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5 Takeaways From Tax Court's Solar Project Ruling

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In a case decided last week, the U.S. Tax Court ruled in the taxpayer's favor as to three California distributed generation solar projects' eligibility for the energy credit under Section 48 and bonus depreciation under Section 168. However, the Tax Court did reduce the taxpayer's basis in the projects and the taxpayer in the case enjoyed significant procedural advantages due to mistakes by the IRS.

In the matter of Donald and Sheila Golan v. Commissioner of Internal Revenue[1], in late 2010 a solar contractor installed solar equipment on the roofs of three host properties and entered into power purchase agreements, or PPAs, with the property owners. The PPAs provided that the hosts would purchase electricity generated by the solar equipment at a discount to utility rates, while the solar contractor would retain the ownership of the equipment, including the right to any tax or other financial benefits and would service and repair the equipment.

Golan, the taxpayer, in 2011 purchased the solar equipment, subject to the PPAs, from the solar contractor for a purported purchase price of $300,000, which was the sum of a purported $90,000 down payment, a $57,750 credit for certain rebates, and a $152,250 promissory note (under which the taxpayer was the obligor but the taxpayer also provided a personal guarantee thereof). The solar projects were not connected to the grid until after the taxpayer acquired them in 2011. The IRS unsuccessfully sought to disallow the taxpayer from taking energy credit and depreciation deduction with respect to the solar equipment.

Before we discuss the substantive holdings in this case, it is important to note that the holdings were based in large part on the IRS, unusually, having the burden of proof. Generally, taxpayers bear the burden of proof; however, the IRS in the notice of deficiency that was generated after the conclusion of the audit of the taxpayer, failed to properly raise the issues in the case. For instance, the notice of deficiency provided that the taxpayer's expenses did not qualify for the "rehabilitation credit" under Section 47 or expensing of business assets under Section 179; thus, missing that the tax credit in question was the energy credit under Section 48, and the deductions in question arose under Section 168(k) (bonus depreciation). These mistakes were fortuitous for the taxpayer as they shifted the burden of proof to the IRS with respect to the actual issues in the case.

The atypical procedural posture means that taxpayers need to be cautious in how much weight they place on the case as precedential value as the results could have easily been different if the taxpayer had to shoulder the burden of proof. Similarly to the claims court's opinion in the cash grant case Alta Wind v. United States,[2] Golan is an example of the critical significance of a case's procedural posture.

The Tax Court's ruling included five opinions of note:

First, the taxpayer's basis in the solar equipment for the year in question was reduced from $300,000 to $152,250. The basis reduction was the result of two adjustments. The taxpayer paid none of the $90,000 down payment in 2011 because the taxpayer did not pay anything toward the down payment during that year and even in later years only paid $80,000 of the $90,000 purported amount.

Further, the Tax Court properly concluded that the taxpayer was not entitled to basis for the $57,750 in utility rebates that were assigned to the solar contractor: "Golan neither received nor reported the rebates as income. We therefore find on the record before us the credit was really a purchase price reduction ... and never recognized as taxable income by the taxpayer."

Second, the taxpayer satisfied the requirements of Section 168(k)(5) bonus depreciation, which at that time required the taxpayer to be the "original user" of the personal property for it to be eligible. The IRS argued that the solar projects were placed in service by the solar contract, prior to their purchase by the taxpayer, even though the projects were not connected to the grid until after the taxpayer owned them. The Tax Court did not apply the five-factor placed-in-service test that IRS rulings apply to power projects.[3] Rather, it simply held that "the solar equipment was not ready and available for full operation on a regular basis for its intended use until it was connected to the electric grid. [W]e hold that [the taxpayer] placed the solar equipment in service in 2011" when the interconnection with the grid occurred.

