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

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

THURSDAY, NOVEMBER 29, 2018

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

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Solar Tax Equity Structures

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The tax benefits on solar projects amount to roughly 44¢ per dollar of capital cost.
Solar tax equity deal volume was $4 billion in 2017. Wind and solar together were $10 billion. Deal volume is expected to be flat in 2018 and to increase in 2019 and 2020, unless macroeconomic issues intervene.

slow start

Solar projects must be under construction by December 2019 to qualify for an investment tax credit at the full 30% rate. The credit drops to 26% for projects starting construction in 2020 and 22% for 2021 projects. After that, the credit reverts to its permanent level of 10%.

four years

2023

Solar developers are still feeling their way on strategies to start construction, but tax equity investors strongly advise stockpiling enough equipment to amount to at least 5% of the total project cost.

physical work

Large corporate profits have brought a number of new tax equity investors into the market, notwithstanding the fall in tax rates. There are a little under three dozen tax equity investors who come in and out of the big-ticket market. Just two banks could account for 60% of the market this year.

Most want to see a minimum ticket size of $40 to $50 million. Another dozen investors will do smaller deals.

Tax equity yields were headed down, but appear to have stabilized. Utility-scale solar yields are in the mid-6% range unlevered for the least risky deals involving the most experienced sponsors. Merchant solar is in the low 7% range. Margins for rooftop solar for brand-name developers are 300 basis points higher.

