

Estate Planning and New IRS Centralized Partnership Audit Rules: Impact on Trusts Holding Partnership Interests

Opt-Out Provisions and Limitations, Designating Partnership Representative, and Alternatives to Partnerships

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HOW PARTNERSHIP AUDIT RULES IMPACT FAMILY PARTNERSHIPS

IRS Reasons for Changes:

- Large increase in complex partnerships since TEFRA was enacted in 1982
- Trouble finding ultimate partner responsible for tax
- Too many resources needed to assess and collect small amounts from hundreds of partners
- Lack of a single decision maker during audit
- Too many partners participating in audit

Critical Dates

- 11/2/15 Passage of the Bipartisan Budget Act of 2015
- 6/14/17 Proposed regulations released and comment period opened
- 8/14/17 Comment period closed
- 9/18/17 IRS Public Hearing on proposed regulations
- 1/1/18 Effective date of the Centralized Partnership Audit Rules
- 3/3/18 Consolidated Appropriation Act (Appropriations Act) with technical corrections
- 3/15/19 Due Date – First full year returns subject to new Audit Rules
- Late 2019
or Early 2020 Estimated date for start of first audits conducted under new Audit Rules

Definitions

Reviewed Year – The partnership tax year that was under audit

Adjustment Year – The partnership tax year in which audit adjustments are determined

NOPPA – IRS “notice of proposed partnership adjustment” – initial adjustment notice

FPA – IRS “notice of final partnership adjustment”

Partnership Representative (“PR”) – Person or entity that has sole authority to act on behalf of the partnership under the new Partnership Audit Rules

Definitions (cont'd)

Imputed Underpayment – Under the default rule, the amount that a partnership must pay if the IRS makes an adjustment

- computed based on the highest tax rate for an individual or corporate rate for a corporation
- partnership may request to modify the imputed underpayment if a partner is tax-exempt or the rate used in calculating the imputed underpayment is based on class of income and taxpayer (e.g., capital gain rate)

General Overview

Four Options:

- Opt-Out
- Partnership Pays
- Partnership elects to “Push-Out”
- Partners elect to “Pull-In”

Opt-Out

- Annual election by Partnership
- Pre-TEFRA rules apply to audit
- Eligibility requirements
 - 100 or fewer partners – must be individuals, estates of deceased partners, C corporations, S corporations, or foreign entity that would be a C corporation
 - No more than 100 partners but each S Corp shareholder counts as a partner.
 - No partnerships, LLCs (including Disregarded LLCs) or trusts as partners
 - Partnership must notify the partners of the election

Opt-Out Election (sample language)

- 1) The Company shall not elect into application of the audit procedures under Section 1101(g)(4) of the Bipartisan Budget Act of 2015 for any tax year ended on or before December 31, 2017.
- 2) The Company shall elect out of application of those audit procedures in accordance with Section 6221(b) of the Internal Revenue Code for any tax year ended on or after January 1, 2018.

Partnership Pays

- Tax on audit adjustment is computed at the highest IRC §§ 1 or 11 rate in current year and partnership pays directly.
- Current partners bear economic burden
- “Imputed underpayment” reduced if:
 - Reviewed year partners file amended returns and pay the tax; or,
 - If the partnership can document a lower rate or tax exempt status for any or all partners

Partnership Pays (cont'd)

- Adjustments that do not result in an imputed underpayment are taken into account by the partnership on its return for the adjustment year as a change in non-separately stated income or loss or separately stated items, as applicable.
- Interest and penalties determined at the partnership level
- If partnership no longer exists, former partners are responsible for the adjustment

General Overview – Imputed Underpayment

- Computation of Imputed Underpayment amount:
 - Net all adjustments of items of income, gain, loss or deduction and multiply the net amount by the highest rate of tax in effect for the review year under IRC §§ 1 or 11.
 - Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income.
 - Any adjustments to credits are an increase or decrease in the amount of tax due.

General Overview – Push-Out

- Adjustment made to reviewed year partners
 - Not later than 45 days after the date of the FPA
 - The partnership furnishes statement to the IRS and to each reviewed-year partner of the partner's share of any adjustment to income, gain, loss, deduction or credit

Push-Out Statement

- “6226 Statement” includes:
 - Share of initially reported items;
 - Share of adjustments for reviewed year;
 - Share of adjustments for intervening years;
 - Share of penalties (no opportunity to raise penalty defenses to any penalty reflected on the 6226 statement); and
 - “Safe Harbor Amount”.

