Overview and Applicability or Partnership Tax Audit and Collections Rules Including Final and Reproposed Regulations

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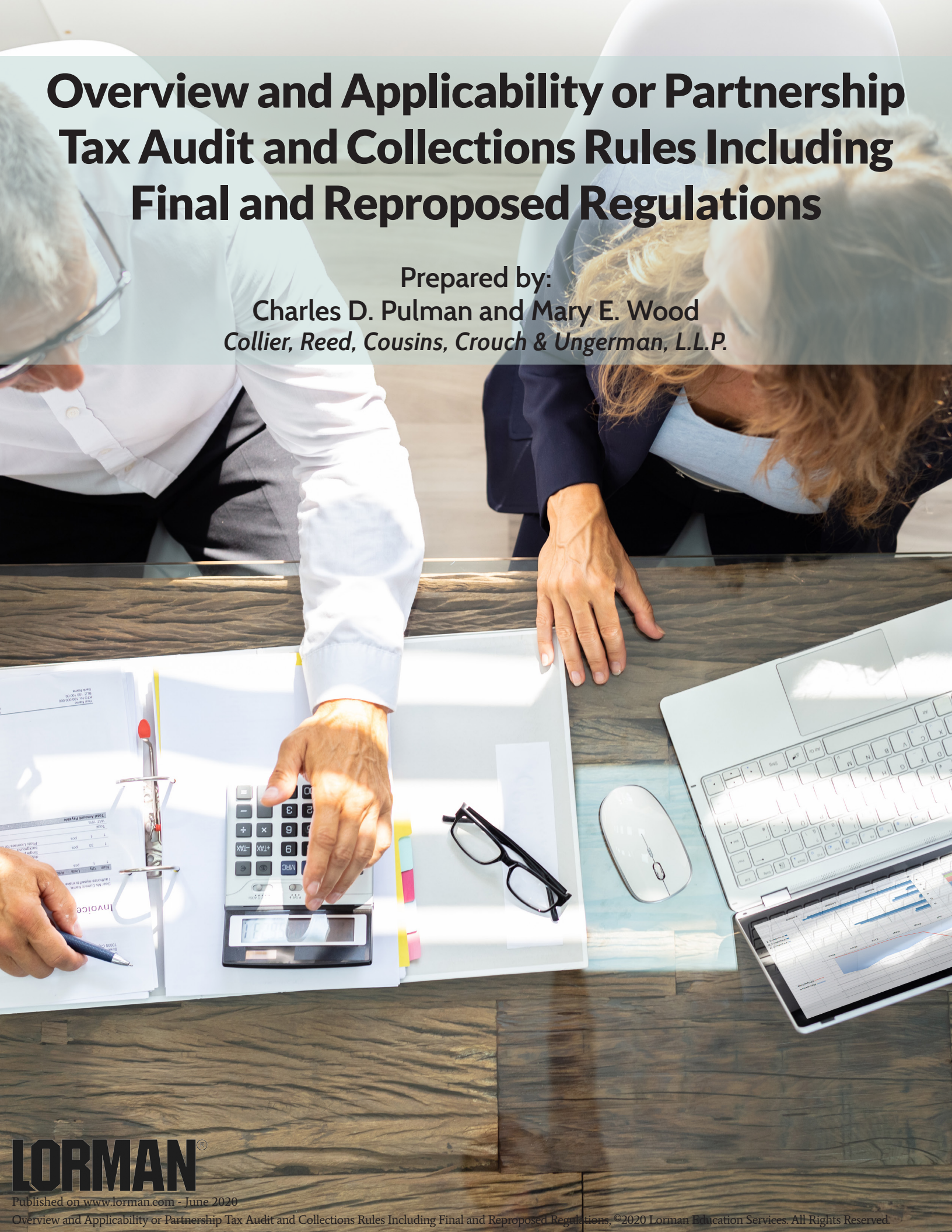

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PARTNERSHIP TAX AUDIT AND COLLECTIONS RULES INCLUDING FINAL AND REPROPOSED REGULATIONS

