Update – Partnership Tax, State Tax and Other Important Updates

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Overview

- Summary of New Partnership Audit Rules
- Tax Update on Multiple Topics
- Discussion of TN Tax Planning

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Bipartisan Budget Act of 2015 – “BBA”

- Congress repealed and replaced the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) and electing large partnership (ELP) rules with a new regime for partnership adjustments and audits that is focused on partnership-level assessments and collections.
- Game changer that is going to force most partnerships to amend partnership agreements to take into account the potential partnership entity level assessments.

Highlights of BBA

New Partnership Audit Rules

- Changes the way tax is assessed and collected for partnerships
  - Computation of partnership tax deficiencies
  - Potentially who pays the tax resulting from partnership audits
- Two major exceptions to the new default rule
  - Election: Eligible Small Partnerships
  - Election: Partnership “Pushes” Underpayment to Partners
- Partners have severely reduced ability to participate and be informed by the IRS of partnership audits
  - Partnership Representative

Purpose of BBA – Replace TEFRA

- TEFRA – Key elements:
  - Audit process determined at partnership level (instead of multiple audits at individual partner level);
  - IRS interacts with "tax matters partner" (who must be a partner);
  - Resulting deficiencies flow through to partners;
  - Collection efforts at partner level, which proved administratively burdensome with large partnerships with tens of thousands of partners, especially where IRS attempted to collect very small amounts from thousands of partners (cost outweighed collections).

- IRS did not have the resources or capability to audit large partnerships and multi-tiered partnerships due to complexity of allocating adjustments to ultimate partners and assessing tax.

- Result was that IRS audited less than 1% of large partnerships and collected very little tax from these audits.

BBA – Key Benefits

- Benefits of BBA over TEFRA:
  - Easier for IRS to audit partnerships <u>and collect</u> tax;
  - No right to notice/participation in audits by individual partners;
  - Statutory default is to collect tax at partnership level; thus, burden of passing adjustment through to the partners shifts from the IRS to the partnership.
- Congress estimates partnership audits under the new rules will generate approximately $10 billion in tax revenue.

Effective Date of New Partnership Audit Procedures

- Effective for partnership tax years beginning after December 31, 2017

- Partnerships may elect to have the rules apply earlier (for tax years beginning after November 2, 2015).
  - Query whether partnerships should elect in early?

- The delayed effective date does not mean that partnership tax advisors can take a siesta until the end of 2017. The changes have profound implications for partnership agreements drafted today and afterward – and also for partnership agreements drafted yesterday and before.

Key Definitions

- **"<u>Reviewed Year</u>" – Partnership tax year or return under audit**
- **"<u>Adjustment Year</u>" – Generally the year in which the adjustment for the "reviewed year" becomes final (i.e., under court decision or notice of final partnership adjustment)**
- **"<u>Imputed Underpayment Amount</u>" – <u>Net</u> non-favorable adjustments to the partnership tax year multiplied by the applicable tax rate(s)**
- **"<u>Partnership Representative</u>" – Party selected to represent the partnership before the IRS and to make tax decisions on behalf of the partnership**

Highlights of New Partnership Audit Procedures

- Audits (and any litigation) conducted at the partnership level.
- Default rule is that partnership is assessed tax liability on the "Imputed Underpayment Amount"
  - Partnership is generally assessed tax at the highest rate under Sec. 1 or Sec. 11 (i.e., 39.6%), unless it can demonstrate that the tax should be lower (corporate partners or individual partners subject to lower capital gains or dividend rate)
  - "Imputed Underpayment Amount" is reduced to the extent partners "for the reviewed year" file amended returns and pay the tax
  - Partnership can elect to file adjusted partner statements (quasi amended K-1s) for each partner for the "reviewed year"
  - Special rule for reallocation of distributive share
  - Negative adjustments reduce income in adjustment year

Example

- A, B and C are equal partners. In 2018, partnership reports $30 of income. In 2020, partnership reports $90 of income. IRS audits partnership and determines income in 2018 should have been $0.
- Under current law, the partners can file for refunds of $10 each.
- Under BBA, the partnership would reduce its 2020 income from $90 to $60, and each partner should be allocated only $20 of 2020 income (instead of $30). Thus, partners over-report income in 2018 and under-report income in 2020 (rough justice).
- What if character is different?
- What happens to outside basis? Presumably it increases by $30 allocation in 2018, and then only increases by $60 (not $90) in 2020.

