The global wind energy industry has entered a challenging period. Although global cumulative wind power capacity increased by nearly 21% in 2011, that growth is lower than the 29% average annual growth rate the industry has experienced over the last 10 years. Many markets that historically have been at the forefront of the wind energy industry have seen declines.

Governments around the world have encouraged wind energy development through a variety of measures, including feed-in tariffs and cash subsidies. By contrast, the focus in the U.S. has been on the use of tax-related incentives. Owners of U.S. wind projects are able to reduce their taxable income significantly in the early years of a project through the use of accelerated depreciation deductions, as well as reduce their federal tax liability for the first 10 years of a project by the use of the production tax credit (PTC). However, at this point, it is still unclear if Congress will extend the PTC beyond its Dec. 31 deadline.

Unfortunately, many U.S. wind project developers are small companies that lack the tax base needed to use the tax benefits generated by wind projects. To prevent these benefits from going to waste, developers started partnering with other investors – typically, large financial institutions and utility affiliates – that have enough income from their other business activities to be able to use the project’s tax benefits from the outset.

In these arrangements, which typically span a decade or more, the investor contributes a significant amount of equity to the project in return for nearly all of the project’s tax benefits as well as some portion of the project’s cash revenues. Then, once the total return earned by the investor reaches a pre-negotiated internal rate of return, the tax benefit and cash-revenue streams are reallocated to the developer and the investor (i.e., “flipped”) based on a pre-negotiated agreement.

A foreign company that invests in a U.S. wind energy project faces a similar situation to that of a developer, in that it is unlikely to have enough U.S. taxable income to use its share of the project’s tax benefits. For these companies, the benefit of investing in a U.S. wind energy project would have to be realized in another way. One possibility is vertical integration. By investing in a wind project in the U.S., a foreign equipment or service provider may be able to gain direct access to a U.S. customer for its equipment or services, and this access may serve as a stepping stone to the broader U.S. wind energy market.

**U.S. ownership structures**

Most U.S. wind projects are held through limited liability companies (LLCs). In this structure, the developer and the investor in the project each own an interest in the LLC, which owns the project. For U.S. tax purposes, the LLC is treated as a partnership, allowing the tax benefits and cash revenue from the project to be allocated – and later reallocated – at the “flip” point, in the manner agreed upon by the parties.

A foreign manufacturer or service provider would participate in this structure by setting up two new entities. The first entity would be a U.S. holding company that would hold the foreign company’s interest in the project company. The foreign company would capitalize the holding company with the cash that it plans to invest in the project company, and the holding company would then use that cash to buy the developer’s interest in the LLC that owns the project.

There are two benefits to this structure. First, the existence of the U.S. holding company prevents the foreign company from being treated as engaged in the same U.S. business in which the project company is engaged.
Under U.S. tax rules, a foreign entity that owns an interest in a U.S. business through one or more partnership entities is treated as being engaged directly in that business. That can result in numerous unwelcome consequences for the foreign entity, starting with the obligation to file an annual U.S. tax return and report and pay U.S. taxes on its share of the income of the wind project (even if that income is not distributed). By using a U.S. corporation to “block” the wind project’s business from flowing up to the foreign company, the U.S. corporation – and not the foreign company – becomes subject to those obligations.

The second benefit of the U.S. blocker corporation structure is that it allows the foreign company to manage its exchange rate when it repatriates its earnings from the wind project to its home country. Controlling the timing of its repatriation of earnings may also allow the company to more efficiently manage its foreign-exchange exposure with respect to those earnings.

The second entity that a foreign company would need to form is another corporation that will either sell the foreign company’s equipment or provide services to the project company. If the foreign company is selling equipment, the subsidiary corporation should be foreign, and all of the sales-related activities of that foreign subsidiary corporation should occur outside the U.S. Any sales-related activities that occur in the U.S. should be conducted solely by independent sales agents. Most importantly, title to the equipment should be passed on to the project company outside of the U.S. Following these recommendations will likely prevent the income from the equipment sales from being taxed in the U.S.

If the foreign corporation is providing services, and those services are performed by employees of the foreign corporation, it will cause the foreign corporation to be engaged in a U.S. business. As noted previously, this means that the foreign corporation would be required to file a U.S. tax return and report and pay tax on its income from those services. To prevent this from happening, the foreign company should form a U.S. corporation that will employ the people who will perform the services. The U.S. corporation will have gross income from the project company’s payments for those services, but it will be able to reduce that gross income by any expenses related to those services. The U.S. corporation will file its own U.S. tax return and report and pay tax on its net income from the performance of those services.

The use of a U.S. corporation to act as a holding company that owns the foreign investor’s interest in the wind project or to perform any services for the project company results in an additional level of tax when the U.S. corporation makes a distribution to the foreign investor. This tax is a withholding tax that is imposed on any dividend distributions to a foreign shareholder. The U.S. withholding-tax rate is 30% of the gross amount of the distribution, and is collected and forwarded to the U.S. Internal Revenue Service at the time of the distribution by the U.S. corporation.

However, if the foreign investor resides in a country that has an income-tax treaty in effect with the U.S. – such as the U.K., Spain, Germany, Korea and China – the 30% rate may be reduced, or even eliminated.

Other aspects of a U.S. ownership structure include placement of debt (whether at the project company level or the investor level), whether deductions can be claimed with respect to that debt, the ability to claim other benefits under an income-tax treaty, and U.S. taxes that might apply when the foreign company decides to terminate its investment.

Effective management of these issues is possible and will depend on the foreign investor and its objectives in making the investment in the U.S. wind project.

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