a related person of such user.¹⁵ A substantial user includes any non-exempt person who regularly uses a part of the facility in his trade or business.¹⁶ A non-exempt person will be considered a substantial user of a facility if:

- 1) The gross revenue derived by the user with respect to the facility is more than 5% of the total revenue derived by all users of the facility;
- 2) The amount of the area of the facility occupied by the user is more than 5% of the entire usable area of the facility; or
- 3) The facility, or any part thereof, is constructed, reconstructed, or acquired specifically for a non-exempt person.¹⁷

Substantial users may also include a non-exempt person who has a contractual or preemptive right to the exclusive use of the property, or a portion of the property, of the facility; a lessee

¹²26 U.S.C. § 103(b)(6).

¹³26 U.S.C. § 103(b)(4)(E).

¹⁴26 U.S.C. § 103(b)(4)(H).

¹⁵26 C.F.R. § 1.103-11(a).

¹⁶26 C.F.R. § 1.103-11(b).

¹⁷Id.

or sublessee of all or any portion of the facility; or a licensee or similar person whose use is regular and is not merely a casual, infrequent, or sporadic use of the facility.¹⁸

1. The Small Issue Exemption

The small issue exemption is a general term that actually embraces two types of exemptions: (1) an exemption for bond issues not exceeding \$1,000,000, and (2) the special election that exempts bond issues not exceeding \$10,000,000. In both instances, the bond proceeds may be used for the development of a privately owned hydroelectric generating facility. The Code does somewhat limit the use of the proceeds from a \$1 million limit issue and, to an even greater extent, from a \$10 million special election issue.¹⁹ The issuing entity may choose either form of the exemption. Since the guidelines for the \$10 million exemption are build upon those of the \$1 million exemption, the latter will be discussed first.

a. The \$1,000,000 Small Issue

The \$1 million small issue exemption applies to Industrial Development Bonds which are part of an issue with an aggregate authorized face value of \$1,000,000 or less.²⁰ In addition, substantially all of the proceeds of the issue must be used for either of the following qualified purposes:

- 1) for the acquisition, construction, reconstruction, or improvement of depreciable land or property; or

¹⁸Id.

¹⁹26 U.S.C. §§ 103(b)(6)(A), 103(b)(6)(D).

²⁰26 U.S.C. § 103(b)(6)(A).

- 2) to redeem all or part of a previously issued exempt small issue.²¹

The phrase "substantially all" has been determined to require that 90% of the proceeds of the issue must be used for one of the two qualified purposes.²² Two rules apply for purposes of the "substantially all" test. First, the proceeds are reduced by amounts which are properly allocable on a pro rata basis between proceeds used for the exempt facility and proceeds used for other purposes. That is, if only a part of the proceeds of an issue is used for a qualifying purpose, the 90% test is only applicable to that portion of the proceeds. Second, amounts used for a qualifying purpose include amounts properly chargeable to the project's capital account, regardless of whether such amounts are actually capitalized.²³ In addition, funds used to provide working capital do not satisfy the 90% test. Hence, no more than 10% of the bond issue can be used as working capital or used for any other non-qualifying purpose, e.g., to finance inventory.

The "substantially all" test should not be much of a problem for hydroelectric development, since most of the expenditures associated with the construction of a new dam or the retrofitting of an old one involve the acquisition, construction, reconstruction, or improvement of property subject to a depreciation allowance. The only major expenses falling outside of this condition would seem to be the purchase of land and some of the costs of any engineering or feasibility studies.

²¹Id.

²²26 C.F.R. §§ 1.103-10(b)(1)(ii), 1.103-8(a)(1)(i).

²³26 C.F.R. § 1.103-8(a)(1)(i); See also, Rev. Rul. 81-23, 1981-1 C.B. 50.

