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David Burton writes that despite the importance of the ''developer fee'' in renewable energy transactions, there is very little guidance in the tax law for determining when a developer's fee will be respected as reasonable and included in the as-set's basis for tax purposes. Burton examines how the fees are treated by institutions such as the IRS, the use of developer fee notes in projects and best practices for structuring de-veloper fees in a transaction.

Project Finance Developer Fees Explained

BY DAVID BURTON

In many renewable energy transactions, a ''developer fee'' is a critical feature—it is often the means by which the developer extracts its profits from months or years of work and risk.

In addition, all or part of the fee may be included in the property's eligible basis for purposes of accelerated depreciation and the investment tax credit, thereby increasing the tax benefits available to a tax investor. Yet there is very little guidance in the tax law for determining when a developer's fee will be respected as reasonable and included in the asset's basis for tax purposes.

As noted by the Internal Revenue Service in one training guide, ''Unfortunately, development fees are not defined in the Code or any court case.''[1] There is also no set ''definition'' in the project finance industry, where a reference to ''developer fees'' can have several different meanings.

For example, the term ''developer fee'' is sometimes used generically to refer to the profit earned by the developer from a project, regardless of whether that amount is labeled a fee or reflects the excess of the sales price over the development costs. In other words, the developer may say that it earned a $1 million development fee when it sells a project for $1 million above cost even though the buyer didn't actually pay a ''fee.''

To the uninitiated, this terminology may seem inappropriate; for instance, if you sold your house for $100,000 more than you paid for it, you wouldn't refer to the $100,000 as a ''fee.'' A National Renewable Energy Laboratory (NREL) report acknowledges that in the project finance industry such a profit ''may be labeled a 'development fee'.''[2]

In the context of a developer's gain on sale, NREL estimated in a 2013 report that a typical solar developer by entering into a sale-leaseback can pocket between 9 percent and 19 percent of the sales price after transaction expenses, reserves for rental payments and operations and maintenance expenses, and allocable overhead.[3]

[1] ''IRS MSSP Training Guide Low-Income Housing Credit,'' Ch. 3.

[2] NREL, ''Financing, Overhead and Profit'' (David Feldman et al.), at fn.16.

[3] NREL, ''Benchmarking Non-Hardware Balance of System (Soft) Costs for U.S. Photovoltaic System,'' at 31-36 (Barry Friedman et al.) (2013). If the sale-leaseback involves relatively fungible property, such as residential solar systems, the developer should proceed with caution if it plans to sell the property in a sale-leaseback for more than it does in a straight sale. For instance, if the developer sells solar systems to homeowners in New Jersey for $4 a watt, the developer should consider carefully whether it can justify selling a portfolio of New

Further, another NREL report discussing the gain on sale concept provides that, "once they have structured the financial transaction, the developer sells the system to the tax-equity provider, with a 15 percent margin on all their direct costs associated with the project (including items purchased from the EPC installer)."[4] In a footnote, the report provides the IRS "usually allows a development fee at a maximum of 15 percent of the cost of the project to the integrator."[5] Despite sounding like a statement of the IRS's customary practice, the report cites nothing as evidence of the IRS's view or practice on this matter.[6]

Sometimes a transaction will specify a specific amount due as a "fee" from the project company to the developer for the development work done by the developer. The theory for this is that the relationship between the project company and developer doesn't change the fact that the developer is providing services and those services would have to be paid for if provided by an unrelated third-party consultant.

The development fee concept comes up in yet another manner in the context of an appraisal valuation for a project. In applying the cost method of valuation, if the appraiser looked to only the actual costs the appraiser would be excluding profit. That would result in a flawed valuation as any business must make a profit in order to continue in business for the long term.

The concept of "developer's fee" versus "developer's profit" (i.e., entrepreneurial incentive) is blurred.

An appraiser will typically use the actual cost of the project (including the actual cost of any services provided by the seller (i.e., the developer) of the project during development and construction) and then layer on top of that a reasonable profit. To avoid confusion with actual fees, some appraisers refer to this concept as "entrepreneurial incentive," which is expressed as a percentage markup on the actual out-of-pocket costs to build the project (including interest capitalized during construction). The conventional wisdom among appraisers appears to be that a reasonable charge for entrepreneurial incentive is in the range of 15 percent to 20 percent.[7]

While the general validity of including a markup for a developer's profit (i.e., entrepreneurial incentive) in eligible basis appears to have been approved in the context of the investment tax credit,[8] there is only one federal case that provides any specific guidance on what is considered a reasonable profit for this purpose. In a case involving the acquisition of a hydroelectric project, the Tax Court considered both the appropriate valuation methodology and whether to include development fees in the cost basis of the project.

