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2016 Deloitte Alternative Energy Seminar

Setting new sights

November 14-16, 2016

Deloitte Center *for* Energy Solutions

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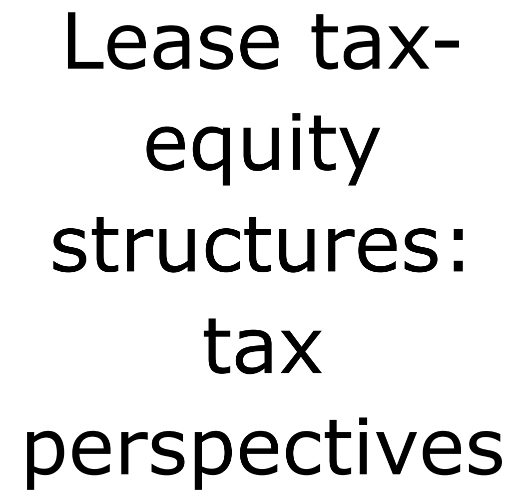

Lease tax-equity structures: tax perspectives

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Agenda

- Overview 4
- Leasing vs. flip structure 5
- Tax equity leasing structures 9
  - ◦ Sale-leaseback structure 10
  - ◦ Inverted lease structure 14
- Treasury guidance on inverted leases 18
- Recapture and other considerations 23
- Tax ownership/true lease analysis 26
- Section 467 lease concepts 32

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Overview

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Overview
Leasing vs. flip structure

IRC section 45 PTC

- In order to claim the PTC, taxpayer must be the owner of the property and the producer of the electricity
- Leasing structures not available (except for biomass)

IRC section 48 ITC

- Must be original user (first person to use the property for its intended function)
- Can decouple the owner of property from the producer of the electricity
- Leasing structures are available

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Overview
Leasing vs. flip structure

Unique aspects of the investment tax credit

- Property must:
  (1) be constructed or acquired by the taxpayer,
  (2) commence original use with the taxpayer, and
  (3) be depreciable by the taxpayer
- Sale-leaseback:
  - Still treated as original use property in hands of lessor
  - Three-month window for sale-leaseback
- Inverted lease:
  - Pass-through "original use" designation to tenant
  - Lease pass-through election

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Overview
Leasing vs. flip structure

- Percentage of capital cost
  - Partnership flip: Less than 100% financing (typically 50-60%)
  - Lease: Can provide 100% financing
- Residual value
  - Partnership flip: As low as 4.95% after flip
  - Sale-leaseback: Extend lease or buy back the entire project at FMV
  - Inverted lease: Ownership retained by Sponsor
- Three-month window for sale-leaseback deals
  - Technology risk
- Lease terms that impact the risk to the parties
  - Lessee has hell-or-high-water obligation to pay rent without regard to the performance of the ITC-eligible property

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Overview
Tax-exempt use property

- No ITC if property is owned by or leased to tax-exempt entities
  - Property leased to a partnership is treated as leased proportionately to its partners which could result in a proportionate loss of ITC
  - Property owned by a partnership is treated as owned proportionately by its partners if the partnership makes nonqualified allocations to tax exempt entity partners. This could result in a proportionate loss of ITC
- ITC can be preserved by putting a blocker entity (C corp. making a §168(h)(6)(F) election) between the tax exempt entity and the partnership owning the property

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Tax equity leasing structures

