

Structuring Construction and Tax Equity Bridge Financings

Strafford Webinar

October 10, 2024

Norton Rose Fulbright
David Burton
Rebecca Abou-Chedid

Tax Rule: Credits Can't be Paid for Before the Start of the Year in which the Credit Accrues

- The tax credit transfer regulations do not allow tax credits to be paid before the start of the tax year in which credit accrues
 - For ITC, that is the start of the tax year in which the project is placed in service
 - For the PTC, for the first year that is the start of the tax year in which the project is placed in service and for the remaining years the first day of each tax year (e.g., January 1 for a calendar year taxpayer)
- Buyer and seller can enter into a forward agreement to transfer tax credits in future years, but buyer cannot prepay
- The IRS does not consider tax credits to be transferred until buyer and seller each file their tax return for the year in question with a tax credit transfer election statement

Commercial Consequences: No Prepayment

- To generate cash from tax credits that cannot be sold yet, sponsors need a *transfer bridge loan* (TReBL)
 - A “naked” TReBL is a bridge loan to be repaid with the proceeds of a tax credit transfer for which there is not a signed tax credit transfer agreement
 - A “contracted” TReBL is secured by a signed tax credit transfer agreement
- What if the tax credit buyer is not investment grade
 - Many banks will view that as naked
 - There is an insurance product available that back-stops the transfer payment obligation (or the tax equity contribution obligation) of tax credit buyers (or tax equity investors) that are not investment grade

Lender Considerations for Transfer Bridge Loans

- TReBL underwriting standards for naked tax credit transfers
 - Lenders will consider several factors in sizing the TReBL:
 - Is the Project eligible for ITC adders? Can the adders be subjectively confirmed by the Lender?
 - Is the Lender willing to size the TReBL assuming that there will be a “step up” in the tax basis?
 - Lenders will often disburse a naked TReBL at a reduced advance rate and will require additional upfront equity or other credit support until a milestone date where they will require a contracted tax credit transfer agreement

Lender Considerations for Transfer Bridge Loans

- TReBL underwriting standards for “contracted” tax credit transfers
 - Larger financial institutions will only underwrite loans to an investment grade tax credit buyer (or an entity that is guaranteed by an investment grade parent or can otherwise provide credit support, such as a letter of credit or insurance)
 - Some Lenders may be willing to lend to a project with a sub-investment grade buyer but may charge higher interest rates or require credit support from the Sponsor
 - If the tax credit buyer is an “aggregator” (an entity which pools tax credit buyers and tax equity investors who individually have smaller tax appetites), lenders will often want to know the identity of the ultimate buyers and require a guarantee or funding assurance letter from them

Tax Rule: Tax Credit Buyer Suffers Recapture, Unless a Partnership Interest is Transferred

- Despite the efforts of the renewable energy industry, Treasury decided that the buyer of investment tax credits (ITC) should generally be at risk of suffering “recapture”
 - Even though the buyer owns no equity in the project and has no control over the project
- The one exception is that if the tax credit seller is a partnership and what is sold is a partnership interest
 - Then the seller of the partnership interest suffers the recapture
 - There is no recapture at all if the seller of the partnership transfers less than 1/3 of its original partnership interest (including multiple transfers and changes in the profit allocation percentage)

