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Partnership Tax Returns: High-Risk and Challenging Aspects

Anticipating the Most Serious and Costly Errors, and Evaluating Alternative Solutions

THURSDAY, FEBRUARY 19, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Vicki Meyer, Owner, **Vicki Meyer Consulting**, Orlando, Fla.

David Patch, Senior Director, National Tax Office Partnership Group, **BDO USA**, Bethesda, Md.

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Partnership Tax Returns: High-Risk and Challenging Aspects

Feb. 19, 2015

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Today's Program

Program Materials

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RETURN RISKS, FOCUS AND MITIGATION

Return Risks

- Technical
  - Possibly alleviated or remedied in audit or by amended return
- Accuracy and preparer penalties
  - Possibly mitigated by disclosures
- Missed method or strategy that seems obvious, causing economic harm to a party
- Administrative costs and hardships

Risk Focus

- Permanent tax effects
  - Could be timing item that reverses many years in the future
- Tax rate differences (capital gain vs. ordinary)
- Second-party risk – your client, the partnership, or partners
  - Each partner is a potential claimant.
- Third-party risk: Banks, financial institutions, up-the-chain owners
- Overall impact on partners
  - Administrative hardships
  - Delays

Know Thy Client And Thyself

- The number one risk in any engagement is in CLIENT ACCEPTANCE.
- Different CPA markets have different risk assessments.
- Different industries have different risk assessments.

Risk Mitigation

- Engagement letters
- Risk transference to either attorneys or back to client
- Sect. 9100
  - Treas. Reg. §301.9100-1(c): IRS discretion to grant a reasonable extension of time for making an election
  - Treas. Reg. §301.9100-2: **Automatic** extensions of time for **regulatory** and **statutory** elections
  - Treas. Reg. §301.9100-3: **Non-automatic** extensions of time for **regulatory** elections that do not meet the requirements of Treas. Reg. §301.9100-2 (**9100 relief**)

9100 Relief

Requirements

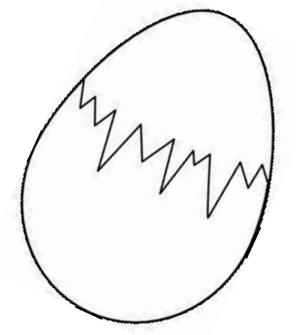
- Taxpayer “acted reasonably and in good faith.”
  - Reliance on qualified tax professional
  - Sought relief before the IRS detected the failure
- Not good faith if:
  - **Seeks to alter a position subject to an accuracy related penalty**
  - Made an informed decision to not make the election
- Relief must not prejudice the interests of the government.
  - Does not mean that prejudice exists if the relief will reduce the taxpayers’ taxes, but rather that the tax liability is lower than if the taxpayer had made a timely election

9100 Relief (Cont.)

Requirements

- Relief must not prejudice the interests of the government
  - Does not mean that prejudice exists if the relief will reduce the taxpayers' taxes, but rather that the tax liability is lower than if the taxpayer had made a timely election

Sect. 9100 Relief Isn't Always What It Is Cracked Up To Be



- Affidavit of culpability?
- Insurance carrier issues
- Time constraints
- Cost of missing automatic window, going the PLR route
- Permanent loss of item if relief fails

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RELEVANT PROFESSIONAL STANDARDS

Relevant Professional Standards

- NEW AICPA Code of Conduct – 1.300.001 General Standards Rule

Competence - Care - Planning & Supervision - Sufficient Relevant Data

- Tax Practice Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings*
- Circular 230
  - Diligence as to accuracy (§10.22)
  - Due diligence standards – returns/docs (§10.34)
  - Conflicting interests (§10.29)
  - Impact of *Loving*

Vicki Meyer, Meyer Consulting, PLLC
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HIGH-RISK ISSUES

#1 Conflicting Interests (§10.29)

One client's interest directly adverse to another

- Significant risk of material limitation of representation of one client by responsibilities to either another client, a former client, a third person, OR by the PERSONAL INTERESTS OF THE PRACTITIONER
- Prepare returns for pass-through entity and one or more owners
- Entity-level tax recommendations that impact your client's personal return, but you do not prepare returns for all owners
- IRS examinations
  - Practitioner recommended a position that is now under review by IRS .
  - Errors or omissions on prior-year returns

#1 Conflicting Interests (§10.29) (Cont.)

