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Introduction to Tax Equity Structures – Part I

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Introduction to Tax Equity Structures

Part I –

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

Part II –

- Inverted Lease Structure
- Power Prepayment Structure
- Summary of Major Tax Issues
- Yieldco and Other Financing Trends

Summary of Qualifying Resources and Facilities

Energy property	ITC rate *	Placed-in-service date	Treasury grant **	Notes
Solar	30%	Before 1/1/2017	30%	
	10%			
Fuel cell	30%	Before 1/1/2017	30%	
Stationary microturbine	10%	Before 1/1/2017	10%	
Geothermal heat pump	10%	Before 1/1/2017	10%	
Small wind	30%	Before 1/1/2017	30%	
Combined heat/power	10%	Before 1/1/2017	10%	
Geothermal	10%		10%	Alternatively, PTC is available.

* Available for public utility property in tax years ending after 2/13/2008.

** For Treasury grant eligibility, construction must have begun by the end of 2011 and an initial application must have been filed by 10/1/2012. Does not reflect reduction due to sequestration.

Summary of Qualifying Resources and Facilities

Qualified Resources/ Facilities	Credit Amount for 2014	Begun Construction Date	30% ITC in lieu of PTC
Wind	2.3 cents/kwh* (10 years)	Before 1/1/2014	If elected
Geothermal (new facilities)	2.3 cents/kwh* (10 years)	Before 1/1/2014	If elected
Closed-loop biomass	2.3 cents/kwh* (10 years)	Before 1/1/2014	If elected
Open-loop biomass	1.1 cent/kwh* (10 years)	Before 1/1/2014	If elected
Municipal solid waste (landfill gas, trash)	1.1 cent/kwh* (10 years)	Before 1/1/2014	If elected
Hydropower, Marine and hydrokinetic renewables (including small irrigation power)	1.1 cents/kwh* (10 years)	Before 1/1/2014	If elected

* Adjusts for inflation. 2014 rate.

Tax Incentives are Integral to Project Economics

- What if I can’t monetize the incentives currently?
  - 1-year carryback / 20-year carryover period
  - Multiple monetization structures are utilized
    - Partnership flip
    - Sale-leaseback
    - Inverted lease
    - Power prepayment

Partnership Flip Structures

Partnership Flip

Participant	Role
1. Tax Investor	• Possesses sufficient taxable income to monetize tax benefits (both tax credits and accelerated MACRS tax depreciation) • Subject to Passive Activity rules? • Funds a percentage of total project costs • Target IRR earned through allocation of 99% of tax credits and taxable losses/income and distributable cash • Typically exits the project after the flip when the Developer/Sponsor exercises FMV purchase option

Partnership Flip

Participant	Role
2. Developer / Sponsor	• ROI earned through cash flows, minimum 1% allocation of tax benefits and long-term ownership • FMV purchase option on Tax Investor’s residual interest

