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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

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THURSDAY, JUNE 4, 2020

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Today's faculty features:

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# Solar Tax Equity Structures

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**The US government offers two tax benefits for renewable energy projects: a tax credit and depreciation. They amount to at least 44¢ per dollar of capital cost for the typical solar project. Few developers can use them efficiently. Therefore, finding value for them is the core financing strategy for most solar companies.**

**Tax equity covers 30% to 40% of the cost of a typical solar project. The developer must fill in the rest of the capital stack with debt or equity. Many sponsors also raise back-levered debt. Such debt is cheaper than tax equity even though it stands behind the tax equity in priority of repayment. Competitive pressures mean back-levered lenders are not charging larger spreads than they would charge for senior debt at the project level.**

**We saw more than 40 tax equity investors in the solar market in the 18 months before COVID-19 hit. Roughly 50% of tax equity last year was supplied by just two large banks. Many developers report the tide has been flowing out lately on tax equity, even though most mainstream tax equity investors report they expect to do the same volume as last year.**

**inappropriate TEIs**

**Tax equity yields appear to have widened by about 50 basis points since March. Until then, they had been trending down. Utility-scale solar yields were in the 6% range for experienced sponsors. Yields for brand-name rooftop developers had fallen below 8%. Tax equity investors charge structuring and unused commitment fees and price to a second all-in yield 50 to 100 bps higher.**

**\$1.08 to \$1.12**

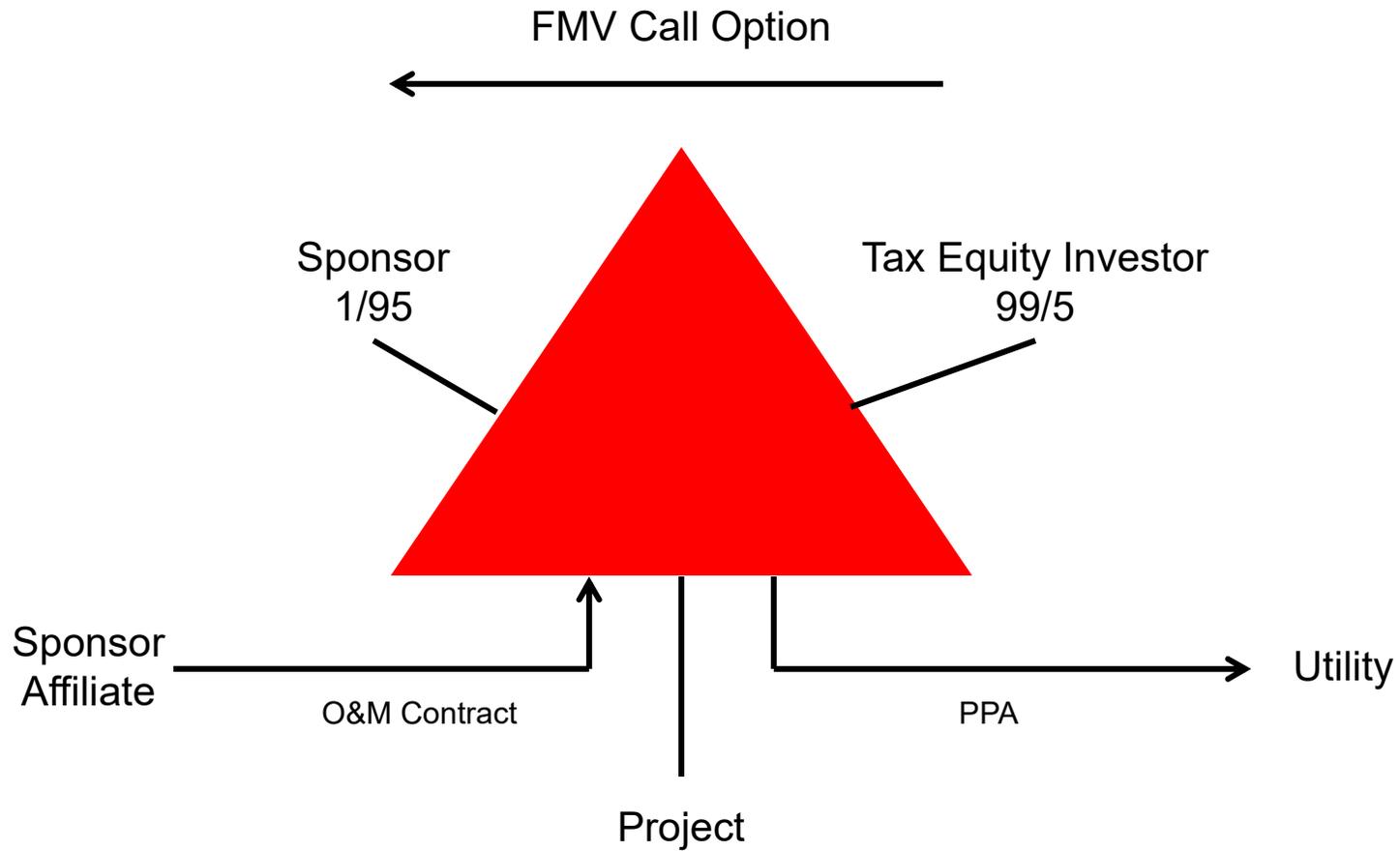
**There are three main solar tax equity structures with two significant variations. The three are partnership flips, inverted leases and sale-leasebacks.**

