Tax Executives Institute
Detroit Chapter Meeting

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Navigating LB&I’s New Issue-Focused Audit Process
Current State of IRS: Doing Less with Less

- $900 million in budget cuts since 2010
  - Small increase in 2016 ($250 million) allocated to customer service/telephone assistance/fraud detection/cybersecurity
  - Continuing resolution through April 2017, no increase likely in 2017
  - Trump’s 2018 IRS budget priorities unknown

- Overall staffing down by 20%, from 94,700 to 76,500
  - Effectively a hiring freeze
  - Revenue Agents down 25% from almost 14,000 to 10,600
  - Appeals Officers down from 1,000 to 760 last year, back up to 1,000
  - Significant increases in executive/senior management retirements
  - 51% of executives and 41% of managers eligible to retire in 2016
  - 25% of overall workforce eligible to retire in 2015 (40% by 2019)

- Audit rate lowest since 2004: large business audits declined 22% since last year
Current State of IRS: Doing Less with Less

Source – Syracuse Univ. TRAC IRS -- http://trac.syr.edu/tracirs
The only constant is change.  Heraclitus (535-475 BC)
Concept of Operations (CONOPS) and the IRS “Future State”

• Began development in 2014 in response to IRS challenges
  – Significant budget reductions since 2010
  – Increased responsibilities: unfunded mandates of FATCA and ACA implementation
  – Technology concerns: identity theft, cyber attacks

• High level restructuring initiative across major divisions including LB&I and SB/SE
  – Guiding principles would change the way that the IRS operates
  – Goal was to increase efficiency in era of declining resources

• Became the cornerstone of the LB&I reorganization
  – Intended to fundamentally transform IRS interactions with taxpayers
Objectives of Reorganization

• Change the way LB&I is structured
  – One LB&I, practice areas, compliance areas

• Issue focus: select work based on compliance risk
  – Choose issues by employing data analytics and specialized staff

• Collaboration: seek ways to involve taxpayers in Exam process and create incentives for cooperation

• Develop better training and career paths and better tools and support
  – Knowledge management, deployment, mentors

• Define the compliance outcomes of all LB&I work
2016 LB&I Reorganization In Context

- CONOPS in development (2014)
- IDR Directive (March 2014)
- Centralized risk assessment pilot program (April 2014)
- Appeals judicial approach & culture (July 2014)
- LB&I reorganization announced (Sept 2015)
- IRS enterprise concept of operations (CONOPS) (March 2016)
- Pub. No. 5125 (February 2016)
-IRM updated (March 2016)
- New process for cases starting as of May 1, 2016
- LB&I announces initial 13 campaigns (Jan. 31, 2017)
LB&I Reorganization Overview

• Changes to LB&I organization chart create “one LB&I”
  – Single Deputy Commissioner
    ▪ International/Domestic Deputy Commissioners merge
  – Two Assistant Deputy Commissioners: International, Compliance Integration
  – Eliminate industry designations
  – Move to issue-based examinations

• 9 new practice areas:
  – A Practice Area is a group of employees organized together to focus on one or more areas of expertise
  – Each Practice Area will study compliance issues within their area of expertise and suggest campaigns to be included in the compliance plan
LB&I High-Level Organization

Double-lined boxes indicate Executive Level
Issue-Focused Exam Process: Identification of Issues

- Centralized risk model for case/issue selection
  - Greater use of predictive analytics
- Focus on streamlined audits with issue-focused approach
- Develop “campaigns” to alter taxpayer behavior
- Create tailored treatment streams to address areas of noncompliance
- Eliminate Coordinated Industry Case (CIC) Program
  - Audit Issues Rather Than Returns, But . . .
    - Largest Taxpayers Still Under Continuous Audit
    - Examiners May Still Identify Their Own Issues
  - Implications
    - Rev. Proc. 94-69 disclosures
    - Designated summonses
    - Delegation orders
Campaign Approach