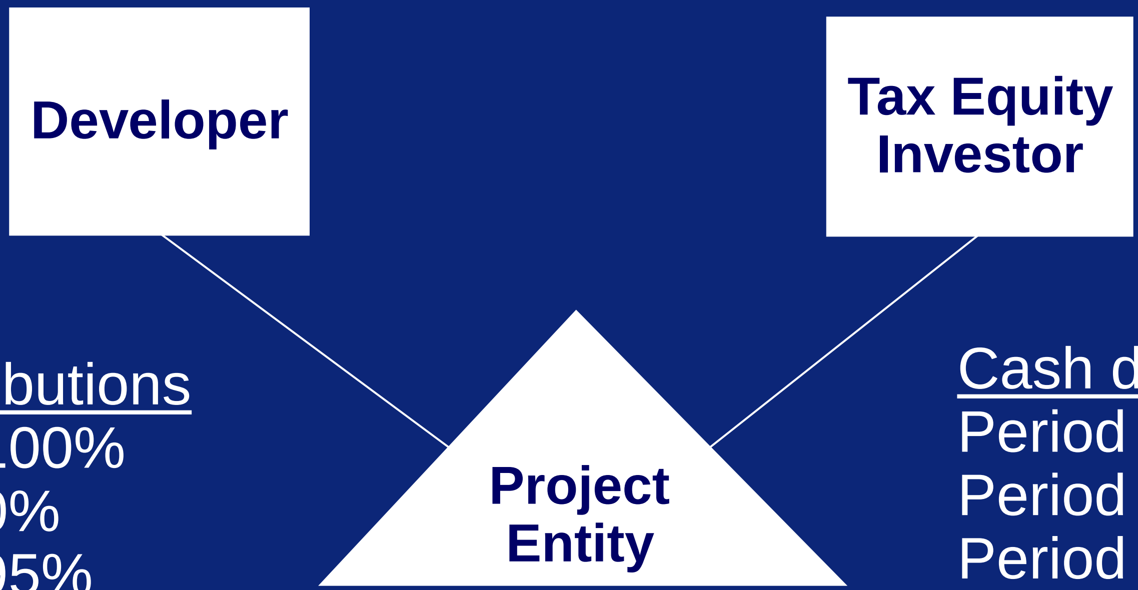
Partnership Flip

- IRC Section 45 PTC
  - In order to claim the PTC, taxpayer must be the owner of the assets <u>and</u> the producer of the electricity
  - Leasing structures not available (except for biomass)
  - Partnership can be both owner <u>and</u> producer
    - Partnership special allocation rules are utilized to specially allocate the incentives to an investor
  - Safe Harbor for wind PTC flip (Rev. Proc. 2007-65)

Is the Tax Investor a Valid Partner?

- Must assure that the partnership owns the assets and the partners own their interests
- Rev. Proc. 2007-65
- *Historic Boardwalk Hall, LLC v. Commissioner*
- Rev. Proc. 2014-12
- Does the Tax Investor have enough upside and downside to be the tax-law owner?

Partnership Flip



Developer

<u>Cash distributions</u>
Period 1: 100%
Period 2: 0%
Period 3: 95%

<u>Gross income (loss)</u>
Period 1: 1%
Period 2: 1%
Period 3: 95%

Tax Equity Investor

<u>Cash distributions</u>
Period 1: 0%
Period 2: 100%
Period 3: 5%

<u>Gross income (loss)</u>
Period 1: 99%
Period 2: 99%
Period 3: 5%

Rev. Proc. 2007-65
Example 1

Codification of Economic Substance

Joint Committee report distinguishes transactions involving ITC and PTC in Footnote 344:

"If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed…Thus, for example it is not intended that a tax credit (e.g., …Section 45 (production tax credit)…Section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage."

Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," fn. 344

Partnership Flip Structure with PTCs

- Ownership structure and allocations must be respected for Federal income tax purposes
  - Safe Harbor only applies to wind PTC partnership flips (Rev. Proc. 2007-65)
- No recapture provisions or limitations on PTC to tax exempt or foreign investors (must be US project to qualify for PTC)
- Depreciation limitations
  - MACRS may be limited if tax exempt ownership in structure

Partnership Flip with ITC

- In general, the same concepts as PTC flip structures
- Partnering prior to commercial operation date is required
- Ownership structure and allocations must be respected for Federal income tax purposes, however, no safe harbors
- Recapture of ITC during first 5 years
  - Vests 20% per year
  - Grant in lieu of ITC has favorable recapture rules

Partnership Flip with ITC

- Potential limitation of ITC if tax exempt ownership in structure
  - Deal by deal consideration and potential impacts of blocker corporations
- Basis reduction
  - Depreciable (inside) basis must be reduced by 50% of the ITC benefit
  - Outside basis of partnership interest must be reduced by the same amount

Tax Basics – Partnership Flip

Significant Tax Issues

- Is tax investor a valid partner?
- Economic substance
- Allocation of partnership items
- Tax-exempt use property
- Purchase rights
- Guarantees and loans
- Recapture provisions

