Ampersand Clarifies Power Project Placed-In-Service Analysis

By **David Burton and Viktoria Vozarova** (March 14, 2022)

David Burton

Viktoria Vozarova

On Feb. 24, the U.S. Court of Appeals for the Federal Circuit released its decision in Ampersand Chowchilla Biomass LLC v. U.S.,[1] in which the court considered when a power generation project is placed in service for federal income tax purposes.

The case arose in the context of a now-lapsed cash grant program, created as part of the American Recovery and Reinvestment Act in 2009 to increase investment in domestic clean energy production. Under the program, the U.S. Department of the Treasury provided a cash grant of 30% of eligible basis in lieu of tax credits.

The rules for the grant were supposed to mimic the rules of the investment tax credit under Section 48 of the Internal Revenue Code. Accordingly, although the cash grant program is long over, these cases have implications for tax planning for today's power generation projects.

In the Ampersand case, the court found two California facilities were ready and available to produce and sell electricity in 2008 when the facilities were synchronized to the transmission grid, began selling electricity, and operated under their power purchase agreements, or PPAs. In other words, the plants were placed in service in 2008.

The case clarifies the meaning of the terms of art "assigned function" and "critical testing" with respect to the placed-in-service doctrine as applied to power generation projects.

Background

In 2007, California Biomass Fund I LLC, or CalBio, acquired two defunct open-loop biomass facilities, and began restoring and upgrading them to be operational in 2008.

As part of the acquisition, CalBio assumed certain PPAs, which were later amended to relax their production requirements. CalBio also entered into interconnection agreements that required the facilities to satisfy pre-parallel testing requirements.[2]

The California air quality district where the facilities are located required an authority to construct, or ATC, permit for the construction of these facilities. During the renovations in 2007, CalBio secured ATC permits for the facilities.

These permits allowed construction on the facilities, and allowed the facilities to generate and sell electricity. The permits could be converted into permits to operate after the facilities met certain conditions, like emissions tests.

Biomass facilities often have difficulties passing emissions tests. So instead of shutting down biomass facilities at the first sign of noncompliance — which could lead to agricultural waste being burned in open fields, causing more environmental pollution — the local air pollution control district has a notice of violation process, in which the district fines and oversees noncompliant facilities until they are brought back into compliance.

In April and July 2008, the two facilities had their initial fires to start burning biomass. In May 2008 and August 2008, CalBio labeled the facilities "in operation." The facilities passed pre-parallel testing pursuant to the interconnection agreements in June 2008 and August 2008, respectively.

Following these events, the facilities began selling electricity on the spot market. In December 2008, one of the facilities met the requirements of its PPA, and started selling its electricity to PG&E Corp.

The second facility did not start selling its electricity until February 2009, but this facility had met the requirements of its PPA based on data from the third and fourth quarters of 2008.

The facilities operated fairly continuously once they started in 2008. One facility operated at 42% capacity, and the second operated at 34.1% capacity. The facilities were occasionally noncompliant with emissions regulations, but the air district allowed the facilities to continue operating, and never revoked their ATC permits.

In early 2009, Congress passed the Recovery Act. The act's purposes included providing "investments needed to increase economic efficiency" and investing in "environmental protection and other infrastructure that will provide long-term economic benefits."

The Recovery Act allowed project owners to receive a grant if they placed a renewable energy facility in service during 2009 or 2010, or if they began constructing one in 2009 or 2010 that they later placed in service before the relevant tax credit termination date.

At the time of the passage of the act, CalBio was experiencing financial difficulties, and investigated whether it could apply for Section 1603 grants for the two facilities. It ultimately concluded that it could not apply for the Section 1603 grants, because the facilities had been placed in service prior to the required period.

Finding no resolution to its continuing financial problems, the entity suspended operations in June 2010 and decided to sell the facilities. In December 2010, Akeida Environmental Fund LP acquired the facilities using two project companies — Ampersand Chowchilla Biomass LLC and Merced Power LLC — which were the cash grant applicants and are the named appellants in the case.

