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The solar financing market is maturing. You can tell because new money is crowding into the market, and the capital stacks are getting more complicated.

Many of these funky structures even have names, like the “Double Dundas,” “Around the World,” “Walk the Dog,” etc.

This can leave new entrants wondering what the relative risks and rewards are for each structure. This is particularly true if a project sponsor or seller says to an investor or buyer that it will only consider bids that assume a particular structure.

We get calls fairly often from potential buyers/investors saying, “A developer told me I would only win a bid for a project if I assumed an inverted lease in my model. What is that, anyway? Is it risky?”

In this article, we attempt to decode these complicated structures and put risk into perspective.

The US government subsidizes the cost of many renewable power projects through tax benefits. These tax benefits can be worth upwards of 50% of a project's cost. They primarily include tax credits and the ability to write off the cost of the project on an accelerated basis.

Developers cannot typically make efficient use of the benefits, so they typically will enter into a transaction with a tax-efficient investor to barter the bulk of the tax benefits away in exchange for an investment in the project. We call this bartering transaction a “tax equity” transaction and the investors “tax equity investors.”

There are a few different avenues in which cash hungry investors without a tax appetite can still participate. Generally, this involves either buying a developer's entire interest in a project or entering into a joint venture with the developer in which the investor gets most of the developer's share of the cash flow. There is still room for traditional tax equity investors to participate to soak up the tax benefits. Alternatively, these investors could provide debt financing (sometimes mezzanine) at one or more layers of the ownership structure.

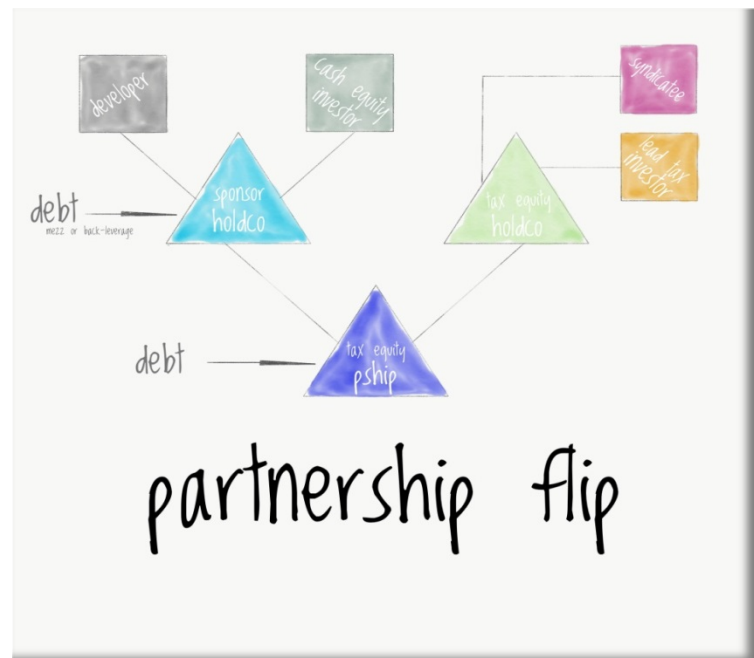
We have seen these “cash equity” investors come in to a deal during construction, shortly after construction, and even several years after a project has been in service. The risk profile differs depending on timing, but there is generally no deadline by which a cash equity investor needs to be on board assuming it does not expect to use US tax benefits.

PRIMARY US SOLAR TAX-EQUITY STRUCTURES

US solar tax-equity transactions take three primary forms: partnership flip, inverted lease and sale-leaseback. There are many iterations of each structure. Once tax equity is placed, the key to reducing the overall cost of capital is to monetize the remaining cash flow streams with one or more layers of debt or cash equity.

To help potential cash investors understand the framework, here is a quick summary of the structures.

Partnership Flip





The most common structure in the US solar market is a partnership flip. This structure is not unique to the renewables world. In fact, we often see something similar in oil and gas, real estate and private equity partnerships. The basic concept is to use the inherent flexibility of partnerships to change who gets what when, and to favor the partner with the money for the first stage of the partnership's life.

