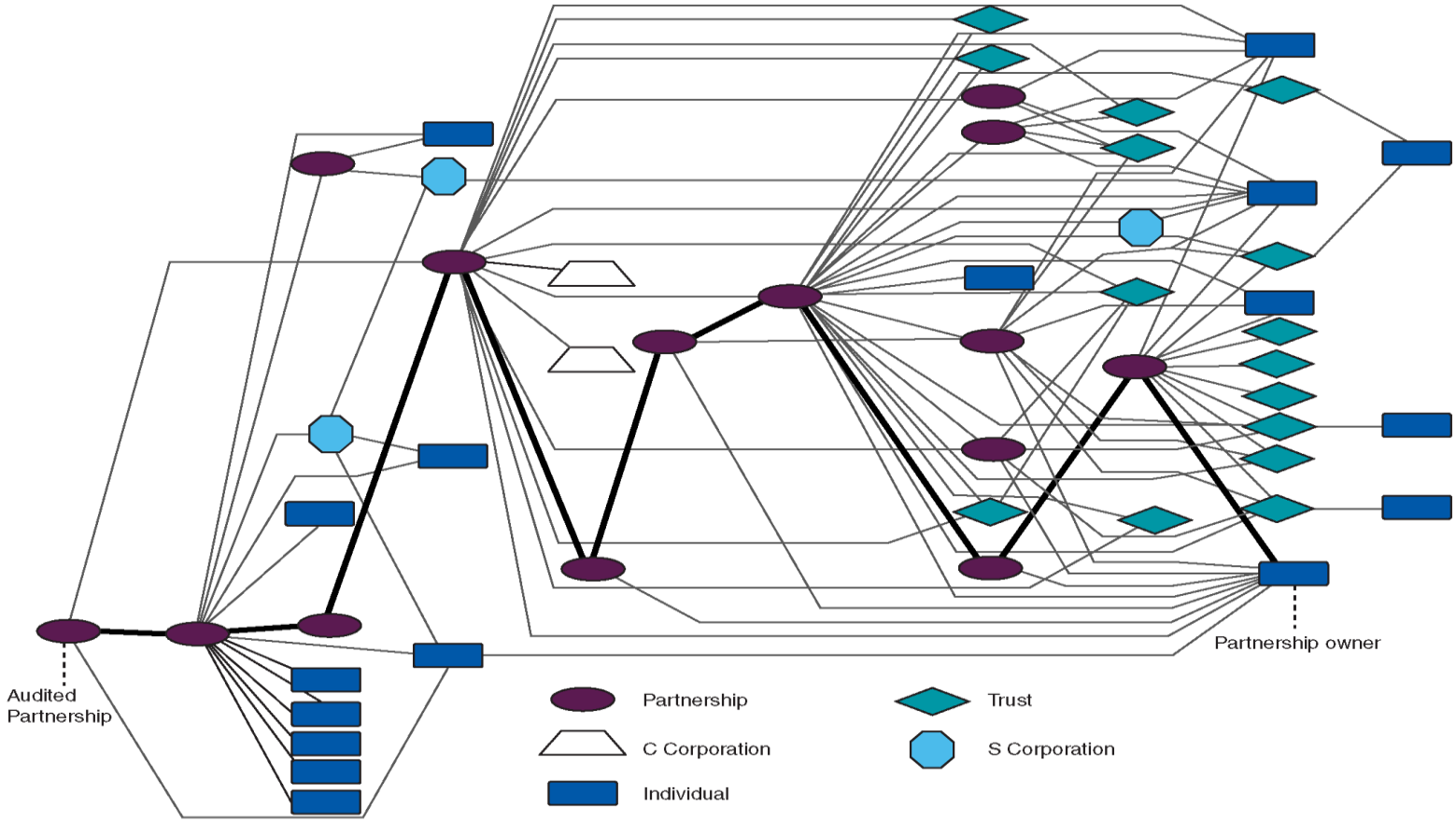
What Every Accountant Needs To Know About The New Partnership Audit Rules

