NEW PARTNERSHIP AUDIT RULES AND REPEAL OF TEFRA

T. Joshua Wu, J.D., LL.M.
JW | Law PLLC
www.jwlawdc.com
TOPICS

- Current Partnership Audit Rules (TEFRA)
- Reasons for Repeal of TEFRA
- Changes in the Bipartisan Budget Act (BBA)
- BBA Key Terms and Collection Methods
- Proposed BBA Regulations
- Early Election into the BBA
- Impact of the BBA on Partnerships
Poll Question #1

- Have you discussed the changes to the IRS partnership audit rules with your clients?
EXAMPLE

Walter and Jesse form a partnership that will own and operate a chain of chicken restaurants called “Los Pollos Hermanos” (LPH). Walter will handle the day-to-day affairs of the partnership whereas Jesse will spend his time advertising and marketing the restaurant. Both will serve as general partners, though they are looking for outside investors to join as limited partners. We will be advising LPH on both the TEFRA audit rules and the new BBA audit rules.
CURRENT PARTNERSHIP AUDIT RULES (TEFRA)

- The importance of partnerships
  - Between 2002 and 2011, the number of partnerships increased 47% while C corporations decreased by 22%.

- Original reasons for implementing TEFRA
  - Increased partnership audit efficiency
  - Difficulty obtaining statute of limitations waivers
  - Difficulty obtaining partnership/partner information

- Most partnerships subject to TEFRA (except small partnerships and Electing Large Partnerships)

- Partnership level proceedings versus partner level proceedings
CURRENT PARTNERSHIP AUDIT RULES (TEFRA)

• The Tax Matters Partner
  • Designated by the partnership or, if no such designation is made, by regulation.
  • Serves as primary interface with the IRS.

• Notice Partner
  • If 100 or fewer partners, every direct partner is a notice partner.
  • If 100 or more partners, only partners with greater than 1% profits interest are notice partners.

• Partnership Item
• Affected Item
Poll Question #2

- Walter and Jesse receive a great deal of interest in LPH and bring on 25 limited partners, thereby taking them out of the small partnership exception. Who should be designated as the tax matters partner?
CURRENT PARTNERSHIP AUDIT RULES (TEFRA) – STATUTE OF LIMITATIONS

• Three years after the later of the filing of, or the filing deadline for, the partnership return. I.R.C. § 6229(a).

• Code Section 6229 is an extension of the Section 6501 general limitations period, not a stand-alone period.
  • See e.g., Rhone-Poulenc Surfactants & Specialties, LP v. Comm’r, 114 T.C. 533, 542-43 (2000).

• TMP may extend on behalf of partnership
Current Partnership Audit Rules (TEFRA) – Audit Process

Figure 3: Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Audit Process

1. IRS identifies and notifies Tax Matters Partner (TMP) and partners with notification rights

2. IRS begins field audit of books and records of large partnership

3. IRS completes audit work and determines audit adjustment, if any, and shares determination with TMP and partners with notification rights

4. IRS passes through any audit adjustment to taxable partners’ returns (campus audits)

Source: GAO analysis of IRS documentation. | GAO-14-732
ISSUES WITH TEFRA – AUDIT RATES

• In 2012, IRS closed 84 partnership field audits – or a 0.8% audit rate, which was well below that of C corporations at 27.1%.

Table 4: Audit 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>Audit Rate</td>
<td>0.5%</td>
<td>0.6</td>
<td>0.6</td>
<td>1.4</td>
<td>0.7</td>
<td>0.8</td>
<td>N/A</td>
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<tr>
<td>Large Corporations</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Audit Rate</td>
<td>20.6</td>
<td>21.4</td>
<td>20.8</td>
<td>20.6</td>
<td>23.1</td>
<td>27.1</td>
<td>27.4</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

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.
ISSUES WITH TEFRA – AUDIT ADJUSTMENTS

• Most large partnership audits did not result in tax adjustments, whereas comparable C corporation audits resulted in much higher tax adjustment rates.

<table>
<thead>
<tr>
<th>Table 5: No Change Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Year</td>
</tr>
<tr>
<td>Large Partnerships</td>
</tr>
<tr>
<td>No Change Rate</td>
</tr>
<tr>
<td>Large Corporations</td>
</tr>
<tr>
<td>No Change Rate</td>
</tr>
</tbody>
</table>

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

Note: For partnerships, the no change rate means that the audits made no changes to the partnership’s reported income, loss, deductions, or credits reflected on the tax return or 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 no change rate for corporations means that the audits made no changes in the tax liability reported on the corporate tax return (e.g., tax, penalties, or refundable credits).
ISSUES WITH TEFRA – EXAMPLE OF PARTNERSHIP STRUCTURE

Figure 7: Example of Partnership Structure

Source: GAO analysis of IRS documentation I GAO-14-732
Changes to Partnership Audit Rules

• Bipartisan Budget Act of 2015 (BBA) replaced TEFRA

• New Partnership Representative (PR)
  • Each partnership must designate a PR. If no designation is made, the IRS may select one.
  • Additional authority to represent partnership in tax matters (section 6223)
  • Authority to bind partnership
    • Partners lack participation and notice rights
  • Not required to be a partner
BBA Key Terms

- **Reviewed year (section 6225(d)(1))**
  - The partnership tax year to which the item being adjusted relates

- **Adjustment year (section 6225(d)(2))**
  - The partnership tax year in which (1) the adjustment is determined in court, (2) the administrative adjustment request is made, or (3) the notice of final partnership adjustment is issued.

