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Advising Partners and Partnerships Under the New Centralized Partnership Audit Rules: The Need to Amend Partnership and LLC Operating Agreements

Presented by

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Mr. August is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. In many instances he works with corporate and real estate counsel on selecting the proper entity in which to engage in domestic or foreign business or investment operations. He has been involved in structuring as well as negotiating merger and acquisitions, both taxable and non-taxable, joint ventures, financings, workouts and recapitalizations. He also represents clients in tax controversy and litigation in challenging the positions maintained by the Internal Revenue Service and other taxing authorities. He has also worked with the National Office of the Internal Revenue Service in filing private letter rulings or pursuing the competent authority provisions of a particular bilateral tax treaty involving the United States and a foreign country. He is a Life Sustaining Member of the American Law Institute and member of the New York, Pennsylvania and Florida Bar Associations.
Bipartisan Budget Act of 2015 (BBA): Centralized Partnership Audit Rules

The Bipartisan Budget Act of 2015 (the BBA), P.L.114-74, §1101, made significant changes to the partnership audit rules. The BBA repealed §6221–§6252 (the TEFRA rules) and added new rules under §§6221–§6241 that apply to all entities taxable as partnerships. A partnership with 100 or fewer partners is permitted elect out of the partnership audit rules. See §6221(b), as amended by the BBA, §1101. Each shareholder of an S corporation partner, as well as the S corporation, is counted separately for the 100 partners or less exception. §6221(b)(2)(A), as amended. The new partnership audit rules generally apply to returns for partnership tax years beginning after December 31, 2017. However, a partnership may elect to apply the new rules to any partnership return filed for a partnership tax year beginning after November 2, 2015, and before January 1, 2018.
BBA Guidance Update from the Internal Revenue Service and Tax Technical Corrections Act


- Notice 2016-23, 2016-13 IRB. Service’s list for “comments” on BBA.

- Notice of Proposed Rulemaking REG-136118-15 (6/14/2017) a/r/a “June 14 NOPRM”.
  - June 14 NPRM contained rules pertaining to (1) the scope and election out of the new BBA (2) consistency in reporting by partners, (3) the powers and duties of the partnership representative, (4) partnership adjustments made by the IRS and determinations of the amount of the partnership’s liability (imputed underpayment), (5) the filing of administrative adjustment requests, and (6) the election for partners to take the partnership adjustments into account (§§6221 through 6227 and 6241).
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act (cont’d)

– June 14 NPRM reserved comment on (1) how partners take into account basis adjustments and tax attributes in push-outs under §§6226 and 6227 for AARs (2) rules pertaining to foreign entity partners; (3) adjustments to outside basis, capital accounts, partnership’s asset basis and book value in property (4) rules coordinating the AAR with foreign tax credits.

• Proposed Regulations on International Provisions under the BBA. REG 119337-17 (11/30/2017).

  – Included rules for tiered partnership structures
  – Applicable rules as to administrative and procedural provisions
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act (cont’d)

• Final Regulations on Election-out Under Section 6221(b) (2/2/2018)
  – Coverage: (1) determining number of partners (100 or fewer); (2) who is an eligible partner for an “eligible partnership” per §6221(b); and (3) election-out mechanics and disclosure requirements.
  – Requirement of Section 6221(b)(1)(C). Certain partnerships with 100 or fewer partners may elect, by its partnership representative, for a particular partnership taxable year to avoid application of the centralized audit rules, provided that each of the partners is “an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner”.


BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act (cont’d)

• Preamble to June 14 NPRM: Notice Not to Expand “Eligible Partners”
  – “It would undermine the benefits of the new regime to expand the group of partnerships that are eligible to elect out of the new regime. Moreover, it would be unwise to do so at a time before the first returns for taxable years subject to the new regime have been filed.”

• Final Election-Out Regulations. Keep the same limitation on who is an eligible partner.
  – Partnership
  – Defective entity S shareholder does not disqualify S corporation partner
  – Disregarded entity ineligible direct partner
  – Election-out mechanics. Election-out must be made on the eligible partnership’s timely filed return—including extensions—for the taxpayer year to which the election applies and must include all information required by the IRS. Notification to partners within 30 days.
  – Election-out by partnership that is itself a partner. Still results in the BBA rules being applied to the upper-tier partner despite its having elected out.
  – De Facto Partnership Issues
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act (cont’d)

- Proposed Regulations 82 FR 50144-01 (12/19/2017) (December 19 NPRM) Push-out Election Rules under Sections 6226 and 6227
  - Rules pertaining to the assessment and collection of tax, penalties and interest, and periods of limitation under the BBA; include judicial review provisions
  - Allows multi-tiered partnerships to be part of the push-out election process with each level of the partnership tiers having the right to pay the resulting assessment or timely push-out the required tax payment to its partners
  - Adopts multiple imputed underpayments for §6225 purposes (see June 14 NRPM). The partnership could elect to push-out the specific imputed underpayment to the affected partners which the partnership could pay the general imputed underpayment.
  - Requirements for push-out election
    - Partnership must file push-out within 45 days after the FPA is mailed per §6231
    - Partnership must furnish a statement of each partner’s share of adjustments to its reviewed year partners no later than 60 days after the partnership adjustments become final, i.e., expiration to file judicial petition per §6234 or when decision is final
    - Contents of push-out election statements. See Prop. Reg. §301.6226-2(e).
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act

• Two Categories of Section 6226(b)(2) Adjustments for Push-out Elections.
  – Reviewed or “first affected” year.
  – Intervening year(s). Increase for first affected and subsequent years based on push-out statement.
  – Adjustments to tax attributes.

