

## Using Inverted Leases to Finance Renewable Energy Projects

Evaluating Tax Risks, Navigating Structural Variations, Leveraging Pass-Through Election

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# Inverted Leases

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**Inverted leases are a structure used to raise tax equity for renewable energy projects. The structure is used mainly in the solar rooftop market. About 10% to 20% of tax equity transactions in that market today involve an inverted lease.**

**The other two tax equity structures are partnership flips and sale-leasebacks. All wind and other projects that rely on production tax credits use partnership flips. This is required by statute. Sale-leasebacks are somewhat more common in utility-scale projects, but far less common today than in the past.**

**The US government offers two tax benefits for renewable energy projects: a tax credit and depreciation. They amount to at least 56¢ per dollar of capital cost for the typical solar or wind project. Few developers can use them efficiently. Therefore, finding value for them is the core financing strategy for many US renewable energy companies.**



**Tax equity covers 20% to 85% of the cost of a project. The developer must fill in the rest of the capital stack with debt or equity.**

**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.**

**Inverted leases raise the least amount of capital: roughly 20% to 42% of the capital stack. A partnership flip raises 35% to 50% of the typical solar project. 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.**

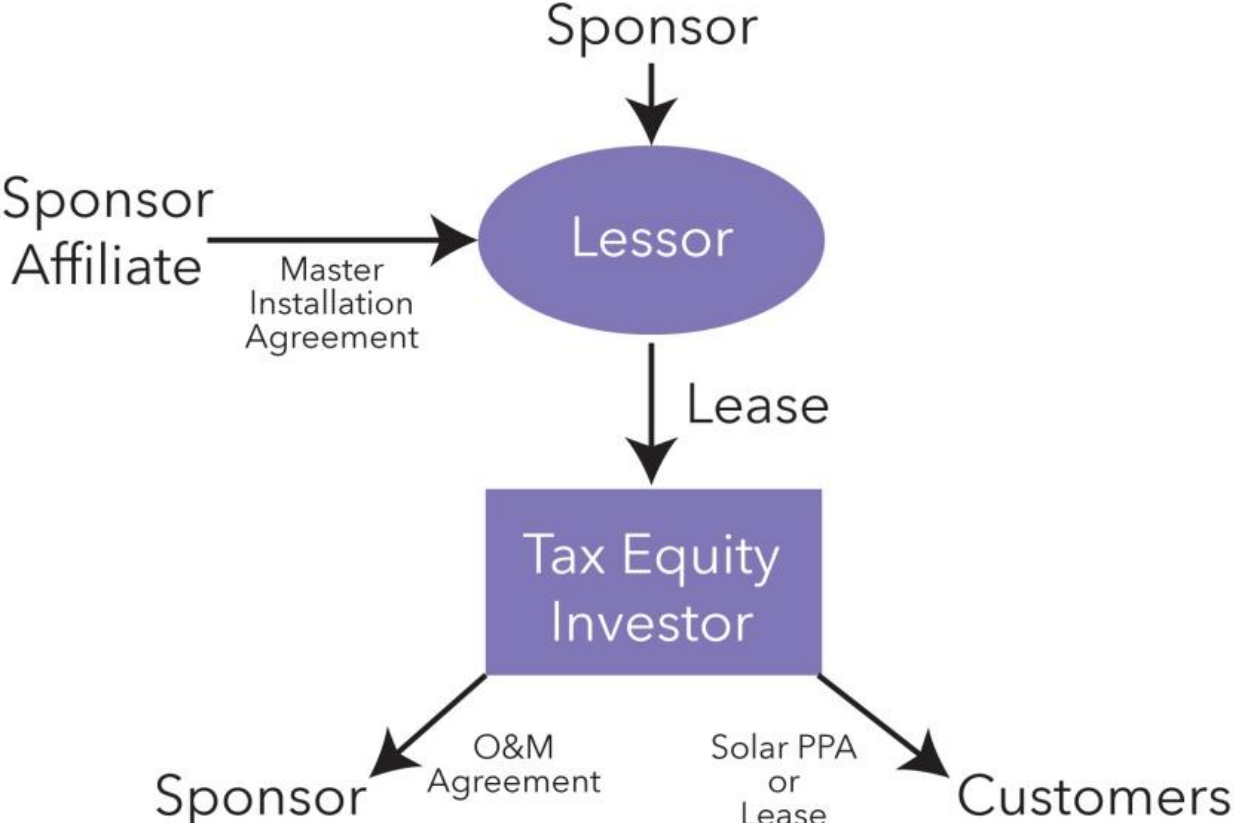
**The developer may bear more tax risk with an inverted lease or sale-leaseback than a partnership flip. Developers in lease transactions are more likely to have to indemnify the tax equity investor for loss of tax benefits. Tax indemnities are usually more limited in partnership flips. In a flip, the tax equity investor simply sits on the deal with a large share of the economics until it reaches its target yield.**

