

# US Inbound Investment Strategies For Renewable Energy

*by Keith Martin, in Washington*

A new wave of Chinese, Spanish and some other European and Latin American companies is investing in US renewable energy projects. Much of the attention is focused on the solar sector, but there have also been some notable recent purchases of interests in operating wind farms and other wind projects nearing the start of construction.

An issue for non-US companies investing in renewable energy projects in the United States is how to structure the investments.

The answer depends on the particular facts, but a good default position is the following:

Hold each project through a separate Delaware limited liability company (unless the business is rooftop solar installations or other forms of “distributed” energy, in which case it may be better to pool multiple projects in a single holding company).

File a form with the US tax authorities within 75 days after the Delaware limited liability company is formed to treat it as a corporation for US tax purposes.

Take care in what order assets accumulate in the LLC.

Make sure that at no point is 50% or more of the value in assets that are considered US real property.

Consider capitalizing the company with three parts debt to two parts equity.

View this default position as a working hypothesis. Test whether the overall tax burden not only in the United States, but also in the home country of the investor, can be reduced by tweaking the structure.

This article is aimed more at foreign companies and private equity funds investing in the United States than individual investors. Many of the basic principles are the same, but there are additional complications — and opportunities — for individual investors. (One of the more frustrating truths about the US tax laws is that the rules are often more complicated for individuals than for large corporations.)

## Initial Challenges

Europeans warmed more quickly to renewable energy than the Americans did. European companies built up impressive

early experience with wind and solar projects and new waste gasification technologies.

When demand for renewable energy began to grow more rapidly in the United States in the early part of the last decade, Europeans initially found several things daunting about the US market.

One was the complexity. Each of the 50 states and the District of Columbia, an enclave where the national government is based, has its own public utility commission that regulates electricity supply, and each has its own tax rules. Taxes at the federal level can reach close to 55% on the operating earnings that a foreign investor might earn from a US project, and there are additional state and local taxes to pay.

The other issue was that the US government subsidizes renewable energy projects heavily through the tax code. The federal government pays currently 56¢ per dollar of capital cost of solar projects, at least that amount for wind and geothermal projects, and slightly less for biomass projects through tax subsidies. New foreign entrants come without a US tax base. This puts them at a disadvantage when trying to compete with the incumbent US utilities.

However, they soon realize that regulated utilities are not the main competition. Most renewable energy development is by unregulated independent power companies, few of whom can use the subsidies either. Most of these developers essentially barter the tax subsidies to large banks, insurance companies and other “tax equity” investors in exchange for capital to pay part of the cost of their projects. There are currently 18 active tax equity investors and three basic tax equity structures in use, with many variations on the basic structures.

## US Holding Company?

It is usually better to hold US investments through a US holding company than to invest directly from abroad.

There are at least three reasons.

First, investing directly will cause the foreign company or investment fund to be considered engaged in a US trade or business and require it to file US tax

*/ continued page 2*

## US Inbound Structures

*continued from page 1*

returns as if it were an American company.

US renewable energy projects are almost always owned by special-purpose limited liability companies that are transparent for tax purposes, meaning there is no US income tax at the project company level. This allows tax subsidies on the projects and earnings to pass through to the owners of the project company. It is important for being able to raise tax equity to help finance the project.

A foreign company or investment fund investing in such a transparent entity will be considered engaged directly in a US trade or business and become subject to US income tax at a 35% rate on its share of net income earned by the project company. The foreign owner will have to file US tax returns. It will be taxed on its share of income whether or not any cash is distributed to it. If the project company has more than one owner, then the project company will be treated for US tax purposes as a partnership and be required to withhold income taxes on the share of its net income that is allocated to foreign owners.

Second, investing directly from abroad will also subject the foreign company or investment fund to a “branch profits tax” in the United States that is collected in theory at the US border on any earnings that the foreign owner brings home, but that will be levied in practice without waiting for earnings to be repatriated.

