WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

Clean Energy Tax Credit Transfers – Buyer Due Diligence Considerations in an Evolving Market

November 19, 2024

AUTHORS

Ryan Giggs | Robert Jacobson | Amanda Rosenberg | S. Kris Agarwal
Nicholas Hawks

As the clean energy tax credit market continues to gain momentum and an increasing number of taxpayers are entering the space as first-time buyers, we highlight some of the key risks associated with the purchase of these credits and related diligence considerations for buyers in evaluating and mitigating such risks.[1]

Background

As a part of the Inflation Reduction Act of 2022, Section 6418 was added to the Internal Revenue Code (the "Code"), permitting "eligible taxpayers" to sell certain federal income tax credits – namely, the production tax credit under Section 45 of the Code ("PTC") and the investment tax credit under Section 48 of the Code ("ITC") – to unrelated taxpayers in exchange for cash. Section 6418 of the Code has the potential to further fuel the development of clean energy projects across the United States by:

- Lowering the cost of capital by allowing project sponsors and developers to sell tax credits directly to third parties;
- Expanding the pool of potential investors for energy transition projects; and
- Providing greater flexibility for tax equity investors who may not have the tax capacity for the full amount of tax credits or depreciation, or who may be looking to diversify their risk exposure across multiple projects.

[1] This article is intended to serve as a high-level summary of certain topics related to the purchase and sale of clean energy tax credits and is therefore not an exhaustive breakdown of the various risk identification, allocation, and mitigation considerations to be taken into account by new or existing market participants.

July 2024 marked the one-year anniversary of the release of the preliminary guidance and proposed regulations by the Internal Revenue Service (the "IRS") and the Treasury Department under Section 6418 of the Code.[2] While the tax credit transfer market is still in its infancy, with the first tax credit transactions occurring in the second half of 2023, the total value of tax credit transfer deals for 2024 is estimated to be between $20 billion and $25 billion,[3] with similar figures predicted for 2025.[4]

As this market continues to grow and evolve, there is an increasing number of first-time buyers, each of whom should become familiar with the various risks involved and the corresponding measures buyers can (and should) take to mitigate such risks prior to entering into an arrangement to purchase tax credits. While the recent elections in the United States have introduced an element of uncertainty into the marketplace, we continue to see buyers active in the market for tax credits as part of their tax reduction strategies. We anticipate the market to stay active in the future, with a measured focus on potential changes in tax law.

This article focuses on buyer due diligence considerations in connection with the purchase of the two most commonly transacted clean energy credits – PTCs and ITCs – and discusses these credits primarily in the context of solar, wind, and battery energy storage projects.

Primary Buyer Risks – Disallowance and Recapture

The primary risks buyers face when purchasing clean energy tax credits are *disallowance* – which applies to both PTC and ITC transactions – and *recapture* – which applies only to ITC transactions.

Disallowance

If the IRS determines that a sponsor or developer of a project claimed a greater amount of tax credits than it was eligible to claim (which could result from, among other things, (i) not satisfying eligibility criteria for the "five times" increased base credit amount, (ii) not meeting requirements to claim any "adder," (iii) allocating excess basis to ITC-eligible property, or (iv) claiming an excess PTC), then the excess portion of the credit is disallowed. Notably, the regulations operate to potentially protect buyers because any disallowance first reduces credits retained by the seller. Particularly in "hybrid" transactions (*i.e.*, transactions in which the tax credit transfer happens in addition to a tax equity partnership-flip deal pursuant to which a tax equity investor monetizes deprecation and, typically, a portion of the ITCs), the "first loss" position of the seller (including the tax equity investor who is monetizing tax credits ahead of the tax credit purchaser) can provide significant structural protection. Additionally, the IRS may also impose a 20% excessive credit transfer penalty on the buyer

[2] The IRS released its final regulations applicable to tax credit transfers under Section 6418 of the Code on April 25, 2024 (89 Fed. Reg. 34,770 (Apr. 30, 2024) (Final Rule: Transfer of Certain Credits)). The final regulations, which became effective as of July 1, 2024, can be found here, and a brief initial summary of the same can be found here.

[3] See, https://www.cruxclimate.com/insights/highlights-from-mid-year-market-intelligence-report.

[4] See, https://www.reunioninfra.com/insights/how-big-is-the-transferable-tax-credit-market#total-market.

of the credits (although a buyer may be able to avoid this penalty if it is able to demonstrate that the excessive credit transfer resulted from a "reasonable cause," which can be accomplished by establishing that the buyer conducted sufficient due diligence regarding the amount of credits).[5] The application of this 20% penalty is mitigated in hybrid deals to the extent the seller retains credits.

Recapture

Unlike PTCs, which are claimed on an annual basis for ten years based on the amount of electricity produced by the qualifying project during the year, ITCs are generated when the project is placed in service based on the underlying project's cost and vest ratably over a five-year period following the project's placed-in-service date. As such, unvested ITCs are subject to "recapture" during such five-year period under certain circumstances. Examples of recapture events include a sale of the underlying project, the long-term cessation of project operations, and casualty events. Unlike with disallowance, recapture at the project level is borne *pari passu* by sellers and buyers.

Risk Mitigation – Buyer Due Diligence Considerations

Typical documentation for tax credit transfer transactions includes a purchase agreement documenting the actual purchase and sale of the credits and may also include (i) if the seller is not an independently creditworthy entity, a parent guaranty from an affiliate of the seller backstopping the seller's obligations in the transfer agreement, and (ii) a tax credit insurance policy, which insures against the disallowance and recapture risks discussed above, and which may be placed by either the buyer or the seller depending upon the circumstances.

