# Current Federal Tax Developments

Kaplan Professional Education

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## Section: 25D
## Battery Added in Later Year to Solar Energy System Ruled to Qualify for Credit

### Citation: Private Letter Ruling 201809003, 3/2/18

In Private Letter Ruling 201809003 the IRS ruled that a taxpayer who added a storage battery to an existing solar energy system for which a credit had been claimed in a prior year qualified for the solar device credit under IRC §25D(a)(1). But the IRS noted that there was an important factor in the facts the taxpayer provided that allowed for the credit.

The transaction in question and what the taxpayer is installing on his/her property is described as follows:

> *You are purchasing an energy storage product from an installer that can be integrated into existing Solar Energy Systems as an additional Solar Energy System Component. The product is comprised of 1) an AC battery; 2) an inverter that will convert solar electricity between AC and DC so the battery can charge and discharge the solar electricity; 3) required wiring to interconnect the product into your current Solar Energy System Components and your dwelling unit; and 4) a software management tool that will monitor and control the charging and discharging of energy (collectively, the "Battery"). You represent that the Battery is AC coupled to any new or existing Solar Energy System. The Battery contains a meter with current transformers that monitor the solar production and grid import as well as internal meters within the Battery that monitor charge and discharge power. When the Battery is constrained to charge only from solar, the software monitors these signals (every 0.1 seconds) and controls the Battery such that charging only occurs when the Solar Energy System is producing energy and only up to the instantaneous solar power. Thus all energy that is used to charge the Battery can be effectively assured to come from the Solar Energy System. Your purchase price for the Battery will include the labor costs allocable to onsite preparation, assembly, and original installation of the Battery. You intend for the original installation of the Battery to be completed in Year 2. The Battery is expected to have a storage capacity of 13.5 kilowatt hours ("kWh") and a power rating of 5 kilowatts ("kW").*
>
> *Software controls will ensure your Battery will store solar electricity generated by the PV Panel and use it a later point in time – either later in the day or at night. In addition, integrating the Battery into the other Solar Energy System Components will enable you to disconnect from the grid in the event of a grid outage and continue using solar electricity in compliance with electrical codes when other Solar Energy Systems without a Battery will be forced to cease operating. The remaining useful life of your Solar Energy System is expected to exceed the useful life of the Battery and, much like a typical inverter, the Battery will likely need to be replaced at some point during the remaining useful life of the Solar Energy System.*

The IRS granted the taxpayer's request that the service rule that the battery system qualified for the credit and that the fact it was installed in a year after the other components were installed would not bar the credit in the year the battery is installed.

But IRS noted that it was crucial that the battery system was designed so that it could only store energy generated by the solar system, stating:

> *Your representation that all energy that is used to charge the Battery can be effectively assured to come from the Solar Energy System is essential for this ruling. Section 25D(d)(1) of the Code includes as a requirement in its definition of "qualified solar water heating property expenditure" that at least half of*

> *the energy used by such property for such purpose is derived from the sun. The definition of "qualified solar electric property expenditure" under § 25D(d)(2) omits this language. Thus, the Congress purposefully chose to include a 50 percent usage requirement in the definition of "qualified solar water heating property", but the Congress did not include such language in the definition of "qualified solar electric property." This demonstrates that the Congress expects the energy used by a "qualified solar electric property expenditure" to be derived solely from the sun. Accordingly, 100 percent of the energy used by the Battery must be derived from the sun. If this is not the case, the Battery does not meet the definition of "qualified solar electric property" in the Code.*

The last sentence of that paragraph makes clear that even very minimal use of the battery to store other energy would be fatal to the credit in the view of the author of this ruling. The homeowner may or may be willing to accept that limitation on the battery's use to be able to claim the credit, but advisers faced with clients trying to claim such a credit must insure that the only source of power to the battery will be the solar system—or be ready to argue that this ruling is overly restrictive in its analysis.