**Each of the tax equity structures raises a different amount of tax equity, allocates risk differently and imposes a deadline on when the tax equity investor must fund its investment.**

**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



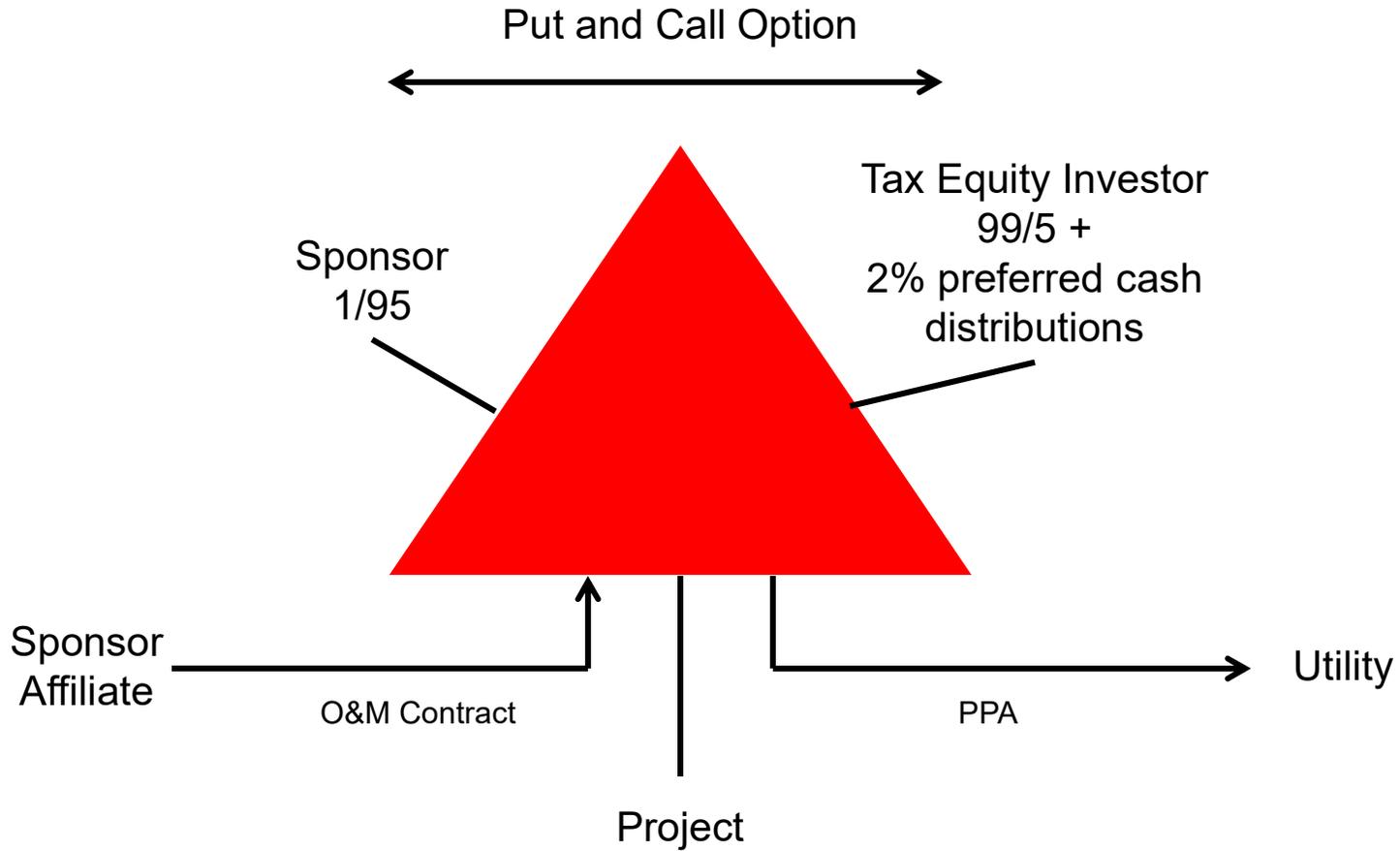
**The IRS issued guidelines for partnership flip transactions in 2007. The guidelines provide a "safe harbor" for transactions that conform to them. Most do. The IRS said recently that the guidelines were written with wind projects in mind and are not a safe harbor for solar transactions.**

