Interpreting Partnership Agreements and Reporting Terms on Form 1065

TUESDAY, FEBRUARY 21, 2017, 1:00-2:50 pm Eastern

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Interpreting Partnership Agreements and Reporting Terms on Form 1065

Feb. 21, 2017

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Overview

- Background and Stakes
- Contractual Interpretation Issues
- Interpretation of §704(b) Capital Account Maintenance Rules
- Interpretation of Other Tax Provisions
- Examples – Disputes and Resolutions

Terminology

- For brevity and because of the relative popularity of limited liability companies, these slides will often refer to LLCs, but such term should be understood to include general partnerships, limited partnerships, LLPs, LLLPs, and other entities that are taxed as partnerships for federal income tax purposes.
- Similarly, references to operating agreements also include partnership agreements, and references to members also include partners.

Interpretation of Partnership Agreements

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Background

- Most operating agreements provide for capital accounts.
- A capital account is to a member what a stock certificate is to a shareholder – arguably the most important representation of the member's ownership.
- Operating agreements that provide for capital accounts also generally provide rules for calculating the starting balance of these accounts and adjustments based on the profits, losses, contributions, distributions, and other events.
- In some instances, these rules repeat or cross reference the capital account maintenance regulations under §704(b).

Stakes – Targeted Allocations

- In some cases, members will agree on distributions and then provided for "targeted" allocations that result in capital account balances that are in accordance with the agreed shares of the partnership's assets.
- If mistakes creep into the calculation of those balances, a member may receive allocations of income and loss that are incorrect.

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Stakes – Tax Distributions

- In many cases, the operating agreement will provide for “tax distributions” – cash distributions to members to pay estimated and actual taxes.
- Often, these distributions are a function of income and loss allocations for the current or prior year.
- If mistakes are made in the calculations of income and loss allocations, then the tax distribution amounts may be erroneous as well.

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Stakes – Regular Distributions

- In some cases, the members will agree on allocations and then provide for distributions that are a function of, or are triggered by, some metric involving these allocations.
- For example, a junior tranche of members may not be untitled to distributions until a senior level of member receives allocations that reach a specified dollar amount or IRR.
- If there are mistakes in allocations, they will cascade through to these calculations as well.

Stakes – Proceeds on Liquidation

- In many cases, a member's right to share in a liquidation of the LLC is a function of the member's capital account balance.
- If mistakes have crept into the calculation of that balance, a member may be over- or under-paid.
- Even if the operating agreement does not provide for liquidation in accordance with capital account balances, the tax code may require it – errors will have tax complications as well.

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Contractual Interpretation Issues

- Many errors in partnership tax returns arise from interpretations of the operating agreement.
- For simplicity, we refer to these as contractual interpretation issues.
- In practice, there are three major areas of contractual interpretation issues:
  - yield/preferred return/IRR calculations
  - flip events
  - hypercomplexity

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Yield/Preferred Return/IRR

- Many operating agreements provide for different classes of members who are entitled to different economic rights. For example, a senior member may be entitled to a preferred return on his/her investment.
- Often, the description of that return is lacking. Problems can arise if the parties have different views of how the calculation should be interpreted.
- "Class A members shall be entitled to a 10% preferred return on their capital contributions."
    - Is this a compounding return or a simple return?
    - What is the basis for the return? The original investment? The member's capital account balance, as adjusted?
    - What happens if there are insufficient funds to pay distributions?

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Yield/Preferred Return/IRR

- There are ways to avoid these problems:
  - better descriptions (could refer to Excel calc functions, etc.)
  - numerical examples included as exhibits
  - circulating the calculation ahead of time
  - requiring the LLC to include calculations to the members so that disagreements can be flushed out ASAP.
- If problems do arise, alternative dispute resolution (“ADR”) provisions can shield the LLC and its members from litigation sink holes:
  - Interpretation differences can be resolved by arbitration, a panel of experts, etc.
  - Some agreements grant the LLC full discretion to interpret the operating agreement.

