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OCC codifies rules governing national banks' lending power to make tax equity investments

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Highlights

- A new regulation from the Office of the Comptroller of the Currency (OCC), effective April 1, 2021, codifies and expands prior OCC interpretations dealing with the use of national bank lending powers to engage in tax equity financings.
- It applies, on its face, to all national banks and federal savings associations (collectively, "national banks"). State-chartered banks regulated by the Federal Reserve or the FDIC probably will be able to rely on the new regulation as well.
- National banks may invest in "tax equity financings" provided that such transactions are the "functional equivalent" of loans, as defined through a seven-part test set out in the new regulation and fulfill five additional specified conditions.
- The regulation does ***not*** apply to, or limit, tax equity investments permitted by another authority, such as the community development or merchant banking authorities.
- The OCC has addressed many concerns raised by parties with respect to the proposed regulation, seeking to ensure that the OCC regulations and IRS tax equity guidance are harmonized, although we expect further analysis will still be required.
- The national bank must be a passive investor in the transaction and not be able to direct the affairs of the project company.
- Without the OCC's prior approval, national banks must limit their tax equity finance transactions to no more than 5 percent of capital and surplus, as defined in the final rule, and the OCC can approve an aggregate limit of up to 15 percent of capital and surplus.
- For each tax equity finance transaction, banks subject to the rule must provide written notification to its OCC supervisory office before engaging in the transaction, including the national bank's evaluation of the risks posed by the transaction.

Introduction

The Office of the Comptroller of the Currency ("OCC") has finalized the codification of its rules governing tax equity financings, with an effective date of April 1, 2021.[1] Tax equity financings refer to transactions in which a national bank provides equity financing to fund projects that generate tax credits or other tax benefits, and the use of an equity-based structure allows the transfer of those credits and other tax benefits to the bank. The OCC stated that the legal permissibility of a tax equity finance transaction "is agnostic as to end-user segment and underlying asset." As such, the rule will apply to, among other investments, transactions involving tax credits pursuant to Internal Revenue Code Sections 45 (production tax credit for renewable energy), 45Q (carbon capture and sequestration), 47 (historic preservation), and 48 (investment tax credit for renewable energy), and other types of tax benefits may also apply.

The rule can also apply to Section 42 (low-income housing), although these investments are more likely to be made under the authority of the OCC's community development regulations.

The final rule expressly supports national bank tax equity investments involving utility-scale renewable power-generation facilities, as well as solar financings involving residential installations and solar financings involving non-utility commercial offtakers.

Background

The OCC Final Rule (the "Rule") was adopted as part of a more-extensive update of the OCC's Activities and Operations Rule proposed in July. The Rule codifies, with few modifications, the OCC's prior determinations set forth in several of its Corporate Decisions and Interpretive Letters that permitted national banks to take equity positions in various tax-favored projects, notwithstanding the general prohibition on a bank's ownership of equity interests.

The Rule addresses a national bank's use of its lending authority under 12 U.S.C. 24 Seventh. It is important to remember that this is distinct from tax equity investments in community development and public welfare projects, such as investments that benefit low- and moderate-income housing, New Markets Tax Credit transactions, and similar projects that are permitted under separate statutory authority. A national bank can elect to rely on either authority if the relevant conditions are met. It is also distinct from financial holding companies' use of their merchant banking powers to effect these investments.

The Rule applies directly to national banks and federal savings associations, but under existing rules and practices, it is also likely to govern such investments by state-chartered banks regulated by state banking authorities and the Federal Reserve or the FDIC.

The Rule

The Rule provides that national banks may engage in tax equity transactions using their lending authority under Section 24 Seventh only if the transactions are the "functional equivalent" of loans, as defined therein, and fulfill specified conditions. The OCC's release makes it clear that a transaction can be a standalone investment, or it can be effected through a fund structure provided (presumably) each of the fund's investments and the fund itself qualifies under the Rule.

Functional Equivalent of a Loan

[1] See OCC News Release 2020-158, November 23, 2020. The final rule is available at 85 Federal Register 83686 (December 22, 2020). The Rule will be codified as 12 CFR §7.1025 Tax equity finance transactions by national banks and Federal savings associations.

To be the "functional equivalent of a loan," a transaction must fulfill seven requirements.

First, the structure must be necessary to allow the tax credits *or other tax benefits* to be available to the bank.

Second, the transaction must have "limited tenure and … not [be] indefinite, including retaining a limited investment interest that is required by law to obtain continuing tax benefits or needed to obtain the expected rate of return." This broad statement is intended to liberalize the requirement in a key OCC interpretation (OCC Interpretive Letter #1139), which mandates that "[p]ursuant to the terms of the financing, the unaffiliated minority owner of the Company must have a call option to purchase the project at fair market value after a pre-negotiated amount of time passes or after the Bank receives a pre-negotiated rate of return from the financing." Under the Rule, a national bank must be able to achieve its targeted return in a reasonable time, and the transaction must have a defined termination point, which can be met if the transaction will terminate within a reasonable time or if a project sponsor has an option to purchase the bank's interest at or near fair market value (which can also be a price fixed to enable the bank to recover its initially anticipated return on the investment). The OCC's rationale is that the bank cannot control whether it retains the interest indefinitely. In this regard, the Rule is consistent with the safe harbor parameters set forth for renewable energy transactions under Internal Revenue Service ("IRS") Revenue Procedure 2007-65, which permits a project sponsor to have a fair market value call option on the investor's interest.

