KIRKLAND **ALERT**

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Federal Circuit Says a Portion of the Purchase Price for Wind Farms May be Allocable to Intangibles, Reversing Court of Claims

A recent U.S. Court of Appeals for the Federal Circuit decision could have significant implications for cash grant and investment tax credit calculations in the renewable project finance industry.

The case reverses a U.S. Court of Federal Claims decision from 2016 awarding the wind farm owners more than $206 million in damages.

The Court of Appeals ruled that a portion of the owners' tax bases in six new wind farms that were purchased at a premium above the seller's cost could be allocable to goodwill and other intangible assets, and thus ineligible for cash grant payments that the owners received under section 1603 of the American Recovery and Reinvestment Act of 2009. The logic extends to projects that currently qualify for investment tax credits, which are similarly structured and are similarly calculated as a percentage of eligible cost basis.

The case, *Alta Wind I Owner-Lessor C et al v. United States,* reverses a U.S. Court of Federal Claims decision from 2016 awarding the wind farm owners more than $206 million in damages. The case has been remanded to the Court of Claims for a factual determination as to the allocation of the purchase prices for the wind farms using the methodology described in section 1060 of the Internal Revenue Code. The Court of Claims previously held that section 1060 did not apply.

Background

The case involves six wind farms that are part of the Alta Wind Energy Center near Los Angeles, California. It is one of the largest on-shore wind power projects in the world.

Oak Creek Energy Systems and Allco Wind Energy began developing the Alta Wind project in 2006. Among other things, they secured a Master Power Purchase and Wind Project Development Agreement with Southern California Edison ("SCE") under which SCE agreed to buy all of the project's output for approximately 24 years. SCE also committed to enter into separate long-term power purchase agreements ("PPAs") for each wind farm in the project, with the price to be set in accordance with a formula described in the master contract with SCE.

Terra-Gen Power acquired Allco's U.S. wind energy business for $394 million in 2008. (The Alta Wind assets were valued at approximately $350 million at the time.) Terra-Gen completed the development and construction of the project, and sought bidders to acquire the individual wind farms that made up the larger project on a piecemeal basis.

The cash grant program was enacted as part of the American Recovery and Reinvestment Act of 2009 to incentivize investment in renewable energy projects.

Terra-Gen's decision to sell was largely motivated by its corporate structure rendering it ineligible for section 1603 cash grants that were available as a temporary federal tax incentive at the time. The cash grant program was enacted as part of the American Recovery and Reinvestment Act of 2009 to incentivize investment in renewable energy projects. The program gave project owners the option to take a cash payment from the U.S. Department of the Treasury for the same amount that it would otherwise have been able to claim as a federal investment tax credit (i.e., 30% of an owner's basis in the electrical generating equipment in a project).

Between 2010 and 2012, Terra-Gen sold six of the Alta Wind facilities to various investors for an aggregate purchase price of more than $2.6 billion. Five of the six transactions were structured as sale-leasebacks in which Terra-Gen sold the facilities to buyers who then immediately leased them back to Terra-Gen, allowing Terra-Gen to continue to operate and manage the facilities and retain PPA income (in exchange for lease payments to the buyers). The sixth facility was transferred in an outright sale. None of the wind farms were operational before they were sold, but all of them were put in service shortly after the sale.

The owners of the six wind farms sought an aggregate cash grant award of approximately $703 million, which was calculated as 30% of the aggregate purchase price of the facilities less the portion of the purchase price allocable to grant-ineligible property like real estate, transmission equipment and buildings. The owners did not allocate any portion of the purchase price to goodwill or other intangible assets, including the PPAs.

The government awarded the owners $495 million in cash grants. The owners sued for the shortfall, and the government counter-claimed, asserting that it had actually overpaid the owners by $59 million.

The government's theory was that the owners should have allocated their purchase price among the bases of the assets using section 1060 of the Internal Revenue Code, and assigned value to goodwill and intangible assets.

The Court of Claims held in favor of the owners on October 24, 2016, awarding them damages of more than $206 million. The court held that

goodwill cannot attach to a wind farm before it is placed in service, and that PPAs do not have intangible value independent of the assets themselves. In the court's view, any amount paid for the PPAs is treated as basis in the assets and is eligible for a cash grant.

At first blush, the characterization of a wind asset as a trade or business sounds far-fetched.

The government appealed.

The Federal Circuit Decision

The Federal Circuit vacated the Court of Claims decision on July 27, 2018, and sent the case back to the Court of Claims to determine the proper allocation of the purchase prices under section 1060. The case will be reassigned to a different judge.

Unlike the wind farm owners' preferred method of including the entire purchase price in the basis of the wind farm except for grant-ineligible assets, section 1060 requires the purchase price to be allocated in a waterfall fashion among seven different asset classes. Any portion of the purchase price that is not allocable to one of the tangible asset classes is allocated to intangible assets and goodwill and going concern value.

