Solar Financing Tax Equity Structures: Sale-Leasebacks, Inverted Leases and Partnership Flips
Choosing the Right Structure, Weighing Advantages and Drawbacks of Various Structures

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Solar Tax Equity Structures

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The tax benefits on solar projects amount to roughly 56¢ per dollar of capital cost. Solar tax equity deal volume was $5 billion in 2016. Wind and solar together were $11 billion, down from $14 to $15 billion in 2015. Deal volume feels stronger in 2017 after a slow start.
We see at least 35 tax equity investors. More than 40% of tax equity last year was supplied by just three large banks. It can be hard for anyone other than the most experienced developers to raise tax equity. For example, 90% of the tax equity in the solar residential rooftop market goes to just three companies.

inappropriate TEIs
By and large, tax equity yields have been trending down. Utility-scale solar yields are in the mid-6\% to mid-7\% range unleveraged for the least risky deals involving the most experienced sponsors. Yields for brand-name rooftop developers start at 9\%. Tax equity investors are charging structuring and unused commitment fees and are pricing to a second all-in yield 50 to 100 bps higher.

$1.10 to $1.32
Tax equity accounts for 30% to 50% of the typical capital stack in a solar project. Many sponsors also raise back-levered debt. The spread on back-levered debt can be as little as 25 bps wider than the spread on project-level debt.
A great deal of attention is being paid this year to potential changes in tax law and to the Suniva tariff petition. We will return to these subjects later in the program.
Community solar has turned a corner with the financial community. At least five community solar tax equity deals have closed, and a sixth deal is currently in the market.
There are three main solar tax equity 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.

call option
Basic Yield Flip

FMV Call Option

Sponsor
1/95

Tax Equity Investor
99/5

O&M Contract

PPA

Project

Utility

Sponsor Affiliate
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

Sponsor 1/95

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

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
In many solar deals, the income allocated to the tax equity investor drops to 67% after year 1 until the partnership turns tax positive. The sharing ratio is often restored to 99% once the partnership starts earning income.
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 30% to 50% 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

Sponsor Affiliate

Master Installation Agreement

Lessor

Lease

Tax Equity Investor

Sponsor

O&M Agreement

Solar PPA or Lease

Customers
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 40% 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, vacancy risk 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.
Republicans hope to move a tax bill through Congress this fall. Many tax equity investors are already sizing their investments in anticipation of a corporate rate reduction. The investor will invest more at the end of 2018 if proposed changes taken into account for purposes of pricing are not ultimately enacted.
Some tax equity investors are asking for broader protection from future tax law changes. Most investors are taking a 50% depreciation bonus to accelerate deductions into 2017 when the tax rate is likely to remain 35%.

“proposed tax change”
Suniva is asking for import tariffs of 40¢ a watt on solar cells and a floor price of 78¢ a watt on panels. The hearing in the US International Trade Commission is this week. Tariffs could be imposed by the end of the year. The threat of tariffs is making it hard to sign new power contracts and to finance projects that have not locked in panels.
Cash sweeps are another source of tension in deals. Sponsors want to retain enough cash to cover debt service on back-levered debt. Many investors agree to limit sweeps to 50% to 75% of cash or, in some cases, to prevent the sweep from reaching cash to cover principal and interest on the debt.

change of control
tax insurance
In most deals, a “push-out election” is made to address new partnership audit rules. The IRS will assess back taxes at the partnership level starting with the 2018 tax year.
Other current issues in deals include the following:

- unwinds
- option strike prices
- Volcker rule
- affiliate sales
- service contracts
- sponsor DROs
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