Sale Lease-Back Transactions

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Monetizing Tax Benefits

Why do it?

• Developers often cannot effectively utilize benefits tax credits provide

• Allows developers to transfer tax incentives to “tax equity” investors, enabling developers to share in economic benefits
Requires Structuring

• Tax credits cannot be sold

• Structuring goal: Have tax equity investor treated as an owner of the project for federal income tax purposes
Sale-Leaseback (Step 1: Sale)

Developer/lessor

Cash for project

Tax Equity Investor/lessee

- Developer sells project to Tax Equity Investor
- Tax Equity Investor is owner of the property for federal tax purposes and entitled to ITC and tax depreciation (reduced by 50% of ITC)

Power and REC sales

Project

Power Purchaser

$100% of tax benefits from Project (as owner)
Sale-Leaseback (Step 2: Leaseback)

- Developer enters PPA to sell power to Power Purchaser
- Developer bears all operating costs
- Lease typically grants lessee FMV purchase option at end of lease term (and often at fixed times during term)
- If lessee does not exercise purchase option at expiration of lease term control of system reverts back to Tax Equity Investor
- Developer receives 100% of cash flows (after rent service)
Common Structuring Concerns

- Will Tax Equity Investor be respected as an owner?

- Will allocation of credits and other tax benefits be respected?
• IRS scrutinizes lease structures to determine whether it is a “true lease” or if there has been a disguised sale.

• Economic substance and benefits and burdens tests. Frank Lyon Co. v. United States, 435 U.S. 561 (1978)

• Some courts have enumerated lists of “tax ownership” characteristics. Grodt & Mckay Realty, Inc. v. Commissioner, 77 T.C. 1221, (1981)

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- No Limited Use Property
- No lessee loans or guarantees
- Purchases and sale rights
- Minimum investment “at risk”
- Pre-tax profit
Pros and Cons of Sale-Leaseback

Developer’s Perspective

+ No upfront equity contribution required from developer
+ Developer receives upfront cash flows in form of asset sale and can grow business with current cash flow
+ Ideal structure for underperforming projects
+ Developer receives 100% of financing to construct project

- More costly than partnership flip to buy back project because Tax Equity Investor owns entire project at end of lease and residual value is over 20%
- Compared to partnership flip, developer may need to offer broader indemnities against loss of tax benefits
Pros and Cons of Sale-Leaseback

Tax Equity Investor’s Perspective

+ Familiar structure for banks - Banks historically engaged in leasing arrangements to capture tax benefits which operator cannot fully utilize
+ Passive role for Tax Equity Investor
+ Tax benefits are fully transferable
+ Reduced construction risk
+ Flexibility: structure can be put in place 3 months after PIS, minimizes PIS/construction risk
+ Tax Equity Investor receives 100% of tax benefits (unlike partnership flip where Class B Member receives 1%)
+ Basis for tax purposes = to price paid for system (which may be higher than costs to build system)

- Most significant equity contribution required from Tax Equity Investor (compared to other structures)
- Early buyout option limits Tax Equity Investor upside
- Structure must satisfy strict IRS rules regarding lease characteristics
Thank You!

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