

2020 – A SWITCHBACK YEAR FOR TAX EQUITY

THE YEAR 2020 STARTED WITH THE EXPECTATION THAT VOLUME RECORDS WOULD BE SET FOR TAX EQUITY. BY LATE IN THE FIRST QUARTER, THE PANDEMIC WAS IN FULL SWING, CONSTRUCTION CREWS WERE SIDELINED AND BANKS AND LAW FIRMS HAD TO WORK FROM HOME TO PUT ORDERS IN PLACE. THE RENEWABLE ENERGY FINANCE INDUSTRY WAS BRACED FOR A DOWNTURN WITH VARIOUS PARTICIPANTS ADOPTING AUSTERITY MEASURES. BY **DAVID BURTON**, PARTNER, **NORTON ROSE FULBRIGHT**.

Displaying its customary resilience, the industry learned to adapt and the year ended by meeting the expectation to set records for tax equity volume. The estimate is that there will be US\$15bn of tax equity volume in 2020, which is approximately a 25% increase from 2019.

There is still a sense that some smaller sponsors have not been able to raise tax equity in 2020; however, syndicators looking this autumn to provide tax equity for commercial scale solar projects that would be operational by year-end did not find sponsors who wanted to transact.

Concerns about Covid-19 caused CapitalOne and student loan servicer Nelnet to exit the tax equity market. SunTrust, after being merged with BB&T and renamed Truist, exited, which presumably was the result of a US\$1.1bn increase in its deferred tax assets from 2018 to 2019. The slack from these departures was more than picked up by the remaining investors and new entrants dipping a toe in the water.

Joe Biden won the election; however, unless the Democrats win both Senate run-offs in Georgia, the Republicans will retain control of the Senate. Without the Senate, Biden's actions will be constrained to executive actions and legislation with at least a handful of Republican supporters in the Senate. The tax credit area with the most bipartisan support will likely be expanding tax credits for carbon capture. Further, an extension of the credits for solar and wind has more than a fighting chance: 60% of voters are concerned about climate change and historically tax credits for renewable energy has been the federal legislative policy to address it that both parties could agree on.

Biden has already announced that he will rejoin the Paris Climate Accord; the exit from that accord harmed the tax equity market little and similarly rejoining will not move the needle much. Biden is also expected to lift the pause on East Coast offshore wind that was purportedly to allow for a study. Finally, the IRS may actually publish the update of the investment tax credit (ITC) regulations that it started drafting late in the second Obama administration.

Tax risk insurance becomes mainstream

The one area of the tax equity industry that has sufficient supply for demand is insurers for tax risk. The insurance industry spent the last five years expanding its tax risk insurance offerings for the tax equity industry, and the use of it has gone from exotic to commonplace.

The risk that is most typically insured is the issue of whether solar projects were properly valued for purposes of determining their tax basis eligible for the ITC. However, in both wind and solar transactions, insurance is being purchased to cover certain questions about how to interpret the IRS's "begun construction" notices that determine what level of tax credit a project qualifies for.

Further, there are a handful of skittish solar tax equity investors that require a bumper-to-bumper tax risk insurance policy. The fact that these skittish investors can win certain deals, despite their returns being burdened by this insurance premium reflects that the supply and demand dynamic is still out of whack for tax equity investment generally.

Covid-19 and the supply chain

As Covid-19 first impacted the supply chain in China, 2020 began with industry participants asking what would happen if the closures or slowing of Chinese factories and shipping due to Covid-19 caused equipment paid for at the end of 2019 to not be delivered by April 15. The concern about April 15 stemmed from the tax code's requirement that for a sponsor to treat a cost as incurred in 2019 the equipment must be reasonably expected to be delivered within three and a half months of payment. This requirement comes into play when a sponsor seeks to be deemed to have begun construction on a project for tax credit eligibility purposes by meeting the five percent safe harbour by spending 5% of the cost of the project at the end of the year for equipment that would be delivered during the succeeding three and a half months.

Tax advisers were sanguine about the implications of deliveries being delayed due to Covid-19 as the standard is what was the reasonable expectation for delivery at the time of payment, rather than when the equipment was actually

delivered. Nonetheless, the IRS got wind of the concern and issued Notice 2020-41, which provides that so long as the equipment was delivered by October 15 2020, the sponsor will be deemed to have had a reasonable expectation of delivery within three and a half months of payment in 2019.