Sale Leaseback Structure

Sale Leaseback – Players

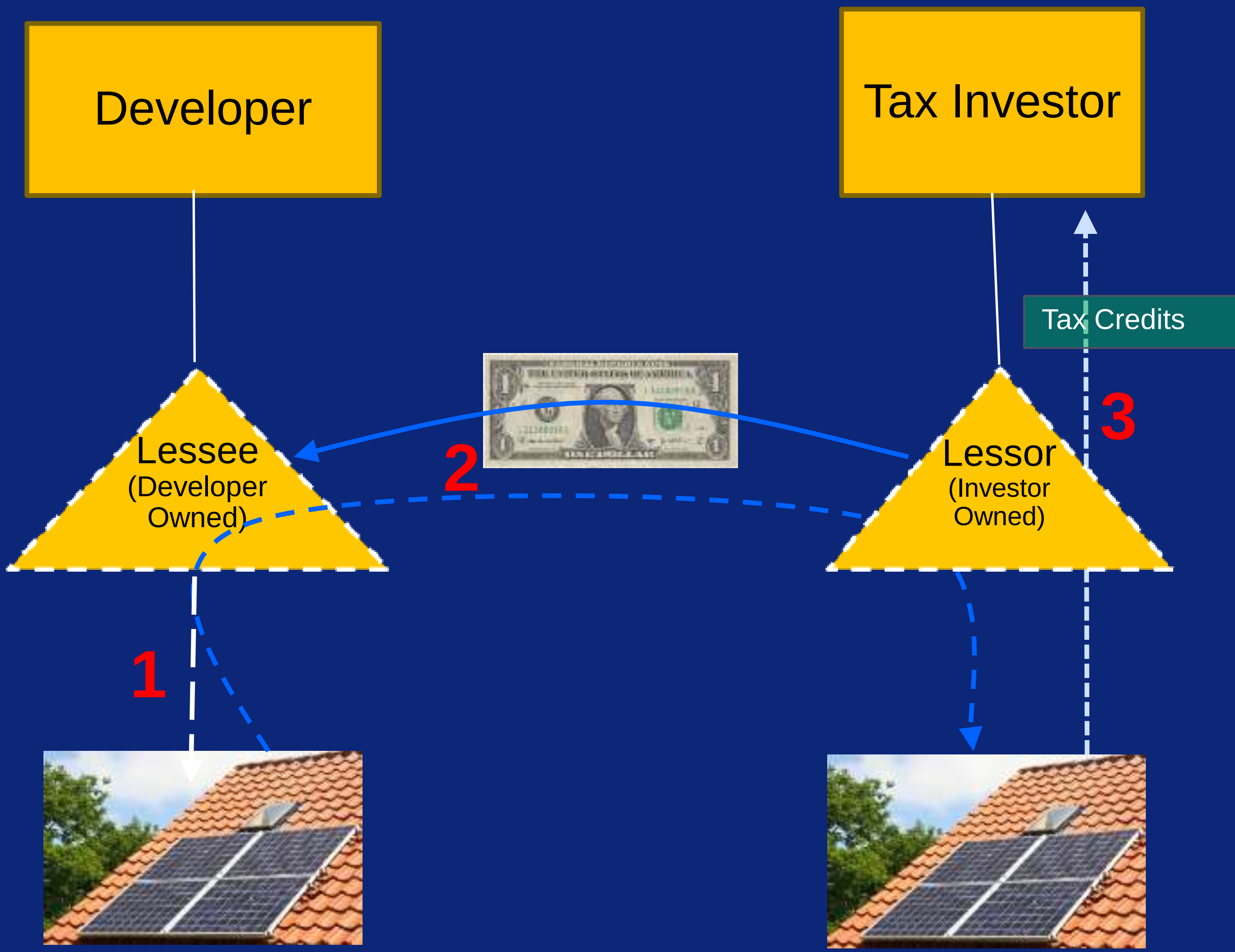
Participant	Role
1. Tax Investor	• Possesses sufficient taxable income to monetize tax benefits (both tax credits and accelerated MACRS tax depreciation) • May fund up to 100% of total project costs • After-tax IRR earned through utilization of 100% of tax credits, accelerated depreciation, and rent income • Typically exits the project after the end of the lease term
2. Developer / Operator	• ROI earned through cash flows from PPA and sale of RECs • Purchase option for Tax Investor's residual interest

Sale Leaseback Structure – (Construct / Sell)

