Understanding the New Partnership IRS Audit Rules

PRESENTED BY:

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August 3, 2017
Welcome & Introductions
Your Presenters

› **Moderator**
  
  Kevin Carney, CPA

› **Panelists**

  Rob Velotta, CPA, MT
  Donna Weaver, CPA, MT
Background
September 2014 GAO Report to Congress

- From 2002 to 2011, the number of partnerships increased 47% to 3.3m, while number of C corporations decreased by 22% to 1.6m
Large partnerships — more than 100 direct and indirect partners and more than $100m in total assets — tripled in that time period to more than 10,000.

Figure 6: Number of and Percentage Increase in Large Partnerships, by Direct and Indirect Partners, Tax Years 2002 and 2011

Source: GAO analysis of IRS data from Enhanced Large Partnership Indicator File and Business Returns Transaction File, Compliance Data Warehouse. [GAO-14-732]
Table 10: Large Partnerships by Average and Median Number of Direct Partners, and Direct and Indirect Partners, Tax Years 2002 to 2011

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average and Median Number of Direct Partners</td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Average</td>
<td>453</td>
<td>531</td>
<td>595</td>
<td>622</td>
<td>585</td>
<td>587</td>
<td>631</td>
<td>899</td>
<td>934</td>
<td>980</td>
</tr>
<tr>
<td>Median</td>
<td>38</td>
<td>42</td>
<td>43</td>
<td>43</td>
<td>32</td>
<td>32</td>
<td>25</td>
<td>27</td>
<td>28</td>
<td>26</td>
</tr>
<tr>
<td>Average and Median Number of Direct and Indirect Partners</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>12,007</td>
<td>8,150</td>
<td>9,346</td>
<td>16,882</td>
<td>30,674</td>
<td>73,684</td>
<td>61,269</td>
<td>113,722</td>
<td>14,721</td>
<td>29,998</td>
</tr>
<tr>
<td>Median</td>
<td>1,352</td>
<td>1,327</td>
<td>1,549</td>
<td>1,414</td>
<td>1,757</td>
<td>1,793</td>
<td>3,133</td>
<td>3,071</td>
<td>1,619</td>
<td>2,776</td>
</tr>
</tbody>
</table>

Source: GAO analysis of IRS data from the Enhanced Large Partnership Indicator (ELPI) File and Business Returns Transaction File, Compliance Data Warehouse. (GAO-14-732)

Note: Because the ELPI file does not have complete K-1 data from Schedule(s) K-1 for partners, which are information returns that the partnership sends to the partners to report partners' share of the partnership's income, deductions, credits, etc., the extent of tiering represents a minimum amount and entity counts are approximate.
Partnership Adjustment Before Changes

› Small Partnerships
  - 10 or fewer partners at all times during the tax year
  - All partners must be U.S. persons, resident aliens, C corporations or estates of deceased partnerships
  - Does not apply if any partner is a trust (including grantor trust), S corporation, partnership, single member LLC, nominee, or nonresident alien individual
  - An investor in a non-TEFRA entity may be examined for both pass-through and non pass-through issues. Statute of limitations for non-TEFRA pass-through entities, including non-TEFRA key cases, is controlled at the investor level

› TEFRA (Tax Equity and Fiscal Responsibility Act of 1982)
  - Consolidated audit procedures
TEFRA Issues

› IRS processes changes to partners’ returns and tiered structure via a campus audit (linking of tax returns of direct and indirect partners to partnership)
› Identification of Tax Matters Partner
› 3-year statute at partnership level; TEFRA generally requires that audit adjustments be passed through to partners within a 1-year assessment period
Electing Large Partnership Issues

