

Partnerships as Taxable Entities: IRS Releases Partnership Audit Regulations

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Prior to TEFRA

- ▶ Any adjustment to item attributable to partner's interest in partnership required IRS exam of partner
- ▶ Separate proceedings resulted in inconsistent treatment with respect to same partnership items
- ▶ Not all parties subject to examination
 - *e.g.* – Statute of limitations

TEFRA - 1982

- ▶ Unified rules to allow IRS adjustments to partnership items of partnership in one proceeding
- ▶ Computational adjustments to partners' returns to reflect proper treatment of partnership items
 - Factual determinations related to partner needed to be done through deficiency procedures at partner level

Why Change the Law?

- ▶ Increased number and complexity of partnerships
- ▶ Substantial increase in number of large partnerships
- ▶ ELP regime elective
- ▶ Audits couldn't keep pace
 - 27.1% 2012 audit rate for large corporations
 - 0.8% 2012 audit rate for large partnerships
- ▶ Passage of adjustments to partnership items to partners complex and time consuming

Expect Substantial Increase in Partnership Audits?

- ▶ Preamble says yes

Timing

- ▶ Partnership taxable years beginning after 2017
- ▶ No delay in proposed regulations

General Rule

- ▶ All adjustments determined at partnership level
- ▶ Chapter 1 (Income Tax) assessed and collected at partnership level
- ▶ Penalties and additions to tax related to an adjustment determined at partnership level

Items Subject to Partnership

Level Adjustment

- ▶ Amount, character, source and timing
- ▶ Character, timing and source of partnership activities
- ▶ Contributions / distributions
- ▶ Basis of partnership assets
- ▶ Value of partnership assets
- ▶ FTC separate categories
- ▶ Timing and amount of partnership creditable FTC
- ▶ Partnership elections
- ▶ Items related to transactions between parties and partnerships (including disguised sales and guaranteed payments)
- ▶ Partners' capital accounts
- ▶ Items related to termination of partnership

Not Picked Up

- ▶ Anything outside Chapter 1 of Subtitle A
 - Tax on self-employment income
 - Medicare tax
 - Chapter 3 withholding on foreign persons
 - FATCA withholding
 - Employment taxes and other taxes in other subtitles
- ▶ IRS may separately examine the partnership or the partners outside centralized audit regime
- ▶ Example: Must go after partners separately for 3.8% Medicare tax on unreported dividend income

Election Out of Centralized Audit Regime

- ▶ Eligible Partnership
 - 100 or fewer partners during year
 - All partners eligible
- ▶ 100 Partners
 - Partnership required to furnish 100 or fewer statements (K-1s)
 - Only consider statements required even if furnish more
 - Count statements required to be issued by S Corporation partners
 - Example: If partnership required to issue 50 K-1s and S Corp partner required to issue 51 K-1s to its shareholders, partnership not eligible

Election Out

- ▶ Eligible Partners
 - Individual
 - C corporation
 - Eligible foreign entity
 - Per se corporations
 - Default to corporation
 - Elect to be treated as a corporation on Form 8832
 - S corporation
 - Estate of deceased partner
- ▶ NOT Partnerships
 - FOF investor precludes election out
- ▶ Tax-exempt organizations are treated as corporations if formed as corporations, but not if formed as trusts

Specific Ineligible Partners

- ▶ DREs (absurd – not partners)
- ▶ Nominees (absurd – not partners)
- ▶ Partnerships
 - Carry partnership precludes election out
 - LLC GP precludes election out
- ▶ Estates other than of deceased partners
- ▶ Trusts
- ▶ 81-100 trusts
- ▶ Any real burden? Not for nominee and DRE – doesn't multiply partners

Electing Out

- ▶ On timely filed 1065
 - If late – no election out
- ▶ Foreign partnership only files returns if it has USSI or is ETB
 - May be too late to elect out
 - Need to file skeleton return just to elect out?
- ▶ Must notify partners within 30 days of election
- ▶ Information for each partner
 - Name
 - Taxpayer ID Number
 - Tax classification
 - Same information for each shareholder of S Corp
- ▶ Foreign partners?
 - Preamble assumes that all foreign partners must have TINs
 - Not true if no return required and no treaty
 - Could preclude election out – IRS requested comments on foreign partners

Effect of Election Out

- ▶ Pre TEFRA Rules
 - Partner-level deficiency proceedings
 - Risks of inconsistent results
 - Different venues
- ▶ IRS still intends to increase partnership audits
- ▶ Will specifically ensure electing out not to frustrate IRS efforts and that all partners are identified
 - *e.g.*, will confirm that no partners are really nominees
 - *e.g.*, will look at whether 2 partnerships are really 1 with more than 100 partners or ineligible partners
 - Impact on master-feeder structures or parallel partnerships?

