Establishing a Community Tax Equity Investment Company to Invest in Renewable Energy Projects

25x’25 Alliance
Energy for Economic Growth Initiative

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Tax incentives can help support the economics of renewable energy projects being developed by cooperatives. Several offerings by cooperative lenders – National Rural Utilities Cooperative Finance Corporation (CFC) and the National Renewables Cooperative Organization (NRCO) expanding on their sCOOP program with Federated Rural Electric Insurance Exchange and CoBank Farm Credit Leasing – are available to support cooperatives' renewable development efforts, among other tools. NRECA is working with its membership and other partners to provide tax equity tools as part of its solar business and technology strategies for the membership. Although there are excellent financial tools available to support some cooperatives, not all cooperatives can take advantage of those tools. Accordingly, 25x'25 and NRECA set out to determine whether other options exist for tax equity participation, utilizing local tax equity investors to support local energy projects. No one tool works for all purposes or for all cooperatives and with the 2016 end of year elimination of the Investment Tax Credit looming, the effort to identify other financing tools led to this collaboration.

This paper was developed by the EEG Tax Equity Business and Finance Model team with the support of Kemp Smith, LLP a law firm based in Austin, Texas. Kemp Smith LLP provided information in this paper as a service to the 25x'25 Energy for Economic Growth Steering Committee. While some of the information in this paper is about legal issues, it is not legal advice. This paper is not a tax opinion, nor does it opine on tax law and should not be relied upon as tax advice. Moreover, due to the rapidly changing nature of the law, Kemp Smith LLP makes no warranty or guarantee concerning the accuracy or reliability of the content of this paper. Further, some of the information in this paper is of a financial nature. All discussions of business entities, arrangements, and financial figures, rates of returns, and other information are purely hypothetical in nature. They do not reflect any actual project either real or perceived. The construction, ownership, and operation of a power plant, has certain inherent risks including but not limited to: failure to return on investment; lack of proper financing, management, and operation; faulty design or construction; revenues not meeting expectations; acts of God, war, or other natural and unnatural causes that can damage or destroy the property. Investors interested in investing in any project should consult with the appropriate professionals concerning all aspects of the project.

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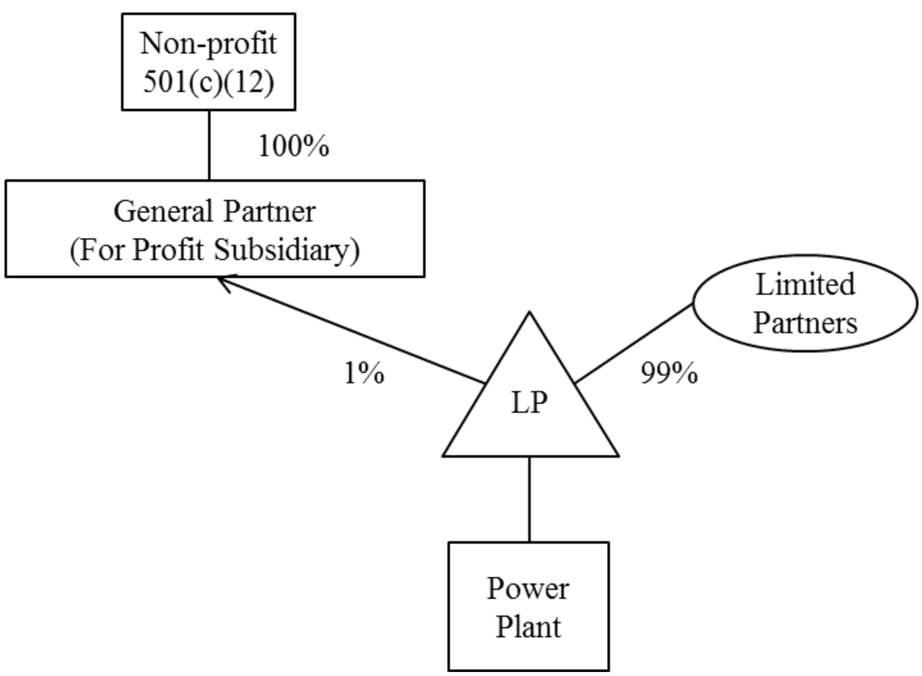
ESTABLISHING A COMMUNITY TAX EQUITY INVESTMENT COMPANY TO INVEST IN RENEWABLE ENERGY PROJECTS[1]