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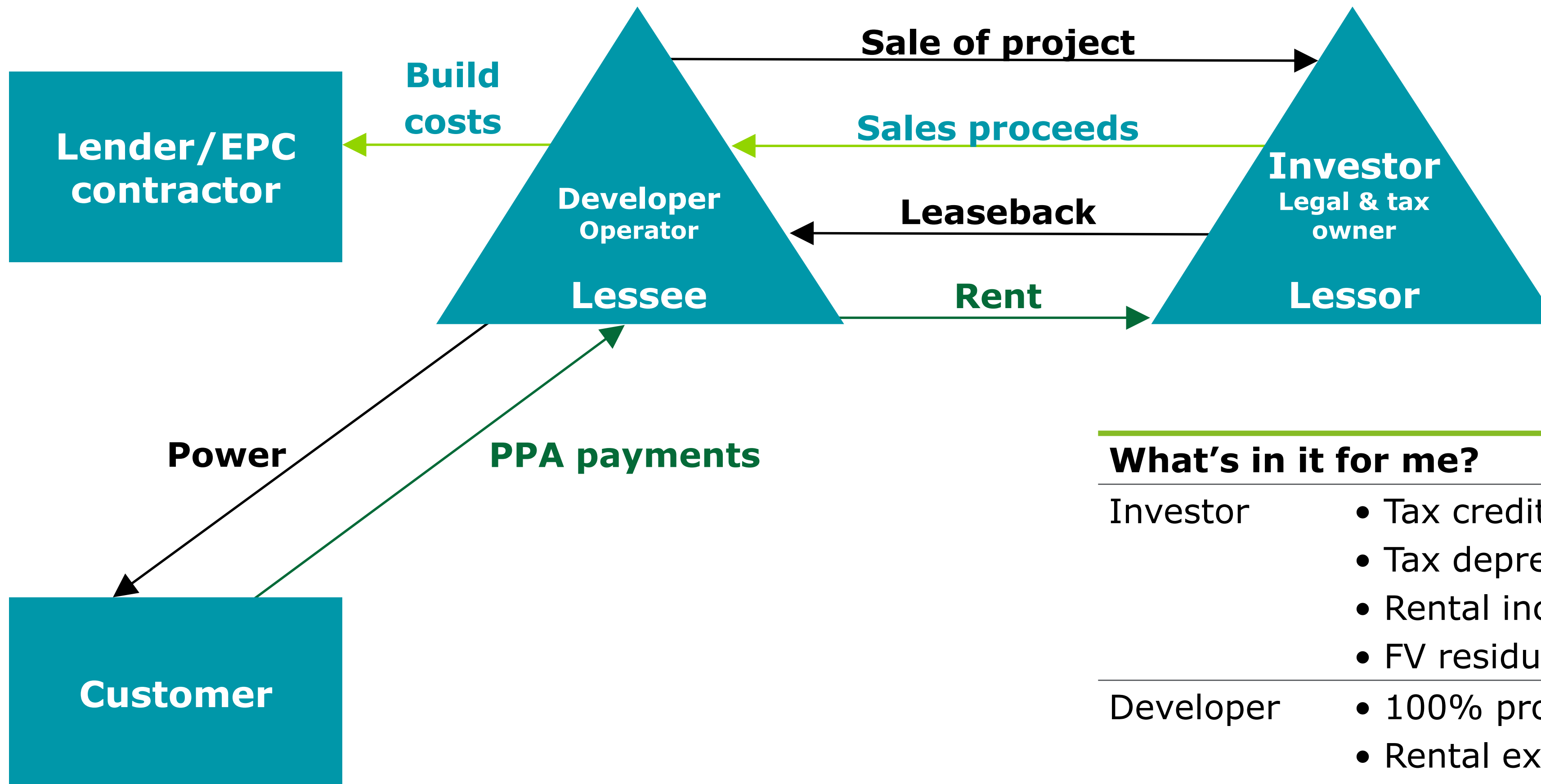
Tax equity leasing structures
Sale-leaseback—Structure



What's in it for me?

Investor	• Tax credits • Tax depreciation • Rental income • FV residual buyout or renewal
Developer	• 100% project finance • Rental expense • O&M expense • Income from PPAs and REC sales > rent

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Tax equity leasing structures
Sale-leaseback—tax basics

Time period	Developer/operator (Lessee)	Tax equity investor (Lessor)
• Construction period and placed in service	(Project development costs)	
• Sale of project (90-day rule) and lease agreement	FMV purchase price (project development costs) gain on disposition	(FMV purchase price) x 30% ITC
• Operations during tax credit period	PPA revenue (Rent) (O&M)	Rent (Depreciation) (P&I on acquisition indebtedness)
• Exit	(FMV purchase price = 20% residual value)	FMV purchase price = 20% residual value