Akeida spent nearly $15 million improving the facilities, which passed emissions testing in August 2011. In October 2011, Akeida's project companies applied for Section 1603 grants, claiming that the facilities were placed in service when Akeida's emissions improvements were certified on Aug. 11, 2011. They requested a $12 million grant for each facility.

The Treasury declined to pay the full grant applied for because, according to the Treasury, most of the property had been placed in service in 2008. Instead, out of the $12 million requested for each facility, the Treasury paid only $1.1 million for each.

Akeida's project companies sued for the remainder. In 2020, the Court of Federal Claims ruled for the government, finding that the facilities were placed in service in 2008.

In a two-part analysis, the Court of Federal Claims first applied the definition of "placed in service" from the tax regulations, which required it to determine the taxable year in which the property is available for a specifically assigned function.[3]

Second, the court applied a five-factor test, drawn from Internal Revenue Service revenue rulings and Oglethorpe Power Corp. v. Commissioner,[4] to determine when the facilities achieved their specifically assigned function, and were, therefore, placed in service. The five-factor test examines:

1. Whether the necessary permits for operation have been obtained;
2. Whether critical preoperational testing has been completed;
3. Whether the taxpayer has control of the facility;
4. Whether the unit has been synchronized with the transmission grid; and
5. Whether daily or regular operation has begun.

The trial court found that all five factors indicated that much of each facility was placed in service in 2008. Therefore, the court concluded that the project companies were not entitled to the full grant money that they had applied for, because much of each facility was placed in service outside of the statute's designated time period.

Appeal to the Federal Circuit Court

The Court of Appeals for the Federal Circuit affirmed the decision of the lower court. In doing so, it agreed with the U.S. Court of Appeals for the Fifth Circuit's 1995 ruling in Sealy Power Ltd. v. Commissioner[5] that to be placed in service, a facility need not achieve ideal or near-ideal production levels.

In reaching its holding, the Federal Circuit applied the pertinent regulation which provides that "placed in service" means property being in a condition or state of readiness and availability for a specifically assigned function.[6]

Implicit in the Federal Circuit's holding is that "state of readiness" is a relatively generic standard, rather than one that considers whether particular PPA production thresholds are met.

The Federal Circuit concluded that neither the statute nor the regulations state or imply that the property must produce an anticipated or projected amount before it may be considered ready and available for a specifically assigned function.

The Federal Circuit explained that neither the statute nor the regulation required the strict construction asserted by the project companies. Thus, the Federal Circuit agreed with the trial court that a specifically assigned function need not require ideal or near-ideal production levels.

Next, the Federal Circuit noted that the trial court had found that all five factors under the five-factor test indicated that most of each facility was placed in service in 2008. Thus, the property was placed in service outside of the statute's designated time period.

In this fact-specific analysis, the project companies argued that the facilities' specifically assigned function is to produce electricity on a baseload basis for sale at the quantities required under the PPAs, reliably, and in compliance with applicable law.

The lower court rejected this argument, and concluded that the parties' course of dealing under the PPAs shows a flexible contractual relationship allowing less-than-consistent baseload production.

The circuit court sustained the lower court's rejection of the project companies' assertion that the facilities had to operate in accordance with environmental laws and regulations. The trial court had determined "that achieving compliance with environmental law was not part and parcel of the facilities' function to produce electricity using biomass."

The lower court also found that, even when the facilities did not comply with environmental laws, their continued operation prevented burning waste in open fields, which the clean air district determined to be more harmful than the facilities operating with emissions violations.

Lastly, the Federal Circuit examined the lower court's application of the five-factor test to determine when a facility achieves its specifically assigned function and is, therefore, placed in service. The Federal Circuit addressed only the contested factors — the first, second and fifth of the five factors set forth above:

- Necessary permits: The appellant's ATC permits allowed them to operate the facilities by producing and selling electricity. While the facilities occasionally went out of compliance, the district never revoked permits, and allowed the facilities to continue operating.

