

# New IRS Partnership Audit Regulations: What Every Tax Adviser Needs to Know

WEDNESDAY, MAY 11, 2016, 1:00-2:50 pm Eastern

## IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code.** You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.
- To earn full credit, you must remain connected for the entire program.

## WHO TO CONTACT DURING THE LIVE EVENT

**For Additional Registrations:**

-Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

**For Assistance During the Live Program:**

-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

## *Tips for Optimal Quality*

FOR LIVE PROGRAM ONLY

---

### *Sound Quality*

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

# New IRS Partnership Audit Regulations

---

May 11, 2016

---

Kathleen (Kat) Saunders Gregor, Partner  
Ropes & Gray  
[kathleen.gregor@ropesgray.com](mailto:kathleen.gregor@ropesgray.com)

Joseph C. Mandarino, Partner  
Smith Gambrell & Russell  
[jmandarino@sgrlaw.com](mailto:jmandarino@sgrlaw.com)

Elizabeth M. Norman, Partner  
Nutter McClennen & Fish  
[enorman@nutter.com](mailto:enorman@nutter.com)

# Notice

---

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

ROPES & GRAY

SMITH, GAMBRELL  
& RUSSELL, LLP  
*Attorneys at Law*

 Nutter

# Partnership Audit Reform

The Bipartisan Budget Act of 2015

May 11, 2016

# Agenda

---

- Old Regime – TEFRA
- Overview of the New Rules – Bipartisan Budget Act
  - Partnership Representative
  - Electing Out for Small Partnerships
  - Default Regime: Imputed Underpayment
  - Default Regime: No Imputed Underpayment
  - Alternative Regime: “Push-Out Election”
  - Administrative Adjustment Rules
  - Other Changes
- Current Implications
- Q&A



# Agenda

---

- Old Regime – TEFRA
- Overview of the New Rules – Bipartisan Budget Act
  - Partnership Representative
  - Electing Out for Small Partnerships
  - Default Regime: Imputed Underpayment
  - Default Regime: No Imputed Underpayment
  - Alternative Regime: “Push-Out Election”
  - Administrative Adjustment Rules
  - Other Changes
- Current Implications
- Q&A



# Old Regime: TEFRA

## Current Partnership Audit Rules

---

- Audits of private equity funds and other large partnerships already increasing
- Most commonly, TEFRA rules provide unified examination procedures
  - Partnership items are determined at partnership level
  - Resulting adjustments are pushed out to partners and the IRS collects tax from individual partners using computational adjustments
- TEFRA statute of limitations is based on the longer of the limitations period of the partnership or the individual partner owing tax
- Tax Matters Partner (“TMP”) controls, but must notify partners of TEFRA audit proceedings, and partners have the right to participate in the audit or litigation
- Small partnerships of less than 10 qualifying partners are not subject to TEFRA rules, and partnership items are audited at the partner level
- Large partnerships (more than 100 partners) have streamlined examination rules (infrequently used)
- Partners can file petition with court to review partnership items, if TMP does not