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Flip Events

- Some operating agreements will have shifting allocations/distributions based on certain events.
- Some of these events may be the attainment of certain yield/preferred return/IRR goal posts, but some may be dependent on the attainment of certain profit or revenue targets, zoning or licensing results, financing events, or calendar dates.
- Problems can be avoided by the use of better descriptions.
- An additional approach is to provide regular notices of the existence of flip events and how "close" they are.
- As above, ADR clauses will not foreclose a dispute over the timing or existence of a flip event, but can minimize the pain of such disputes.

Hypercomplexity

- Particularly with large projects that involve a number of investors with different economics, the operation of allocations and distributions can involve many different tiers or waterfalls, numerous flip events, and/or a significant number of conditional or contingent allocations and distributions.
- While any one of these provisions may be administrable, the weight and complexity of multiple provisions can make an operating agreement difficult to interpret.
- Particularly if there were several waves of investment, and different deals were struck each time, the parties may not agree on the interaction of different provisions and disputes may arise.

Hypercomplexity

- There may be no way to avoid hypercomplexity, especially when there are different groups of investors who came in at different stages and have different economic deals.
- Ways to avoid disputes in this area include better descriptions and the inclusion of numerical examples as exhibits.
- If problems do arise, ADR provisions can temper the time and expense of disputes.

Interpretation of §704(b) Capital Account Maintenance Rules

- In most operating agreements, there is a lengthy set of rules, many of which are culled from, or refer to, the tax regulations issued under IRC 704(b) (the capital account maintenance rules).
- These provisions are often adopted whole scale, even if there is no tax attorney or expert advising the LLC or its members.
- As a result, disputes can arise because the members did not have a good understanding of how these rules and regulations operate.

Capital Account Maintenance Rules

- Some common issues that come up in practice are:
  - differences between GAAP and tax capital accounts
  - contributions of non-negotiable notes by members
  - distributions of LLC notes to members
  - contributions of property subject to nonrecourse debt
  - revaluations of capital accounts
  - IRC §704(c) allocations
  - successor capital accounts
  - oil & gas depletion and related issues

Capital Account Maintenance Rules

- How can these issues be avoided?
- With proper drafting, disputes involving the *interpretation* of the capital account maintenance rules can be minimized. If compliance with these rules is mandated in the operating agreement, there may be few areas of interpretational differences.
- Instead, disputes really boil down to the fact that members often didn't understand how these rules would operate.
- That is a different complaint and one for which there may be no remedy at law.
- Some solutions to "I-didn't-understand-what-I-was-signing" are to document that members were advised that the tax aspects of an investment in an LLC are complicated and to obtain their own tax advice.
- ADR clauses can also be helpful.

Interpretation of Other Tax Provisions

- The remaining category of items that can give rise to interpretational differences is a catch all.
- Many of these items can have secondary effects on income/loss allocations and distributions that may affect capital account balances.
- Common items are:
  - operation of the minimum gain chargeback rules
  - allocation of partnership liabilities
  - elective and mandatory basis adjustments

Other Tax Provisions

- It is difficult to forestall disputes over these types of provisions.
- As with the capital account rules, in many cases the substance of the complaint is that a member did not understand how a specific tax provision might affect the economics of his/her investment.
- Thus, disclaimers and ADR clauses can help to tamp this down.

Contractual Interpretation Example

- The balance of this section considers two examples that involve a dispute over a preferred return clause.
- We hope to examine the consequences of the dispute and how the parties could proceed, including settlement options.

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Example – Base Facts

- Newco has three members, A, B and C.
- A invests $1 million and is entitled to a preferred return of 10% on that amount. Once A receives her $1 million plus the preferred return, A is entitled to a 40% interest in profits and losses.
- B invests $200,000 and is entitled to a 40% interest in profits and losses, subject to A's preferred return.
- C invests no money but is given a profits interest of 20%.
- Newco invests the total of $1.2 million in a single investment asset.
- For the first three years, Newco has losses.
- At the start of Year 4, Newco sells the investment asset for $3 million.

Example – Base Facts

- The allocations made by Newco for the four-year period are as follows:

Year	total income/loss	A	B	C	totals
1	-100,000	100,000	-133,000	-67,000	-100,000
2	-100,000	100,000	-133,000	-67,000	-100,000
3	-100,000	100,000	-133,000	-67,000	-100,000
4	2,300,000	920,000	920,000	460,000	2,300,000
	2,000,000	1,220,000	521,000	259,000	2,000,000

1,000,000	purchase price
-300,000	depreciation
700,000	tax basis

3,000,000	amount received
-700,000	tax basis
2,300,000	gain

Example – Base Facts

- A argues that she is entitled to $331,000 in preferred returns (i.e., 10% compounded annually for three years) before the 40% share kicks in.
- B and C argue that A is only entitled to $300,000 (i.e., a 10% simple return) before A's 40% share kicks in.