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I. OVERVIEW

A. Background

On September 18, 2014, the Government Accountability Office ("**GAO**") issued a report to Congress relating to the IRS's effectiveness in auditing large partnerships, which were defined as those partnerships with $100 million or more in assets and 100 or more direct and indirect partners. The report found substantial disparities in the IRS's audit rates of large partnerships and comparable large C corporations with $100 million or more in assets. Specifically, the GAO found that although the number of large partnerships in operation from 2002 through 2011 had nearly tripled, the IRS audit rate of those partnerships in 2012 was 0.8%. In contrast, the GAO found that the IRS audit rate of large C corporations was 27.1% in 2012 notwithstanding a significant 22% decrease in the number of large C corporations in operation from 2002 through 2011.

In the report, the IRS identified several potential reasons for the disparity in audit rates. First, the IRS indicated that it was difficult to identify the appropriate partnership to audit when the partnership was part of a complex tiered-partnership structure. Second, the IRS indicated that the complexities in the TEFRA audit procedures made it more difficult to timely assess tax related to the partnership within the general 3-year statute of limitations period. Third, the IRS indicated that the TEFRA audit procedures resulted in burdensome time and costs to the IRS because after the IRS determined adjustments of tax items at the

partnership level, the IRS was required to recalculate the tax liability of each partner based on the partnership adjustment.

The GAO report recommended several legislative proposals to increase the IRS's audit rates of large partnerships. The most significant legislative proposal in the report was to require large partnerships to pay any tax due at the partnership level. The GAO noted that such a change would "save the . . . [IRS's] resources that are now devoted to the paper driven, labor intensive process of passing adjustments through to large numbers of partners."

On February 2, 2015, President Obama submitted his fiscal year 2016 budget proposal to the United States Congress. In his budget proposal, President Obama recommended repealing the existing TEFRA and electing large partnership audit procedures because those audit procedures were "inefficient and more complex than those applicable to other large entities." In their place, President Obama recommended enactment of a new partnership audit regime where the IRS would audit the partnership and make adjustments at the partnership level.

Congress responded to the GAO report with several legislative proposals. Most notably, in June 2015, Rep. Renacci (R-OH) and Rep. Kind (D-WI) introduced H.R. 2821, the Partnership Audit Simplification Act. The Act sought to replace the existing TEFRA and electing large partnership audit rules with rules that would require partnerships to be audited and tax collected at the partnership level.

On November 2, 2015, President Obama signed into law H.R. 1314, the Bipartisan Budget Act of 2015 ("**BBA**"), which adopted many of the revised partnership audit rules

in H.R. 2821 as new Sections 6221 to 6241 of subchapter C of chapter 63 of the Internal Revenue Code of 1986, as amended. BBA was further amended by the Protecting Americans from Tax Hikes Act of 2015 ("**PATH Act**"). Congress estimates that the new partnership audit rules will bring in an additional $13.4 billion in tax revenue over the next 10 years.

The Joint Committee on Taxation issued "General Explanation of Tax Legislation Enacted in 2015" dated March 2016 ("**Blue Book**"), discussing the new partnership audit rules in Title XI, pages 51 to 83.

On January 18, 2017, Proposed Regulations (REG-136118-15) were issued. On June 14, 2017, the Proposed Regulations were reissued with minor changes. Additional Proposed Regulations (REG-119337-17) were issued on November 30, 2017, dealing with certain international tax issues, on December 19, 2017, (REG-120232-17; REG-120233-17) dealing primarily with tiered partnership structures, and on February 2, 2018, (REG-118067-17) dealing with adjustments to tax attributes. In addition, final Regulations were issued on January 2, 2018, dealing with the Opt Out Election (TD 9829) and on August 9, 2018, dealing with Partnership Representative (TD 9839). It is important to note that later Proposed Regulations not only contained new provisions but also amended, in some cases, prior Proposed Regulations. In addition, in March 2018, Congress passed the Tax Technical Corrections Act of 2018 (P.L. 115-141) ("**TTCA**"), further amending and adding new provisions to the Audit Regime.

