

Tax Credit Transfer Bridge Loans: Structuring Issues and Considerations

by Eli Katz and Kelly Cataldo, Latham & Watkins LLP, with Practical Law

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A Practice Note discussing tax credit transfer bridge loans, loan facilities entered into by project owners to finance their projects and that are repaid with the proceeds of a tax credit sale. This Note also discusses how these loans may be structured to reduce the risk of tax credit recapture and the contractual and structural measures tax credit bridge lenders may implement to ensure the security and repayment of these loans.

The Inflation Reduction Act of 2022 (IRA) (Pub. L. 117-169, 136 Stat. 1818 (2022)), a key piece of US industrial and energy policy, is having a transformative effect on clean energy project financing and development. The IRA heralded new opportunities for project developers to monetize tax credits and arrange project financing for renewable energy and energy transition projects in the US. Following the enactment of the IRA, project developers now have the option to monetize these credits by selling their tax credits to unrelated third parties in addition to the well-established tax equity market.

Project finance markets are beginning to coalesce around novel financing structures designed to make optimal use of the IRA's provisions. This Practice Note examines key structural changes implemented under the IRA, with a focus on how these changes are:

- Shaping the way US renewable energy and energy transition projects are capitalized.
- Influencing project financing structures for clean energy projects.

This Note also examines how project developers are raising bridge financing before receipt of the purchase price from a sale of qualifying tax credits.

Selling Tax Credits

Most US wind and solar projects qualify for either an investment tax credit (ITC) under Section 48 (Section 48 ITC) of the Internal Revenue Code (IRC or Code), which

is available when a project is completed, or a production tax credit (PTC) under Section 45 of the Code (Section 45 PTC), which is generated over a ten-year period starting when the project is placed in service.

The IRA introduced significant changes to the Code to accelerate the energy transition. These changes include:

- Extending existing tax credits through the next decade.
- Creating new tax credit bonuses (also referred to as adders) for projects in fossil fuel communities and those that use certain domestic components.
- Establishing new tax credits for emerging technologies, such as stand-alone battery energy storage systems and clean hydrogen projects.

(See [Legal Updates, Inflation Reduction Act: Key Energy Provisions and IRS Issues Proposed Rules Regarding Clean Hydrogen Tax Credits and Practice Note, Battery Energy Storage Financing Structures and Revenue Strategies Post-Inflation Reduction Act.](#))

One of the most fundamental changes the IRA introduced is the right of project owners to sell their tax credits for cash to unrelated third parties in the open market. Before the passage of the IRA, tax credits could not be bought and sold. If a project developer did not have sufficient tax liability to take advantage of tax credits, they could monetize them only through complex and structured transactions, including joint ventures known as tax equity partnerships (see [Practice Note, Sources of Available Project Financing: Tax Equity](#)).

Following the enactment of the IRA, most tax credits, including the Section 45 PTC and Section 48 ITC, may be sold in the market under Section 6418 of the Code. This change, coupled with detailed Internal Revenue Service (IRS) regulations, are transforming the US renewable energy project finance market (26 C.F.R. §§1.6418-0 to 1.6418-5; and see [Practice Notes, Transferability and Direct Pay Provisions for Clean Energy Projects Under the Inflation Reduction Act and Buying and Selling Clean Energy Tax Credits: Key Issues and Risk Mitigation Strategies](#)).

Financing clean energy projects that sell tax credits to unrelated third parties involves new considerations and opportunities. These include how project owners can:

- Obtain needed financing before the time when a tax credit may be sold.
- Protect against the risk of ITC recapture. The Section 48 ITC may be recaptured under several circumstances including if the lender forecloses on the project and the project changes ownership at any time during the five-year period after a taxpayer has claimed the ITC (IRC § 50).

Payment Limitations

Under Section 6418 of the Code:

- The payment for the tax credit must be made in cash and within a window of time starting at the beginning of the year in which the credit is generated and ending on the date the tax return is filed for the credit. For example, if a filing is made to extend the tax return filing deadline, the buyer may pay from January of a given year up to midsummer (or later) of the following year.
- Buyers cannot prepay the tax credit purchase price. Tax credit buyers cannot provide bridge capital to project developers whose projects have not yet earned their tax credits.

To address these limitations, project developers are turning to banks and other capital sources in the form of tax credit bridge loans to secure the funds needed until they receive the purchase price under their tax credit transfer agreements (see [Practice Note, Tax Credit Transfer Agreements: Common Negotiation Points](#)).