The IRS asserted that the purchase price included "going concern" value that wouldn't be eligible for the investment tax credit or depreciation, while the taxpayer asserted that all of the cost was attributable to the hydro plant. If the markup on the plant was reasonable compensation to the seller for work performed by the seller, then there was no going concern value to decrease the investment tax credit.

In the hydro plant case, the IRS's valuation expert testified at trial that the appropriate valuation was the seller's cost plus 13 percent developer's profit. The 13 percent was based on the weighted average cost of capital (WACC) of the taxpayer. The expert didn't explain the relevance of the WACC to the developer fee, and the Tax Court concluded that the IRS expert's calculation was "idiosyncratic."

The taxpayer's valuation expert testified that the appropriate valuation was the seller's cost, plus a 15 percent turnkey premium, plus a 20 percent developer's profit.

The Tax Court sided with the taxpayer's expert, concluding:

> In calculating a developer's profit, [the taxpayer's expert] looked to conditions encountered by persons selling hydroelectric assets in the northeastern United States in December 1987. [He] determined an appropriate range for a developer's profit was 20 to 25 percent. [He] applied a developer's profit of 20 percent. We do not believe [he] overstated the developer's profit, and we accept this calculation of that profit figure.[9]

Based on this holding, it appeared reasonable to conclude that a 20 percent developer's profit wouldn't be considered outside the acceptable range for purposes of tax basis eligible for the investment tax credit. However, many tax advisers also cautioned that 20 percent couldn't simply be added as a matter of practice across

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Jersey residential solar systems to a bank in a sale-leaseback for $5 a watt.

[4] "Financing, Overhead and Profit," at 9.

[5] "Financing Overhead and Profit," at fn. 16.

[6] Id.

[7] Mark Pomy Kacz, "Defining and Supporting Entrepreneurial Profit, Entrepreneurial Incentive, and External Obsolescence," Appraisal J., Fall 2009, at 348. One point addressed in neither the tax law nor the literature is what effect does the quality of the project have on developer fees. It would seem reasonable that higher quality projects would merit developer fees at the higher end of the range. Looking to economic behavior outside of project finance to support this, the profit margin is higher on a Ferrari than on a Fiat. However, if what makes the project be of a higher quality is the power purchase agreement (e.g., superior pricing) for the sale of the output from the project, then it appears to be the IRS's view that any developer fee allocable to the work associated with obtaining the power purchase agreement would have to be capitalized into the basis of the power purchase agreement and wouldn't result in basis eligible for accelerated depreciation (or, accordingly, the investment tax credit). See PLR 201249013 (Sept. 6, 2012) (revoking PLR 201214007 (Jan. 3, 2012)). The industry hasn't acquiesced to the IRS's revised view, and the issue is one of the topics of Section 1603 cash grant litigation brought by developers in the U.S. Court of Federal Claims. See note 10 for more about the Section 1603 cash grant.

[8] See *Tanner v. Commissioner*, T.C. Memo 1992-235 ("the sum of [the wind farm developer's] direct and indirect costs, including a reasonable profit, approximated the [wind] turbine fair market value as well as the purchase price paid by petitioners"). While *Tanner* appears to generally support the notion that a developer is entitled to some reasonable fee and this amount can be included in basis, neither the text of the opinion nor the facts of the case give any guidance on what constitutes a "reasonable" profit percentage.

[9] *Utilicorp United Inc. v. Commissioner*, T.C. Memo 1997-47.

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the board. The amount had to also be in line with the fair market value of the services actually provided and the entrepreneurial risk borne by the developer.

The Treasury Department issued official guidance (''the Memorandum'') in June 2012 for determining the amount of basis that is considered eligible for ''Section 1603 grants'' in lieu of tax credits.[10] The Memorandum stated that eligible cost could include a reasonable markup, and appeared to endorse 20 percent, subject to the caveat that the appropriate markup percentage depends on the specific project involved.