1. Developer buys or obtains long term lease rights and installs solar panels

2. Tax Investor purchases the installed panels from Developer

3. Tax Investor will receive the 30% Investment Tax Credit based upon the purchase price and accelerated depreciation

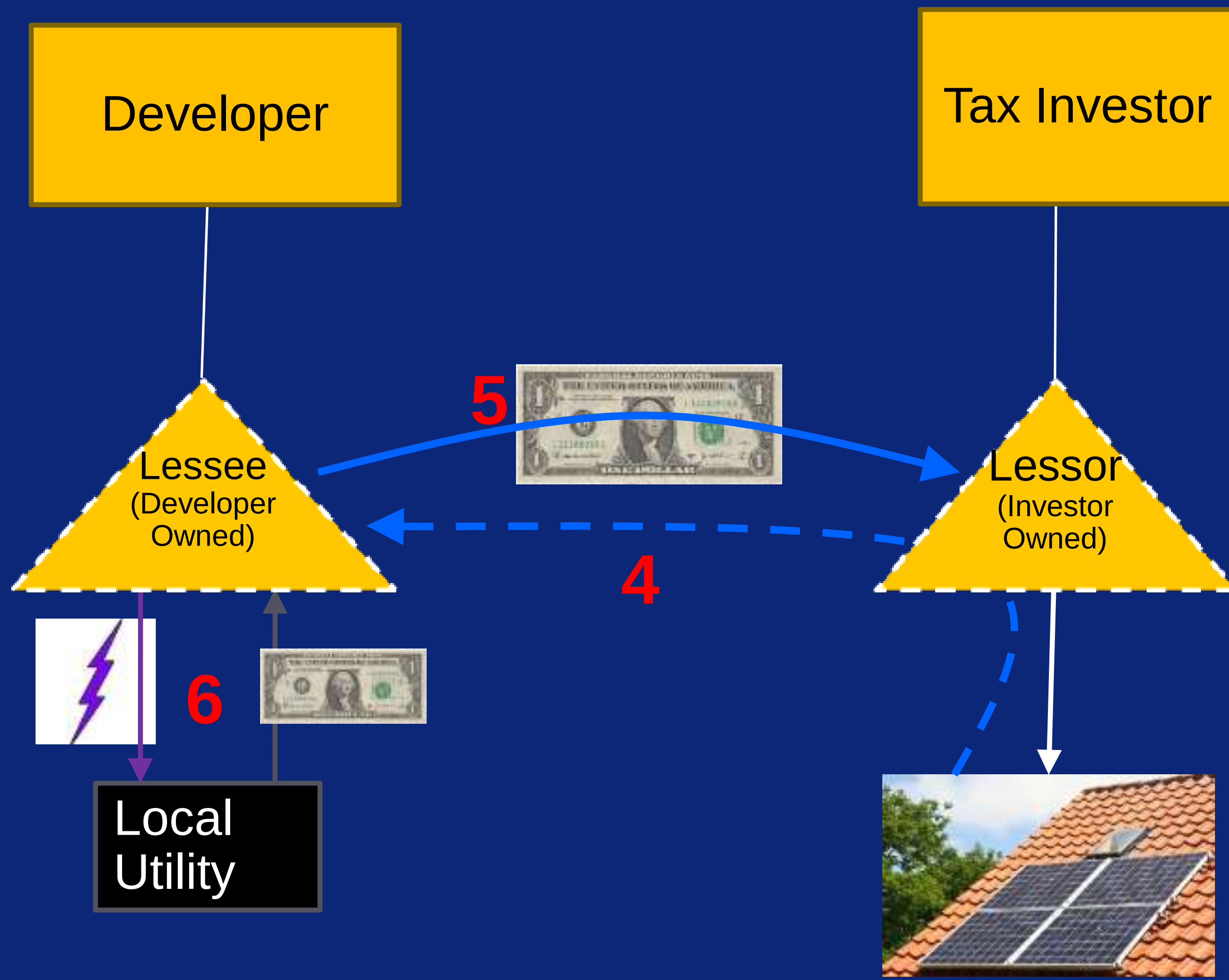


Sale Leaseback Structure – (Leaseback / Operate)

4. Tax Investor will lease the panels back to the Developer pursuant to a LT lease

5. Developer will make annual lease payments to the Tax Investor to cover debt service

6. Developer enters into Power Purchase agreement to sell electricity from panels



Tax Basics – Sale Leaseback

Time Period		Developer/Operator (Lessee)		Tax 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 Basics – Sale Leaseback

Significant Tax Issues

- Tax ownership / true lease vs. financing characterization
  - Lease vs. loan
  - Lease vs. partnership
  - Substance and form
- 90-day rule
- Tax credit recapture
- Basis reduction = 50% of credit
- Tax-exempt use property
- Structuring with ARRA 1603 grants

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