

Fundamental Partnership Audit Reform, Part 1—How It Happened?

D.C. Bar Panel
Tuesday, February 2, 2016 at 12:00 p.m.
Washington, D.C.

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Ryan McCormick
The Real Estate Roundtable, Washington, D.C.



The Real Estate Roundtable



Caplin & Drysdale



Outline

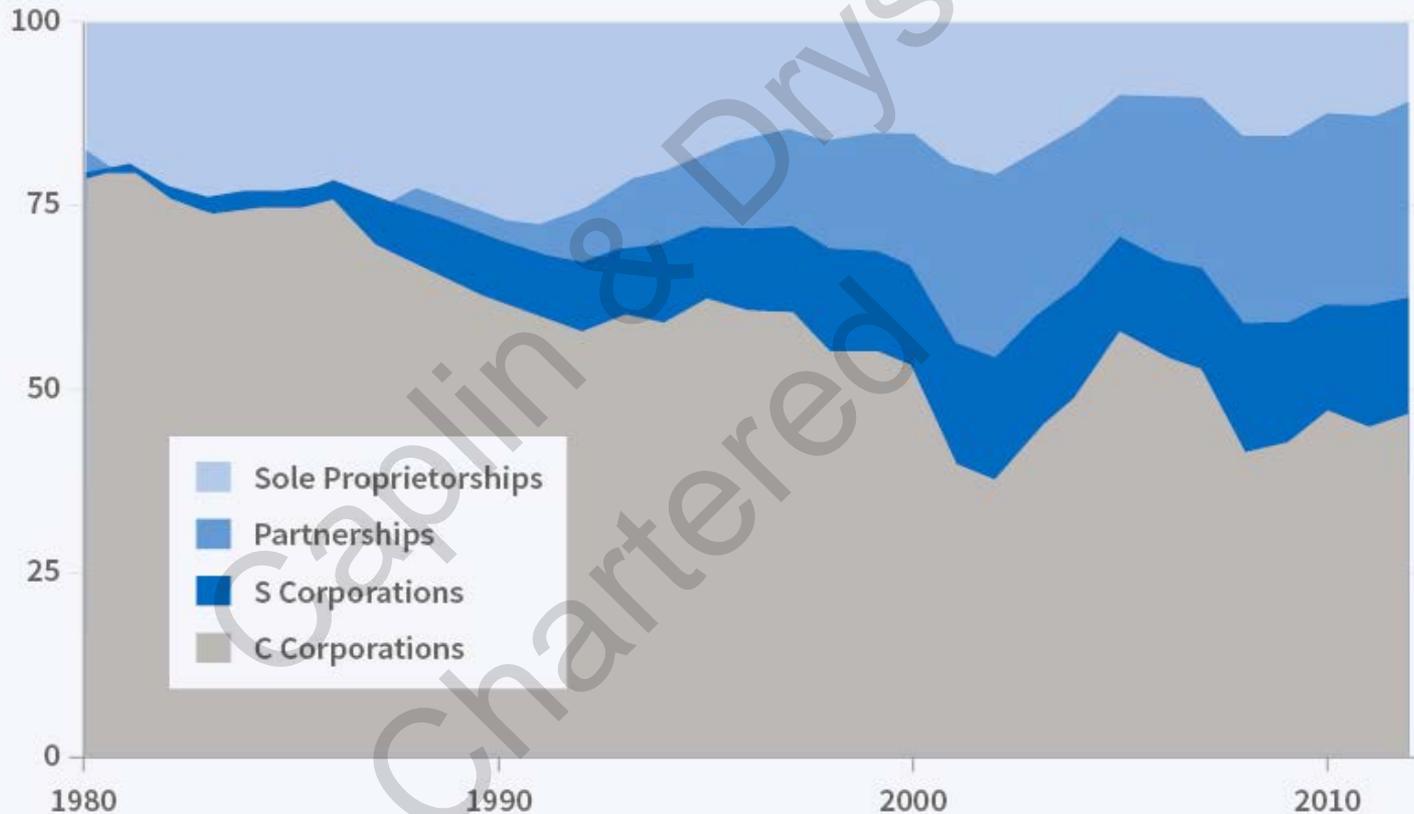
- I. Reasons for Change
- II. Industry Reactions
- III. Overview of Statutory Provisions
- IV. Examples and Discussion

