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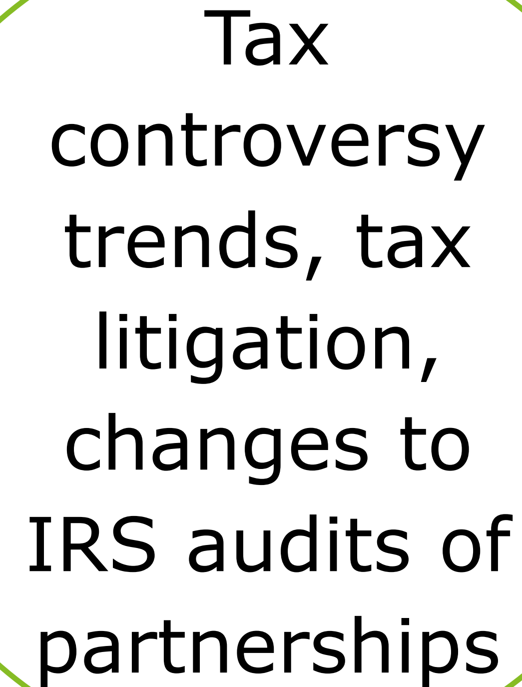

Tax controversy trends, tax litigation, changes to IRS audits of partnerships

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Contents

New partnership audit rules

- Current law basics: Partners pay the tax in most cases
- New regime: Partnership pays the tax
- New regime: Relief and modifications
- Partnership representative: Designation and rights and responsibilities
- Due diligence: Other considerations

Tax controversy trends

Alta Wind

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Current law basics:
Partners pay the tax in most cases

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Current law basics

- For audits of partnership returns for tax years beginning before 2018, three sets of rules govern the procedures depending on the size of the partnership.
- Most partnerships are required to follow unified partnership audit rules (commonly referred to as “TEFRA” rules).
- IRS has to audit partners individually if a partnership has 10 or fewer partners.
  - Such small partnerships can elect, but are not required, to follow the TEFRA rules.
- Partnerships with at least 100 partners can elect to apply simplified audit procedures for electing large partnerships (ELPs).

Except in the case of ELPs, the **partners** and not the partnership, are obligated to pay the tax (fewer than 20 ELPs in 2011).

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Basics of TEFRA audit rules

- Tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) is determined at the partnership level.
- Partners are generally represented by a general partner, the tax matters partner.
  - For a LLC classified as a partnership for federal income tax purposes, each "member-manager" is a general partner.
- Any partner has the right to participate in any administrative proceeding relating to the determination of partnership items at the partnership level, as well as the right to file petition for a readjustment of the partnership items in judicial proceeding.

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New regime:
Partnership pays the tax

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Partnership liability

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New regime: Centralized audit rules

- Repealed TEFRA and ELP Audit Rules (Applicable for Partnership Taxable Years Beginning after 12/31/2017)
- Default: Tax is Assessed and Collected From the Partnership
  - The IRS is no longer required to determine each partner's share of the adjustments made to partnership items followed by a separate computation adjustment for each partner to assess the correct tax due.
  - Instead, the partnership is liable for an "imputed underpayment" based on the adjustments made at the partnership level, as reflected in the notice of proposed partnership adjustment (NOPPA).
  - "Imputed underpayment" must be paid by the partnership as if a tax imposed for the adjustment year.
  - "Adjustment year" means the partnership taxable year in which the adjustment becomes final.
- Default: Adjustment Year Partners Bear Economic Cost of the Tax
  - Imputed underpayment is a non-deductible expense treated as an expenditure under section 705(a)(2)(B).

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Computation of imputed underpayment

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Computation of imputed underpayment

- Inflated imputed underpayments
  - "Imputed underpayment" is calculated by multiplying the total netted partnership adjustments by the highest rate of federal income tax in effect for the reviewed year under section 1 or 11, adjusted by increases or decreases in credits resulting from partnership adjustments.

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Total netted partnership adjustments

- Similar items of income, gain, loss, or reduction are netted. Dissimilar items are not. Net nonpositive items are disregarded for purpose of calculating the imputed underpayment.
  - Example: ordinary income and capital loss cannot be netted.
- Only the positive adjustments arising from reallocation of a distributive share of item from one partner to another are taken into account when determining the imputed underpayment.

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Applicable rate

- The imputed underpayment is calculated by multiplying the total netted partnership adjustment by the highest rate of tax in effect for the reviewed year for either corporations or individuals, whichever is highest.
  - If 2018 is the reviewed year, and the rate is the same as 2017, the individual rate would be the highest rate.

