Solar Financing Tax Equity Structures: Sale-Leasebacks, Inverted Leases and Partnership Flips

Choosing the Right Structure, Weighing Advantages and Drawbacks of Various Structures

THURSDAY, AUGUST 13, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Keith Martin, Partner, Chadbourne & Parke, Washington, D.C.

Jorge Medina, Assistant General Counsel, SolarCity, San Mateo, Calif.

The audio portion of the conference may be accessed via the telephone or by using your computer’s speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.
Tips for Optimal Quality

**Sound Quality**
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-328-9525 and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Continuing Education Credits

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about CLE credit processing call us at 1-800-926-7926 ext. 35.
Solar Tax Equity Structures

Keith Martin
kmartin@chadbourne.com

Jorge Medina
jmedina@solarcity.com
The tax benefits on solar projects amount to roughly 56¢ per dollar of capital cost. Solar tax equity deal volume was $4.5 billion in 2014. Wind and solar together were $10.1 billion. Deal volume is expected to be higher in 2015.
Solar projects must be in service by December 2016 to qualify for a 30% investment tax credit. The credit drops to 10% after 2016. There is a reasonable chance that Congress will convert the 2016 deadline into a deadline merely to start construction, but it may not happen this year.

tax extenders
We see at least 32 tax equity investors currently in the market.

There are at least another nine tax equity investors who have done some deals, but do not appear to be active currently.

National Bank of Arizona
Washington Gas
Honda
Ulupono Initiative
CIRI
Standard Chartered
PG&E
Sempra
One West
Another 12 companies are on lists of potential tax equity investors.

- Silicon Valley Bank
- Allianz
- CIT
- BBVA
- Samsung
- LG Corporation
- BB&T
- Fifth Third
- Intel
- New York Life
- Microsoft
- Facebook
- Starbucks
Tax equity yields in the last six months have been trending down, although tax equity investors are recovering some of the decline in fees and are often pricing to a second yield 50-bps higher at year 20. Utility-scale solar yields are 7.25% to 8% unleveraged for the least risky deals involving the most experienced sponsors. Rooftop solar for brand-name developers is a little below 9%.

$1.10 to $1.32
Leverage can increase yield by at least 500 bps. There is little debt ahead of tax equity in the capital structure. The market consensus on forbearance has largely collapsed.
There are three main structures with two significant variations. The three are partnership flips, inverted leases and sale-leasebacks.
A partnership flip is a simple concept. A sponsor brings in a tax equity investor as a partner to own a renewable energy project together. The partnership allocates taxable income and loss 99% to the tax equity investor until the investor reaches a target yield, after which its share of income and loss drops to 5% and the sponsor has an option to buy the investor's interest. Cash may be distributed in a different ratio before the flip.

cash drought
yield cos
call option
Basic Yield Flip

FMV Call Option

Sponsor 1/95

Tax Equity Investor 99/5

Sponsor Affiliate

O&M Contract

Project

PPA

Utility
The IRS issued guidelines for partnership flip transactions in 2007. The guidelines provide a "safe harbor" for transactions that conform to them. Most do. The IRS said recently that the guidelines were written with wind projects in mind and are not a safe harbor for solar transactions.

central tension
There are two main variations in flip structures. In addition to the yield-based flip, there is also a fixed-flip structure that is offered by a small subset of tax equity investors and that leaves as much cash as possible for the sponsor.

2% preferred cash distributions
put and call
Fixed Flip

Put and Call Option

Tax Equity Investor
99/5 + 2% preferred cash distributions

Sponsor 1/95

Sponsor Affiliate

O&M Contract

Project

PPA

Utility
The sponsor is responsible for day-to-day management of the project. TEI consent is required for a list of "major decisions."
The TEI may invest by buying an interest in the partnership from the sponsor ("purchase model") or by making capital contributions to the partnership ("contribution model"). The purchase model may give the TEI a larger basis step up for calculating tax benefits.
Almost all partnership flip transactions have "absorption" issues. Each partner has a "capital account" and "outside basis" that are two ways of measuring what the partner put into the deal and what it is allowed to take out in tax benefits. Most TEIs run out of capital account before they are able to absorb 99% of the depreciation.

DRO
Yield-based flips in the solar market price to reach yield in six to eight years. Fixed-flip deals flip at five to six years. Investors want at least a 2% pre-tax yield.
In a sale-leaseback, the solar company sells the project to a tax equity investor and leases it back. Unlike a flip where the TEI gets at most 99% of the tax benefits, all the tax benefits are transferred to the TEI without complicated partnership accounting. The TEI calculates them on the fair market value purchase price it pays for the project. The lessee has a gain on sale to the extent the project is worth more than it cost to build.
Sale-Leaseback

Tax Equity Investor

Lessor

Debt

Sale

Lease

Sponsor

PPA

Utility

Project
A flip raises 40% to 70% of the project value. A sale-leaseback raises 100% in theory. In practice, the sponsor is usually required to repay part of the purchase price as prepaid rent.

section 467 loan
The IRS has guidelines for leveraged leases where the lessor raises part of the purchase price by borrowing from a bank. These guidelines limit the term of the leaseback to 80% of the expected life and value of the project. If the lessee wants to keep the project at the end of the lease, the lessee must repurchase it. Any lessee purchase option cannot be at a price that makes the option reasonably likely to be exercised.

