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Introduction to Tax Equity Structures and YieldCos – Part II

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September 28, 2015

Introduction to Tax Equity Structures

Part I –

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

Part II –

- Inverted Lease Structure
- YieldCos
- Power Prepayment Structure
- Summary of Major Tax Issues

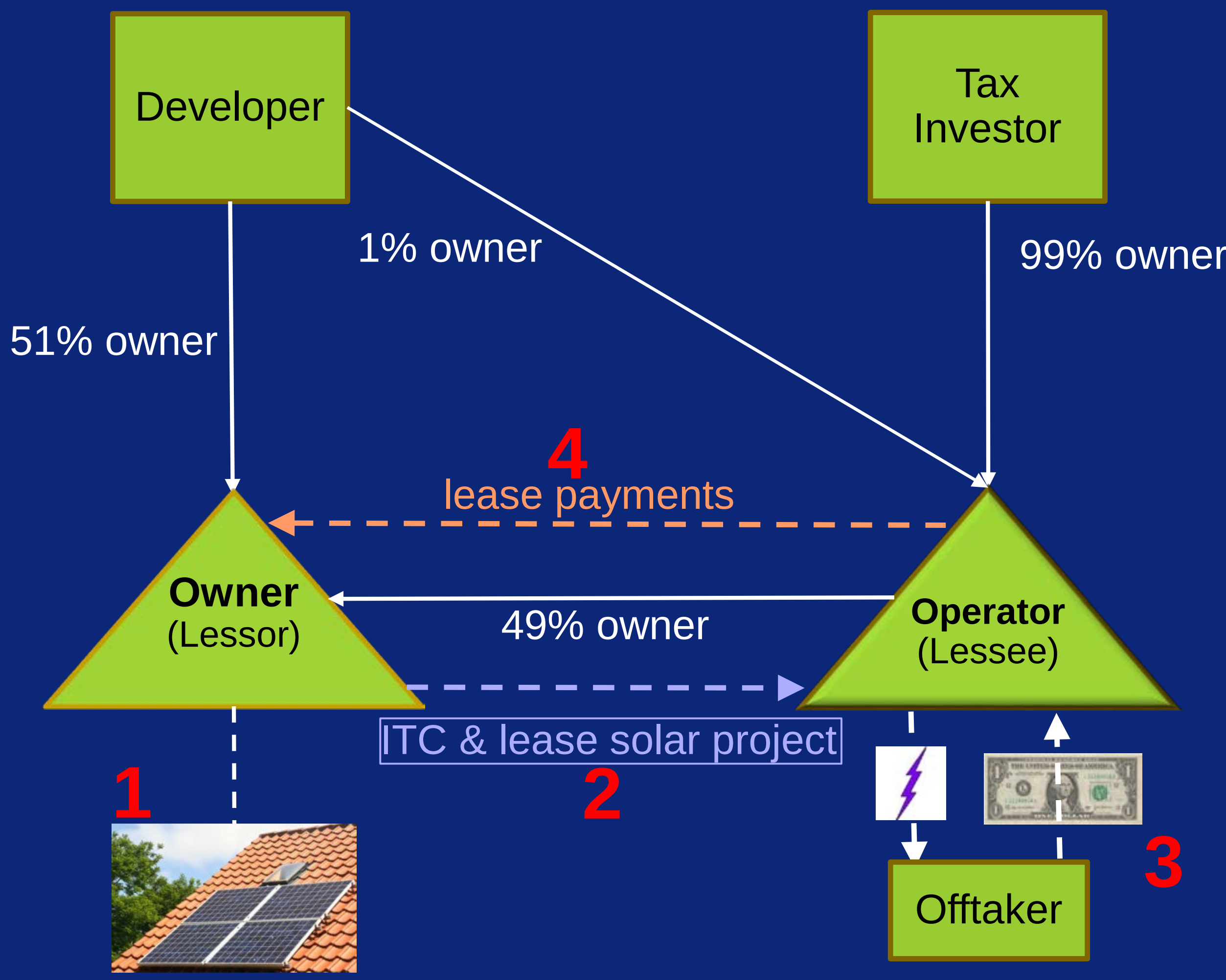
Inverted Lease Structure

Inverted Lease – Players

Participant	Role
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 up to 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 Operator as lessee; 99% of credits allocated to Tax Investor
3. Operator enters into Power Purchase Agreement to sell electricity from panels
4. Operator makes annual lease payments to Owner to cover debt service



Tax Basics – Inverted Lease

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				“Deemed“ FMV Purchase Price x30% = ITC
• Operations During Tax Credit Period		Rent (Depreciation) (P&I on acquisition indebtedness)		PPA Revenue (Rent) (O&M)
• Exit		(Greater of FMV of Member Interest or 20% Member Paid in Capital)		Greater of FMV of Member Interest or 20% Member Paid in Capital

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
- Eligible basis – Valuation Issues
- Income from basis adjustment
- Partnership allocations
- Tax credit recapture
- Tax-exempt use property limitations

