

New IRS Partnership Audit Rules for Tax Counsel: Preparing for Massive Changes

Partnership Agreement Drafting Considerations, Commercial Impacts,
Transfers and Admissions of New Partners

WEDNESDAY, FEBRUARY 8, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Heath Martin, **Davies Ward Phillips & Vineberg**, New York

Jonathan Stein, Counsel, **Goulston & Storrs**, New York

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BACKGROUND: THE RISE AND FALL OF THE TEFRA AUDIT RULES

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Life Before TEFRA

- In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (“TEFRA”).
- Before the passage of TEFRA, the IRS could not audit partnerships at the entity level.
- Instead any audit adjustment had to be made to an individual partner’s return pursuant to an audit of the individual partner.
- This led to inconsistent results: one partner’s settlement or judicial proceeding was not binding on another partner.
- In addition, the applicable statute of limitations was that of the partner, not the partnership.
- Finally, there was no duty for partners to report items consistently with the partnership.

TEFRA Features

- Partnership Level Determination:
 - TEFRA shifted the audit of partnership items from each individual partner to the partnership level by mandating that the tax treatment of any “partnership item,” as well as the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item must be made at the partnership level.
- Consistency Requirement:
 - Unless the Service is notified of an inconsistent treatment, TEFRA mandated that each partner’s tax treatment of partnership items must be consistent with the treatment of those items at the partnership level.
 - The consistency requirement applied not only upon the filing of each partner’s return, but also if the partnership return is adjusted as the result of an audit.

TEFRA Features

- Unified Partnership Audits
 - After TEFRA, the audit of certain partnerships were unified proceedings. The Service was generally required to issue formal notice directly to all known partners at the start of an audit.
- Tax Matters Partner
 - TEFRA created the “tax matters partner,” a partner charged with coordinating the audit and any judicial proceeding for the partnership.
 - But TEFRA still gave individual partners the right to participate in an audit or judicial proceeding and to negotiate his or her own settlement with the IRS.
 - Although the TMP was charged with keeping each partner informed of all administrative and judicial proceedings at the partnership level of partnership items, the TMP was not subject to penalty for failure to perform.

TEFRA Features

- Final Partnership Administrative Adjustment
 - A TEFRA audit concluded when the Service mailed to the TMP (and to each partner who does not settle) a notice of final partnership administrative adjustment.
 - Individual partners could challenge the Service's findings from the audit in court, if the TMP chose not to do so.
- Statute of Limitations
 - TEFRA gave the IRS one year after the issuance of the FPAA to audit and collect tax in respect of partnership items from the individual partners

GAO Summary of TEFRA features

Table 2: Select Features of Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Audit Procedures

Consistency Reporting Requirement	Certain items, known as partnership items, are determined at the partnership level and all partners must report these items consistent with how the partnership reports them. Some items include each partner's share of the partnership's income, gain, loss, deductions, and credits.
Tax Matters Partner (TMP)	The TMP is the primary representative of the partnership in dealing with IRS as well as the partners. The TMP can be a general partner designated by the partnership or, if no TMP is designated, the general partner with largest profit interest. Under certain circumstances, IRS may select a partner to be the TMP.
Statute of Limitations	In general, a 3-year statute of limitations applies to assessments of returns of partners in TEFRA partnerships. ^a
Notice and Participation Partner Rights	<ul style="list-style-type: none"> • Certain partners and groups are entitled to receive notices at the beginning and conclusion of the audit. • The TMP is required to keep partners informed of certain steps of the audit and the partners have the right to participate in any or all of these steps. • Certain partners can challenge IRS's findings from the audit in court, if the TMP chooses not to do so.
Timeline of Procedures	The statute and regulations define a number of timelines at stages of the audit that IRS, the TMP, or partners should complete, such as sending out the notification at the beginning and conclusion of the audit.

