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In this article, Burton describes three recent IRS private letter rulings that grant taxpayers permission to make late tax elections regarding their inverted lease structures, which are a common financing structure for residential solar projects.

In two identical private letter rulings, LTR 201550024 and LTR 201550023, which were made public on December 11, the IRS granted a lessor in an inverted lease permission to make a late election to pass through to the lessee the 30 percent investment tax credit (ITC) under section 48. The IRS issued a third ruling, LTR 201552004, for a similarly structured transaction, permitting a late election out of bonus depreciation.

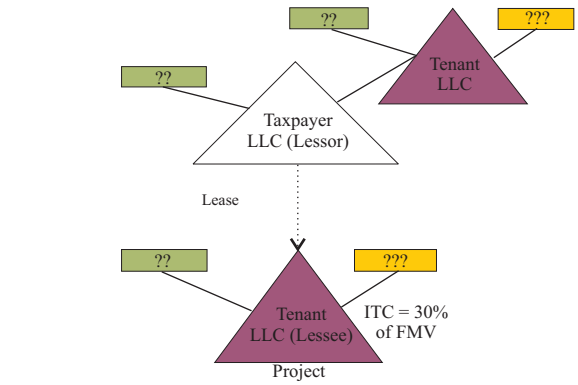
The two rulings granting permission to make a late election to pass through the ITC have sparse facts and do not specify the type of renewable energy resource involved, although solar would be a good guess. It is clear the party that would benefit from the passthrough election is a limited liability company that is intended to be taxed as a partnership. That party is the lessee in the transactional structure.

The ruling states that the lessee is one of the members of the lessor. The lessor is also a limited liability company intended to be taxed as a partnership.

The sparse facts suggest a transaction diagram along the lines of Figure 1.

The rectangles are members of the LLCs; neither identifying information nor their LLC ownership percentages are provided in the rulings. Most significantly, the lessee is a member of the lessor *and* leases the project.

Figure 1



Note: Each entity with a colored fill is the same entity with matching color.

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The rulings don't provide facts regarding the other members of the lessor or any members of the lessee. We do know that the lessor and lessee each have at least two members because each purports to be a partnership for federal income tax purposes.

As shown in the diagram above, the lessee was intended to be the taxpayer that claimed the ITC. The rulings don't address the term of the lease. One would expect the term to be (1) more than five years to avoid recapture of the ITC that would result from an expiration of the lease during the five-year recapture period,[1] and (2) less than 80 percent of the useful life of the solar project to be within the IRS's rulings guidelines for leveraged leases.[2]

The lessor's tax return preparer, rather than filing an election to pass through the ITC to the lessee, prepared the lessor's return so that it claimed the ITC. Because the lessor is a partnership, the tax

[1]*See* reg. section 1.47-2(b)(2)(iii).

[2]*See* Rev. Proc. 2001-28; 2001-1 C.B. 1156, section 4.01(3). However, these are merely advance ruling guidelines, and the courts have ruled favorably on lease transactions that are outside of this guideline and other aspects of the advance ruling guidelines. *See, e.g., Torres v. Commissioner*, 88 T.C. 702 (1987) (15-year lease of computer equipment with a 15- to 18-year useful life).

return preparer then allocated 100 percent of the ITC to the lessee in its capacity as a member of the lessor.

Given the confusing structure of the same entity being the lessee and a member of the lessor, the tax return preparer's error is relatively understandable and something many students of the inverted lease structure can empathize with.

In these two passthrough election rulings, the IRS ruled that the lessor would have 120 days to amend its prior tax return, and on its amended return, it could make the election to pass through the ITC to the lessee.

Tax Benefits in an Inverted Lease Structure

Some taxpayers may have been tempted to overlook the tax return preparer's error with a rationale along the lines of "close enough for government work." The two taxpayers that requested these rulings were likely motivated to fix the errors because the passthrough typically results in a larger ITC amount than the amount the lessor in this structure would be entitled to if it claimed the ITC.

In an inverted or passthrough lease structure,[3] the project is typically contributed to the lessor. That results in carryover basis, rather than a step-up to a fair market value basis.