In evaluating whether to enter into the tax credit transfer market, while a potential buyer will benefit from, and should likely find comfort in (i) the extensive project-level and tax due diligence or project development work previously conducted by the seller (and a tax equity investor, if applicable – *e.g.*, in the aforementioned "hybrid" structure), (ii) the representations and warranties and covenants being made by the seller in the transfer agreement, (iii) the contractual indemnity provided by the seller in the transfer agreement, (iv) the parent guaranty, and (v) the protections provided by a tax credit insurance policy, it should also conduct its own due diligence prior to entering into any definitive agreement for the purchase of clean energy tax credits.

The following is a non-exhaustive list of key deliverables and considerations for buyers to diligence in the process of evaluating, structuring, and negotiating a tax credit transfer transaction. Where appropriate, we have indicated where certain items may apply only to the sale of either ITCs or PTCs and, as a general matter, we note that the exact nature and scope of any given due diligence checklist will ultimately depend on, and be informed by, the complexities and specific characteristics of the underlying project(s) and the parties participating in the deal.

---

[5] Treas. Reg. § 1.6418-5(a)(4).

Seller, Project Company, Guarantor, and Project Background Information – These materials go to confirming the structure from which the credits are being purchased.

- Project summary
- Corporate organization chart for all entities involved in the transaction
- Identities of equity holders in the project
- Organizational documents and operating agreements for all entities involved in the transaction
- State and federal tax, UCC, bankruptcy, judgment, and litigation searches
- If the project was acquired by the seller from another party, the agreements by which such acquisition was effectuated
- Financial projections or financial model applicable to the project

Seller and Guarantor Financial Information – These materials are used to establish the creditworthiness of the seller and, if applicable, the guarantor.

- Most recent three years of audited financial statements
- Most recent unaudited financial statements
- Schedule of contingent liabilities

Loan and Project Documents – These materials should be reviewed to (i) confirm that the project is operating and generating the applicable credits or will meet applicable construction targets in order to be operating and generating the credits in the future, and (ii) better understand how operational risks to the project have been mitigated by the seller. Interruptions in project operations could reduce the amount of PTCs that a buyer might otherwise contract to purchase, or, in respect of ITCs, could result in recapture events under the Code.

- Revenue contracts and offtake agreements
- Summary of insurance program and copies of applicable policies, including any tax credit-specific insurance
- Independent insurance consultant report
- Independent engineer report
- Beginning of construction certificate and construction schedule
- Substantial completion certificate

Applicable Credit, Multiplier, and/or Bonus Credit (Adder) Qualification

- Evidence that the seller is eligible to sell the tax credits (*i.e.*, confirmation that the seller is not related to the buyer)
- IRS registration number for the credits
- Documentation confirming that the project has satisfied the requisite conditions to be deemed to have been “placed in service” under the Code

- Documentation confirming compliance with prevailing wage and apprenticeship requirements or that the project qualifies for an exception from such compliance
- Documentation confirming that the project qualifies for any bonus tax credits (*e.g.*, energy community, domestic content, and/or low-income bonus credits), if applicable

PTC-Specific Considerations/ Deliverables

- Evidence that the project has been "placed in service" under the Code and has not been operating for more than ten years
- Production report from the project's revenue-grade meter
- Confirmation that the electricity is being purchased by an unrelated offtaker
- Information sufficient for buyer to understand circumstances under which the project may generate less electricity than anticipated (*e.g.*, curtailment events)

ITC-Specific Considerations/ Deliverables

- Cost segregation study from a third-party accounting firm verifying seller's cost basis calculations
- Appraisal confirming project's fair market value (if seller has stepped up the cost basis)
- Evidence confirming project's ability to continue operating as a qualified energy facility (e.g., documentation confirming the project has sufficient property and casualty insurance coverage, the project has adequate site control, has adequate interconnection rights, and that the seller has alternatives in the event of a counterparty default)
- Interparty Agreement or Forbearance Agreement with any project lenders to prevent recapture due to foreclosure
- Evidence that no recapture has occurred

Conclusion

The Inflation Reduction Act's creation of a secondary market for certain clean energy tax credits significantly increased the flow of capital into the U.S. clean energy sector and is helping to close the gap toward achieving decarbonization and energy transition initiatives. Given its early stage of development, all stakeholders – both established and new – must work together to efficiently and fairly identify, allocate, and mitigate risks in order to sustainably grow this market in a way that instills investor confidence and continues to encourage broader market participation.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Ryan Giggs
713 510 1735
rgiggs@willkie.com

Robert Jacobson
713 510 1713
rjacobson@willkie.com

Amanda Rosenberg
310 728 8313
arosenberg@willkie.com

S. Kris Agarwal
713 510 1778
kagarwal@willkie.com

Nicholas Hawks
212 728 3577
nhawks@willkie.com

Copyright © 2024 Willkie Farr & Gallagher LLP.

This alert is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This alert may be considered advertising under applicable state laws.

Willkie Farr & Gallagher LLP is an international law firm with offices in Brussels, Chicago, Dallas, Frankfurt, Houston, London, Los Angeles, Milan, Munich, New York, Palo Alto, Paris, Rome, San Francisco and Washington. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.