• Identify areas of greatest non-compliance
  – Data analytics
  – Feedback from Field
  – Feedback from tax community
• Deploy resources to those areas
• Transparent to taxpayers
• Focus on mid-market companies
Risk Identification

• Centralization of issue selection
  – Governance Board decides issues to address and how
  – Issues pre-identified for examiners
  – Separation of classifiers from examiners

• Role of Compliance Planning and Analytics (CPA)
  – Brings all workload selection areas into one office
  – Increased focus on data analytics
  – More data becoming available (e.g., country-by-country reporting)

• Goal is to move from a reactive return-focused risk approach to a more proactive position
Campaign Approach

• 13 initial campaigns reveal emphasis on
  – International Issues
  – Mid-market taxpayers
  – Alternative techniques to auditing
  – Low-hanging fruit

• LB&I continuing discussions with tax community to identify future campaigns
LB&I Knowledge Management

• Issue Practice Groups (IPGs), International Practice Networks (IPNs)
  – Facilitated knowledge management, collaboration
  – Developed practice units on various issues

• International practice units (IPUs) are available

• Domestic issue directives also published.

• IPUs may foreshadow future campaigns – LB&I already invested in issues

• Important resources for understanding how LB&I issue team may approach your issue
Publication 5125: LB&I Examination Process

• To be provided to taxpayers at opening conference
• Goal: To complete exam in an efficient and effective manner through collaborative efforts.
• Provides expectations for both IRS and taxpayers
• Outlines 3-Phase Exam process
  – Planning Phase
  – Execution Phase
  – Resolution Phase
• Details set forth in IRM 4.46.1, .3, .4, and .5, all updated in March 2016
Issue-Focused Exam Process: The Examination

- Issue Team to take responsibility
- Collaboration with taxpayer emphasized
- Resolve issues at earliest appropriate point
  - Exam to seek taxpayer agreement on facts before NOPA
  - Exam Team required to consider Fast Track Settlement
- Rules of engagement
  - Prior system relied on domestic chain, which failed to resolve problems on international issues
  - New system allows moving up substantive, geographic chains, no one decision maker for all of the issues
  - Accountability is diffused
Roles and Responsibilities of IRS Team (IRM 4.46.1)

• Case Manager – holds overall responsibility of the examination; but is not granted “51% control” over the case
• Issue Manager – oversees planning, execution, and resolution of the issue; one issue manager per issue under examination
• Other member – Team Coordinator; Issue Team member
  – Principles of Collaboration (IRM 4.46.1.4) replace Rules of Engagement (formerly IRM 4.51.1)
• Emphasis on collaboration among all parties and timely elevation of concerns
• Provides guidelines for when internal elevation may be appropriate
IDR Process (IRM Exhibit 4.46.4-1)

• Requirements for issuing IDRs
  – IDRs to be single issue, “issue focused”
  – The issue, the information sought, and how the information relates to the issue to be discussed with the taxpayer prior to issuance
    – “Reasonable timeframe” to be discussed with taxpayer, set by exam
• Timely review and follow-up by Exam concerning responses once submitted
Acknowledgment of Facts (AOF) (IRM 4.46.4.9)

• IRS is required to prepare a statement of facts on Form 886-A as part of its consideration of each issue.
• IRS is also expected to issue a pro-forma IDR to seek to obtain a written AOF from the taxpayer and to incorporate any additional facts in the write-up.
• IRM provides instructions to Exam if the taxpayer
  – Agrees with the facts,
  – Provides additional facts,
  – Identifies disputed facts, or
  – Does not respond to the AOF IDR.
Acknowledgment of Facts: Form IDR

Form 4564
(Rev. September 2005)

Department of the Treasury — Internal Revenue Service
Information Document Request

To: (Name of Taxpayer and Company Division or Branch)

Subject

SIN number  Submitted to:

Dates of Previous Requests (mm/dd/yyyy)

Please return Part 2 with listed documents to requester identified below.

Description of documents requested

The purpose of this IDR is to ensure that all relevant facts, whether favorable to the taxpayer or LB&I, are being considered before the Form 5701, Notice of Proposed Adjustment (NOPA) is issued.

