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Legal Update
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Court of Federal Claims to Treasury: "Basis Equals Purchase Price"

On October 31, 2016, the US Court of Federal Claims decided that Halloween was the perfect day to release its opinion in *Alta v. United States*, and the plaintiffs no doubt are enjoying this treat.

The case came about when the plaintiffs brought suit against the Treasury for the alleged underpayment of over $206 million in grants under section 1603 of the American Recovery and Reinvestment Tax Act of 2009. That section provides the owners of certain renewable energy projects with a grant equal to 30 percent of the specified energy property's basis.

As the court aptly stated: "And therein lies the dispute." Importantly, the court emphasized the general rule that "[b]asis, as defined in the IRC, is the cost of property to its owner" and, while there are "exceptions to the general rule that purchase price determines basis," such exceptions did not apply under the facts of this case. Accordingly, the court found that the plaintiffs were entitled to the full amount of their grants and awarded damages equal to the shortfall plus reasonable costs.

The cases involved 20 plaintiffs, all of which were special purpose limited liability companies organized for the benefit of various institutional investors. For 19 of the plaintiffs, the purported basis was set via a sale of a wind project or an undivided interest therein to it from the developer that was followed by a lease back to the developer. For one plaintiff, the basis was set in outright sale from the developer to the plaintiff without a lease; that is, the plaintiff operated the project directly. 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 government, in denying payment of the full amount of the grant applied for, argued that basis should be calculated from "the value of each wind farm's grant-eligible constituent parts and their respective development and construction costs." Everything else would be categorized as either goodwill or going-concern value. Accepting the plaintiffs' argument, argued the government, would mean accepting an inflated and improper number far in excess of what the assets would justify.

The plaintiffs' determination of eligible basis was purchase price "minus small allocations for ineligible property such as land and transmission lines."

To support its determination of eligible basis, the government called Dr. John Parsons as an expert witness. Parsons is a Senior Lecturer at MIT Sloan School of Business and an author of economic texts. Parsons, under penalty of perjury, failed to disclose a number of texts he authored for Marxist and East German publications. When presented with an expert witness who intentionally removed from his CV publications related to his field of expertise and then denied having done so on multiple

occasions, the court found that it had "no choice but to exclude Dr. Parsons[']" testimony. Without Parsons, the government had no expert witness to rebut plaintiffs' experts and out of hand lost the option to pursue its counterclaims. Left only with the primary issue question of basis, the court proceeded.

Below is a summary of the salient points to be taken from the court's opinion in *Alta*.

No Basis Was Allocated to the PPA

Analogizing the PPA at issue to a ground lease that is transferred in connection with the sale of the fee simple interest in the land, the court held that the PPA cannot be "considered a separate asset from the underlying land, even if the land lease terms are better than market."[1] Continuing on, the court stated that the PPA here related only to their specific wind farm facilities. The court found it neither transferable nor assignable. "[T]he close nexus between the wind farm facilities and their respective PPAs means that they cannot be viewed as separate intangible assets."

This finding is contrary to the IRS's revocation of a prior taxpayer-friendly private letter ruling.[2] That revocation implied that basis should be allocated to a PPA with pricing above that available in the market at the time of the sale of the project subject to the PPA. There is now an open question whether the industry is going to follow the apparent IRS position or the court's decision in *Alta*. Court cases have greater precedential value than a private letter ruling, but the government will likely appeal this case. The Department of Justice has 60 days from the date the judgment was entered to do so, and the Court of Federal Claims can extend the appeal deadline.[3] The judgment was entered on October 24, so keep an eye out in late December for the government's response.

Projects Have Neither Goodwill nor "Going Concern" Value Prior to Being Operational[4]

Defining goodwill as the expectancy of continued patronage, the court was able to quickly do away with the government's contention that any portion of the purchase price came from goodwill. "[G]oodwill is not a free floating residual category to which one must allocate any value attached to a group of assets that exceeds the development and construction costs of those assets." Instead, the court found goodwill to refer to the "ability to attract and maintain customer relationships over time." With this definition in hand, the court focused on the fact that the wind farms were yet to reach commercial operations at the time of sale. Acknowledging that "goodwill may attach where even one customer purchases all of a businesses output 'for a long series of years,'"[5] the court found that "the fact that the Alta facilities . . . were not yet operational when purchased is dispositive here." It continued: "Because both parties had not yet begun performance under the PPAs at the time of purchase, … this expectancy [of continued patronage] could not have existed at that time, so goodwill could not have attached." The court rejected the government's argument that the location of the facilities adds goodwill because "the value of an asset's permanent location is part of the basis of the asset itself, and is not goodwill or any other separate intangible asset."

Turning then to "going concern" value, which the court defined as the "special value inherent in a functioning established plant continuing to operate, to do business, and to earn money, with its staff and personnel," the issue again was the fact that the Alta assets were yet to reach commercial operations. The court noted the lack of cash flows or any other "continuing" aspect of the transaction when closing the door on the

opportunity for the Alta transaction and those like it to have any "going concern" value.

Turnkey Value Is Part of the Tangible Assets

"This is the real sticking point in this case," said the court. After addressing the government's goodwill and going concern arguments, the court did away with the government's attempt to place any turnkey value of the transaction under one of those two umbrellas. Citing to *Miami Valley*,[6] the court found that turnkey value was not the same as going-concern value; rather than purchasing an existing business, the buyer "is purchasing a put-together facility that is *ready* for operation." The value, then, is derived from the potential of the tangible assets themselves, rather than some separate intangible.

