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TAX EQUITY INVESTMENTS OVERVIEW

Frequently Asked Questions



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THIS DOCUMENT HAS BEEN PREPARED TO PROVIDE SOME BACKGROUND AND CONTEXT TO TAX EQUITY INVESTMENTS GENERALLY. THIS IS NOT A SOLICITATION AND NO FACTS RELATING TO ACTUAL INVESTMENTS ARE PRESENTED. THE DISCUSSION OF U.S. FEDERAL TAX IMPLICATIONS OF SUCH INVESTMENTS IS MEANT TO BE GENERAL IN NATURE AND DOES NOT DISCUSS ALL ASPECTS OF U.S. FEDERAL INCOME TAXATION THAT MAY BE RELEVANT TO A PROSPECTIVE INVESTOR IN LIGHT OF ITS PARTICULAR CIRCUMSTANCES. IN ADDITION, THE DISCUSSION DOES NOT DESCRIBE ANY TAX CONSEQUENCES ARISING UNDER THE LAWS OF ANY LOCAL, STATE, OR FOREIGN JURISDICTIONS AND DOES NOT ADDRESS ANY ASPECTS OF U.S. FEDERAL TAX LAW OTHER THAN INCOME TAXATION. ANYONE CONSIDERING MAKING A TAX EQUITY INVESTMENT SHOULD CONSULT ITS OWN INDEPENDENT TAX, LEGAL OR FINANCIAL ADVISOR. THROUGH THIS DOCUMENT, NEITHER DISTRIBUTED SUN NOR DLA PIPER LLP (US) IS MAKING ANY REPRESENTATIONS OR WARRANTIES TO ANYONE. THIS DOCUMENT IS NOT INTENDED TO BE AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO PURCHASE ANY SECURITIES. THIS DOCUMENT IS NOT INTENDED TO PROVIDE ANY LEGAL, TAX OR INVESTMENT ADVICE.

What are the tax-based incentives available to investors in solar systems?

To incentivize more investments in renewable energy, the Internal Revenue Code provides owners of solar photovoltaic arrays with the right to claim an Investment Tax Credit (“ITC”) equal to 30% of the eligible costs incurred in placing a solar PV array in service (i.e., the depreciable tangible personal property that is a part of the project). While the laws governing the ITC have been amended several times, most recently in 2015, the latest amendment sets the ITC at the current level of 30% for projects on which construction begins by the end of 2019, decreasing to 26% for projects on which construction begins in 2020, 22% for projects on which construction begins in 2021 and 10% for projects on which construction begins in 2022 and any project that is not placed in service by the end of 2023.

Do I need to be qualified to monetize the ITC?

For individual investors, including individuals who are partners in a partnership, members in an LLC or shareholders of S Corporations: The individual partner/member/shareholder of the PV system owner can monetize all of the ITC provided that the ITC is not more than the amount that the individual has at risk in the investment (i.e., the amount of capital invested and debt for which the lender has recourse to the individual) and that the taxes owed are on passive income. Consult your advisor to determine whether your income is from passive sources.

For C corporation investors with fewer than 5 owners owning 50% or more of the outstanding stock: The C corporation may claim all of the ITC provided that the ITC is not more than the amount that the corporation has at risk in the investment and not more than the corporation’s passive activity gross income plus its “net active income.” (“Net active income” is computed by making certain adjustments to the company’s gross income by excluding passive activity gross income and passive activity deductions.)

For C corporation investors with more than 5 owners owning 50% of the outstanding stock: The C Corporation can use the ITC against taxes owed by the corporation and the tax losses can be used against taxable income.

Investors have to be “accredited investors” as defined by the Securities Exchange Commission in Section Rule 501 of Regulation D.

Are there other tax-based incentives available to a PV system owner?

The Omnibus Spending Bill, passed in December 2015, allows the PV system owner to depreciate 50% of the system’s eligible depreciable basis in the first year. The owner is also allowed to depreciate the PV system under an accelerated 5-year Modified Accelerated Cost Recovery System. Cumulatively, the owner may depreciate 60% of the depreciable basis in the first year, providing a sizable tax benefit to the owner.

When is the ITC available to an owner or investor?

The ITC is available to the legal owner (or partners/members in an owner organized as a partnership or LLC) of a PV system on the date the PV system is “placed in service.” The ITC is claimed on the federal income tax return for the year in which the “placed-in-service” date occurs. The tax law defines the placed-in-service date as the date when all of the following have occurred with respect to the system: (1) passage of control to the legal owner/operator, (2) successful completion of critical tests, (3) system is available to operate regularly or continuously to serve its intended purpose, (4) receipt of all the licenses and permits to operate, and (5) synchronization to the grid or power off-taker.

May all of the ITC be monetized immediately?