Please review the attached Form 886-A and respond accordingly in writing to the LB&I issue team by the agreed upon date, (MM/DD/YYYY).

(a) Taxpayer agrees to the facts as written.

(b) Taxpayer provides additional relevant facts and supporting documentation.

(c) Taxpayer identifies disputed facts and provides clarification and/or supporting documentation.

Appeals will return the case to exam if the taxpayer presents new information during the Appeals process that was not shared with LB&I during the examination. Therefore, the taxpayer has the primary responsibility to ensure all relevant facts are provided to the LB&I issue team.

While the interpretation of the law or the amount of the proposed adjustment may be unagreed, all relevant facts should be included in the Form 886-A.

Your response to the facts does not indicate agreement to the issue or any proposed tax adjustment. It is only to acknowledge that all of the relevant facts have been identified.

Your response or lack of response to the IDR will be included in the Form 886-A when the NOPA is issued.
Claim for Refund Procedures (IRM 4.46.3)

- Informal claims within first 30 days
  - Should include factual support so that no IDR's necessary
  - Discuss deficiency in claims and provide opportunity to correct
  - Claims risk assessed like other issues
  - Claims can extend audit timeline

- Later claims require formal amended return
  - Form 1120X with supporting documentation
Special Topic: CAP

- Compliance Assurance Process (CAP)
  - Rosemary Sereti, others at LB&I evaluating CAP
  - LB&I has closed the CAP program to new entrants
  - Those currently in program may remain, for now
  - Discussion of creating CAP-like program that is less resource intensive
Alternatives on Conclusion of Exam

Once receive a Notice of Proposed Adjustments:

• Fast Track
• IRS Appeals
• Request Competent Authority assistance
• Request Notice of Deficiency and Proceed to Litigation
  – Tax Court without payment
  – Pay tax, claim refund, and file suit for refund in Federal District Court or Court of Federal Claims
• Concede the issue
IRS Appeals

• Designed as “independent” settlement forum
• “Mission” of IRS Appeals: To settle cases

To resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer, and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service

– Consider “hazards of litigation”
– Do not consider costs of litigation (no nuisance settlements)
IRS Appeals

• Taxpayer submits formal written Protest
  – Exam team will review and prepare written “rebuttal” to Protest
  – Pre-submission conference with IRS exam and IRS Appeals

• Appeals conference follows pre-submission conference (usually same day)
  – Normal procedure is to exclude Exam (ex parte rules apply)
Appeals Reorganization

• Appeals reorganization background
  – Appeals Judicial Approach and Culture (begins 2013)
  – TIGTA Report on penalty cases (July 2015)
  – New procedures for docketed cases, Rev. Proc. 2016-22 (March 2016)
  – New Internal Revenue Manual (IRM) provisions on conference procedures (Oct. 2016)
  – New organizational structure (Oct. 2016)
  – Changes to ATCL settlement authority (2016)
Appeals Reorganization

• Changes to Appeals structure
• Appeals Judicial Approach and Culture (AJAC)
• Procedural changes
Changes in Appeals Workforce

<table>
<thead>
<tr>
<th></th>
<th>FY 2014</th>
<th>FY 2015</th>
<th>FY 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Staffing</td>
<td>1,708</td>
<td>1,569</td>
<td>1,449</td>
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<tr>
<td>Cases In</td>
<td>113,608</td>
<td>113,870</td>
<td>114,362</td>
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<tr>
<td>Case Closures</td>
<td>115,472</td>
<td>117,673</td>
<td>111,345</td>
</tr>
</tbody>
</table>

Source: IRS Data Book Table 30.
Appeals’ Structure

Donna Hansberry
Chief

Nikole Flax
Deputy Chief

Scott Reisher
Director, Collection

Area 1

Area 2

Area 3

Area 4

John Cardone
Director, Examination

Area 5

Area 6

Area 7

Area 8

Area 9 (ATCL)