Most countries collect two taxes on earnings: there is an income tax inside the country and a withholding tax at the border on dividends, interest and other payments across the border. The US withholding tax rate is 30%, but it is often reduced or waived entirely by bilateral tax treaties between the United States and other countries.

The United States started imposing a separate branch profits tax in 1986 on foreign companies that engage directly in business in the United States. Such companies escape US withholding taxes since earnings are repatriated to the head office merely by transferring them within the foreign corporation, not by paying a “dividend.” The branch profits tax rate is the same as the withholding tax rate, but the main problems are that it is more difficult to control the timing and the tax is more complicated than the withholding tax to calculate. (US tax treaties that reduce withholding tax rates usually also reduce the branch profits tax rate, but it is important to check. Older tax treaties that were in effect before 1986 may prevent the US from collecting branch profits taxes.)

Branch profits taxes are collected on the “dividend equivalent amount,” meaning the earnings and profits the foreign

company had from US business operations from which it could have paid a dividend. The amount is increased to the extent the foreign company had a lower net investment in the US business operation at the end of the year than when the year started. It is reduced to the extent the foreign company had a larger net investment in the US business operation at year end. The net investment is calculated by subtracting any debt related to the US business operation from the adjusted basis that the foreign company has in the assets used in that business. Unless significant capital additions are being made, the net equity will usually draw down as the existing assets depreciate.

Third, direct investment could also make it more expensive to exit the investment later.

The United States does not tax foreigners on their capital gains when US investments are sold, with one major exception. Congress became concerned in 1984 about growing Japanese investment in US farmland. The concern was that this would bid up prices and make it harder for smaller family farms to survive. It was too hard to define farmland, and so Congress ended up requiring that foreigners pay taxes on sales of interests in any “US real property.” Part of a wind, solar, geothermal, biomass or other renewable energy project is considered real property. However, even if none of it were, the Internal Revenue Service has ruled that at least part of the gain a foreign company receives from sale of an interest in a US partnership is “effectively connected” income, meaning it is subject to net income taxes at a 35% rate. The foreign company will be taxed this way on the lesser of its gain or the share of gain the foreign company would have had to report as a partner if the partnership had sold all of its assets and liquidated.

One way to avoid a tax on exit is to hold the partnership interest or project through a US holding company that is treated as a corporation for tax purposes. Shares in the corporation can normally be sold without having to pay a US tax on the gain.

Care must be taken to avoid turning the US holding company into a “US real property holding corporation.” It will be considered a holding company for real estate investments if at least half its total assets by market value are interests in US real property. Once the company becomes tainted with this label, then the taint will last for at least five years. Its assets are tested on numerous “testing dates.”

The developer of a renewable energy project often signs an option to buy or lease a site as one of the first steps in the development process. In the case of a wind / *continued page 3*

## US Inbound Structures

*continued from page 2*

farm, he erects a meteorological tower and monitors the wind speed on the site for at least one to two years. Other early steps in the development process are to get in line to connect the project to the utility grid, obtain permits to build and negotiate a long-term contract to sell the electricity from the project to a nearby utility. It is important not to put the development assets under the holding company while 50% or more of the value is in the site. The US independent power industry takes the position that a site lease has value only to the extent the rents the developer is required to pay are below market. Its position is that a power contract has value only to the extent that the electricity prices are above market, so other contracts may not have much offsetting value beyond the cost to put them in place.

### Delaware LLC

It is usually best to use a Delaware limited liability company as the US holding company.

Delaware has the most well developed body of corporate law among all the states, except possibly New York. Its limited liability company statute allows flexibility in terms of business arrangements among the owners. Most US lawyers at the larger US law firms are familiar with the Delaware statute; they are not as familiar with statutes in other states. This has sometimes led to situations where developers who have formed project companies in other states have had to reorganize them in Delaware before banks and tax equity investors will provide financing.

A limited liability company is like a corporation in that its owners are shielded from liability for the company's debts, but it has a lot more flexibility in terms of permissible business arrangements. It can function like a corporation with a board of directors, officers and periodic dividends to shareholders, or it can operate like a partnership where the members run the business directly and agree to changing ratios over time for distributing earnings.