The not for profit, tax exempt status of rural electric cooperatives makes it difficult for cooperatives to take advantage of the Investment Tax Credit (ITC) available through the federal tax code. For rural electric cooperatives that have found a for profit entity to pursue the tax credits, the lack of equity investment dollars is an additional obstacle to take advantage of the ITC. The purpose of this paper is to provide a roadmap of how a cooperative's for profit entity could raise equity from multiple investors to support a renewable energy project. This paper discusses only one approach for such a group or *community* of investors. Responsible investing is not a *one size fits all* approach. Under the model and hypothetical put forward in this paper the investors would all have other *passive* income so that they would be able to monetize the ITC. The paper adopts a limited partnership model for ownership of the hypothetical solar power plant.

I. The Model

This section outlines the basic hypothetical circumstance on which the remainder of this paper will be based. The hypothetical is construed for a rural electric cooperative through a wholly owned, for profit subsidiary to sponsor a solar power plant. The subsidiary would serve as a general partner in a limited partnership.

Hypothetical Organizational Structure



[1] The paper focuses on a solar power plant as eligible property upon which an investor can claim the ITC. Consultation with an attorney and tax professional is strongly encouraged to determine whether the proposed renewable property is eligible for the ITC.

Hypothetical Construction Cost

Cost/Watt	1 MW Plant	2 MW Plant
$1.50	$1,500,000	$3,000,000
$1.75	$1,750,000	$3,500,000
$2.00	$2,000,000	$4,000,000

Hypothetical Investors

The hypothetical assumes that 25 investors will be located, and each investor will contribute $20,000 in exchange for a 3.96 percent limited partnership interest.[2]

Hypothetical Anticipated Returns

This hypothetical assumes that (1) the limited partnership will construct and own a 1 MWdc solar power plant for $2.00 per watt or $2,000,000; (2) 25 investors contribute $20,000 each so that the limited partnership will have $500,000 in equity; (3) the remaining $1,500,000 in costs will be financed with debt over a 20 year note at the federal financing bank rate of 2.41%[3]; (4) the solar power plant will generate $125,000 per year of revenue; and (5) the expenses will be $100,000 per year (assumes debt service, operating and maintenance, and insurance).

The benefit to the Cooperative would accrue through a power purchase agreement at or close to avoided cost with a subsidiary company that takes advantage of the ITC and other financial benefits (e.g., accelerated depreciation). As will be discussed later in the paper, the anticipated ITC will equal $600,000 which will be returned to the tax equity investors as part of their return on investment[4].

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[2] 99% ÷ 25

[3] http://www.rd.usda.gov/programs-services/services/rural-utilities-loan-interest-rates (reviewed on August 17, 2015).

[4] A 5 year projection is illustrated for discussion purposes. Internal Revenue Code recapture rules are discussed later in the paper. For Investment Tax Credit purposes, the recapture rules require investors to remain part of the company for 5 years. A buyout or flip would be discussed on an individual deal basis. According the revenue model in this paper, the company would receive $25,000 per year in profits. Depending on the allocations in the limited partnership agreement, the 25 investors could receive monetized tax credits of $24,000 per investor in the first year the property is in service and close to $1000 per year in profits.

Year	Revenue	Expenses	Anticipated Profit	ITC
1	$125,000	$100,000	$25,000	$600,000
2	$125,000	$100,000	$25,000	
3	$125,000	$100,000	$25,000	
4	$125,000	$100,000	$25,000	
5	$125,000	$100,000	$25,000	

A Note on Wholly Owned, For Profit Subsidiaries: The Member Income Test

To qualify for exemption under IRC Section 501(c)(12), Cooperatives must operate in accordance with cooperative principles. In addition, they must meet the income test requiring that most income of the Cooperative must be collected from members. Thus, to operate on a cooperative basis, cooperatives must satisfy the traditional cooperative principles, which include: subordination of capital, democratic control, and allocation and return of net margins based on patronage. In 2013, the IRS noted Cooperative reporting irregularities (this was for all manner of cooperatives, not focused on rural electric cooperatives). Since then, the IRS has conducted compliance checks of Cooperatives. These compliance checks involved questionnaires and examinations through which the IRS checks the member income test and whether they were being operated on a cooperative or mutual basis. Given heightened scrutiny, Cooperatives should ensure they are operating in accordance with their nonprofit requirements.

