Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also: §§ 45, 704, 1.704-1)

Rev. Proc. 2007-65

SECTION 1. PURPOSE

Notice 2006-88, 2006-42 I.R.B. 686, regarding Electricity Produced from Open-Loop Biomass, announced that the Internal Revenue Service (the "Service") would not rule on any issues under Subchapter K for partnerships claiming the credit under § 45 of the Internal Revenue Code. This revenue procedure establishes the requirements (the Safe Harbor) under which the Service will respect the allocation of § 45 wind energy production tax credits by partnerships in accordance with § 704(b). The Treasury Department and the Service intend for the Safe Harbor to simplify the application of § 45 to partners and partnerships that own and produce electricity from qualified wind energy facilities.

SECTION 2. BACKGROUND

Section 45 provides for a renewable electricity production credit in an amount equal to the product of 1.5 cents, multiplied by the kilowatt hours of electricity 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 sold by the taxpayer to an unrelated person during the taxable year.

Section 45(c)(1) defines "qualified energy resources" to include wind. Section 45(d)(1) 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, 2008.

Under Rev. Rul. 94-31, 1994-1 C.B. 16, with respect to electricity produced from wind energy, the term "facility" under § 45(d)(1) means each separate wind turbine, together with the tower on which the turbine is mounted and the supporting pad on which the tower is situated. Although § 45 does not define "placed in service," the term has been defined for purposes of the deduction for depreciation and the investment tax credit. For these purposes, property is considered to be placed in service in the taxable year that the property is placed in a condition or state of readiness and available for a specifically assigned function. See §§ 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i) of the Income Tax Regulations.

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 credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit 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 adjustments) for the year, then the partners' interests in the partnership with respect to 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. Section 1.704-1(b)(4)(ii) further provides that identical principles apply in determining the partners' interests in the partnership regarding tax credits, such as the credit under § 45, that arise from receipts of the partnership (whether or not taxable).

SECTION 3. SCOPE

The Safe Harbor in section 4 of this revenue procedure applies to any partnership (the “Project Company”) between a project developer (the “Developer”) and one or more investors, as defined in section 4.01 (the “Investors”), with the Project Company owning and operating the project containing the qualified energy facilities

("Wind Farm" and for purposes of this definition the term does not include energy produced from such Wind Farm). In addition to the Project Company, the Developer, and the Investors, wind energy transactions typically involve lenders, land owners, a turbine supplier, a construction contractor, power purchasers, and a project operator. In order to qualify for the Safe Harbor all of the requirements set forth in section 4 of this revenue procedure must be met. This Safe Harbor will apply only if the Developer, Investors and Project Company satisfy each and every requirement in section 4 of this revenue procedure. Furthermore, this revenue procedure applies only to partners or partnerships with § 45 production tax credits from renewable resources from wind. Thus, this revenue procedure does not apply to any other tax credits.

The Service generally will closely scrutinize a Project Company as a partnership or Investors as partners if a Project Company's partnership agreement does not satisfy each requirement of this revenue procedure. The Safe Harbor in this revenue procedure is to provide guidance to taxpayers establishing or participating in wind energy partnerships in lieu of taxpayers requesting a letter ruling. Therefore, the Service will not rule on any issues under Subchapter K for partnerships claiming the credit under § 45.

SECTION 4. SAFE HARBOR

.01 Investors Defined. Investors are partners in the Project Company whose investment return is reasonably anticipated to be derived from both § 45 credits and participation in operating cash flow.

.02 Partners' Minimum Partnership Interest. The Developer must have a minimum one percent interest in each material item of partnership income, gain, loss, deduction and credit at all times during the existence of the Project Company. Each Investor must have, at all times during the period it owns a partnership interest in the Project Company, a minimum interest in each material item of partnership income and gain equal to 5 percent of the Investor's percentage interest in partnership income and gain for the taxable year for which the Investor's percentage share of income and gain will be the largest, as adjusted for sales, redemptions or dilution of its interest.

