Internal Revenue Service

Number: **200318066**
Release Date: 5/2/2003
Index No.: 45.01-00

Department of the Treasury

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CC:PSI:5 — PLR-142985-02
Date:
January 29, 2003

LEGEND

Taxpayer =

Corp 1 =

LLC1 =

ProjectCo =

Project Partnership =

State A =

State B =

State C =

County =

Utility =

Vendor 1 =

Vendor 2 =

Agency 1 =

Agency 2 =

Act =

a =

b =

c =

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aa =

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Dear

This letter responds to your letters dated August 5, 2002, and November 6, 2002, requesting rulings on behalf of Project Partnership, regarding Project Partnership's qualification for tax credits under section 45 of the Internal Revenue Code from an aa megawatt wind-based generation project consisting of bb separate cc MW wind turbine generators located in County (Project).

You represent that the facts are as follows.

LLC 1 formed ProjectCo on a. Following the formation of ProjectCo, Taxpayer acquired a b percent membership interest in ProjectCo in exchange for a cash contribution of $c. ProjectCo used this cash contribution to purchase ground lease options (described below) and other development rights for the Project from LLC1.

LLC1 acquired various options to lease land for the Project (the "Ground Lease options"). The Ground Lease Options grant the holder of the option the right to lease (or, in certain circumstances, to purchase) all or part of the land (collectively, the "Ground Lease"). LLC1 sold the Ground Lease options to ProjectCo. ProjectCo will exercise the Ground Lease Options and will pay rent under the ground lease equal to the greater of (i) a fixed cash amount per wind turbine generator located on the leased land, (ii) an amount determined by multiplying a unit price by the number of kilowatt-hours of electricity produced by the wind turbine generators located on the leased land, or (iii) a fixed percentage of the gross revenue derived from the sale of electricity produced by the wind turbine generators located on the leased land ("Ground Lease Rent").

Pursuant to a power purchase agreement (the "PPA") with Utility dated d, ProjectCo will sell to Utility electricity produced from the Project that is not needed to operate the Project over the PPA's approximately e-year term at a base price of a fixed amount per MWh. ProjectCo entered into an interconnection agreement with Utility on f (the "Interconnection Agreement"). Pursuant to the Interconnection Agreement, certain interconnection facilities will be constructed (at Taxpayer's cost) to permit the interconnection of the Project with Utility's system.

ProjectCo will enter into a supply and installation agreement (the "Supply and Installation Agreement") with Vendor 1, an unrelated party that is the vendor of the wind turbine generators to be used by the Project. ProjectCo also expects to enter into a balance of plant engineering, procurement and construction agreement with Vendor 2, an unrelated party, to build the rest of the Project (the "Balance of Plant Agreement"). Both agreements will require the Project to be substantially completed by a specified date and will include a liquidated damages clause providing that in the event of a non-excused delay in project completion, ProjectCo will receive liquidated damages proportional to the length of the delay. Vendor 1 will also warrant the performance of the installed wind turbine generators and it will pay liquidated damages to Project Partnership to the extent that the generators fall below certain performance standards.

ProjectCo will purchase LLC1's b percent interest in ProjectCo at the commencement of construction of the Project. Upon the sale of LLC1's interest, ProjectCo will be treated as a disregarded entity for federal tax purposes. ProjectCo will borrow from third-party lenders to fund the expected $p construction cost of the Project. The permanent financing for the project is expected to consist of a single tranche of approximately $dd combining both a term loan and a production tax credit loan (the "Combined Loan"). In connection with the financing, Taxpayer will enter into an agreement (the "Equity Contribution Agreement") in favor of the lenders to make contributions to ProjectCo in the amount of $r when construction is completed (the

"Fixed Contribution Obligation") plus additional semi-annual contributions (the "PTC Contribution Obligation") that are measured by the lesser of i) the debt service on the production tax credit portion of the Combined Loan, and ii) the product of cc cents, as adjusted pursuant to § 45(b)(1) and the "PTC Rate" and the number of kilowatt hours of electricity produced by the Project during the semi-annual period. The contributions to satisfy the PTC Contribution Obligation are expected to be approximately s percent of the § 45 tax credits generated by the Project in each semi-annual period over a t-year period commencing when the wind turbines in the Project are placed in service.

The Partnership Agreement will provide that each partner will be required to contribute its pro rata share of i) an initial equity contribution equal in amount to the Initial Payment, the $v Initial Contribution, and ii) semi-annual capital contributions (the "Semi-Annual Partner Contributions") equal to an agreed percentage of an amount equal to the product of the number of kilowatt hours of electricity produced by the Project during the applicable semi-annual period and the PTC rate. The initial Contribution, all Semi-Annual Partner Contributions and all current distributions will be made by the partners in accordance with their respective percentage interests. All items of income, gain, loss, deduction and credit of Project Partnership will be allocated to the partners in accordance with their respective percentage interests. Project Partnership will use the Initial Contribution to make the Initial Payment pursuant to the Purchase and Sale Agreement. The Semi-Annual Partner Contributions will be used by Project Partnership to make the PTC Capital Contribution to ProjectCo pursuant to the Equity Contribution Agreement.