• Safe Harbor Amount or Interest Safe Harbor Amount
  – Applies to reviewed year partner to pay amount of tax and/or interest in lieu of making detailed tax calculations for the reviewed and intervening years. Prop. Reg. §301.6226-3(c). (safe harbor interest is based on underpayment rate plus 5 percentage points).
  – Contrast for push-out purposes reviewed year partners pay interest at the underpayment rate under §6621(a)(2) plus 3 percentage points.

• Penalties, Additions to Tax, or Additional Amounts Determined at the Partnership Level
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act

• Section 6227: AAR
  – Partnership may file AAR to correct one or more errors in a prior year partnership return. No partner (unlike TEFRA) may file an AAR.
  – Partnership representative only may file an AAR
  – Period to file AAR: 3 years from later of filing the partnership return or due date for filing excluding extensions
  – Notice of administrative proceeding (audit). Bars filing AAR.

• Adjustments from Filing AAR. Where an imputed underpayment results the partnership may approach the issue in the same manner as under §6225 (imputed underpayment) or §6226 (push-out election). See Prop. Reg. §301.6227-2(b)(1)(partnership payment as adjusted for permitted modifications).
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act

• Proposed Regulations on Sections 6226 and 6227 for Push-Out Elections and Tiered Partnerships (12/19/2017).
  – Precursor to Tax Technical Corrections Act (2018). Allow adjustments to be pushed out to upper tier partnerships or S corporation to the ultimate tax-paying owners.
  – Election to push-out at each tier.
  – New development. The December 19 NPRM allows for partner level defenses to penalties, additions to tax or additional amounts related to an adjustment reflected on a push out statement provided however that the partner seeking penalty abatement first pays the penalty and files a claim for refund.
    • Partner-level defenses limited to those that are personal in nature to the partner such as reasonable cause and good faith per §6664(c)
  – Deadline for furnishing partners push-out election statements. No later than extended due date for return for adjustment year of the partnership that made the election.
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act

- Proposed Regulations REG-119067-17 (2/18/2018) on Adjusting Tax Attributes under Sections 6225 and Section 6226
  - “Partnership adjustment”, any item of income, gain, loss, deduction or credit of a partnership or any partner’s distributive share
  - Each partnership adjustment is either: (i) taken into account when determining the amount of the imputed underpayment, or (ii) treated as a partnership adjustment that does not give rise to an imputed underpayment. Prop. Reg. §301.6221(a)-1(b).
  - As to partnership adjustments for imputed underpayments, proposed regulations provide: (i) rules for adjusting partnership asset basis and book value, (ii) rules for creating notional items, (iii) rules for allocating these notional items under section 704(b), (iv) successor rules for situations in which reviewed year partners (per Prop. Reg. §301.6241-1(a)(9)) are not adjustment year partners (per Prop. Reg. §301.6241-1(a)(2)), and (v) rules for determining the impact of notional items on tax attributes in certain situations.
BBA Published Guidance from the Internal Revenue Service and Tax Technical Corrections Act

• Proposed Regulations REG-119067-17 (2/18/2018) on Adjusting Tax Attributes under Sections 6225 and Section 6226 (cont’d)
  – Adjustment year partners take into account partnership adjustments.
  – Specified tax attributes: (i) tax basis and book value of partnership assets; (ii) amounts determine under §704(c); (iii) partners’ capital accounts per Treas. Reg. §1.704-1(b)(2).
  – For payment of imputed underpayment. Regulations require adjustments to specified tax attributes on a partnership-adjustment-by-partnership-adjustment basis.
  – Notional items. Per Prop. Reg. §1.6225-4(b)(3) an item is a “notional item” when its sole purpose is to affect partner-level specified tax attributes; notional items are not considered items for purposes of adjusting other tax attributes. These rules, intended to prevent double taxation, reverse out the reviewed year allocation to the extent required. It also impacts the adjustment year partner’s outside basis and capital accounts. In the case of a partnership adjustment that reflects a net increase or net decrease in credits as determined under Prop. Reg. §301.6225-1(d), the partnership creates one or more notional items of income, gain, loss, or deduction that reflects the change in the item giving rise to the credit.
  – Application of the substantial economic effect test on allocation of notional items
Tax Technical Corrections Act of 2018 and the BBA

• Scope of the BBA.
  – The 2015 version of the BBA applied to adjustments to partnership “items of income, gain, loss, deduction or credit”
  – The TTCA 2018 announces the term “partnership-related item”; which is “any item or amount with respect to the partnership (without regard to whether the item or amount appears on the partnership’s return and including an imputed underpayment and an item or amount relating to any transaction with, basis in, or liability of the partnership)” needed in determining the liability of any person. Revises §6241(2)(B)(definition of “partnership-related” item). Corresponding references throughout BBA.
  – See Joint Committee on Taxation. “..[T]hese partnership audit rules are not narrower than the.....TEFRA partnership audit rules, but rather, are intended to have a scope sufficient to address those items desried as partnerships items, affected items and computational items” under TEFRA. See Treas. Regs. §§301.6231(a)(3), -(a)(5) and -(a)(6) and other items.
Tax Technical Corrections Act of 2018 and the BBA

