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Wind Projects Win Over $206 Million in Section 1603 Grant Litigation

On October 24, 2016, in *Alta Wind I Owner-Lessor C et al. v. United States*, Nos. 13-402T et al., the US Court of Federal Claims (the Court) ruled in favor of the owners of six wind farm facilities who had applied for grant funds under Section 1603 of the American Recovery and Reinvestment Act (the 1603 Grant). This case is an important development in the renewable energy area as the Court rejected all of the government's arguments for reducing the 1603 Grant. Treasury routinely made these same arguments to reduce the 1603 Grants claimed by numerous parties in renewable energy projects that qualified for the 1603 Grant program.

The wind farm owners had sought over $206 million in the litigation, which they alleged the Treasury Department had underpaid, and Court's decision awarded the entire underpaid amount to the plaintiffs. The *Alta Wind* case involved 20 plaintiffs and eight complaints, each of which involved the sale and leaseback of wind energy facilities. The developer was both the seller and the lessee in the sale-leaseback transactions.

The *Alta Wind* case is one of numerous cases in which Treasury reduced grant awards to applicants on the basis that the purchase price paid for renewable energy facilities involved "peculiar circumstances" and required allocation of cost basis to nonqualified intangible assets. As the Court summarized, "[t]he government maintains that basis really should be calculated from the value of each wind farm's grant-eligible constituent parts and their respective development and construction costs, citing a myriad of factors that allegedly made the purchase prices an unfair measure of each wind farm's value." The Government also argued in *Alta Wind* that "the residual method of accounting" under Internal Revenue Code (IRC) Section 1060 was applicable. The Court rejected those lines of attack by Treasury and upheld the cost basis reported by the wind farm owners as evidenced by the purchase price they paid.

A copy of the *Alta Wind* opinion is available here. The Court had previously granted the government's motion for full discovery and stayed the wind farm owners' summary judgment motions. For prior alert, click here. The *Alta Wind* case is one of a number of Section 1603 Grant cases being litigated in the Court of Federal Claims.

Purchase Price Basis

The crux of the dispute in *Alta Wind* was whether the purchase price paid by the wind farm owners to the developer in the sale-leaseback transactions should be respected as the basis for purposes of calculating their grant award or whether Treasury was entitled to look beyond the stated purchase price to apply a residual valuation analysis. The Court summarized the core dispute in its opinion as follows:

> The question in this suit has always been what the basis of Altas I-VI is. If the Court were to follow the Government's approach in awarding the Section 1603 grants, basis would mean the development and construction costs of each Alta facility—i.e., a grant predicated on the "cost method" of tax valuation. Plaintiffs' approach, on the other hand, would mean that the Alta Wind facilities' purchase prices, minus reasonable allocations

> for ineligible property under Section 1603, would be used to calculate basis. [Record citations omitted.]

The Court recognized as a general rule that "[b]asis, as defined in the IRC, is the cost of property to its owner." The Court noted that there are exceptions to this general rule, each of which it addressed in its opinion, but soundly rejected the government's attempt to limit Section 1603 Grant basis to development and construction costs and a "cost method" of tax valuation: "If Congress had intended some other definition of 'basis' to apply in situations like this, then it should have said so when it drafted the statute."

Section 1060 Analysis

The government argued that the Court must analyze the basis of the wind farm facilities using the residual accounting method prescribed by IRC § 1060. The Court noted that both parties agreed that the price the plaintiffs paid for the wind farm facilities was higher than the mere cost of developing and assembling the facilities. "Therefore, the question is whether some of this additional value constitutes goodwill or going concern value."

The Court concluded that no goodwill value could attach to the wind farm facilities. The Court defined goodwill as "a distinct concept that represents the value a business acquires from its ability to attract and maintain customer relationships." The Court concluded that no goodwill value was apparent where the wind farm facilities, when sold, (1) were not yet operational, (2) had lined up only one long-term customer to buy the entirety of their electricity output for the foreseeable future, and (3) were not capable of taking on any other customers. The Court also rejected the government's argument that the location of the wind farm facilities adds goodwill:

> It is undisputed that the Alta facilities' location added value to the wind farm facilities. However, 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. *See, e.g.*, IRS Tech. Adv. Mem. 317001, 1993 WL 134598 (Apr. 30, 1993) (finding that a transponder's physical location "is reflected in its value, and cannot be separated from the transponder itself"). Any other approach would not make sense, as it would mean that property values in places like New York City would be made up largely of goodwill as a separate intangible asset.

