Structuring Lease Investments – Tax Perspective

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Agenda

- Overview – Leasing vs. Flip Structure
- Tax Equity Leasing Structures
  - Sale-Leaseback Structure
  - Inverted Lease Structure
- Tax Ownership/True Lease Analysis
- Recapture and Other Considerations
- Section 467 Lease Concepts

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 and ARRA 1603 Grant
  - 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

Leasing vs. Flip Structure

- Unique aspects of the Investment Tax Credit (ITC) / 1603
  - 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

Leasing vs. Flip Structure

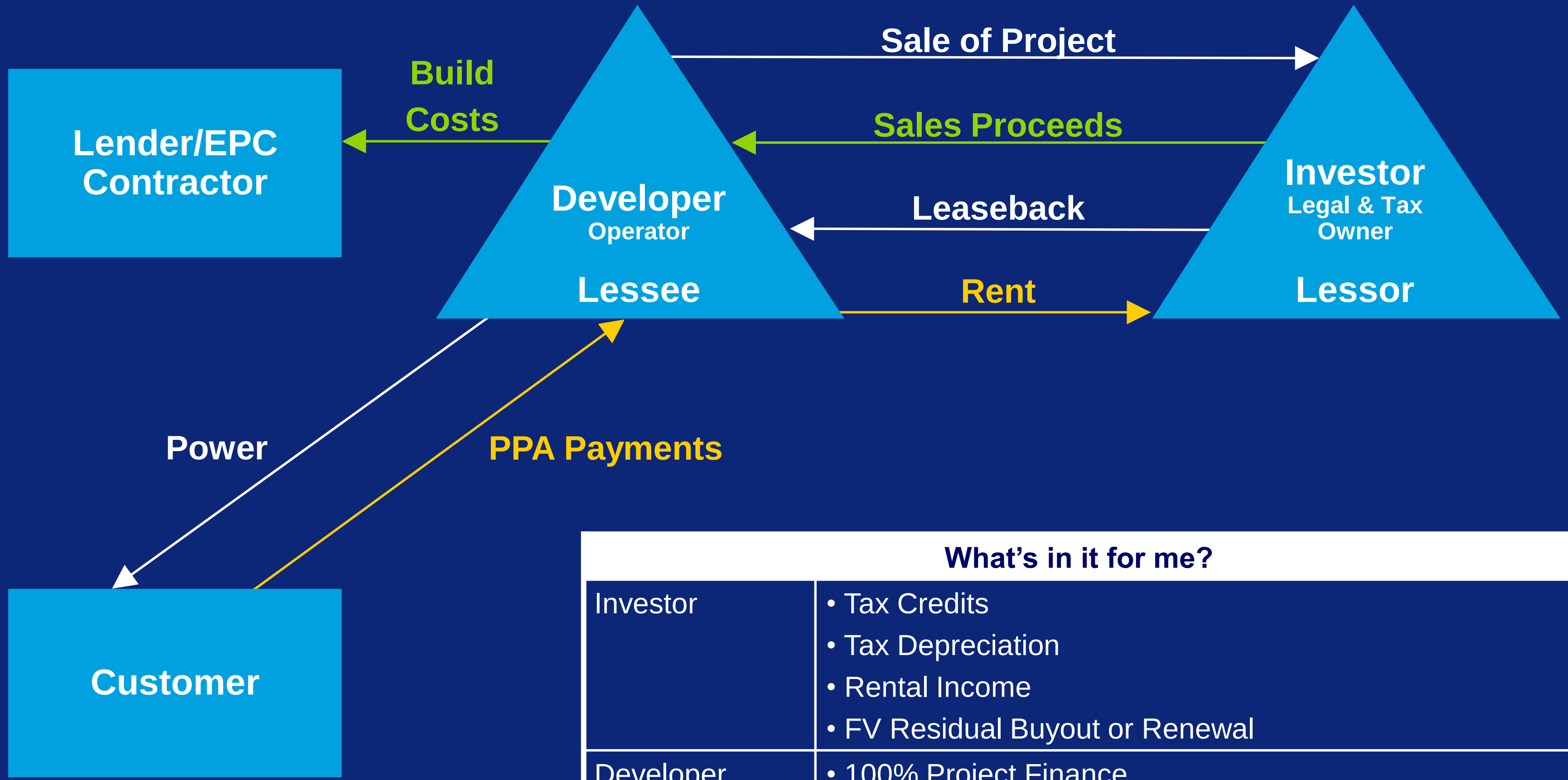
- Percentage of capital cost
  - Partnership flip: Less than 100% financing (typically 50-60%)
  - Lease: Can provide 100% financing
- Residual value
  - Partnership flip: As low as 4.95% after flip
  - Sale-leaseback: Extend lease or buy back the entire project at FMV
  - Inverted lease: Ownership retained 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

