Financial Incentives for Renewable Energy Projects

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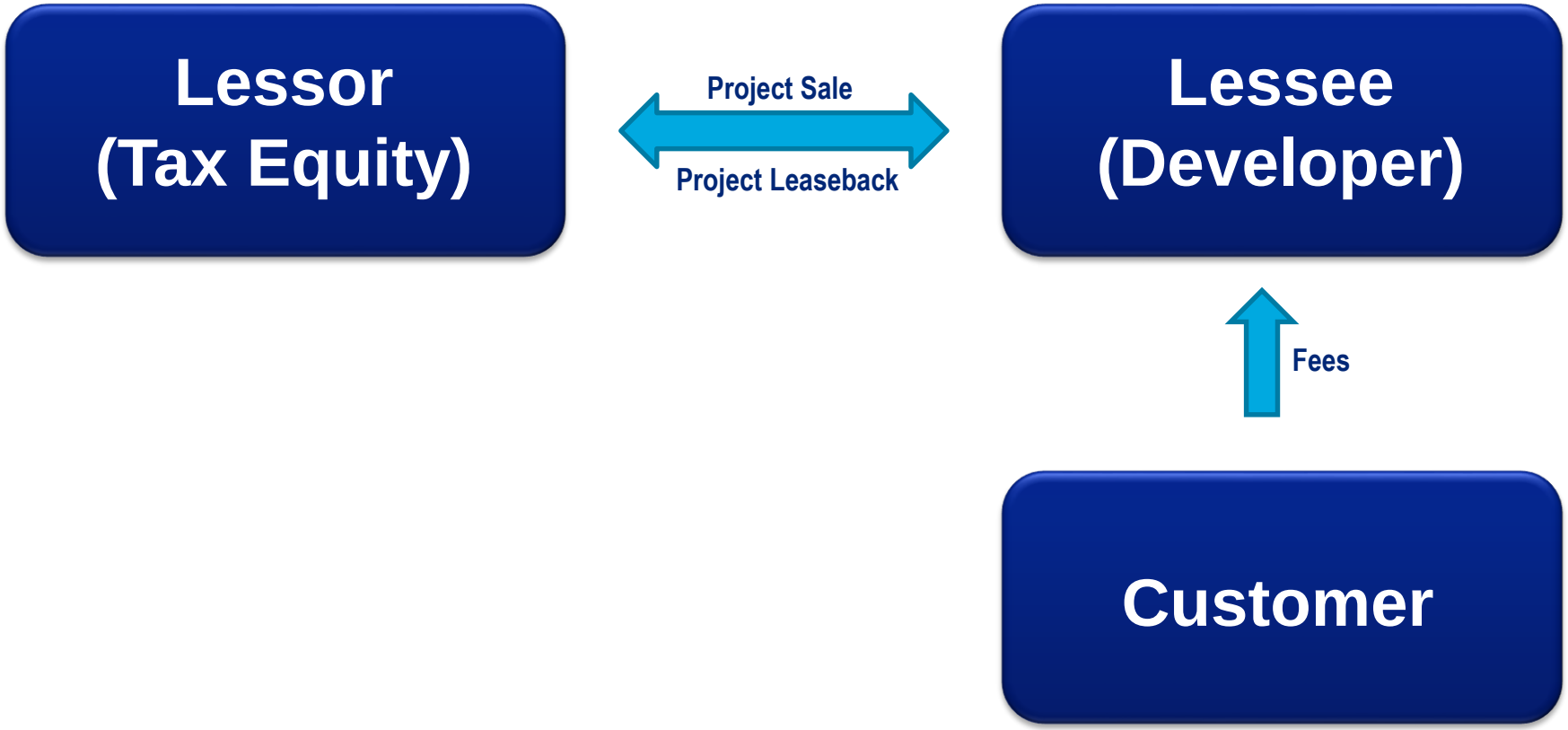
Holland & Knight

Participation Level for Investment

- **Developer/Sponsor**
  - The originators of a project.
  - Gathering of assets, land leases, supply agreements, leverage, engineering, procurement and construction and power purchase agreement.
    - design, build and sell a project – immediate cash return.
    - design, build and own (including partial ownership) – longer term investment.
- **Cash Equity**
  - Project sponsors often retain all or a portion of cash equity.
  - Cash equity investors can also be passive investors interested in project cash flow.
  - Objective is secure ROI on predictable cash returns.
- **Tax Equity**
  - Generally passive investors with ability to absorb tax incentives.
  - Mostly large corporation and banks, but can include funds.
  - Objective is reasonably secure ROI over a specified period driven from tax incentives.

