The Unwind: 'I Don't Want It'

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In this article, the authors consider pre-operational investment situations in which the investor and sponsor contemplate contractual alternatives in the event that a renewable energy facility isn't timely completed. They argue that although it may make commercial sense for the investor to want to divest itself of the nonperforming asset or for the sponsor to liquidate its interest, those arrangements have serious tax implications and exacerbate the placed-in-service issue.

In the inaugural column of "Power and Taxes," we discussed the tensions surrounding the requirement that an investor be an owner when a project is placed in service in order to qualify for the investment tax credit under section 48, and we suggested that investors take a cautionary approach when deciding the dates on which they invest.[1] In this column, we discuss a companion issue that invariably arises when an equity investor, observing that advice, invests before a renewable energy facility is up and running. If the unexpected occurs and the facility does not become operational at a defined point (for example, the facility fails to satisfy a completion deadline imposed by an off-take power purchase agreement), both parties will usually want out of the deal. The investor would want to divest itself of the nonperforming asset, and the sponsor would likely just as soon cut its losses and liquidate its interest (or, just as probable, a construction lender would require that it do so).

This potential circumstance leads the parties to contemplate a wide range of alternatives — from subtle construction completion backstops to outright unwinds. Although these types of arrangements make commercial sense, they have serious tax implications and exacerbate the placed-in-service issue.

The Law

Tax law has long embraced the condition precedent and condition subsequent dichotomy. If a condition precedent in a sales transaction exists, the sale is not complete for tax purposes until the condition precedent is satisfied, is waived, or otherwise falls away. For example, the Tax Court has held that a sale of property will not be treated as complete for tax purposes unless and until the seller can deliver good title to the property.[2] Conversely, if a sale is subject to a condition subsequent, the transaction is viewed as closed despite the existence of the condition.[3] For example, the presence of a ministerial condition, such as recording the title or providing confirmation of the sale, has been treated

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[1] *See* Sean Moran et al., "Renewable Power Facilities: Placed-in-Service Issues," *Tax Notes*, May 23, 2016, p. 1109.

[2] *See Dyke v. Commissioner*, 6 T.C. 1134 (1946) (sale of a property was conditioned on proof of, and delivery from escrow of, good title); *Perry v. Commissioner*, T.C. Memo 1976-381 (sale of corporation's stock was conditioned on shareholder approval and passing of title and of risk of loss); and *White v. Commissioner*, T.C. Memo 1970-132 (sale of building was conditioned on delivery of good title).

[3] *See Herbert J. Investment Corp. v. United States*, 360 F. Supp. 825 (E.D. Wis. 1973), *aff'd*, 500 F.2d 44 (7th Cir. 1974) (discussed below); *Frost Lumber Industries Inc. v. Commissioner*, 128 F.2d 693 (5th Cir. 1942) (formally establishing boundaries, determining acreage, and examining title at the time of the purported closing of the transaction were considered future contingencies insufficient to treat sale as incomplete upon exercise of option); and *Smith v. Commissioner*, T.C. Memo 1962-128, *aff'd*, 324 F.2d 725 (9th Cir. 1963) (buyer's option to create bulk sale escrow to cover potential liabilities exceeding those assumed by buyer and to return property if those liabilities existed is considered a condition subsequent).

as a condition subsequent, which does not prevent a transaction from closing.[4]

Despite this seemingly straightforward rule, definitively categorizing a condition as one or the other is challenging.

A condition precedent will not be treated as such unless there is a legitimate possibility that the condition could fail to be satisfied. In other words, if the condition to the closing of the transaction is a mere formality or if the condition is highly likely to occur, a transaction will be considered closed even though that condition has not yet occurred.[5]