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I. Reasons for Change

THE RAPID GROWTH OF PASS-THROUGH BUSINESSES

Percentage of total net business income

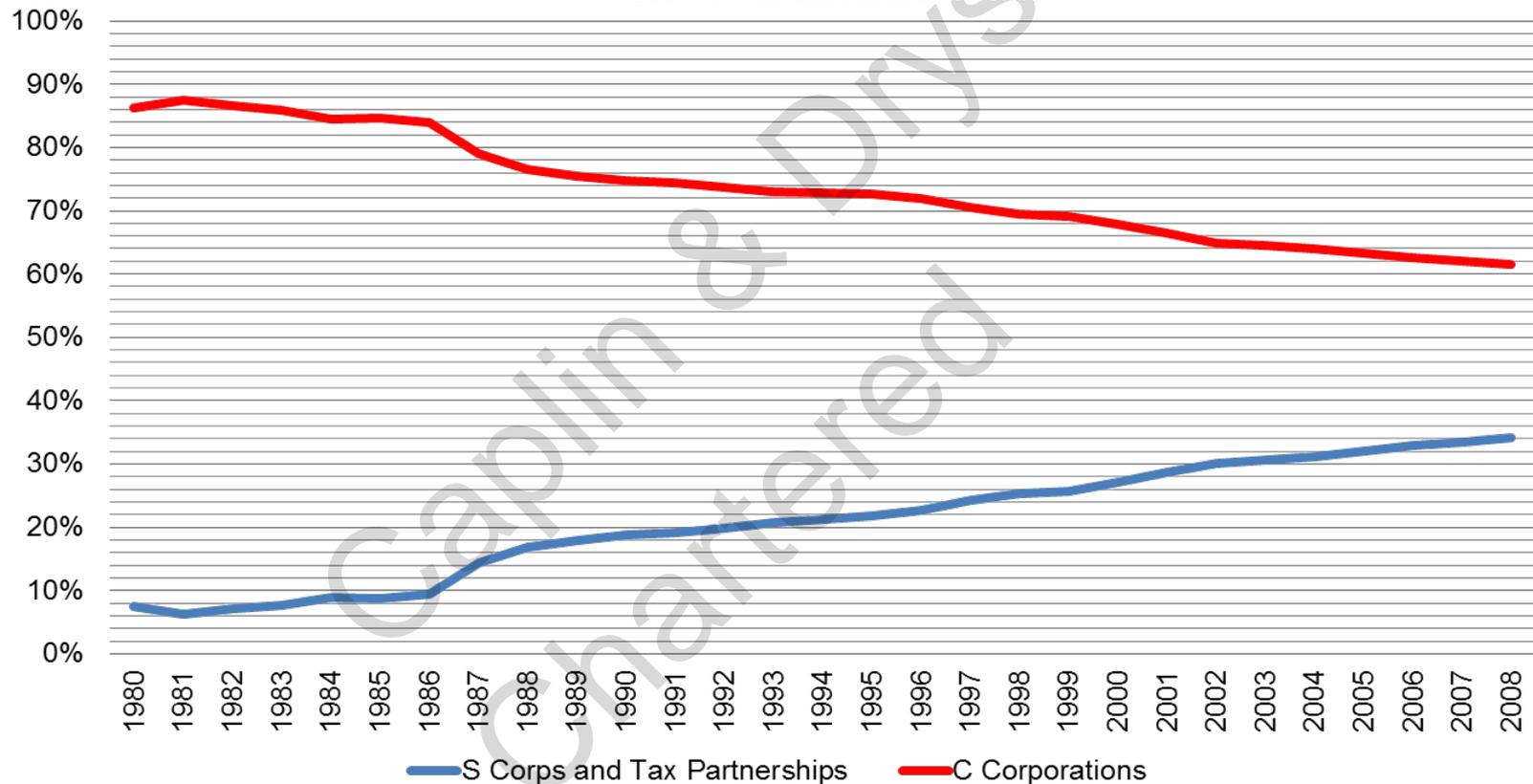


Source: Authors' calculations, Department of the Treasury data

I. Reasons for Change

Percent of total business receipts
C corporations versus tax partnerships and S corporations

