Houlihan Lokey

New Energy Transition Credits May Provide Investment Opportunities for ESG-Focused Investors Looking to Reduce Taxes

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Houlihan Lokey is pleased to present its tax insights on the Inflation Reduction Act of 2022 (the “IRA” or the “Act”), available here. This insight is the second in a series from Houlihan Lokey’s M&A Tax team diving into areas of the IRA that may impact clients. See the first insight here.

Introduction

On August 16, 2022, President Biden signed into law the IRA, which, according to Congressional Budget Office estimates, features $370 billion in clean energy incentives for developers and investors in energy transition projects over the next 10 years. A recent Credit Suisse report estimates that total clean-energy-related government spending could top $800 billion. Together, these initiatives represent the single largest climate finance investment in U.S. history.

Arguably, the most notable provision in the Act is the enhanced credit monetization alternatives to traditional tax equity financing structures. For decades, renewable energy projects in the U.S. have benefitted from significant federal tax incentives—in the form of both tax credits as well as accelerated depreciation on most of the equipment used in renewables projects. In a typical case, these benefits may constitute more than half of the total value realized on a renewables investment. The tax incentives (and the overall speed of growth in the green energy market) were historically limited by the fact that would-be project developers themselves rarely have the proper tax profile to utilize them. In addition, energy tax credits have historically been nonsalable and nonrefundable. Considering these constraints, advisors developed various complex “tax equity” financing structures to monetize these valuable tax attributes for use by tax investors.

While the Act continues to constrain credit refundability via its limited “direct pay” mechanism, which is available in many cases only to certain tax advantaged parties and/or with respect to a reduced subset of eligible credits, the monetization of energy tax credits via the Act’s one-time credit transferability regime is already giving form to a new market for ESG-concerned investment in the renewable energy and energy storage sectors.

This article describes the existing tax equity market very generally, highlighting its purpose mechanics and its drawbacks; details the third-party sale provision in the IRA; and concludes with a forward-looking glimpse of a market-based system for green impact investment.

Traditional Tax Equity Financing

Pre-IRA, the ineligibility of anyone besides an economic owner (or, under special rules, a lessee) of the project to claim tax credits and other tax benefits caused a major structural limitation on existing energy transition subsidies. Because the developers of these projects are rarely able to utilize the generated tax benefits themselves, monetizing these benefits is a core financing strategy underpinning most renewables projects. Typically, renewables developers enter transactions with passive equity investors (i.e., tax equity investors) to whom the benefits are effectively bartered in return for capital to finance the project.

Tax equity investors are typically profitable, taxpaying entities—such as banks and large corporations—with predictable tax liabilities. For a tax equity investor to have a requisite ownership interest in the project assets, these transactions occur within a partnership or other contractual agreement. The tax equity investors may then use the tax incentives and depreciation deductions to generate a return through the reduction of tax on their other income. Tax equity investors generally desire to be bought out of the investment after the desired yield is achieved—usually after 5–10 years.

While traditional tax equity structures have erstwhile been necessary to effectively monetize the tax benefits of renewable investments, they also have significant drawbacks. Primary drawbacks of tax equity investing are its inherent complexity, high cost to entry, and higher cost of capital. Within structured tax equity partnerships, the tax equity investor is a true joint venture partner and takes on more operational risk than a would-be lender. Because of the heightened risk, underwriting standards are necessarily high, and tax equity investors tend to assume a portion of the oversight and credit-qualification compliance monitoring. Additionally, tax equity investors often insist on structural subordination of debt and forbearance and these structures often require back-levered debt at the developer/sponsor level rather than project-level debt. This results in an increased cost of borrowing.