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

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

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

Sale-Leaseback – Pros and Cons

Advantages

- 100% financing secured by PPA
- Tax structure risk low

•Tax equity insulated from technology and operations risk

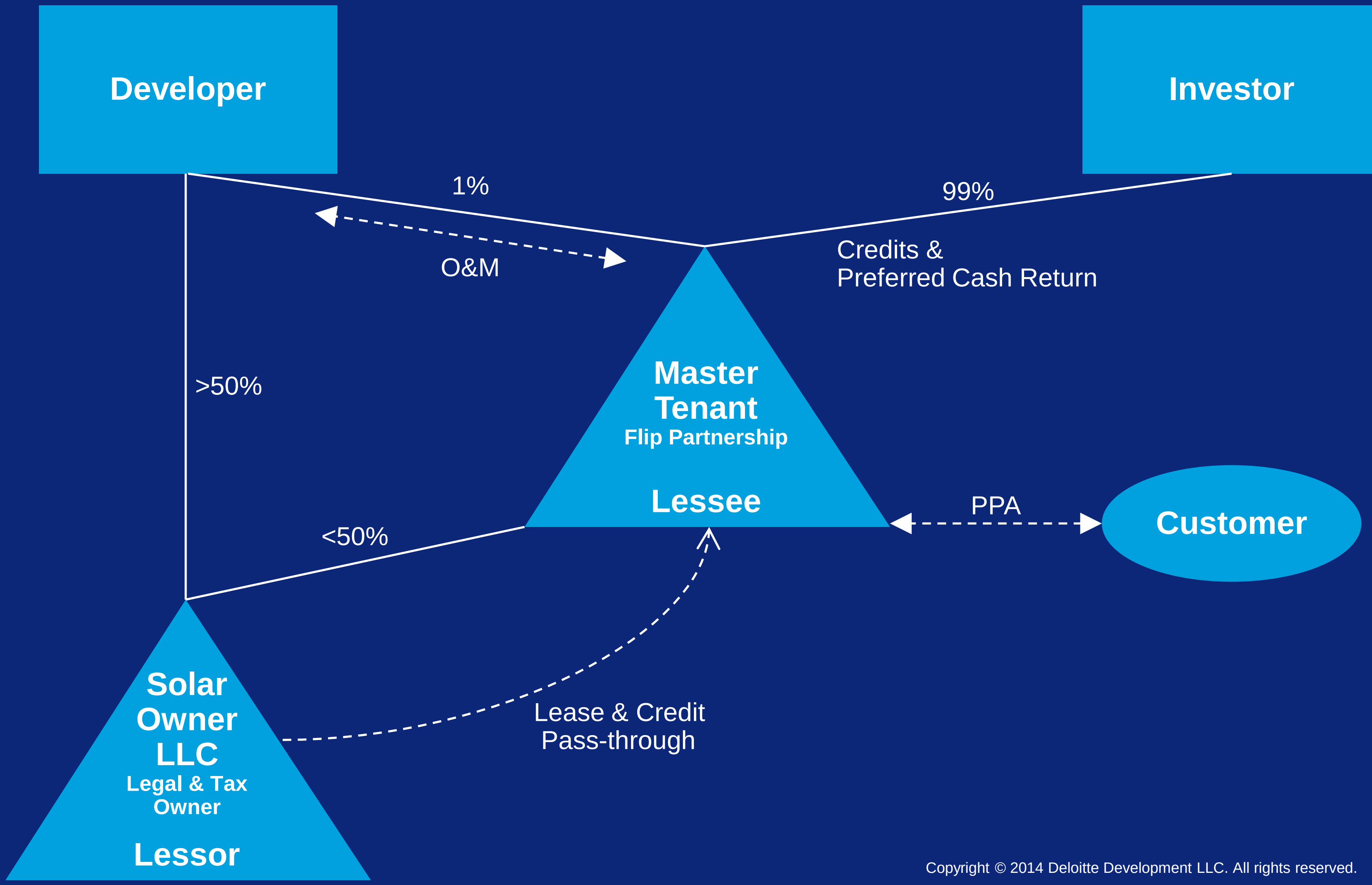
Disadvantages

- 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

Sale-Leaseback – Tax Issues

- Tax ownership
  - Lease vs. loan
  - Lease vs. partnership
  - Substance vs. form
- Three-month rule
- Tax-credit recapture
- Basis reduction = 50% of credit
- Reduced Depreciation
- Tax-exempt use property limitations
- Structuring with ARRA 1603 grants

Inverted Lease – Structure



Inverted Lease – Tax Basics

Time Period		Developer/Owner (Lessor)		Tax Investor/Operator (Lessee)
• 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

Inverted Lease – Pros and Cons

Advantages

- ITC equals 30% of FMV (rather than cost basis)
- Lower exit cost (sponsor retains property at end of lease)
- 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
- Tax equity NOT insulated from technology and operations risk
- Annual income inclusion = 3% of FMV for 5 years (in lieu of $15 basis adjustment)

