

SUNNY DISPOSITIONS

Modernizing Investment Tax Credit Recapture Rules for Solar Energy Project Finance After The Stimulus

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Disclaimer

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Introduction

The deadline for “commence construction” applications for the 1603 Treasury Program is October, 1, 2012, after which the U.S. Treasury will no longer accept new applications for businesses to receive grants in lieu of the Section 48 Investment Tax Credit (“ITC”) for clean energy projects. The program technically expired on January 1, 2012, but one industry estimation suggests between \$3.5 billion and \$4.5 billion in 1603 awards will be issued in 2012 alone due to the availability of a 5% ‘safe harbor’ test, explored further later in this paper.¹ Assuming a grant will be claimed in lieu of a 30% credit for the majority of projects, this range suggests that between \$11.67 billion and \$15 billion in 1603-eligible energy property will be placed in service in 2012 alone. GTM Research estimates that solar companies safe harbored “at least one gigawatt”² of solar photovoltaic (“PV”) modules, enough generating capacity to power approximately 169,000 homes in the United States.³

Due to the front-loaded nature of safe-harbored project pipelines, interviews with numerous transactional attorneys and firms indicate many solar developers will not rely on the ITC to finance projects until the end of 2012 or early 2013.⁴ Developers returning to traditional ITC financing practices will face a relatively illiquid market for solar projects due to onerous recapture rules governing the transferability of projects, which were temporarily rendered moot in 2009 when Congress created the Section 1603

¹ *United States Renewable Energy Attractiveness Indices*, Ernst & Young, 6 (Feb. 2012), [http://www.ey.com/Publication/vwLUAssets/US_Attractiveness_Indices_Issue/\\$FILE/US_Attractiveness_Indices_Issue.pdf](http://www.ey.com/Publication/vwLUAssets/US_Attractiveness_Indices_Issue/$FILE/US_Attractiveness_Indices_Issue.pdf).

² U.S. Solar Market Insight Report Q1 2012 Executive Summary, GTM Research & Solar Energy Industries Association, 6 (June 2012)(hereinafter “SMI Q1 2012”), <http://www.slideshare.net/SEIA/us-solar-market-insight-report-q1-2012>.

³ *What’s In a Megawatt of Solar?*, Solar Energy Industries Association, 3 (May 2012), <http://www.seia.org/policy/solar-technology/photovoltaic-solar-electric/whats-megawatt>.

⁴ Gloria Gonzalez, *US Solar Developers Face Financing Bottleneck*, ENVIRONMENTAL FINANCE, May 2, 2012, <http://www.environmental-finance.com/news/view/2466>.

Treasury Program in the American Recovery and Reinvestment Act (“ARRA”). 2012 is a timely occasion to re-consider the recapture rules applied to solar energy projects. The current commercial solar ITC has only existed for six years, yet the recapture statute governing the credit was written into the Tax Code for a separate tax incentive *50 years* ago this year. In order to advance U.S. energy policy goals today and enhance the effectiveness of existing incentives for solar energy after the Obama Administration’s stimulus, recapture rules governing the Section 48 ITC should be modernized to permit disposition of energy property within the five-year recapture period.

The Section 48 Investment Tax Credit Today and the 1603 Treasury Program

A commercial solar ITC is currently available to businesses that install qualifying solar energy property, providing a dollar-for-dollar credit against federal tax liability in the taxable year in which the property is placed into service.⁵ “Investment tax credits lower the user cost of capital by reducing the effective acquisition cost of a capital asset.”⁶ A general 10% business ITC was previously available but increased to 30% for solar energy property in the Energy Policy Act of 2005.⁷ Congress subsequently revised and extended the 30% credit in 2008, and it is currently set to return to a 10% credit at the end of 2016.⁸ As the primary federal policy incentive for solar energy deployment, the Solar Energy Industries Association (“SEIA”) credits the ITC with “spurr[ing] unprecedented growth in the U.S. solar industry,” specifically doubling installed PV capacity in the first year that the incentive was available and propelling a compound

⁵ I.R.C. § 48 (West 2012).

⁶ STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., BACKGROUND AND PRESENT LAW RELATING TO COST RECOVERY AND DOMESTIC PRODUCTION ACTIVITIES, Feb. 27, 2012, at 68, <https://www.jct.gov/publications.html?func=showdown&id=4401>.

⁷ Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat 594.

⁸ Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat 3765. On January 1, 2017, solar energy property will be eligible for the permanent 10% general business ITC. § 48(a)(2)(A)(ii) (West 2012).

annual growth rate of 76% over the last six years.⁹ The U.S. solar industry placed into service a mere 79 MW of solar PV in 2005¹⁰ but installed a staggering 1,855 MW in 2011.¹¹ SEIA currently projects over 3,000 MW will be installed in 2012 and over 8,000 MW installed in 2016 when the 30% ITC expires under current law.¹²

Beginning on the date that a solar project is placed in service, Section 50 of the Internal Revenue Code requires complete or partial recapture of the tax credit in the first five years of service if the project “is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer.”¹³ “Disposition’ means to transfer or otherwise relinquish ownership of property.”¹⁴ If a taxpayer in a partnership transfers more than 1/3 of its ownership interest in the project, the party’s proportionate share of the ITC will be recaptured.¹⁵ Recapture is not required in three narrow exceptions where property is transferred by reason of death or incident of divorce or by a change in the form of business of the taxpayer.¹⁶ Although the credit is claimed in the year the asset is placed in service, the value of the credit vests 20% each year over the five-year recapture period, which serves as the basis for the amount of recaptured credit if the asset is sold before 100% of the credit fully vests.¹⁷ Rather than amend a previous year’s tax return,

⁹ *Backgrounder: Success of the Section 1603 Treasury Program*, Solar Energy Industries Association, 2 (rev. June 11, 2012)(hereinafter SEIA 1603 Backgrounder),

http://www.seia.org/galleries/pdf/factsheet_Backgrounder_Success_of_1603_Treasury_Program.pdf.

¹⁰ U.S. Solar Market Insight 2010 Year in Review Executive Summary, GTM Research & Solar Energy Industries Association, 2 (March 2011), <http://www.slideshare.net/SEIA/us-solar-market-insight-report-2010>.

¹¹ SMI Q1 2012, *supra* note 2, at 2.

¹² *Id.* at 10.

¹³ I.R.C. § 50 (West 2012).

¹⁴ *Rome I, Ltd. v. Comm’r*, 96 T.C. 697, 704 (1991)(finding nothing “in the statute or legislative history that gives the term ‘disposition’ something other than its plain meaning”).

¹⁵ Treas. Reg. § 1.47–6(a)(2).

¹⁶ § 50(a)(4) (West).

¹⁷ § 50(a)(1)(B) (West). For example, a tax credit of \$30 for a project with an eligible costs basis of \$100 will vest \$6 each year for five years. If the asset is sold or transferred in year three, only \$18 has vested and \$12 in tax credits must be recaptured.

the taxpayer increases his tax liability by the amount of the recaptured credit in the year the recapture event occurs.¹⁸

The Impact of the 2008 Financial Crisis

A developer will often seek to monetize tax benefits by recruiting a third party with sufficient tax liabilities to fund a portion of the project's initial construction costs through a capital contribution, or 'tax equity' investment, in exchange for a share of the project's cash flow and nearly all of the tax benefits.¹⁹ "Many renewable energy developers are smaller companies that operate with narrow profit margins and lower tax liabilities and, consequently, may be unable to use the tax credits immediately."²⁰ Only large financial institutions with significant, predictable tax liabilities historically invested in renewable energy projects.²¹ But the financial crisis of 2008 shook the renewable energy sector to its core, as mounting losses on Wall Street ate away at companies' profits, thereby reducing their tax liabilities and need for credits and/or deductions.²² Some financial firms permanently exited the market altogether, including AIG, Lehman Brothers, Merrill Lynch, Wachovia, and ABN Amro.²³ Based on industry surveys, the approximately 20 institutions actively investing in renewable energy in 2007 fell to

¹⁸ § 50(a)(1)(A) (West).

¹⁹ Keith Martin, *Guide to Federal Tax Incentives for Solar Energy*, Ver. 6.0, Solar Energy Industries Association, 7 (April 5, 2012); Scott Fisher, Steve Corneli & Steve Taub, *Tax Credits, Tax Equity and Alternatives To Spur Clean Energy Financing*, U.S. Partnership for Renewable Energy Finance, 1 (September 2011), <http://uspref.org/wp-content/uploads/2011/09/Tax-Credits-Tax-Equity-for-Clean-Energy-Financing.pdf>.

²⁰ Robbins, Sinae Han. *Future of Tax Equity Financing for Renewables*, TAX NOTES TODAY (April 1, 2010).

²¹ See SEIA 1603 Backgrounder, *supra* note 9, at 2.

²² Paul Schwabe, Karlynn Cory & James Newcomb, *Renewable Energy Project Financing: Impacts of the Financial Crisis and Federal Legislation*, National Renewable Energy Laboratory, 3 (July 2009), <http://www.nrel.gov/docs/fy09osti/44930.pdf>.

²³ *Renewable Energy Project Finance in the U.S.: 2010-2013 Overview and Future Outlook*, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. and GTM Research, Figure 3-5 (January 2012), <http://www.mintz.com/media/pnc/5/media.2775.pdf>.

roughly eight in 2008 and “shrunk” to between four and six by early 2009.²⁴ “The associated decline in overall tax equity financing provided to renewable energy projects was equally dramatic, falling from a record \$6.1 billion in 2007 to \$3.4 billion in 2008 and \$1.2 billion in 2009.”²⁵

Congress created the 1603 Treasury Program in 2009 in the American Recovery and Reinvestment Act to fill the void and permit a taxpayer to claim a cash grant from the U.S. Treasury in lieu of the ITC that the taxpayer would otherwise claim.²⁶ ARRA Section 1603(f) required the U.S. Treasury...

“...to apply rules *similar to the rules of section 50*. In applying such rules, if the property is disposed of, or otherwise ceases to be specified energy property, the Secretary of the Treasury shall provide for the recapture of the appropriate percentage of the grant amount *in such manner as the Secretary of the Treasury determines appropriate*” (emphasis added).²⁷

“Accordingly, based upon this statutory provision and legislative history, Treasury could have adopted the approach that all of the constraints and parameters applicable to the IRC [S]ection 48 ITC are to be incorporated into [1603]...with respect to a recapture of the ITC.”²⁸ Instead, Treasury’s published guidance only calls for recapture “[i]f the applicant disposes of the property to a disqualified person or the property ceases to qualify as a specified energy property within five years from the date the property is placed in

²⁴ *Id.*; Schwabe, *supra* note 22, at 4.

²⁵ See SEIA 1603 Backgrounder, *supra* note 9, at 2. http://www.seia.org/galleries/pdf/factsheet_Backgrounder_Success_of_1603_Treasury_Program.pdf; See also *ITC Cash Grant Market Observations*, U.S. Partnership for Renewable Energy Finance, 4 (Dec. 2011), <http://uspref.org/wp-content/uploads/2011/07/US-PREF-ITC-Grant-Market-Observations-12.1.2011-v2.pdf>.

²⁶ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1603, 123 Stat. 115 [hereinafter ARRA].

²⁷ ARRA § 1603(f).

²⁸ John C. Lorentzen et al., *The American Recovery And Reinvestment Act Of 2009: Payments For Specified Energy Property In Lieu Of Tax Credits For Renewable And Alternative Projects*, Winston & Strawn LLP, 2 (July 2009), http://www.winston.com/siteFiles/Publications/Grant_in_Lieu_Guidance.pdf.

service.”²⁹ In short, the 1603 guidance only contemplates “three narrow circumstances,” specifically, “change in use,” “the project is permanently shut down,” or “the project or a partnership interest is transferred to a [disqualified person].”³⁰ The definition of “disqualified person” is limited to a “federal, state or local government agency or instrumentality, an entity exempted from taxes under section 501(c) of the U.S. tax code, an electric cooperative or an Indian tribe.”³¹ The 1603 guidance states, “Selling or otherwise disposing of the property to an entity other than a disqualified person does not result in recapture provided the property continues to qualify as a specified energy property and provided the purchaser of the property agrees to be jointly liable with the applicant for any recapture.”³²

The primary carryover from Section 50 recapture rules is the requirement that 20% of the grant value vests each year over the five-year recapture period.³³ Transaction attorneys quickly noted that Treasury did not adopt a “strict incorporation approach” in designing the recapture rules and described the provision as “the most significant and helpful to project developers going forward.”³⁴ Tax experts noted that Treasury faced the difficult task of balancing tax precedent and economic necessity in a timely manner.

“After Congress passed ARRA, Treasury had only a few months to structure a grant program that applied the rules of sections 45 and 48 while carrying out the underlying rationale of the act to provide grant money as

²⁹ U.S. TREASURY DEP’T OF THE FISCAL ASSISTANT SEC’Y, PAYMENTS FOR SPECIFIED ENERGY PROPERTY IN LIEU OF TAX CREDITS UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, PROGRAM GUIDANCE, 19 (rev. April 2011)(hereinafter 1603 GUIDANCE), [http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20\(2\)%20clean.pdf](http://www.treasury.gov/initiatives/recovery/Documents/B%20Guidance%203-29-11%20revised%20(2)%20clean.pdf).