Sale Leaseback



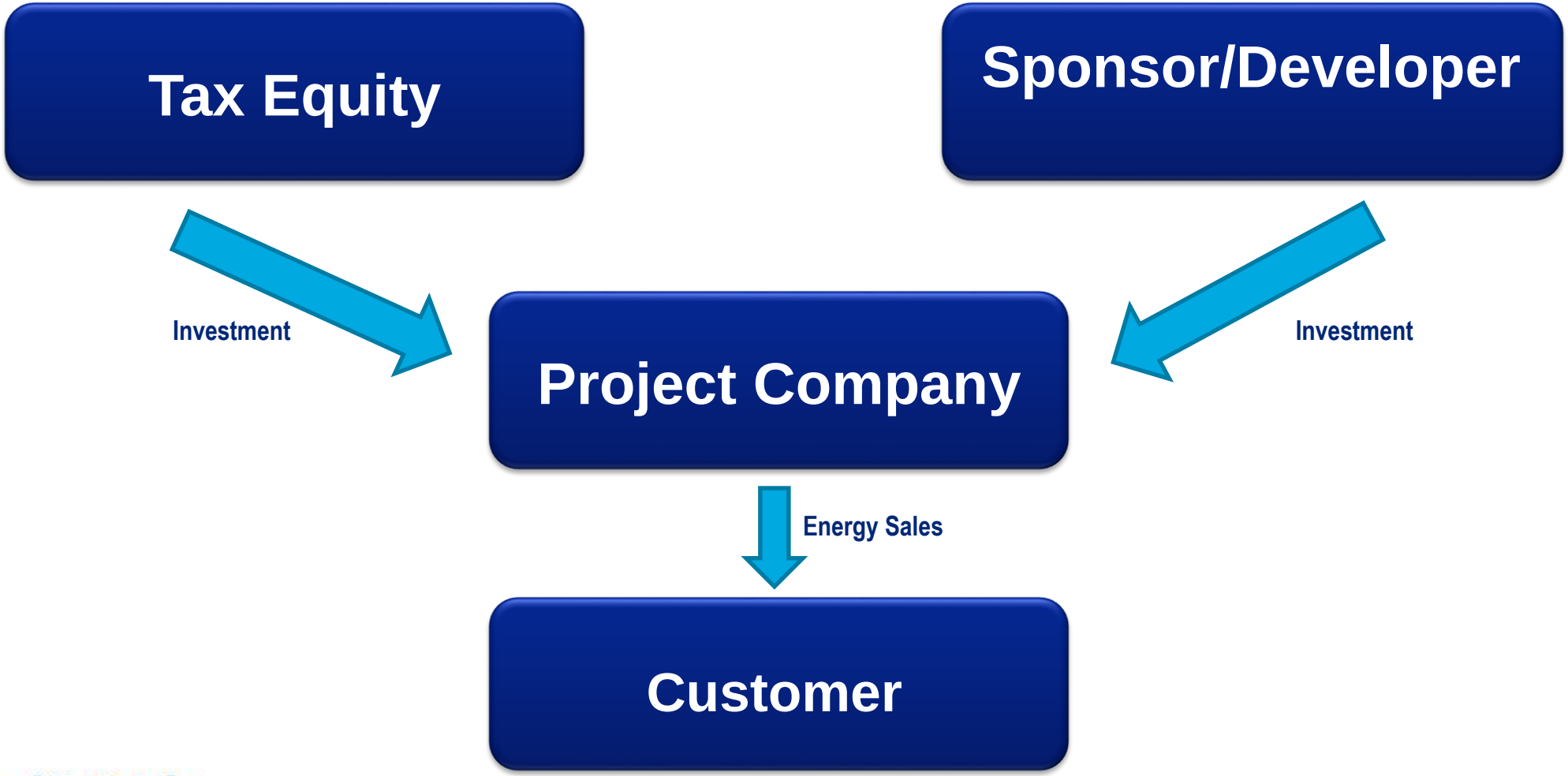
Tax Equity Structures

» **Sale Leaseback**

- Developer originates customers, develops project.
- Tax equity purchases project from developer.
- Tax equity leases project to developer. Developer makes lease payments to tax equity.
- Customer pays fees to developer which are used to pay rent.
- Tax equity uses 100% of tax credits, which are valued based on purchase price paid by tax equity for the project (may be higher than developer's cost).
- Lease must be structured so that FMV at end of lease is at least 20% of initial value.
- Developer can repurchase project at the end of the lease at FMV.