## Section: 61
## Tax Court Disagrees With US District Court Over Potential Tax Exemption for Sale of Gravel

### Citation: Perkins v. United States, No. 1:16-cv-00495, 8/4/17, Perkins v. Commissioner, 150 T.C. No. 6, 3/1/18

The Tax Court and U.S. District Court were considering the same basic issue for different years for the same taxpayers. The courts came to opposite conclusions in the issue. The United States District Court for the Western District of New York ruled in 2017 that the taxpayers in *Perkins v. United States*, No. 1:16-cv-00495, plausibly stated a claim for exemption from taxation for the 2010 sale of gravel based on two treaties between the United States and the Seneca Nation. But in a case looking at the same two cases, the Tax Court decided in the case of *Perkins v. Commissioner*, 150 T.C. No. 6 that no exemption was available to the taxpayers under those treaties for sales of gravel in other years.

Alice Perkins is an enrolled member of the Seneca Nation and had received permission from the Seneca Nation to remove and sell gravel from lands held by Nation. She and her husband lived on Seneca property. For the years in question they sold gravel which they had mined from Seneca lands.

The Perkins claimed that, based on two treaties, they should be exempt from taxation on the sale of that gravel. They based this claim on terms of two different treaties.

The first treaty, the Canandaigua Treaty, provided the following basis upon which the taxpayers claimed exemption from tax, as described in the District Court opinion:

> *The plaintiffs argue that their income from the sale of gravel from Seneca land is tax exempt under the Canandaigua Treaty. See Docket Item 7 ¶¶ 10-14. In that treaty, the United States*
>
> > *acknowledge [sic] all the land within the aforementioned boundaries, to be the property of the Seneka [sic] nation; and the United States will never claim the same, nor disturb the Seneka [sic] nation, nor any of the Six Nations, or of their Indian friends residing thereon and united with them, in the free use and enjoyment thereof.*

> *Docket Item 14-1 at 2 (Canandaigua Treaty, art. III, Nov. 11, 1794, 7 Stat. 44) (emphasis added). The plaintiffs claim that taxes on the land itself, or on income derived from the land, would have been viewed by the Seneca Nation as a burden on its free use and enjoyment of that land. See Docket Item 7 ¶ 14. For that reason, the plaintiffs argue, the treaty exempts the Seneca Nation and "their Indian friends" from such taxes.*

The taxpayers also argued that a separate treaty, the 1842 Treaty, also exempts the income from tax.

> *Like the Canandaigua Treaty, the 1842 Treaty appears on its face to provide a tax exemption. In fact, the tax exemption in the 1842 Treaty is even more explicit:*
>
> > *The parties to this compact mutually agree to solicit the influence of the Government of the United States to protect such of the lands of the Seneca Indians, within the State of New York, as may from time to time remain in their possession from all taxes, and assessments for roads, highways, or any other purpose until such lands shall be sold and conveyed by the said Indians, and the possession thereof shall have been relinquished by them.*
>
> *Docket Item 14-2 at 5 (1842 Treaty, art. IX)*

The District Court decided to deny the IRS's petition to dismiss the claim, finding that a plausible claim for relief had been stated by the taxpayers.

On the Canandaigua Treaty the District Court first found that the provision granting free use and enjoyment meant that it would not be encumbered by taxes. And, citing dicta in cases from the Ninth and Third Circuit Courts of Appeal, the District Court found that as the gravel was derived from the land, that protection extended to selling the gravel.

The Court also rejected the IRS's argument that any exemption only applied to the Seneca Nation as an entity, and not individual members of the Nation. As the District Court notes:

> *The Canandaigua Treaty provides that "the United States will never . . . disturb the Seneka [sic] nation," or "their Indian friends residing thereon and united with them, in the free use and enjoyment" of the Seneca land. Docket Item 14-1 at 2 (Canandaigua Treaty, art. III) (emphasis added). The Canandaigua Treaty thus benefits not only the Seneca Nation itself, but also its "Indian Friends" residing on and using the nation's land. On a motion to dismiss, the facts pleaded in the complaint are accepted as true, and here the amended complaint alleges that plaintiff Alice Perkins is a member of the Seneca Nation and has leasehold and permit rights to mine and sell gravel. See Docket Item 7 ¶¶ 1, 21, 22, 25. The plaintiffs thus have stated a plausible claim for relief as "Indian Friends" under the Canandaigua Treaty.*