The Joint Committee on Taxation issued "Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules

Committee Print 115-66) dated March 2018, discussing the TTCA and its amendments to PAR.

On August 13, 2018, Treasury withdrew the prior Proposed Regulations and issued new re-Proposed Regulations under PAR that superseded the prior Proposed Regulations other than the Regulations that had been finalized (Opt Out and Partnership Representative) (REG-136118-15). References in this paper to Proposed Regulations are to the re-Proposed Regulations filed on August 13, 2018, unless otherwise noted.

Finally, on December 17, 2018, Treasury issued new final Regulations (TD 9844) that finalized almost all of the sections in the re-Proposed Regulations except for the sections dealing with tax attributes, which are still in proposed form.

B. Effective Date

1. Generally: The Revised Partnership Audit Rules ("**PAR**" or **"Audit Regime**") apply to returns filed for partnership taxable years beginning after December 31, 2017. PAR applies to an entity taxed as a partnership for federal tax purposes, such as a limited partnership and a limited liability company. Section 6231.

2. Administrative Adjustments Requests ("**AAR**"): In the case of an AAR, the PAR apply to requests with respect to returns filed for partnership taxable years beginning after December 31, 2017. Prop. Reg. § 301.6227-1(i).

3. Earlier Application Election (Opt In): A partnership may elect (at the time and in such form as the Secretary may prescribe) for the PAR (other than

Section 6221(b) which provides for the Opt Out Election for partnerships with 100 or fewer partners) to apply to any return of the partnership filed for taxable years beginning after the date of the enactment of the PAR (November 2, 2015) and before January 1, 2018. Section 1101(g)(4) of the BBA.

a. An election may only be made for partnership tax returns filed for tax years beginning after November 2, 2015.

b. A partnership may not elect into the new rules for purposes of electing out. (This prevents partnerships subject to TEFRA from avoiding both TEFRA and the new rules, thereby forcing the IRS to audit each partner individually.)

c. Once the election is made for a tax year, it cannot be revoked without IRS consent.

d. An election will not be valid if it frustrates the purpose of the new audit rules. (One example is where the partnership is not liquid enough to pay the entity level tax.)

e. To make the election, the partnership must submit a written statement within 30 days of the IRS first notifying the partnership that its return for an eligible tax year has been selected for audit. Alternatively the partnership may make an election with the filing of an AAR in the manner to-be-prescribed by the IRS (i.e., new form).

f. Among other things, the statement must include identifying information about the partnership, the person signing the statement and his or her authority to do so, and the person designated as the partnership representative.

g. The statement must include several representations regarding the partnership's intent and liquidity, including that: (i) the partnership is not insolvent nor does it anticipate becoming insolvent, (ii) the partnership is not currently pursuing bankruptcy nor anticipating a bankruptcy filing, and (iii) the partnership has sufficient assets, and reasonably expects to have sufficient assets, to pay any tax liability ultimately determined.

h. Either the Tax Matters Partner or an individual authorized to sign a partnership return is authorized to make the election.

i. Perhaps most significant, the statement must include a representation, signed under penalties of perjury, that the individual signing the statement is duly authorized to make the election and that to the best of his or her belief, the statement is true, correct and complete.

j. The IRS has issued Regulations set forth in §301.9100-22 to address the rules for a partnership to elect to apply PAR to taxable years beginning after November 2, 2015, and before January 1, 2018.

k. The Blue Book at page 83 suggests a reason for making this election is "to obviate the need to furnish amended Schedules K-1 to correct a partnership-level error" or for partners "to file amended Federal and State income tax returns."

C. **Repeal of Old Sections and Addition of New Sections**

PAR repeal entirely subchapter C of Chapter 63 which includes the audit rules under the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (referred to herein as "**TEFRA**"), and subchapter D of Chapter 63 which provides audit rules for electing large partnerships. The repeal of these sections is effective for tax years beginning after December 31, 2017.

