Current Federal Tax Developments

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SECTION: 136
PAYMENT TO CONSUMER WHO INSTALLED PHOTOVOLTAIC EQUIPMENT A NONTAXABLE SUBSIDY

Citation: PLR 201607004, 2/12/16

The IRS in Private Letter Ruling 201607004 ruled that a particular state organization's payments to subsidize residential solar photovoltaic systems was an energy conversion subsidy under IRC §136 that was excludable from income.

Under this program the organization will pay the consumer a subsidy to cover part of the cost of installing an approved photovoltaic system. The organization is entitled to any credits and any other "tradable energy or environmental related commodity produced or created by the PV systems." The organization insures that the size of the unit installed is not larger than what would be expected to be necessary to provide for the customer's use of electricity.

Under IRC §136(a), gross income does not include the value any direct or indirect subsidy provided by a public utility for costs related to the purchase or installation of energy conservation measures. A taxpayer reduces the basis of any such property acquired by the amount of subsidy. As well, the taxpayer is not allowed a "double benefit" for any such expenditure (that is, a credit or other deduction related to the subsidized portion of the cost).

The IRS therefore concludes in this case:

> The statutory requirements for the exclusion of the above described subsidies made by Organization from the gross income of the residential PV system owners are satisfied in the instant circumstances. The payments are made for purposes, and within the limitations, described in § 136(c)(1). Under the legislative scheme enacted by State as administered through Organization, the described payments are made "directly or indirectly" by Utility A and Utility B satisfying the terms of § 136(c)(2)(B), through Organization, to the residential customers.
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> We conclude, therefore, that the above described subsidies made by Organization are excludable from the gross incomes of the residential PV system owners for federal income tax purposes, under § 136 of the Code.

The ruling may cause some readers to vaguely recall that earlier they had read about a similar program where the IRS gave a ruling that seemed to hold directly the opposite, finding that the payment represented income. If so, you are likely thinking of PLR 201035003.

In that case the taxpayer received a single upfront payment from the utility for power expected to be generated by the renewable energy system installed. The taxpayer sought, and received, a ruling in that case that the amount was not a subsidy but rather was gross income—the exact opposite of what this taxpayer asked for.

You might wonder why a taxpayer would want the amount included in income—but recall that if the purchase is subsidized the taxpayer cannot claim a credit (such as the federal energy credit under IRC §25D) on the amount of the subsidy. In that case, unlike this one, the consumer retained rights to any credits and, at least for some taxpayers, the credit on that amount paid (which would reduce basis if it was a subsidy, and thus reduce the credit) was expected to be larger than the tax due on the income.

In the case that the IRS just issued the ruling on, remember that the consumer did not retain any rights to claim any credits. So in this case, if the amount was not a subsidy there would have been a tax cost to entering the program.

It's tough to know exactly what facts in the two cases are key to explain the different results, aside from the fact that the taxpayers asking for the rulings wanted the different results. The most plausible explanation (aside from just giving the answer asked for) is that the current program was designed specifically to limit the production to the amount needed by the customer, while the program covered by the 2010 ruling was meant to allow the utilities to meet their goals for total production from renewable resources. But, as should be clear, it's not absolutely the case that those two goals must be at odds with each other.

SECTION: 170
DEDUCTION ALLOWED TO PARTNERSHIP, AS PAYMENT OF CONTRIBUITON BY RELATED CORPORATION FOUND TO BE A MISTAKE THAT TAXPAYER CORRECTED

Citation: Green v. United States, 117 AFTR 2d ¶ 2016-418, DC WD Okla., Case No. CIV-13-1237-D, 2/10/16

Related taxpayers were allowed to treat a charitable contribution as made by a partnership rather than a related corporation that accidentally made the contribution in the case of *Green v. United States*, 117 AFTR 2d ¶ 2016-418, DC WD Okla., Case No. CIV-13-1237-D.