The tax alchemy occurs with the passthrough election. The passthrough election permits the lessee to determine its ITC basis using the project's *notional* fair market value.[4] This calculation is sanctioned by the code even though the lessee may have yet to incur any cost regarding the property (that is, to have paid any rent), and whatever amount of rent it has paid is certainly significantly less than the FMV of the project. Further, the lessor or one of its members likely constructed the project at a cost materially less than the FMV of a fully operational project. Thus, the ITC is calculated based on the FMV, even though no party to the transaction actually incurred that amount.

Further, the only income the lessor realizes from the transaction is rental income under the lease. That is, the transaction doesn't trigger a tax gain for the lessor, despite the ITC being calculated based on the project's FMV.

The one drawback of the tax economics of the structure is that the depreciable basis is not *stepped up*. That is, the basis remains equal to the cost to construct the project.

Capturing some depreciation benefits — even those calculated based on the project's cost to construct — is the reason for the convoluted partnership structure. To benefit from the ITC calculation resulting from the passthrough election, the tax equity investor (the party who can use this ITC) must be a member of the lessee. With each lessee and lessor being a partnership, and the lessee being a member of the lessor, some of the lessor's depreciation may be allocated to the lessee. The lessee then further allocates the depreciation to its partners, which includes the tax equity investor. Thus, the structure achieves:

1. an ITC calculation based on the project's "fair market value";[5]
2. avoidance of a sale of the project, so there is no taxable gain recognition; and
3. some depreciation is allocated to the tax equity investor through its membership in the lessee, which is a member of the lessor.

IRS Precedent for the Inverted Lease Structure

The inverted lease structure was originally developed for transactions involving rehabilitation investment tax credits (historic tax credits). It was then adopted by some participants in the distributed generation solar industry. For years, there was no guidance to look to regarding the structure. The historic tax credit community became worried about its structuring practices following an adverse holding from the Third Circuit, although that case did not involve an inverted lease structure.[6] Thus, it requested guidance from the IRS. After being prodded by members of Congress,[7] the IRS issued Rev. Proc. 2014-12, 2014-3 IRB 415. Example 2 in section 5 of the revenue procedure posits an inverted lease structure generally similar to the one described in these private letter rulings and concludes that the IRS would not challenge it. However, the IRS's example leaves key economic parameters undefined,[8] so taxpayers and their advisers are left guessing as to the details of an acceptable economic structure for an inverted lease. Further, the revenue procedure, on its face, is limited to rehabilitation tax credits under section 47.[9] Therefore, the two private letter rulings addressing the correction of the

[3]Generally, the term "inverted lease" is used by tax credit investors to refer to the structure above with the overlapping partnerships, while the term "passthrough lease" is used to refer to the same lease structure, but without the partnerships (that is, the lessor and lessee are not related).

[4]Section 50(d)(5) (referencing former section 48(d)(1)(A)).

[5]*Id.*

[6]*Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012).

[7]*See, e.g.*, Letter from Rep. Niki Tsongas, D-Mass., to Jacob Lew, Secretary of the Treasury (Apr. 26, 2013).

[8]*See* David Burton, "IRS Guidance for Historic Tax Credit Transactions," Tax Equity Telegraph (Jan. 12, 2016); and David Burton, "Informal Clarification of Historic Tax Credit Safe Harbor," Tax Equity Telegraph (Jan. 12, 2016).

[9]Rev. Proc. 2014-12, 2014-3 IRB 415, section 1.

passthrough election are the first time the IRS acknowledged, to any extent, that an inverted lease structure may be permissible in a section 48 energy credit (for example, solar) transaction.

However, by addressing the correction of the passthrough election in these private letter rulings, the IRS seemed to go out of its way to avoid any inference that it is blessing the structure. First, it kept the facts extremely vague, so there was no inference about how to structure those transactions. Second, it included the following broad caveat:

> In particular, we express no opinion on whether all of the conditions in [reg.] section 1.48-4(a)(1) are satisfied, whether [lessor's] expenditures with respect to Property qualify for the energy credit under section 48, whether [lessor] and [lessee] are partnerships for federal tax purposes, whether any member of [lessor] or [lessee] are partners for federal tax purposes or whether the lease at issue is a lease for federal tax purposes.