Tax Equity Structures

Partnership Flip



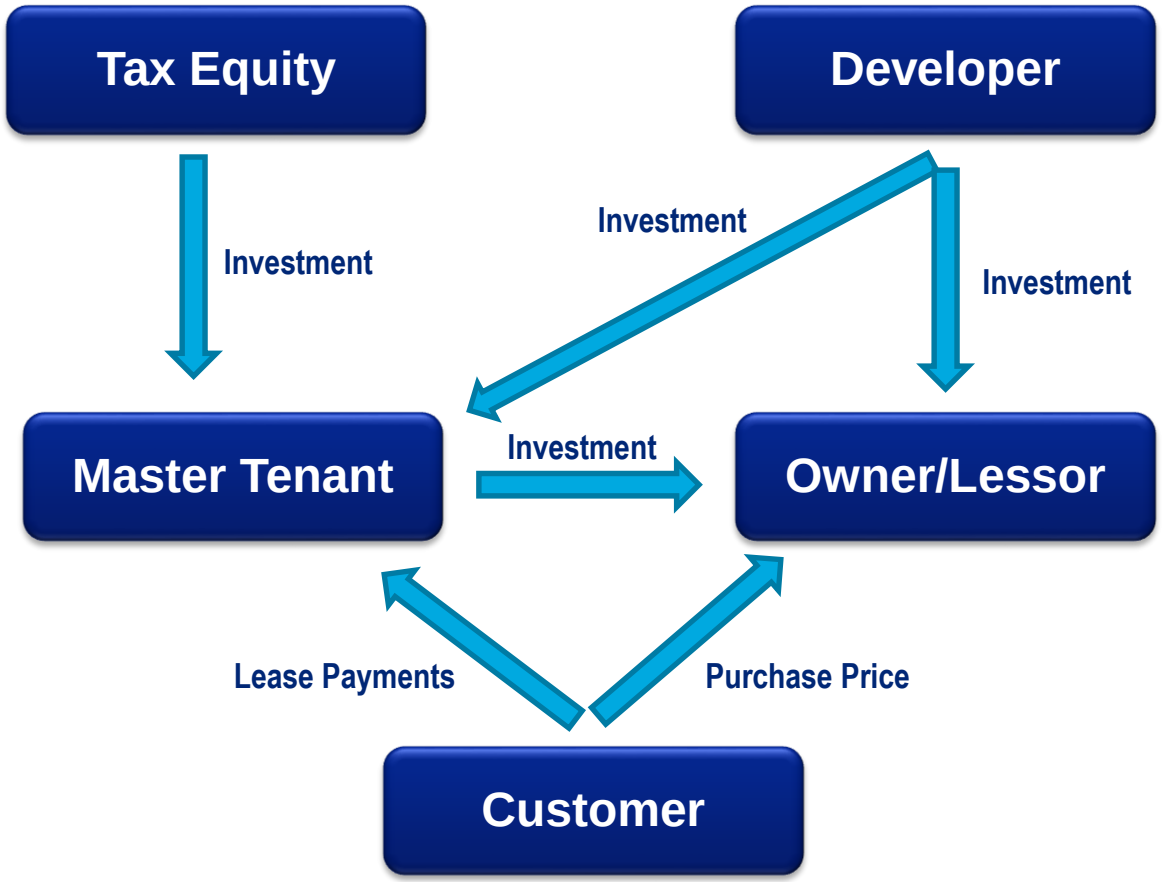
Tax Equity Structures

» **Partnership Flip**

- Developer and tax equity form and capitalize project company. Usually, 40% funded by tax equity and 60% funded by developer.
- Project company builds project or purchases project prior to placed in service date.
- Customer pays for energy.
- Tax credits and net income (loss) flow mostly (usually 99%) to tax equity, plus sufficient cash to meet defined IRR, until flip date.
- After flip date, tax credits are fully utilized, most of net income (loss) flows to developer (usually 95%).
- Less than 100% of tax credits flow to tax equity. If sponsor has no ability to absorb remaining tax credits, the structure can be inefficient.
- Sponsor can purchase tax equity's position after flip date at the greater of FMV and the amount needed to give tax equity its targeted IRR.