David Gair
Gray Reed

TSCPA Texas Tax Institute 2018

GRAY REED
ATTORNEYS & COUNSELORS

Intended Consequences

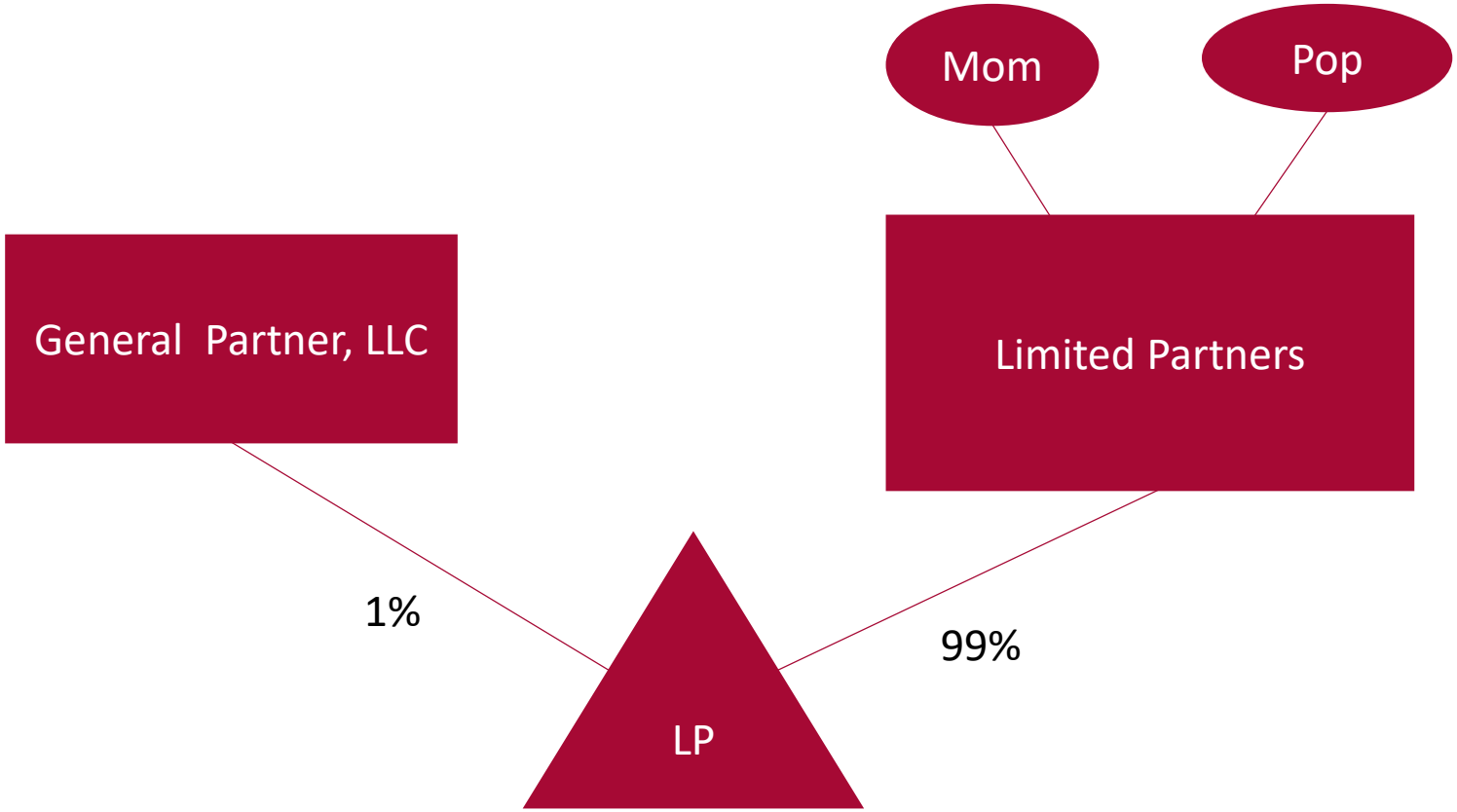


Source: GAO analysis of IRS documentation. I GAO-14-732

BBA – Benefits for Government

- Focus is to make it easier for IRS to audit and collect tax.
- Individual partners no longer have rights to notice or participation.
- Default is to collect tax at partnership level and not have to chase partners.
- Estimates of $10 billion in new revenue generation.