Push-Out Computation

- Taxes increased in current year based as if amended for the reviewed year through the current year.
 - Includes all adjustments, including those that would have been disregarded in determining the imputed underpayment
 - Technical Corrections permits a reviewed year partner to take tax increases and decreases into account.
 - Additional taxes are due with the return for the taxable year for which the statement is received.
- Interest on the additional tax to the partner is determined from the due date of the partner's return for the reviewed year at the IRS interest rate on underpayments plus two percent
- Must also adjust intervening year tax attributes to reflect the adjustments

Initial Problems With the Push-Out

- How do you handle tiered partnerships?
 - Technical Corrections permits adjustments to be pushed out through a tiered partnership structure.
 - See Pull-In Method
- Technical Corrections also provides the IRS rule-making authority for trusts receiving push-out statements.
- Proposed Regs issued in June 2017 contain push-out election is procedures.
- If a partnership agreement requires Push-Out, is it binding on the Partners?

Push-Out Safe Harbor

The proposed regulations provide an easier approach to the Push-Out

- Partnership will calculate the Safe Harbor Amount
- The statement that the partnership furnishes to the reviewed year partners includes this amount with the partner's share of adjustments.
- A partner may elect to pay the Safe Harbor Amount in lieu of computing the correct amount of tax based on an amended return prepared by the Partner having the actual amount of tax due for the reviewed year.
- Calculated based on imputed underpayment, but only based on the partner's share of partnership adjustments.

Push-Out Election (sample provision)

In the event of an audit of the Company, the Partnership Representative shall have the right to make any election(s) and to take any action(s) as provided under Section 1101 of the Bipartisan Budget Act of 2015, including any election under Section 6226 of the Internal Revenue Code. If an election is taken under Section 6226 of the Internal Revenue Code, each Member agrees to take his or her share of any adjustment into account as required under Section 6226(b) of the Internal Revenue Code. To the extent that any or all of an adjustment is paid by the Company, each Member agrees to immediately pay over to the Company the amount of the Member's share of the adjustment paid by the Company.

Pull-In Method

- Added by Technical Corrections
- Alternative Method for filing Amended Returns
- IRS determines Partnership Imputed Underpayment
- Imputed Underpayment is reduced by adjustments to partnership-related items that direct and indirect review year partners take into account

Pull-In Method (cont'd)

- Technical Corrections provides that for purposes of amended returns and Pull-In procedures, tax related to a reviewed year partnership item and the effect of the adjustments on tax attributes may be determined and assessed without regard to otherwise applicable statute of limitations in §§ 6501 and 6511.

Pull-In Method (cont'd)

- Provide IRS with information necessary to make calculation of tax
- Partner pays tax as would be calculated under push-out method
- All partners do not have to participate
- Partner tax information is due within 270 days after NOPPA (unless extended by IRS)
- Payment due 270 days after NOPPA is mailed

Pull-In Method (cont'd)

- Partner responsible for making payment unless IRS provides person, such as partnership or a third party, may remit payment on partner's behalf
- For administrative convenience, partner payments and partner information may be collected centrally by a third party (e.g., IRS, law firm, accounting firm or Partnership Representative)
- Applies to tiered partnerships

Amended Return Election (sample provision)

Upon the request of the Partnership Representative, each member agrees to file an amended U.S. federal income tax return for the taxable year to which an Imputed Underpayment Amount relates and to pay any tax due in accordance with Section 6225(c)(2) of the Internal Revenue Code. Each member further agrees to comply with requests by the Partnership Representative for information necessary to determine whether any Imputed Underpayment Amount may be modified under Section 6225(c) of the Internal Revenue Code, including information related to determining the portion of the Imputed Underpayment Amount allocable to (i) a tax-exempt entity, (ii) a C Corporation, or (iii) an Individual.

Partnership Representative

- Partnership must designate a partnership representative:
 - Any person (including an entity) must have a substantial presence in the U.S.
 - Designated on the return each year
 - May not be changed until the IRS issues a notice of administrative proceeding for the partnership for that year or the partnership files an Administrative Adjustment Request for the year
- The partnership representative has the sole authority to act on behalf of the partnership – can bind partnership and partners

Partnership Representative (sample provisions)

- A. For the tax years beginning on or after January 2, 2018, [Name of Appointee] shall serve as the Partnership Representative of the Company (as provided in Section 6223(a) of the Bipartisan Budget Act of 2015). The Partnership Representative may be replaced by Members holding a majority of membership interests if he or she resigns, dies or is unable to act.
- B. The Partnership Representative shall give notice to the Members concerning any audit and all significant developments in that audit; and shall make no major audit decision except with the consent of Members holding a majority of membership interests.
- C. The Company shall reimburse and indemnify the Partnership Representative for all reasonable out-of-pocket costs and expenses, as well as damages incurred by the Partnership Representative in connection with any administrative or judicial proceedings with respect to any tax liability of the Company or Members (as the case may be).

