

# Understanding the New Partnership IRS Audit Rules

*PRESENTED BY:*

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# Welcome & Introductions

# Your Presenters

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## › Moderator

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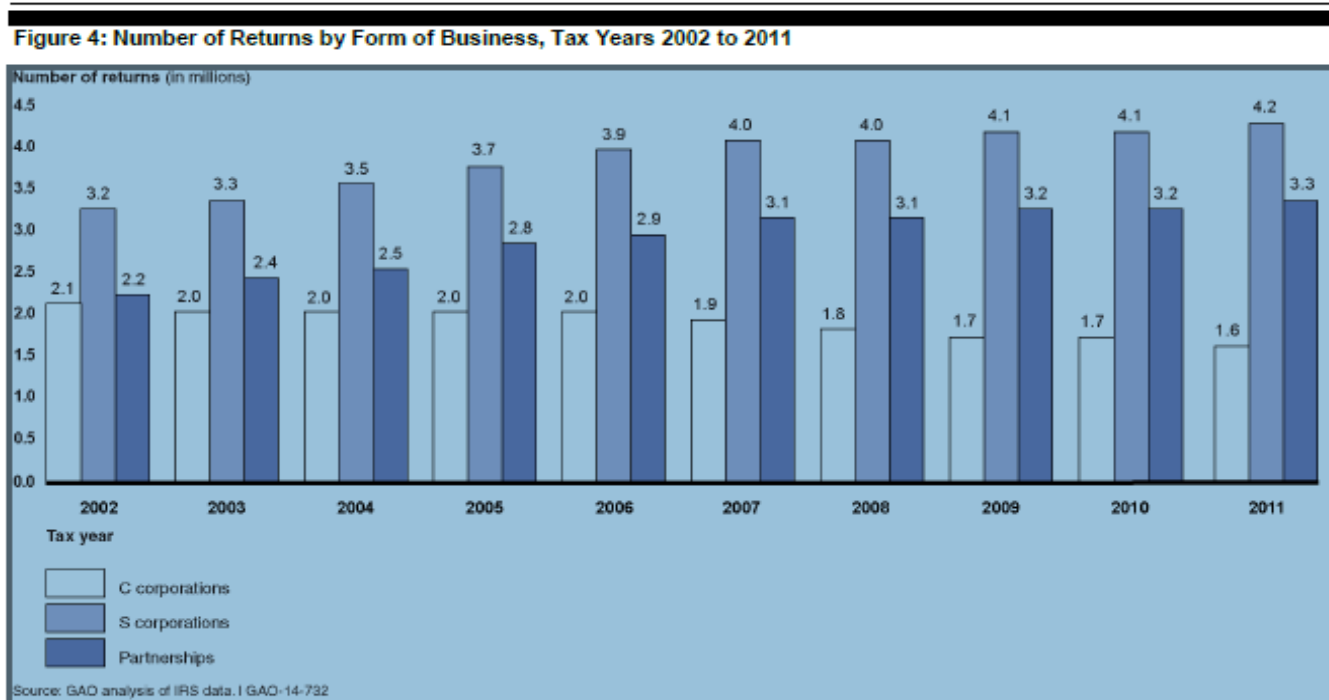
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Background

# September 2014 GAO Report to Congress

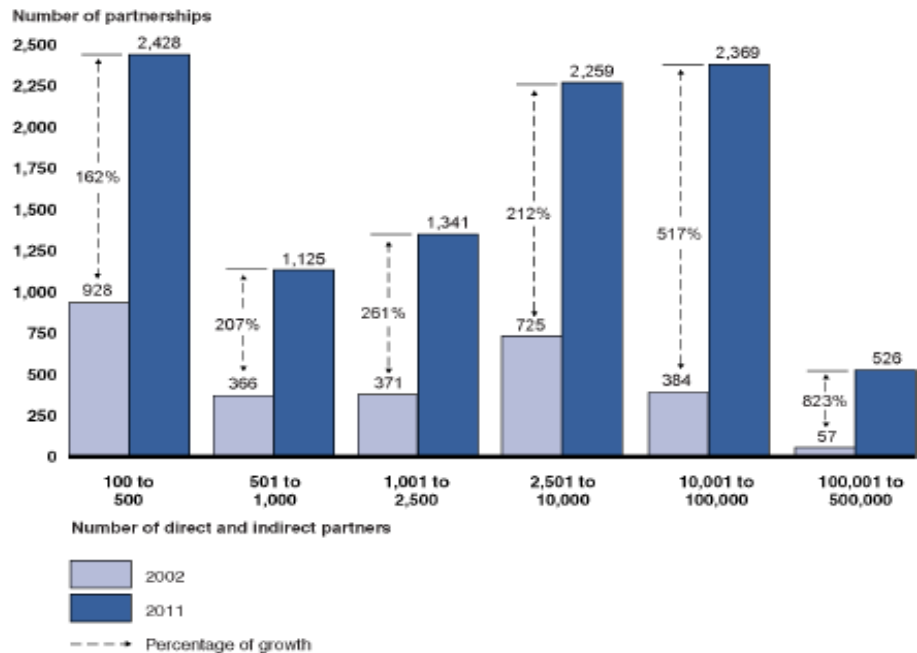
- › From 2002 to 2011, the number of partnerships increased 47% to 3.3m, while number of C corporations decreased by 22% to 1.6m



