

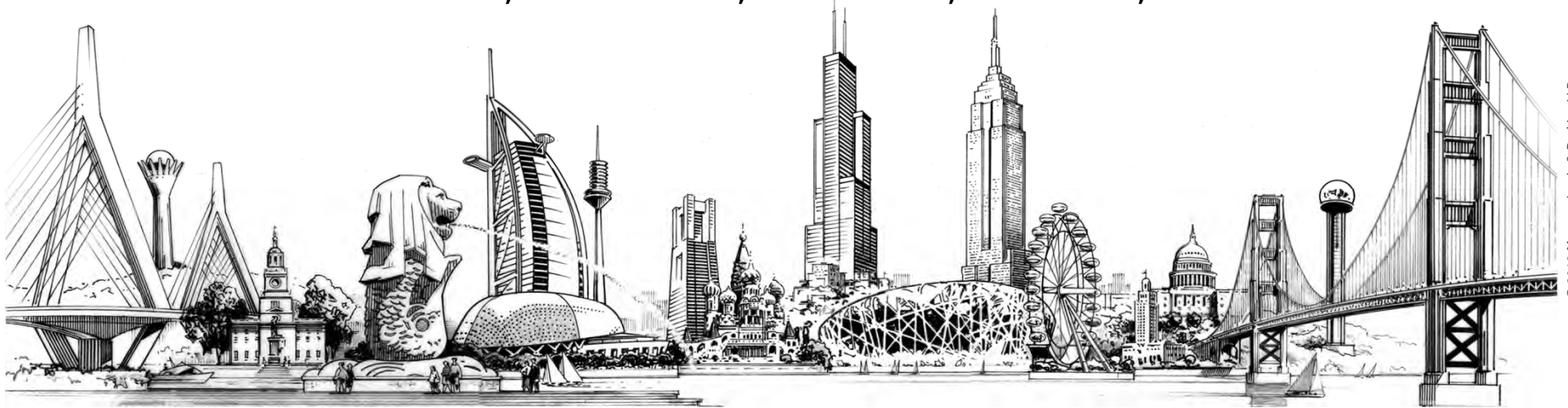
Morgan Lewis

FINAL PARTNERSHIP AUDIT RULES

The Final Regulations, IRS Implementation, and Impact on Partnerships

February 7, 2019 Webcast

Presenters: Jennifer Breen, Sarah Brodie, Sheri Dillon, Bill McKee, and Will Nelson



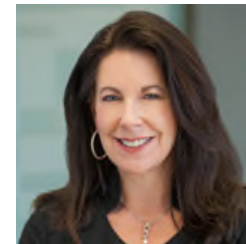
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Roadmap for Today's Presentation

- Initial Impressions Regarding the Evolution of the Rules
- BBA: IN or OUT?
 - Who should elect out and why
 - Alternatives and considerations when you do not elect out
- The Centralized Partnership Audit Regime – Key Final Regulations
 - Scope - §301.6241-1(6)
 - The Imputed Underpayment - §301.6225-1(a)&(b)
 - Modification – §301.6225-2
 - Push out
 - Appeals & Judicial Review
- IRS Implementation of the Regime

Path to Final Guidance

- June 2017 - proposed regulations on certain implementation rules
- November 2017 - proposed regulations on international issues
- December 2017 - proposed regulations on the push-out election, tiered partnerships and other administrative provisions
- January 2018 - final regulations on electing out
- February 2018 - proposed rules regarding basis and capital account issues
- August 2018 - final regulations on partnership representative
- August 2018 - proposed Regulations withdrawn and repropounded to reflect changes made by the Technical Corrections Act of 2018
- December 2018 - final procedural regulations released

Initial Impressions

- Overall structure and operation of this regime has remained consistent throughout the iterations of the regulations.
- Centralized vs. Streamlined
 - The “core feature” of the centralized partnership audit regime is to provide a centralized method of examining items of a partnership.
 - The approach shifts the responsibility from the IRS to the partnership and the partners to account for specific facts and circumstances in arriving at and ultimately paying a proposed liability.
 - Ultimately, the guiding principles of the regime is ease of examination and collection for the IRS, even if it results in rough justice.

BBA: IN OR OUT?

... AND WHAT IF THERE IS NO OPTION?

Structure: Election Out

- Should you elect out?
- Often, yes, IF:
 - You're eligible,
 - Your partners are willing to be audited directly (many will not – sponsored partnership especially),
 - You're willing to give partners full access to partnership's books and records, and
 - You think you can adequately control transfers of partnership interests
- How do you control transfers?
 - Standard language about how transfers in contravention are null and void
 - Any transfers in contravention mean that the transferor/transferee have NO say in partnership audits

Structure: Alternatives within BBA Rules

What if you don't elect out?