Source: Internal Revenue Code and IRS documentation | GAO-14-732

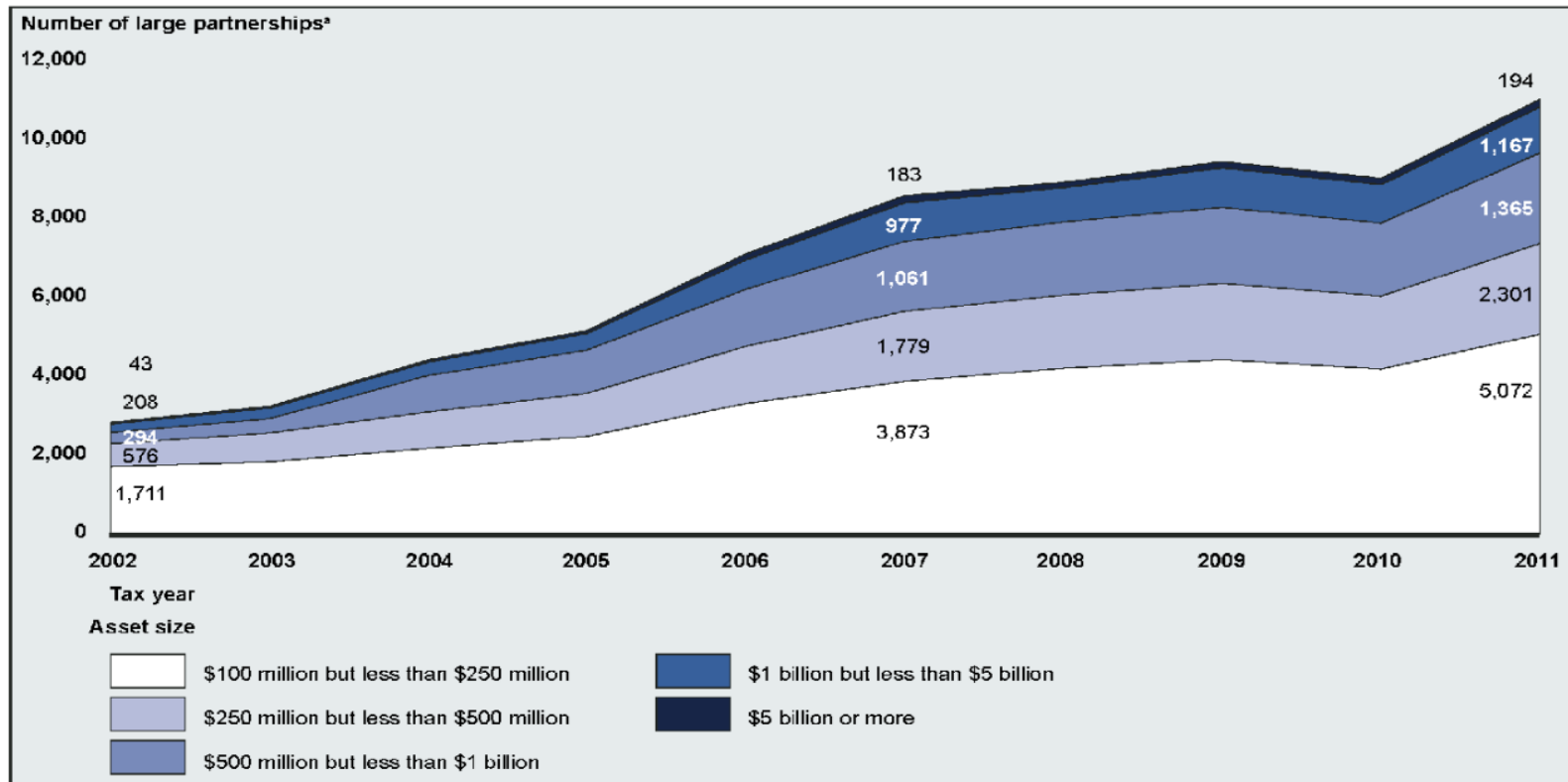
^aTEFRA also provides that the period for auditing partnerships does not expire before 3 years after the original due date of the return or date of return filing, whichever is later. This provision of TEFRA can extend, but never shorten the statute of limitations. According to IRS officials, it does audit partnerships covered by TEFRA beyond the 3-year time frame established in section 6229 in cases where the statute of limitations under section 6501 has yet to expire for one or more partners.

Shortcomings of TEFRA

- Too much complexity
 - Massive amounts of litigation on issues related to statute of limitations and whether or not a particular item is a partnership item
- Tax Matters Partner
 - No remedy for an individual partner if the tax matters partner failed to notify other partners
 - IRS difficulty in identifying tax matters partner would frustrate audit proceedings
- The Death Knell – Large Tiered Partnerships...

