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Q&A Tax Credit Equity v. Section 1603 Cash Grant

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Question: How much cash will developers of renewable energy projects be able to raise with traditional tax credit equity compared to what they have been able to raise with the Section 1603 cash grant?

Answer: Unfortunately we won't know for sure until sometime after the grant has expired. As such, renewable energy project developers should ensure they have satisfied the Section 1603 cash grant safe harbor criteria for any projects not completed before 2012 sooner rather than later. (In other words, don't wait until December!)

Background

Prior to passage of the American Recovery and Reinvestment Act of 2009, renewable energy project developers would create a special purpose entity (i.e. a partnership for tax purposes) that would admit at least one widely held corporation as a limited tax equity partner (TEP). The TEP would contribute equity to the limited partnership (LP) in exchange for being allocated renewable energy investment tax credits (ITC) and other benefits. Frequently, the developer and TEP would own 1 percent and 99 percent, respectively, of the LP for the first five years and then their respective ownership interests would flip to 95 percent and 5 percent, respectively, on a go-forward basis. Because of various tax rules, the TEP would be required to remain in the LP for at least five years or face tax credit recapture. Following the fifth anniversary of the TEP's admission to the LP, there would generally be a call option allowing the developer an opportunity to redeem the TEP's interest. Once the TEP was redeemed from the LP, the developer would then own the project for the remainder of the partnership, which typically lasts at least through the end of the power purchase agreement or longer. The successful execution of these LPs often required skilled tax advisors and carefully documented business arrangements. Although this is an effective and useful way of financing and developing renewable energy projects, it is also inherently more complex than electing to take the cash grant in lieu of ITCs that was created by the Recovery Act.

The cash grant option empowered many developers to own a renewable energy project without a TEP or LP, providing a clearer and simpler path to financing. Since the creation of the grant, the renewable energy industry at large overwhelmingly moved from raising traditional tax credit equity in favor of the grant. And now that the Section 1603 grant is set to expire at the end of 2011, renewable energy project developers are eager to determine how much cash they will be able to raise with traditional ITC investors.

Analysis

Trying to estimate the amount of equity a renewable energy project can raise is difficult for several reasons. First, because of the ubiquitous use of the grant in lieu of raising tax equity, there is limited recent anecdotal evidence to evaluate. Because TEPs have limited recent track records it is difficult to ascertain the type and number of investors that will be ready and able to enter the market in the post-grant era. Furthermore, the few renewable energy project developers that have recently raised financing from TEPs have done so in a non-traditional manner. For example, some TEPs have made investments in exchange for a distribution of the grant plus other benefits. From this, one might assume that for these TEPs to continue investing they will need to have tax liability sufficient to jus-

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tify investing in ITC projects on par with the grant projects in which they have invested. But is this is a realistic assumption?

A key point to consider is the primary reason a TEP would invest in the ITC. Probably the most comparable tax credit to the renewable energy ITC is the historic rehabilitation tax credit (HTC). Although there are obvious differences between a historically rehabilitated building and a renewable energy facility, the two tax credits themselves are very comparable. Both tax credits are earned in the year the projects are ready and available for their intended use and each are subject to five-year tax credit recapture periods. Users of these tax credits are subject to the at-risk and passive activity loss rules. The credits are allocated in a similar manner and taxpayers claiming the tax credits must be able to demonstrate that their investment has a profit motive and that the investment overall has economic substance. There are other notable similarities but these are typically the issues with which the TEPs and their advisors are generally most concerned.

One significant distinction between the HTC and the ITC is that there is no grant in lieu of tax credit option for owners of HTC buildings. As such, there is a current HTC TEP market that can be used as a basis to evaluate how much equity is raised in exchange for investing in historic tax credit projects. Because the HTC and the ITC are so comparable, it's likely that renewable energy project developers will look to the HTC TEPs as a natural equity source once the Section 1603 grant expires.

So, how much tax equity are historic rehabilitation project developers able to raise in the current market? The answer varies depending on several factors, including project location risk, development risk, cash flow risk, debt and other financing source risk. During 2011 there have been reports of HTC TEPs investing at a rate of more than $1 per dollar of tax credit they are allocated. There have also been examples of TEPs investing at rates below $1. How does a renewable energy project developer know if its project will attract equity at a rate greater than $1? Unfortunately, for the reasons stated above, this is still very uncertain.

Conclusion

The most conservative way to manage the uncertainty of the renewable energy tax credit equity market would be for project developers to ensure they have satisfied the Section 1603 cash grant safe harbor criteria for any projects not completed before 2012. This involves, among other things, demonstrating that construction commenced after 2008 and before 2012. Projects can do this either by demonstrating that physical work of a significant nature has taken place prior to 2012 or that the project has paid for or incurred more than 5 percent of project costs. In either case, most projects will be required to have either an engineer or CPA provide documentation that supports that the criteria have been met.

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Taking these steps will not only manage downside risk, it will also strengthen a project's overall negotiating position. For more information on satisfying the Section 1603 cash grant safe harbor criteria, tune into Novogradac & Company's 1603 Grant Safe Harbor webinar on September 22 or send an email to Tony.Grappone@novoco.com. ❖

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