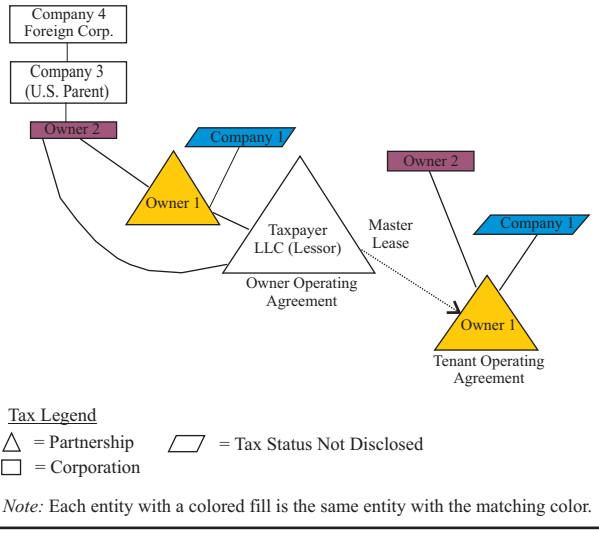
The granting by the IRS of an extension to file an election is often a matter of a mere formality of the taxpayer submitting the request, particularly if a tax adviser admits to making an error in the preparation of the taxpayer's return. Nonetheless, the IRS has the ability to deny a request for an extension if the requested extension is not in the interest of "sound tax administration."[10] Therefore, we can at least conclude that the IRS wasn't so concerned about these two inverted lease transactions that it concluded granting the extension that wasn't in the interest of sound tax administration.

IRS Permits Late Election

A third private letter ruling further highlights the confusion that an inverted lease transaction can cause. In LTR 201552004, the IRS granted a partnership an extension to elect out of the additional depreciation allowance, colloquially known as "bonus depreciation," provided for in section 168(k). That election is required to be made on the originally filed tax return. The taxpayer mistakenly failed to make the election, so it requested a ruling that it could make the election on its amended tax return.

The facts of this ruling are even more cryptic than the passthrough election rulings. For instance, the ruling does not even disclose whether ITC eligible property is involved. Nonetheless, the lease between two partnerships with overlapping partners strongly suggests an inverted lease of ITC eligible property. Further, that the property qualified for bonus depreciation suggests it was renewable energy property, rather than a rehabilitated historic building.[11]

Figure 2



Note: Each entity with a colored fill is the same entity with the matching color.

The IRS granted the taxpayer's request to make a late election out of bonus depreciation on its amended tax return. This is not surprising "as the Vice President of Taxation for Company 4" admitted to preparing the return and missing the election. The most factual detail in the ruling related to what this tax practitioner did not do: "Neither the [Vice President of Taxation] nor any member of Company's 4 tax department was involved in negotiating or preparing the Owner Operating Agreement or the Tenant Operating Agreement. . . . In addition neither . . . reviewed these agreements . . . prior to the preparation of the tax return."

The bonus depreciation election private letter ruling was issued by the Income Tax and Accounting branch of the IRS Office of Chief Counsel, while the passthrough election private letter rulings were issued by the Passthroughs and Special Industries branch of chief counsel.

It is interesting that the branches took different approaches to the caveats in their respective rulings. The passthrough election rulings each included the caveat that the ruling didn't reach a conclusion regarding the tax characterization of the lease or the partnerships, while the bonus depreciation election ruling did not contain that caveat. Would it be too much to infer that the Income Tax and Accounting branch has a more favorable view of the inverted lease structure than the Passthroughs and Special Industries branch? It may

[10]Rev. Proc. 2015-1, 2015-1 IRB 1, section 2.01.

[11]*See* section 168(k)(2)(A)(i)(I) (requiring bonus depreciation eligible property to have a class life of 20 years or less).

be that Income Tax and Accounting determined that the scope of the conclusion was limited to the late election out of bonus depreciation and spoke for itself, while Passthroughs and Special Industries opted for the "belt and suspenders" approach by narrowly defining the scope *and* including a litany of caveats.

Given the prevalence of the inverted lease structure in the distributed generation solar industry, the IRS will likely intersect with the structure regularly in coming years. It will be interesting to observe the outcome of the IRS's review of transactions involving this structure.