Section 48 ITCs are granted in one installment once the project is placed in service. The project developer can therefore repay the tax credit bridge loan when the tax credit buyer pays for the credit. This payment may be made after substantial completion and term conversion but not later than the tax credit filing date in the year

following the year in which the project is placed in service.

By contrast, Section 45 PTCs are generated annually as the project produces power and sells it to unrelated third parties. In bridge financings of Section 45 PTC transactions, the tax credit bridge loan will likely be paid in installments over a period that could be as long as ten years, as this is the period over which Section 45 PTCs are generated.

Tax credit bridge loans are distinguishable from term loans, which are typically sized on and repaid with cash revenues generated by a project from the sale of energy. Tax credit bridge loans are expected to be repaid from the proceeds generated from the sale of tax credits.

ITC Recapture

The Section 48 ITC is claimed in full when a project is completed but vests over a five-year period in equal 20% installments. If the project loses its tax credit qualification status at any point during this five-year period, the unvested part of the credit is recaptured and must be repaid to the IRS (IRC § 50).

This rule applies to Section 48 ITCs claimed by project owners (including a project developer and a tax equity investor) and those purchased by tax credit buyers in the open market. Recapture is most commonly caused by a casualty event that destroys the project, a systemic design failure that renders the project inoperable, or a sale of the project assets or equity during the five-year recapture period.

Tax credit bridge loans are repayable with the proceeds of the sale of the Section 48 ITC, including any payments for any applicable bonus credits for which the project may qualify. Because the bridge loans are not required to be repaid before the project is placed in service and ITCs vest over a five-year period after the project is placed in service, it is possible for the ITC to be recaptured before the bridge loans are repaid. However, the project developers' obligation to repay these loans is not affected by a recapture of the ITC.

For more information on the recapture of Section 48 ITC, see [Practice Note, Buying and Selling Clean Energy Tax Credits: Key Issues and Risk Mitigation Strategies](#).

Clean Energy Project Financing Structures Before the IRA

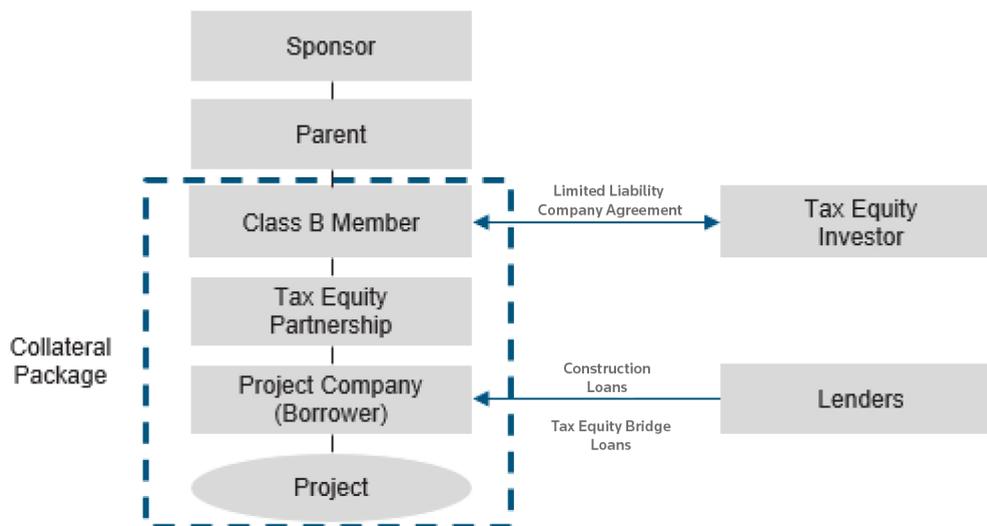
Tax equity investors typically do not take construction risk and fund their commitments only once the project has achieved specified completion milestones. Project

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developers can obtain loans from lenders against the tax equity investors' binding commitments to raise the capital needed to construct renewable energy projects.

The structure of a typical tax equity bridge loan (TEBL) facility is depicted in Image 1 below.

Image 1



Like a construction loan, the TEBL is drawn during construction and used to pay project costs as incurred (see [Practice Note, Construction Financing: Overview](#)). The TEBL is secured by the assets of and the project developer's equity in the project company. The TEBL is sized based on and is repaid with the proceeds of the tax equity investor's future funding commitment. As a result, lenders focus on the credit quality of the tax equity investor and any conditions to its funding obligations that may hamper the project company's ability to repay the TEBL.

