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Tax Equity Financial Structures

The developer of a renewable project often does not have sufficient tax capacity to use the tax credits and depreciation deductions generated by the project. 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 cannot use. By passing some of this benefit to the developer, and by receiving some pre-tax cash from operations, tax equity can provide a project with much more favorable financing than traditional borrowing. Three commonly used financial structures are the Partnership Flip, the Solar Sale/Leaseback, and the Solar Lease-Pass-Through[1].

Each of these structures provides a mechanism for the tax equity to receive the investment tax credit (ITC) or production tax credits (PTC) and, for partnership flip and sale/leaseback structures, the accelerated depreciation deductions that are available for new renewable energy installations. These tax benefits allow the tax equity to reduce the tax liability it has incurred from other activities.

In a **Partnership Flip** structure, the tax equity purchases a portion of the project, which the developer continues to operate and maintain. The developer owns the balance of the project, and the two partners disproportionately share cash and taxable income from operations. The tax equity is initially allocated most of the cash, tax credits and taxable income until he achieves his required rate of return. The sharing percentages then "flip" and a significant majority of the cash and taxable income is allocated to the developer. The tax equity enjoys most, but not all, of the tax benefits and the developer typically has an option to purchase the investor's interest in the partnership on or after the flip-date.

In a **Solar Sale/Leaseback**, the tax equity buys the project for Fair Market Value and leases it back to the developer, who becomes the lessee. From these sale proceeds, the lessee often makes a large (typically up to 20% of FMV) prepayment of rent that helps reduce future rentals, ensuring that revenue from operations is sufficient to pay them. This structure efficiently passes all tax benefits to the tax equity, but leaves the developer without ownership of the asset. The developer may be able to purchase the project back from the tax equity as an Early Buyout Option or for the then FMV at the end of the lease.

A **Solar Lease Pass-Through** (also called an "inverted lease") is a unique structure where the tax equity acts as the lessee rather than the lessor. The developer continues to own and operate the facility, retains the depreciation deductions that help offset the rental income, and transfers the ITC to an investor. The investor/lessee pays the developer a large prepayment of rent, called the credit price, that is usually in the range of 1.2 to 1.3 times the ITC. For remainder of the lease term, the lessee receives the operating cash flow from the project, using a portion of it to pay the rent and retaining the balance. The lessee may require a return on its investment, usually expressed as an XIRR on its pre-tax cash flows including the ITC. Typical returns may be in the 2.00% to 3.00% range. The tax equity never owns the asset and the developer retains an undivided and controlling interest in the project.

[1] Sale/Leaseback and Lease Pass-Through structures are 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.

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