



Warren & Selbert

Simple as ABC.

Solar Lease Pass-Through Structures

A Lease Pass-Through¹ may also be called an Inverted Lease because the developer, who is the lessee in a sale/leaseback transaction, is the lessor in a lease pass-through and the investor/tax equity, who is the lessor in other leases, is the lessee. One advantage for the developer of a lease pass-through over a sale/leaseback is that he retains ownership of the facility.

The developer of a solar project often does not have sufficient tax capacity to use the Investment Tax Credit (ITC)² generated by the project. In order to monetize this tax benefit, the developer can enter into a lease pass-through transaction with an investor. Unlike a sale/leaseback, which allows for a three-month window after the in-service date to transfer the ITC to the investor, a lease pass-through transaction must be in place on the in-service date and the ITC transfers immediately to the lessee.

The developer installs, operates and maintains the project and negotiates the sale of the power under a long-term Power Purchase Agreement (PPA). He estimates the project's future expenses and the resulting EBITDA is used to establish the value of the project. The developer enters into a lease pass-through with an investor who can use the ITC. The amount that the investor pays the developer is usually in the range of 1.2 to 1.3 times the ITC and is referred to as the credit price.

The PPA term is typically much longer than the lease term, for example a 20-year PPA with an 8-year lease. At the beginning of the lease, the lessee makes a prepayment of rent equal to the credit price and for the remainder of the lease receives the EBITDA, using a portion of this to pay the rent and retaining the balance. The lessee may require a return on his investment, usually expressed as an XIRR on his pre-tax cash flows including the ITC. Typical returns may be in the 2.00% to 3.00% range.

The receipt of ITC usually results in a reduction in the depreciable basis equal to half of the ITC. Because the lessee has no depreciable asset, he reports income of that amount spread straight-line over the life of the corresponding asset, which is five years for solar assets. Since the lessee reports income equal to the required basis reduction, the lessor depreciates the full value of the asset.

The economics for the lessor are different from a traditional lease since the lessor's return is calculated over the longer PPA term. During the lease term, the lessor receives a portion of the EBITDA as rent, but from the end of the lease until the end of the PPA term the lessor receives all the EBITDA. Because of a very large prepayment of rent equal to the credit price and rapid depreciation on the full basis of the asset, the lessor's initial investment is paid down quickly. As a result, these leases seldom include any borrowing and accounted for as direct leases.

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¹ Lease Pass-Through structures may consist of nested Master-Tenant partnerships, which adds significant complexity that is not addressed by this discussion; nonetheless, the basic concepts apply.

² This structure is not appropriate for facilities that generate a Production Tax Credit (PTC) because a facility must be owned and operated by the taxpayer to qualify for PTC; thus the PTC cannot pass through to the lessee.