Example – Base Facts

- Under A's interpretation, the allocations for the four-year period should have been as follows:

Year	total income/loss	A	B	C	totals
1	-100,000	100,000	-133,000	-67,000	-100,000
2	-110,000	110,000	-140,000	-70,000	-100,000
3	-121,000	121,000	-147,333	-73,667	-100,000
4	2,300,000	920,000	920,000	460,000	2,300,000
	2,000,000	1,251,000	499,333	249,667	2,000,000

1,000,000	purchase price
-300,000	depreciation
700,000	tax basis
3,000,000	amount received
-700,000	tax basis
2,300,000	gain

Example 1

- If there are dispute resolutions provisions in the operating agreement, this may be resolved quickly.
- If she is not bound by such provisions, A could sue to enforce her view of the agreement.
- Litigation would be time consuming. Even ADR could take so long that, in the interim, Newco would have to file tax returns and issue K-1s.
- If Newco stuck to its position, the dispute over how to interpret A’s preferred return would affect the allocation of income and distribution of proceeds.

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Example 1

- If A were ultimately successful in ADR or litigation, Newco and the other members might have to make up the preferred return shortfall.
- But this could be years after Newco sells its investment asset.
- Normally, A would be required to include the K-1 information on her personal return.
- However, there is a procedure under which A could take an inconsistent position, disclose it to the IRS and then (potentially) avoid penalties.
- IRS Form 8082 (Notice of Inconsistent Treatment) is used for this purpose.

Example 1

- Conversely, A could report the K-1 as prepared by Newco and proceed with ADR or litigation.
- If A were ultimately successful, A would then have two options:
    - File amended returns to correct the capital account mistakes and other disputed items.
    - Treat the litigation outcome as a separate taxable event.
- The former is more complicated and the other participants might not go along.
- The latter can sometimes be simpler. One important qualification is to ensure that the parties characterize the settlement consistent with the dispute from which it arises.

Example 1

- For example, if A prevailed in ADR or litigation and it was determined that A should have received a preferred return of $331,000 instead of $300,000, then A would be entitled to $31,000 in damages plus (in many cases) interest, and (in rarer cases) attorney fees.
- The preferred return income is likely to be characterized as ordinary income.
- Under the Arrowsmith case, A may be required to report these damages as ordinary.
- Characterization of judicial interest?
- Characterization of attorney fees?

Example 2

- Same facts as Example 1, but assume that as soon as A brings up her claim, B and C quickly agree with her.
- The parties then have to fix the problem.
- After three years of errors, if A should have been allocated more income (and, therefore, B and C allocated more loss), there are at least two options to the parties:
  - fix by filing amended returns, or
  - fix with a catch up allocation in the current period.

Example 2

- Filing amended returns can raise several issues.
  - cost of prep for amended returns
  - closed tax years
  - interest and penalties for retroactive allocations
- Catch-up allocations (net allocations that eliminate the difference between the erroneous capital account balances and what the parties agree should be the true balances) are much simpler.
- But can the parties make catch up allocations?

Example 2

- The allure of a catch up allocation is that amended returns are unnecessary. Instead, the correct balances are determined and the LLC determines the plug allocation that will result in those balances.
- Under IRC §761(c), retroactive allocations that go back a single year appear to be allowed under certain circumstances:

> *For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.*

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Example 2

- Some would read this to mean that filing amended returns cannot be done if the "new" interpretation is in substance a retroactive amendment of the operating agreement. Under this view, only a catch up allocation (or possibly a one-year-back allocation) could be done.

- Conversely, if the parties agree that the new interpretation is the correct interpretation and should have been applied in prior years (but was not), then the filing of amended returns does not involve the amendment of the operating agreement but the application of the original intent of that agreement. Accordingly, IRC §761(c) should pose no barrier to the filing of amended returns.