The case involved Hob-Lob Limited Partnership which owns many, not all, Hobby Lobby Stores. Hobby Lobby (the corporation) paid $7.5 in contributions to two charitable organizations in 2004. The taxpayers claimed that this had been a mistake, and that the contributions were intended to have been made by the partnership, of which a 99% interest was held by the taxpayer in this case.

The error had been noticed by the taxpayers. Letters of correction were sent to the charities, the amount was reflected as Hob-Lob's on its audited financial statements and Hob-Lob reimbursed the corporation for the contribution.

Charitable contributions are subject to very different limits on the amounts deductible based on the type of taxpayer making the contribution and, generally, a C corporation faces the smallest percentage of income limitation while a trust (which is the ultimate taxpayer in this case), while subject to various special rules for allowance of a deduction, has no percentage of income limitation on the deduction.

As well, the value of a deduction to the different taxpayers is impacted by the marginal rates imposed, which again are different based on the type of taxpayers involved. Here a C corporation has the lowest top marginal rate, while trusts very quickly pay at the highest individual marginal rates.

Even if the corporation were an S corporation, if the contribution is made by that entity it would flow to the shareholders (which very likely would not end up being the trust, at least in whole) and would be subject to basis limitations that might deny those shareholders a current benefit.

So the question of what entity gets this deduction (the partnership or the corporation) is most often not a trivial matter. The IRS argued that the test is simply based on what entity paid the expense—the taxpayers cannot assign the deduction after the fact when they determine that the original structure carries tax disadvantages.

The IRS cited the case of *Comm'r. v. Nat'l Alfalfa Dehydrating & Milling, Co.*, 417 U.S. 134 (1974) where the Supreme Court denied the taxpayer a deduction where the taxpayer argued it could have been structured differently. The IRS argued that fact that Hob-Lob *could* have made the contribution is not relevant since it did not actually make the contribution.

The District Court in this case disagreed. First, the Court briefly indicated that charitable contributions are subject to a different standard than other deductions (quoting from the Sixth Circuit decision in the case of *Weingarden v. Comm'r*, 825 F.2d 1027, 1029 (6th Cir. 1987) that charitable deductions are not matters of legislative grace, but rather statements of public policy).

The Court then goes on to hold it found this was a true mistake and that the deduction should be allowed to the partnership:

> Although originally issued on Hobby Lobby checks, the Subject Contributions were ultimately borne by Hob-Lob. Once discovered, the clerical error was thoroughly addressed — letters of correction were

> sent, affidavits were signed, books were corrected, and most importantly, Hob-Lob reimbursed Hobby Lobby's account for the full amount of the Subject Contributions. Plaintiff is not seeking a deduction for the Trust based on a hypothetical situation as was the case in *Nat'l Alfalfa Dehydrating & Milling, Co*. Rather, Plaintiff requests relief in accordance with corrected financial statements that reflect actual contributions made by Hob-Lob. To disallow a charitable deduction simply because of a clerical error goes against the liberal policy of encouraging charitable giving and distorts the Supreme Court's holding in *Nat'l Alfalfa Dehydrating & Milling, Co*.

Advisers should be careful not to take too much comfort in this decision. First, as the above paragraph makes clear, the Court found a true mistake rather than after-the-fact tax planning. Second, the opinion strongly suggests that had the deduction been other than a charitable contribution the decision might be different.

The decision is based on the very specific facts in this case. It does not stand for the proposition that anything an adviser finds the taxpayer did during the year that could have been done differently can be "restructured" before preparing the return to be more tax advantageous (that would seem right in line with the *Nat'l Alfalfa* decision's fact pattern.)

Rather, it can provide some justification where there is a true mistake to claiming the deduction on the proper return, assuming that the parties are made whole. But it will be important to document how the mistake was uncovered and to show that the intent all along had been to have the transaction undertaken by the other taxpayer.

Better yet is to advise clients strongly to be very careful when they have a number of related entities they control to be sure to make payments out of the proper checkbook. While this was a "win" for the taxpayers, a bigger win would have been never to have had an issue for the IRS to question to begin with, and that's the goal we should have our clients strive for.