Neither Alta's Particular Sale-Leaseback nor Its Section 1603 Indemnities Created the "Peculiar Circumstances" Necessary to Set Aside Plaintiff's Basis Estimate

If the government were able to convince the court that there were some "peculiar circumstances" in the structuring of the deal, then the court would have been able to disregard plaintiffs' basis proposal.[7] Going one step further, the court found it reasonable to set aside purchase-price basis only if there were peculiar circumstances *and* those circumstances led to a "*highly* inflated purchase price."

The first potentially peculiar circumstance that the court looked to was the sale-leaseback aspect of the transaction. Because the "Section 1603 grant program explicitly envisioned sale-leaseback structures," the court required the government to show "some indication that the parties to the transactions adjusted various aspects of the sale and leaseback prices in order to highly inflate the purchase prices." The government presented no evidence at trial to suggest that this occurred, and the prices paid for the two sale-leaseback projects in question were comparable to the project sold without being followed by a leaseback. Finally, the rent prepayments under the lease made business sense to the court, which held those prepayments to provide the lessee "breathing room" in the event that the special purpose lessee's revenues were lower than expected. For these and other reasons, the court found nothing in the sale-leaseback transactions that would suggest the parties manipulated the deal to artificially inflate the purchase price.

The project's sponsor indemnified the purchasers/plaintiffs for any shortfall in the section 1603 grant. These indemnities, however, presented no "peculiar circumstances" in the court's eyes. They are common in the field, and one of plaintiffs' experts testified that similar "tax" indemnities existed in every lease transaction he worked on. "Nothing about this enhanced value estimate is peculiar; rather '[w]hen examining a transaction, the reality that the tax laws affect the shape of most business transactions cannot be ignored.'"[8] The court went on to say that "the weight of the evidence confirmed that similar tax-related indemnities are common in complex commercial transactions like this one." The tax indemnities therefore "confirmed the fair market value of the facilities once expected grant amounts were taken into account, and did not give rise to peculiar circumstances."

Pro Rata Indirect Allocation for Costs Is a Valid Method for Determining Basis

No longer bogged down with assertions of "peculiar circumstances," the court set out to assess plaintiffs' process for dictating which parts of its assets were eligible and which were ineligible for section 1603 grants. The sponsor provided to the plaintiffs "cost schedules for the

Alta projects that broke down the total development and construction costs into various components, including property that was eligible for a section 1603 grant and property that was not." Those schedules showed:

> [The sponsor] 'capitalized' the indirect costs into the hard assets—meaning that the indirect cost effectively becomes part of the hard asset. In some instances indirect costs were entirely eligible—for instance, if they were associated with only eligible assets, such as permits for the wind turbines. In other instances, indirect costs were entirely ineligible, such as costs related solely to electricity transmission. Finally, some indirect costs, like interest during construction, related to the entire Facility and were thus partially eligible and partially ineligible. Such indirect costs were apportioned pro rata among all of the direct costs. To illustrate, if the Facility's eligible direct costs were twice as high as the Facility's ineligible direct costs, then the indirect costs were spread among the direct cost of items using the same 2:1 ratio.

The government had argued that plaintiffs' use of pro rata allocation was as wildly inappropriate as it was inaccurate. It argued that the presence of section 1603 property increased the value of wind farms, such that a pro rata method would overstate the eligible basis. For that reason, the government argued, calculating the value of the assets by cost would be the most precise method. However, the government did not present evidence at trial to demonstrate that the pro rata method was not reasonable.

The court was not persuaded by the government's "attack[s] on the logic behind any pro rata allocation method Plaintiffs could possibly use in this case." Taking a pragmatic approach, the court said, "[i]n the real world, this grant-eligible property is hopelessly intertwined with grant-ineligible property. . . .[A]ny pro-rata allocation method will necessarily involve extrapolation based on the construction and development costs of the grant-eligible and grant-ineligible property under Section 1603, and the Court finds Plaintiffs' allocations to be reasonable." Given the absence of a different definition of "basis" from Congress, the court found that Plaintiffs took the "least imperfect way possible."

As a tip, the court gave meaningful weight to the rule of thumb in the industry that 95 percent of wind farm construction costs are grant-eligible. While this does not mean that 95 percent of every project's costs will always be eligible for ITC/1603, this is a helpful measuring stick for third-party valuations.

Conclusion

At its heart, this was a case about foundational principles of the allocation calculation. The case is a victory for the plaintiffs and the renewable energy industry as a whole. It remains to be seen if subsequent section 1603 cases will distinguish the *Alta* judgment due to the government's lack of an expert witness. Further, industry participants can't take for granted that this treat won't become a trick until the government's right to appeal lapses or the Federal Circuit rules on any government appeal.

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Endnotes

[1] *See Schubert v. Comm'r*, 33 T.C. 1048, 1053 (1960), aff'd, 286 F.2d 573 (4th Cir. 1961).

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

[3] Rule 4(a)(1)(B)(i) FRCP.

[4] The parties' focus on goodwill and "going concern" value stemmed from the potential application of I.R.C. § 1060. If the assets were found to have either goodwill or "going concern" value, the parties would have been forced to apply the "'residual method' of pricing as provided in I.R.C. § 338(b)(5) to value the grant-eligible assets," effectively eviscerating plaintiffs' basis calculation.

[5] Quoting *Pfleghar Hardware Specialty Co. v. Blair*, 30 F.2d 614, 617 & n.9 (2d Cir. 1929).

[6] *Miami Val. Broad. Corp. v. US*, 499 F.2d 677 (Ct. Cl. 1974).

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

[8] Quoting *Tanner v. Comm'r*, T.C. Mem. 1992-235, 1992 WL 79077 (April 21, 1992).

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