Imputed Underpayment Amount

- ▶ General Rule – Partnership pays it in the adjustment year
- ▶ Calculation:
 - $IU = (\text{Net Partnership Adjustment} \times \text{Highest Rate In Reviewed Year}) \pm \text{Change in tax credits}$
 - Note – Highest rate for any taxpayer applied. So, if individual rates higher than corporate, highest individual rates apply even if all members corporations
- ▶ If net change is a negative amount, it is an adjustment that does not result in an imputed underpayment

Grouping and Netting of Adjustments

- ▶ 3 Main Groupings:
 - Reallocations among partners
 - Adjustments to partnership credits
 - All remaining adjustments (residual)
- ▶ Subgroupings
 - Character (capital versus ordinary)
 - Short-term versus long-term
 - Preferences
 - Restrictions
 - Limitations

Reallocation Grouping

- ▶ Treated as 2 adjustments:
 - Decrease in amounts allocation to 1 partner
 - Increase in amounts allocated to other partner(s)
- ▶ Decrease for 1 partner may not offset increase for others
- ▶ Net non-positive adjustment is disregarded in calculating imputed underpayment amount

Modification of Imputed Underpayment

- ▶ Preamble – Suggests that it may be faster if partnership provides information before the NOPPA
- ▶ After the NOPPA is issued, modification procedures are the only formal route to change imputed underpayment

Modification of Adjustments That Do Not Result in Imputed Underpayment

- ▶ Not allowed unless NOPPA sets forth imputed underpayment
- ▶ Partners whose reallocation adjustment does not result in an imputed underpayment must file an amended return in order for the partnership to claim a modification

Adjustments That Do Not Result in Imputed Underpayment

- ▶ Taken into account in adjustment year (not reviewed year).
- ▶ If elect to have partners file amended returns in modification process , it is taken into account on reviewed year returns
- ▶ Generally, no specific allocation rules
- ▶ In case of reallocations among partners, then allocate to:
 - Adjustment year partners which were partners in reviewed year and to which amounts reallocated
 - Else to adjustment year partners which are successors to reviewed year partners
 - Else to adjustment year partners according to adjustment year partners' distributive shares

How to Request Modifications

- ▶ Generally 270 days between NOPPA and FPA
- ▶ The IRS still may initiate a proceeding against a partner even if it approves modification
 - *e.g.*, Accepting 0% tax rate for tax-exempt partner does not preclude determining in another proceeding that the tax-exempt organization is not tax-exempt
- ▶ The review of information, etc. related to the modification is considered a review ONLY with respect to the partnership. IRS still can go after a partner

What IRS Will Request for Modification

- ▶ Structure
- ▶ Allocations
- ▶ Ownership and changes in ownership of partnership, partners and indirect partners
- ▶ Side agreements
- ▶ Information related to pass-through partners

Types of Modifications

▶ Amended Returns

- Reviewed year partners file amended returns for reviewed year and any relevant intervening years and pay tax, penalties and interest

▶ Tax-Exempt Partners

- Must establish entity would not be subject to tax (e.g., not UBTI)
- Failure to request tax-exempt modification may be examined to determine if failure shifted benefits to another party potentially raising private inurement, self-dealing excise tax or ERISA issues
 - Preamble says fix in LPA
 - Also taking comments

Types of Modifications

- ▶ Rate Modification
 - e.g., rate for C corporation lower than individual
 - Rate will be highest for that type of taxpayer on that type of income

Push Out Election

- ▶ Partnership may push out adjustments to the reviewed year partners rather than paying imputed understatement
 - Reviewed year partners take into account their share of adjustments
 - May be made with respect to some or all adjustments
 - Modifications reported to reviewed year partners
 - Adjustments that do not result in imputed underpayment are included in the reviewed year partners' share of the partnership adjustments (not in the adjustment year as in case of partnership payment)
- ▶ Must provide statements to reviewed year partners and file with IRS electronically
- ▶ Higher interest rates applies to underpayments (5 points over ST rate)

Making Push Out Election

- ▶ 45 days of mailing of FPA – no extensions
- ▶ Signed by partnership representative
- ▶ Include name, address TIN of partnership
- ▶ Taxable year to which election applies
- ▶ Imputed underpayment(s) to which election applies
- ▶ Name, address, TIN and other required information (from instructions and other guidance) for each reviewed year partner
- ▶ Copy of FPA attached to election
- ▶ All partners are bound

Push Out Statements

- ▶ Separate from K-1s
- ▶ Cannot combine multiple reviewed years
- ▶ Provide w/i 60 days of partnership adjustment becoming final