1. Old Rules: Taxable years prior to December 31, 2017, will continue to be governed by old Sections 6221-6234, 6240-6242, 6245-6248, 6251-6252, and 6255.

2. New Rules: Taxable years after December 31, 2017, will be governed by new Sections 6221, 6222, 6223, 6225, 6226, 6227, 6231, 6232, 6233, 6234, 6235, and 6241.

3. Proposed Regulations: Proposed Regulations remain as of the date of this paper for Section 1.704-1, 1.705-1, 1.706-4, 301.6225-4 and 301.6226-4.

4. Final Regulations. Final Regulations under Section 6221 (Opt Out Election) were issued on January 2, 2018, and under Section 6223 (Partnership Representative) were issued on August 9, 2018 and for

Sections 6221, 6222, 6225 to 6227, 6231 to 6235 and 6241 on December 17, 2018.

5. TTCA. Tax Technical Corrections Act of 2018 not only clarified or amended the Audit Regime but also adopted new provisions and concepts.

6. All "Section" references in this Outline are to the Internal Revenue Code of 1986, as amended (the "**Code**"), unless otherwise indicated.

II. APPLICABILITY (SECTION 6221)

A. General Rule Regarding Determinations and Applicability to All Partnerships

1. New Law: Section 6221(a) provides a general rule that the following shall be determined at the partnership level:

   a. any adjustment to a "partnership-related item," which is defined in Section 6241(2) and in Reg. § 301.6241-1(a)(6);

   b. the assessment and collection of any tax attributable thereto; and

   c. the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any partnership related item regardless of whether the item or amount appears on the partnership return.

2. Partnership-Related Item. The term "**partnership-related item**" is defined broadly in Reg. § 301.6241-1(a)(6) as (i) any item or amount with respect to a partnership that is relevant in determining the tax liability of any person under chapter 1 of subtitle A of the Code, (ii) any partner's distributive share

of any such item or amount, and (iii) any Imputed Underpayment Amount. Reg. § 301.6241-1(a)(6)(ii).

Whether an item or amount is with respect to a partnership is determined under Reg. § 301.6241-1(a)(6)(iii). Under the Regulation, an item or amount is with respect to a partnership if the item or amount is shown or reflected, or required to be shown or reflected, on a return of the partnership under Section 6031, the regulations thereunder, or the forms and instructions prescribed by the IRS for the partnership's taxable year or is required to be maintained in the partnership's books or records.

An item or amount does not include an item or amount shown or required to be shown on the return of a person (other than the partnership) that results after application of the Code to a partnership-related item based on that person's specific facts and circumstances. Reg. § 301.6241-1(a)(6)(iii).

3. Examples of Partnership-Related Items: Reg. § 301.6241-1(a)(6)(v) describes partnership-related items as including:

   a. character, timing, source and amount of income, etc., items;

   b. character, timing and source of partnership activities;

   c. contributions and distributions;

   d. basis and value of assets;

   e. amount and character of liabilities;

   f. category, timing, and amount of creditable expenditures;

   g. elections under Section 754;

h. allocations and special allocations; and

i. identity of a person as a partner.

4. Items Not Covered by PAR: Reg. § 301.6241-6(a)(1) states that PAR only applies to tax imposed by chapter 1 of Subtitle A of the Code. Therefore, PAR does not cover the following:

a. self-employment tax (chapter 2);

b. unearned income Medicare contribution (chapter 2A);

c. withholding on NRA or foreign corporation (chapter 3); and

d. taxes to enforce foreign accounts (chapter 4).

See also Section 6241(9)(A).

5. Penalty Defenses: Penalty defenses are addressed in Reg. § 301.6225-2(d)(2)(viii) (modification procedures); Reg. § 301.6226-3(d)(3) (Push Out election); and Reg. § 301.6233(a)-1(c)(2)(D) (Imputed Underpayment Amount) and are discussed throughout this paper.

