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New Tax Laws Relating to IRS Examination of and Tax Collection from Partnerships:

Implications for Existing and Future Partnership and LLC Agreements

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Washington, DC and New York, NY
January 26, 2016

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AGENDA

I. TEFRA – Reasons for Repeal
- The TEFRA partnership provisions were difficult to implement
- The complexity resulted in fewer examinations
- The complexity resulted in lost tax revenue

II. Legislative Overhaul – Bipartisan Budget Act of 2015
- TEFRA repealed
- New terms of art
- New tax collection concepts

III. Options for a Partnership or LLC Facing IRS Examination and/or Collection
- Collect from Partnership - Default
- Elect Out on Timely Filed Return
- Revised K-1 Procedure

IV. Issues to Consider in Drafting Documents

V. Questions

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I. TEFRA – REASONS FOR REPEAL

A. The TEFRA Partnership provisions were difficult to implement.

1. Pre-TEFRA

- Audits were only conducted at the partner level; if the IRS wanted to audit a partnership item, the IRS had to audit each partner individually.
- Created duplication of effort and administrative difficulties.
- Also led to inconsistencies in how partners were treated

2. TEFRA was designed to address these problems by allowing an audit of partnership items to be conducted at the partnership level. The TEFRA provisions are incorporated in Sections 6221-6234 of the Code.

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I. TEFRA – REASONS FOR REPEAL

A. The TEFRA Partnership provisions were difficult to implement (cont).

3. TEFRA enacted in 1982 to create examination efficiencies.

4. But the new rules created examination complexities.

"The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field….Its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries."

Foxman v. Commissioner, 41 T.C. 535, 551 (1964)

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I. TEFRA – REASONS FOR REPEAL

B. The complexity of TEFRA resulted in fewer examinations.

1. In 2011

a. SB/SE (which Audits partnerships with $10 million or less in assets) Conducted about 5,150 partnership audits.

b. LB&I (Audits partnerships with more then $10 million in assets), audited about 150 partnerships even though almost 200,000 pass through entities had more than $10 million in assets.

2. In fiscal 2013, IRS audited 14,870 partnerships representing 0.4% of the total partnership returns filed the previous year and 44 percent of those audits were closed with no change.

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I. TEFRA – REASONS FOR REPEAL

C. The complexity resulted in lost tax revenue.

National Bureau of Economic Research (September, 2015) working paper found:

- "Pass-through' businesses like partnerships and S-corporations now generate over half of U.S. business income and account for over half of the post-1980 rise in the top 1% income share." p. 1.

- "Our inability to unambiguously trace 30 percent of partnership income or the originating partnership underscores the concern that the current U.S. tax code encourages firms to organize opaquely in partnership form in order to minimize tax burdens." p. 24.

The new rules are expected to raise $9 billion in new tax revenue.