Section 1060 applies when the acquisition of a group of assets constitutes a trade or business. At first blush, the characterization of a wind asset as a trade or business sounds far-fetched. However, the regulations under section 1060 create a generous framework of what constitutes a trade or business. Assets fall into this category if they are used in an active business or, if based on all the surrounding facts and circumstances, goodwill or going concern value "*could under any circumstances*" attach to the assets.

Goodwill represents the value attributable to "the expectancy of continued customer patronage."

The wind farms were not operational so the court focused on whether goodwill or going concern value could attach to them in the future. In essence, the court was asked to decide whether it was conceivable that goodwill could ever attach to the wind farms. Analyzing a list of indicative factors in the regulations, the court concluded that it was "readily apparent" that goodwill could attach to the assets once they began operating. It found the following points persuasive:

- There were intangible assets present — namely the transmission rights (which the Court of Claims ignored because the owners had already excluded them from their purchase price calculations) and, potentially, at

least some portion of the PPAs. The court thought SCE's commitment to purchase power for 24 years under a known formula was a customer relationship such that at least a portion of the PPAs "may be characterized as customer-based intangibles."

- The purchase prices for the facilities were well in excess of their development costs.

- The purchase included several related agreements between the seller and the buyers, including the leases (in the five transactions that were structured as sale-leasebacks) and seller indemnities related to the value of the cash grant.

The case is significant because similar facts are present in virtually all purchases of renewable assets that qualify for investment tax credits.

The Federal Circuit also disagreed with the Court of Claims holding that the fact that the wind farms were not operational at the time of purchase made section 1060 inapplicable. In addition to citing an example in the regulations suggesting that goodwill can arise from a contract for post-acquisition services, the court found it significant that the wind farms were "on the cusp" of operating, that there were customer agreements in place much like an operating business would have, and that the purchase prices were negotiated based on anticipated cash flows once the wind farms were operational.

Having established that the wind farms constitute a trade or business, the court then addressed the turn-key nature of wind farms and the relationship of turn-key asset value to a section 1060 allocation. The decision agreed that "turn-key" value — i.e., the incremental value a buyer would pay for assurance that the assets are ready for use is considered part of the tangible assets and included in basis for purposes of calculating the cash grant. On remand, the Court of Claims will have to decide how much of the purchase price in excess of the seller's development costs falls into this grant-eligible turn-key value category, rather than into goodwill and other intangibles.

Analysis

The Federal Circuit's holding that section 1060 would apply to the acquisition of a pre-operational wind farm comes as somewhat of a surprise. Many in the renewables industry did not view such assets as a full-fledged "trade or business" subject to section 1060. The case is significant because similar facts are present in virtually all purchases of renewable assets that qualify for investment tax credits. It will be interesting to see how the Court of Claims ultimately allocates the purchase price, and whether the market starts to build in a basis haircut for goodwill and intangibles. This would be a significant departure from current practice for residential portfolio financings in

particular, which generally assume 100% tax credit-eligibility backed by an indemnity (and often insurance as well).

The Federal Circuit decision is largely premised on the idea that the existence of a PPA combined with the near-operational status of the assets (most of which were sold and simultaneously leased-back to begin operation) is sufficient to create the expectancy of a continued payment stream, which in turn creates goodwill. This raises the question of the extent to which there was really an expectation of "continued customer patronage" before the wind farms were operational. The court appropriately cites an example in the regulations demonstrating that this issue is not dispositive (as the Court of Claims had concluded). However, given that the existence of goodwill is based on all of the surrounding facts and circumstances, the fact that the wind farms were not operational at the time of sale should have cut against a finding of pre-existing goodwill. The buyers likely had a baseline expectation that SCE would make its payments under the contracts, but attributing separate intangible value to this expectation seems somewhat premature in the absence of an actual track record of payments and operational performance.

The Federal Circuit's suggestion that PPAs likely have at least some intangible value conflicts with the views of many professionals in the renewables industry who have argued that PPAs do not have discrete value unless, at a minimum, the pricing is above market. One reason is that, in the leasing context, section 167(c) provides that no portion of the depreciable basis of property acquired subject to a lease should be allocated to the leasehold interest. There is no evident policy rationale for treating PPAs differently. A PPA is really nothing more than a contract to sell the output of the wind farm, and unless that contract calls for above-market payments, the justification for separating the contract as a separate asset seems hard to fathom.

The purchase price allocation that the Court of Claims ultimately approves will be closely watched in the renewables industry. In particular it will be interesting to see how much intangible value (if any) is allocated to the grant-ineligible PPAs. Likewise, it will be interesting to see the extent to which the Court of Claims treats the delta between the purchase prices and the seller's costs as cash grant-eligible turn-key value that the buyers were willing to pay for the convenience of acquiring a fully built and contracted project, and how tax professionals and investment bankers view turn-key value going forward.

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If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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