Super Tax Exempt Limited Partners in Private Equity Funds: Impact on Solar Projects

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Private equity and venture funds have been critical partners of the solar industry in recent years. Fund managers and the limited partners in their funds have sought broad exposure to solar assets—both utility-scale and commercial and industrial-scale—in search of increasingly attractive returns and the opportunity to participate in sustainable and clean energy projects. Solar developers, therefore, have found a reliable participant in their projects and routinely take on equity and debt financing from private equity and venture funds at all stages of project development, including providing construction financing prior to commercial operations or serving as permanent financing for operational projects.

Certain tax-exempt entities with preferential tax status (Super Tax Exempts) are significant investors in private equity funds, particularly those platforms dedicated to energy and infrastructure asset classes. Super Tax Exempts generally include state and local governmental agencies and instrumentalities, including public pension funds, that usually take the position that they are exempt from federal income tax under Section 115 of the Internal Revenue Code of 1986, as amended (the Code). Based on this position, unlike nongovernmental exempt organizations, such as charitable organizations, certain colleges, and universities, and private foundations, Super Tax Exempts generally are not subject to federal income tax on income from activities unrelated to the organization’s charitable, educational, or other tax-exempt purposes (unrelated taxable business income or UBTI) and therefore are effectively subject to no federal income tax whatsoever.

However, the preferential tax status afforded to Super Tax Exempts can come at a tax cost elsewhere. For example, a Super Tax Exempt’s indirect ownership interest in an operational solar project, including through a limited partner investment in a private equity fund, may have a material adverse impact on the federal income tax benefits that the developer or its other investors (including tax equity investors) receive from the project. Accordingly, solar developers should be cognizant of the tax risks associated with the direct or indirect ownership of solar projects by Super Tax Exempts.

Super Tax Exempt Impact on Solar Project Tax Benefits

A Super Tax Exempt’s indirect ownership in a solar project can cause a portion of the project’s assets to be classified as tax-exempt use property under Code Section 168(h)(6).[1] If this classification applies when a solar project is placed in service or repowered (that is, improved with creditable and depreciable improvements), a percentage of the investment tax credit (ITC) otherwise generated by the project would be disallowed under Code Section 50(a) and a corresponding percentage of the project's tangible property would be recoverable on a straight-line basis under the alternative depreciation system (ADS) rather on an accelerated basis. In this case, the requirement to use ADS would effectively deny 100 percent expensing on the same percentage of the project's tangible property under Code Section 168(k), as in effect following the passage of the Tax Cut and Jobs Act in 2017.[2] If, instead, the tax-exempt use property classification applies within 5 years of the day the solar project is placed in service (or repowered), a portion of the solar project's ITCs would be subject to recapture under Code Section 50(b) and any remaining depreciation in the project's assets would become subject to ADS.

Importantly, these ITC and depreciation limitations would be applicable to the partnership owning the solar project,[3] rather than the Super Tax Exempt alone, and therefore all of the owners of the project, including tax equity investors, would bear the impact of the resulting tax consequences.

A portion of a solar project will be treated as tax-exempt use property if (1) a Super Tax Exempt owns an equity interest in the project through one or more intervening partnerships and (2) any partnership allocation made, directly or indirectly, to the Super Tax-Exempt is not a "qualified allocation." In order to be a qualified allocation, an allocation must be consistent with the Super Tax Exempt being allocated, directly or indirectly, the same distributive share of each item of income, gain, loss, deduction, credit, and basis of the project partnership during the entire period of the Super Tax-Exempt's investment, and such allocation must have substantial economic effect within the meaning of Code Section 704(b)(2). If a Super Tax Exempt is deemed to receive non-qualified allocations, the portion of the project treated as tax-exempt use property generally will equal the highest percentage of the project partnership's income or gain that may be allocated, directly or indirectly, to the Super Tax Exempt.[4]

For purposes of these rules, if Super Tax Exempts own more than 50 percent (by value) of the stock of a corporation, the corporation (referred to as a tax-exempt controlled entity) will be treated as a Super Tax Exempt.

The application of these rules generally requires a Super Tax Exempt to receive, directly or indirectly through intervening partnerships, a static, pro rata percentage of all allocations attributable to the project for the entirety of its investment. Such a pro rata arrangement is highly unlikely to be found in private equity funds, which typically are structured in partnership form and provide a non-pro rata share of the fund's income and gains (often referred to as a carry) to the sponsor in consideration of the sponsor's management services to the fund. As a result, because the typical fund's allocations are non-qualified, a Super Tax Exempt investing in a solar project through a private equity fund would likely cause the project to be classified as tax-exempt use property to the extent of the Super Tax Exempt's highest possible percentage of the project's income or gain allocation, which should equal, at least, the Super Tax Exempt's percentage of capital contributed to the project.