- Partnership-related Item (cont’d).
  - Example. Item or amount to a partner’s transaction with a partnership other than in his capacity as a member under §707(a) is still a partnership-related item. Note the power of the partnership representative as to the “non-partner” (partner).
  - Example. Item or amount on determination of adjusted basis of partner’s interest in the partnership or inside asset basis of the partnership of partnership property.
  - Example. Item or amount relating to liability of a partnership, an item or amount relating to determining partnership liability or effect on a partner of a decrease or increase in a partner’s share of partnership liabilities.
Tax Technical Corrections Act of 2018 and the BBA

  – Substantially the same as in technical corrects submitted in December 2016, H.R. 6439
  – TTCA 2018 clarify the scope of the BBA partnership audit rules
  – Provide amendments to the computation of the imputed underpayment
  – Provide amendments to the modification rules in section 6225(b) for imputed underpayment amounts
  – Introduce a new “pull-in” modification
  – Alternative “push-out” payment provision
  – Other Provisions
Tax Technical Corrections Act of 2018 and the BBA

• Partnership-related Item (Cont’d).
  – Exception. Partnership-related items or amounts do not apply to taxes imposed or required to be deducted or withheld under chapters 2 (self-employment income) or 2A (tax on net investment income), 3 (withholding tax on NRAs) or 4 (FACTA withholding) unless otherwise provided. But, partnership-related adjustments do apply for purposes of computing the amounts under these exceptions. A special timing rule applies for situations involving chapters 3 and 4. It is the collection of the tax required under these provisions that is outside of the BBA.
  – Statute of Limitations under Chapter 2/2A. Attributable to a partnership adjustment expires one year after: (i) final court determination under §6234 or (ii) in any other case, 90 days after the date on which notice of final partnership adjustment (“FPA”) is mailed per §6231.
Tax Technical Corrections Act of 2018 and the BBA

• Partnership-related Item (cont’d).
  – Special timing rule for Chapters 3 (NRA withheld’) and 4 (FACTA). The tax is determined with respect to the reviewed year but is imposed with respect to the adjustment year. The amount required to be deducted or withheld is determined in the adjustment year. See §6225(d).
  – Example. IRS audit of partnership increases ECI allocable to upper tier foreign partners by $100x. Section 1446 imposes $35x (hypothetically) be withheld by partnership for the adjustment year. But the withholding is for an upper-tier partnership in which the foreign partners are members. Push-out election made per §6226 and statement issued to upper-tier partnership. The amount of withholding tax is based on the adjustment year. The due date for upper-tier partnership’s payment of withholding tax is on or before the due date, including extensions, for the return for the adjustment year of the partnership.
Tax Technical Corrections Act of 2018 and the BBA

• Partnership-related Item (cont’d).
  – Court has jurisdiction to determine all partnership-related items for the partnership taxable year under the FPA, the proper allocation of such items among the partners, the applicability of any penalty, additional to tax or additional amount for which the partnership may be liable.
  – Includes therefore determinations under sections 707, 752, 722, etc.
Tax Technical Corrections Act of 2018 and the BBA

• Netting Allowed in the Determination of Imputed Underpayments. §§6225(a), 6225(b) revised to “partnership-related items” instead of “separately stated income or loss”.
  – Confirms Proposed Regulations. Items of different character are not netted together in determining amount of impute underpayment. Highest rate then applied under §§1 or 11 to the reviewed year.
  – Sections 702(a)(1)-702(a)(8) distributive shares separately “netted”.
  – Reallocation of distributive shares from among partners. Portion of any part of decrease in income or increase in share of deduction is ignored.
  – Limitations applied at the direct or indirect partner unless otherwise provided such as §§465 or 469.
  – Adjustments to credits separately determined and netted in computing the imputed underpayment.
Tax Technical Corrections Act of 2018 and the BBA

- New Pull-In Alternative Procedure to Filing Amended Returns Under Section 6225(c)
  - Modification of Imputed Underpayments. Partnership permitted to modify imputed underpayment by allowing reviewed-year partners to take adjustments into account as provided. Procedures must occur within period ending 270 days after the notice of proposed adjustment is mailed (“NOPA”) unless extension is consented to. §6225(c)(7).
  - Amended returns of partners. §6225(c)(2)(A). TTCA clarifies amended return modification rules. Payment of any tax due with amended returns required. Payment of interest, penalties and additions to tax may be done by IRS bill. Not all partners required to participate. Direct and indirect reviewed-year partners may participate.
  - Alternative procedure. §6225(c)(2)(B).
Tax Technical Corrections Act of 2018 and the BBA

• TTCA Pull-In Modification Rule in Section 6225(c)(2)(B).
  – Pull-In Defined. Reviewed-year partners may pay the tax that would be due with amended returns, make
    binding changes to their tax attributes for post-reviewed (interim and later) years and provide IRS with
    additional information substantiation computation of tax was correct.
  – No amend returns required.
  – Impact on tax attributes in interim years require amended returns be filed?
  – Pull-In and amended return modifications. May be used by direct and indirect reviewed year partners with
    respect to tiered partnerships. Not all direct and indirect reviewed year partners are required to pull-in.
  – Due date of payment. Within 270 days after the date of NOPA is mailed (unless period is extended by
    consent).
  – Information requests by IRS under pull-in must be satisfied with applicable 270 day post NOPA period.
  – Collector of pull-in partners’ information? By partner? Partnership representative?
Tax Technical Corrections Act of 2018 and the BBA

