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2016 Deloitte Alternative Energy Seminar

Setting new sights

November 14-16, 2016

Deloitte Center *for*
Energy Solutions

A large, thin green circle that frames the central text.

Tax
controversy
trends and
changes to
IRS audits of
partnerships

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New partnership audit rules

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- Overview of new law
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Background – Why the need for new partnership audit rules?

Why the need for new partnership audit rules?

- **September 2014**

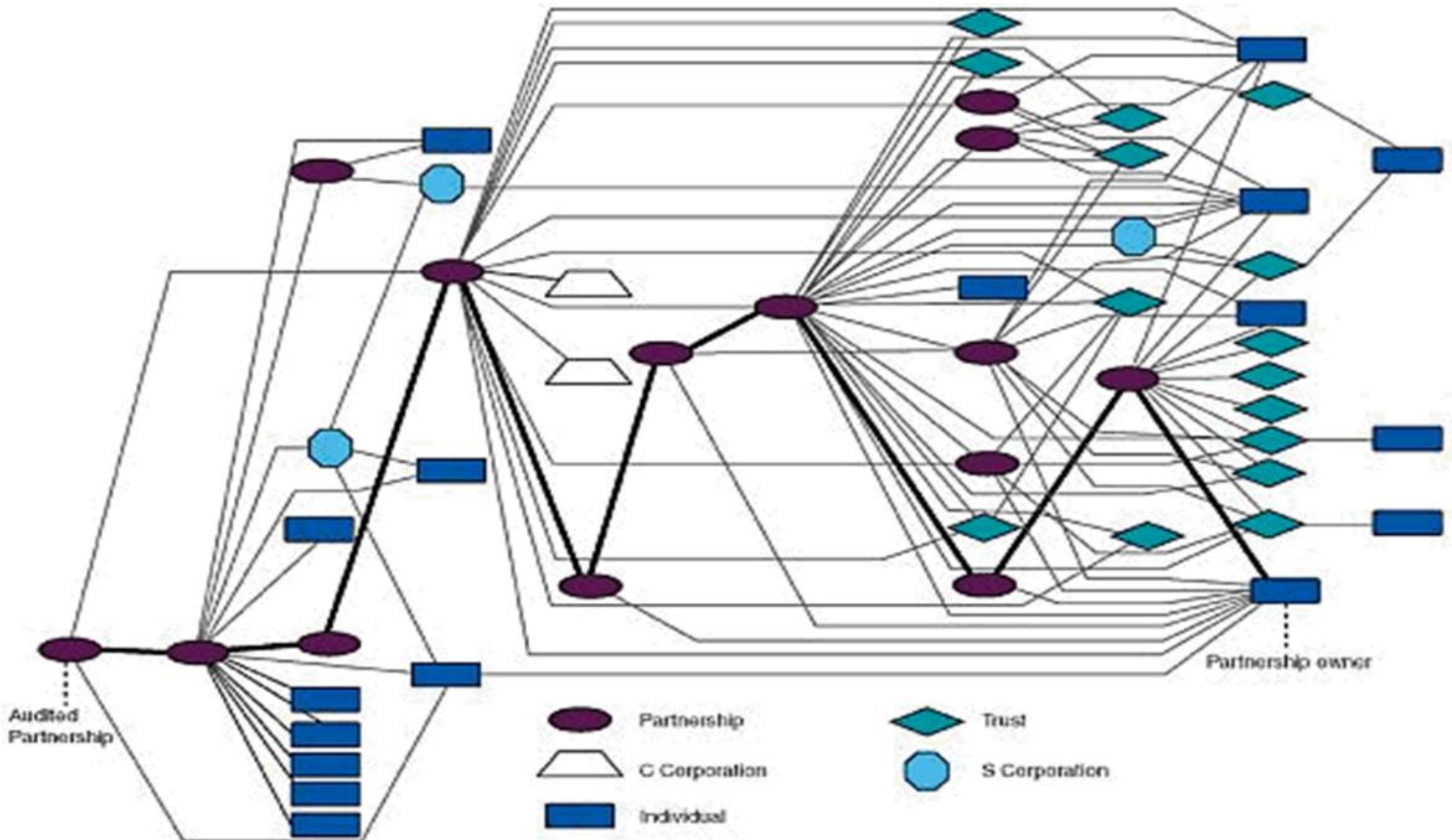
- Government Accountability Office (GAO) Report – “Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency”

