SEIA FINANCE AND TAX Seminar

February 18-19, 2016

Deep Dive: Inverted Leases

SEIA Solar Energy Industries Association®

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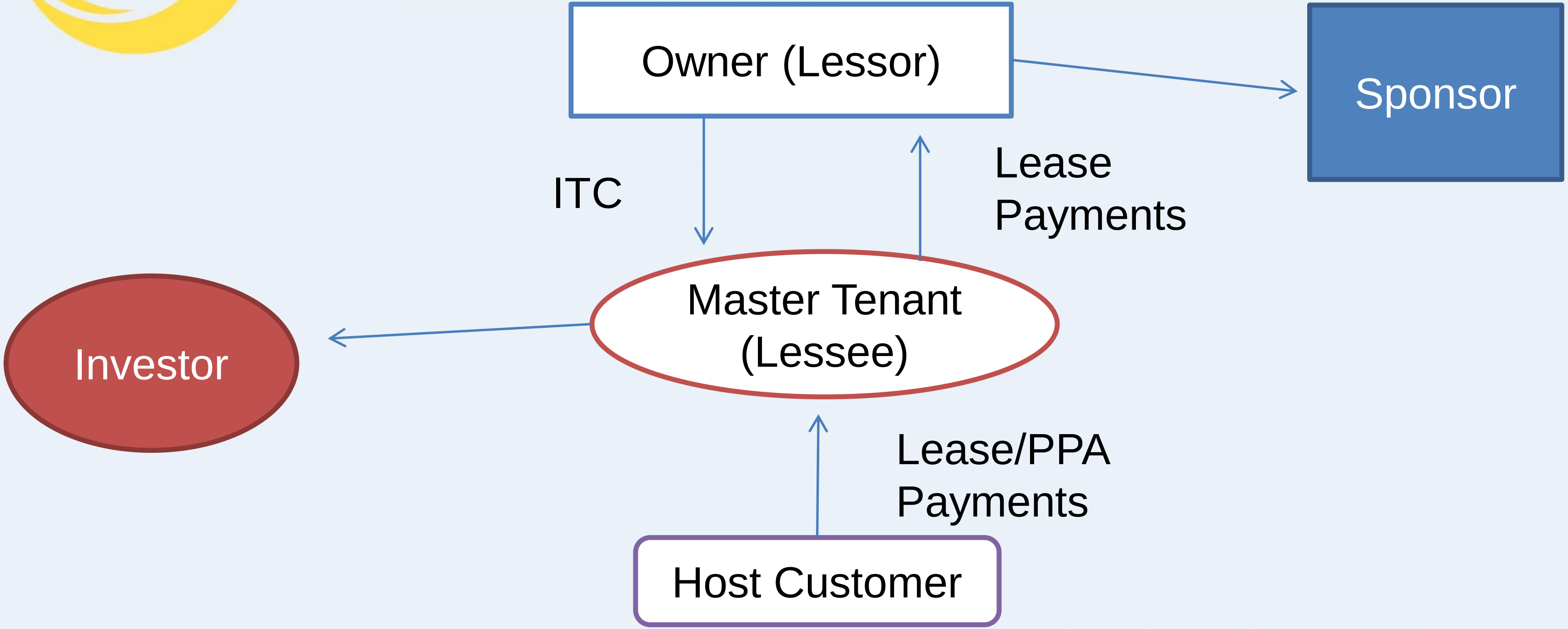
Structural Overview



The Basics

- A lease pass-through provides a special exception that allows the Lessee to claim the ITC even though it is not the tax owner of the property

- For purposes of determining the amount of the ITC the lessee is deemed to be the purchaser of the leased assets with a tax basis equal to the “fair market value” (typically determined by appraisal)

- A Lessor can pass-through the ITC, but not depreciation or state tax credits

- Certain lessors are ineligible to pass-through the credit
  - Tax exempt entities; Mutual savings banks; REITs

The Basic (cont.)