For purposes of the small issue exemption, obligations are part of the same issue if:

- 1) the obligations are sold at the same time;
- 2) the obligations are sold pursuant to a common plan of marketing;
- 3) the obligations are sold at substantially the same rate of interest; and
- 4) a common or pooled security will be used or available to pay debt service for the obligations.²⁴

A common plan of marketing exists where bonds are sold under the same indenture or where the purchase of one bond is conditioned on the purchase of another bond by the same holder. Security for bonds is common or pooled if the same funds are available to, or the same person may, pay debt service on the bonds, or when the bonds are guaranteed by the same person or by a pledge of the same assets.²⁵

The proceeds of a \$1 million exempt small issue may be combined with other financing arrangements to fund projects costing more than \$1 million. The additional capital need not be raised by tax-exempt financing, so long as the security for the separate bond issue is distinguishable. Such a combination of financing is possible under the \$10 million special election exemption only to the extent of the \$10 million aggregate limit. However, the \$1 million small issue exemption is not available with respect to any obligation that is issued after September 3, 1982 and that is part of an issue which includes other obligations

²⁴Prop. Reg. §§ 1.103-10(a), 1.103-7(b)(6).

²⁵Id.; See also, Rev. Rul. 78-159, 1978-1 C.B. 27, Rev. Rul. 77-55, 1977-1 C.B. 18, Rev. Rul. 81-216, 1981-36 IRB 6.

which are exempt from tax under any provision other than the small issue exemption. This rule does not apply to the \$10 million small issue exemption.²⁶

A developer whose project was financed by the proceeds from an exempt small issue may use the proceeds of a second bond issue, up to the \$1 million limit, to redeem that part of the first issue which remains outstanding, and use the remaining proceeds for any allowable expenditures.²⁷ For example, if \$100,000 of a \$700,000 issue has been repaid, leaving \$600,000 outstanding, a developer might use the proceeds of a new \$1 million issuance to retire the remaining \$600,000 debt, and expend the leftover \$400,000 for additional equipment to increase the capacity of the project. (Of course, both issues must satisfy the requirements of an exempt small issue.) The rule here is that the total outstanding indebtedness is permitted to always be \$1 million.²⁸ However, for obligations issued after September 3, 1982, separate lots of obligations which would otherwise be treated as part of a single issue under the above rule will be treated as separate issues, unless the obligations are to be used for facilities located in more than one state or for facilities whose principal user will be the same person or related persons.²⁹

²⁶ 26 U.S.C. § 103(b)(6)(M).

²⁷ 26 U.S.C. § 103(b)(6)(B); 26 C.F.R. § 1.103-10(d)(1).

²⁸ Rev. Rul. 74-380, 1974-2 C.B. 32; 26 C.F.R. § 1.103-10(f) example (4).

²⁹ 26 U.S.C. § 103(b)(6)(K).

It is important to note that for purposes of calculating the \$1 million limit, the IRS will aggregate the outstanding indebtedness of all prior exempt small issues to be utilized by one principal user (or related person) for facilities located within the same municipality or unincorporated portion of one county, including those issued by a different governmental corporation.³⁰ The Service has indicated that a "principal user" of a facility is any person who uses more than 10% of the facility, as measured by the amount paid for the use of the facility. In the case of leased property, the lessor and any lessee who rents more than 10% (by value) of the facility will be treated as principal users.³¹ Related persons include parent and subsidiary corporations, commonly controlled corporations, commonly controlled partnerships, a partnership and its controlling partner, and certain related individuals.³²

Finally, outstanding bonds issued after August 7, 1972 with respect to contiguous or integrated facilities located on both sides of a border between two jurisdictions will be treated as prior issues made in both jurisdictions.³³ Such a situation could arise in a hydroelectric development located on a river which is also a political boundary.

³⁰26 U.S.C. § 103(b)(6)(B).

³¹Private Rulings 7938040, 7817108.

³²26 U.S.C. § 103(b)(6)(C); 26 C.F.R. § 1.103-10(e).

³³26 C.F.R. § 1.103-10(a)(2)(i).

b) The \$10,000,000 Small Issue

The Revenue Act of 1978 allowed the issuance of exempt bonds with a face value of up to \$10 million.³⁴ The rules for this small issue are the same as those for the \$1 million small issue, with two additional requirements.