For example, in *Herbert Investment Corp. v. United States*,[6] in accordance with an agreement entered into April 1, 1968, the seller transferred specified tangible and intangible assets of a business to the buyer. Final consummation of the agreement was contingent on the Interstate Commerce Commission (ICC) granting permanent authority to the buyer to engage in the seller's business. Although the court went so far as to recognize that full approval by the ICC was more than a mere formality and that the purchase could not be final without it, the court focused on the intention of the parties and their view of the outstanding ICC condition in deciding that the sale constituted a closed transaction on April 1, 1968. An important point is that the parties were so confident that the required approval would be forthcoming that they committed themselves to the agreement as demonstrated by the transfer of total control of the business to the buyer. Thus, the court found that the parties were in substance treating the condition as a "real, but highly unlikely, condition subsequent," which was not an impediment to closing the transaction.[7] Conversely, in *Rosenthal v. Commissioner*,[8] the Tax Court determined that the transaction was not closed because of the condition precedent of ICC approval. In that case, unlike *Herbert Investment*, the parties had agreed that final approval by the ICC was needed before delivery of the assets of the seller's business and payment by the buyer for those assets.[9]

The Tax Court also looked at the intent of the parties in *Tennessee Natural Gas Lines v. Commissioner*.[10] In that case, the sale of a natural gas facility was subject to regulatory approval. The regulatory approval condition was treated as a condition subsequent by the parties, and, even though title did not pass until that approval, the condition did not prevent the shifting of the burdens of ownership. Among the factors considered important by the Tax Court were that before regulatory approval (1) the buyer paid the purchase price for the facility, (2) the books and records of the seller and buyer reflected the transfer, (3) the sale was reported to the SEC, and (4) the buyer paid property taxes following the purported sale. Therefore, the condition requiring regulatory approval was held not to be an impediment to the finality of the transaction.

Similarly, the ability to unwind a transaction in the future does not necessarily cause the transaction to not be closed if the unwind is not a certainty. For example, in *Metropolitan Commercial Corp. v. Commissioner*,[11] a seller gave the buyer a future put option for half the stock sold to the buyer in a purported sale. The court held that the put option did not prevent the sale from being considered a closed transaction because (1) there was an actual transfer of the stock; (2) the purchaser received all rights to the stock, including the right of disposition thereof; and (3) the purchaser was under no obligation to resell the stock to the seller. According to the Tax Court, "there is nothing inharmonious between

[4]*Charles Schwab Corp. v. Commissioner*, 107 T.C. 282 (1996), *aff'd*, 161 F.3d 1231 (9th Cir. 1998) (holding that the ministerial functions of recording, figuring, confirming, comparing, and booking regarding a stock trade did not constitute completion of that trade).

[5]*Cf. Bankers Trust Co. v. United States*, 518 F.2d 1210 (Ct. Cl. 1975) (based on surrounding circumstances, approval of sale of a corporation's stock by the shareholder was more than a mere formality); and *Ayres v. Commissioner*, T.C. Memo 1983-202 (a purchase agreement not considered closed because it was uncertain whether conditions to good title, requisite occupancy, and adequate financing would be satisfied).

[6]360 F. Supp. 825.

[7]*See also Baird v. Commissioner*, 68 T.C. 115, 127 (1977) (sale was deemed to occur before shareholder approval because the benefits of ownership had passed, and the required shareholder approval was "of little moment" because the majority of shareholders and directors, who had already participated in the negotiations and signed the agreement, were unlikely to vote against it).

[8]32 T.C. 225 (1959).

[9]*See also Newburg v. Commissioner*, T.C. Memo 1965-46 (closed transaction did not occur when sale of property was expressly conditioned on, and would await the approval of, state public utilities commission).

[10]71 T.C. 74 (1978).

[11]22 T.C.M. 533 (1963). *Cf.* section 1091; *Doyle v. Commissioner*, 286 F.2d 654 (7th Cir. 1961) (holding that a short sale of stock was not closed when the transaction involved a repurchase of identical stock and the taxpayer never gave up control of the stock); *Estate of Estroff v. Commissioner*, T.C. Memo 1983-666 (holding that a sale of stock was a wash sale that should not be respected; the taxpayer entered into an agreement to sell shares of stock and repurchase those shares at the same price within 30 days); Rev. Rul. 2005-5, 2008-1 C.B. 271 (loss was disallowed on a sale when the taxpayer sold stock and caused an IRA for his benefit to purchase identical stock on the next day); and Rev. Rul. 85-87, 1985-1 C.B. 286 (loss was disallowed under section 1091 when, within 30 days of the sale of stock, the taxpayer sold an "in the money" put option for the stock and, based on the objective factors at the time the put was sold, there was no substantial likelihood that the put would not be exercised).

the conception of an absolute or completed sale and an agreement to repurchase later at the option of the purchaser.''[12] The court reached a similar conclusion in *Robinson v. Commissioner*,[13] in which it held that a purchaser's right to put shares of stock to a seller did not prevent finality of the sale because there was no assurance that the purchaser would elect to exercise that right.

