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Lessons From Tax Court's Nixing Of Investor's Energy Credits

By **David Burton** (April 12, 2021, 4:21 PM EDT)

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The U.S. Tax Court just published a decision addressing the first of 200 cases involving individual taxpayers that invested in a tax shelter scheme involving lenses intended for concentrated solar projects: Preston and Elizabeth Olsen v. Commissioner of Internal Revenue.[1]

The Olsens' case may have been selected as the test case because Preston Olsen is a partner in a national law firm's bond practice, so it sends the message to the other taxpayers that if this lawyer cannot prevail then your odds are not good.

The opinion is effectively a case study in how not to structure an investment in solar equipment, particularly an investment by an individual.

From 2010 through 2014, Olsen purchased lenses that were intended to be used for concentrated solar power.

His intent was to use the investment tax credits and accelerated deprecation associated with such solar equipment to zero out his tax liability in each year from 2010 to 2014 from being employed by and then a partner with a large law firm.

The plan did not play out as he intended.

Equipment Must Be Placed in Service

His first mistake was that the lenses were never actually placed in service, yet he claimed the investment tax credit and depreciation on them, which is not permitted.[2]

The taxpayer's own expert witness testified that the tax shelter promoter "'activated the system' for a 30-minute period, but the system 'wasn't connected to anything' and 'wasn't putting anything on the [electric] grid.'"

The Tax Court described its five factor weighted test to evaluate whether a power generation project has been placed in service:

> 1) whether the necessary permits and licenses 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.[3]

The Tax Court concluded that each of these factors weighed against the taxpayer.

The promoter had sent the taxpayer reports "that the lenses had been 'put into service' in December of each year.'" This report seemed to have been some sort of an attempt to replicate a permission to operate notice that a utility sends a solar project owner. However, the taxpayer did not even try to persuade the Tax Court that promoter's reports governed the issue.

Rather, the taxpayer argued that the solar lenses were placed in service because they were held out for lease based on a lease agreement between the taxpayer and the promoter. The taxpayer cited the 1987 Tax Court decision Cooper v. Commissioner of Internal Revenue for the proposition that solar hot water heaters were placed in service when they were subject to a lease without being operational yet.[4]

The Tax Court distinguished solar lenses from the case involving the solar hot water heaters as the solar hot water heaters were in a ready condition, while the "lenses were mere components of a system, and … they remained unwrapped on pallets."

Passive Activity Constraints

The promoter was aware of the limitation in the passive activity loss rules that limit the ability of individual taxpayers from using passive losses or tax credits to reduce the tax liability on their income from their employment or profession, or their investment portfolio.[5]

As the Tax Court's opinion properly describes, an individual can avoid an activity being deemed passive, if the individual materially participates, and is involved in "operations on a basis that is 'regular,' 'continuous,' and 'substantial.'[6]"

The promoter had what sounded like a tax planning strategy garnered from cocktail party chatter to address the concern. The promoter "suggested that this problem could be obviated by creating an LLC and designating [the promoter] as the LLC's representative. As long as the 'representative' logged enough hours, [Olsen] was supposedly 'free to work as little as he would like in his solar business.'"

There was a nugget of an idea in the promoter's assertion, but the execution was flawed. The nugget of the idea is that the two cases held, where the taxpayer is a trust, the hours are measured for purposes of avoiding application of the passive activity loss rules by the activities of the trustee, rather than the beneficiary.[7]

However, the entity must be recognized by the tax law as a trust to conserve or protect property,[8] such as a testamentary trust[9] or a complex residuary trust,[10] rather than as a business entity.[11]

Unfortunately, Olsen formed a limited liability company rather than a trust, so he did not even get to the question of the nature of the trust for income tax purposes or the adequacy of the hours performed by the promoter.

Further, even if the legal entity selection had taken these principles into account, the effort would not have been successful.

That is because the lenses were purported to be leased by the taxpayer to the promoter, and equipment leasing is per se passive — i.e., but for a de minimis exception it is passive, regardless of the level of activity undertaken by the taxpayer.

As the court wrote the "purported lens-leasing activity was a passive activity because it consisted of 'rental activity' that did not involve a 'real property business.'"

A Slow Process

In transactional tax planning, the question often arises: If the Internal Revenue Service challenges the transaction, how long could it take to reach a final determination of the tax treatment of the transaction?

The question has particular economic ramifications because, if the taxpayer loses in Tax Court, underpayment interest is owed the IRS from the day the tax return was due through the payment of the tax after the Tax Court's ruling.[12]

In this instance, the taxpayer first purchased the solar lenses in 2010 and the opinion was released in 2021, so 11 years from the outset of the transaction to a Tax Court opinion should not be an unexpected time frame.

In this case, the IRS tried to assert a 20% penalty but conceded the point as the IRS auditor "did not secure timely supervisory approval for them."[13] If the penalties had been applicable, interest would have been owed on the penalties from when the IRS first asserted them in the audit through the payment after the Tax Court's ruling.

As the popularity of renewable energy grows, more high tax bracket individual taxpayers will consider investing in renewables beyond what they can install on the roofs of their homes.[14] This case provides a map of some of the landmines associated with such a strategy.

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[1] Tax Court docket numbers 26469-14, 21247-16 (Apr. 6, 2021).

[2] I.R.C. § 48(a)(1), Treas. Reg. § 1.167(a)-10(b).

[3] Citing Green Gas Del. Statutory Tr. v. Commissioner, 147 T.C. 1, 51 (2016) (quoting Sealy Power Ltd., 46 F.3d 382, 395 (5th Cir. 1995).

[4] Cooper v. Commissioner, 88 T.C. 84, 113-114 (1987).

[5] IRC. § 469.

[6] IRC §§ 469(c)(1) and (h)(1). For detail on the regulations that implement these rules and provide certain hours based thresholds see Burton, David, Hunting Unicorns: Individuals as Tax Equity Investors, Power Finance and Risk (Aug. 17, 2012), available at https://www.projectfinance.law/media/5528/passive-activity-loss-article-unicorns-by-david-burton.pdf.

[7] See Mattie K. Carter Trust v. U.S., 256 F.Supp. 2d 536 (N.D. Tex. 2003); Frank Aragona Trust v. Commissioner, 142 T.C. 165 (2014).

[8] See Treas. Reg. § 3301.7701-4(a).

[9] E.g., Carter Trust, supra.

[10] E.g., Aragona Trust, supra.

[11] See Treas. Reg. § 3301.7701-4(b) (referencing § 3301.7701-2).

[12] If the taxpayer opts to litigate in federal district court or the federal claims court, the taxpayer has to file a refund claim, and so must pay the tax to establish jurisdiction. In such cases the payment of the tax tolls the accrual or subsequent interest.

[13] See IRC § 6751(b)(1).

[14] See IRC § 25D.