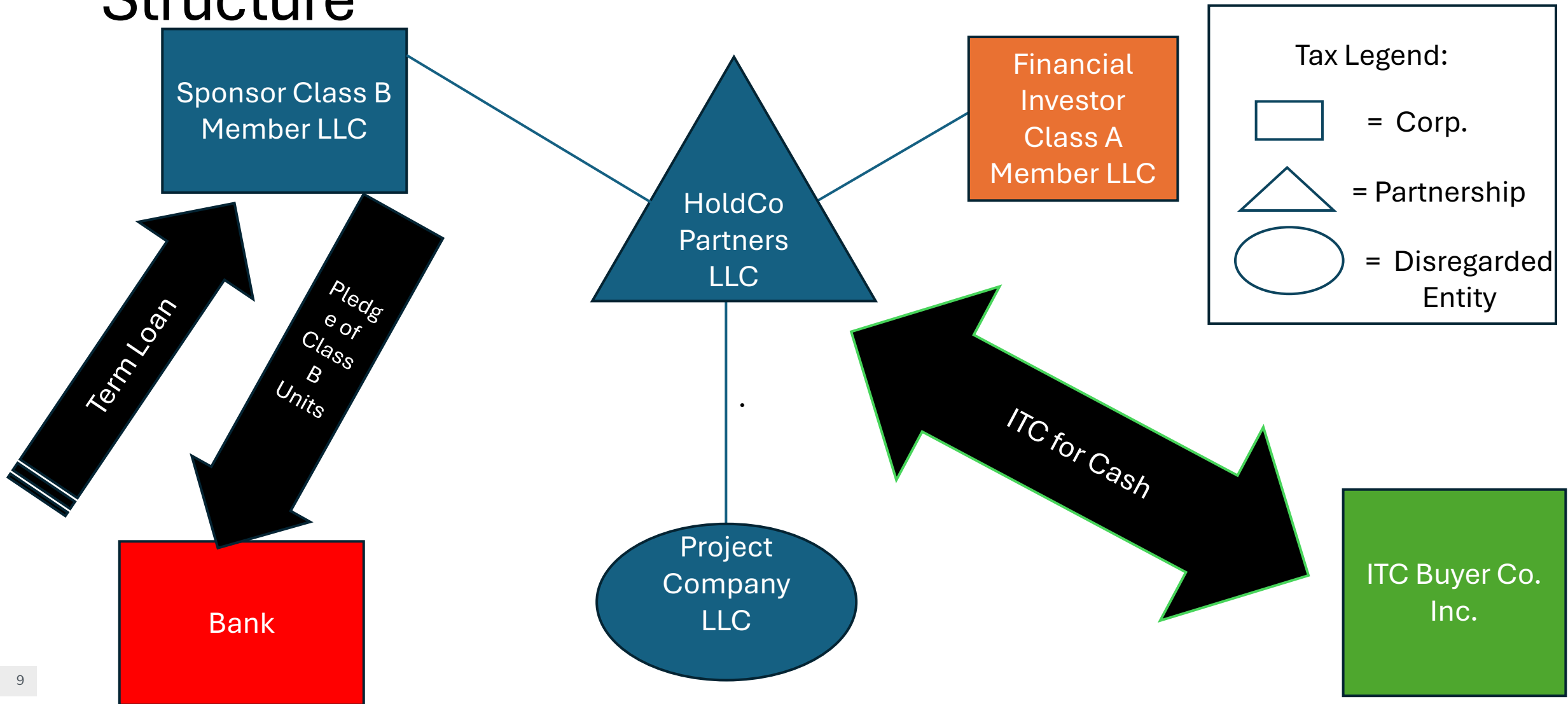
Commercial Consequences: Partnership Recapture Rule

- Many sponsors of ITC projects need term debt and to sell the ITC
- A creditor's foreclosure on the physical project or the equity in a single member limited liability company (LLC) that owns the project results in recapture
 - The ITC buyer suffers that recapture
- Tax credit buyers and insurers of tax credit buyers often require a forbearance agreement (or an interparty agreement) that prevents the lender from foreclosing on the project company or project during the five-year recapture period (plus a cushion in some instances)

Commercial Consequences: Partnership Recapture Rule

- A lender often requires collateral it can foreclose on during the recapture period
- A lender can foreclose on a partnership interest without triggering recapture for the ITC buyer
 - The former owner of the partnership interest does suffer recapture

Commercial Consequences: Partnership Recapture Rule - Investor Member Partnership Structure



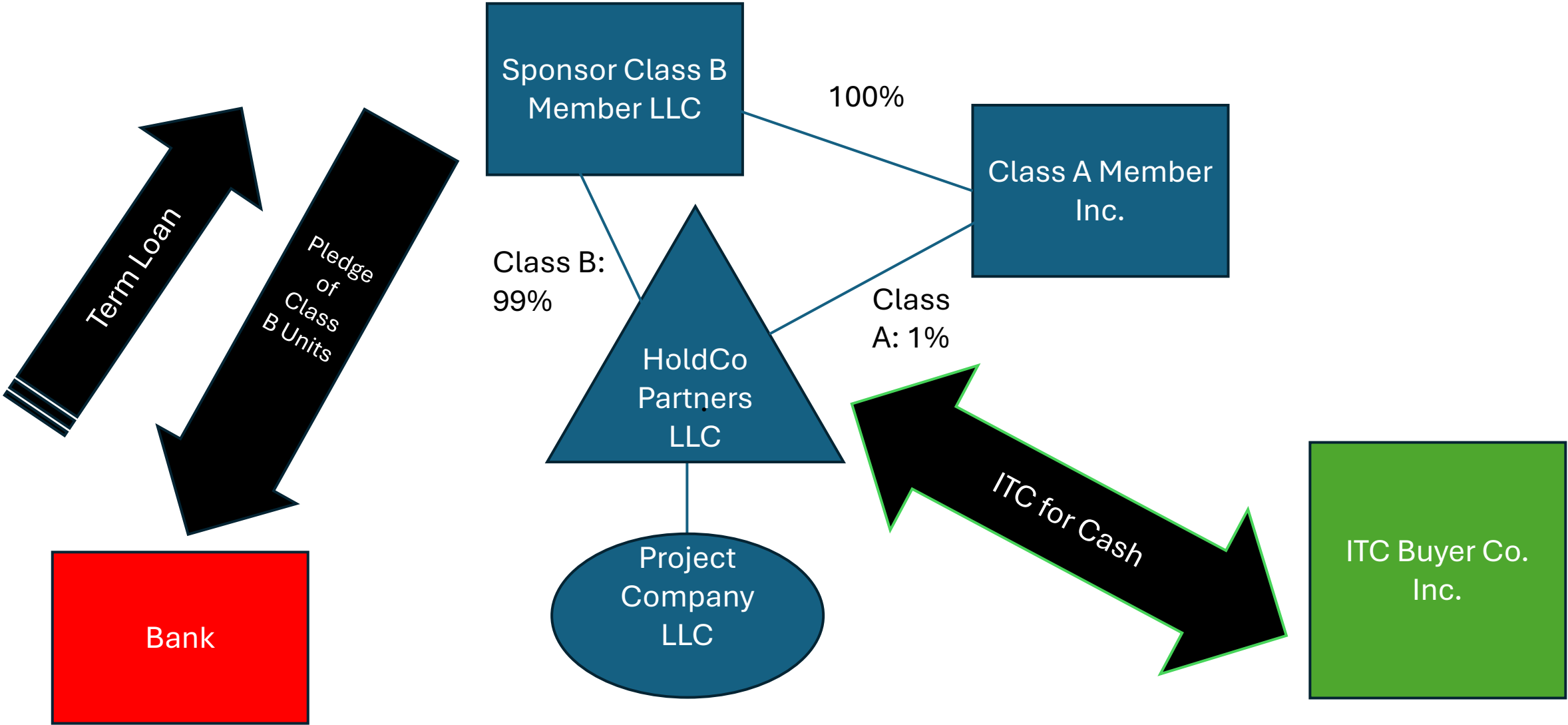
Commercial Consequences: Partnership Recapture Rule