Shortcomings of TEFRA

GAO: During tax years 2002 through 2011, the number of large partnerships with 100 or more direct and indirect partners as well as \$100 million or more in assets more than tripled to 10,099—an increase of 257 percent.



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

^aSome large partnerships may not have reached the \$100 million asset threshold without ownership interests in other partnerships. The average asset size is also higher than it would be without those ownership interests. IRS data do not indicate how many large partnerships would have fallen below the \$100 million threshold without their ownership interests in other partnerships.

Shortcomings of TEFRA

- GAO: According to IRS data, in fiscal year 2012, IRS audited large partnerships at 0.8% percent audit rate.
- The audit rate for C corporations with \$100 million or more in assets was 27.1% in the same period.

Table 4: Audit Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013

	Fiscal Year						
	2007	2008	2009	2010	2011	2012	2013
Large Partnerships							
Audit Rate	0.5%	0.6	0.6	1.4	0.7	0.8	N/A
Large Corporations							
Audit Rate	20.6	21.4	20.8	20.6	23.1	27.1	27.4

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

Note: For any large partnership, the number of audited returns closed in a fiscal year may include returns from multiple tax years. Calendar year 2012 partnership filings were not available when we did our analysis to compute the audit rate for fiscal year 2013.

Shortcomings of TEFRA

TEFRA audits are too labor intensive for the IRS

- The process of linking partnership returns (Forms 1065), Schedule K- 1s, and partners' returns (Forms 1040) is largely manual and paper driven. According to IRS officials, the campus information systems do not have the capability to automate the process. Paper copies of all these returns must be retrieved and linked in a very labor intensive process.
- The portion of the partnership audit adjustment that gets passed through to each partner must be manually determined by using the ownership share reported on the relevant Schedule K-1.

Shortcomings of TEFRA

Passing through audit adjustments to numerous partners may not be worth the effort

- The Schedule K-1 information may not always be accurate, requiring IRS to contact the partnership and review the partnership agreement to clarify ownership shares among the partners.
- A copy of the partnership agreement must usually be requested from the partnership being audited and for potentially each partnership within the partnership structure that is linked. Partnership agreements may include special allocation for some income items that supersede the ownership interest reported on the Schedule K-1.
- Finding special allocations requires detailed reviews of the partnership agreements of the partnerships within the partnership structure. According to IRS officials, this step cannot be automated. IRS officials also said that partnerships could provide special allocation schedules to IRS, which would eliminate the need to review the entire agreement.

Shortcomings of TEFRA

Passing through audit adjustments to numerous partners may not be worth the effort

- Since IRS generally has one year after the 3-year statute of limitations ends to pass through adjustments, the IRS has to start linking returns before it knows whether there will be an audit adjustment or whether an adjustment will be large enough to merit passing through.
- In a large partnership, dividing the adjustment among hundreds or thousands of partners may result in amounts that are so small that IRS deems them not worth the cost to pass through.

OVERVIEW OF NEW PARTNERSHIP AUDIT RULES

**New IRS Partnership Audit Rules for Tax Counsel:
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Legislative Background of BBA

- Current rules are based on proposed Partnership Audit Simplification Act of 2015 (H.R. 2821, 114th Cong.) and the Tax Reform Act of 2014 (H.R. 1, 113th Cong.).
- Enacted on November 2, 2015 as part of the Bipartisan Budget Act of 2015 (H.R. 1314, 114th Cong. / PL 114-74).
- New rules are at Sections 6221 through 6241 of the Code.

Post-Enactment Developments

- Technical Corrections made as part of the PATH Act in December 2015.
- Tax Technical Corrections Act of 2016
 - Includes provisions on the scope of the new partnership audit rules, netting of adjustments, modifications to imputed underpayments (the "pull-in procedure"), push-out of adjustments in tiered structures
 - Bill was not passed in 2016 but gives an idea of what future bills may look like.
- Proposed regulations released on January 18, 2017 (“Regulations”).
 - Regulations were withdrawn in the wake of the President's January 20 ban on regulations not yet submitted to the Federal Register.
 - Regulations are likely to resurface in substantially the same form.

