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Partnership Character Planning Before and After the Audit

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Partnership character planning before and after the audit

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Netting, Rates, and Loss Limitations

- Individual top rates: 20%, 25%, 39.6% <u>+ 3.8%</u>
- Corporate top rates: 35%
- Loss Limitations
  - Capital losses do not net against ordinary income BUT ordinary losses do net against capital gains – IRS Says: Heads I win, Tails you lose
  - Corporations – no preferred rate for cap gains AND can only carry forward capital losses for 5 years (or back 3 years)

Basic Planning Considerations

- Concepts:
  - Corporations don't mind soaking up ordinary income (e.g., partnership with corporation and individual as partners)
  - Avoid wasting capital gains against ordinary losses
  - Avoid capital losses, but if have them, match with capital gains
- Timing example:
  - Fund sells good investments early for $100M of capital gains and saves the $10M loss dogs until the end of the fund term. Result: $10M capital loss at end without offsetting capital gain to use it. Solution, Fund could have sold $10M of the gain assets on an installment basis to defer the capital gains until the later loss year.

Basic Planning – Partner Redemption

- Issue: Sizing Character of Partner Redemption Payments
  - Section 736(b) payments are treated as distributions: Can mean capital gain (or capital loss) to partner being redeemed
  - Section 736(a) payments are allocations/guaranteed payments: reduce income taxed to continuing partners
- Partner redemption example:
  - Section 736(a) vs. (b) redemption payment to corporate “blocker” partner who is indifferent as to income character but can’t use a net capital loss
  - Total payment of $5M, Corporate Blocker Partner’s basis is $1M. Compare: $5M §736(a) vs. $4M §736(a) and $1M §736(b)

Basic Planning – S Corp Distribution

- Issue: Distributions in excess of outside basis when ordinary income is "trapped" in S corporation
- S corp debt-financed distribution example:
  - X owns 100% of S corp with zero inside and outside tax basis. S corp owns $2M of ordinary income assets, borrows $1M and distributes to X. Result: $1M of capital gain currently, BUT when S corp is eventually liquidated or sells the assets, there is $2M of ordinary income and $1M of potentially useless capital loss.
    - Alternatives: Loan to X (with possible guarantee by S corp but subject to Plantation Patterns "who is borrower"); Back-to-back loan from bank to S corp and S corp to X.

Capital Gain Planning

- **Selling recently developed property:**
  - If long-term land and short-term building, higher purchase price allocation to land helps seller, although harms buyer.
  - Where is the value add? <u>Consider when selling long-term building that has recent short-term tenant improvements</u>. Presumably the value is in the long-term building and the tenant build out construction is really just a cost (especially if a different construction entity is earning the construction profit).
- **Example**
  - Buy property in year 1 for $20M, make improvements in year 3 for $10M and sell six months after improvements complete for $40M. Where is the gain attributable to? Distinguish Rev. Rul. 75-524.

Capital Gain Planning

- Estate/term for years
  - IRS held that sale of "lead" and "remainder" interest in §1231 asset to unrelated parties creates capital gain. Lead interest was a 50-year "estate for years." *See* Richard Hansen Land, Inc., T.C. 1993-248, PLR 200846012, and PLR 200850009
  - Lead interest buyer gives up remainder interest but benefits by depreciating 100% of purchase. *But see* §167(e)(1) (denying amortization for term interest if remainder is held by related party)
- Wait on sale until long-term
  - Forward contract to sell
  - Put/call options
  - Consider impact of other factors such as deposits, intervening loans, and §460 (if there is a construction contingency).

