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Tangible Basis of Property: Who Decides?

By James Dawson, Alexander R. Olama, and Chad M. Vanderhoef*

In California Ridge Wind Energy LLC, et al. v. United States, *the U.S. Court of Appeals for the Federal Circuit addressed whether the amount of the developer's fee claimed by the appellees should be included in the tangible basis of the property. The Federal Circuit upheld the U.S. Court of Federal Claims' decision for the government and appellees will have to repay the government based on its counterclaim that appellees had overinflated their tangible basis. The authors of this article discuss the decision and its implications.*

The American Recovery and Reinvestment Act of 2009 ("ARRA") Section 1603 provided a cash grant ("Grant") for "specified energy property" (as defined in ARRA Section 1603(d)). Specified energy property, within the meaning of ARRA Section 1603, consisted of two broad categories of property—certain property that was part of a facility described in Internal Revenue Code ("IRC" or "Code") § 45, Qualified Facility Property,[1] and certain other property described in IRC § 48, specified energy property.[2]

BACKGROUND

Grants under ARRA Section 1603 were intended by Congress to serve as a substitute for investment tax credit ("ITC") at the election of a taxpayer. Under ARRA Section 1603(b)(2)(A), Grants were equal to the amount of ITC otherwise allowable for the investment in the specified energy property, i.e., 30 percent of the tax basis of specified energy property placed in service by a taxpayer prior to December 31, 2016. Applicants who received payments for property under ARRA Section 1603 were not eligible for the production credit or ITC under IRC §§ 45 and 48 with respect to the same property for the taxable year of the payment or subsequent years. In addition, any credit under

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[1] "Qualified Facility Property" was property that was an integral part of a qualified facility described in IRC § 45(d)(1), (2), (3), (4), (6), (7), (9) or (11).

[2] Specified energy property for purposes of ARRA Section 1603 included, in addition to qualified property that was part of a qualified facility, any other energy property described under IRC § 48 (e.g., qualified solar and wind facilities as defined in IRC §§ 48(a)(2)(i)(II) and 48(a)(3)(A)).

IRC § 48 previously allowed with respect to progress expenditures for the property had to be recaptured.

The following example illustrates how an issue as to qualified tangible property's basis can arise: In 2009, Developer obtains regulatory approval as to a power purchase agreement ("PPA") with a State-Based Utility. The term of the PPA is for 20 years at $145 per megawatt hour ("MWh"). The PPA was facility-specific, meaning that all electricity produced at the solar facility must be sold pursuant to the PPA, and that all electricity sold pursuant to the PPA must be generated at the facility. In 2010, Developer starts seeking and obtaining permits as to the solar facility associated with the PPA. In 2011, a third company ("Purchaser") approaches Developer as to acquiring the solar project and enters into negotiations to purchase the solar project. As part of the negotiations, Developer will also be the sole contractor. Developer will assign various permits and rights, including the PPA, to the new company formed by Purchaser. Purchaser, through the new company, will enter into a separate Engineering, Procurement, and Construction agreement ("EPC"), with Developer to build the solar facility as a turnkey project. The EPC agreement was negotiated, in part, based on the discounted cash flow of the PPA. The deal between Developer and Purchaser is finalized in 2012. The turnkey project is completed and turned over to Purchaser in August 2015.

As required by the U.S. Department of the Treasury, all of the project costs, including the EPC costs, have been allocated between qualified and nonqualified costs and certified by an independent accounting firm and the Grant applications are based on these certified qualified costs.[3] In 2012, market PPA prices dropped to $100 per MWh. In August 2015, market PPA prices dropped to $75 per MWh. In May 2016, the government does not remit all of the payments requested in Purchaser's applications and challenges the qualified cost basis as allocated.