First, the issuing governmental body must elect to have the \$10 million limit apply.³⁵ This requirement is fulfilled simply by filing a certificate with the IRS. Such an election applies only to the individual issue under consideration, and has no bearing on any prior or subsequent issue.

Second, certain capital expenditures must be deducted from the \$10 million limit in computing the permissible amount of the issue subject to this exemption. Capital expenditures paid or incurred during a six-year period beginning three months before the date of the issue and ending three months after the issue must be included to determine whether the \$10 million limit has been respected.³⁶ If the total of the project costs and the includable capital expenditures exceeds \$10 million, then only \$1 million of the bonds will be tax exempt. Prior issues, as well as prior and subsequent capital expenditures, will be aggregated in this computation.³⁷ It is crucial that the private developer consider this limitation when making business decisions, for some

³⁴P.L. 95-600, § 331 (a).

³⁵26 U.S.C. § 103(b)(6)(D).

³⁶26 U.S.C. § 103(b)(6)(D)(ii).

³⁷Id.

seemingly unrelated business expenditures may be included in the computation of the \$10 million limit, thus jeopardizing the tax-exempt status of the project financing.

The capital expenditures made within the six-year period which are taken into account are defined as those:³⁸

- 1) properly chargeable to a capital account, despite any Code provisions which might permit expensing such capital items;
- 2) made with respect to any facility located within the same political subdivision and principally used by the enterprise for whom the issue was floated, or a related person;
- 3) not financed out of proceeds of prior outstanding issues (this prevents aggregating the same expenditure twice); and
- 4) made by a state or local government which are incurred to benefit the property of the principal user, or a related user.³⁹

The following hypothetical example illustrates the second test above. Municipality A elects to issue a million dollar bond to finance the retrofitting of an old dam, formerly used and now again to be used, to provide power for manufacturer B. Two years after the issue, manufacturer C constructs, at the cost of \$3 million, a warehouse at another site in Municipal A.

Manufacturers B and C are both owned by holding company D. C's expenditure is includable in the calculation of the \$10 million limit because it was made with respect to a facility within the same political subdivision by a person related to the enterprise

³⁸26 C.F.R. §§ 1.103-10(b)(2)(ii) and (iii).

³⁹See, 26 C.F.R. § 1.103-10(f), example 14.

for whom the issue in question was made. Since the total relevant expenditures are now outside the \$10 million calling the interest on the bonds would not be tax-exempt.

Capital expenditures which are not taken into account for the \$10 million exempt small issue are those:⁴⁰

- 1) to replace property destroyed, or damaged by a casualty (up to fair market value);
- 2) required by change in federal or state law;
- 3) necessitated by unforeseen circumstances (up to \$1,000,000);⁴¹ or
- 4) Made by a public utility which is not the principal user of the facility.

A final exception to the capital expenditure computation concerns projects funded under Urban Development Action Grants (UDAGs).⁴² For such projects, the Code permits up to \$10 million in capital expenditures to be excluded from the \$10 million exempt small issue calculation. In essence, this allows up to \$20 million of financing for a hydroelectric project which is linked with a UDAG, provided that no more than \$10 million is in the form of tax-exempt small issue bonds.

⁴⁰26 U.S.C. § 103(b)(6)(E).

⁴¹Examples include strikes, inflation, architectural modifications, erroneous cost estimates, weak soil support for foundations, or increased engineering fees.

⁴²UDAGs are not directly available to private developers. Eligible municipalities, however, may serve as a conduit of grant money to private developers.

2. The Local Furnishing Exemption

The local furnishing of electrical energy exemption may provide another method for a hydroelectric developer to obtain tax-exempt Industrial Development Bond financing.⁴³ Its primary advantage over the small issue exemption is the absence of the amount of issuance and capital expenditure limitations. However, the terms of the exemption are exacting and compliance depends to a degree on factors outside the developer's control. Where the location of the facility makes this exemption potentially available, compliance will be difficult and may require compromising other project objectives.