The Court also concluded that no going concern value could attach to the wind farm facilities. The Court defined going concern value 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.'…It is 'manifested in the business' ability to resume business activity without interruption and to continue generating sales after an acquisition.'" When sold, the Alta wind farm facilities were fully developed and constructed but they were not yet operational and, therefore, the Court concluded that there was no "functioning established plant" and no going concern value when the facilities were sold.

Importantly, the Court distinguished what it termed the "turn-key value" of the developed wind farm facilities, which essentially describes value a facility has when it is ready for immediate use after purchase. The Court recognized that the facilities "had additional value over their development and construction costs because they were ready-to-use wind farm facilities located in the windy Tehachapi Region, not just collections of turbines lying on the ground somewhere. This is the real sticking point in this case." The Court explained that "turn-key value" is considered part of the tangible assets:

> It is important to note that turn-key value is not the same thing as "going concern" value. In a turn-key transaction, the buyer is not purchasing an operating business; rather, he is purchasing a put-together facility that is ready for operation. This distinction is important because turn-key value, unlike going concern value or goodwill, is considered part of the tangible assets in a transaction rather than a separate intangible asset. *See, e.g.*, IRS

Tech. Adv. Mem. 0907024, 2009 WL 356169 ("[C]ase law supports a conclusion that it is appropriate to value interrelated assets in the aggregate and that the synergistic value of a collection of assets is attributable to those assets rather than a conceptually distinguishable goodwill or going concern value element.")

Peculiar Circumstances

As the Court determined that the term "basis" is generally the cost of property to its owner, it next turned to whether the sale-leaseback transactions and certain indemnities provided by the developer constituted "peculiar circumstances" that create an exception to this general rule. The Court agreed that the existence of "peculiar circumstances" may require closer examination of the purchase price. As the Court explained, "[a]t bottom, 'peculiar circumstances' exist if the parties appear to be unduly manipulating the purchase price by entering into separate agreements at or near the time of purchase, causing the purchase price to be highly inflated." The Court noted that "it is important to note that the Court should disregard the purchase price as basis only if the evidence shows that peculiar circumstances have *highly* inflated the purchase price."

Applying these principles, the Court held that no peculiar circumstances had been shown that would overcome the general purchase price rule. First, the Court found that all of the Alta transactions occurred at arm's length between sophisticated and self-interested parties. Second, the Court concluded that the presence of a sale-leaseback transaction in and of itself is not a peculiar circumstance, and the government failed to present any evidence at trial to show that the parties to the transactions adjusted any aspects of the sale and leaseback prices in order to highly inflate the purchase prices. Third, the Court analyzed the various side agreements, such as the "wake payment" (i.e., compensation to a project for the disruption in wind-flow from another project) and Section 1603 Grant indemnity agreements (i.e., the developer agreed to indemnify the plaintiffs for any difference in the amount of the grant claimed and the amount of grant awarded), between the developer and the plaintiffs and concluded those agreements did not give rise to peculiar circumstances.

It should be noted that the Court was able to determine that the price paid in the sale-leaseback transactions had not been highly inflated because the per-kilowatt cost paid in those transactions was essentially the same per-kilowatt price paid in the outright sales of other projects.

The Court also found that rent prepayments did not create peculiar circumstances. The purpose of the rent prepayments was merely to reduce the periodic rent payments due under the lease agreements to help ensure that the projects' cash-flows would be sufficient to cover the rent payments due. There was no evidence that the prepayments inflated the purchase price in any way.

Pro-Rata Allocations

The Court considered whether the plaintiffs' allocation of indirect costs between eligible and ineligible property was reasonable. The plaintiffs' accountants had allocated indirect costs pro-rata using the same ratio of direct costs to eligible and ineligible property. The Court found this method reasonable in the absence of contrary evidence. The Court noted that Edward Settle of NREL had testified that both the industry and NREL use a "rule of thumb" that treats 95 percent of wind farm construction costs as grant-eligible and stated that "[t]his rule of thumb indicates that it is reasonable to allocate ninety-five percent of a purchase price to eligible property." The Court upheld the accountants' allocations of 93.1 percent for one wind farm and 96.9 percent for another wind farm as reasonable allocations of eligible property and indirect costs.

