

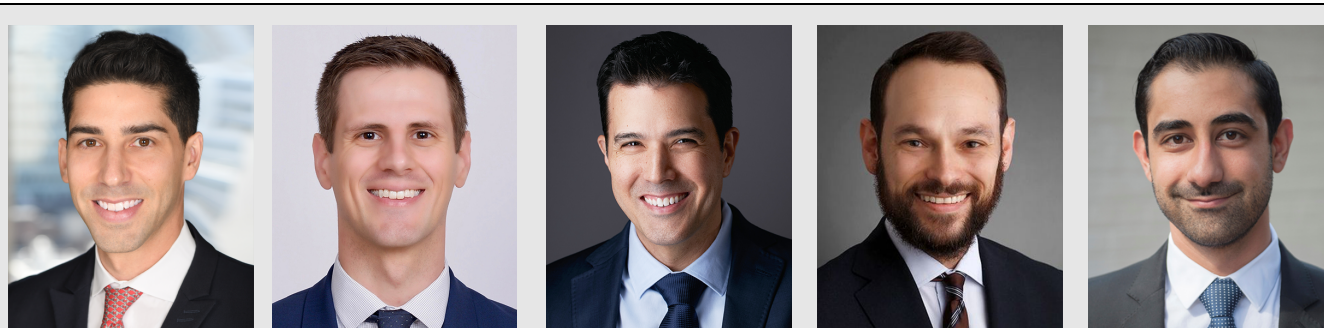
## Energy Tax Credits: Mitigating Risk With Tax Insurance and Market Trends

by Jordan Tamchin, Joshua Emmett,  
Matthew Movafaghi, Ben Gerber, and Hamed Khashayar

Reprinted from *Tax Notes Federal*, April 15, 2024, p. 489

## Energy Tax Credits: Mitigating Risk With Tax Insurance and Market Trends

by Jordan Tamchin, Joshua Emmett, Matthew Movafaghi, Ben Gerber, and Hamed Khashayar



Jordan Tamchin

Joshua Emmett

Matthew Movafaghi

Ben Gerber

Hamed Khashayar

Jordan Tamchin, Joshua Emmett, Matthew Movafaghi, Ben Gerber, and Hamed Khashayar are tax insurance brokers at CAC Specialty, an integrated specialty insurance brokerage and investment banking business.

In this article, the authors explain the tax risks of renewable energy transactions and offer tax insurance solutions as well as a review of recent developments in the tax insurance market that can help reduce those risks.

Copyright 2024 Jordan Tamchin, Joshua Emmett, Matthew Movafaghi,  
Ben Gerber, and Hamed Khashayar.  
All rights reserved.

The Inflation Reduction Act of 2022 provides incentives to developers, sponsors, tax equity investors, and companies with tax capacity — and the market has moved quickly to capitalize. Those incentives, however, are not free from risk. This article identifies the universe of tax risks in renewable energy transactions and how to transfer those risks to the insurance market.<sup>1</sup>

We first focus on tax risks in section 48 investment tax credit transactions after the enactment of the IRA, whether the ITCs are

monetized via section 6418 transfers, traditional tax equity, or hybrid structures (which have become increasingly popular). We provide an overview of each insurable tax risk, the documentation required by insurers to underwrite the risk, and — in some cases — case studies of recently placed tax insurance policies to solve more obscure issues. The case studies are meant to showcase the ability of the tax insurance product to reward innovation when clients, advisers, tax insurance brokers, and insurers work together to solve unique issues.

The second section of this article discusses trends and developments in the tax insurance market. This includes (1) a solution for developers with smaller projects that are typically priced out of tax insurance by minimum premium

<sup>1</sup>The focus of this article is not on the tax law itself, which has already been written about extensively by tax lawyers at law firms that specialize in project finance. For a more detailed discussion, please see our article, Jordan Tamchin, Jessica Kirk, and Matthew Movafaghi, “Clean Energy Tax Credits and Mitigating Investment Risk,” *Tax Notes Federal*, Aug. 29, 2022, p. 1393.

requirements and underwriting fees, (2) a discussion of the significant increase in the use of hybrid tax insurance and representation and warranty insurance (RWI) for tax equity transactions as well as tax credit transfers, and (3) solutions that provide tax credit purchasers greater assurance that misrepresentations by the developer or recapture caused by the voluntary actions of the developer will not trigger exclusions under the policy.<sup>2</sup>

### I. Insurable Tax Risks

Tax insurance is an effective and economical risk management tool used to provide certainty to tax positions.<sup>3</sup> It has played a significant role in the adoption of transferability of tax credits, particularly transferring ITCs. It is helpful to organize the universe of tax risks for an ITC transaction into three risk categories: (1) qualification, (2) recapture, and (3) structure.

