The Dawn of a New Era for Partnership Examinations

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Overview

• Summary of New Partnership Audit Rules
• Open Issues
• Drafting Considerations in Partnership Agreements
Bipartisan Budget Act of 2015

Congress repealed and replaced the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) and electing large partnership (ELP) rules with a new regime for partnership adjustments and audits that is focused on partnership-level assessments and collections.

Game changer that is going to force most partnerships to amend partnership agreements to take into account the potential partnership entity level assessments and payments.
Purpose of the Bipartisan Budget Act of 2015

• **TEFRA**
  - IRS did not have the resources or capability to audit large partnerships and multi-tiered partnerships because of the complexity of allocating adjustments to ultimate partners and assessing tax.
  - The use of partnerships and LLCs has increased dramatically, but IRS audits of partnerships have not increased to keep up with these trends because administrative burdens in auditing partnerships prevented the IRS from increasing partnership audits.

• **Electing Large Partnership (ELP) Rules**
  - Enacted to provide an elective alternative regime for large partnerships that avoids some of the administrative complexities but less than 1% of large partnerships elected to be subject to these rules.

• Congress estimates partnership audits under the new rules will generate approximately $10 billion in tax revenue.
Effective Date of New Partnership Audit Procedures

• Effective for partnership tax years beginning after 2017

• Partnerships may elect to have the rules apply earlier (for tax years beginning after November 2, 2015)
Audits and Litigation. Requires partnership-level resolution of all items of partnership income, deduction, gain, loss or credit.

Assessment and Collection. Default rule is that the partnership is assessed tax liability on the “Imputed Underpayment Amount”

- Partnership is generally assessed tax at the highest rate applicable to individuals, unless it can demonstrate that the tax should be lower (corporate partners or individual partners subject to lower capital gains or dividend rate)

- “Imputed Underpayment Amount” is reduced to the extent partners “for the reviewed year” file amended returns and pay the tax

- Partnership can elect to file adjusted partner statements (equivalent to amended K-1s) for each partner for the “reviewed year”
“Reviewed Year” – Partnership tax year or return under audit
“Adjustment Year” – Year in which the adjustment for the “reviewed year”:
  - Year in which partnership adjustment becomes final under a court decision;
  - Year in which an adjustment is made pursuant to an administrative adjustment request; or
  - In all other cases, the year in which the final partnership adjustment is mailed.
“Imputed Underpayment Amount” – Net non-favorable adjustments to the partnership tax year multiplied by the applicable tax rate(s)
“Partnership Representative” – Party selected to represent the partnership before the IRS and to make tax decisions on behalf of the partnership
Partnership Level Determination

• All partners are bound by a final resolution in the partnership proceeding

• Unlike under TEFRA, partners do not have the right to participate in the proceeding or receive notice of the proceedings from the IRS

• Penalties determined at the partnership level; no partner level defenses to penalties

• Only partnership-level statute of limitations are relevant – a partner’s statute of limitations is no longer taken into account, unless the partnership elects out of the new rules
Each partnership must designate a “Partnership Representative” (PR)

The PR has the sole authority to act on behalf of the partnership

PR must be a “person” with a substantial U.S. presence
  - Under 7701(a)(1), the term “person” includes, an individual, trust, estate, partnership, association, company, or corporation
  - if an entity is designated as the PR, a responsible person (corporate officer, partner, trustee, etc.) must act on behalf of the PR

PR is *not* required to be a partner in the partnership

IRS will appoint a PR if the partnership does not designate one
• Computation of Imputed Underpayment Amount

- All adjustments to income, gain, deduction, and loss are netted and multiplied by the highest rate in Code Section 1 or 11

- Any increase or decrease in loss is treated as a decrease or increase in income

- After the Imputed Underpayment Amount is calculated, changes in credits are taken into account as a increase or decrease in the Imputed Underpayment Amount, as appropriate under the circumstances

- Tax assessment is made for the Adjustment Year; not the Reviewed Year
Partnership Tax Assessment – “Imputed Underpayment Amount”