- Established by Taxpayer Relief Act of 1997
- 100 or more direct partners and can not be engaged in providing services or a commodity pool
- ELP vs. TEFRA
  - Partnership may pay tax on audit adjustments instead of partners
  - Partnership must report fewer items to partners
  - Section 772(a)(1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities; (3) net capital gain or loss, separately computed for passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment, separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credits; (8) rehabilitation credits; (9) foreign income taxes; an (10) other items as determined by Secretary
- Few partnerships have elected ELP status
Table 5: No Change Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Partnerships</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No Change Rate</td>
<td>85.3</td>
<td>77.8</td>
<td>82.6</td>
<td>51.6</td>
<td>77.0</td>
<td>66.7</td>
<td>64.2</td>
</tr>
<tr>
<td>Large Corporations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No Change Rate</td>
<td>16.2</td>
<td>22.1</td>
<td>18.6</td>
<td>18.7</td>
<td>20.4</td>
<td>27.2</td>
<td>21.4</td>
</tr>
</tbody>
</table>

Source: GAO analysis of IRS data from IRS data book and Audit Information Management System, Compliance Data Warehouse. | GAO-14-732
Partnership Audit Provisions

› Bipartisan Budget Act of 2015 repealed TEFRA and ELP rules
› IRC Sections 6221 through 6241
› Proposed regulations issued on January 18, 2017
› Regulations that had been sent to Office of the Federal Register, but not yet published, were withdrawn for review by Trump administration on January 20, 2017
Overview of Key Rule Provisions
Partnership Audit Provisions

› Proposed regulations reissued in June 2017, comments due 08/14/17, hearing 09/18/17

› Proposed regulations generally effective for partnership returns filed for tax years beginning after December 31, 2017. Early adoption may be elected

› AICPA request to delay effectiveness for one year, to be effective December 31, 2018
New IRS Audit Rules – Key Definitions

› **Reviewed Year**: year under audit (year to which the item being adjusted relates)

› **Adjustment Year**: year audit or judicial review is completed (court decision, notice of final partnership adjustment is mailed)

› **Imputed Underpayment** *(the tax due)*: net non-favorable adjustment to the partnership tax year multiplied by the highest applicable tax rate

› **Partnership Representative**: Replaces Tax Matters Partner (TMP)
Partnership Representative

› Each partnership must designate a partnership representative (TMP eliminated)
› Must have a substantial presence in the U.S.
› Does **NOT** have to be a partner of the partnership
› Has “sole authority to act on behalf of the partnership” and to bind the partnership and all partners with respect to IRS audits
› Representative has no explicit obligation to act in the best interest of the partnership
› If none designated by the partnership, IRS may designate partnership representative
Partnership Representative Under Proposed Regulations

› If representative is an entity, partnership must appoint sole individual through whom it will act

› Must be made on partnership return for the taxable year to which the designation applies

› May not be changed either by resignation or revocation until
  - Partnership files an administrative adjustment request
  - Upon receipt of a notice of administrative proceeding from IRS
Partnership Representative Under Proposed Regulations

› Sole Authority to Act

- Partnership designates P as partnership representative
- Partnership agreement includes clause that requires P to consult with an identified management group before taking any action with respect to an IRS administrative proceeding
- P consents to an extension of time for the IRS to mail final notice of partnership adjustment and does NOT consult with the management group before doing so
- P’s consent provided to the IRS is valid
New IRS Audit Rules Overview

› All notices sent to the partnership and partnership representative (not to individual partners)
  - Audit notices
  - Proposed partnership adjustments
  - Final partnership adjustments
New IRS Audit Rules Overview

- **Partnership level determination**
  - Assess and collect taxes, penalties and interest associated with audit adjustments at the partnership level rather than flowing through to individual partners
  - Net partnership adjustments are taxed at highest individual or corporate rate during the tax year at issue (imputed underpayment)
  - Partnership pays tax in adjustment year, not reviewed year
  - Imputed underpayment treated as nondeductible expense by the partnership
New IRS Audit Rules Overview

- IRS will assess in tax year of the adjustment not the year to which the adjustment relates
  - IRS audits 2018 return in 2020
  - Any tax, penalty and interest is imposed on 2020 tax return
  - All partners in 2020 are liable **even if not a partner in 2018**
  - Tax, interest and penalties determined at the partnership level and all are **NOT** deductible
New IRS Audit Rules Overview

