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Room For Tax Equity In A Cash-Grant World

Though the cash grants have been popular in stabilizing wind energy projects, tax equity still plays a pivotal role in project finance.

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Last February, Congress attempted to revitalize a struggling renewable energy market by authorizing the U.S. Department of the Treasury to provide cash grants to wind and other renewable energy projects to serve as a new source of capital. After all, most of the institutional investors that were active in mid-2008 had paused their renewable energy activities by early 2009. The cash grant changed all of that, and the program has been wildly successful. Many investors have returned to the market, and several new players have emerged. The program's success is based on the ease with which cash grants can be worked into a project's capital structure.

Prior to the authorization of the cash-grant program, a wind project qualified for tax credits based on the amount of power it produced and sold to an unrelated entity. Tax credits, however, are valuable only to the extent they can be used. A taxpayer can use tax credits only if it has a tax liability.

In addition, individuals and small companies find it difficult to use these credits even when they have tax liabilities due to restrictive tax rules. None of these restrictions applies to the recipient of a cash grant, so there are many planning opportunities available.

Lenders are being asked to "bridge" the cash grant, either during construction or from a project's commercial operation date until the grant arrives. Because project debt is a relatively cheap source of capital, the bridge structure is attractive. Construction lenders will lend against only a portion of a project's cost, so developers want to find other sources of construction-period capital.

The availability of a relatively certain source of capital – the grant – has enabled many lenders to become comfortable with additional project debt. Without the cash grant, the only way to find a larger percentage of debt was to obtain a commitment from an investor to make an equity investment at the time of project completion.

A developer must decide if it makes sense to seek a tax-equity commitment or rely purely on the receipt of a cash grant to obtain a bridge. A tax-equity investment (i.e., when some of the return comes from tax benefits) is similar to term debt, but it is often far more expensive. Bridge-loan sizing will vary depending on the risks the lender identifies. Most risks can be adequately mitigated.

The principal risks with extending credit against the cash grant include the following:

■ **The project fails to qualify for a grant.** A project can qualify for a cash grant if it goes online in 2009 or 2010, or its construction starts in 2009 or 2010 and it goes into service by the end of 2012 (for wind projects). There is a later deadline for other renewable energy technologies. The borrower has to file an application before Oct. 1, 2011, and the project cannot be owned – directly or indirectly – by certain nontaxable entities (except through a taxable C corporation). As we approach the cash-grant construction deadline, the risk of not qualifying becomes more acute.

■ **The grant comes in short of expectations.** The borrower is disqualified from receiving the cash grant prior to its receipt (i.e., either the borrower or one of its direct or indirect owners becomes a tax-exempt entity).

■ **The grant is clawed back after it is received.** The grant can be recaptured within the first five years of operation if the project is taken out of service, if the project is not used to generate power from wind or if an impermissible person takes a direct or indirect ownership interest in the project.

The most difficult risk to guard against fully is an upstream transfer that causes the grant to be recaptured or disallowed. The worst case is when

the borrower makes this transfer before the project receives the grant. Once the cash grant is paid, the government's recapture claim should not extend to the lender. The lender's security interest in the project may well be superior to any claim the government would bring.

Lenders have been sizing the bridge loan at approximately 95% of projected grant proceeds. They have also adopted a number of techniques to assure that their loans will be repaid by the cash grants.

First, most lenders will require the borrower's counsel to issue an opinion that the project will qualify for the grant. Because this opinion is issued before the project is built, it must assume certain future facts, making the conclusions somewhat less certain.

Second, a lender can take a power of attorney from the borrower that enables it to file the grant application on the borrower's behalf.

Third, it can obtain a cost-segregation report based on the construction budget prior to funding (updated before each draw).

Finally, a lender may insist on a sponsor indemnity against actions that could cause the grant to be disallowed or recaptured. The scope of the sponsor's indemnity can range from a promise not to undertake certain acts, such as becoming a disqualified person, all the way to a firm sponsor guarantee that the grant will come in at a certain level.