**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



**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 or by making capital contributions to the partnership. In most transactions, the developer sells the project company near the end of construction to the partnership as a way of stepping up the asset basis for calculating tax benefits to fair market value.**

**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.**

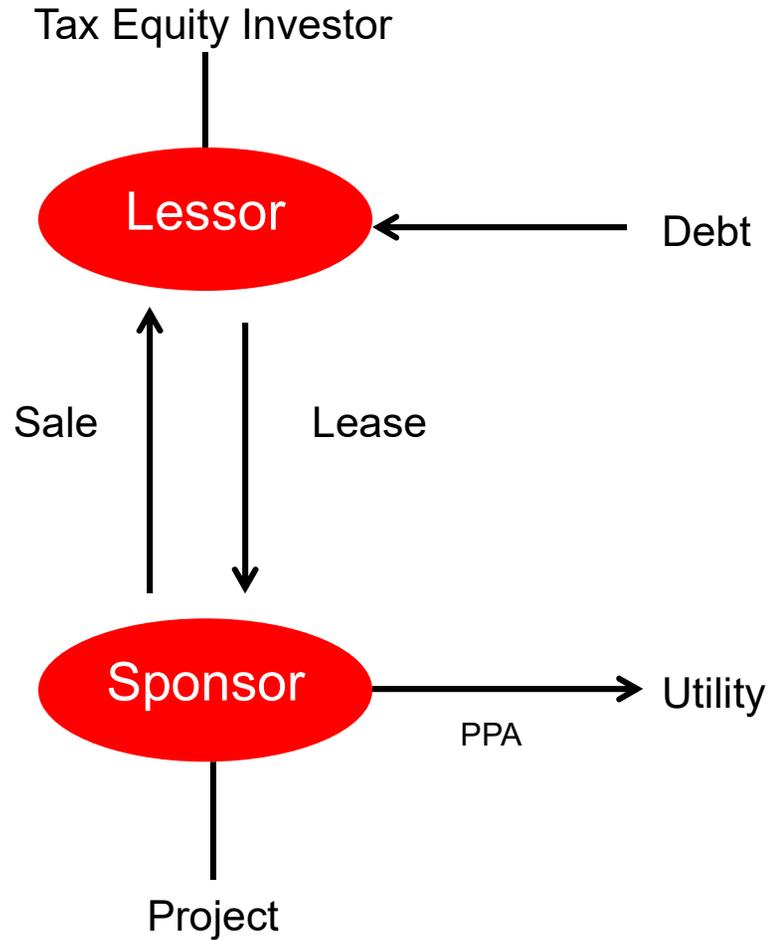
**DRO**

**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



**A flip raises 30% to 40% of the project value. A sale-leaseback raises in theory the full fair market value, but in practice, the developer is usually required to return 15% to 20% of the amount at inception 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.**