- Lessor does not reduce its tax basis, instead, Lessee reports income equal to half of the ITC ratably over the 5 year recapture period

- Election to pass-through is irrevocable and must be filed by both parties before tax return deadline (can be done on a system by system basis, or as a single election for all items placed-in service by Lessor in that tax year)

- Disposition by Lessee during the 5 year recapture period causes recapture

- Lessor transfers are generally fine, unless the transfer is to a ineligible Lessor

Economic Attributes

- Structure typically used in residential or small and mid-size commercial funds
- Master Lease term may vary in length
- Rent pre-payments are common
- The portion of Host Customer rents that are retained by the Lessee can vary substantially by transaction
- Fair market value/ITC basis indemnities are common as a carryover from the Treasury cash grant program

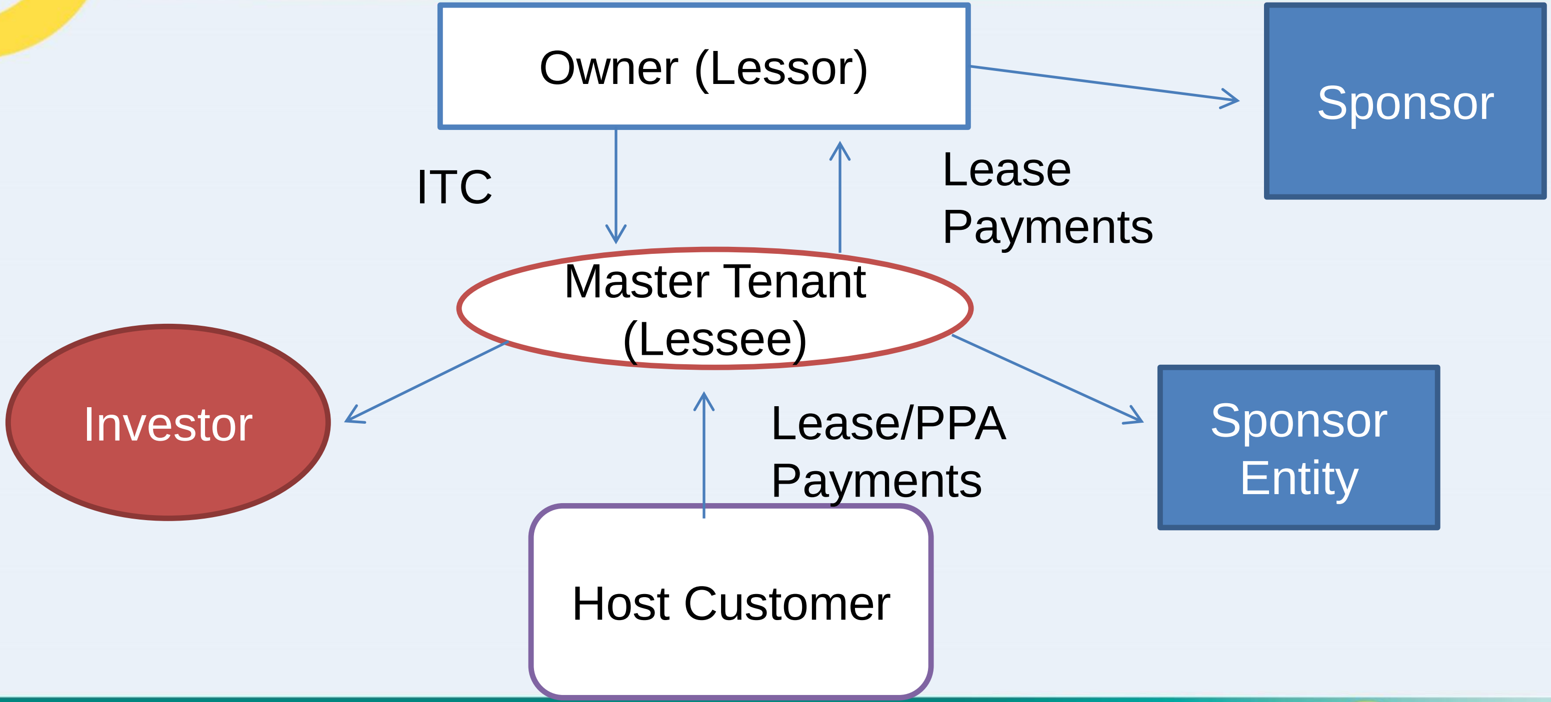
Tax Attributes

Lessor
• Deductions for depreciation
• Tax on rental income from master lease

Lessee
• Claims the ITC
• Income from host customer contracts
• Deductions for rent payments to Lessor
• 5yr income inclusion equal to 50% of ITC