Jennifer Vozne
Director, Specialized Examination Programs & Referrals

Area 10
(E&G, TEGE, TEFRA, INNSP, PENAP)

Area 11
(International)

Technical Guidance

Technical Support

Art Appraisal Services

Anita Hill
Director, Case & Operations Support

Policy

Business Systems Planning

Human Capital

L&E + Knowledge Management

Finance

Planning, Quality & Analysis

Account & Processing Support
 Appeals Judicial Approach and Culture Project (AJAC)

• Non-docketed cases:
  – Appeals will not consider **new facts** not presented to Exam
  – Appeals will not raise **new issues** not considered by Exam

  • See IRM 8.6.1.6 (New Issues and Reopening Old Issues); Appeals Policy Statements 8-2 and 8-3 (IRM 1.2.17)
New Issues at Appeals

• Appeals will not raise new issues not considered by Exam
• Appeals will not reopen previously agreed issues
• Taxpayer can raise new issues or new theories
  – Appeals can consider (without developing new facts)
  – Appeals to request review and comment from Exam
  – 210 days required on statute of limitations to consult Exam
New Facts at Appeals

• Appeals will not engage in fact-finding
• AOF IDR aimed at ensuring that Appeals is not considering new facts
• New information or evidence means
  – Not shared with Exam
  – In view of Appeals Office, merits additional analysis or investigative action
  – New information provided after NOPA or with Protest may extend Exam (possible additional IDR)
Docketed Cases and Appeals

• Rev. Proc. 2016-22:
  – Cases filed in Tax Court automatically referred to Appeals
  – Counsel can request to attend settlement conference

• New issues, facts – Appeals retains jurisdiction
  – Appeals shares new issue, facts with counsel
  – New procedure for “Docketed Examination Assistance.”
    See new IRM § 8.4.4; Appeals Policy Directive (June 24, 2016)
  – Taxpayer can see, respond to Exam’s new analysis
Impact of AJAC on Exam Strategy

• No new issues places premium on allowing Exam to present case without comment from taxpayer
  – Unintended result

• No new facts requires taxpayer to present all facts as part of examination process
  – Protest is end of Exam, so should present facts in Protest
  – If need expert, must present opinion to Exam before Appeals
Modifications to Appeals Procedures

• Minimum 365 days on statute of limitations
• Fewer face-to-face Appeals conferences
• Rapid Appeals Process (i.e., mediation)
• Appeals can invite Exam to attend conference, but must avoid *ex parte* communications
• Changes to settlement authority of Appeals Team Case Leaders (ATCLs)
IRS Appeals Trends

• Centralization of decision-making at Appeals
  – Issue Specialists are controlling more cases

• *Ex parte* rules eroding
  – Rapid Appeals Process
  – Involve exam in the Appeals presentation
Impact of Centralization Appeals

• Rise of Technical Specialists leads to less favorable results at Appeals

• Unclear, but Appeals advantage appears to be eroding
Prohibition on *Ex parte* Communications

- Adopted as required by the Restructuring and Reform Act of 1998 (with the Taxpayer Bill of Rights) to assure Appeals independence
- Appeals may not communicate with IRS personnel in other functions (i.e. Exam) without the taxpayer (or representative) being provided the opportunity to participate in the communication
- Appeals may discuss case with Exam in presence of taxpayer
  
Rapid Appeals Process (IRM 8.26.11)

• Appeals program similar to Fast Track Settlement, but Appeals, rather than Exam in FTS, has settlement authority

• Mediation (by Appeals officer acting as mediator) between taxpayer and Exam

• Exam remains part of Appeals process, ex parte waived
Exam Participation in Appeals

• Appeals Officers may request to extend Pre-Submission conference, include Exam in discussion of case for extended period
  – Technically not Rapid Appeals Process

• Taxpayer can say “No,” but first consider tactical impacts
## Alternative Dispute Resolution Programs