The Internal Revenue Service ("IRS") has always had the ability to challenge a party's allocation. The general rules as to reallocation can be summarized as follows:

- The economic substance of a transaction, rather than its form, is controlling for federal income tax purposes; thus, courts may pierce the

[3] U.S. Department of the Treasury, Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009: Program Guidance, at 17 (2011), *available at* https://www.treasury.gov/initiatives/recovery/Documents/GUIDANCE.pdf.

form of a transaction and tax the substance.[4]

- The underlying philosophy of the "substance over form" doctrine is to prevent taxpayers via an express contractual allocation from attempting to subvert the taxing statutes by relying upon mere legal formality.[5]
- Generally, a contractual allocation will be upheld if it has "economic reality," i.e., some independent basis in fact or some arguable relationship with business reality so that reasonable persons might bargain for such an agreement.[6]
- To determine whether a contractual allocation has economic reality, the courts will examine the facts and circumstances of the particular case.[7]
- If the parties to a contract have adverse tax interests, the courts will give more deference to the form of their agreement. However, if the parties to a contract do not have adverse tax interests, the courts will carefully scrutinize their contractual allocations.[8]
- Pursuant to IRC § 1060—buyer and seller, but not the IRS, are bound by their written allocations unless their agreement is unenforceable because of fraud, duress, undue influence, mistake or other such circumstance.[9]

LOWER COURT DECISION

In *California Ridge Wind Energy LLC, et al. v. United States*[10] and *Bishop Hill Energy, LLC v. United States*,[11] the issue was not whether a development fee can be included in basis but rather the amount of the development fee paid by the limited liability company ("LLC") to its parent company. The U.S. Court of Federal Claims treated this as a tax case. Thus, even though the government

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[4] *See Griffiths v. Commissioner*, 308 U.S. 355, 356357 [23 AFTR 784] (1939); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

[5] *See Major v. Commissioner*, 76 T.C. 239, 246 (1981); *Schulz v. Commissioner*, 294 F.2d 52, 56 (9th Cir. 1961), affg. 34 T.C. 235 (1960); *ODell Co. v. Commissioner*, 61 T.C. 461, 467 (1974).

[6] *See Schulz v. Comm'r*, *supra* at 55.

[7] *See* at 54; *Major v. Comm'r*, *supra* at 250.

[8] *See Schulz v. Comm'r*, *supra*; *Buffalo Tool & Die Manufacturing Co. v. Comm'r,* 74 T.C. 441, 447–448 (1980); *Lemery v. Comm'r*, 52 T.C. 367, 376 (1969), aff'd, per curiam 451 F.2d 173 (9th Cir. 1971).

[9] *See Nestle Holdings, Inc., v. Comm'r*, TC Memo 1995-441 (1995), aff'd, 152 F.3d 83 (2d Cir. 1998).

[10] 143 Fed. Cl. 757, 763 (2019).

[11] 143 Fed. Cl. 540, 545 (2019).

made a counterclaim seeking excess payment, the burden was on the LLC to substantiate the fee. The court agreed with the government and held that the LLCs had failed their burden of establishing the business purpose or the economic substance of the development fee. Accordingly, the court agreed with the government and found the development fees to be a sham. The case was then appealed.

FEDERAL CIRCUIT COURT DECISION

In *California Ridge Wind Energy LLC, et al. v. United States*,[12] the U.S. Court of Appeals for the Federal Circuit upheld the lower court's ruling that the development fees were a sham. The Federal Circuit Court provided additional facts that it was troubled by and applied the peculiar circumstance test.

The Peculiar Circumstance Test

In *California Ridge Wind Energy LLC, et al. v. United States,* the LLCs complied with the requirements of the program and allocated the cost as required under the ARRA Section 1603 program[13] and the Code. The government alleged "sham transaction" not as to the entire transaction, but to just one aspect of the transaction—the developer's fee. The court used the peculiar circumstance test to attack the substance of the fee.[14] The facts that troubled the appellate court most were: the time between the development of the project, entering into development agreement, and payment of the funds.[15] The Federal Circuit Court stated: "Here, not only was the amount of the development fee negotiated between related entities, the fee was paid in a round-trip transaction such that neither the payor nor the payee was materially affected by the transaction. Such circumstances are 'peculiar.' " Thus, the government was successful in culling out the element of the transaction that it viewed as contrary to arm's-length and forcing the taxpayer to justify what had been previously accepted as a cost.[16]

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[12] ___ F.3d ___(Fed. Cir. 2020).

