

NEWS ANALYSIS: TRANSFER MARKET EXPECTED TO EXPLODE DESPITE PREFERENCE FOR TAX EQUITY

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While the tax transfer market comes with its downsides and limitation, it is still expected to grow larger than the traditional tax equity market due to the level of expected demand, Andrew Vitelli, Chuck Stanley and Kyle Younker explain in Part II of a series on transferability.

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Over the next several years, the need to monetize tax credits is expected to skyrocket across the renewable energy industry. ACORE, an industry advocacy group, says the tax equity market must increase from between USD 18bn to USD 20bn to USD 50bn over the next three years to meet demand. An analysis by [Goldman Sachs](#) predicted the Inflation Reduction Act (IRA) would provide USD 1.2trn in federal incentives – more than three times what the act was projected to cost.

No one expects the traditional tax equity market, historically around USD 20bn annually, to be able to scale up dramatically. The difference will be made up in the tax transferability market opened up by the IRA. But the common view in the industry holds that challenges in the nascent transfer market will leave tax equity as the preference for most sponsors, with those unable to tap the tax equity market taking advantage of transferability.

Several factors have curbed the appeal of transferability, those spoken to for this article say. One is the threat of recapture, or of tax credits being reclaimed by the federal government, including due to a project sale. [Part I of this series](#) explored how the possibility of recapture is affecting the transferability market following a guidance [published in June](#) by the IRS.

Traditional tax equity deals have other advantages over transfer deals. Typical tax equity deals allow the tax equity investor to monetize depreciation, a challenge in many transfer deals. And a “step up” in a tax equity deal increases the tax credits received from the cost of the project to its fair market value once operational.

Investors and developers in the renewables industry are looking for ways around these challenges, and industry professionals are divided over how insurmountable they will prove to be.

“It’s going to take a couple of years for the transfer market to truly develop and truly grow into what it has the potential to be,” says Gary Durden, a partner and managing director at CohnReznick Capital. “Structures are going to have to be developed by banks and brokers who can build a product that is attractive to the new investor base. But I think eventually, it could get to the point where the transfer market is much larger than the tax equity market.”

Step up and depreciation

Under traditional tax equity structures, tax credits were rewarded not just for the cost to build the project but for the fair market value of the projects. Several structures emerged to maximize this figure as close as possible to the project’s full value.

in most cases, it involves selling an ownership interest to a third party and bringing in an appraiser to value the project.

Since the transfer of tax credits does not require an asset sale, the industry is still searching for ways to fully tap projects' fair asset value.

Investors could potentially sell a minority stake to an equity investor in order to establish that fair market value. But the market is still working out exactly what these deals will look like.

"I think the industry is still determining what investors and the IRS will accept," says Bryen Alperin, a managing director at Foss & Co. For example, selling 1% of a project just to establish a valuation, he says, "probably won't hold up."

"It makes it a little more difficult for developers in that they now need to find an actual buyer at that valuation rather than just getting an appraisal that establishes the fair market value within a tax equity structure such as an inverted lease," Alperin adds.

Kyle Kidd, a partner at M&A tax advisory Leo Berwick, says his firm gets a ton of questions about whether a tax basis step up to fair value is feasible in transfer deals.

"If the industry can't figure out a way to achieve step ups on these ITC deals, it just means that the traditional tax equity partnership structures are better for developers, in most cases," Kidd says. "I see that as a downfall of transferability if that can't be figured out."

Some spoken to for this article are confident that innovative step-up structures will emerge, though no one knows exactly what these structures will look like and whether they will come from incumbents or new players in the market.

"I know that there are a ton of very smart, creative, entrepreneurial folks who are trying to figure out alternative structures," says Chris Roetheli, a senior vice president at US Bancorp Impact Finance.

Another attractive aspect of the tax equity market has historically been the ability to monetize a project's depreciation. Tax equity investors have historically paid a premium due in part to anticipated tax savings from depreciation.

But the IRS has stated that generally only a taxpayer that has an ownership interest in a project – and not a transferee of a tax credit – can claim tax depreciation associated with the project.

While recapture and the difficulty in achieving tax credits based on fair asset value applies only to ITC deals, depreciation affects both ITC and PTC deals.

Some in the industry think that monetizing depreciation will be less of a hurdle than expected.

"A huge amount of the industry can absolutely use depreciation," says one renewables-focused investment banker. "They have been taught by the tax equity industry that that is something that they are never supposed to ask, but our analysis is that a bunch of the development flip companies and companies that don't keep their assets end up paying taxes. If you sell all your credits, that's what I think is going to occur."