Overview of New Audit Rules

- New default regime under which the IRS can make adjustments to partnership items at the partnership level, and then collect tax, penalties and interest from the partnership.
- Qualifying partnerships may elect out of the default regime by filing an annual election and providing information about their partners.
- A partnership that receives an adjustment may elect to amend K-1s and have the partners pay the additional tax.
- The rules for electing large partnerships have been repealed

Default Regime

Partnership-level Assessment Under Section 6221(a)

- Any adjustment to items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level pursuant to this subchapter.

Default Regime

Requirement of Consistency Under Section 6222(a)

- A partner shall, on the partner's return, treat each item of income, gain, loss, deduction, or credit attributable to a partnership in a manner which is consistent with the treatment of such income, gain, loss, deduction, or credit on the partnership return.
- Underpayments due to inconsistent treatment are assessed and collected as a math error.
- Partner can avoid consistency requirement by filing a statement identifying the inconsistency.

Default Regime

Partnership Representative Under Section 6223

- The partnership shall designate a partnership representative, who has the sole authority to act on behalf of the partnership in an audit.
- A partnership and all partners are bound by actions taken by the partnership and any final decision with respect to the partnership.
- The partnership representative has to be a partner (or other person) with a substantial presence in the United States.
- If the partnership fails to designate a partnership representative, the IRS can select "any person" to be the partnership representative.

Default Regime

Partnership Representative – Regulations

- Regulations require the partnership representative to be available to meet with the IRS in the United States and to have a U.S. address, U.S. phone number and U.S. TIN.
- If the partnership representative is an entity, the partnership must designate an individual who will act for that entity.
- Regulations specify that a partnership representative has sole authority to act for the partnership, and no state law or partnership agreement can limit that authority.
- Regulations provide that a person is ineligible to be a partnership representative in the case of death, court order on capacity, an injunction, incarceration, liquidation, etc.

Calculating the Adjustment

Imputed Underpayments Under Section 6225

- The partnership must pay the amount of any imputed underpayment.
- The imputed underpayment is the net adjustment of items of income, gain, loss, or deduction multiplied by the highest tax rate in effect for the reviewed year under Section 1 or 11.
- Adjustments to credits are added to or subtracted from the amount determined above.
- Regulations provide that payments of tax, interest and penalties are not deductible (i.e. they're 705(a)(2)(B) payments). The IRS intends to provide rules on how to allocate these payments and adjust inside basis.

Calculating the Adjustment

Imputed Underpayments – Special Rules

- In the case of reallocations from one partner to another, a decrease in income or gain, and an increase in deduction, loss, or credit, is ignored.
- Modifications may be made to the imputed underpayment if the partnership demonstrates that a portion of the reallocation would go to tax-exempt entities.
- Similarly, modifications may be made to reflect amounts allocable to a C corporation or to an individual as capital gain or qualified dividends.
- Imputed underpayment is assessed in adjustment year, not the year under review.

Calculating the Adjustment

Modification Regime – Regulations

- Regulations allow a partnership representative to request the amount of an imputed underpayment to be reduced.
- Partnership must substantiate the modification, including by submitting tax returns, partnership operating documents, certifications and other information and by describing the structure, allocations, ownership, ownership changes, and identity of direct and indirect partners.
- Modifications may be requested based on (i) amended returns by partners, (ii) tax-exempt partners (including foreign persons), (iii) tax rate, (iv) passive losses of a PTP, or (v) status of partner as RIC or REIT. Partnership may request a modification on other bases.
- Technical Corrections Act provides "pull-in" procedure for modifications.

Calculating the Adjustment

Partnerships that Cease to Exist

- Regulations provide that the partners of a partnership at the time that the partnership ceases to exist are liable for imputed underpayments.
- If a partner is itself a partnership, the partners of that partnership could be liable for the imputed underpayment.
- IRS can determine that a partnership has ceased to exist if it terminates under 708(b)(1)(A) or does not have the ability to pay an imputed underpayment.

Election to Opt Out of Default Regime

Election to Opt Out Appears in Section 6221(b)

- The election must be filed annually with the partnership's tax return.
- The election is only available to a partnership that issues 100 or fewer K-1s in the taxable year.
- Special rules for counting the 100 partners:
 - Each partner must be an individual, a C corporation, any foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner.
 - Partnerships must look-through S corporations and disclose the identify of each shareholder (including TINs). Regulations provide that it's OK if an S corporation shareholder is an "ineligible partner."
 - Under Regulations, K-1s issued to spouses count as two partners.