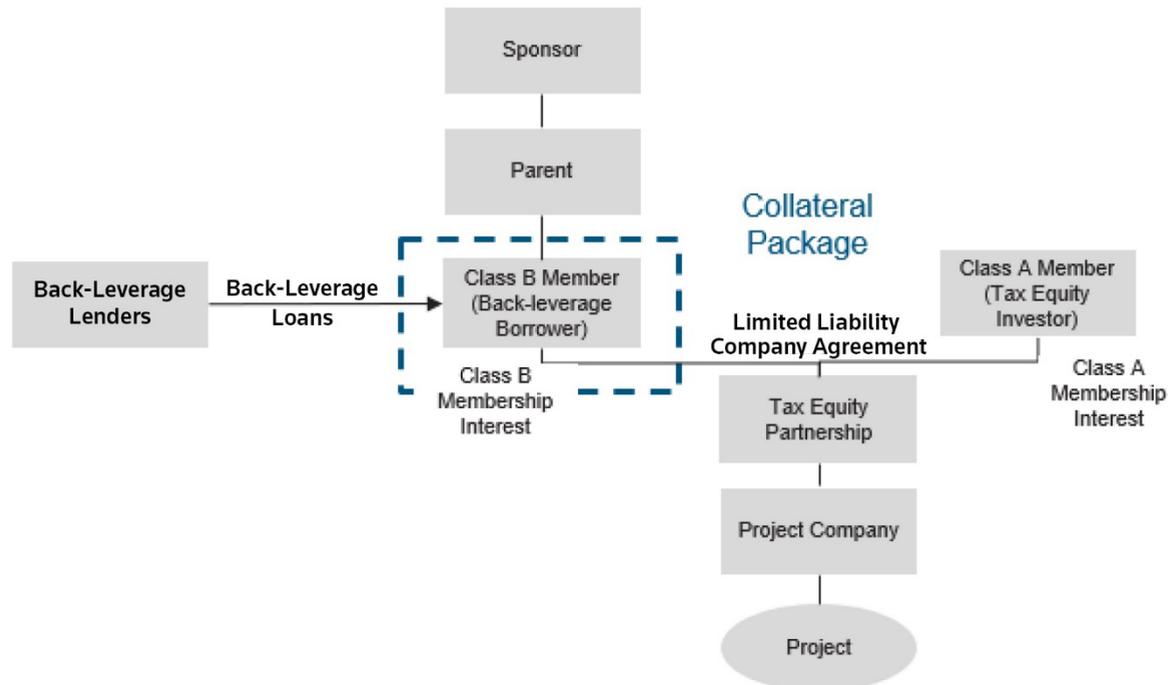
A tax equity investor generally memorializes its commitment in an equity capital contribution agreement, which is signed concurrently with or shortly after the closing of the bridge loan facilities. Once the project is operational, the tax equity investor funds its commitment and the project company repays the TEBL with the proceeds. Any remaining construction loans are then typically repaid with proceeds of a term loan (term

conversion). For more information on term conversions, see [Practice Note, Financial Covenants: Project Finance Transactions](#).

Tax equity investors generally do not permit the tax equity partnership to incur secured debt. They want to ensure that there are no secured creditors that would have a right of priority in payment over the tax equity investors who anticipate receiving a return on its capital contributions (see [Practice Note, Sources of Available Project Financing: Tax Equity](#)).

All security interests granted by the project company to secure the TEBL are therefore released at term conversion. The term loan is secured by assets of and equity in the term borrower (an entity owned by the project developer). The term lenders are structurally subordinated to the tax equity partnership. This structure, known as a back leverage loan, and the associated collateral package are depicted in Image 2 below.

Image 2



Tax Credit Bridge Loans and Other Considerations

Bridge financing structures for tax credit sales borrow heavily from TEBL structures but with significant differences and new considerations. Monetizing tax credits through tax credit sales creates timing mismatches, as project developers require significant capital for construction before tax credit buyers are permitted to pay for the credits (see Payment Limitations). Tax credit transfer bridge loan (TCTBL) facilities, which are sized based on the projected sale price of the tax credits, can be used to bridge this gap.

Tax Credit Transfer Bridge Loans Versus Tax Equity Bridge Loans

TCTBL facilities for Section 48 ITC transactions are structurally similar to TEBL facilities, with the loans incurred during the construction period being repaid on a lump-sum basis with the proceeds of the sale of the ITCs. Tax credit sales are not tied to construction completion milestones. As a result, the repayment of the TCTBL (which depends on when the tax credit buyer agrees to pay for the credits) may be misaligned with the term conversion and the incurrence of long-term financing.