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Tax equity leasing structures
Sale-leaseback—advantages and disadvantages

- Advantages
  - 100% financing secured by PPA
  - Tax structure risk low
  - Tax equity insulated from technology and operations risk
- Disadvantages
  - Higher exit costs
  - Relatively expensive source of capital ("black box")
  - Depreciation benefits not generally valued by tax equity
  - Basis reduction = 85% of eligible cost basis depreciated

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Tax equity leasing structures
Sale-leaseback—tax issues

- Tax Ownership
  - Lease vs. loan
  - Substance vs. form
- Three-month rule
- Tax-credit recapture
- Basis reduction = 50% of credit
- Tax-exempt use property limitations

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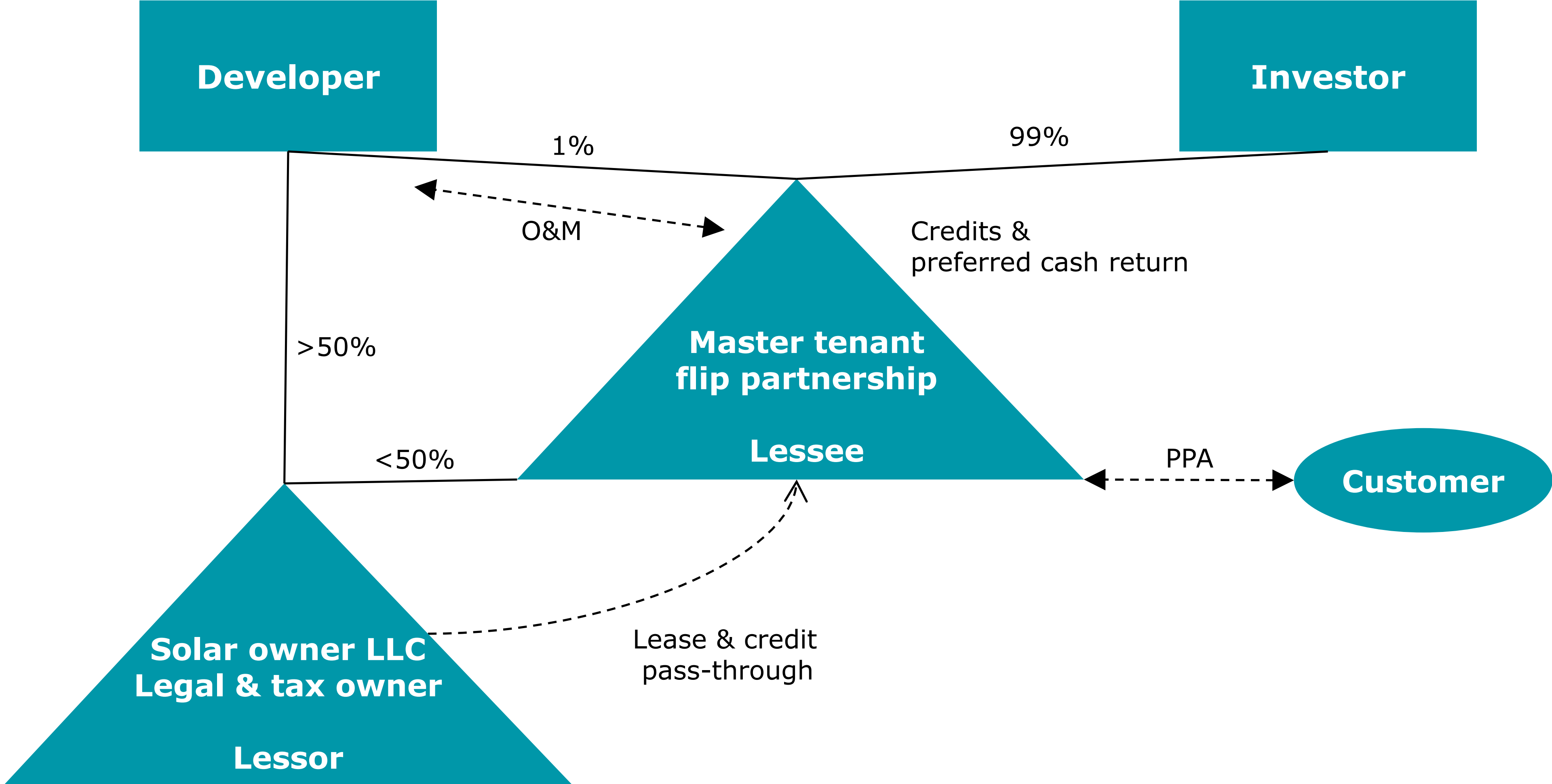
Tax equity leasing structures
Inverted lease—structure