In a partnership flip, the developer dumps the project into a partnership with a tax equity investor. The tax equity investor contributes cash. A cash equity investor could invest as a third partner or invest alongside the developer in one or more upper-tier joint ventures. The project will throw off cash, depreciation and tax credits. The parties typically allocate somewhere around 99% of the tax benefits and roughly 20-50% of the cash to the tax equity investor until the tax equity investor reaches a target yield or a fixed date passes. After the yield or fixed date is reached, the tax equity investor's share of tax items is decreased (usually to 5%), along with its share of cash. The non-tax equity partners will get the bulk of the cash for the remaining life of the partnership. Some partnerships give the tax equity investor a fixed priority cash return each quarter or year, with a small residual, as opposed to merely giving the investor 20-50% of whatever the available cash might be.

Partnership flips have to be structured in a way that will make the tax equity investor comfortable that the IRS will allow it to keep its share of the intended tax benefits. For this, it is important that the company be treated as a partnership, the tax equity investor be treated as a partner in that partnership and the tax allocations be structured consistent with section 704(b) of the Internal Revenue Code (and its regulations). If any one of those items is not true, the tax credit or depreciation may either be unavailable in full or be in an amount that is less than expected.

The IRS issued a safe harbor in 2007 that blesses a form of the partnership flip structure in the context of wind farms (Rev. Proc. 2007-65). The IRS has not yet come out with a counterpart for other renewable power technologies, but most people in the industry use the wind safe harbor (or concepts from it) as an analogy for how the IRS and

Treasury think about partnership flips in the context of non-wind projects. The IRS national office wrote an internal memo in 2015 that said the 2007 safe harbor does not apply to solar transactions (CCA 201524024). However, the author proceeded to use the concepts in Rev. Proc. 2007-65 to analyze whether the solar partnership "passed muster," suggesting that while Rev. Proc. 2007-65 is not a solar safe harbor, it is very close to being one. Geothermal, fuel cell, biogas, landfill gas and biomass projects use these structures as well.

The safe harbor requires the tax equity investor to invest at least 20% of its total expected investment in a project before the project is online. The safe harbor also requires the tax equity investor to take no more than 99% of the tax items or less than 5%. Cash can be shared in any agreed ratio (and can vary from deal to deal). The developer cannot fund tax equity investor's investment or guarantee the tax credits the investor will receive.

The developer often has an option to buy out the tax equity investor for the fair value of the tax equity investor's interest (essentially, the net present of its 5% residual stake).

In some cases the buyout price is the greater of a yield bogey for the tax equity investor and the fair market value of the investor's interest. A minority of transactions also give the tax equity investor the right to put its interest to the developer, usually for no more than the value of the tax equity investor's interest in the partnership, although not technically consistent with Rev. Proc. 2007-65.

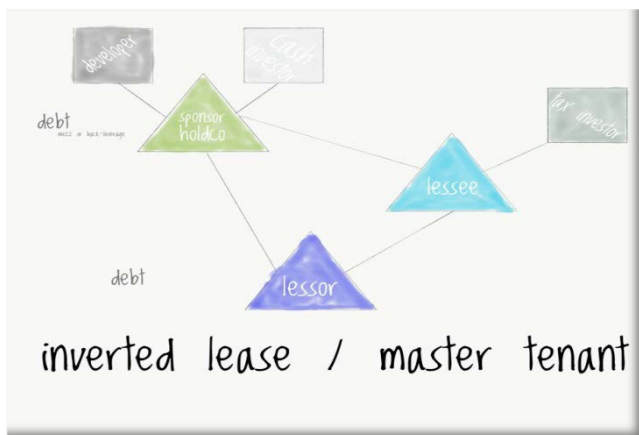
Most tax lawyers want to make sure that the tax equity investor earns at least a 2% (some have a higher threshold, few have a lower one) pre-tax internal rate of return on its investment over the life of the deal, taking into account only the contributions the tax equity investor makes, the cash it receives and the tax credit (i.e., excluding other tax items). Some believe that the "life of the deal" only includes the period where the project owner is contractually entitled to operate at its present location, unless an appraiser can opine that it is feasible to move the project to a new location to close out its economic useful life.