Qualification risk includes everything that can affect the amount of ITCs claimed by the taxpayer. For example, one qualification risk is whether the IRS will respect the appraised fair market value of a project and the allocation of tax basis to ITC-eligible assets. Other examples include whether a project will satisfy the “prevailing wage and apprenticeship” requirements and whether a project will be eligible for the “energy community” adder or “domestic content” adder.

Recapture risk refers to section 50, which requires a taxpayer to reduce the amount of ITCs claimed in a tax year if the property generating the ITCs is “disposed of, or otherwise ceases to be investment credit property.” That can include both voluntary actions (for example, selling an interest in the project or project company) and events outside the taxpayer’s control (for example, a hailstorm that destroys some or all of a project).

Structure risk captures anything to do with the tax structure used, whether it is a partnership flip, sale-leaseback, inverted lease, section 6418 transfer, or a hybrid structure.

<sup>2</sup> All references to recapture are to section 50.

<sup>3</sup> For a more detailed discussion, please see our article, Movafaghi and Tamchin, “A Tax Practitioner’s Guide to Tax Insurance,” *Tax Notes Federal*, July 12, 2021, p. 201.

### A. Qualification Risk

While most qualification risks are relatively routine when it comes to underwriting, the two that have become a focus for developers, tax equity investors, and tax credit purchasers are the appraised FMV of a project and the domestic content adder. Also, while qualifying for the energy community adder can be relatively straightforward, there are edge cases with complicated fact patterns that require special attention.

#### 1. Developer markups and valuations.

The amount of ITCs that can be claimed by the taxpayer depends on the tax basis allocated to the project’s ITC-eligible assets. The tax basis of a project is generally equal to the capitalized costs incurred by the developer in constructing the project. The tax basis can be increased, or “stepped-up,” by selling the project to a partnership. The stepped-up tax basis of the project is equal to the purchase price of the project, and that tax basis is allocated among the ITC-eligible and non-ITC-eligible assets comprising the project. The purchase price is supported by a third-party appraisal.

The delta between the capitalized costs incurred by a developer and the appraised value is commonly referred to as the “developer markup,” which represents the value added by the developer and rewards the developer for the entrepreneurial risk taken in constructing the project.

IRS audit activity of ITCs has increased, with the primary focus being the valuation of the project and the amount of developer markup included in the appraised value. The IRS is taking the position that, despite a third-party appraisal and a transaction that is priced using the appraised value, valuations are artificially inflated, and the developer markup is not defensible.<sup>4</sup>

In examination, the IRS carefully reviews the appraisal and challenges the assumptions and methods used by the appraiser. It is important that each appraisal is carefully tailored to the

<sup>4</sup> For a more detailed discussion of the “developer markup” in a tax equity transaction, see Tamchin, “Transactional Tax Risks in Renewable Energy Investment,” *Law360*, June 15, 2020.

specific facts of the project. Comparable cost data, discount rates, and merchant curves are just a few examples of areas that the IRS has focused on.

The recent increase in IRS audit activity around valuations has caused a shift in the tax insurance market. While the insurance market is still insuring transactions with developer markups in excess of 20 percent, underwriters are also scrutinizing the assumptions and methods of the appraisal. More underwriters are requiring appraisals that rely solely on the income approach (which typically results in a higher fair market value than a cost-plus approach) to include a strong justification for the inputs used. For example, if the appraisal uses the same discount rate for the years the project is selling electricity under a fixed price power purchase agreement as for the years the project is selling the electricity on a merchant basis, underwriters want to understand why a higher discount rate was not used for the uncontracted portion. Accordingly, it is becoming best practice for the appraisal to include a discussion and defense of the developer markup, particularly for projects with a relatively high developer markup. For example, if the developer is fully vertically integrated and constructs the project at a cost significantly less than its competitors, the appraisal should include an explanation of why the developer is more efficient and why the project yields a higher developer markup.