- But what if there is no investor member?
- Sponsors may form “internal” partnerships to allow foreclosure on a partnership interest without triggering recapture for the ITC buyer
- These internal partnerships come in two flavors 99/1 and 94/5/1

Commercial Consequences: Partnership Recapture Rule – 99/1 Structure

- The partnership is straight-up: the cash distribution ratio and the allocation of profits and losses (tax allocation) ratio are each 99/1
- A 1% partnership interest held by a c-corporation
 - The c-corporation is wholly-owned by the sponsor
- The sponsor owns a 99% interest
 - The 99% interest is pledged to the lender, and the lender can foreclose on it before the end of the recapture period
 - If the lender foreclosed on the 99% interest the sponsor suffers ITC recapture

Commercial Consequences: Partnership Recapture Rule -99/1

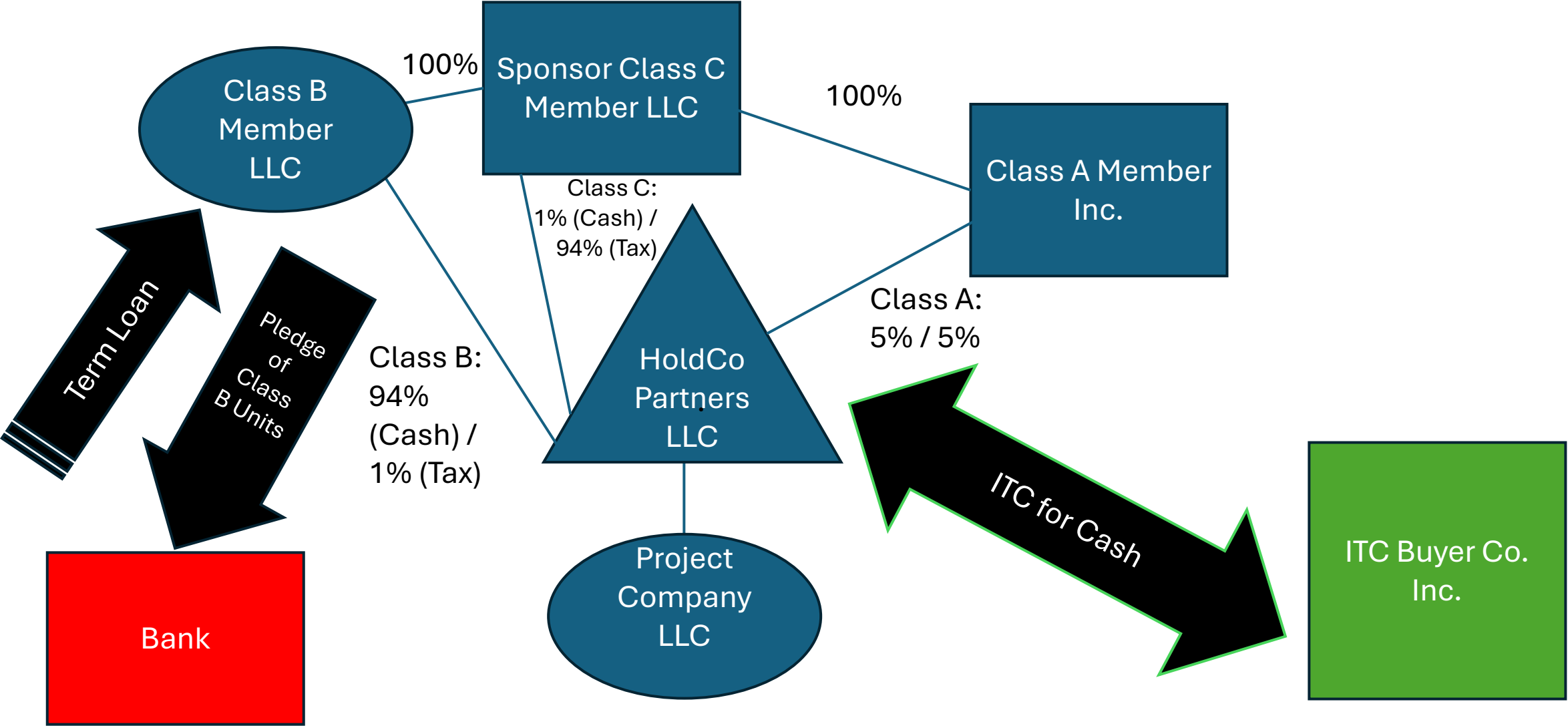


Commercial Consequences: Partnership Recapture Rule – 94/5/1 (aka 98/1/1)