Section 467 Loan
• Treats pre-payment as a loan, adds interest component, typically recognized over term of agreement

Structural Variations



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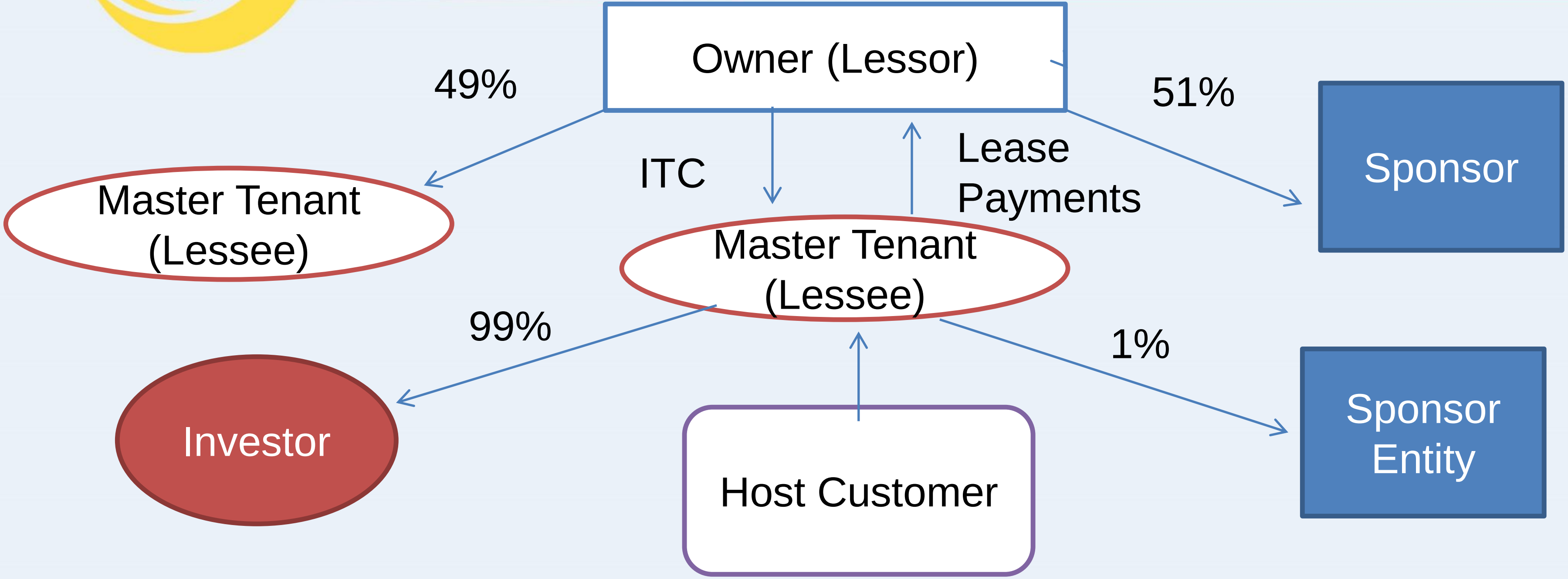

