

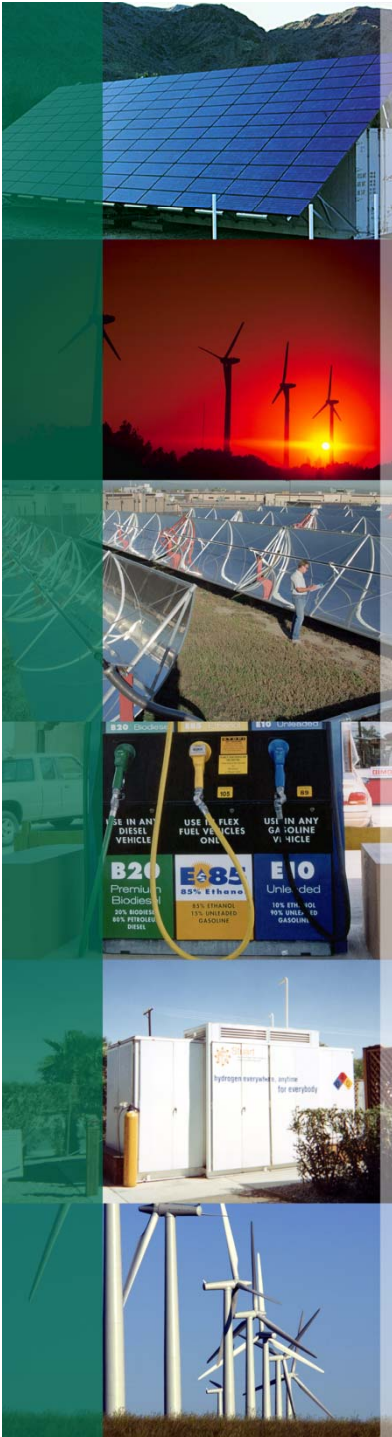
Leasing Structures for Investment Tax Credit Renewable Projects

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Circular 230

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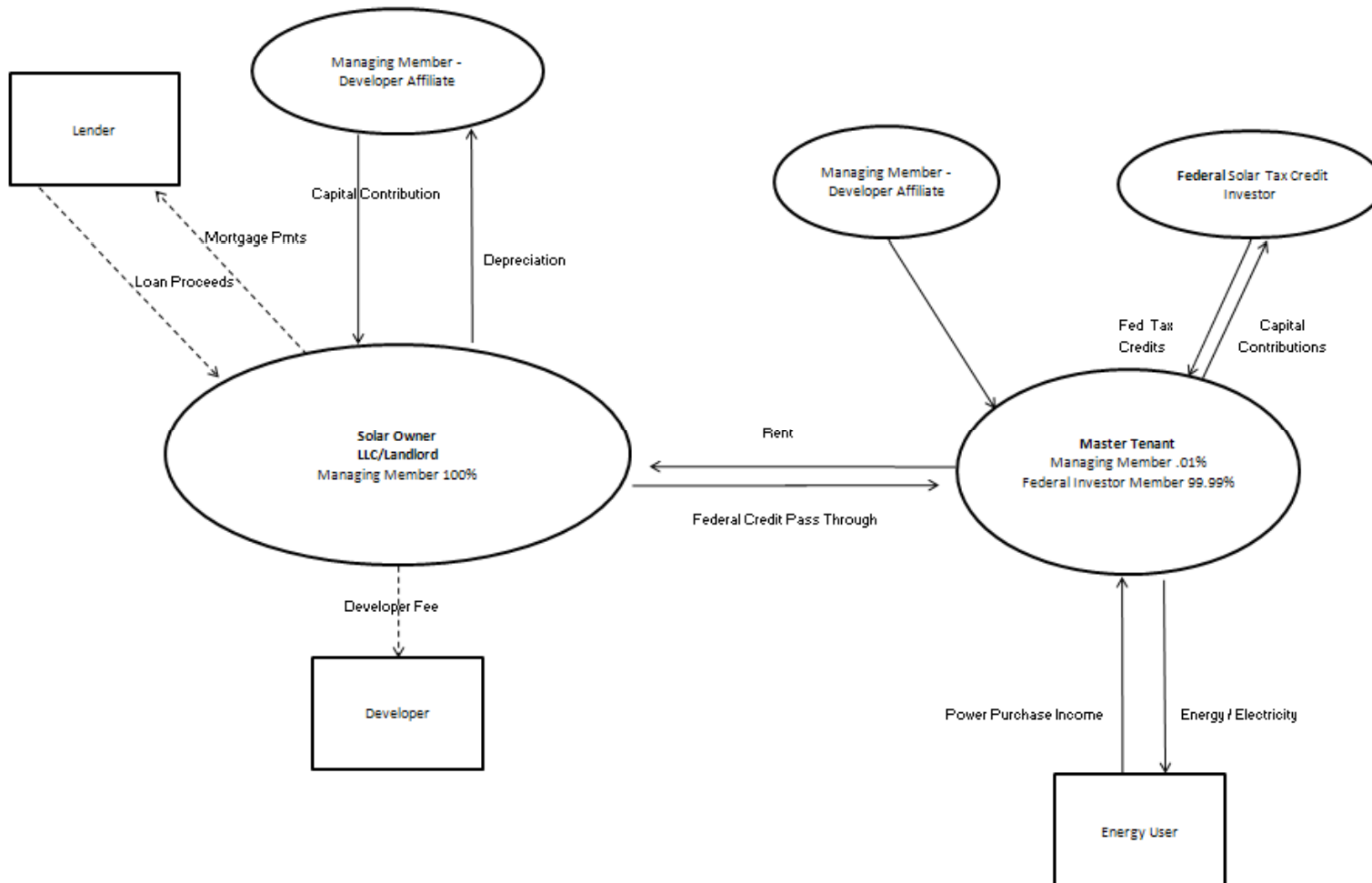
Terminology