In order to qualify for this exemption, substantially all of the proceeds of such a bond issue must be used to provide the qualifying exempt facility.⁴⁴ This substantial use requirement is met if 90% or more of the proceeds used are expenditures (paid or incurred) chargeable to the facility's capital account.⁴⁵ The Treasury Regulations define an exempt facility to include any land, building, or other property which is functionally related and subordinate to the facility.⁴⁶ Expenditures for land acquisition (for dam site as well as property needed for impoundment), generation equipment, and transmission lines should all be allowed by this provision.

⁴³26 U.S.C. § 103(b)(4)(E).

⁴⁴Id.

⁴⁵26 C.F.R. § 1.103-8(a)(1)(i).

⁴⁶26 C.F.R. § 1.103-8(a)(3).

Under this Code exemption, options for disposition of the facility's output are limited to a public use requirement.⁴⁷ This requirement will be fulfilled by meeting the following dual test:

- 1) The owner or operator must be obligated by law, ordinance, or regulation to furnish electrical energy to all persons within its service area who desire electrical service; and
- 2) It must be reasonably expected that such a facility will serve or be available to a large segment of the general public in the service area.⁴⁸

This public use test may preclude the local furnishing of electricity exemption for projects which will supply electricity only to a single large "ultimate" user, such as an industrial plant, but should offer no difficulty in sales to a local utility. Such a rule would be consistent with the provisions in the Treasury Regulations that a facility which is made available exclusively to a non-exempt person satisfies the public use test provided that the non-exempt user is a person which directly serves the public.⁴⁹

Ultimately, the definition of facilities for the local furnishing of electric energy will determine a private hydro developer's ability to utilize this exemption. Four criteria must be satisfied to enable such projects to qualify. Qualifying facilities are those which:

⁴⁷26 C.F.R. § 1.103-8(a)(2).

⁴⁸26 C.F.R. § 1.103-8(f)(1)(ii).

⁴⁹26 C.F.R. § 1.103-8(a)(2).

- 1) are subject to the allowance for depreciation provided in Code § 167, or land;
- 2) produce, collect, generate, transmit, store, distribute, or convey electric energy;
- 3) are in the trade or business of furnishing electric energy; and
- 4) are part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than two contiguous counties (or a political equivalent). Such counties need not be located in one state.⁵⁰

This two county limit may pose a hurdle which a hydroelectric project cannot overcome. Since most electric generation projects and their distribution systems are integrated into an electric supply grid, it is difficult to definitively establish that a particular electric supply will not be distributed beyond two particular counties.

To be certain of limited distribution, the local system would have to be completely isolated from the grid. Points of interconnection may have switches maintained in an open (disconnected) position, thereby electrically isolating the local system. Interconnection is permitted for the emergency transfer of electricity,⁵¹ and in emergency situations, the switches may be closed (connected) to permit temporary transfers of power. The Service will apparently approve any such arrangement where there are assurances against any net outflow of power from the system over an extended period of time.⁵²

⁵⁰26 C.F.R. §1.103-8(f)(2)(iii).

⁵¹Id.

⁵²Private Letter Ruling 710126059A.

According to some bond counsel, where the local generation facility capacity is less than the lowest service area demand and flow to the grid is precluded by breakers, the local furnishing requirement will likely be satisfied. A favorable opinion was provided for such a case where the remaining demand was constantly supplied from outside the two county limits and breakers were installed to sever the connection if a reversal in flow occurred.⁵³

One recent Private Letter Ruling appears to permit a project to qualify if it can be established that the power will be fed into a distribution circuit which is located within two contiguous counties and provides service principally to customers within those counties. The service qualified the bond issue even though the distribution circuit was owned by a wholly owned subsidiary of a multi-county utility.⁵⁴ However, in another series of letter rulings, tax-exempt status was denied where the power was fed into a local distribution circuit owned by a multi-county utility.⁵⁵ Although all private letter rulings are decided on an individual basis, with no precedential value attributed to those decided previously, they do provide some insight into current IRS

⁵³Opinion provided to the city of Portland, Oregon, by bond counsel regarding the status of bonds to be issued to finance a city SSH project selling to the grid. No IRS ruling was sought.