³⁰ Keith Martin, John Marciano & Eli Katz, *Treasury Rolls Out Cash Grant Program*, Chadbourne & Parke LLP, 2 (July 2009), <http://www.chadbourne.com/files/Publication/5e9e15bb-df44-41b5-ae10-b9f4ab024f77/Presentation/PublicationAttachment/9322d704-15d6-415c-8672-c64b2ca3403c/CashGrantProgram.pdf>.

³¹ Martin, *Guide to Federal Tax Incentives for Solar Energy*, at 34; 1603 GUIDANCE at 19.

³² *Id.*

³³ *Id.*

³⁴ Lorentzen, *supra* note 28, at 4.

quickly as possible. To accomplish that task, it had to dust off regulations that had not been in use since 1990 and loosen the existing ITC recapture and ineligible investor rules in a manner that promoted investment activity while still applying the overall mandates of those rules.”³⁵

During its initial drafting process, Treasury staff reviewed the recapture rules’ legislative history and gathered feedback from lenders and transaction attorneys on the restrictions associated with the ITC.³⁶ Upon review of the initial 1603 Guidance, one law firm editorialized that, “Treasury...recognized that, even if the original investor disposes of its interest in the project, if the project continues to generate energy in the statutorily favored manner, the public policy goal of investment in a long-term asset has been achieved and recapture is not appropriate. Treasury...is to be commended for its practical approach on this issue.”³⁷

The first grant for a solar system was awarded on September 1, 2009, and as of late July 2012, Treasury awarded \$2.763 billion for 44,052 individual solar systems.³⁸ Calculating from a grant equal to 30% of the eligible cost basis, this amounts to roughly \$6.45 billion in associated private sector investment in solar. Awards for solar projects comprise 3,307 MW of electric generating capacity.³⁹ For some perspective, the U.S. installed 4,436 MW of solar electric generating capacity from 2009 through Q2 2012.⁴⁰

³⁵ Noah Baer, *Does IRS Tax Credit Guidance Apply to the ARRA Grant?*, Tax Notes Today (April 27, 2010).

³⁶ Interview with Keith Martin, Partner, Chadbourne & Parke LLP, in D.C. (May 11, 2012); Interview with Sean Shimamoto, Partner, Skadden, Arps, Slate, Meagher & Flom LLP, in D.C. (May 16, 2012); Martin, *supra* note 30, at 2.

³⁷ Lorentzen, *supra* note 28, at 5.

³⁸ U.S. TREASURY DEP’T OF THE FISCAL ASSISTANT SEC’Y, OVERVIEW AND STATUS UPDATE OF THE §1603 PROGRAM, 2 (rev. July 2012)(hereinafter 1603 STATUS UPDATE), <http://www.treasury.gov/initiatives/recovery/Documents/Status%20overview.pdf>

³⁹ *Id.*

⁴⁰ U.S. Solar Market Insight Report Q2 2012 Executive Summary, GTM Research & Solar Energy Industries Association, 3 (September 2012), <https://www.slideshare.net/SEIA/us-solar-market-insight-report-q2-2012>; SMI Q1 2012, at 2; U.S. Solar Market Insight Report 2011 Year in Review, Executive

Solar industry representatives praise the 1603 Treasury Program as “one of the most successful policies ever enacted to deploy renewable energy”⁴¹ and “critical”⁴² to the solar industry’s growth in the aftermath of the economic crisis of 2008. Vice President Joe Biden offered the Obama Administration’s full support for its stimulus program, calling on Congress in 2010 to extend the “hugely successful” program.⁴³

Projects seeking to qualify for the 1603 Treasury Program must have commenced construction in 2009, 2010, or 2011.⁴⁴ In order to have commenced construction, a company can satisfy one of two tests.⁴⁵ The developer can begin “physical work of a significant nature,” which “includes any physical work on the specified energy property at the site” as well as “physical work that has taken place under a binding written contract for the manufacture, construction, or production of specified energy property for use by the applicant’s facility provided the contract is entered into prior to the work taking place.”⁴⁶

Summary, GTM Research & Solar Energy Industries Association, 2 (March 2012), <http://www.slideshare.net/SEIA/us-solar-market-insight-report>.

⁴¹ Rhone Resch, *Congress: Extend Job-Creating Programs*, Comment to *Should Congress Renew Clean-Energy Tax Credits?*, NATIONAL JOURNAL (Dec. 5, 2011, 6:56 AM), <http://energy.nationaljournal.com/2011/12/should-congress-renew-cleanene.php#2128346>.

⁴² Press Release, Solar Energy Industries Association, President Obama, Bipartisan Champions in Congress Save Jobs for Thousands in U.S. Solar Industry (Dec. 17, 2010), available at http://www.seia.org/cs/news_detail?pressrelease.id=1181.

⁴³ Ben Geman, *Biden Presses Congress on Renewable Grant Program, Tax Credits*, E2 WIRE (Nov. 9, 2010, 8:28 PM), <http://thehill.com/blogs/e2-wire/e2-wire/128515-biden-presses-congress-on-renewable-grant-program-tax-credits>.

⁴⁴ 1603 GUIDANCE at 2.

⁴⁵ *Id.* at 6-7.

⁴⁶ U.S. TREASURY DEP'T OF THE FISCAL ASSISTANT SEC'Y, PAYMENTS FOR SPECIFIED ENERGY PROPERTY IN LIEU OF TAX CREDITS UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, FREQUENTLY ASKED QUESTIONS, BEGUN CONSTRUCTION, Q2 (December 2011)(hereinafter 1603 BEGUN CONSTRUCTION Q&A), <http://www.treasury.gov/initiatives/recovery/Documents/FAQs%20for%20Begun%20Construction%20we b4.pdf>.

Alternatively, the company can satisfy a ‘safe harbor’ if it “pays or incurs 5% or more of the total cost of the specified energy property before the end of 2011.”⁴⁷ Once construction is deemed to have commenced through either test, the company will be eligible to receive a 1603 award if the project is placed in service by the credit termination date, or December 31, 2016, in the case of solar energy property.⁴⁸ This safe harbor accelerated investment in 2011 as developers rushed to place orders for equipment and solar panels prior to December 31, resulting in the aforementioned delayed transition from 1603 to the ITC as developers work through their extended pipelines of 1603-eligible projects.

Characteristics of Energy Finance

Fully understanding the implications of this transition from 1603 back to the ITC requires understanding how a project developer applies available layers of capital to finance a renewable energy project.⁴⁹ Project finance is a model of financing popularized in the 1970s and 1980s for large infrastructure projects, especially in emerging markets.⁵⁰ In the energy sector, it is an attractive alternative to self-financing a project with cash or incurring commercial debt on-balance sheet. “The basic premise of project finance is that lenders loan money for the development of a project solely based on the specific project’s

⁴⁷ 1603 BEGUN CONSTRUCTION Q&A at Q15.

⁴⁸ 1603 GUIDANCE at 5.

⁴⁹ *For Alternative Energy Securitization, Growth Will Require Clear and Consistent Government Policy*, U.S. Structured Credit Roundtables, DLA Piper, 23 (2011), available at http://www.dlapiper.com/files/Publication/c90109ee-32b4-4df3-a0bd-49bf4f979c5e/Presentation/PublicationAttachment/19fe15bf-f12e-4cb2-8ebd-4bfb3d88d05c/SandP_Roundtable_article.pdf. “From the standpoint of a CFO of a renewable energy company, he or she is just trying to stack capital, going from cheapest to most expensive, to cover the full project cost. The entire cost can’t be found in one place.” *Id.*

⁵⁰ Chris Groobey, John Pierce, Michael Faber & Greg Broome, *Project Finance Primer for Renewable Energy and Clean Tech Projects*, Wilson Sonsini Goodrick & Rosati, 1 (August 2010), http://www.wsgr.com/PDFSearch/ctp_guide.pdf. See also E.R. Yescombe, *PRINCIPLES OF PROJECT FINANCE*, (2002); Scott L. Hoffman, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE: A RESOURCE FOR GOVERNMENTS, SPONSORS, LAWYERS, AND PROJECT PARTICIPANTS*, 3rd ed., 2007.

risk and future cash flows.”⁵¹ Loans may take many forms, including “construction loans, term loans, working capital loans, and/or a letter of credit facility.”⁵²

From the perspective of the developer and investors, a “fully leveraged” project financing can “increase dramatically” internal rates of return as well as free up capital for investment in other projects in the pipeline.⁵³ Most financings require a contracted long-term revenue stream that can be secured to ensure loan repayment. In the energy context, a developer will often sign a power purchase agreement (PPA) with a utility or other power offtaker, but cash flows are contracted in other sectors through long-term operating agreements as in toll roads, capacity purchase agreements as in electricity transmission lines, and production sharing agreements as in oil field development.⁵⁴

Recourse vs. Non-recourse Debt

A signature element of project financing is the reliance on non-recourse debt at the project level. The developer, or project ‘sponsor’, will house the project in a special purpose entity, often a limited liability company (“project company”), where the only collateral posted to cover the loan is the project company’s assets. In the event of default⁵⁵, the lender’s claim is limited to the project company’s assets and may not extend further to the assets of the sponsor’s holding company.⁵⁶

In exchange for providing debt with no recourse against the sponsor, the lender will attempt to shift risk to the developer by insisting on a “‘sealed system’ of security

⁵¹ Groobey, *supra* note 50, at 1.

⁵² *Id.* at 9.

⁵³ *Id.* at 3.

⁵⁴ *Id.* at 2.

⁵⁵ “‘Event of Default’ is the legal term for the circumstance that allows project finance lenders to exercise their remedies under the financing documentation, including acceleration of the outstanding debt and foreclosure.” *Id.* at 12. Default will be triggered by non-payment of fees, principal, or interest on the loan, but the scope of the loan agreement will also contemplate many non-payment obligations, including breaches of warranty, non-appealable negative legal judgments, failure to obtain permits, etc. *Id.*

⁵⁶ *Id.* at 1.

arrangements” where “to the fullest extent possible, all project assets and revenues are sealed off from other creditors...to ensure they do not escape the system and jeopardize repayment of the debt.”⁵⁷ In practice, the lenders will require a “comprehensive security package” in which all current and future assets of the project company will be pledged to the lender.⁵⁸ Counterparties with an ownership stake in the project must also pledge their equity interests and sign consents to collateral assignment to “ensure a seamless transition [of the assets] to the lender or subsequent owner” in the event that the lender must foreclose.⁵⁹

A sponsor may also bring in another lender to provide an additional tranche project-level debt that will be secondary to the senior lender. When this ‘subordinated debt’ is introduced, an “inter-creditor agreement will be negotiated...pursuant to which the senior lenders will obtain standard terms of subordination to ensure their senior lien and payment positions vis-à-vis the subordinated lenders and any unsecured creditors in the case of any Event of Default by the Project Company or its bankruptcy or insolvency.”⁶⁰

Tax Equity Financing

Leveraged deals, or deals incorporating project-level debt, were not common in the early days of the solar ITC. Prior to creation of the 1603 Treasury Program, “fewer than 10%” of renewable energy transactions incorporated leverage.⁶¹ Tax equity

⁵⁷ Edward D. Einowski & Katherine A. Roek, *Risk Shifting Major Element in Project Finance for Renewables*, 24 NAT. GAS & ELEC., Oct. 2007, at 1, 5.

⁵⁸ Groobey, *supra* note 50, at 10.

⁵⁹ *Id.* at 5.

⁶⁰ *Id.* at 13.

⁶¹ Keith Martin, *Solar War Stories: From the Financial Front Lines*, PROJECT FINANCE NEWSWIRE, May 2012, at 47, 51, available at http://www.chadbourne.com/files/Publication/33595324-e9f9-4c78-b284-993c23e71709/Presentation/PublicationAttachment/d6849213-1c27-49c4-a263-9a6393d3a2a1/project_finance_nw_may12.pdf.

investors are a routine source of financing through the monetization of federal tax incentives.⁶² Most tax equity transactions are variations of the following three structures.⁶³ In a ‘sale leaseback,’ the developer “sell[s] the project to another company that can use the tax benefits and lease[s] it back.”⁶⁴ In a ‘partnership flip,’ the developer recruits “an institutional equity investor that can use the tax benefits as a partner to own the project... and allocate[s] 99 percent of the tax subsidies to the institutional investor in exchange for the capital to build the project.”⁶⁵ In an ‘inverted pass-through lease,’ the developer “leases the project to a tax equity investor and elects to pass through the commercial tax credit...to the tax equity investor.”⁶⁶

The Six Layers of Capital for Energy Financing

“Financing is the search for lowest cost capital.”⁶⁷ Upon passage of ARRA, renewable energy developers had six layers of capital on which they could potentially rely. From least expensive to most expensive, the six layers were (1) a government grant through the 1603 Treasury Program; (2) government-guaranteed debt through the Department of Energy Loan Guarantee Program; (3) commercial debt; (4) tax equity; (5) subordinated debt; and (6) true equity.⁶⁸

⁶² Michael Mendelsohn, Claire Kreycik, Lori Bird, Paul Schwabe & Karlynn Cory, *The Impact of Financial Structure on the Cost of Solar Energy*, National Renewable Energy Laboratory, 1 (March 2012), <http://www.nrel.gov/docs/fy12osti/53086.pdf>. In addition to the 30% ITC, the value of accelerated depreciation equals approximately 26% of the cost of the project. See Mark Bolinger, *Financing Non-Residential Photovoltaic Projects: Options and Implications*, Lawrence Berkeley National Laboratory, 6 (January 2009), <http://eetd.lbl.gov/ea/ems/reports/lbnl-1410e.pdf>.