› Requires a partner treat each item of income, gain, loss, deduction or credit attributable to a partnership consistently with how those items are treated on the partnership return

› If partnership ceases to exist, the partnership adjustment is taken into account by the former partners

› Favorable adjustment taken into account on partnership return for the adjustment year
  - Current partners, not reviewed year partners, benefit from overstatements of income in prior years
Partnerships Affected

› Impacts all partnerships regardless of size
› Includes all partnerships and entities that should be classified as partnerships (non-filing partnerships)
› Some partnerships may be able to elect out if they meet certain criteria
The Opt Out Election

› Certain partnerships may opt out if
  - Have 100 partners or fewer
  - Eligible partners are individuals, C Corps., foreign entities (that would be treated as C Corps. if domestic entities), S Corps. or estates of deceased partners
  - Partnerships with RICs & REITs as partners are eligible to elect out
    - S Corp. look through rule
Partnerships with partners that are partnerships or trusts CANNOT opt out
How to Elect Out (Opt Out Election)

› Must be done on a timely-filed return - annual election
› Must notify all partners that election has been made
› Must disclose to IRS name, taxpayer ID and tax classification of all partners, including such information for each S Corp. shareholder
› If elect out, tax treatment of adjustment to partnership’s items of income, gain, loss, deduction or credit will be determined at the partner level
› Each partner handles own audit, makes own decisions, and pays own professional fees (not bound by decisions of partnership representative)
Elect Out Under Proposed Regulations

› Not valid unless all of the requirements are met

› Partner count is based on number of statements (K-1s) partnership is required to furnish to partners

› S Corp. partners must take into account each statement (K-1) they are required to furnish

- I.E. – Partnership with 51 partners, 50 individuals and one S-Corp., but S-Corp. has 50 shareholders, thus partnership deemed to have 101 partners (50+1+50) due to 101 statements required to be issued, thus opt out election is not available
Elect Out Under Proposed Regulations

› Partners who are husband and wife count as two separate partners, provided that each receive separate K-1s

› Cannot make election if partnership has partners that are NOT eligible, such as partnerships, trusts, foreign entity, disregarded entity, nominee or estate of individual other than a deceased partner
Elect Out Under Proposed Regulations

- Must disclose certain information to the IRS for each person that was a partner at any time during the tax year to which election applies.
- Partnership must notify each partner that the election was made within 30 days of making election.
- IRS will open deficiency proceedings at the partner level.

"IRS will review elections carefully to ensure that such election is not being used solely to frustrate IRS compliance efforts"
Calculation of Assessment
Partnership Adjustment Under Proposed Regulations

› In general, the imputed underpayment is calculated by multiplying the total positive netted partnership adjustment by the highest federal tax rate for the reviewed year (currently 39.6%), then increased or decreased by any adjustment to the partnerships credits

› Imputed underpayments will be determined by a grouping and netting process
  - i.e. - Items of same character are netted separately and then totaled
    - Net ord. inc. adj. $40 + $20 net cap. inc. adj. = $60 x highest rate
  - After netting groups/subgroups, any net non-positive adjustments are disregarded in the calculation of the imputed underpayment

› Adjustments between taxable years cannot be netted

› Can be multiple imputed underpayments – only one general, but other specific

› Imputed underpayments are assessed and collected at the partnership level in the adjustment year
  - Payments are not deductible by the partnership
Partnership Adjustment Under Proposed Regulations

› Three types of groupings which divide the adjustments
  - Reallocation grouping – adjustments that reallocate items among the partners
  - Credit grouping – adjustments to partnership credits
  - Residual grouping – all remaining adjustments, these are grouped together according to character, preferences, restrictions and other limitations

› Within groupings there may be subgroupings
  - I.E. – Residual grouping may be ordinary subgrouping and capital subgrouping
  - Reallocation among partners – decrease in deduction for one partner is separate subgrouping from increase in deduction of the second partner
Partnership Adjustment Under Proposed Regulations