- Energy Credit = Investment Tax Credit = ITC (Internal Revenue Code Section §48)
- Production Tax Credit = PTC (Section §45)
- Election to treat lessee as having purchased ITC property = lease-passthrough; master tenant; “inverted lease”

Note: The term “inverted lease” appears to be a description coined by a prominent law firm and is of recent origin. As compared to who receives the tax benefits in a sale leaseback transaction, the passthrough of the credit in effect reverses or “inverts” the party who receives the tax credits.



Pass-Thru Structure #1





Overview of Pass-Thru Structure #1 – Lessor

- Project sponsor/developer on the left side is lessor.
- Lessee of ITC property (for example, solar panels, etc) is on the right and pays rent to the lessor.
- Ownership for state law and federal tax deduction purposes remains with lessor on the left. Lessor retains the depreciation deductions.
- On left, “GP” or managing member is project developer.
- Debt is paid by the lessor.

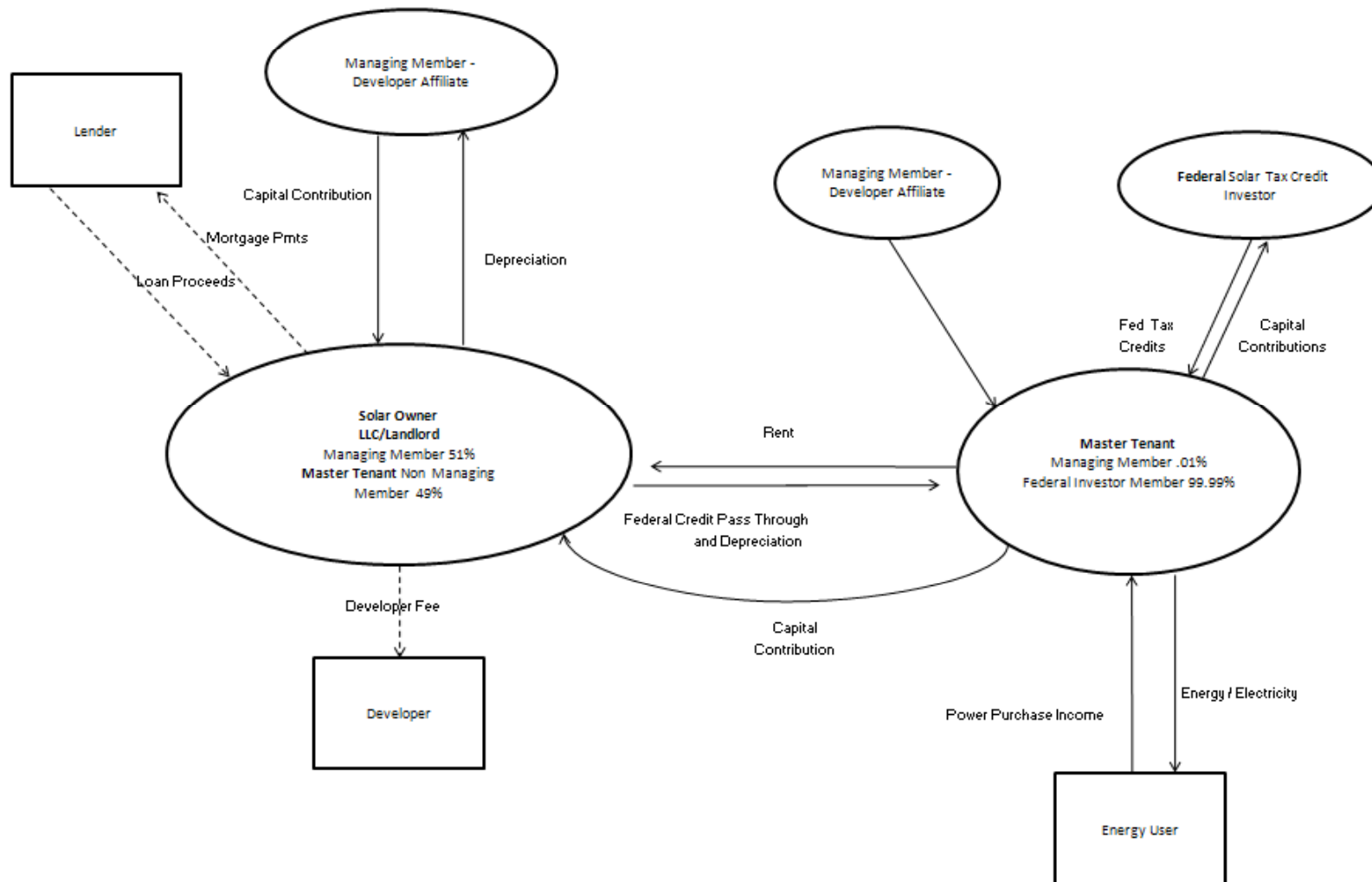


Overview of Pass-Thru Structure #1 – Lessee

- On the right, GP or managing member can be the GP or managing member of the lessor entity (sandwich), or can be the fund sponsor/tax equity syndicator.
- LP or majority member is tax equity investor (99-1, 99-5). More than one investor may be allowed.
- Lessor files federal “pass-thru” tax election.
- Lessee claims the federal investment tax credit.
- Credits allocated by profit ratio.