Comparison – Sale Leaseback vs. Inverted Lease

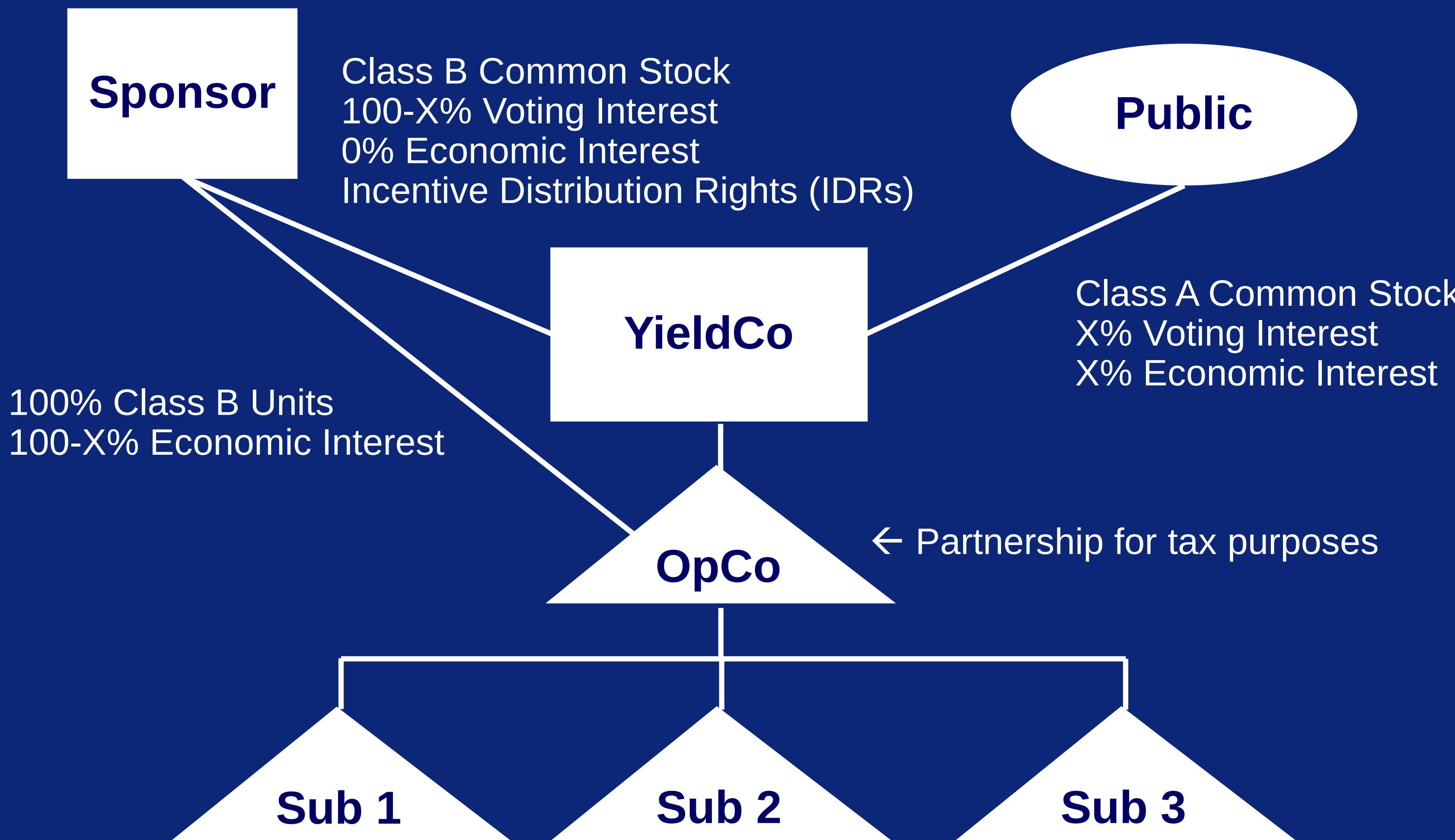
		Sale Leaseback		Inverted Lease
FINANCING		• Investor provides 100% financing (secured by PPA)		• Investor provides tax equity portion of financing (less project level equity and debt) (secured by PPA)
EXIT COST		• Higher exit costs = 20% of expected FMV to purchase project at end of lease term (or FMV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

Comparison – Sale Leaseback vs. Inverted Lease

	Sale Leaseback	Inverted Lease
TECHNOLOGY RISK	• Insulates Investor from technology risk since financing closes 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 investor recognizes 50% basis adjustment into income (offset by allocable share of 49% full depreciation and rent • This "anti-depreciation" increases Tax Investor's capital account and basis allowing basis recovery on disposition • Increases the yield to Investor

YieldCos

Example Yieldco Structure



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 lower cost of capital 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 – Basic Concepts

- Growth
  - Refresh YieldCo tax shield
  - ROFO pipeline
  - Third party acquisitions