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Example

- Partnership reported on its 2019 partnership return long-term capital gain of $125.
- During an audit, the IRS determines the long-term capital gain should have been reported as ordinary income of $125, resulting in an increase in ordinary income of $125 as well as a decrease of longer-term capital gain of $125.
- The imputed underpayment is $50 (calculated as $125*40% (i.e. the highest tax rate in effect for 2019)).
- The $125 decrease in long-term capital gain will be taken into account by the partnership for the adjustment year.

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Underpayment computation – what to watch for

- Any post-2017 years under review? Partnership may be liable for the tax in a later year (adjustment year); copies of NOPPA and FPA, if any.
- Does seller indemnify buyer for reviewed year adjustment owed by partnership in post purchase adjustment year?
  - Buyer's indemnification should take into account underpayment inflation (rate and adjustments).
- Does partnership agreement address allocation of underpayment expense?
- Does partnership agreement obligate partners to reimburse the partnership for the partner's allocable share of the imputed underpayment?
- Escrow amount calculated correctly for exiting partner?

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New regime: Relief and modifications

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Options available to partnership for years after 12/31/2017

- Election out by eligible partnerships
- Modification procedures (aka “pull-in” procedures)
- Push-out procedures

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Election out

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Election out

- A partnership may elect out of the new regime if, for that taxable year:
  - It is required to furnish 100 or fewer K-1s;
  - Each partner is an individual, a C corp, any foreign entity that would be treated as a C corp were it domestic, an S corp, or an estate of a deceased partner;
    - Each S corp owner is treated as one partner (in addition to the S corp)
  - The election is made with a timely filed return for such taxable year and includes a disclosure of the name and correct TIN of each partner / S corp shareholder
    - Proposed regs also require disclosure of federal tax classification of each partner and affirmation of eligibility of each partner
  - The partnership notifies each partner within 30 days of making the election
  - Election can only be revoked with the consent of the IRS

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Effect of election out – no partnership underpayment liability

- Partnerships that elect out will be subject to the pre-TEFRA audit procedures.
- The IRS will be required to open deficiency proceedings at the partner level to adjust items associated with the partnership, resolve issues, and assess and collect any tax that may result from the adjustments.

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Election out – what to watch for

- Review tax returns to determine whether election out has been made.
- Review partnership agreement to determine obligation to elect out for years for which return has yet to be filed.
- Confirm qualification to elect out, if the target partnership elects out.
- Does agreement limit ability of Partnership Representative to elect out?
- Any limitation on transferability of a partnership interest so as to prevent partnership from not being able to elect out?

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Modification procedures (aka “pull-in” procedures)

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Modification of imputed underpayment ("pull-in" procedures)

- A partnership has options to request modifications to the computation of an imputed underpayment set forth in the NOPPA by submitting information within 270 days following the date of the NOPPA.
  - Can be extended with the consent of the IRS.
- Any requested modification must be approved by the IRS.

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Ways to modify imputed underpayment

- Reviewed year partners can amend prior year tax returns to pick up income adjustments reducing the total netted partnership adjustments.
- Partnership adjustments allocable to tax exempt partners can be disregarded for purposes of calculating imputed underpayment.
- Modification of applicable highest tax rate
- Additional types of modification have been prescribed by the IRS in the proposed regulations.

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Modification procedures ("pull-in" procedures)

- Partnerships must substantiate facts supporting a request for modification.
  - The documents and other information necessary to substantiate a particular request for modification is based on the facts and circumstances of each request, as well as the types of modification requested, and may include tax returns, partnership operating documents, certifications in the form and manner required with respect to the particular modification.
- Partnership representative must furnish to the IRS a detailed description of the structure, allocations, ownership, and ownership changes, the partners of the partnership, and, if relevant, any indirect partners for each taxable year relevant to the request for modification, as well as the partnership agreement.

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Modification based on tax exempt partners

- Imputed underpayment may be reduced if partnership demonstrates that a portion of partnership adjustments are allocable to a tax-exempt entity as defined in section 168(h)(2)(A), (C), or (D):
  - The U.S., any State or political subdivision, US possession, or any agency or instrumentality
  - Entities exempt from tax
  - Foreign person or entity
  - Indian tribal government
- The partnership must provide documentation to support the tax-exempt partner's status and the portion of the imputed underpayment allocable to the tax-exempt partner.