Unlike a corporation, the owners can choose how they want a limited liability company to be taxed.

An election should usually be filed with the Internal Revenue Service within 75 days after the limited liability company is formed to treat it as a corporation for US tax purposes. The election is filed on Form 8832. The form is available on the IRS website at [www.irs.gov](http://www.irs.gov).

The reason for filing within 75 days is that is the period that

the election can relate back. The owners are free to change their minds later about the tax classification if the LLC has been a corporation from inception; otherwise, they are locked into the elected status for five years.

If no election is filed, then the LLC will be treated as a partnership for US tax purposes, if it has more than one owner, or as a "disregarded entity," if it has only one owner. A "disregarded entity" is ignored. It is treated for US tax purposes as if it does not exist.

### Single Holding Company?

A separate holding company for each investment will allow more options when it comes time to exit a project. One project can be sold without having to sell others.

However, there is a tradeoff. Renewable energy projects in the United States usually do not start generating taxable income until three to four years after a project has started operating because of the large amounts of tax depreciation and tax credits to which the owner is entitled. The owner is better off using this tax shield himself if he has other income that can be sheltered with it rather than bartering it in the tax equity market where he will get less than full value for it. Using a single holding company for all projects will eventually create a tax base against which the tax shield can be used. A consolidated US income tax return cannot be filed for a series of separate US holding companies. Corporations can join in filing a consolidated return only if they are at least 80% owned by vote and value by a common US parent company.

It may be possible to get the benefits of consolidation while keeping separate US holding companies for each project by having whichever holding companies are earning taxable income enter into tax equity transactions with project companies that have just put new projects in service. These "cross chain" tax equity transactions raise a number of tax issues that require careful consideration and are beyond the scope of this article.

Other considerations may come into play.

For example, the foreign company may put employees on the ground in the United States. They may have responsibility for business operations not just in the United States, but also in Canada and Mexico or even into Central and South America. Depending on the nature of the business, it may make sense for administrative convenience to put all the western hemisphere operations under a single US holding company, but to make that holding company a disregarded Delaware limited liability company that sits atop separate / *continued page 4*

## US Inbound Structures

*continued from page 3*

subsidiary holding companies for each project in the United States and for business operations in each of the other countries. However, the US employees should stay in one of the subsidiary US holding companies. Making them employees of the disregarded umbrella holding company would cause the foreign parent company to have a “permanent establishment” in the United States. Since the umbrella company does not exist for US tax purposes, whatever it does is treated as done by its foreign parent company directly. Under US tax treaties, business profits of a foreign entity cannot be taxed in the United States unless attributable to a permanent establishment of the foreign entity in the US. A portion of the profits earned by the foreign parent could be attributed to the permanent establishment under US attribution rules.

### Accumulating Assets

Care should be taken about the order in which assets accumulate under the US holding company for each project.

Developers of US renewable energy projects usually secure an interest in a site for the project at an early stage the development process. At no point should 50% or more of the value be in assets that are considered interests in US real property.

The asset mix of the holding company will be tested on a series of “testing dates.” The testing dates include the last day of each tax year of the holding company, and each day that an interest in US real property is acquired or sold. Once the holding company is tainted, the taint will last for at least five years. A tainted company is called a “US real property holding corporation.”

Paying attention to the asset mix will make it more likely that the foreign company or investment fund can sell its interest in the project in the future without having to pay US taxes on its gain.

Any such sale would have to be of shares in the US holding company. As long as the holding company is not tainted, then no US tax will have to be paid on the gain.

If a tax is owed, then the gain will be treated as “effectively connected” income from a US trade or business, and will have to be reported by the seller by filing a US tax return. It will be subject to taxes not only at a 35% federal rate, but also to a branch profits tax. However, rather than take chances, US law requires the buyer to withhold 10% of the gross purchase price. The seller can get back any excess taxes it paid on its actual gain by filing a US tax return.