B. Option to Opt Out for Certain Partnerships with 100 or Fewer Partners

1. General Opt Out Election: Section 6221(b) states that PAR does not apply with respect to any partnership for any taxable year if:

a. the partnership elects out for such taxable year;

b. for such taxable year, the partnership is required to furnish 100 or fewer statements under Section 6031(b) with respect to its partners (*i.e.*, Schedule K-1s);

c. each of the partners of such partnership 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 (Section 6221(b)(1)(c)). Reg. § 301.6221(b)-1(b)(3)(i);

d. the election is made with a timely filed return for such taxable year and includes a disclosure of the name and taxpayer identification number of each partner at any time during the taxable year of such partnership; and

e. the partnership notifies such partners of such election within 30 days of making the election (Reg. § 301.6221(b) – 1(c)(3)). The Opt Out Election is binding unless the IRS determines the election is invalid. Reg. § 301.6221(b) – 1(e). Thus, an invalid election remains binding unless the IRS determines the election is invalid. The Regulations do not provide for a time frame for the IRS to determine if the election is invalid.

Under Reg. § 301.6221(b) – 1(b)(3)(ii), the following are not eligible entities: trusts, partnership, non-C corp. foreign entity, disregarded entity, nominee or estate of non-deceased individual.

Several professional organizations suggested "eligible entities" be expanded to include single member LLC, trusts, IRA, qualified plans, and exempt organizations. The Blue Book gives examples of a partnership with

a partner including a disregarded entity, a trust, a grantor trust or a partnership partner electing out of PAR, thus indicating that Congress contemplated these entities may be eligible entities. Blue Book at 60. The final Regulations did not adopt these suggestions.

2. Special Rules for S Corporation Partners: For any partner that is an S corporation, the partnership must disclose the name and taxpayer identification number of each S corporation shareholder for the taxable year of the S corporation ending with or within the partnership taxable year for which the election to opt out is made. The statements such S corporation is required to furnish shall be treated as statements furnished by the partnership for purposes of applying the 100 partner rule. Reg. § 301.6221(b) – 1(c)(2).

3. Spouse Partners. Under the Regulations, a Schedule K-1 issued to one spouse owning a community property interest in the partnership is considered as one Schedule K-1. If both spouses each own a community property interest and receive separate Schedules K-1, then the number of Schedules K-1 for this purpose is two. See Reg. § 301.6221(b)-1(b)(2)(iii), Ex. 1-2.

4. Tax-Exempt Partners. The Regulations do not specifically address this point. However, the preamble to the Regulations indicate that a tax-exempt organization should be treated as a C corporation for purposes of PAR,

provided the tax-exempt organization is not classified as a trust for federal income tax purposes.

5. Partnership Partners: Under Reg. § 301.6221(b) – 1(d), if a partnership (P2) is a partner in another partnership (P1) and P2 opts out of PAR, P2 is subject to the same rules under PAR with respect to its interest in P1 as any other partner in P1.

6. Foreign and Other Partners: The Secretary may provide for alternative identification of any foreign partners. The Secretary may by regulation or other guidance prescribe rules similar to the rules above with respect to any partners not described above. Section 6221(b)(2)(B), (C). Reg. § 301.6221(b)-1(b)(3)(iii) states a foreign entity is an eligible partner if the entity would be classified as a per se corporation under Reg. § 301.7701-2(b)(1), (3) – (8), or is classified by default as a corporation under Reg. § 301.7701-3(b)(2)(i)(B), or an election be a corporation is made under Reg. § 301.7701-3(c).

7. Audit of Partnership Opting Out: IRS audit, deficiency, assessment and collection proceedings are conducted at each partner level under pre-TEFRA procedures and rules, including statute of limitations and venue.

8. Final Regulations. The Regulations under Section 6221 are final.

9. Election Out Form. Schedule B-2 to Form 1065 is used to opt-out. In addition, Schedule B, Item 25 refers to an election to opt-out.