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<th>Audit Programs</th>
<th>Appeals Programs</th>
<th>International Programs</th>
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<td>Compliance Assurance Process</td>
<td>Technical Advice Memoranda</td>
<td>Early Referral</td>
<td>Advance Pricing Agreements</td>
</tr>
<tr>
<td>Pre-Filing Agreement Program</td>
<td>Fast Track Settlement</td>
<td>Rapid Appeals Process</td>
<td>Competent Authority</td>
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<tr>
<td>Private Letter Rulings</td>
<td>Delegation Orders 4-24 and 4-25 (Appeals settlements, coordinated issues)</td>
<td>Post-Appeals Mediation</td>
<td>Simultaneous Examination Program</td>
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<tr>
<td>Industry Issue Resolution Program</td>
<td>Accelerated Issue Resolution</td>
<td></td>
<td>Simultaneous Appeals/Competent Authority</td>
</tr>
</tbody>
</table>
Fast Track Settlement (Rev. Proc. 2003-40)

- Mediation (by Appeals officer acting as mediator) between taxpayer and Exam
  - Provides settlement authority to Exam, including “hazard” settlements
- Designed for resolution within 120 days
  - Taxpayer and IRS must have decision-maker present
- Either party may request on receipt of Notice of Proposed Adjustments (NOPA)
  - IRM directs Exam to suggest
  - Both parties must agree
Fast Track Settlement

- Can withdraw at any time
- Can still go to IRS Appeals (or litigation)
  - Post-Appeals Mediation not permitted
- Timing: After NOPA and before 30-day letter
- Taxpayer presents position in Fast Track Memorandum
**Fast Track**

- Requires IRS approval
- No “hot” interest
- Fast?
  - Single meeting
  - Lower administrative costs
- Decision maker: IRS Exam
- *Ex parte* not applicable
- Two bites: Fast Track Settlement + Appeals

**Appeals**

- No IRS approval required
- Hot interest
- Less Fast
  - Multiple meetings
  - Higher administrative costs
- Decision maker: Appeals
- *Ex parte* rules apply
- Two bites: Appeals + Post-Appeals Mediation
Fast Track

- May submit new facts
- Educate Exam about legal arguments, may respond
- Exam may raise new issues

Appeals

- No New Facts
- Exam locked-in and no new legal arguments
- Not raise new issues
Post-Appeals Mediation

- Non-binding mediation process following unsuccessful efforts at Appeals settlement
  - Designed to be used where limited issues remain unresolved
- Available to all LB&I taxpayers
  - Unavailable if Fast Track used at Exam
- Appeals Officer as mediator, taxpayer may use non-IRS co-mediator at taxpayer expense
Partnership Audits

Coming Changes to the Partnership Audit Regime; The BBA Replaces TEFRA
Partnership Taxation

• Partnership is not subject to income tax
• “Partnership items” are passed through to partners
• Partners report the partnership items and are taxed accordingly
Partnership Audits

- **TEFRA (1982)**
  - Partnership items determined at the partnership level
  - Additional tax assessed to the partners

- **ELP (1997)**
  - Partnership level audit
  - Additional tax generally assessed to partners, but through election could be assessed at partnership level

- **BBA (2015)**
  - Partnership level audit
  - Additional tax may be assessed at partnership level or pushed out to partners

- **Partner level audit**
  - If no other regime applies
TEFRA: applicability

• Applies to all partnerships except “small partnerships”
  – A small partnership has ten or fewer partners who are individuals (other than nonresident aliens), C corporations, or estates of deceased partners
  – Single member LLC is disqualifying partner for this purpose
  – Most corporate joint ventures are small partnerships
• Small partnerships can elect into TEFRA
• In 2013, 72% of partnerships identified as not subject to TEFRA
TEFRA: tax matters partner

- Partnership designates “Tax Matters Partner”
  - Must be partner
  - Represents the partnership
  - Can extend SOL, file for refund, settle with IRS, etc.
TEFRA: contractual restrictions on TMP