⁵⁴Private Letter Rulings 8235074 (1982).

⁵⁵Private Letter Rulings 8041074 (1980), 8051026 (1980), 8242055 (1982), 8224095 (1982).

positions. These recent rulings seem to suggest that the IRS is restricting the local furnishing of electricity definition to facilities selling to distribution systems which only service a two county area.

3. The Qualified Hydroelectric Generating Facilities Exemption

The Crude Oil Windfall Profit Tax Act (COWPTA) created a special class of tax-exempt issue for certain hydroelectric projects. Under the Act, the interest on municipal bonds used to finance qualified hydroelectric generating facilities is exempt from federal income taxation.⁵⁶ Since public ownership of the dam site is a requirement for qualification under this exemption, private developers may not directly utilize this exemption for financing their own projects. Nevertheless, this provision of the Code is mentioned here because it may enable private developers to benefit from selected forms of participation in municipal SSH projects. Such private participation may consist of arrangements that provide for: 1) development/operations contracts with the municipality; or 2) joint ventures. These arrangements will be discussed in detail following a brief summary of the salient provisions of the exemption.

The general requirements are the same as those applying to other exempt activities under Code §103 (b)(4). That is, the exemption only applies to IDBs in which a substantial (90%) portion of the proceeds are applied to the exempt activity and which satisfy the public use test.⁵⁷

⁵⁶26 U.S.C. §103 (b)(4)(H).

⁵⁷26 C.F.R. §§1.103-8(a)(1) and (2).

A qualifying facility consists of "qualified hydroelectric generating property" under Code §48(1)(13) installed at a qualified hydroelectric site which is owned for tax purposes by a government entity as of October 18, 1979 and continuously thereafter for the life of the tax-exempt debt.⁵⁸ No significant enlargement is permitted after this date.⁵⁹ Sites not utilizing any dam or impoundment of water qualify without regard to the date of ownership. Finally, the project must be one with generation capacity of less than 125 MW.⁶⁰

Qualified hydroelectric generating property includes equipment for generating electric energy from water, structures for housing this equipment, fish passageways, and dam rehabilitation property, required by reason of the installation of the electrical generation equipment at the qualified site.⁶¹ Transmission stage equipment is specifically excluded from the definition of qualified property.⁶² Permitted dam rehabilitation includes renovation, reconstruction of breached structures, and, in some instances, complete replacement of entire impoundment structures.⁶³ Qualified property must also be owned, for tax purposes, by a government entity continuously during the life of the tax-exempt debt.

⁵⁸See, 26 U.S.C. §103(b)(3)(B); Energy Tax Credit discussion, supra.

⁵⁹HR Rep. No 817, 96th Cong., 2nd Sess., 149.

⁶⁰26 U.S.C. §48 (1)(13)(B).

⁶¹26 U.S.C. §48 (1)(13)(A).

⁶²Id.

⁶³P.L. 96-223, 96th Cong. 2nd Sess., Conf. Rep. No. 96-817, p. 149 (March 7, 1980).

The amount of tax-exempt proceeds available under this financing method hinges on eligible costs and the size of the generating capacity of the project. Eligible costs are those costs reasonably expected to be the costs to the governmental body attributable to periods after October 18, 1979 and before January 1, 1986.⁶⁴ Thus, if a municipality is a co-developer in a joint venture with a private concern, one-half of the amount for qualified hydroelectric generating property would be eligible costs.

Proceeds applicable towards the eligible costs, are proportionate to the total generating capacity of the facility. Qualified property of projects with capacities of 25 MW or less may be financed by exempt proceeds in total. This proportion decreases to zero as capacity increases to the maximum capacity limit of 125 MW.