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Tax equity leasing structures
Inverted lease—tax basics

Time period	Developer/operator (lessee)	Tax equity investor (lessor)
• Construction period and placed in service	(Project development costs)	
• Transfer possession under LT lease/48(d) election	(Avoid gain on disposition)	"Deemed" FMV purchase price x30% = ITC
• Operations during tax credit period	Rent (depreciation) (P&I on acquisition indebtedness)	PPA revenue (rent) (O&m)
• Exit	(Put/call price)	Put/call price

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Tax equity leasing structures
Inverted lease—advantages and disadvantages

- Advantages
  - ITC equals 30% of FMV (rather than cost basis)
  - Lower exit cost (sponsor retains property at end of lease)
  - Can be more efficient use of depreciation benefits
  - No basis reduction = 100% of eligible cost basis depreciated (rather than $85)
- Disadvantages
  - Tax structure risk can be higher (but see RP 2014-12)
  - Tax equity NOT insulated from technology and operations risk
  - Annual income inclusion = 3% of FMV for 5 years (in lieu of $15 basis adjustment)

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Tax equity leasing structures
Inverted lease—tax issues

- Tax ownership
  - Lease vs. loan
  - Substance vs. form
- Valuation of energy property
- Lease pass-through election
- Income from basis adjustment (IRC section 50(d))
- Partnership allocations
- Tax-credit recapture
- Tax-exempt use property limitations

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Treasury guidance on inverted leases

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IRC section 50(d) regulations
Inverted "pass-through lease" structure

- Treasury Department and IRS released temporary regulations (Treasury Decision 9776) and, by cross-reference, proposed regulations, concerning the income inclusion rules under section 50(d)(5) that apply to a lessee of investment credit property when a lessor of that property elects to treat the lessee as having acquired the property and thereby eligible to claim an Investment Tax Credit ("ITC") – so-called inverted or pass-through lease structures
- Generally, if an owner of investment credit property claims the ITC, the owner must reduce the basis in such property by an amount of the ITC
  - 50% for energy property
- However, when a lessor of investment credit property elects to pass through the credit to a lessee under Treas. Reg. §1.48-4, the lessee is deemed as acquiring the property for fair market value
- In lieu of a basis adjustment, the lessee is required to include in gross income, over the shortest recovery period, 50% of the amount of the energy credit

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IRC section 50(d) regulations
New regulations

- As noted in the preamble, some partnerships and S corporations have taken the position that this income is includible by the partnership or S corporation and that their partners or S corporation shareholders are entitled to increase their bases in their partnership interests or S corporation stock as a result of the income inclusion
- IRS and Treasury provide that such basis increases are "inconsistent with congressional intent," which would "thwart the purpose of the income inclusion" and "confer an unintended benefit" that is not available to any other credit claimant
- Temporary regulations provide that any gross income required to be ratably included is not an item of partnership income for purposes of Subchapter K or an item of S corporation income for purposes of subchapter S
- Each partner or S corporation shareholder that is an "ultimate credit claimant" is treated as the lessee for purposes of the income inclusion rules
- An "ultimate credit claimant" is defined as any partner or S corporation shareholder that files a Form 3468 with its income tax return

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IRC section 50(d) regulations
New regulations