May represent if:

- YOU have reasonable belief in ability to provide competent, diligent representation to each affected client.
- Not legally prohibited
- EACH affected client waives conflict, by giving INFORMED consent in writing at the time conflict is known.
- Retain consents for at least 36 months after engagement concludes
- Provide written consents, on request, to any officer/employee of IRS

Conflicting Interests Applied To Partnerships

- Conflicts under sections 736(a) and (b)
- Sect. 704(c)elections (traditional, curative, remedial), especially with regarded to intangibles under Sect. 197
- Valuations
  - Book-ups
  - Sect. 1060
  - Sect. 754 adjustments
  - Sect. 751(a) or Sect. 751(b) disclosures
- Any election that affects the partners in partnership differently, or favors one particular partner
- Tax matters partner issues

#2 Missed Opportunities For Elections: Partnership Elections

- Sect. 179 - electing depreciation method or in/out of bonus
- Sect. 614 – Definition of property – mines, wells
- Sect. 1033 – involuntary conversions
- Sect. 754 - step up the basis of assets OR mandatory adjustments
- Sect. 743(e) - electing large partnership
- Sect. 761 - election to not be taxed as a partnership (certain joint ventures)
- Disregarded entity election – missed Form 8832 elections

#2 Missed Opportunities For Elections: Partnership Elections (Cont.)

Sect. 59(e) – election to deduct ratably IDC, mining or research and experimental expenditures

Sect. 108 – Cancellation of indebtedness (COD) income

Sect. 199 – DMD determined at partner level

Sect. 617 - deduction and recapture of certain mining expenditures

Sect. 901 – foreign tax credit

#3 Improper Year-End

- Majority owner, principal owner, least aggregate deferral methods not applied properly
- Missed elections under Sect. 444 for other than a required year-end

#4 Improper Categorization Of Partners

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? (see instructions)

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) . . . . ☐

- Incorrect identification of how interest is held; disregarded entities?
- May effect upstream tax returns
- May impact SE tax, material participation standards and withholding

#5 Technical Terminations

- Sale or exchange of 50% or more of the interests in partnership profits and capital within a 12-month period
- Not identifying correctly or timely
- Not marking page 1 correctly
- Deducting organization and startup costs: new regulations require carryover to new partnership
- Selecting the correct tax year going forward

G Check applicable boxes: **(1)** ☐ Initial return **(2)** ☐ Final return **(3)** ☐ Name change **(4)** ☐ Address change **(5)** ☐ Amended return
(6) ☐ Technical termination - also check (1) or (2)

H Check accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶

J Check if Schedules C and M-3 are attached . . . . ☐

#5 Technical Terminations (Cont.)

- Service center “nightmares”; late filing penalty based on number of partners
- Sect. 754 considerations
  - Missed election on return of terminating partnership: Sect. 754 election of a partnership that terminates under Sect. 708(b)(1)(B) does not carry over to the new partnership
- Other elections and methods

G Check applicable boxes: **(1)** ☐ Initial return **(2)** ☐ Final return **(3)** ☐ Name change **(4)** ☐ Address change **(5)** ☐ Amended return
(6) ☐ Technical termination - also check (1) or (2)
H Check accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶
J Check if Schedules C and M-3 are attached . . . . ☐

#6 Liability Characterization And Allocation

K	Partner's share of liabilities at year end:		
	Nonrecourse	$	
	Qualified nonrecourse financing .	$	
	Recourse	$	

- Failure to identify liabilities, or use of non-tax numbers
- Improper classification of recourse, non-recourse and qualified non-recourse debt
- Improper allocation
- Failure to include lower-tier partnership liabilities

#6 Liability Characterization And Allocation

An "obligation" is only a "liability" for tax purposes if incurring the liability:

- Creates or increases the basis of any of the obligor's assets (including cash);
- Gives rise to an immediate tax deduction to the obligor; or
- Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Items identified as liabilities on a GAAP balance sheet may not be liabilities for tax purposes

#6 Liability Characterization And Allocation

- Recourse debt is a liability for which a partner or related person bears the economic risk
  - General Partners
  - Guarantors
  - Partners as lenders
  - All sources of liability considered
- Nonrecourse debt
  - Everything else
  - LLC debts

#6 Liability Characterization And Allocation

- Qualified Nonrecourse Debt
  - Activity of holding real property
  - Secured by real property used in that activity
  - Borrowed from a qualified person or from a federal, state or local government; or guaranteed by any federal, state or local government
  - No person is personally liable
  - Not convertible