SECTION: 451
TAXPAYER'S RIGHT TO INCOME NEITHER FIXED NOR CAPABLE OF REASONABLE ESTIMATE AT YEAR END, SO NOT INCLUDED IN INCOME UNTIL RECEIVED

Citation: Chief Counsel Advice 201607026, 2/12/16

All too often we, as tax practitioners, are tempted to say that a matter is "just timing" when looking at whether something has been properly handled on a tax return. That is, it was properly included in income or properly deducted, just perhaps in the wrong year.

But, as we all know when we think about the issue, "just timing" is actually a very important issue to our clients and the IRS, as well in the financial reporting arena when preparing financial statements. But tax rules and FASB's provisions don't look at the matter in the same way.

Right now, of course, the Financial Accounting Standards Board is in the process of moving to a new revenue recognition standard, but conceptually the goal for financial reporting is the same as it's been in the past—to attempt to reasonably match revenue with expenses using the best available information at the time a statement is prepared. That can include information obtained after the end of the year in question, so long as its available when the financial statement is being prepared.

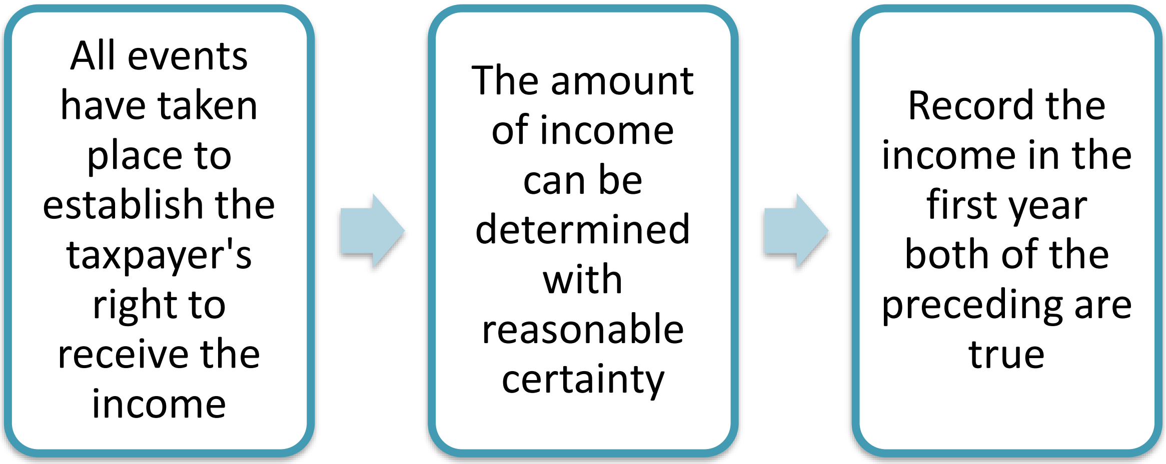
Taxes don't work that way, and in Chief Counsel Advice 201607026 the IRS looks at applying the tax rules to a situation involving Medicare incentive payments to certain providers under provision of the Affordable Care Act.

The tax rules for income recognition for a taxpayer on the accrual basis of accounting is summarized as follows in the memorandum:

> Section 451 of the Internal Revenue Code provides the general rule that the amount of any gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless such amount is to be properly accounted for in a different period. Accrual method taxpayers recognize income

"when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy." Section 1.446-1(c)(ii) of the Treasury Regulations.

So, effectively, an accrual basis taxpayer is going to recognize income using the following test:



The program in question gave an incentive a qualifying electing organization (referred to as "affordable care organizations" or ACOs) receiving fee for service (FFS) payments under Medicare to receive payments for "shared savings" for a group of patients if the organization meets certain quality performance standards.