Inverted Lease – Tax Issues

- Tax ownership
  - Lease vs. loan
  - Lease vs. partnership
  - Substance vs. form
- Lease pass-through election
- Income from basis adjustment
- Partnership allocations
- Tax-credit recapture
- Tax-exempt use property limitations
- Structuring with ARRA 1603 grants

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 depreciated)		• Owner entity depreciates 100% of basis • Tax Equity recognizes 15% FMV into income (sheltered by allocable share of tax losses attributable to <50% interest held by Master Tenant in Owner Entity) • This “anti-depreciation” increases Tax Investor’s capital account and basis allowing basis recovery on disposition • Increases the yield to Tax Equity

Tax Ownership / True Lease Analysis

Tax Ownership / True Lease Analysis

- Lease structures are viewed by the IRS as a potential vehicle by which taxpayers may transfer tax benefits through disguised sales
- Benefits and burdens analysis
  - *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)
  - Rev. Proc. 2001-28

Tax Ownership / True Lease Analysis

Case law

- Legal title
- Parties' treatment
- Equity in the property
- FMV purchase price
- Risk of loss
- Residual value
- Profits from ultimate sale
- FMV purchase option
- FMV renewal

Rev. Proc. 2001-28

- Pre-tax profit
- Residual value and useful life
- Limited use property
- FMV purchase option
- FMV renewal
- Residual value and useful life
- Minimum unconditional "at risk" investment

Tax Ownership / True Lease Analysis

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

Tax Ownership / True Lease Analysis

Lessor must maintain a minimum “at risk” amount

- The excess of the cumulative payments required to have been paid by the Lessee over the cumulative disbursements required to have been paid by the Lessor must never exceed the sum of:
  - (i) any excess of the lessor's initial Equity Investment over 20 percent of the cost of the property plus
  - (ii) the cumulative *pro rata* portion of the projected profit from the transaction (exclusive of tax benefits)

Tax Ownership / True Lease Analysis

Example of maintaining minimum “at risk” amount

- Assume that Lessor has purchased equipment for $1,000. This equipment was financed by $200 of the Lessor’s own cash and $800 of non-recourse debt from Lender. The Lessor leases the equipment to Lessee for a period of five years at a rent of $230 per year. At the end of the lease, it is expected that the equipment will have a residual value of $300. In order to service the non-recourse debt, Lessor will make payments to Lender of $180 per year for a period of five years.

Tax Ownership / True Lease Analysis

Example of maintaining minimum “at risk” amount

- First, determine the overall “profit” to the Lessor

Item	Amount
Total Rent Received over 5 Years	$ 1,150
Residual Value	$ 300
Disbursement over 5 Years	$ (900)
Total Profit	**$ 550**

Tax Ownership / True Lease Analysis

Example of maintaining minimum “at risk” amount

- Next, note that the excess of the Lessor’s receipts over required Lessor payments *must never* exceed the pro-rata profit

Lessor Cash Flow	**1**	**2**	**3**	**4**	**5**
Receipts from Lessee	$ 230	$ 230	$ 230	$ 230	$ 230
Lessor’s Debt Service	$ (180)	$ (180)	$ (180)	$ (180)	$ (180)
Cumulative Excess of Receipts from Lessee over Lessor’s Debt Service	$ 50	$ 100	$ 150	$ 200	$ 250
Cumulative Pro-Rata Profit	$ 110	$ 220	$ 330	$ 440	$ 550

Tax Ownership / True Lease Analysis

Practical Limitations of maintaining 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 amount of the size of prepayments that can be received from Lessee

Recapture and Other Considerations

Recapture and 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)

Recapture and 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

Section 467 Lease Concepts

Section 467 Lease Concepts

Section 467 Rental Agreements

- Increasing or decreasing rents, or
- Prepaid or deferred rents
- >$250,000

Rental Agreement

- Use of tangible property
- True lease for federal income tax purposes

Section 467 Rent

- Fixed rent for any rental period
- Contingent rent that accrues during the tax year

Section 467 Lease Concepts

Fixed Rent for a Rental Period

- Disqualified leaseback or long-term agreement = Constant Rental Accrual
- Prepaid or deferred rents which does not provide adequate interest on fixed rent = Proportional Rental Accrual
- Rental agreement without prepaid or deferred rents or which does provide adequate interest on fixed rent = Rental Agreement Accrual

Section 467 Lease Concepts

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

Section 467 Lease Concepts

Tax avoidance:

- IRS will closely scrutinize a lease agreement between parties where a significant difference between the marginal tax rates is reasonably expected during lease term
- Significant difference = more than 10% during any rental period to which the rental agreement allocates annualized fixed rent that is less than (or greater than) the average rent allocated to all calendar years
- Safe-Harbor – Uneven rent test (90% / 110%)
  - Rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than 10%

Section 467 Lease Concepts Case Study Examples

See Handouts

Questions?

Deloitte.