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Example 2

- If IRC §761(c) does not prevent the parties from filing amended returns or utilizing a catch-up allocation, are there policy concerns that are implicated?
- In this example, A should have been allocated more income and B and C should have been allocated more loss in the three prior years.
- For B and C, the filing of amended returns that report more loss is unlikely to cause negative ramifications. However, if A underreported its income, the filing of amended returns may result in penalties and interest.
- A would generally prefer a catch up allocation under these facts.

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Example 2

- Could the IRS treat a catch up allocation as a "shifting allocation" and thereby ignore it?
- Under Treas. Reg. §1.704-1(b)(2)(iii)(b)(1), a shifting allocation can be disregarded if, among other things,

> *The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).*

Example 2

- Under our facts, A is arguing that it should have been allocated more income in prior years. It would follow, then, that under this position A would recognize less gain in the year that Newco disposes of its sole asset.
- Conversely, A's position means that B and C should have been allocated less income in years 1-3, and more gain in year 4.
- If B and C were in higher tax brackets than A in years 1-3, the IRS could argue that use of a catch up allocation versus amended returns means that there was "a strong likelihood" that the overall tax liability would be reduced as a result of the catch-up allocation.
- This would create a presumption that the allocation was an impermissible "shifting allocation." The burden would fall on the taxpayers to overcome this presumption "by a showing of facts and circumstances that prove otherwise."

Example 2

- A similar analysis would apply under the test for impermissible "transitory allocations."
- However, it would appear from these facts that a catch up allocation would not meet the definition of a transitory allocation. A transitory allocation occurs is present if

> *a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)") . . . .*
>
> *Treas. Reg. 1.704-1(b)(2)(iii)(c).*

- Note that a catch up allocation does not flip back but, instead, charts a new course of allocations that are intended to be different from the original allocations.
- But under different facts, this could be an issue.

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Example 2

- If the IRS raises the argument that a catch up allocation is an impermissible shifting allocation, could the parties rebut the presumption?
- If the interpretational dispute was sufficient clear, it is possible that the parties could rebut the presumption.
- However, even if they could not rebut the presumption, and the IRS prevailed, the effect of disregarding the catch up allocation would only have an effect for tax purposes.
- That is, A would be entitled to the additional $31,000 in preferred return, but arguably would not pay tax on it (B and C would). Conversely, A would recognize an additional $31,000 in capital gain for taxes purposes in year 4.

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Example 2

- The IRS is likely to worry that a faux contractual dispute could be used to make an opportunistic change in tax allocations.
- If the parties were motivated for tax and not economic reasons, then the IRS might reasonably fear that the claimed dispute was really a sham.
- But under our facts, the settlement of the dispute would result in A actually receiving an additional $31,000, while B and C would receive $31,000 less. That is a settlement that has real economics and would seem to suggest that there was an actual dispute. It is not logical that B and C would agree to forego $31,000 in cash proceeds simply to obtain $31,000 of tax losses.
- Key – does the settlement result in a real change in economics?

Summary

- There are a number of provisions that can give rise to disputes that affect allocations, distributions, and capital account balances.
- Tighter drafting, disclaimers, and ADR clauses can help minimize this.
- If the parties resolve matters on their own or one party prevails in ADR or court, errors can be fixed by amending returns or a catch up allocation.
- While catch up allocations are attractive, the parties must be aware that the IRS could disregard the allocations.
- Documenting a clear dispute, and showing that the catch up allocations result in a real economic change will help protect the parties. Often this will mean that a distribution must follow or match the catch up allocation.

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Retroactive Partnership Agreement Amendments

- IRC § 761(c) - For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

Retroactive Partnership Agreement Amendments

- Modifications are for the current tax year.
- Must be agreed to by all the partners or as otherwise required by the operating agreement.
- Modifications relate back to the beginning of the tax year.

Retroactive Partnership Agreement Amendments

- Typical retroactive amendments alter the profit and loss sharing ratios
- Must apply only to the profit and loss from the current tax year, but can address unrealized appreciation. PLR 9821051.
- Often retroactive amendments are made to reflect the value of the services provided during the prior year.