ALTERNATIVE TO PAYMENT OF IMPUTED UNDERPAYMENT BY PARTNERSHIP

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Alternative Regime: Passing the liability on to the partners

BBA Section 6226: Partnership can elect out of BBA Section 6225

- The partnership can elect out of the default rules with respect to partnership payment of underpayments if, within 45 days of receiving the final audit adjustment notice, the partnership elects the alternative regime and furnishes each partner for the reviewed year with a statement (similar to a K-1) of such partner's share of any adjustment.
- This election allows the partnership to push the burden of an imputed underpayment to reviewed year partners and have such partners report additional tax on their current year return.
- This election avoids entity level payment of tax and shifting of liability between current and former partners.
- Comes at a cost: The interest rate is 2% higher than the rate for a BBA Section 6225 underpayment.

Alternative Regime: Passing the liability on to the partners

BBA Section 6226: Mechanics of reporting adjustment

Tax liability for the year in which the partner receives a statement of the partner's share of any adjustment is determined as follows:

- Calculate hypothetical increase in tax liability under chapter 1 for partner's reviewed year that would occur if the partner's share of adjustments were taken into account for the reviewed year
- Determine effect of such hypothetical increase on tax attributes
- Calculate hypothetical increase in tax liability under chapter 1 for years between reviewed year and adjustment year due to changes in tax attributes
- The sum of such increase is a liability for the year in which the statement was furnished

Alternative Regime: Passing the liability on to the partners

BBA Section 6226: Mechanics of reporting adjustment

- The Tax Technical Corrections Act clarifies that the calculations required by Section 6226 take into account both “increases” and “decreases” of the hypothetical tax liability.
- The Regulations take the position that only “increases” in tax liability are considered in the calculation.

- Penalties are determined at the partnership level and the partners of the reviewed year are liable for such penalties. The Regulations provide that such penalties are generally shared in the same proportion as the underlying adjustments to tax.

Alternative Regime: Passing the liability on to the partners

BBA Section 6226: Uncertainties

- The statute is not clear on how this election works in the context of a tiered partnership
- Will the upper tier partnership have the same 45 day period to make an election to pass the liability onto its partners, and so on up the chain?
- The Technical Corrections Act provides procedures for a partnership to further push out adjustments to higher-tier partners.
- Treasury takes the position that higher-tier push-outs should not be permitted.
- The Regulations reserve on the issue.

Alternative Regime: Passing the liability on to the partners

Factors to consider in whether to elect the alternative regime

- Size of the adjustment
- Cash flow available to pay the adjustment
- Ability to recoup cost of adjustment paid by partnership from future cash flow
- Time and expense of preparing adjusted K-1's for reviewed year partners
- Extent of turnover among partners between current year and reviewed year
- Cost of additional 2% interest

DRAFTING FOR THE NEW AUDIT RULES

**New IRS Partnership Audit Rules for Tax Counsel:
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Drafting for the new audit rules

Electing out of the new rules

For any year in which the Partnership is eligible to make the election in Section 6221(b), as amended by the BBA, to have Subchapter C of Chapter 63 of the Code not apply to the Partnership, the General Partner shall cause the Partnership to timely make such election.

Drafting for the new audit rules

Appointing the partnership representative

The Partners hereby appoint the General Partner [alternately, “the Tax Matters Partner”] as the “partnership representative” of the Partnership pursuant to Section 6223(a) of the Code as amended by the Bipartisan Budget Act of 2015 (the “BBA”).

The Partnership Representative shall have no personal liability arising out of his, her or its good faith performance of his, her or its duties as the Partnership Representative hereunder.

Drafting for the new audit rules

Ensuring that obligations survive

The obligations of each Partner or former Partner under this Section shall survive the transfer or redemption by such Partner of its Partnership Interest and the termination of this Agreement or the dissolution of the Partnership.

Drafting for the new audit rules

The Alternative Regime as the “default”

For tax years beginning after December 31, 2017, if the Partnership receives a notice of final partnership adjustment, and if the cost to the Partnership of satisfying such partnership adjustment exceeds \$[___], then, no later than 45 days after the receipt of such notice, the Partnership Representative shall (i) elect the application of Code Section 6226, as amended by the BBA, to such adjustment, and (ii) furnish each Partner with the statement required by Code Section 6226(a), as amended by the BBA.