#6 Liability Characterization And Allocation

- Recourse debt must be allocated to the partner who bears the economic risk (proposed rules changes!)
- Nonrecourse and Qualified Nonrecourse debt is allocated based on a 3-tiered rule
  - Minimum Gain
  - Tax Minimum Gain
  - Profits Interests
    - Lots of flexibility in defining profits interest
    - Doesn’t need to be same method each year

#6 Liability Characterization And Allocation

- An upper-tier partnership's share of a lower-tier partnership's liabilities are treated as liabilities of the upper-tier partnership
  - Should be allocated to the upper-tier partners on their K-1s
  - Any lower-tier partnership liabilities owed to the upper-tier partnership are excluded
  - Sometime hard to verify the lower-tier's liability allocations

#6 Liability Characterization And Allocation

- Partners may not claim partnership losses in excess of basis (§704(d))
- Individuals and certain corporations may not claim partnership losses in excess of *at-risk* basis (§465)
- Liabilities may provide basis and at-risk basis
  - Recourse debt provides tax basis and may provide at-risk basis
  - Qualified Nonrecourse debt provides tax basis and at-risk basis
  - Nonrecourse debt provides tax basis but not at-risk basis

#6 Liability Characterization And Allocation

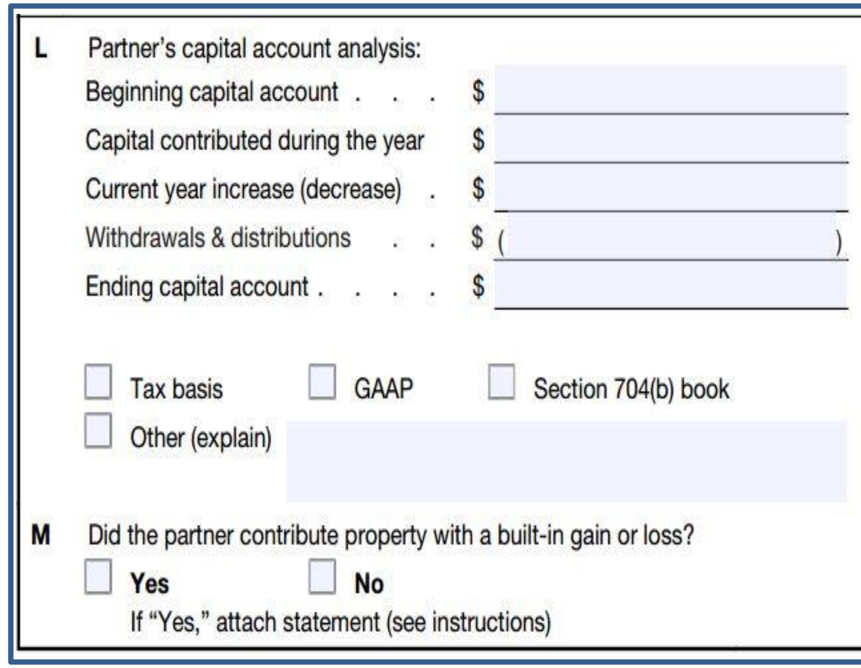
- Liability allocation do not generally affect the allocation of partnership profits and losses
  - Loss allocations are limited by capital accounts that are not affected by liability allocations
  - Exception for certain losses attributable to recourse debt
  - May create a deficit restoration obligation allowing a partner to have a negative capital account
- Liability allocations may affect a partner's ability to claim losses once allocated

#6 Liability Characterization And Allocation

- Improper liability treatment may cause partner errors:
  - Inappropriate gain recognition or nonrecognition
    - Missed basis adjustments
  - Failure to limit loss deductions
  - Incorrect allocations
    - Non-recourse deductions and minimum gain chargebacks
    - Creation of a deficit restoration obligation
  - Failure to recognize a transaction as a disguised sale
- Liability allocations may at times be unimportant

#7 Capital Accounts

- Improper identification of presentation basis (tax, GAAP, Sect. 704(b) or other)
- Failure to properly calculate basis under the method identified



L Partner's capital account analysis:

Beginning capital account . . .	$	
Capital contributed during the year	$	
Current year increase (decrease) .	$	
Withdrawals & distributions . .	$	( )
Ending capital account	$	

☐ Tax basis ☐ GAAP ☐ Section 704(b) book

☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?