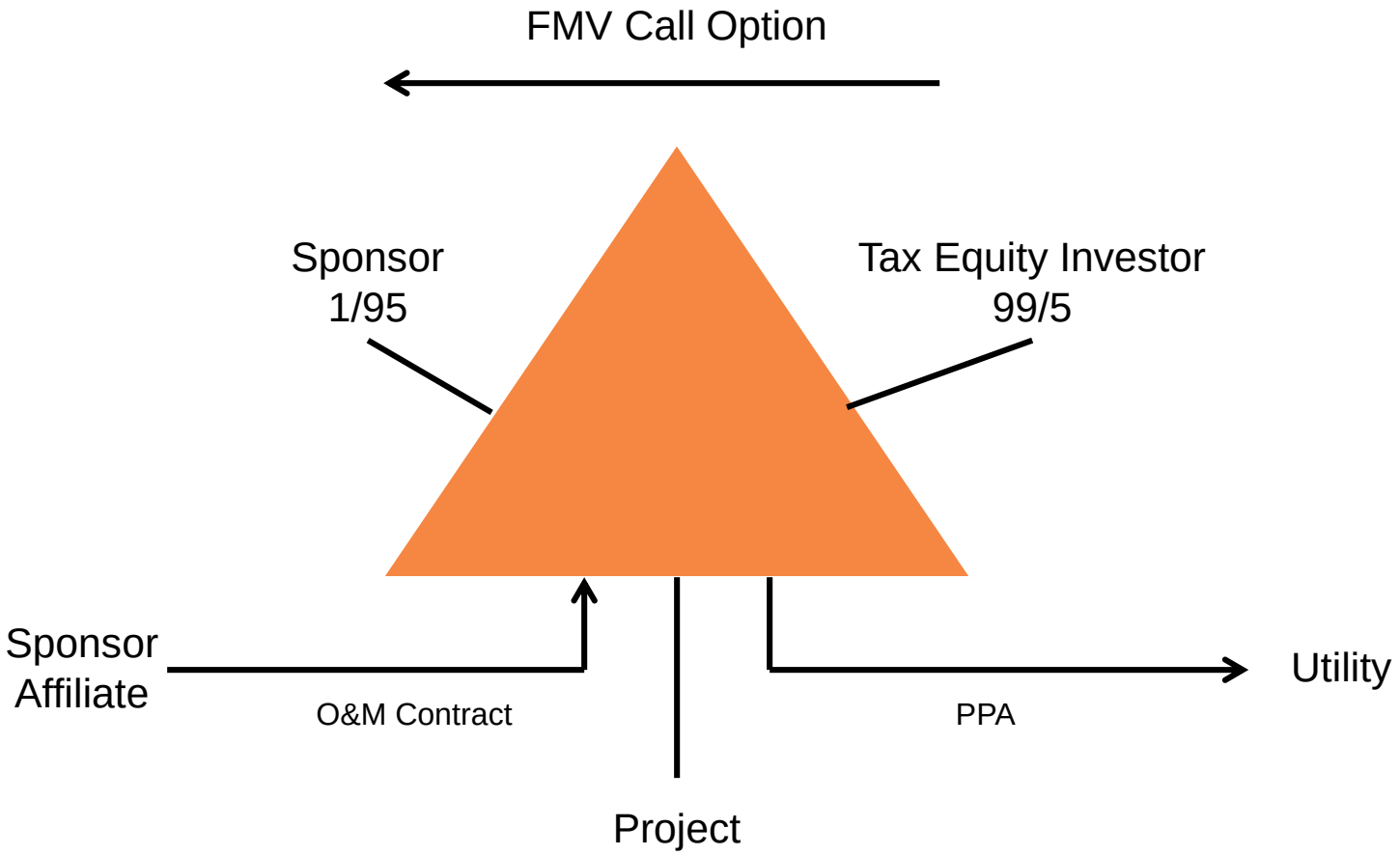
inverted leases

Leverage can increase yield by up to 500 bps. There is little debt ahead of tax equity in the capital structure, although forbearance terms are becoming more standardized.

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.

Basic Yield Flip



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 that the guidelines were written with wind projects in mind and are not a safe harbor for solar transactions.