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Limits to Retroactive Amendments

- Amendments to allocations must comply with IRC § 704(c).
- Amendments cannot be made to allocate income or loss to a partner that was not a partner at the time the income or loss was accrued.
- Existing partners cannot receive retroactive allocations of additional capital contributions.
- Recourse liability may be altered by removing deficit restoration obligations.

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Limits to Retroactive Amendments

- However, recourse liability most likely cannot be created by retroactively making a partner bear personal responsibility for debt.

Form of Retroactive Amendments

- Modifications must be adopted as required by the operating agreement.
- Oral agreements, while obviously not preferred, are binding, so long as the operating agreement does not require written amendments.
- Written modifications with agreement of all partners are strongly preferred.

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New Audit Rules

Background – The TEFRA Audit Rules

54

TEFRA - BACKGROUND

- 1970s and 1980s saw a marked increase in the use of large partnerships, as the rise of syndicated tax shelters relied heavily on tax partnerships
- TEFRA - Tax Equity and Fiscal Responsibility Act of 1982
- Objective of TEFRA audit rules was to enhance enforcement of tax rules for larger partnerships by streamlining the partnership audit procedure through entity-level examination
- If IRS was successful under a TEFRA audit, the partnership would file amended returns and each partner was required to report the change consistently

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PRE-TEFRA PROBLEMS

- Pre-TEFRA audits required the IRS to conduct audits and control returns at the partner level
- IRS generally identified a partnership it wanted to audit, and then attacked at the partner level and audit partners
  - Wholly impractical for partnerships with hundreds, and sometimes thousands of partners
  - Led to inconsistent treatment of different partners from the same partnership (appeals may be in different locations, ruling law may differ, statute of limitation periods may differ between partners, etc.)
  - Actual adjustment for each partner often didn't justify resources expended to collect the additional tax
  - Tiered partnerships provided additional enforcement hurdles
  - Settlement with one partner did not bind any other partners, and each partner

TEFRA – AN OVERVIEW

- Audits now conducted at the entity level
- Statute of limitations controlled at the entity level
- Requires consistency between partnership tax returns and returns of the partners
- Established difference between "partnership items" and "non-partnership items" for audit purposes
  - Partnership Items: Items required to be taken into account for the Partnership's taxable year to the extent such item is more appropriately determined at the partnership level than at the partner level (Code Sec. 6231)
  - Non-Partnership Items: any item which is not a Partnership Item
- Certain partners permitted to participate in the partnership audit and challenge certain adjustments if not otherwise addressed by the TMP

TEFRA – AN OVERVIEW

- Partnership audits are coordinated through the “Tax Matters Partner” (the “TMP”)
  - Authorized to extend statutes of limitation for all partners’ partnership items
  - Authorized to execute settlement agreements
  - Required to keep partners informed on the audit proceeding and acts as the liaison between the IRS and the partners
- At the conclusion of an audit, adjustments are determined by the service center and can be assessed against partners without a notice of deficiency

TEFRA - EXAMPLE

- Newco is an LLC taxed as a partnership. It is formed in 2011 with 50 partners. In that year, Newco reported $5 million in depreciation deductions which it allocated to its partners.
- In 2012, the IRS audits Newco and determines that the depreciation related to a power facility that was not placed in service until 2012.
- Newco appeals the determination, but in 2013, after going through appeals, Newco agrees to the adjustment.

TEFRA – EXAMPLE

- As part of the settlement, Newco issues amended K-1s to each partner that reverses the depreciation deduction. It also issues amended 2012 K-1s, correcting the depreciation taken in that year.
- Note that, per the TEFRA rules, each partner is required to take a consistent position with these amended K-1s (or disclose that they are taking inconsistent positions).
- The IRS did not have to perform 50 separate audits to achieve this result.

GAO QUICKIE SUMMARY OF TEFRA AUDIT RULES

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	• 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 I GAO-14-732

[a]TEFRA 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.