Yes. Once claimed on the federal income tax return for the year in which the PV system is placed in service, the entire ITC is available for the owner’s use immediately and can be credited dollar for dollar against the owner’s taxes, subject to the limitations discussed above. However, the ITC vests, ratably over the first five (5) years after the PV system is placed in service (the “Recapture Period”). The recipients of the ITC will have to recapture, by reimbursing the IRS for any unvested portion of the ITC, if any disqualifying events occur during the Recapture Period. This reimbursement obligation is referred to as “recapture.”

What are disqualifying events?

The Treasury Regulations establish certain disqualifying events resulting in recapture. The prospective PV system owner should be concerned about these events and should ensure that these events do not occur, or have an extremely low likelihood of occurring. Two events that can trigger disqualification and recapture are a change in ownership of the system and the system failing to operate (or be available for operation, if the outage is from force majeure events) during the Recapture Period. Another disqualifying event is the ITC recipient becoming a disqualified person, such as a tax-exempt entity or a REIT.

What is the vesting schedule for the ITC?

For each full year of operation after the PV system is placed in service, 20% of the value of the ITC (6% of the eligible costs) will be vested. For example, if a disqualifying event happens 3 years and 11 months after the PV system is placed in service, 60% of the ITC will have vested and the owner will have to reimburse, to the IRS, 40% of the ITC that has not vested. After five (5) years, 100% of the ITC will vest and no portion will be at risk.

What happens if the owner does not have to pay taxes?

Any unused ITC, from the current tax year, can be carried back to the previous tax year, if the ITC cannot be monetized in the current year and if taxes were owed in the previous year (again, subject to the limitations described above). Any unused ITC can then be carried forward for up to 20 years after the year in which the PV system is placed in service.

What happens when the owner cannot use the ITC immediately?

In the event an owner of a PV system does not have the tax exposure necessary to utilize the ITC efficiently, a variety of finance structures are available to facilitate investment by taxpayers that can efficiently use the ITC. The ultimate choice of the finance structure is determined by the investor and their advisors.

What are Tax Equity Investments?

Investors that make equity contributions and receive allocations of the ITC and other tax benefits such as depreciation are called tax equity investors (the “Investors”). These investments made by Investors are called tax equity investments.

What is the partnership-flip structure?

Partnership flip structures are used commonly by Investors to monetize the ITC and depreciation benefits from PV systems. In this structure, the Investor contributes a predetermined amount of capital required by a project. The remaining capital is usually funded by other equity investors (typically the project sponsors or “Sponsors”) through a mix of equity contributions and debt. In return for its contributions, the Investor receives 99% of the ownership of the project company owning the PV system. During each of the first five (5) years, the Investor receives an allocation of 99% of the ITC, 99% of all taxable income (or losses, which is typical in the first few years of the project as a result of depreciation deductions) and a small stream of cash flow annually (typically 2 – 4% of the value of the investment). After 5 years or when the Investor’s target yield (usually based upon a specified internal rate of return) has been achieved (whichever is later), the ownership of the project company owning the PV system “flips,” causing the Sponsor to own 95% and the Investor to own 5%. The Sponsor typically has a right once the flip has occurred to acquire the Investor’s 5% residual interest at the fair market value of that residual interest at the time of the acquisition by the Sponsor.

Are other structures used for Tax Equity Investments?

Other structures used for Tax Equity Investments are the so-called inverted lease or lease-pass-through structure and the sale-leaseback structure. As the names denote, both of these structures involve the creation of a lessor-lessee relationship, with the Tax Equity Investor investing in the lessee entity in the inverted lease structure and the purchaser-lessor entity in the sale-leaseback structure. Each of these structures has advantages and disadvantages when compared to the partnership flip structure discussed above. Investors should carefully consider these advantages and disadvantages in selecting the structure they wish to use, and should also consider the compatibility of the structure selected with future modifications in the capital structure of the project or projects that may be contemplated. For example, as securitization becomes a more common means of refinancing solar PV portfolios, the compatibility of each of these structures with securitization structures should be considered.

What is the Sponsor’s motivation?

Sponsors seek a return on their capital over the life of a PV system, typically over 20 years. Sponsors are responsible for, motivated and incentivized to keep a PV system operating in optimal condition over its lifetime in order to receive their intended return on capital. Because Sponsors typically do not have enough tax liability to utilize the ITC or the accelerated depreciation benefits efficiently, they are incentivized to offer Tax Equity Investments to the Investor and to offer a preferred return on their capital to help finance the project.

What kind of returns do Tax Equity Investments provide?

Investors receive their return through the tax benefits described above, plus cash distributions from the PV system owner. The following table shows a hypothetical illustration of an Investor’s after-tax return assuming a Tax Equity Investment of \$1,000,000:

Investment and Return Example			
Timeline	After-Tax Return	Return on Investment	Internal Rate of Return
Investment	(\$1,000,000)		
Year 1	\$820,685	82.1%	-47.3%
Year 2	\$166,667	98.7%	-2.39%
Year 3	\$25,000	101.2%	2.18%
Year 4	\$25,000	103.7%	5.99%
Year 5	\$25,000	106.2%	8.99%
Year 6	\$25,000	108.7%	11.29%
Investment Returned	\$1,087,351		
Return Multiple	108.7%		
IRR	11.29%		

What is the difference between Internal Rate of Return and Cumulative Return?