- Thus, each partner or S corporation shareholder that is an "ultimate credit claimant" must include in gross income the credit amount required under the regulations in proportion to its credit amount claimed
- The temporary regulations also provide that if after the recapture period, but prior to the expiration of the recovery period, there is a lease termination or the lessee disposes of the lease, the lessee may make an irrevocable election in such tax year to include in gross income any remaining income required to be taken into account (or if an ultimate credit claimant, in the tax year when that claimant no longer owns its entire direct or indirect interest in the lessee partnership or S corporation)
- Effective for projects placed in service on or after September 20, 2016.
- Notice provides that it should not create any inference about proper interpretation of 50(d) prior to its issuance.
- Despite this, Deloitte believes that the common practice of increasing partner basis was supported by the law and guidance that existed prior to the Notice.

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Tax equity leasing structures
Sale-leaseback vs. inverted lease

	Sale-leaseback	Inverted lease
Financing	• Investor provides 100% financing (secured by PPA)	• Investor provides approximately 40-50% financing (secured by PPA)
Exit cost	• Higher exit costs = 20% of expected FMV to purchase project at end of lease term (or FMV rent)	• Lower exit costs = put/call price at the end of the tax credit period
Operations risk	• Insulates tax investor from operations risk by separating ownership from operations	• Tax Equity takes on a share of operations risk but will seek to transfer this risk contractually to Developer through O&M agreement
Technology risk	• Insulates tax investor from technology risk since financing closed after placed in service date	• Tax investor has technology risk since financing must be closed prior to placed in service date
Basis adjustment	• Tax investor benefits reduced by 50% basis adjustment (only 85% of property cost depreciated)	• Owner entity depreciates 100% of cost basis • Tax Equity recognizes 50(d) income equal to 15% of FMV (50% of 30% the ITC based on FMV)

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Recapture and other considerations

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Recapture and other considerations
Other considerations

- The investment credit is subject to several special rules collected in section 50:
  - Recapture Rules in section 50(a)
  - Ineligible Property Rules in section 50(b)
  - Basis Adjustment Rules in section 50(c)
- Section 50(c)(1) provides that the basis of property is reduced by the amount of the credit
  - In the case of energy credits, the basis of property is reduced by only 50% of the amount of the credit
- The credit does not directly affect either the partners' adjusted bases in their partnership interests or their section 704(b) capital accounts; however, the reduction of the partnership's basis for its investment credit property under section 50(c) triggers corresponding changes in the partners' capital accounts and the adjusted bases of their partnership interests under Treas. Reg. § 1.704-1(b)(2)(iv)(j) and section 50(c)(5)

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Recapture and other considerations
Other considerations

- Additional rules are provided for recapture at the partner level upon a premature transfer of a partner’s partnership interest in profits or other events that reduce a partner’s interest in profits to less than two thirds of the partner’s original interest in the credit
- Recapture can also be triggered upon certain transfers of the ITC property where the “mere change in form” exception is not met
- Due to code section renumbering, regulations relating to section 50 are found in regulations referring to sections 46-48
- The investment credit can be passed through to a lessee of the property
  - Income inclusion rule for the lessee in lieu of a basis reduction for the lessor
  - Special recapture rule applies in the context of a lease pass-through election because the lessee is deemed to have acquired the property from the lessor

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Tax ownership/true lease analysis

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Tax ownership/True lease analysis
In general

- Lease structures are viewed by the IRS as a potential vehicle by which taxpayers may transfer tax benefits through disguised sales
- Benefits and burdens of ownership
  - *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)
  - *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981)
  - *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985)
  - *Torres v. Commissioner*, 88 T.C. 702 (1987)

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Tax ownership/true lease analysis
Benefits and burdens