The inability to transfer depreciation could further splinter the market, according to Kirkland & Ellis partner Sam Kamyans, by facilitating new non-tax-equity partnerships where, alongside project economics, monetization of depreciation is a key benefit for the sponsor's joint venture partner.

Advantages to the transfer market

Can transferability become the default or preferred option, even if tax equity is available? Industry views are split on this, depending on the situation.

"I don't think it's as simple as saying one is better than the other," says Alperin. "There are use cases for both and I think that they will co-exist, and they may even sometimes co-exist on the same deal."

There will be instances where transfer will be the obvious choice, industry pros say. In a PTC deal, this will often be the case if the owner has a way to monetize depreciation, since recapture and step-up are not a factor.

Developers looking to operate a project on a merchant basis may also favor transfer, as tax equity investors favor contracted projects, several sources said.

For yieldcos, going the transfer route could benefit them for accounting purposes. Doing a transfer deal will make their cash available for distribution (CAFD) more attractive, according to David Burton, a tax equity-focused partner at Norton Rose

Fulbright.

“Money you raise from a tax equity investor does not get included in CAFD, but money you raise from selling tax credits does,” he explains. If you do a transfer deal rather than a traditional tax equity deal, “it looks like all of a sudden you have more free cash flow even though you haven't really changed your business that much.”

But often the biggest advantage to transferability is simplicity, several sources say.

“A transfer deal should be cleaner, simpler, faster, less due diligence, less documentation, more flexibility,” says Durden.

Recent IRS guidance like the one on recapture, though, means these deals will be not quite as simple as the industry hoped. This may especially be an impediment for smaller deals, as the diligence and associated costs can discourage buyers.

The recapture threat is only one area where IRS guidelines turned out to be more rigid than expected. In another example, credits cannot be sold from the lessee position, which makes transferability unworkable in an inverted lease structure. There is also concern over the threat of a 20% excessive transfer penalty on taxpayers who overclaim their share of tax credits. One senior partner at an energy transition-focused PE firm says he has diminished his views on transferability based on the recent IRS guidance and worries that the risks and complexities will shrink the number of parties participating in the market.

“Treasury erred on the side of tax caution,” says Burton, “rather than on the side of, let's do everything we can to spur the renewable energy industry.”

In a statement, Deputy Secretary of Treasury Wally Adeyemo called direct pay and transferability “one of the law's most significant reforms and key to achieving the Inflation Reduction Act's economic, climate, and equity goals. These new tools are going to dramatically expand the reach of these credits.”

In early deals, wind and solar transfer credits have been trading at around 92 or 93 cents on the dollar, while for technologies like biogas that number is around 85 cents. The investment banker believes that, with time, wind and solar credits will eventually sell for 97 to 98 cents on the dollar.

Even if project sponsors prefer tax equity, most expect the transfer market to grow larger, perhaps far larger, than the tax equity market in the coming years. Some project the need for tax credits to triple or even quadruple in the coming years, while the tax equity available at best grows slowly from its current roughly USD 20bn per year level.

Existing tax equity investors will also be active in the transfer market. JP Morgan, historically one of the two largest tax equity investors representing roughly a quarter of the tax equity market, expects to ramp up its tax credit transfer activity in the coming years, according to Managing Director Rubiao Song.

“The increase on the tax equity side is going to be slow or is going to be capped flat,” says Song, who leads the firm's tax equity energy investments group. “The increase will come from the credit transfer.”

Song also noted that capital requirements for large banks are expected to increase in the coming years, which would make the transfer market relatively more attractive.

“That is really going to have a huge impact on the traditional tax equity market,” says Song. “That is basically going to push more traditional tax equity investors into credit transfer.”

Roetheli says US Bancorp Impact Finance will remain heavily weighted towards tax equity.

“That is in our DNA, and we think that is still an execution that most of our sponsor partners would prefer,” he adds. “We will continue to do tax equity investments with our partners, but then allow for transferability of those credits to third-party investors to recycle capital and bring additional liquidity into the market.”

All things considered, Louise Pesce, a managing director of renewables project finance at MUFGE, says many sponsors are not necessarily comparing the direct economics of traditional tax equity versus transferability, but instead are weighing the benefit of getting a structure in place sooner. As a sponsor, she said, “If I've only got four suppliers of traditional tax equity versus some interesting offers on transferability – can I hold out and hope to get a tax equity commitment from someone, or do I take an offer that's on the table now?”

“Transactions are going to flow,” says Carl Fleming, a renewable energy focused partner at McDermott Will & Emery. “It’s happening pretty quickly in terms of getting transfers done, and I think that guidance hasn’t slowed things down at all.”

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