Another shift in the tax insurance market is reflected in the underwriter's terms for insuring a project's valuation. Instead of declining the risk transfer, one way underwriters are managing the perceived risk of higher valuations and developer markups is to include a retention, which is essentially a deductible, that shifts the first risk of loss back to the taxpayer. For example, if the appraised value is \$100 and the underwriter is only comfortable with a valuation of \$90, the underwriter may include a \$3 ( $\$10 \times 30$  percent ITC rate) retention so that the first \$3 of loss remains with the taxpayer. While this example is overly simplified, it is meant to demonstrate how the tax insurance market has adapted to changing market conditions. The upshot of this discussion is that premiums have not increased in line with higher developer markups. The underwriters seem to be keeping their premiums relatively

fixed to remain competitive while, in some cases, managing risk by adjusting retentions.

## 2. Domestic content and energy community adders.

### a. Domestic content adder.

Projects placed in service in 2023 or later qualify for the 10 percent ITC domestic content adder if (1) all steel and iron manufacturing processes take place in the United States and (2) the costs and components of manufactured products mined, produced, or manufactured in the United States meet the "adjusted percentage rule," a statutorily required minimum percentage of 40 percent for projects that begin construction before 2025.<sup>5</sup> Project owners claiming the domestic content adder must certify its qualification to the IRS as part of their annual federal income tax return filed for the year the project is placed in service.<sup>6</sup>

The domestic content adder incentivizes developers to use U.S.-sourced iron, steel, and manufactured products; however, it has been difficult for developers to determine whether their projects qualify for such adder. Part of the difficulty is that the manufacturers face competing interests: Disclose granular cost information and risk revealing sensitive financial data to competitors or keep the information private and risk reduced demand (and price) for their products.

Since Q2 2023, developers and investors have been asking how they can insure the domestic content adder for projects under development. In the summer of 2023, CAC Specialty placed the first tax insurance policy to insure the domestic content adder.<sup>7</sup> Since then, CAC Specialty has placed several additional policies that have included coverage for the domestic content adder.

CAC Specialty placement case study — domestic content adder:

- *Facts:* A developer was in the process of negotiating tax equity financing for a solar

<sup>5</sup>This number is 20 percent for offshore wind facilities. This article does not contemplate the domestic content adder as it applies under sections 45Y and 48E.

<sup>6</sup>Notice 2023-38, 2023-22 IRB 872. See also Norton Rose Fulbright LLP, "Domestic Content Bonus Credit" (May 2023).

<sup>7</sup>To the authors' knowledge.

project that included an increased funding amount if the project qualified for the domestic content adder.

- *Issue:* A lack of clarity in the guidance made it difficult for the tax equity investor to get comfortable pricing the transaction including the 10 percent ITC domestic content adder.
- *Solution:* CAC Specialty placed a tax insurance policy that included coverage for the domestic content adder, which required the insured to provide the final costs of constructing the project and the amount of cost incurred that was included in the manufactured product numerator.

#### *i. Overview of domestic content underwriting requirements.*

An underwriter's diligence typically centers around a memo prepared by a law firm, accounting firm or other third-party adviser that thoroughly analyzes the qualification strategy of the project seeking coverage for the domestic content adder. The underwriters will be looking to the memo as a roadmap for their own diligence. Connecting the dots between the memo and the supporting documentation makes it easier for an underwriter to provide competitive proposals on a risk transfer after they complete their initial review of a submission. Seeing a well-organized memo with supporting documentation signals a smooth underwriting process. Conversely, a submission with disorganized materials and without a memo may deter the underwriters, who do not want to spend weeks negotiating and underwriting a policy only to have it fall apart because they can't get comfortable with the risk.

The available IRS guidance is unclear in its definition of what constitutes a manufactured product, and further, developers generally are working without perfect information from manufacturers. Therefore, it is better for the memo to include as much information as possible with well-reasoned arguments when there is not a clear answer. Please note that the below summary is not an exhaustive list of diligence items, and underwriting should be tailored to the project. It is important to work with experienced advisers who can facilitate the process.

#### *ii. Describe the universe of project components.*

The memo should provide a list of all manufactured products that will be included in the project (for example, the battery pack, battery container/housing, modules, inverters, racking/trackers, cables, and substation equipment, as applicable) and steel and iron used. For each component, the memo should include a description of the component, whether it is a "U.S. manufactured product," a "manufactured product component of non-U.S. manufactured products," or otherwise, and the applicable direct material and direct labor costs. To the extent a component is not clearly described in the available guidance, the memo should include a rationale for its inclusion or exclusion from the applicable calculation.

Supporting documentation includes:

- correspondence with manufacturers that confirm their anticipated domestic content percentages and any agreements that include representations/certifications to the percentages;
- invoices for manufactured products and iron/steel;
- evidence of payments; and
- relevant portions of agreements discussing domestic content requirements.

