SEIA FINANCE AND TAX Seminar

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Foundation: Sale Leasebacks

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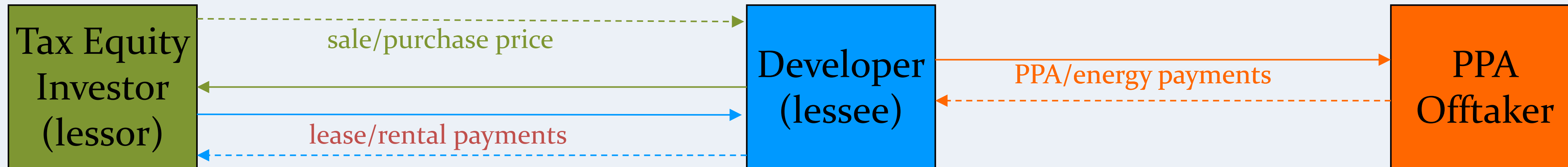
Sale-Leaseback Structure



- Developer sells project to Tax Equity Investor and then leases it back
  - Developer delivers power to offtaker via a PPA and manages project company (lessee) obligations
  - Lessee pays portion of project EBITDA to Tax Equity investor as rent each period; developer takes surplus cash each period
- Tax Equity Investor, as owner/lessor, receives:
  - ITC and tax depreciation which is reduced by 50% of the ITC
  - Rent
- Developer, as lessee, typically retains periodic options to purchase the project for its fair market value

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Key differences: lease v. loan

- Lessor is legal (holds title) and substantive owner
- Subordinated liens are not permitted in a lease
- Lessor has risk of value at the end
- Rents often lower than principal & interest due to tax benefits for lessor
- Lease remedies in a default include Stipulated Loss Value ("SLV")
  - SLV formula protects the lessor's book value and after-tax yield (includes reversal of tax benefits)

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Leasing Fundamentals: Diagram

Tax Equity/Lessor (Project Owner)

Sale

Leaseback

Developer/Lessee (Project Operator)

Tax Credits

Distributable Cash Flow

Tax Savings (Liabilities) [MACRS]

Distributable Cash Flow

Tax Savings (Liabilities [Lease Expense]

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Tax treatment of a true lease

- If a properly structured true lease, the lessor is considered to be the owner of the leased asset for tax purposes and is entitled to certain tax benefits
- The primary tax benefits are 30% ITC (or cash grant) and 5-year MACRS
- Basis is reduced by ½ of ITC/Grant, so depreciation is based on 85%
- MACRS depreciation is beneficial to taxpayers (who owe tax)

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Tax treatment of a loan

For tax purposes, a lender is not the tax owner of an asset that serves as collateral for its loan. The tax treatment of a loan is therefore dramatically different than the tax treatment of a lease.

- The user owns the property
- The financier does not claim tax depreciation
- The payments on the loan from the customer are divided into interest and principal
- The interest is taxable to the financier, and the principal is return of capital and is tax free

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Basics of US taxation

- Lessors accrues federal income tax at 35%
- Owners of equipment/property are entitled to recover their costs through tax depreciation
- Solar equipment is depreciated using "5 year" MACRS and generally the "half year" convention so there are actually 6 years of depreciation deductions

	MACRS
Year	**"5 Year"**
1	20.00%
2	32.00%
3	19.20%
4	11.52%
5	11.52%
6	5.76%

- For solar with ITC/grant, all percentages would be multiplied by 85% due to the 15% basis reduction
- Congress periodically enacts *bonus depreciation:* 50% of cost depreciated in first year; bonus was extended through 2014 by the Tax Increase Prevention Act of 2014
  - Remainder of depreciation recovered using 200% declining balance