Drafting for the new audit rules

Authority of Partnership Representative – Maximalist

The Partnership Representative, in its sole discretion, shall have the right to make on behalf of the Partnership any and all elections and take any and all actions that are available to be made or taken by the Partnership Representative or the Partnership under the BBA (including an election under Section 6226 of the Code as amended by the BBA), and the Partners shall take such actions requested by the Partnership Representative consistent with any such elections made and actions requested by the Partnership Representative, including filing amended tax returns and paying any tax due in accordance with Section 6225(c)(2) of the Code as amended by the BBA.

Drafting for the new audit rules

Authority of Partnership Representative – More Limited

The Partnership Representative shall promptly notify the Partners upon the receipt of a notice of final partnership adjustment, and shall take such actions as directed by a majority of the Partners in writing within 15 days after the receipt of such notice, including whether to file a petition in Tax Court, cause the Partnership to pay the amount of any such adjustment to the IRS, or make the election under Section 6226 as amended by the BBA.

Drafting for the new audit rules

Partner Notice and Participation

The Partnership Representative shall give the Partners prompt notice of any inquiry or other communication received from the IRS or other applicable tax authority regarding the tax treatment of the Partnership or the Partners, and shall, to the extent possible, give the Partners prior notice of and a reasonable opportunity to review and comment upon any written communication the Partnership Representative intends to make to any such taxing authority in connection with any examination, audit or other inquiry involving the Partnership.

Drafting for the new audit rules

Partnership pays the adjustment

To the extent that the Partnership Representative does not make the election under Code Section 6226 as amended by the BBA with respect to a material imputed underpayment amount (determined in the Partnership Representative's sole discretion), the Partnership Representative shall use commercially reasonable efforts to (i) make any modifications available under Code Section 6225(c)(3), (4) and (5), as amended by the BBA, and (ii) if requested by a Partner, provide to such Partner information allowing such Partner to file an amended federal income tax return, as described in Code §6225(c)(2) as amended by the BBA, to the extent that such amended return and payment of any related federal income taxes would reduce any taxes payable by the Partnership with respect to the imputed underpayment amount (after taking into account any modifications described in clause (i)).

Drafting for the new audit rules

Partners reimburse partnership for adjustment

If the Partnership pays any imputed adjustment amount under Code Section 6225 as amended by the BBA, the General Partner shall seek payment from the Partners (including any former Partner) to whom such liability relates, and each such Partner hereby agrees to pay such amount to the Partnership, and such amount shall not be treated as a Capital Contribution.

Any amount not paid under the preceding paragraph by a Partner (or former Partner) at the time requested by the General Partner shall accrue interest at the Prime Rate until paid, and such Partner (or former Partner) shall also be liable to the Partnership for any damages resulting from a delay in making such payment beyond the date such payment is requested by the General Partner.

Without reduction in a Partner's (or former Partner's) obligation under the preceding paragraphs, any imputed adjustment amount paid by the Partnership that is attributable to a Partner (or former Partner), and that is not paid by such Partner shall be treated as a distribution to such Partner (or former Partner).

Drafting for the new audit rules

Indemnity from former partners

To the extent that a portion of the tax liabilities imposed under Code Section 6225 as amended by the BBA relates to a former Partner, the General Partner may require a former Partner to indemnify the Partnership for its allocable portion of such tax. Each Limited Partner acknowledges that, notwithstanding the transfer of all or any portion of its interest in the Partnership, it may remain liable for tax liabilities with respect to its allocable share of income and gain of the Partnership for the Partnership's taxable years (or portions thereof) prior to such transfer or redemption.

Drafting for the new audit rules

Flexibility!

Notwithstanding any other provision of this Agreement, the General Partner shall be authorized to amend the provisions of this Agreement to address the final audit procedures in effect pursuant to Sections 6221 through 6235 of the Code and the Regulations promulgated thereunder for such tax years.

Thank You

Heath Martin

Davies Ward Phillips & Vineberg

hmartin@dwpv.com

Jonathan Stein

Goulston & Storrs

jstein@goulstonstorrs.com

Q&A

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Thanks.

Please join us for our next conference, “Structuring Foreign Investment in U.S. Real Estate: Entity Selection and Transaction Structures,” scheduled on Thursday, February 23, 2017 starting at 1pm EST.

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