- **March 2015**

- Treasury Inspector General for Tax Administration (TIGTA) Report – “Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process”
Increase Prevention Act enacted on December 19, 2014 extended PTC and ITC in lieu of PTC for facilities that had Begun Construction before January 1, 2015

- Protecting American from Tax Hikes Act of 2015 (“PATH Act”) and Consolidated Appropriations Act of 2015 (together “Tax Extenders”) enacted on December 18, 2015, provided the current long term extension and phase out

The GAO "Spider Web" Chart



(GAO, p. 17)

Overview of New Law – Bipartisan Budget Act (BBA)

Major changes in the Bipartisan Budget Act (BBA)

JOINT COMMITTEE ON TAXATION
October 28, 2015
JCX-135-15

ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN H.R. 1314,
THE "BIPARTISAN BUDGET ACT OF 2015,"
SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON OCTOBER 28, 2015

Fiscal Years 2016 - 2025

[Millions of Dollars]

Provision	Effective	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
V. Pension Provisions													
1. Single employer plan annual premium rates.....	pyba 12/31/16	----- Estimate To Be Provided By The Congressional Budget Office -----											
2. Pension payment acceleration.....	DOE	----- Estimate To Be Provided By The Congressional Budget Office -----											
3. Mortality tables [1] [2].....	pyba 12/31/15	3	6	9	22	36	92	216	280	250	205	76	1,118
4. Extension of current funding stabilization percentages to 2018, 2019, and 2020 [1] [3] [4].....	pyba 12/31/15	---	---	174	797	1,704	2,303	2,024	875	-120	-1,223	2,675	6,534
Total of Pension Provisions.....		3	6	183	819	1,740	2,395	2,240	1,155	130	-1,018	2,751	7,652
XI. Revenue Provisions Related to Tax Compliance													
1. Partnership audits and adjustments.....	rffp tyba 12/31/17	[5]	[5]	[5]	843	1,165	1,260	1,383	1,505	1,565	1,604	2,008	9,325
2. Partnership interests created by gift.....	tyba 12/31/15	266	325	282	240	199	161	124	99	97	101	1,312	1,894
Total of Revenue Provisions Related to Tax Compliance.....		266	325	282	1,083	1,364	1,421	1,507	1,604	1,662	1,705	3,320	11,219
NET TOTAL		269	331	465	1,902	3,104	3,816	3,747	2,759	1,792	687	6,071	18,871

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is assumed to be November 1, 2015.

Legend for "Effective" column:

DOE = date of enactment

rffp = returns filed for partnership

pyba = plan years beginning after

tyba = taxable years beginning after

[1] Estimate does not include effects on PBGC premiums, which are estimated by the Congressional Budget Office.

[2] Estimate includes the following effects:

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Total Revenue Effect.....	3	6	9	22	36	92	216	280	250	205	76	1,118
On-budget effects.....	2	6	9	21	35	87	204	267	239	196	73	1,064
Off-budget effects.....	---	---	---	1	1	5	12	13	12	9	3	54

[3] This estimate is the net effect of the funding stabilization provision with pension package interaction.

[4] Estimate includes the following effects:

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2016-20	2016-25
Total Revenue Effect.....	---	---	174	797	1,704	2,303	2,024	875	-120	-1,223	2,675	6,534
On-budget effects.....	---	---	163	753	1,619	2,198	1,940	853	-104	-1,159	2,535	6,263
Off-budget effects.....	---	---	11	44	85	105	84	22	-16	-64	140	271

[5] Gain or loss of less than \$500,000.

Major changes in the BBA (cont.)