.03 Investor's Minimum Unconditional Investment. On or before the later of the date the Wind Farm is placed in service or the date the Investor acquires its interest in the Project Company, the Investor must make a minimum unconditional investment in the Project Company (the "Investor Minimum Investment"). The Investor must maintain the Investor Minimum Investment throughout the duration of its ownership of its partnership interest in the Project Company, except that the Investor Minimum Investment can be reduced as a result of distributions of cash flow from the Project Company's operation of the Wind Farm or in connection with section 4.05. Contributions required to be made in the future will not be included in the Investor Minimum Investment until the contributions are actually made to the partnership. The Investor Minimum Investment must be equal to at least 20 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions required to be made by the Investor under the partnership agreement. The Investor must not be protected against loss of any portion of the Investor Minimum Investment through any arrangement, directly or indirectly, with the Developer, any other Investor, the turbine supplier or the power purchaser or any party related to the Developer, other Investors, turbine supplier or the power purchaser.

.04 Contingent Consideration. At least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an Investor with respect to an interest in the Project Company must be fixed and determinable obligations that are not contingent in amount or certainty of payment.

.05 Purchase Rights. Neither the Developer, the Investors nor any related parties may have a contractual right to purchase, at any time, the Wind Farm, any property included in the Wind Farm or an interest in the Project Company at a price less than its fair market value determined at the time of exercise of the contractual right to purchase, and provided further that the Developer (or any party related to the Developer) may not have a contractual right to purchase the Wind Farm or an interest in the Project Company earlier than 5 years after the qualified facility is first placed into service.

Any determination of the fair market value of the Wind Farm or an interest in the Project Company may take into account: (i) contracts or other arrangements creating rights or obligations (excluding power purchase agreements) only if such contracts or other arrangements creating rights or obligations are entered into in the ordinary course of the Wind Farm's business and are negotiated at arm's length with parties not related to the Project Company or Investors; and (ii) any power purchase contract only if such contract is entered into with parties not related to (within the meaning of § 45(e)(4)) to the Project Company.

.06 Sale Rights. The Project Company may not have a contractual right to cause any party to purchase the Wind Farm or any property included in the Wind Farm, excluding electricity, from the Project Company. An Investor may not have a contractual right to cause any party to purchase its partnership interest in the Project Company.

.07 Guarantees and Loans. No person may guarantee or otherwise insure the Investor the right to any allocation of the credit under § 45.

The Project Company must bear the risk that the available wind resource is not as great as anticipated or projected. The Developer, the turbine supplier, or any power purchaser may not provide a guarantee that the wind resource will be available at a certain level. A guarantee regarding wind resource availability may be provided by a third party not related to the Developer, the turbine supplier, any power purchaser, or any other project participant if the Project Company or an Investor directly pays the cost of or premium for such guarantee. For example, a weather derivative contract between the Project Company and an unrelated third party (such as an insurance company) is an acceptable guarantee.

A long-term power purchase agreement entered into between the Project

Company and a party not related to the Project Company under § 45(e)(4) does not constitute a guarantee. However, a Take or Pay contract between related parties would constitute a guarantee and is not permissible. Any sale of electricity between related persons as defined in § 45(e)(4) will not qualify for the credit under § 45.

The Developer (or a party related to the Developer) may not lend any Investor the funds to acquire any part of the Investor's interest in the Project Company or guarantee any indebtedness incurred or created in connection with the acquisition of such Investor's interest in the Project Company.

.08 Allocation of § 45 Production Tax Credits. The § 45 credit must be allocated in accordance with § 1.704-1(b)(4)(ii).

.09 Separate Activity for Purposes of § 469. For purposes of the passive activity loss rules, under § 1.469-4(d)(4) each qualified facility will be treated as a separate activity for purposes of § 469 and that activity may not be grouped with any other activity, except other qualified wind facilities. Thus, generally, only entities not subject to § 469, and not individuals, will be able to offset non-project income with credits received as a passive investor in a partnership.

.10 Definition of Related Party. Except as otherwise provided, for purposes of this revenue procedure parties are related if they bear a relationship to each other that is specified in § 267(b) or 707(b)(1).