- economic compulsion
- equity investment
Sale-leasebacks remain common in the C&I and utility-scale solar markets. They are uncommon in the rooftop market, where the deals are split currently between partnership flips and inverted leases. Rooftop companies dislike sale-leasebacks because they feel the TEIs pay too little at inception for the residual value.
Inverted leases are used mainly in the rooftop market. Think of a yo-yo. The solar company assigns customer agreements and leases rooftop solar systems in tranches to a tax equity investor who collects the customer revenue and pays most of it to the solar company as rent. The solar company passes through the investment credit to the tax equity investor. It keeps the depreciation. The solar company takes the asset back at the end of the lease.
Basic Inverted Lease

Sponsor

Assignment of customer agreements

Lessor

Master Installation Agreement

Lease

Sponsor

O&M Agreement

Tax Equity Investor

Solar PPA or Lease

Customers

Sponsor Affiliate
Sponsors like inverted leases because they get the asset back without having to pay for it, and the investment credit is calculated on the fair market value of the solar equipment rather than its cost. Unlike a sale-leaseback, the step up in asset basis does not come at a cost to the sponsor of a tax on a commensurate gain.
There are no IRS guidelines for inverted leases, unlike the other two structures. However, the structure is common in historic tax credit deals, and the IRS acknowledged it in guidelines in early 2014 to unfreeze the historic tax credit market after a US appeals struck down an aggressive form of the structure in a case called Historic Boardwalk.
The TEI must have upside potential and downside risk to be considered a real lessee. Some tax counsel like to see a "merchant tail.” Others focus on the amount of prepaid rent paid by the lessee and want to see at least a 20% rent prepayment.

big four
Inverted leases raise 20% to 45% of project value. The central challenge in inverted leases is how the capital raised by the structure moves from the TEI to the sponsor. In the conservative form, it moves as prepaid rent. In an overlapping ownership structure, the lessor makes a capital contribution to the lessor, and the lessee owns 49% of the lessor.
Overlapping Ownership
Inverted Lease

Sponsor 51%

Lessee 49%

Lease

FMV Call Option

Sponsor 1/99

Tax Equity Investor 99/5
+ withdrawal right
The three structures vary in terms of the amount of capital raised, risk allocation and the timing of when the TEI must invest. The sponsor must turn to other sources of capital (debt and equity) to raise the rest of the project cost.
Focusing on risks, in a sale-leaseback, the sponsor has a hell-or-high-water obligation to pay rent and must indemnify the TEI for loss of tax benefits and any acceleration of rental income due to a lessee breach of a representation or covenant. In a flip, the TEI's return turns on how well the project performs. The TEI's protection is it sits on the project at a 99% level until it reaches a target yield.

inverted lease
The principal business risks in any transaction are weather, technology and offtaker credit.
Basis risk tends to be borne by the sponsor, although this has been true only since 2010. Tax risks about which the sponsor has special insight are borne by the sponsor. Tax risks into which both the sponsor and TEI have equal insight are borne by the TEI. Risks over which neither has special insight are jump balls.

fixed tax assumptions
Turning to timing, the TEI must be a partner in a flip deal before the project is placed in service. In some transactions, the TEI makes enough of its investment before the project is put in service to be a partner and contributes the rest after final completion. Inverted leases must be done before assets go into service. A sale-leaseback can be done up to three months after the asset is put in service.

unwind risk
The investment credit vests over five years. The unvested credits will be recaptured if the assets are disposed of or a partner disposes of his interest or there is more than a one-third reduction in his share of partnership profits during the first five years.

stop loss shift
lock-in effect
The asset basis must be reduced by half the investment credit. In an inverted lease, since the lessee claims the credit but does not claim depreciation, it must report 50% of the credit as income ratably over five years. If the lessee is a partnership, some TEIs use the income to increase "outside basis" and then claim a loss when they withdraw from the partnership. An IRS notice is expected on this subject.
Some recurring issues in deals are the following:

- inappropriate TEIs
- basis risk
- output forecasts
- cash sweeps
- book loss
- change-in-law risk
- affiliate sales
- merchant risk
- OCC
- Volcker rule
Solar Tax Equity Structures

Keith Martin
kmartin@chadbourne.com

Jorge Medina
jmedina@solarcity.com