Partnership Representative (cont'd)

- If a partnership fails to designate a representative, the IRS may select any person to act as the partnership representative
 - Question: will the default be the partner with the largest interest in the partnership as under TEFRA?
- The partnership and all partners are bound by all actions taken by the partnership representative
 - Also by any final decision in a proceeding brought under the BBA with respect to the partnership
- Other partners have no statutory right to participate in any partnership proceedings

What If a Partnership Ceases to Exist?

- IRS determines that a partnership “ceases to exist” before the entire amount due has been paid:
 - There is a forced 6226 push-out to the adjustment-year partners or, if the partnership ceased to exist before adjustment year, then to the partners in last year of existence.
- IRS has “sole discretion” to determine if the partnership ceased to exist if either:
 - IRS determines that amount partnership owes is not collectible, or
 - The partnership is terminated as defined by IRC §708(b)(1)(A)

Can there be an appeal?

Possible Issues:

- A determination by the IRS that an election to opt out under §6221 is invalid.
- A denial by the IRS of a requested modification to an imputed underpayment amount.
- A denial by the IRS of a partner-level defense raised by the partnership prior to issuance of a FPA.
- The underlying adjustments to the partnership's return appearing on a Notice of Proposed Partnership Adjustment ("NOPPA").
- A determination by the IRS that a partnership has ceased to exist under §6241.

Issue:

- How do Partnership Audit Rules impact closely held family partnerships?

Issue:

Trusts as Members

For probate avoidance and estate administration, individuals often transfer membership interests to a revocable trust (or another form of trust). Under the Bipartisan Budget Act of 2015, these companies can't qualify for small partnership status. So the "Opt-Out" Election is not available for these companies.

Solution: Individual Ownership

Owners may elect to hold their interests as individuals, so a Company could distribute those interests out to the member/settlor in order to qualify for small partnership status. In that regard, owners may opt to follow the Transfer on Death Security Registration Act in effect under state law to avoid probate (Texas and Louisiana are the only states in which the Transfer on Death Security Registration Act is not effective).

Single Member LLCs and Multi-Member LLCs and Tiered Partnerships

- Small partnership status is not available if an owner is a single member LLC or another partnership.
- Individuals owning their interests through single member LLCs should consider holding them instead as individuals.
- Members or LLCs that are members of a Company should consider having those interests distributed pro rata to the members.

Areas to Address

- Advisors should explain the audit rules to clients and inform them of how these rules are relevant to them, as well as advise them to those actions that should be taken to respond to these rules.
- Companies that qualify for small partnership status should consider including provisions in their operating agreements that will preserve their BBA small partnership status (i.e., No member shall transfer his or her interests to a person who is ineligible to be a partner of a BBA small partnerships).

Areas to Address

- Companies that are not currently qualified as BBA small partnerships may consider restructuring their ownership arrangements to qualify as BBA small partnerships.
- In creating new entities, consideration should be given to ownership structures that will qualify as BBA small partnerships.
- To the extent that this ownership structure is not possible, BBA partnership audit provisions should be adopted, such as the appointment of a partnership representative and/or Push-Out election.

Areas to Address

- The partnership audit rules apply only to partnerships and not to S corporations. Thus an easy way for multi-member LLCs to avoid the BBA rules is by electing to be S corporations under the Check-the-Box Regulations.
- Because members in the adjustment year bear the burden of underpayments in reviewed year, members who are “buying in” should ensure that the operating agreement includes provisions that address changes in ownership interest (push-out election).

Take Away

- Given the lack of regulatory guidance, provisions should be drafted with maximum flexibility.
- Possibly include tax escrow/indemnification provisions for exiting members.
- Address information rights of members and companies, such as potentially confidential financial information (i.e., basis, carry overs).

Other Issues:

- Watch for final regulations
- Will there be state legislation conforming or not to the new regime

Considerations for Partnership Agreement

- Partnership Representative
 - Who has power to appoint?
 - Any limits on authority?
 - Any mandatory actions?
 - Successor
- Should opt-out be prohibited if partnership qualifies?
- Should push-out be mandatory?
- Can Pull-In be prohibited?
- Should reviewed year former partners be required to reimburse the partnership for imputed underpayments?
- Require partners to cooperate?
- Require prior partners for review years to pay?

Thank You

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