Accounting for Partnership Flip Structures and Leases

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Agenda

Partnership Flip
Sale Leaseback
Q&A
# Partnership Flip - Players

<table>
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<tr>
<th>Participant</th>
<th>Role</th>
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| Developer                | • Typically the operator and managing member of the partnership  
                                 • ROI earned largely through cash flows from PPA  
                                 • Purchase option for Tax Equity Investor’s residual interest |
| Tax Equity Investor      | • Possesses sufficient taxable income to monetize tax benefits (credits & accelerated depreciation)  
                                 • ROI earned through allocation of tax benefits and then cash flows after 1\textsuperscript{st} flip  
                                 • Typically exits when after-tax IRR is earned |
Partnership Flip Structure

**Developer**

- Cash distributions
  - Period 1: 100%
  - Period 2: 0%
  - Period 3: 95%

- Gross income (loss)
  - Period 1: 1%
  - Period 2: 1%
  - Period 3: 95%

**Tax Equity Investor**

- Cash distributions
  - Period 1: 0%
  - Period 2: 100%
  - Period 3: 5%

- Gross income (loss)
  - Period 1: 99%
  - Period 2: 99%
  - Period 3: 5%

**Project Entity**

- Power Purchase Agreement

**Utility**
Developer Accounting Considerations - Real Estate Rules & Consolidation
Sale of Investment in Project Entity by Developer

If developer sells interest in Project Entity that is in substance real estate and has option to repurchase that interest

- Consolidation
- Equity Method
- Cost Method
- Fair Value

Project assets remain on books of developer

Real estate rules: Account as financing, leasing, or profit sharing arrangement
Sale of Investment in Project Entity by Developer (cont.)

• Do real estate accounting rules apply?
  – If developer sells an investment in a project entity that is in substance real estate:
    • Real estate accounting rules apply to sale of investment (EITF 98-8 or ASC 360-20)

• What is frequently the consequence?
  – As a result of continuing involvement (e.g., repurchase option), transaction is not accounted for as a sale, but as a financing, leasing, or profit sharing arrangement
Real Estate Rules

• Apply to all sales of real estate (and investments in entities that are in substance real estate) including real estate with property improvements or integral equipment on leased land

• Integral equipment is any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost (ASC 360-20-15 (FIN 43; EITF 00-13))
  - Significant cost – 10 percent threshold
Consolidation and Variable Interest Considerations

• Two consolidation models
  – Variable interest model: ASC 810-10 (FIN 46R)
  – Voting interest model: ASC 810-10 (ARB 51)

• Which model to use?
  – Determine whether the project entity is:
    • Within the scope of the variable interest guidance, and
    • A variable interest entity (VIE)
  – If yes, apply the variable interest model; otherwise, apply the voting interest model
VIE Definition

- Insufficient equity investment at risk, or
- Investors do not have rights/obligations of owners
  - Right to receive expected residual returns
  - Obligation to absorb expected losses
  - Right to make decisions
  - Substantially all of activities on behalf of ONE investor **and** disproportionate voting rights
Consolidation Under the Variable Interest Model

• Enterprise with controlling financial interest in entity:
  – Power to direct activities of VIE that most significantly impact entity’s economic performance, and
  – Obligation to absorb losses of VIE or right to receive benefits from entity if rights/obligations could potentially be significant to VIE
Consolidation Under the Variable Interest Model (cont.)

• Evaluate power to direct the most significant activities impacting the VIE’s economic performance:
  – Consider all risks and related activities that the entity was designed to create
  – Potential activities:
    • Siting
    • Construction and/or financing
    • PPA and/or remarketing power at end of PPA
    • Dispatch
    • Maintenance
Developer – Summary Flowchart

Is the equity interest in an entity that is considered in substance real estate (need to consider whether assets are "integral equipment" to underlying real estate)?

Yes

Does the transaction qualify for the full accrual method under real estate sales accounting?

Yes

Deconsolidate and record a gain or loss in accordance with ASC 810. If any equity interest is retained, follow Investor accounting (see following slides)

Account for the transaction as a secured borrowing (financing)

No

Does the transaction qualify as a sale under ASC 860 (financial asset transfer guidance)

No

Does the developer continue to consolidate under ASC 810?

No

Developer records a non-controlling interest (or obligation) and records future income or loss using a profit sharing method (e.g., HLBV)

Yes

Developer records profit or loss on transaction and a non-controlling interest.