Holding Periods - Overview

- More than 12-month holding period required for long-term capital gain.
  - For real property, starts with placed-in-service date (needs to be property used in trade or business)
  - Independent of inventory/dealer property test (i.e., if dealer property, gain is ordinary even if held for over 12 months). See Fargo case (T.C. Memo. 2015-96)
- Holding period carries over if basis determined in whole or in part by prior asset – §1223
  - Contribution to partnership replicates holding period onto partnership basis and inside partnership assets
  - Holding period from exchanged property carries over to replacement property in §1031

Holding Periods – Partnerships

- If partnership sells asset, holding period determined based on partnership's holding period, not partner's. Rev. Rul. 68-79

- If property is distributed from a partnership to a partner, the inside holding period carries out. §735(b)

- Net cash contributions by a partner to a partnership in a 12-month window create a split holding period. Reg. §1.1223-3

Holding Periods – Planning

- Do NOT distribute short-term assets out to a partner with a long-term interest
  - If receiving partner plans to sell its assets, consider selling partnership interest instead.
- Consider selling partnership interest instead of assets if long-term partner and short-term assets
- If planning on selling partnership interest and made cash contributions in prior 12 months, distribute cash to partner first to avoid split holding period

Holding Periods – Planning

- If partner has long-term partnership interest and partnership has short-term assets, beware of technical terminations or partnership divisions that may convert partnership interest to short-term
- If have a long-term option or purchase contract and instead decide to sell in the near future
  - Sell the option/purchase contract – *see* Long v. Comm'r (2014)
  - Contribute the option to a partnership or REIT to replicate holding period onto partnership or REIT interest and then sell interest in the entity. (Note, sale of REIT stock means buyer's basis increase not immediately pushed to assets.)

Recapture - Overview

- Section 1245 recapture
  - Non-real estate depreciation is fully recaptured at ordinary income rates. Consider impact of cost segregation study on future §1245 recapture (e.g., is it reasonable to assume value equals basis).
- Section 1250 recapture
  - Real estate depreciation subject to §1250 recapture only to the extent of accelerated depreciation.
  - Don't forget to check to see if bonus depreciation was taken.
- Unrecaptured Section 1250 gain – §1(h)(6)
  - 25% rate applicable to straight-line portion of real property depreciation

Recapture – Planning/Observations

- Sales of partnership interest
  - If a partner sells its interest, §754 election is important to wipe out seller's share of recapture. See §1.1245-1(e)(3) & §1.1250-1(f)
  - Similarly, a §754 election is necessary to wipe out seller's share of ordinary income (beyond just recapture).
    - Example. Seller's partnership interest contains $1M of ordinary income and $1.5M of capital loss. Even though seller has net loss on sale, need §754 election to step up ordinary assets and step down capital losses.

Recapture – Planning/Observations

- Redemptions of partnership interest
  - §1245 and §1250 recapture shifting is generally prevented by §751(b) hot asset rules. If a redemption would result in a shift, there is a deemed distribution of pro rata share of hot/cold assets and deemed taxable exchange. Note that proposed §751(b) regulations will fix the inherent flaw in existing rules that are theoretically based on gross value of assets instead of the ordinary income component of assets.
  - Unrecaptured §1250 gain <u>excluded</u> from §751(b) type of principles per regulations. The net result is that a redemption for cash can bypass a partner's share of 25% rate gain, but it may be that the remaining partners are left holding the bag. If remaining partner is a corporation, no net cost.

Recapture – Planning/Observations

- Contributions of property to partnerships
  - Historical depreciation carries over into the partnership. Although traced to the contributing partner, if gain limitation is applicable to contributing partner, excess recapture can apply to non-contributing partner.
  - Example: A bought §1245 property for $300 and depreciated it to $100. When the property was worth $150, A contributed it for a 50% interest in the AB partnership (B contributed $150 cash). AB partnership sells the property later for $200. $50 is allocated to A as §704(c) and the other $50 is allocated $25 each to A and B as §704(b) gain.
    - Recomputed basis of $300 exceeds $100 tax basis by $200, which exceeds the $100 of gain recognized by AB partnership. Because recapture exceeds A's share of gain, it is then allocated to B. See Reg. §1.1245-1(e)(2)(i).

