TEFRA Repeal

Essential Changes To Partnership & Operating Agreements

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Scope of New Law

- Bipartisan Budget Act of 2015 made significant changes to partnership audit procedures
- New rules apply to all entities taxed as partnerships
- Includes multi-member LLCs unless they have elected to be treated as C corporations or S corporations
- Changes are more than procedural – affect drafting of partnership and operating agreements

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Today's Webinar

- Partnership Taxation - Competing Aggregate and Entity Concepts
- Overview of Prior Law - Tax Equity and Fiscal Responsibility Act of 1982
- Overview of the New Law – Bipartisan Budget Act of 2015
- Drafting Considerations - Drafting for TEFRA Repeal

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Entity vs. Aggregate Concepts

- Aggregate Concept
  - The partnership is an aggregate of the owners, not a separate taxpayer
  - Each partner is a co-owner with an undivided interest in the partnership's assets
  - Each partner accounts separately for her share of all partnership transactions
- Entity Concept
  - The partnership is a separate and distinct taxpayer (separate accounting method, taxable year, etc.)
  - Each partner owns an undivided interest in the entity itself (not just the assets)

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Subchapter K's Hybrid Approach

- For most cases, partnership is treated as an aggregate of the partners
  - Partnership is not a taxpayer
  - Partners report their shares of partnership tax items on their own returns
- But there are situations where partnerships are treated like entities
  - Partnership must adopt its own accounting method and taxable year
  - Partnership must report its taxable income on an information return
  - Partnership has a basis in each of its assets
  - Character of partnership income is determined at the partnership level
  - Partnership must compute its income using various elections (how to depreciate, whether to use installment method, etc.)

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Overview of TEFRA

Overview of the Tax Equity and Fiscal Responsibility Act of 1982

TEFRA

- Enacted in 1982
- Related reporting and audit procedures for electing large partnerships have been in place since 1998
- Creates three categories of partnerships for audit purposes:
  - Partnerships with no more than 10 qualified partners
  - Partnerships with more than 10 partners
  - Electing large partnerships

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Partnerships with No More than 10 Partners

- All partners must qualify
  - No flow-through entities - Only individuals, estates, or C corporations
- Audited at the partner level unless partners elect to be governed by TEFRA
- Each partner can only participate in that partner's audit
- The partnership tax returns are only audited in connection with a partner's tax return
- IRS makes adjustments to partnership return, but collects from partners by issuing a separate notice of deficiency to each partner

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Partnerships with More than 10 Partners

- More than 10 qualified partners or any non-qualified partners
- Audited under unified TEFRA audit procedures
- IRS conducts one audit at partnership level and issues one Final Partnership Administrative Adjustment to the partnership
- IRS can deal with Tax Matters Partner, but other partners can participate in judicial or administrative proceedings
- Partners are re-assessed for the tax resulting from the FPAA
- Audit vs. Collection - Taxes still collected at partner level

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Electing Large Partnerships (ELPs)

- If election is made, IRS uses unified audit procedures
- Assessments and adjustments occur at the partnership level
- Each partner must report each partnership item consistently with the partnership return
  - Unlike the TEFRA rules, partners cannot take positions that are inconsistent with the partnership by notifying the IRS
- Adjustments made to partnership items are taken into account by the partners in the year in which the adjustments take effect, regardless of whether that partner was a member of the partnership during that year
- Rarely elected (less advantageous than TEFRA because of fewer partner participation rights)

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The New Audit Rules and Why They Matter

The Bipartisan Budget Act of 2015

Background of BBA

- Enacted as part of a larger budget compromise and promoted as a way to raise revenue through compliance instead of raising revenue through taxes
- New provisions facilitate tax collection by allowing the IRS to collect taxes directly from the partnerships themselves (instead of going after each partner individually)
- Shift from aggregate concept to entity concept for taxes resulting from audits
- Shifts collection burden from IRS to the separate partners (IRS simply collects from partnership and lets the partners work it out among themselves)
- Mandatory Effective Date: January 1, 2018
  - Partnerships can opt in for any tax year beginning after November 2, 2015