Interestingly, the IRS used the placed-in-service argument to attack the bonus depreciation eligibility, but seemed to miss the fact that if the projects were placed in service before the taxpayer's acquisition, then there was no energy credit as that statute also has a requirement "that original use of such property commences with the taxpayer."[4]

Third, the taxpayer was "at risk" under Section 465 with respect to the promissory note for depreciation purposes. The Tax Court rejected the IRS's argument that the solar contractor, as the lender under the promissory note, had a prohibited continuing interest in the projects. The court reasoned that the solar contractor was not entitled to any assets of the projects upon a liquidation and had only permitted gross receipts interest, not the prohibited "net profits" interests, in the projects. The opinion provides, "To be sure, the promissory note requires [the taxpayer] to pay [the solar contractor] all monthly revenue generated by the solar equipment. However, [the solar contractor's] right to all monthly revenue is a gross receipts interest, which the regulations permit."

An interesting nuance is that the Tax Court appeared to have little concern that the promissory note was "a 'cash flow' instrument, the note had maturity date [in 2041], but did not have fixed payment amount. Instead it required Golan to pay towards the note all monthly revenue generated by the solar equipment." Presumably, Golan was personally liable on the remaining balance of the note in 2041 when the note "matures," but that is not specifically addressed in the opinion. Given the failure of Golan to pay the down payment in 2011 and the cash flow limitation in the note, the IRS seems to have possibly missed the argument that the solar contractor was the owner of the projects in 2011 when they were placed in service.

Further, the Tax Court commented in a footnote that the taxpayer "granted [the solar contractor] an option

to purchase the solar equipment for the outstanding balance of the promissory note” after the five-year tax credit recapture period. If the projects performed well, the balance of the note in five years could have been paid down to a modest level. That balance could well be less than the fair market value of the projects at that time. Thus, the solar contractor could have been the beneficiary of a bargain or compelled purchase option to acquire the projects from the taxpayer. That would have been a further indication that the solar contractor, not the taxpayer, was the owner of the projects. However, the opinion provides “[n]either party mentioned this agreement at trial or on brief.”

Fourth, the taxpayer was not subject to the Section 469 passive activity loss limitations with respect to the projects. The Tax Court found the taxpayer’s testimony credible and held the taxpayer spent more than 100 hours on the projects during the year in question and no other person spent more time than that. The IRS had the burden of proof on that issue. There is no explanation as to what the taxpayer did to achieve the 100 hours.[5] However, it is comforting to know that in concept an individual can meet the 100 hours requirement in a solar PPA deal.

Lastly, no accuracy-related penalty was imposed on the taxpayer, even on the unpaid down payment that taxpayer claimed to be part of the projects’ basis. The Tax Court’s rationale for not imposing penalties was that the taxpayer reasonably relied on the CPA that prepared his return. This conclusion as to reasonable reliance on the CPA seems lenient to us because for a taxpayer to avoid penalties based on professional advice, the “advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to now, is unlikely to be true.”[6]

The only explanation as to how the CPA included the unpaid down payment in 2011 in the taxpayer’s basis is that either the taxpayer represented to the CPA that he paid the down payment in 2011 when the taxpayer knew he did not or the CPA failed to request such confirmation. Thus, either the taxpayer made a representation he knew was untrue or the CPA missed such an obvious issue that he was not qualified to prepare the return. Either way, in the abstract, it seems like this would have been an appropriate instance for understatement penalties to apply.

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[1] Golan v. Commissioner of Internal Revenue, T.C. Memo. 2018-76 (June 5, 2018).

[2] Alta Wind I Owner-Lessor C v. United States, 128 Fed. Cl. 702 (2016).

[3] See, e.g., Rev. Rul. 76-256; P.LR. 201326008 (Jun. 28, 2013); P.L.R. 201326009 (Jun. 28, 2013).

[4] I.R.C. § 48(a)(3)(B)(ii). There is an exception for sale-leasebacks within three-months of the placed in service date. I.R.C. § 50(d)(4).

[5] For an example of the detailed evidence required to document 100 hours of work in a taxable year, see the Tax Court’s opinion in Leland v. Commissioner, T.C. Memo 2015-240.

[6] Treas. Reg. § 1. 6664-4(c)(ii).