New Partnership Representative Final Regulations Under Section 6223 Centralized Audit Regime

THURSDAY, OCTOBER 25, 2018, 1:00-2:50 pm Eastern

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PARTNERSHIP AUDIT RULES

IRS Reasons for Changes:

- 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
- 8/9/18 Effective Date of Final Regulations.
- 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
  - Years when it would owe less taxes are disregarded
  - 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 form 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?
  - At the moment, there is no guidance allowing a push out beyond the first-tier and there is, technically, a statutory restriction
  - See Pull-In Method
- The actual mechanism for making the push out election is uncertain.
- 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)

- 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

- Each Partnership must have a partnership representative (Treas. Reg. 301.6223-1(a)).
  - There may be only one partnership representative for a partnership taxable year at any given time.
  - Each partnership is required to designate a partnership representative for each taxable year (as provided by the Final Regulations).
  - A partnership representative may not be designated pursuant to a power of attorney (Form 2848).
  - Designation stays in effect until terminated by resignation, revocation or IRS determination that it is no longer in effect.
  - The partnership representative has the sole authority to act on behalf of the partnership – can bind partnership and partners

Eligibility to Serve as Partnership Representative

- Any person as defined in IRC 7701(a)(1), including an entity, may serve as a partnership representative if he, she or it has a "substantial presence" in the United States.
- The final regulations made clear that a partnership may designate itself as its own partnership representative, and that a disregarded entity may also be designated as a partnership representative.

Eligibility to Serve as Partnership Representative

- In the case where a disregarded entity, a partnership or other entity is appointed as Partnership Representative, the partnership must also appoint a designated individual or a person through whom “Entity Partnership Representative” acts.
- The designated individual must be appointed at the same time as designation of the entity partnership representative.

Eligibility to Serve as Partnership Representative

- Does a designated individual have to be an employee of the Partnership Representative? Can an entity with no employees serve as Partnership Representative?
- Answer: Final regulations made clear that the designated individual does not have to be an employee; and that an entity with no employees can serve as a Partnership Representative.

Eligibility to Serve as Partnership Representative

- Rationale/Basis: Appointment of a Partnership Representative and the designated individual allows the IRS and the partnership to easily identify who can act on behalf of the partnership representative without having to inquire into who has state law authority to act on behalf of the entity partnership representative.

Substantial Presence

- The “person” appointed to serve as Partnership Representative must have a substantial presence in the United States. Substantial presence is determined as follows:
  - The person makes themselves available to meet in person with the IRS in the United States at a reasonable time and place; and
  - the person has a United States taxpayer identification number, street address that is in the United States, and a telephone number with a United States area code.

Capacity to Act Requirement?

- Final regulations removed the capacity-to-act requirement, which was initially intended to apply when a person died, became incapacitated, or was unable to serve as Partnership Representative.
- It was removed because the partnership should have great flexibility in selected who shall serve as Partnership Representative so long as the person meets the “substantial presence” requirement.

Changing the Partnership Representative

- Final regulations maintain the rule that a partnership representative may only be changed in the context of an administrative proceeding; or in connection with the filing of an administrative adjustment request.
- To change the partnership representative prior to the beginning of an administrative proceeding, the regulations were revised to allow the partnership to make a change by revocation when the partnership is notified that its return was selected for examination.

Identification of Partnership Representative

- The regulations provide that a partnership must designate the partnership representative on the partnership tax return for that partnership taxable year (Form 1065).
- The rational for the rule is that such identification on an annual basis with the return provides certainty regarding who is the partnership representative for a particular taxable year.

Resignation of Partnership Representative

- A Partnership Representative may not resign at the same time he, she or it files an administrative adjustment request, but he, she or it may resign after a notice of administrative adjustment.
- Unlike the proposed regulations, a Partnership Representative or designated individual may not appoint his, her or its successor. The IRS reasoned that the resignation should be the last act of the Partnership Representative.

Resignation Requirement

- Written Notice to IRS – Partnership Representative must serve written notice to the IRS as prescribed.
- Within 30 days of receipt of that notice, the IRS will send written confirmation of receipt of written notification to the partnership.
- Effective Date of Resignation: Effective immediately upon the IRS written receipt.

Effect of Resignation

- As of the effective date of the resignation,
  - Resigning Partnership Representative (and designated individual) may not take any action on behalf of partnership;
  - Appointment is no longer in effect for taxable year affected by the resignation;
  - In the case of an Entity Partnership Representative, the appointment of the designated individual is also no longer effective
  - In the case of resignation of a designated individual, the designation of the Entity Partnership Representative is also not effective.

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 Designation Not in Effect

- A Partnership Representative designation is in effect unless and until the IRS determines otherwise.
- Thus, a Partnership Representative designated on the partnership tax return is the partnership representative even if the person lacks substantial presence in the United States.
- If a partnership fails to designate a Partnership Representative, the IRS may select any person to act as the Partnership Representative. However, the IRS may not appoint an IRS employee, agent or contractor cannot be appointed as Partnership Representative.

IRS Designation

- The IRS may also appoint an Entity Partnership Representative. To the extent that the IRS designates an Entity Partnership Representative, it must also appoint a designated individual to act on behalf of the Entity Partnership Representative.

Authority of Partnership Representative

- Binding nature of actions: The actions taken by the Partnership Representative and partnership bind the partnership, all partners of the partnership and other persons whose tax liability is determined in part of whole by the agreed upon adjustments.
- A resignation or revocation does affect the validity of any actions taken prior to such resignation or revocation.

Authority of Partnership Representative

- Partnership Representative has sole authority to act on behalf of the partnership.
- In the case of an “Entity Partnership Representative”, the designated individual ha sole authority to act on behalf of the Entity Partnership Representative and the partnership.
- No partner or any other person may participate in an administrative proceeding with the IRS consent.

Authority of Partnership Representative

- Designation of the Partnership Representative on the partnership tax return provides the authority to bind the partnership.
- A partnership that has to appoint a designated individual acts through such individual.

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.

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?

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

- Even with the adoption of the final regulations, 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).