In contrast, repayments under TCTBLs for Section 45 PTCs are likely to occur over a multi-year period as the PTCs

are generated and sold. These loans are sized against the projected aggregate payments from the sale of credits and are repaid on an amortization schedule sculpted to match the PTC installment payments under the tax credit transfer agreement. Similar to ITC sales, there may be a mismatch between term conversion and repayment of the TCTBL facility for PTCs.

Similar to tax equity bridge lenders' diligence of tax equity investors, TCTBL lenders must evaluate the creditworthiness of the tax credit buyer given that they are bridging to its commitment to buy the credits. The credit analysis for Section 45 PTC sales is even more important given the long tenor of the TCTBL facility. In addition to the collateral that lenders require from the back-leverage borrower, lenders may insist on protections from the buyer to ensure their source of repayment will remain creditworthy over the tax credit transfer agreement term. These protections may include financial covenants (such as minimum liquidity or ratings requirements) and credit support (such as parent company guarantees or letters of credit).

Sizing of the TCTBL

While the mature TEBL market has settled around a 95% to 98% advance rate against a tax equity commitment, debt sizing in the nascent TCTBL market continues to evolve. Debt sizing for Section 45 PTC sales is further

complicated by the longer-term repayment period and the fact that PTCs, and therefore the corresponding payments from a tax credit buyer, fluctuate based on a project's generation profile and possible curtailment.

Some near-term projects may not have arranged tax credit sale agreements at financial close of the bridge loan, as the demand for construction financing is outpacing the ability of project developers to source tax credit buyers on attractive terms. Some lenders are advancing TCTBL commitments against the value of uncommitted credits at advance rates that range from 50% to 75% of expected credit value. Other lenders are requiring full or partial developer credit support during the period before a tax credit purchase commitment is executed, which credit support is more likely to be available for established project developers or those with strong balance sheets. Providing sufficient credit support to back stop an uncommitted bridge loan may be more challenging for less well-capitalized developers.

Structuring Tax Credit Transfer Bridge Loans

TCTBL structures use two variations on the conventional TEBL project financing structure, with:

- The first, depicted in Image 3 and similar to a conventional tax equity partnership, designed to avoid a recapture event if the lenders foreclose (see Managing Section 48 ITC Recapture).
- The second, depicted in Image 4, applicable to sales of Section 45 PTCs where recapture is not an issue (see Structuring Section 45 PTC Sale Bridge Loans).

Managing Section 48 ITC Recapture

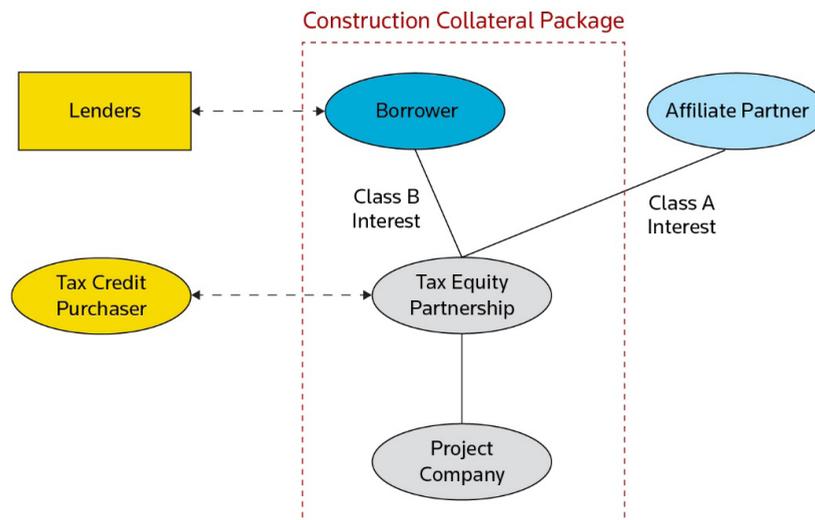
The IRS may recapture the Section 48 ITC under certain circumstances, including a change in the ownership of the project. Lender foreclosure on the assets of or equity in the project company during the five-year period after a project is placed in service may trigger the recapture of the unvested portion of the ITC (which may be as much as 100% if the change of control occurs in the first year after the ITC is claimed).

A recapture event would cause a tax credit buyer to lose its tax credit and would likely trigger an indemnity obligation from the project owner who sold the credits (see [Practice Notes, Buying and Selling Clean Energy Tax Credits: Key Issues and Risk Mitigation Strategies: Indemnification and Tax Credit Transfer Agreements: Common Negotiation Points: Seller Indemnification Obligations](#)).