[13] The costs and allocation of costs were reviewed by a Big Four accounting firm.

[14] *See Lemmen v. Comm'r*, 77 T.C. 1326, 1348 (1981). The U.S. Court of Federal Claims primarily relied on *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (2006), to scrutinize the transaction.

[15] It appears that the formal development agreements were entered into shortly before the application of the Grants were submitted, i.e., depending on the particular transaction four to six years.

[16] *See Utilicorp United, Inc. & Subsid. v. Comm'r*, TC Memo 1997-47. In its appellant brief, appellant detailed the testimony that they believed justified the developer's fee. *See* p. 6–10 of Docket No. 23 *California Ridge Wind Energy LLC, et al. v. United States,* Case: 19-1463 filed Sept. 12, 2019. In the industry it is common for the developer to be compensated for the risk

Interestingly, the government did not rely on IRC § 1060, which they had relied on in *Alta Wind I Owner-Lessor C v. United States*.[17] In *Alta Wind,* the item subject to attack was the PPA. The government relied on IRC § 1060 to invalidate the stepped-up basis that was attributable to intangibles. Per the government, the amount of the intangible was to be determined on a cost plus basis. In contrast, the industry position is that a facility-specific PPA is analogous to a lease of tangible property. Under a lease, the lessor provides the lessee with the enjoyment of a designated asset during the term of the lease. Generally, there is no ability on the part of a lessor to substitute another asset for the leased asset. In other words, a lessee has a real stake in the leased property itself. Standing alone, a lessor's interest in a lease has no value or significance. In fact, a lessor cannot meaningfully transfer its interest as lessor in a lease without transferring the underlying property because, absent the property, a transferee could not discharge its obligations under the lease (i.e., to provide the subject property). Thus, just like a lease, the PPA stream of income is ingrained in the value of the tangible assets. Yet, the Federal Circuit Court found in passing that a PPA, or at least some portion thereof, may be characterized as customer-based intangible assets under IRC § 197.[18]

OTHER ARRA SECTION 1603 CASES

Before the U.S. Court of Federal Claims, there are other cases where the government is challenging the negotiated purchase price, i.e., fair market value, between unrelated third parties.[19] In these cases, the government is analyzing the individual assets/components of the transaction and attempting to recalculate/reallocate to assets it has deemed to be an intangible asset.

CONCLUSION

Taxpayers should keep an eye on ARRA Section 1603 cases as to the following:

- What asset(s) the government views as an intangible asset(s)?

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in securing the permits, financing, power purchase agreements, etc.

[17] 897 F.3d 1365 (Fed. Cir. 2018), *rev'g* 128 Fed. Cl. 702 (2016).

[18] *See Alta Wind*, 897 F.3d at 1373-74. The government's expert in *Alta Wind* advocated that the cost-plus method, not the income approach, was the appropriate way to determine the intangible values such as IRC § 197 assets and goodwill. However, at trial he was excluded. The Federal Circuit Court found said exclusion to be reversible error. The remand was highly anticipated in hopes of resolving the valuation issue. However, the valuation issue will have to wait as currently pending before the U.S. Court of Federal Claims is a Motion to Dismiss filed by the government regarding jurisdictional issues as to standing and whether petitioners have demonstrated injury.

[19] *See* "Clean Energy Grant Reversal May Leave Industry Cautious," *Bloomberg News*, Jan. 14, 2019.

- Under what theory (IRC 1060; peculiar circumstance) will the government attempt to set aside the parties' allocations?
- What method will the government uses to value the intangible, i.e., cost plus or some unknown novel methodology?

Whether the court allows IRC § 1060, sham transaction, peculiar circumstance or the government's valuation methods to take precedence over the parties' negotiated purchase price and allocation will be interesting. More important will be the impact to taxpayers if the government prevails in ARRA Section 1603 cases and how will the IRS apply those results to lower the tangible basis, which in turn will lower the basis for ITCs, and which may impact a company's earnings.