It is helpful if the memo includes excerpts of agreements that require contractors/subcontractors to represent that they will use iron/steel that complies with the domestic content requirements and any certifications following completion of the work that the materials satisfy the domestic content requirements.

#### *iii. Domestic cost percentage calculation.*

The memo should include a calculation of the "domestic cost percentage" based on all available information. This is calculated by dividing the "domestic manufactured products and components cost" by the "total manufactured products cost." The "domestic manufactured products and components cost" includes all "direct materials and direct labor costs," as defined by Treasury regulations.<sup>8</sup> All parties

<sup>8</sup> See reg. section 1.263A-1(e)(2)(i).

recognize that this number is subject to change as the project is constructed. The projects for which CAC Specialty has successfully insured the domestic content adder typically have a significant cushion above the required adjusted percentage (that is, currently 40 percent). The expected adjusted percentage for these successfully insured projects have been as high as 65 percent, while others had expected adjusted percentages in the low 50s. Any tax policy that includes coverage for the domestic content adder will require that the final “domestic cost percentage” calculation at the placed-in-service date satisfies the “adjusted percentage rule.”

*iv. Third-party verification.*

Although not strictly required, it is helpful to have an independent engineer or third-party consultant report that describes the anticipated costs (and once placed in service, the actual costs) and the percentage of costs that will count toward the manufactured product requirement for the domestic content adder.

*b. Energy community adder.*

The 10 percent ITC energy community adder offers investment incentives in areas falling into at least one of three categories: (1) areas with higher than average unemployment that have historically depended on industries related to fossil fuels for employment, (2) areas affected by the closure of coal mines and coal-fired electric plants, and (3) brownfield sites. A project is considered located in an energy community if it is in an energy community on at least one of two dates: (1) the date construction of the project began and (2) the date the project is placed in service. The qualification of a project for the energy community adder under any of these categories is insurable.

*i. Category 1: unemployment data.*

One way a project can qualify for the energy community adder is if it is located in a metropolitan statistical area (MSA) or non-MSA that has historically depended on fossil fuel-related employment and has an unemployment rate that is higher than the national average. Qualification under this category can be relatively straightforward and requires little more than a short memo from the developer that provides (1) the location of the project, (2) a reference to the

applicable appendix and page number of Notice 2023-29, 2023-29 IRB 1, or Notice 2024-30, 2024-15 IRB 1, and (3) the unemployment data for the applicable MSA/non-MSA.

There is one twist to the rule that a project is considered placed in service in an energy community if it is located in an energy community when construction of the project began: Notice 2023-29 states that the Treasury Department and the IRS would issue a list identifying the qualifying MSAs and non-MSAs; however, the first listing would apply to periods beginning on or after January 1, 2023 (that is, using 2022 unemployment data). For subsequent years, the unemployment data will apply from the date the unemployment data is released for the prior year (typically in May) until the data for the subsequent year is released (again, typically in May).<sup>9</sup>

That can create tension for projects that are relying on a beginning of construction date before January 29, 2023, to be grandfathered out of the prevailing wage and apprenticeship rules if: (1) construction of the project began before January 1, 2023, and (2) the project will not be placed in service before May 2024 when the unemployment data for 2023 is released.

Because these projects began construction before January 1, 2023, they cannot be eligible for the energy community adder based on the date construction of the project began. Instead, the project would need to rely on the applicable unemployment data based on the date the project is placed in service. If the project is not expected to be placed in service before May 2024 and, therefore, unable to rely on currently available unemployment data, the energy community status of the project will be left in limbo. That can create modeling issues for project developers. CAC Specialty has successfully used tax insurance to solve this issue.

CAC Specialty placement case study — energy community adder based on 2024 unemployment data:

- *Facts:* A project began construction before January 1, 2023, and is expected to be placed

<sup>9</sup> For example, the energy communities defined by the 2022 unemployment rates were designated in May 2023 and will remain in place until the next update, expected to be in May 2024.

in service in 2025. As a result, the project could only qualify for the energy community adder if it qualifies when the project is placed in service. Qualification would rely on 2024 unemployment data.

- *Issue:* The client was in the process of bidding power purchase agreements, and the difference between a 30 percent ITC and 40 percent ITC made a material difference in their minimum bid.
- *Solution:* CAC Specialty placed a tax insurance policy that would insure any reduction to the ITC amount that resulted from the project failing to qualify for the energy community adder based on 2024 unemployment data. CAC Specialty worked with the client to gather sufficient historical unemployment data to get the underwriter comfortable with the risk transfer. The client was able to include the 10 percent ITC energy community adder in its model and price their power purchase agreement bid accordingly.