The exact amount of the proceeds which may be used is determined by the product of the eligible cost and the "installed capacity fraction."⁶⁵ Installed capacity includes the capacity of electrical generating equipment installed at a qualified site during the three taxable years following the taxable years in which the equipment is placed in service.⁶⁶ The term "installed capacity fraction" means the fraction of which:

- 1) The numerator is 25, reduced by 1 for each megawatt by which the installed capacity exceeds 100 MW; and

⁶⁴26 U.S.C. §103(b)(8)(E). This period is extended to January 1, 1989 for projects with applications docketed by FERC before January 1, 1986.

⁶⁵26 U.S.C. § 103 (b)(8)(C).

⁶⁶26 U.S.C. § 48(1)(13)(E).

- 2) The denominator is the number of megawatts of installed capacity (but not in excess of 100).⁶⁷

The primary beneficiaries of this exemption are municipalities owning hydroelectric sites that desire to finance, construct, and own a hydroelectric project which will sell more than 25% of its energy under contract to a non exempt entity (e.g., an investor-owned utility). As the Service has interpreted the "trade or business" and "security interest" tests for electric generating projects, such projects would not qualify for tax-exempt financing unless they met the conditions of a 103(b) exemption. However, many municipalities will lack the in-house expertise for such an activity.

An opportunity is presented here for a private developer to profit from a contractual relation with the public entity to develop and operate the hydroelectric facility. Compensation by the public entity to the private contractor may be used on a flat fee for specific work performed or on a percentage of the revenues generated. However, the contracts would have to be drafted so that the municipality clearly remains the owner of the facility. If the Service finds that the benefits and burdens of ownership appear to the Service to have shifted from the municipality to the private developer, the tax-exempt status of the IDBs will be in jeopardy.⁶⁸

⁶⁷26 U.S.C. § 103(b)(3)(D).

⁶⁸26 U.S.C. § 103(b)(3)(B)(ii); Rev. Rul. 68-590, 1968-2 C.B. 66.

Small municipal projects (up to 25 MW) enjoy the maximum benefit of this exemption. However, the exemption may also be used for projects up to 125 MW in size, illustrated by the following example. Assume that a municipality enters into a joint venture with a private concern to install an additional 40 MW of generating capacity to an existing dam owned by a municipality, at which 10 MW of generating capacity presently exists. The entire project cost is \$30 million, of which \$20 million is qualified hydroelectric generating property and functionally related and subordinate equipment. As an equal joint venturer, the municipality's share of the cost of the qualified hydroelectric generating facility is \$10 million. The maximum amount of bond proceeds that can be used for qualified property is \$5 million (25 divided by 50 multiplied by \$10 million).

It should be noted that interest on these bonds is not excludable when such bonds are held by a substantial user of the facility, or a related person. Further, these IDBs must be issued in registered form as to principal and interest for the entire life of the obligation, and payment of the principal and interest may not be guaranteed or paid, in whole or in part, directly or indirectly, with funds from any federal, state, or local program whose principal purpose is to encourage the conservation or production of energy.⁶⁹

4. Other Exemptions of Potential Use to a SSH Project

In addition to the exemptions discussed above, there are other categories of exempt facilities which are not specifically designed as incentives for energy production, but which may

⁶⁹26 U.S.C. § 103(h).

nevertheless be a source of financing for portions of certain hydroelectric projects. For example, an exemption for facilities for furnishing water is available with respect to dams built for water supply purposes.⁷⁰ The water from such a dam may also be used for the generation of electricity, provided that substantially all of the water is ultimately used for water supply purposes. Thus, the proceeds of bonds issued under this exemption may be used to finance the dam structure and other civil works associated with a hydroelectric project, although the bond proceeds cannot be used for the electric generating equipment itself unless the requirements of the hydropower exemption or the exemption for the local furnishing of electricity are also satisfied.⁷¹ Because this exemption is only indirectly related to hydroelectric production, a detailed discussion of its provisions is beyond the scope of this manual.

E. TEFRA Changes

The Tax Equity and Fiscal Responsibility Act made several changes in the use of tax-exempt bonds for private activities.⁷² These changes include the following:

1. Information Reporting Requirement. The bonds will not be tax exempt unless the issuer submits to the IRS certain information such as the amount of lendable proceeds, interest

⁷⁰26 U.S.C. § 103(b)(4)(G); 26 C.F.R. § 1.103-8(h).