Bramblett Planning

- Sale to S Corporation Development Co.
  - If landowner begins to develop real estate held for investment, landowner can inadvertently convert a capital asset into an ordinary inventory asset. As a result, a subsequent sale of the property can produce ordinary income as opposed to capital gain.
  - If landowner sells investment property to a related partnership so that the partnership can develop the property, the sale can generate ordinary income under §707(b)(2) if the property is other than a capital asset in the hands of the related partnership.
  - Possible Solution: sale of investment property to an S corporation development company. *See, e.g.,* Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992).

Bramblett Planning (cont.)

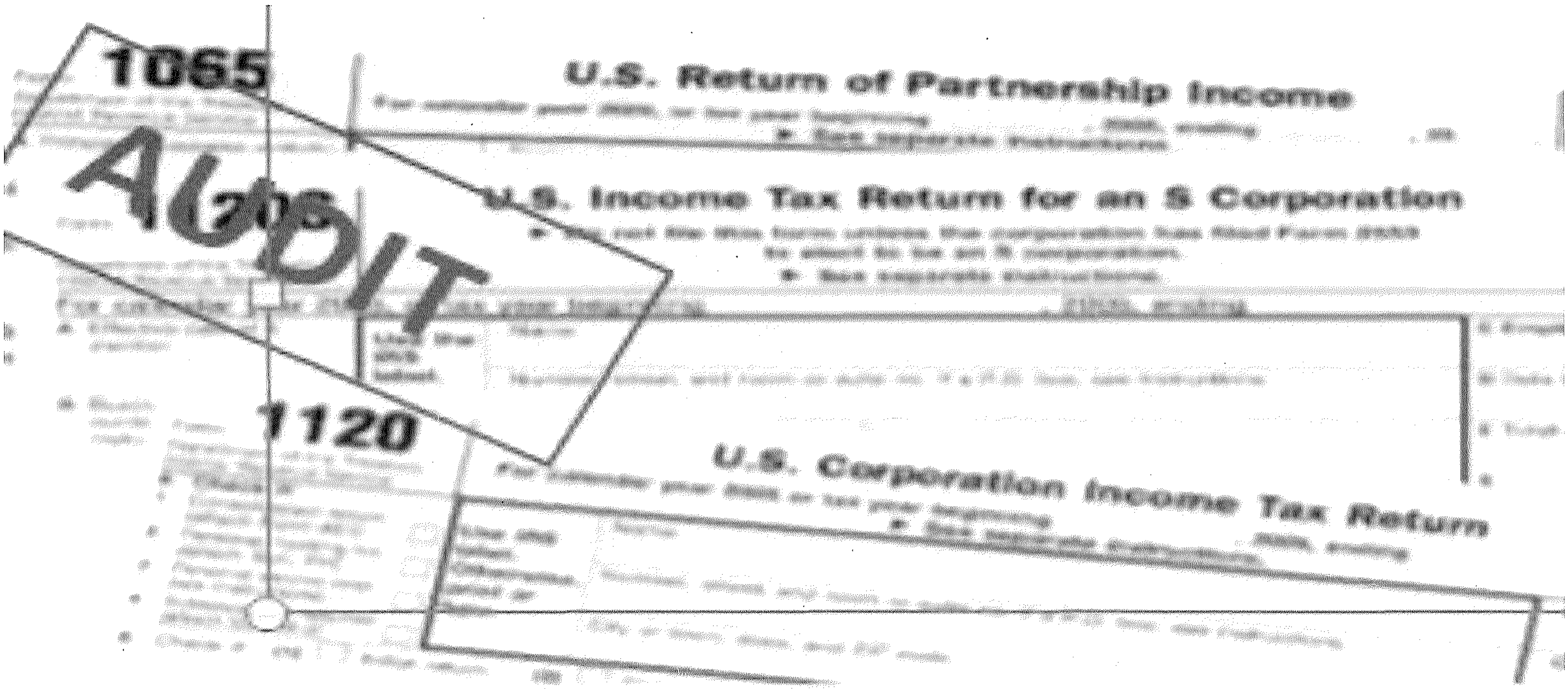
- Facts and Terms of the Sale are Critically Important
  - Capitalization of development co.
  - Purchase price and financing
  - Profit potential for development co.
  - Debt vs. equity issues with deferred payments
  - Final payment obligation under note
  - Sale formalities
  - Pre-selling
  - Common ownership
  - Separateness