Power Purchase Agreements

Similar to other 1603 Grant cases, the government argued that the plaintiffs' allocation failed to account for the power purchase agreements (PPAs), which the government argued are "intangible, ineligible property." The Court rejected this argument, concluding that the PPAs were not separate intangible assets from the wind farm facilities:

> The Government argues that PPAs must be classified as "customer-based intangibles" within the meaning of 26 U.S.C. § 197(d)(2)(A)(iii). However, the Court finds Plaintiffs' treatment of the PPAs more persuasive. Plaintiffs' approach treats the PPAs like land leases. A land lease is not considered a separate asset from the underlying land, even if the land lease terms are better than market. As with land leases—which relate only to the specific parcel of land leased—the PPAs each relate only to their specific wind farm facilities and are not transferable or assignable. Dr. Maydew [plaintiffs' expert] found that these characteristics mean the PPAs may not be viewed as separate assets from their underlying facilities from a tax accounting perspective. Therefore, the close nexus between the wind farm facilities and their respective PPAs means that the PPAs cannot be viewed as separate intangible assets.

The Court held that "[i]n the real world, this grant-ineligible property is hopelessly intertwined with grant-eligible property. Having both types of property in one place makes a wind farm valuable as a wind farm generating cash flows, and not just as a disjointed collection of random assets. Therefore, any pro-rata allocation method will necessarily involve extrapolation based on construction and development costs of the grant-eligible property under Section 1603, and the Court finds Plaintiffs' allocations to be reasonable."

Government's Expert

The Court excluded the testimony of the government's expert at trial. The Court explained, at length in its opinion, that the government's expert was untruthful with respect to certain articles he had written and had failed to disclose in his testimony. The government did not identify any additional expert witnesses, and it introduced no expert testimony or rebuttal to the plaintiffs' experts. As a result, the government's counterclaims failed for lack of evidence.

Conclusions

This case is an important development in the renewable energy area as the Court rejected all of the government's arguments for a reduction in the 1603 Grant. These are the same arguments Treasury routinely made to reduce the 1603 Grants paid on other renewable energy projects that qualified under the 1603 Grant program. These principles also apply for purposes of determining qualified basis for purposes of the investment tax credit for renewable energy projects under IRC § 48. Although the Court's decision may be appealed to the Federal Circuit Court of Appeals, the Court's reasoning in *Alta Wind* is well grounded and supported by legal precedent. Applicants that received reduced grant awards on similar grounds to those in *Alta Wind* should consider whether there is an opportunity to recover unpaid amounts by filing suit in the U.S. Court of Federal Claims.

Applicants under the 1603 Grant program whose awards have been reduced or disallowed by Treasury are entitled to file suit in the Court under the Tucker Act, 28 U.S.C. § 1491. *See ARRA Energy Co. v. United States*, 97 Fed. Cl. 12 (2011). Roughly 20 cases have been filed since the Court "opened its doors" to such suits in 2011. Affected applicants who believe their grants have erroneously been reduced and have not filed suit may still be able to do so. However, they need to be aware of the time limit under the statute of limitations for filing such suits.

The Tucker Act provides for a generous six-year statute of limitations, and applicants need to consider when this statute of limitations begins. Suit must be filed within six years after the claim first accrues. 28 U.S.C. § 2501. A claim first accrues when all the events have occurred that fix the alleged liability of the government and entitle the claimant to institute an action. *See Ingrum v. United States*, 560 F.3d 1311 (Fed. Cir. 2009). While the Treasury award date may be the most logical point of accrual in most cases, the Court has not had occasion to decide when a 1603 Grant claim first accrues. Applicants who received a reduced or disallowed 1603 Grant that they believe was erroneous should be considering when the statute of limitations might apply to their facts and filing suit in short order.

The tax controversy team at Hunton & Williams LLP consists of a cross-practice group with significant experience in energy tax credits and 1603 Grants, tax controversy and litigation. The tax controversy team handled the first 1603 Grant case to go to a full trial in the Court, resulting in a decision in favor of the applicant, and currently is handling other Treasury grant cases in the Court. Hunton & Williams LLP is well positioned to assist 1603 Grant applicants resolve disputes with Treasury. Please contact us if you require assistance with Treasury's denial or reduction of 1603 Grant amounts.

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