**Sale-leasebacks buy the most time to raise tax equity. The tax equity investor must be in the deal before the project is put in service in both an inverted lease and partnership flip. A sale-leaseback gives the developer up to three months after the project goes into service.**

**Drilling down into the details of inverted leases: they are a simple concept. Think of a yo-yo. A solar rooftop 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 two tax benefits on the solar equipment are bifurcated. The solar company passes through the investment tax credit to the tax equity investor as lessee. It keeps the depreciation and uses it to shelter the rents paid by the tax equity investor. That's why the structure raises the least amount of capital.**

# Basic Inverted Lease





**Solar rooftop companies like inverted leases because they get the equipment back when the lease ends without having to pay for it.**

**Another benefit is IRS regulations allow the investment tax credit to be calculated on the fair market value of the equipment rather than its cost. This "step up" in basis does not come at a cost to the solar company of a tax on a commensurate gain. There is no sale of the equipment that would trigger a tax.**

**The solar company can monetize the projected rents by borrowing "back-levered" debt. Such debt may be easier to put in place than a similar borrowing in a partnership flip structure.**

**Both solar companies and tax equity investors like the relatively short term of the financing. The primary disadvantages are it is a more complicated structure than the alternatives, does not raise as much capital, and fewer tax equity investors offer the structure.**

**The market was originally drawn to the structure in 2009 as a way for investors without tax capacity to continue doing deals during the Treasury cash grant era. The recent drop off in use of the structure is due to a variety of factors.**

**Not all sponsors can use the structure.  
Government agencies, tax-exempt entities, Indian tribes and real estate investment trusts cannot elect to pass through the investment tax credit to a lessee.**

**Normally when a solar company claims an investment tax credit, it must reduce its tax basis in the equipment for calculating depreciation by half the investment credit. In this case, the tax equity investor reports half the investment credit as income ratably over five years.**

**inclusion assumptions**

**Treas. Reg. § 1.150-1T**

**Inverted leases have terms of seven to 24 years, depending on the counsel acting for the tax equity investor. Some tax counsel like to see a “merchant tail,” meaning the lease should run at least 20% longer than the customer agreements. In deals with long lease terms, the lessee usually has an option to cut the transaction short.**



**The tax equity investor must have upside potential and downside risk to be considered a true lessee. If there is no substance to its role as lessee, then it will not be able to claim the investment tax credit. Some of the big four accounting firms treat inverted lease transactions as loans rather than real leases.**

**Some tax counsel believe the tax equity investor is a real lessee based on market exposure if the lease runs longer than the customer agreements. Others focus on the amount of prepaid rent that is paid by the lessee and want to see at least 20% prepaid rent. However, too much prepaid rent can make the deal look like a loan.**

**In the more conservative deals, the tax equity investor has a hell-or-high-water obligation to pay fixed rents to the solar company. In some deals, part of the rent is contingent on output or lessee cash flow; contingent rent adds tax risk to the structure. The portion of the customer revenue that is retained by the lessee can vary substantially.**

