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Businesses Need Flexibility Until Tax-and-Climate Law Is Clearer

Businesses negotiating renewable energy deals should be ready to pivot and reassess contractual terms following the expected release of additional guidance on the tax-and-climate law, say three Sidley Austin partners.

The Inflation Reduction Act is an absolute game changer that is expected to drive unprecedented investment and expansion of the clean energy economy. A broad range of clean energy technologies now have long-term and stable tax credits through at least the next decade, and can monetize these tax incentives efficiently by using diverse transaction structures.

The IRS already has issued several notices addressing the new law's prevailing wage and apprenticeship requirements and the new "energy community" bonus for qualifying projects. The Treasury Department has also confirmed that additional guidance is expected in the coming months addressing the new direct-pay and transferability rules for monetizing relevant tax credits, and a second set of guidance on the prevailing wage and apprenticeship requirements.

In the meantime, for participants with active transactions in this evolving market, the name of the game is flexibility.

Moving Forward

Many developers are moving forward with their projects by accounting for the remaining uncertainty in their financing arrangements as best as they can. These negotiations are producing novel commercial arrangements that address various scenarios based on anticipated future guidance, as well as how investors and financing parties will attribute value to additional tax benefits that may be available.

This is the case for projects that qualify for the new tax credit "adders." Those that qualify for production tax credits or investment tax credits also may qualify for an incremental 10% adder if the project satisfies the "domestic content" requirement or is in an "energy community." These adders will significantly boost a project's economics, but the basis and procedures to qualify remain unclear.

The recently issued guidance on the "energy community" adder is helpful, but additional data and relevant economic information are still needed.

The lack of current data (in certain cases) supporting whether an energy project is in an “energy community,” or has sufficient US manufactured products to satisfy the “domestic content” requirement, creates a dilemma for developers that are looking to sell their projects or to finance them using third party investors’ funds.

On the one hand, developers are looking to benefit from the potential added economics if their projects ultimately qualify for enhanced credit amounts. On the other hand, buyers and financing parties may not be willing to pay or fund additional amounts for incremental tax credits until there is sufficient clarity on establishing eligibility.

One common approach being used to bridge this divide is a contingent payment arrangement. Parties agree that if a project is deemed eligible for incremental tax credits (following additional guidance or relevant data), an investor or buyer will make an additional payment, in some cases with payment timing tied to a liquidity event such as a sale of the project or funding by lenders or tax equity investors.

Complex Negotiations

Negotiations surrounding such arrangements are often complex and require flexibility. The parties must agree on how to account for variables such as the timing and substance of the relevant eligibility determination, as well as for the projected economic value of the incremental tax credits and which party bears any downside risk.

Similar issues arise in the case of the new direct-pay and transferability alternatives for monetizing tax credits. Owners of projects now can transfer and sell tax credits to third parties for cash, while certain types of entities or technologies can receive a direct payment from the government for the applicable tax credits.

Both alternatives are expected to expand the pool of potential investors and available capital to finance renewable energy projects. But these alternatives raise questions about the treatment and eligibility for direct-pay for partnerships that are owned by both tax-exempt and taxable entities, as well as a determination as to what actions could trigger a recapture of the credits and which party is responsible for such recapture or reduction of tax credits following future audits.

Until relevant guidance is available, parties will continue looking for commercial solutions to address unanswered, tax-related questions. These include contractually determining the risk allocation between developers and investors for any reduction or recapture of the tax credits in the event of a future tax audit. Parties often negotiate timing of payments for such credits, notwithstanding the timing for filing relevant IRS forms while including certain true-up provisions to address any variations in the eventual credit amount.

In the case of the prevailing wage and apprenticeship requirements, the anticipated guidance is expected to clarify certain terms and establish the relevant documentation that developers and contractors need to prove such requirements are met. Until such guidance is issued, parties are often agreeing on certain documentation and recurring reports, while discussing ways and costs of potentially revising these agreements later, if needed.

Tax insurance policies are another solution being used to mitigate risks relating to uncertainty under the new law. Tax insurance providers are adapting their offerings to keep pace with the evolving market and rules and are, in turn, offering products that can help to close transactions, including with respect to transferability of tax credits.

Conclusion

Regardless of the need for additional guidance and clarity, deals involving renewables continue apace. Parties are finding ways to sign term sheets and close deals, penciling out a path forward despite uncertainty. The key to negotiations and finding commercial solutions in these deals, until the remaining relevant questions are answered, remains flexibility.

Parties will need to continue adapting and responding to new guidance and rules as they move forward with transactions and be ready to pivot and reassess deal terms as more clarity is provided by the relevant agencies.

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