An Internal Rate of Return (“IRR”) is the annualized interest rate, over the investment period, paid to the investor on the investment made. In the example above, the IRR, or annualized interest rate, is 30.44% in part because the ITC is available to be monetized by the Investor immediately when the PV array is commissioned.

The Cumulative Return is the ratio of the Total Capital Returned to the Total Invested, providing the Investor with an overall idea of the quantum of cash flows during the same period of investment. In this example, the Cumulative Return, or the investment return multiple, is 112.3% - meaning that \$1 million invested receives \$1.123MM (rounded) over the six-year period.

What is the Residual Value of Ownership after the ownership flip?

Typically, investments will be made under a partnership-flip structure. As stated above, under this investment structure, the Investor’s share of ownership and benefits from the PV system will “flip” from 99% (for the first six years) to 5% (for the remainder of the term, usually 14 years). After this flip in ownership occurs, the project Sponsor (or the long-term equity investor) has the right to buy the Investor’s residual 5% ownership at fair market value (“FMV”). The FMV is usually the net present value of the future benefits attributable to the 5% residual interest, using a discount rate appropriate at the time the FMV is calculated.

What risks do Tax Equity Investments carry?

Typically, Investors may be concerned by project cost overruns, loss of revenue agreements, lesser-than-expected solar resource availability, equipment malfunction and foreclosure of the PV system by a project lender.

Can the Sponsor guarantee that the Investor will receive the ITC or that it will not be recaptured?

No. No party, including the Sponsor, may guarantee that the Investor will receive the ITC, or indemnify the Investor, if the ITC is unavailable. This is mandated by the IRS.

What measures are available to minimize risks of recapture?

It is possible to mitigate risks by contracting the risk away to different counterparties. Typically, the Sponsor is responsible under an Operating Agreement to prevent any disqualifying events from occurring. A skilled investment manager can navigate these risks and mitigate them cost-effectively.

RISK	MITIGATION
Cost Overruns	Fixed price or guaranteed maximum price contracts for procurement and construction.
Counterparty Payment	Rigorous credit assessments of credit upfront determine the nature of credit worthiness of the long-term buyer. Credit enhancements are sought if the credit worthiness of a counterparty is not up to investment standards.
Revenue Loss	Due diligence on revenue contracts – modifications if necessary. Contracts are executed only with credit-worthy counterparties. Additional credit enhancements are sought when counterparty credit is less-than-optimal (below investment-grade).

RISK	MITIGATION
Equipment Malfunction	Typically, PV panels carry a 25-year power warranty and PV inverters carry a warranty of 5 – 10 years from the respective manufacturers. The installation carries a 5-year warranty from the installer. A detailed commissioning process will minimize any risk of equipment malfunction.
Reduced Resource Availability	Prior to making the investment, rigorous analyses are conducted to calculate the probabilities of exceedance – P50, P75, P99 estimates, from over 60 years of historical resource data.
Foreclosure by Lender	Prior to making the investment, the coverage ratios on debt service (principal and interest) are verified and stress-tested. In addition, structure a standstill period during which the lender may not foreclose on the project. (Note: in the inverted lease structure referred to above, foreclosure on the PV assets will not normally trigger recapture for the Investor as long as the Investor’s lessee position is not disturbed.)

Are corporate financial statements affected by the ITC and MACRS deductions?

The ITC and deductions from owning PV systems are typically not reported on GAAP-basis financial statements of a corporation, even though it receives 99% of the ITC and deductions. The current and deferred tax impact, if any, on account of the deductions is recorded on the financial statements below the line and typically do not affect earnings.

Are PV systems consolidated on books of the corporate tax equity investor?

No. The financials of the PV system owner (typically organized as a special purpose entity) are typically consolidated on the statements of the Sponsor. This is because the Investor delegates the responsibility to make decisions concerning day-to-day operations, under an operating agreement, to the Sponsor based on a mutually agreed-upon rule-set.

Have other corporations invested tax equity in PV systems?

Yes, several corporations have made tax equity investments. General Electric, Microsoft, Google, Honda, and Washington Gas are examples of corporations that have made tax equity investments in PV systems. Banks such as JP Morgan, Citi, Bank of America, PNC, State Street, Wells Fargo, US Bank, National Bank of Arizona, Goldman Sachs, Rabobank, and Morgan Stanley are examples of financial institutions that have made tax equity investments in PV systems. New investors routinely invest tax equity in PV systems and perceive the investment profile to be very similar to investing in mortgages where an asset owner seeks a return on invested capital based on long-term cash flows from the underlying asset.