⁶³ Martin, *Guide to Federal Tax Incentives for Solar Energy* at 7.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ Martin, *supra* note 61, at 51.

⁶⁸ *Id.*

The Section 1703 Loan Guarantee Program⁶⁹ provides guarantees for commercial loans obtained by the applicant company. In addition, the Section 1705 Loan Guarantee Program⁷⁰ provided similar guarantees but also permitted applicants to borrow directly from the U.S. Treasury Federal Financing Bank at a favorable 37.5 basis points over LIBOR.⁷¹ In both programs, the government guarantee reduces the risk to the lender of non-payment, and results in a lower interest rate. NRG Energy's \$1.2 billion loan guarantee for its California Valley Solar Ranch project reportedly received a 3.5% interest rate.⁷² If the project relied solely on commercial debt from private lenders, NRG executives projected the California Valley Solar Ranch would have faced a 7% interest rate.⁷³ In September 2011, the pre-tax cost of tax equity capital to a developer was approximately 12-13%, in contrast to a historic low of 9% at the peak of investment in 2007, and as high as 15% or more in 2009 at the height of the recession.⁷⁴ As previously discussed, subordinated debt will be more expensive because it is second in line to senior lender and the risk of non-payment is higher.⁷⁵ Project or development equity is normally most expensive of all, because investors are only paid their return after debt and tax

⁶⁹ Energy Policy Act of 2005 § 1703.

⁷⁰ ARRA § 1705.

⁷¹ Brian Eckhouse, *Abengoa Snags \$1.2B Federal Loan*, POWER, FINANCE & RISK, Sept. 12, 2011. LIBOR, the London Interbank Offered Rate, is “the interest rate at which large international banks are willing to lend each other money on a short-term basis,” and serves as a “globally accepted benchmark for interest rates.” Alan Zibel, *Q&A: What is Libor, and How Does it Affect You?*, ASSOCIATED PRESS, Sept. 30, 2008, available at http://seattletimes.nwsourc.com/html/business/technology/2008215959_weblibor30.html.

⁷² Eric Lipton & Clifford Krauss, *A Gold Rush of Subsidies in Clean Energy Search*, N.Y. TIMES, November 11, 2011, at A1.

⁷³ *Id.*

⁷⁴ Fisher, *supra* note 20, at 2-3; U.S. Partnership for Renewable Energy Finance, *supra* note 25, at 3 (estimating a 11-12% pre-tax cost of tax equity financing in December 2011).

⁷⁵ Groobey, *supra* note 50, at 13.

equity obligations are satisfied.⁷⁶ In late 2011, development equity investors required an estimated 8-15% return.⁷⁷

The two lowest-cost options of the 1603 Treasury Program and federal loan guarantees are no longer available, which leaves commercial debt and equity from the private sector to fill the gap. Optimizing the capital structure is increasingly important for the most cost-competitive financing of renewable energy projects.⁷⁸ According to a recent analysis of financing structures by the National Renewable Energy Laboratory (“NREL”), the ability to add project-level debt can significantly decrease the levelized cost of energy (“LCOE”) for solar projects.⁷⁹ In the case of a photovoltaic (“PV”) plant, the LCOE dropped 20-50% versus equity-only financing. For a Concentrating Solar Power (“CSP”) plant, the LCOE dropped 29-35% versus equity-only financing.⁸⁰

Negative Impacts of Recapture Rule for Early Dispositions

Illiquidity Impedes the Development of a Secondary Market for Solar Assets

Adding debt to a transaction, however, is easier said than done. Prior to creation of 1603, developers, lenders, and investors had yet to establish market terms to efficiently address concerns over recapture risk, and a “period of sorting out” is expected to begin in

⁷⁶ Paul Schwabe, *Peeling the Onion: The Layers of Capital Structures*, NREL Project Finance Blog (October 25, 2010, 7:19 AM), <https://financere.nrel.gov/finance/content/peeling-onion-layers-capital-structures>.

⁷⁷ Mintz Levin, *supra* note 23, at 11.

⁷⁸ Gloria Gonzalez, *Focus on ‘Soft Costs’ could Help US Solar Compete without Federal Subsidy – Developers*, ENVIRONMENTAL FINANCE, June 25, 2012, <http://www.environmental-finance.com/news/view/2587>.

⁷⁹ LCOE is “an economic assessment of the cost of the energy-generating system including all the costs over its lifetime: initial investment, operations and maintenance, cost of fuel, cost of capital.” *Simple Levelized Cost of Energy (LCOE) Calculator Documentation*, National Renewable Energy Laboratory, http://www.nrel.gov/analysis/lcoe_documentation.html. It is the price, expressed in a net present value of cents per kilowatt-hour, “at which energy must be sold to break even over the lifetime of the technology.” *Id.*

⁸⁰ Mendelsohn, *supra* note 62, at 21.

late 2012 and early 2013.⁸¹ At the outset, “many investors have little interest in assets that cannot be sold at short notice for net asset value.”⁸² Recapture “headaches”⁸³ from solar “credits are particularly vexing for liquidity-seekers.”⁸⁴ “There is option value in being able to sell an asset whenever you want. Frequently this is called the liquidity premium, where a more liquid property has more value.”⁸⁵ Moreover, the illiquid ITC prohibits the transfer of projects, which “limits the fungibility that is necessary for the development of a viable secondary market.”⁸⁶ For example, industry analysts predicted the sunset of stimulus-era programs would result in a robust period of mergers and acquisitions (“M&A”) in renewable energy projects as “developers look for ways to raise capital to drive development” and larger established companies with strong balance sheets look to diversify their energy holdings.⁸⁷ Interest in project sales would also be accelerated by economically distressed tax equity investors “similarly looking to exit their positions to raise cash.”⁸⁸ A 2012 industry survey reported solar PV as the most preferred sector for acquisitions among renewable energy technologies.⁸⁹ Yet with the exception of 1603 projects not subject to limits on early disposition, ITC recapture rules

⁸¹ Telephone Interview with Ed Feo, Managing Director and Co-Managing Partner, USRG Renewable Finance (March 15, 2012).

⁸² Stefan Linder & Michel Di Capua, *Re-imagining Solar Financing*, Bloomberg New Energy Finance, 16 (June 2012), available at http://www.reznickgroup.com/sites/reznickgroup.com/files/Re-imagining-US-Solar-Financing_rev3.pdf.

⁸³ *Id.* at 24.

⁸⁴ *Id.* at 16.

⁸⁵ E-mail from Matthew Meares, Director of Project Finance, Amonix, Inc., to author (Aug. 11, 2011, 1:29 AM)(on file with author).

⁸⁶ *Reassessing Renewable Energy Subsidies*, Bipartisan Policy Center, 11 (March 2011), available at http://bipartisanpolicy.org/sites/default/files/BPC_RE%20Issue%20Brief_3-22.pdf.

⁸⁷ Holly Fletcher, *Renewable M&A Set For Steady Flow*, POWER, FINANCE AND RISK, Dec. 19, 2011.

⁸⁸ Ellen S. Friedman, *New Options for Renewable Energy Financing*, EXECUTIVE COUNSEL, 5 (July/Aug. 2009), available at http://www.nixonpeabody.com/linked_media/publications/RenewableEnergy_ExecutiveCounsel_EllenFriedman.pdf.

⁸⁹ *Green Power 2012: The KPMG Renewable Energy M&A Report*, KPMG, at 29 (May 18, 2012), <http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Advisory/Green-Power-2012-Web-copy.pdf>.

will prohibit the sale of solar projects already placed in service for the first five years, discouraging M&A activity in projects with successful operational histories that may be most appealing to investors. This also constrains developers who may wish to raise capital for subsequent projects and tax equity investors that need to exit their investments.

Inter-Creditor Friction Increases Transaction Costs

The profile of a tax equity investor is very similar to subordinated debt, requiring a certain return but standing second in line to the senior lender.⁹⁰ But unlike a pure subordinated lender, tax equity investors face the additional risk that foreclosure could trigger recapture of tax benefits. As a result, “The most significant cost of tax equity...is that it makes obtaining project level debt more difficult.”⁹¹ Investors often request a forbearance agreement or ‘standstill period’ “as a practical accommodation on the part of lenders to give the tax equity participants protection and comfort to take part in the transaction.”⁹² “The key element in a forbearance agreement is the lender’s covenant to forbear from foreclosing on a significant portion of its collateral if the project defaults.”⁹³

The difficulty in negotiating forbearance and inter-creditor agreement text can consume a considerable amount of time and money for all parties. Some lenders report recapture risk alone consuming approximately two to three months or more.⁹⁴ Delays often occur when the tax equity investor or legal counsel are relatively inexperienced with the ITC recapture rules. If the investor and/or counsel are not comfortable with the basic mechanics of the structuring, negotiations over recapture risk can “threaten to

⁹⁰ Schwabe, *supra* note 74.

⁹¹ Fisher, *supra* note 20, at 3.

⁹² Sosi Biricik & Lindsay Herrell, *Forbearance Agreements in Wind Farm Financing*, NORTH AMERICAN WINDPOWER (March 2009), available at http://www.lw.com/upload/pubContent/_pdf/pub2581_1.pdf.

⁹³ *Id.*

⁹⁴ Telephone Interview with Chris Diaz, Senior Vice President, Renewable Energy, Seminole Financial Services (March 15, 2012); Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012).

scuttle the entire deal,” and “the lender ends up paying for that lack of experience and bears the cost of educating the counter-party” on how the risks may be minimized.⁹⁵

Even if the parties understand the nature of the recapture risk, the parties may nonetheless disagree over whether forbearance terms are even appropriate for an inter-creditor agreement. The tax equity investor will often request forbearance for at least the full five-year vestment period, whereas the lender providing debt on a non-recourse basis will want to retain the right to foreclose on the project assets to safeguard its security. Many lenders see forbearance “violating the premise of the debt’s pricing,” because the “grand deal for cheap debt” is a lender’s right to take control of the project in the event of default.⁹⁶ Chris Diaz of Seminole Financial Services compares the negotiating process to struggling with a Rubik’s Cube puzzle when one side’s color is properly configured but the rest of the cube is completely mis-matched:

“Each party will offer recapture terms perfectly consistent with its own interests, but it will cause problems for the other sides of the transaction. The tax equity investor wants to hold the lender’s feet to the fire, but it is difficult to get a lender comfortable giving up his only remedy of foreclosure for five years. Ultimately, they must try to find a middle ground, and it is an arduous process.”⁹⁷

If a compromise is reached, costly revisions to other project documents are often necessary to conform the ultimate terms.⁹⁸ A single institution could hypothetically provide both debt and tax equity for a single project.⁹⁹ But these

⁹⁵ Telephone Interview with Chris Diaz, Senior Vice President, Renewable Energy, Seminole Financial Services (March 15, 2012)

⁹⁶ Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012).

⁹⁷ Telephone Interview with Chris Diaz, Senior Vice President, Renewable Energy, Seminole Financial Services (March 15, 2012).

⁹⁸ Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012).

⁹⁹ *E.g.*, AES Solar, AES Solar and Met Life Announce the Financing and Start of Construction of its Ilumina Project (Sept. 2011), *available at* http://www.aes.com/pub-sites/sites/GLOBAL/content/live/02013915b0333013094ad1bf6006fde/1033/Ilumina_Press_Release_-_Final_-_Sept_2011.pdf.

“combined offerings” are rare occurrences, despite the perceived “alignment” benefits from dealing with a single party.¹⁰⁰ In reality, it may present similar challenges, as separate business units within the company may have separate negotiating counsel and the debt portion may be structured for subsequent sale to other investors.¹⁰¹ In any case, the original counter-parties must anticipate inter-creditor and forbearance issues.

Increased Cost Threatens Optimal Capital Structuring and PPA Clearing Price

Like other risk factors in a transaction, the ease or difficulty with which parties address ITC recapture may determine the success or failure of the entire project. Recounting a 15 MW solar PV project that fell apart because the parties could not find agreement, one leading project finance attorney described the unfortunate consequences that developers struggle to avoid.