As explained by Treasury in the Memorandum:

> The Section 1603 review team will accept a cost approach that includes only eligible property and a markup that is consistent with industry standards and with the scope of work for which the markup is received. While appropriate markups are case-specific and can depend on the ultimate transaction price, the 1603 review team has found that appropriate markups typically fall in the range of 10 to 20 percent.[11]

Again, the concept of ''developer's fee'' versus ''developer's profit'' (i.e., entrepreneurial incentive) is blurred. For instance, Treasury refers to it as a ''markup'' but then refers to the ''scope of work for which the markup is received.'' Treasury's approach is similar to a homeowner making a profit on the sale of a house and asking if the profit was consistent with the ''scope of work.'' Treasury appears to be indicating that ''profit'' and ''fees'' are economically equivalent.

Thus, when there is potential motivation for the parties to increase the consideration to the detriment of the government (i.e., to increase the price in order to recognize a larger Cash Grant (or investment tax credit)), according to Treasury both profit and fees should be evaluated under a similar standard: The amount must reflect the value of the services provided.

For a brief time, tax advisers took comfort from the Memorandum and believed that developer's profit or developer's fees between 10 percent to 20 percent of actual construction costs[12] would be accepted as reasonable.

Unfortunately, a few months after Treasury published the Memorandum, practitioners started hearing informal reports that Treasury was ''haircutting'' Cash Grant applications that included developer fees in that range. This was followed by further informal reports that Treasury had unofficially indicated to some applicants that it considered a 5 percent developer fee to be appropriate. It is possible, however, that Treasury's view with respect to 5 percent developer fees may be limited to instances in which the party providing the development services has the same corporate parent as the project company paying the fee, and neither the project itself nor a material interest therein is sold to a third-party investor; the lack of any third parties' involvement in such a transaction adds skepticism as to the market nature of the fee paid between affiliates.

Nonetheless, it is very troubling that there is no explanation for the significant deviation from the 10 percent to 20 percent range identified in the Memorandum as being typical in the industry. The Memorandum is still available on Treasury's website, and there has never been any official communication regarding a lower range or the reasons why a lower range might be more appropriate.

Moreover, Treasury's unofficial communications and the haircutting done with respect to Cash Grant applications brushes aside the Tax Court's decision in *Utilicorp United Inc. v. Commissioner*, T.C. Memo 1997-47, which held that a 20 percent developer's profit was reasonable, and could be included in basis and the opinions of valuation experts assisting many Cash Grant applicants as to the reasonableness of the development fee for specific projects.

Structuring a Developer Fee

Highlights of the best practices for structuring an energy project developer fee:

- A written contract should be executed documenting services to be provided and the amount of the fee.
- The fee needs to be reasonable and arm's length for the services provided; it should be paid to the specific entity that provided the development services or that entered into a subcontract arrangement to have the development services provided.
- If a developer fee note is used, the note should be a legally enforceable obligation and shouldn't be contingent on available cash flow; it can, however, be recourse only to the project.

Developer Fee Notes

Another situation where there might be some uncertainty about whether the fee is properly included in tax basis is when there is a ''developer fee note.'' Rather than paying the fee in cash, the project company accrues the fee and provides the developer with a promissory note obligating the project company to pay the fee in installments over time.

Conceptually, the fact that the obligation to pay the developer fee is structured as a loan doesn't affect the analysis of whether the developer fee should be included in basis. There would, however, be an issue if the developer fee weren't respected as genuine indebtedness for income tax purposes. The indebtedness

[10] The cash grant is provided for in Section 1603 of division B of the American Recovery and Reinvestment Act (Pub. L. No. 111–5), as amended (Cash Grant). For wind and solar projects, the Cash Grant is 30 percent of ''eligible basis.'' Solar projects have until the end of 2016 to be ''placed in service''; however, a preliminary cash grant application must have been filed before the end of 2012. Wind projects must have been placed in service before the end of 2012.

[11] U.S. Treasury, ''Evaluating Cost Basis for Solar Photovoltaic Properties'' (June 30, 2012) (available at http://www.treasury.gov/initiatives/recovery/Documents/N%20Evaluating_Cost_Basis_for_Solar_PV_Properties%20final.pdf).