In addition, the IRS has established additional requirements that specifically apply to Cooperatives, including a test which qualifies the income of the members. Those examinations include resolving various issues, such as: defining income; defining income collected from members; defining when income collected for the sole purpose of meeting losses and expenses; and the treatment of the income of subsidiaries and related entities. These are issues which the particular Cooperative will need to resolve and examine prior to deciding whether the model described above will benefit the Cooperative. Cooperatives should review their compliance with the tax laws. To summarize, in order to qualify for exemption under IRC Section 501(c)(12), an organization must: (1) meet the organizational and operational requirements that apply to one of the types of organizations described in the IRC, regulations derived from the Code and revenue rulings; and (2) receive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses.

A tax is imposed on unrelated business income (sometimes "**UBIT**") earned by Cooperatives, unrelated to carrying out its exempt purpose.[5] Income earned by electric cooperatives from activities described in IRC Section 501(c)(12)(H) is excluded from the definition of unrelated business taxable income.[6] On the other hand, interest earned on debt-

[5] *See* IRC §511(a)(1)

[6] *See* IRC §512(b)(18)

financed income is subject to tax under IRC Section 511.[7] A Cooperative must take income from all sources for computation under the 85-percent member income test, including capital gains from the sale of assets where the gain arises from an incidental disposition of assets upon dissolution.[8] When a Cooperative leases power facilities to a nonmember power company, and the nonmember power company furnishes electric energy to the cooperative members, the payments are not an interchange of power. Rather, they are rental payments that the cooperative must include in income to determine whether it meets the 85-percent member income requirement for exemption from federal tax.[9]

In the hypothetical organizational structure discussed in this paper, the Cooperative will transfer their unrelated business activities to a taxable entity subsidiary in order to insulate the Cooperative from UBIT. Separate incorporation is essential when the level of unrelated business activities is large enough to imperil the organization's own exempt status if conducted directly. The integrity of affiliated organizations, exempt or taxable, as separate entities is relevant both under tax law and under general corporation law. Disregard of the corporate integrity can lead to denial of tax exemption, due to attribution of the activities or perceived character of the affiliates, and liability for the debts of affiliates to the organization. Care should be taken to ensure that corporate integrity is maintained and that other exempt rules are followed for the particular Cooperative to maintain its exemption.

II. The Investors: Raising Equity from the Community

This section discusses how a company can raise capital from multiple investors. In order to maximize the opportunities for local, community investment, which means aggregating many small investors, the company will most likely have to sell and issue ownership interests which would be considered securities.

In our case, the company will likely be organized as a limited partnership. A limited partnership is a type of partnership where the general partner is responsible for the management and debts of the company. The Cooperative's for profit subsidiary will serve as the general partner in this example. The limited partnership will sell and issue limited partnership interests in the company for a predetermined set price. The limited partners will each have an ownership interest in the company, but they will not be involved in the management or operations of the company.

A. Registration: In general

The U.S Congress created the Securities and Exchange Commission (SEC) to protect investors by enforcing our nation's securities laws. The SEC requires that companies disclose important financial information through the registration of securities. The information enables investors to make informed decisions about whether to purchase a company's securities. In general, all securities offered in the U.S. must be registered with the SEC or must qualify for an

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[7] Southwest Tex. Elec. Coop. v. Commissioner, T.C. Memo 1994-363 (1994)

[8] Mountain Water Co. of La Crescenta v. Commissioner, 35 T.C. 418 (1960), *acquiescence on other issues*, 1961-2 C.B. 5; Cate Ditch Co. v. U.S., 194 F.Supp. 688 (D.Cal.1961)

[9] *See* Rev. Rul. 65-174, 1965-2 C.B. 169

exemption from the registration requirements. Registration statements and prospectuses become public shortly after the company files them with the SEC.

Registration and compliance can be expensive, time-consuming, and can expose the company to additional oversight by federal and state regulators. Failure to comply with securities laws can result in fines, give investors a right to rescind their investments, and preclude the use of exemptions in future offerings.

1. Disclosure Forms

Even if a company can find an exemption from the registration requirements, substantial offering materials may still be required. The company must provide a prospectus, or offering memorandum to purchasers of the securities. A prospectus is a document that must explain the offer, including the terms, issuer, and planned use of the money, historical financial statements, and other information that could help an individual decide whether the investment is appropriate for him/her.