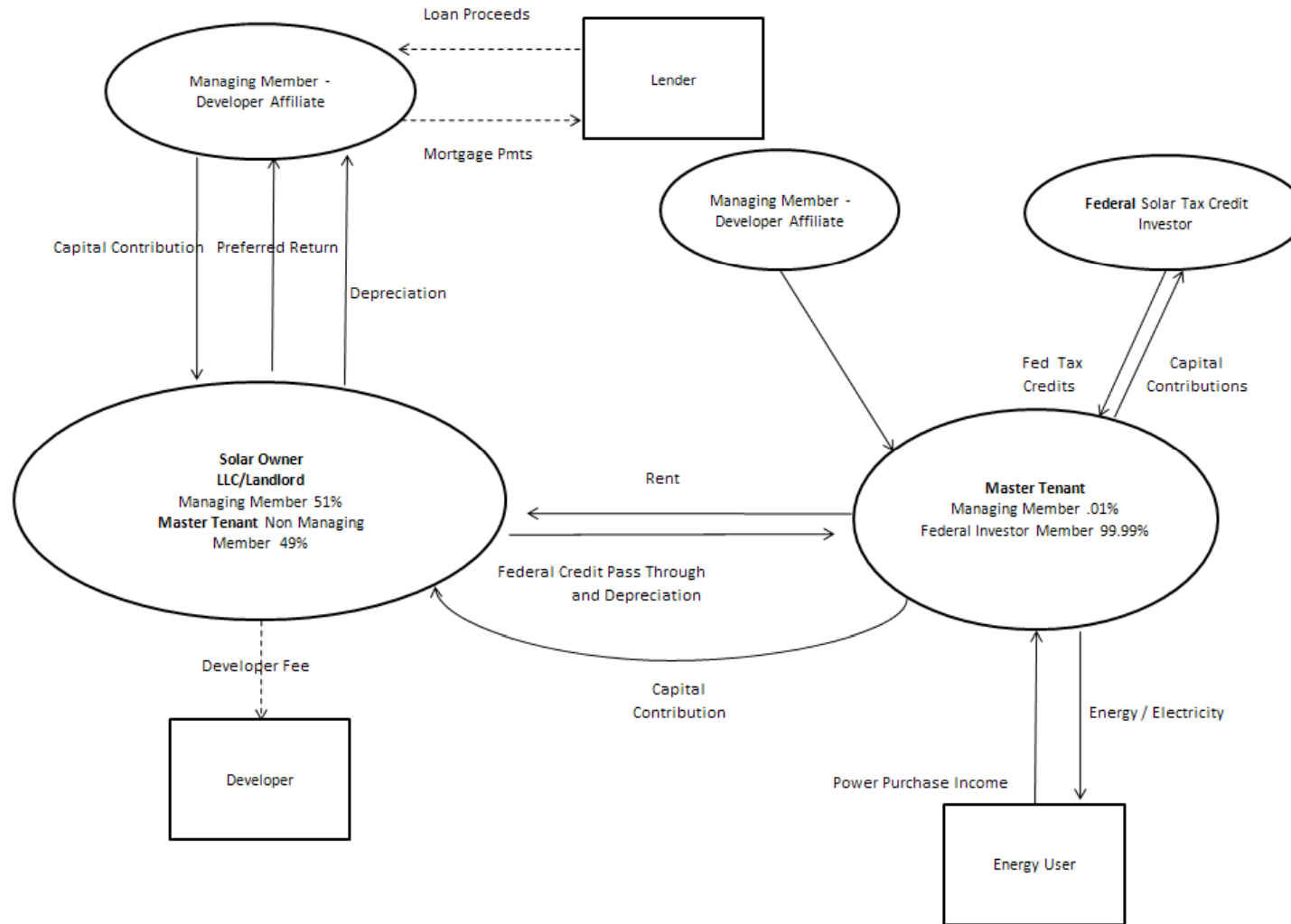


Pass-Thru Structure #2





Pass-thru Structure #2 with Backlever



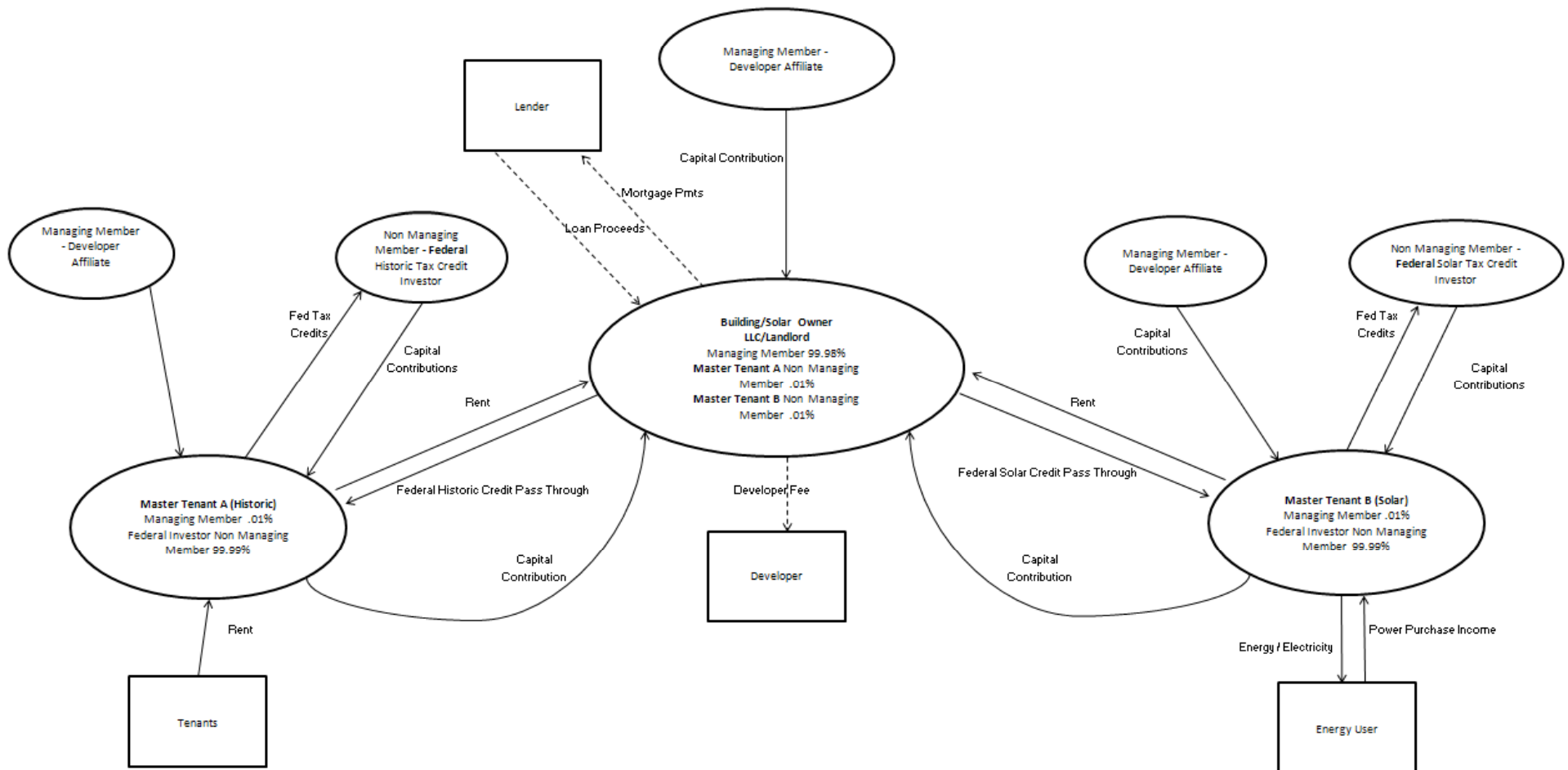


Overview of Pass-Thru Structure 2

- Structural components similar to Structure #1.
- Lessee entity owns a % equity interest in lessor entity.
- Lessee contributes cash equity into lessor entity in exchange for a % interest. This cash equity will, in combination with debt and other sources, typically cover acquisition and construction of the project.
- Depreciation deductions of lessor allocate by % to lessee entity.