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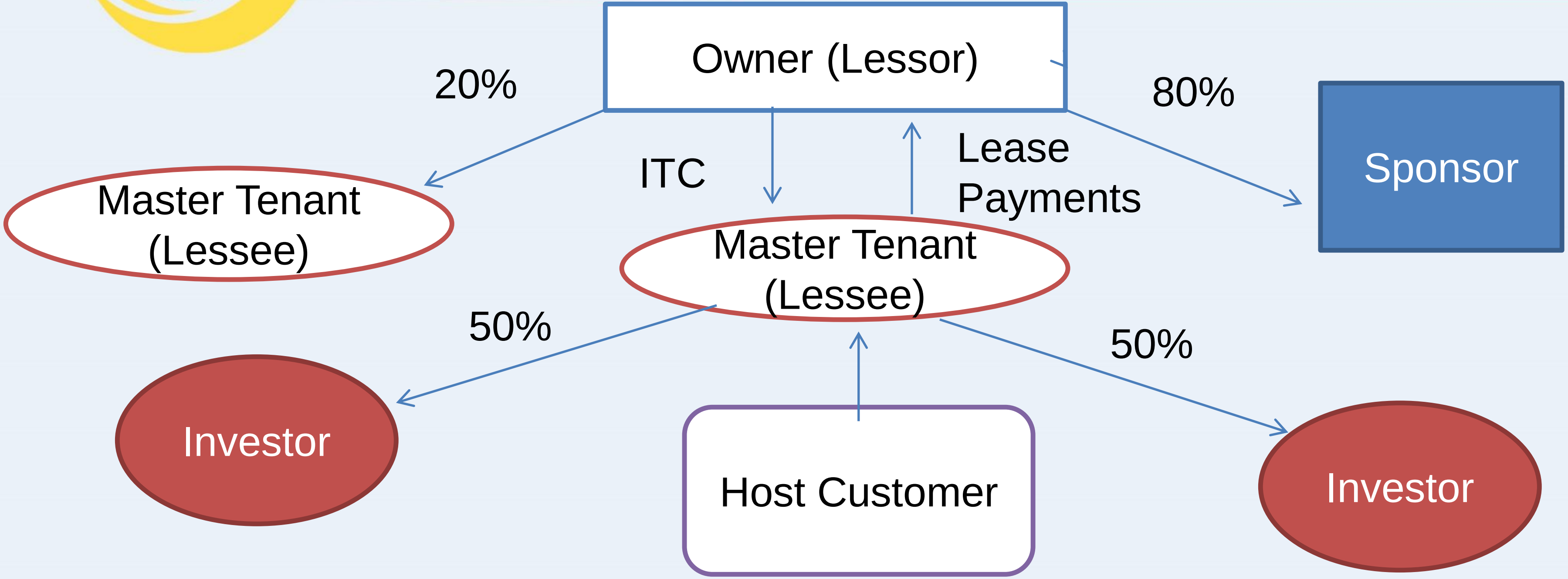

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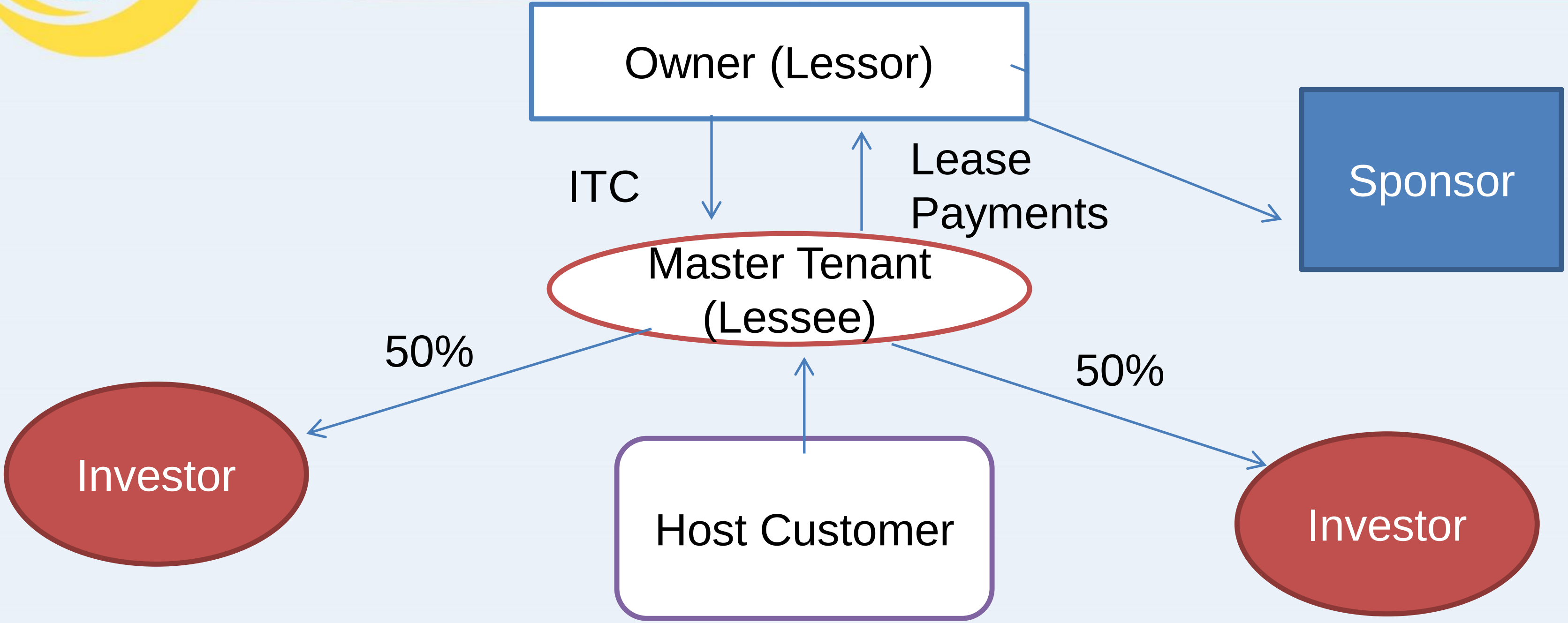