Member Interest	Tax Allocation %	Cash Distribution %	Owned By	Pledged to Lender
Class A	5%	5%	C-Corp (that is owned by Sponsor)	No
Class B	1%	94%	Disregarded LLC (that is owned by Sponsor)	No
Class C	94%	1%	Sponsor	Yes

- There are no guidelines on how to structure these partnership interests. Different transactions use different percentages (e.g., 98/1/1)
- Lender can foreclose and get 94% of the cash distributions
- **Foreclosure on Class C** does **not** trigger recapture for Sponsor (or anyone else) because Sponsor's profits allocation goes from 95% (1% + 94%) to 94% (i.e., it declines by less than 1/3)
- What's the point of Class? Class A is necessary to make HoldCo have two "regarded" partners (Sponsor & C-Corp) as is necessary to be recognized as a partnership

Commercial Consequences: Partnership Recapture Rule -94/5/1



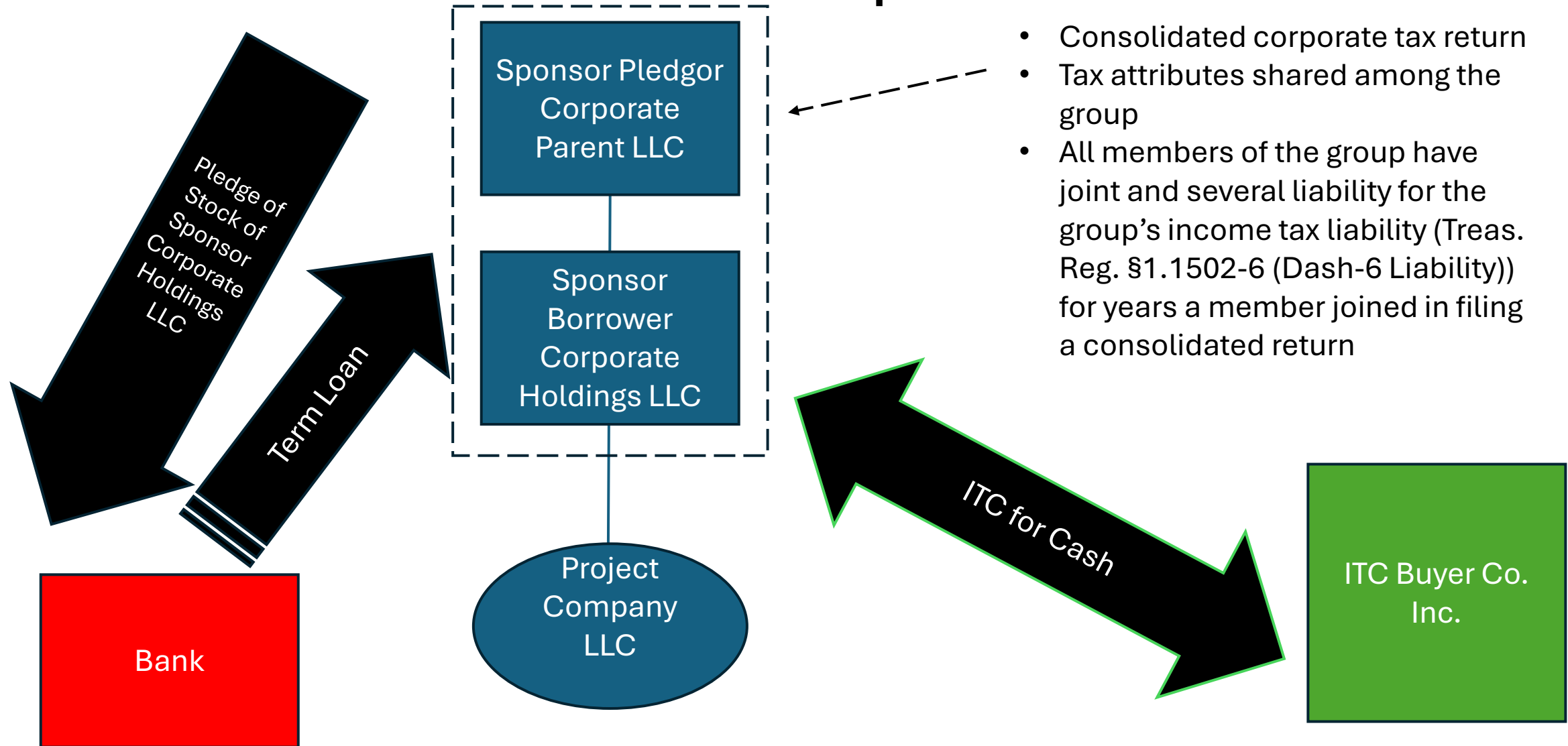
Tax Rule: No Recapture from a Transfer of C-Corp Stock