• Additional Applicable Rules to Partner Modifications and Pull-ins
  – Adjustments for reallocation of items between partners. Each affected partner must participate in the amended return or pull-in procedure and meet all requirements.
  – Adjustments to reviewed years and post-reviewed years. No statute of limitations for purposes of §§6501 and 6511. The Joint Committee Report states that “these results apply only with respect to adjustments to partnership-related items for the reviewed year (and the effect of such adjustments on any tax attributes).”
  – Adjustments made by taxpayer on amended return or pull-in are binding for the reviewed year and any taxable year for which a tax attribute is affected by such adjustment.
  – Subject to consistency requirement in §6222. Example would be where partner engages in §6225(c)(2) modification for the reviewed year but does not take such into account for subsequent years. Any underpayment attributable to such failure may be assessed as a math error under §6222(b).
  – Tiered partnerships and S corporations. Some partners or S shareholders may participate in the modification/pull-in rules provided all of the requirements are met and others may not.
Tax Technical Corrections Act of 2018 and the BBA

• Additional Applicable Rules to Partner Modifications and Pull-ins (cont’d)
  – Information requirements. IRS may require all information going up a chain of ownership in a tiered structure, i.e., the IRS may require each partnership in the chain between the relevant partner and the audited partnership must meet all requirements for filing amended returns or participating in the pull-in.
  – Each shareholder of an S corporation is simply one chain, what about an ESBT?
  – Adjustments not treated as amended return. See §6225(c)(2)(F).

• Clarification of Sections 6225(c)(3) (tax-exempt partners) and 6225(c)(4)(applicable highest rates) and 6225(c)(5)(certain passive losses of publicly traded partnerships).

• Modification Procedures Not Resulting in an Imputed Underpayment. Modification provisions are still available. See §6225(d)(9).
Tax Technical Corrections Act of 2018 and the BBA

• Push-out Procedure for Tiered Partnerships and S Corporations: Section 6226
  – Partner Receives Push-out Statement.
    • File with IRS a partnership adjustment tracking report
    • Furnish statements to partners per §6226(a)(2) or compute and pay its imputed underpayment under §6225 (other than certain modification-related rules)
      – No modification for amended returns and pull-ins
      – 270 day information delivery rule applies per §6225(c)(7)
      – Section 6225(c)(9), modification of adjustment not causing imputed underpayment applies
    • Netting all partnership adjustments applies for imputed underpayment, including limitations and applying highest rate of tax under §§1 or 11.
Tax Technical Corrections Act of 2018 and the BBA

- Due Date for payment of imputed underpayment or furnishing statements to partner and filing of partnership adjustment tracking report is the due date (including extensions allowed) for the adjustment year of the audited partnership.
Tax Technical Corrections Act of 2018 and the BBA

- Failure of Partnership or S Corporation to Pay Imputed Underpayment; Assessment and Collection Authority of IRS For imputed Underpayments. See amended §§6232, 6501(c)(4)
  - Failure by partnership to pay imputed underpayment, i.e., failing to make push-out election, or interest/penalties per §6226. Interest rate(federal short term rate +5% points) increases and assessment and collection against adjustment-year partners for their pro-rata shares may be made.
  - Applies to upper-tier partnership or S corporation which fails to pay imputed underpayment per §6226(b)(4)(A)(ii)(including any failure to furnish statements treated as a failure to pay imputed underpayment per §6651(i).
Tax Technical Corrections Act of 2018 and the BBA

• Specified Similar Amounts. Includes amount required to be paid by former partners including partners that are partnerships) of a lower-tier partnership that has ceased or terminated (not including a technical termination) as well as interest or penalties with respect to such amount.

• Two Year Assessment Period. The date the IRS issues notice and demand for payment starts the 2 year period in which the IRS may assess the adjustment-year partners (or former partners). The limitation period also applies to a court proceeding begun without assessment as to a partner. The period may be expanded by agreement.

• Extension of Two Year Period by Agreement. Section 6501(c)(4) revised to permit extension of statute of limitation by agreement and is not limited to periods set forth in §6501 but applies to period for assessment against partners for failure of partnership to pay imputed underpayment. §6232(f).
Tax Technical Corrections Act of 2018 and the BBA

• Section 6232
  – Section 6232(a). An imputed underpayment will be assessed and collected in the same manner as if it were an income tax imposed for the adjustment year, except that the deficiency procedures don’t apply and in the case of an administrative adjustment request under section 6227, the underpayment must be paid when the request is filed.
Tax Technical Corrections Act of 2018 and the BBA

• Section 6232 (cont’d)
  – Section 6232(b). Except as otherwise provided in the assessment procedures of the Code (or with regard to specified similar amounts described below), no assessment of an imputed underpayment may be made (and no levy or proceeding in any court for the collection of any amount resulting from an adjustment may be made, begun or prosecuted) before:
    • (A) the close of the 90th day after the day on which a notice of a final partnership adjustment is mailed, and
    • (B) if a petition is filed relating to the notice under section 6234 the decision of the court becomes final. However, the IRS will be allowed to file a proof of claim, request for payment, or take any other action in a Title 11 Bankruptcy case without regard to the restriction on assessments and collection of deficiencies. Section 6241(6)(A). For actions that the proposed regs specifically allow IRS to take, see Prop Reg §301.6241-2(a)(4).
Tax Technical Corrections Act of 2018 and the BBA