The District Court also found that the 1842 Treaty provided a similarly plausible claim. The Court rejected the view that that language only barred real estate taxes from being imposed on the land. The Court held:

> *The treaty protects "the lands of the Seneca Indians . . . from all taxes." Docket Item 14-2 at 5 (1842 Treaty, art. IX) (emphasis added). Given the liberal principles of treaty construction that apply here, there is no reason to believe that one rule would apply to taxing the dirt, gravel, and foliage that make up the property and another to the property itself — if "the property" can even be distinguished from the dirt, gravel, and foliage that comprise it. In other words, the language of the 1842 Treaty provides no reason to distinguish between exemptions from what we think of as a real property tax and*

> *exemptions from a tax on what makes up that real property. So the government's motion to dismiss is denied under the 1842 Treaty as well.*

However, a majority of the Tax Court did not agree with this view.

The Tax Court holds that the Canandaigua Treaty does not confer rights on individuals, but rather only the Seneca Nation as a whole. The District Court had used the "friends" term to cover the members of the Seneca Nation, but the Tax Court rejected that view, holding:

> *The District Court read the phrase "or of their Indian friends residing thereon" as creating rights for the Perkinses themselves. Perkins, 2017 WL 3326818, at *4. We must respectfully disagree — the phrase is part of a list that includes the Nation and any of the other nations of the Iroquois Confederacy. We don't think that the phrase "or of their Indian friends residing thereon and united with them" can reasonably be read as creating personal rights — the class of "Indian friends" being limited to those "friends" who have become "united" with one of the Iroquois nations.*

The Court also rejected the view that the intent of the provision was to provide a tax exemption, noting:

> *By its express terms, the treaty protects the Seneca Nation's lands from being "disturbed", which is different from creating a tax exemption. The rest of that sentence — "it shall remain theirs, until they choose to sell the same to the people of the United States, who have the right to purchase" — doesn't make sense as a tax-exemption provision, but makes perfect sense as a restriction on alienation of the Nation's lands. The inclusion of "Indian friends residing thereon and united with them" means that the Nation gets to choose who is a member of the Nation and perhaps even can be seen as a promise not to use non-Seneca Indians as putative sellers of Seneca land.*

With regard to the 1842 Treaty, the Tax Court held that the treaty only exempted real property from tax and that once the gravel was removed from the land it was no longer real property. As the Tax Court opinion continues, outlining its disagreement with the District Court reasoning:

> *We, on the other hand, are persuaded by the Second Circuit's reading of the 1842 Treaty, and we don't find it difficult to distinguish real property from the gravel severed from it. Black's Law Dictionary 1412 (10th ed. 2014) defines real property as "[l]and and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land." The gravel wasn't attached to the land when it was sold, so the Perkinses aren't exempt from tax on the sale of the gravel under the 1842 Treaty. Cf. In re Briggs Ave. in New York, 89 N.E. 814, 816 (N.Y. 1909) (a building that is severed from real property becomes personal property).*

Assuming one or both cases are appealed, the Second Circuit will have to determine which analysis it will choose to follow—or perhaps come up with its own reasoning in this area.

But the case does illustrate the importance of the choice of venue for taxpayers preparing to challenge the IRS in court. Actually going "both ways" by using different approaches in different years is not something normally seen, but finding that the different courts can come to different results is not terribly surprising.

## Section: 1061
## S Corporations Not Exempted from Applicable Partnership Interest Rule of IRC §1061

### Citation: Notice 2018-8, 3/1/18

The IRS issued guidance promised by Treasury Secretary Steven Mnuchin in his testimony in February before the Senate Finance Committee regarding the carried interest rules added in IRC §1061 by the Tax Cuts and Jobs Act. Notice 2018-18 provides guidance on regulations the IRS plans to issue in this area.

