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Tax Indemnity Issues For Developers Seeking Investment Tax Credit Deals

Some renewable energy developers may be rethinking their willingness to protect a tax equity investor's expected tax benefits.

David Burton

There are a number of renewable energy developers who are licking their wounds after having agreed to indemnify tax equity investors for shortfalls in U.S. Department of Treasury cash grant proceeds. There are generally two causes of such shortfalls: budget sequestration as enacted by Congress and the Treasury haircutting the cash grant due to skepticism regarding the fair market value of projects.

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As the cash grant program winds down, some of these developers may be rethinking their willingness to protect a tax equity investor's expected tax benefits and might believe they should refuse to provide indemnity protection for the investment tax credit (ITC) in new transactions so as to avoid the outcome suffered in the cash grant transactions. Giving in to that reflex could turn out be a less than optimal decision.

In the current market, where the demand for tax equity exceeds the supply, if tax equity investors are not provided ITC indemnities, the tax equity investors will assume the worst in their pricing models. Thus, developers' deal economics will be comparable from the ITC benefit to what would have occurred if the Internal Revenue Service (IRS) aggressively audited every deal and prevailed. However, not every deal will be audited, and the IRS will not prevail in every ITC audit it initiates.

Second, an IRS audit is a completely different animal than the Treasury cash grant process. At the Treasury, the administrators of the grant program are effectively prosecutor, judge and jury. If they approve less than what an applicant applied for, the applicant is left appealing to those same administrators in an informal process. Fortunately, the IRS has more robust checks and balances.

Most tax equity investors are audited continually. Therefore, an ITC audit would start with the IRS team assigned to the tax equity investor. If the issue cannot be resolved with the audit team in a manner satisfactory to the taxpayer, the taxpayer may appeal to a relatively independent IRS appeals officer (or a panel thereof for large or complex issues). The appeals officer is responsible for "applying the tax laws reasonably and impartially in an effort to achieve the primary goal of settlement. The appeals officer ... is authorized to enter into settlement(s) ... based on the perceived hazards of litigation."

Further, if a taxpayer is unhappy with the outcome of the appeal within the IRS, there is more flexibility in litigation strategy than there is with the cash grant program. The taxpayer has the choice of three venues: bring an action in tax court or pay the tax in question and bring a suit for a refund in the local federal district court or claims court. For the cash grant program, there is only one venue: the court of claims.

Having forum options not only provides the taxpayer with key strategic choices, it also means improved chances of prevailing. For instance, the tax court may be less likely to brush aside taxpayer-favorable precedent, as the Treasury has done in some instances.

It is worth noting that in the case of a partnership transaction, the developer would have the ability to negotiate directly with the IRS because the audit would be conducted at the partnership level and controlled by the "tax matters partner," which would typically be the developer. Of course, the developer would need to consult with the tax equity investor partner and obtain its consent before settling.

It is relatively customary in tax indemnities in leases that the tax equity investor, if requested by the developer, must contest the dispute through the trial court level. In contrast, cash grant indemnity contest rights are typically quite limited.

In cash grant transactions, the developer's contest rights are limited for three reasons. First, there is no formal administrative appeals process. Second, many tax equity investors are financial institutions regulated by the Treasury, so they do not want to be obligated to do anything that could potentially antagonize a regulator. Finally, the cash grant program is subject to disclosure to Congress and

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under the Freedom of Information Act. Therefore, tax equity investors are concerned that contesting a cash grant dispute could lead to unwanted attention from the Treasury, Congress or the press. Thus, many cash grant indemnities provide that the tax equity investor will enter into informal discussions with the Treasury only to the extent the investor determines that doing so is unlikely to harm its interests.

Fortunately, like tax returns, tax audits are confidential and cannot even be disclosed to other components of the federal government. Therefore, there is no question of disclosure to the Treasury, Congress or the public as long as the dispute is within the jurisdiction of the IRS. However, once the tax equity investor brings an action in court, the dispute is part of the public record.

Many developers found the cash grant indemnity process to be jarring. The tax equity investor would receive an “award letter” from the Treasury providing for a smaller cash grant than the parties anticipated. Several days later, the Treasury would wire the reduced grant amount, and then the developer would receive a notice from the tax equity investor demanding payment of the indemnity. All of this can happen in a short time frame; if it occurs at the end of a quarter, it may provide the developer with insufficient time to prepare for the financial statement consequences.

In contrast, an IRS audit starts with a “notice of proposed adjustment.” The tax equity investor must notify the developer of that notice (or vice versa in the case of a partnership transaction). The audit followed by the appeal within the IRS will likely take at least several months, so the developer is unlikely to be surprised by an indemnity demand.

Generally, under the indemnity terms, in a lease transaction, the tax equity investor selects the counsel for the dispute, decides whether to bring an appeal within the IRS and selects the forum for any litigation. This allocation of discretion in favor of the tax equity investor is a function of the fact that the developer’s transaction is unlikely to be the tax equity investor’s sole dispute with the IRS. Nonetheless, the developer does have some ability to have input into the process. Tax equity investors are generally obligated to consult in good faith with the developer and its counsel regarding strategic decisions (e.g., venue) and provide the developer’s counsel with drafts of documents and pleadings and consider the developer’s counsel’s comments in good faith.

Finally, as most developers do not have tax appetite, a tax equity investor permits the developer to unlock value that is otherwise unavailable to it. To the extent a developer has presented the transaction to an investor as providing a certain level of ITC or cash grant benefit, it is reasonable for the investor to request an indemnity for any shortfall. The only way this expectation as to risk allocation is likely to change is if there is a shift in supply and demand in the tax equity market in favor of developers.

Thus, the process for tax disputes is sufficiently different from the process for cash grant disputes that developers should not conclude from their cash grant indemnity experience that the answer in investment tax credit transactions is to refuse to provide indemnities. However, there are best practices that developers should use when agreeing to tax indemnities. These are as follows:

- The developer’s management should understand the scope of the tax indemnity and potential exposure.
- If the indemnity relates to fair market value, the developer’s management should review the fair market value methodology used in the transaction (e.g., the appraisal) and seek to understand, and minimize if possible, any differences between that methodology and conclusions and the developer’s internal valuations.
- If “controlling” the audit process is important to the developer’s management, the developer should consider opting for a partnership structure in which it is the “tax matters partner.”
- A tax indemnity in a lease structure should include the following protections for the developer with respect to contest rights:

1. The tax equity investor must be obligated to promptly notify the developer upon receipt of a notice of proposed adjustment or other writing indicating that the IRS has an issue with the transaction.
2. The tax equity investor must forgo any right to indemnity if it settles the dispute without the developer’s consent.
3. The tax equity investor must be obligated to consult with the developer and its counsel regarding strategic decisions, such as venue and pursuing IRS appeals.
4. The tax equity investor must be obligated to keep the developer apprised of the progress of the audit.
5. The tax equity investor must be obligated to consider in good faith the developer’s counsel’s comments to pleadings and other documents.
6. The tax equity investor must be prohibited from paying the tax without the developer’s consent, as doing so will preclude bringing an action in tax court.

Developers would be wise to provide tax indemnities in ITC transactions, as doing so is likely to mean significantly better economics for developers. The tax protections afforded to both the tax equity investor and developer in terms of its arrangement with the investor are substantially different under the Internal Revenue Code than with respect to the Treasury’s cash grant program, where there is not much in the way of formal procedures for challenging a reduced award.

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