Even the IRS has gone so far as to find that the ability of a purchaser to reconvey sold property does not disrupt the closing of the sale if the reconveyance is subject to a contingency.[14] In Rev. Rul. 80-58,[15] for example, the IRS ruled that a completed sale occurred even though the seller would accept reconveyance of the subject land if the buyer was unable to rezone the land for the buyer's intended business purposes.[16] The same has been held to be true if the seller holds a conditional right to repurchase[17] and when a transaction simply includes a possible post-closing adjustment to the purchase price.[18]

Although the guidance is limited to partnership allocations of the rehabilitation credits available under section 47, the IRS in Rev. Rul. 2014-12[19] issued a safe harbor that approves a sponsor-developer's ability to provide specific guarantees without causing an investment to fail to be respected. Under the safe harbor, a sponsor-developer may guarantee the performance of any acts necessary to claim historic rehabilitation credits, provided the guarantee is not funded (that is, no money or property is set aside to fund all or any portion of the guarantee).[20] Examples of a permissible unfunded guarantee include a completion guarantee, operating deficit guarantee, environmental indemnities, and financial covenants.[21] As such, at least in some circumstances, the IRS has determined that a transaction should not fail to be respected merely because one of the parties agrees to provide a post-closing guarantee of construction completion.

The Issue

Ideally, when investors and sponsors are considering contractual alternatives in the event a facility is not timely completed, they will conclude that even though the facility will not be in service when the investor enters the transaction, the risk of not achieving satisfactory commercial operation is so low that it is not worth adding conditions that may be close to the precedent line and thereby cloud the

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[12] 22 T.C.M. at 539.

[13] *Robinson v. Commissioner*, T.C. Memo 1973-242.

[14] GCM 37830 (Jan. 19, 1979) (completed sale occurred despite potential reconveyance of the subject land if specified earnings figures were achieved); GCM 39690 (Jan. 25, 1988) (quoting GCM 37830, stating ''the agreement to refund the purchase price is a condition subsequent to the sale, one that does not affect the determination that a sale takes place for purposes of computing a gain or loss, but that requires further action by the seller upon the later occurrence of the contingency'').

[15] 1980-1 C.B. 181.

[16] Under Rev. Rul. 80-58, if the sale and rescission occurred within the same tax year, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year for that transaction. *See also* Rev. Rul. 74-501, 1974-2 C.B. 98.

[17] *See, e.g., Major Realty Corp. v. Commissioner*, T.C. Memo 1981-361, *aff'd in relevant part*, 749 F.2d 1483 (11th Cir. 1985) (the seller's right to rescind the transaction did not prevent it from being closed because the transaction was subject to a condition subsequent within the control of buyer (and the seller had an enforceable right against the buyer to enforce compliance with the condition)).

[18] *Helvering v. Nibley-Mimnaugh Lumber Co.*, 70 F.2d 843 (D.C. Cir. 1934) (a post-sale adjustment to the purchase price in the event title was unsatisfactory to the purchaser and could not be cured did not prevent an accrual basis taxpayer from closing a sale).

[19] 2014-3 IRB 415.