- **Statute of limitations (section 6235)**
  - Later of 3 years after the partnership return is filed, the return due date, or the date the partnership filed an AAR.

- **Imputed underpayment**
  - Determined by netting all adjustments of income, gain, loss, or deduction and multiplying such net amount by the highest rate of tax in effect for the reviewed year.
EXAMPLE

- It’s 2020, and it’s been a rough couple of years for LPH. Given a new diet craze that calls for no chicken, people have stopped eating at LPH. In 2019, 15 limited partners sold their interest to a new partner, Gus Fring, who has made Walter’s life miserable. To make matters worse, Walter (who has been named PR) receives an audit notice for LPH for the 2018 tax year.
  - Reviewed year: 2018
  - Adjustment year: 2020
Poll Question #3

- Under the BBA, the Partnership Representative has the following powers:
THE NEW BBA REGIME

• Collecting from the Partnership
  • Default rule (6225) ("imputed underpayment")
    • Tax, interest and penalties collected at partnership level
    • Partner Amended Returns (6225(c))
      • Reviewed year partners may amend returns to reflect imputed underpayment
      • Imputed underpayment may be reduced based on partnership interests held by tax-exempt partners
  • Electing Out on Timely Filed Return (6221(b))
    • Partnership required to furnish 100 or fewer K-1s may elect out of new rules
    • Partners must be individuals, C corporations, foreign entities that would be treated as C corporations, S corporations, or estates of a deceased partner.
    • Regulations should clarify treatment of tiered partnerships and disregarded entities.
THE NEW BBA REGIME

• Collecting from the Partnership (continued)
  • Revised K-1 Procedure or “Push Out” (6226)
    • Partnership may issue revised “K-1s” to the partners and IRS reflecting each reviewed year partners’ share of audit adjustments

• Partnership Request for Administrative Adjustment
  • Filed within three years from later of date that return was filed or unextended return due date
EXAMPLE

• Same facts as previous example. The IRS determines that LPH failed to report over $2 million in taxes on its Form 1065 for 2018.

• Assuming the highest marginal tax rate is the same as today, LPH will be subject to a 39.6% tax on the $2 million underpayment. This will affect the 2020 (adjustment year), not 2018 (reviewed year), partners.

• This is especially bad news for Gus Fring, who wasn’t even a partner in 2018. If Gus has a lower tax rate than 39.6% (or tax credits, NOLs, etc.), he may file an amended return, pay the allocable portion of the tax taking into account his tax rate, NOLs, etc.

• If LPH elects to “push-out”, Gus would not need to file amended returns because the reviewed year, rather than adjustment year, partners would be affected.
Proposed Regulations (REG-136118-15)

- Sent to Federal Register – January 19, 2017
- Withdrawn – January 20, 2017
- Re-issued – June 13, 2017

Purpose

- To “increase the ability of the IRS to audit large partnerships” and “increase the number of partnership audits” for both partnerships subject to the new rules and those that opt-out.

Limitations on Electing Out

- Partnerships must affirmatively elect out to “increase[] the likelihood that a partnership will be subject to the more streamlined…procedures of the centralized partnership audit regime.”
PROPOSED REGULATIONS (REG-136118-15)

- Extension of time to modify imputed underpayment
- Designation of the partnership representative
  - The IRS may designate any person as the partnership representative.
  - The IRS will consider whether the person is a partner in the partnership along with other factors listed in proposed section 301.6223-1(f)(5)(ii)
  - For IRS purposes, authority of PR may not be limited by state law or contractual agreement
- Push-Out method on adjustment-by-adjustment basis
Poll Question #4

- What concerns your clients the most about the BBA audit provisions?
BBA Impact

• Early election into new partnership audit rules
  • Temporary regulations issued on August 5, 2016 (301.9100-22T)
  • See Treasury Memo LB&I-04-0617-003

• Impact on partnership agreements
  • Agreement on control of audit process
  • Rights of partners
  • Allocation of adjustments
  • Treatment of former partners
  • Potential disincentive for new investment
Questions?

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SPEAKERS

T. Joshua Wu
(571) 294-3850
jwu@jwlawdc.com
LinkedIn
Twitter: @jwlawdc