Fact Sheet

ACORE
AMERICAN COUNCIL ON RENEWABLE ENERGY

Tax Equity: Enabling Clean Energy and Growing the American Economy

Tax equity provides a critical financing source for clean energy projects. In a typical tax equity transaction, an investor funds a large portion of a wind, solar, storage, or other clean energy project's overall financing in exchange for a share of the project's tax credits (i.e., the Production Tax Credit (PTC) and Investment Tax Credit (ITC)), other tax benefits, and cash flows.

Why is it important?

Tax equity investments have several key benefits for renewable energy projects:

1. Enabling Project Financing: The tax equity investor provides between one-third to two-thirds of the total capital of a clean energy project, injecting essential upfront capital into its development.

2. Fully Utilizing Tax Incentives: Project sponsors often lack sufficient tax capacity to take full advantage of the federal tax incentives (the PTC and ITC[1]) available for clean energy projects. Tax equity transactions allow the project sponsor to monetize the federal tax credits and other tax benefits for clean energy by exchanging them with financing from a tax equity investor.

3. Enhancing Financial Stability: Tax equity provides additional value to project sponsors in the form of long-term commitments to fund projects, which the sponsors can use to raise construction finance.

Who makes tax equity investments?

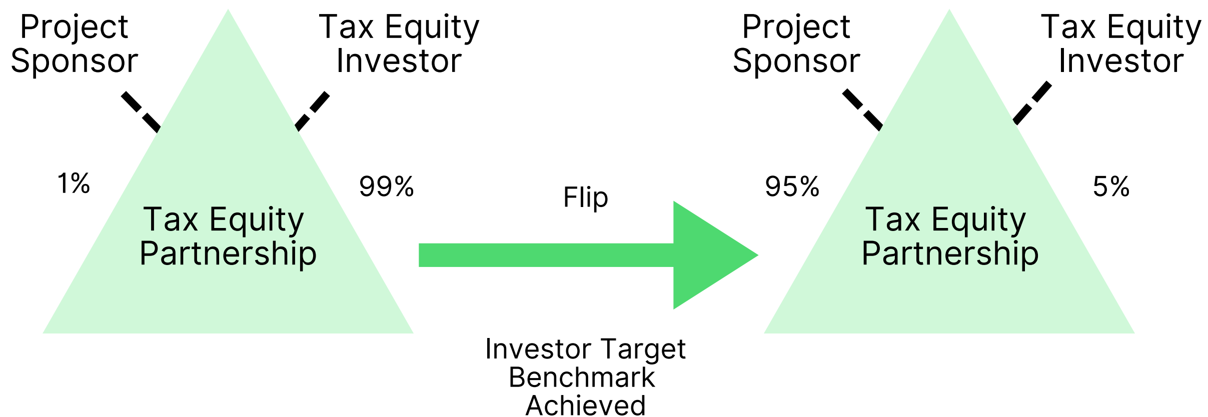
Tax equity structures are complex, and transactions can be expensive to structure. Domestic banks represent approximately 80% of the annual clean energy tax equity market. Other tax equity investors in the market include insurance companies and other large tax-paying corporations.

How does it work?

Renewable energy projects are often held in limited liability corporations (LLC) and taxed as partnerships. In a typical transaction, the project sponsor will form a partnership with a tax equity investor to jointly own the project LLC. The tax equity investor acts as a passive owner and receives a pre-negotiated rate of return, around 80% of which comes from tax credits and other tax-related benefits, like the ability to claim all the depreciation of the project's qualified assets in the first five years of the project; the rest of the return comes from the cash flows of the project.

[1] The ITC is a tax credit that is based on a percentage of the project's cost as a one-time credit in the year in which the project is placed in service. The PTC is a per-kilowatt hour (kWh) tax credit for electricity generated by renewable energy and other qualifying technologies, paid over a 10-year period.

Figure 1: Basic Partnership Flip Transaction



Partnership flips are the predominant tax equity structure in the U.S. clean energy market for both PTC and ITC investments. The tax equity investor typically receives 99% of the tax attributes and a minority share of the cash, often between 5% and 30%. The initial allocation of benefits is sustained until a specific predetermined benchmark is reached. Once the target benchmark is reached, the tax allocations and cash distributions received by the tax equity investor decrease, usually to about 5%. The developer then inherits most of the remaining financial and tax benefits and has the option to buy the investor's remaining interest.

Risk Profile of Tax Equity Investments

Investors view tax equity as a low-risk asset class with attractive risk-adjusted returns, due to the following characteristics:

- Stable, predictable returns from tax credits and accelerated depreciation benefits.
- Positioning as senior equity above the project sponsor's junior equity, which ensures priority for the tax equity investor in earnings and distributions.
- Limited exposure to development and construction risks.
- Robust underwriting processes and structures to perform well under various stress scenarios.
- A short investment horizon over which the substantial majority of tax benefits will be received (6-10 years), which is much less than the useful life of the asset (25-30 years).

Looking Ahead

To meet the goals of the Inflation Reduction Act (IRA), tax equity will need to increase from a $20 billion annual market today to over $50 billion. While the IRA introduced transferability and direct pay as other options to monetize the PTC and ITC, these options are intended to be additive to the tax equity market, which will serve to optimize their benefits. Traditional tax equity is expected to maintain a large share of the market and provide the most overall economic value for project sponsors. Tax equity players will also serve an important role in providing due diligence and syndication services for non-traditional investors.

To read ACORE's full report on tax equity, visit acore.org/resources/the-risk-profile-of-renewable-energy-tax-equity-investments/