“When debt walks, optimal capital structuring has not been achieved. Unreasonable forbearance terms from either party can blow up a deal, and recapture risk causes that friction. The unfortunate alternative is relying on tax equity alone, which is more expensive, lowers the developer’s return, and ultimately increases the cost of the power contract. It is a ridiculous reason not to do a deal and holds back many quality projects from moving forward.”¹⁰²

Debt “significantly increases the risk profile of the transaction for the tax equity investor.”¹⁰³ Compensating for this increased risk and the illiquid nature of the investment, the tax equity investor will require a higher return with a significant yield

¹⁰⁰ Martin, *supra* note 61, at 52.

¹⁰¹ Telephone Interview with John Marciano, III, Associate, Chadbourne & Parke LLP (June 26, 2012).

¹⁰² Telephone Interview with Ed Feo, Managing Director and Co-Managing Partner, USRG Renewable Finance (March 15, 2012).

¹⁰³ Keith Martin, *Trends in Tax Equity for Renewable Energy*, Project Finance NewsWire, 27, 29 (January 2009), available at <http://www.chadbourne.com/files/Publication/810dde60-3c78-4a9a-9c5d-a5fae8014b4f/Presentation/PublicationAttachment/51fc06c5-1407-48ac-9dff-a605de0f58e1/pfn0109.pdf>.

premium that increases the cost of capital for the developer.¹⁰⁴ The premium charged for combining tax equity and debt is a function of the transactional “sausage-making” required to convene multiple parties with varied interests in a single transaction.¹⁰⁵ For the few investors that have agreed to project-level debt in the past, they charged a premium of roughly 200-300 basis points.¹⁰⁶ A January 2012 report estimated that tax equity investors required after-tax returns in the range of 7.5-12%, compared to 9.5-16% for a leveraged PV project.¹⁰⁷ Yield premiums for leveraged transactions are now around 725 basis points.¹⁰⁸

Even a 2% premium has a significant impact on the LCOE. For a hypothetical PV plant, NREL calculated the LCOE increases by \$.025 per kilowatt-hour (kWh) of electricity for sale leaseback transactions and \$.05 per kWh for partnership flips.¹⁰⁹ In February 2012, industry leaders roughly approximated that for every 100 basis point increase in the cost of capital, the economic “clearing price” for the PPA for electricity increases by approximately \$.015 per kWh, ultimately leading to higher costs for the party purchasing the power.¹¹⁰

1603 Minimizes Recapture as a Risk Variable

Under 1603 rules, transfer of property is allowed as long as it is not to a disqualified person. A bank is not a disqualified person and would therefore be able to

¹⁰⁴ Mendelsohn, *supra* note 62.

¹⁰⁵ Keith Martin, *Mock Tax Equity Negotiation*, PROJECT FINANCE NEWSWIRE, July 2010, at 32, 34 available at <http://www.chadbourne.com/files/Publication/747fa2c3-ebe5-425b-8114-407bc2e2a7dd/Presentation/PublicationAttachment/30b573ec-b30c-448d-9964-4330375a249e/pfn0710.pdf>.

¹⁰⁶ Fisher, *supra* note 20, at 3.

¹⁰⁷ Mintz Levin, *supra* note 23, at Figure 3-2.

¹⁰⁸ Martin, *supra* note 61, at 51; E-mail from Matthew Meares, Director of Project Finance, Amonix, Inc., to author (June 20, 2011, 10:56 PM)(on file with author).

¹⁰⁹ Mendelsohn, *supra* note 62, at 23-24.

¹¹⁰ Martin, *supra* note 61, at 51.

foreclose on a project without triggering recapture. It should be noted that a “larger issue” is the potential for investors in a 1603 deal to be flushed out from receiving their target yield if the bank forecloses on the project before their pre-determined exit.¹¹¹ In that case, the lender and tax equity investor would negotiate more straightforward forbearance on full project foreclosure until the investor’s internal rate of return is reached, but allow the bank to foreclose on the developer’s interest in the project in the meantime and “take over day-to-day control of the project.”¹¹²

As a result of differing recapture provisions in the 1603 Treasury Program, standard “market” forbearance terms have yet to be established for ITC based transactions.¹¹³ For many banks, ITC recapture may determine whether a deal is even possible, not just the pricing of the tax equity. Some will simply refuse to entertain project proposals incorporating project-level debt. For those that will move forward on a deal, forbearance terms may swing between one and six-year forbearance periods. In the small number of leveraged deals that occurred across renewable energy technologies in 2006 and 2007 prior to the recession, investors and sponsors could only negotiate forbearance for non-monetary defaults.¹¹⁴

One solution often mentioned is for the lender to grant some level of forbearance with an extended cure period. The lender agrees to provide notice to the tax equity investor in an event of default, and the investor has the right to cure, or resolve, the deficiency. Cure rights may distinguish non-monetary defaults from monetary defaults in

¹¹¹ Martin, *supra* note 109, at 34-35.

¹¹² *Id.* In the wind context, See Sosi Biricik & Scott Morris, *Government Recapture Rights Under ARRA's Renewable Energy Grant Program*, NORTH AMERICAN CLEAN ENERGY, 96 (Sept.-Oct. 2010), available at http://www.lw.com/upload/pubContent/_pdf/pub3740_1.pdf.

¹¹³ Telephone Interview with Albert Luu, Director of Structure Finance, SolarCity (March 15, 2012).

¹¹⁴ Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012).

which the developer is unable to meet its debt service obligation. In some instances, the lender may provide no forbearance for a monetary default but will forbear under other default events, such as when technical problems with the system temporarily halt or reduce system output.¹¹⁵ A normal 15-day cure period may be extended to 60 or 90 days.¹¹⁶ Mandatory consultations with lenders may be required within 30 days.¹¹⁷ In most cases, the tax equity investor will cure by funding the developer's debt service shortfall. But lenders are likely to limit the number of cures on a default, and once the cure rights expire, the lender may foreclose.

“In theory the lender should be indifferent so long as the loan is current. But it is highly unlikely that lenders would be willing to agree to forbearance provisions that provided an unlimited number of monetary cures to the tax equity investor because of the concern that there could be systemic issues with the underlying asset and once the tax equity investor is out of the transaction or decides to no longer cure monetary defaults, the lender is left with a non-performing asset.”¹¹⁸

Despite these lender requirements, developers relying on the ITC may nonetheless feel stronger market pressure to forge more favorable terms for investors in order to attract the relatively smaller pool of tax equity players, which could take some lenders out of consideration and ultimately lead to a less competitive market.

Eliminating Early Disposition as a Recapture Event is Consistent with Legislative Treatment of Federal Tax Credits

The success of the 1603 Treasury Program suggests elimination of early disposition as a recapture event could modernize the solar ITC and yield significant

¹¹⁵ Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012). But in non-monetary defaults, an open question is the terms under which a party can prove the technical issue in question is cureable, which requires parties to anticipate and negotiate an acceptable, independent third party to provide technical review. *Id.*

¹¹⁶ Telephone Interview with Chris Diaz, Senior Vice President, Renewable Energy, Seminole Financial Services (March 15, 2012).

¹¹⁷ Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012).

¹¹⁸ Telephone Interview with Albert Luu, Director of Structure Finance, SolarCity (March 15, 2012).

public policy benefits fully consistent with both the original legislative intent of the ITC and more recent legislative treatment of other tax credits.

Legislative History of the ITC and Recapture Rules

ITC Origins

The investment tax credit was originally designed as a policy mechanism for broad economic stimulus. An ITC proposal originated in work by economist E. Cary Brown in the U.S. and a similar incentive passed in Belgium in 1954 as a “potentially promising catalyst for increased investment growth” with “the notion of a tax credit for investment as a stimulus alternative to accelerated depreciation.”¹¹⁹ The Revenue Act of 1962¹²⁰ created a 7% investment credit that Congress intended to “encourage modernization and expansion of the Nation’s productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over their productive lives.”¹²¹ The credit would provide a “direct offset” against companies’ tax liabilities to “stimulate investment” by “reduc[ing] the cost of acquiring depreciable assets, “increase[ing] the expected profit from their use,” and “increase[ing] the funds available for investment.”¹²²

Allowable credit for any taxable year was not to exceed \$25,000 of taxpayer's liability plus 25% of the amount in excess of \$25,000.¹²³ The allowable credit was

¹¹⁹ Robert E. Rosacker & Richard W. Metcalf, *United States Federal Tax Policy Surrounding the Investment Tax Credit: A Review of Legislative Intent and Empirical Research Findings over Thirty Years (1962-1991)*, 9 AKRON TAX J. 59, 62-63 (1992).

¹²⁰ Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960 (1962).

¹²¹ CONF. REP. NO. 87-2508 (1962), reprinted in 1962 U.S.C.C.A.N. 3732, 3734.

¹²² H.R. REP. NO. 87-1447, at 8 (1962).

¹²³ Revenue Act of 1962, § 46.

calculated by the expected useful life of the property, and no credit was allowed for property with an expected life of less than four years.¹²⁴

“The incentive effect [was] concentrated on new investment.”¹²⁵ The credit, originally under Section 38 of the Internal Revenue Code, was primarily for machinery and equipment, but applied to all “tangible personal property, or other tangible property (not including a building or structural components) if such other property was used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communication, electrical energy, gas, water or sewage disposal services, or as a research or storage facility.”¹²⁶ Upon signing the Revenue Act of 1962 into law, President Kennedy described the ITC as a policy mechanism to, “provide added stimulus to investment in machinery and equipment, and give American firms tax treatment which compares favorably with their competitors in world markets.”¹²⁷

While concentrated on new investment, Congress nonetheless extended a “limited credit” to used property that was “newly acquired” due to “the greater dependence of small business on used property.”¹²⁸ Thus, it was possible for multiple parties to separately claim an ITC on a single asset if the asset was purchased by a separate party that did not originally operate the asset. The extension of the ITC to used property was limited to \$50,000 in each taxable year.¹²⁹

¹²⁴ *Id.*

¹²⁵ H.R. REP. NO. 87-1447, at 14 (1962).

¹²⁶ Revenue Act of 1962 at § 48(a).

¹²⁷ *Statement on Signing Revenue Act of 1962* (Oct. 16, 1962), John F. Kennedy Presidential Library and Museum, available at <http://www.jfklibrary.org/Asset-Viewer/Archives/JFKPOF-041-012.aspx>.

¹²⁸ H.R. REP. NO. 87-1447, at 9 (1962); Revenue Act of 1962, at § 48(c).

¹²⁹ *Id.* at § 48(c)(2).

Genesis of ITC Recapture Rules

The Revenue Act of 1962 would require complete or partial recapture of the credit if “during any taxable year, investment credit property is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer, before the close of the recapture period.”¹³⁰ In the Kennedy Administration’s initial proposal to Congress in 1961, Secretary of Treasury C. Douglas Dillon outlined a credit recapture rule to establish “safeguards against the quick turnover of property” and prevent “two types of abuse.”¹³¹ Specifically, recapture on any early disposition would deter “repeated purchases and resales of properties merely to get additional tax benefits.”¹³² In theory, businesses could be motivated to engage in asset “churning” merely for the tax benefits rather than to put equipment to productive economic use.¹³³ Second, Dillon argued a recapture rule would preclude “the purchase of extra equipment...merely for purposes of resale to others who did not qualify.”¹³⁴ The proposal excepted recapture for asset dispositions upon termination of a business.¹³⁵

The discussion draft bill that originally emerged in the House of Representatives featured a recapture framework clouded by “much uncertainty.”¹³⁶ Any early disposition or cessation of the qualifying property within six years of being placed into service would result in the asset “excluded from qualified investment back in the year in which the

¹³⁰ *Id.* at § 47(a).

¹³¹ D. Douglas Dillon, *Detailed Explanation of the President’s Recommendations Contained in His Message on Taxation*, Testimony submitted to the House Ways & Means Committee, 253, 259 (May 3, 1961).

¹³² *Id.*

¹³³ Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 709, n. 263 at 825 (2012).

¹³⁴ Dillon at 259.

¹³⁵ *Id.* at 259-260.

¹³⁶ Richard M. Gaberman, *Federal Tax Legislation*, 3 B.C.L. REV. 232, 236 (1962).

credit was taken.”¹³⁷ The rules would be subject to a three-year statute of limitations beginning on the tax return filing date for the year in which the recapture event occurred.¹³⁸ The rule would also permit discretionary enforcement of the provision, only if Treasury “determine[d]...that the allowance of the credit with respect to the property would confer a benefit which is inconsistent with the purposes of the investment tax credit provision.”¹³⁹

The recapture language that emerged in the final House and Senate bills rejected conferring discretionary enforcement powers to the Treasury. The ultimate text approved by Congress is what exists today in Section 50. The bills’ accompanying committee reports only stated the recapture rules were designed “to guard against a quick turnover of assets by those seeking multiple credit.”¹⁴⁰ “Property [would] be considered disposed of whenever it is sold, exchanged, transferred, distributed, involuntarily converted, or disposed of by gift.”¹⁴¹ Subsequent regulations promulgated by the U.S. Treasury would clarify that “the term ‘disposition’ includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest and a gift, but such term does not include a mere transfer of title to a creditor upon creation of a security interest.”¹⁴² The rules were described as a “special adjustment” to ensure the credit’s actual useful life, in the hands of the taxpayer, aligned with the expected useful life when the credit was

¹³⁷ STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 90TH CONG., GENERAL EXPLANATION OF COMMITTEE DISCUSSION DRAFT OF REVENUE BILL OF 1961 RELEASED FOR INFORMATION AND STUDY, Aug. 24, 1961, at 10.