The carried interest provision of IRC §1361 provides a special three-year rule that will apply to capital gains generated by that interest. IRC §1361(a) provides:

> *(a) In general*
>
> *If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of—*
>
> > *(1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over*
> >
> > *(2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections [1] 1222 by substituting "3 years" for "1 year",*
>
> *shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).*

An applicable interest is defined at IRC §1061(c)(1) -(3) as:

> *(1) In general*
>
> *Except as provided in this paragraph or paragraph (4), the term "applicable partnership interest" means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. The previous sentence shall not apply to an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity.*
>
> *(2) Applicable trade or business*
>
> *The term "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of—*
>
> > *(A) raising or returning capital, and*
> >
> > *(B) either—*
> >
> > > *(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or*
> > >
> > > *(ii) developing specified assets.*

> *(3) Specified asset*
>
> *The term "specified asset" means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), commodities (as defined in section 475(e)(2)), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.*

The law was aimed at reducing to a certain extent the benefit of structuring a compensation package for a partner who managed the investment to include a profits interest in the partnership rather than taking a fee for the management services. By doing so, the manager's income related to managing the partnership could be taxed primarily at the lower long-term capital gain rates.

While that advantageous treatment would remain in place for qualified dividends, only gains arising from assets held more than 3 years would qualify for the lower rate when this provision applies.

But an issue arose with an exception found at IRC §1061(c)(4)(A) which provides:

> *(4) Exceptions*
>
> *The term "applicable partnership interest" shall not include—*
>
> > *(A) any interest in a partnership directly or indirectly held by a corporation, …*

Several advisers noted that, based on the language of that provision, if a partner to whom this rule would apply contributed his/her interest to an S corporation wholly owned by that person, the interest would now be excluded from being treated as an "applicable partnership interest." Thus, by simply creating an S corporation to hold his/her interest the manager would be able to sidestep the three-year holding rule and continue to receive long term rates on gains for assets held more than one year but which weren't held more than three years.

The Treasury Secretary was asked about this provision in his testimony before the Senate Finance Committee and promised that the IRS was going to release guidance that would attempt to block this strategy.

The guidance does little more than simple state the following about the future regulations under this section:

> *The regulations will provide that the term "corporation" in section 1061(c)(4)(A) does not include an S corporation*

The notice goes on to state that these future regulations will be effective for tax years beginning after December 31, 2017, meaning the agency will not allow those who formed corporations before this notice was issued to obtain the sought-after treatment.

Some advisers have questioned if, in fact, the IRS has the authority to administratively limit the definition of corporations in this provision. That may be a moot point if Congress includes a specific provision limiting this rule to applying only to C corporations in a technical corrections bill later this year. Otherwise it seems very possible that this question may eventually be decided in court.

## Section: 3402
## IRS Releases Online W-4 Calculator and 2018 Form W-4

### Citation: W-4 Withholding Calculator, IRS Website, https://www.irs.gov/individuals/irs-withholding-calculator, 2/28/18

The IRS released the revised W-4 Withholding Calculator on their website on February 28 along with the revised 2018 version of Form W-4. The revision arrived slightly later than promised by Treasury Secretary Steven Mnuchin who testified on February 15 that the calculator would be out within a week.

The revised calculator takes into account changes made by the Tax Cuts and Jobs Act. The calculator works for most individuals, but the IRS warns that it is not meant for taxpayers with more complex situations.

As the website warns:

> IMPORTANT NOTE: This Withholding Calculator works for most taxpayers. People with more complex tax situations should use the instructions in Publication 505, *Tax Withholding and Estimated Tax*, expected to be updated in early spring. This includes taxpayers who owe self-employment tax, alternative minimum tax, the tax on unearned income of dependents or certain other taxes, and people with long-term capital gains or qualified dividends.

Since spring begins on March 20 this year, the publication is likely a few weeks away from being published.