• Section 6232 (cont’d)
  – Section 6232(c). Notwithstanding the section 7241(a) bar on injunctions on tax collection, any action before the above assessment periods may be enjoined in the proper court, including the Tax Court. However, the Tax Court will not have jurisdiction to enjoin any action under this rule unless a timely petition has been filed and then only for the adjustments that are the subject of the petition.
• Section 6232 (cont’d)
  – Section 6232(d). *Exceptions to restrictions on adjustments*
    (1) Adjustments arising out of math or clerical errors
      (A) In general
      If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to a [1] item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.
      (B) Special rule
      If a partnership is a partner in another partnership, any adjustment on account of such partnership’s failure to comply with the requirements of section 6222(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph (A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment. (bold added)
Tax Technical Corrections Act of 2018 and the BBA

• Section 6232 (cont’d)
  – Section 6232(d). *Exceptions to restrictions on adjustments* (cont’d)
    (2) Partnership may waive restrictions
    The partnership may at any time (whether or not any notice of partnership adjustment has been issued), by a signed notice in writing filed with the Secretary, waive the restrictions provided in subsection (b) on the making of any partnership adjustment.
  – Section 6232(e). *Limit where no proceeding begun*
    If no proceeding under section 6234 is begun with respect to any notice of a final partnership adjustment during the 90-day period described in subsection (b) thereof, the amount for which the partnership is liable under section 6225 shall not exceed the amount determined in accordance with such notice.
Tax Technical Corrections Act of 2018 and the BBA

• Partnership Ceases to Exist.
• Section 6241(7).
  “(7) Treatment where partnership ceases to exist If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.”
• Definition of “Former Partners”.
• Partner/Former Partner Liability. Proportionate share of imputed underpayment, interest and penalties IRS determines based on distributive share of items.
• Partner Payments. Reduce partnership’s obligation to pay where payment made before (but not after) partnership payments. The partner may receive a credit or refund for any part of a payment it makes that the partnership pays.
Partnership Representative: Replacement for Tax Matters Partner

§6223 Partners bound by actions of partnership.

(a) Designation of partnership representative.
Each partnership shall designate (in the manner prescribed by the Secretary) a partner (or other person) with a substantial presence in the United States as the partnership representative who shall have the sole authority to act on behalf of the partnership under this subchapter. In any case in which such a designation is not in effect, the Secretary may select any person as the partnership representative.

(b) Binding effect.
A partnership and all partners of such partnership shall be bound—

(1) by actions taken under this subchapter by the partnership, and

(2) by any final decision in a proceeding brought under this subchapter with respect to the partnership.
Partnership Representative: Replacement for Tax Matters Partner

• Requirement of each partnership; must designate a partnership representative, but only one.
• Designation remains in effect for a taxable year until terminated by: (i) resignation; (ii) valid revocation; or (iii) determination by IRS designation not in effect. The designation may also be superseded by a subsequent designation for such year.
• Designation is for one taxable year. The designation is generally effective on the date that the partnership return is filed.
• Protective election if venture does not consider the venture to be a partnership?
• Should election be made where partnership elects out?
• Prop. Reg. §301.6223-2(c)....sole authority to act on behalf of the partnership
• Eligibility to serve as a partnership representative. Prop. Reg. §301.6223-1(b)(3)
Partnership Representative: Replacement for Tax Matters Partner

(Cont’d)
• Any “person” per section 7701(a)(1) having “capacity to act” per Prop. Reg. §301.6223-1(b)(4)
• Who has a substantial presence in the United States
• Eligibility of an entity to be a partnership representative provided an individual with a substantial presence in the United States is appointed by the partnership as the sole individual through whom the partnership will act
• Appointment of designated individual at the time of the designation of the entity partnership representative.
• If designated individual is not appointment, IRS may determine entity partnership representative designation is not in effect
Application of the Centralized Partnership Audit Rules to S Corporations and Their Shareholders

- Subchapter S Corporations
  - Definition. A “small business corporation” for which an election, made under §1362(a) is in effect. A “small business corporation” is defined under §1361(b)(1) as a domestic corporation that:
    - Is Not an Ineligible Corporation per §1361(b)(2)
    - Does Not Have More Than 100 Shareholders.
    - Has No Nonresident Shareholders; and
    - Does Not Have More Than One Class of Stock. Differences in voting rights are permitted.
Pass-Through Taxation

• Taxation of S Corporations.
  – In General. An S corporation generally pays no tax on its income and receives no tax benefit from its losses, it is a pass-thru entity subject to certain exceptions, such as the built-in gains tax under §1374 and the passive investment tax under §1375. The individual items of income, deduction, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder and non-separately computed income or loss pass through to the shareholders on a per-share, per day, basis based on each shareholder’s proportionate stock ownership in the corporation. §1363(a)(computation of taxable income); §1366 (pass thru of tax items and characterization of tax items); §1367 (adjustments to basis for pass thru of tax items and distributions); §1368 (characterization of distributions). Treas. Reg. §1.1363-1(a).
Pass-Through Taxation