¹³⁸ *Id.*

¹³⁹ *Id.* Enumerated factors for Treasury to consider included, but were not limited to, (1) “the relationship of the taxpayer to the transferee or lessee,” (2) “subsequent use of the property,” (3) “the frequency of the disposition of the assets,” and whether the transfer or lease serves a bona fide business purpose.” *Id.*

¹⁴⁰ S. REP. NO. 87-1881, at 18 (1962), reprinted in 1962 U.S.C.C.A.N. 3304, 3320.

¹⁴¹ *Id.* at 148-49.

¹⁴² Treas. Reg. § 1.47-2.

initially claimed.¹⁴³ Recapture would require “reductions in investment credits (which would have resulted in the prior years) had the investment credits allowable been determined on the basis of the actual useful life of the property rather than its estimated useful life.”¹⁴⁴ By requiring an increase in the tax collected in the year of the recapture event without charging interest, Congressional staff limited the recapture rule exceptions to “transfer of property by reason of the death of the taxpayer or in the case of corporations where a successor corporation ‘stands in the shoes’” of the predecessor corporation” and holds the property for the remainder of the recapture period.¹⁴⁵

Subsequent Legislative History Concerning the ITC

Before the first investment credit for energy property was created, the ITC would be suspended¹⁴⁶, terminated¹⁴⁷, reinstated¹⁴⁸, increased¹⁴⁹, and extended¹⁵⁰ by Congress. Throughout this process, recapture rules related to early disposition remained unchanged. The Tax Reduction Act of 1975 increased the investment credit to 10%.¹⁵¹ “As an aid to small businesses,”¹⁵² the cap on used property was later increased to \$100,000.¹⁵³

In the Revenue Act of 1978, Congress permanently extended the ITC at 10% and permanently extended the ITC for used property with a \$100,000 cap.¹⁵⁴ In the Energy Tax Act passed that same year, Congress enacted two tax credits. The first was a 10% residential energy credit for individual homeowners to apply to their personal income tax

¹⁴³ H.R. REP. NO. 87-1447, at 8 (1962).

¹⁴⁴ S. REP. NO. 87-1881, at 18 (1962).

¹⁴⁵ *Id.*

¹⁴⁶ Pub. L. No. 89-800, 80 Stat. 1508 (1966).

¹⁴⁷ Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

¹⁴⁸ Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (1971).

¹⁴⁹ Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975).

¹⁵⁰ Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

¹⁵¹ Tax Reduction Act of 1975.

¹⁵² STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94th Cong., SUMMARY OF TAX REDUCTION ACT OF 1975, H.R. 2166 (March 4, 1975), at 4.

¹⁵³ Tax Reform Act of 1976.

¹⁵⁴ Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978).

liability, capped at \$2,200 and limited only to solar energy property that heated water.¹⁵⁵

In designing the credit, the statute neither applied the provisions of Section 47 nor created new recapture provisions. Instead the credit was limited to solar energy property “the original use of which begins with the taxpayer... which can reasonably be expected to remain in operation for at least 5 years.”¹⁵⁶ Thus, a homeowner’s sale of the energy property would not trigger recapture, because the ‘original use’ language barred solar property from receiving multiple credit as new and used property, which was allowed under the original investment credit in 1962. The second credit created in the legislation was a new 10% business ITC under Section 46.¹⁵⁷ By placing the new ITC within the existing statute, Congress applied the “general rules for applying the regular investment credit,” which included the Section 47 recapture provisions related to early dispositions.¹⁵⁸

Subsequent legislation in 1980 would make the residential energy ITC permanent¹⁵⁹ and finally expand the scope of technologies qualifying for the credit to include solar energy property that generates electricity.¹⁶⁰ In the Economic Recovery Tax Act of 1981, Congress eliminated expected useful life of property to determine the amount of credit that could be claimed. If the property qualified for Accelerated Cost Recovery System recovery periods of five, 10, or 15 years, the taxpayer could claim 100% of the investment credit.¹⁶¹ The legislation also increased the used property ITC

¹⁵⁵ Energy Tax Act of 1978, Pub. L. No. 95-618, § 101, 92 Stat. 3174 (1978).

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ Energy Tax Act of 1978, at § 301(a).

¹⁵⁹ Technical Corrections Act of 1979, Pub. L. No. 96-222, § 2, 94 Stat. 194 (1979).

¹⁶⁰ Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 202, 94 Stat. 229 (1980).

¹⁶¹ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 211, 95 Stat. 172 (1981).

cap as high as \$150,000.¹⁶² Congress would ultimately combine the various investment tax credits in 1984 into a single "general business credit."¹⁶³ In the Tax Reform Act of 1986, Congress terminated the ITC in order to "finance the substantial reduction in tax rates"¹⁶⁴ and eliminate "economic distortion caused by the existence of the regular credit."¹⁶⁵ Although the credit was terminated, the bill "left intact the statutory ITC framework," including the recapture rules under Section 47.¹⁶⁶ "The primary rationale for this action appears related to non-repeal of the historic buildings credit."¹⁶⁷

In the Revenue Reconciliation Act of 1990, Congress re-animated the ITC and, in an "effort to rid the Code of expired and obsolete provisions,"¹⁶⁸ re-organized the tax code rules concerning the Investment Tax Credit to remove all credits but a Historic Rehabilitation Credit under Section 47, the Energy Credit under Section 48 and a Reforestation Credit under Section 48.¹⁶⁹ Recapture rules and other eligibility requirements moved from former Section 48 to Section 50.

Congress extended the energy credit in the Tax Extension Act of 1991¹⁷⁰ and permanently extended the credit in 1992 at a rate of 10%.¹⁷¹ Congress also created a new production-based incentive under Section 45 known as the Production Tax Credit ("PTC"), which would permit a project owner to claim an inflation-adjusted tax credit of 1.5 cents per kWh of electricity generated from qualifying property in a taxable year for a

¹⁶² *Id.* at § 213.

¹⁶³ Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 473, 98 Stat. 494 (1984).

¹⁶⁴ Donald T. Williamson & David W. Pijor, *Income Tax Credits: The Investment Credit*, Tax Management, 191-5th, Bureau of National Affairs, A-20 (Jan. 5, 1998).

¹⁶⁵ STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (May 4, 1987), at 98.

¹⁶⁶ *Id.* at 150.

¹⁶⁷ Rosacker, at 59-60.

¹⁶⁸ Williamson, at A-38.

¹⁶⁹ Omnibus Budget Reconciliation Act of 1990, § 11813, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

¹⁷⁰ Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686 (1991).

¹⁷¹ Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992).

period of ten years after the project is placed into service.¹⁷² Congress briefly moved solar energy property to the PTC¹⁷³ before creating a separate “business solar investment tax credit” in the Energy Policy Act of 2005 and increasing the rate to 30%.¹⁷⁴

The Section 48 ITC was extended for one year in 2006¹⁷⁵ and extended for eight years in the Emergency Economic Stabilization Act of 2008¹⁷⁶ before the American Recovery and Reinvestment Act created the 1603 Treasury Program to award grants in lieu of the ITC.¹⁷⁷ Congress extended the 1603 Treasury Program for one year in December 2010,¹⁷⁸ and it expired on December 31, 2011.

Judicial Application of Recapture Rules and Interpretation of Legislative Intent

Although the ITC is no longer under Section 38 of the IRC, the extensive body of law concerning former Section 38 property still applies. Solar energy property eligible for the ITC is subject to recapture for voluntary transfers of property to creditors or in bankruptcy proceedings within the recapture period.¹⁷⁹ Recapture is also triggered in cases of involuntary transfers of the property, including foreclosure of the property and foreclosure of ownership interest in the property. In *Millar v. Commissioner*, a creditor’s satisfaction of an outstanding loan through foreclosure of the debtor’s pledged ownership interest in a subchapter S corporation triggered partial recapture of credit claimed on

¹⁷² *Id.*

¹⁷³ American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (2004).

¹⁷⁴ Energy Policy Act of 2005, Pub. L. No. 109–58, 119 Stat. 594 (2005).

¹⁷⁵ Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, 120 Stat. 2922 (2006).

¹⁷⁶ Emergency Economic Stabilization, Energy Improvement and Extension, and Tax Extenders and AMT Relief Acts of 2008, Pub. L. No. 110–343, 122 Stat. 3765 (2008).

¹⁷⁷ ARRA § 1603.

¹⁷⁸ Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111–312 (Dec. 17, 2010), 124 Stat 3296 (2010).

¹⁷⁹ *Mueller v. Comm’r.*, 60 T.C. 36, 47 (1973)(concluding the “broad language” of the recapture statute as applied by the Senate Finance Committee report “manifests an intention to include within its scope” transfers of an asset to a bankruptcy trustee); *Lang v. Comm’r.*, 46 T.C.M. 976 (1982)(holding a taxpayer’s transfer by warranty deed of Section 38 property to its creditor in satisfaction of the taxpayer’s indebtedness constitutes a recapture event).

Section 38 property owned by the corporation.¹⁸⁰ In *Bremer v. Commissioner*, disposition by foreclosure sale by creditors of resort hotel property constituted a recapture event.¹⁸¹ Similarly, in *Lang v. Commissioner*, a taxpayer's transfer by warranty deed of section 38 property to its creditor in satisfaction of the taxpayer's indebtedness constituted a recapture event.¹⁸²

In *Bremer*, the Tax Court asserted that “the ‘quick-turnover’ type situation” was not intended by Congress “to exclusively define or in any manner circumscribe the scope of the recapture rule but instead simply sought to illustrate a particular instance warranting application of the rule. Congress intended no such restriction but rather contemplated broad application of section 47(a)(1).”¹⁸³ But the court also contended that the recapture rules are “not a penalty provision” but an “adjustment mechanism” to require “the actual useful life of section 38 property comport with the estimated useful life.”¹⁸⁴ The early disposition constraint was, therefore, a means by which to maintain the administrative accuracy of the investment credit. This is understandable given the early legislative history pegging the ITC to the expected useful life of the asset. But Congress relaxed even this requirement over time as legislators decided to align the ITC with recovery periods under accelerated depreciation.

Other court opinions emphasized the disposition rule’s role of deterring tax abuses through premature bailouts. In *Charbonnet v. United States*, the Fifth Circuit Court of Appeals concluded risk-free tax benefits were central to the purpose of the

¹⁸⁰ *Millar v. Comm’r.*, 34 T.C.M. (CCH) 555 (1975), rev’d on other grounds, 577 F.2d 212 (3d Cir. 1978); *See also Moudy v. C. I. R.*, 59 T.C.M. (CCH) 280 (1990)(finding creditors’ repossession of machine property for which credit was claimed triggered credit recapture).

¹⁸¹ *Bremer v. Comm’r.*, 66 T.C. 360, 364 (1976).

¹⁸² *Lang*, 46 T.C.M. at 976.

¹⁸³ *Bremer*, 66 T.C. at 366.

¹⁸⁴ *Id.*

recapture rules when it affirmed in 1972 the government’s determination of ITC recapture after a taxpayer reduced below 66% his ownership interest in a former Subchapter S corporation that claimed an investment tax credit on Section 38 property.¹⁸⁵ The court asserted, “Congress evidently was concerned with abuse of the credit by shareholders bailing out prematurely.”¹⁸⁶ “By bailing out early, the taxpayer reaps a tax benefit without himself suffering the risk throughout the estimated useful life. To plug this loophole the Commissioner promulgated Treas. Reg. § 1.47-4.”¹⁸⁷

In the eyes of the Fifth Circuit, it was not enough that the corporate entity remained invested in the property for “domestic economic stimulus.”¹⁸⁸ By merely disposing of one’s interest, the court argued the taxpayer runs afoul of the “considered economic decision[s]” Congress wished to encourage and results in an “overall investment pattern [that] does not fully satisfy the ends of the investment credit and, in Congress’ estimation, merits partial recapture of credit.”¹⁸⁹ More recently, the Tax Court flatly surmised in *Historic Boardwalk Hall, LLC v. Commissioner* that the recapture statute “demonstrates an anticipation of repurchase and creates a disincentive...[as] a means to police early dispositions and created a deterrent to a premature buyout.”¹⁹⁰

¹⁸⁵ Charbonnet v. United States, 455 F.2d 1195 (5th Cir. 1972).

¹⁸⁶ *Id.* at 1199.

¹⁸⁷ *Id.* at 1198.

¹⁸⁸ *Id.* at 1199.

¹⁸⁹ *Charbonnet*, 455 F.2d at 1199; *See Ranier v. United States*, 871 F.2d 607, 610-11 (6th Cir. 1989)(applying *Charbonnet* to deny exempting taxpayer from recapture liability even when a subsequent purchaser of corporate shares agrees to pay for any ITC recapture liability if property owned by the corporation for which a credit had been claimed is sold before the end of the useful life and the sale price for the corporate shares is reduced at the outset to reflect the potential recapture amount). *See also Giovanini v. United States*, 9 F.3d 783, 789 (9th Cir. 1993)(quoting *Charbonnet* in affirming judgment for taxpayer where merger of S corporation into C corporation resulted in taxpayer’s interest shrinking by 80% but where taxpayer “continues to participate as a shareholder” and “risk-taker” in the venture which owns the assets on which credit was claimed).