- Computation of Imputed Underpayment Amount
  - Partnership can submit evidence to reduce the imputed underpayment by the portion that would be allocable to tax exempt entities
  - Partnership can submit evidence to modify the “Applicable Highest Tax Rate” to individuals
    - Partner receiving allocation is a corporation subject to 35% maximum tax rate
    - Partner receiving allocation of capital gains and dividends is an individual subject to reduced tax rates
    - S corporations are treated as individuals
    - Applicable rate is always the highest rate with respect to the income
    - Secretary is authorized to issue regulations or other guidance for additional modifications to the Imputed Underpayment Amount
• Imputed Underpayment Amount – Partner Amended Tax Returns

- Partners who were partners during the “Reviewed Year” file amended returns taking into account their distributive share of partnership adjustments and pay the applicable tax (notwithstanding statute of limitations issues with respect to the partner’s return)

- Partnership is permitted to reduce the Imputed Underpayment Amount by the applicable tax attributable to the partners who filed amended returns

- Reduction in Imputed Underpayment Amount is based on the partners’ distributive share of partnership adjustments
Partnership Tax Assessment – “Imputed Underpayment Amount”

- Imputed Underpayment Amount – Time for Submission of Documents and Evidence
  - Partnership has 270 days from the date when the Notice of Proposed Adjustment is mailed to the partnership (pursuant to Code Section 6231) to file any documents or evidence to have the Imputed Underpayment Reduced
  - IRS must approve any modification of the imputed underpayment amount
PARTNERSHIP AUDIT – NO IMPUTED UNDERPAYMENT AMOUNT

- No Imputed Underpayment – Taxpayer Favorable Adjustment

  - Under 6225(a)(2), the partnership takes into account the taxpayer favorable adjustment as a decrease in non-separately stated income, or an increase in non-separately stated loss. If the item is a credit, it is taken into account by the partnership as a separately stated item.

  - The adjustment is taken into account in the “adjustment year” as an adjustment to partnership income or loss and then flows through to the partners. Returns are not amended because the partnership is taking the item into account in the “adjustment year.”

  - Thus, current year partners benefit from an adjustment made for a prior tax year. Partners for the reviewed year cannot file amended returns to get the benefit from the audit adjustment.
Alternatives to Partnership-Level Assessment: Election Out for Small Partnerships

- **Opt-Out for “Small” Partnerships**
  - Partnerships with 100 partners or less can opt out of the entity-level partnership determination
    - Year by year election
    - The election must include a disclosure of the name and TIN of the each partner
  - Partners must be individuals, C corporations (including any foreign entity that would be treated as a C corporation if domestic), S Corporations or estates of deceased partners (no upper-tier partnerships)
    - S corporation shareholders must be counted for purposes of the 100 partner test and disclosed to the IRS
Alternatives to Partnership-Level Assessment: Election Out for Small Partnerships

- Opt-Out for “Small” Partnerships

  - The partnership must notify each partner of the election out.

  - If election is made, IRS must make determinations at the partner level (similar to the TEFRA small partnership rules)

  - Query whether 100 partners is still too large and will still impose an administrative burden on the IRS
Partnership Election to Issue Adjusted Partner Statements under Section 6226

- Any partnership may elect to issue adjusted “statements” (essentially amended K-1s) to the partners who were partners during the reviewed year

- Election must be made within 45 days of receiving the notice of final partnership adjustment

- Partnership must then furnish statements to each partner for the reviewed year and to the IRS

- The partners receiving the statements are subject to tax in the year of the statement, but the tax due equals the amount of tax that would have been owed in the reviewed year and intervening years to the extent of a tax increase due to the adjustment to tax attributes

- Tax attributes in the adjustment year are also adjusted
Alternatives to Partnership-Level Assessment: Amended Statements

• Partnership Election to Issue Amended “Statements”
  - Reviewed year partners are liable for interest and penalties
  - Interest is charged at higher rate (2 percentage points higher than rate in Section 6621(c) (interest charged from due date of partnership return for the reviewed year)
  - Reviewed year partners have no right to an administrative or judicial review
    • Not required by statute to consent to issuance of statements
    • Bound by partnership-level determination
  - No joint and several liability
Notice of Partnership Proceedings

- IRS must mail to the partnership and the partnership representative:
  - Notice of any administrative proceeding initiated at the partnership level
  - Notice of any proposed partnership adjustment (NOPA)
    - The IRS may rescind any NOPA with the partnership’s consent.
  - Notice of any final partnership adjustment (FPA)
    - May not be mailed earlier than 270 days after the date on which the NOPA is mailed

- No deficiency assessment may be made before the close of the 90th day after the day on which the FPA was mailed and, if the a petition is filed, the decision of the court has become final
Suit may be brought within 90 days of when an FPA is mailed in either:
  - The Tax Court,
  - The district court in which the partnership’s principal place of business is located, or
  - The Court of Federal Claims.