A Note on Disclosures and Disclaimers

This memorandum does not delve into the details required in a prospectus. Nevertheless, an investment in a solar project requires careful consideration and full disclosure of the risks involved. While the prospectus must include a discussion of the material risk factors relevant to an investment in the company, all materials discussing the investment should include a disclosure of the risks inherent in the investment. Examples of the types of risks inherent in the project include, but are not limited to:

- There is currently no public trading market for the limited partnership interests, and there may never be one.

- The fact that limited partners are passive investors and will not have the opportunity to evaluate investments in a solar project before the general partner makes them.

- Whether the company is able (or not) to raise substantial funds, how the company will be limited in the size or number of investments in solar projects, and the value of the limited partnership interests may fluctuate with the performance of the specific investments made by the company.

- The operating history of the general partner and company. Whether the general partner and company have established financing sources. The fact that performance of any prior solar facility investment programs may not be indicative of future results. Experience of the project sponsor in managing a solar investment company or any other kind of investment program.

- The revenues and any subsequent returns to the investors are based in part on the successful execution of a power purchase agreement and the performance of the power purchase agreement may not provide the revenues as anticipated.

- Any conflicts of interest any advisors, affiliates, executive officers, and others may have by participating in the company or the investment; how those conflicts arise (e.g., because of compensation, fiduciary duties, or other business arrangements); and, how the company will deal with the conflicts.

- Any limitation to sell limited partnership interests. For example, since the project is focused on providing the investors the ability to use tax credits to offset other passive income or losses, IRS recapture rules require the investors to hold the investment for a certain amount of time.

- Whether some of or all of the company's distributions will come from sources other than cash flow from operations, the sources, and the impact of distributions depending on the source. In addition, there can be no assurance that any distributions will be made, and distributions are not guaranteed. Further, there can be no assurance that tax credits will be available to offset other passive income or losses.

- The tax election of the limited partnership and how that relates to the investors.

- Any other risks related to investments in solar facilities including renewal or non-renewal of a power purchase agreements, losses from natural and unnatural causes, operational or mechanical failure, permitting or regulatory issues, and anything else that may impact the specific investment.

2. Federal Registration Requirements

To raise capital through the sale of debt or partnership units (collectively referred to in this article as "**securities**"), the company must register the securities with the SEC under the Securities Act of 1933 ("**Act**")[10], as well as with the applicable state securities administrators. On the state level, "Blue Sky" registrations must be filed, which varies from state to state based on their individual securities laws (discussed in more detail below).

The main purpose of registering a securities offering with the SEC is to provide the public access to information about the company and the sale of its securities. Registration requires the work of attorneys and accountants with specific experience. All registrations are filed electronically on the US governments EDGAR online system and are available for review by the public. Registrations, including the prospectus, may be several hundred pages when complete. There are several parts and steps to an SEC registration. It is beyond the scope of this paper to detail the steps; however, some of the steps are as follows:

- Form S-1. This form is the basic registration filing document. It includes two parts: Part I is the prospectus, which is the disclosure booklet that the company will give to all interested purchasers, and provides details of the company, its business, its financial status, risk factors and management details; and Part II has additional information such as copies of all material contracts that the company is a party to. The S-1 also requires

[10] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a et seq.)

disclosure of information about the officers and directors of the company, and their compensation; details on all transactions between owners, officers and directors and the company; a summary of all legal proceedings in which the company is involved; and details about the securities offered and their pricing and value. Regulation S-K contains all of the information and rules for filing the Form S-1 and preparing the prospectus.

- Financial Statements. The registration includes sophisticated audited or certified financial statements of the company which must be prepared using GAAP accounting and following the requirements of Regulation S-X.

- Within 30 to 60 days of filing the registration materials, the SEC may require additional information to be filed by issuing a "comment letter" to the company. Sometimes this is followed by additional comment letters asking for even more material.

- Form 10-K, Form 10-Q, and Form 8-K. As soon as the SEC accepts the registration statement, the company must begin filing annual reports, quarterly reports, and reports of any material changes. These require complex legal opinions and audited financial statements.

B. Regulation and Disclosure Exemptions

There are a number of exemptions from full registration and documentation that may be available. For the purpose of this article, we will focus on what are called Regulation D Exemptions and specifically the Rule 505 exemption.

1. Regulation D Exemptions.

In 1982, the SEC adopted a set of rules known as Regulation D (usually referred to as "**Reg. D**")[11]. Reg. D provides three different exemptions from the registration and document delivery requirements. They are set forth in SEC Rules 504, 505, and 506. Each Rule applies to different levels of investments being raised and to different types of investors. Each rule also has different limitations on how the company can advertise or market its securities.

