




2017 Deloitte Renewable Energy Seminar

Innovating for tomorrow

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Energy Solutions



Lease
tax-equity
structures:
Tax
perspectives

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 31

Overview

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

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

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

Overview

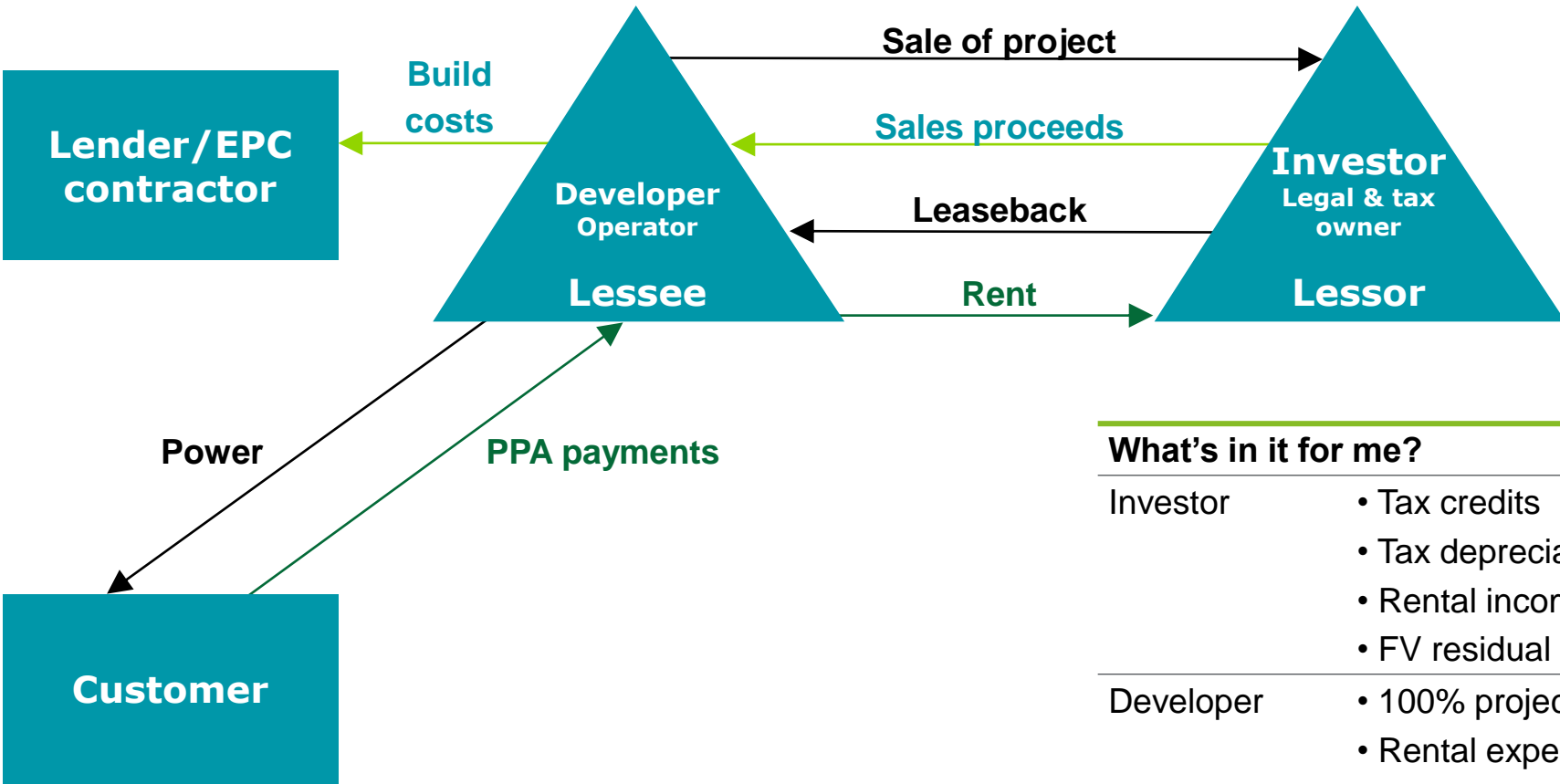
Tax-exempt use property

- 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 an IRC Section 168(h)(6)(F) election) between the tax exempt entity and the partnership owning the property

Tax equity leasing structures

Tax equity leasing structures

Sale-leaseback – Structure



What's in it for me?

