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Europeans boost investment in US renewables: US holding corporation or direct investment?

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A company considering a US dollar investment should consider the US tax implications of the structure of its investment. A careful plan today can avoid a costly headache tomorrow.

Recent events in Southern Europe have prompted European companies to seek a haven in US dollar investments. The U.S. attracted $28.7 billion in foreign direct investment between January and March, the 12th consecutive quarter of positive flows. The US renewable energy market has benefited from this inflow of foreign capital.

Developers, such as Origis Energy, an investment fund focused on the development, acquisition, financing and operation of large-scale solar PV plants across Europe, are expanding into the United States because their investors are seeking US dollar investments. Furthermore, Guy Vanderhaegen, Managing Partner at Origis Energy, believes the US market provides a good balance between the risk profile of the projects and the returns that can be realized and that the US market will be a sustainable market going forward and not a growth and bust market as seen in Spain and other parts of Europe.

Unlike most of the world, which subsidizes renewable energy projects through feed-in tariffs, the United States uses tax subsidies. Developers and other investors that are not US taxpayers may not be able to utilize the tax benefits efficiently. They typically barter these benefits to banks, large insurance companies and other "tax equity" investors.

Holding the project in a Delaware LLC, a flow-through entity, makes it easier to efficiently pass these benefits through to a "tax equity investor".

Most Non-US companies will hold the Delaware LLC through a US entity that is taxed as a corporation. They will not want to invest directly in a Delaware LLC for at least three reasons.

First, it will require the non-US taxpayer to file a US tax return.

Second, it will subject the non-US investor to a "branch profits" tax. This is an additional tax (equivalent to a dividend withholding tax) that may be triggered even where the non-US parent does not receive a dividend.

Third, it will make it more expensive to sell the investment. A sale of the Delaware LLC will generally be taxed in the United States.

Renewable Energy Tax Incentives

Most renewable energy subsidies in the United States are in the form of tax subsidies. The federal government pays about 56 cents per dollar of the capital cost of a solar project and at least that amount for wind and geothermal projects.

The most significant subsidies are an investment tax credit (ITC), a production tax credit (PTC) and depreciation.

The ITC is a credit for 30% of the cost of the energy producing assets in a renewable energy project. The PTC is a credit for 2.2 cents per kWh produced and sold to a third party. Solar projects can claim only the ITC. Other renewable technologies have a choice.

A tax credit allows a taxpayer to reduce its taxes dollar for dollar. For example, a $100 tax credit reduces a taxpayer's taxes by $100.

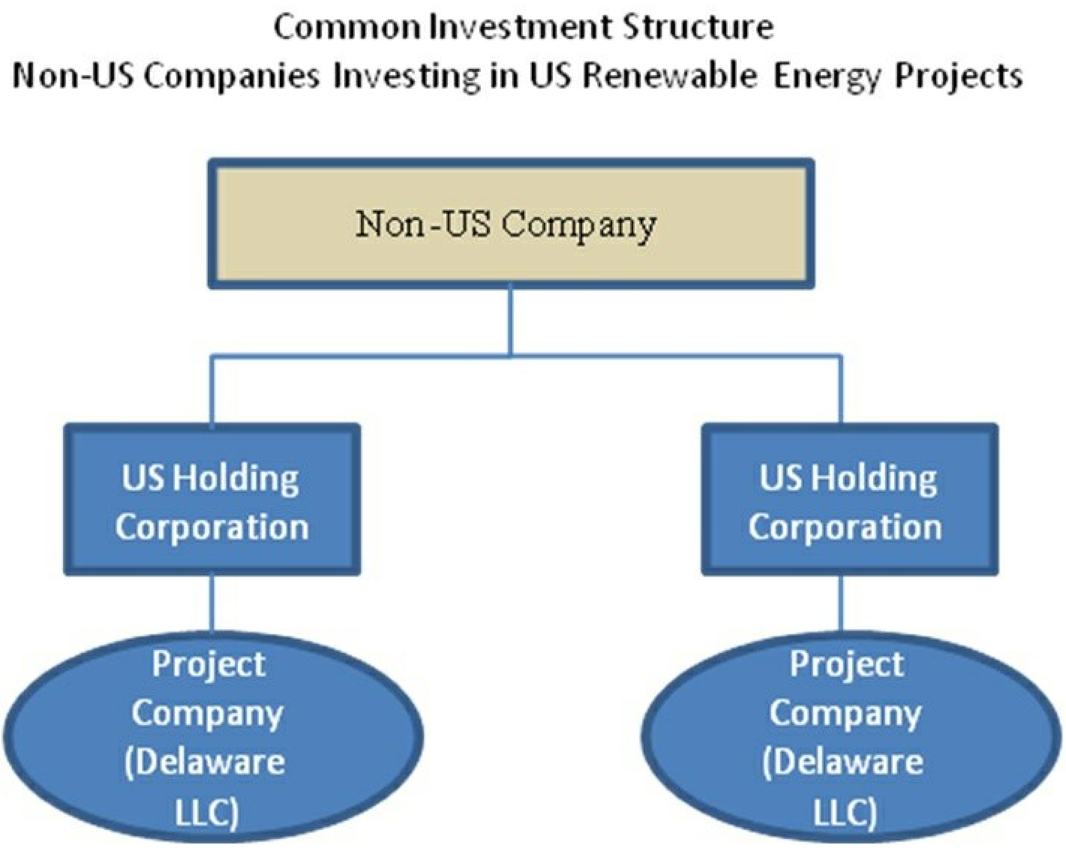
Depreciation is the ability to deduct the cost of a project over time. The US federal tax rate for corporations is 35%, so a $100 tax deduction will equal $35.