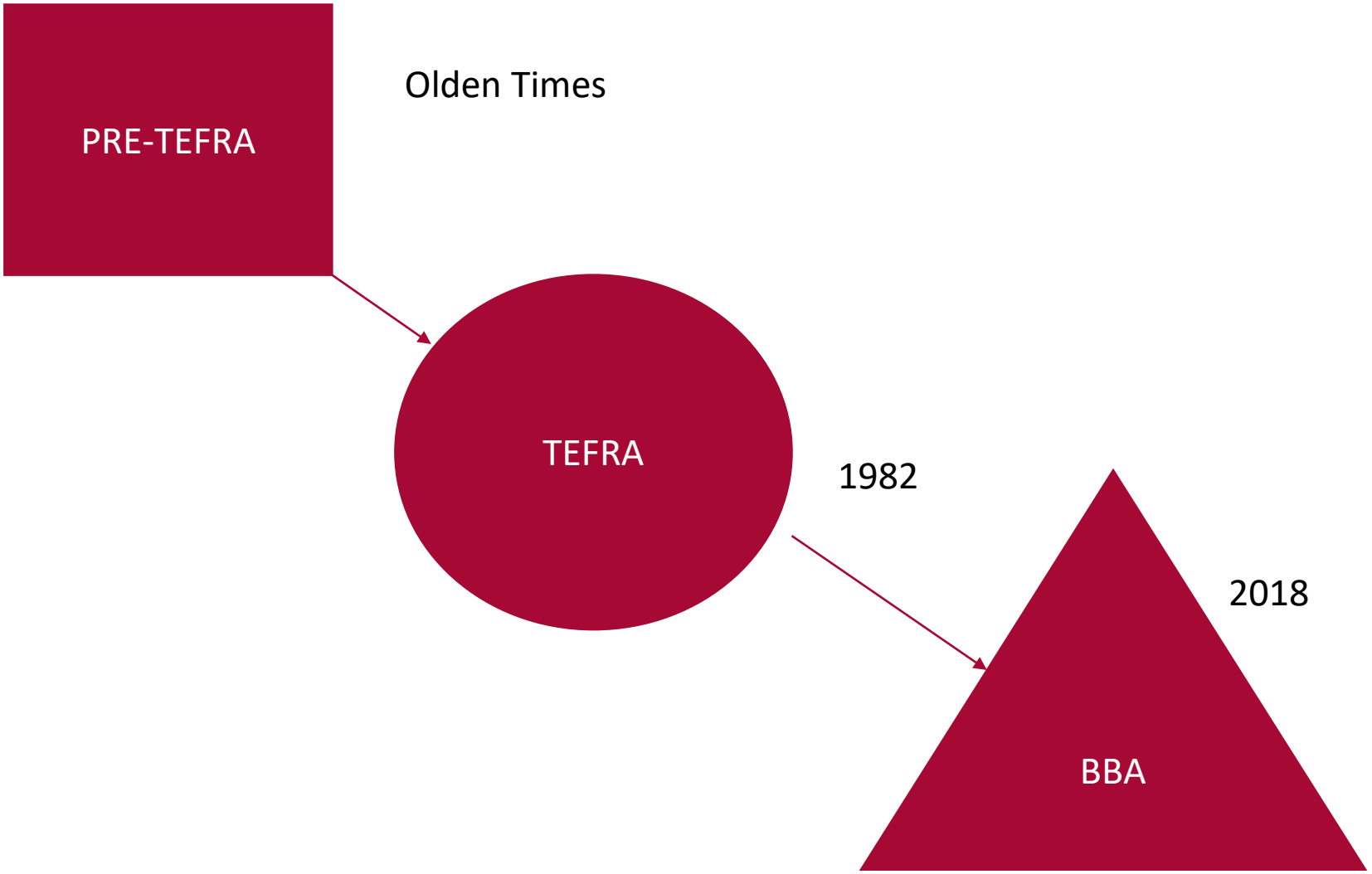
Unintended Consequences



Action Steps for Clients

- Amend partnership and LLC Agreement
- Review buy-sell agreements
- Does this affect loan agreements?
- Does this affect Redemption and Dissolution Agreements?
- Does this affect Merger Agreements?