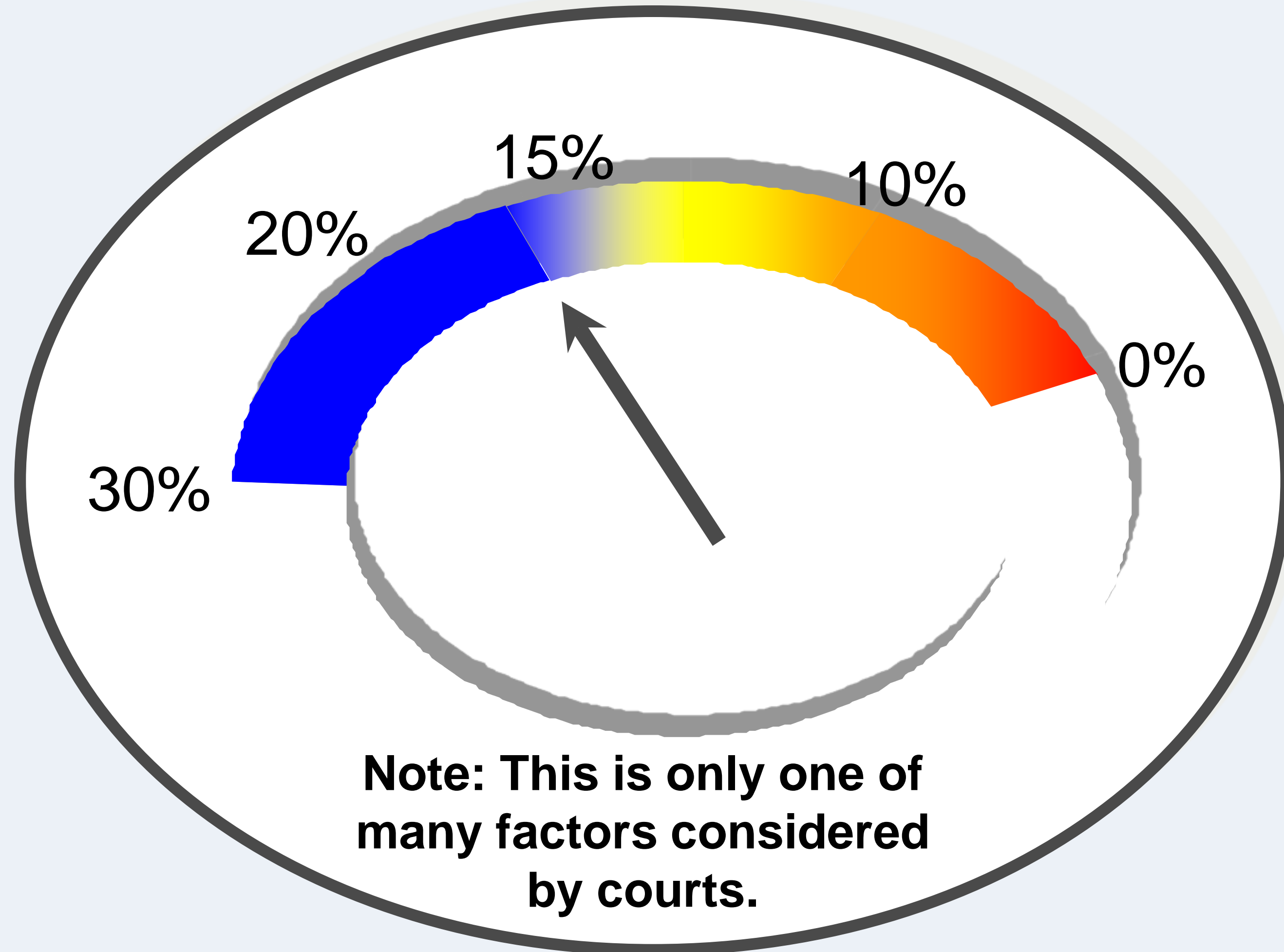
Who "owns" and takes tax write-offs on leased solar projects?

- Lessor has expectation that leased equipment will have significant residual value and useful life at end of lease
- Lessee does not have purchase option for less than the leased equipment's <u>expected</u> fair market value at that time
- Lessor has the upside reward and downside risk of the equipment's value at the end of the lease
- The equipment can be reasonably returned by lessee at end of lease and is valuable to someone other than the lessee

How much residual risk is enough?