As the memorandum describes the program:

> Section 1899(d)(2) of the SSA *(Social Security Act)* provides that, if the ACO meets the quality performance standards established by the Secretary, "a percent (as determined appropriate by the Secretary) of the difference between such estimated average per capita Medicare expenditures in a year, adjusted for beneficiary characteristics, under the ACO and such benchmark for the ACO may be paid to the ACO as shared savings and the remainder of such difference shall be retained by the program under this title." This percentage is referred to as the "savings rate." This section also requires the Secretary to establish limits on the total amount of shared savings that may be paid to an ACO. This limit is referred to as the "sharing cap."

The taxpayer in question had organizations that were participating in this program for the years in question. However the taxpayer argued that, due to a number of uncertainties related to the program, the amount it had earned for a year was not properly reportable in that year but rather in a later year when it actually received payment under the program.

Examination did not initially agree with this view and asked the Chief Counsel's office for guidance. Based on the facts of this situation, the Chief Counsel's office sided with the taxpayer.

The income in question failed to meet the first criteria (the "all events test") because the taxpayer did not have a fixed right to receive the income as of the end of the tax year. The memo points out:

> For instance, the beneficiaries used to determine an ACO's performance are assigned retroactively, after a three month claims run-out. The MSR *(minimum savings rate)* is dependent on the number of assigned beneficiaries and, during the tax years at issue, knowable only after the final number of assigned beneficiaries is determined. The benchmark of expected average per capita FSS *(sic)*

> expenditures is determined approximately six months after the performance year ends. The beneficiary per capita costs for the performance year are determined retrospectively, after the three month claims run-out, and can include FFS claims billed by other practitioners if the FFS beneficiaries received care outside the care rendered to them by the ACO practitioners. At the conclusion of their tax year, the ACO practitioners may not have knowledge of all of the other FFS claims.

As well, the National Office concludes that, as of the end of the year, the amount cannot be determined with reasonable accuracy. This determination is made as of the end of the tax year. While the amount doesn't have to be absolutely certain to be the amount received (any difference is taken into account in the year received if there is a difference), there must be a reasonable basis for the estimate.

In this case the memorandum concludes there is no such reasonable basis given the facts. As the analysis continues:

> In the instant case, the facts from which a calculation could be made were not knowable at the end of the tax year. At the end of the tax year, the Taxpayer did not know the beneficiaries used to determine its performance as those beneficiaries were not assigned until after a three month claims run-out after the close of the performance year. The MSR is dependent on the number of assigned beneficiaries and knowable only after the final number of assigned beneficiaries is determined. The performance benchmark is determined approximately six months after the performance year ends. The beneficiary per capita costs are determined after the three month claims run-out. The Taxpayer is given the sample of beneficiaries for whom it must report quality performance on certain measures after the close of the performance year and this quality performance impacts the final savings rate.

Of course most taxpayers are not organizations participating in this particular program. But the analysis of the law the memorandum goes through applies in any case where the question arises regarding the proper year in which an item is to be recognized for income tax purposes.

SECTION: 6228
FACT THAT TMP HAD BEEN DISSOLVED FIVE YEARS EARLIER DID NOT RENDER FPAA INVALID, PETITION BY NOTICE PARTNER FILED ONE DAY LATE

Citation: Berkshire 2006-5 LLP et al. v. Commissioner, TC Memo 2016-25, 2/17/16

Being a date late in filing a Tax Court petition is a problem, as the Tax Court loses jurisdiction once the time period for the filing expires. In the case of *Berkshire 2006-5 LLP et al. v. Commissioner*, TC Memo 2016-25 the taxpayer looked to overcome that problem by noting that the tax matters partners of the partnership in question had been dissolved before the final partnership administrative adjustment (FPAA) was issued.

The case involves the scheduled to be repealed TEFRA partnership examination procedures[1], which applied to the partnership in question. Under IRC §6223(a) the IRS is required to send a copy of the FPAA to the tax matters partner (TMP). Under IRC §6226(a) the TMP may file a petition challenging the FPAA with the Tax Court within 90 days after the FPAA is mailed to the TMP.

