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PROPERTY & CASUALTY

# Hybrid Transfer Structures and Tax Credit Insurance


## Abstract

The Inflation Reduction Act (IRA) has significantly impacted the renewable energy sector, mainly through the introduction of Section 6418 of the Internal Revenue Code. This section allows the transfer of certain energy tax credits, enabling greater flexibility and liquidity in the market. One innovative tool emerging in this landscape is tax credit insurance, which provides protection and stability in tax credit transactions. This white paper explores the role and benefits of tax credit insurance, focusing on its application in T-Flip and hybrid tax equity structures.


## Introduction

The renewable energy sector in the United States has seen substantial growth driven by various incentives, including tax credits. The Inflation Reduction Act of 2022 further bolstered these incentives by introducing Section 6418, which allows the transfer of certain energy tax credits. This provision facilitates the sale and monetization of tax credits, enhancing liquidity and encouraging investment in renewable energy projects.

However, the transfer and utilization of tax credits come with inherent risks, including recapture risk, IRS audits and changes in tax law. Tax credit insurance has emerged as a vital tool to mitigate these risks, providing assurance to both sellers and buyers of tax credits.

## Understanding Section 6418 of the Internal Revenue Code

Section 6418, enacted under the IRA, permits the transfer of certain energy tax credits from the entity that generates the credits to another taxpayer. This transferability is a significant development, as it allows entities with limited tax liability to monetize their tax credits by selling them to entities with higher tax liabilities.

Key points of Section 6418 include the following:

- **Eligibility:** Various renewable energy projects, such as solar, wind and geothermal, are eligible for transferable tax credits.
- **Transfer Process:** The transfer must be made for cash, and the selling entity cannot receive more than the value of the tax credits sold.
- **Buyer Usage:** Subject to certain limitations, buyers can use the tax credits to offset their federal income tax liability.

## Issues with Direct Tax Credit Transfers

While there are certainly many benefits of direct transfers of the tax credit, like the ability to monetize tax credits after the project has been placed in service, simpler structuring and a broader investor pool, there are downsides to a direct transfer by not fully monetizing the value of the tax assets of the project. Accordingly, different structuring alternatives have emerged to increase the value of the tax assets for all parties. Generally, this structure involves elements of a traditional partnership flip structure, where the project SPV is sold to an unrelated partnership. That partnership sells or facilitates the sale of the tax credits generated from the project to third-party buyers.

## Role of Tax Credit Insurance

Tax credit insurance is a financial product designed to mitigate the risks associated with using and transferring tax credits. This insurance provides protection against the potential disallowance or recapture of tax credits by tax authorities. By securing these credits, stakeholders can confidently engage in transactions, knowing their financial benefits are safeguarded.

### Benefits of Tax Credit Insurance in a Hybrid/T-Flip Structure

#### Risk Mitigation

- Protection against disallowance: Tax credit insurance protects investors, tax credit buyers and developers from the risk of tax authorities disallowing the credits. This assurance is crucial in complex transactions where the stakes are high.
- Recapture risk reduction: If tax credits are recaptured or disallowed by tax authorities, the insurance covers the financial loss and contest costs, ensuring the stability of the investment.
- Inflation Reduction Act adder protection: Tax credit insurance can also protect against the IRS disallowing any of the tax credit adders enacted under the Inflation Reduction Act (e.g., prevailing wage and apprenticeship, Energy Community, domestic content).

#### Enhanced Investor Confidence

- Attracting tax equity investors: The presence of tax credit insurance makes the investment more attractive to tax equity investors and credit buyers who may otherwise be hesitant due to the complexities and risks involved. This can lead to more competitive financing terms and lower cost of capital.
- Broadening the investor base: Insurance can attract a broader range of investors, including those who may not have the expertise to assess the intricacies of tax credit compliance.

#### Optimizing Financial Structures

- Facilitating hybrid structures: Tax credit insurance provides the security needed to blend various financing methods, optimizing the capital stack. This can result in more favorable financing conditions and improved project economics.
- Supporting T-Flip transactions: In a T-flip structure, insurance ensures that stakeholders' anticipated returns are protected, which can lead to a smoother transition of ownership back to the developer and better align interests.

## Conclusion

The introduction of Section 6418 under the Inflation Reduction Act has created new opportunities for monetizing and transferring energy tax credits. However, these opportunities come with inherent risks that can deter potential investors. Tax credit insurance offers a valuable solution by mitigating these risks and enhancing the security of tax credit transactions.

In T-Flip and hybrid tax equity structures, tax credit insurance plays a crucial role in facilitating investments, reducing financial risks and attracting a diverse range of investors. As the renewable energy sector continues to grow, tax credit insurance will likely become increasingly important, ensuring the stability and success of tax credit transactions.

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*1. Internal Revenue Service. (2022). "Inflation Reduction Act of 2022: Summary of Energy Tax Provisions."*

*2. Renewable Energy Tax Credits under the Inflation Reduction Act: Opportunities and Challenges. (2023). Journal of Renewable Energy Finance.*

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