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Tax Shelters

Eight Lessons for Tax Equity Investors From Recent Tax Shelter Cases

By David Burton

Institutional investors in the renewable energy industry have thus far been spared the pain of tax litigation; nonetheless, a recent string of government wins in corporate tax shelter cases in the federal appellate courts offer lessons for the renewables industry.

Below are eight lessons from these cases that industry players should heed.

1. A Good Cause Is Not Enough

Courts will take a critical view of aggressive transactions, even if the transaction raised capital for a good cause. Specifically, the Third Circuit ruled against a historic tax credit transaction that provided capital for the refurbishment of Boardwalk Hall in Atlantic City, N.J.[1]

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[1], 694 F.3d 425, 462-463 (3d Cir.2012).

Prior to this case, some participants in historic tax credit transactions believed they had a relatively free hand to structure the transactions in a manner most convenient from a commercial perspective, because it was thought that the government was unlikely to challenge a transaction that provided capital for a worthy cause, like refurbishing a landmark building.

The lesson from the case for the renewable energy industry is that tax equity investors cannot merely wrap themselves in “green” flags and structure transactions without careful adherence to common law tax principles, like substance over form and the step transaction doctrine, and key regulatory guidance like the partnership capital account rules.

2. No Negative Cues to the Government

The current trend in tax litigation is for the government to attack transactions on “economic substance” grounds. Determining economic substance is time consuming and necessitates a detailed analysis of facts by the Internal Revenue Service, Department of Justice, and the courts.

Humans by nature seek to minimize time and effort required to complete complicated processes. This has led courts and the government to look for cues that shortcut the analytical process.[2] Tax equity investors are well advised to avoid these cues.

[2]*See* Jasper L. Cummings, Jr., “Magical Thinking and Tax Shelters,” 138 *Tax Notes* 981, 983 (2013).

Specifically, tax equity investors need to ensure that documents prepared internally for underwriting and portfolio management purposes are consistent with the tax requirements of the transaction.

In one case, an internal accountant justified a transaction as a “finance lease” for purposes of Financial Accounting Statement 13 of generally accepted accounting principles based on the fact that the counterparty was likely to exercise its fixed price purchase option. This statement conflicted with the intended tax structuring and a third-party appraisal. The internal accountant later retracted his statement that the fixed purchase option was likely to be exercised. Nonetheless, the government used the retracted statement as a sword in litigation, and the Federal Circuit cited the statement as one of the pillars of its analysis in ruling against the taxpayer.[3]

[3], 703 F.3d 1367 (Fed. Cir. 2013).

3. Business Purpose First

It is preferable for the non-tax business purpose of a transaction to be known to the taxpayer before a tax adviser says: “We need a business purpose.” Tax advisers who concoct a business purpose after the execution of a tax-advantaged transaction have been indicted; some have even been convicted of criminal offenses.[4]

[4] *See*, 703 F.3d 46, 106-108 (2d Cir. 2012).

Taxpayers that do not think about pre-tax profit until they need a business purpose in litigation are not viewed favorably by the courts.[5] If pre-tax profit is the taxpayer's business purpose, there should be a clear calculation of the pre-tax return in the first deal model, and a pre-tax return should be specified in term sheets and proposals and should be included in management approval documents as one of the benefits of the investment.

[5]*ACM Partnership v. Comr.*, 157 F.3d 231, 258 (3d Cir.1998); *CMA Consolidated Inc. v. Comr.*, T.C. Memo 2005-16.

4. What Is Said in PowerPoint Matters

Marketing documents prepared by financial advisers and brokers matter to courts, even if the definitive contracts vary from what was written in the sales pitch.

In one instance, a broker's pitch described, as a purchase of tax credits, what was intended for tax purposes to be an equity investment. The definitive contracts went to some lengths to avoid any such references, but the Third Circuit found the transaction to be effectively a sale of tax credits, which is not permitted by the Internal Revenue Code, and relied in part on the broker's pitch to reach that conclusion.[6]

[6]*Historic Boardwalk Hall*, 694 F.3d at 433-436.

It is critical to remember that—from the first email—tax equity investors are creating an evidentiary record that will be examined with a critical eye.

5. The Judge May Have
A Different Perspective

Lawyers render opinions based on the law to date, but an appellate judge may not appreciate the historical development of the tax law in a particular area or the consequences for various industries in changing long-standing common law principles.

The Federal Circuit ruled that a cross-border lease was not a lease in substance, because the user of the leased asset was "reasonably likely" to exercise its purchase option.[7] A "reasonably likely" standard had not previously been articulated as the benchmark for evaluating whether a lease purchase option would cause the lease to be recharacterized for tax purposes. If, at the time the transaction was executed, a poll had been taken of leading law firms regarding the standard to evaluate a lease purchase option, it is likely none would have responded that the standard is "reasonably likely." It is not the standard published by the Service[8] or used by the Supreme Court to evaluate a real estate sale-leaseback that provided the lessee with multiple fixed price purchase options.[9] Nonetheless, a judge that disliked the transaction before him concocted it to avoid a taxpayer victory.