No

Developer does not record profit or loss on transaction and records as financing, leasing, or profit-sharing arrangement

No

continuing involvement

Yes

Profit Sharing

Financing

Developer records a financing obligation that accretes (according to the targeted return) and is reduced by distributions and allocated tax benefits. Developer may also record an obligation for the call or put option

Note: Leasing method is not observed in practice because these partnership flip structures do not resemble leasing arrangements.

Key:

- Common practice
- Not common practice

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Financing Method

- Continue to report the assets and liabilities of the project, including the related results of operations
- Record cash received from Investor as a financing obligation
- Accrete the obligation according to the target rate of return using the effective interest method
- Record reductions to the financing obligation for distributions and allocation of tax benefits
  - Reductions for allocated tax benefits are income (consider appropriate recognition pattern)
- Consider option value
  - Record at fair value at inception and adjust to fair value at each period with an offset to “debt discount”
  - Amortize “discount” using the effective interest method
Tax Equity
Investor
Accounting
Considerations-
Equity Method
Accounting for Investment in an Entity

- **Developer and Investor**
  - **Consolidation**
  - **Equity Method**
  - **Cost Method**
  - **Fair Value**

**Income Allocation:**
- ASC 323-10 (APB 18)
- ASC 970-323 (SOP 78-9)
- Other Methods?
Equity Method

• If consolidation is not appropriate, most equity interests in entities (including tax equity interest) are accounted for under the equity method.

• The equity method is appropriate if an investor exercises significant influence over operating or financial policies of an investee.

• The fair value option may be available for an investment that qualifies for the equity method, if it does not cause income recognition of tax benefits before they are earned.
Application of Equity Method

• Record investment in entity at cost
• Adjust carrying amount of investment to investor’s share of earnings or losses
• Conventional application:
  – Use “percentage ownership interest” approach to investee’s U.S. GAAP net income or loss for the period to determine investor’s share of investee’s earnings or losses
Application of Equity Method (cont.)

• Alternative applications:
  – Traditional HLBV method
  – Modified percentage of ownership method
  – Other approaches may be acceptable (par 4 of EITF 99-10)
  – FASB considering whether scope of current effective yield (ASC 323-740) and proportional amortization (ASU 2014-01) accounting for low income housing investments be extended to other tax structures, like alternative energy

• Consider economic substance of the agreements
Hypothetical Liquidation at Book Value (HLBV) Method

• The HBLV Method is an income or loss allocation method that overcomes challenges with the conventional application of the equity method
  – Balance sheet oriented approach
  – Determines how better (or worse) off the investor is at the end of the period than it was at the beginning of the period (taking into consideration only those transactions and other events recognized by the investee under U.S. GAAP)
Hypothetical Liquidation at Book Value (HLBV) Method \textit{(cont.)}

- Generally, the HLBV Method and other approaches are not considered appropriate where the conventional equity method can be applied.

- Challenges to conventional application of equity method:
  - Investee’s capital structure provides different rights and priorities to its owners or ownership percentages are not specified.
Concept of HLBV Method

- Company assumes liquidation of assets at book value
- Determine how much to allocate to each investor
- The change in the allocated amount to each investor during the period is book income/loss allocated to that investor (adjusted for distributions and contributions)
ASC 970-323 (SOP 78-9), Accounting for Investments in Real Estate Ventures

• Issued to provide accounting guidance for investments in real estate entities
• Often used by analogy in other industries
• ASC 970-323-35-17 states:
  – “… to determine the investor’s share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation…”
Modified %age Ownership Method

• Product of the %age of project lifetime earnings expected to be realized by the investor, multiplied by project’s current period earnings (adjusted for book depreciation)

• Book depreciation is excluded as all is expected to be allocated to tax equity investor

• Results in an allocation of income that is directionally consistent with earnings results of the underlying project
Investor – Summary Flowchart

Does the Investor consolidate the investee under ASC 810?

Yes → Record investee as a subsidiary of the Investor

No →

Does the Investor exercise significant influence over the investee?

Yes →

Does the equity security have a readily determinable fair value?

Yes →

Use ASC 320 to classify according to the nature of the investment – trading or available for sale?

Yes → Trading

No → Available for Sale

Trading securities are reported at fair value each reporting period with gains and losses reported in earnings

No →

AFS securities are reported at fair value each reporting period with gains and losses reported in OCI. Impairment considerations.