- **TEFRA and Electing Large Partnerships Repealed Effective 2018**

- Applicable for partnership taxable years beginning after 12/31/2017
- Possibility for early application under the **election in** rules for partnership taxable years beginning after 11/2/2015
- Subject to the small partnership **election out** rules

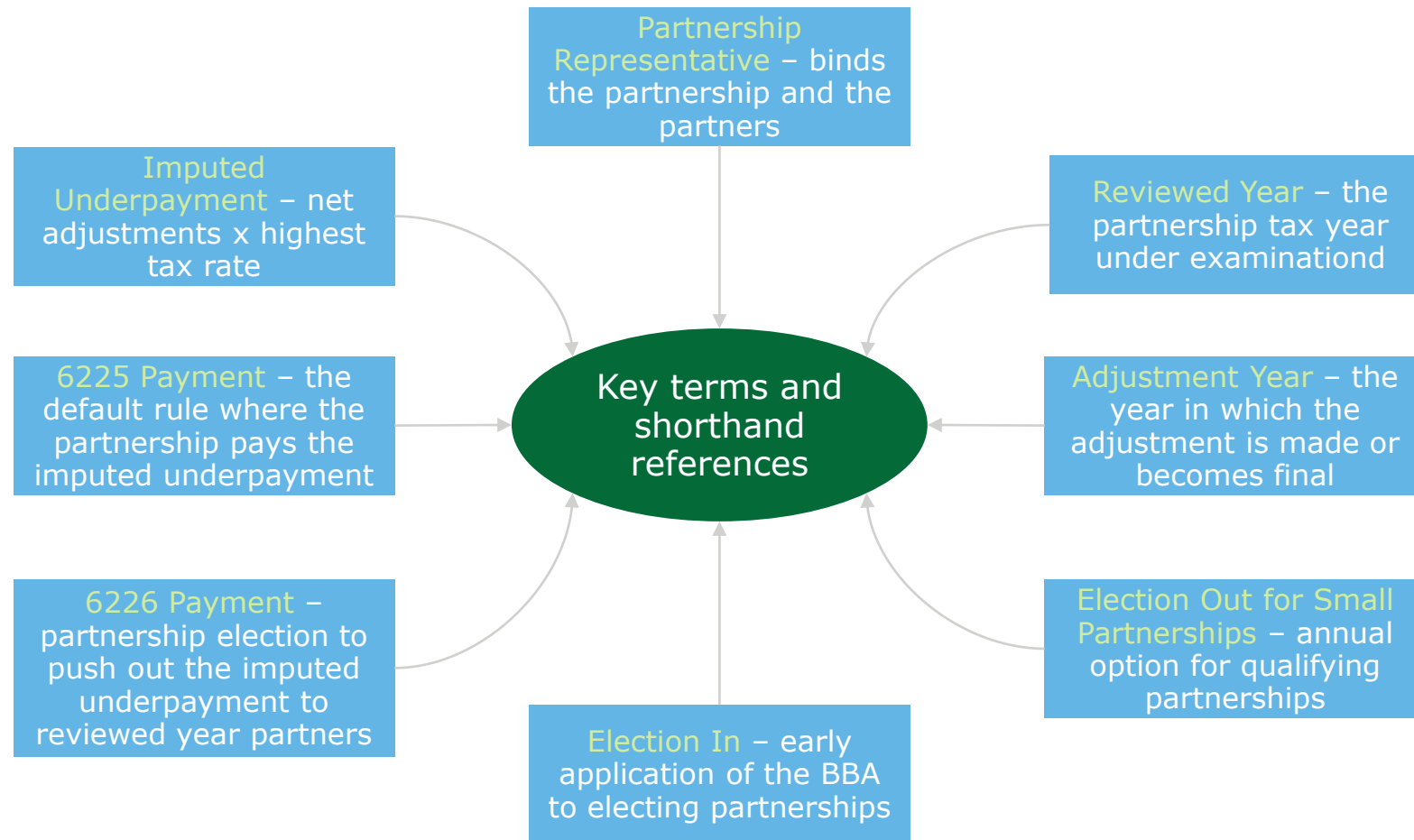
- **Exams Conducted, Adjustments Assessed and Collected, and Penalties Determined at the Partnership Level**

