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Unclear Which Way Wind Blows After Reversal Of Alta Wind

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On July 27, 2018, the U.S. Court of Appeals for the Federal Circuit handed down its decision in Alta Wind Owner Lessor C et al. v. United States,[1] reversing a taxpayer-friendly decision by the Court of Federal Claims in 2016 that had been widely applauded by the renewable energy sector, which benefits from valuable federal income tax subsidies generated by their projects. The Federal Circuit decision is narrow and its implications for the renewable energy sector are not yet clear. While Alta Wind centered on a now-expired cash grant program under Section 1603 of the American Recovery and Reinvestment Tax Act, the decision has implications for renewable energy projects eligible for the IRC Section 48 investment tax credit — generally equal to 30 percent of the basis of qualified energy property.

The key holding in the case was that the "residual method" set forth in Section 1060 of the Internal Revenue Code[2] must be applied when allocating the purchase price for certain acquisitions of renewable energy property. Applying the residual method under IRC Section 1060 makes it more likely that some portion of the purchase price must be allocated to something other than the physical energy generation assets, such as a power purchase agreement, or PPA, thereby reducing the amount of the investment tax credit that may be claimed.

A lower investment tax credit may reduce the amount of so-called "tax equity" that renewable energy developers typically rely on to finance their projects. Importantly, the decision does not mandate that value be allocated to contracts or other intangible assets — it simply validates one of the central arguments advanced by the U.S. Department of Treasury that, in certain circumstances, a portion of the purchase price paid for a renewable energy asset should not be eligible for cash grants or the investment tax credit. The ultimate question — one of valuation — will be determined on remand.

At the center of the dispute was the amount of cash grants payable by Treasury to the purchasers of six wind farms developed by Terra-Gen. The Treasury program entitled owners of renewable energy property placed in service between 2009 and 2011 to cash grants equal to 30 percent of the basis of "specified energy property" — generally, depreciable tangible property — in lieu of claiming the investment and production tax credits.[3] Terra-Gen constructed each wind farm, obtained the necessary permits and licenses and entered into PPAs to sell the electricity produced, prior to selling — and in all but one case, leasing back — the wind farms to tax equity investors, at a premium above Terra-Gen's costs, shortly before they were ready to be placed "in service" for U.S. federal income tax purposes.[4] Plaintiffs, supported by opinions from KPMG, allocated the entire purchase price to tangible property and sought cash grants equal to 30 percent of the purchase price allocated to specified energy property. Treasury instead awarded cash grants equal only to 30 percent of the grant-eligible construction and development costs incurred by Terra-Gen, arguing that plaintiffs erred in their failure to allocate any portion of the premium or "step-up" from the purchase to intangible assets, such as the PPAs or goodwill or going concern value. Plaintiffs then filed suit in the Court of Federal Claims seeking to compel Treasury to pay the additional cash grants to which they believed they were entitled.

Court of Federal Claims

In the trial court proceedings, the Treasury advanced a number of theories in support of its position that a large portion of the purchase price should be allocated to something other than the physical energy generation assets. It argued that a significant portion of the purchase price paid for the projects was attributable to goodwill, going concern value, the PPA or other intangible rights, none of which were eligible for a cash grant. It also pointed to the related party nature of the sale-leaseback to support its contention that "peculiar circumstances" existed to disregard the sale price paid for the assets.

In rejecting each of these arguments, the Court of Federal Claims held that the increased value of the wind farms was instead attributable to grant-eligible "turn-key value" — a term it used to refer to the value of an asset over and above the cost of each individual component before it is assembled into a complete and functioning unit. The court held that the wind farms could not have goodwill or going concern value because the wind farms had been sold prior to becoming operational. It further held that PPAs were not separate intangible assets with value independent of the tangible property constituting the wind farms because of the close nexus between a wind farm and the related PPA, and the fact that the contract could not be sold or assigned separate and apart from the facility. Lastly, the court was not convinced that a sale-leaseback transaction with customary rent prepayment and indemnities presented peculiar circumstances that supported a finding that the purchase price of the wind farms was highly inflated.

In an unusual twist, the Court of Federal Claims excluded in part the testimony of the government's sole expert valuation witness, rejecting the expert's credibility after the plaintiffs asserted he had attempted to conceal from his background certain socialist writings he had published.

Stung by its loss on all counts, the Treasury quickly appealed the decision to the U.S. Court of Appeals for the Federal Circuit.

Federal Circuit

On appeal, the Federal Circuit disagreed with the Court of Federal Claims on a fairly narrow basis and remanded the case back for further decision. Notably, the appellate court held that the trial court inappropriately limited the testimony of the government's expert and took the unusual step of remanding the case to a new judge.