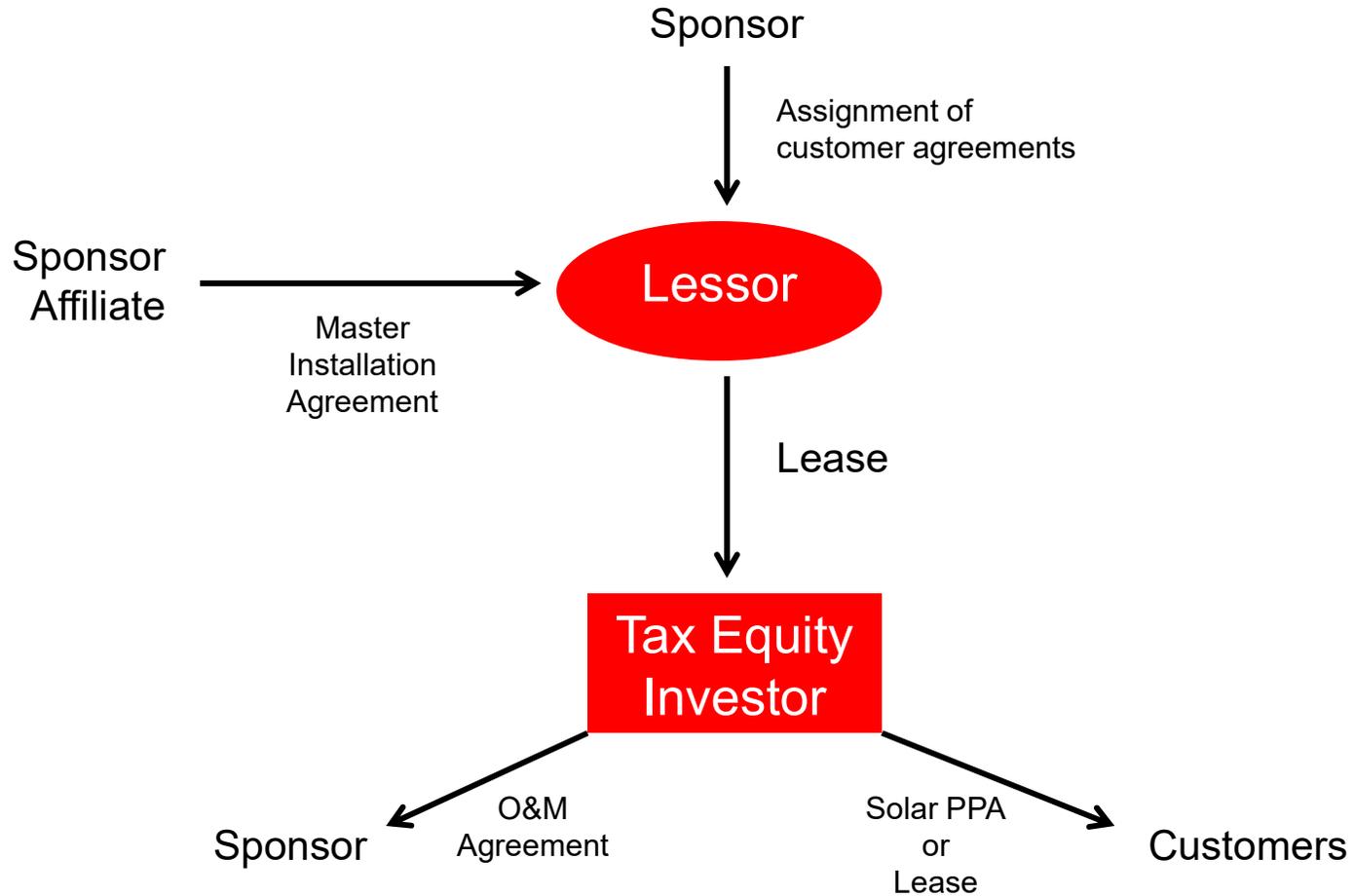
**economic compulsion**

**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



**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.**

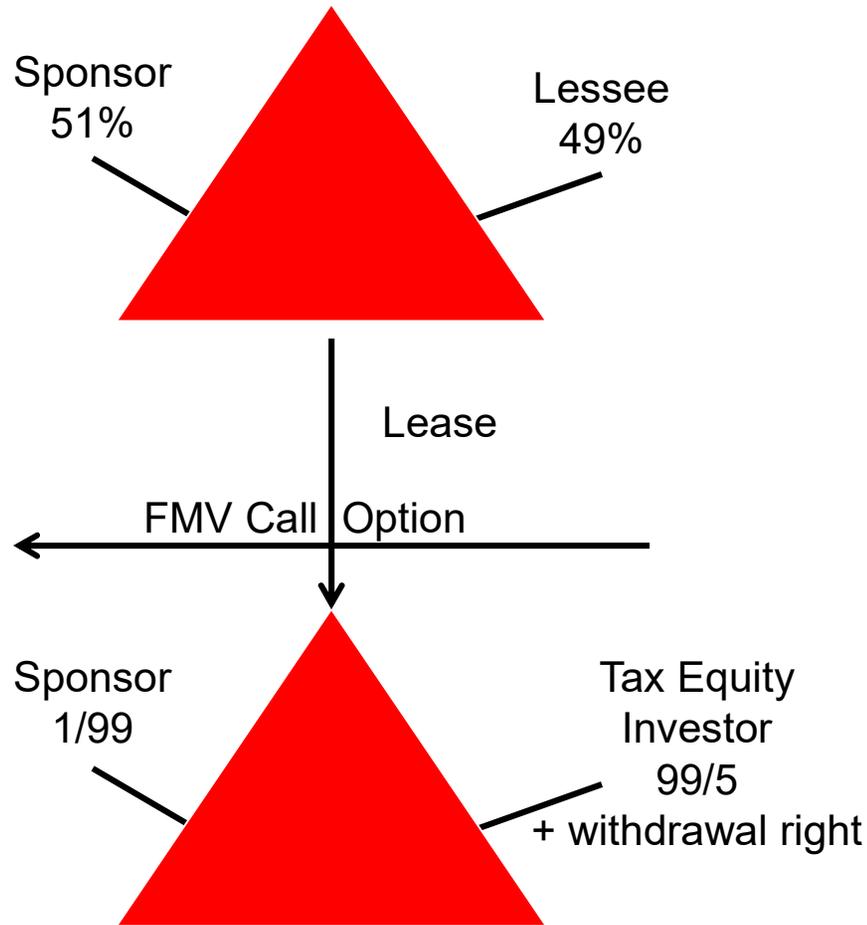
**There are no IRS guidelines for inverted leases, unlike the other two structures. However, the structure is common in historic tax credit deals, and the IRS acknowledged it in guidelines in early 2014 to unfreeze the historic tax credit market after a US appeals struck down an aggressive form of the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



**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, curtailment risk, electricity basis risk and offtaker credit.**

**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**

**A central challenge in all solar 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. The market has been watching two key cases moving through the courts. The developer lost a key developer fee case (California Ridge) last month on appeal. A basis allocation case (Alta Wind) is headed to retrial.**

**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**

**Many tax equity investors are limiting the percentage markup they are willing to see in fair market value above cost. Some are requiring tax insurance to cover basis risk in the residential rooftop market. Premiums on tax insurance run generally 2.5% to 3.5% of the potential payout.**

**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**

**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.**

**Property taxes are an ever-present issue in transactions involving solar equipment in California. Any change in ownership of solar equipment after initial installation will trigger a property tax reassessment. A “split-roll” initiative on the California ballot in November could roil the market.**

## **Other issues in deals include the following:**

**unwinds**

**option strike prices**

**affiliate sales**

**service contracts**

**sponsor DROs**

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