A deposit is required to bring suit in the district court or Court of Federal Claims equal to the amount of the imputed underpayment.

The court has jurisdiction to determine:
  - all items of income, gain, loss, deduction, or credit of the partnership for the taxable year to which the FPA relates,
  - the proper allocation of items among partners, and
  - penalties, additions to tax, and other amounts for which the partnership may be liable.
Partnership Request for Administrative Adjustment

- Partnership mechanism for requesting adjustments to tax year (no more amending returns)
- Filed within 3 years from the later of
  - The date that the partnership return was filed
  - The unextended due date of the partnership return
- If request shows Imputed Underpayment Amount, then
  - Partnership must pay the Imputed Underpayment Amount when filing the requests, or
  - Partnership issues amended K-1s similar to the procedures in Section 6626
- If request does not show Imputed Underpayment Amount, then the partnership issues amended K-1s to the partners
Open Issues: Election to Apply New Partnership Audit Rules Now

• Procedure to elect to have the new partnership audit rules apply now
  - In what circumstances would a partnership want to have the new partnership audit rules apply now?
Open Issues: Election to Opt-Out

- Procedure to elect out of the new partnership audit rules
  - If a partner is a disregarded entity and its owner is an individual, C corporation, or S corporation, or estate, can the partnership elect out?
  - If a partner is a grantor trust, can the partnership elect out?
  - Should every partnership with 100 or less qualifying partners elect out?
  - In what circumstances would a partnership not want to elect out?
  - Does the IRS have the authority to extend the election out rules to tiered partnerships?
Open Issues: Partnership Representative

- What are the procedures for designating a PR (on the return)?
- How frequently can a partnership change its PR designation?
- If the partnership does not designate a PR, what rules or guidelines will govern the IRS’s PR designation?
Open Issues: Imputed Underpayment Amount

- What procedures will apply to reduce the Imputed Underpayment Amount by taxes paid by the partners on amended returns?

- The Imputed Underpayment Amount can be reduced if “allocable” to a tax-exempt partner, corporate partner or—in the case of a qualified dividend or capital gain—an individual. Does this refer to the partners in the Reviewed Year or the Adjustment Year?

  - Note: Section 6225(c)(4)(B) refers to the partner’s distributive share in the reviewed year

- Does the Imputed Underpayment Amount take into account adjustments that result from changes to tax attributes in the years following the reviewed year? If not, how are such adjustments taken into account?
Open Issues: Reallocations Among Partners

- How is the Imputed Underpayment Amount computed when the adjustment is a reallocation among the partners?
- Who pays the tax?
Open Issues: Election to Issue Amended Statements

• How will the Election to Issue Amended Statements work in a tiered setting?

  - E.g. Will the election apply to a partnership tier such that the partnership is required to issue amended statements or can it pay the entity-level assessment? Will the IRS require that the first tier pay the entity-level assessment?

  - What if one of the tiers from the Reviewed Year has terminated before the Adjustment Year?

• How is the tax computed if the tax would decrease in the intervening years due to an adjustment to tax attributes?

• What happens if all of the reviewed year partners don’t pay?
Impact on Partnership Governance and Partnership Agreements

• Should amendments be made now to existing partnership agreements?

• Should provisions be added now to new partnership agreements?
1. Provisions for selecting Partnership Representative and restrictions on actions taken by PR
   a. Statute extensions
   b. Settlements
   c. Election out
   d. Amended statements

2. Provisions allowing or requiring an election out of the partnership entity-level assessment pursuant to Section 6626

3. Escrow and indemnification provisions when partners sell their interests

4. Provisions requiring upper-tier flow-through entities to share identifying information about their owners
Impact on Partnership Governance and Partnership Agreements

5. Provisions regarding adjusted partner statements
   a. Notice?
   b. Consent of partners for reviewed year?

6. Information-sharing provisions to allow partnership to determine if ultimate owners are:
   a. Corporations
   b. Individuals entitled to lower capital gain and dividend rates
   c. Tax exempt entities

7. Provisions specially allocating tax payments among partners