#### *ii. Category 2: coal closures.*

The 10 percent ITC energy community adder is available to projects located within a census tract in which a coal mine has closed after December 31, 1999, a coal-fired electric generating unit that was retired after December 31, 2009, or a census tract directly adjoining such a census tract with such a closed coal mine or retired coal-fired electric generating unit. The energy community adder for coal closures generally is the most straightforward. If a developer is seeking tax insurance that provides coverage for the energy community adder based on a coal closure, a memo from management with detailed location information can be sufficient for underwriting, although a third-party memo is generally preferred.

A U.S. Department of Energy website, [energycommunities.gov](https://energycommunities.gov), includes a map with every census tract with a coal closure and every census tract directly adjoining a census tract with a coal closure. The coal closure information used for this website was pulled from the U.S. Department of Labor's Mine Safety and Health Administration, and the retired coal-fired electric generating unit information is based on how it was classified by the U.S. Energy Information

Administration of the U.S. Department of Energy in the Preliminary Monthly Electric Generator Inventory or the Electric Generator Inventory.

Interesting issues can arise when the Mine Safety and Health Administration does not include a coal closure or the Energy Information Administration does not include a retired coal-fired electric generating unit, either by error or because they have irregular location information and are excluded (for example, the coordinates do not place the mines or units in the listed county and state, or the coordinates only extend to the tenths place). In these cases, taxpayers may be able to provide evidence to the Mine Safety and Health Administration or Energy Information Administration to correct the irregular location information.<sup>10</sup> Tax insurance can be obtained to cover the qualification of a project for the energy community adder that is based on such a coal closure.

CAC Specialty placement case study — energy community adder based on coal-fired electric generating unit:

- *Facts:* A project was located in census tract Z. Census tract Z adjoined census tract Y but not census tract X. Census tract X clearly contained a coal-fired electric generating unit that had been retired after 2009 and was included in the appendices to the IRS notices stating it was a qualifying census tract. Census tract Y was not included in the appendices to the IRS notices as a qualifying census tract. However, the coal-fired electric generating unit was located on the border of census tract X and Y, and there was a strong argument that a critical component was located in census tract Y. If correct, the project would qualify for the energy community adder as a result of being located in a census tract (census tract Z) adjoining a census tract (census tract Y) that contained a closed coal-fired electric generating unit.
- *Issue:* The client was in the process of negotiating transaction documents as part of its ITC monetization strategy. The difference between a 30 percent ITC and 40

<sup>10</sup> Similar for retired coal-fired electric generating units.

percent ITC made a significant difference in the economics of the project, and the counterparties wanted additional comfort before executing the transaction based on a 40 percent ITC.

- *Solution:* CAC Specialty placed a tax insurance policy insuring any reduction of the ITC that resulted from the project failing to qualify for the energy community adder. CAC Specialty worked with the client and their outside counsel to assemble a package of supporting documentation — including legal analysis and strong factual support — that substantiated the position.

### *iii. Category 3: brownfields.*

The 10 percent ITC energy community adder is available for projects located on a brownfield site as defined in the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. This category of the energy community adder creates a crossover of environmental and tax law that can present unique challenges, and with most attorneys specializing in either the tax or environmental rules, it requires coordination among experts to reach a legal conclusion.

Notice 2023-29 provides three safe harbors for claiming the energy community adder under this category. The first requires the site to have been previously assessed through federal, state, territory, or federally recognized Indian tribal brownfield resources as meeting the definition of a brownfield site. The second requires a Phase II environmental site assessment that confirms the presence on the site of a hazardous substance. The third category under Notice 2023-29 applies only to projects with a nameplate capacity of less than 5 MWac and requires a Phase I environmental site assessment that identifies the presence or potential presence of a hazardous substance or a pollutant or contaminant as defined in 42 U.S.C. section 9601(39) (the Comprehensive Environmental Response, Compensation, and Liability Act). A memo prepared by a third-party, typically a law firm, that analyzes the qualification of the project for the energy community adder because of its brownfield status will be required for underwriting.