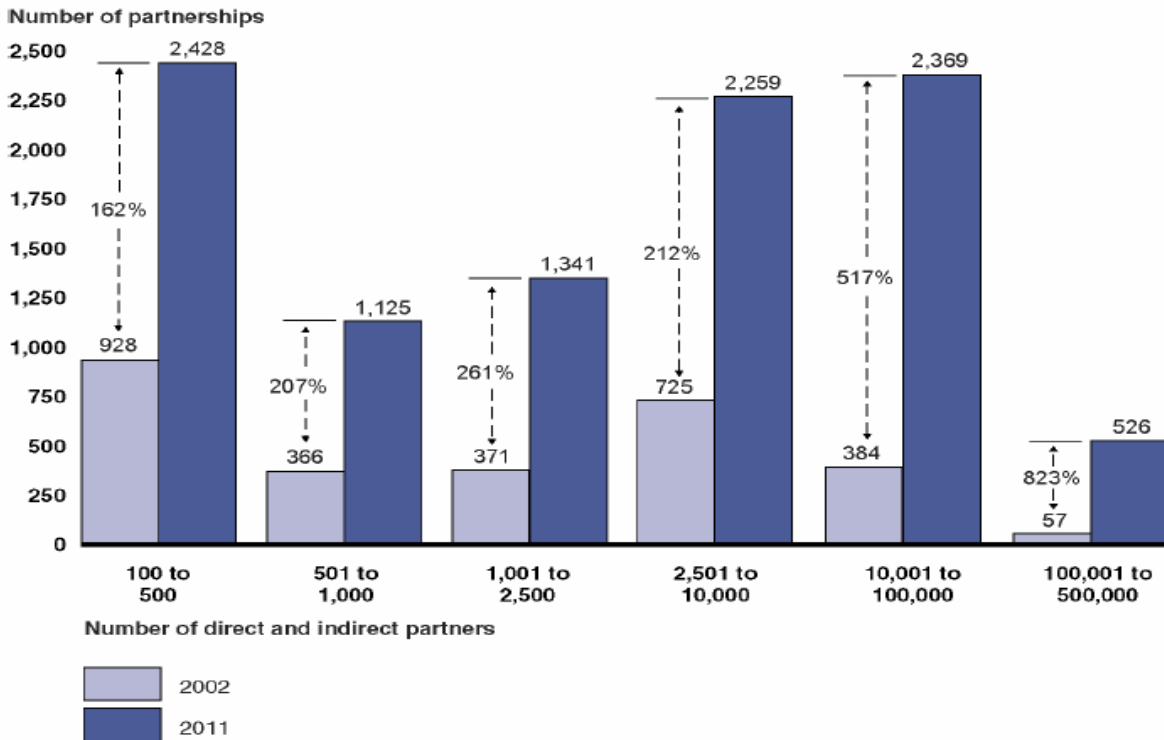




# Problems With TEFRA

In the previous Congress, GAO issued reports on audits of “large” partnerships – found extensive under-enforcement

**Figure 6: Number of and Percentage Increase in Large Partnerships, by Direct and Indirect Partners, Tax Years 2002 and 2011**



Significant growth in partnerships with **>\$100 million** and **>100 partners** since **2002**

Only **.8%** of large partnerships audited in 2012, compared to **27.1%** of large corporations

Source: GAO



# Problems With TEFRA, cont...

---

## GAO's findings included:

- Too few large partnerships are audited
- Most audits result in no change or changes are small
- According to IRS auditors, collection is difficult, particularly with respect to tiered partnerships, where computational adjustments are too costly or complicated
- Determining each partner's share of adjustments is paper and labor intensive

## GAO's recommendations included:

- Congress should consider requiring a large partnership to identify a partner to represent it during audits and to pay taxes on audit adjustments at partnership level
- IRS should define large partnerships, track audit results using revised codes, and implement project planning principles for audit procedure projects



# Agenda

---

- Old Regime – TEFRA
- Overview of the New Rules – Bipartisan Budget Act
  - Partnership Representative
  - Electing Out for Small Partnerships
  - Default Regime: Imputed Underpayment
  - Default Regime: No Imputed Underpayment
  - Alternative Regime: “Push-Out Election”
  - Administrative Adjustment Rules
  - Other Changes
- Current Implications
- Q&A



# Overview of New Partnership Audit Rules

---

- New law replaces entire partnership audit regime, including TEFRA
- Takes effect for partnership returns filed for taxable years beginning after 2017
- Adopts a centralized system under which any adjustment to items of partnership income, deduction, gain, loss or credit is determined at the partnership level
- Default rule is that the partnership will be assessed tax liability (including interest and penalties) on adjusted partnership items at the partnership level



# Partnership Representative

---

- The partnership designates a Partnership Representative that has the authority to conduct the examination and generally to bind the partnership and the partners
  - Partnership and all partners bound by the actions and decisions
  - Replaces Tax Matters Partner role
- The Partnership Representative does not sign tax return (GP or LLC member signs)
- If no designation, Secretary may select any person
- **Important** - the Partnership Representative does not need to be a partner.
- Partnership Representative must have substantial U.S. presence
  - What is intended by “substantial U.S. presence”?



