TAX CREDITS TRENDS

Transferable Inflation Reduction Act (IRA) Tax Credits: Considerations for Tax Credit Bridge Lenders

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Enacted in 2022, the Inflation Reduction Act (IRA) allows the transfer of certain tax credits, enabling unrelated parties to purchase them for cash. Lenders who want to use tax credits to secure loans should consider tax credit insurance and consult legal, tax, and insurance professionals to navigate new financing structures.

Enacted in 2022, the Inflation Reduction Act (IRA) allows the transfer of certain tax credits outside of traditional tax equity partnership structures. This enables unrelated parties to purchase tax credits for cash, without the need for complex equity arrangements. It also changes the manner in which lenders may secure tax credit bridge loans. This article sets forth certain factors potential lenders should consider when contemplating tax credit secured financing in the IRA era.

Impact of the Transferability on Tax Credit Bridge Loans

Traditional tax credit financing involves tax equity facilities in the form of (i) partnership flips, (ii) inverted leases, or (iii) sale-leasebacks. It generally requires investors with substantial tax liabilities who are willing to assume the certain obligations associated with ownership in the underlying project in exchange for the tax credits. Under this construct a lender providing a loan that is sized to consider the value of the tax credits (known as a "tax equity bridge loan" or "tax credit bridge loan") generally necessitated a firm tax equity commitment that could be enforced directly by the lenders following a foreclosure. Without that, the lenders could not have confidence there would be a means to monetize the tax credits, and the loan could effectively be undercollateralized.

The IRA introduced new Section 6418 of the Internal Revenue Code, which allows taxpayers owning eligible projects the right to sell certain investment tax credits (ITCs), production tax credits (PTCs), or several other credits which may be available to them on the open market to unrelated entities. In doing so, it provides an alternative platform to tax equity financing which enables lenders to extend tax credit bridge loans without the need for a tax equity commitment. Instead, lenders can underwrite to a forward purchase commitment from a creditworthy buyer of the tax credits. Further, some lenders have grown comfortable underwriting to no tax credit monetization commitment at all, relying instead on the fact that transferability has opened the market up to a sufficiently broad pool of potential taxpayers that there will always be someone willing to purchase the credits. Note, however, that a higher coverage ratio is typically associated with these so-called "merchant" tax credit bridge financings.

Tax credit transfers, however, are subject to strict procedural limitations. First, any purchases of tax credits are required to be made entirely in cash. Second, while ITCs can be claimed in full at the completion of a project, they are subject to recapture for a disposition, change in ownership, change in use, or withdrawal of all or part of the project from service (including in the event of a casualty) within the first five years after a project is placed in service, with the potential recapture amount decreasing by 20% of the credit each year of the recapture period. Third, potential buyers are

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prohibited from paying for tax credits earlier than the first day of the taxable year in which the tax credits accrue. Finally, tax credits can only be transferred once.

The strict procedural and timing requirements limit project companies' ability to sell tax credits for cash needed to fund for project costs. Practically speaking, the recapture rules for ITC and the single-transfer rule applicable to all IRA credits limit a lender's ability to directly secure loans with a pledge or collateral assignment of the tax credits themselves. However, tax credit transfers may create bridge financing opportunities for interested lenders who can secure loans with a pledge or collateral assignment of a PTC-generating project, an interest in an entity that owns (directly or indirectly) a tax credit-generating project, or a bank account into which the buyer of a tax credit is directed to deposit proceeds from a negotiated tax credit transfer. Nevertheless, due to the novelty of such financing structures, there are potential risks and uncertainties that lenders should carefully consider, as further discussed below.

Risk Factors

New tax credit monetization strategies require an updated approach to collateral packages. Lenders must evaluate the creditworthiness of both the project and the buyer. For ITCs, the possibility of recapture must be managed, which means that the lender typically cannot foreclose on the project itself or on the membership interests of the project company, though could in some circumstances have a security interest in the stock of a corporation or certain interests in a partnership that owns a project. In some cases, blockers may be strategically interposed in the organizational structure to facilitate a foreclosure on a controlling interest in an ITC asset without

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Some have expressed a theoretical concern that the loan itself might be characterized as a payment for a tax credit, which would negatively implicate the single-transfer rule. The IRS has specifically declined to provide guidance with respect to third-party lenders providing funds to a tax credit seller, and specifically noted in regulations on tax credit transfers that whether such an upfront loan is a payment for a tax credit (which would prevent the subsequent transfer of the tax credit to a buyer) is subject to a "facts and circumstances" analysis. However, the application of the facts and circumstances test to properly structured tax credit bridge loans generally have not deterred transactions in the market. The single-transfer rule likewise limits a lender's ability to take possession of an accrued tax credit itself, as no further transfer would be possible.

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There is also a risk that Congress could repeal tax credit transferability prior to the closing of a particular sale.

Recommendations for Lenders

First and foremost, lenders need careful due diligence to ensure that the amount of tax credits has been properly determined and all procedural and registration requirements have been met by the project owner to properly claim the tax credits, including proper pre-registrations and initial tax return elections. It is important for lenders to fully appreciate the ongoing compliance and reporting requirements associated with the specific project.

In addition, lenders should consider additional risk-mitigation measures such as tax credit insurance to cover recapture, penalties, disallowance, and borrower defaults.

Conclusion

While the IRA offers new opportunities to monetize tax credits, lenders providing financing in the context of tax credit transfers are entering relatively uncharted waters. As market players seek to maximize the benefits of the IRA, lenders can expect increasingly fluid project financing structures. Lenders should proceed with trusted legal, tax and insurance professionals to navigate this market evolution.

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