Source: IRS Statistics of Income



Industry Reactions

II. Industry Reactions

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III. Overview of Statutory Provisions

- A. TEFRA Repealed
 - Bipartisan Budget Act of 2015

TEFRA RIP

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:

III. Overview of Statutory Provisions

B. New Terms of Art

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

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
 - “Special” K-1
 - “Push Out”

III. Overview of Statutory Provisions

B. New Terms of Art

1. Partnership Representative (section 6223)

- a. Party selected to represent partnership before IRS and make tax decisions
- b. Sole authority
- c. Not required to be a partner
- d. Person with substantial U.S. presence (under section 7701(a)(1)), includes individual, trust, estate, partnership, association, company, or corporation
- e. IRS will appoint if partnership does not
- f. Unlike TEFRA, partners do not have the right to participate in the proceedings or receive notice of proceedings from IRS. Section 6231.

III. Overview of Statutory Provisions

B. New Terms of Art

1. Partnership Representative
2. Imputed Underpayment – Net non-favorable adjustments to partnership tax year multiplied by the highest applicable tax rate
3. Reviewed Year (section 6225(d)(1)) – Partnership tax year under audit.
4. Adjustment Year (section 6225(d)(2)) – Year in which the adjustment for the reviewed year is made
 - a. Year in which partnership adjustment becomes final under a court decision
 - b. Year in which adjustment is made pursuant to an administrative adjustment request
 - c. Year in which final partnership adjustment (FPA) is made (all other cases)

- C. Statute of Limitations on Assessment – only determined at the partnership level. Section 6235.

III. Overview of Statutory Provisions

A. Collecting from Partnership – Default (section 6225)

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, 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).
4. The tax to be paid is based on the "imputed underpayment".
5. Penalties (and defenses) determined at partnership level. Section 6233.

III. Overview of Statutory Provisions

A. Collecting from Partnership – Default

5. Generally, the imputed underpayment is calculated at the highest marginal tax rate for the reviewed year (39.6%).
6. Reduction to Imputed Underpayment - A partnership can reduce the amount of the “imputed underpayment” or actual tax by:
 - The “reviewed year” partners who file amended returns and pay the tax attributable to their allocable adjustment amounts. The partnership must submit information to the IRS sufficient to modify the “imputed payment amount” within 270 days after the notice of proposed adjustments.
 - Regulations will provide for taking into account a lower rate of tax with respect to (a) ordinary income of a C corporation, (b) capital gain and qualified dividends of an individual, and (c) tax exempt partners (0% tax rate).
 - IRS must approve modifications.

III. Overview of Statutory Provisions

B. Elect Out on Timely Filed Return (section 6221(b))

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.
 - Year-by-year election
 - Provide name and TIN of each partner
 - Query whether can elect out if partner is a grantor trust.
2. 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).

III. Overview of Statutory Provisions

C. Revised K-1 Procedure (section 6226).

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 (*i.e.*, amended Schedule K-1) and the “reviewed year” partner will pay the additional amount with their respective current year individual tax return.
3. The added tax due from the partner is computed as if it were an amended return for the “reviewed year “ with adjustments for tax attributes for later years.

III. Overview of Statutory Provisions

C. Revised K-1 Procedure (section 6226).

4. An election under this provision increases the applicable underpayment interest rate by two percentage points.
5. Partners also liable for penalties.
6. Reviewed year partners have no right to an administrative or judicial review.

Examples and Discussion

IV. Examples and Discussion