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Q&A Passive Loss Issues In Connection with Solar Investments

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Question: Can individuals (and solar developers) use investment tax credits and depreciation deductions from an investment in a solar project to decrease their federal income tax liability?

Answer: Yes, but only after considering the passive loss and at-risk rules.

As everyone knows the U.S. capital markets have been extremely challenging in the last year. Because tax equity from the traditional sources (banks, insurance companies, etc.) dried up, many solar developers looked to individual investors and others as alternative sources of tax credit equity. Developers also explored the possibility of “self funding” and using the tax benefits themselves.

Background

The passive activity loss rules were enacted as part of the Tax Reform Act of 1986 in an effort by Congress to prevent the use of losses from activities in which an investor didn't actively participate to offset that investor's wage, interest and dividend income. The passive loss rules apply to individuals, estates, trusts, closely held C Corporations and personal service corporations. There are two types of activities that are classified as passive activities. The first type is defined as an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in the activity if, during the taxable year at issue, it satisfied at least one of seven tests outlined in the Temporary Regulations. The tests attempt to determine whether the taxpayer's participa-

tion in the activity is sufficient to establish the activity to be considered **NOT** a passive activity.

Second, by definition the term passive activity includes “any rental activity.” Generally, the determination that a rental activity is a passive activity is not affected by whether or not the taxpayer materially participates. According to the Internal Revenue Service (IRS), an activity is considered a rental activity if tangible property held in connection with the activity is used by customers or held for use by customers, and the gross income attributable to the activity represents amounts paid or to be paid for the use of such tangible property, without regard to whether customers' use of the property is due to a lease or to a service contract or other arrangement that is not denominated a lease.

PPAs and Leases are Most Likely Rental Activities

In the context of a solar investment tax credit transaction, the owner of the solar facility typically enters into a power purchase agreement (PPA) or lease with a host, under which the host purchases the electricity produced by the solar facility. Further, it is standard practice to structure PPAs as service contracts to meet statutory IRS safe harbors when the host customer is a not-for-profit organization. The issue is that PPAs or leases will likely be considered rental activities, as outlined above. Accordingly, if the activity is determined to be a rental activity it is a passive activity by definition.

While solar equipment is often sold with a manufacturer's warranty for periods of 10 years or longer, it can be depreciated over five years for federal income tax purposes. As such,

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a solar project generates a significant amount of depreciation deductions in a relatively short time frame, which generally exceeds the amount of electricity revenue from the PPA or lease. In addition, the 30 percent investment tax credit (available for most types of solar property) is generated 100 percent on the day the solar facility is placed in service. Therefore, the owner of a solar installation can generally expect to be allocated passive investment tax credits in the first year and net passive activity losses during the first five to six years of the transaction.

Real estate industry professionals enjoy certain rules that mitigate the rental activity limitation. Generally, as long as those real estate professionals spend more than half of their time providing services in connection with a qualified real property trade or business, losses and credits from rental activities will be considered active and can be used to offset other types of income (e.g. wages, interest and dividends). No such rules currently exist for the renewable energy industry (including solar transactions).

Investors and solar developers that decide to “self fund” and that are subject to the passive loss rules (individuals, closely held c-corps etc.) that invest in a solar investment tax credit transaction should ensure they have, or will have, sufficient passive income to effectively use the tax credits and losses generated from the solar facility. Generally, if passive losses or credits cannot be used in the taxable year incurred, they are carried forward to the next taxable year. Previously disallowed passive losses (but not passive credits) will be allowed when the taxpayer disposes of his entire interest in the passive activity to an unrelated party in a taxable transaction. Investors are advised to consult with their tax advisors in connection with these issues. ♦

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