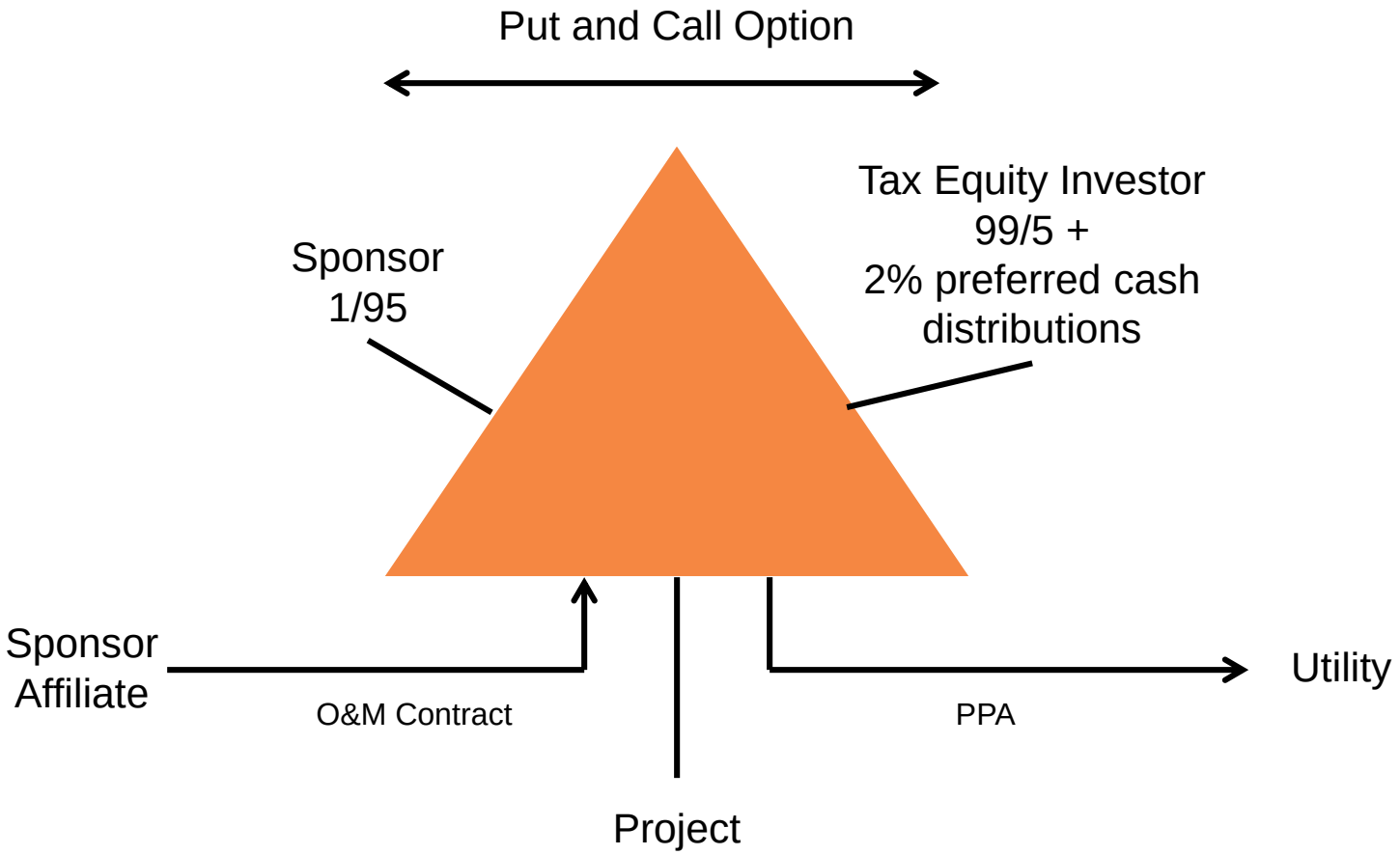
central tension

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



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").

A central challenge in all deals is how to get a step up in tax basis so that the tax benefits are calculated on the fair market value of the project rather than its cost. Three cases moving through the courts have created uncertainty.

project company sale

developer fees

disguised sale

Another challenge is that 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.

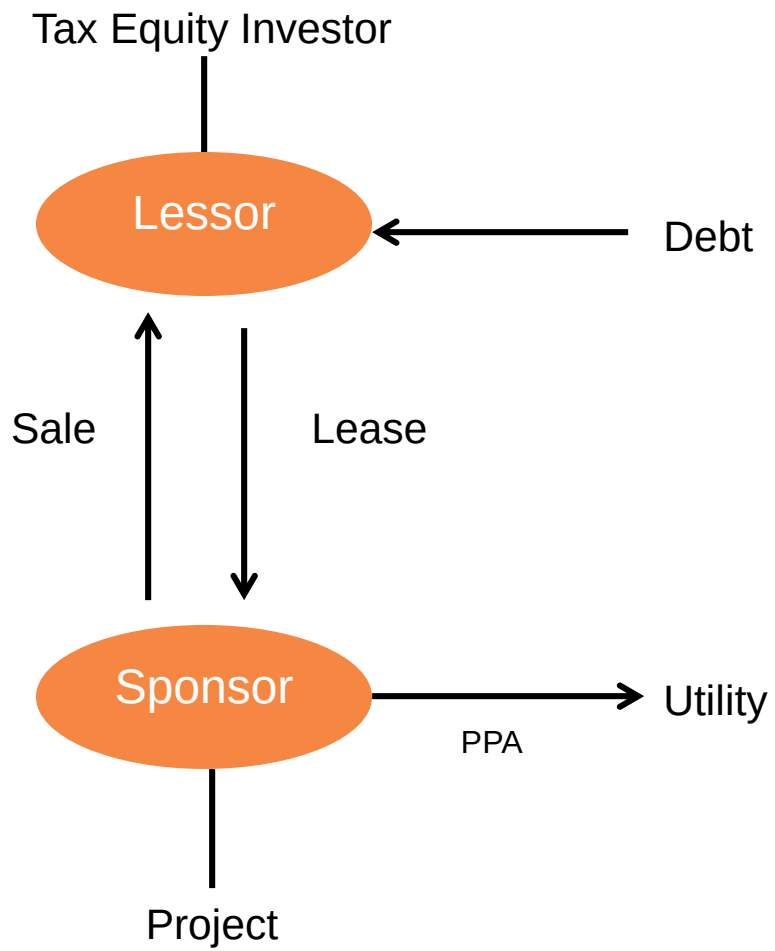
DRO

The IRS expressed doubts in October 2016 about whether some DROs are real. There should be "commercially reasonable provisions for enforcement and collection of the obligation," and the partner should be "required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership."