The basis used to calculate the investment tax credit is the partnership's cost to acquire or produce the project. The depreciable basis of the project is reduced by 1/2 of the investment tax credits claimed by the project's owner.

Partnership flips are often viewed as the most conservative structure by new investors that are not familiar with tax credit transactions, although they might have an argument from investors that are active in the historic tax credit world. Several large banks have found it more difficult to get comfortable with the other structures (although we cannot say they have never done the other structures), largely because they are already familiar with partnerships from other contexts.

Inverted Lease



Another common structure is the inverted lease. An inverted lease is the only circumstance where someone other than the owner of the project is permitted to claim the tax credits. A special exception to this general rule says that if a project is leased before being put to use, the project

owner can elect to pass-through the credit to the lessee. The lessee claims the credit based on the project's fair market value (as opposed to the cost of the project, which is used in the other two structures).

In exchange for permitting the lessee to claim the credit based on the project's value, the lessee must recognize income equal to 1/2 of the credit over five years on a straight line basis (this is sometimes called "reverse depreciation"). The lessor (as owner) claims the depreciation from the project (without any reduction due to the tax credit claimed by the lessee).

The inverted lease comes in several variants. In some of the variants, the lessee will take an ownership interest in the lessor in order to be allocated a portion of the project's depreciation. Most deals limit the lessee's share of the lessor to no more than 49.99%.

The IRS issued a safe harbor (Rev. Proc. 2014-12) to provide guideposts for structuring historic tax credit inverted lease transactions. The renewable energy industry has largely adopted these guidelines for inverted leases in the renewable energy space, as they are also generally consistent with the partnership flip guidelines (with a few notable exceptions).

The safe harbor is similar to the partnership flip guidelines and similar sale-leaseback guidelines in that it tries to put the tax equity investor ever so slightly more at risk than a lender would be. The main structural risks are whether the lease between the lessor and lessee is a true lease and, in the case where the lessee owns a piece of the lessor, whether the lessee is a partnership with the developer and investor and whether the lessor is a partnership of the lessee and developer.



The tax equity investor needs to have at least 20% of its investment for a project in the deal at the time a project starts operations. Similar to the partnership flip guidelines, no more than 25% of its expected investment may be contingent and the developer may not guarantee the tax credits the tax equity investor is promised.

One of the features of the inverted lease from years past was that the tax equity investor took 99% of the investment credit and basically a fixed amount of cash. Then, it was almost certain to exit as a predetermined time. The arrangement looked almost exactly like a loan, except it was paid back in credits and cash, rather than just cash. The 2014 inverted lease safe harbor addresses this in two ways.

First, it says that the tax equity investor needs to receive value commensurate with its “overall percentage interest in the partnership.” Discussions with the IRS national office staff that drafted the Rev. Proc. suggest this was meant to say that the tax equity investor’s return has to be subject to some variability. Most inverted lease transactions give the tax equity investor a preferred return equal to $x\%$ of its investment each year.

Usually, this percentage is 2% per year, although we do see quite a bit of variance from investor to investor (sometimes the return ends after a pre-defined date). The IRS says this is OK, but it wants to see the tax equity investor earn some part of its return from cash subject to the variance of the project’s operations. In the old days (before the *Historic Boardwalk Hall* case that precipitated Rev. Proc. 2014-12), most tax equity investors permitted developers to receive very large fees designed to soak up all the cash other than the preferred return (the tax equity investors wanted to come very close to buying the credits).

The second way the safe harbor gives a ragged edge to the tax equity investor’s return is to require all fees to be “arm’s-length.” This makes it more likely that the tax equity

investor will receive some of the cash available for distribution after the preferred return is paid. Some tax equity investors have reduced their preferred return and made sure to increase the amount of cash they expect to receive out of residual cash flows. Others have kept the preferred return the same and require much higher yields or returns on investment than before.

