

Tax Equity with Tax Rate Uncertainty

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anticipate Congress to pass federal tax legislation by the end of 2018. While generally attractive for economic growth, a reduction in the corporate tax rate—a likely component of the legislation—creates an uncertain environment for renewable energy investments. A number of large corporate investors with tax appetite, known as “tax equity,” have consistently reduced the cost of project development by monetizing tax benefits that developers (“cash equity”) are unable to initially utilize. By passing on some of this benefit to the cash equity, and by receiving some pre-tax cash from operations, tax equity can provide a project with much more favorable financing than traditional borrowing.

The tax equity market commonly uses three financial structures: prepayment lease, partnership flip, and inverted lease. Each of these structures provides a mechanism for the tax equity to receive the investment tax credit (ITC), or production tax credits (PTC), that are available for new renewable energy installations through the Consolidated Appropriations Act of 2016. In addition to tax credits, renewable projects also qualify for accelerated depreciation. Together, these allow the tax equity to reduce the tax liability it has incurred from its other activities. Cash equity often does not have the capacity to use the credits, or depreciation deductions. By using one of the three financing structures, the tax equity and cash equity can share the tax benefits efficiently.



In a **prepayment lease**, the tax equity is a lessor that buys the entire project from the developer, and then leases it to the cash equity (often the same entity) in exchange for rent. The cash equity pays some of the rent upfront using proceeds from the sale. This helps to reduce future rentals, ensuring that revenue from operations is sufficient to pay them. A prepayment lease efficiently passes all tax benefits to the tax equity, but leaves the cash equity without ownership of the asset. Reacquisition of the project during the term of the lease can be expensive.

In a **partnership flip** structure, the tax equity purchases a portion of the project. The cash equity owns the other portion of the project, and the two partners disproportionately share cash and taxable income from operations. When the tax equity achieves a required internal rate of return (IRR), the sharing percentages “flip”, and a significant majority of the cash and taxable income is provided to the cash equity. The tax equity is not able to use all the tax benefits in a partnership flip structure, but the cash equity retains a controlling interest in the asset.

An **inverted lease** (also called a “lease pass-through”) is a unique structure where the tax equity acts as the lessee rather than the lessor. The cash equity fully owns the asset, and the tax equity pays rent to the cash equity while directly receiving the revenue from underlying production. As lessor, the cash equity transfers the ITC to the lessee, so the tax equity benefits from both the credit, and the revenue it keeps after paying rents. For its part, the tax equity makes a significant prepayment of rent upfront. The tax equity never owns the asset in an inverted lease, so it gets none of the accelerated depreciation, but the cash equity retains an undivided, and controlling interest in the project.

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As tax equity contemplates a large investment in a renewable energy project, one of its most important criteria is its ability to achieve an expected IRR. Much of the return on the investment is in the form of tax benefits, so there is considerable risk in predicting future tax rates. This risk has two components: the direct reduction of tax benefits associated with depreciation, and the loss of tax appetite for credits because taxes have decreased.

Under all financing structures, a drop in tax rates directly affects the economics of the investment. It is common for tax equity to request an indemnification in the original documents, when it is concerned about future tax rates. An indemnification could require the cash equity to make a restitution payment to the tax equity, to offset the impact of a lower tax rate. A concern of such clauses is that the IRS could construe them as providing an unreasonable amount of risk mitigation. In those circumstances, the structure could be considered invalid, and lose its beneficial tax status.

If the tax equity anticipates a loss of tax appetite over time, the reliance on PTCs will come under increased scrutiny. Tax credits, in years with a small tax bill, will be all but useless to the tax equity. This may lead it to elect ITC rather than PTCs in wind power deals, just to avoid the uncertainty in future years; or tax equity may show more interest in solar transactions because of the comparably beneficial amount of ITC.

Yet another potential impact of tax rate uncertainty is the deterrence of new tax equity entrants into the market. Credit approvals are difficult enough internally without also having wavering confidence in the future

of the tax system. Companies with plans to invest in renewables could wait until there is more certainty in the market, or they may instead direct their attention to other investments with less tax rate exposure.

Tax rate uncertainty may curb some enthusiasm in the tax equity market for renewable energy finance. It may deter new participants contemplating entry into the market, and it may change the types of tax credits that tax equity is willing to receive. Negotiations may also become more difficult as tax equity looks for ways to help reduce their economic downside. Despite the potential negative impact of a reduction in tax rates, we do not expect a significant change in the level of activity in the market, until the scope of the legislative changes become clearer.



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