- There is no recapture when C-corp stock is sold, even if all of the stock of the C-corp is sold
- An LLC can be taxed as a C-corp by making a corporate election on IRS Form 8832
 - If use an actual “Inc.,” then IRS Form 8832 is not needed
 - LLCs have more flexible governance rules under state law than C-corps, so they often preferred by general counsels

Commercial Consequences: No Recapture from a Transfer of C-Corp Stock

- C-corp stock can be pledged to a lender
- Lender can foreclose on the stock during the recapture period
- Lender can take over economic ownership of 100% of the project without recapture being triggered

Commercial Consequences: No Recapture from Foreclosure on C-Corp Stock



Commercial Consequences: Post Foreclosure Structure



- Bank can sell the stock of Sponsor Borrower Corporate Holdings LLC without recapture
- Bank's Buyer would not get a step-up in the tax basis of the project for its purchase price (i.e., step in the shoes depreciation)
 - Bank's Buyer's purchase price would be "hung up" in the outside basis of the stock of Sponsor Borrower Corporate Holdings LLC
- The IRS could be a creditor of Sponsor Borrower Corporate Holdings LLC due to *Dash 6 Liability* for years it joined in filing a consolidated tax return

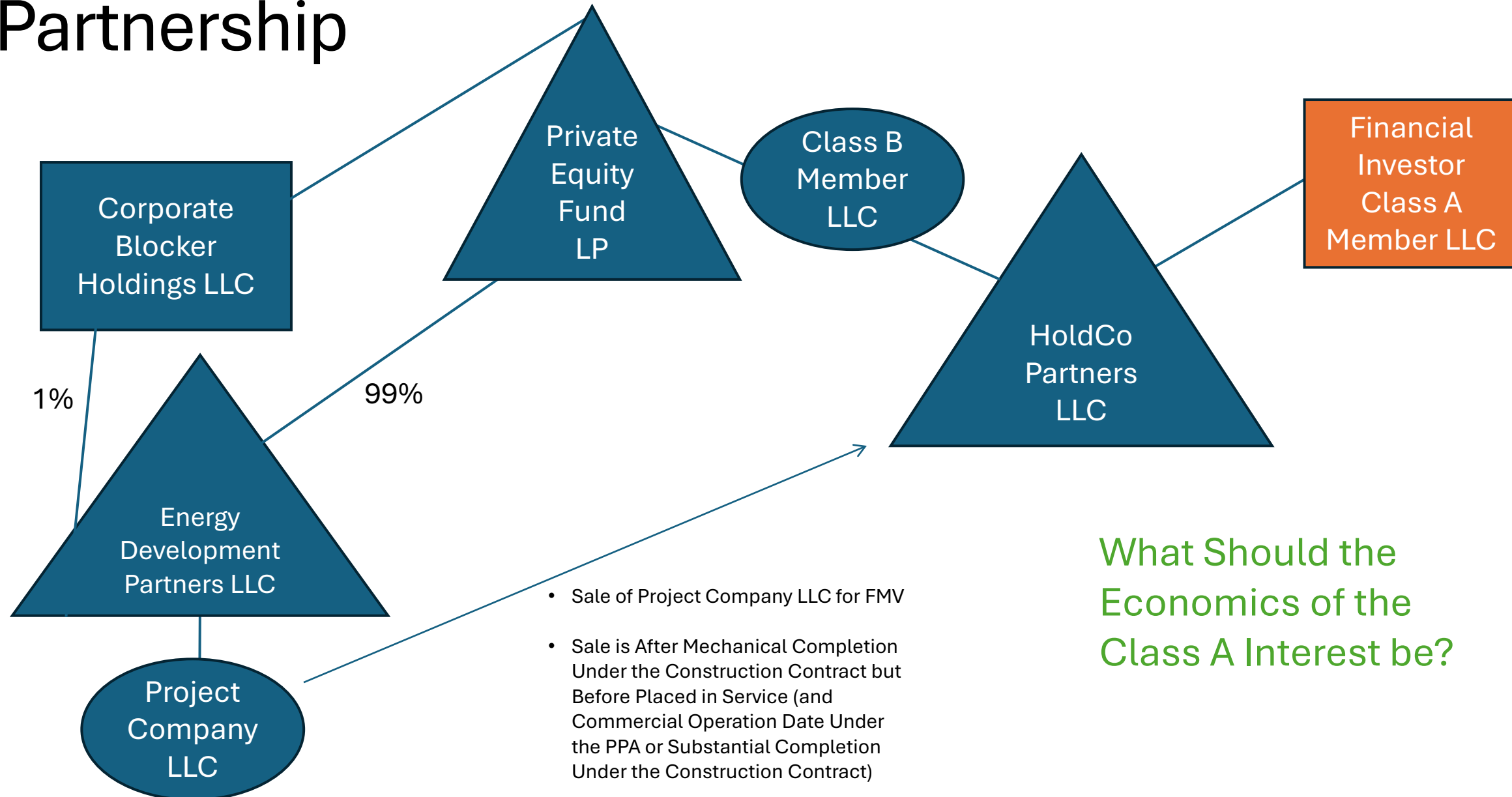
Tax Rule: Lease Pass-Through Election Can't be Used with an ITC Transfer