Payment of Pushed Out Amounts

- ▶ Partners pay their share in the taxable year which includes the date the push out statement was furnished (the reporting year)
- ▶ Additional tax is the aggregate of adjustments or a safe harbor (potentially higher, but easier to calculate amount)
- ▶ Penalties, additions to tax and interest also due
- ▶ Partner that is itself a partnership has to pay the tax
 - Technical corrections (not adopted) would have fixed this
 - IRS has significant concerns with the fix
 - Proposed regulations reserve on the issue of tiered partnerships

Partnership Representative

- ▶ Replaces Tax Matters Partner
- ▶ Requirements:
 - Need not be a partner
 - Any person including an entity
 - If entity, must appoint single individual to act on behalf of the entity
 - Must have capacity to act
 - Must have substantial presence in U.S.
 - Able to meet with IRS in US at reasonable times and places as necessary and appropriate
 - US Taxpayer ID Number
 - US street address and phone number-reachable by IRS during normal business hours
 - Individual designee of entity also must meet these requirements

Partnership Representative

Designation

- ▶ Appointment valid until affirmative action to terminate
 - Representative resigns
 - Partnership revokes designation
 - IRS determines designation not in effect
- ▶ Appoint on tax return for tax year
 - Separate for each year
 - No carryover one year to next
 - Applies to the tax year even if rep for another year is different
 - Stays in effect until event above

Partnership Representative

Limitations on Change

- ▶ No resignation or revocation until IRS issues notice of administrative proceeding or partnership files administrative adjustment request
 - Same rule applies to the designated individual of partnership representative that is an entity
 - How to deal with employee terminations / resignations?
- ▶ If IRS determines that no designation is in effect – *e.g.*, it determines that the partnership representative does not have capacity or substantial presence in the US.
 - IRS may designate if not timely designated or multiple revocations

Partnership Representative

Designation Not In Effect

- ▶ IRS notifies partnership and last representative
- ▶ Normally partnership has 30 days to appoint
- ▶ If IRS cannot determine who appointed, IRS appoints without giving partnership opportunity

Partnership Representative

Authority

- ▶ All partners are bound by actions (and final decision in action)
- ▶ Settlements
- ▶ Final partnership adjustment
- ▶ Election to have partners adjust returns rather than pay imputed underpayment
- ▶ Extending period for adjustment
- ▶ Applies even in elect out of centralized audit regime
- ▶ Sole authority to act on behalf of partnership
- ▶ No other partners may participate in or contest results of examination / proceeding without IRS permission

Impact of Agreement / State Law

- ▶ Cannot limit broad authority by state law on agreement
 - Actions binding
 - May be liable for damages on termination

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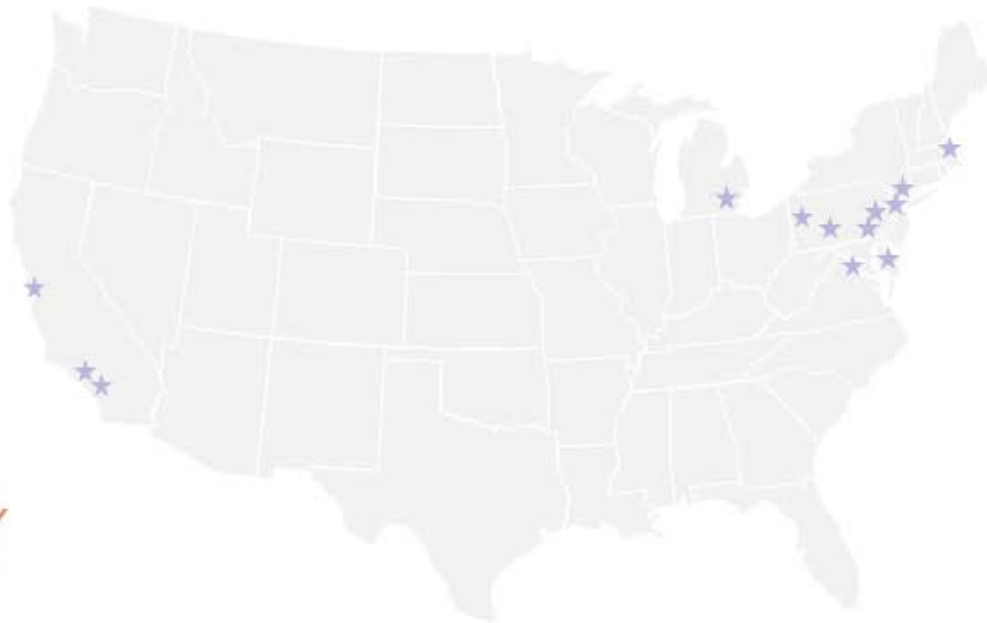
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