[12] The Memorandum didn't address the fact pattern where the developer owned the construction company; in that scenario the ''actual'' cost to construct wouldn't include a profit on the construction. Nonetheless, as businesses don't stay in business unless they make a profit, it would appear reasonable in such a case for the ''actual construction costs'' to include a deemed profit on the construction.

characterization will turn on whether the interest rate and term are arm's length, the cumulative indebtedness secured by the project is less by a meaningful amount than the project's fair market value[13] and the note is properly positioned in the capital structure. For instance, questions would be raised if payments on the note were subordinated to equity distributions.

In transactions involving a developer fee note a tax equity investor could be tempted to insist that the debt service payments with respect to the developer fee note be subordinated to distributions to the tax equity investor. Tax equity investors may be served well to avoid this temptation: Subordinating the debt service with respect to a developer fee note to distributions to the tax equity could arguably raise one of two negative tax implications.

The first potential implication is that the developer fee note is actually an equity interest, which could mean some or all of the developer fee isn't included in tax basis. The second is that the tax equity is actually characterized as debt for income tax purposes, which would mean the tax equity investor isn't entitled to the investment tax credit or accelerated depreciation.

Best Practices

Of the three uses of the term ''developer fee,'' only the actual ''fee'' charged for service lends itself to structuring best practices, as the other two are outside of the hands of the tax adviser.

The developer fee that is actually just a colloquial expression for gain on sale is to some extent beyond the control of an adviser structuring a transaction as there must be a buyer prepared to pay a price that results in a gain to a developer/seller.

The developer fee referred to by some appraisers as ''entrepreneurial incentive'' only arises in a ''cost method'' valuation that without the entrepreneurial incentive results in a meaningfully lower valuation than one of the other two methods. Thus, it is within the narrow domain of appraisers performing certain valuations rather than the domain of tax advisers.

An adviser seeking to structure an actual developer fee paid for services should endeavor to adhere to the following best practices:

- The parties should execute a written contract documenting the specific development services to be provided and the amount of the fee.

- It needs to be clear that the developer fee (or a specific portion thereof) is for services that are considered to be related to the types of costs that are considered eligible costs for purposes of the investment tax credit and/or accelerated depreciation (e.g., not real estate). This can be achieved by having the development services agreement either limit the contracted services to such eligible costs, or reasonably allocate the fee between eligible and ineligible costs. The IRS isn't bound by such an allocation, but if the allocation is reasonable, there should be little cause for the IRS to challenge it.

- The fee needs to be reasonable and arm's length for the services provided (i.e., the amount that an unrelated consultant would have charged for the services and the risks borne). To the extent out-of-pocket costs are incurred to provide the services, the fee would reasonably be expected to include such costs, plus a reasonable markup. It may be appropriate to further increase the fee for specialized expertise involved in providing the services or economic risk borne (e.g., advancing the costs of obtaining permits for a project that may not be approved to be constructed).

- It is best to execute the agreement as early in the process as possible—ideally, before any covered services are provided. However, a later execution of the development services agreement shouldn't be fatal, as many professionals (outside the development fee context) are known to start working for an eager customer prior to documenting the contractual arrangements.

- If a developer fee note is used, the note should be a legally enforceable obligation and shouldn't be contingent on available cash flow.[14] It can, however, be recourse only to the project.

- The development fee should be paid to the specific entity that provided the development services or that entered into a subcontract arrangement to have the development services provided on its behalf. Paying the fee to a different entity can raise questions as to the federal and state tax reporting regarding how the services were performed by one entity, but the cash for the services ended up in a different entity.

- The parties should retain documentation supporting the services provided and the fee paid.[15]

[13] ''IRS MSSP Training Guide Low-Income Housing Credit,'' Ch. 3 (citing *Crane v. Commissioner*, 331 U.S. 1 (1947)).

[14] ''IRS MSSP Training Guide Rehabilitation Tax Credit,'' Ch. 19 (citing *Brassard v. United States*, 183 F.3d 909 (8th Cir. 1999)). If payment of the note is contingent on actual cash flow, it is likely that the developer fee won't be treated as realized (even for an accrual basis taxpayer) until it is actually paid, which could be years after the asset is ''placed in service'' for tax purposes. Because the basis of a newly constructed project generally includes only the costs attributable to constructing the asset (plus certain transaction expenses that are considered acquisition-related), the project's tax basis generally wouldn't include fees that are paid years after the asset is placed in service.

[15] ''IRS MSSP Training Guide Rehabilitation Tax Credit,'' Ch. 19.

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