CAC Specialty placement case study — energy community adder based on brownfield status:

- *Facts:* A project with a nameplate capacity of less than 5 MWac received a Phase I environmental site assessment that indicated the presence or potential presence of a hazardous substance or a pollutant or contaminant as defined in the Comprehensive Environmental Response, Compensation, and Liability Act.
- *Issue:* The client was in the process of negotiating transaction documents as part of its ITC transaction. The difference between a 30 percent ITC and 40 percent ITC made a significant difference in the economics of the project, and the counterparties wanted additional comfort before executing the transaction based on a 40 percent ITC.
- *Solution:* CAC Specialty placed a tax insurance policy insuring any reduction of the ITC that resulted from the project failing to qualify for the energy community adder. CAC Specialty worked with the client and their outside counsel to assemble a package of supporting documentation — including legal analysis of the environmental and tax law and strong factual support provided in the Phase I environmental site assessment — that substantiated the position.

## **B. Recapture Risk**

Tax insurance for section 50 recapture addresses the risk that project's ITCs will be recaptured, even if the ITCs initially were properly claimed.

ITCs are subject to a five-year recapture period. The following causes of recapture generally have been of most concern to financing parties: (1) foreclosure on a security interest in the project (that is, project-level debt) and (2) a natural peril that destroys the project.

In the early days of tax insurance, recapture risk coverage was especially important when there was project-level debt that was not subject to a forbearance agreement with the lender during the five-year recapture period. Tax equity investors were concerned that the lender may foreclose on the project during the recapture



period, triggering a recapture of the project's ITCs.

As the market matured, tax equity investors started to require that the projects they financed be unencumbered. The result was that most permanent debt became back-leveraged debt (that is, a loan made to the sponsor, who contributes the funds to the tax equity partnership), which is typically secured by the sponsor's interest in the tax equity partnership (and, therefore, any foreclosure would be on the sponsor's interest and not the project, which is unencumbered). The back-leverage structure limits recapture risk to the sponsor's 1 percent allocation of ITCs from the tax equity partnership.

In section 6418 transfers without a tax equity investor, we are seeing an increase in project-level debt that is not subject to a forbearance agreement with the lender. Thus, the tax credit purchaser is exposed to the recapture risk if a lender forecloses on the project. We have successfully placed tax insurance policies that insure this recapture risk caused by foreclosure.

Typically, underwriters will want to evaluate the economics of the project by reviewing the base case model, underlying credit agreement, and offtake agreements to understand the ratio of debt-to-equity financing, cash flows, debt service coverage ratio, and interest reserves.

CAC Specialty placement case study — recapture risk with project-level debt:

- *Facts:* A developer was seeking tax insurance in connection with a section 6418 transfer of ITCs that included recapture risk. The projects generating the ITCs were each subject to project-level debt, and the lender was unwilling to enter into a forbearance agreement.
- *Issue:* The client was required to obtain a tax insurance policy under the terms of the tax credit purchase agreement that included coverage for the recapture risk.
- *Solution:* CAC Specialty placed a tax insurance policy that included coverage for the recapture risk. The management team prepared a short memo that summarized the key terms of the project-level debt and the economics of the project. CAC Specialty presented the management memo to the insurance markets and advocated why,

despite a lack of forbearance agreement with the lender, the risk of recapture caused by project-level foreclosure was low.

A hardening in the property and casualty (P&C) insurance market has created a gap in coverage for many projects located in parts of the country at higher-than-average risk of catastrophic casualty events. For example, there can be sublimits for hail for projects located in the Electric Reliability Council of Texas jurisdiction. If a project suffers a casualty loss during the ITC recapture period and there is insufficient coverage under the P&C policy to rebuild, there is a chance that the project will remain out of service and the ITCs will be recaptured.

The risk of ITC recapture because of a casualty event has given some tax equity investors and tax credit purchasers pause when considering projects located in areas that are subject to P&C sublimits. Tax insurance provides a neat solution for the risk of recapture attributable to a casualty event.

As part of tax insurance underwriting, insurers require developers to provide documentation of the negotiated P&C insurance requirements with the financing parties, third-party insurance reports, and any P&C insurance coverage. Underwriters typically want to see coverage for the full replacement cost value of the project with an industry standard sublimit (if any). If there is a sublimit for natural catastrophes, underwriters want to understand how such sublimit is determined and if any natural catastrophe modeling was performed to determine if the sublimit is sufficient.

CAC Specialty placement case study — portfolio recapture policy to protect balance sheet:

- *Facts:* A sponsor has a large portfolio of operational projects that have obtained tax equity financing. Some, but not all, projects were already covered by tax insurance policies that included coverage for the recapture risk.
- *Issue:* The sponsor was interested in protecting their balance sheet in the event that a project was subject to recapture and a tax insurance policy was either not in place or had insufficient limits.
- *Solution:* CAC Specialty placed a tax insurance policy (which is referred to as a

“master recapture policy”) that included coverage for the recapture risk that would be in excess of any existing tax insurance policies and provide dollar-one coverage for the projects that were not covered by an existing tax insurance policy.