The Rule's requirement for the limited tenure to be outside of the control of the bank is inconsistent with select IRS guidance. In particular, IRS Revenue Procedure 2014-12 ("2014-12"), applicable to historic rehabilitation tax credits under IRC Section 47, expressly prohibits call options, and a bank's put option — even a fair market value put option — as permitted by 2014-12, would not satisfy the Rule's requirement because the bank has the sole discretion in whether to put its interest or hold the investment indefinitely. The OCC offered that the bank in such tax equity transactions could couple the put option with a contract provision providing that after a certain amount of time has passed or a certain rate of return has been reached, the interest will revert from the bank to the sponsor; however, this seems contrary to another provision within 2014-12, which requires that an investor's interest not be reduced below 5% of its highest interest. We note that IRS Revenue Procedure 2020-12, providing a safe-harbor for IRC Section 45Q tax credit transactions, contains a prohibition on call options similar to 2014-12. Thus, with historic rehabilitation and carbon capture tax equity investments, further analysis, or perhaps a change in the Rule or the IRS's safe harbors, may be required.[2] Tax credit investments covered by other Code sections that do not benefit from a safe harbor, such as Section 48 energy credits for solar, should be able to use a call option and thereby comply with the Rule. Still, as discussed below, any transaction will require a tax opinion or a good faith belief that tax requirements have been met, regardless of whether the IRS has provided a safe harbor for the particular credit.

The Rule does not prescribe a fixed holding period, and the OCC has acknowledged that the period can be based on the holding period required by law for the bank to realize the tax benefit, such as the 15-year holding period for LIHTC investments. The Rule specifically permits a national bank to retain a limited

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[2] National banks may take advantage of alternative investment authorities, discussed above, with respect to historic and carbon capture tax equity transactions if the relevant conditions are met. We note that IRC Section 45Q provides for a 12-year tax credit term, which exceeds the 10-year term for investments permitted under a bank's merchant banking authority for direct equity investments. A financial holding company could, however, invest through a "qualified" private equity fund. Under these rules, the merchant bank subsidiary could own up to 25% of the fund, which can have a 15-year life, and retain its investment for up to15 years. See FRB's Regulation Y, 12 C.F.R. 225, Subpart J, Sections 225.172 and 225.173. However, as a practical matter, the cost of funding the merchant bank subsidiary is substantially higher than funding tax credit investments through the bank, which limits the utility of the merchant bank authority for this purpose.

interest *that is required by law* to obtain continuing tax benefits or needed to obtain the expected rate of return. For example, many renewable energy facility and historic tax credit investments require the investor to hold its interest for at least five years after the credit-generating asset is placed in service to avoid recapture of the credit. However, the requirement that an investor retain a minimum of 5% of its initial interest is contained in IRS safe harbors — effectively, no-action standards issued by the IRS — that are not statutory in nature. The OCC or the IRS will probably have to provide further clarification if the desire is for national banks to make investments in these facilities.

Third, the tax benefits and other payments from the operation of the project received by the bank from the transaction must repay the investment and provide the expected rate of return, as determined at the time of underwriting. In connection with this requirement, the OCC's release states that a bank investor cannot place undue reliance in its credit analysis on its residual interest in a project. However, subject to the discussion above, a national bank may be required under an applicable IRS safe harbor to retain its post-flip residual interest for a lengthy period. The Rule makes no mention of a residual interest, which is intended to provide flexibility to allow national banks under this authority to conform to the IRS safe harbors. To the extent that the Rule does not require a national bank to divest its post-flip residual interest at a specified time, the Rule enables a national bank to establish a requisite "profit motive," which is a *sine qua non* to establish ownership of the tax credits and to retain the tax benefit.

Fourth, the bank must not rely on appreciation of value in the project or property rights underlying the project for repayment.

Fifth, the bank must use — and document that it uses — underwriting and credit approval criteria and standards that are substantially equivalent to those it would use for a commercial loan. The OCC advises that, to comply with this requirement, the documents governing the transaction should contain terms and conditions equivalent to those found in documents governing typical lending relationships and transactions.

Sixth, the national bank must be a passive investor in the transaction and not be able to direct the affairs of the project company. The OCC explains that, apart from workout scenarios, the bank *cannot be able* to direct day-to-day operations of the project, and that terms, conditions, and covenants that are substantially similar to those found in commercial lending agreements will not violate this requirement. This should not affect the typical tax equity finance transaction, in which the investor has typical limited partner or investor member rights.