Investor	<ul style="list-style-type: none"> • Tax credits • Tax depreciation • Rental income • FV residual buyout or renewal
Developer	<ul style="list-style-type: none"> • 100% project finance • Rental expense • O&M expense • Income from PPAs and REC sales > rent

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 - <u>(project development costs)</u> = gain on disposition	(FMV purchase price) <u>x 30%</u> = 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

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

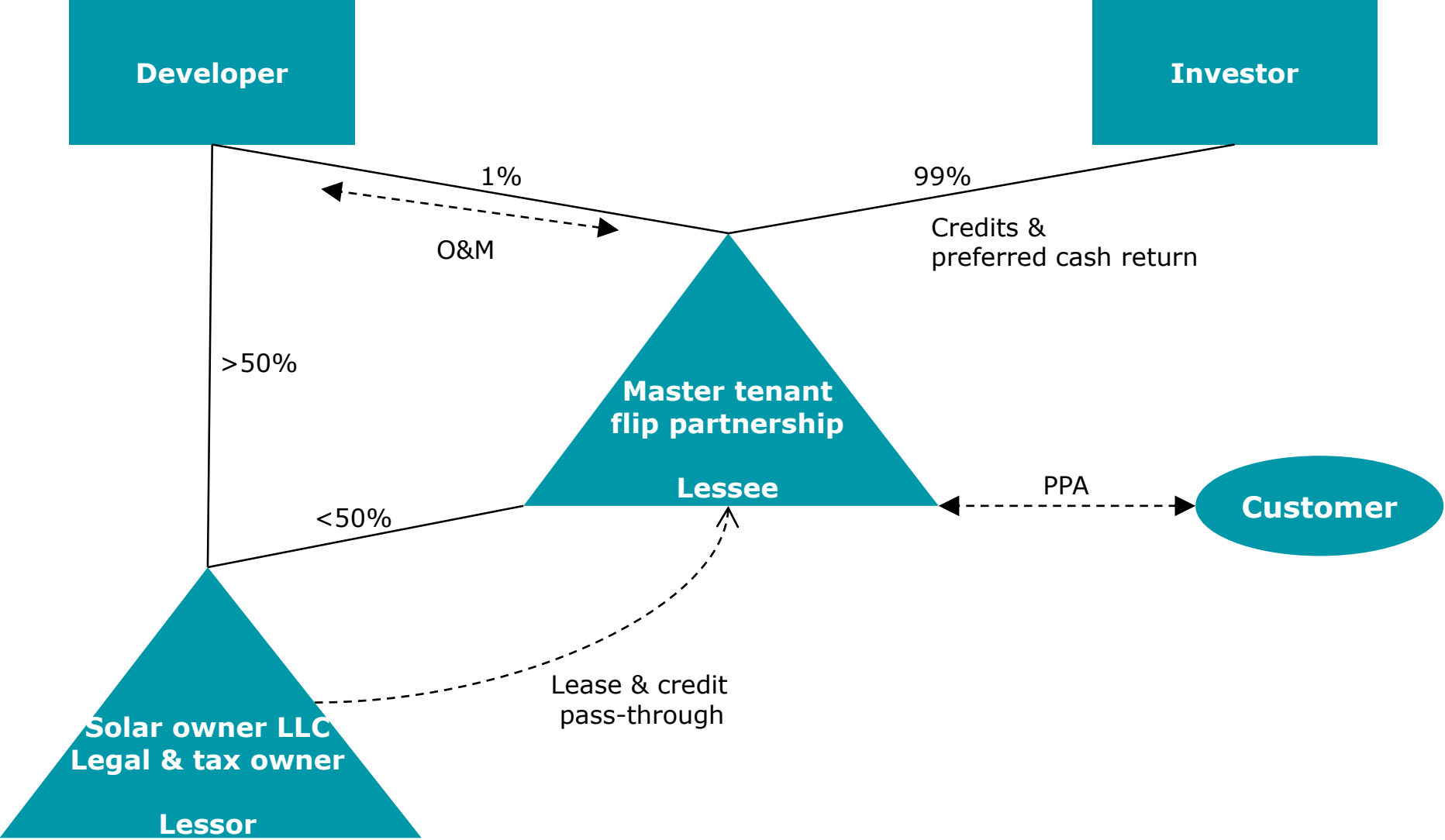
Tax equity leasing structures

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

Tax equity leasing structures

Inverted lease – Structure



Tax equity leasing structures

Inverted lease – Tax basics

Time Period	Developer/Operator (Lessor)	Tax Equity Investor (Lessee)
<ul style="list-style-type: none">Construction Period and Placed in Service	(Project Development Costs)	
<ul style="list-style-type: none">Transfer Possession under LT Lease/48(d) Election	(Avoid gain on disposition)	“Deemed” FMV Purchase Price x 30% = ITC
<ul style="list-style-type: none">Operations During Tax Credit Period	Rent (Depreciation) (P&I on acquisition indebtedness)	PPA Revenue (Rent) (O&M)
<ul style="list-style-type: none">Exit	(Put/Call Price)	Put/Call Price

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 Rev. Proc. 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)

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

Treasury guidance on inverted leases

IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1T

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 IRC 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. Section 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

IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1T

- 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

IRC Section 50(d) Regulations – Treas. Reg. Section 1.50-1T

- 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 IRC Section 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.

Tax equity leasing structures

Sale-leaseback vs. inverted lease

	Sale-leaseback	Inverted lease
Financing	<ul style="list-style-type: none"> Investor provides 100% financing (secured by PPA) 	<ul style="list-style-type: none"> Investor provides approximately 40-50% financing (secured by PPA)
Exit cost	<ul style="list-style-type: none"> Higher exit costs = 20% of expected FMV to purchase project at end of lease term (or FMV rent) 	<ul style="list-style-type: none"> Lower exit costs = put/call price at the end of the tax credit period