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Modification based on a rate of tax lower than the highest applicable tax rate

- Imputed underpayment may be reduced if partnership demonstrates that a portion of imputed underpayment is allocable to C corporations or individuals with a lower tax rate.
  - The lower rate may not be less than the highest rate in effect with respect to the type of income and taxpayer.
  - So, for example, the highest statutory rate in effect for all C corporations would apply, regardless of the marginal rate that would apply to the C corporation partner based on the amount of the C corporation's taxable income.

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Modification procedures – what to watch for

- If imputed underpayment is proposed, request a copy of any request for modification and information submitted in support of the request (e.g. the 270 day requirement, subsequent communication).
- Request a copy of any written approval from IRS for any modification.
- Does the partnership agreement give “credit” to the partners who amend their returns reducing the imputed underpayment of the partnership?
- Does the partnership agreement give “credit” to the tax exempt partners automatically?
- Does the partnership agreement require the reviewed year partners to amend prior year tax returns? How is it monitored?

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Push out procedures

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Push out procedures

- A partnership may elect to have its reviewed year partners take into account the partnership adjustments made by the IRS and pay any tax due on their tax returns for the “reporting year” (discussed on a later slide) as a result of those adjustments, as well as penalties and interests.
- The partnership is not required to pay the imputed underpayment if all adjustments are pushed out.
- Such election is revocable only with the consent of the IRS.

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Push out procedures

- To push out the adjustments to the reviewed year partners, the partnership must (i) make an election no later than 45 days after the date the FPA is mailed by the IRS and (ii) furnish a statement of each partner's share of any adjustment as determined in the FPA to its reviewed year partners.
- The statements must be furnished to the reviewed year partners no later than 60 days after the date the partnership adjustments become finally determined.
  - The partnership adjustments become finally determined upon the later of the expiration of the time to file a petition with a court (e.g. 90 days) or, if a petition is filed, the date when the court's decision becomes final.

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Push out procedures

- The tax due from the partner is computed by taking into account the amount by which the tax reported on the return for the reviewed year would increase, with adjustments for tax attributes for later years that would increase the amount of tax due.
- The increase in income tax is reported on the return for the partner's taxable year that includes the date the partnership furnished the statement to the partner (reporting year) even if he is no longer a partner.

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Push out procedures – penalties and interest

- The push-out election increases the applicable underpayment interest rate by two percentage points.
- Partners are also liable for penalties.
- Partners have no right to an administrative or judicial review.
- The regulations reserve on the issue of amended statements issued to pass-through partners and partners that are foreign entities.

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Push out – what to watch for

- Does the partnership agreement mandate the partnership make a push-out election?
- If so, for any year for which the push out election was made, was the election validly made?
- How does the partnership ensure the statements are mailed to the correct address for the reviewed year partners?

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Taxpayer representative: Designation and rights, powers, and responsibilities

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Designation

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Designation

For taxable year beginning after December 31, 2017:

- Partnership must designate a partner or other person (that meets certain requirements) as *Partnership Representative.*
- Partnership Representative has SOLE authority to act on behalf of partnership:
  - Other partners/persons cannot participate in exams or proceedings.
  - All partners are bound by its decisions.
- If the partnership doesn't designate, the Government can select a Partnership Representative for the partnership.

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Designation (cont.)

Requirements for Partnership Representative:

- A “person” – individual or entity
- If an entity (“Entity Partnership Representative”), the partnership must designate an individual (“Designated Individual”) to act for the entity.
- Partnership Representative (or Designated Individual):
  - Must have a “substantial US presence,” i.e., U.S. address, Tel. no. and TIN
  - Must have the capacity to act

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Designation (cont.)

Designation is made for each taxable year on the partnership's income tax return for that year – designation in the partnership agreement is not sufficient.

Partnership Representative can resign after return has been filed.

- PR may appoint a successor in the resignation.
- If not, IRS will give partnership 30 days to appoint a successor.

Designation can be revoked by the partnership after return has been filed only if an exam has commenced or the partnership files an amended return.

- Partnership must notify IRS and must appoint a successor.

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Designation – what to watch for

- Has a designation been made on the return?
- Is the designee qualified?
- Has the designee resigned?
- Has the designation been revoked?