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



A flip used to raise 40% to 50% of the value of a typical solar project. After tax reform, subtract 3% to 8%. 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

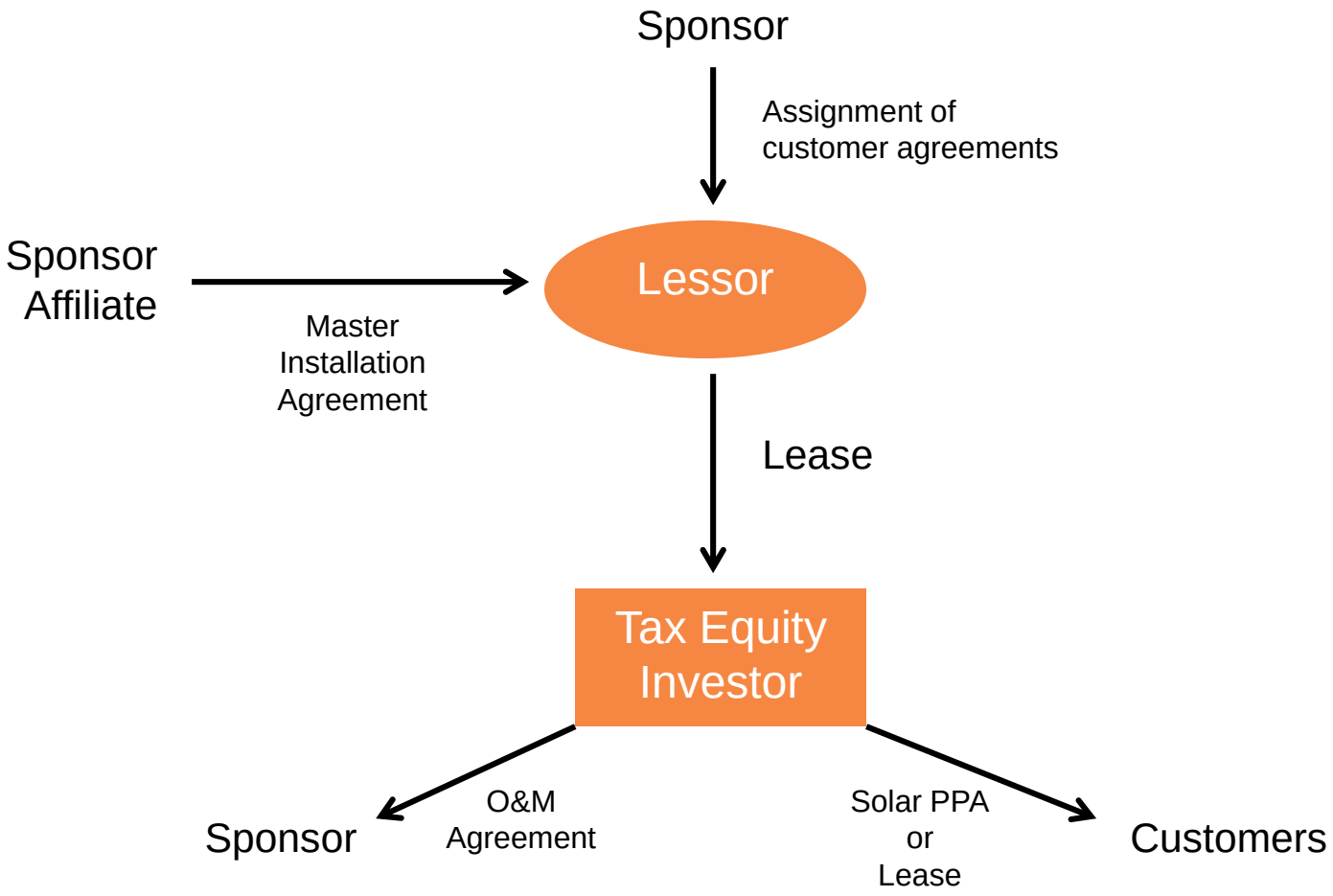
FPOs

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 had been used mainly in the rooftop market, but are now getting more use in utility-scale projects. 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



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.