## Section 6221(b) (Small partnership election out)

---

- Requirements to make election out of new rules:
  - Partnership with 100 or fewer required Schedules K-1
  - Each partner must be an individual, a C corporation, foreign entity that would be treated as a C corporation if domestic, an S corporation, or an estate of a deceased partner
  - Annual election on a timely filed return
  - Partnership required to advise all partners of the election and provide name and TINs to IRS of each partner
  - Special look-through counting and disclosure rules for S corporation Schedule K-1s
  - Awaiting guidance on treatment of other types of entities, including disregarded entities
- Once elect out, partnership items are audited on each separate partner's return



# Section 6225: Imputed Underpayment

---

- Assessment will be made against the partnership in the year in which the adjustment is finally determined – this means that partners may bear the burden of taxes that would have been owed by partners in earlier years
- The highest marginal rate will be applied to determine tax liability (called “imputed underpayment”)
- Modification of the imputed underpayment possible based on the tax status of partners (such as corporations with a lower marginal rate, non-U.S. partners, or tax-exempt partners)
- Imputed underpayment may be reduced if partners in the year under audit voluntarily file amended tax returns and pay the tax due
- Details remain to be worked out in regulations



# Section 6225: Imputed Underpayment

## Timing and amount of adjustments

- Partnership pays any imputed underpayment amount in the “adjustment year”
  - Note that adjustment year is not the earlier “reviewed year” that gave rise to the adjustment.
- Imputed Underpayment =  
net of all the adjustments  
*multiplied by*  
highest tax rate in effect (under section 1 or 11) in the reviewed year applicable to either corporations or individuals  
  
Subject to modifications, to be discussed in the following slides
- Important - Audit adjustment which reallocates the distributive share among partners disregards any decrease in income or gain and any increase in deduction, loss or credit.





# Section 6225: Imputed Underpayment

---

## Timing and amount of adjustments

- Interest determined from day after the due date of reviewed year tax return and ending on due date of the adjustment year tax return (or date payment is made if earlier).
- Any penalty or addition to tax is also determined at the partnership level.
- No deduction allowed for any payments made by partnership.



# Section 6225: Imputed Underpayment

## Reductions in Applicable Rate

- Tax- Exempt Partners
  - IUA determined without regard to portion allocable to a partner that would not owe tax because of its status as a tax-exempt entity (under section 168(h)(2) (this includes non-U.S. partners)
  - Burden of proof appears to be on the partnership
- Highest Applicable Tax Rate Reductions
  - Reduced with respect to any portion of IUA allocable to a partner which
    - In the case of ordinary income, is a C corporation
    - In the case of a capital gain or qualified dividend, is an individual
      - Treats S corporation as an individual
  - Lower rate cannot be less than the highest rate with respect to the income and taxpayer
- Variable rate reductions if imputed underpayment is attributable to multiple items of different character
- Treasury has authority to include other reductions



# Section 6225: Imputed Underpayment

---

## Reductions Based on Amended Returns

- Imputed underpayment is reduced by the portion of tax attributable to a partner who has filed an amended return, if:
  - Partner files the amended return for the reviewed year consistent with the proposed audit adjustment,
  - Partner takes into account all adjustments (including any other taxable year with respect to which an tax attribute is affected by the adjustment), and
  - Partner pays tax due with such return(s), including penalties and interest
- For reallocations of distributive share, all partners affected by the reallocation must file amended returns to be taken into account in determining the Imputed Adjustment



# Section 6225: Imputed Underpayment

---

## Procedures

- “270-day rule” for submitting information to reduce the underpayment under section 6225:
  - Any documents required to be submitted to reduce the underpayment at the partnership level shall be provided to the Secretary no later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed under section 6231 unless such period is extended with the consent of the Secretary
- The Secretary then has a period of time before issuing an FPA, taking into account a partnership’s proposed imputed underpayment
- After receiving an FPA, the partnership can bring a judicial challenge
- Unclear whether partnership can challenge just the calculation (or the Secretary’s acceptance of) the imputed underpayment calculation



# Section 6225: No Imputed Underpayment

---

- Audit adjustments that do not result in an “imputed underpayment amount” (“IUA”) shall be taken into account by the partnership in the “adjustment year” in the following manner:
  - As a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8)
  - Or, in the case of an item of credit, as a separately stated item
- Open questions (areas for guidance):
  - Treatment of adjustments to character, timing, liabilities
  - Possible distortion: net adjustments to losses are all reported as ordinary income