☐ **Yes** ☐ **No**

If "Yes," attach statement (see instructions)

#7 Capital Accounts

- Failure to properly present capital accounts on the K-1 may cause partner errors
  - Basis / at-risk basis
  - Projections
- Failure to maintain capital accounts may lead to errors on the partnership return
  - Deficit capital accounts
  - Distributions in excess of basis and resulting partnership basis adjustments
  - Targeted allocations

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#8 Grouping Of Passive Activities

- By not separately disclosing activities, you may have made an election that cannot be changed without consent of commissioner.
- In first year partner is subject to Sec. 1411, tax can re-group without permission.
- Groupings made to avoid Sec. 1411 tax

PARTNERSHIP			ACTIVITY NAME(S)					
		A						
		B						
ACTIVITY NAME(S)		C						
		D						
		E						
			Activity A	Activity B	Activity C	Activity D	Activity E	TOTAL
SCHEDULE K-1 LINE REFERENCES								
1.	Ordinary Business Income (Loss)							
2.	Net Rental Real Estate Income (Loss)							
3.	Other Net Rental Income (Loss)							

#9 Anything Foreign

- Schedule B and C questions
- FBAR (OPR – lack of documentation is misconduct)
- FACTA
- Withholding issues
- Foreign asset report delayed for partnerships until at least 2014
- Engagement letters to mitigate exposure?
- Missed foreign information filings by partnership/partner
  - Forms 5471, 8865, 8858, etc.
  - Offshore voluntary disclosure program
    - Announced Jan. 9, 2012; uncertain duration

#10 Ownership Percentages

- May contradict partner's own concept of his or her interest
- Changes to K-1 instructions made in 2010
  - Overriding software to get to "1"
  - On entrance or departure of a partner, amounts may be greater than "1"
- Third-party reliance on K-1
- TEFRA examinations resulting in "computational adjustments" may rely on these percentages.
  - Communicate with TEFRA unit

#11 W-2s Issued To Partners

- In general, cannot be an employee and a partner at the same time – Sect. 707(c)
- Guaranteed payments deductible to partnership based on the partnership's method of accounting
- Taxable to partner based on K-1 year, not necessarily year cash received
  - Sect. 461(h) contingencies built into bonuses?
- Includes certain amounts paid for medical insurance for a partner, a partner's spouse or dependents
- Once detected, amend W-2/W-3?

#12 High Error Rate Items

- Hedge Funds - Filing returns with missing information; working with estimated lower-tier information; UBTI computations; Form 8082 – notice of inconsistent treatment or administrative adjustment.
- Publically Traded Partnerships (PTP) - not identifying; incorrectly combining with other passive activities.
- Reportable Transactions - Missed Form 8886; disclosures from lower-tier partnerships (see Notice 2006-16); changes to reportable transaction rules.

#13 New Tangible Repair Regs

- Partial Asset Dispositions (PADs) Method Change - #205, #206 #196
- Impermissible to permissible depreciation methods - #7
- Basis may be different for Sec. 754 partners.
- Calculate Sec. 481 adjustment with/without Sec 754 difference.
- Allocate and/or disclose Sec 754 portion to appropriate partners.

#14 Targeted Allocations

- Safe harbor method –
  - Allocations specified by the agreement
  - Capital accounts track contributions, distributions and allocations
  - Liquidating distributions based on capital accounts
- Targeted Allocations
  - Liquidating distributions specified by the agreement
  - Allocations line up capital accounts with liquidating distribution s
  - No authoritative guidance

#14 Targeted Allocations: Typical Language

Except as provided, Net Profits and Net Losses for each period shall be allocated to the Members in such a manner that, as of the end of such period, to the extent possible, each Member's Adjusted Capital Account equals the amount that would be distributed to such Member if the Company were to (i) sell all its assets for an amount equal to Gross Asset Value, and (ii) distribute the proceeds in accordance with the liquidating distribution provisions of this agreement.

#14 Targeted Allocations: Example

Safe Harbor	
	Capital Account
Beginning	$50
Taxable Income	$100
Ending	***Calculated***

Target	
	Capital Account
Beginning	$50
Taxable Income	***Calculated***
Distribution Rights	$150

- Agreement specifies how to allocate income
- Ending capital determines distribution rights

- Agreement specifies liquidating distributions
- Allocations plug to line up ending capital with distributions

#14 Targeted Allocations: Drafter vs. Preparer Risk

Drafter

- Reduces the risk that incorrect or unexpected allocations will alter the economic deal
- Economics are defined by the distribution provisions
  - Easier to draft
  - Less complex