- Critical testing: The trial court had held that the critical tests were (1) pre-parallel testing and (2) testing required under the PPAs. Because the facilities passed these tests by 2008, the trial court concluded that the facilities had passed the critical tests necessary for proper operations by 2008. The Federal Circuit concluded that the facilities could and did operate without passing environmental tests, and the facilities passed all pre-parallel testing and the testing required by the PPAs by 2008, allowing them to generate and sell electricity starting that year.

- Regular operation: The Federal Circuit concluded that the facilities were generating and selling a substantial amount of electricity in 2008. While the facilities occasionally shut down, the trial court did not clearly err in finding that facilities nonetheless, operated regularly.

Takeaways

The placed-in-service analysis is not one size fits all for power generation projects. Rather, the local regulatory requirements, the particular safety testing required for the technology in question, and the testing requirements of the interconnection agreement and the PPA must be evaluated.

Further, the opinion suggest that the specifically assigned function[7] of a power project is an engineering concept, rather than a question of satisfying the production levels required by a PPA. That is, a project is able to serve its specifically assigned function if it generates meaningful power in the manner it was designed to — even if it falls below the contractual production threshold provided for in its PPA.

This holding is consistent with twin private letter rulings from 2013, in which the IRS ruled

that a solar project could be placed in service, even if the project was potentially subject to periodic curtailment because certain network upgrades that the PPA with the utility required the project owner to provide were not yet complete.[8]

The private letter rulings held that the network upgrades were not necessary for the safe operation of the project, but rather were required by the utility to ensure grid reliability. Thus, in these rulings, as in Ampersand, placed-in-service status was determined by the ability of the project to safely generate meaningful amounts of electricity that could be dispatched to the grid — not by the project's ability to comply with PPAs that are a function of individual negotiations.

It can be difficult to reconcile the holdings in different placed-in-service cases.[9] For instance, in this case, one of the projects was determined by the Federal Circuit to have been placed in service in 2008, when it operated at approximately one-third capacity, and was not able to comply with emissions rules.

In contrast, the Tax Court held in Brown v. Commissioner in 2013 that a corporate jet that was flown primarily to business meetings carrying its owner was not placed in service because it was not ready for specifically assigned function. The Tax Court determined that the owner needed the plane to conduct business meetings in the air, and because the plane had not received its ordered upgrades of a larger screen and a conference table, it was not placed in service.[10]

Under the placed-in-service doctrine, are optimally sized video monitors and added conference tables for corporate jets more significant than a power generation project operating at more than 50% capacity and complying with emissions rules?

David Burton is a partner and Viktoria Vozarova is an associate at Norton Rose Fulbright.

[1] Ampersand Chowchilla Biomass LLC v. United States, No. 2021-1385 (February 24, 2022).

[2] Pre-parallel testing ensures that the facilities can operate at the same frequency and in the same phase as the transmission grid, so that the facilities do not damage the grid.

[3] Treas. Reg. § 1.46-3(d)(1)(ii).

[4] Oglethorpe Power Corp. v. Commissioner, 60 T.C.M. (CCH) 850 (1990).

[5] Sealy Power Ltd. v. Commissioner, 46 F.3d 382 (5th Cir. 1995).

[6] Treas. Reg. § 1.46-3(d)(1)(ii).

[7] Treas. Reg. § 1.46-3(d)(1)(ii).

[8] P.L.R. 201326008 & 201326009 (Jun. 28, 2013).

[9] See Jasper Cummings Jr., When is Property Placed in Service, Tax Notes, Oct. 20, 2015 ("Although [the term placed in service] has no general definition in the code or regulations, the IRS acts as if it did. This flexibility in interpretation allows the IRS to argue out of both sides of its mouth, sometimes speeding up and sometimes slowing down what it means to be placed in service").

[10] See David Burton, Salesman Penalized for 'Placed in Service' Interpretation, Tax Notes, Feb. 17, 2014. Brown v. Commissioner, T.C. Memo. 2013-275 ("We agree with Brown that the Challenger 'was fully functional for air transportation.' But that's not quite the right question. The regulation tells us to decide when the plane was ready and available for a 'specifically assigned function.' Reg. Section 1.167(a)- 11(e)(1)(i).").