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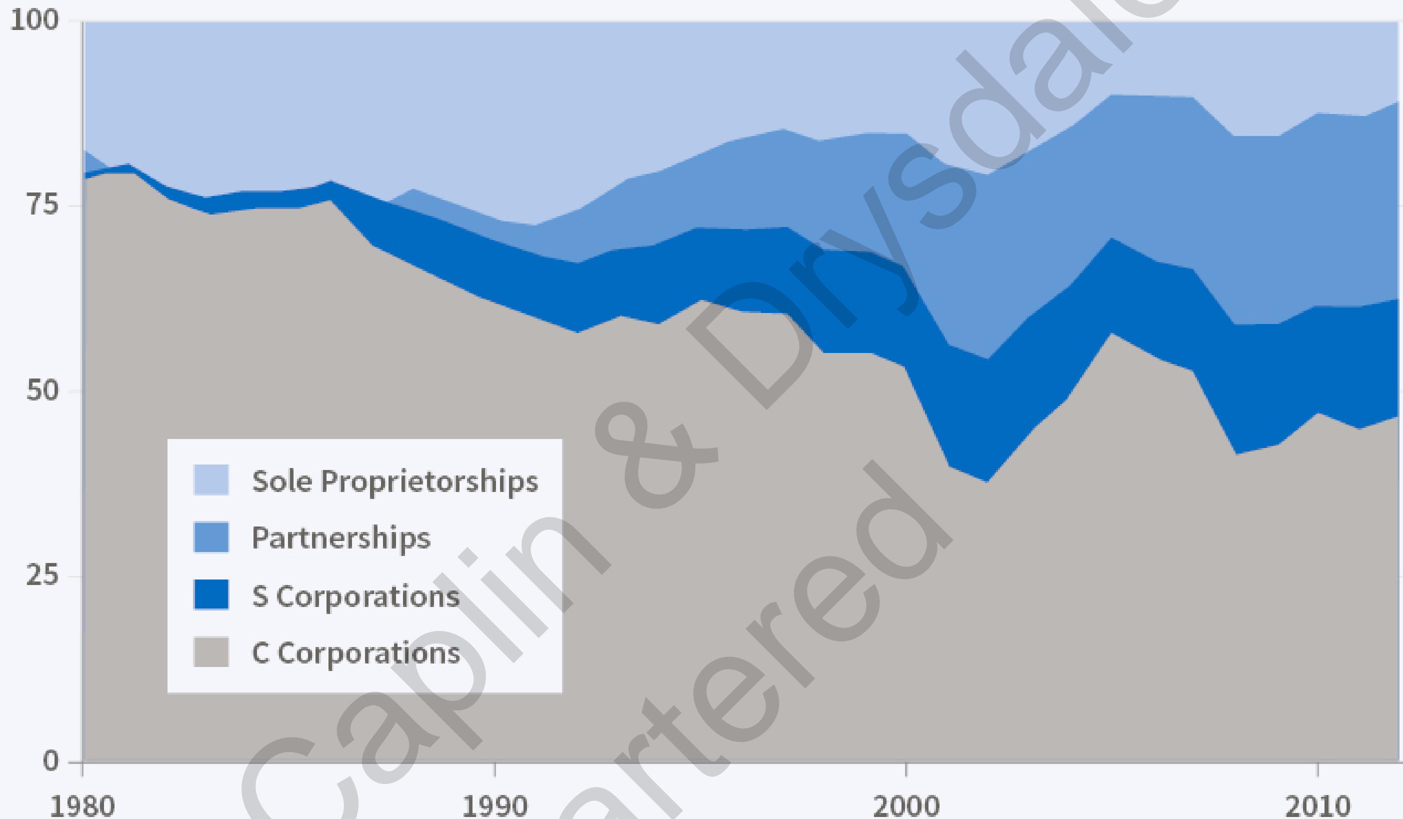
I. TEFRA – REASONS FOR REPEAL



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I. TEFRA – REASONS FOR REPEAL

Partnerships may now settle and pay tax on behalf of their partners.

I.R.M. 4.31.2.2.9 (10/1/10): **SECURING AGREEMENTS FOR TAX ASSESSMENTS AT THE PARTNERSHIP LEVEL**

1. Some partnerships request to settle and pay tax deficiencies on behalf of their partners. When such a request is made, local counsel must be consulted.
2. The details of a partnership level settlement are explained in a Form 906, Closing Agreement on Final Determination Covering Specific Matters. A partnership level agreement can only be secured when the adjustments passing through to all underlying partners will result in a deficiency. If any partner is subject to a refund, then a partnership level agreement cannot be secured. All partners must be adjusted individually.
3. The highest effective tax rate should be used when calculating the amount of tax owed. The partnership must also pay all additions to tax including interest and penalties.
4. The Form 906 should be executed in the field before sending a copy to the CTF.

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II. Legislative Overhaul – Bipartisan Budget Act of 2015

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II. LEGISLATIVE OVERHAUL – BIPARTISAN BUDGET ACT OF 2015

A. TEFRA Repealed

B. New Terms of Art

1. Partnership Representative
2. Imputed Underpayment
3. Reviewed Year
4. Adjustment Year

TITLE XI—REVENUE PROVISIONS RELATED TO TAX COMPLIANCE

SEC. 1101. PARTNERSHIP AUDITS AND ADJUSTMENTS.

(a) REPEAL OF TEFRA PARTNERSHIP AUDIT RULES.—Chapter 63 of the Internal Revenue Code of 1986 is amended by striking subchapter C (and by striking the item relating to such subchapter in the table of subchapters for such chapter).

(b) REPEAL OF ELECTING LARGE PARTNERSHIP RULES.—

(1) IN GENERAL.—Subchapter K of chapter 1 of such Code is amended by striking part IV (and by striking the item relating to such part in the table of parts for such subchapter).

(2) ASSESSMENT RULES RELATING TO ELECTING LARGE PARTNERSHIPS.—Chapter 63 of such Code is amended by striking subchapter D (and by striking the item relating to such subchapter in the table of subchapters for such chapter).