Preparer

- More difficult to determine allocations
  - Allocations are not specified but are derived from distribution provisions
  - Requires accurate maintenance of capital accounts
- Transfers risk to tax return preparers

#14 Targeted Allocations: Substantial Economic Effect

- Do not satisfy the economic effect requirements
  - May or may not have economic effect “equivalence”
  - May or may not be in accordance with “PIP”
  - May or may not be respected (no authoritative guidance)
- Lack of economic effect raises other issues
  - Allocation of nonrecourse deductions and liabilities
  - Exceptions to debt-financed UBTI (fractions rule)

#14 Targeted Allocations

- What if Profit or Loss is insufficient to achieve Target?
- e.g., Preferred returns
  - A member's right to liquidating distributions may increase in a loss year due to a preferred return
  - Effectively shifts capital between partners
  - Should gross income / deductions be specially allocated to hit target? What if gross items are insufficient?
  - Should a guaranteed payment be accrued?

#15 Partnership Agreement Modifications

- Under section 761(c), a partnership agreement may be amended with respect to a year until the unextended due date of the return
- Contemporaneous partners may change the way they share income retroactively
  - Overrides section 706(d) to some extent
  - Cannot allocate income to someone who was not yet a partner
  - Cannot relate to subsequent contributions by existing partners
- No retroactive changes allowed other than to the partnership agreement (e.g., cannot retroactively modify guarantees)

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RECENT PARTNERSHIP GUIDANCE

Recent Partnership Guidance

Final & Proposed Noncompensatory Partnership Option Regs

- Treatment of non-compensatory options issued by a partnership
- Includes convertible debt and convertible equity
- Generally provides for nonrecognition on receipt and exercise
- Accounting rules for economic shifts
- Taxability of lapse, cash settlement
- Specifies circumstances in which an option holder will be treated as a partner
- Significant questions remain unanswered

Recent Partnership Guidance

Proposed Debt Allocation Regulations

- More than one partner bears the risk of loss
- Tiered partnerships
- Relatedness tests
- Recognition of Payment Obligations
- Bottom Guarantees
- Net Value Requirement
- Nonrecourse Liability Allocations

Recent Partnership Guidance

Proposed Loss Transfer Regulations

- Prohibition on built-in loss shifting under section 704(c)(1)(C).
- Section 743 substantial built-in loss
- Electing Investment Partnerships
- Section 734 substantial basis reduction
- Section 755 basis adjustment allocation rules
- No Netting of 704(c) layers

Recent Partnership Guidance

Proposed Disguised Sale Regulations

- Debt Financed Distributions
- Preformation Expenditures
- Qualified Liabilities
- Tiered Partnerships
- Assets-Over Mergers
- Disguised Sales of Property to a Partner

Recent Partnership Guidance

Leveraged Partnership Cases

***Canal Corporation*, 135 TC 199 (2010)**

- Canal contributed $775m business into a partnership
- Partnership borrowed $755m and distributed to Canal
- Not a “disguised sale” as long as debt allocated to Canal
- Court: Canal didn’t really have risk of loss – debt to other partner

Chief Counsel Advice 201324013

- Pending litigation on similar transaction involving Tribune Company / Newsday sale to Cablevision
- Similar challenge expected on Tribune Company transaction involving the Chicago Cubs

Vicki Meyer, Meyer Consulting, PLLC

SUGGESTED READING

Suggested Reading

Brock, Noel P., "Targeted Partnership Allocations: Part I," *The Tax Adviser* June 2013

Brock, Noel P., "Targeted Partnership Allocations: Part II," *The Tax Adviser* July 2013

Standards of Tax Practice Committee, ABA Tax Section, " Dealing with Conflicts of Interest and Related Issues in 9100 Situations," *Web at American Bar*

Suggested Reading (Cont.)

AICPA Partnership Taxation Technical Resource Panel, "Partnership & Partner Elections" (revised February 2010), *Web at AICPA Tax Section Member*

Swann, Deborah and Sowell, Jim, "Flexibility in Retroactive Partnership Agreement Amendments," *The Tax Advisor*, June 2008

IRS, "Partnership - Audit Technique Guide - Revised 12/2007, last reviewed or updated January 2013," *Web at www.irs.gov*

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Q&A

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Please join us for our next tax conference, “Form 8903: Domestic Production Activities Deduction for Pass-Thrus and Other Business Entities - Mastering Complex Determinations, Calculations and Reporting Challenges for the DPAD,” scheduled on Wednesday, February 25, 2015, starting at 1pm EST.

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