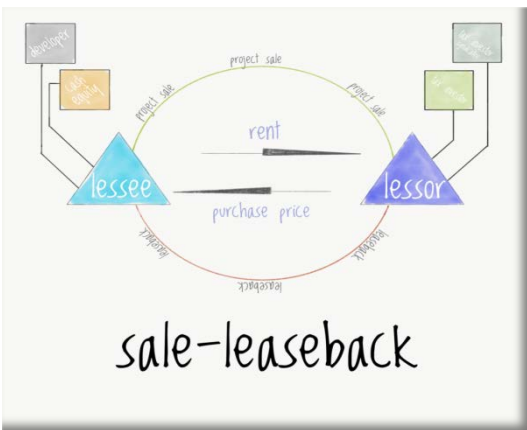
The safe harbor found two other ways to increase risk to the tax equity investor to make its interest more equity-like. The first is to require that the lease between the lessor and lessee be slightly longer than any customer lease. So, for example, if you have a 20 year customer lease, you might try for a 25 year head (or master) lease. The second is that the developer could not pre-fund its guarantee requirements except for 1-year of operational expenditures (which are minimal). On the plus side, the IRS explicitly acknowledged that third party insurance is permitted to cover lost tax benefits and other potential exposure for the tax equity investor, as long as the insurer is a third party and the developer does not pay for it.

Finally, unlike the partnership flip safe harbor, the IRS said that the developer may not have a call option on the tax equity investor’s interest, and the tax equity investor may have a put right (the opposite of the flip guidelines).

Some of the tax-equity investors that most frequently use this structure have been active for years in the historic tax credit markets where the inverted lease is the preferred structure. The decision-makers have grown comfortable with the structure, even though it may look complicated. Tax-equity investors often want to stick with what has worked for them in the past. Many aggregator/syndicator groups also use the inverted lease structure, since they were also active in those other markets (or they are merely copying old (sometimes very old) deal papers).



Sale-Leaseback



The third structure we see in the US solar market is the sale-leaseback. There is generally less economic incentive for cash equity participation in a sale-leaseback compared to the other two structures, so we will only describe it briefly.

However, we do see cash-minded entities make back-leverage loans secured by the parties' membership interests, so the structure is not without its opportunities.

In a sale-leaseback, the developer sells the project to a tax equity investor.

If the tax equity investor wants to claim an investment credit on the project, it has to acquire the project no later than three months of putting the project online.

The tax equity investor leases the project back to the developer and receives rent for the term of the lease. The tax equity investor recognizes taxable gain on the sale of the project to the lessor.

The developer keeps any extra revenue produced by the project's over-production. The tax equity investor has full ownership and retains the right to all cash flows after the lease ends (a lease is usually 10-20 years). The developer often gets the right to purchase the project for its full fair market value at the end of the lease.

Like the partnership structure, the basis used for the tax credits is the cost to the owner (generally, the price at which the project is purchased from the developer). The depreciable basis is reduced by $\frac{1}{2}$ of the tax credits claimed.

Also like the partnership structure, it is important that the tax equity investor be treated as the owner of the project, rather than a lender.

EVALUATING STRUCTURES – CASH EQUITY CONSIDERATIONS

Baseline Choice of Structure

The tax equity structure used in a particular financing depends on a number of things, but primarily on the tax equity investor's preferences and the developer's long-term goals.

Some developers are starting to make money and this is resulting in a sensitivity to whether the structure produces a tax gain on formation of the deal.

The contribution of a project to a partnership flip does not produce any taxable gain for the sponsor due to the contribution of a project to a partnership if the tax equity investor also contributes cash to the partnership that is used by the partnership to finish the project. However, it is common for the partnership to purchase the project (or for the tax equity investor to purchase a portion of the project). A purchase will generate a tax bill for the seller (who is typically the project sponsor and usually a member of the partnership). Similarly, a sale to a lessor in a sale-leaseback produces a tax gain.

There is no tax on the formation of the inverted lease structure because leasing a project is not a taxable event. This is why one might hear people say that the project can step-up its basis without an immediate cost in an inverted lease.



The main take away should be that the developer's share of risks in each structure is relatively similar between the inverted lease, partnership and most sale-leasebacks.

Some cash equity investors or lenders enter the market thinking they only want to get involved in partnership flip transactions due to a perception that the structure is safer. Perhaps they heard an offhand remark at a conference suggesting one was "better" than the other.