- Like TEFRA, requires partnership-level resolution of partnership income, gain, loss, deduction or credit
- Unlike TEFRA, the partnership, not the partners, is assessed tax based on the imputed underpayment amount at the highest applicable federal tax rate
- Subject to some key exceptions

- **Tax Matters Partner (TMP) is Replaced With the Partnership Representative (PR)**

- PR has the sole authority to act on behalf of the partnership
- PR does not have to be a partner in the partnership

Major partnership changes in the BBA (cont.)



Comparison TEFRA vs. BBA

Comparison TEFRA vs. BBA

- To whom do the rules apply?

TEFRA

- All partnerships, except
 - Those with 10 or fewer partners who are individuals (other than nonresident aliens), C-corporations or an estate of a deceased partner; and
 - Those who elect to be treated under the ELP rules
- Small partnerships can elect in

BBA

- All partnerships unless subject to a valid election out
- Election Out Rules:
 - 100 or fewer partners who are individuals, C-corps, S-corps, foreign entities treated as C-corps, or estates of deceased partners;
 - Annual election timely filed that discloses the name and identification number of each partner;
 - Partnership must notify each partner that the election out was made; and
 - S-corporation shareholders are counted for purposes of the 100 partner test
 - Disregarded entities – separately counted under legislative history as though they received a K-1

Comparison TEFRA vs. BBA (cont.)

- Treatment of items on a partnership tax return

TEFRA

- Partnership tax items are categorized as follows:
 - Partnership items
 - Affected items
 - Non-partnership items
- Partnership items can only be adjusted through a TEFRA examination
- Affected items can be:
 - Computational: can be adjusted directly on the partner's return without more data from the partner (e.g., items impacted by AGI adjustments)
 - Factual: require a factual determination made at the partner level (e.g., determination of outside basis)
- Non-partnership items are adjusted at the partner level only

BBA

- All items of income, gain, loss, deduction or credit of a partnership are determined at the partnership level
- This also includes:
 - The partner's distributive share of any such item
 - The applicability of any penalty, addition to tax or additional amount that relates to any such item or share

Comparison TEFRA vs. BBA (cont.)

- Consistent reporting between a partner and the partnership

TEFRA

- All partnership items must be reported consistently by the partner
- A partner can treat a partnership item on its tax return differently than the item was treated on the partnership return
- A partner who adopts inconsistent treatment must notify the IRS (Form 8082)

BBA

- All items of income, gain, loss, deduction or credit of a partnership must be reported consistently by the partner
- Unless subject to the exception below, any inconsistent treatment is subject to immediate assessment (without the benefit of the deficiency proceedings) as though it were a mathematical or clerical error
- Exception:
 - Similar to the TEFRA rules, partners can provide notice of inconsistent treatment and avoid the immediate assessment rules

Comparison TEFRA vs. BBA (cont.)

- Who can bind the partnership and its partners

TEFRA

- Tax Matters Partner (TMP)
 - Represents the partnership during IRS examinations and civil litigation
 - Receives IRS notices and is obligated to keep certain partners informed
 - Must be a partner
 - Selected by IRS if not selected by the partnership
- IRS must give notice to all partners of the beginning and completion of administrative proceedings

BBA

- Partnership Representative (PR)
 - Possesses the sole authority to act on behalf of the partnership
 - All partners are bound by the acts of the PR
 - No notice of IRS exam activities needs to be provided to anyone other than the PR
 - Partners have no statutory right to participate in any IRS exam, appeal or litigation
 - PR does not need to be a partner but must have a substantial US presence
 - PR will be selected by IRS if not selected by the partnership

Comparison TEFRA vs. BBA (cont.)