- Large imputed underpayment initially
- NOPPA / Modification Procedures
 - Amended Returns?
 - Underpayment recomputed by ignoring adjustments taken into account on partner amended return
 - Re-ups prior return, new 270-day statute
 - Partnership liable unless it can prove tax was actually paid by partners
 - Pull-in § 6225(c)(2)(B)
 - Amended return “lite”
 - No unfavorable interest rules
 - Partnership liable unless it can prove tax was actually paid by partners
 - Few details currently available
 - No refunds available

Structure: Alternatives within BBA Rules

- Push-out - § 6226
 - Election not made until after modification procedure complete,
 - Interest is 2% higher than regular rate
 - Unfavorable rules on interest for intervening years: no interest on overpayments, no netting
 - Partnership no longer liable
 - Taxes correct partners at generally correct amounts

Structure: Alternatives within BBA Rules

- Partnership pays - § 6225
 - Less administrative hassle – attractive for smaller adjustments
 - Partners do not need to be involved
 - Attractive for very large partnerships, even if total adjustment is large
 - Investment partnerships may not want to inform their partners that problems exist
 - Modification procedure will hopefully be effective and reasonably administered
 - Partnership agreement should allocate tax burden among partners
 - Partners can indemnify partnership for taxes paid (contribution obligation)
 - Partnership can elect to reduce future distributions
 - Less attractive when there has been significant partner turnover

Structure: Alternatives within BBA Rules

- Generally leave choice to partnership representative
 - Generally, have consent requirements
 - May require push out if adjustment exceeds threshold amount
- One size does not fit all

THE CENTRALIZED PARTNERSHIP AUDIT REGIME REGULATIONS

Proposed vs. Final

- Scope of the regime was clarified and narrowed
- Imputed underpayment computation was clarified
- Rules for computing penalties were revised
- Consistency requirements changed
 - Notice of inconsistent treatment not permitted after NAP
 - Notice of inconsistent treatment permitted for an AAR item
 - If no Form 1065 is filed, partner is always inconsistent
- Final Regulations do not address:
 - Appeals
 - Basis and capital account issues

Scope of the Regime §301.6241-1(6)

- The regime only applies to “partnership related items” under chapter 1 of subtitle A
- Partnership related item defined as any item of amount with respect to the partnership that is relevant in determining the income tax liability of any person
- “With respect to the partnership” is defined to **only include** items reflected or required to be reflected on the partnership return or required to be maintained in partnership books and records
 - This does concept does not extend to items or amounts that are reported by 3rd parties and that are not otherwise defined as partnership-related items by the regulations
 - Excludes items **voluntarily** maintained in partnership’s books and records
- Imputed underpayment is always a partnership item

Scope of the Regime (cont'd)

- TEFRA concepts of “affected items” and “computational adjustments” are not included in the regime
- Examples of partnership related items
 - Character, timing, source, and amount of a partnership’s income, gain, loss, deductions, or credits
 - Contributions to and distributions from a partnership
 - Transactions between a partnership and a partner (e.g. disguised sale)
 - Items relating to partnership termination and partners’ capital accounts
 - Whether a person is a partner and whether a partnership exists
 - Partnership’s basis in its assets
 - Amount and character of partnership liabilities
 - Partnership allocations

Scope of the Regime – Observations and Questions

- How do these issues play out under the regime?
 - Debt vs. Equity
 - Passive vs. Active
 - Recourse vs. Nonrecourse
 - Section 199A
- Could the scope of the regime create situations where a partner is whipsawed due to the statute of limitations?

The Imputed Underpayment - §301.6225-1(a) & (b)

- Determination of the Imputed Underpayment (“IU”)
 - All adjustments are appropriately netted and multiplied by the highest rate in Section 1 or 11 for the reviewed year
 - No netting across taxable years
 - Changes in credits are taken into account as an increase or decrease in the IU as appropriate under the circumstances
- Grouping, subgrouping and netting rules apply to adjustments within a taxable year.
 - The “design” of these rules is to create an imputed underpayment amount that is based upon the highest rate and disregards any taxpayer favorable adjustments and will likely reflect an amount that is larger than the cumulative amount of tax the partners would have paid separately.