Strict Limitations and Limited Opportunities

The practical implication of Code Section 168(h)(6) is that a Super Tax Exempt generally cannot be a limited partner in a private equity fund that invests in operational solar projects, either by direct investment or by funding a solar developer that retains an equity stake in its projects. Otherwise, the adverse tax consequences described above may apply and a project's anticipated tax benefits may be significantly reduced.

No project stakeholder has more to lose under Code Section 168(h)(6) than a tax equity investor in a newly operational or repowered project. The presence of a Super Tax Exempt investor in the ownership chain could materially reduce the tax benefits offered by the project, which represent a key element of the tax equity investor's after-tax return. However, tax equity investors typically are well-acquainted with this risk, given the high cost of inadvertent Super Tax Exempt ownership, and will raise the issue while performing due diligence on the solar developer and its partners or in the course of structuring and negotiating the project's capital stack (including, for instance, by requesting representations that the project's ownership chain does not include Super Tax Exempts or that the project does not otherwise constitute tax-exempt use property). A developer that constructs, finances, and operates solar projects on its own balance sheet should take extra care to perform similar due diligence on its own investors, particularly private equity investors, to ensure that any upstream Super Tax Exempt is identified prior to a project being placed in service or repowered.

A Super Tax Exempt may, under narrow circumstances, retain equity exposure to an operational solar project without giving rise to adverse tax consequences. Code Section 168(h)(6) provides a path. A Super Tax Exempt may hold its fund investment through a wholly-owned corporate subsidiary (often referred to as a blocker) and make a special cleansing election under Code Section 168(h)(6)(F) to permit the blocker to escape classification as a tax-exempt controlled entity. This structure comes with a high tax cost, however, because the Super Tax Exempt would be required to bear the additional corporate income tax payable by the blocker and, on account of the cleansing election, report any gain from the sale of blocker stock, or dividends or interest received from the blocker, as UBTI.

A Super Tax Exempt can avoid relying on the cleansing election by making its fund investment through a corporate blocker that is owned 50 percent or more (by value) by non-Super Tax Exempts, including non-U.S. investors. Super Tax Exempts may find opportunities to utilize this structure where the fund is anticipating non-U.S. investors that would require a blocker to prevent exposure to U.S. business income (effectively connected income or ECI). This solution has its shortcoming as well. As noted above, the blocker would result in the imposition of corporate income tax on the Super Tax Exempt's investment in the project and, in addition, the Super Tax Exempt would be required to take a non-controlling interest in the blocker opposite foreign investors that likely have different investment profiles than the Super Tax Exempt.

Finally, a private equity fund with Super Tax Exempt ownership could cause each limited partner to receive a static, pro rata share of each item of income, gain, loss, deduction, credit, and basis from the portfolio level, thereby causing all fund allocations to be qualified allocations. To accomplish this goal, the sponsor typically receives its carry as a fee instead of a non-pro rata allocation of the fund's income and gain. If executed properly, this structure may permit one or more Super Tax Exempts to retain economic exposure to operational solar projects through the fund without causing the project assets to be treated as tax-exempt use property. This solution would come at a tax cost to the sponsor, however, because the sponsor's carry would be subject to ordinary income tax rates without any opportunity for reduced capital gains rates.[5]

Indeed, Super Tax Exempts may, and often do, seek exposure to solar developers that sell early-stage projects to other developers prior to full notice to proceed. These early-stage projects have not been placed in service for federal income tax purposes and therefore are not yet eligible for ITCs or accelerated depreciation. Super Tax-Exempt ownership at this stage therefore should have no impact on the project's eventual capacity to generate ITCs and accelerated depreciation. Extra care should give given, however, to ensure that an early-stage development platform does not seek to finance, construct, and place one of its own projects into service if Super Tax Exempts continue to hold an indirect interest in its projects without first considering the Code Section 168(h)(6) risk.

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1. Code Section 168(h)(1) limits the availability of certain tax benefits in the case of depreciable property leased by a taxable entity to a tax-exempt entity. Code Section 168(h)(6) extends these limitations to depreciable property owned by tax-exempt entities indirectly through one or more partnerships. Both rules include an exception for property used in a trade or business that gives rise to UBTI in the hands of the tax-exempt entity or entities.

2. Under current law, 100 percent expensing under Code Section 168(k) will be available for tangible property placed in service in 2021 and 2022, followed by a staged phase out: 80 percent for property placed in service in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026, and 0 percent in 2027 and forward.

3. The term “partnership” includes partnerships formed under state law and other juridical entities classified as partnerships for federal income tax purposes, including limited liability companies that have not elected corporate tax classification.

4. Allocations required to be made under Code Section 704(c) are not taken into account in determining whether an allocation is a qualified allocation or whether a portion of a solar project is tax-exempt use property.

5. A sponsor’s carry typically is structured as a non-pro rata allocation of the fund’s profits and, if the fund’s profits are comprised of long-term capital gains in the hands of the fund, this character (and the opportunity for reduced rates of taxation) generally will pass through to the sponsor.

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