- Cases have granted lease treatment with residual risk as low as 10% or less
  - 15% - Dunlop v. Com’r, 74 T.C. 1377 (1980)
  - 13% - Mukerji v. Com’r, 87 T.C. 926 (1986)
  - 10% - LTV Corp v. Com’r, 63 T.C. 39 (1974)
- Courts have denied lease treatment with residual risk as high as 9% -- if there was no profit potential
  - 7-9% - Coleman v. Com’r, 87 T.C. No. 12 (1986), aff’d 833 F.2d 303 (3d Cir. 1987) (no profit potential, even with residual)
  - 0% - Johns v. Com’r, 1987 T.C.M. No. 163 (1987)
- IRS Ruling Position: 20% remaining residual value (without inflation)
  - Before 1975, the IRS routinely ruled on leveraged leases with 15% residual value

Residual Value Meter



Lessee Purchase Options

- Focus is on whether "lessor" is truly at risk to the property at the end of the lease – IRS Notice 2005-13
- A purchase option that is "nominal in relation to the value of the property" indicates a loan, not lease – Rev. Rul. 55-540
- If lessee is economically compelled to purchase the property at a fixed price, lessor is not owner
  - E.g., FPO at 73% of FMV – *M&W Gear Co. v. Com'r*, 446 F.2d 841 (7th Cir. 1971)
  - E.g., lessee loses money if it doesn't purchase – *Comtel v. Com'r*, 376 F.2d 791 (2d Cir. 1967)
  - Matching puts and calls – *Kwiat v. Com'r*, 64 T.C.M. 327 (1992)
  - Hidden Lessee costs of not exercising – IRS Notice 2005-13

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Fixed Purchase Options (FPO)

- Courts (as well as IRS) have traditionally accepted an FPO equal to the projected FMV of the property as of the exercise date
  - *Belz Investment Co. v. Com'r*, 72 T.C. 1209 (1979), *aff'd*, 661 F.2d 1222 (6th Cir. 1981); *LTV Corp. v. Com'r*, 63 T.C. 39 (1974)
  - PLR 8814006; PLR 8130087, amended by PLR 8140086; TAM 9313001
- The lessor will still bear the risk of diminution in property value

IRS leasing guidelines: more conservative than case law standard

- 40 years ago: IRS was spending a lot of time issuing comfort rulings
- 1975: Set standards for issuing a private ruling
  - Does not change the law
  - Is not to be used on audit
- Rev. Proc. 2001-28
  - Originally Rev. Proc. 75-21,

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Rev. Proc. 2001-28 Characteristics: More Conservative than Case Law Standard

- Net Lease is permissible
  - Lessee may be responsible for taxes, insurance, and maintenance
  - Minimal cash flow after rent payments cover debt service
  - Lessor has no risk to property during term of lease
- Lease term is limited
  - Must have 20% of property life and property value remaining at end of lease (without regard to inflation)
- Leveraged Lease
  - Nonrecourse loan for up to 80% of purchase price - raises "recapture" challenges in ITC deals
    - $\geq$20% equity required
  - No lessee financing permitted (i.e., the lessee may not lend the lessor the lessor's investment)

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Rev. Proc. 2001-28 (cont.)

- No fixed-price purchase options
  - Lessee option to purchase okay if floats with FMV
  - Can't have fixed price option, even if at or above expected FMV
    - But Supreme Court blessed fixed price options in *Frank Lyon*
    - Rendered guidelines somewhat impractical
- Lessor must have positive cash flow including residual
  - Can't use inflation in valuing residual
  - Can't count tax benefits in positive cash flow (legislative history provides ITC counts as "profit")
  - May be minimal – tax counsel generally requires more
- Can't be "limited-use property"
  - E.g., smoke stack leased separately from the factory

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Rev. Proc. 2001-28

- Section 3:

  "... These guidelines do not define, as a matter of law, whether a transactions is or is not a lease for Federal income tax purposes and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances."

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