Partnership Representative

- **Each partnership must designate a "Partnership Representative" (PR) who has the *sole authority* to act on behalf of the partnership**
- **PR must be a "person" with a substantial U.S. presence**
  - **Under 7701(a)(1), the term "person" includes, an individual, trust, estate, partnership, association, company, or corporation**
  - **Guidance is needed as to who can act on behalf of an entity that is designated as the PR**
  - **Substantial U.S. presence is not defined. But See Treas. Reg. § 301.7701(b)-1 for guidance on "substantial U.S. presence"**
  - **PR is *not* required to be a partner in the partnership (i.e., now the CFO can serve in this role, but cannot sign tax return if not a partner)**
- **IRS will appoint a PR if the partnership does not designate one. Regulations weight a set of factors to determine who should be the PR.**
- **Identify the PR in the annual tax return and the election is only good for that year.**

Partnership Representative

- Reg provide rules on who it would name as the partnership representative.
  - view of the partners having a majority interest in the partnership regarding the designation
  - general knowledge of the person in tax matters and the administrative operation of the partnership
  - The person's access to the books and records of the partnership
  - Whether the person is a United States Person (under 7701(a)(30))
- If a PR resigns, he may be able to appoint a successor PR to represent the partnership. Partnership may also be able to appoint a successor PR.
- Partnership can also revoke a designation once the partnership has received a notice of administrative proceeding.

Example

- IRS asserts imputed underpayment against Partnership in the amount of $1,000. PR decides not to notify the Partners of the IRS audit, and PR (on behalf of Partnership) chooses to accept the underpayment and not seek administrative or judicial review (without informing any of its partners).

  PR further elects to push out the tax on the partners. Partner A has a 10% share and receives an adjusted K-1 showing $100 of additional income, the tax on which is $39.60. If Partner A disagrees with the imputed underpayment, what can Partner A do?

- Partner A has no right to challenge the initial audit and assessment. Partner A must pay the tax or face IRS collections.

Partnership Level Determination

- All partners are bound by a final resolution in the partnership proceeding
- Unlike under TEFRA, partners do not have the right to participate in the proceeding or receive notice of the proceedings from the IRS
- Penalties determined at the partnership level; no partner level defenses to penalties
- Only partnership-level statute of limitations relevant – a partner's statute of limitations is no longer taken into account, unless the partnership elects out of the new rules

Partnership Tax Assessment – "Imputed Underpayment Amount"

- Computation of Imputed Underpayment Amount
  - All adjustments to income, gain, deduction, and loss are <u>netted</u> and multiplied by the highest rate in Code Section 1 (39.6%) or Code Section 11 (35%) (which currently would be 39.6%) [Note: The highest rate aspect will encourage "push out" elections]
  - Any increase or decrease in loss is treated as a decrease or increase in income
  - After the Imputed Underpayment Amount is calculated, changes in credits are taken into account as a increase or decrease in the Imputed Underpayment Amount, as appropriate under the circumstances
  - Tax assessment is made for the Adjustment Year; not the Reviewed Year.

Partnership Tax Assessment – “Imputed Underpayment Amount”

- Computation of Imputed Underpayment Amount to Reduce **Rate**
  - Partnership can submit evidence to reduce the imputed underpayment by the portion that would be allocable to tax exempt entities. .
  - Partnership can submit evidence to modify the “Applicable Highest Tax Rate” as follows:
    - Partner receiving allocation is a corporation subject to 35% maximum tax rate
    - Partner receiving allocation of capital gains and dividends is an individual subject to reduced tax rates
    - Partner is a partner in an MLP and has suspended passive activity losses related to the MLP (see 469(k))
    - Applicable rate is always the highest rate with respect to the income
    - Secretary is authorized to issue regulations or other guidance for additional modifications to the Imputed Underpayment Amount