Key:
- Common practice
- Not common practice

Investor applies the equity method (ASC 323) – recognizes investment at cost and receives allocated profit or loss according to equity method accounting (e.g., HLBV). Investor evaluates investment for impairment in future periods.

Investor applies the cost method (ASC 325-20) – recognizes investment at cost. Investor evaluates investment for impairment in future periods.

Note: Investors may have the option to elect the fair value option for their non-consolidated investments. Accounting is equivalent to trading classification.
Alternative Structure: Sale Leaseback
Partnership Flip Structure
Leaseback / Operate Alternative

- **Developer**: 100% ownership
- **Tax Equity Investor**: 100% ownership

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**Lessee enters into LT leaseback**

**Lessee enters into LT leaseback**

**Power Purchase Agreement “PPA”**

**Solar Farm**

**Utility**

**Developer sells installed panels to Tax Investor**
Developer / Lessee Accounting Considerations
Leasing

• For the Developer:
  – Are the assets sold and subsequently leased back in-substance real estate subject to ASC 360-20?
  • For example, treatment may be different for a residential solar panels vs. a solar farm

– If the assets are in-substance real estate, need to determine if the sale-leaseback transaction qualifies for sale-leaseback accounting (asset derecognition and deferred profit recognition) following the real estate rules in ASC 360-20 and ASC 840-40
Leasing

• For the Developer:
  – If the assets are non-real estate, there are no special rules or additional criteria to qualify for sale-leaseback accounting (i.e. not required to assess continuing involvement)
  – Apply sales-leaseback accounting:
    • Calculate the gain/loss to be recognized
    • Determine if the seller/lessee’s retained use of the property is considered minor, more than minor, but less than substantially all (90%), or substantially all to determine the profit deferral
    • Allocate and recognize the gain as provided by ASC 840-40 over the remaining lease term
Leasing

• For the Lessee:
  – Determine whether the leaseback is an operating or capital lease
  • Consider the impact of the asset’s economic life, purchase/renewal options, title transfer, payments to be included in MLPs
  – Typically the intent is for the leaseback to be an operating lease so the Tax Investor is the owner of the assets
  • Note, however, the criteria for tax ownership may be different than the criteria for accounting classification
Consolidation: Lessee

• Does the Lessee’s leaseback of the assets represent a variable interest in the Lessor entity?
  – Operating lease
    • Consistent with prevailing market terms?
    • Residual value guarantee (or similar arrangement) or fixed-price purchase option?
  – Capital lease
Consolidation: Lessee

• Does the Lessee have the power to direct the activities that most significantly impact the economic performance of the Lessor entity?
  – Ongoing activities of the Lessor may have little or no effect on economic performance (e.g. admin?)
  – Power analysis may focus on the decisions made at the Lessor’s inception as the initial design may have had the most significant impact on the economic performance of the Lessor
  – Consider whether the economic interest of one party is so significant that it suggests the design decisions were made by that party or on its behalf
Consolidation: Developer

• Assume the Developer provides a guarantee of the Tax Investor’s investment in the Lessor (e.g. through the conveyance of tax credits through the Tax Investor’s interest in the Lessor or via a cash payment)
  – Guarantee provides the Developer with a variable interest in the Lessor
  – Lessor then meets the definition of VIE as the sole equity holder (the Tax Investor) does not absorb expected losses
  – Developer may be identified as the primary beneficiary
Consolidation: Developer (cont.)

• Assuming the Developer consolidates the Lessor, how should the Tax Investor’s interest in the Lessor be presented in the Developer’s financial statements?

• Liability (or some other deferred credit) or Equity (non-controlling interest)
Consolidation: Developer (cont.)

• Factors to consider:
  Liability
  – Represents an obligation to transfer assets
  – Value not derived from Lessor’s operations
  – Does not carry substantive voting rights
  – Limited down-side risk; capped up-side potential

Equity (non-controlling interest)
  – Equity is the legal form of the interest
  – No characteristics of a share (ASC 480-10)
  – Substantive initial investment to acquire
Tax Equity
Investor / Lessor
Accounting Considerations
Leasing / Consolidation

• Determine whether the leaseback is an operating or capital lease
  – Additional criteria from the Lessor perspective

• If consolidation of the Lessor is not appropriate, determine how to apply equity method
Questions?
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