If the TMP fails to file a Tax Court petition, IRC §6226(b) allows a notice partner (a partner whose name and address is furnished to the IRS) to file a petition within 60 days (or 150 days after the TMP mailing). The IRS has 60 days after mailing the FPAA to the TMP to mail a copy of the FPAA to the notice partners (which effectively gives those partners 90 days notice before their deadline for filing a petition).

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[1] The TEFRA provisions were prospectively repealed by the Bipartisan Budget Act of 2015, but will continue to apply to examinations of returns of covered partnerships for tax years beginning before January 1, 2018 unless the partnership elects to have the new system apply when it files returns for years beginning after November 2015.

In this case the TMP had a bit of a problem. As the Court describes the matter:

> Berkshire Resources, LLC (Berkshire Resources), was the general partner and TMP for all three partnerships. In 2009 the Securities and Exchange Commission filed fraud complaints against the principals of Berkshire Resources, and the State of Wisconsin administratively dissolved Berkshire Resources on June 10, 2009.

On June 5, 2014 the IRS issued the FPAA for the partnership, denying a deduction for all of the intangible drilling costs reported by the partnership. The IRS then mailed the TMP notices as follows:

> The Commissioner issued each partnership's FPAA on June 5, 2014, and mailed an FPAA addressed to each "Tax Matters Partner" at each partnership's address on that date. That same day the Commissioner also mailed a copy of each partnership's FPAA to "Berkshire Resources" as TMP to three different addresses, i.e., each of three separate FPAAs was sent to each of three separate addresses, for a total of nine FPAAs in addition to the three FPAAs sent to "Tax Matters Partner".

One of the notice partners did file a petition, but it was one day after the 150 day period ended. So the taxpayer attempted to argue that the FPAA wasn't properly issued—after all, the TMP had been defunct for five years before the FPAA was issued, so the partner argued that the original mailing date shouldn't start the clock running.

Unfortunately for the partner, the TEFRA partnership examination provisions generally require the partnership to give notice of a new TMP or new address for the TMP. As the Court notes:

> The last known address rules that apply to notices of deficiency do not apply to FPAAs. Instead, the Commissioner must send the FPAA to the address listed on the partnership return for the year in issue. The Commissioner is not required to update the partnership's address unless someone sends a written statement on behalf of the partnership to notify the Commissioner of the new information. This statement generally must be mailed to the Internal Revenue Service (IRS) service center where the partnership return was filed and must contain: the partnership's name; a statement that the information provided is furnished to correct or supplement earlier information; the corrected or additional information; the tax year to which the information relates; the name, address, taxpayer identification number, and signature of the person supplying the information; and the name of each partner for whom this information is supplied.

The IRS sent a number of notices to various addresses, both of the partnership and of the TMP. The Court continues:

> Mr. Hattler does not allege that the Commissioner was properly notified of a new address or that the FPAAs were sent to the wrong address. He merely alleges that the Commissioner should have known that the address for the partnership was no longer valid; however, he does not allege that the IRS was properly notified of a change of address in the manner required under section 6223(c). Accordingly, the Commissioner satisfied the notice requirement and properly sent the FPAAs for each partnership to the TMP.

What about the fact that the TMP had been dissolved? That doesn't matter under the TEFRA rules, as the IRS can satisfy the provision by mailing to the "Tax Matters Partner" at the partnership's address, which it did (in addition to multiple mailings to addresses it knew of for the listed TMP).

Finally the taxpayer argues the IRS should have appointed a new TMP, since it was aware that the old one had been dissolved. The Court disagreed, noting:

> The Commissioner's authority to select a TMP is very limited. First, the partnership must not have designated a TMP or the [*9] TMP's authority must have terminated. Then, the TMP is the general partner with the largest profits interest by operation of law. Only if that test is "impracticable to apply" can the Commissioner select a TMP. And in any event, there is simply nothing in section 6231(a)(7) that requires the Commissioner to select a TMP.

The Court notes that the partner in question was timely notified, so he wasn't prejudiced in terms of filing the petition that was entirely under his control. He filed his petition one day late—and, unfortunately for the partner, this a "bright line" rule, and he clearly fell on the wrong side of that line.