• Partnership agreements generally provide for significant restrictions on TMP
  – Requirement to keep members informed about proceedings and discussions with tax authorities
  – TMP can’t take material actions without the consent of [other members]/[the board]
    ▪ E.g., extend SOL, settle audits, file suit
  – TMP can’t bind another member without the consent of that member
TEFRA: notice partners

- Other partners with a one-percent or greater interest (or any partner if fewer than 100 partners) are “Notice Partners”
  - Entitled to receive notice of proceedings
  - Can bring action if TMP does not
  - Participate in any proceeding brought by TMP
  - TMP generally cannot bind Notice Partner to settlement
TEFRA: stages of audit

- IRS issues Notice of Beginning of Partnership Audit (“NBAP”)
- When the examination is complete, IRS sends 60-day letter to TMP, informing TMP of the right to go to Appeals
- If no settlement at Appeals, Final Partnership Administrative Adjustment (“FPAA”) is sent to TMP and Notice Partners
- TMP may bring suit within 90 days after FPAA is issued
- A Notice Partner may bring suit in the following 60 days if the TMP does not
- FPAA is final 150 days after it is issued, if suit is not brought, or when court’s decision becomes final and period to appeal has expired
- IRS makes adjustments at the partner level and begins deficiency proceedings for certain affected items
**TEFRA: stages of audit**

- “Partnership items” are determined at partnership level
- Penalties and additions to tax determined at partnership level and assessed directly against partners
  - Partner-level defense must be raised in a separate refund action
- “Affected items” are adjusted at the partner level
TEFRA: statute of limitations

- Minimum statute of limitations of three years
  - Generally three years after partnership return is filed or, if greater, the normal section 6501 three-year statute of limitations for a partner
  - Usual extensions for significant understatements of gross income, fraud, and no return
  - If a partner (including an indirect partner) is not identified on a partnership return, the SOL is extended for a year after the partner is identified
Bipartisan Budget Act of 2015 (“BBA”)

• IRS cannot effectively audit large and multi-tiered partnerships because of complexity of allocating adjustments to partners
• The Electing Large Partnership (ELP) rules provided an alternative but were rarely elected
• Prior proposals
• TEFRA and ELP Rules repealed and replaced
• Congress estimates new rules will raise $9.3 billion
• Package of proposed regulations released in January 2017
BBA: effective date

- Effective for partnership years beginning after 2017
- Under proposed and temporary regulations, may elect in for partnership years beginning after November 2, 2015
Which regime applies in 2016 and 2017?

<table>
<thead>
<tr>
<th>Partnership tax year beginning between 11/3/2015 and 12/31/17</th>
<th>Partnership tax year beginning after 12/31/17</th>
</tr>
</thead>
<tbody>
<tr>
<td>TEFRA “small partnership” (10 or fewer partners of a certain type)</td>
<td>Neither, unless (1) elect into TEFRA or (2) elect into BBA</td>
</tr>
<tr>
<td>BBA “small partnership” (100 or fewer partners of a certain type)</td>
<td>TEFRA unless elect into BBA</td>
</tr>
<tr>
<td>All other partnerships</td>
<td>TEFRA unless elect into BBA</td>
</tr>
</tbody>
</table>

• Assuming ELP rules do not apply.
BBA: election out

- Partnership may elect out by noting election on its return
  - Must have 100 or fewer partners, and
  - No partner that is itself a partnership or trust.
  - Proposed regulations include single member LLC in list of disqualifying partners.
  - S corporations may be partners but each S corporation shareholder is counted against 100-partner limit
  - Election made for each taxable year
BBA: election out

• Is election out a good idea?
  – Potential whipsaw issues (allocable share of profit or loss, whether a person is a partner)
  – Potential inconsistent adjustments if statute of limitations is not open for all partners or partners appeal in different litigation forums
  – Partner may not have records supporting items on K-1
BBA: partnership representative

• Audit still commenced at the partnership level
• TMP replaced with “Partnership Representative”
  – No need to be partner but must have a substantial presence in the United States
  – Exclusive right to take action with respect to audit—no concept of “Notice Partner”
• Partnership Representative designated on tax return for each year.
BBA: stages of audit