Advantages/Disadvantages

The primary disadvantages of this structure are:

- More complex structure than others
    - -Requires more new investor education
    - -Can be more costly and time consuming to execute
- Does not efficiently monetize tax depreciation
- Somewhat less deal history and tax authority behind the structure

The principal advantages are:

- Fair market value computation of the ITC without a sale
- Easier for Developers to back-leverage and securitize
- Ability for the investor to exit early without a buyout

Tax Pressure Points

- ITC Amount/Recapture
- True Lease
- Tax Ownership
- Change in Law
- Property Taxes (California)

Recent IRS Guidance

- As a reaction to the *Historic Boardwalk* decision, the IRS issued Revenue Procedure 2014-12 to establish a “safe harbor” for partnership allocations of the IRC Section 47 historic rehabilitation tax credit.
- The safe harbor is limited to partnership allocations of the credit but it addresses both partnership flip transactions and pass-through lease transactions that contain partnerships.
- The Revenue Procedure does not directly apply to renewable energy transactions but contains certain general tax principals that may be more broadly applicable.

Key Aspects of the Rev. Proc.

• The Revenue Procedure contains several requirements consistent with the Wind Safe Harbor (Rev. Proc. 2007-56), while other aspects are in direct contradiction. Notably, the Revenue Procedure prohibits call options but put options at fair market value or less are permissible.

•The investor must participate in partnership profits and losses in a fashion “commensurate with investor’s overall percentage in the partnership.”

•The developer may only provide certain guaranties, which must be unfunded.

•In a lease pass-through the investor may not have a direct investment in the owner/landlord, and the master tenant is prohibited from subleasing the building back to the owner/developer.

•The value of the investor’s interest (a) cannot be artificially reduced by fees or unreasonable arrangements, and (b) cannot be reduced by disproportionate distributions or below market valuation.

Reaction to Revenue Procedure

- The Guidelines are a mix of bright line standards and general principles that in certain areas can create unclear results.
- The initial reaction of tax counsel has generally been that the new rules were so specific the rehabilitation credit that they are unlikely to have a substantial effect on the broader tax equity market but it has had some impact.
- The real test will likely be determined over time as the application of the standards comes more clearly into view.

Emerging Issues

- Structure seems somewhat less common after Boardwalk

- Risk mitigations on single investor structures
  - Contingent Rent
  - IRR contingent purchase options
  - Forbearance

- Master Lease term length

- Assumptions around 5 year income inclusion

Questions

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