- Payment of partnership adjustments

TEFRA

- Any tax, penalties and interest are assessed and collected at the partner level
- Tax due determined by the individual partner's tax situation

BBA

- Default rule: the partnership, rather than the partners, pays the "imputed underpayment"
- Adjustments are taken into account in the "adjustment year"
- Imputed underpayment is calculated by multiplying the net adjustment by the highest statutory corporate or individual rate

Comparison TEFRA vs. BBA (cont.)

- Rules related to modification of imputed underpayment

TEFRA

- Not applicable under TEFRA

BBA

- The imputed underpayment can be modified:
 - If the reviewed-year partners file amended returns
 - If the partnership demonstrates an allocable share to a tax-exempt entity
 - If the partnership demonstrates that a lower tax rate applies to some portion
- Information demonstrating entitlement to modification must be submitted within 270 days after the notice of proposed adjustment
- IRS must consent to such modification

Comparison TEFRA vs. BBA (cont.)

- Rules relating to election to push out the imputed underpayment

TEFRA

- Not applicable under TEFRA

BBA

- Alternative payment option:
 - Partnership can elect to issue amended statements to the partners of the "reviewed year"
 - Election to do so must be made no later than 45 days after the date of notice of final partnership adjustment
 - The partners must take into account their share of the adjustment in the reviewed year (and subsequent years as applicable) without rights to contest
 - Interest charged at underpayment rate + 2%

Comparison TEFRA vs. BBA (cont.)

- How are penalties treated?

TEFRA

- Penalties determined at both the partnership and partner level
- Defenses may be asserted at both the partnership and partner level

BBA

- Penalties and defenses are determined at the partnership level
- The partnership is liable for penalties, additions to tax and additional amounts
 - Interest and penalties potentially associated with the partnership's failure to pay an imputed underpayment in a timely manner

Comparison TEFRA vs. BBA (cont.)

- Administrative adjustment requests

TEFRA

- Rather than each partner separately filing amended returns, a TMP is permitted to adjust a previously filed partnership return by filing an administrative adjustment request (AAR)
 - Partner AARs are permitted as well
- Process required the “TEFRA Unit” to match the AAR to the partner’s tax returns in order to flow through the adjustment
- Due to resource constraints, for AARs requesting refunds, IRS began to require each partner to separately amend and attach a copy of the letter from the TMP notifying the partner that the IRS has agreed with the AAR

BBA

- Only the partnership can file an AAR
 - Must be filed within 3 years from the later of the due date of the partnership return (determined without regard to extensions) or the actual filing date
- If the AAR results in an imputed underpayment, the partnership can pay the amount due or the partners can do so
 - Adjustments similar to the imputed underpayment rules apply to AAR amounts due
- If the AAR results in a refund, the refund is not paid to the partnership
 - Instead, statements are furnished to the reviewed year partners

Comparison TEFRA vs. BBA (cont.)

- Statute of limitations on assessments

TEFRA

- Generally, three years from the filing of the partnership return
- Assessment period for individual partners may be longer

BBA

- No adjustment for any partnership taxable year may be made after the later of:
 - Three years after the return is filed
 - Three years after the return was due
 - Three years after the partnership filed an administrative adjustment
 - YES – the filing of an administrative adjustment request extends the statute of limitations on assessments!
- The partner's statute of limitations is not taken into account

What remains uncertain – Notice 2016-23

- **IRS and treasury intend to issue guidance on the new rules**
 - Initial guidance targeted to cover the election in rules
 - Guidance will be retroactive to November 2, 2015
 - The IRS recommended approach regarding electing in – wait until guidance is issued
- **Application of the election out rules**
 - Currently, applies to partnerships with 100 or fewer K-1s
 - Question: Should a similar rule to the rule applicable to S-corporations be crafted for other partners?
 - Question: What will be the impact of JCT Blue Book discussion of disregarded entities?
- **Selection of the partnership representative**
 - Currently, any person with a substantial US presence
 - Question: What limitations are appropriate on the selection of the PR, either by the partnership or by the IRS?

What remains uncertain – Notice 2016-23 (cont.)