Tax Equity Structures

Inverted Lease



Tax Equity Structures

- **Inverted Lease**
  - Tax equity and developer make capital contributions to master tenant, usually 1% for developer and 99% for tax equity.
  - Developer contributes capital to owner/lessor to own 51%.
  - Master tenant makes capital contribution to owner/lessor to own 49%.
  - Owner/lessor leases system to master tenant. Owner/lessor also makes election to pass through to tax credit benefits to master tenant.
  - Master tenant subleases system to customer. Customer pays rent to master tenant, which pass through a portion of rent to owner/lessor.
  - Customer pays owner/lessor after end of lease term.
  - Structure allows developer to take a portion of allowable depreciation.
  - Tax equity receives less than 100% of benefit of tax credits.

Issues for Private Equity

- Tax exempt or foreign ownership – The ability of tax equity partnerships to take advantage of tax credits is impeded if the partnership has ownership that is tax exempt or a non-US taxpayer. If a private equity fund includes foreign or tax-exempt investors, structures may need to be imposed to maximize tax credit use. This may entail a blocker entity, which may not be tax-efficient to the fund.

- Tax equity partnerships must own the underlying project, and tax equity investors must make their related capital contribution, prior to its placed in service date. This may affect the fundraising period of a private equity fund. A private equity fund that makes tax-equity invested usually must be closed to new investors prior to the placed in service date of the underlying project.

Impact of Tax Reform

» Reduction of Corporate Tax Rate

- Recent tax reform left federal tax credit regime unchanged.
- Although tax reform did not change tax credits, the corporate tax rate was reduced from 35% to 21%. This had the effect of reducing the value of tax credits generally.
- To address the anticipated reduction in the corporate tax rate, many transactions that closed in 2017 included a one-time repricing to reset deals to take the reduced tax rate into consideration.
- Experts have stated that tax equity's portion of the capital stack may be reduced from roughly 40%-50% to 35%, but there may be other reasons beyond the tax rate for such a reduction. For example, lower energy rates affect returns and risk, which can reduce the supply of tax equity financing.

Impact of Tax Reform

» Base Erosion Anti-Abuse Tax

- Tax reform included a new base erosion anti-abuse tax (“BEAT”).
- BEAT was designed to address the practice by multinationals of reducing US tax liability by making intercompany payments to foreign affiliates that could be deducted from US taxes. BEAT is structured to assure that multinationals do not, through cross-border intercompany payments, reduce their taxes to less than a certain percentage (10%, 5% for 2018) of their taxable income.
- BEAT applies only to large multinational corporations (3-year average of $500 million of gross receipts and related-party payments totaling 3% or more of total deductions for the year), however some of these include tax equity investors.
- Under BEAT, “taxable income” is broadly calculated to include (a) deductible cross-border payments to affiliates and (b) a certain percentage of tax losses claimed that were carried from another year.

Impact of Tax Reform

» Base Erosion Anti-Abuse Tax

- BEAT calculation: BEAT = X – Y where:

  - X= 10% (11% for banks) * taxable income after including (a) deductible cross-border payments to affiliates and (b) a certain percentage of tax losses claimed that were carried from another year, and

  - Y= the tax liability of the corporation as reduced by all tax credits other than certain favored tax credits (until after 2025).

  - Favored tax credits through 2025 include all R&D credits and 80% of PTC and ITC. Only 20% of ITC and PTC act to reduce “Y” through 2025.

Impact of Tax Reform

- Base Erosion Anti-Abuse Tax
  - BEAT requires a calculation each year. The more that tax liability is reduced by tax credits, the greater the amount of BEAT.
  - BEAT presents a problem for tax equity because it makes it more difficult to predict the value of tax credits in the future. This is less of an issue for ITC, where the entire credit is earned in the year of funding, than it is for PTC, which is earned over a 10-year stream.
  - Early reviews suggest, however, that BEAT may not be as much of a problem as anticipated.
- 100% Bonus Depreciation – tax reform legislation now permits 100% bonus depreciation for projects placed in service after September 17, 2017 and before 2023.
- Full expensing of property acquired after placed in service date.

Marc S. Reisler

Marc S. Reisler is a partner in the Business Section of Holland & Knight's New York office. He focuses primarily on secured and unsecured commercial finance transactions. Mr. Reisler represents commercial banks, investment banks as well as non-bank lenders, such as hedge funds and finance companies. He also represents buyers and sellers in corporate acquisitions.

