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Desert Sunlight Opinion Sheds Light on Purchase Price Allocations For ITC

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The Court of Federal Claims in its summary judgment opinion in the *Desert Sunlight*[1] case clarified the application of the purchase price allocation rules to determine the investment tax credit (ITC).

Section 1603 of the American Recovery and Reinvestment Tax Act,[2] which was enacted in early 2009 to stimulate the economy in light of the financial crisis that started in 2008, provided a federal grant in lieu of tax credits with respect to certain energy property. As is the case with ITC, the amount of the grant was 30% of the basis of the eligible property. The program has expired.

FACTS OF THE TRANSACTION

In 2011, First Solar sold a 50% interest in each of Desert Sunlight 250, LLC and Desert Sunlight 300, LLC (each, an LLC) to NextEra and GE Energy Financial Services (GE).

The LLCs borrowed $1.461 billion from several banks, and the Department of Energy (DOE) guaranteed 80% of the loan. The LLCs entered into contracts for First Solar to provide the equipment for the projects, much of which First Solar would manufacture, and to construct the projects pursuant to Engineering, Procurement and Construction (EPC) Agreements.

The pricing of the contracts was set to provide NextEra and GE an agreed return on equity (ROE):[3]

> using . . . an intricate, multi-tab Excel spreadsheet aimed at calculating the [contract priced] based on the . . . expected ROE. [The m]odel calculates the expected ROE by considering various factors, including expected debt terms, plant performance . . ., interconnection energization date, energization dates . . ., substantial completion date and . . . commercial operation dates, future operating, certain owner costs and future maintenance expenses. [The] calculations embedded in the [m]odel [were] not be changed or revised for any reason, including the discovery of a mathematical or formulaic error (internal quotation marks omitted).

1603 CASH GRANT APPLICATION

KPMG prepared cost segregation reports in support of the amount asserted by the LLCs to be eligible for the 1603 cash grant. Deloitte, as required by the Treasury, attested to the accuracy of the applications submitted by the LLCs.

Upon the projects being placed in service, the LLCs applied to the Treasury for 1603 cash grants of almost $615 million and were paid only approximately $555 million or approximately a $60 million shortfall.

The LLCs and the Treasury undertook lengthy discussions to attempt to resolve the dispute. Without a satisfactory resolution, the LLCs brought an action in the Court of Federal Claims to recover the shortfall.

The LLCs and the Department of Justice (DOJ) continued the discussions and began an extensive discovery process. Before going to trial, the LLCs and DOJ each made motions for summary judgment on certain issues for which they felt there was no material question of fact that merited a trial. Some of the issues raised by the parties are so obvious to be sur-

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[1] *Desert Sunlight 250, LLC v. United States*, No. 17-1826 T, 2021 BL 420292 (Fed. Cl. Oct. 8, 2021).

[2] Pub. L. No. 111-5.

[3] *Desert Sunlight 250, LLC*, 2021 BL 420292 at *8.

prising and suggest there must have been the product of some difficult discussions between the parties.

DOE HAD DETERMINED A HIGHER VALUE FOR THE PROJECTS FROM THE OUTSET

DOE undertook its own review process to confirm the EPC agreement price was appropriate before it agreed to provide a loan guarantee:[4]