Example

- Partnership has 3 equal partners – A, B and C. A is itself a partnership with 2 equal partners, both are tax exempt entities. B is a corporation taxed at 35%. C is an individual. An audit results in a $90 increase in Partnership's long term capital gain for the audit year.
- If Partnership pays the tax due under the default rule, the tax is $35.64 ($90 x 39.6%).
- Partnership can submit evidence to reduce the imputed underpayment as follows:
  - B's share = $30 x 35% = $10.50
  - C's share = $30 x 20% = $6
  - A's share = $0?
- If successful, the tax burden has been reduced to $16.50. [query how the resulting tax burden is now allocated among the partners]

Example

- In 2018, A and B own Partnership 50/50, and Partnership reports $1M deduction (allocated 50/50). In 2019, A sells her interest to C for a gain. C succeeds to A's capital account. In 2020, IRS disallows the 2018 deduction, resulting in 2020 underpayment of $396,000 ($1M x 39.6%). Partnership is liable for the underpayment, which, with interest and penalties, comes out to $500,000. B and C indirectly bear this burden. What are the basis and capital account adjustments?

  Texas Tax Section comments recommend:

  - Allocate $1M 2020 income to B and C 50/50. This increases outside basis and capital accounts by $500,000 each.
  - Allocate $500k payment (nondeductible) to B and C 50/50. This decreases outside basis and capital accounts by $250,000 each.

Partnership Tax Assessment – "Imputed Underpayment Amount"

- Imputed Underpayment Amount – Partner Amended Tax Returns to **<u>reduce the amount payable</u>**
  - Partners who were partners during the "Reviewed Year" file amended returns taking into account their distributive share of partnership adjustments and pay the applicable tax (notwithstanding statute of limitations issues with respect to the partner's return)
  - Partnership is permitted to reduce the Imputed Underpayment Amount by the applicable tax attributable to the partners who filed amended returns
  - Reduction in Imputed Underpayment Amount is based on the partners' distributive share of partnership adjustments

Partnership Tax Assessment – "Imputed Underpayment Amount"

- Imputed Underpayment Amount – Time for Submission of Documents and Evidence

    - Partnership has 270 days from the date when the Notice of Proposed Adjustment is mailed to the partnership (pursuant to Code Section 6231) to file any documents or evidence to have the Imputed Underpayment reduced

    - IRS must approve any modification of the Imputed Underpayment Amount

    - Documents must be drafted in a manner to comply with this timeline

Partnership Audit – No Imputed Underpayment Amount

- No Imputed Underpayment – Taxpayer Favorable Adjustment
  - Under 6225(a)(2), the partnership takes into account the taxpayer favorable adjustment as a decrease in non-separately stated income, or an increase in non-separately stated loss. If the item is a credit, it is taken into account by the partnership as a separately stated item.
  - The adjustment is taken into account in the “adjustment year” as an adjustment to partnership income or loss and then flows through to the partners. Returns are not amended because the partnership is taking the item into account in the “adjustment year.”
  - Thus, current year partners benefit from an adjustment made for a prior tax year. Partners for the reviewed year cannot file amended returns to get the benefit from the audit adjustment.

Example

- Partnership AB reports $0 income in year 1 and $20,000 of income in year 2. A year 4 audit shows $10,000 should have been reported in each of years 1 and 2. Thus, there is an imputed underpayment in year 1 of $3,960. The partnership pays this amount, plus interest, at the end of year 4. What happens to the year 2 amount?
- Year 2 now has a $10,000 overpayment (because $10,000 was reallocated to year 1 in the audit). This is reported as a taxable loss in year 4, and A and B each get a year 4 K-1 showing a $5,000 loss.
  - If A also has $5,000 of income in year 4, A can offset this income with the $5,000 loss.
  - If B has no income in year 4, B must carry the loss forward and hope to be able to use it.
  - Note that A and B get no interest benefit on the loss moved from year 2 to year 4.

Opt-Out Provisions for Small Partnerships

Alternatives to Partnership-Level Assessment: Election Out for Small Partnerships

- Opt-Out for "Small" Partnerships
  - Partnerships with 100 partners or less can opt out of the entity-level partnership determination
  - Year by year election
  - The election must include a disclosure of the name and TIN of the each partner
  - Technically, it is 100 or less K-1s, so may be less than 100 partners
    - Partners must be individuals, C corporations (including any foreign entity that would be treated as a C corporation if domestic), S Corporations or estates of deceased partners (no upper-tier partnerships)
    - S corporation shareholders must be counted for purposes of the 100 partner test and disclosed to the IRS
  - What about partnerships, single member LLCs and grantor trusts? New regulations do not allow them.