ProjectCo will use these contributions, together with any available operating cash flow after payment of expenses (including Combined Loan service and Ground Lease rent) to pay amounts due with respect to the Combined Loan. After providing for such amounts, ProjectCo will make distributions to the Project Partnership, which amounts, together with the amounts by which the Partners Semi-Annual Contribution exceeds the PTC Contribution Obligation under the Equity Contributions Agreement, would be available for the Project Partnership to make the Periodic Payments under the Purchase and Sale Agreement.

ProjectCo expects to hire an operator to provide operation and certain maintenance services for the Project (the "O&M Agreement"). The operator under the O&M Agreement is expected to be an affiliate of the Taxpayer's parent corporation. Taxpayer also expects to enter into a maintenance and service agreement with Vendor 1 for the wind-turbine generators and related equipment for an initial y-year period (the "Maintenance and Service Agreement"). The compensation paid to the operator under the O&M Agreement and to the service provider under the Services Agreement is expected to be a fixed amount per year per wind turbine generator included in the Project, subject to an annual adjustment for inflation. The terms of the O&M Agreement and the Services Agreement will be negotiated at arm's length and the amounts paid to the operator and service provider will reflect reasonable compensation for services rendered.

Agency 1 has agreed to provide cash proceeds to ProjectCo under the terms and conditions of an agreement between Agency 1 and ProjectCo (the "Agency 1 Agreement"). Under the Agency 1 Agreement, Agency 1 will disburse the proceeds to ProjectCo when the Project is completed and in service (the "Commencement Date") in the form of a single advance supplemental production payment. ProjectCo is required to spend the proceeds on operating expenses during the j-year period beginning on the Commencement Date (the "Expenditure Requirement"). ProjectCo will earn the proceeds as it produces and sells electricity during the y-year period commencing with the Commencement Date (the "Performance requirement"). To the extent that either the Expenditure Requirement or the Performance Requirement is not satisfied, ProjectCo is required to repay Agency 1.

Pursuant to a loan guarantee and reimbursement agreement, (the Agency 2 Loan Guarantee"), between ProjectCo and Agency 2, Agency 2 will provide a loan guarantee in favor of the lender to ProjectCo under the construction and term financing.

The Agency 2 Loan Guarantee will be for approximately z months' debt service on the Combined Loan.

ProjectCo has applied to the relevant local authorities for designation of the Project Site as an Enterprise Zone. An enterprise zone is an area that meets the requirements set forth in the Act. The purpose of the Act is to stimulate business and industrial growth and retention in, and stimulate neighborhood revitalization of, areas in which pervasive poverty, unemployment and economic distress exist. If the Project site is designated as an enterprise zone under the Act, the acquisition of building materials to be incorporated into the Project would not be subject to certain sales and use taxes imposed by State C.

Taxpayer represents the following. The Utility is not a related person to the Project Partnership within the meaning of § 45(d)(3). The electricity generated by the wind turbines within the Project is not being sold to a utility pursuant to a contract originally entered into before January 1, 1987. The Project Partnership projects that at the end of the term of the Ground Lease, it will be economically feasible for ProjectCo to remove the Project's wind turbines from the land.

Taxpayer requests the following rulings:

1. Following the transfer of the ProjectCo membership interests to Project Partnership, the production of electricity from the Project wind turbines will be attributable solely to Project Partnership, and as a result, Project Partnership will be entitled to the § 45 tax credits for electricity that is sold to unrelated persons.

2. The § 45 credit attributable to Project Partnership may be passed through to and allocated among the partners of Project partnership under the principles in § 702(a)(7), in accordance with each partner's interest in the Project partnership at the time the § 45 credit arises.

3. Any termination of the Project Partnership under § 708(b)(1)(B) arising from sales or exchanges of interests in Project Partnership will not preclude Project Partnership as reconstituted from taking the § 45 credit for the production and sale of electricity from the Project wind turbines to unrelated persons.

4. The proceeds from the Agency 1 Agreement, the Agency 2 Loan Guarantee, and the State C sales/use tax exemption will not be considered 1) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the Project; 2) proceeds of an issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103;

3) subsidized energy financing provided (directly or indirectly) under a Federal, State, or local program provided in connection with the Project; or 4) other credit within the meaning of § 45(b)(3)(A)(1)(iv).

Under § 45, the renewable electricity production credit for any taxable year is an amount equal to the product of 1.5 cents, multiplied by the kilowatt hours of electricity 1) produced by the taxpayer from qualified energy resources, and at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service, and 2) sold by the taxpayer to an unrelated person during the taxable year.