**Solar companies have an interest in minimizing the share of customer revenue retained by the lessor. They prefer to monetize future revenue at a back-levered debt rate rather than a higher tax equity yield. Most tax equity investors require at least a 2% pre-tax yield.**

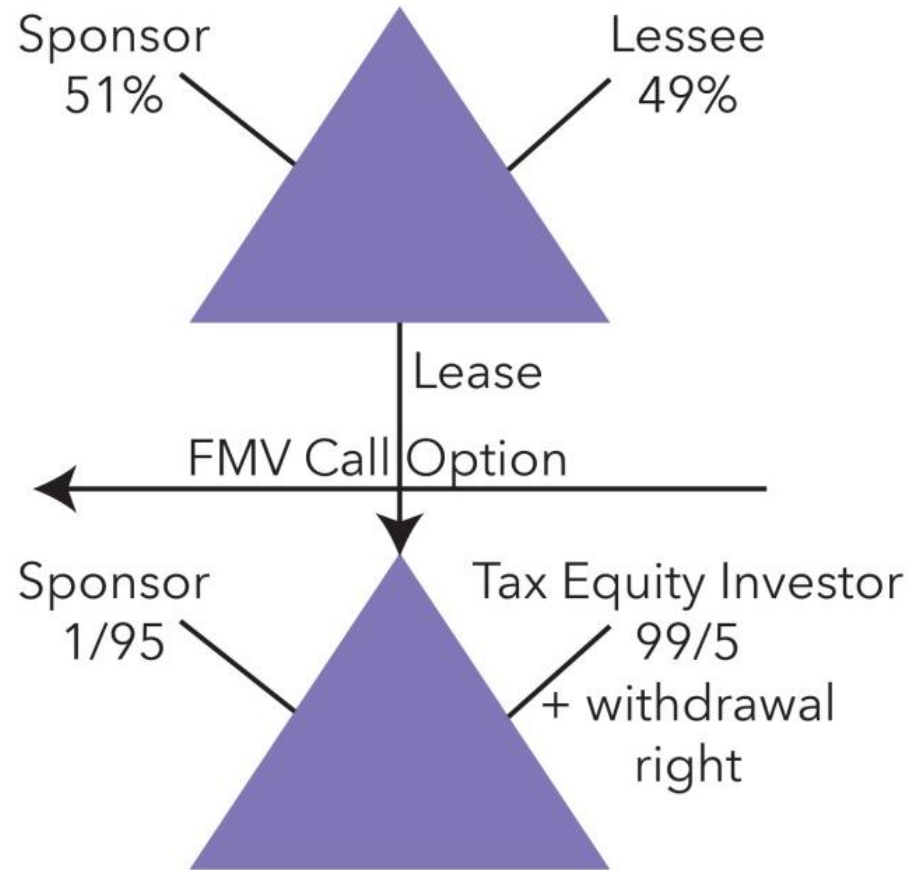
**There are no IRS guidelines for inverted leases, unlike partnership flips and sale-leasebacks. However, the structure is common in historic tax credit deals, and the IRS acknowledged it in guidelines in early 2014 to unfreeze the historic tax credit market after a US appeals court struck down an aggressive form of the structure in *Historic Boardwalk*.**

**Rev. Proc. 2014-12**

**The central challenge in inverted leases is how the 20% to 45% of the capital stack raised by the structure moves from the tax equity investor to the solar company. In the conservative form of the structure, it moves from the lessee to lessor as prepaid rent.**

**In a more aggressive overlapping ownership structure, the tax equity investor makes a capital contribution to a lessee partnership, and the lessee makes a capital contribution of the amount to the lessor in exchange for a 49% interest in the lessor. The capital contribution may be distributed by the lessor partnership to the solar company tax free. The investor is able to claim not only the investment credit, but also 49% of the depreciation on the solar assets.**

# Overlapping Ownership Inverted Lease





**In some transactions, the sponsor owns 100% of the lessor and takes a small interest in the lessee (1% to 5%) as managing member to allow the tax investor to avoid consolidating the lessee.**