In a conventional tax equity partnership, after an ITC asset is placed in service, the term lenders do not have liens on the tax equity investor or on its interests in the tax equity partnership. A foreclosure will be on the term borrower and its interests in the partnership and does not result in a recapture of the tax credit allocated to the tax equity investor (see [Clean Energy Project Financing Structures Before the IRA](#)).

To achieve a similar result in a tax credit sale structure, the project owner may choose to hold the project in a joint venture between the term borrower and an affiliate and to allocate the ITC to the affiliate. The affiliate's equity and assets are not part of the lenders' collateral, thereby avoiding recapture if the lenders foreclose on the term borrower. Image 3 below outlines a deal structure that avoids Section 48 ITC structure.

Image 3



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This structure is easily adaptable for a tax equity partnership or tax credit transfer transaction. It may therefore be attractive to both project developers and lenders, because it provides the flexibility to toggle between a bridge loan repayment from a tax equity investor or a tax credit buyer.

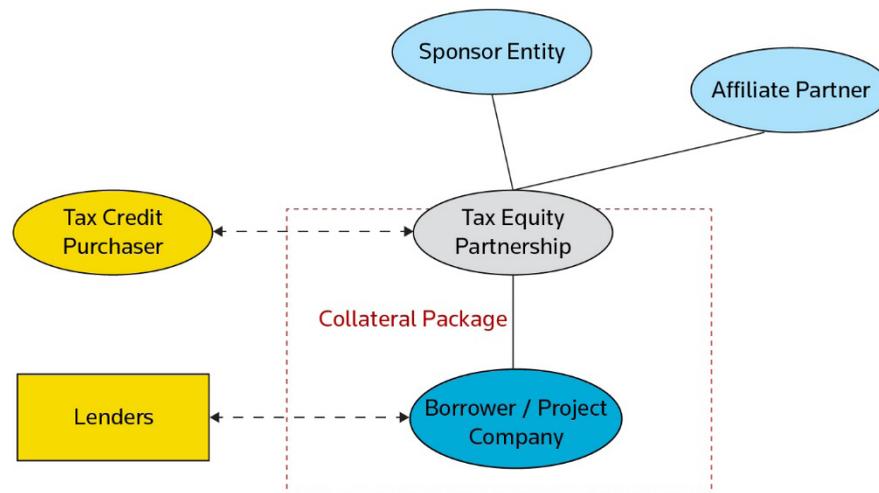
For transactions in which this flexibility is desired, lenders and borrowers should determine the base case assumption of the value of the credits for debt sizing purposes and provide flexibility for prepayments and

incremental borrowings to toggle to the correct advance rate once the final take-out structure is known.

Structuring Section 45 PTC Sale Bridge Loans

In a Section 45 PTC sale transaction, in which tax credit recapture is not a concern, the term lender may negotiate to maintain asset-level collateral for the tenor of the loans. One variation of this structure is depicted in Image 4 below.

Image 4



This structure is more favorable for lenders than the conventional back leverage structure, as it permits the lenders to maintain asset-level liens throughout the term of the financing and to remain structurally senior to obligations under the tax credit transfer agreement. Lenders may also require a pledge of the tax credit transfer agreement and associated deposit account (for example, if they are bridging to payments under the agreement).

Intercreditor Terms

TCTBL lenders must conduct due diligence on the terms in the tax credit sale agreement and evaluate the project owner or seller's obligations under these agreements. The terms reviewed include:

- Remedies for underperformance for Section 45 PTC transfer agreements with minimum output requirements.

- Liquidated damages payable by the seller for shortfalls in delivering the amount of credits that were promised to the tax credit buyer.
- The scope of indemnities offered by sellers. This may include coverage for recapture regarding a Section 48 ITC transfer agreement.

Back-leverage lenders will attempt to ensure they are shielded from or have seniority over the seller's obligations to a tax credit buyer. Back-leverage lenders may require guarantees or other credit support in the event the seller is subject to indemnity obligations under the tax credit sale agreement. Interparty agreements may provide certain terms that apply before foreclosure (such as forbearance and cure rights) and specify the TCTBL lenders' rights to enforce the tax credit buyer's commitment to purchase tax credits if the applicable conditions in the transfer agreement are satisfied.

Looking Forward

The IRA has heralded new opportunities to monetize tax credits and arrange project financing for renewable energy and energy transition projects in the US. The financing landscape will remain dynamic as market players adapt to new transaction structures that enable optimal use of

the new subsidy regimes and as developers and lenders continue to find solutions to optimize the value of the new subsidies in the IRA.

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