“Double-50(d)” Structure



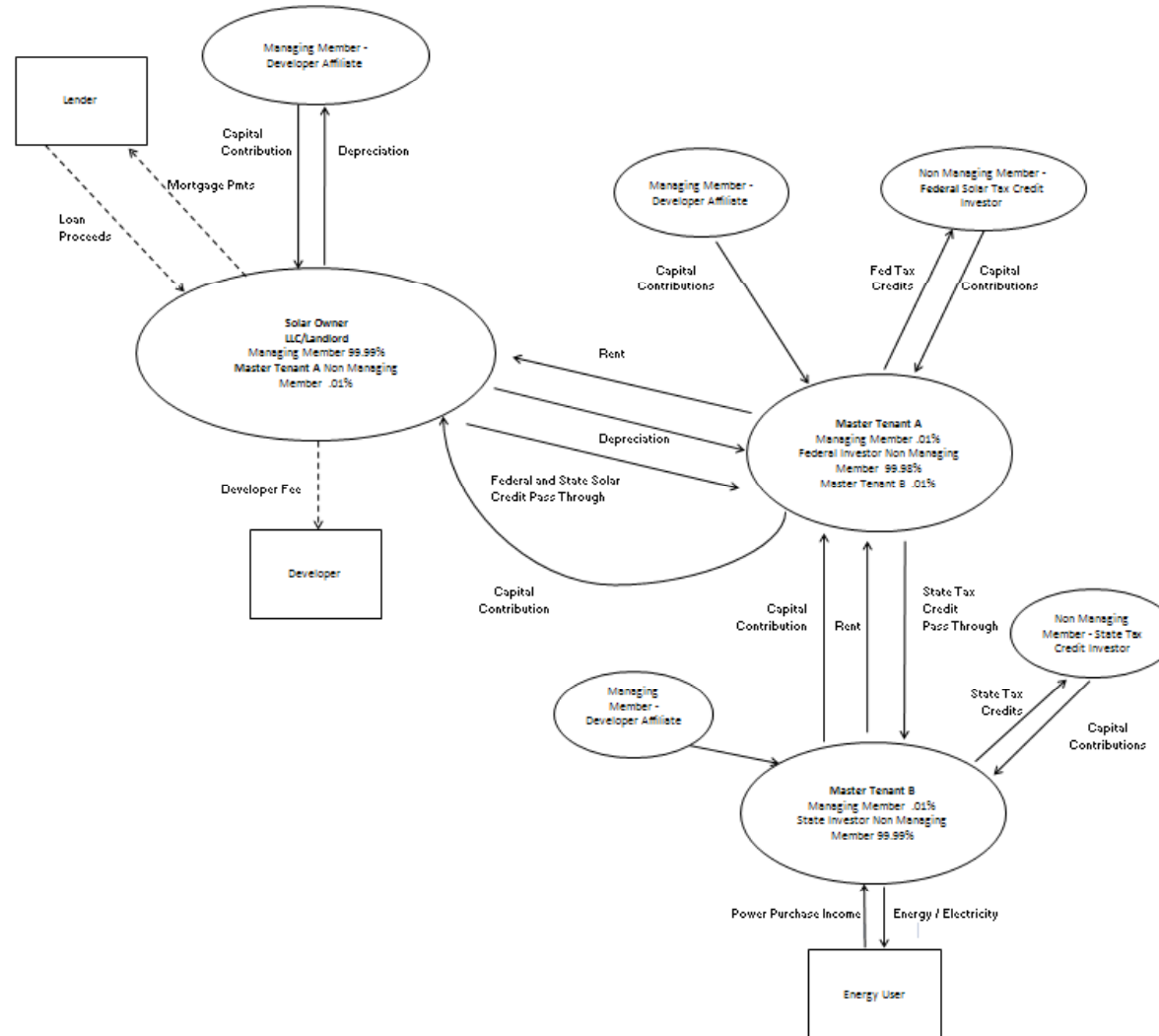


Overview of “Double-50(d)” Structure

- Separate elections.
- Applicable to combined credit deals. For example, IRC Section §47 (historic-rehabilitation tax credit) and §48 (energy credit/ITC).
- Historic-rehabilitation tax credits pass through to entity on the left.
- Energy ITC credits pass through to entity on the right.
- Issue?? Reg. §1.46-4(d)(4) (aggregated lease rules – noncorporate lessors)
- Different majority owners in each Investor entity.



“Triple-50(d)”/“Chained” Structure





Overview of “Triple-50(d)”/“Chained” Structure

- Similar in concept to the double election above.
- Two elections made by lessor entity to first lessee.
- Single election made by first lessee to sub-lessee.
- Can be used to allow bifurcation of state tax credits.



Essentials of Pass-Thru Taxation

- Code & Regs:
 - Current IRC Section §48
 - Current IRC Section §50
 - Old “Pre-1990 TRA” IRC Sections §§46 and 48
 - Old and New Treasury Regulations for above

- Authority for Passthrough:
 - Old Section §48(d), “New” Treasury Regulation §1.48-4 allows lessee to claim the tax credit. Pass-thru NOT allowed by REITs or RICs (Reg. §1.48-4(a)(1)(v)).

- Recapture – see section §50(a). Five-year recapture period. 20% per year. Counted from placed in service date, not fiscal or calendar tax year.



Essentials of Pass-Thru Taxation

- Credit is separated from depreciation.
 - Lessee may own a % of lessor to get depreciation.

- Basis Reduction: IRC Section §50(c)(3); 50% of tax credit amount
 - No basis reduction by lessor with pass-thru to lessee. With pass-thru, lessee recognizes income over 5 years equal to 50% of the amount of credit. See old section §48(d)(5).

- Lessee often will have a PPA/service contract/sublease to energy offtaker.



Essentials of Pass-Thru Economics

- Lease must be a bona fide lease.
- Revenue to lessee covers lease expense to lessor.
- Lessor has income from lease revenue and uses it to offset debt service.
- Remaining depreciation and operating expense also offsets income of lessor.