> DOE took multiple steps to assess First Solar's total EPC price. . . . DOE conducted its own due diligence and determined that there was a reasonable assumption that, based on the proposed total EPC . . . price, the loan would be repaid. It did so by comparing the proposed total EPC . . . price to other projects in its internal databases. DOE then engaged in interagency discussions with Treasury, which was concerned that the proposed total EPC . . . price was too high in comparison to several other projects. Specifically, in June 2011 — before the more than $400 million reduction from First Solar's proposed total EPC . . . price and before the [project] was built with a 740.7/MWdc generating capacity — the total EPC Agreement price was proposed by First Solar at $2.97/Wdc (including labor adjustments), and Treasury indicated that a comparable EPC agreement price would be $2.80/Wdc without labor adjustments and $2.92/Wdc with labor adjustments. To assuage Treasury's concerns, DOE consulted numerous experts for their assessment of the proposed total EPC . . . price.
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> . . . [DOE] coordinated with the National Renewable Energy Laboratory (NREL), one of the seventeen national labs within DOE, to conduct its review using the NREL's solar PV cost estimating tool—bottom-up cost modeling. . . . Upon completion of the . . . NREL review, the [DOE program manager], issued a memorandum to the Loan Program Office that concluded that First Solar's proposed total EPC . . . price is ''below the current estimated average total project cost for comparable projects and [is] within a reasonable range of the expected system price, as estimated using NREL's internal solar PV cost estimating tool'' (citations to transcripts and pleadings omitted).

In effect, the DOE in the process of underwriting the loan guaranty for the Desert Sunlight project analyzed and confirmed the EPC agreement's pricing was not above market. The court did not have to rule on the merits of DOJ's assertion because the court's opinion only addresses a motion for summary judgment, which is only to be granted when there is no dispute regarding material facts. The court wrote that it ''is a matter for determination at trial.

DOJ'S LEGAL CONTENTIONS

First, DOJ contended that the LLCs could not challenge the 1603 award because they did not submit to Treasury an IRS Form 8594, *Asset Acquisition Statement Under Section 1060*, with a §1060[5] purchase price allocation. The judge rejected this, somewhat absurd contention, by noting that if a Form 8594 was required that the Treasury should have requested it before paying anything and that there were numerous document requests from the Treasury and none of them mentioned an IRS Form 8594.

The Federal Circuit in *Alta Wind*[6] held that a new renewable energy project was subject to the purchase price allocation process provided for in IRS Form 8594. That process allocates the purchase price to one of seven ''classes:''[7]

> Class I: Cash and general deposit accounts.
>
> Class II: Actively traded personal property, certificates of deposits, U.S. government securities and publicly traded stock.
>
> Class III: Debt instruments (including accounts receivable).
>
> Class IV: Inventory and other property held for sale to customers.
>
> Class V: Assets that do not fit within any other class, including tangible property.
>
> Class VI: §197 intangibles, including contract rights, but not goodwill and going concern value.
>
> Class VII: Goodwill and going concern value.

DOJ then contended in *Desert Sunlight* that the low interest rate DOE guaranteed loan was a ''Class III'' (debt instruments) asset for purchase price allocation purposes under §1060. The judge properly noted that a loan is a liability, so it cannot be an asset whether Class III or otherwise.

DOJ took another crack at what is a related argument that basis/FMV had to be allocated to DOE loan guarantee. The judge rejected that argument primarily

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[4] *Desert Sunlight 250, LLC*, 2021 BL 420292 at *6–7.

[5] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[6] *Alta Wind I Owner Lessor C v. United States*, 897 F.3d 1365 (Fed. Cir. 2018).

[7] *Alta Wind I Owner Lessor C*, 897 F.3d at 1376.

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because §48 provides that after 2008 that there is no reduction in the ITC for subsidized financing.[8]

Next, DOJ contended that in the §1060 waterfall that even if all of the basis is absorbed by the value of asset Classes I through V, that basis could still be allocated to asset Classes VI and VII. The court properly disagreed with DOJ and cited *Alta Wind* as so holding.

Finally, DOJ contended that the Standard Large Generator Interconnection Agreement (LGIA) should be classified as Class VI (intangible), while the LLCs contended it is Class V (tangible personal property and assets not in any other class). The court agreed with the LLCs. The opinion notes that during the litigation KPMG valued the LGIA and determined it had no or negligible value. In my experience, KPMG's conclusion is consistent with typical segregation reports delivered in connection with renewable energy transactions

LLCS' LEGAL CONTENTION

The LLCs asked the court to hold that as a matter of law that sales tax, interest during construction, and early completion bonuses are capitalized into the asset the taxpayer is constructing. DOJ did not fight this, and the court ruled as requested by the LLCs. It is not clear why this was an issue at all given the fact there are Treasury regulations on point as cited by the court.[9]