• IRS issues a notice of administrative proceeding to the partnership or partnership representative
• If applicable, IRS calculates “imputed underpayment” and mails notice of proposed partnership adjustment (NOPPA)
• Partnership has 270 days to submit information to reduce imputed underpayment
• IRS issues notice of final partnership adjustment (FPA)
• Partnership has 45 days after issuance of FPA to determine whether to make “push out” election
• Partnership has 90 days after issuance of FPA to file a petition in court
BBA: applicability

• Under TEFRA, partnership items are determined at partnership level.
• Separate partner proceedings are necessary for affected items and partner items.
• Same result under BBA?
BBA: payment of tax

- Three ways tax can be paid
  - By partnership on current year return (“imputed underpayment”)
  - By partners on amended returns for reviewed year
  - By partners on returns for current year (“push out election”)
BBA: imputed underpayment

- General rule is that imputed underpayment imposed on the partnership rather than on the partners
- Liability computed by netting all adjustments and multiplying by highest individual tax rate (39.6%), unless partnership can show rate should be lower
- Payment is made for the tax year in which the adjustment is final, not for the tax year audited
  - Audit adjustment in 2020 with respect to 2018 return results in tax owed on partnership’s 2020 return
- Interest and penalties assessed at partnership level
  - Any penalty defense must be raised at partnership level
BBA: imputed underpayment

- IRS and Treasury to provide rules allowing for modification of imputed underpayment in certain situations, including:
  - Adjustment where partners are tax-exempt entities that would not have been subject to tax on their share of income or gain
  - Adjustment for rates applicable to C corporations or individuals earning qualified dividends or capital gain
  - Reviewed year partners file amended returns and pay additional tax due for understated income
- Broad authority to provide additional modifications
- Information must be provided to IRS (or amended returns must be filed) within 270 days after NOPPA
Example:

In 2018, partnership AB takes excessive depreciation deductions of $1 million, allocated 50% to A and 50% to B (both corporations). The IRS makes an audit adjustment in 2020. After modification to account for the 35% rate applicable to corporations, the imputed underpayment is calculated as $350,000.
**BBA: imputed underpayment**

- Imputed underpayment is not deductible
- Each partner’s outside basis in its partnership interest reduced by its share of the imputed underpayment.
  - How do you determine a partner’s share?
  - Presumably each partner’s outside basis is also increased by its share of the underlying income.
    - In previous example, each partner’s outside basis is reduced by $175,000 (its share of the imputed underpayment) but increased by $500,000 (to correct for the depreciation deductions erroneously taken)
    - Presumably the partnership’s basis in the asset should be increased by $1 million.
BBA: imputed underpayment

- Imputed underpayment reduced to the extent partners file amended returns and pay associated tax.
- If A and B both file amended returns for 2018, omit the excess depreciation deductions, and pay the tax due, the imputed underpayment is reduced to zero.
  - What if A has an NOL carryforward in 2018 that was otherwise carried to 2019 but can now be used in 2018? Does A have to file an amended 2019 return in order to reduce imputed underpayment?
- If only A files an amended return, partnership still has imputed underpayment of $175,000.
  - How to ensure A does not bear the cost?
BBA: imputed underpayment

• What if, in 2019, A had sold its partnership interest to C?
• Does the partnership agreement obligate A to bear its share of the cost of the imputed underpayment?
• If so, how is the payment by A treated?
  – Is A deemed to contribute the funds to the partnership and receive an allocation of its share of the underpayment?
    ▪ If so, is A’s outside basis in its partnership interest at the time of sale increased by $500,000?
    ▪ Can A file an amended return claiming less gain or more loss on the 2019 sale? Or does A take a capital loss in 2020?
  – Or does A’s payment to the partnership cause the partnership to have taxable income?
BBA: misallocation of income