Tax-equity financings

However, in a world with cash grants, tax-equity investors still play an important role in financing wind projects.

Construction lenders may still bridge to a take-out by tax equity, but the tax equity typically assumes the risk on the cash grant by committing to fund its investment when the project reaches completion.

Tax equity and lenders require most of the same protections with respect to sponsor eligibility and the projected size of the grant. Tax-equity investments in a project that qualifies for the cash grant generally serve two purposes.

First, for many sponsors that cannot otherwise use the tax depreciation from their projects, tax equity typically provides the lowest cost of capital the sponsors can attract to their project. Importantly, if a project receives a cash grant on wind property, the tax rules limit its depreciation to 85% of the cost of the property. Second, involving a tax-equity investor in the transaction can help increase the overall amount of the grant.

Tax-equity investments come in three main forms: A partnership flip, a sale-leaseback or a lease pass-through.

In a partnership flip, an investor usually will purchase an interest in a project company from the developer. The investor will receive 99% of the income and losses and a specified percentage of cash (including the grant), until it reaches its required return. At that point, the investor's share of income, losses and cash will shift down to 5%. The developer has an option to purchase the investor's 5% interest for fair market value. Neither the investor nor the developer can be a tax-exempt entity, unless it invests through a taxable C corporation.

Partnership flips can be structured in a number of ways, and in some structures, the tax rules will treat the sponsor as selling part of the project to the investor. The partnership takes a basis equal to the developer's basis in the portion of the assets it contributes and a basis equal to the fair market value of the assets the investor contributes.

Only the basis of the eligible property determines the grant amount. If the project's value is higher than its cost, this structure may well permit an increase in the basis used to calculate the grant by the amount of gain the developer recognizes on its sale of the partnership interest to the investor.

Although the IRS has not yet formally ruled on the allocation of exempt income, it is generally understood that when the partnership receives the grant, it must allocate tax-exempt income associated with the grant to each partner based on its profit/loss sharing ratio.

This allocation increases the partners' outside basis and capital accounts at no expense, thereby allowing each partner to receive more tax-free cash. If a partner receives a distribution in excess of its outside basis, it will have to report taxable gain. The partnership generally can distribute the proceeds of the cash grant however the partners decide.

In a sale-leaseback, the developer sells the project to an investor for its full value. The developer pays tax on the difference between the purchase price and the project's cost. The investor then leases the project back to the developer. At the end of the lease term, the developer can purchase the project, but only for its full value.

The investor, as lessor, generally can claim the cash grant based on the price it paid for the project. The lessor allocates the fair-market-value purchase price between eligible and ineligible property. The amount allocated to the eligible property is used to determine the grant amount.

In addition, if the developer is a tax-exempt entity or is owned by a tax-exempt entity, then this structure is the only one that permits the developer to continue operating the project and still share in the benefits of the cash grant. However, the use of the project by a tax-exempt lessee will cause the lessor to lose some of the value of the depreciation.

In the lease pass-through structure, the developer leases the project to the investor, and a rule permits the lessee to claim the grant. The lease must be a "true lease" for tax purposes, so the lessee should be sure to take a bona-fide lessee position with some exposure to the project's operating risk and the opportunity to earn a meaningful non-tax return on its investment.

This is the only structure in which a non-owner can claim the grant. The depreciation stays with the lessor. However, because the lessor does not claim the grant, it can claim 100% of the depreciation. The lessee must include half of the grant in its income, mostly over five years.

Perhaps the biggest benefit of this structure is that the lessee can claim the grant based on the project's value. Yet unlike a sale-leaseback, where the developer is taxed on any gain from the sale to the investor, this step-up is tax-free.

A variant of this structure may permit the investor to have an interest in both the lessor and lessee entities and potentially claim some portion of the depreciation benefits, as well as the grant.

For more on project finance-related content, be sure to attend the American Wind Energy Association's (AWEA) WINDPOWER 2010 Conference & Exhibition, which will be held May 23-26 in Dallas. WP

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