• Taxation of S Corporations (cont’d).
  – Distributions. Generally a shareholder in an S corporation is permitted to recover tax-free her share of income of the corporation which was passed thru and allocated to such shareholder. §1368(b)(S corporation having no earnings and profits). Where an S corporation has earnings and profits from prior C years or as acquired from a target corporation in a non-taxable acquisition described in §381(a), distributions can be made first out of the corporation’s accumulated adjustments account before being sourced from earnings and profits. Any excess is treated as a recovery of stock basis and then gain. §1368(c)(3). See §1368(e)(1)(accumulated adjustments account).
S Corporations As Partners in Entities Taxable as Partnerships

• In General. While a partnership may not be a shareholder in an S corporation, an S corporation is permitted for federal income tax purposes, to be a partner in an multi-member entity taxable as a partnership. Treas. Reg. §§301.7701-2, 301.7701-3. Indeed, two S corporations may be the sole partners, either through direct ownership or indirectly through a defective entity, in the partnership. See, e.g., Unquest Delaware, LLC v. United States, 294 F. Supp. 3d 107, 118-121 (WDNY 2018). August, “S Corporation as a Joint Venture Partner: Recent Private Letter Rulings Fail to Reveal Scope of Revenue Ruling 77-220,” 5 J. P'ship Tax'n 369 (1989); Cahill, “Structuring Alternatives With S Corporations,” 1 S Corps. 25 (Spring 1988); Caspar, “S Corporations as Partners: The Parameters of Revenue Ruling 77-220,” 1 S Corps. 107 (Autumn 1988); Krane & Gallagher, “Preserving Subchapter S Status in Partnership Arrangements and Acquisition Transactions,” 65 Taxes 862 (1987).
S Corporations As Partners in Entities Taxable as Partnerships (cont’d)

• Use of S Corporations As Partners.
  – To Avoid the One Class of Stock Limitation. Issuance of hybrid debt, preferred capital interests, waterfall distributions, issuance of carried (profits) interest.
  – To Engage in Foreign Operations and Benefit From Single Level Taxation and Claiming (Direct) Foreign Tax Credits.
  – To Reduce the Impact of State Income Taxation.
  – In Acquisitions of S Corporation Targets Where Shareholders of Target Required or Desire to Keep Equity Position in Acquiring Entity.
  – To Serve as Managing Member of a Partnership, including Family Limited Partnerships.
S Corporation Procedural Issues

• S Corporations, In General, Are Not Subject to the Unified Audit Rules. §§6221-6241.
  – Subchapter S Revision Act of 1982 (“SSRA”), P.L. No. 97-354. Passed shortly after TEFRA (subchapter D of chapter 63, former §§6241-6245). Once of the reforms made by SSRA was the extension of the TEFRA unified partnership audit procedures to S corporations. This included: (i) the consistency requirement; (ii) due process procedural rights to notice and right to participate; (iii) assessment, refund and judicial review procedures; and (iv) S items treated like partnership items.
  – The Legislative History to SSRA. Stated that S corporation rules would follow corresponding partnership rules but the regulations to be issued may modify such rules where appropriate to take into account the difference between a corporation and a partnership. As with partnerships, the regulations may treat certain corporate items as other than corporate items for purposes of these audit rules, where special enforcement problems arise. S. Rep. No. 640, 97th Cong., 2d Sess. 25, reprinted in 1982-2 C.B. 718.
S Corporation Procedural Issues (cont’d)

– Temporary Regulations on the application of TEFRA to Subchapter S corporations were issued in 1987. T.D. 8122, 52 Fed. Reg. 3001 (1/22/1987). Unless specifically provided in the rule-making, the TEFRA audit procedures applied.

– Repeal of SSRA Provision on Subjecting S Corporations to the TEFRA Unified Audit Rules. The Small Business Job Protection Act of 1996 repealed the application of TEFRA to S corporations for taxable years beginning after 1996. P.L. No. 104-188, §1307(c)(1). Therefore §6229(a) no longer applied, i.e., the S corporation’s statute of limitations controlled even though shareholder’s statute of limitations had run.

– Section 6037(c) Requires The Shareholders to Report Consistently With the S Corporation Return Unless An Inconsistency Statement Is Filed. §6037(c)(2). See also Treas. Reg. §301.6222(a)-1(c), Ex. 2. (See IRS Form 8082).

S Corporation and Shareholders Statutes of Limitations

In General

• Corporate Level. In accordance with §6037(a), every S corporation is required for each taxable year to make a return and set forth additional information described in the statute and by regulations and forms issued by the Treasury and the IRS. As per the last sentence of §6037(a), the filing of Form 1120S starts the running of the statutes of limitations for the corporation, including for purposes of the built-in gains tax or the passive investment income tax. It is also treated as starting the statute of limitations where the IRS alleges that the corporation was not an eligible S corporation and should have been taxed under Subchapter C as a regular corporation. Treas. Reg. §1.6037-1(c). See also §6501(g)(1).
S Corporation and Shareholders Statutes of Limitations
In General (cont’d)

• Shareholder Level. The statute of limitations is measured separately for each shareholder of an S corporation. For example, the statute of limitations that applies to a deficiency in a shareholder's taxes relates to the date on which the shareholder files a return, not the date on which the S corporation files its return. This is true even if the deficiency results from an increase in corporate income or a disallowance of a corporate deduction that passed through to the shareholder.