The faster the deductions may be claimed the greater the value of the depreciation. Solar and wind assets may be depreciated over 5-years on an accelerated basis. Conventional power plants are depreciated over 15 or more years, with less acceleration.

Most non-US developers and investors quickly realize that they cannot efficiently utilize these tax benefits because they do not owe US taxes. Instead, they seek to barter the 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 to 22 active tax equity investors.

Investment Structure

Below is a chart of a typical structure for a non-US company investing into a US renewable energy project. 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.



For simplicity, let's walk through the structure bottom to top.

Project Company (Delaware LLC)

US renewable energy projects are almost always held through a Delaware limited liability company (LLC). The advantages of forming an LLC are that the members are afforded limited liability and have the flexibility of being taxed as a flow-through entity or electing to be taxed as a corporation. Delaware is typically chosen as the state of formation because it has the most developed body of corporate law. In cases where LLCs are formed in other states, it is not uncommon for banks and other tax equity investors to request that the LLC be reorganized in Delaware before they will finance the project.

Absent an election, a Delaware LLC will be treated as a transparent entity for US federal income tax purposes, meaning no income taxes are paid at the entity level. Any income, gain or loss flows through to the owners of the LLC, in this case, the US holding corporation.

Furthermore, the tax subsidies automatically flow-through to the owners of the project company. This provides flexibility to bring in a tax equity investor that can capitalize the project in exchange for the tax benefits. The US tax code does not allow a direct sale of tax benefits, so these transactions will need to be carefully structured to ensure that the tax equity investor can utilize the credits and deductions.

As a transparent entity, each of the owners of the project company will be treated as engaged in a US trade or business and will be required to file a US tax return. Each owner will be required to pay US income tax at a 35% rate on their share of the net income from the project.

US Holding Corporation

Non-US investors can hold their interest in the Delaware LLC directly, through a US corporation or through a non-US holding corporation.

Most non-US investors will not want to hold their US investment directly for at least three reasons.

First, a direct investment by a non-US company in the Delaware LLC will require the non-US company to file a US tax return in the United States.

Second, a direct investment will subject the non-US company to a "branch profits tax". The United States taxes a corporation on its income when it is earned. Shareholders are then taxed on dividends they receive from the corporation. The US government collects the dividend tax from foreign shareholders in the form of a withholding tax.

When a non-US company invests directly into the United States, there is no dividend on which to collect a tax. However, in order to make sure non-US companies do not have an advantage over US corporations, the US government imposes a branch profits tax on a "dividend equivalent amount".

This is a complex calculation, but generally is the non-US company's share of the net income from the Delaware LLC, decreased by additional investments in the United States and increased by any withdrawal of investment from the United States.

The tax is imposed regardless of whether the non-US company receives cash from its US investment. That means the non-US company cannot control the timing of the tax on its US operations. Dividends are much more predictable, the taxes are withheld when the dividend is actually paid.

Third, more taxes will be imposed on the exit of a direct investment. A sale of the Delaware LLC generally will be subject to tax in the United States, whereas the sale of the stock of a corporation that holds the Delaware LLC generally will not be taxable.

One exception to this rule is where the US holding corporation held US real property that was 50% or more of its total assets, at any time in the preceding five years. Since the Delaware LLC is a transparent entity, the US holding corporation will do this analysis as if it was the direct owner of the assets of the Delaware LLC.

In general, most companies take the position that solar panels and wind turbines are not real property, although this is not 100% clear under US tax law. Therefore, the primary reason these companies become tainted is because in the early development stage, they acquire rights to land that represents 50% or more of the assets of the company. Care should be taken not to put these assets in the US holding corporaiton until 50% or more of the assets would be non-real property assets.

Holding the Delaware LLC through a non-US holding corporation is an improvement over a direct investment. Such investment vehicle will shield the non-US company from filing a U.S. tax return directly and will eliminate any taxes on exit - through the sale of the non-US holding corporation. However, such non-US holding corporation will be subject to the branch profits tax.

As a default, a US corporation is generally the preferred holding company for the Delaware LLC that houses the US renewable project.

Separate US Holding Corporation and Delaware LLC for each Project

A separate US holding corporation and Delaware LLC should be organized for each project. This will allow for easy exit by selling one project without having to sell other projects housed under a single US holding corporation.

This structure may be cumbersome for non-US investors focused on distributed solar projects because of administrative costs and the difficulty in obtaining financing for each individual project. Distributed solar projects are typically grouped in tranches under a single US holding corporation and under a single Delaware LLC.

If the investor's goal is to build a US-based business that could use the tax incentives available to renewable projects, then it may be beneficial to invest through a single US holding corporation. The trade-off is that it limits the investor's ability to exit the investment in a single project without incurring a tax liability.

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