### C. Tax Structure Risks

In more traditional tax equity structures, the risk that the tax structure will be respected by the IRS is borne by the tax equity investor. This concept is typically captured by including “fixed tax assumptions” or “excluded events” in the tax equity partnership agreement. In the event of a successful challenge of the tax structure by the IRS, the disallowance of partnership items (including ITCs and other tax benefits) will be borne by the tax equity investor.

A typical condition precedent to tax equity investor’s funding is that the tax equity investor receives an opinion of counsel that the tax structure will be respected. Because these opinions are usually delivered at a high level of comfort and the structures have been used countless times for nearly two decades, a partnership flip structure is typically not included as an insured tax position in a tax insurance policy. Including the structure risk as an insured tax position generally would not increase the direct cost of the tax insurance policy, but it expands the scope of confirmatory diligence during the underwriting process.

However, recent innovations in tax structuring regarding section 6418 transfers have increased interest in seeking insurance coverage for the tax structure risk. A hybrid tax equity and transferability structure that allows projects to receive a stepped-up tax basis equal to FMV before transferring the ITCs has become increasingly popular. This structure, sometimes referred to as a “T-flip,” combining “P-flip,” shorthand for partnership-flip, and “T” for transferability.

A T-flip is generally structured using a partnership with allocations of partnership items and distributions of cash that use a “flip” mechanic, similar to a typical tax equity transaction. The key difference is that the amount of cash funded by the investor in a T-flip is much less than in a traditional tax equity P-flip because

the investor in a T-flip is only taking a minority interest in the partnership (typically around 20 percent).

As some tax counsel have become familiar with this structure, at least in concept, developers are considering whether the T-flip structure — with its added complexity and cost — makes sense for a specific transaction. However, the tax opinions delivered are based on the facts of the underlying transaction (not in concept). Because there is no precedent transaction that has been evaluated by the IRS, and the revenue procedures that blessed the partnership flip structure are not directly applicable, tax counsel may not be able to write an opinion at the same high level of comfort that they could with a traditional partnership flip structure. Tax insurance is an excellent solution for this uncertainty, and CAC Specialty has placed multiple policies that include T-flip structure risk as an insured tax position. Tax insurance underwriters generally require a tax memo or opinion regarding the structure (again, typically provided by the tax equity investor’s counsel), the underlying transaction documents, and base case model to get comfortable with the structure risk.

## II. Insurance Policy Trends

2023 was a year of massive change in terms of monetizing tax credits. The ability to transfer the risk of section 6418 transfers, the energy community and domestic content adders, and “T-flips” to the insurance market was mostly theoretical at the beginning of 2023 but now is routine, with well-established underwriting processes. The following discussion highlights a few trends that may not be getting as much attention but that can solve problems and facilitate transactions getting closed.

### A. Policies With Limits Under \$5 Million

The addition of section 6418 by the IRA was intended to open up tax credit monetization for projects that were unable to access the tax equity market. However, tax credit purchasers have been requiring tax insurance on the ITCs being transferred. Although technically possible to obtain tax insurance for any amount of ITCs being transferred, minimum premium requirements and fixed underwriting costs can make smaller tax insurance policies uneconomical. This is a

common fact pattern for developers of smaller projects.

To make insuring smaller projects more cost effective, some developers have bundled multiple smaller projects in a single tax insurance policy to benefit from economies of scale. However, it is not always possible to obtain a tax insurance policy for a portfolio of projects that will be placed in service over several months (or multiple years), which would complicate the underwriting process. Moreover, in some circumstances, tax credit purchasers and tax equity investors may not want to be on the same tax insurance policy as other tax credit purchasers and tax equity investors.

There is an alternative path forward for developers with a strong pipeline of smaller projects. CAC Specialty has fostered exclusive relationships between insurers and developers, optimizing the underwriting process to reduce outside counsel costs and policy negotiations. The benefit for the insurer is that it has a relatively steady flow of premiums that requires minimal resources from its underwriting team. In addition to monetizing the tax credits (which may not have otherwise happened but for the insurance), the insured will benefit from reduced underwriting fees and minimum premium requirements (that is, significant cost savings).