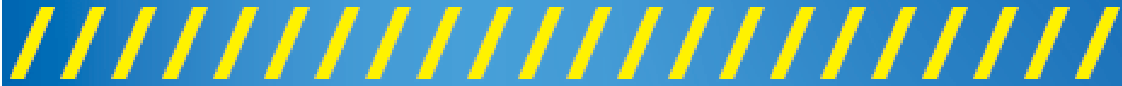
(c) PARTNERSHIP AUDIT REFORM.—

(1) IN GENERAL.—Chapter 63 of such Code, as amended by the preceding provisions of this section, is amended by inserting after subchapter B the following new subchapter:

II. TEFRA OVERHAUL – BIPARTISAN BUDGET ACT OF 2015

C. New Tax Collection Concepts

1. Collecting from Partnership – Default
    - Partner Amended Returns within 270 Days of Notice of Proposed Adjustment
2. Electing Out on Timely Filed Return
3. Revised K-1 Procedure within 45 Days of Final Notice



III. Options for a Partnership or LLC Facing IRS Examination or Collection

III. OPTIONS FOR A PARTNERSHIP (OR LLC) :

A. Collecting from Partnership – Default

1. As under TEFRA, tax adjustments will continue to be made at the partnership level.
2. However, unlike under TEFRA, unless a partnership is eligible to make an annual election and does in fact make the election on its return, the tax attributable to an adjustment, and related interest and penalties, will be collected at the partnership level.
3. When the IRS makes a tax adjustment, the partnership's current partners (the "adjustment year" partners) will effectively pay the tax for the persons who were partners in the taxable year for which the adjustment was made (the "reviewed year" partners), unless the partnership agreement provides otherwise.
4. The tax to be paid is based on another new concept, a calculation called the "imputed underpayment".

III. OPTIONS FOR A PARTNERSHIP OR LLC FACING IRS EXAMINATION OR COLLECTION:

A. Collecting from Partnership – Default

5. Generally, the imputed underpayment is calculated at the highest marginal tax rate for the reviewed year.
   a. A partnership can reduce the amount of the "imputed underpayment" by the amount of tax paid by the "reviewed year" partners who file amended returns and pay the tax attributable to them. The partnership must submit information to the IRS sufficient to modify the "imputed payment amount" within 270 days after the notice of proposed adjustments.
   b. Regulations will provide for taking into account a lower rate of tax with respect to ordinary income of a C corporation or capital gain and qualified dividends of an individual.
   c. Regulations will also provide for determining the imputed underpayment without regard to the portion allocable to tax exempt partners.

III. OPTIONS FOR A PARTNERSHIP OR LLC FACING IRS EXAMINATION OR COLLECTION

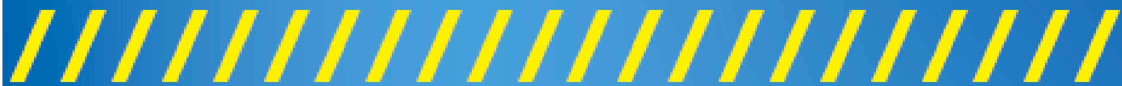
B. Elect Out on Timely Filed Return

1. If a partnership has fewer than 100 partners and no partner is itself a partnership (or an entity that has elected to be treated as a partnership, like a limited liability company), then the partnership can make an annual “opt out” election on a timely filed tax return.
2. If preserving this option is important to a partnership, its partnership agreement should be amended to limit the number of partners to 99 or 100 and to restrict the ability of other partnerships to join the partnership as a partner.
3. If a partnership elects out of the new regime, the partnership and partners will be examined under the rules applicable to individual taxpayers Section 6221(b) of the code.

III. OPTIONS FOR A PARTNERSHIP OR LLC FACING IRS EXAMINATION OR COLLECTION

C. <u>Revised K-1 procedure.</u>

1. Within 45 days of receiving a notice of final partnership adjustment, any partnership, regardless of size, may elect out of the "imputed underpayment" process so long as it provides the IRS with "a statement of each partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment)."
2. Under this procedure, "reviewed year" partners calculate their share of additional tax due based on the statement described above (*i.e.*, like an amended Schedule K-1). and the "reviewed year" partner will pay the additional amount with their respective current year individual tax return.
3. An election under this provision, however, increases the applicable underpayment interest rate by two percentage points.
4. The new statute requires fast action by the partnership (*i.e.*, 45 days) to perform computations and send the proper notices.
5. Therefore, a procedure should be put in place to accomplish this procedural route.



IV. Issues to Consider in Drafting Documents

IV. ISSUES TO BE CONSIDERED IN DRAFTING DOCUMENTS

A. Partnership and LLC Agreements
   1. Management and control of the process
   2. Rights of partners
   3. Allocation provisions
   4. Treatment of former partners

B. Disclosure Issues

C. Impact on Ancillary Agreements

ADDITIONAL QUESTIONS FOR THE SPEAKERS

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Next Webinar on the Topic in March, 2016