The various constraints to tax equity financing have resulted in a significant gap between market capital and carbon emissions goals and available project financing. Renewable energy tax equity was a $17 billion–$18 billion market in 2020 and was expected to top $20 billion in 2021. And yet, according to BloombergNEF, a clean energy research group, of the 57 gigawatts of wind and solar projects slated to begin construction in 2020–2021, more than 36 gigawatts struggled or were delayed in finding tax equity investment. One reason for this gap between viable projects and available financing is that the tax equity market is 80% composed of its top five investors. From 2020 to 2021, more than half of tax equity investments came from either JP Morgan or Bank of America. The reason for this lack of investor diversity is in large part due to the lack of institutional capacity of most would-be investors to navigate and manage the complexity of these structures, including the buyside diligence and ongoing oversight and compliance monitoring. The high nonlinear soft costs associated with entry into this market tends to require larger, utility-scale projects utilizing “proven” technology. The technical constraints of traditional partnership-based tax equity investing also often lead to undesirable collateral results and uncertainty.

Transferability of Energy Credits Under the IRA

The IRA enacted the new Section 6418, which generally allows an eligible taxpayer to elect to transfer all or any part of certain tax credits to an unrelated taxpayer in exchange for cash payment. An eligible taxpayer includes any taxpayer other than a tax-exempt organization and certain governmental or quasi-governmental entities (which may utilize the alternative “direct pay” mechanism). The transaction would result in neither taxable income to seller nor deductible expense to buyer. Following the transfer, the transferee investor is treated as the taxpayer for purposes of claiming the credit. Additional transfers are not permitted.

Credits that are available to be transferred include, among others:

- Extended and expanded traditional renewable energy credits such as the Section 45 production tax credit (PTC) and the Section 48 investment tax credit (ITC) for projects that begin construction before 2025;

- "Technology neutral" successor credits to the PTC and ITC for projects that begin construction after 2024 (Sections 45Y and 48E, respectively);
- The carbon capture credit under Section 45Q for equipment placed in service after 2022;
- The zero-emission nuclear power production credit under Section 45U;
- The clean hydrogen production credit under Section 45V; and
- The qualifying advanced energy project credit under Section 48C.

Eligible credits do not include credits that have been carried back or forward. Transferees may carry back eligible credits for up to three years provided the credit arose in a tax year after 2023 and the transferee is willing to file an amended return.

With respect to production-based tax credits, the election to sell credits would be made annually with respect to each facility. If the project is held by a partnership or S corporation, the election would be made at the entity level. The buyer would take the purchased credits into account the first taxable year ending with, or after, the taxable year of the transferor. A 20% excessive payments penalty may apply if it is determined that the amount of payment related to the transfer was excessive, unless the taxpayer can show reasonable cause for claiming the excessive payment.

Toward a Market-Based System

The onset of credit salability is expected to facilitate simplified transactions and provide more flexibility and optionality for both project developers and tax investors. By lowering the cost and removing certain institutional barriers to entry into the renewables market, new categories of ESG-conscious investors may enter this space. Increased capital from investors with more diverse tax and risk appetites at a lower overall cost of capital should in turn expand developers' access to available financing, broadening the range of viable investments (including in more novel technology) and accelerating the green energy transition. A more developed market would standardize diligence processes, valuation mechanisms, and contractual risk allocation (e.g., via guarantees, indemnities, and insurance).

Traditional partnership-based tax equity investing will likely remain a feature of the green energy landscape, especially in the ITC space for those who are willing to tolerate more complexity and ownership risk in exchange for the accelerated depreciation benefit and/or other noncredit attributes. These structures may even evolve and give way to new structures.

Transferability will also come with its own associated risks (including uncertainty around recapture and heightened qualification risk)—and the one-time transfer restriction may inhibit market liquidity and pricing efficiency.

There remain numerous technical questions. Promised IRS guidance should help. On October 5, the Service issued Notice 2022-50, requesting that comments on the credit transfer mechanisms be submitted by early November.

Conclusion

The historical limitations on developers' ability to fully absorb the tax benefits of government subsidies and the complex structures that arose in response to them limited the diversity of transaction counterparties, hindered development of new technology investment, and created a widening gap between available financing and broader market goals. The energy transition provisions in the IRA, and particularly the one-time credit transferability provision, may provide a spark to ignite this burgeoning market.

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