  – See also Bufferd v. Commissioner, 113 S.Ct. 927 (1993) (application of statute of limitations under the former small S corporation exception to the unified audit rules where the S corporation’s tax year was statute-barred; shareholder extended limitations period for his return based on application of §6501(a)). Taxpayer Relief Act of 1997, P.L. No. 105-34, 1284(a) modifying §6501(a)(last sentence).
Application of TEFRA Unified Audit Rules to S Corporations

• Small Partnership Exception. In general the TEFRA unified audit rules apply to any partnership required to file a return of partnership income under section 6031. See section 6231(a)(1)(A). However, the TEFRA provisions do not apply to a partnership which qualifies as a small partnership under (TEFRA section 6231(a)(1)(B)) and makes an election to that effect. In general, for taxable years beginning on or before December 31, 2017, the small partnership election could be made by a partnership in which there are ten or fewer partners, each of whom is an individual (other than a nonresident alien) an estate of a deceased partner or a C corporation. Treas. Reg. §301.6231(a)(1)-1(a)(2) provides that the small partnership exception does not apply if any partner during the taxable year is a “pass-thru partner” as defined in section 6231(a)(9).
Application of TEFRA Unified Audit Rules to S Corporations (cont’d)

• “Pass-Thru Partner”. Under section 6231(a)(9), a pass thru partner includes a “partnership, estate, trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership….“ Where legal title to a partnership is held in the name of a person other than the ultimate owner, the holder of legal title is considered a “pass-thru partner”. Compare *White v. Comm’r*, TC Memo. 1991-552 (custodian for minor children not a pass-thru partner since children held legal title). But a grantor trust holding legal title to an interest in an S corporation was a “pass-thru partner”. *Primco Management Co. v. Comm’r*, TC Memo. 1997-332.
TEFRA Partnership Unified Audit Rules

- Rev. Rul. 2004-88, 2004-2 CB 185. Held that a single member LLC treated as a disregarded entity under the check-the-box regulations is a pass thru partner under section 6231(a)(1) and therefore the partnership in which the single member LLC is a partner disqualifies the partnership from filing under the small partnership exception to TEFRA. In the same ruling, the Service held that a disregarded entity for federal tax purposes but a general partner under state law, could be designated as the tax matters partner of a partnership subject to the TEFRA audit provisions.

- Seaview Trading, LLC v. Comm’r, 858 F.2d 1281 (9th Cir. 2017) TEFRA case involving LLC/partnership formed and held indirectly by ostensible TMP (individual) and his father through their respective single-member LLCs/disregarded entities. The Ninth Circuit held that despite their elected classification as a “small partnership” not subject to the entity level audit rules partnership was subject to TEFRA since the, single-member LLCs clearly constituted pass-thru partners for Code Sec. 6231(a)(9) purposes, and as such excluded partnership from small partnership treatment.
TEFRA Partnership Unified Audit Rules (cont’d)

- *Mellow Partners v. Comm’r*, 890 F.3d 1070 (CA Dist. Col. 2018). Again two disregarded single-member LLCs formed partnership but moved for dismissal of case filed with Tax Court on grounds that FPAA was invalid due to the small partnership exception. The Tax Court denied the motion holding that Treas. Reg. §301.6231(a)(1)-1(a)(2) and other authorities, each LLC was a pass-thru partner per section 6231(a)(9). Tax Court found deficiencies in tax and penalties. Affirmed on appeal with CA Dist. Col. also citing Rev. Rul. 2004-88, supra.
BBA Centralized Partnership Audit Rules: Election Out

- Election Out for Certain Partnership With 100 or Fewer Partners. Section 6221(b)
  - Annual Election.
  - Partnership Required to Furnish 100 or less K-1s (per §6231(b))
  - Each partner is an individual, C corporation, any foreign corporation that would be treated as a C corporation were it domestic, an S corporation or an estate of a deceased partner
  - Provided a timely election is filed by the partnership representative and the partnership notifies each such partner of the election
  - Special information of each shareholder in the S corporation required as is notice by S corporation to each shareholder of the election-out
BBA Centralized Partnership Audit Rules: Election Out (cont’d)

• Rule-Making Comments and Response. The Preamble to the June 14 NPRM noted that the IRS had received comments suggesting that it should exercise its authority under section 6221(b)(2)(C) to expand the types of persons who are “eligible partners” for the election-out rule in section 6221(b). The government responded that allowing partnerships, single member limited liability companies, and grantors of grantor trusts to be eligible partners would pose additional tax administration and collection problems for the Service. Obviously, the Service may have been stunned by Congress's unexplained expansion of the TEFRA “10 or fewer” eligible election-out rule to the new “100 or fewer K-1” rule. See August, “New Final and Proposed Regulations on the Centralized Partnership Audit Regime”, Corporate Tax’n (WG&L) (Jul/Aug 2018).
BBA Centralized Partnership Audit Rules: Election Out (cont’d)

• Final Regulations to Election-Out Rule.
  – Treas. Reg. §301.6221(b)-1(b)(3).
  – Eligible Partners. Individual (including non-residents), a C corporation defined under section 1361(a)(2), an eligible foreign entity (taxable as a domestic corporation were it organized in the US), an S corporation or an estate of a deceased partner.
  – An S Corporation is an eligible partner regardless of whether one or more shareholders of the S corporation, i.e., indirect partners, are not an eligible partner.
BBA Centralized Partnership Audit Rules: Election Out (cont’d)