# Section 6226: Push Out Election

---

- As an alternative to the partnership paying directly, partnerships can push out adjustments to each partner who was in the partnership during the reviewed year
  - Each partner pays the tax, interest and penalties with current year return
  - Partner required to re-calculate reviewed year and intervening years' tax
  - Partner required to take into account the amount by which the partner's tax would increase, plus tax increases due to any change in tax attributes caused by the adjustment
  - Interest rate on unpaid tax is normal underpayment rate plus 2%
  - This alternative is elected within 45 days after the issuance of the Notice of Final Partnership Adjustment
  - Not clear if this alternative will be available for tiered partnerships



# Section 6226: Push Out Election

---

## Timing

- Election is made within 45 days following the receipt of a Final Partnership Adjustment (FPA)
- FPA is only issued *after* partnership has opportunity to negotiate with IRS regarding imputed underpayment amount

## Areas for guidance

- Combination of methods: Treasury might consider permitting a hybrid structure – this works with the timing
- Treatment of tiered partnerships and other pass-throughs
- Coordination between push-out election and judicial relief (but see PATH Act language)



# Administrative Adjustment Requests

---

## Partnership Administrative Adjustment Request

- Allows partnership to file an amended return within 3 years of the filing of the partnership return but prior to notice of administrative proceeding for the year
  - Partnership can pay tax when it files the AAR
    - Rules do not appear to allow partners to file amended returns to reduce adjustment
  - Partnership can elect to have the partner(s) pay the tax under the section 6226 provisions
    - Increased interest provision does not apply





# Statute of Limitations

---

## Section 6235 (Statute of limitations)

- Includes new special rules:
  - Adjustment must be made before a date 3 years after the latest of:
    - The date the partnership return for the reviewed year was filed,
    - The return due date for the taxable year, or
    - The date that the partnership filed an AAR under section 6227
  - In case of any modification under section 6225(c), the date that is 270 days (plus any additional time granted by Treasury) after the date everything required to be submitted is submitted
  - In the case of any notice of proposed partnership adjustment, the date that is 270 days after such notice
  - Additional time for extension by agreements, false returns, substantial omission of income, and no return



# Other Important Changes

---

- Section 6241 (Definitions and special rules)
  - Treasury has authority to write rules for partnerships that cease to exist
  - Except for the modification of IUA and the election for partner to pay tax, Schedules K-1 cannot be amended after the due date of partnership return unless allowed by Treasury rules
  - Section 6501(g), which provides that refund claims for TEFRA partnership items could only be brought under the TEFRA rules, will be repealed
  - No guidance on how partnership or partners may file refund claims and seek judicial review under the new regime
- Only Partnership Representative can file court petition challenging audit adjustment
  - Partners lose significant notice and participation rights under the TEFRA regulations
  - Prior rights were set out, in large part, in regulations – will Treasury propose similar rules here?



# Agenda

---

- Old Regime – TEFRA
- Overview of the New Rules – Bipartisan Budget Act
  - Partnership Representative
  - Electing Out for Small Partnerships
  - Default Regime: Imputed Underpayment
  - Default Regime: No Imputed Underpayment
  - Alternative Regime: “Push-Out Election”
  - Administrative Adjustment Rules
  - Other Changes
- **Current Implications**
- Q&A



# Looking Ahead

---

- What does this mean?
  - Buyer of a partnership interest and/or remaining partners inherit tax risk related to former partners
  - Partners have fewer statutory rights to notice and participation in audits
- What should be done now?
  - Update documents (particularly for new entities)
  - Identify partnerships that are eligible to opt out of new rules, ensure authority to opt out
- Key areas of agreements affected
  - Control and process surrounding IRS audits
  - Identification of TMP and partnership representation
  - Allocations and distribution provisions – is tax a deemed loan?
  - Coordination with clawback provisions
  - Indemnification from former partners



# Looking Ahead

---

- State Tax Considerations – playing catch-up?
- Due Diligence
- Financial Statement Implications



# Kat Saunders Gregor

---



Kat is a partner in the tax & benefits department at Ropes & Gray. Kat's practice encompasses a wide range of partnership and international tax issues, with a focus on disputes with the IRS and other administrative bodies. Kat regularly represents private investment funds, institutional investors, private companies and high net worth individuals before the U.S. Tax Court, U.S. Court of Federal Claims and the IRS, as well as non-U.S. tax authorities. Kat advises private investment fund managers on structuring and launching funds, and has worked extensively on fund investment and secondary transactions. She also represents public and private clients in ongoing tax issues, as well as merger, acquisition and restructuring transactions.