- Benefits and burdens of ownership factors:
  - Whether legal title passes to the transferee
  - How the parties treat the transaction
  - Whether the transferee acquires an equity interest in the property
  - Whether the agreement imposes a present obligation on the transferor to execute and deliver a deed and a present obligation on the transferee to make payments
  - Whether the transferee is vested with the right of possession
  - Whether the transferee pays income and property taxes on the property
  - Whether the transferee bears the risk of economic loss or physical damage to the property
  - Whether the transferee receives the profits from the operation, retention, and sale of the property
  - The existence of useful life of the property in excess of the lease term
  - The existence of a purchase option at less than fair market value
  - Whether renewal rentals at the end of the lease term are set at fair market rent
  - Whether there is a reasonable possibility that the purported owner of the property can recoup his investment in the property from the income producing potential and residual value of the property
- Facts and circumstances analysis (no one factor is determinative)

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Tax ownership/true lease analysis
Rev. Proc. 2001-28

- Safe harbor guidelines under which IRS will issue advance ruling that leveraged lease transaction is true lease
- Leveraged lease transactions only
  - Three-party transaction involving (1) lessee, (2) lessor and (3) lender
  - Lender loans lessor substantial financing (50-80%) to buy leased property
  - Lender looks to leased property and lease payments for recourse on loan
- Advance ruling purposes only
  - Assist taxpayers in preparing ruling requests
  - Not intended to be used for audit purposes
  - Does not define, as a matter of law, whether a transaction is a true lease for federal income tax purposes
  - Failure to meet guidelines does not mean that a transaction is not a true lease
- Guidelines remain important resource

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Tax ownership/true lease analysis
Rev. Proc. 2001-28 (cont.)

Pre-tax profit

- The lessor must expect, without taking into account tax benefits, including credits:
  - Overall profit—Lessee payments plus value of the residual should exceed lessor's aggregate disbursements and lessor equity, including financing fees
  - Positive cash flow—aggregate amount to be paid to lessor over the lease exceeds by a reasonable amount lessor's aggregate disbursements over the lease
- Cash on cash return
  - General rule of thumb is 3%
  - Because alternative energy transactions are cash poor, the rule of thumb is often modified by reducing 3% to 2% and by treating the tax credit (but not deprecation) either as cash or a reduction in investment

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Tax ownership/true lease analysis
Rev. Proc. 2001-28 (cont.)

Lessor must maintain minimum “at risk” amount

- Requires Lessor to always have 20% “at risk” investment in property
- Limits extent to which nonrecourse financing can be used
- Limits the prepayments that can be received from Lessee

Residual value and life

- Guidelines require 20%; courts have approved less
- Effect of renewals (fair rental value)

Purchase options

- Options vs. Puts
- Fair Market Value vs. Fixed Price

Limited use property

- Commercially feasible to sell or re-lease

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Section 467 lease concepts

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Section 467 lease concepts
What is it?

- Required method of tax accounting for rent under certain leases
- Puts certain lessors and lessees on an accrual basis to avoid timing mismatches (e.g., between cash and accrual basis taxpayers)
- When is section 467 applicable?
  - Agreement (written or oral)
  - True lease for federal income tax purposes
  - Provides for use of tangible property
  - Aggregate rents exceed $250,000, and
  - Either:
    - Increasing or decreasing rents, or
    - Prepaid or deferred rents
- Section 467 Rent
  - Fixed rent for any rental period
  - Contingent rent that accrues during the tax year

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Section 467 lease concepts
Exceptions to increasing or decreasing rent

- Rent holiday period of three months or less at beginning of lease term
- Certain contingent rents
  - Qualified percentage rents (*i.e.*, rent equals fixed percentage of lessee's receipts or sales)
  - Adjustments based on reasonable price index
  - Third-party costs (e.g., real estate taxes; insurance premiums)
  - Late payment charges
  - Loss payment provision
  - Qualified TRAC provision
  - Residual condition provision
  - Tax indemnity provision
  - Variable interest rate provision (i.e., rent is adjusted by changes in the amount of interest payable by lessor on debt incurred to acquire leased property)

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Section 467 lease concepts
Deferred or prepaid rent

- Deferred rent
  - Cumulative rent allocated to all periods as of the close of any calendar year exceeds the cumulative rent payable as of the close of the succeeding calendar year
- Prepaid rent
  - Cumulative rent payable as of the close of any calendar year exceeds the cumulative rent allocated to all periods as of the close of the succeeding calendar year
- No deferred or prepaid rent
  - Lease does not contain separate allocation and payment schedules, or
  - Rent is payable under the payment schedule no more than one year after or one year before the year in which it is accrued under the allocation schedule
- If no separate allocation schedule, payment schedule is allocation schedule
  - See, *e.g.*, TAM 9406003 (where no separate allocation schedule and payment schedule provides rent holiday, zero rent allocated to rent holiday period)

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Section 467 lease concepts
Deferred or prepaid rent (cont.)