History of Partnership Audit Regimes



Bipartisan Budget Act of 2015

- § 6221 - Determination at partnership level.
- § 6222 - Partner's return must be consistent with partnership return.
- § 6223 - Partners bound by actions of partnership.
- § 6225 - Partnership adjustment by Secretary.
- § 6226 - Alternative to payment of imputed underpayment by partnership.
- § 6227 - Administrative adjustment request by partnership.
- § 6231 - Notice of proceedings and adjustment.
- § 6232 - Assessment, collection, and payment.
- § 6233 - Interest and penalties.
- § 6234 - Judicial review of partnership adjustment.
- § 6235 - Period of limitations on making adjustments.
- § 6241 - Definitions and special rules.

Regulations History

June 2017
Proposed regulation with several bracketed items.

Nov. 2017
Proposed regulations on coordination for international issues.

Dec. 2017
Proposed regulations on "push out" through tiers and administrative issues.

Jan. 2018
Final regulations on electing out.

Aug. 2018
Final regulations on Partnership Representatives

More regulations to come for other items.

When is the law in effect?

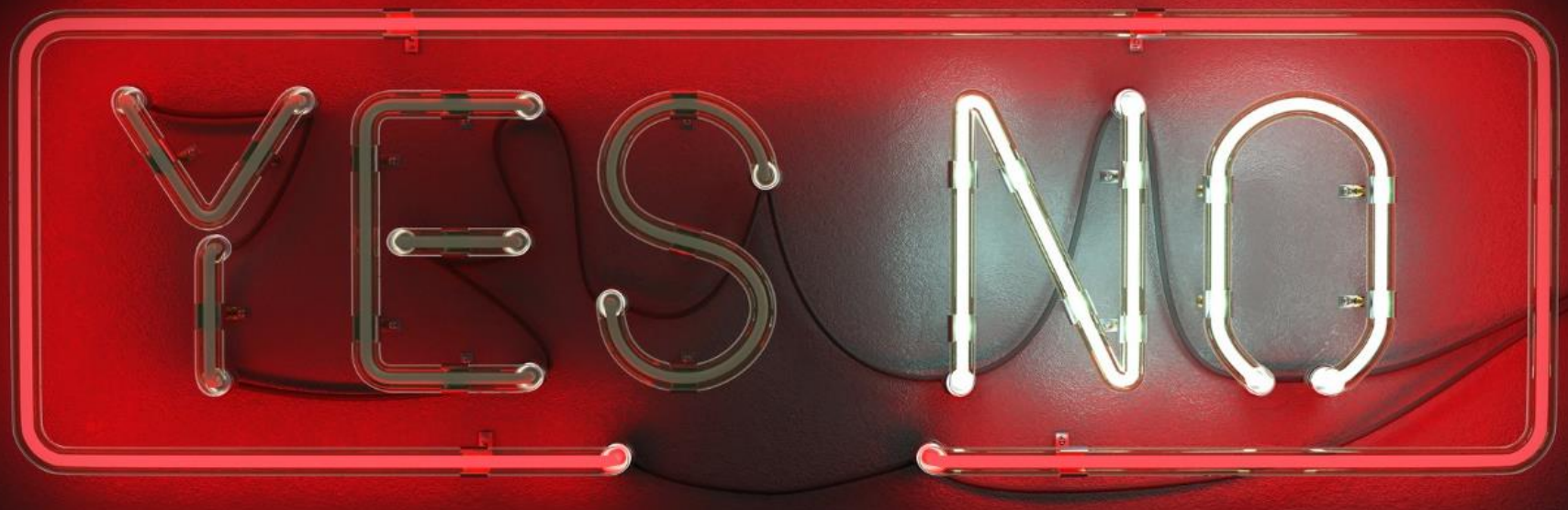
Effective for all partnership years after **December 31, 2017**. And prior years that were elected into this treatment.

What is a partnership item?