• Example:
  • In 2018, partnership AB has income of $1 million, which the partnership allocates 100% to A. In 2020, the IRS determines that the partnership should have allocated the income 50% to A and 50% to B. Both A and B are corporations.
  • Imputed underpayment is $175,000 unless both partners file amended returns for 2018.
BBA: push out election

- Even if partnership has not elected out, it may avoid paying the adjustment if it elects to issue the partners revised K-1s
  - Partners pay the adjustment on their return for the year in which the revised K-1 is issued
  - Tax due includes the increase in what the tax would have been in the reviewed year, taking into account the adjustment, plus any increase in tax in intervening years resulting from adjustment to tax attributes
  - Partnership must make election within 45 days of receiving the FPA
    - What if there is a settlement pre-FPA?
  - Partners have no right to administrative or judicial review
BBA: push out election

Example:
- In 2018, partnership AB understated income by $1 million, which should have been allocated 50% to A and 50% to B. In 2019, A sold its partnership interest. In 2020, the IRS audits the partnership and adjusts 2018 income. The partnership elects to push out the adjustment.

- A has additional tax due in 2020 based on a hypothetical inclusion of income in 2018.
- Income inclusion should have increased A’s basis, resulting in less gain on sale, but how does A claim this benefit?
What if a partner is itself a partnership?

- Does the upper-tier partnership have to pay the tax due, or push it out to its own partners, or is it elective?
- Does the answer change if the upper-tier partnership had elected out of the BBA rules?
- If the upper-tier partnership has to pay the tax due, what rate applies? Can it reduce the rate by showing that its partners are tax-exempt entities or corporations?
- Technical Corrections Act of 2016 would have allowed upper-tier partnership to push out the tax.
BBA: push out election

• Interest determined at partner level, and is short-term rate plus 5%.
• Penalties and additions to tax determined at partnership level, but imposed on reviewed year partners.
• How to determine a partner’s share of penalties?
BBA: imputed underpayment vs. push out election

• Could be a difference in the amount due
  – Rates applicable to partnership and reviewed year partners
  – Ability to use partner attributes (and effect on partner attributes in later years).
  – Different interest rates
BBA: statute of limitations

- Statute of limitations is generally three years from date the partnership return is filed (or when due, if later)
- Limited exceptions when NOPPA issued
- FPA suspends adjustment period
Considerations for LLC agreement

• Most partnership agreements provide rules for dealing with TEFRA audits
  – E.g., appoint a tax matters partner, outline how the tax matter partner is to act, how the audit may be conducted, what rights other partners have, etc.

• Before the effective date, need to revise the partnership agreement
Considerations for LLC agreement

- Will the partnership elect out?
- Will the partnership elect in early?
Considerations for LLC agreement

• Partnership representative
  – Who will it be?
  – How much power will it have?
    ▪ Only the representative receives notice from IRS and has sole power to act (extend SOL, file suit, or settle case).
    ▪ May wish to restrict representative from taking action without consent from partners or to compel action in certain situations (e.g., file suit)
    ▪ Recourse if partnership representative acts in a manner contrary to the agreement?
  – Indemnification for liability for actions taken?
Considerations for LLC agreement

• Rights of other partners during proceedings
  – Notification
  – Participation
  – Consent

• Address cooperation of partners
  – In calculating imputed underpayment
  – Agreeing to file amended returns?
Considerations for LLC agreement

- Process for deciding whether partnership pays imputed underpayment or pushes the adjustment out
- Address effect of imputed underpayment
  - How allocated to partners
  - Do previous partners agree to indemnify partnership?
Purchasing a partnership interest

- Once BBA is effective, partnership itself could have tax liability
  - Need to allocate risk between buyer and seller
  - Additional due diligence will be necessary
  - Additional reps and indemnity

- If audit adjustment results in tax benefit to buyer, seller may want to be paid
Purchasing a partnership interest

• If partnership ceases to exist prior to assessment, the historic partners are liable for underpayment under regulations to be drafted

• If 100% of the partnership interests are purchased, a partnership is treated as ceasing to exist for this purpose
Questions?

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