MATERIAL QUESTION OF FACT

Finally, unsurprisingly, the judge held that there is a material issue of fact as to whether the cost segregation provided by KPMG and submitted as part of the grant application properly reflected fair market value (FMV) of the projects' assets. This holding means the case will go to trial. That trial is scheduled to start June 6, 2022, with time set aside by the court through July 1, 2022.[10]

DOJ'S VIEW OF FMV

DOJ tried to go a step further and posit that the fact NextEra and GE purchased the project from First Solar, an unrelated party, is not relevant to the determination of FMV. This contention was based on DOJ's theory that a definition of FMV in the Treasury regulations refers to a *hypothetical* buyer and a *hypothetical* seller,[11] and the purchase from First Solar was *not hypothetical*. The regulation in question does not actually use the word ''hypothetical,'' but rather refers to ''fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.''

The court properly noted that the definition in question is from the estate tax rules.[12] In estate tax, the valuation question is what was the value of the assets on the date of death and that has to be hypothetical. The court, in my view properly concluded:[13]

> *Whitehouse*[14] . . . does not suggest overlooking the price at which an actual buyer and seller transferred property at arm's length, as the government posits. . . . *Pabst*[15] does not support the government's proposition that an actual transaction's actual price is necessarily insufficient, and that further evidence must be shown in valuing assets and that price could potentially be as important as other evidence in determining the assets' fair market value . . . [T]he government and the court are *not* bound by the [LLCs'] allocation of assets, *not* that their allocation is irrelevant (emphasis added).

IMPLICATIONS OF THE CASE

Although, not cited in this opinion, a 2009 Tax Court opinion provides a useful insight: ''Valuation is not a precise science, and the fair market value of property on a given date is a question of fact to be resolved on the basis of the entire record''[16] Given the inherent imprecision in valuation and the lack of guidance about the valuation of renewable energy projects provided by the Treasury or the IRS, it seems appropriate that if a valuation is supported by a reasonable appraisal from a qualified independent appraiser that valuation should be given some weight by the courts and the IRS.

Given the facts of the case and the tone of the opinion, it seems likely the case will be settled by the parties for an amount close to the shortfall in the 1603 grant proceeds that the LLCs brought the case to recover.

Many renewable energy appraisals define FMV by citing to the estate tax regulation that DOJ cited. Ap-

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[8] §48(a)(4).

[9] *See* Reg. §1.263A-1.

[10] Desert Sunlight 250, LLC et al v. United States, No. 1:17-cv-01826 (Fed. Cl. Nov 21, 2017) (scheduling order), https://aboutbtax.com/0Xv.

[11] *See* Reg. §20.2031-1(b).

[12] Reg. §20.2031-1(b).

[13] *Desert Sunlight 250, LLC*, 2021 BL 420292 at *22.

[14] *Whitehouse Hotel Ltd. Partnership v. Commissioner*, 615 F.3d 321 (5th Cir. 2010).

[15] *Pabst Brewing Co. v. Commissioner*, T.C. Memo 1995-239.

[16] *Kiva Dunes v. Commissioner*, T.C. Memo 2009-145.

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praisals prepared to support income tax reporting referencing that estate tax regulation never made much sense to me. It seems to me that in appraisals prepared to support income tax reporting that a more appropriate citation would be to an income tax regulation. The same definition of FMV appears in the income tax regulations for purposes of determining a charitable donation for the donation of property used to fulfill the charity's mission.[17]

Finally, the opinion includes a helpful discussion of KPMG's cost segregation process that involves the categorization of project costs into direct and indirect expenses and ITC eligible and ineligible expenses. Any tax practitioner seeking to better understand cost segregation methodology would be well-served to read the opinion's summary of KPMG's methodology.

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[17] Reg. §1.170A-1(c)(2).

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