Alternatives to Partnership-Level Assessment: Election Out for Small Partnerships

- Opt-Out for "Small" Partnerships
  - The partnership must notify each partner of the election out within 30 days of making the election.
  - If election is made, IRS must make determinations at the partner level (similar to the TEFRA small partnership rules)
  - <u>Election must be made on a timely filed return (including extensions) per the new regulations</u>
- Should partnerships eligible to elect out do so? If they do, the partnership audit is back to "prehistoric era" where if you have 99 partners you can have 99 separate audits and 99 different results.
- General consensus among practitioners so far seems to be to recommend electing out if possible.
  - For this reason, IRS public comments have expressed reluctance to expand election out.

Example

- Fund has 99 partners, 98 of whom are individuals and one of which is a single member LLC (a disregarded entity) owned by an individual. Can Fund elect out? Bluebook indicates that Fund should look through to the owner, so election out should be available.

- Same, but now Fund has 97 individual partners and 2 DRE partners owned by corporation. Are there 101 partners here? Bluebook says count both DRE and owner, so 101. Fund has 98 partners, 97 of whom are individuals and one of which is a general partnership consisting of two individuals. Due to the general partnership partner, Fund is ineligible to elect out (unless IRS issues regulations saying otherwise).

- Total number of K-1s throughout the chain is 100 or less.

- Only 2 tiers of partnerships allowed. Why limit to 2 tiers?

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Alternatives to Partnership-Level Assessment: “Push Out” Election

Alternatives to Partnership-Level Assessment: "Push Out" Election

- Partnership Election to Issue Adjusted Partner Statements under Section 6226 ("Push Out" election)
  - Any partnership may elect to issue adjusted "statements" (essentially amended K-1s) to the partners who were partners during the reviewed year
  - Election must be made within 45 days of receiving the notice of final partnership adjustment
  - Partnership must then furnish statements to each partner for the reviewed year and to the IRS within 60 days according to new IRS regs
  - The partners receiving the statements are subject to tax in the year of the statement, but the tax due equals the amount of tax that would have been owed in the reviewed year and intervening years to the extent of a tax increase due to the adjustment to tax attributes
  - Tax attributes in the adjustment year are also adjusted

Alternatives to Partnership-Level Assessment: Amended Statements

- Partnership Election to Issue Amended "Statements"
  - Reviewed year partners are liable for interest and penalties
  - Interest is charged at higher rate (2 percentage points higher than rate in Section 6621(c) (interest charged from due date of partnership return for the reviewed year)
  - Reviewed year partners have no right to an administrative or judicial review
    - Not required by statute to consent to issuance of statements
    - Bound by partnership-level determination
  - No joint and several liability
- Will the "push out" election become the de facto default rule?
- What result if partner receiving adjusted K-1 fails to pay the tax? Must the partnership now pay?

Example

- In 2018, A and B own Partnership 50/50. B is itself a 50/50 partnership between D and E. Partnership reports $1M deduction (allocated 50/50 to A and B). In 2020, IRS disallows the 2018 deduction, resulting in 2020 underpayment of $396,000 ($1M x 39.6%). Partnership is liable for the underpayment, which, with interest and penalties, comes out to $500,000, but chooses to make the push out election to A and B. What is the consequence to B? Possibilities:
  - B, as a flow through entity, is ineligible to make a subsequent push out election and so must pay the tax ($198,000 @ 39.6%).
  - [Note: As a further alternative B, as a flow through entity, is not a taxpayer and so even if not eligible to make a push out election, may be permitted (or required) to pass through the $500,000 item to D and E on regular K-1s.]

Example

- Partnership has 3 equal partners – A, B and C. A is itself a partnership with 2 equal partners, both are tax exempt entities.