- The character, timing, source, and amount of the partnership's **income, gain, loss, deductions, and credits**;
- The character, timing, and source of the **partnership's activities**;
- The character, timing, source, value, and amount of any **contributions to, and distributions** from, the partnership;
- The partnership's **basis** in its assets, the character and type of the assets, and the value of the assets;
- The amount and character of **partnership liabilities** and any changes to those liabilities from the preceding tax year;
- The category, timing, and amount of the partnership's **creditable expenditures**;
- Any item or amount resulting from a **partnership termination**;
- Any item or amount relating to a Code Sec. **754 election.**

New Vocabulary

- **Reviewed Year**: The tax year to which IRS adjustments are proposed.
- **Adjustment Year**: The partnership tax year in which IRS adjustments are made .
- **Opt-out Election**: Election out of the BBA audit regime.
- **Push-out Election**: Election to pass adjustments to partners after audit.
- **Partnership Representative:** Person or entity designated to act on behalf of partnership.
- **Imputed Underpayment:** Net non-favorable adjustments to the partnership tax year multiplied by highest tax rates.



How to Elect Out

1) Must be done annually on **timely filed** return.
2) Statement to IRS & Partners: a) Partner Name, b) U.S. tax classification, c) taxpayer identification number, d) statement that each partner is an eligible partner.

- The partnership must notify each partner within 30 days after making the election.

DON’T FAIL!

Election to Opt-Out

Who can opt out?

Partnerships with 100 or fewer partners

Partners must be:

- Individuals
- C Corporations
- S Corporations (special rule)
- Estates of deceased partners

Election to Opt-Out

Who is INELIGIBLE to opt out?

- DREs
- Partnerships
- Trusts (including grantor trusts)
- Certain foreign entities
- Estates of individuals other than deceased partners
- Nominees

Election to Opt-Out

What happens if you opt out?

- Audits occur at partner level
- Notice of Deficiency procedures apply

Pluses and Minuses of Election to Opt Out

Partnership

- Lack of single voice?
- Partnership pays
- Higher tax rate

Partners

- Avoid imputed tax regime – lower tax
- Partners all have burden in audit

You can't or didn't opt out – what now?

New rules on who is responsible!

What is a representative?

- Partnership must designate a partnership representative:
  - Any person (can be an entity).
  - Substantial presence in the U.S. (for entity and designated person).
- The partnership representative has the sole authority to act on behalf of the partnership for purposes of the BBA.
- If a partnership fails to designate a representative, the IRS may select <u>any</u> person to act as the partnership representative.
- The partnership and all partners are bound by actions taken under the BBA by the partnership; and by any final decision in a proceeding brought under the BBA with respect to the partnership.
- Does not provide a statutory right to other partners to participate.

Who should be the PR?

- Third party paid PR?
- General Partner?
- Partner with largest profit interest?
- CPA or Attorney?
- CFO?

PR Example

IRS audits LLC and asserts imputed underpayment of $100,000. PR fails to do her work, doesn't notify anyone, and does not seek administrative or judicial review. Partnership now has a tax bill of $37,000 (37%). What can the partnership do?

- No right to challenge, have to go through refund procedures.

Company Agreement Provisions

- Standards for selecting, terminating or replacing PR.
- Duties of PR to notify other partners?
- What decisions can PR make on her own?
- Can PR extend SOL?
- When can PR settle audit?
- When can PR go to court?
- When can PR make elections?
- How about indemnification of PR?

Company Agreement Provisions Continued

- Should CA require PR to seek lowest rate of tax?
- Have provision that provides company can pay tax from operating accounts, do a capital call or apply for loan to pay?
- Allocation of tax burden among partners?
- Indemnification and clawback provisions for former partners.

Consistency Requirement

- Partners must report partnership items consistently with the partnership return, failure to do so will result in a correction that is assessed and collected as a “mathematical error”.
- A partner may take inconsistent position if she files a statement identifying the inconsistency, but this is not binding on the partnership.

Statute of Limitations

The statute of limitations runs at the partnership level, and expires on the later of

1. The date which is three years after the latest of (a) the date on which the partnership return was filed, (b) the return due date, or (c) the date on which the partnership filed an AAR;
2. If the imputed underpayment was modified under § 6225(c) (reduction for tax-exempt partners, special rates, etc.), the date 270 days after all required information was submitted to the Service; or
3. 330 days after the date of any notice of proposed partnership adjustment (plus the number of days of any extension consented to by the Secretary under § 6225(c)(7)).