Section 1239 Trap

- S corporation liquidation (actual or deemed)
  - Example: PE Fund seeks to buy S corporation owned 80% by A and 20% by B. A and B consider converting S corporation into an LLC tax as a partnership in advance of sale.
  - Conversion will inadvertently trigger §1239 and potentially create ordinary income for A on the deemed liquidation that results from the entity conversion.
  - §1239 triggers ordinary income on dispositions of depreciable property between related parties
  - For purposes of §1239, property amortized under §197 presumably will be treated as depreciable property
  - What if the S corporation holds all of its assets through a partnership interest? Distinguish Rev. Rul. 72-172.

A couple years later . . .

The New Partnership Audit Rules



Partnership Audit Rules – State of Play

- New entity-level audits apply to most partnerships for **tax years starting January 1, 2018**.
- Temporary Regulations published August 2015 on how to "opt-in" to the new audit rules early.
- Draft technical correction bill to clean up critical open questions.
- Extensive proposed regulations with more guidance expected by 12/31/17.
- Starting January 1, 2018 TEFRA and the electing large partnership rules **are abolished**.
- **Immediate attention needed for JV agreements.**

Small Partnership Election Out? What is it?

- If partnership consists of one hundred or fewer partners, none of which are partnerships, single member LLCs, or grantor trusts, then the partnership can elect out of the post-2018 entity level audit rules (the "BBA") and IRS would have to audit each partner individually.

- This election out is done annually on the tax return.

Small Partnership Election Out? Considerations

- Unless you are the Partnership Representative with full control over the audit, election out should strongly be considered for a typical 2 member JV. The partnership must make the election for each year it wants to elect out of the BBA rules.
- Considerations
  - Who is the PR, and what control do they have?
  - Do partners have differing tax positions?
  - Partnerships that elect out to consider whether a partner will be restricted from transferring its partnership interest to a party that would result in the election out to be invalid.

Deciding on the Partnership Representative

- PR has sole decision making authority with IRS, including settlements and statute of limitations extensions. Imperative to contractually limit PR if you are not the PR.

- PR requirements: (1) must be able to meet in person with the IRS at a reasonable time and place, (2) must have a street address, (3) must have a taxpayer identification number, and (4) must have the capacity to act. The PR may be an entity, including the partnership itself. If an entity is appointed, including the partnership itself, as PR, the entity must concurrently appoint a Designated Individual ("DI") that will communicate with the IRS.

How much authority to give to the PR?

- The partnership agreement controls the level of authority granted to the PR and, consequently the DI. The partners can vest absolute authority in the PR/DI, have limited approval rights over its actions, or control PR/DI through governance provisions.
  - Grant full independence to PR/DI.
  - Select items that PR/DI needs partner consent, and determine which partners' consent is needed.
  - Require all material PR/DI decisions to obtain approval of select partners, or the board/managing member.
  - Other?

Potential Major Audit Decisions for Joint Agreement?

- Extending the statute of limitations.
- Settlement or litigation.
- Filing for administrative adjustment.
- Review/comment rights for all material correspondence with IRS.
- Receipt of copies of all material IRS notices.

Potential Major Audit Decisions for Joint Agreement?

- Venue selection.
- Counsel selection.
- Code Section 6226 Push-Out election.
- Code Section 6225 Amended return option.
- Appointing a new PR/DI.