SECTION 5. EXAMPLES

.01 Example 1. The following is an example of a valid wind energy limited liability company that is classified as a partnership for federal tax purposes. Developer is a C corporation that owns and manages wind-based generation projects. Project Company is a limited liability company (LLC) that has been formed by Developer to develop, own and manage a renewable energy project that utilizes wind turbines to produce electricity from wind (the Project). Investor is a C corporation that invests in renewable energy projects primarily to benefit from § 45 credits. Developer has caused LLC to enter into, or has assigned to LLC, a number a contracts or agreements relating to the development of the Project.

Developer will own all of LLC during construction of the Project. Construction of the Project will be financed with $100x of construction financing. When construction of the Project is substantially complete, pursuant to a Membership Interest Purchase and Equity Capital Contribution Agreement, (1) Developer will contribute $15x to LLC, and (2) Investor will acquire newly issued membership interests from LLC in exchange for an upfront cash capital contribution in the amount of $10x which is 20% of Investor's total agreed capital contributions to LLC of $50x. Developer, as the developer of the Project, has not provided a guarantee to LLC or Investor regarding the level of the available wind resource at the Project or the amount of § 45 credits.

Pursuant to the limited liability company operating agreement (the "Operating Agreement"), Developer will have the right to manage LLC, subject to the right of Investor to consent to certain activities. Below is a chart and explanation that generally describes the distribution and allocation provisions applicable to Developer and Investor over various time periods.

	Developer		Investor	
	Cash	Gross Income/Loss and Section 45 Credits	Cash	Gross Income/Loss and Section 45 Credits
Period 1	100%	1%	0%	99%
Period 2	0%	1%	100%	99%
Period 3	95%	95%	5%	5%

During Period 1, 99% of LLC's gross income or loss and the § 45 credits will be allocated to Investor, and 100% of LLC's cash flows will be distributed to Developer. Period 1 will continue until the earlier of (i) such time that Developer has received aggregate cash distributions in an amount equal to the aggregate contributions made by Developer (i.e., $15x) and (ii) a fixed outside date. Period 1 is expected to last four to six years. When Period 1 ends, Period 2 will begin.

During Period 2, 99% of LLC's gross income or loss and the § 45 credits will be allocated to, and 100% of LLC's cash flows will be distributed to Investor. Period 2 will continue until Investor has achieved an agreed after-tax internal rate of return (the "Flip Point"). Although the Flip Point might occur sooner, it is expected that the Flip Point will not occur until after the end of year 10 of the Project, at which time § 45 credits will no longer be available for the production and sale of electricity from the Project. Period 2 is expected to last four to six years. When Period 2 ends, Period 3 will begin. Moreover, upon the tenth anniversary of Investor's investment, Developer will have the option to purchase Y's interest for its then-appraised fair market value. Assuming that option is not exercised, during Period 3, 5% of LLC's gross income or loss and § 45 credits will be allocated to, and 5% of LLC's cash flows will be distributed to, Investor; and 95% of LLC's gross income or loss and § 45 credits will be allocated to, and 95% of LLC's cash flows will be distributed to, Developer. Period 3 will continue for the remaining life of the Project.

.02 Example 2. The facts are the same as in Example 1, except Investor is initially allocated 99.5% of LLC's gross income or loss and § 45 credits. Under these facts, the wind energy limited liability company's classification as a valid partnership would be closely scrutinized by the Service. Likewise, if any other provision of this safe harbor is not followed for any wind energy partnerships, the Service will closely scrutinize the validity of such purported partnerships.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for transactions entered into on or after the date of publication in the Internal Revenue Bulletin. If a Project Company, Developer and Investor satisfied all the requirements of the Safe Harbor provided in section 4 of this revenue procedure for transactions entered into before the date of publication of this revenue procedure in the Internal Revenue Bulletin, the Service will not challenge the allocation of § 45 wind energy production tax credits by the partnership that are in accordance with § 704(b) for such taxable year(s).

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Vishal R. Amin and Richard T. Probst of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure contact Vishal R. Amin or Richard T. Probst at (202) 622-3060 (not a toll free call).