2. Rule 505.

This paper only discusses Rule 505 of the Reg. D exemptions. Rule 505 of Reg. D provides an exemption from the registration requirements of the federal securities laws[12]. To qualify for this exemption, a company:

- Can only offer and sell no more than $5 million of its securities in any 12-month period;

[11] 17 C.F.R. § 230.500 *et seq*.

[12] 17 C.F.R. § 230.505.

- May sell to an unlimited number of "accredited investors[13]" and up to 35 other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions;

- Must inform purchasers that they are receiving "restricted" securities. "Restricted" securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. Restricted securities must be held by the purchaser for investment, not resale, and cannot be re-sold for six months or longer without registering them; and

- *Cannot use general solicitation or advertising to sell the securities.* This means sales generally must be made to persons already known to the company, and marketing by traditional media, online media, and even social media is not allowed. You may however approach anyone privately and directly via phone, in person, by letter or e-mail.

Disclosure to Investors. Companies have some flexibility as to what type of information is given to accredited investors, but it must give non-accredited investors disclosure documents that generally are equivalent to those used in registered offerings, such as financial statements and project overview. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well. The company must also be available to answer questions by prospective purchasers.

Financial statement requirements applicable to this type of offering[14]:

- Financial statements, which are part of the original offering documents, must be certified by an independent public accountant;

- If a company (other than a limited partnership) cannot obtain audited financial statements without unreasonable effort or expense, only the company's balance sheet (to be dated within 120 days of the start of the offering) must be audited; and

- Limited partnerships which are unable to obtain required financial statements without unreasonable effort or expense may furnish audited financial statements prepared under the federal income tax laws.

[13] An *accredited investor*, in the context of a natural person, includes anyone who:

- earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, ***OR***

- has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person’s primary residence) and has a reasonable expectation of reaching that same level in the current year.

Accredited investor rules for entities are complex and are found in Rule 501 of Regulation D. *See* 17 C.F.R. § 230.501(a).

[14] 17 C.F.R. § 230.502(b)(2).

In order to qualify for a Rule 505 exemption, a company must file a Form D with the SEC (discussed in more detail below).

3. SEC Filing Requirements With Exemption

The advantage of a Reg. D exemption is that it allows a company to sell its securities without going through the full SEC registration process. Each company must, however, file a From D disclosure with the SEC within 15 days after selling its first security[15]. The Form D is filed electronically and the public can view it on the EDGAR database online[16]. Although significantly more simple than a full registration, Form D still requires information about the company and its formation, names and information about the management, details on the offering and securities, and financial disclosures. A Form D may later be amended. Both Form D and the EDGAR database are accessible for reference via the SEC website.

4. State Requirements

All sales of securities must be registered pursuant to the SEC rules **and** the state regulatory agencies for **<u>each state</u>** where the securities are to be sold, unless an exemption to registration applies. State securities statutes (often referred to as "Blue Sky" laws because they are intended to protect investors from schemes that have "as much value as a patch of blue sky") govern registration of securities offerings in that state, as well as exemptions from the state registration requirements. These laws vary greatly from state to state and must be considered carefully.

III. Tax Treatment

To have the greatest flexibility in allocating income and tax incentives among the owners, the ideal organizational structure at this time appears to be a limited partnership. Allocations of items of credits, income, loss, and deductions must be allocated among the partners in accordance with IRC Section 704(b). Partnership allocations will be respected by the IRS so long as the allocations have substantial economic effect. Substantiality is largely based on the particular facts and circumstances of the situation.[17] If an allocation does not have substantial economic effect pursuant to the IRC Section 704(b) rules, then the allocations of partnership attributes will be assigned to the partners in accordance with a the partners interest in the partnership. In order to locate genuine investors, the partnership will need to generate a profit. Therefore, the project must take advantage of the energy investment tax credit (the "**ITC**") in order to maximize the potential for making a profit. Unfortunately, the ITC is designed to benefit only a narrowly tailored segment of the population, which could have a detrimental impact on the feasibility of this project if capitalizing on the ITC is a primary objective.

a. Calculating the ITC

The ITC is calculated as follows:

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[15] 17 C.F.R. § 230.503(a).

[16] 17 C.F.R. § 230.503(b).

[17] *See* Rev. Proc. 2007-65, 2007-45 I.R.B. 967.