  B is a corporation taxed at 35%. C is an individual. An audit results in a $90 increase in Partnership's long term capital gain for the audit year. Partnership makes the push out election and provides A, B and C each with an adjusted statement showing a $30 increase in long term capital gain. Results:

  - B pays tax of $10.50;
  - C pays tax of $6.00;
  - Does A pay tax of $11.88 ($30 x 39.6%)? Or can A make its own push out election and send statements to its two tax exempt partners, who pay $0 tax? Bluebook implies that A must pay the tax here. If so, can A follow the procedures in 6225(c) to reduce the tax to $0 based on having tax exempt partners? (No provision)

Statute of Limitations

- The statute of limitations runs at the partnership level, not the partner level
- Secretary may adjust an item on a partnership return at any time within:
- 3 years after the later of:
  - Date partnership return was filed
  - The partnership return due date; or
  - The date on which the partnership filed an administrative adjustment request

Partnership Ceases to Exist

- 6247(7): "If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary."
- What does "ceases to exist" mean? Which "former partners" must pay the tax? Those immediately prior to ceasing to exist, or those from the reviewed year?
- Can a partnership facing a significant imputed underpayment intentionally remain in existence until after the adjustment takes effect – e.g., by operating an ice cream cart – in order for the entity to have primary liability for the tax that it can never pay? It seems that a partnership with no assets would prefer the default 6225 treatment.
  - Bluebook indicates that partnership lacking significant activity, income or assets is deemed to cease to exist.
- Application to partnership that becomes a DRE? Who is liable? Can IRS still pursue the entity?

Partnership Ceases to Exist

- If the entity is unable to pay the tax the following liabilities arise with respect to the deficiency

Entity	Liability	Comment
General Partnership	Each partner 100% liable	Joint and several liability
Limited Partnership	General partner 100% liable	Joint and several liability for general partner, limited liability for limited partner
Limited Liability Company	No member liable	Limited liability for members

New Proposed Regulations Issued June 13, 2017

New Proposed Regs

- Substantially similar to the 2016 Proposed Regs which were issued and intended to be published in January, but President Trump's freeze stopped the publishing of the Regs.
- Regs propose to cover all items and information related to or derived from the partnership. Tax, penalties and additions to tax would all be determined at the partnership level.
- Require a qualified partnership representative to be appointed, and if not, the IRS will choose a partnership representative for the partnership.
- Require that the partner's treatment of each item attributable to the partnerhsip would have to be consistent with the treatment of those items on the partnership return.

New Proposed Regs

- The June Proposed Regulations are nearly identical to the January Proposed Regulations. The only significant difference is with respect to push-out in the context of tiered partnerships. The January Proposed Regulations reserved on the issue of whether a push-out election could be made through a tiered partnership structure. The Proposed Regulations still reserve on the issue but state that this will be the topic of other proposed regulations "to be published in the near future."
- The Preamble to the Proposed Regulations states that the IRS is seeking comments on the information tracking and other information from a partnership (at the bottom of a tiered structure) under examination that the IRS would need for the IRS to monitor whether push-out adjustments properly flowed through the tiers.
- The ability to push an adjustment through the tiers of a partnership is an important one to many taxpayers and will likely be highlighted by most commenters to the Proposed Regulations.

Tax Updates

Virtual Appeals Conferences?

- IRS has announced that starting on August 1, 2017, it will start a pilot program under which the Office of Appeals will offer taxpayers and their representatives a web-based virtual Appeals Conference option.
- Current options are in-person, over the phone, or on videoconference technology available at a limited number of IRS offices.
- This will allow Appeals Officers to conduct the conference using a secure, web-based screen-sharing platform to connect with taxpayers anywhere they have internet access.
- New Release 2017-122

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Social Security Wage Base Increase?

- **IRS has announced that the SSA Office of Chief Actuary has project, under all three of its methods of forecasting, that the Social Security wage base will increase from $127,200 to $130,500 for 2018.**
- **Initial forecasts are as follows:**
- **2018 - $130,500**
- **2019 - $135,600**
- **2020 - $142,200**
- **2021 - $148,500**
- **2022 - $155,100**
- **2023 - $161,700**
- **2024 - $168,000**
- **2025 - $174,300**
- **2026 - $180,900**
- **Also – forecasted that the Social Security Trust fund will be insolvent in 2034 and the Disability Insurance trust fund will become involved in 2023.**

IRS and PTIN Fees

- Steele v. U.S. (DC July 10, 2017)
- Distribution court permanently enjoyed the IRS from charging fees for PTINs and orders IRS to make a full refund of all PTIN fees from September 1, 2010 through the present.
- If you want to pursue your refund, you can go to www.ptinclassaction.com

Private Letter Rulings Now Require Online Payments

IRS is now requiring that user fee payments for letter rulings, closing agreements and certain other rulings will have to pay their fees online starting August 15, 2017.

