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USA – Rhode Island: Trends & Developments

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USA – RHODE ISLAND



Trends and Developments

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State Tax Credit Collateral

In today's environment of high land values and higher-cost loans, commercial real estate development projects are relying heavily on state subsidies to fill gaps in the capital stack. Developers are searching for grants, real estate tax stabilisation agreements and tax credit incentives to pencil out the deal. This chapter of the guide explores bridge financing for real estate deals secured by transferable state tax credits (hereinafter, a "State Tax Credit Bridge Loan").

Once thought of as "out of the box" collateral, lending against state tax credits has become increasingly commonplace amongst community, regional and national banks that are willing to offer these types of bridge facilities to win certain development deals. In Rhode Island, state credits tied to property development include historic preservation credits, low-income housing credits and Rebuild RI credits. In Massachusetts, in addition to historic preservation credits and low-income housing credits, the state offers market-rate housing development credits in gateway cities and brownfields credits. Connecticut offers urban and industrial redevelopment tax credits. Each state has its own unique state tax credit programmes to encourage development (hereinafter "State Tax Credits").

State Tax Credit Award

The first step is to confirm that the entity that will receive the award of tax credits – typically the property owner or ground lessee (hereinafter, the "Project LLC") – has secured an award of tax credits. This is often referred to as a "conditional award", contingent upon successful completion of the project in compliance with the particular credit programme requirements. The conditional award should be evidenced by an award letter from the state agency administering the award or the state's department of revenue. In some instances, the Project LLC is required to enter into a contract with the agency administering the award. It is important to obtain all of the credit documentation available, including the initial application, the conditional award letter(s), any contract memorialising the credit terms, and any other correspondence between the applicant, the state agency administering the programme and the state agency that will ultimately issue the credit certificates. The documentation will contain material information such as (i) whether the

credit amount is fixed or tied to a percentage of eligible project costs subject to a programme cap; and (ii) what year the credits will be awarded. It will also identify the applicant/awardee, which may need to be updated via assignment to the Project LLC.

Be wary of requests to bridge State Tax Credits that have been sought under a competitive programme with no award secured to date. Most State Tax Credits are highly competitive with limited funding and a great number of applicants. Furthermore, certain credit programmes require the applicant to certify that the credit fills a gap in the financing, which will be renounced if the project commences work without the credit award. In general, credit programmes will not allow for an award to be made to a project that has been completed. Without an award, there is no collateral to secure the State Tax Credit Bridge Loan.

A cautionary tale follows an applicant that applied in 2013 for credits under the Rhode Island Historic Preservation Tax Credit (RI HTC) Program, administered by the Rhode Island Department of Revenue, Division of Taxation (the "Division"), which maintains a queue for applicants waiting to receive a credit award. The taxpayer's claim for credit eligibility was denied because the building was placed into service, evidenced by receipt of a certificate of occupancy for the entire building and lease-up of the first floor of the building, prior to the credits becoming available to the taxpayer in 2014. See *State of Rhode Island Division of Taxation Administrative Hearing Final Decision and Order, Case No 14-T-0068 (2015)*.

Programme Logistics and Compliance

To properly underwrite a State Tax Credit Bridge Loan, a full review of the credit programme's enabling legislation and regulations is necessary. Every state credit programme is unique and credit programmes can vary wildly even in the same state. To value the State Tax Credits as collateral, and understand how to perfect a security interest in such credits, it is essential to ascertain whether it is a certificated credit that can be freely sold to third parties, an allocated credit that must be passed through to a member, and/or a refundable credit providing for a dollar-for-dollar refund.

For transferable, certificated credits, the lender should have a grasp on the following:

- any restrictions on transferability, such as a one-time transfer rule;
- the process and timeline to transfer the credits;
- what taxes may be offset by the particular credit;
- the tax year(s) for which credit certificate(s) will be awarded along with any carry-back and carry-forward rules; and
- whether the buyer bears any recapture risk.

These key factors will affect the saleability and potential pool of buyers and the pricing that such credits will command. Timing of the sale greatly impacts the buyer's internal return on investment (IRR). Buyers will pay more for credits that can be immediately used on a tax return than for credits that cannot be used for a year or more in advance.

Aside from the time value of money considerations, careful attention should be paid to the compliance provisions. While the parties may surmise that successful completion of the project is paramount to generation of the tax credits, leading the lender to focus entirely on mitigating the construction risk, failure to comply with a programme requirement may cause a full revocation of such State Tax Credits. It is far less likely that the lender and the borrower will be involved in a dispute over rights to the State Tax Credits than the scenario in which the tax credits are never issued because the conditions to achieving the award are not met. Common pitfalls include:

- failure to file the documentation or pay the fees to successfully reserve the conditional award;
- failure to timely submit the required reporting;
- failure to comply with any labour and wage requirements under the programme; and
- failure to complete the project by the established deadline.

Using the RI HTC again as an example, a USD5 million tax credit award was revoked due to the developer's failure to complete the project by the substantial-completion deadline. See *Fuller Mill Realty, LLC v Rhode Island Department of Revenue Division of Taxation*, 313 A.3d 377 (R.I. 2024). A new condition under

recently enacted RI HTC legislation requires projects with hard costs over USD25 million to pay prevailing wages for all labour on the project and to submit all necessary paperwork regarding such wages in order to validly claim the credit.

Monetisation Process for State Tax Credits

With the credit award in hand and a decent understanding of the credit programme, the lender must gain knowledge of the monetisation process in order to properly calculate the term of the State Tax Credit Bridge Loan. A general rule of thumb is that it may take up to six months following project completion for State Tax Credit certificates to be issued. Some of these state credit programmes require an audit or cost certification to support the eligible expenditures for submission along with all other required documentation to the applicable state agency to review. Additionally, the credit programme may have other prerequisites to be satisfied, such as a lease-up component, approval by the state agency of the scope of work completed and/or recording of a restrictive covenant or regulatory agreement. Lenders should anticipate building in an extension option as the project may encounter construction delays and it may take longer than six months to submit the required information and allow the state to review and process the state tax credit certificates.

State Tax Credit Bridge Loan Structure and Security

The State Tax Credit Bridge Loan may take the form of a credit enhancement to the senior loan with a paydown component at monetisation or as a separate bridge loan secured by a second mortgage on the subject property. Ideally, the Project LLC will be the borrower. If that is not feasible, perhaps because the credits will be allocated to the managing member, there is a different lender at the Project LLC level and/or the federal tax credit investor will not allow it, then the managing member receiving an allocation of the credits may be the borrower and the Project LLC should guaranty the loan.

Pursuant to Article 9 of the Uniform Commercial Code, personal property and fixtures may serve as collateral for a secured transaction. Despite very little case law on point and most cases dealing with tax credit

refunds or non-transferable federal credits, a 1997 US Bankruptcy Court case affirmed that the debtor's right to an earned income tax credit constituted a "thing in action" falling under the definition of "general intangibles", which includes "any personal property, including things in action, other than goods, accounts, chattel paper, documents, instruments and money". The court found that the lender had a valid security interest in the tax credit as the debtor had a transferable property interest in the tax credit, the debtor granted a security interest in the tax credit to the lender in the loan agreement which adequately described the collateral and value was given for such security. See *In re Richardson*, 216 B.R. 206 (Bankr. S.D. Ohio 1997). Although far from well settled, the market consensus is that State Tax Credits qualify as "general intangibles". See Christopher K. Odinet, "Testing the Reach of UCC Article 9: The Question of Tax Credit Collateral in Secured Transactions", 64 S.C.L. Rev. 143 (2012) available at the [Texas A&M Law Scholarship](#) repository (noting that credits have "amorphous and unique qualities" that "do not fit neatly in to the traditional categories of collateral under the UCC's article 9").

