The Changing Landscape of Tax Administration: Hot Topics of IRS Audits of Partnerships and S Corporations (Slides)

Robert D. Schachat
Deborah M. Nolan

Repository Citation
https://scholarship.law.wm.edu/tax/38

Copyright © 2009 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
The Changing Landscape of Tax Administration: Hot Topics of IRS Audits of Partnerships and S Corporations

William and Mary Tax Conference
Robert D. Schachat
Deborah M. Nolan
Ernst & Young LLP
13 November 2009
Notice

- These slides are for educational purposes only and are not intended, and should not be relied upon, as accounting advice.

- Any tax advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.
Global megatrends – responding to and planning for change

01 Accelerating pace of globalization
02 Shifting economy
03 Changing approach from tax administrations
04 Regulatory and Legislative Change
Steady course, uncharted waters: Findings from EY global tax risk survey (2008)

Tax risk is an integral part of the entire tax life cycle

Leading companies spend more time dealing with tax authority examinations than routine compliance

88% of respondents report that “success in dealing with tax authorities” is critically or very important as a performance measure

Almost half spend at least 10% of their time identifying, managing, tracking and/or reporting tax risk to management or to the board
Impact on Global Tax Directors – complexity throughout the Tax Life Cycle

Global Tax Director

Planning

Excise taxes

VAT / GST

Corporate & income taxes

Employment taxes

International cross border taxes

Personal taxes

Withholding taxes

State & local taxes

Transaction taxes

Indirect taxes

Compliance

Global tax controversy and risk management
DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Organization and Top Officials

Doug Shulman
Commissioner

Jonathan Davis
Chief of Staff

Ruth Perez
Deputy Chief of Staff

Debra Clivio
Executive Director, Office of Equity, Diversity and Inclusion

Patrick McCarty (acting)
Director, Research, Analysis and Statistics

Frank Keigh
Chief, Communications and External Affairs

Linda Stiff
Deputy Commissioner for Services and Enforcement

Steve Miller
Commissioner, Large and Mid-Size Business

Richard Byrd
Commissioner, Wage and Investment

Sarah Fai Ingram
Commissioner, Tax Exempt and Government Entities

Karen Hawkins
Director, Office of Professional Responsibility

Steve Willits
Director, Whistleblower Office

Eileen Mayer
Chief, Criminal Investigation

Chris Wagner
Commissioner, Small Business/Self-Employed

Mark Ernst
Deputy Commissioner for Operations Support

Terry Mihelcic
Chief Technology Officer

Alison Doone
Chief Financial Officer

David Grant
Chief, Agency-Wide Shared Services

Jim Falcone
Chief, Human Capital

Deborah West
Director, Office of Privacy, Information Protection & Data Security

* With respect to tax litigation and the legal interpretation of tax law, the Chief Counsel also reports to the General Counsel of the Treasury Department. On matters solely related to tax policy, the Chief Counsel reports to the Treasury General Counsel.
LMSB Organizational Structure
Number of returns by business type

Number of returns with assets equal to or greater than $10 million

IRS: changing landscape

- Risk assessment models
  - Increased transparency and disclosure
  - Leveraging Technology
- Issue focused strategy
  - Tiered issues
- Globalization strategy
- New approaches to issue resolution and compliance assurance
- Balancing service and enforcement
  - Audit coverage
  - Voluntary disclosures
  - Penalties
Partnership Issues
Non-Owner Contributions to Capital

- Corporations and partnerships often receive government subsidies, e.g., tax increment financing.
- Section 118 allows a corporation to exclude from gross income amounts received from a non-shareholder contribution.
- However, §118 does not mention partnerships.
- Prior to enactment of §118, the exclusion was permitted under case law.
Non-Owner Contributions to Capital

- Some partnerships take the position that the exclusion is allowable under the case law.
- IRS granted a favorable PLR to a partnership.
  - PLR 8038037 (June 24, 1980).
- However, this favorable position was later reversed.
  - TAM 9032001 (January 12, 1990).
- The current IRS position is that a partnership is not entitled to an exclusion for non-owner contributions.
- This issue is now included as a “tier one” audit issue.
Passive Activity Limitations

► Temp. Reg. §1.469-5T(a) provides seven different ways to achieve material participation in an activity.
  ► Most common method is more than 500 hours for the year.
► Temp. Reg. §1.469-5T(e)(3) provides that a “limited partner” is treated as materially participating in the activity of the limited partnership only under four of the seven tests.
► Since the temporary regs were issued, many investments have been made through limited liability companies.
► Question: is an LLC member a limited partner for this purpose?
Passive Activity Limitations

- Recent court decisions are favorable and generally do not treat an LLC member as a limited partner for this purpose.
  - Gregg v. US, 186 FSupp2d 1123 (DCOre 2000).
  - Thompson v. US, __ F3d __ (FedClCt July 20, 2009).
- However, the importance of these cases is perhaps overblown because:
  - Even if the LLC member is treated as a limited partner for this purpose, he or she can still materially participate in the activity under four of the seven tests, including the most commonly satisfied test of more than 500 hours for the year.
Partnership Tax Allocations

Allocations of partnership net income and loss are generally respected for federal income tax purposes if:

- Such allocations are provided in the partnership agreement; and
- Such allocations have "substantial economic effect."
  - Section 704(b) and Reg. §1.704-1(b).

Such allocations are also generally respected if:

- In accordance with partners' interests in the partnership (PIP).
- "Deemed" to be in accordance with PIP.
  - E.g., nonrecourse deductions, tax credits.
Partnership Tax Allocations

- Tax allocations have substantial economic effect if:
  - Such allocations have "economic effect"; and
  - Such "economic effect" is "substantial."
    - Reg. §1.704-1(b).