The fact is, however, that the cash equity investor never needs to bear the structural risk. That is, the tax equity investor should bear the risk that the IRS blows up the deal. If you see a partnership or inverted lease deal where the sponsor bears structural risk, run! Some sale-leasebacks do put structural risk on the tax equity investor, but the tax equity investor often can be pushed to take the structural risk (you just have to ask).

For a cash equity investor, the chief motivator is achieving a clear path to cash (with as little potential for variance as possible).

If cash equity is on board before tax equity funds into the deal, it will have a seat at the table for structuring discussions and will generally be in a better position to protect its interests.

If cash equity is buying into an existing deal, it will have a hard time changing the underlying transaction negotiated between the tax equity investor and the developer. That being said, almost all of the risks it would try to push back to the tax equity investor can be diligenced or covered by a back-to-back indemnity from the developer.

Cash Share

Cash is king for cash equity, so the number one consideration is how to get, and keep, cash (this includes whether there is an indemnity obligation into which the cash investor is being asked to step).

The inverted lease structure is commonly known as the structure that requires the least amount of cash to be sent to

the tax equity investor, leaving more for the developer or cash equity. Inverted leases are also very leverage or back-leverage friendly.

A partnership flip transaction where the flip date is fixed in time and where the tax equity investor's cash share is paid via a preferred return is also very debt-friendly. The structure leaves a good amount of predictable cash to the developer/cash equity. A partnership flip transaction where the flip floats depending on whether the tax equity investor has achieved a given rate of return requires more thought. A lender or cash equity investor will have to take into account the possibility that cash may be diverted if the project underperforms. In these cases, it is important to understand whether there is a grace period before a sweep kicks in or whether there is a cap on the total amount of cash a tax equity investor may sweep in a given period.

In most partnership flip and inverted lease transactions, the tax equity investor may sweep a portion of the developer's cash where an indemnity remains unpaid or if there is a tax law change. Like the sweep that applies if a yield-based flip is delayed, it is important to understand what portion of the developer's cash may be diverted. In most cases, there is a cap (usually around 50%). In some cases, cash may only be diverted after the developer has received enough cash to pay currently scheduled principal and interest on backleverage debt.

Cash sweeps for tax law changes are a relatively new development in the US solar market, and there is significant variation in how tax equity investors approach them.

Cash equity's exposure to cash sweeps depends on where it sits in the deal. If cash equity is a partner of a three-partner partnership with tax equity and the developer, the sweeps may be limited to the developer's share of cash unless for some reason cash equity is responsible for something that causes the tax equity investor to suffer a loss. This is more likely to occur if the cash equity enters the deal prior to or concurrent with closing on the tax-equity transaction. In an inverted lease, this would be the equivalent to investing alongside the tax equity investor in the lessee.



It is more complicated when cash equity buys into an existing deal or an upper tier partnership with the developer. In that case, most of the developer's cash really belongs to cash equity, so cash equity is exposed to some degree to the promises that the developer made to tax equity at the lower tier level. Cash equity will need to be mindful of the potential for sweeps and try to think of ways to maintain its upper tier cash yield. One example might be an upper tier sweep of future developer cash to mitigate the impact of a tax equity sweep down below. Alternatively, the cash equity investor may need to look to a direct indemnity from the developer (or a creditworthy parent). In a minority of cases, we see the cash equity investor rely on a backstop from a third party insurer or guarantor, but these arrangements are becoming more common.

Indemnification Generally

A developer usually agrees to indemnify the tax equity investor. This is true for all tax equity structures, although the scope may vary marginally.

Lately, we have seen a number of cash equity investors buy all or substantially all (i.e., 99%) of the developer's interest in the tax equity deal. In this scenario, cash equity generally needs to be ready to assume the developer's indemnity obligations.

If the underlying project portfolio is under construction or has been recently placed in service when cash equity acquires its interest, the developer will try to shift all of its risk over to cash equity. It is easier to diligence the risks in an early-stage deal, and cash equity can find some additional comfort in the fact that tax equity will have evaluated project risks fairly recently and gotten comfortable funding into the deal. In addition, developers are reluctant to retain indemnification obligations in such transactions because it may result in unfavorable revenue recognition treatment for accounting purposes. If the portfolio is more mature, cash equity has a better case for asking the developer to maintain some of the pre-existing guaranties and to indemnify cash equity if something goes wrong, particularly to the extent the indemnity arises due to something prior to the cash equity entering the deal.