If the holding company is tainted by having owned too much US real property in the last five years, then it may be better to sell its assets and liquidate the holding company rather than sell shares in the holding company directly. The holding company will be subject to US income taxes at a 35% rate on the asset sale, but there will usually not be any further withholding or branch profits tax to distribute the sales proceeds to the foreign owner.

However, there is a risk of an “accumulated earnings tax.” US corporations that accumulate significant earnings rather than pay dividends are exposed to a penalty tax at a 15% rate. The tax is imposed at the corporate level. The rate increases to 39.6% after 2012. The aim of the tax is to prevent corporations from waiting to pay dividends until a shareholder has losses that can be used as shelter or not paying dividends at all to enable individual US shareholders to convert them into capital gains at lower tax rates or foreign shareholders to avoid taxes altogether by eventually selling the corporate shares. The tax is infrequently imposed. It requires the IRS to substitute its business judgment for the judgment of corporate management by concluding that the corporation allowed earnings to accumulate beyond the reasonable needs of the business.

Another strategy to avoid a tax on exit is to sell shares in a foreign entity treated as a corporation for US tax purposes that owns shares in the US holding company. The US tax net does not reach such a sale.

While the strategy of using a separate US holding company for each project and electing to treat it as a corporation gives a foreign company a way to exit US projects directly without having to pay US tax on gain, the foreign owner may find it hard to arrange such an exit in practice. The exit requires selling shares in the US holding company rather than selling the interest it holds in the US project company.

Other things being equal, buyers prefer to buy assets.

One reason is fear of unknown liabilities in the corporate holding company, including the possibility that the holding company joined at some time in the past with other corporations in filing a consolidated return at the federal level or combined return at the state level. In such cases, the holding company may be subject to what US tax lawyers call “dash six” liability, or liability for unpaid taxes on the consolidated or combined return.

Another reason is anyone paying a premium over the current tax basis the project company has in its assets will want the premium to be reflected in a “step up” in the tax basis so that he can recover the premium through / *continued page 5*

## In Other News

*continued from page 4*

additional depreciation. The value of the step up tends to be higher in renewable energy projects than in other types of businesses because renewable energy assets are subject to faster depreciation allowances. There is usually no additional depreciation for the premium if corporate shares are purchased. This becomes a math exercise. The buyer will pay less because of inability to step up asset basis. The issue is whether the tax savings to the seller are worth the lower purchase price.

It is rare to see direct sales of project assets, because the assets usually include a power contract, interconnection queue position and permits that require consent from other parties to transfer. Most “asset” sales are sales of the project company or an interest in the project company.

### Capitalization

Some time should be spent thinking about how to capitalize each US holding company, assuming part of the capital cost of the project will come from overseas rather than raising the entire cost locally.

The way to think about the question is to focus on the overall tax burden on the operating earnings from the project — not just in the United States, but also at the US border when earnings are repatriated and in the home country of the foreign company or investment fund. The US corporate income tax is 35%. There is a 30% withholding tax on dividends when earnings are repatriated. The withholding tax is often reduced under bilateral US tax treaties.

If the foreign investor injects part of its investment in the US holding company as a loan rather than injecting it entirely as equity, then the share of earnings pulled out as interest on the loan will attract a US withholding tax, but at least the interest will be deductible, reducing the income on which the 35% corporate tax has to be paid. This is called “earnings stripping.” Some US tax treaties waive withholding taxes altogether on interest while reducing, but not eliminating, the rate on dividends.

One problem with trying to strip earnings is that capital-intensive businesses run losses. There may be no earnings to strip. The typical renewable energy project does not turn tax positive until sometime in the fourth year after the project goes into service. If the developer retains the US tax subsidies, rather than barter them in a tax equity transaction, then it can be as long as nine years before the project turns tax positive. Unused tax subsidies can be carried forward up to 20

years and used to shelter future income from the project from tax. Stripping earnings during a period when the US holding company is in a net loss position has the effect potentially to increase the overall tax burden. It may subject the earnings to a withholding tax earlier in time at the US border or in the foreign country, assuming the earnings are not exempted from taxes in the home country under a participation exemption or similar provision and the foreign country does not already tax them by looking through the US holding company under a controlled foreign corporation regime.