Under § 45(b)(3), the amount of the credit with respect to any project for any taxable year is reduced by an amount equal to the product of 1) the amount of the credit otherwise allowable for such year and 2) a fraction, the numerator of which is the sum of i) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the project; ii) proceeds of an issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103; iii) the aggregate amount of subsidized energy financing provided (directly or indirectly) under a Federal, State, or local program in connection with the project; and iv) the amount of any other credit allowable with respect to any property which is part of the project, and the denominator of which is the aggregate amount of additions to the capital account for the project for the taxable year and all prior taxable years.

A similar reduction exists under § 29(b)(3) relating to governmental grants or subsidized energy financing provided in connection with a nonconventional source fuel project. Section 29 was added to the Code as a part of the Crude Oil Windfall Profit Tax of 1980, section 231, 1980-3 C.B. 1, 40. The Conference Report, in explaining the reduction mechanism found in § 29(b)(3), states that the § 29 credit is reduced in proportion to federal grants provided in connection with the construction or acquisition of the facility. H.R. Rep. No. 96-817 (Conf. Rep.), 96th Cong., 2d Sess. (1980), 1980-3 C.B. 245, 300.

Section 45(c)(1) defines “qualified energy resources” to include wind. Section 45(c)(3)(A) defines a “qualified facility” in the case of a facility using wind to produce electricity as any facility owned by the taxpayer that is originally placed in service after December 31, 1993, and before January 1, 2002.

Section 45 does not define the term “grant.” However, the term is defined in § 1.148-6(d)(4)(iii) of the Income Tax regulations (involving arbitrage bonds) as a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor.

Section 45(b)(3)(A)(ii) provides that for purposes of § 45, tax-exempt bonds consist of an issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103. The proceeds of such reduce the amount of credit for any taxable year.

Section 45 does not define subsidized energy financing. However, under § 48(a)(4)(C), the term means financing provided under a Federal, State, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

Section 702(a)(7) provides that each partner determines the partner's income tax by taking into account separately the partner's distributive share of the partnership's other items of income, gain, loss, deductions, or credit to the extent provided by regulations prescribed by the Secretary. Under § 1.702-1(a), the distributive share is determined under § 704 and § 1.704-1.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit is, except as otherwise provided in chapter 1 of subtitle A of Title 26, determined by the partnership agreement. Under § 704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (i) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (ii) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) lacks substantial economic effect.

Section 1.704-1(b)(4)(ii) provides that allocations of tax credits and tax credit recapture (except for § 38 property) are not reflected by adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under § 1.704-1(b)(2)(ii)(b)(1), and the tax credit and tax recapture must be allocated in accordance with the partner's interest in the partnership as of the time the credit or recapture arises. If a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustment) for the year, the partners' interests in the partnership regarding the credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments). See § 1.704-1(b)(5), Example 11. Identical principles apply in determining the partner's interest in the partnership regarding tax credits that arise from income of the partnership (whether or not taxable). If a partnership receipt gives rise to a tax credit, such as the credit under § 45, and that receipt also gives rise to a valid allocation of partnership income, the partners' interests in the partnership with respect to the item of credit will be in the same proportion as the partners' respective distributive shares of such income. See § 1.704-(b)(4)(ii).

Section 708(b)(1)(B) provides that a partnership will be considered as terminated if, within a 12 month period, there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits.

Under § 1.708-1(b)(4), if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur. The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership. Immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership, or for its dissolution and winding up.

Section 7701(a)(14) provides that the term “taxpayer” means any person subject to any internal revenue tax. Section 7701(a)(1) provides that when used in Title 26, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term “person” will be construed to mean and include an individual, trust, estate, partnership, association, company, or corporation.

Section 301.7701-3(b) of the Procedure and Administration Regulations provides that unless it elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

Based solely on the representations and the relevant law and regulations set forth above, we conclude as follows:

1. Following the transfer of the ProjectCo membership interests to Project Partnership, the production of electricity from the Project wind turbines will be attributable solely to Project Partnership, and as a result, Project Partnership will be entitled to the § 45 tax credits for electricity that is sold to unrelated persons.

2. The § 45 credits attributable to Project Partnership may be passed through and allocated among the partners of Project Partnership under the principles of § 702(a)(7) in accordance with each partner’s interest in Project Partnership at the time the § 45 credit arises.

3. A future termination of Project Partnership under § 708(b)(1)(B) will not preclude the reconstituted partnership from claiming the § 45 credit for the sale of electricity to unrelated persons that is generated from the Project wind turbines.

4. The proceeds from the Agency 1 Agreement, the Agency 2 Loan Guarantee, and the State C sales/use tax exemption will not be considered 1) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the Project; 2) proceeds of an issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103; 3) subsidized energy financing provided (directly or indirectly) under a Federal, State, or local program provided in connection with the Project; or 4) other credit within the meaning of § 45(b)(3)(A)(1)(iv).

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations. In particular, no opinion is expressed or implied regarding how the partners' interests in the Partnership are determined. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney filed with this request, we are sending copies of this letter ruling to your authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy