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Legal Update
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Tax Incentive Update: Federal Circuit Rules on Calculation of Basis for Energy Projects

Recently, in *Alta Wind I Owner Lessor C et al. v. United States* ("Alta Wind"),[1] the US Court of Appeals for the Federal Circuit ("Federal Circuit") vacated and remanded the decision of the US Federal Court of Claims ("Claims Court"), which had awarded the owners of six California wind farms approximately $206 million of Section 1603 grants.[2] Certainly, the renewable energy industry would have preferred the lower court's decision to have been upheld. Nonetheless, for the various reasons discussed below, it remains to be seen whether the narrow legal holding of the Federal Circuit in this case will have any meaningful impact on the value of expected tax benefits to the industry. The more important decision will be the Claims Court's decision on remand. (Interestingly, the Federal Circuit took the unusual step of reassigning the case on remand.)

The dispute centered on the method for calculating the amount of the Section 1603 cash grant. However, the ultimate decision may have significant implications to the calculation of eligible basis for purposes of the investment tax credit ("ITC") and accelerated depreciation because Congress provided that the Section 1603 cash grant rules "mimic" the ITC rules in Section 48 of the Internal Revenue Code ("Code").[3]

The decision is likely to have more significance for the solar industry than the wind industry, as wind projects typically claim the Code Section 45 production tax credit ("PTC"), which is 2.4 cents per kilowatt hour of production during the first 10 years of a project's operation (for projects that "began construction" prior to the end of 2016). The method for calculating the tax basis (or the fair market value) of the project has no bearing on the amount of the PTC. Accordingly, the outcome of the decision on remand is of less significance to the wind industry, although the calculation of basis does remain relevant for depreciation.

Background

Section 1603 of the American Recovery and Reinvestment Tax Act, which was enacted in early 2009 to stimulate the economy in light of the financial crisis that started in 2008, provided a federal grant in lieu of tax credits with respect to certain energy property. As is the case with ITC, the amount of the grant was 30 percent of the basis of the eligible property. The program has expired.

The *Alta Wind* decision addressed consolidated cases involving 20 plaintiffs, all of which were special purpose limited liability companies organized for the benefit of various institutional investors. The plaintiffs owned six of the 11 wind farms comprising the Alta Wind Energy Center.[4] Each project was acquired from Terra-Gen Power LLC ("Terra-Gen") after years of development work by Terra-Gen.[5] For five of the projects, the plaintiffs' purchases were pursuant to sale-leaseback transactions. For the sixth project, the purchase was an outright sale.[6]

All of the wind projects were contracted to Southern California Edison pursuant to a long-term fixed-price power purchase agreement ("PPA"). All of the projects were sold prior to their start of commercial operation.

The plaintiffs applied to the Department of the Treasury ("Treasury") for a grant equal to 30 percent of the purchase price basis of the eligible property. The plaintiffs determined the purchase price basis by deducting from their purchase price "small allocations for ineligible property such as land and transmission lines." Treasury disagreed with the plaintiffs' approach and only paid grants equal to 30 percent of the development and construction costs of the eligible property.

The plaintiffs brought a lawsuit against the government in the Claims Court seeking additional grants of over $206 million, which represented the difference between the grants awarded and the grants calculated using the purchase price basis. The government counterclaimed. It asserted that the plaintiffs should return approximately $59 million of the grant received because these were indirect costs incurred by Terra-Gen that should be ineligible for the grant.

A significant obstacle for the government was that the Claims Court excluded the testimony of Dr. John Parsons. Parsons is a senior lecturer at the MIT Sloan School of Business and an author of economic texts. Parsons was the government's expert witness to support the determination of eligible basis. Without his testimony, the government had no expert witness to rebut the plaintiffs' experts and out of hand lost the option to pursue its counterclaims. The Claims Court excluded Parsons' testimony on the basis of credibility because Parsons failed to disclose certain publications on his CV and lied about the omission during his deposition.

The Claims Court ruled for the plaintiffs. The court stated that the basis of a property should be the cost to its owner, which would be the purchase price of the projects in this case. Here, the price the plaintiffs paid was higher than the out-of-pocket cost of developing and constructing the projects. The government argued that Section 1060 of the Code applied and the excess was goodwill or going concern value. The government also argued that the PPA had intangible value. The Claims Court rejected these arguments, instead concluding that the excess could be "turn-key" value. Turn-key value is the value derived from purchasing a facility ready for "immediate" use after purchase, as opposed to a collection of parts or an untested system or even a complete facility without operating permits.

The Federal Circuit held that the Claims Court was incorrect in determining that Section 1060 of the Code did not apply here because the projects had not been placed in service and, for this reason, vacated the Claims Court's decision. The Federal Circuit found that Section 1060 of the Code and the implementing regulations required taxpayers to allocate the purchase price among different asset classes based on each property's fair market value.[7] Thus, the Federal Circuit found that a certain portion of the purchase price could in theory be attributable to the value of goodwill and other intangibles, whereas the Claims Court decision had attributed no value to intangibles. The court remanded the case to the Claims Court for factual findings to determine the proper allocation of the purchase price. In addition, the Federal Circuit held that the Claims Court's exclusion of Parsons' testimony was a reversible error.

Adoption of the Residual Method

Section 1060 requires taxpayers to use the residual method in cases of "applicable asset acquisitions."[8] An applicable asset acquisition occurs when either (i) the use of the acquired assets would constitute an active trade or business or (ii) goodwill or going concern value "could" attach to the acquired assets.[9]

The Claims Court found that Section 1060 did not apply because goodwill and going concern value could not attach to a project until after it became operational. The Federal Circuit disagreed, based on its interpretation of the regulation quoted in the prior paragraph, focusing on the word "could" in the regulation. Pursuant to the regulation, the Federal Circuit examined the totality of the circumstances in determining whether any intangible value could exist in the transaction.[10]

The Federal Circuit gave particular consideration to three factors set forth in the regulation: (i) the presence of intangible assets, (ii) the existence of an excess of the total consideration over the aggregate cost of the assets purchased and (iii) any related transactions, including leases, licenses or other project agreements.[11] As the last two indisputably existed in the Alta transactions, the focus was on the first factor—the presence of intangible assets.

The Claims Court found that no intangibles existed in the transaction. The lower court stated that, by definition, no goodwill or going concern value could attach to any of the facilities before they became operational.[12] In addition, the Claims Court concluded that the PPAs were not separate intangible assets because they were closely related to the specific facilities and were neither transferrable nor assignable.

The Federal Circuit disagreed on both points.

First, the Federal Circuit stated that even if technically no goodwill existed when the project was sold, there was an expectation that goodwill *could* attach "immediately" after the transactions when the projects were placed into service. The expectation was baked into the purchase prices. The Federal Circuit relied heavily on the fact that no development work was necessary at the time of sale. It stated that "[i]n this way, the plaintiffs' relationship with [the offtaker] was largely identical to the kind of customer relationship that an operating business has with its customers." The Federal Circuit further found that the substantial history between the projects and the offtaker and the provision of the initial operation dates and guaranteed operation dates in the PPAs were facts that would suggest that goodwill could accumulate in the form of expectation even before the CODs.

Second, the Federal Circuit found that intangible value could in theory stem from the PPAs and other contracts entered into as part of the transactions. The court determined that the PPAs could constitute customer-based intangible assets because the PPAs represented the customer's commitment to purchase all energy generated at set prices before the projects were complete. The court further found that other contracts, such as the interconnection agreements that conferred transmission rights to the wind farms, could also be treated as intangible assets.

The Federal Circuit relied heavily on Example 4 in the regulation to support its finding that goodwill could arise from a contractual relationship.[13] In Example 4, a manufacturing company entered into a long-term agreement with a bookkeeping business for its bookkeeping services and, in exchange, the bookkeeping business agreed to purchase from the manufacturing company its internal bookkeeping department. The regulation concluded that the transfer of the manufacturing company's internal bookkeeping department is an applicable asset acquisition. The regulation provided that goodwill is "the value of a trade or business attributable to the expectancy of continued customer patronage."[14] The Claims Court read this regulation as suggesting that no goodwill could exist before a project commenced operation. However, the Federal Circuit viewed Example 4 as suggesting that goodwill could accumulate even if the expectation of "continued" customer patronage would begin only after the transaction.

The Federal Circuit did not further clarify the valuation method of the project assets. The Federal Circuit remanded the case back to the Claims Court to find proper allocations of purchase price to each project property. It is clear from the Federal Circuit's decision that a portion of the purchase price would be allocated to intangibles, thus this portion would be excluded from the facilities' bases in determining the amount of grant. Nonetheless, it is still possible that the Claims Court could ultimately determine there is only minimal value associated with goodwill and other intangibles. If that were the case, the ultimate amount of the Section 1603 grant would probably not be significantly affected.

It is worth noting that the Federal Circuit did not completely disapprove of the Claims Court's view that goodwill would only exist after the project began operation. The Federal Circuit only found that goodwill "*could* have attached to the group of assets transferred in the Alta transactions *immediately after the transaction*" (emphasis added). The Federal Circuit explained that due to the readiness of the facilities to be placed in service at the time of the transaction, the expectation that goodwill would accrue in the future itself could constitute an intangible that was baked into the purchase price. The actual value attributable to such expectation could be minimal at the time of the transaction.

Other Issues

Method of appraisal. The Federal Circuit noted that the purchase prices for the Alta wind farms were negotiated based on anticipated cash flows that the projects would generate once they became operational. This fact supported the court's finding that intangibles existed in the transaction because, as the court stated, essentially, the plaintiffs "were purchasing the expectation of future cash flows based on an established customer relationship."[15] However, it is unclear whether the court would have viewed the transaction differently if the plaintiffs had adopted the cost approach in determining the purchase price of the specific projects. That is, if rather than focusing on the present value of the expected discounted cash flows, the parties had focused on Terra-Gen's developmental and construction costs, plus a reasonable profit. However, such valuations do not reflect the thinking in the business world, where buyers are far less concerned about sellers' costs than they are about the available profit level as a result of paying the purchase price to acquire an asset.

Turn-key value. The turn-key value is the incremental value that a purchaser paid for an assurance that the facility would function as a unit without the need of substantial adjustment and coordination.[16]

The Federal Circuit and the Claims Court agreed that turn-key value accounted for at least part of the purchase price. The Claims Court treated the excess of the projects' purchase price over the aggregate value of the project property as turn-key value. However, the Federal Circuit found that the excess could be allocated to intangibles as well. The Federal Circuit found that the value derived from having secured a customer contract, regulatory approvals, transmission rights and various other arrangements that ensured the immediate operation of the wind farms was separate from the turn-key value. Therefore, in allocating the excess value on remand, the Claims Court would need to distinguish between turn-key value and the value of any intangible assets.

Claims Court's exclusion of government's witness. It is worth noting that the Federal Circuit ordered that the case be assigned to a different judge on remand. As discussed above, the Claims Court's judge excluded the testimony of the government's only witness and barred the witness from being cross-examined by the government partly due to his failure to disclose five articles he published from 1986 to 1989 on socialism. The Federal Circuit found that the government should have been permitted to cross-examine the witness, but the Federal

Circuit left it for the Claims Court to determine on remand the credibility of the witness's testimony.

Lessons from *Alta Wind*

The Federal Circuit's decision made two things clear. First, in the view of the Federal Circuit, Section 1060 of the Code would apply to a sale of an energy facility notwithstanding that it had not been placed into service at the time of the transaction. This means that the residual method would be adopted in determining the basis of such facility. This also means that both the buyers (the plaintiffs) and the seller (Terra-Gen) of the wind farms presumably should report this transaction on Internal Revenue Service ("IRS") Form 8594.[17]

Second, goodwill and other intangible value could accrue even before the projects were placed into service, provided that the projects were expected to commence operation immediately after the acquisition.

However, neither the Claims Court nor the Federal Circuit addressed the plaintiffs' argument that no intangible value should be attributed to the project agreements when the terms of these agreements were not more favorable than market.

In this context, we recall that the IRS first expressed its understanding on the subject matter through a 2012 private letter ruling[18] concluding that when a taxpayer purchased wind energy facilities subject to a site-specific power purchase agreement, none of the purchase price needed to be allocated to the power purchase agreement in determining the basis of the wind generation assets. Thus, the entire basis amount could be allocated to the adjusted basis of the wind generation assets. However, that ruling was revoked eight months later by another private letter ruling[19] because the favorable ruling appeared to conflict with a memorandum previously issued by Treasury addressing the issue. In the subsequent ruling, the IRS concluded that the earlier ruling no longer represented the IRS's position on this issue that the portion of the purchase price attributable to the power purchase agreement should be included in its adjusted basis of the wind generation assets.

Nevertheless, even if the PPAs and other project contracts were found to have intangible value, this alone might not significantly impact the amount of the grant the plaintiffs would receive. The Claims Court could find that the value of the intangible is minimal.

If the outcome in the Claims Court leaves open the risk of the residual method attributing anything other than an insignificant amount of value to intangibles and goodwill/going concern value, then other project owners in ITC (but not cash grant, which must be litigated in the Claims Court) disputes with the IRS may want to avoid the potential for similar risk by litigating in a jurisdiction not bound by the holdings of the Federal Circuit, which at present is the only jurisdiction with a settled position on the application of Code Section 1060 to an asset acquisition where the project has not yet been placed in service. This would be done by litigating in the Tax Court or paying the tax and suing for a refund in the district court in which the taxpayer's principal place of business is located. Neither the Tax Court nor a district court would be required to treat a decision of the Federal Circuit as *stare decisis*. Of course, those courts could adopt its holding on the residual method if they agreed with the reasoning.

Given the Federal Circuit's holding, a material question is how to determine if a PPA has intangible value. A difficulty is presented due to the fact that there is typically a time period gap between when a PPA price is agreed to and when the project starts selling power; and market prices can change in the interim. For instance, if (i) a PPA was agreed to in 2015 but (ii) due to the time it takes to obtain the necessary permits and construct the project, power is not sold until 2018, and (iii) between 2015 and 2018 the price

of power declined, should the determination of whether the PPA that was signed in 2015 be made by comparing it to other PPAs signed in 2015 or by comparing it to PPAs signed in 2018 (that may not have power sold under them for the several years it may take to construct the applicable projects). It seems more analytically defensible to compare a PPA signed in 2015 to other PPAs signed in 2015. However, as an anecdotal matter, that is not the approach that Treasury took in administering the cash grant program, but Treasury's reasoning was never expressed.

At the trial level, the government asserted "peculiar circumstances"[20] existed in the form of the federal grant and the sale-leaseback and that such "circumstances" justified second-guessing of the purported purchase price despite the buyers (the plaintiffs) and the seller (Terra-Gen) being unrelated. The Claims Court ruled that no such "peculiar circumstances" were present. Importantly, the Federal Circuit did not expressly disagree with that holding. Therefore, in ITC transactions, taxpayers can take some comfort in knowing that a purchase price is not subject to special scrutiny.

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Endnotes

[1] 897 F.3d 1365 (2018).

[2] For prior coverage of this case, *see* Burton, *Court of Federal Claims Awards $206 Million to Alta Wind Cash Grant Applicants*, reprinted at https://www.taxequitytimes.com/2016/10/court-federal-claims-awards-206-million-alta-wind-cash-grant-applicants/ and Davis and Burton, *Court of Federal Claims to Treasury: "Basis Equals Purchase Price,"* reprinted at https://www.taxequitytimes.com/2016/11/court-of-federal-claims-to-treasury-basis-equals-purchase-price/. The Claims Court decision is available at 128 Fed Cl. 702 (2016).

[3] 111 H. Rpt. 16 provides that "It is intended that the grant provision mimic the operation of the credit under section 48. For example, the amount of the grant is not includable in gross income. However, the basis of the property is reduced by fifty percent of the amount of the grant. In addition, some or all of each grant is subject to recapture if the grant eligible property is disposed of by the grant recipient within five years of being placed in service."

[4] The Alta Wind Energy Center may be one of the largest wind centers in the world.

[5] The projects were initially developed through the joint efforts of Oak Creek Energy Systems and Allco Wind Energy Management Pty. Ltd. ("Allco"). The projects and their associated development rights were later transferred to Terra-Gen in its acquisition of Allco's US wind energy business.

[6] The government argued that the sale lease back transactions and other related transactions between the plaintiffs and Terra-Gen created "peculiar" circumstances, which would justify not using the purchase price for determining basis. The Claims Court found that there were no special circumstances and the Federal Circuit did not disagree.

[7] The value would be allocated on a waterfall basis among seven classes of assets. These asset classes include: Class I: cash and general deposit accounts; Class II: actively traded personal property, including certificates of deposits, foreign currency, US government securities and publicly traded stock; Class III: debt instruments; Class IV:

inventory and other property held for sale to customers; Class V: assets that do not fit within any other class, including tangible property; Class VI: Code Section 197 intangibles, except goodwill and going concern value; Class VII: goodwill and going concern value. *See* Regulation § 1.338-6(b). In *Alta Wind*, the tangible assets would be Class V assets. The contractual rights, if determined to be intangibles, would be Class VI assets. Goodwill and going concern value, if any, would be Class VII assets. This method of allocation is referred to as the "residual method."

[8] Code § 1060(a).

[9] Regulation § 1.1060-1(b)(2)(i).

[10] *See* Regulation § 1.1060-1(b)(2)(iii) (providing that in making the determination of whether a transaction is an "applicable asset acquisition," all the facts and circumstances surrounding the transaction should be taken into account).

[11] *See* Regulation § 1.1060-1(b)(2)(iii)(A)-(C).

[12] The Claims Court stated that goodwill is the value a business acquired from its ability to attract and maintain customer relationships over time and going concern value is the value inherent in an established plant continuing to operate.

[13] Regulation § 1.1060-1(b)(3).

[14] Regulation § 1.197-2(b)(1).

[15] The court overlooks the fact that the same discounted cash flow modeling approach is used to evaluate projects without PPAs. In such situations, appraisers typically use projected energy prices and it is not unusual for those prices to be higher than fixed rates under PPAs; albeit there is more risk.

[16] *See* Miami Valley Broadcasting Corp. v. United States, 499 F.2d 677, 680 (Ct. Cl. 1974).

[17] The failure to file a correct Form 8594 by the due date without reasonable cause may trigger the imposition of penalties pursuant to Sections 6721 through 6724 of the Code. The penalty for failure to file a correct information return on the prescribed date is generally $250 per return.

[18] P.L.R. 201214007 (Jan 3, 2012).

[19] P.L.R. 201249013 (Dec. 12, 2012).

[20] *See* Lemmen v. Comm'r, 77 T.C. 1326, 1348 (1981) (quoting Bixby v. Comm'r, 58 T.C. 757, 776 (1972)).