

Preferred Equity Monetizations Unlock Energy Tax Credits

By **Eric Pogue, Jonathan Platt and Noah Pollak** (March 2, 2026, 5:38 PM EST)

The landscape for monetizing federal tax credits associated with energy projects continues to evolve. Since the Inflation Reduction Act was passed in 2022, project sponsors have employed various capital structures to capture the value of federal energy tax credits.

A notable development is the emergence of preferred equity monetization, or PEM, structures, which combine elements of tax credit transfers and tax equity partnership-flip transactions with hybrid capital structures.

The prevalence of the PEM structure is not surprising, as it coincides with a larger financing trend in the market that is intensifying in the first quarter of 2026: the significant role of private capital with respect to funding energy and infrastructure projects, including those related to artificial intelligence.[1]



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Background and Market Overview

Eligible Projects and Available Credits

Projects eligible for investment tax credits, or ITCs, under the Inflation Reduction Act, as modified by the One Big Beautiful Bill Act, include solar projects, energy storage systems, wind projects, fuel cells, geothermal projects, new nuclear projects and certain manufacturing projects.

While production tax credits, or PTCs, remain available for certain energy transition projects, for purposes of this discussion, we focus on ITC structures.

Traditional Tax Equity Structures

Tax equity partnership-flip transactions have served as the dominant mechanism for monetizing federal energy tax credits for more than 15 years. A tax equity investor contributes capital to a partnership in exchange for tax credits, other tax benefits — including depreciation — and a share of project cash flows.

Upon the investor receiving a target yield, economic and governance rights flip back to the project sponsor.

Due to structuring complexity — including the fact that the investor needed to have a large tax appetite — the tax equity investor market has been mostly limited to banks, insurance companies and certain strategic corporate entities.

Tax Credit Transferability

The Inflation Reduction Act introduced direct transfers or sales of tax credits to third parties. Tax credit sales offer a streamlined alternative, allowing project sponsors to monetize credits without forming partnership structures.

However, tax credit sales yield lower proceeds, because they do not create an ITC step-up or mechanism to monetize depreciation.

Hybrid Capital and Preferred Equity Monetizations

Hybrid capital — known by many terms in the market, including alternative finance, structured finance and quasi-equity — broadly comprises structured solutions with features of both debt and equity. The primary purpose for these structures, simply put, is to raise significant capital.

Hybrid capital, like tax equity, is unique because it balances the ability to preserve upside equity returns to project sponsors — by prescribing investors' target returns — with mitigating potential adverse impacts that traditional debt products can have to sponsor balance sheets, and in turn, sponsor share prices and credit ratings.

Hybrid capital is used by a variety of entities seeking to raise capital and is industry-agnostic.

In the energy and infrastructure context, hybrid capital frequently involves raising significant capital for new asset development — e.g., data centers and energy generation — when:

- A project sponsor forms a joint venture with a private capital investor;
- The private capital investor funds its investment into the joint venture via a private capital structured instrument; and
- The private capital investor recoups its investment and achieves its return via priority or preferred distributions.



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Against this backdrop, an alternative to tax equity and third-party tax credit transfer transactions has emerged in the context of financing projects that are eligible for ITCs. Specifically, PEMs are transactions that are an amalgam of the hybrid capital model, traditional tax equity and tax credit transfers.

In PEM transactions for ITC projects, project sponsors form a joint venture — i.e., a partnership — with a private capital investor, wherein the investor funds an up-front investment and receives its return via preferred equity distributions from the partnership.

Like traditional tax equity, the PEM structure includes a sale from the project sponsor to a joint venture — i.e., a partnership between the project sponsor and the investor — that facilitates a step-up of the project's tax basis.

In the PEM structure, unlike in tax equity, the investor is not itself monetizing the tax benefits — ITCs or depreciation — but rather facilitating a step-up of the ITC basis, and, in turn, the sale of the ITCs to a third party.

Accordingly, project sponsors using a PEM structure enjoy a higher tax basis in ITC-qualifying assets, and monetize those ITCs via a third-party transfer, but are not able to monetize other tax benefits associated with their project, most notably depreciation.

The trade-off for the project sponsor becomes balancing (1) the benefit of access to a larger pool of private capital investors for PEM transactions relative to traditional tax equity investors, which can in some cases also provide more flexibility in terms, with (2) the drawback of not being able to monetize the other tax benefits via the PEM structure.[2]

Summary of Economic Features

The table below compares the economic features of tax credit transfers, PEMs and tax equity partnership-flip transactions.

	Tax Credit Transfers*	Preferred Equity Monetizations**	Tax Equity (Partnership-Flip)
Is ITC monetized?	YES	YES	YES
Does structure facilitate an ITC step-up?	NO	YES	YES
Does investor advance funds against project cash flows?	NO	YES	YES
Is depreciation monetized?	NO	NO	YES

*Here we are referring to tax credit transfers that are not coupled with a tax equity or PEM.

**PEMs in this table refer to preferred equity investments coupled with a tax credit transfer.

Key Features of PEM Transactions

A key feature of PEM transactions is access to the broad private capital market, including private equity, private credit funds, insurance capital and family offices.

Although market terms for PEM transactions have largely tracked those of tax equity transactions, a key reason for hybrid capital, and, in turn, PEMs, becoming commonplace is the flexibility available in structuring such transactions. The below summary is an overview of the most common characteristics that we have seen in recent transactions.

Key Similarities to Tax Equity

PEM transactions share several foundational characteristics with tax equity transactions. In both structures, the investor contributes capital in exchange for a priority economic position in the project company.