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Rights, powers, and responsibilities

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Powers of partnership representative

Partnership representative actions:

- Elect out
- Extend the statute of limitations on assessment
- Determination not to contest results of an examination
- Make a Push Out election
- Enter into settlements
- Determination not to appeal a court decision

Those actions bind:

- The partnership
- All partners, including partnerships that have elected out
- Any other person whose tax liability is directly or indirectly affected by adjustments

PR is NOT required to notify the partners of the commencement of an audit.

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Powers of partnership representative (cont.)

“No state law, partnership agreement or other document or agreement may limit of the partnership representative of designated individual.”

- Agreement may, however, impose constraints.
- Other partners’ remedies may be limited to an action against the Partnership Representative for breach of agreement.

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Best practice around partnership representative

- Specifically list all actions that MUST be taken by the partnership representative.
- Consider listing all actions that MAY be taken and whether:
  - Partners need to be informed
  - Partners need to approve in advance
- Indemnification of the PR
  - By other partners
  - By the partnership
- Payment of expenses of the PR
- Compensation
- Authority of the PR to retain legal and accounting support
- Supervision/oversight by the partners or by a partner’s representative

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Powers of the PR – what to watch for

- Does the partnership agreement require the PR to notify the other partners upon commencement of an audit or at any other time?
- Does the partnership agreement attempt to limit the actions of the Partnership Representative or Designated Individual?
- What constraints, if any, are imposed upon the Partnership Representative with respect to taking actions, e.g.:
  - Providing notice to other partners
  - Obtaining consent to actions
  - Providing opportunity for comment
- What are remedies in the event of an action inconsistent with such constraints?

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Other considerations

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Do the considerations change depending upon the type of acquisitions?

- Types of transactions
  - Acquisition of an interest of an existing partnership
  - Contribution to an existing partnership in a section 721 contribution
  - Formation of a new partnership by contributing property or cash
  - Acquisition of all of the outstanding interests of a partnership resulting in a termination of the partnership
  - Continuation of a partnership

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Cease to exist rule

Under the proposed regulations, if the IRS determines that a partnership ceases to exist, the partnership adjustments are taken into account by the "former partners" of the partnership. The term "former partners" means the adjustment year partners of a partnership that has ceased to exist, or the partners of the partnership for the last year for which the final return was filed if the adjustment year post dates the final year.

Need to include indemnification/reimbursement by seller for any tax liabilities triggered by this rule.

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Buying a partnership interest from a partnership representative

- Does the buyer become the partnership representative?
  - No
- Should the buyer become the partnership representative?
  - Partnership representative may resign by notifying IRS, which may include the designation of a successor.
  - Does the partnership agreement authorize the partnership representative to designate the successor?

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Tax controversy trends

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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.”

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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)

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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

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Alta Wind – Litigation

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Alta Wind – Litigation

- 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.
- 20 plaintiffs, 8 complaints
- Service's expert witness testimony dismissed.
- Appealed to Federal Circuit: Government brief filed in April; Response brief filed in June; Reply to response brief filed in July; Hearing in the case expected in November/December 2017, or early 2018.

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Alta Wind – Litigation (cont.)

Alta Wind v. U.S. (Court of Federal Claims - Filed October 31, 2016)

- 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

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Alta Wind – Litigation (cont.)

No "peculiar circumstances" indicating inflated purchase prices such as:

- Unduly manipulating purchase price
- Entering into separate agreements
- Causing purchase price to be *highly inflated*
- Sale-leaseback NOT per se peculiar circumstances

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Alta Wind – Litigation (cont.)

Appellant Brief (Filed April 27, 2017)

- CFC was wrong in ruling IRC 1060 does not apply.
- CFC misapplied the “peculiar circumstances” exception.
- CFC’s decision to exclude testimony of Government’s expert was reversible error.
- Conclusion: Reverse and remand for further proceedings.

Appellee Brief (Filed June 8, 2017)

- Plaintiffs’ bases were property determined by the purchase prices.
- There were no intangibles to which the purchase prices should be allocated.
- Purchase price was appropriately allocated among the tangible assets.
- CFC did not err in excluding Parsons.
- Conclusion: Judgement should be affirmed.

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Alta Wind – Litigation (cont.)

Appellant Reply Brief (Filed July 20, 2017)

- Section 1060 applies to the Alta transactions.
- Plaintiffs all but acknowledge that the CFC misapplied law regarding "peculiar circumstances."
- CFC's exclusion of Parson's testimony was wrong as a matter of law and a travesty of justice.
- Conclusion: Judgement should be reversed, and the case remanded for further proceedings.

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Questions?

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