› After grouping, items in the same group or subgroup are netted

- Net positive adjustments – Imputed Underpayment (tax due). IU is multiplied by the highest rate for the reviewed year

- Net non-positive adjustment (favorable adjustment) is taken into account in the adjustment year
Modifying Imputed Adjustments – Reducing Tax Due

Generally, partnerships must pay tax equal to the “imputed underpayment” unless partnership can demonstrate that the adjustment would be lower if it were based on certain partner-level information from the reviewed year.

Partnership submits this info to the IRS - must be submitted no later than 270 days after the date the notice of proposed partnership adjustment is mailed; IRS can extend this time period.

- IRS cannot issue a notice of final partnership adjustment until the end of the 270 day period.

I.E. – partnership has tax exempt partner, partners taxed as lower rates (c-corps.), income items taxed at lower rates (capital gains), and/or partners already file amended return which includes their share of the adjustments, etc.
Modifying Imputed Adjustments Under Proposed Regulations

› Partnership representative must submit for any request for modification all relevant information
  - Information to be furnished to the IRS must include a detailed description of the partnership structure, allocations, ownership, ownership changes, its partners, the partnership agreement, etc. for each taxable year relevant to the request for modification

› Types of modifications defined and examples are included in proposed regs
  - Amended return by partner for all taxable years and partner had made full payment of taxes penalties and interest
  - Tax exempt partner modification
  - Modification based on tax rate that is lower than highest rate (capital gain rate)

› Modification shall be made only upon approval by Secretary
Push Out Election
Push Out Election

- Partnership pushes adjustments to partners in the reviewed year
- Tax burden borne by prior partners (reviewed year partners)
- Election must be made within 45 days of notice of the final partnership adjustment
Push Out Election

› Each partner in the reviewed year picks up his share of the audit adjustment in taxable income for the reviewed year

- Must recomputed tax for such year and pay with return for the taxable year in which the partnership furnished the required statement (no amended returns filed)

- Must also recomputed taxable income for each succeeding tax year to the extent that a change in tax attributes, as a result of the audit adjustment, would increase the tax due

- Reviewed year partners liable for tax, penalties and interest – interest is increased by 2%
Push Out Election Under Proposed Regulations

› Cannot extend 45-day period for making election
› Election must be signed by the partnership representative and contain required info
› Statements with prescribed information (not K-1s) must be furnished to the reviewed year partners and the IRS no later than 60 days after the date all partnership adjustments are finally determined
Partnerships Ceasing to Exist

› If partnership ceases to exist before adjustment takes effect, the adjustment may be taken into account by the former partners of the partnership

› If technical termination of partnership, the successor partnership will be responsible for adjustment/imputed underpayment
Look Ahead & Takeaways
What To Consider Now?

- Consult legal related to amendment of partnership agreements
  - Designate Partnership Representative and who makes future designations?
  - Indemnification of Partnership Representative and/or impose requirements on Partnership Representative?
  - Grant Managing Member/GP to make appropriate considerations?
  - Specific elections made by partnership to opt out, push out, modify calculations, etc. vs. general GP provisions?
  - Consider entering and exiting partners’ interests?
  - Limit new partners who could prevent partnership from opting out of regime?
What To Consider Now?

› New partnerships – consider addressing rules
› How will assessments be treated for economic purposes?
  - Mandatory capital contribution for professional fees
  - Distribution provisions affected by tax assessments?
  - Impact to withdrawing partners, any claw back or hold back for items
  - Assessment year vs. reviewed year partner items
› State tax conformity
Partner/Investor Consideration

› Has partnership addressed?
› As a new partner, what exposure do you have related prior years?
› Indemnifications or continued exposure after redemption?
› Requirements to treat tax items consistently with partnership’s tax return?
Questions?
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Future Events

› Next Webinar

Early winter 2018
Thank you.