Introduction to Tax Equity Structures

Part I –
- Summary of Qualifying Resources and Facilities
- Partnership Flip Structure
- Sale Leaseback Structure

Part II –
- Inverted Lease Structure
- Power Prepayment Structure
- Summary of Major Tax Issues
- Yieldco and Other Financing Trends
Inverted Lease Structure
## Inverted Lease – Players

<table>
<thead>
<tr>
<th>Participant</th>
<th>Role</th>
</tr>
</thead>
</table>
| **1. Tax Investor / Operator** | • Possesses sufficient taxable income to monetize tax benefits (both tax credits and accelerated MACRS tax depreciation)  
                              | • Typically funds tax equity portion of total project costs (less project level equity and debt)  
                              | • IRR earned through allocation of 99% of tax credits and 49% of tax losses/income and distributable cash  
                              | • Typically exits the project after the credit period upon option exercise                                                                 |
| **2. Developer (O&M Agreement)** | • ROI earned through cash flows from Lease income and long term ownership of panels  
                                    | • Purchase option on Tax Investor’s residual interest |
Inverted Lease Structure

1. Owner obtains long term lease rights and installs solar panels
2. Owner leases the panels to Operator & makes election to pass through credits to lessee allocated 99% to Tax Investor
3. Operator enters into Power Purchase agreement to sell electricity from panels
4. Operator will make annual lease payments to the Owner to cover debt service

Developer

1% owner

Owner (Lessor)

51% owner

Operator (Lessee)

49% owner

Tax Investor

99% owner

Tax Credits

Local Utility

Lease panels

1

2

3

4
# Tax Basics – Inverted Lease

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Developer/Owner (Lessor)</th>
<th>Tax Investor/Operator (Lessee)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Construction Period and Placed in Service</td>
<td>(Project Development Costs)</td>
<td></td>
</tr>
<tr>
<td>• Transfer Possession under LT Lease / 48(d) Election</td>
<td></td>
<td>“Deemed“ FMV Purchase Price x30% = ITC</td>
</tr>
<tr>
<td>• Operations During Tax Credit Period</td>
<td>Rent (Depreciation) (P&amp;I on acquisition indebtedness)</td>
<td>PPA Revenue (Rent) (O&amp;M)</td>
</tr>
<tr>
<td>• Exit</td>
<td>(Greater of FMV of Member Interest or 20% Member Paid in Capital)</td>
<td>Greater of FMV of Member Interest or 20% Member Paid in Capital</td>
</tr>
</tbody>
</table>
Tax Basics – Inverted Lease

Significant Tax Issues
• Tax ownership / true lease vs. financing characterization
  – Lease vs. loan
  – Lease vs. partnership
  – Substance and form
• Lease pass-through election
• Income from basis adjustment
• Partnership allocations
• Tax credit recapture
• Tax-exempt use property limitations
# Comparison – Sale Leaseback vs. Inverted Lease

<table>
<thead>
<tr>
<th></th>
<th>Sale Leaseback</th>
<th>Inverted Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FINANCING</strong></td>
<td>• Investor provides 100% financing (secured by PPA)</td>
<td>• Investor provides tax equity portion of financing (less project level equity and debt) (secured by PPA)</td>
</tr>
<tr>
<td><strong>EXIT COST</strong></td>
<td>• Higher exit costs = 20% of expected FMV to purchase project at end of lease term (or FMV rent)</td>
<td>• Lower exit costs = Greater of 20% of Investor Member PIC or FMV of Member Interest</td>
</tr>
<tr>
<td><strong>OPERATING RISK</strong></td>
<td>• Insulates tax investor from operation risk by separating ownership from operations</td>
<td>• Tax investor takes on a share of operation risk but will seek to transfer this risk contractually to Developer through O&amp;M agreement</td>
</tr>
</tbody>
</table>
Comparison –
Sale Leaseback vs. Inverted Lease

<table>
<thead>
<tr>
<th></th>
<th>Sale Leaseback</th>
<th>Inverted Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>TECHNOLOGY RISK</td>
<td>• Insulates Investor from technology risk since financing closes after placed in service date</td>
<td>• Tax investor has technology risk since financing must be closed prior to placed in service date</td>
</tr>
<tr>
<td>BASIS ADJUSTMENT</td>
<td>• Tax investor benefits reduced by 50% basis adjustment (only 85% of property depreciated)</td>
<td>• Owner entity depreciates 100% of basis&lt;br&gt; • Tax investor recognizes 50% basis adjustment into income (offset by allocable share of 49% full depreciation and rent)&lt;br&gt; • This “anti-depreciation” increases Tax Investor’s capital account and basis allowing basis recovery on disposition&lt;br&gt; • Increases the yield to Investor</td>
</tr>
</tbody>
</table>
Power Prepayment Structure
Power Prepayment Structure

**Tax Equity**

Project (Owner) SPE

- Prepay for Tier 1 power
- Tier 2 power billed monthly
  - Pass-thru some O&M costs

**Lender**

Electricity Buyer (Tax-Exempt)

