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Modeling Concepts – Inverted Lease Structures

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Inverted Lease Tax Concepts



Inverted Lease – Overview

- Exception to general rule that only tax owner can claim tax benefits
 - Lessee entitled to 30% ITC
 - ITC calculated on FMV of project
 - Lessee recognizes taxable income ratably over 5 years equal to $\frac{1}{2}$ of ITC
- Depreciation deductions calculated by Lessor
 - No ITC basis adjustment
 - Depreciable basis calculated based on project cost (as opposed to FMV for ITC calculation)

Investment Characteristics

- Determination of Investment Amount (Investor → Lessee)
 - Sized based on achieving after-tax IRR
 - Sized based on \$ per credit
 - Valuing depreciation and state incentives
- Investment in Lessor
 - Rent Prepayment + Lease Payments
 - Tax Rent Accruals vs. Cash Rent
 - Rent prepayments treated as loans
 - Section 467 / Section 752
 - Equity Investment in Lessor Partnership

Tax Basics – Inverted Lease

- Tax Ownership – True lease vs. financing characterization
- Section 467 Rental Agreements
 - Uneven Rent Test (“90 / 110” Test)
- Eligible basis – Valuation Issues
- Lease Pass-Through Election
- Tax Credit Recapture
- Income from Basis Reduction
- Partnership Allocations
- Tax-Exempt Use Property

Section 467 Rent Concepts

- In certain cases where there are prepaid or deferred rents, section 467 may require prepaid or deferred amount to be treated as an interest bearing loan
- Application of the section 467 accrual rules may require Lessors and Lessees to recognize interest and impute a “new” rental amount differing from the amount specified in the lease
 - Section 467 does not change the total amount deductible over the term of the lease, it merely changes the timing of the “net” deduction

Section 467 Rent Concepts

- Under certain circumstances, the section 467 rental accrual may call for an unfavorable “constant rental accrual”
 - Constant rental accrual method is used only when the IRS treats a lease agreement as being a disqualified leaseback or long term agreement that is for the principal purpose of tax avoidance
 - Constant rental accrual may be avoided if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than +/- 10% (110/90 Safe Harbor)

Inverted Lease Examples



For Discussion Purposes Only

- The examples discussed in this presentation are intended to facilitate a discussion related to selected tax concepts relevant to partnership flip project models. The examples are not intended to illustrate a project that complies or does not comply with the tax rules. In some cases, the examples deliberately deviate from the tax rules to illustrate the concept for discussion purposes. Please consult your tax advisor when modeling the tax concepts discussed throughout the deck. The rules are very complex and each project's facts and circumstances are unique.



Questions?

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