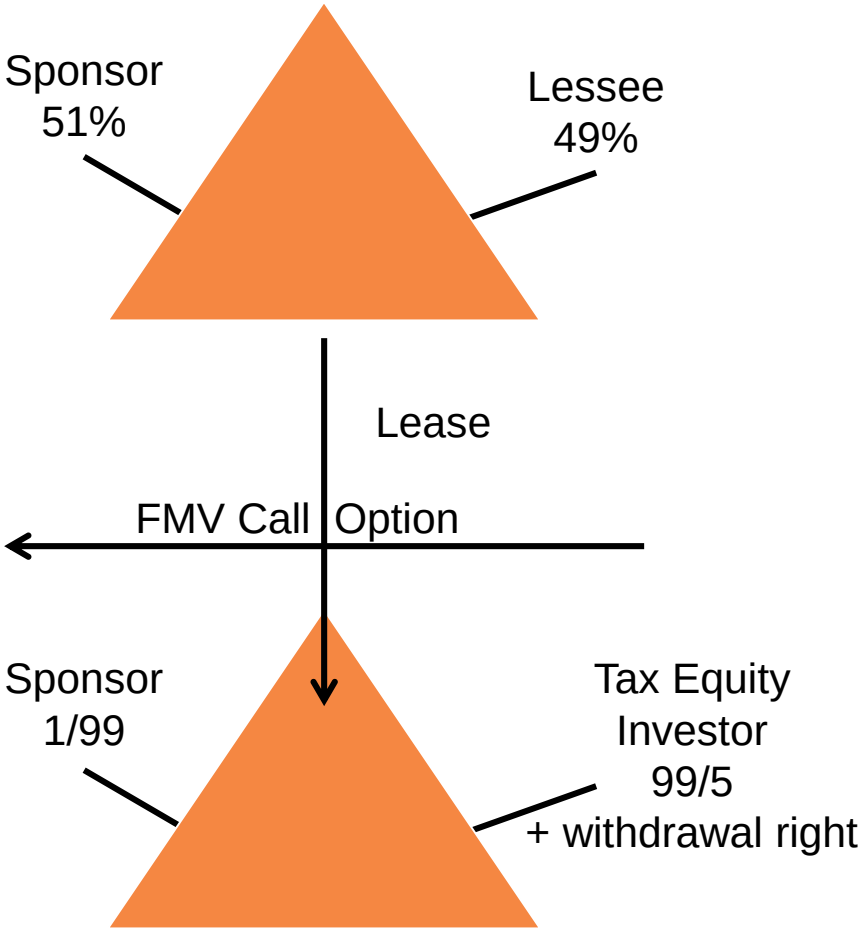
There are no IRS guidelines for inverted leases, unlike the other two structures. However, the structure is common in historic tax credit deals, and the IRS acknowledged it in guidelines in early 2014 to unfreeze the historic tax credit market after a US appeals struck down an aggressive form of the 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 the smallest share 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 up to 49% of the lessor.

Overlapping Ownership Inverted Lease



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 tax equity loss share often drops to 67% starting in year two until the first year the partnership turns tax positive as a way of reducing the downward pressure on the TEI capital account. Most tax equity investors want then to hold a 99% income ratio until there has been at least a full year of meaningful taxable income.

transitory allocations

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 used the income to increase "outside basis" and then claim a loss when they withdrew from the partnership.
The IRS put a halt to this practice.

Few tax equity investors are willing to take a 100% depreciation bonus. Even where they are willing, it creates capital account complications.

Some tax equity investors are comfortable taking less than 5% of cash after the flip.

In deals where the tax equity investor receives 2% preferred cash distributions and little other cash, the sponsor ends up with a deficit capital account. Many tax equity investors require the sponsor to agree to a DRO.

The Historic Boardwalk guidelines bar funded indemnities, meaning property or money cannot be set aside to ensure payment. Requiring a guarantor to have a minimum net worth is considered funding a guarantee. There is a debate among tax counsel about whether the prohibition should apply in the solar and wind tax equity markets.

Some recurring issues in deals are the following:

- inappropriate TEIs
- tax insurance
- batteries
- cash sweeps
- book loss
- change-in-law risk
- affiliate sales
- merchant risk
- OCC
- Volcker rule

Solar Tax Equity Structures

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