In the same notice, the IRS extended its safe harbour for projects to be complete from four to five years for projects that were deemed to have begun construction in 2016 or 2017. The most significant beneficiary of this leniency is offshore wind, while it is largely irrelevant to the solar industry as December 31 2019 was the first deadline for solar projects to have begun construction.

Carbon capture tax credit guidance

The IRS published guidance addressing tax credits for capturing carbon dioxide that would otherwise be released into the atmosphere. Notice 2020-12 addresses when a carbon capture project would be deemed to have begun construction for tax credit eligibility purposes and generally tracks the comparable rules for wind and solar.

Revenue Procedure 2020-12 provides a safe harbour for structuring carbon capture tax equity partnerships. The safe harbour is a hybrid of principles from the wind safe harbour in Revenue Procedure 2007-65 and the historic tax credit safe harbour in Revenue Procedure 2014-12. Two variations from the guidance for wind tax credits is that carbon capture partnerships are allowed to have 50% pay go, meaning 50% of the tax equity investor's contributions to the partnership can be contingent on the performance of the project, while for wind tax equity partnerships pay go is limited to 25%. This means tax equity investors in carbon capture partnerships can take less production risk than tax equity investors in wind partnerships.

The other variation is that Revenue Procedure 2020-12 provides that the investor may have the right to put to the developer its partnership interest at a price not greater than the *then* fair market value of the interest. Such an option provides the investor with confidence that it can exit the transaction, although, it does not know in advance at what price. This parameter is consistent with the safe harbour for historic tax credits in Revenue Procedure 2014-12.

In contrast, Revenue Procedure 2007-65 only allows wind developers to have a call option over the investor's interest and at first required the call price to be then fair market value; however, after requests from wind sponsors, the

IRS in 2009 softened the rule to provide that a fixed price that was a reasonable projection of fair market value was permissible. There is no apparent analytical explanation as to why then fair market value put options are permissible for carbon capture and historic tax credit investors, while wind investors cannot have put options but wind sponsors can have a fixed-price call option so long as it is not a bargain.

Developer fees and tax indemnities

In May, the Federal Circuit sustained a trial court's ruling that Invenenergy was not successful in increasing the tax basis of two of its wind projects by paying a developer fee to an affiliate. The case arose in the context of Invenenergy suing the Treasury for paying it a smaller cash grant than it had applied for under the now lapsed cash grant programme. The case has tax implications because Congress mandated that the cash grant rules mimic the ITC rules.

The case appeared to be the nail in the coffin for structures in which a developer pays fees to the sponsor's affiliate to increase the tax basis and the resulting ITC. Much of the market has moved towards a structure that involves the sponsor's affiliate selling the project to the tax equity partnership for a price intended to be fair market value as determined by an appraisal, rather than the tax equity partnership paying the sponsor's affiliate a developer fee. The advantage of the fair market value structure is that the tax equity partnership only has to prove that the sale price is consistent with the fair market value, rather than proving both (i) that the developer fee is fair market value compensation for the services actually provided by the sponsor's affiliate and (ii) the resulting basis is not more than the fair market value of the project.

Despite this case, some sponsors continue to use the developer fee structure. Such sponsors apparently believe if they have to litigate with the IRS, that they can avoid the Federal Circuit's holding by opting for the Tax Court or their local federal district court and they will be able to persuade a different judge of the bona fides of their developer fee structure.

On a brighter note, in two cash grant cases the Department of Justice (DoJ) unsuccessfully asserted that the project company lacked standing to sue the Treasury for haircutting its cash grant payments because the project company, which is owned by a leasing company, had been indemnified for the cash grant shortfall by the sponsor. If DoJ had prevailed in these cases, it could have meant that calling on a federal income tax indemnity would preclude the ability to challenge an adverse IRS audit in court. Fortunately, Court of Federal Claims judges held in both cases that tax indemnities are analogous to insurance policies and, as is the case with insurance policies, just because the victim was compensated by its own insurance does not mean there is not standing to bring a law suit against the party that is purported to have injured the victim. ■

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