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Hunting Unicorns: Individuals As Tax Equity Investors

*This week's Industry Current is written by **David Burton***

As tax equity yields remain high and renewable energy is touted by the White House, the phone rings several times a month with the request to structure a fund that permits tax credits and accelerated depreciation to be passed through to individual investors. I call these eager, hopeful fund managers, unicorn hunters, as they are pursuing a valuable quarry that does not exist.

The best proof that tax equity for individuals is not feasible under current law is that the bulge bracket investment banks have yet to launch such a fund. Every investment bank in the country has retail clients asking to invest in green energy, and the banks would be thrilled to provide these clients with a fund that generated a 6% after-tax yield (which is significantly below current tax equity rates).

The obstacles in the tax law for tax equity for individuals stem from the fact that in the 1980s tax shelter promoters ran amuck peddling transactions that required little equity investment or operating risk but purported to produce substantial tax benefits. Congress was not pleased and took decisive action to preclude individuals from using tax benefits associated with tax credit, depreciation and non-recourse debt deals. Congress determined that such exotic species were suited only for widely-held C-corporations, which were already subject to two layers of tax and presumably had management sophisticated enough to sort through the good, the bad and the ugly.

Congress excluded individuals from this arena by enacting the passive activity loss rules and the at-risk rules. At a high level, the passive activity loss rules provide that individuals cannot use depreciation, tax credits, or interest expense (other than the home mortgage deduction) to reduce their taxes on income from their jobs or investment portfolios. The at-risk rules provide that individuals may not deduct interest from non-recourse debt (broadly defined) or claim depreciation deductions funded thereby.

The passive activity loss rules have an exception for activities in which individual taxpayers "materially participate." When the aspiring renewable energy fund managers hear that, they think they have caught a glimpse of the unicorn's tail. Certainly, if there's an exception, they can meet it by having their investors oversee the investment by holding a few management meetings, preferably in a location with a PGA golf course.

The problem is the passive activity loss rules define "material participation" narrowly. There are three ways to "materially participate" that are relevant in this context:

· spend more than 500 hours a year working at it: obviously not realistic for most individuals investors;
· the individual's participation consists of substantially all of the participation in the activity for all individuals (including individuals who are not owners): this means when the blade on the wind turbine breaks, the investor has to tie a rope around her waist and climb up to fix it; or
· the individual participates in the activity for more than 100 hours and no other individual participates more (including individuals who are not owners): this means no one can work even part-time at the renewable energy project.

The challenge of meeting this material participation standard is demonstrated by a recent trilogy of Tax Court cases involving solar hot water heaters in Hawaii. The individual taxpayers purchased solar hot water heaters that were installed at the homes of third-party customers. The customers made monthly payments for the hot water heaters. The payments were collected and accounted for by a contractor affiliated with the manufacturer of the hot water heaters. The taxpayers asserted that they were entitled to use the federal investment tax credits and depreciation deductions from the hot water heaters to offset their other taxable income. The Tax Court disagreed, even though one of the taxpayers solicited potential customers and handled the collections for the first year, because the taxpayers did not materially participate as the contractor "collected most of the ratepayer's payments, maintained records regarding the income, and made … excise tax payments," according to *Lum v. Commissioner, T.C. Memo. 2012-103*.

The way to enable individual investors to invest in these transactions is to exempt renewable energy deals from the passive activity loss at-risk rules. Proposals to change these rules actually achieve initial traction with the renewable energy industry's friends in Congress, until the politicians discuss it with the lawyers employed by Congressional committees to advise on tax issues. Those technicians remember, or at least read about in law school, the 1980s cattle farm and **Andy Warhol** lithograph tax shelters sold in shopping malls. They find the idea of waiving these rules for renewable energy about as appealing as removing modern plumbing from the Capitol.

Here's what the technicians do not understand. Tax equity under the current rules is expensive—a very good rate is 8% after-tax and many deals require double-digit returns. Introducing retail investors to the market will bring down returns--lower tax equity returns mean each dollar of tax benefit results in more watts of green energy. For example, one developer recently estimated that a 1% reduction in a project's cost of capital reduced project costs by 10%.

Further, the problems of the 1980s will not be repeated. The industry is content to have the tax benefits only be able to be passed through by master limited partnerships. An MLP is a publicly traded entity with a board, general counsel, cfo and tax manager. Therefore, it has the necessary professionals to make prudent investments and comply with complex tax rules. It files financial statements with the **Securities and Exchange Commission** and tax disclosures with the U.S. **Internal Revenue Service**.

The annual 90% qualifying income test for MLPs would also need to be amended to deem gross income for renewable energy to be qualifying income. The investment tax credit recapture rules would also need to be amended to have transfer of MLPs interests not trigger recapture of the investment tax credit.

Further, the MLP could be made subject to the "uncertain tax position" rules which require accounting reserves and financial statement and tax return disclosures for any tax position that is not likely to survive IRS scrutiny. In addition, the IRS audit rules could be changed to empower the IRS to audit and collect tax underpayments from the MLP directly, rather than having to chase thousands of individual investors. Thus, such transparency and accountability will preclude a repeat of tax problems of the 1980s, while resulting in more green energy for each dollar of tax benefits. Rather than hunting unicorns, the renewable energy industry should coalesce in support of the necessary MLP legislative changes.