**In some deals, a sponsor affiliate enters into a master installation agreement with the lessor to install solar systems as customer agreements are signed. More commonly, the sponsor contributes the equipment to the lessor which then leases it to the tax equity investor.**

**The sponsor still maintains the equipment under contract to the lessee and deals with the customers. It is the managing member in any lessee partnership.**

**In deals with a partnership in either the lessor or lessee position, there may be a flip down in the tax equity investor's interest and a call option for the sponsor to buy the investor's remaining interest after the flip or a withdrawal right for the tax equity investor or both.**

**Focusing on the tax treatment to each of the parties, the lessor must report the rent it receives as income, but has the depreciation as shelter. The lessee may prepay part of the rent. That part is treated as a "section 467 loan" and is reported by the lessor as income over time.**

**The lessee must report the revenue from customers as income. It deducts the rent paid to the lessor and claims an investment tax credit on the solar equipment. Any prepaid rent is deducted over the same period the lessor reports it as income. The lessee reports half the investment credit as income over five years.**

**The tax equity investor is locked in for five years. The "unvested" investment credit must be repaid to the US government if the lease terminates or the investor transfers its leasehold interest within five years after equipment is put in service. A transfer of the equipment by the lessor while it remains subject to the lease does not trigger recapture, unless the transfer is to someone like a government or tax-exempt entity that cannot elect to pass through investment credits.**

**The IRS and Treasury inspector general have probed into the inverted lease structure on audit, but not taken issue with it. Nevertheless, the structure is perceived as carrying more tax risk.**



**Many tax equity investors are limiting the percentage markup they are willing to see in fair market value above cost, although this is most common in utility-scale projects. Tax basis risk is borne in most deals by the sponsor. Tax loss insurance is being used in some solar tax equity transactions to avoid diversions of cash flow to cover tax indemnities, but it is expensive.**

**In general, tax risks about which the sponsor has special insight are borne by the sponsor. An example is facts that go to when a project was placed in service. Tax risks into which both the sponsor and tax equity investor have equal insight are borne by the tax equity investor. An example is whether the inverted lease structure works.**

**Risks into which neither party has special insight are usually a matter for negotiation. The biggest such risk this year is tax change risk. The risk is being put on sponsors, but the market is still feeling its way on how to address it. Some sponsors are insisting on claiming bonus depreciation to help mitigate the potential effects of tax law changes in 2018 and beyond.**

**Progress on tax reform has stalled while Congress waits for Trump to reveal what he wants. No one expects a completed tax bill on the president's desk before December 1 at the earliest. Lower tax rates are expected to be phased in starting next year because of cost.**

**There are six tax changes potentially in play that could affect the economics of inverted lease transactions. House Republican leaders have lined up behind a plan that would reduce the corporate tax rate to 20%, allow the full cost of new equipment to be deducted immediately, deny interest deductions, exempt export earnings from income taxes, and deny any cost recovery on imported goods and services. Congress could also change the existing phase-out schedule for the solar ITC, although this is not expected.**

**Some tax equity investors are already pricing deals using a 25% or 20% corporate tax rate. There is a one-time price reset at the end of 2018 or sooner after a tax overhaul bill clears Congress. A materially adverse *proposed* change in tax law not reflected in the pricing model is grounds to stop funding additional tranches. The parties debate at what stage in the legislative process it is appropriate to cut off further funding.**

**imported equipment**

**Tax equity investors generally have an incentive to accelerate tax equity deals into 2017 when deductions can be taken against a 35% tax rate. However, this may be less true of inverted lease transactions where the depreciation remains with the solar company.**

**The lack of depreciation benefits makes tax reform somewhat less of an issue in inverted leases. In fact, without depreciation benefits, the investor's return is likely to increase significantly from a lower tax rate unless the ITC is overhauled by Congress.**



**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. Putting a tax equity partnership in place is not considered a change in ownership, but later exercise of a sponsor call option or investor put is.**

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