- The IRA was silent on lease pass-through elections (aka inverted leases) that allow the ITC to be calculated on FMV, rather than tax basis
- Despite this silence, the tax credit transfer regulations provide that ITC resulting from a lease pass-through election cannot be transferred
 - Treasury's view is that the lease pass-through election is already a transfer of the ITC, so the ITC cannot be transferred again to a tax credit buyer
- For ITC projects for which a tax credit transfer is planned, this rule takes away one of the tools tax advisors use to have ITC calculated FMV (as opposed to basis from out-of-pocket costs)

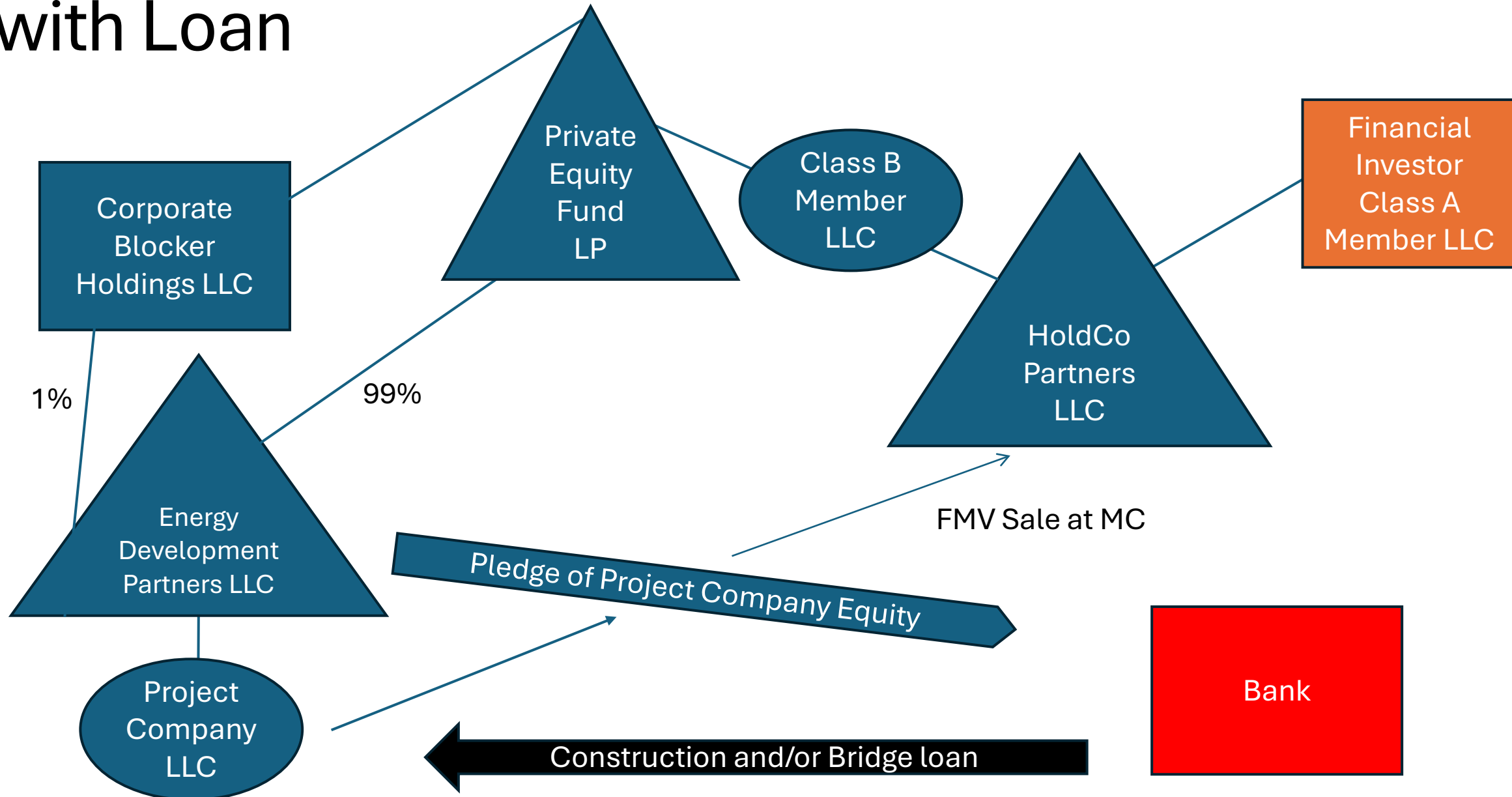
Commercial Consequences: Sale to Partnership to Step-Up Basis from Cost to FMV