# September 2014 GAO Report to Congress

- › 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

# September 2014 GAO Report to Congress

**Table 10: Large Partnerships by Average and Median Number of Direct Partners, and Direct and Indirect Partners, Tax Years 2002 to 2011**

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

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

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## › 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

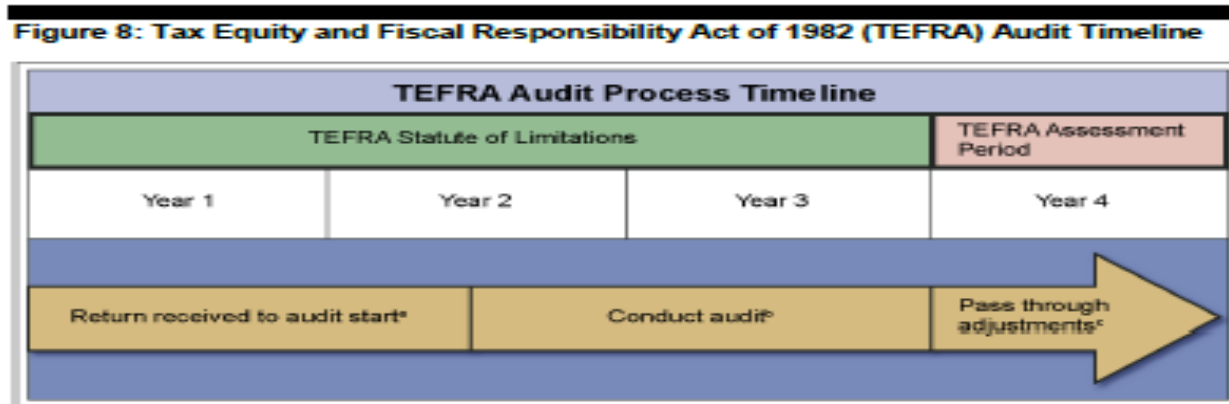
## › TEFRA (Tax Equity and Fiscal Responsibility Act of 1982)

- 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



Source: GAO analysis of IRS data and documentation. | GAO-14-732

Notes: A 3-year statute of limitations governs the time to complete partnership audits.

\*In fiscal year 2013, IRS took an average of 1.4 years from when a large partnership return is received to start the audit.

†In fiscal year 2013, IRS took an average of 1.5 years to conduct a large partnership audit.

‡IRS generally completes within 1-year the assessment of audit adjustments to partners of the large partnership.

# Electing Large Partnership Issues

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- › 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

# September 2014 GAO Report to Congress

**Table 5: No Change Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013**

	Fiscal Year						
	2007	2008	2009	2010	2011	2012	2013
<b>Large Partnerships</b>							
No Change Rate	85.3	77.8	82.8	51.8	77.0	88.7	84.2
<b>Large Corporations</b>							
No Change Rate	18.2	22.1	18.8	18.7	20.4	27.2	21.4

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

# Partnership Audit Provisions

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- › 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

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- › 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

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- › **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

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- › 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

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- › 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

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## › 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

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- › 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

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## › 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

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- › 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

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- › 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

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- › 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

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- › 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)

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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- › 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

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

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- › 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

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- › 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?

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- › 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?

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- › 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

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- › 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?

# Contact Information

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# Future Events

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- › Next Webinar

Early winter 2018

Thank you.

*Information presented is not meant to constitute legal, accounting or other professional advice. Any action taken based on information in this presentation should be taken only after a detailed review of the specific facts and circumstances. Information is current as of the date presented.*

August 3, 2017