ITC = Energy Percentage x Basis of Energy Property.[18]

i. What is the Energy Percentage?

The energy percentage is either 30 percent or 10 percent depending on the type of energy property being developed.[19] A solar power plant will receive the 30 percent energy percentage if it is activated on or before December 31, 2016.[20] Solar power plants activated after this date will receive the 10 percent energy percentage.[21] Therefore, solar power is working against a December 31, 2016 deadline.

ii. Example

If the cost basis of a solar power plant is $2.0 million and it is brought online prior to January 1, 2017, the ITC would be $600,000.[22] If this same solar power plant is brought online on or after January 1, 2017, the ITC will only be $200,000.[23] Therefore, it is imperative to an investor seeking to capitalize on the ITC to activate the solar power plant prior to January 1, 2017.

b. Passive Income

Even if a solar power plant can be activated prior to January 1, 2017, the ITC will only be useful to taxpayers with ***passive income***. Therefore, the investor should have other passive activities in addition to the investor's interest company.

i. Defined

Passive income is income derived from a passive activity. A passive activity is generally an activity that either: (a) involves a trade or business in which the taxpayer does not materially participate or (b) a rental activity.[24] Income from a passive activity does not include "portfolio income," which generally includes gross income from: interest; dividends; annuities; real estate investment trusts; regulated investment companies; real estate mortgage investments conduits; common trust funds; controlled foreign corporations; qualified electing funds; cooperatives; gain from the disposition of property that generates portfolio income; and gain from the disposition of property held for investment.[25]

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[18] IRC §48(a)(1).

[19] IRC §48(a)(2)(A).

[20] *See* IRC §§48(a)(2)(A)(i)(II), (III) (reference to §48(a)(3)(A)(ii)).

[21] See *id.*

[22] $1,750,000 x 30%

[23] $1,750,000 x 10%

[24] *See* IRC §469(c)(1)-(2).

[25] *See* Treas. Regs. §1.469-2T(c)(3)(i)(A); §1.469-2T(c)(3)(i)(B).

ii. Passive Activity Loss Limitations

Even if a taxpayer has passive income, the IRS limits the amount of passive income that a taxpayer may deduct through the passive activity loss ("**PAL**") limitations.[26] The PAL limitations deny a taxpayer a deduction for the amount of the PAL which exceeds the taxpayer's passive income.[27]

Pass-through entities, such as partnerships, are subject to the PAL rules.[28] There are several tests to determine whether a taxpayer materially participates in a business. Generally, in order to materially participate, the taxpayer must satisfy one of the following tests for material participation: (a) 500 hours of participation in the activity during the tax year;[29] (b) the individual's participation in the activity constitutes substantially all of the participation in the activity by individuals during the tax year (including non-owners);[30] (c) the individual participates in the activity for more than 100 hours during the tax year, and no other individual (including a non-owner) participates more in the activity;[31] the individual materially participated in the activity in five of the ten preceding tax years (the "**5 of 10 Rule**"), not including years in which material participation was based on the 5 of 10 Rule;[32] (d) the activity is a personal service activity, and the individual materially participated in the activity in three prior tax years;[33] or the individual participated in the activity on a regular, continuous, and substantial basis during the tax year.[34] Further, under the regulations, an individual who holds a limited partnership interest in a partnership is not considered to materially participate in an activity conducted by the partnership unless the partner participates more than 500 hours per year, satisfies the 5 of 10 rule, or the activity is a personal service activity and the partner materially participated in the activity in three prior tax years.[35]

The limited partners in the proposed entity will not materially participate in the business. Therefore, the PAL limitations will apply; this means that losses from the passive activities may only be deducted against income generated from passive activities. As a result, these rules largely limit the ability for smaller entities, including local communities, from taking advantage of the ITC, which is why these groups previously relied on the now expired cash grants.

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[26] *See* Treas. Reg. §1.469-2T(b)(1).

[27] *See* Treas. Reg. §1.469-2T(c)(1).

[28] *See* IRC §469.

[29] *See* Treas. Reg. §1.469-5T(a)(1).

[30] *See* Treas. Reg. §1.469-5T(a)(2).

[31] *See* Treas. Reg. §1.469-5T(a)(3).

[32] *See* Treas. Reg. §1.469-5T(a)(5).

[33] *See* Treas. Reg. §1.469-5T(a)(6).

[34] *See* Treas. Reg. §1.469-5T(a)(7).