- **Imputed underpayments**

- Currently, partnerships can elect to pay an imputed underpayment rather than passing adjustments through to the partners

- Multiple questions:

- How should netting of this underpayment be determined?

- How should character changes be handled?

- What about passive losses and UBTI?

- What if the adjustment made during an examination does not result in an imputed underpayment?

- Procedural aspects of requesting modification of an imputed underpayment (e.g., timing, documentation)

- **How partnerships make administrative adjustment requests**

- Comments requested on the mechanics of such a request and the steps the IRS should take upon receipt of an AAR

- What review options should exist for the partnership with respect to IRS actions taken on an AAR?

Impact to tax equity partnerships

Impact to tax equity partnerships

Start now

- Understand the new rules and consider whether comments should be provided pursuant to Notice 2016-23
- Determine whether to opt in prior to the effective date
- Consider list of potential partnership representatives and associated rights and obligations

Complete within 6 months or so

- Analyze existing partnerships to assess the impact to current/former partners for potential partnership liabilities
- Consider whether the partnership is ready for IRS examinations
- Consider whether partnership agreements need to be modified to account for the BBA rules

Complete prior to BBA effective date

- Complete audit readiness assessments
- Calculate hypothetical tax consequences of IRS adjustment and run “what if” scenarios under IRC 6225 and 6226
- Determine whether to elect out (if a small partnership)
- Complete the modification of all partnership agreements to be consistent with all terms of the BBA

Ongoing efforts after BBA effective date

- Elect out if appropriate
- IRS exam planning
- Partnership level reserve computations (as needed)
- Escrows for departing partners

Tax controversy trends

Tax controversy trends – background

- Section 1603 grant controversy
 - Many taxpayers were challenged on section 1603 grant requests
 - Issues raised by treasury
 - Valuation
 - Purchase price allocations
 - Eligible basis
 - Development fees
 - Affiliated party transactions
 - Projects awarded grants on a “cost-plus” basis
 - Treasury white paper “evaluating cost basis for photovoltaic properties”
 - “While appropriate markups are case-specific and can depend on the ultimate transaction price, the 1603 review team has found that appropriate markups typically fall in the range of 10 to 20 percent.”

Tax controversy trends – Congressional inquiry

- Congressional inquiry into use of certain energy-related tax provisions
 - September 14, 2016 – senator hatch and representative brady issued letters to 7 companies
 - Residential solar installers (SolarCity, Sunrun, Sungevity)
 - Method of determining FMV for both PPAS and solar leases
 - Describe use of independent appraisals to support values reported for claiming ITC and 1603 grants and provide list of appraisers
 - Describe third party financing, including tax equity structures and affiliated investment in financing funds
 - Identify 1603 grants received including amounts assigned third parties
 - Describe the use tax loss insurance
 - Solar utilities (SunEdison, Abengoa, NextEra, NRG)
 - Provide organization chart and describe ownership stake in YieldCo(s) and the applicable contractual arrangements between company and YieldCo(s)
 - Identify which, if any, subsidiaries have filed for bankruptcy protection in the preceding 3 years
 - Provide list of all 1603 grants

Tax controversy trends – IRS audit activity

- IRS Audits / Tax Controversy
 - Starting to see more audit activity, particularly solar ITC
 - Issues raised by IRS
 - Reconciling 1603 grant award “haircuts” with the ITC claimed on substantially similar installations
 - Understanding tax equity structures
 - Valuation
 - Purchase price allocations
 - Eligible basis
 - Development fees
 - Affiliated party transactions
 - Long process / multiple IDRs
 - Unlike 1603 grant program hazards of litigation must be taken into account by IRS (at least at the Appeals level)

Tax controversy trends – 1603 litigation

Alta Wind v. US (October 24, 2016, unsealed October 31, 2016)