Observation: The purpose for the enactment of TEFRA was to eliminate duplicative litigation and inconsistent treatment among partners. Because partnerships with a large number of partners will be eligible to opt out, this would appear to have the opposite effect. Specifically, a partnership with up to 100 qualifying partners could elect out and very likely would. This would mean that, if the IRS wanted to audit that partnership, it would have to open an audit for all 100 partners. Moreover, each partner should be able to litigate the adjustments against him/her separately, potentially in different courts, creating the potential for inconsistent results on identical issues. In addition, a successful audit at the partner level will largely depend on the partnership's cooperation in providing information and documentation. Failure to do so could be very detrimental to a partner. The partners may want to have their partnership agreement include language requiring the partnership to cooperate in a partner-level audit.

III. CONSISTENCY REQUIREMENT (SECTION 6222)

A. Consistency Generally Required

Section 6222 sets forth the general requirement that a partner treat any partnership-related item in a manner which is consistent with the treatment of such item on the partnership return. Reg. § 301.6222-1(a)(1) adds that consistency includes amount, timing and character of the item and is measured by the partnership return actually filed. In addition, these rules apply to a partnership (P1) who is a partner in another partnership (P2) without regard to whether P1 has opted out of PAR. If a partnership return is not filed, a partner's treatment of items is per se inconsistent. Reg. § 301.6222-1(a)(3).

B. Failure to Be Consistent

1. Underpayment of Tax: Reg. § 301.6222-1(b)(1) gives the IRS the power to adjust the partner's return to make the return consistent with the partnership's return and to determine the underpayment of tax. The underpayment of tax is assessed and collected in the same manner as if such underpayment were on account of a mathematical or clerical error appearing on the partner's return. Reg. § 301.6222-1(b)(2). For these purposes, the term "partner's return" includes any return, statement, schedule, or list, and any amendment or supplement thereto, filed by the partner with respect to any tax imposed by the Code.

2. No Abatement of Assessment: Section 6222(b) states that paragraph (2) of Section 6213(b) (abatement of assessment request) does not apply to an assessment treated as a mathematical or clerical error under PAR (unless an exception applies). Reg. § 301.6222-1(b)(2).

Observation: As a practical matter, the above provisions permit the IRS to make an assessment resulting from an inconsistent position on a summary basis without affording the taxpayer any administrative or judicial relief, if none of the exceptions below apply.

3. Notice and Adjustment of Inconsistency:

   a. Statement of Inconsistent Treatment: The consistency requirement and assessment provisions do not apply if the partner files with the Secretary a statement specifically identifying the inconsistent item

on the partnership return according to forms, instructions and other guidance prescribed by the IRS. Reg. § 301.6222-1(c)(1). These rules apply even if the partnership does not file a return; however, it is not clear what information would be included in the statement in this case. Section 6222(c). However, this exception does not apply to the treatment of an item binding on the partner under Section 6223, i.e., actions taken by the partnership under PAR (i.e., Push Out) or a final decision in a proceeding under PAR. Reg. § 301.6222-1(c)(2). Form 8082 is used for notice of inconsistent treatment.

b. Incorrect Partnership Statement: A partner is treated as satisfying the statement of inconsistency if the partner demonstrates that the treatment of the item on the partner's return is consistent with the treatment of the item on the statement, schedule or other IRS form furnished to the partner by the partnership and the partner elects to have Section 6222 apply. Reg. § 301.6222-1(d). The time, substance and manner of the election are set forth in this Reg. The election must be made within 60 days after the IRS notifies the partner of the inconsistency. If the inconsistency is not clear, the election must explain how the partner's treatment is consistent.

c. Adjustments: If a partner properly and timely notifies the IRS of an inconsistency and the IRS disagrees, the IRS can commence a

proceeding to adjust or contest the item in question. Reg. § 301.6222-1(c)(4)(ii). In that proceeding, the IRS can "also adjust any item on the partner's return, including items that are not partnership-related items." *Id.* Example 2 of this Regulation clarifies that the proceeding is under subchapter B of Chapter 63 (i.e., the normal assessment and deficiency proceedings).

d. Partnership Not Bound: Any final decision with respect to an inconsistent position identified under these exceptions to which the partnership is not a party is not binding on the partnership. Reg. § 301.6222-1(c)(4)(ii).