



## Alternative & Renewable Energy Tax Newsalert

### IRS guidance on auditing new "economic substance" provisions may give comfort to renewable energy investors

On July 15th, the IRS's Large Business & Industry Division published a directive (the "LB&I Directive") for examiners and managers on how to apply the recently codified provisions of the economic substance doctrine to business transactions. Under the Health Care and Education Reconciliation Act of 2010, Congress codified the common-law economic substance test and established a strict liability penalty of up to 40% for engaging in transactions that lack economic substance.

Although the Joint Committee on Taxation's report on this legislation clarifies that the codification of economic substance was not intended to affect certain alternative energy tax credit transactions, there has been some concern that the IRS could seek to apply the economic substance doctrine to transaction structures that allocate energy tax credits among investors.

The LB&I Directive outlines a four-step process in which IRS exam teams should engage before asserting economic substance penalties against taxpayers. Importantly, Step 1 instructs IRS personnel that application of the doctrine "likely is not appropriate" for a "[t]ransaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives."

Although examiners may continue with their analysis of transactions that meet one of the Step 1 conditions to evaluate issues such as non-tax profit potential or whether the transaction is "highly structured," Step 3 of the LB&I Directive requires the specific approval of an examiner's

manager in consultation with local IRS counsel in order to assert that an alternative energy credit transaction lacks economic substance. All such assertions then must be referred to LB&I's director of field operations for final approval.

#### ***PwC Observations***

The LB&I Directive should provide some welcome clarity on these issues and is fully consistent with Congressional intent. Earlier this year, staff members from the IRS's Office of Chief Counsel created some potential uncertainty around these issues with public comments on the limited application of the IRS's "partnership flip" guidance (Rev. Proc. 2007-65) and concerns about creating new standards for economic substance in alternative energy transactions. (For more on this issue, see our [May 10th Newsalert](#).) The LB&I directive appears to clarify that many transactional structures -- both within and without delineated IRS safe harbors -- can be viewed as fully consistent with both Congressional intent for the energy tax credits and the economic substance doctrine. However, because the existing safe harbors are incomplete, companies should examine these issues carefully when planning renewable energy transactions.

#### **For more information**

For the full text of the LB&I Directive, click [this link](#). For prior alerts on alternative and renewable energy tax issues, please see our [news archive](#).



In addition to the Alternative & Renewable Energy Tax News alert, PwC also publishes a cross-disciplinary News alert providing updates on cleantech, sustainable development, and the business impacts of US climate and energy policy. For further information and to sign up for these alerts, click [here](#).

For more information about using energy tax incentives to meet your renewable energy goals, please contact a member of PwC's Sustainable Business Solutions tax team:

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