To secure the State Tax Credit Bridge Loan, the lender will take a security interest in the credits, including any conditional awards, incentive agreements and credit certificates, any refunds, any and all tax credit allocation, transfer or purchase agreements to monetise the credits, and the proceeds from the sale thereof. It will perfect its interest by filing a UCC-1 financing statement. A power of attorney will be necessary for the lender to speak with the state agency regarding the particular credit to be earned by the Project LLC such as the status of issuance of the credit certificate, or details on the transfer of such certificate. Note that some states, such as Rhode Island, have a special form of power of attorney for this purpose.

The lender should further require evidence of the end-user buyer's binding commitment to purchase the State Tax Credits. It is important for the lender to confirm the purchase price of the State Tax Credits to properly size the State Tax Credit Bridge Loan. For instance, for a USD1 million credit award with a sale price of USD0.92, the net sales proceeds will be USD920,000. The lender may elect to apply anywhere from a 75% to 95% loan-to-value test and bridge

USD828,000 of the USD920,000 net value, keeping in mind whether the credit amount is subject to fluctuation. Although somewhat unlikely, if a project comes in under-budget, and the eligible expenditures are less than the original projected amount, the credits may be reduced.

In addition to identifying the end-user buyer and confirming the contractual relationship for the sale of the credits to such buyer, the lender should take a collateral assignment of such purchase agreement. That agreement should require a direction of payment directing that the sales proceeds be wired directly to the lender to pay off the State Tax Credit Bridge Loan before any excess funds are received by the borrower. The Project LLC should be ready to sell the credits to the end-user buyer promptly upon issuance of the state tax credit certificates.

More complex tax structures include allocating credits and donating credits. The form of security will need to be adjusted accordingly. For credit allocations, the lender should obtain an assignment of capital contributions. For credits that are donated then sold, with the proceeds being loaned back into the project, the lender should obtain a lien on those loan proceeds.

For refundable credits, the lender should direct the state agency to pay the refund directly to the lender upon written request of the Project LLC and the lender. Typically, refunds are issued on a set schedule which may be once or twice per year. The lender will need to be aware of the timing for calculating the term of the State Tax Credit Bridge Loan.

The lender should obtain guarantees and junior mortgages, and any other collateral available, to protect against the risk that the project will not be completed, or will not be completed in accordance with the credit programme rules, and the State Tax Credits will never materialise to repay the State Tax Credit Bridge Loan.

Many of these projects have federal credit components and investors in the deal that are heavily reliant upon project completion to receive the federal credits for which they have invested. The lender may be asked to enter into an agreement with the investor: (i) to confirm that the investor has the right to step into

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the shoes of the Project LLC and complete the project; and (ii) to confirm that the lender cannot foreclose on the subject property or to agree to certain restrictions on foreclosure.

If the lender is providing the State Tax Credit Bridge Loan but is not providing the senior debt, the lender should also enter into an Intercreditor and Subordination Agreement with the senior lender. The State Tax Credit Bridge Lender should be careful to carve out its first priority interest in and to the State Tax Credits, and ensure that any payment subordination in a default scenario does not include repayments to the State Tax Credit Bridge Loan lender from a State Tax Credit source.

Risk/Reward for Bridging State Tax Credits

Lenders should not shy away from bridging State Tax Credits. They should, however, hire counsel to fully review the state tax credit programme to assess the true value and transferability of the credits and to advise as to the risks associated with the particular credit programme and how best to mitigate those risks.

State Tax Credit Bridge Loans represent a significant opportunity for lenders willing to understand the nuances of these financing structures. With proper due diligence, experienced counsel, and careful attention to programme compliance requirements, these transactions can provide competitive returns while helping developers bridge critical financing gaps in today's challenging market. As state incentive programmes continue to expand and evolve, lenders who develop expertise in this area will be well positioned to capture market share in the growing development finance sector.

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