The Computation of the Imputed Underpayment

Step 1 – Group Adjustments §301.6225-1(c)

- Adjustments placed in one of four groupings
 - 1) Reallocation
 - 2) Credit
 - 3) Creditable Expenditures (including creditable foreign tax expenditures)
 - 4) Residual
- Residual grouping further put into subgrouping based on character, etc., so items of different character are not netted
- Adjustments resulting from reallocations are placed into separate subgroups
- IRS can modify the groupings at its discretion

The IU Computation

Step 2 – Net Groups and Subgroups §301.6225-1(d)-(f)

- Items in same group or subgroup are netted. Net positive amounts aggregated.
- Net negative adjustment (i.e., taxpayer favorable adjustment) in residual or reallocation group
 - Is NOT an imputed underpayment
 - Taken into account in the adjustment year

Step 3 – Compute Imputed Underpayment:

- Multiply aggregated amount by highest tax rate for reviewed year and apply adjustments to credits. This is the imputed underpayment.

Multiple IUs §301.6225-1(g)

- IRS may designate, in its discretion, a single or multiple IUs with respect to a partner or various partners
 - Decision is based on the nature of the partnership adjustments
 - Decision is at the discretion of the IRS
 - Partnerships may request in modification that the IRS create multiple imputed underpayments, but the IRS is not required to do so
 - If multiple imputed underpayments designated by the IRS, the partnership may separately elect to push out each imputed underpayment

Modification of the IU §301.6225-2

- Once the adjustments that make up an IU have been determined, the partnership representative has the opportunity (generally within 270 days of the NOPPA) to request modifications to the IU
- Partnership Representative must submit all necessary documents and information to substantiate the modification
- The standard of review for the IRS's rejection of a proposed modification appears to be "abuse of discretion"

Modification of the IU §301.6225-2

- Types of modifications that the IRS will consider:
 - Modifications that affect the *rate* of tax:
 - Taxpayers in different tax brackets,
 - Closing agreements,
 - Tax Treaties,
 - Other (unspecified) modifications
 - Modifications that exclude items from the IU:
 - Tax paid on amended returns or under the alternative procedure to amended returns,
 - Passive activity losses,
 - Qualified investment entities,
 - Closing agreements,
 - Tax treaties,
 - Other (unspecified) modifications
- Since the IU is calculated using the highest rate under *either* § 1 or § 11, the determination of whether a partner is a c-corporation is part of the determination of the IU, rather than a modification

Amended Return Modification §301.6225-2(d)(2)

- The IU is reduced by the allocable share of adjustments taken into account by a reviewed year partner on an amended return filed for the reviewed year and all intervening years so long as the partner pays the applicable tax, interest and penalties
 - Using this alternative “re-ups” the positions taken on each amended tax return, and starts a new 270 day statute of limitations (the statute of limitations in §6501 is turned off)
 - The partnership representative must provide affidavits from each partner that partner filed amended returns and paid tax due
 - In a reallocation adjustment, all partners affected by the reallocation must file amended returns unless the adjustment is taken into account by some other type of modification
 - Indirect partners can file amended returns
 - Can give rise to a refund

“Alternative Procedure” Modification §301.6225-2(d)(2)(x)

- This alternative was added because taxpayers were concerned about re-upping all of the positions taken on their tax returns
- Details on how the procedure works are limited – more guidance is promised
- Appears to reach the same result as filing an amended return, without re-upping non-partnership return positions, although refunds are unavailable
- Both amended returns and alternative procedure filings are available even if the partner’s statute of limitations has closed

Push Out §301.6226-1

- Once the Partnership Representative has received IRS approval to modify the IU, the partnership can elect to “push out” the remaining IU to the partners (or can elect to push out the entire IU if no modifications are approved)
 - A valid push-out election means the partnership is no longer liable for the IU
 - Valid election requires furnishing tracking statements to the IRS to allow the IRS to identify the partners and their share of the adjustment
 - Partnership must make push-out election within 45 days of the date the FPA was mailed, and statements are due 60 days after (i) the 90 days period for going to court has lapsed, or (ii) a court determination is final

Push Out (cont'd)

- A reviewed-year partner must pay additional chapter 1 tax on the return for the year the statement is received equal to the aggregate of the “correction amounts,” plus penalties and interest
 - The correction amounts are any changes in taxes payable for the reviewed year and all intervening years had the adjustments been properly reported
- Interest on the tax due is two percentage points higher than the normal underpayment interest rate
 - No interest is paid on overpayments

Planning Note

- Planning Note: If there is any possibility of a push-out election, partnership agreements should require the partnership representative to solicit information (and payments – either via amended returns or alternative procedure payments) from partners that will allow maximum modification of the IU
 - The 2 percent additional interest only applies to the IU that is pushed out
 - The push out is only to partners that did not participate in the amended return/alternative procedure payment process

Push Out – Tiered Partnerships §301.6226-3(e)