The primary issue on which the Federal Circuit differed from the lower court was whether it was possible — as a legal matter — for some of the purchase price for the wind farms to be attributable to goodwill or going concern value. This specific legal question turned on whether the purchase of a wind farm not yet placed in service is an “applicable asset acquisition” subject to the “residual method” of allocation. An “applicable asset acquisition” is defined as “any transfer ... of assets which constitutes a trade or business.”[5] If each wind farm constituted a “trade or business,” the residual method would require plaintiffs to allocate the purchase price to specific classes of assets in a descending order — based on their fair market value — with any excess allocated to goodwill and going concern value.[6] In practice, most renewable energy developers allocate any step-up in tax basis realized prior to the date a project is placed in service for tax purposes ratably across the tangible assets of the projects, with the result that most of the step-up is allocated to property eligible for cash grants or investment tax credits. If the “residual method” would attach value to ineligible intangible assets, it will produce smaller cash grants — or lower investment tax credits — than the “unallocated method” preferred by plaintiffs and the industry generally. As previously noted, the Court of Federal Claims had agreed with plaintiffs on this issue, ruling that the sales of the wind farms were not “applicable asset acquisitions” because, among other things, the wind farms were not operational at the time of sale and the PPAs did not have any value because they could not be assigned or separated from the underlying tangible energy property.[7]

The Federal Circuit reversed and remanded, finding that the wind farms had the necessary indicia to be treated as trades or businesses, including the existence of intangible assets, a purchase price well in excess of the assets’ book value and the presence of related agreements — such as the sale-leaseback agreements.[8] The court was not troubled by plaintiffs’ inability to assign the PPAs, holding that the agreements constituted a valuable customer relationship with the power purchaser.[9] While the Court of Federal Claims had concluded that goodwill could not attach to businesses that were not yet operational, the Federal Circuit disagreed, citing examples in the Treasury Regulations in which the residual method was applied to acquisitions of assets that were not operating businesses at the time of purchase.[10] The Federal Circuit also held that the Court of Federal Claims inappropriately ascribed all of the difference between the wind farms’ purchase price and their development and construction costs to “turn-key value.” The Federal Circuit ruled instead that various intangible assets of the wind farms had value and ordered the Court of Federal Claims to properly distinguish between turn-key value and the value of these intangible assets on remand.[11]

Observations

Alta Wind has been closely followed by the renewable energy industry because the cash grant statute at issue was patterned off the investment tax credit rules in the Internal Revenue Code and the issue of how to determine “eligible basis” is the same in both the cash grant and investment tax credit contexts. Also, Alta Wind closely paralleled the fact patterns that are common in the development and financing of renewable energy projects, where a developer builds and sells a project for a purchase price that is greater than its cost — indeed, any successful business must be premised on the ability to sell something for greater than cost. The taxpayer victory at the Court of Federal Claims was widely cited as further support for the premise that the term “basis” in the tax credit context properly includes the value enhancements that accompany the development and assembly of raw materials into a completed project.

The decision by the Federal Circuit reclaims some of the ground won by taxpayers in the Court of Federal Claims, though how much will be determined on remand.

Read narrowly, the reversal by the Federal Circuit does nothing more than require the application of the “residual method” to a newly-constructed asset that is on the cusp of becoming operational. Yet, even without the application of this method, the cash grant program required applicants to allocate purchase price among all purchased assets — both those that are eligible and ineligible for the cash grant. Indeed that is exactly the valuation analysis that was performed by the plaintiffs as part of their cash grant applications, the conclusions of which were accepted by the Court of Federal Claims. The Federal Circuit decision requiring the use of an alternate method of allocation should not change the relative values between eligible and ineligible property. The critical — and perhaps only relevant — question remains unaddressed: How much of the fair market value of a completed project, if any, should be allocated to something other than eligible energy property.

The decision leaves the renewable energy industry with somewhat less certainty on this critical question. By holding that it was possible for goodwill or going concern value to exist with respect to a renewable energy project that was not yet operational, the Federal Circuit seemed to tip its hand to the Treasury by implying that using the residual method must somehow result in a greater portion of the purchase price being allocated to assets ineligible for cash grants and, by extension, investment tax credits. The resolution of this issue remains to be seen.

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[1] Alta Wind Owner Lessor C et al. v. United States, 2018 U.S. App. LEXIS 20931 (Fed. Cir. July 27, 2018).

[2] Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”) or to the Treasury Regulations promulgated thereunder.

[3] American Recovery and Reinvestment Act, Pub. L. No. 111-5, § 1603, 123 Stat. 115, 364-66.

[4] Allco Wind Energy Management, which Terra-Gen acquired along with the wind farm projects in 2008, its JV partner at the time and Southern California Edison had executed a Master Power Purchase and Wind Project Development Agreement in 2006. This master agreement provided that Southern California Edison would enter into a separate long-term PPA with each wind farm, which could not be assigned by the wind farm.

[5] Section 1060(a). A group of assets constitutes a “trade or business” if their use “would constitute an active business under [Section 355]” or if “goodwill or going concern value could under any circumstances attach” to them. Treas. Reg. Section 1.1060-1(b)(2)(i).

[6] Section 1060 and Treas. Reg. Section 1.338-6 sets forth seven different categories of assets. Value is first allocated to Class I assets up to and in proportion to their fair market value and then to Classes II-VI unless exhausted. Excess is allocated to Class VII (goodwill and going concern value).

[7] Alta Wind I Owner-Lessor C v. United States, 128 Fed. Cl. 702, 715-716, 721 (2016).

[8] Alta Wind I Owner-Lessor C v. United States, 2018 U.S. App. LEXIS 20931 at *16 (Fed. Cir. July 27, 2018).

[9] Id. at *16-17.

[10] Id. at *14-15 (citing Alta Wind, 128 Fed. Cl. at 716; Treas. Reg. Section 1.1060-1(b)(3) Ex. 4).

[11] Id. at *26.