¹⁹⁰ *Historic Boardwalk Hall, LLC v. Comm’r.*, 136 T.C. 1, 34 (2011).

In contrast to the Fifth Circuit’s interpretation of the legislative history, recapture rules in the broader context of the original investment credit statute in 1962 more likely contemplated a general check on abuse through multiple claims of tax benefits for a single substantive investment. In *Long v. United States*, the Sixth Circuit Court of Appeals noted, “One of the reasons giving rise to a multiple credit problems is that an investment credit is allowable both for ‘new [S]ection 38 property’ ...and ‘used [S]ection 38 property.’”¹⁹¹ The Court further noted that Congress restricted the used property credit to property “purchased” at arm’s length.¹⁹² Also, former Section 48(c) excluded from the used property definition property used “by a person who used such property before such acquisition.”¹⁹³ In *United Telecommunications, Inc. v. Commissioner*, the Court noted, “Congress was not oblivious to the necessity for preventing multiple credits...The purpose of [former Section 47]was to obviate quick turnovers of assets by those who were seeking to make *excessive use* of multiple credit” (emphasis added).¹⁹⁴ In this case, the Court was considering separate tax incentives subsidizing the same investment decision. The Court sought to prevent the cost of construction assets from being used twice for investment tax credit purposes: first, when the construction equipment was placed in service and second, as part of the basis of the new self-constructed section 38 property when that asset was placed in service.¹⁹⁵

¹⁹¹ *Long v. United States*, 652 F.2d 675, 681 (6th Cir. 1981).

¹⁹² *Id.*

¹⁹³ 26 C.F.R. § 1.48–3(a)(2)(i); *See Holloman v. Comm’r.*, 551 F.2d 987, 988 (5th Cir. 1977)(finding that “denial of investment credit to taxpayers where the same person has used the property before and after its acquisition was intended to prevent abuse of the investment credit provisions when there has been no real change in ownership or use of the property.”).

¹⁹⁴ *United Telecomm., Inc. v. Comm’r.*, 589 F.2d 1383, 1389 (10th Cir. 1978)(holding that the capitalized costs of construction equipment for which an investment credit was previously claimed could not be added to the eligible costs basis of constructed property that would also be eligible for an investment credit.); Rev. Rul. 81-1, 1981-1 C.B. 18.

¹⁹⁵ *United Telecomm.*, 589 F.2d at 1389.

Congressional Inertia and Tax Credit Recapture Rules

Policy treatment of the ITC can be characterized by an “on-again, off-again history” of tax code alterations due to competing notions of “social objectives, equity concerns, administrative matters, and macro-economic goals.”¹⁹⁶ The scope of the ITC increasingly narrowed to specific sectors of the economy over the last five decades, yet the same recapture rules were pegged to the ITC throughout its modifications, expansions, repeals, and resuscitations. Thus, the original language regarding early disposition remains to this day, despite the fact that used solar energy property, for example, is not eligible for the credit. The current Section 48 solar ITC incorporated the residential ITC’s statutory language concerning property eligibility to limit the credit allowance to solar energy property “the construction, reconstruction, or erection of which is completed by the taxpayer, or (ii) which is acquired by the taxpayer if the original use of such property commences with the taxpayer.”¹⁹⁷ The ITC for solar energy property is only available to the taxpayer that first places the new solar energy property into service.

Section 45 Production Tax Credit

Consideration of other tax credit frameworks within and outside renewable energy suggest Congress could revise its approach to recapture rules for the solar energy property. The Section 45 PTC for wind and geothermal project development does not struggle with a similar tax credit recapture constraint for dispositions. Unlike the ITC, the PTC is a credit claimed by the project owner for a period of ten years after the project is placed into service.¹⁹⁸ PTCs are “realized (and vest) in real time,” which gives the

¹⁹⁶ Rosacker, at 62-63.

¹⁹⁷ § 48(a)(3)(B) (West).

¹⁹⁸ I.R.C. § 45(a) (West 2012).

developer the freedom to sell the asset to a purchaser “virtually at any time.”¹⁹⁹ A subsequent purchaser would then be free to claim the cash flows and subsequent PTCs for the remainder of the ten-year period. Importantly, lender foreclosure does not trigger recapture. For wind, closed-loop biomass and geothermal sources, the PTC rate is 1.5 cents per kWh, adjusted for inflation to 2.2 cents per kWh in 2010.²⁰⁰ For open-loop biomass, landfill gas, trash, qualified hydropower or marine and hydrokinetic sources, the adjusted rate is 1.1 cents per kWh in 2010.²⁰¹

Section 42 Low-Income Housing Tax Credit

Congress created the Section 42 Low-Income Housing Tax Credit (“LIHTC”) in the Tax Reform Act of 1986.²⁰² LIHTCs are awarded based on a formula incorporating the eligible cost of construction and the number of low-income housing units maintained in a property each year over a period of fifteen years, known as the ‘compliance period.’²⁰³ The taxpayer may claim 100% of the possible credits in an “accelerated” manner in the first ten years, after which the developer is still subject to recapture if the housing property falls out of compliance in the last five years.²⁰⁴ Congress created new recapture rules within Section 42 rather than impose Section 50 rules. Whereas the recapture amount for the ITC is determined by the ‘unvested’ portion of the credit, non-compliance with LIHTC requirements triggers recapture of any accelerated portion of the

¹⁹⁹ Mark Bolinger, Ryan Wiser, Karlynn Cory & Ted James, *PTC, ITC, or Cash Grant? An Analysis of the Choice Facing Renewable Power Projects in the United States*, Lawrence Berkeley National Laboratory & National Renewable Energy Laboratory, 11 (March 2009), <http://eetd.lbl.gov/ea/emp/reports/lbnl-1642e.pdf>.

²⁰⁰ Credit for Renewable Electricity Production, Refined Coal Production, and Indian Coal Production, and Publication of Inflation Adjustment Factors and Reference Prices for Calendar Year 2012, 77 Fed. Reg. 21,835, 21,836 (April 11, 2002).

²⁰¹ § 45(b)(4)(A) (West).

²⁰² Pub. L. No. 99-514, § 252, 100 Stat. 2085 (1986).

²⁰³ I.R.C. § 42 (West 2012). See Rochelle E. Lento & Daniella Graceffa, *Federal Sources of Financing*, THE LEGAL GUIDE TO AFFORDABLE HOUSING DEVELOPMENT (May 31, 2011).

²⁰⁴ GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 165.

credit plus interest.²⁰⁵ After ten years, the status of the LIHTC therefore becomes analogous to the ITC for solar energy property, whereby the full value of the credit has been claimed by a certain taxable year, yet recapture could be triggered for an additional five years.

Originally, a housing developer claiming LIHTC credits was unable to sell or transfer the housing property to another party at any point within the compliance period unless the taxpayer (1) posted a bond with the Treasury for the full value of the remaining tax credits subject to potential recapture and (2) it could “reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period.”²⁰⁶ If the taxpayer transferred its interest before the end of the compliance period, the bond would be forfeited, or recaptured by, the federal government.

The Housing and Economic Recovery Act of 2008²⁰⁷ eliminated the recapture bond requirement after incorporating legislation introduced by Representatives Nancy Johnson (R-CT), Charles Rangel (D-NY), and Kenny Hulshof (R-MO).²⁰⁸ Perhaps surprising for the current political environment, this bipartisan piece of legislation had support from Republicans and Democrats since 2003.²⁰⁹ Specifically, the language eliminated the recapture bond and required that the amended LIHTC recapture rules “shall not apply solely by reason of the disposition of a building (or an interest therein) if it is reasonably expected that such building will continue to be operated as a qualified low-income building for the remaining compliance period with respect to such

²⁰⁵ § 42(j)(2).

²⁰⁶ § 252.

²⁰⁷ §3004. Housing and Economic Recovery Act of 2008, Pub. L. No. 110–289, 122 Stat. 2654 (2008).

²⁰⁸ H.R. 1468, 109th Cong. (2005).

²⁰⁹ H.R. 3610, 108th Cong. (2003); S. 2689, 108th Cong. (2003).

building.”²¹⁰ In essence, “If the buyer of the property intends to step into the shoes of the seller and continue operating the property as a low-income housing project, there is no recapture of previously claimed credits.”²¹¹ A subsequent memorandum from the IRS in 2011 would confirm this would also apply even in the case of foreclosure as long as the building continues to operate as qualified low-income housing facility.²¹²

LIHTC recapture provisions were a response to the concern that “owners would claim the benefits of the tax credits and then avoid the continuing compliance requirements by transferring the credits to a straw party with minimal assets that the IRS could go after to collect recapture tax liability.”²¹³ “This concern about potential investor abuse of housing tax credits was based on experience with pre-1986 affordable housing tax incentives that supported an aggressive tax shelter market dominated by individual investors.”²¹⁴ In a letter supporting modification to the recapture rules, industry representatives express concern the recapture bond placed an “unnecessary and expensive requirement” on developers.²¹⁵ “The bonding requirement could be expensive, was cumbersome to calculate, and was viewed as an impediment to movement into and out of the investor market.”²¹⁶ An industry survey of investors found that “50% [of respondents]

²¹⁰ I.R.C. §42(j)(6) (West 2012).

²¹¹ Amanda Talbot, *Recapture Exposed*, NOVOGRADAC JOURNAL OF TAX CREDITS (October 2010), available at http://www.novoco.com/journal/2010/10/novogradac_jtc_2010-10_pc_pg37.pdf.

²¹² I.R.S. Gen. Couns. Mem. 201146016 (Oct. 18, 2011).

²¹³ 149 Cong. Rec. E2409-03, E2409-03 (daily ed. Nov. 21, 2003) (statement of Rep. Amo Houghton).

²¹⁴ Fred H. Copeman, *Coalition Continues to Pursue Revision to Recapture Bond Requirements*, LIHTC MONTHLY REPORT, 1 (Dec. 2003), available at http://www.novoco.com/low_income_housing/news/article_of_month/article_of_month_1203.pdf.

²¹⁵ 150 Cong. Rec. S8475-01, S8477 (daily ed. July 20, 2004) (letter of support for H.R. 3610).

²¹⁶ Terence Kimm, *Reznick Responds: Doing Deals Under the New Law*, AFFORDABLE HOUSING FINANCE (October 8, 2008), <http://www.housingfinance.com/news/100808-reznick-responds.htm> (last visited July 10, 2012).

indicated that the length of the investment and holding period was a significant factor in their decision to exit the market.”²¹⁷

Housing developers felt that “investors with shorter time horizons may be willing to invest in LIHTC projects.”²¹⁸ The Local Initiatives Support Corporation, the parent company of one of the leading national syndicators of low-income housing tax credits, noted in 2008 that the recapture bond change was “designed to stimulate more investment” and “increase the liquidity of Housing Credit investments” by removing “an unnecessary rule that makes investments less attractive.”²¹⁹ Introducing the bill on the floor of the United States Senate, Senator Blanche Lincoln said, “These changes will improve the overall efficiency of the housing program and ensure that more dollars actually flow into affordable housing.”²²⁰

Robert Rozen of Washington Council Ernst & Young co-managed the Recapture Bond Coalition advocacy effort to revise the recapture bond requirement but noted that industry saw value in the rules as a policy safeguard.²²¹ “Recapture is very important to the LIHTC industry. It is a fundamental requirement that makes the program so successful. Investors are motivated to ensure the property remains in compliance.”²²² An industry report in 2010 estimated an aggregate foreclosure rate of 0.62% by property

²¹⁷ Ernst & Young, Low-Income Housing Tax Credit Investment Survey, 18 (Oct. 8, 2009),

<http://www.enterprisecommunity.com/servlet/servlet.FileDownload?file=00P30000007ZuC7EAK>.

²¹⁸ See Glenn A. Graff, Michael Novogradac & Nicolo Pinoli, *Federal Stimulus Legislation Promoting Affordable Housing*, THE LEGAL GUIDE TO AFFORDABLE HOUSING DEVELOPMENT (May 31, 2011).

²¹⁹ *Housing Credit Modernization Becomes Law*. Local Initiatives Support Corporation, 1 (July 30, 2008), available at http://www.lisc.org/docs/news/073008_HR3221_LIHTC_summary.pdf.

²²⁰ 150 Cong. Rec. S8475-01, S8476 (daily ed. July 20, 2004) (statement of Sen. Blanche Lincoln).

²²¹ Interview with Robert Rozen, Partner, Washington Council Ernst & Young, in D.C. (March 29, 2012).