- Basis issue from sale of wind projects via sale leaseback
- Cash grant requested based on 30% of purchase price allocated to eligible property
- Treasury reduced grant award to 30% of Alta's cost to build wind projects
- Court awarded \$206 million in damages
- Court rejected government's arguments holding:
 - Section 1060 does not apply
 - No goodwill or going concern value could attach
 - PPAs were not separate intangible assets with value independent of tangible property
 - Wind projects had "Turn-Key Value"
 - No "peculiar circumstances" indicating inflated purchase prices
 - Pro-rata allocations are reasonable

Tax controversy trends – 1603 litigation (cont'd)

LCM Energy Solutions v. US (October 27, 2016)

- LCM sued for basis reductions equal to approximately \$400,000 in DG solar systems (roughly 50% haircut)
- Court determined Treasury was correct to disregard taxpayer's claimed basis and use "the better, more reasonable approach" to use installation costs plus a 20% profits, which is what Treasury did in issuing the original 1603 grants
- Court rejected Government counterclaims

GUSC Energy Inc. v. US (November 8, 2016)

- Treasury awarded 6.6% of claimed award for co-generation biomass plant where only 6.6% of total steam available for end-use was converted to electricity
- Government expert proposed an "efficiency method" allocation by focusing on energy used for electricity generation, and comparing that generation efficiency to the efficiency of a hypothetical electricity-only biomass plant (i.e., facility generates 15.24% of the electricity it would generate if it only generated electricity)
- Plaintiff expert argued 100% of costs should be treated as qualifying because all equipment used was necessary for the generation of electricity

Tax controversy trends – 1603 litigation (cont'd)

GUSC Energy Inc. v. US (November 8, 2016)

- Court cited W. E. Partners and three-step inquiry to analyze whether 1603 grant should be awarded to owner of open-loop biomass facility:
 1. The facility must be a “qualified facility”
 2. The property costs claimed as basis in the facility must related to “qualified property”, and
 3. The cost basis claimed for qualified property must relate to a “qualifying activity”
- Government conceded certain additional costs originally excluded including “iron works”, site clean-up, paving, and landscaping are eligible costs that related to qualified property.
- As a co-generation facility the Court found the steam generated to serve predominately significant role in heating, rather than electricity generation. In fact, the plant terminated operations during summer months when thermal energy was no longer required.
- Court choose to follow “energy efficient method” allocation presented at trial by Government’s expert witness and rejected policy arguments made by the Plaintiff
- Court also rejected Government claims to recapture grant based on prolonged periods where the plant ceased operations

Tax indemnities

Rev. Proc. 2014-12 – Permissible guarantees

The following *unfunded* guarantees may be provided to the investor

- Guarantees for the performance of any acts necessary to claim the tax credits;
- Guarantees for the avoidance of any act (or omissions) that would cause the Partnership to fail to qualify for the tax credits or that would result in a recapture of the tax credits; and,
- Guarantees that are not described as impermissible guarantees under Rev. Proc. 2014-12.

Examples of *unfunded* guarantees permitted under this section include:

- Completion guarantees
- Operating deficit guarantees
- Environmental indemnities
- Financial covenants

Rev. Proc. 2014-12 – Impermissible guarantees

The following guarantees may NOT be provided to the tax-equity investor:

- Sponsor cannot indemnify the tax-equity investor against the loss of tax credits or guarantee "cash equivalent of tax credits" if the IRS challenges the transaction structure
- Sponsor cannot agree to make capital contributions to partnership to ensure the partnership will have enough cash to make distributions to the tax-equity investor
- Sponsor cannot pay the tax-equity investor's "costs" or indemnify for its "costs" if the IRS challenges the tax credits
- This requirement does not prohibit the investor from procuring insurance from persons not involved with the transaction or the partnership

Typical tax indemnities provided by sponsor

- Tax structure risk – NO
- Begun construction risk – NO
- ITC basis risk - YES
 - Fair market value
 - Development fee
 - Affiliated party transactions
 - Eligible basis
- IRC section 50(d) – NOT ANYMORE
- ITC recapture risk – YES, but only to the extent attributable to actions undertaken by the sponsor

War stories – IRS audit activity

War stories – IRS audit activities

- SolarCity's experience
- Deloitte's experience

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