⁷¹H.R. No. 1800, 95th Cong., 2nd Sess., p. 238; Buck L.E., Goodwin L.M., Alternative Energy, The Federal Role (1982).

⁷²TEFRA, P.L. 97-248, §§ 214-221.

rate, term, and principal user(s) of the issue. This requirement applies to all types of bonds which the developer of a cogeneration project would be able to utilize if issued after December 31, 1982.⁷³

2. Public Approval Requirements. The bonds will not be tax exempt unless (1) reasonable public notice is given and a public hearing is held, and (2) the issuance is approved (after the hearing) either by an elected public official or elected legislative body, or a voter referendum is held at such a time and in the same manner as that for other governmental spending issues under applicable state or local law. With some exceptions, this approval is required for bonds issued after December 31, 1982. Special rules apply as to the form, place, and type of public hearing required depending upon the size and location of the proposed project which will utilize the proceeds of the issue.⁷⁴

3. Restrictions on Depreciation Deductions. To the extent that a project is financed with the proceeds of a tax-exempt bond issuance, it is eligible for depreciation deductions only on a straight-line basis (rather than the accelerated ACRS deductions) over the length of the ACRS recovery period. This limitation in depreciation deductions applies to the first and any subsequent owner(s) who acquires the property while the IDBs (including any refunding issues) are outstanding. The limitation does not apply if construction on any part of the facility begins before July 1, 1982.⁷⁵

⁷³26 U.S.C. § 103(1).

⁷⁴26 U.S.C. § 103(k).

⁷⁵26 U.S.C. § 168(f)(12).

4. Small Issue Exemption. This exception has been repealed for all obligations issued after December 31, 1986. Until that date, the \$1 million small exemption is unavailable for any IDBs issued as part of a single issue along with any other obligations, the interest on which is tax free under any provision other than the small issue exception.⁷⁶

5. Relationship of Bond Maturity to Asset Life. A requirement that bond life (adjusted to take certain factors into account) not exceed expected asset life (similarly adjusted) by more than 20% has been added by TEFRA. The economic life of the assets is to be determined according to the pre-ERTA ADR system (see the discussion of depreciation under Code § 167, supra), although case-by-case determinations are available. If less than 25% of the bond proceeds are used to acquire land, the economic life of the assets financed is determined without regard to the land, but for situations which exceed that limit, the land is assumed to have a life of 50 years.⁷⁷

6. Registration Requirement. IDBs issued after December 31, 1982 must be issued in registered form to retain their tax-exempt status. Bonds are registered for purposes of this requirement if the right to receive the principal and interest on the bonds can only be transferred through a book entry sufficient to identify the ultimate beneficial owner of the obligation.⁷⁸

⁷⁶26 U.S.C. § 103(b)(3)(N).

⁷⁷26 U.S.C. § 103(b)(14).

⁷⁸26 U.S.C. § 103(j).

Numerous sanctions in addition to the loss of the tax exemption are imposed for the failure to comply with the registration requirement. No interest deduction is allowed for interest paid with respect to unregistered obligations issued after December 31, 1982.⁷⁹ In addition, an excise tax is imposed on the issue of any such obligation,⁸⁰ and loss deductions⁸¹ and capital gains⁸² treatment are denied to such obligations.

7. Multiple Lot IDBs. Separate lots of qualifying small issue bonds (not exceeding 1 million or 10 million dollars, depending on use of the § 103(a)(6)(d) election) may be aggregated into a single series without the loss of small issue status. The only exception is for lots used for facilities in more than one state or where the proceeds of the separate lots are used for facilities with the same principal user.⁸²

⁷⁹26 U.S.C. § 163(f).

⁸⁰26 U.S.C. § 4701.

⁸¹26 U.S.C. § 165(j).

⁸²26 U.S.C. § 1232(d).

⁸³26 U.S.C. § 103(b)(6)(k).