## Partner

Ropes & Gray  
Prudential Tower  
800 Boylston Street  
Boston, MA 02199-3600

Kat.Gregor@ropesgray.com  
T: 1 617 951 7064

Kat previously practiced as a CPA with the Middle Market Advisory Services group of PricewaterhouseCoopers LLP, where she advised venture capital funds and their portfolio companies on tax compliance, planning, and controversy matters.



# Joseph C. Mandarinino

---



## Partner

Smith, Gambrell & Russell, LLP  
Promenade, Suite 3100  
1230 Peachtree Street N.E.  
Atlanta, GA 30309

jmandarino@sgrlaw.com  
T: 404-815-3685

Mr. Mandarinino's practice focuses on tax and finance. He is well versed in a wide variety of businesses and transactions:

- ▶ Structuring M&A transactions, for both purchasers and sellers
- ▶ International transactions (inbound and outbound)
- ▶ Structuring private equity funds for a variety of different investment objectives, asset classes, and investor types, including limited partnerships and RICs
- ▶ Workouts, restructurings and bankruptcy
- ▶ Tax aspects of real estate development, property finance, and like-kind exchanges
- ▶ Transactions involving C corporations, S corporations, partnerships and LLCs
- ▶ Financial products
- ▶ Negotiating executive compensation and incentive arrangements (qualified and non-qualified) for both corporations and pass-through entities
- ▶ Tax aspects of real estate development, property finance, and like-kind exchanges
- ▶ Estate and business succession planning
- ▶ Tax-exempt organizations, including healthcare, advocacy and religious organizations
- ▶ State and local income, excise, sales and use taxes, including qualifying for state and local incentives, optimizing multi-state operations, structuring efficient remote seller arrangements, and obtaining voluntary disclosure agreements
- ▶ GAAP/tax compliance, including disclosure and ASC 740-10 issues

Mr. Mandarinino's practice also includes representation in tax controversy work. This includes handling and assisting in tax audits and appeals, obtaining rulings or advice from federal, state and foreign tax authorities, and regulatory hearings, as well as Tax Court and District Court litigation.



# Elizabeth M. Norman

---



## Partner

Nutter McClennen & Fish  
Seaport West  
155 Seaport Boulevard  
Boston, MA 02210

enorman@nutter.com  
T: 617.439.2438

Elizabeth M. Norman is a partner in the Tax Department. She focuses her practice on advising private investment funds and public and private companies on a broad range of tax issues involved in mergers, acquisitions and restructurings. She counsels clients on real estate taxation issues, including the tax-efficient structuring of real property investments, and represents lenders and borrowers in a variety of financing transactions.

Elizabeth has extensive experience advising clients on domestic and international corporate restructurings, U.S. and cross-border tax issues, including the structuring and U.S. federal tax treatment of outbound investments, subpart F income, foreign tax credits, FATCA compliance, classification and interpretation, and the negotiation of joint venture agreements to facilitate domestic and international investments. She represents private equity funds and investors in fund formations and secondary sales of fund interests, specializing in strategic guidance for tax-exempt and non-U.S. investors.

Elizabeth is a member of the Boston Bar Association. She serves as director and vice president of governance for the Massachusetts National Organization for Women and previously served as a director of the Boys & Girls Club of Middlesex County.

Prior to joining Nutter, Elizabeth was a senior tax associate at an international law firm in Boston. During law school, she served on the editorial board of the Michigan Law Review and was a Clarence Darrow Scholar.





# Agenda

---

- Old Regime – TEFRA
- Overview of the New Rules – Bipartisan Budget Act
  - Partnership Representative
  - Electing Out for Small Partnerships
  - Default Regime: Imputed Underpayment
  - Default Regime: No Imputed Underpayment
  - Alternative Regime: “Push-Out Election”
  - Administrative Adjustment Rules
  - Other Changes
- Current Implications
- Q&A