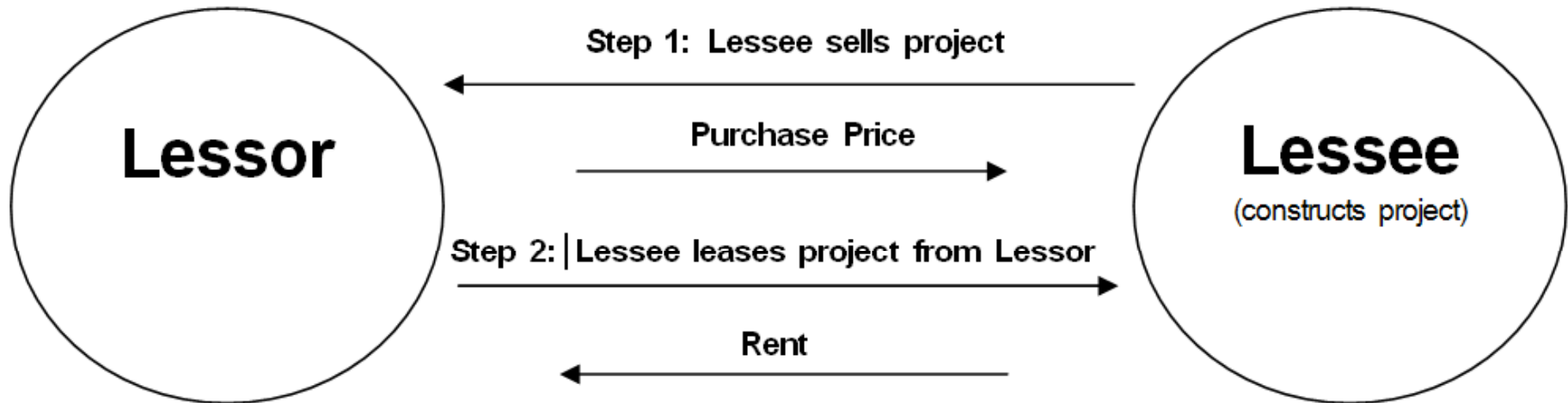


Critical Issues – Taxation

- 1-3% cash-on-cash return to tax equity investor typically suffices for profit motive and or reliance on Sacks case.
- Exit: May be by flip/put/call or some combination or other means of buyout.
- Buyout must be at FMV at time of exit.



Sale Leaseback Structure



Tax Benefits Reside Here



Overview of Sale Leaseback Structure

- Allows the renewable energy project developer to construct and **sell the energy project** to an institutional investor but then **lease that project back** from the new institutional owner.
- Under special federal income tax rules that apply expressly to sale-leaseback transactions for investment tax credit projects, an investor/buyer in a sale-leaseback transaction has **up to 3 months following the project seller's placed in service date** to acquire the project and not lose eligibility for the investment tax credit.



Overview of Sale Leaseback Structure

- If the developer-lessee wants to continue operating/using the project after the lease term ends, then lessee must either negotiate an extension at then-current market rent or buy the project.
- The original developer can buy back the project for a fixed price negotiated in advance, but the price will be the **expected value of the project/residual** – unlike in a partnership flip, where the developer gets back 95% of the project without any additional cash outlay and has to pay the market value of only a 5% interest to recover the balance of the project.



Overview of Sale Leaseback Structure

- From the lessor's perspective, the residual value of the property at the end of the lease term (combined with the rents, the ITC, and tax depreciation deductions) will generate a large after-tax yield to the lessor.
- Transactions can be structured to also generate a positive pre-tax yield and cash-on-cash return without regard to tax benefits.



Leased Property – 1603 Grant

- A lessor may irrevocably elect to pass-through the payment to a lessee.
- The lessor and lessee must agree in writing, that the lessor waives all right to a Section 1603 payment or a PTC or ITC with respect to the Property, **BEFORE** the lessee may apply for a Section 1603 payment with respect to such Property.



Leased Property - 1603 Grant

- The lessee must agree to include 50% of the payment ratably in gross income over the five year recapture period.
- Both the lessor and the lessee must be persons eligible to receive a payment.
- This election may not be made by a lessor that is a mutual savings bank or similar financial organization, a regulated investment company or a real estate investment trust.



Leased Property - 1603 Grant

- The lessor's election is made by a written agreement and contains the following:
 - Waiver of the lessor's right to receive any Section 1603 payment or claim a PTC or ITC
 - All information necessary to determine the amount of lessee's Section 1603 payment
 - The name, address, and EIN of the lessor and lessee
 - A description of each Property with respect to which the election is being made
 - The date on which possession of the Property is transferred to lessee
 - Lessee's consent to the election



Sale Leaseback Transactions - 1603 Grant

- The lessee may claim the payment if:
 - The lessee must be the person who originally placed the Property in service.
 - The Property must be sold and leased back by the lessee, or must be leased to the lessee, within three months after the date the Property was originally placed in service.
 - The lessee and lessor must not make an election to preclude application of the sale-leaseback rules.



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