



Warren & Selbert

Simple as ABC.

Solar Sale/Leaseback Structures

The developer of a solar project who chooses to use a sale/leaseback structure often does not have sufficient tax capacity to use the Investment Tax Credit (ITC)¹ and depreciation deductions generated by the project. In order to monetize these tax benefits, the developer can enter into a sale/leaseback transaction with an investor within three months after the in-service date. Although ITC is only available for new equipment, there is a provision in the tax code that the ITC can be transferred to a lessor in a sale/leaseback transaction within three months of the in-service date.

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 including those for operations and maintenance, accounting and management, site leases, property taxes, insurance, and inverter repair and replacement. The resulting net operating cash flow or EBITDA (earnings before interest, taxes, depreciation and amortization) is used to establish the value of the project. The developer sells the project and leases it back for a term no longer than the PPA term since the PPA revenue is a necessary component of the EBITDA used to make the rental payments under the lease.

In addition to having the security of a PPA agreement as the source of revenue for the EBITDA, the lessor requires an EBITDA coverage ratio, typically in the 1.15 to 1.25 range, to guarantee that the developer has sufficient revenue to pay the rent even if the project does not generate the full amount of expected EBITDA. Some lessors also require that the developer set aside a rent reserve at lease inception with an amount equal to several months' average rent. The funds in this account can be used to supplement the EBITDA if it falls short of the amount needed to pay the rent. Any remaining balance in the reserve account is returned to the lessee at the end of the transaction.

At the beginning of the sale/leaseback, the lessor purchases the project from the developer/lessee for its estimated Fair Market Value (FMV). From these proceeds, the lessee often makes a large (typically up to 20% of FMV) prepayment of rent to the lessor and sets up a rent reserve if required. During the term of the lease, the lessee receives EBITDA from the project and pays rent to the lessor. The large prepayment of rent can be beneficial to the economics of the transaction because the lessor receives cash at the beginning of the transaction but the taxable income is spread over the life of the lease by the 467 loan. The prepayment reduces the lessor's net investment and allows for lower future rent and lower total rent than had there been no prepayment.

The economics for the lessor are typical of any true lease. The lessor receives his required rate of return from the ITC, depreciation deductions and rent. Because of a potential 20% prepayment, a 30% ITC and rapid depreciation, the lessor's initial investment is paid down quickly. As a result, these leases seldom include any borrowing and are accounted for as direct leases.

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¹ 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 be claimed by the lessor.