Scope of Indemnities

The tax investor typically bears the risk that the IRS blows up the structure. For a partnership, this means the tax equity investor bears the risk that the project is owned by a partnership, each partner is a partner, and tax allocations will be respected. For a sale-leaseback or inverted lease, this typically means that depreciation schedules will be respected and the lease is a "true-lease." Where an inverted lease involves partnerships (like in the structure where the lessee is a partner with the developer in the lessor and the lessee is itself a partnership of the tax equity investor and the developer), the tax equity investor bears risks similar to those in a partnership flip.

The risk that the IRS does not respect the basis used to calculate tax credits is almost uniformly borne by the developer, and the tax equity investor will expect an indemnity to cover any related loss (guaranteed by a creditworthy entity). Since most transactions involve related parties with the developer on more than one side of the transaction or some similar continuity of ownership, basis risk usually cannot be eliminated completely. It is an issue regardless of which tax equity structure is chosen.

The parties need to document that the transactions contemplated have occurred on an arm's-length basis. That means a good cost segregation report and appraisal are key.

In partnership transactions, some tax counsel worry that the sale of a project from the developer to a partnership in which the developer (or an affiliate) is a partner could be recharacterized as a partial sale and partial capital contribution. This would give the partnership a lower basis for calculating tax credits and depreciation because part of the project would take a carryover cost basis and only a portion would receive a "step-up" to fair market value. This is not an issue in an inverted lease or a sale-leaseback transaction. Although this risk technically is a structural risk, most transactions require the sponsor to bear it.



In all of the structures, virtually all tax equity investors push onto the developer the entire risk that the IRS challenges the basis on which the tax credit is calculated. However, in some variants of the inverted lease (that are less common in today's market), the basis risk is capped at the difference between the project's value and the developer's cost to build the project.

In some cases (primarily sale-leasebacks and yield-based partnership flips with large banks that historically have invested in wind), that indemnity extends to depreciation basis as well. Inverted lease transactions do not contain a depreciation indemnity typically.

In all cases, the developer bears the risk that the project was placed in service too early. It also bears the risk that the tax credits are recaptured (although the scope of this requirement varies by deal). In no case will the developer have to bear the risk that the tax equity investor causes a credit to be recaptured.

Many of the tax equity investors that are active in the inverted lease segment of the market or that price their investment in a partnership flip on a dollar per dollar of tax credit basis expect complete coverage for lost tax credits unless the credits are lost due to a structural risk borne by the tax equity investor. By complete coverage, we mean that they do not necessarily tie the indemnity to a breach of a representation or covenant. They merely say, if they do not get the credit, they want indemnification, except in four or five circumstances (discussed above as structural risks).

Lost tax credits or depreciation due to a change in tax law are typically addressed through cash flow diversions to the tax equity investor, rather than an indemnity.

In sale-leaseback transactions, the indemnity coverage typically extends to all tax benefits, except for any loss of the benefits due to a structural risk (and the indemnity is often not necessarily triggered by a breach of a representation or covenant). We do see some middle-market sale-leaseback transactions where the tax equity investor expects full coverage for structural risks as well.

There are a number of other risks that vary as to whether the developer will be expected to indemnify the tax equity investor if they arise. These include, for example, eligibility for a state property tax exclusion, a sales tax exemption, SRECs, community solar programs, etc.

Buyback

The cost to buy the project after the tax equity investor is ready to exit varies from structure to structure.

In a sale-leaseback, the project usually may be repurchased from the tax equity investor at the end of the lease term. The price is pegged to fair market value of the project. That means a sale-leaseback will be the most expensive transaction structure for the developer to hold onto the project throughout its life.

In a partnership flip, the cost is much lower, because the purchase price is usually merely the net present value of the tax equity investor's post-flip cash flows, which is usually 5%, although there is sometimes a minimum dollar threshold.

The buyback mechanism in inverted lease deals varies, but it is usually expressed as the lower of the fair market value of the investor's interest in the lessee and a fixed amount.

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