– Ineligible Partners:
  • A partnership
  • A trust
  • A foreign entity that is not an eligible foreign entity, as defined
  • A disregarded entity per Treas. Reg. §301.7701-2(c)(2)(i)
  • As estate of an individual other than a deceased partner or
  • Any person that holds an interest in the partnership on behalf of another person, such as a nominee or grantor trust
BBA Centralized Partnership Audit Rules: Election Out (cont’d)

See, e.g., IRC §§ 6221(b)(1)(C), 6221(b)(2) (post-2017 version) (S corporation may, under specified conditions, be partner in partnership electing out of unified audit procedures), 6231(a)(9) (pre-2018 version) (term “pass-thru partner” defined as including S corporation “through whom other persons hold an interest in [a] partnership”), 6241(c)(2)(D) (pre-2018 version) (regarding reporting consistency requirements where partner is S corporation).
Provisions to Consider for Partnership and LLC Operating Agreements for TEFRA and BBA Agreements

• TEFRA Still Applies for All Tax Years Ending on or Before December 31, 2017
• Eligible Small Partnership Provisions. No Single Member LLCs or LLC or Corporations Allowed. Approval of Transfers.
• The Tax Matters Partner Provisions.
  – Qualifications
  – Appointment
  – Duties and Obligations to Partners; Notice and Information Requirements
  – Ability to Bind Partners Who are not Notice Partners
• TEFRA Partnership and LLC Agreements Continued
  – Fiduciary Duty of TMP
  – General Partner or Managing Member Requirement
  – Ability to Hire and Fire CPA Firm, Tax Counsel
  – Indemnification for Not Meeting Standard of Care
  – Ability to Settle Out Audits, Appeals, Cases
  – Term of the TMP
  – Conflicts of Interest
  – How Does the TMP Protect Himself From Claims of Partners?
• TEFRA Partnership and LLC Agreements Continued
  – Should the TMP be the Return Preparer or Tax Advisor for the Partnership?
  – Selection of Judicial Form to Challenge Partnership Adjustments
  – Restrictions On Settlement. The TMP may not enter into a settlement with the IRS on a tax audit, based on a schedule of adjustments, without first notifying all partners of the proposed adjustments and receiving the consent of a majority (or super-majority) of the partners, based on percentage ownership interest, to agree to the settlement.
**TEFRA Proceedings.**

- **Notice to Partners.** The TMP must notify all partners within the required number of days of: (a) receipt of a notice of proposed adjustment ("NOPA") from the IRS for the commencement of an audit of the partnership; (b) receipt of an FPAA from the IRS in accordance with Section 6223; (c) the partnership's filing of a petition for judicial review of any FPAA; (d) any and all information required under Section 6223(g); and (e) all other information required to be delivered to the partners in accordance with the terms of the partnership agreement.

- **Limitations on Actions of TMP.** The TMP may not (or may), unless he first receives the necessary prior approval by appropriate written resolution of the partners in accordance with the agreed terms of the partnership agreement, (a) enter into a settlement with the IRS on any tax audit, appeal, or judicial proceeding; (b) file a petition for judicial review of an FPAA pursuant to Section 6226; (c) intervene in any action brought by any other partner for judicial review of a final administrative adjustment; (d) file a request for an administrative adjustment with the IRS or file a petition for judicial review with respect to the request; (e) enter into an agreement to extend the statute of limitations for assessment of tax under Section 6229; or (f) take any other action on behalf of the partners or partnerships pertaining to any administrative or judicial proceeding to the extent allowed by the Code or regulations.
• Drafting Issues Under the Centralized Partnership Audit Rules
  – Selection of Partnership Representative and Substantial Presence Requirement
  – Must the Partnership Representative be a General Partner/Managing Member?
  – Term of the Partnership Representative
  – Selection of Partnership Representative as the Partnership
  – Selection of Designated Partnership Representative
  – Duties and Obligations of the Partnership Representative
  – Notice to Partners, Including Direct and Indirect Partners
• Drafting Issues Under the Centralized Partnership Audit Rules: the Partnership Representative
  – Budgets for IRS and State Audits
  – Ability of Partnership Representative to Select CPA Firm and Tax Counsel
  – Settlement Authority
  – Choice of Forum Authority
  – Resignation and Appointment of a Successor Partnership Representative
  – Indemnification Provisions
  – Standard of Care under Agreement/State Law
• Requirement of Election Out? Eligible Partners.
• Inability of Many Family Partnerships to Elect Out
• Admission of Ineligible Partner
• Modification Procedures Under Section 6225(c)
  – Requirement of Filing Amended Return and Payment of Tax
  – Requirement of Pull-in Modification and Payment
  – Requirement of Partners to Provide All Necessary and Relevant Tax Information
• Partnership Assessment and Collection
  – Discretion of Partnership Representative to Seek Assessment and Make Payment from the Partnership
  – Discretion of Partnership Representative to Break Up Imputed Underpayment into Multiple Imputed Underpayments with IRS Consent
  – Push-Out Elections? Mandatory?
  – What if Partnership Representative Commits a Contractual Breach
  – Insurance for Misconduct of Partnership Representative
New Centralized Partnership Audit Rules

- Partnership Agreements Under the Centralized Audit Rules
  - Clawback Adjustments to Former Partners
  - Advance of Push-out Payments as Deemed Distributions
  - Notional Adjustments to Adjustment Year Partners
- Mid-Entry Partners/Members and Purchasers of Partnership Interests
  - Enhanced Warranties and Indemnifications
  - Clawback Provisions and Escrows
- Termination of Partnership Issues
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