- Adjustments can be pushed out through the multiple tiers of ownership to the ultimate owner
- Pass-through partner must furnish statements to its partners (the affected partners)
- If the pass-through partner does not furnish statements, the pass-through partner must pay an imputed underpayment
 - Pass-through affected partners can elect to push or pay
 - If the pass-through partner elects to pay, they still must furnish tracking statement
 - Pass-through partners cannot get modifications on their own, they must go to the source partnership during the modification process of the source partnership

Appeals

- Appeals is outside the scope of the final regulations
 - Preamble repeatedly states that Appeals procedures will be addressed in future guidance
 - Also states that “ IRS plans to adopt procedures for [appeal of] adjustments made during the examination prior to the mailing of a NOPPA.”
 - Partnerships will therefore know which adjustments are agreed or unagreed at the time of any modification request

Judicial Review §301.6234-1

- Suit may be brought by the PR within 90 days of when an FPA is mailed in:
 - Tax Court
 - District Court in which the partnership's principal place of business is located
 - Court of Federal Claims
- Court has jurisdiction to determine:
 - Adjustments
 - Modifications
 - Proper allocation of items among partners
 - Penalties, additions to tax and other amounts for which the partnership may be liable
- Standard of review?

IRS IMPLEMENTATION OF THE REGIME

Implementation of the Centralized Audit Regime

- The IRS has been working on IRM provisions, training modules, forms, publications and other guidance implementing the BBA
- Holly Paz, Director of the Pass-Through Entities Practice Area, had indicated that LB&I is holding publication of these materials until the regulations were finalized
- The TEFRA Unit will be reworked into the “BBA Unit” and will handle all Modifications.
- Questions remain
 - Examinations that straddle TEFRA and BBA: How will this work?

Questions?

Closing Thoughts

APPENDIX

PENALTIES

Penalties §301.6233(a)-1

- Penalties determined at the partnership level as if the partnership had been an individual in the reviewed year and the IU was an underpayment of tax or understatement for that year.
 - Partnerships facts and circumstances are relevant for penalty defenses
 - Actions of partner could be relevant to partnership's defense
 - However, partner-level defenses cannot be not raised unless an amended return is filed, push-out occurs, or a refund suit is filed by a partner
- Final Regulations addressed concerns with approach in proposed regulations, which maximized penalties
- Final Regulations create a six step approach to computing penalties to allow for negative adjustments to be take (somewhat) into account
 - The approach uses section 6225 groupings

Penalties (cont'd)

- Negative adjustments offset positive adjustments with a group or subgroup, then against adjustments subject to the lowest penalty, there are special rules for negative credits.
- Six-step calculation
 - 1) Total all non-credit adjustments subject to penalty at highest rate
 - 2) Multiply the total in step 1 by the highest rate of tax under section 1 or 11
 - 3) Repeat steps 1 and 2 for all other modified tax rates
 - 4) Total results of steps 1 – 3
 - 5) Net all credit adjustments, if positive, increase total in step 4. If negative decrease total, applying first to portion with no penalty then against portion with lowest penalty rate
 - 6) Multiply step 5 total by penalty rate

Penalties – Example of Application

*Source *Treas. Reg. § 301.6233(a)-1(c)(2)(v)(C) Example 4*

- Partnership issued NOPPA proposing:
 - \$100 *positive* adjustment to ordinary income, subject to 20% negligence penalty
 - \$10 *positive* adjustment to credits, subject to 20% negligence penalty
 - \$300 *positive* adjustment to long-term capital gain, no penalty applies
 - \$50 *negative* adjustment to ordinary income, subgrouped with \$100 adjustment
- Calculation of imputed underpayment subject to 20% penalty:
 - Step 1: $(\$100 - \$50) = \$50$
 - Steps 2-4: $\$50 \times 40\% \text{ [Tax Rate]} = \20
 - Step 5: $\$20 + \$10 = \$30$
 - Step 6: $\$30 \times 20\% \text{ [Penalty Rate]} = \6

Penalties – Example of Application

- Partnership issued NOPPA proposing:
 - \$100 *positive* adjustment to ordinary income, subject to 20% negligence penalty
 - \$20 *positive* adjustment to ordinary income, no penalty applies
 - \$10 *positive* adjustment to credits, subject to 20% negligence penalty
 - \$300 *positive* adjustment to long-term capital gain, no penalty applies
 - \$80 *negative* adjustment to ordinary income, subgrouped with \$120 in adjustments
- Calculation of imputed underpayment subject to 20% penalty:
 - Step 1: \$80 negative applied first to \$20 not subject to penalty and then remainder (\$60) used to reduce the \$100 to \$40
 - Steps 2-4: $\$40 \times 40\% \text{ [Tax Rate]} = \16
 - Step 5: $\$16 + \$10 = \$26$
 - Step 6: $\$26 \times 20\% \text{ [Penalty Rate]} = \5.20