YieldCo – Tax Issues

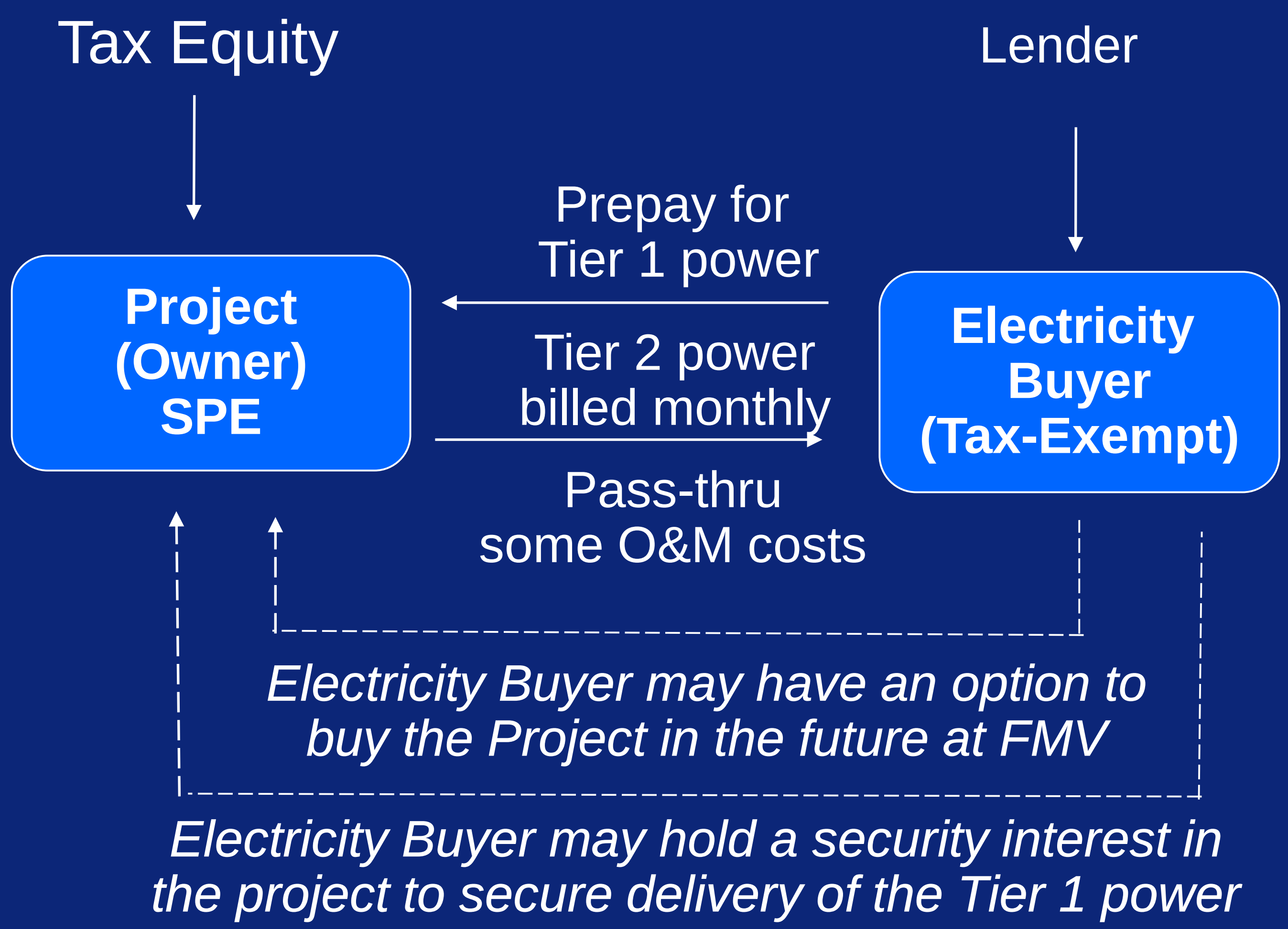
- Formation Considerations
  - Disguised Sale
    - Exceptions (e.g., pre-formation capex, qualified liabilities)
    - ITC recapture
  - C corporation – Potential for Double Taxation
    - Estimated YieldCo Tax Shield
    - Dividends vs. Return of Basis or Capital Gain
  - Method for 704(c) Allocation
  - Section 382 Limitations on Tax Attribute Utilization
  - Partnership Technical Termination
  - Tax Treatment for non-U.S. Holders of Yieldco Stock

YieldCo – Tax Issues *(cont.)*

- Post-Formation Considerations
  - Ongoing Management of E&P and Tax Depreciation
  - ITC Recapture
    - Substantial Interest in Trade or Business for Mere Change in Form
  - Accommodating Tax Equity Structures
    - Inverted Lease
    - Partnership flip
    - Limited value of sale leaseback

Power Prepayment Structure

Power Prepayment Structure



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

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

Tax Basics – Power Prepay Structure

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 then 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 and closely-held)
- Passive activity rules (for individuals and closely-held)
- 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

Questions?

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