The investor receives distributions from project cash flows, and the project sponsor typically retains residual upside after the investor achieves its target return. Both structures require detailed attention to partnership or limited liability company operating agreements, including provisions governing capital contributions, distribution waterfalls and buyout mechanics.

In our experience, the starting place for the papers in PEM transactions is typically tax equity papers — i.e., equity capital contribution agreements, membership interest purchase agreements and limited liability company agreements that are used in tax equity transactions.

At a more granular level, we have listed below some of the key features of PEM transactions that are shared with tax equity.

20/80 Funding Structure

Like tax equity, PEM transactions for ITCs typically track a funding structure tied to 20% of the capital being contributed at the project's mechanical completion, and the remaining 80% at substantial completion of the project.

Under this structure, an investor can limit its risk during development, while still becoming a member for tax purposes prior to the project being placed in service.

Flip Architecture

PEM transactions typically track to a return. Preferred distributions go to the private capital investor — including make-whole

payments to the extent prior priority payments are missed — and such distributions are tracked against a target return.

After the return is achieved, like tax equity — and more general hybrid capital transactions, in our experience — the economics largely revert to the project sponsor. Similarly, governance rights typically step down, and put options and/or call options spring into place after the flip, effectively creating an exit path for the investor after five years.

Tax Features and Protections

A PEM investor is typically not monetizing ITCs or other tax benefits, given a number of factors — e.g., the PEM investor may be receiving some of its return from the proceeds of the tax credit transfer, market practice and preferences around complying with tax safe harbors, etc.

But in our experience, PEM transactions largely include the tax features and protections of a tax equity transaction. By way of example, PEM investors frequently require tax-based conditions precedent to funding, including receipt of a tax opinion from its counsel, and benefit from a suite of tax representations and indemnities from the project sponsor.

Governance Rights

Governance rights in PEM transactions generally track the negative covenant package from tax equity transactions. Major decisions — e.g., incurring project-level debt, changes in insurance or replacement of major project contracts — require investor consent.

Key Differences Relative to Tax Equity

Again, with the caveat that by definition PEM transactions are more bespoke and vary from transaction to transaction, some notable differences between PEMs and tax equity transactions include the following.

Responsibility for Monetizing ITCs

In traditional tax equity the tax equity investor uses the credits, which count toward the tax equity investor's return.^[3] However, in PEM transactions, the project sponsor is responsible for sourcing a buyer and monetizing the tax credits via transferability.

This tracks with the fees payable in connection with the tax credit transfer. In other words, in a PEM transaction, unlike tax equity, the project sponsor is typically responsible for any fees — broker and legal — arising with respect to the tax credit sale.

Economic Benefits From Depreciation

As noted above, in a PEM transaction the investor often does not price-in the economic benefits associated with depreciation.

That being said, in our experience some depreciation benefits nonetheless flow to the investor as a result of some portion — i.e., more than 1% — of the tax benefits, including depreciation, being allocated to the investor.^[4]

Tax and Cash Allocations

The tax and cash allocations in PEM transactions vary across the market.

With respect to tax allocations, which are generally 99/1 in tax equity transactions, these are bespoke, negotiated provisions in PEM transactions — notwithstanding the fact that PEM investors typically do not monetize ITCs or count depreciation benefits toward the flip calculation.

Offtake Features

Although there is not a standard offtake structure associated with PEM transactions, in our experience, the investors in PEM transactions are more flexible regarding merchant exposure — as well as basis risk — than tax equity investors.

Step-Up Percentages

Similar to offtake structures, there is not a market step-up percentage in PEM transactions relative to tax equity.

That being said, in our experience, the investors in PEM transactions — who typically do not bear any tax risk associated with step-ups — are less restrictive on project sponsors with respect to step-up percentages, assuming the sponsor member provides an indemnity or tax credit policy covering the taxable basis risk for the third party monetizing the tax credits.

Tax Credit Insurance

In general, PEM transactions are more likely to require tax credit insurance to cover the tax credit purchaser's exposure to tax risks — i.e., to further insulate the joint venture, and, in turn, the PEM investor from any exposure to the tax credit purchaser for potential tax losses.

Conclusion

In parallel to hybrid capital becoming an increasingly prevalent tool in the energy and infrastructure financing space, PEM structures have become increasingly common in transactions involving ITCs.

This structure — although not entirely unique from tax equity, and not without its economic challenges — provides an interesting option to project sponsors to access broad private capital markets and take advantage of additional structuring flexibility.

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[1] See, e.g., The New Power of Private Credit, Jan. 20, 2026, <https://gfmag.com/private-credit/the-new-power-of-private-credit/> ("Private credit deals have jumped in recent years from traditionally moderate-sized transactions by leveraged or private companies to gigantic financings by investment-grade multinationals"); Private Capital Power \$70 Billion Data Center Surge, Oct. 17, 2025, <https://www.bloomberg.com/news/newsletters/2025-10-17/private-capital-powers-70-billion-data-center-surge>.

[2] For example, related to tax qualification, step-ups, flip term, etc.

[3] Note the spectrum of structures available to project sponsors also includes a structure, sometimes referred to as hybrid tax equity, pursuant to which a tax equity investor enters into a regular tax equity transaction and then facilitates the sale of some or all of the ITCs to a third party.

[4] The result being that the investor receives certain depreciation benefits without making a payment associated with the same, or taking the depreciation benefit into account when tracking its return via a flip calculation.