1.The address for online payment is pay.gov

2.Pay.gov accepts credit card, debit card, direct debit or electronic funds withdrawal from a checking or savings account.

3.Covered rulings:

- **Letter rulings**
- **Closing agreements**
- **Rulings using Form 1128 (Change a tax year), 2553 (S election), 3115 (change in accounting method) and 8716 (election for different tax year).**
- **Determination letters are not affected.**

- **Once payment is made, print a copy of the completed form and the receipt and include these with the letter ruling request. Submit the complete package by mail or hand delivery to**

Mailed	Hand Delivery
Internal Revenue Service CC:PA:LPD:DRU P.O. Box 7604 Ben Franklin Station Washington, DC 20044	Internal Revenue Service CC:PA:LPD:DRU 1111 Constitution Avenue, NW Room 5336 Washington, DC 20224
And Efax to 877-773-4950	

Simplified Method for Portability Election

- Since portability was enacted, an estate had to file a Form 706 (Estate Tax Return) in order to claim portability of estate tax exemption for the surviving spouse.
- IRS had received multiple letter rulings requesting extension of deadline to file a portability election for those estate that did not have an obligation to file the Form 706 upon the first spouse's death.
- Rev. Proc. 2017-34
  - Allows estates for those that died after December 31, 2010, to file for a DSUE if filed on the later of January 2, 2018 or 2 years from the date of death of the decedent.
  - Executor can not have already filed a Form 706
  - Must write at the top of the Form 706 "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER 2010(c)(5)(A)"
- Great planning tool for old estates that need to file a DSUE election.

Closing Letters on Estate

- IRS doesn't automatically issue closing letters, right?
- Currently, the IRS will only issue an estate tax closing letter at the request of an estate, which must be done no sooner than 4 months after the filing of the estate tax return.
- There is an option to confirm status of close by checking for status on an Account Transcript.
- An account transcript that includes transaction code "421" and the explanation "Closed examination of tax return" indicates that the IRS's examination of the estate tax return has been completed and that the IRS examination is closed.
- Must file this via hardcopy request (mail or fax), cannot do it electronically.
- You can still call the IRS to obtain an Estate Tax Closing Letter
- Telephone number is 1-866-699-4083

Supercharging A Roth IRA

- **Summa Holdings, Inc. v. Commissioner (6th Circuit Court of Appeals)**
- **Two business owners established Roth IRAs, and the Roth IRAs then acquired a corporation which was the parent company of an Interest Charged Domestic International Sales Corporation (IC-Disc).**
- **Business owners/Roth IRAs had to pay the unrelated business income tax of 33% when the DISC dividends went into the IRA.**
- **From 2002 to 2008, the owners transferred over $5 million to the Roth IRA. After paying its taxes, each Roth IRA had accumulated over $3 million by 2008. WHOA!**
- **IRS attacked using it's "substance over form" doctrine.**
- **6th Circuit provided a stinging rebuke:**
- - "Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax avoidance—the Commissioner had no basis for recharacterizing the transactions and no basis for recharacterizing the law's application to them."
- **This is a great tool in the appropriate situation**
- **Look out for other opportunities to use a Roth IRA.**

LLC and F&E Tax Exemptions

- **How many people make an "obligated member entity election" for LLCs to be used to avoid F&E taxes?**
- **How many people then use an Irrevocable Trust to avoid liability?**
- **Is this allowed under Tennessee law?**
- **What if you change and made the LLC taxed as an S corporation? Does the future reduction in the Hall Income Tax make this a more enviable entity for tax purposes?**

- **In 2017, Hall Income Tax is 4%, 3% in 2018, 2% in 2019 and 1% in 2020, with a full repeal in 2021.**
- **With no Hall Income Tax and no F&E Tax, does an LLC taxed as an S corporation make more sense in Tennessee?**

Questions?

Presentation available at www.emlaw.com/bcspresentation.pdf

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