[20] *Id.* The Rev. Proc. 2014-12 safe harbor has several other requirements. First, the sponsor must have a minimum 1 percent interest in each material item of partnership income, gain, loss, deduction, and credit (material item) at all times during the project company's existence, and the investor must have a minimum interest in each material item equal to 5 percent of the investor's largest percentage interest in each such item. Second, (1) the investor's partnership interest must be a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest in the partnership, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the partnership to the investor; (2) the reasonably anticipated value of the investment must be contingent on the partnership's net income, gain, and loss and not be substantially fixed in amount; (3) the investor may not be substantially protected from losses from the partnership's activities; and (4) the investor must participate in the partnership's profit activities in a manner that is not limited to a preferred return that is in the nature of a payment for capital. Third, the value of the investor's partnership interest may not be reduced through fees, lease terms, or other arrangements that are unreasonable as compared with those for a real estate development project that does not qualify for section 47 rehabilitation credits, and that value may not be reduced by disproportionate rights to distributions or by issuances of partnership interests or rights to acquire partnership interests for less than fair market value consideration. Fourth, before the date the property is placed in service, the investor must make a minimum 20 percent unconditional investment in the project company and must maintain that investment throughout the duration of its ownership of its partnership interest in the project company. Fifth, at least 75 percent of the investor's capital contributions must be fixed. And finally, neither the sponsor nor the partnership may have a call option to purchase or redeem the investor's interest.

[21] Under Rev. Proc. 2014-12, impermissible guarantees include funded guarantees, guarantees that the investor will receive distributions or consideration in exchange for its partnership interest (other than an FMV sale right), and guarantees of the investor's ability to claim the section 47 credits.

issue of whether the transaction is closed.[22] In practice, however, the possibility of unforeseen circumstance and delays may cause some investors to search for contractual protections. Whether those protections rise to the level of a condition precedent is a difficult legal question.

Analysis

As described above, the existence of a condition precedent may prevent a transaction from being closed for tax purposes.

For example, if the remedy for breach of a guarantee that a facility will be placed in service by a defined date is a full refund of an investor's investment, the IRS might find — or a court might hold — that the contractual protection is akin to a condition precedent and that the ability to unwind the investor's investment is fatal to concluding that the investment was closed or definite when made. Of course, this would be inconsistent with *Metropolitan Commercial Corp.*,[23] which expressly provides that a purchaser may hold a right to rescind the transaction by reconveying the subject property. If this precedent is observed, an investor should be entitled to the right to unwind the transaction and recoup its investment if, for example, the developer-sponsor is unsuccessful in completing the project. Failure to satisfy the condition that triggers rescission (that is, completion) is highly unlikely (and undesirable) and is solely within the control of the developer-sponsor.[24] Accordingly, in keeping with decades of tax law precedent, an investor's ability to unwind its investment in a renewable energy facility should not prevent the investment from being closed in the first instance.

Moreover, Rev. Proc. 2014-12 illustrates that a transaction (namely an investment in a tax credit partnership) will not fail to be respected merely because the seller provides a guarantee of construction completion. Consequently, in keeping with the logic of that revenue procedure, a construction completion guarantee (and an investor's ability to recoup its investment if not satisfied) should be treated as condition subsequent to the closing of an investor's investment.

That said, and as frequently warned, in the absence of clear guidance, the IRS could view this ability to unwind as a condition precedent. To alleviate that risk, if some sort of contractual protection or arrangement is still required to minimize concerns that a project may not become operational, the parties could conceivably attempt to live with a completion guaranty that leaves the remedies unstated. Generally, a completion guaranty merely provides for the promise of completion, and the breach of that promise may not be explicitly stated but would likely result in a refund or cash damages. This type of guaranty is akin to a normal commercial arrangement in which the parties do not anticipate a breach and a breach is unlikely to occur (while simultaneously providing adequate assurance to investors) and, as such, should be no more than a condition subsequent. Nonetheless, extreme caution should be exercised here because there is little precedent on this particular issue and the outcome largely depends on the facts of each individual situation. ■

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[22]We question the general policy underpinning requiring an investment pre-operation. The requirement obviously leads to uncertainty, and the goal it accomplishes is Pyrrhic. We would welcome the opportunity to work with the IRS to establish a more definitive measure of when a facility is placed in service as outlined in the earlier edition of this column. *See* Moran et al., *supra* note 1.

[23]22 T.C.M. 533.

[24]*See Major Realty Corp.*, T.C. Memo 1981-361.