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Highlights of Proposed Regulations
of the New Partnership Audit Regime

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History of the IRS Audit Rules

- Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982
 - Unified audit procedures
- Electing Large Partnership (ELP) of 1997
 - Intended to lessen the administrative work for the IRS by requiring an electing partnership to pay the tax and requiring fewer notices to partners.
- Bipartisan Budget Act (BBA) of 2015
 - Eliminates TEFRA and ELP
 - Intended to implement centralized partnership audit regime

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History (continued)

- US Government Accountability Office (GAO) determined that IRS corporate audit rate was 27.1% in 2012 but for the same period the large partnership audit rate was 0.8%.
- These statistics were the driving force behind the new partnership audit rules enacted by Congress.
- The Proposed Regulations originally issued by the Treasury on January 18, 2017 but withdrawn before publication by the new President Trump regime.
- Proposed Regulations were re-issued on June 13, 2017.
- IRS indicated intent to finalize the regulations by December 31, 2017.

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Applicable Effective Date

- Effective for tax years beginning December 31, 2017
- Option to elect into the regime for tax years after November 2, 2015 and before January 1, 2018

General Rules and Terminology

- Partnership adjustment
 - Any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof
- Return Due Date
 - Due date prescribed for filing the partnership return for such taxable year
- Reviewed year
 - Partnership taxable year to which the item being adjusted relates
- Adjustment year
 - In the case of an adjustment pursuant to the decision of a court proceeding, the taxable year in which such decision becomes final
 - In the case of an administrative adjustment request and any other case, the taxable year in which a notice of final partnership adjustment is mailed

Electing Out

- Eligibility requirements:
 - 100 or fewer partners during the year, and
 - All partners are “eligible partners”
- Election:
 - To be made on timely-filed partnership return for the tax year to which the election relates
 - Must disclose names, TINs and federal classification of shareholders of an S corporation which is a partner
 - All partners must be notified of the election within 30 days.
- Effective election will result in IRS having to open deficiency proceedings, resolve issues and assess and collect tax at the partner level. Each proceeding will be subject to its own statute of limitations (pre-TEFRA rules)

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Opt Out Election (continued)

- Number of partners determined by the number of statements filed by the partnership. If an S corporation is a partner in a partnership its shareholders are counted individually.
- Eligible Partners are:
 - Individuals
 - C corporations
 - S corporation
 - Estate of a deceased partner
 - Eligible Foreign Entity (per se or elected corporation)

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Opt Out Election (Continued)

- NOT eligible:
 - Partnerships
 - Trusts (including grantor trusts)
 - Disregarded Entities
 - Nominees
 - Estates not of a deceased partner

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Consistency Requirement

- Consistent treatment between partner and partnership's tax returns is required as to amount, timing and characterization of income, gain, loss, deduction or credit
- Notification of the inconsistent position with the partnership's originally filed return will result in an evaluation of the position involving only that partner

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Partnership Representative

- May be any person
 - Substantial presence in the US is required (special definition not connected to substantial presence under 7701)
 - Meet with the IRS in the US
 - Be reachable during regular business hours at a US street address and have a US phone number
 - Have a US TIN
 - Need not be a partner to be eligible
 - If an entity is designated, an individual must be appointed to act for the entity
- The partnership must designate a representative in each tax year
 - Designations do not carry over to the following year

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Partnership Representative (Continued)

- If no designation is in effect, the IRS may select any person to serve as representative
 - Once IRS has designated a representative, the partnership may not revoke the designation without IRS consent
- Sole person with binding authority on behalf of the partnership
 - Authority may not be limited by state law or partnership agreement

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Imputed Underpayment

- Partnerships generally responsible for paying imputed underpayment in adjustment year
 - Calculation
 - Total netted partnership adjustment multiplied by the highest rate of federal income tax in effect for reviewed year
 - Increased or decreased by any adjustment to partnership credits
 - Positive result causes imputed underpayment
 - Negative result does not cause imputed underpayment
 - Grouping and Subgrouping
 - Adjustments grouped together and subgrouped within each group depending on their character, account preferences, sources, categories, limitations or other applicable restrictions

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Imputed Underpayment (*continued*)

- Must be paid in the year of adjustment
- Grouping
 - Reallocation grouping
 - Credit grouping
 - Residual grouping
- Subgrouping
 - Ordinary adjustments
 - Capital adjustments
 - Netted only against the same year
- Multiple imputed underpayments
 - Partnership may pay none, some or all of the imputed underpayments and “push out” those adjustments which the partnership chooses not to pay

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Modification of Underpayment

- Right to request modification of a proposed imputed underpayment after notice of proposed partnership adjustment (NOPPA)
 - 7 types of modifications considered by the IRS upon request
 - Amended returns
 - Tax-exempt partners
 - Rate modification
 - Certain passive losses of publicly traded partnerships
 - Number and composition of imputed underpayments
 - Partnerships with partners that are section 860 “qualified investment entities”
 - Partner closing agreements

Alternative Method of Payment or Underpayment

- Election to “Push out” adjustments to reviewed year partners under IRC 6226
 - Shifting of liability to partners in the reviewed year
 - Notice to partners and IRS of election is required
 - Non-revocable except by the IRS
 - Election can only be made within 45 days of the Final Partnership Adjustment (FPA)
 - Required statement to partners containing “safe harbor” amount that partner can elect to pay rather than compute actual effect the adjustment will have on the partner’s reviewed year and intervening years.

Various Open Issues

- Adjustments through multi-tiered pass-through structures
 - No specific guidance yet
 - To be published in the near future
 - Some indication in the Preamble that the IRS will allow push down of the adjustments to lower tier partnerships
- Bases/Capital account adjustments
 - No guidance for the mechanics on the adjustment of outside basis and capital accounts of adjustment year partners' outside bases and capital account with effect on reviewed year partners who must pay the additional tax.
- Treatment of adjustments relating to foreign tax credit calculation
 - No detailed recommendation

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Partnerships that Cease to Exist

- IRS has sole discretion to make the determination that a partnership has ceased to exist
 - Either terminated, or unable to pay amounts owed relating to partnership adjustments
- If ceased to exist, all former partners must take the adjustment into account as if the partnership elected to “push out” its adjustments to its partners

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Implications

- Partnership Representative designation in the agreement
 - Partner vs. non-Partner
 - US presence
 - Indemnification
 - Mechanism for removal or replacement of the Partnership Representative

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Implications (Continued)

- Partnership Agreement changes to provide for ability to:
 - Elect out of the centralized audit regime
 - Have partnership pay without push out election
 - Partnership to push out the payment
- Effect of changes in partners between reviewed year and adjustment year
- Reserve requirements for departing partners

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Implications (Continued)

- Due Diligence will require evaluation of historical liability
- Buyer and Seller have to agree which regime to apply in pre-closing years
- Buyer and Seller should agree whether partnership or partners will pay assessments (push out election will be made)

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22