Year	Allocated rent	Rent payments	(A) Cumulative rent allocated	(B) Cumulative rent payable	Deferred rent if A > B thru next year	Prepaid rent if B > A thru next year
1	100	0	100	0	YES	NO
2	100	0	200	0	YES	NO
3	100	0	300	0	YES	NO
4	100	250	400	250	NO	NO
5	100	250	500	500	NO	NO

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Section 467 lease concepts
Deferred or prepaid rent (cont.)

Year	Allocated rent	Rent payments	(A) Cumulative rent allocated	(B) Cumulative rent payable	Deferred rent if A > B thru next year	Prepaid rent if B > A thru next year
1	100	300	100	300	NO	YES
2	100	50	200	350	NO	YES
3	100	50	300	400	NO	NO
4	100	50	400	450	NO	NO
5	100	50	500	500	NO	NO

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Section 467 lease concepts
Deferred or prepaid rent (cont.)

- Deferred or prepaid rent creates section 467 loan
  - Deferred rent: deemed loan by lessor to lessee
  - Prepaid rent: deemed loan by lessee to lessor
- Portion of allocated rent treated as principal balance of section 467 loan
- Portion of allocated rent treated as section 467 interest
- Portion of allocated rent treated as section 467 rent
  - Lessor and lessee have income and deductions each tax year equal to sum of section 467 rent and section 467 interest
  - Section 467 interest and section 467 loan considered interest and indebtedness for all purposes of Code
- Actual calculation methods too detailed and complicated to review here

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Section 467 lease concepts
Methods of accounting

- Rental Agreement Accrual
  - Lease is not disqualified leaseback or long-term agreement and
  - Either—
    - Lease has no deferred or prepaid rent or
    - Lease has deferred or prepaid rent and provides adequate interest
  - Section 467 rent is allocated rent

- Proportional Rental Accrual
  - Lease is not disqualified leaseback or long-term agreement and
  - Lease has deferred or prepaid rent, but does not provide adequate interest
  - Section 467 rent is set fraction of allocated rent

- Constant Rental Accrual
  - Lease has increasing or decreasing rent and
  - Lease is disqualified leaseback or long-term agreement
  - Section 467 rent is level amount for each rental period

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Section 467 lease concepts
Disqualified leasebacks and long-term agreements

- Leaseback
  - Lessee had interest in property any time within two years of agreement date
- Long-term agreement
  - Lease term exceeds 75% of property's statutory recovery period
- A leaseback or long-term agreement is disqualified only if:
  - A principal purpose for providing increasing or decreasing rent is tax avoidance, and
  - IRS determines that because of tax avoidance purpose, rental agreement should be treated as disqualified
- Agreement closely scrutinized where more than 10% difference in marginal tax rates
  - Considers taxpayer's specific circumstances
  - Clear and convincing evidence to rebut presumption of tax avoidance

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Section 467 lease concepts
Safe harbors to avoid constant rental accrual

- Uneven rent test (aka 90/110 safe harbor)
  - Rent allocated to each calendar year does not vary from average rent allocated to all calendar years by more than 10%
    - Substitute 15% for 10% if long-term agreement and at least 90% of fair market value of leased property consists of real property

- Increase or decrease in rent is wholly attributable to one or more of the following provisions –
  - Contingent rent provision (*e.g.*, adjustments based on reasonable price index)
  - Single rent holiday provision
    - Rent holiday period at beginning of lease term if three months or less or
    - Rent holiday period at any time during lease term if commercially reasonable in locality and does not exceed lesser of 24 months or 10% of lease term

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