PR Information Gathering

- PR/DI must gather information in order to make certain elections and to provide to the IRS in connection with the audit.
  - Require partners to provide timely or else face penalties.
  - Collect information on tiers in advance so as to streamline audit.

Financial Considerations of Imputed Underpayment

- PR/DI can control the allocation of Imputed Underpayment either: (1) unilaterally, or (2) in consultation with the partners or board/managing member. Agreement may provide for a neutral arbitrator if the parties cannot agree on the allocation.
  - Exclusive control over Imputed Underpayment allocation.
  - Joint control over imputed underpayment.
  - Joint control over imputed underpayment with neutral arbitrator if no consensus.
  - Other

Once Imputed Underpayment allocated among partners:

- Company pays on behalf of partners and charges their capital account (treated as a distribution, and any amount in excess of capital account treated as an interest bearing loan to the partner).
- Partners amend returns associated with the Imputed Underpayment and pay their share.
- Partnership elects to "push out" liability to each partner. Gives rise to a 2% higher interest rate on tax liability.

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Partnership Representative/Designated Individual— Liability considerations

- PR/DI are acting on behalf of the partnership, and will therefore need financial protection with respect to their decisions.
  - Obtain directors and officers insurance for PR/DI.
  - In lieu of insurance, expressly provide that the partnership will indemnify the PR/DI except for gross negligence.

PR/DI needs to finance the audit administration.

- The agreement should provide clear instructions for granting cost approvals.
  - Cap budget at a fixed or "reasonable" amount.
  - No fixed budget, but PR/DI to submit advance cost estimates in order to obtain funds.
  - PR/DI has full unlimited discretion.

Liability Issues Upon Liquidation or Partner Departure

- A partnership agreement should expressly provide that departing partners may be liable after they leave the partnership. Additionally, the partnership agreement should provide a mechanic to ensure the partner's potential liability is funded. Upon partner departure:
  - X% Capital account holdback
  - Sign promissory note or provide other security as credit support for an audit.
  - Other

Replacement PR

- If the PR/DI resigns or leaves the partnership, there should be provisions to appoint a replacement. If the PR that appointed the DI is no longer the DI, such DI designation automatically terminates.
  - Automatically appoint non-departing partner as the PR assuming that partner is eligible.
  - Allow partners to decide on a new PR/DI.
  - Allow PR to appoint a replacement PR who will then appoint a new DI.

Collecting from Former Partners

- If the partnership liquidates, and there is an audit after such liquidation related to prior years, the IRS can chase former partners if the partnership has no assets.
  - Capital account holdback post-liquidation for statute of limitations
  - Other credit support from former partners.

Conclusion

- Partnerships provide a wealth of planning opportunities
- Be especially aware of unusable capital losses or inadvertent loss of long-term capital gains
- New partnership audit rules are sure to lead to a true testing of time honored planning ideas
- Planning for the audit requires that the business decision makers actually consider audits
- Once in an audit, there are key decisions that will need to be made at the time, depending on the individual facts.

Speaker Biography

- Brian O'Connor is a partner in the Baltimore, DC and Tysons Corner offices of Venable, where he provides sophisticated tax and business advice to publicly traded and closely held businesses and their owners. His practice focuses on foreign and domestic tax matters for partnerships, LLCs, both C and S corporations, REITs, and RICs. Mr. O'Connor is also an Adjunct Professor at the Georgetown University Law Center LL.M. program, teaching Drafting Partnership and LLC Agreements and Taxation of Real Estate Transactions.

- Steven Schneider is a partner in the DC office of Baker & McKenzie, where he concentrates on the tax aspects of commercial transactions, with a concentration in the taxation of pass-through entities such as partnerships, S corporations, and REITs. He also has significant experience in cross-border issues, real estate, investment funds, tax policy and tax controversy. Mr. Schneider is also an Adjunct Professor at the Georgetown University Law Center LL.M. program, teaching Drafting Partnership and LLC Agreements.

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