TAX COURT RULES

Tax Court Rules

- The Tax Court announced interim and proposed amendments to its rules, Rules 255.1 through 255.7, on December 19, 2018
 - Includes rules applicable to partnerships subject to the centralized partnership audit regime and explanations of those rules
 - Tax Court requested comments with a due date of January 18, 2019
 - Rules generally track the structure of the provisions in place for partnership actions subject to TEFRA

Tax Court Rules

- Rule 255.2(b)(5) – Contents of Petition
 - Rules contemplate that the Tax Court has judicial review over:
 - Determinations with regard to the imputed underpayment
 - Proposed modifications to which the Commissioner did not consent
- Rule 255.6 – Identification and Removal of Partnership Representative
 - At the commencement of a case, if the PR is not identified, Tax Court will take such action as necessary to establish the identity of the PR
 - After the commencement of a case, the Tax Court may remove PR for cause and if a PR' status is terminated for any reason, the partnership shall designate a successor PR as the Tax Court may direct
 - Tax Court explained it was not taking a position on whether it could appoint a PR

Biography



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Bill McKee's practice encompasses all areas of federal taxation, with special emphasis on partnership taxation. Bill served as tax legislative counsel at the US Treasury Department from 1981 to 1983. He is a member of the American Law Institute, the American College of Tax Counsel, and the National Institute for Tax Professionals. Bill co-authored the treatise *Federal Taxation of Partnerships and Partners* (Warren, Gorham & Lamont, 4th edition, 2007) as well as *Structuring and Drafting Partnership Agreements: Including LLC Agreements* (Warren, Gorham & Lamont, 3rd edition, 2003).

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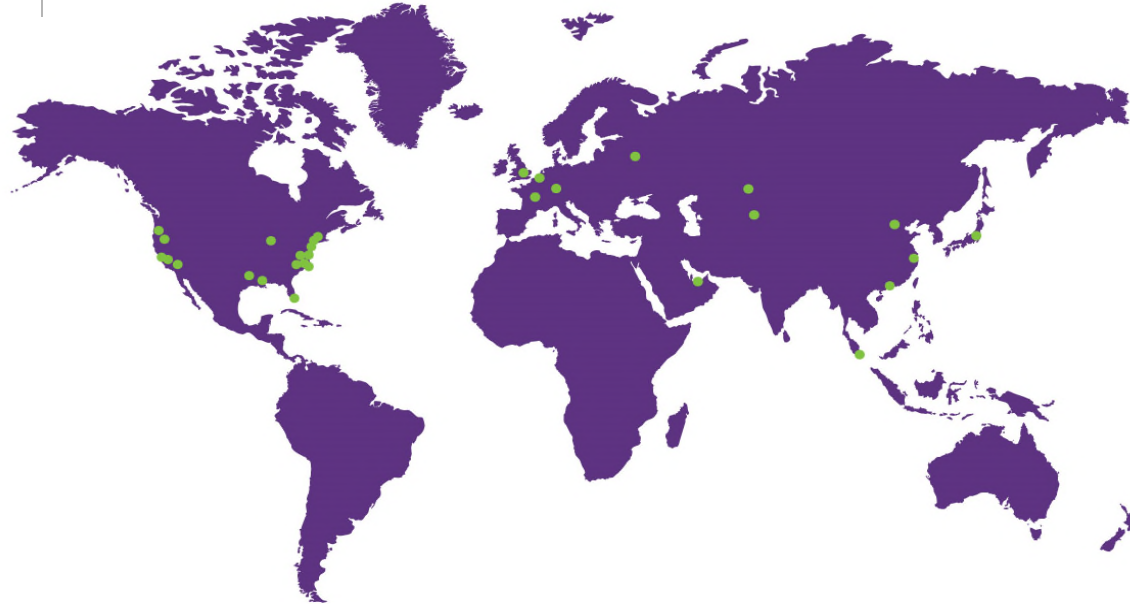
Will Nelson's practice encompasses all areas of federal taxation, with special emphasis on partnership taxation and tax controversy and litigation matters. Previously chief counsel for the Internal Revenue Service, Will co-authored the treatise *Federal Taxation of Partnerships and Partners* (Warren, Gorham & Lamont, 4th edition, 2007) as well as *Structuring and Drafting Partnership Agreements: Including LLC Agreements* (Warren, Gorham & Lamont, 3rd edition, 2003). Will writes on tax law for numerous journals, and he frequently lectures at tax institutes.

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