Seventh, the bank must account for the transaction appropriately initially and on an ongoing basis, and contemporaneously document its accounting assessment and conclusion. The OCC explicitly recognizes that the accounting and tax treatment of tax equity investments may differ from the treatment of a loan.

Additional Conditions on Tax Equity Finance Transactions

The Rule sets forth five additional requirements that a national bank or federal savings association must fulfill to engage in tax equity transactions.

First, the bank cannot control *the sale of energy from the project*. The OCC has advised that the Rule does not specify how a national bank may meet this requirement, but offers some examples, such as having the sponsor enter into a long-term contract with credit-worthy counterparties to sell energy from the project, or having the sponsor bear responsibility for selling generated power in the energy market as long as those sales are stabilized by a hedge contract that provides reasonable price and cash flow certainty. National banks can also invest in projects that sell portions of the generated electricity in the merchant market rather than pursuant to a power purchase agreement or a hedge contract, provided the national bank has reasonably determined that any merchant sales by the project company contribute favorably to the overall financial health of the project company. Contracts can be entered into with the national bank's affiliates as long as the transaction meets the requirements of the rule and, in particular, complies with applicable bank and nonbank rules, including tax rules, governing affiliate transactions. Likewise, the project company's hedging counterparty can be a bank affiliate as long as the transaction is conducted in a safe and sound manner, but the national bank itself cannot be the hedging counterparty for one of its tax equity investments.

The OCC also confirmed that a national bank, consistent with this requirement, can prohibit certain sales or institute certain credit or other requirements for third-party purchasers of the energy if done pursuant to prudent underwriting to ensure the project's success and not in an attempt to control, influence, or manipulate the energy market. While this condition speaks specifically to energy sales, the OCC would be likely to apply this rule, consistent with the requirement of passivity, to other types of revenue-generating activities undertaken by projects.

Second, the OCC imposes aggregate quantitative limits on the total dollar amount of tax equity finance transactions under a bank's lending authority in which a national bank or federal savings association may engage. Specifically, banks subject to the Rule must limit their tax equity finance transactions to no more than 5% of capital and surplus, as defined, without the OCC's prior approval. This is an increase from the 3% limit of prior law. The OCC can approve an aggregate limit of up to 15% of capital and surplus. Note that separate (and additional) aggregate limits will apply to investments under the community development authority.

Third, for each tax equity finance transaction, a national bank must provide written notification to its OCC supervisory office before engaging in the transaction, including its evaluation of the risks posed by the transaction. The notice requirement is a relaxation of the previous requirement, which required both notice ***and*** that the national bank's examiner-in-charge formally provide a non-objection to the investment. It remains to be seen how this will work out in practice.

Fourth, the rule requires that the national bank be able to identify, measure, monitor, and control the associated risks of its tax equity finance transaction activities individually and as a whole on an ongoing basis to ensure that such activities are conducted in a safe and sound manner. The use of the word "control" is intended to reflect the same type of control over credit risk that a bank exercises in connection with its commercial lending business. Thus, it does not affect the no-day-to-day control rule, described above. This provision sets a regulatory expectation that before a bank commences this activity, it will have established appropriate policies and procedures, and determined the level of risk it is willing to assume in these transactions.

Fifth, the national bank must obtain a legal opinion (which may be from in-house counsel) or have other good faith, reasoned bases for making a determination that tax credits or other tax benefits are available before engaging in a tax equity finance transaction. The OCC determined not to require a legal opinion about the availability of tax benefits, but mandated that the bank must have good faith, reasoned bases, for its determination. The bank may not rely solely on the assurances of a person or entity promoting the transaction that tax credits will be available.

It is worth noting that the OCC, without comment, omitted the requirement of Interpretive Letter 1139 that the bank ensure that "insurance coverage is in place to account for the risk of damage to, or destruction of the facility." It may be expected that a bank will address this risk in underwriting the credit, but doing so is no longer an explicit regulatory requirement.

Other Observations

The Rule makes clear that tax equity financings effected under a national bank's lending authority are subject to all of the usual rules governing commercial lending, including loan-to-one-borrower limits and, as applicable, the rules governing affiliate transactions. The capital treatment of these transactions will be subject to the applicable regulatory risk-based capital rules.

The OCC addresses two other matters in its discussion of the Rule.

First, the OCC advises that from a bank regulatory standpoint, a bank investor could fund a portion of its investment during late-stage construction if required to qualify for the tax benefits and adequate protections are in place, but the OCC could not speak to the tax effect of such investment.

Second, the OCC notes that it declined to incorporate specific contractual remedies that a bank should have in place before entering into a tax equity financing, and this affords banks the flexibility to choose the most-appropriate remedies for a given transaction.

Conclusion

The Rule and its accompanying release provide welcome clarification of how national bank lending authority can be applied to tax equity investments. Still, tax credits play a significant role in motivating these investments, making it important for the IRS safe harbors and OCC rules to work together. With that in mind, we have spoken with the OCC about the need for guidance that will address the inconsistencies discussed above. We encourage interested parties to do the same.

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