²²² *Id.*

count since the credit was enacted by Congress.²²³ Industry and policymakers acknowledged the very small foreclosure rate over the history of the credit and “no longer saw the bonds serving a function but raising costs and impeding marketability.”²²⁴

“Policymakers recognized investors should not be impeded from transferring their interest in a project. A more liquid secondary market would create a more efficient market for affordable housing investors and developers. The longer the holding period, the harder it is for an investor to commit capital. So by facilitating a secondary market, the repeal of the recapture rule helps unlock capital from investors concerned about the long holding period.”²²⁵

Senator Maria Cantwell argued in a floor statement that, “The bill eliminates unneeded inefficiencies in the tax laws that serve no public policy purpose.”²²⁶ The bill’s authors included two modifications to “provide the [IRS] with the information necessary to ensure that all recapture liabilities are timely paid.”²²⁷ First, an enhanced reporting requirement would require the owner of a housing property to notify former owners and the IRS of a recapture event.²²⁸ Second, a disposition of the property would automatically extend the statute of limitations for any potential liability to three years after the Secretary of the Treasury is notified of noncompliance.²²⁹

By removing the bond requirement and retaining the ‘reasonable expectation’ language, the current recapture rules governing low-income housing are very similar in effect to the rules promulgated for the 1603 Treasury Program. The taxpayer is free to sell the asset or transfer its interest provided the asset continues to remain eligible

²²³ *The Low-Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance*, Reznick Group, P.C., 9 (Aug. 2011),

http://www.reznickgroup.com/sites/reznickgroup.com/files/papers/reznickgroup_lihtc_survey_2011.pdf.

²²⁴ Interview with Robert Rozen, Partner, Washington Council Ernst & Young, in D.C. (March 29, 2012).

²²⁵ *Id.*

²²⁶ 154 Cong. Rec. S1125-01, S1139 (daily ed Feb. 25, 2008) (statement of Sen. Maria Cantwell).

²²⁷ 150 Cong. Rec. S8475-01, S8476 (daily ed. July 20, 2004) (statement of Sen. Blanche Lincoln).

²²⁸ § 3004.

²²⁹ *Id.*

property throughout the compliance period for the credit claimed. In the case of low-income housing, the parties assign “responsibility for any tax credit noncompliance...[and] typically involves indemnifications, representations and covenants from the buyer that they will maintain compliance and provide notifications if, for some reason, there is a compliance problem.”²³⁰ In a similar fashion, financing agreements involving a 1603 award would include covenants and guarantees by project owners that the asset would not be transferred to a disqualified investor and thus render the property ineligible for the underlying ITC.²³¹

Section 47 Historic Rehabilitation Tax Credit

The Historic Rehabilitation Tax Credit (“HRTC”) under Section 47 of the IRC is subject to the recapture rules of Section 50.²³² According to the IRS, “Congress intended that rehabilitated buildings be retained by the first owner to place the building in service after the rehabilitation is completed and is entitled to take the credit.”²³³ But the HRTC is distinguishable from the solar ITC by the credit’s role to preserve existing buildings rather than ITC’s role to stimulate investment in the construction of new property. Prior to 1976, “there were no incentives for restoring or rehabilitating older buildings in our Nation’s tax laws. Prior law actually encouraged the destruction of these buildings” with deductions for their demolition and quicker depreciation schedules for newer buildings.²³⁴ After creating a series of amortization and depreciation deductions in

²³⁰ Tax Credit Group of Marcus & Millichap, *Tax Credit Recapture Risk: Structuring the Sale of Your LIHTC Asset*, SECTION 42 REVIEW, 1 (Fourth Quarter 2009), available at <http://www.tcg-mm.com/newsletter/TCGNewsletter2-Q409.pdf>.

²³¹ Telephone Interview with Ed Feo, Managing Director and Co-Managing Partner, USRG Renewable Finance (March 15, 2012).

²³² I.R.C. § 47 (West 2012).

²³³ U.S. Dept. of Treas., *Rehabilitation Tax Credit*, Market Segment Specialization Program Publication 3149-109, 9-3 (December 2002), available at <http://www.irs.gov/pub/irs-mssp/rehab.pdf>.

²³⁴ *Id.* at 1-1.

1976²³⁵, Congress created a rehabilitation credit under former Section 48 with the associated recapture provisions.²³⁶

Original Congressional committee report language highlighted a “concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities.”²³⁷ Congress believed “...it is appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures. This *change in the investment credit should promote greater stability in the economic vitality* of areas that have been developing into decaying areas” (emphasis added).²³⁸

Thus, it is more reasonable for disposition constraints to have been applied in 1986 to the HRTC than to the solar ITC today, as Congress intended to promote continued ownership of decaying buildings by offering an incentive that required multi-year ownership in order to take full advantage of the incentive. Ownership can be viewed as a central component of the incentive, as the HRTC serves public policy goals of valuing historical locations and promoting preservation. The rationale is less compelling for housing and energy, which concern the provision of core human needs like shelter and electricity. The ITC for solar energy property spurs investments in the construction of new property to satisfy these needs, and the consistency of ownership is of limited consequence provided the system continues to generate electricity.

²³⁵ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124, 90 Stat. 1520 (1976).

²³⁶ Revenue Act of 1978, Pub. L. No. 95-600, § 315, 92 Stat. 2763 (1978).

²³⁷ H.R. REP. NO. 95-1445, at 86 (1978), *reprinted in* 1978 U.S.C.C.A.N. 7046, 7121.

²³⁸ *Id.*

Positive Impacts Resulting from Modernization of Early Disposition Rule

2012 is an appropriate time to consider modernizing the Section 48 Investment Tax Credit recapture rules for solar energy property in a manner that is consistent with the original intent of the incentive. The IRS rules were an understandable attempt by the federal government to deter tax fraud. But the recapture rules were written long ago to apply to a much broader range of economic transactions, and the disposition requirement is a constraint on the solar industry. “ITC rules have the effect of decreasing liquidity for projects that have been placed in service, which reduces the universe of investors willing to invest in the first place.”²³⁹ At the outset, the current statutory framework denies any credit for used solar energy property, unlike the original design of the Revenue Act of 1962. Furthermore, tax equity is an established investment practice developed by the private sector to facilitate policy outcomes prescribed by Congress. Each investment in a project or fund of small projects results in a return to the investor, consisting of cash and tax benefits, which is a far cry from the asset churning originally contemplated by Congress when businesses could apply the credit broadly to numerous capital expenditures. One could imagine that relaxed recapture rules may motivate an institution to attempt to recycle its capital and finance multiple solar projects until its federal tax liability approaches zero. No evidence has emerged, however, to suggest such behavior has occurred in the LIHTC industry as a result of the 2008 recapture rule revisions. Furthermore, reductions in tax liability should be considered along with the long-term tax revenues generated by increased private sector investment in infrastructure projects.²⁴⁰

²³⁹ Interview with Billy Lee, President, Bright Plain Renewable Energy, in D.C. (March 9, 2012).

²⁴⁰ See Connie Chern, *Paid in Full: An Analysis of the Return to the Federal Taxpayer for Internal Revenue Code Section 48 Solar Energy investment Tax Credit (ITC)*, U.S. Partnership for Renewable Energy Finance (July 12, 2012), available at http://www.uspref.org/images/docs/SC_ITC-Payback_July_12_2012.pdf (calculating that over the 30-year expected life of a commercial solar energy

With respect to project-level debt in a project, the legislative history does not indicate that the original recapture rules were designed to deter leveraging transactions. It is unlikely that removing early disposition as a recapture event would lead to “promiscuous behavior” on the part of developers, since the addition of debt to a transaction is fundamentally motivated by the optimal capital structuring of the project’s economics.²⁴¹ Yet it is clear revision would make it easier for developers to add debt to project transactions and reduce their overall cost of capital. For example, some established tax equity investors currently have a policy against adding debt to tax equity funds for distributed generation projects “due to the complexity surrounding recapture risk, brain damage associated with negotiating forbearance provisions and the fact that the tax equity investor is in a worse collateral position relative to an unlevered transaction.”²⁴² Developers in the commercial and residential rooftop market view affordable access to debt capital markets and the resulting lower overall cost of capital as a key component to increasing the adoption of solar and making solar more affordable for the average consumer.²⁴³ Some companies fully expect residential funds to tap debt financing for cheaper capital if Congress eliminated early disposition as a recapture event.²⁴⁴

Modernization would also reduce a significant barrier for non-traditional investors who would be concerned about the five-year ownership requirement and/or possible

system, standard lease and PPA financing structures “deliver a nominal 10% internal rate of return to the federal government on the ITC,” such that a \$300,000 claimed tax credit yields a \$677,627 nominal benefit to the federal government.). Importantly, this benefit to the federal government is “independent of, and additive to the numerous other benefits of solar projects, including job creation, energy independence, the preservation of natural resources and the health benefits of cleaner air.” *Id.* at 1.

²⁴¹ Telephone Interview with Ed Feo, Managing Director and Co-Managing Partner, USRG Renewable Finance (March 15, 2012).

²⁴² Telephone Interview with Albert Luu, Director of Structure Finance, SolarCity (March 15, 2012).

²⁴³ *Id.*

²⁴⁴ *Id.*

friction with lenders. Many point to Google as the poster child for corporations with large tax liabilities using their balance sheet to supply the tax equity historically provided by Wall Street firms.²⁴⁵ As of June 2012, Google claims to have invested over \$915 million in renewable energy, including investments in 1.8 gigawatts of electric generating assets.²⁴⁶ Despite Google “significantly moving the ball forward,” however, transactional attorneys note that there is a “steep learning curve” for even the most profitable “widget-makers,” especially if their business has very little to do with energy.²⁴⁷ Analysis by Bloomberg New Energy Finance found corporations “reluctant to take on tax equity,” because solar and wind investments are usually a departure from “core business,” and because most companies “do not have a dedicated in-house team to grapple with the complexities of tax equity or to assess projects risks of renewable assets.”²⁴⁸

Senior DOE officials convened a meeting in March of 2012 to shorten that learning curve and “spur more corporations to follow in Google's step.”²⁴⁹ Along with

²⁴⁵ Joel Kirkland, *Cash-Rich Companies Begin to Make Renewable Energy Investments*. N.Y. TIMES (August 18, 2011), available at <http://www.nytimes.com/cwire/2011/08/18/18climatewire-cash-rich-companies-begin-to-make-renewable-e-3023.html>. Chevron Corporation announced in February 2012 that it would pursue similar tax equity investments in solar energy projects in the range of 3-20 MW, but it has yet to announce its first investment as of the date of this writing. Benjamin Romano, *Oil Giant Chevron to Invest Tax Equity in US Solar Projects*, RECHARGE (Feb. 1, 2012), http://www.rechargenews.com/business_area/finance/article300993.ece.

²⁴⁶ GOOGLE GREEN INVESTMENTS, <http://www.google.com/green/energy/investments> (last visited Aug. 3, 2012). Notable solar tax equity investments include a \$280 million investment in distributed rooftop solar projects installed by SolarCity and a \$168 million investment in a utility-scale CSP project developed by BrightSource Energy. *Id.*

²⁴⁷ Interview with Sean Shimamoto, Partner, Skadden, Arps, Slate, Meagher & Flom LLP, in D.C. (May 16, 2012).

²⁴⁸ Michel Di Capua, Dipa Sharif & Amy Grace, *The Return - and Returns - of Tax Equity for US Renewable Projects*, Bloomberg New Energy Finance, 5 (November 2011), available at http://reznickgroup.com/sites/reznickgroup.com/files/papers/taxequity_reznickgroup_wp112011.pdf. California utility Pacific Gas & Electric briefly entered the market in 2010, but CEO Anthony Earley shut down its tax equity investment unit in late 2011 following a deadly, high-profile pipeline explosion that prompted the “need to be focused on our utility.” Mark Chediak & Andrew Herndon, *PG&E Not Seeking More Solar Tax-Equity Deals, CEO Earley Says*, BLOOMBERG (Dec. 13, 2011, 4:54 PM), available at <http://www.bloomberg.com/news/2011-12-13/pg-e-not-seeking-more-solar-tax-equity-deals-ceo-earley-says.html>.

²⁴⁹ Liz Hoffman, *Tax Equity Financing Lures Corporations to Renewables*, LAW360 (March 6, 2012).

leading renewable energy tax and project finance attorneys, nearly 80 representatives from the largest companies in the United States were invited, from Exxon Mobil Corp. to Walt Disney Co.²⁵⁰ Despite enthusiasm in the press and in the Obama Administration, new investors are unlikely to emerge quickly, if at all. A meeting attendee noted IRS audit risk and financial statement risk as two general challenges impeding many corporations from moving into tax equity, but the third risk of ITC recapture is uniquely perplexing within a corporate hierarchy.