US rules also limit the extent to which the US will allow earnings stripping. The US will not allow part of the interest paid to a foreign parent company to be deducted if the debt-to-equity ratio of the US holding company exceeds 1.5 to 1 and the foreign parent company is in a country with a favorable US tax treaty that waives or reduces US withholding taxes on interest payments.

At worst, part of the interest paid to the foreign parent company each year cannot be deducted.

Calculating the share that cannot be deducted is complicated. There are two concepts: “disqualified interest” and “excess interest expense.”

“Disqualified interest” is the interest that is paid to the foreign parent without US withholding tax. For example, if interest paid to the parent is subject to only a 5% withholding tax because of a favorable US tax treaty, then five sixths, or 83.3%, of the interest is considered disqualified.

“Excess interest expense” is the amount by which the net interest the US holding company pays during a year to all lenders exceeds 50% of its income before deducting interest, net operating losses, depreciation and depletion.

The amount of interest that will be disallowed in a year is whichever is less: the disqualified interest or the excess interest expense that year. For example, suppose the US holding company had income — after adding back any deductions it took for interest, net operating loss carrybacks and carryforwards, depreciation and depletion — of \$100 for the year, and the disqualified interest payments to its foreign parent were \$60, then \$10 of interest paid to the parent cannot be deducted. The \$10 can be carried to the next year and deducted then if there is room that year to deduct it under the 50% cap. The cap is cumulative. If interest paid to the foreign parent were only \$40 the first year, then not only would all the interest paid have been deductible but there would also have been \$10 of unused cap to carry forward to future years until used.

*/ continued page 6*

## US Inbound Strategies

*continued from page 5*

Debt borrowed from third parties is treated like a loan from the foreign parent company if repayment is guaranteed by the foreign parent company or an affiliate. In that case, the interest paid to the unrelated lender is disqualified interest to the extent there is no withholding tax on the payment to the unrelated lender. It does not matter that interest paid to the foreign parent would have attracted a full withholding tax. Whether there is a favorable tax treaty with the foreign parent company's home country is irrelevant.

When borrowing from third parties to raise capital for any equity the foreign parent must inject into the project, consider whether the debt should be in a location in the capital structure that allows the interest to be deducted by the foreign parent directly. The US holding company may not have enough tax base to deduct the interest in the US. The foreign parent might borrow directly and inject the funds as equity into the US holding company. This would give the parent an interest deduction at home. There are no earnings to strip in the US. Alternatively, the debt might be put in an entity one tier up from the US holding company that is transparent for tax purposes in the home country of the foreign parent company, and the borrower would then inject the money as equity into the US holding company.

Until recently, it was more common to use an intermediate holding company in a jurisdiction with a favorable tax treaty with the United States to invest in US projects. An example

might be a Dutch holding company. If the foreign investor is in a country without such a tax treaty, this was a way to qualify for a reduced withholding tax rate. However, recently-negotiated US treaties have limitation of benefits clauses that make such treaty shopping difficult. The foreign investor must have a meaningful business presence in the intermediate jurisdiction to be able to benefit from the treaty.

Finally, use of hybrid instruments and hybrid entities might also be considered.

An example of a hybrid instrument is a capital injection by a foreign parent into a US holding company that is viewed as a loan for US tax purposes but as an equity investment for tax purposes in the foreign parent company's home country. Suppose dividends are taxed less heavily than interest in home country X. Injecting capital under a hybrid instrument would allow earnings stripping in the US while allowing repatriated earnings to qualify for reduced taxes on dividends at home.

A hybrid entity is an entity that is viewed as transparent in one country but as a corporation in the other. These can offer benefits in some situations. An example is where taxes paid in the project country might be released for use as foreign tax credits at home or where interest deductions might pass through on borrowed money. There is probably more limited scope for use of such entities in the renewable energy sector because of the US tax profile of such projects than in other sectors. ☺

November 2011