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[7] *Consolidated Edison*, 703 F.3d at 1381.

[8] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (a lease should be recharacterized as an installment sale if the asset "may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments").

[9] *See Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-584 (1978).

Therefore, tax equity investors need to consider how a judge may react to their transaction, rather than merely seeking confident tax opinions based on existing law and filled with assumptions. Tax opinions certainly have an important role and are an excellent mechanism to ensure all tax issues are considered in a transaction, but they are neither crystal balls nor insurance policies.

6. Accountants Can Undermine
Evidentiary Protections

If a taxpayer provides a lawyer's opinion to its accountants, the taxpayer appears to waive the work-product doctrine[10] and the attorney-client privilege with respect to that opinion. These are protections under the rules of evidence that preclude an adversary in litigation (e.g., the IRS) from obtaining certain documents and communications.

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[10] *U.S. v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), *cert. denied* 130 S. Ct. 3320 (2010).

The work-product doctrine appears to be waived because it only applies to work in contemplation of litigation, and the preparation of financial statements was held by the First Circuit to be outside of that scope, even when the accountants were considering the posting of reserves for tax risks that could be litigated.

The attorney-client privilege appears to be waived because the opinion has been shared with a party that is not the client, the attorney, or an agent of the attorney.

When a public company enters into a complex transaction, the company's financial statement auditing firm will frequently ask whether a reserve for the tax risk related to the transaction should be booked in the company's financial statements. A common way to ameliorate the accounting firm's concern is to provide it with a copy of an opinion from the taxpayer's transaction counsel. However, providing the law firm's opinion raises the problem of the waiver of the work-product doctrine and the attorney-client privilege.

A potential, but expensive, solution to this problem is for the public company to request that the accounting firm's tax experts review the transaction and determine its merits rather than providing the legal opinion to the accounting firm. This could happen either contemporaneously with the execution of the transaction or when the accounting firm inquires about the transaction.

It should be noted that under this line of thinking the accounting firm's own work also could be likely obtained by the government in certain circumstances, but such an approach at least avoids a broad “subject matter waiver” that could permit the government to question the taxpayer's attorney about confidential conversations with the client. Further, the accounting firm would ideally limit its analysis and written memorialization to the minimum required by financial statement preparation standards.

7. Avoid ‘Put’ Options

If the expected tax benefit requires the tax equity investor to be a “partner” or an “owner,” the investor would be well-advised not to give itself the benefit of the option to “put” its interest back to the developer (or the right to withdraw from the equity structure, which is a put option by another name).

This advice is contrary to the structuring practices of some tax equity investors that included put options in their deals in order to assure themselves the ability to exit the investment. For instance, the Third Circuit found that a Pitney Bowes affiliate was not in substance a partner in a partnership that owned a building eligible for the federal historic tax credit because, if the other partner did not exercise a call option that required it to pay an amount sufficient to provide an agreed return to Pitney Bowes, the Pitney Bowes affiliate—two years later—was entitled to cause the other partner to purchase its interest at an amount that provided it an agreed return.[11]

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[11] *Historic Boardwalk Hall*, 694 F.3d at 462-463.

This cross-put call arrangement is particularly worrisome, but a best practice would be to avoid puts even if there is not a call option. If a tax equity investor needs a put right in order to be comfortable investing in a tax-advantaged asset, it might be better served to invest its money somewhere else.

8. 99.99 Percent Is Too Much

The IRS has generously blessed wind production tax credit transactions that allocate 99% of the credits to the tax equity investor and a mere 1 percent to the developer.[12] If it is important that a structure be characterized as a partnership, the allocations of tax items should not exceed 99% (unless required by the “regulatory allocation” rules).

[12] Rev. Proc. 2007-65, *2007-45 I.R.B. 967*, §4.02.

An allocation of 99.99% is inviting scrutiny; the additional 0.99% is not worth it. For instance, in *Historic Boardwalk Hall* the Pitney Bowes partner was allocated 99.99% of the tax credit and, for a variety of reasons, was unable to persuade the Third Circuit it was a genuine partner.[13]

[13] *Historic Boardwalk Hall*, 694 F.3d at 459.

The Takeaway

Tax equity investors need to regularly compare their structuring techniques to developments in the tax law. They also need to carefully consider their communication with respect to tax advantaged transactions. Consulting with tax counsel early in the transaction process can aid tax equity investors in avoiding costly pitfalls.