[35] *See* Treas. Reg. §1.469-5T(e)(2).

iii. Example

If a taxpayer has more than one passive activity that generates a net loss in a tax year, the limitation based on the taxpayer's passive activity loss is allocated among the activities whose passive activity deductions exceed their passive activity income.[36] This results in an even smaller amount of the ITC being available to offset against all passive activities of a taxpayer. For an illustration consider the following example:

> Individual ("**Bob**") owns passive activities A, B, and C. A has net passive activity deductions of $9,000, B has net passive activity deductions of $16,000, and C's gross income exceeds its deductions by $4,000. Bob has a passive activity loss of $21,000[37] that has to be allocated between A and B only. A is allocated $7,560[38] of the passive activity loss, and B is allocated $13,440[39] of the passive activity loss.[40]

iv. Carry Forward

Generally, investors should use a tax credit as soon as it is available. However, any deductions disallowed under the PAL rules for a tax year are carried forward to the next year. In the next tax year, each carried forward deduction is attributed to the activity or activities that are a continuation of the activity that generated the deduction.[41] Unfortunately, there is a detrimental economic impact to the taxpayer for carrying tax benefits forward to future tax returns instead of using them in the period in which they were earned. Time-value-of-money factors reduce the value of tax benefits that are carried forward to future taxable years. Additionally, future taxable returns can be very difficult for individuals to predict. Put simply, when deductions are carried forward the cost of energy increases and the rate of return on investment decreases.

c. The Investors

The PAL limitations will limit the amount of tax credits and deductions an investor can take annually, which will in turn diminish the taxpayer's rate of return. This will impact the feasibility of the investment unless the correct investors are located. Ultimately, the ideal investors will be wealthy individuals. For purposes of this investment "wealthy" means two different classes of individuals. The first class is composed of individuals whose earned income exceeds $200,000 (or $300,000 together with a spouse) in each of the prior two years, and who reasonably expect the same for the current year. The second class is composed of individuals who have a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). The members of each of these classes must own multiple

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36 *See* Treas. Reg. §1.469-1T(f)(2)(i)(A).

37 $9,000 + $16,000 – $4,000

38 ($9,000/$25,000) × $21,000

39 (($16,000/$25,000) × $21,000)

40 *See* Treas. Reg. §1.469-1T(f)(2)(i)(D), Ex. 1.

41 *See* Treas. Reg. §1.469-1(f)(4)(i).

businesses so that they will have passive income. Without passive income, the ITC is meaningless to them.

IV. Conclusion

As noted at the start of this paper, responsible investing is not a *one size fits all* approach. This paper presents one concept of how a Cooperative could utilize a for profit subsidiary to set up a limited partnership, sell interests in the limited partnership to raise equity, and allow the investors in the limited partnership to take advantage of the ITC. As noted throughout the paper, any interested Cooperative should consult with its attorneys and other professional advisors before embarking on this or any other concept to finance and build a renewable energy project.

About 25x'25

25x'25 is a diverse alliance of agricultural, forestry, environmental, conservation and other organizations and businesses that are working collaboratively to advance the goal of securing 25 percent of the nation's energy needs from renewable sources by the year 2025. 25x'25 is led by a national steering committee composed of volunteer leaders. The 25x'25 goal has been endorsed by nearly 1,000 partners, 35 current and former governors, 16 state legislatures and the U.S. Congress through The Energy Independence and Security Act of 2007. 25x'25 is a special project of the Energy Future Coalition, a broad-based non-partisan public policy initiative that seeks to bring about change in U.S. energy policy to address overarching challenges related to the production and use of energy.

About Energy for Economic Growth (EEG)

Through this initiative, the 25x'25 Alliance, in collaboration with the National Rural Electric Cooperative Association, is assisting a group of rural electric utilities in developing and piloting renewable energy for economic growth business and community engagement models. As part of the project, 25x'25 is also helping participating rural electric cooperatives and public power providers in sharing their experiences and outcomes with utilities across the country. The goal of the project is to demonstrate how distributed renewable energy generation can be a new vehicle for powering communities and empowering cooperative members to improve the quality of their members' lives. To help sustain the tremendous growth of the distributed generation projects undertaken by co-ops, the Alliance's Energy for Economic Growth (EEG) team focuses on pilot projects that not only produce renewable energy, but also offer important ecosystem service benefits such as carbon sequestration and improvements in soil, water and air quality.

EEG Project Leaders can be found here.