- Tax allocations have economic effect if:
  - The partnership properly maintains capital accounts;
  - Capital accounts govern liquidating distributions; and
  - Either:
    - Basic Test: The partners have a deficit restoration obligation; or
    - Alternate Test: The partnership agreement contains:
      - A prohibition on losses increasing capital account deficits; and
      - A "qualified income offset."
Special Allocations

- A “special” allocation is an allocation which is not made based on a partner’s interest in the partnership. For example, an allocation of 90% of depreciation deductions to one partner in a 50/50 partnership.

- Special allocations are generally not possible in a partnership that requires liquidating distributions to be based on ownership percentages.
Substantiality

- After determining that an allocation has economic effect under either the Basic or Alternate Test, the allocation must also meet the Substantiality requirement.
- This requirement is separate from and in addition to the Basic or Alternate Test.
Substantiality- Continued

- Treas. Reg. §1.704-1(b)(2)(iii):
  
  "... an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."
Substantiality - General Rules

- Intra-year Shifting Rule
- Transitory Allocation Rule
- Overall Tax Effect Rule
  - Value = Basis
Intra-Year Shifting

- Taxable v. tax-exempt income
- Ordinary income v. capital gain
- Ordinary loss v. capital loss
- Domestic v. foreign source income
- Active v. passive income (loss)
- Passive v. portfolio income (loss)
Transitory Allocations

- Testing Period: All tax years in which allocations may occur
- Hallmarks:
  - Aggregate tax reduction
  - Minimal capital impact
- Exceptions:
  - 5-year waiting period
  - Value equals basis rule
Overall Tax Effect Rule

- Disallows an allocation if after-tax economic consequences of at least one partner may, in present value terms, be enhanced, and a strong likelihood exists that after-tax consequences of no partner will, in present value terms, be substantially diminished.
- Take into account partners' non-partnership tax attributes.
- Projected after-tax economic results to each partner under prescribed allocation scheme must be compared to same after-tax economics that would result if the allocations being tested were not included in the agreement.
- However, virtually no guidance as to the factors that should be considered in arriving at this "base-line" allocation.
Fill-Up Allocations

- What is a fill-up allocation?
  - Upon redemption of a partner's entire interest in the partnership, the partnership allocates net or gross income to the exiting partner so that his or her capital account balance is equal to the redemption price.
  - If permissible, the fill-up allocation generally does not adversely affect the exiting partner and is beneficial to the continuing partners.
Fill-Up Allocations

Does this allocation satisfy substantiality?

- The allocation to conform the exiting partner's capital account balance to the redemption price is analogous to the requirement that capital accounts govern liquidating distributions.

- But it is only the interest of the exiting partner, and not the partnership itself, that is liquidating.

- The IRS has announced that it intends to scrutinize this issue.
Anti-abuse Rule

- The partnership anti-abuse rule is imposed in Reg. §1.701-2, issued in 1994.
  - General anti-abuse rule: If a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal income tax liability in a manner that is inconsistent with the intent of Subchapter K, the [IRS] can recast the transaction for federal income tax purposes.
    - Reg. §1.701-2(a).
  - Aggregation rule:
    - Reg. §1.701-2(e).
Anti-abuse Rule

- Practitioners were concerned that the anti-abuse rule would be raised often and in inappropriate circumstances under an uneven standard.
- Accordingly, the IRS issued guidance that the anti-abuse rule would be raised only after approval by the IRS National office.
  - IRS Announcement 94-87.
S Corporation Issues
Shareholder Loans

- In general, a shareholder of an S corporation is entitled to deduct losses from an S corporation only to the extent of his or her tax basis for stock of and loans to the S corporation.
- Section 1366(d)(1).
Shareholder Loans

- A liability of the S corporation to a sister entity owned by the S corporation shareholders is not includible in shareholder basis.
  - Frankel v. Comm’r, 61 TC 343 (1973), aff’d 506 F.2d 1051 (3d Cir 1974).
  - TAM 8426006.
Shareholder Loans

- S corporation shareholders were also denied basis for their liability to an unrelated lender where the S corporation was a co-borrower.
- S shareholders also denied basis for participation in loan to S corporation from unrelated lender; recast as guarantee.
  - Grojean v. Comm’r, 248 F3d 572 (7th Cir 2001).
- S shareholder denied basis for loan to related C corporation later assumed by the S corporation.
Shareholder Loans

An issue arises when the loan to the S corporation was originally made by another entity, e.g., a sister partnership or S corporation, and later transferred to the shareholder of the borrowing S corporation.

In this scenario, the IRS has argued that the loan did not represent an "economic outlay" by the shareholder and, thus, should not included in stock basis.
Shareholder Loans

Contrast the foregoing rules for S shareholder outside basis with partnership rules for sharing partnership liabilities under section 752.

Every dollar of every partnership liability is allocated among the partners.

The test for sharing in partnership recourse liabilities is ultimate personal liability.
Disguised Compensation Payments

- Before 1981, the maximum federal income tax rate on noncorporate taxpayers was 70%.
  - “Earned income” was subject to a 50% top tax rate.
    - Section 1348, repealed in 1981.
- Since 1981, the top tax rate on noncorporate taxpayers generally has been the same for compensation and business income.
  - Employee compensation income is also subject to Social Security tax at combined rates of up to 15.3%.
Disguised Compensation Payments

Thus, shareholder-employees have an incentive to treat income from an S corporation as dividends, and not as compensation.

The IRS position is that amounts treated as dividends, but properly characterized as compensation, is recast and taxed as compensation.

- Rev. Rul. 74-44, 1974-1 CB 287.
- TAM 8206054 (October 29, 1981).
- TAM 8239108 (June 30, 1982).
- TAM 8247006 (August 31, 2006).
Questions
Thank you