TEFRA – THE REALITY

- In 2014 the GAO published a report on TEFRA's Efficiency and Effectiveness
  - Found that between 2002 and 2011 number of large partnerships (i.e. having >100 partners and >$100mm in assets) increased more than 3x
  - Nearly 2/3 of large partnerships had (i) more than 1,000 direct and indirect partners, (ii) six or more tiers, and (iii) reported being in the finance or insurance industry
- Inefficiency with partnership audits manifests in (i) difficulty identifying the TMP, (ii) litigating whether items are partnership items (i.e., governed by the TEFRA audit rules) or non-partnership items (i.e., not governed by the TEFRA audit rules), and (iii) logistics and costs associated with passing through adjustments to ultimate partners
- FY 2012 – IRS .8% of large partnerships as opposed to 27.1% of C-corporations having >$100mm in assets

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NEW RULES – OVERVIEW

- Enacted on November 2, 2015, as part of the Bipartisan Budget Act of 2015
- Is effective for partnership tax years beginning after 2017
  - BUT – may be able to elect to apply new rules to earlier years
- Repeals the TEFRA rules and creates new terms and rules for partnership audits
- New Rules are located in Code Sections 6221 through 6241
- Final Regulations were released on January 19, 2017 and then pulled back on the 20th because of President Trumps executive order limiting new regulations.

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NEW RULES – OVERVIEW

- Like TEFRA, the IRS will audit and litigate partnership items at the partnership level.
- BUT – unlike TEFRA, liability is asserted against the partnership itself at the highest applicable tax rate.
  - HUGE CHANGE IN TAX LAW!!!

PARTNERSHIP REPRESENTATIVE

- Partnership designates a Partnership Representative (the "PR") to conduct the audit with the IRS and bind the partnership and partners
  - Generally replaces the concept of the TMP
  - Does NOT need to be a partner in the partnership
  - Must have substantial U.S. presence
  - Has sole authority to act on behalf of the partnership in an audit and bind the partnership and the partners
- IRS will appoint a partnership representative if one is not otherwise appointed by the partnership
  - Important for GP or manager to appoint a partnership representative if only to block the IRS from picking one
- No authority or standing by partners to participate in audits or challenge assessments

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The Audit Rules -- Consistency

- After the final resolution of an audit, all partners are bound by that determination.
- Partners do not have the right to participate in a proceeding or receive notice of the same – this is another change from TEFRA as it shifts the burden of keeping the partners informed from the IRS to the partnership.
- Partners can file a notice of inconsistent position.

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The Audit Rules – Key Terms

- "Reviewed Year" – the year under audit.
- "Adjustment Year" – the year in which the adjustment for the reviewed year occurs.
  - Can happen by settlement or court decision in the case of an adjustment stemming from an audit.
  - Can also be the year in which an adjustment is made because the partnership requests an administrative adjustment (i.e., tantamount to an amended return).

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Settlement/Payment

- Any adjustment is assessed in the adjustment year, not the reviewed year.
  - Example: IRS audits Newco in 2020 for its 2018 tax year. In 2021, IRS proposes a net adjustment to the 2018 tax year and Newco concedes. The tax liability is assessed in the 2021 tax year.
- Moreover, the tax liability – the "imputed underpayment amount" and any related penalties and interest – are assessed against the partnership, not the partners.

Settlement/Payment – IUA

- "Imputed Underpayment Amount" ("IUA") – the net non-favorable adjustment to the partnership tax year, multiplied by the highest applicable tax rates in section 1 or 11 of the Code (currently 39.6%) with few exceptions.
- Thus, for the first time, income taxes are assessed at the entity level and not at the partner level.
- The burden to collect from partners has been shifted from the IRS to the partnership.

Settlement/Payment – IUA

- Note that penalties are also determined at the partnership level. Any partner-level defenses to penalties are irrelevant.
- Only the partnership statute of limitations controls.
  - For example, the 6-year substantial understatement statute of limitations is determined at the partnership level, not the partner level.

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Settlement/Payment – IUA

- Statute provides that the following should be taken into account in calculating the IUA :
  - if a portion of any reallocation would go to a tax-exempt entity;
  - if ordinary income amounts are allocable to a C corporation;
  - if capital gain or qualified dividends are allocable to individuals; and
  - if there are reallocations from one partner to another that results in a decrease income/gain or a decrease in deductions/losses/credits.

Settlement/Payment – Returns

- The partners for the reviewed may file amended tax returns reflected any partnership adjustment, and pay the resulting tax.
- Such payments will reduce the partnerships IUA by the amount of such taxes.
- It is unclear how this will work. Presumably, there is no credit until the partner level taxes are paid by the partners. Does the partnership then file an entity-level tax refund claim?