## B. Representation and Warranty Insurance

The hybrid tax insurance and RWI policy offers a single insurance product that combines the scope of coverage of the two individual products. The advantage of a hybrid policy is that the all-in cost of the hybrid policy is significantly cheaper than obtaining a separate tax insurance policy and RWI policy and the confirmatory diligence is consolidated into a single process.

Traditional tax equity investors are requiring hybrid policies with increasing frequency, even for U.S.-based sponsors with strong balance sheets. Limits are typically sized based on the investment by the tax equity investor and covers losses for claims under both the RWI component and the insured tax positions.

In addition to the tax risks, some tax credit purchasers are seeking hybrid policies that insure all of the representations and warranties in the tax credit purchase agreement. These tax credit

purchasers want to allay any risk associated with the section 6418 transfer.

## C. Separate Representations Letters

A standard exclusion in tax insurance policies is the material inaccuracy, misrepresentation, or misleading statement in the representations letter delivered by the insured in connection with binding the tax insurance policy. This exclusion is knowledge qualified, requiring actual knowledge of a knowledge party that a statement in the representations letter was materially inaccurate, misrepresented, or misleading when made. If the knowledge party is associated with the sponsor, some tax credit purchasers and tax equity investors feel that there is a gap in coverage provided by the policy.

A solution that underwriters recently have gained familiarity with is to have separate representations letters, one provided by the sponsor and the other provided by the tax credit purchaser or tax equity investor. The exclusion then applies only to the party that had actual knowledge. The result is that if a sponsor had actual knowledge of a misrepresentation in the representations letter, the tax credit purchaser or tax equity investor is not subject to the exclusion and is still able to collect under the tax insurance policy.

Another solution is for the tax credit purchaser to obtain a buy-side policy. In this structure, the tax credit purchaser is the only insured to the policy and is the party executing the representations letter. Additional benefits of a buy-side policy are discussed in the next section.

## D. Buy-Side Policies

Some tax credit purchasers are uncomfortable with a tax insurance policy that covers recapture risk but excludes coverage for recapture events triggered by voluntary actions (for example, selling the project during the recapture period or voluntarily placing the project out of service). A solution is for the tax credit purchaser to obtain a buy-side policy. This means that the tax credit purchaser is the named insured on the policy, and the tax credit seller is not an insured on the policy. Buy-side policies are typically paid for by the tax credit purchaser. There has been a noticeable uptick in buy-side policies in Q1 2024.

A buy-side policy can be structured as a “single-trigger” policy. In that structure, the insurer pays loss to the tax credit purchaser if there is an event that gives rise to loss under the policy. Unless otherwise waived under the terms of the policy, the insurer has the right to subrogate against the seller to the extent of their indemnity obligation to the tax credit purchaser. The idea is that the tax credit purchaser can then look to the credit worthiness of the insurer rather than the seller for loss.

Alternatively, a buy-side policy can be structured as a “double-trigger” in which an insurer pays loss only if (1) there is an event that gives rise to loss under the policy, and (2) the seller fails to pay its indemnity to the tax credit purchaser. In this scenario, the tax credit seller takes the first risk of loss rather than the insurer. The policy essentially becomes a credit enhancement product.

Two additional benefits of a buy-side policy are worth highlighting. First, a buy-side policy gives the underwriter room to be flexible on the diligence materials being provided. That can be helpful when the seller is a tax equity partnership and when the tax equity investor or sponsor does not want to provide the underwriter with the full scope of diligence conducted in connection with their tax equity investment. Second, a buy-side tax insurance policy is generally less expensive than it is when the insurer covers the first dollar of loss without any right of recovery. From the perspective of a tax credit seller, however, under either a single-trigger or double-trigger policy, the seller of tax credits may not be fully protected. For that reason, the purchase of a buy-side policy is typically motivated by a tax credit purchaser seeking the protection of a tax insurance policy when the tax credit seller is indifferent.

### III. Conclusion

Tax insurance’s flexibility to be tailored to address the needs of a specific ITC transaction has been demonstrated in policies that have provided certainty for the domestic content adder, energy community adder, and recapture. Also, recent market trends have enabled (1) insurance policies with lower limits, (2) the use of hybrid tax insurance and RWI policies, (3) executing separate representations letters for sponsors and

investors, and (4) the use of buy-side policies for tax credit purchases.

Developers, sponsors, and investors in the renewable energy industry have moved quickly to capitalize on the tax incentives provided by the IRA. The tax insurance market has also moved quickly to provide insurance solutions that add value and certainty to these transactions — and will continue to do so. ■