“A corporation’s risk tolerance decreases substantially the further it moves away from its core business and expertise. It requires months in educating the various stakeholders in a large corporation that must ultimately sign off on the very notion of tax equity investments. There are so many tax-specific risks that scare a conventional corporate tax department. And unlike investment banks, staff are not used to this type of activity, and, in general, do not have the time or energy needed to push transactions through the proper channels. Additionally, their job descriptions and compensation incentives do not align with these types of activities. This can lead to more internal headaches and challenges. ITC recapture can be especially acute in the education process, because it is often seen internally as a risk variable over which the tax equity investor has no control. Removing ‘early disposition’ as a recapture event would fundamentally alter the risk profile, especially for first-time or relatively new investors.”²⁵¹

Interviews with experienced counsel, developers, and investors reflect an overwhelming consensus that elimination of the early disposition constraint would reduce this perceived risk for tax equity investors and make them more comfortable with transactions incorporating debt at the project level.²⁵²

²⁵⁰ Ryan Tracy, *Renewable Firms Seek Tax-Equity Partners*, WALL STREET JOURNAL, Feb. 11, 2012, at B3.

²⁵¹ Telephone Interview with Jonathan Batarseh, Senior Director, Domestic Tax, The Shaw Group (May 10, 2012).

²⁵² Telephone Interview with Ed Feo, Managing Director and Co-Managing Partner, USRG Renewable Finance (March 15, 2012); Telephone Interview with Chris Diaz, Senior Vice President, Renewable Energy, Seminole Financial Services (March 15, 2012); Telephone Interview with Albert Luu, Director of Structure Finance, SolarCity (March 15, 2012); Telephone Interview with Michael Midden, Co-Head of Energy, Dexia Credit Local (April 5, 2012); Telephone Interview with Jonathan Batarseh, Senior Director,

Finally, modernizing the recapture rules will facilitate the potential introduction of new tax structures that typically involve asset transfers between entities. As one example, some in the investment and policy community consider Master Limited Partnerships to be a promising new vehicle to facilitate “financial innovation so that clean energy sources gain access to the same low-cost capital that traditional energy sources like coal and natural gas enjoy.”²⁵³ Investment from the public capital markets would allow for structured financing to supplement traditional project finance lending for a number of renewable energy technologies.²⁵⁴

Under current law²⁵⁵, MLPs may issue ownership interests, referred to as units, through a public exchange and in a manner very similar to publicly-traded stocks. But as a pass-through partnership, tax is only levied on the individual partners’ ownership interests. In this way, MLPs avoid double taxation at the corporate and shareholder level. Senator Chris Coons of Delaware recently introduced in June 2012 the MLP Parity Act to amend Section 7704(d) of the Internal Revenue Code to include among the list of qualifying income sources all renewable energy technologies under Section 45 and 48, as well as certain biofuels.²⁵⁶

Domestic Tax, The Shaw Group (May 10, 2012); Interview with Sean Shimamoto, Partner, Skadden, Arps, Slate, Meagher & Flom LLP, in D.C. (May 16, 2012).

²⁵³ Felix Mormann & Dan Reicher, *How to Make Renewable Energy Competitive*, N.Y. TIMES (June 1, 2012), available at http://www.nytimes.com/2012/06/02/opinion/how-to-make-renewable-energy-competitive.html?_r=2&ref=opinion; Matt Daily, *Analysis: Solar Firms Seek New Financing as Subsidies Fade*, REUTERS (June 21, 2012), available at <http://in.reuters.com/article/2012/06/21/us-solar-financing-idINBRE85K16520120621>.

²⁵⁴ See Alex Kovacheva & Michel Di Capua, *Master Limited Partnerships for US Renewables: Panacea or Pie in the Sky?*, Bloomberg New Energy Finance (Jan. 2012); Molly F. Sherlock & Mark P. Keightley, *Master Limited Partnerships: A Policy Option for the Renewable Energy Industry*, Congressional Research Service (June 2011).

²⁵⁵ I.R.C. § 7704(d) (West 2012).

²⁵⁶ Press Release, Office of Senator Chris Coons, Senators Coons, Moran Introduce Bill to Spark Investment in Renewable Energy Projects (June 7, 2012), available at <http://www.coons.senate.gov/newsroom/releases/release/senators-coons-moran-introduce-bill-to-spark-investment-in-renewable-energy-projects>.

If permitted by legislation, MLPs would likely take the form of an “exit MLP” or “development MLP,” or a hybrid of the two.²⁵⁷ In the case of the former, an energy company would develop wind and/or solar projects and transfer the operating assets to an MLP in which public investors would purchase units. In the latter, the developer would incorporate itself as an MLP and offer ownership interests to the public. In any case, it is essential that assets be freely transferable. Unlike wind projects, however, transfer of a solar asset to an MLP within five years of being placed in service would constitute a recapture event under Section 50. In addition, some have suggested amending passive loss rules and other regulations to allow MLPs to pass through the tax benefits of the ITC to individual unitholders.²⁵⁸ Assuming these changes were also passed by Congress, these unitholders could trigger recapture of their pro-rata share of the ITC if they were to sell or transfer more than 1/3 of their ownership interest in the partnership. In this scenario, the ITC recapture rules would fundamentally interfere with the mechanics of the partnership, which is designed to be a liquid vehicle for retail investors.

Finally, the basic freedom to sell or transfer ownership of a solar asset in itself provides option value to developers who may wish to sell projects to raise capital for planned development. Revising the recapture rules “would certainly allow for a robust after-market” for solar projects, which was a positive, albeit temporary result of the 1603 rules.²⁵⁹

²⁵⁷ Kovacheva, at 8.

²⁵⁸ W. Bruce Bullock, Bernard L. Weinstein, & Ben Johnson, *Leveling the Playing Field: The Case for Master Limited Partnerships for Renewables*, Maguire Energy Institute, 18 (May 2012), available at http://www.awea.org/newsroom/upload/SMU_MLP_WhitePaper.pdf.

²⁵⁹ Interview with Billy Lee, President, Bright Plain Renewable Energy, in D.C. (March 9, 2012).

Revising Section 50 and Barriers to Recapture Modernization

Just as Congress focused on the desired policy outcome of the credit when revising the LIHTC in 2008, Congress should revise Section 50 for solar energy property to permit growth in the industry. The following suggested amendment to Section 50(a)(4) could serve as a starting point for legislative text:

For purposes of this subsection, the increase in tax under this subsection shall not apply to an energy credit claimed for qualified energy property described in Section 48(a)(3)(A)(i) solely by reason of the disposition of the energy property (or an interest therein) if it remains qualified energy property and there is no change in use as a consequence of the disposition for the remaining recapture period with respect to such energy property.

Refocusing the recapture rules for solar energy property to the scope of use would more closely align the credit with the policy intent of promoting the construction of solar energy property to generate electricity. This statutory construction would deter the discarding of property in asset churning schemes by requiring the taxpayer and subsequent owner to maintain the property's status as qualifying solar energy equipment used to "generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat" under Section 48.²⁶⁰

In exchange for recapture modernization, Congress could apply comparable safeguards established for 1603 and the LIHTC. For example, the revised recapture rules could explicitly prohibit sale to disqualified persons as defined under 1603.²⁶¹ To address concerns over so-called straw party schemes previously envisioned in the LIHTC context, legislation could establish identical reporting requirements with an extended statute of

²⁶⁰ § 48(a)(3)(A)(i) (West).

²⁶¹ A more open question for legislators' consideration is a statutory construction that permits governments and tax-exempt entities to purchase the solar asset within the first five years. Although this deviates from 1603's restrictions on disqualified persons, significant public policy benefits could result from making it easier for schools, local governments, and other non-profit entities to 'go solar.' For example, reduced utility bills allow some budget-constrained schools to retain teachers and academic programs. *See* Jim Carlton, *The Enlightened Classroom*, WALL STREET JOURNAL, June 18, 2012, at R3.

limitations.²⁶² This would not be administratively infeasible for the solar industry, which already complies with more detailed reporting requirements for the 1603 Treasury Program. The taxpayer claiming a 1603 grant must certify to Treasury on an annual basis for five years under penalty of perjury that “the property has not been disposed of to a disqualified person and that the property continues to qualify as specified energy property.”²⁶³

The solar industry undoubtedly faces partisan pressure in addition to general political gridlock in Congress. By most accounts, the 2011 bankruptcy of solar manufacturer Solyndra gave the industry “a black eye” and thrust the industry into a political battle between Republicans and Democrats.²⁶⁴ Industry representatives counter that partisans are using the bankruptcy as a “political issue”²⁶⁵ and “spinning the bankruptcy of Solyndra as an indicator of [the] entire industry”²⁶⁶ despite tremendous growth in recent years. Mitt Romney’s personal appearance at the Solyndra headquarters put solar incentives front-and-center for Republicans in the presidential election.²⁶⁷

²⁶² Alternatively, Congress could mimic 1603 and require the seller and purchaser to accept joint and several liability for any future recapture.

²⁶³ U.S. TREASURY DEP’T OF THE FISCAL ASSISTANT SEC’Y, PAYMENTS FOR SPECIFIED ENERGY PROPERTY IN LIEU OF TAX CREDITS UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, TERMS AND CONDITIONS, 2 (2009), <http://www.treasury.gov/initiatives/recovery/Documents/energy-terms-and-conditions.pdf>; See also U.S. TREASURY DEP’T OF THE FISCAL ASSISTANT SEC’Y, PAYMENTS FOR SPECIFIED ENERGY PROPERTY IN LIEU OF TAX CREDITS UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, ANNUAL PERFORMANCE REPORT AND CERTIFICATION (2009), <http://www.treasury.gov/initiatives/recovery/Documents/energy-terms-and-conditions.pdf>.

²⁶⁴ Darren Samuelsohn, *Solyndra Scandal a PR Nightmare*, POLITICO (Sept. 12, 2011, 11:30 PM), <http://www.politico.com/news/stories/0911/63306.html>; *Renewables: SEIA’s Resch Says Solar Outlook Positive Despite Solyndra Bankruptcy*, ENVIRONMENT & ENERGY NEWS (September 21, 2011), <http://www.eenews.net/tv/transcript/1398>.

²⁶⁵ *Government Role in Solar Energy Industry* (C-SPAN television broadcast September 23, 2011), available at <http://www.c-spanvideo.org/program/301719-4>.

²⁶⁶ Press Release, Solar Energy Industries Association, Solar Works for America: SEIA President Rhone Resch Highlights Solar Job Growth at Solar Power International 2011 (Oct. 17, 2011), available at http://www.seia.org/cs/news_detail?pressrelease.id=1680.

²⁶⁷ Nia-Malika Henderson, *Romney Knocks Obama at Solyndra Headquarters*, WASHINGTON POST, June 1, 2012, at A4.

Politicization of any industry at the presidential level presents significant challenges to bipartisan policymaking on Capitol Hill. The bipartisan effort to revise the LIHTC recapture bond requirement could serve as a model approach for the solar ITC. The Recapture Bond Coalition emphasized support for its proposal from both sides of the political aisle²⁶⁸ and a bipartisan vote in Congress.²⁶⁹ The current commercial ITC for solar energy property within the Energy Policy Act of 2005 was passed by an overwhelmingly bipartisan act of Congress and signed into law by a Republican president.²⁷⁰ Modernizing the recapture rules would not carve out a new incentive but merely optimize tax law for increased solar investment in a manner similar to the LIHTC. Fundamentally, solar ITC recapture rules could move members of Congress beyond political battles over the stimulus and present a reasonable, less contentious modification to the underlying tax credit.

Conclusion

Solar companies accustomed to the 1603 Treasury Program since 2009 should thoroughly consider the implications of ITC recapture rules as the industry shifts away from the grant program in 2012 and 2013. There is a general consensus within the solar industry that all will benefit from a more liquid market where there are more active investors, cost of capital is low, and financial innovations continue apace. Looking ahead,

²⁶⁸ Fred H. Copeman & Robert Rozen, *Coalition Continues to Pursue Revision to Recapture Bond Requirements*, LIHTC MONTHLY REP., December 2003, available at http://www.novoco.com/low_income_housing/news/article_of_month/article_of_month_1203.pdf.

²⁶⁹ *Foreclosure Prevention Act of 2008: Vote Number 186*, United States Senate (July 26, 2008), available at http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=110&session=2&vote=00186. *Foreclosure Prevention Act of 2008: Vote Number 186*, United States House of Representatives (July 23, 2008), available at <http://clerk.house.gov/evs/2008/roll519.xml>.

²⁷⁰ *Energy Policy Act of 2005: Vote Number 213*, United States Senate (July 29, 2004), available at http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=109&session=1&vote=00213; *Energy Policy Act of 2005: Roll Call Vote 445* (July 28, 2004), available at <http://clerk.house.gov/evs/2005/roll445.xml>.

the solar industry will continue to grow due to the overwhelming success of the Section 48 ITC, but its pace of development is hampered by tax credit recapture rules written for a different tax incentive designed for a different economy in a different era. Absent a legislative fix, a return to project financings subject to ITC recapture rules will result in a relatively illiquid market for solar assets and suppress the development of a viable secondary market. Counsel should prepare for these rules to cause friction amongst counter-parties, and developers should thoughtfully review how the associated increase in transaction costs may negatively impact a project's capital structuring and levelized cost of energy.

Acknowledging the industry's bright future by modernizing Section 50 recapture rules to allow for disposition of solar energy property within the five-year recapture period will ensure the ITC continues to facilitate such innovation and industry growth.