Partnerships Affected By New Rules

- The new rules only apply to certain partnerships. If a partnership qualifies, it can elect out on its tax return.
- If the election is effective, the partnership will not be subject to the new rules and, because the TEFRA rules are repealed for all purposes, will not be subject to those rules either.
- Effectively, an electing out partnership can go back to the "bad old days" when the IRS had to audit individual partners.

Election Out

- A partnership can elect out if it has 100 or fewer partners.
- The total partners is determined by counting K-1s, so clarify whether your partnership may be issuing K-1s when unnecessary.
- Also, each shareholder of partner that is an S corporation is included in the count.

Election Out

- Partnerships with 100 or fewer partners, can only elect our if all the partners are one of the following:
  - an individual
  - a C corporation
  - a foreign C corporation
  - an S corporation, or
  - an estate of a deceased partner.
- If there are any other types of entities, or any partners that are themselves taxed as partnerships ("Upper-Tier Partnerships"), then the election out is not permitted.

Election Out

- The “Upper-Tier Partnership” limitation is so significant that it may cause partnerships to limit who can become a partner and to limit transfers so that disqualifying partners cannot enter the partnership.

Push-Out Election

- Another alternative is the so-called “push-out” election.
- Under this approach, the partnership makes a special election without 45 days of receiving a final partnership administrative adjustment (“FPAA”).
- The partnership then issues “statements” (i.e., amended K-1s) to the partners for the reviewed year reflecting the FPAA.

Push-Out Election

- But, for the reviewed year partners it is not as simple as determined the additional tax liability in the reviewed year and paying the tax.
- Each partner also has to take into account any tax liabilities in the interim years as a result of the effect of the resulting change in tax attributes in the reviewed year.
- The sum of such liabilities, plus penalties, plus interest in due in the year in which the statement is issued.
- And, the interest rate is 2% points higher than whatever interest rates would otherwise apply.

Push-Out Election

- The push-out election does save the partnership from paying entity-level taxes and places the burden for those taxes on the reviewed year partners, which seems fairer.
- But the interest rate increase has to be taken into account, and the complicated tax liability calculations that are needed.
- Even with these hurdles, it may be more equitable (from the partnership's perspective) to make this election and it may be simpler than setting up an indemnity regime to recover these amounts.

Effect on Allocation Mistakes

- Generally, a mere correction of a capital account will not trigger the new audit rules – only if the resolution of the error triggers changes in amounts allocated or distributed to the partners.
- In some of our examples, the resolution affects specific partners, but does not result in a change in total income.
- Even in that case, the nature of the partner receiving the allocation matters.
  - This could be the case if income or loss is shifted between a taxable partner and a tax-exempt partner.
  - This could also occur if capital gain or loss is shifted between a corporate partner and an individual partner.
- Any of these types of shifts could result in an imputed underpayment amount – but even this will not be entirely clear until the final regulations are issued.

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Effect on Allocation Mistakes

- Assuming a change in allocations would give rise to an imputed underpayment amount, the next step is to consider the entity-level tax effects.
- As noted, an IUA will generally result in an entity level tax that is born by the partners in the year of adjustment, not in the year from which the error arose.
- In that instance, the parties may decide to make the push out election to tag the IUA to the relevant partners, even though that would result in a higher underpayment interest rate.
- Because of these complexities, it would appear much simpler to avoid several of these issues by making a catch-up election in the year of settlement. Presumably, this would avoid having to navigate the new audit rules altogether.

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Effect on Allocation Mistakes

- If an error has short-changed a departed partner, however, then it would seem to be impossible to easily resolve the matter.
- One solution would be to re-admit the partner for a single year in order to make a catch up allocation. However, this would invite scrutiny under the shifting and transitory allocation rules.
- Another approach, specific to the departed partner problem, is to have the partnership pay a settlement amount to the former partner, the cost of which would could be specially allocated among the remaining partners in the current year to take account of which partners should properly bear the expense.

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Effect on Allocation Mistakes

- While many issues will turn on the issuance of the final regulations, the impact of the new audit rules is likely to make it even more difficult to resolve capital account mistakes.

Thank You

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