- Treasury does not allow a lease pass-through election to be combined with an ITC transfer
- The Federal Circuit restricted developer fees paid to an affiliate to step-up ITC basis the [*California Ridge Wind Energy, LLC*](#)
 - Developer fee must be FMV for the services actually provided
 - Developer Services Agreement must be signed before services are provided
- FMV sale is an alternative
- But what if there is not a tax equity investor to form a partnership to sell the project to?
 - A partnership creates a different taxpayer (i.e., a taxpayer can't sell to itself or a consolidated group member and achieve a basis step-up)
- Financial investors without tax appetite are offering to play the role of the minority partner in partnerships that will buy projects for FMV and sell the ITC

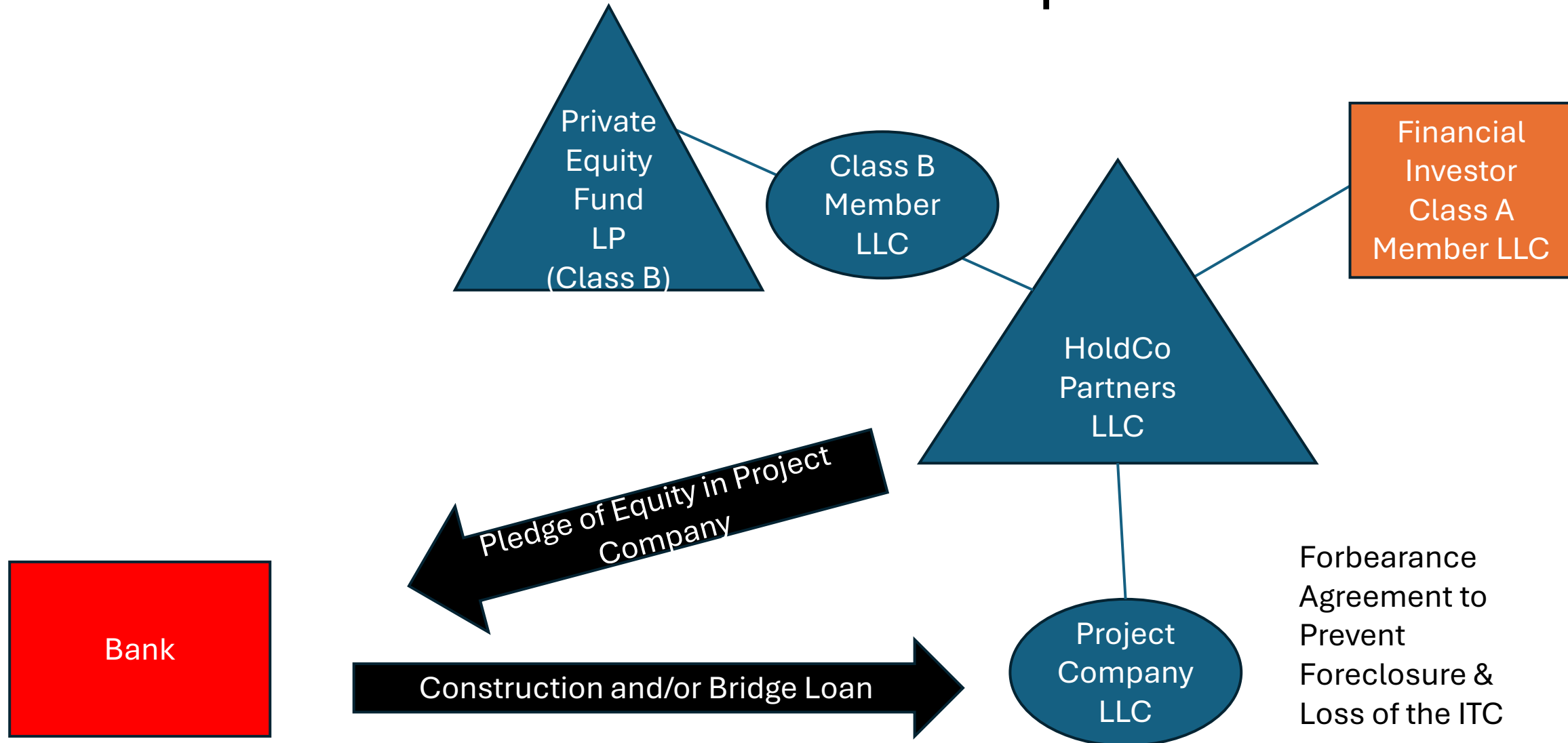
Commercial Consequences: FMV Sale to a Partnership