Operations risk	<ul style="list-style-type: none"> Insulates tax investor from operations risk by separating ownership from operations 	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> Insulates tax investor from technology risk since financing closed after placed in service date 	<ul style="list-style-type: none"> Tax investor has technology risk since financing must be closed prior to placed in service date
Basis adjustment	<ul style="list-style-type: none"> Tax investor benefits reduced by 50% basis adjustment (only 85% of property cost depreciated) 	<ul style="list-style-type: none"> 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)

Recapture and other considerations

Recapture and other considerations

Other considerations

- The investment credit is subject to several special rules collected in IRC Section 50:
 - Recapture Rules in IRC Section 50(a)
 - Ineligible Property Rules in IRC Section 50(b)
 - Basis Adjustment Rules in IRC 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. Section 1.704-1(b)(2)(iv)(j) and IRC Section 50(c)(5)

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

Tax ownership/True lease analysis

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)

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
- Facts and circumstances analysis (no one factor is determinative)

Tax ownership/True lease analysis

Rev. Proc. 2001-28

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 depreciation) either as cash or a reduction in investment

Tax ownership/True lease analysis

Rev. Proc. 2001-28

- 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
- Purchase options
 - Options vs. Puts
 - Fair Market Value vs. Fixed Price
- Limited use property
 - Commercially feasible to sell or re-lease

Section 467 lease concepts

Section 467 lease concepts

In general

- 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

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

Section 467 lease concepts

Disqualified leaseback or long-term agreement

- 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
- 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

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

Section 467 lease concepts

Deferred rent

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

Section 467 lease concepts

Prepaid rent

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

Questions?



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