1. Construction financing provided by debt investors to SPE with take out commitments from Prepaid Power Agreement (e.g., 48%) and Tax Equity (e.g., 52%) for project cost at completion of construction

2. Prepayment repaid in the form of providing discounted electricity to tax-exempts while they hold first liens on project to secure performance

*Electricity Buyer may have an option to buy the Project in the future at FMV*

*Electricity Buyer may hold a security interest in the project to secure delivery of the Tier 1 power*
Power Prepay Structure

Included in lump-sum prepayment
1. Electricity (Tier 1) for x number of years
2. Security interest in project
3. Options to acquire Tier 2 electricity
4. Options to acquire project at FMV

Not included in prepayment
1. Services
2. Environmental attributes (e.g., RECs)
Power Prepay Structure

What if Project produces less than Tier 1 quantity?
• The agreements may provide for shortfall make-up period and/or obligation to purchase replacement power

What if Project produces more electricity than expected?
• Investor will earn more revenue from the sale of the Tier 2 power
Power Prepay Structure

Benefits of Power Prepay Structure

• Allows tax-exempts to come as close to ownership of a project as possible by taking a possessory-like interest in property while still qualifying for federal tax financing subsidies

• Tax-exempt receives discount off cost of electricity in exchange for prepayment

• Tax-exempt can generally borrow more cheaply than a private developer, allowing prepayment to serve as debt-like financing to the developer
Significant Tax Issues

• Service vs. Lease Contract
  – If lease, then tax-exempt use property (no ITC/1603 grant and no MACRS depreciation)

• Project owner must defer income tax recognition on prepayment
  – If can’t defer, tax equity will not have the benefits of tax losses
Service Contract or Lease?

IRC Section 7701(e)

1. Is the energy buyer in physical possession of the facility?
2. Does the energy buyer control the facility?
3. Does the energy buyer have significant economic or possession interest in the facility?
4. Who bears the economic risks if the facility fails to perform and generate electricity?
5. Does the entity generating engage in other substantial services to parties other than the energy buyer?
6. Does the price of the electricity exceed the rental value for the term?
Safe Harbor – Service Contract

IRC Section 7701(e)(3)

Lists three types of facilities that are exempt from the general six-factor test

1. Solid waste disposal
2. Alternative energy
3. Clean water facilities

Under the safe harbor, a purported service arrangement will not be recast as a lease agreement if all of the requirements in IRC Section 7701(e)(4) are true
Safe Harbor – Service Contract

IRC Section 7701(e)(4)

The service recipient (or a related entity) cannot:

1. Operate the facility
2. Bear any significant financial burden if there is nonperformance under the contract (other than for reasons beyond the control of the service provider)
3. Receive any significant financial benefit if the operating costs of the facility are less than the standards of performance or operation under the contract, and
4. Have an option to purchase, or be required to purchase, all or a part of the facility at a fixed and determinable price other than for fair market value
Tax Basics – Power Prepay Structure

Significant Tax Issues (cont.)

- Application of deferral provisions of Reg. 1.451-5
  - Non-application of Inventoriable Goods Exception (i.e., 2-year rule)
  - Owner/producer does not have on hand or available to him through normal source of supply (spot market) goods (electricity) of substantially similar kind (renewable) and in sufficient quantity (all at once ability to deliver) to satisfy agreement in year of advance payment
  - Advance payment received for any taxable year (plus preceding years) do not equal or exceed total costs or expenditures reasonably estimated as includible in inventory with respect to such agreement
Summary of Major Tax Issues
Major Tax Issues

- At risk rules (for individuals)
- Passive activity rules (for individuals)
- Eligible basis
- Tax-exempt use property
- Existence of a valid partnership
- Partnership tax concepts
- Depreciation
- Tax Credit Recapture
- Economic Substance
- Section 467 Leases
- PPA vs. lease
- Existence of “true” debt
- Capital lease vs. operating lease
- Original issue discount
Yieldco
Yieldco

Sponsor

Class B Common Stock
100-X% Voting Interest
0% Economic Interest

100% Class B Units
100-X% Economic Interest

Yieldco Inc.

OpCo

Operating Subsidiaries

Public

Class A Common Stock
X% Voting Interest
X% Economic Interest

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Yieldco – Basic Concepts

• Publicly-traded company formed to own operating assets:
  – Reduces risk to investors by segregating higher-risk development assets from stable operating assets.
  – Allows developers to tap into public markets and raise equity at approximately the same costs as debt because it owns operating assets generating predictable cash flows.
  – Approximately 80% of cash flows after debt service distributed to investors as dividends.

• Developer should have a large portfolio (e.g., over $500 million) of operating assets.
Yieldco – Tax Issues

• C corporation – Double Taxation
• Dividends vs. Return of Basis or Capital Gain
• Tax Equity Financing vs. Self-Shelter Tax Benefits
• Section 382 Limitations on Tax Attribute Utilization
• Valuation Allowances
• Tax Policy – Continued Government Incentives for Renewable Energy?
• Tax Treatment for non-U.S. Holders of Yieldco Stock
• Related Party Transactions