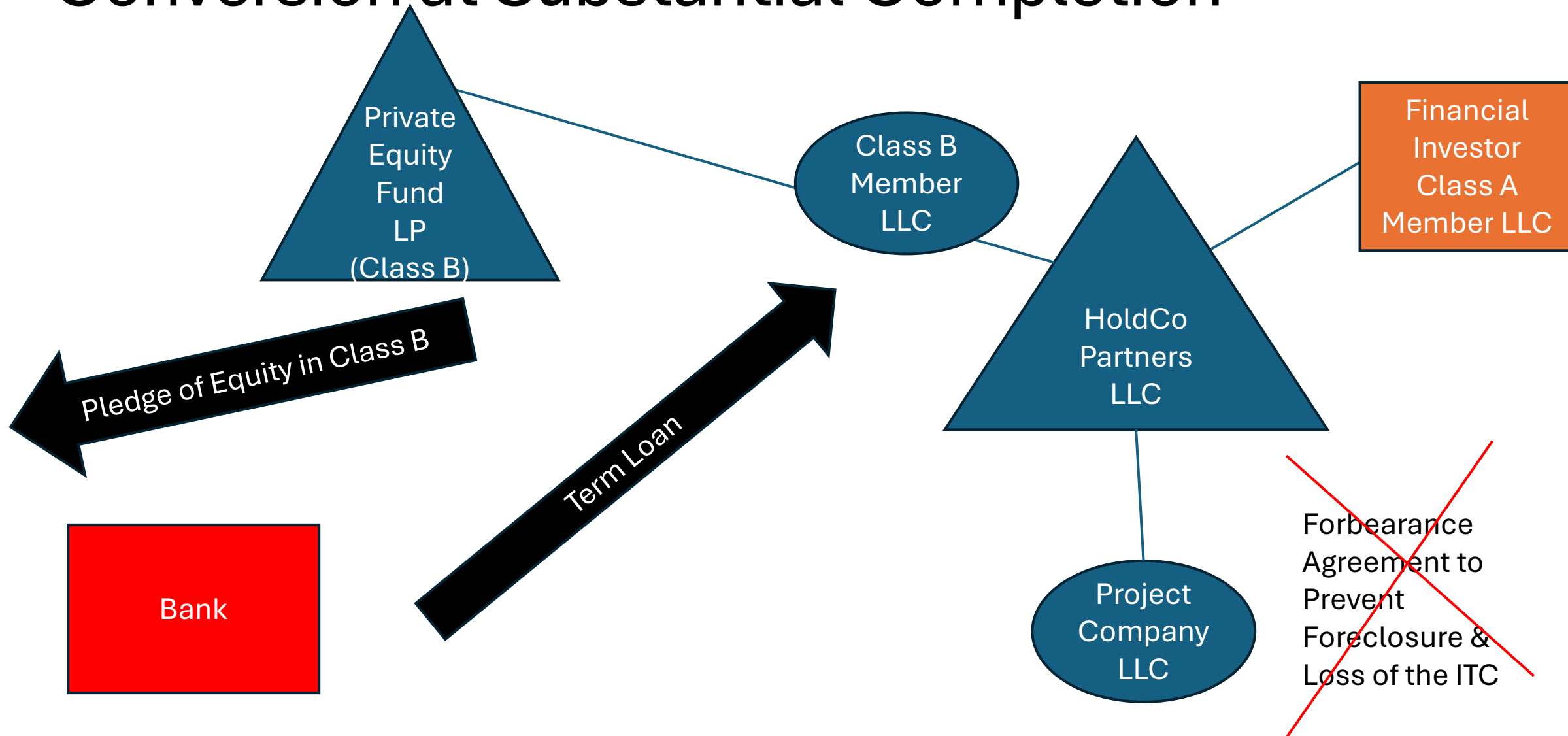
Commercial Consequences: FMV Sale at MC with Loan



Commercial Consequences: Loan Between MC & Term Conversion at Substantial Completion



Commercial Consequences: Term Conversion at Substantial Completion



Commercial Consequences: Respecting the Partnership that Buys the Project

- To ensure the FMV sale to the partnership is respected (and the resulting increase in the ITC), you want to be confident the partnership will be respected as such
 - For the partnership to be respected, the Class A Member must be respected as a partner
 - In theory, the Class A Member should be respected, even if it has a 1 basis point capital interest and a 1 basis point profits interests
 - However, few taxpayers want to push the envelope to that point
 - There is no specific guidance from the IRS on how to structure such a partnership
 - Reasonable minds can (and do differ) over what the appropriate economic parameters are

Commercial Consequences: Class A Economic Parameters

- There seems to be market consensus on the following points:
 - Class A should contribute at least 20% of the FMV of the project
 - Class A's interest should always be at least 5% of distributable cash (or a preferred distribution equivalent to at least that) and 5% of profit/loss
- But there are many other parameters:
 - Is there a minimum amount of unrecovered investment Class A should have after it receives the distribution of its share of tax credit sale proceeds (e.g., 10% of the FMV of the project)?
 - Should Class A have a right to preferred distributions (e.g., 2% of its initial investment a year)? Alternatively, can Class A benefit from a cash sweep if its distributions fall below a threshold?
 - Should Class A's right to cash distributions decrease after it achieves a flip rate? What about with the mere passage of time?
 - Should Class A have the right to "put" its interest to Class B?
 - Should that put right be at a fixed price?
 - Should Class B have a call option to purchase Class A's interest?
 - Should that call option be at fixed price?

Answers to these questions are subjective and structuring practices in the market vary