Statute of Limitations

- If a notice of final partnership adjustment is mailed, the statute is suspended for the period during which a petition may be filed under § 6234 (and, if filed, until the court decision is final), and for one year thereafter.
- This date can be extended by agreement, because of fraud, or because of a substantial omission of income. These rules are similar to the general statutes of limitation.

Payment – How Additional Tax Determined

- Net of all adjustments to items of income, gain, loss, deduction, then
- Multiply by highest individual or corporate rate for the reviewed year
- Then increased or decreased by any adjustment made to the partnership's credits

Payment – How Additional Tax Determined

- Mechanics of computing the underpayment are complex.
- The adjustments are first broken into four categories: reallocations, credits, creditable expenditures, and a residual grouping.
- There is then subgrouping of items which are then netted within each category.

Example

- IRS increases ordinary income by $200, increases long-term capital gain by $75, reduces long-term capital loss by $50, reduces depreciation by $30, and reduces a tax credit by $2.
- The credit is part of the credit grouping.
- The remaining items are in the residual grouping. The adjustments to ordinary income and depreciation are grouped together in the ordinary subgrouping and netted. The depreciation reduction is treated as an increase to ordinary income, such that the ordinary income increase is $230.
- The long-term capital gain and loss are also grouped together, yielding an increase of $125.
- The two subgroups are then added together for a total adjustment of $355.
- Assuming a 37 percent rate, the imputed underpayment is initially $131, which is then increased by the $2 credit adjustment to $133.

Payment – Interest

- Interest rate
- Interest increases 2% if not paid within 10 days

Payment – Modification of Tax

- Amended returns filed by partners that take all adjustments into account and include the payment of the corresponding tax.
- Full Payment Required before approval
- All years amended returns must be filed

Payment - Push Out

- Generally
- Partnership Duties: Two Steps
- Partner Duties: Partners then have to tax share of adjustments into account.
- Interest Rate – Increased 200 basis points

What if Partnership Ceases to Exist Payment – who pays?

- General Rule
- Rule if Partnership ceases to exist

Administrative Adjustment Requests (AARs)

An Administrative Adjustment Request (AAR) is an amended return. Can be accomplished two ways:

1) Form 1065X (Amended Return or Administrative Adjustment Request (AAR)) or
2) Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR))

Administrative Adjustment Requests (AARs)

The AAR cannot be filed more than three years after the later of:

1. the date the partnership return was filed or
2. the last day for filing the partnership return for the year (determined without regard to extensions).
3. No AAR allowed after notice of an administrative proceeding has been mailed.

Notices From IRS – 3 Main Notices

1) Notice of Administrative Partnership Proceeding (sometimes referred to a "NAP") – Audit Begins.
2) Notice of Proposed Partnership Adjustment (sometimes referred to a "NOPPA") – Adjustments Proposed.
3) Notice of Final Partnership Adjustment (sometimes referred to a "FPA") – Adjustments Final.

Notice Of Partnership Adjustment

Provides 90 days to petition for readjustment with the following courts:

1) US Tax Court
2) Court of Federal Claims
3) District Court where principal place of business is located

Choice of Venue

1) US Tax Court – No payment required.
2) Court of Federal Claims – Imputed payment required.
3) District Court – Imputed payment required.

Action Items for CPAs

1) Amend partnership agreements?
2) Restructure?
3) Get template notices and elections ready

David Gair

Gray Reed

- Partner, Tax Section

Education

- B.A., Bates College
- M.A., Middlebury College
- J.D., University of Denver
- LL.M., University of Denver

Other Experience

- He is a professor at SMU Federal Tax Procedure.

BOARD CERTIFIED
Texas Board of Legal Specialization
TAX LAW

GRAY REED & MCGRAW 2019
RECOGNIZED BY
Best Lawyers

BEST LAWYERS IN DALLAS

RATED BY
Super Lawyers
2017
THOMSON REUTERS

Gray Reed

- 140 attorneys
- Full-service, commercial law firm
- Offices in Dallas & Houston
- Opened in 1985
- Tax section was ranked in the 2019 *U.S. News & World Report and Best Lawyers'* "Best Law Firms" rankings