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Practice

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- Cybersecurity, Data Breach and Privacy
- E-Commerce
- Healthcare Technology, Outsourcing and HITECH
- Technology
- Venture Capital and Emerging Companies
- Banking Law
- Intellectual Property
- Outsourcing and Technology Transactions
- Global Cybersecurity and Privacy Policy and Regulation

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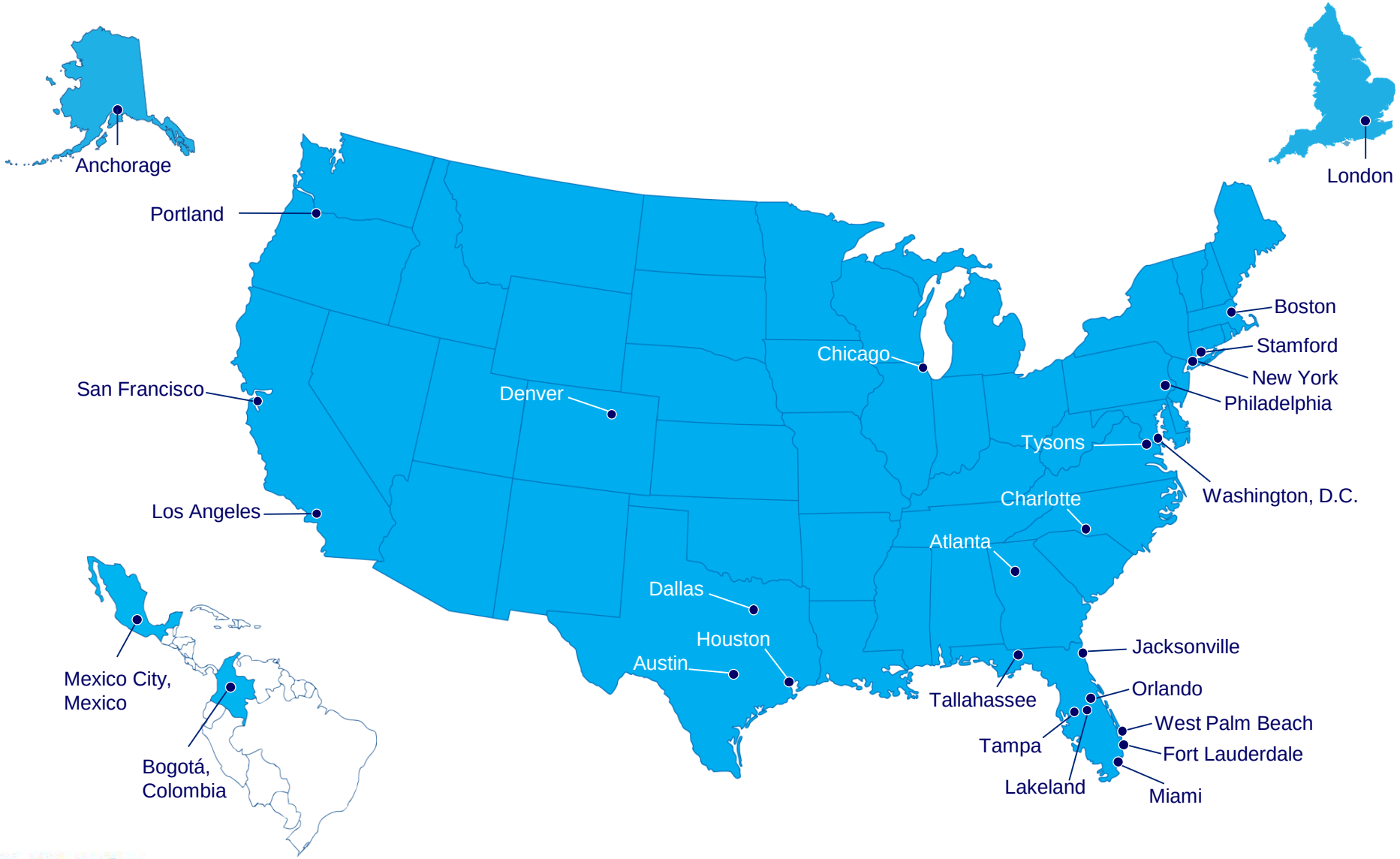

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Questions?

Thank you