PARTNERSHIP TAX 101: NEW IRS AUDIT RULES AND REPEAL OF TEFRA

CPA Academy

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Topics

- Current Partnership Audit Rules (TEFRA)
- Electing Large Partnership Regime
- Reasons for Repeal of TEFRA
- Changes in the Bipartisan Budget Act (BBA)
- BBA Key Terms and Collection Methods
- 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
EXAMPLE

- If Walter and Jesse limit the number of partners in LPH to fewer than 11, the partnership should qualify for the small partnership exception.

- For qualifying small partnerships that do not elect to apply the TEFRA rules, audits and judicial proceedings are conducted, and any resulting assessments are made, at the partner level under the general rules that apply to individual taxpayers.

- The small partnership exception must be made for each separate tax year being examined. The partnership should file a Form 8893 or attach an election statement to the partnership return.
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.
  • Works the with IRS during the examination of the partnership's return
  • Responds to document requests issued to the partnership
  • Executes statute extensions on behalf of partnership
  • Enters into certain settlements with the IRS
  • Provides information to the partners with respect to the audit
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) – OTHER KEY TERMS

- **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**
  - “[S]uch item is more appropriately determined at the partnership level than at the partner level.” I.R.C. § 6231(a)(3)

- **Affected Item**
  - Any item to the extent that such item is affected by a partnership item. I.R.C. § 6231(a)(5).
EXAMPLE

- If Walter is the TMP, and he challenges a proposed exam adjustment, he must notify Jesse and all 25 limited partners of the IRS Appeals conference. The other partners do not have the right to a separate Appeals conference.
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

- IRS identifies and notifies Tax Matters Partner (TMP) and partners with notification rights
- IRS begins field audit of books and records of large partnership
- IRS completes audit work and determines audit adjustment, if any, and shares determination with TMP and partners with notification rights
- IRS passes through any audit adjustment to taxable partners’ returns (campus audits)

Source: GAO analysis of IRS documentation. | GAO-14-732
ELECTING LARGE PARTNERSHIP REGIME

Electing Large Partnership Regime

- An “Electing Large Partnership” is a partnership that:
  - Had at least 100 persons who were partners in the previous partnership taxable year AND
  - Elected to be treated as an Electing Large Partnership

- ELPs are subject to simplified audit rules
  - Adjustments flow through in the year of adjustment, not the taxable year in question
  - More limited notice to non-designated partners
  - No role for individual partners in settlement negotiations, Requests for Administrative Adjustments, or judicial review of IRS adjustments
POLL QUESTION #3

- LPH became a huge success with stores in 23 states. Thousands of people sought to invest in the partnership, and Walter and Jesse chose 250 of their closest friends to join as limited partners. You advise Walter and Jesse about the ELP regime. Who must sign off for the partnership to switch from TEFRA to ELP regime?
ISSUES WITH TEFRA – WHY IT MATTERS

Figure 5: Large Partnerships, Defined to Include Direct and Indirect Partners, by Asset Size, Tax Years 2002 to 2011

Source: GAO analysis of IRS data from Enhanced Large Partnership Indicator File and Business Returns Transaction File, Compliance Data Warehouse. | 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>
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<td>Large Partnerships</td>
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<td>Audit Rate</td>
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<td>0.6</td>
<td>0.6</td>
<td>1.4</td>
<td>0.7</td>
<td>0.8</td>
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<td>Large Corporations</td>
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<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. I 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 5: No Change Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013 |
|-------------------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                                                  | Fiscal Year     |
|                                                  | 2007            | 2008            | 2009            | 2010            | 2011            | 2012            | 2013            |
| **Large Partnerships**                           |                 |                 |                 |                 |                 |                 |                 |
| No Change Rate                                  | 85.3            | 77.8            | 82.6            | 51.6            | 77.0            | 66.7            | 64.2            |
| **Large Corporations**                          |                 |                 |                 |                 |                 |                 |                 |
| No Change Rate                                  | 16.2            | 22.1            | 18.6            | 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. 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
**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.
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
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.
BBA Impact

- Early election into new partnership audit rules
  - Temporary regulations issued on August 5, 2016 (301.9100-22T)

- 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
Poll Question #4

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