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Significant Changes

- Partnership-level Tax Liability for Audit Adjustments
- Adjustments Made in Adjustment Year
- New Section 6221(b) Election
- New Section 6226 Election
- New Section 6225 Option
- The New Role of Partnership Representative

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Partnership-Level Tax Liability

- Under general rule, partnership now required to pay taxes resulting from audit adjustments
  - Substantial departure from prior law, which requires the IRS to collect from the partners instead of the partnership
- Taxes resulting from audit adjustments are referred to as the "imputed underpayment amount" (IUA)
- Tax on IUA collected is calculated using highest individual rate (currently 39.6 percent)
- When computing IUA, the partnership cannot deduct tax, interest, or penalties paid by the partnership during that year

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Shift in Tax Liability

- Because IUA is computed at partnership level, a partner's individual tax attributes are ignored
  - Partner's NOL would not be available to offset partnership income
  - Partner's tax exempt status would not be relevant to the computation of IUA
- BBA directs IRS to issue regulations with procedures for adjusting the IUA to consider the partners' individual tax profiles

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New Section 6221(b) Election

- Code § 6221(b) – Allows small partnerships to elect out of default rules if the following requirements are met:
  - No more than 100 Schedule K-1s
  - Each partner must be either 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
    - **Note: No trusts or other flow-through entities**
  - Partnership must notify each partner of the election
  - Election must be made annually on a timely-filed return
  - Partnership must provide IRS with the names and EINs of each partner (or shareholder in an S corporation partner)

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Should Clients Opt Out Under 6221(b)?

Should you get the individual partners to pay? Or just accept the partnership-level liability under the Act?

- Tax Rate – Partnership assessed at highest tax rate
- Partner-level offsets – NOLs, tax exemptions
- Statute of Limitations – Would you prefer that the SOL apply at the partnership or partner level?
- Net Investment Income Tax and AMT – Assessment at the partnership level could avoid partner-level NIIT and AMT
- State Tax Effects – If partnership is not taxed at the state level
- Ownership – No trust or partnership ownership; less than 100 partners
- Flexibility – Opt out in 2018 and revoke election if needed?

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Adjustments Made in Adjustment Year

- Partnership must make audit adjustments in the year that the audit or judicial review is completed (the "adjustment year"), not in the year to which the adjustment relates (the "reviewed year")
- New partners are now responsible for tax adjustments that relate to a review year when they were not partners

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New 6226 Election

- Code § 6226 – Allows partnership to shift responsibility back to the partners for the audited year if these requirements are met:
  - Partnership must issue a statement to each partner and the IRS
  - Statement must include each partner's share of any adjustment to income, gain, loss, deduction, or credit (adjusted Schedule K-1)
  - The statement must be issued within 45 days from its receipt of final notice of adjustment
- If the partnership complies with Code § 6226, each partner becomes responsible for that partner's share of the adjusted tax

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New Section 6225 Option

- Code § 6225 – In computing the IUA, the partnership may disregard any amount correctly reported on the partner's returns if, within 270 days of receipt of the notice of proposed adjustment:
  - The partnership issued an amended K-1 to at least one partner and at least one partner files an amended return consistent with the amended K-1 and pays all tax in full; or
  - At least one of the partners from the audited year is tax-exempt; or
  - A lower rate should apply because a partner is a C corporation or because an adjustment is made to a qualified dividend or capital gain
- Still allows collection from the partnership, but can lower the amount collected

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New Role of Partnership Representative

- Tax Matters Partner
  - Could extend the statute of limitations and act as the representative of the partnership before the IRS in any audit proceedings
  - Must be partner
  - Non-Exclusive Role – Partners have the right to participate in administrative or judicial proceedings
- Partnership Representative
  - Can bind all partners in an administrative or judicial proceeding
  - Need not be a partner
  - Exclusive Role – Partners may no longer participate in partnership audit or judicial proceeding or receive notice of the proceeding

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Drafting for TEFRA Repeal

Drafting Considerations

- Expanded Role of Partnership Representative
- Opting Out of Partnership-Level Taxation
- Allocation of Tax Liability to Prior-Year Partners
- Flexible Effective Date

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Expanded Role of Partnership Representative

- Standard tax matters partner provisions in partnership and operating agreements are obsolete
  - Question: Does the partnership/operating agreement contain provisions that will soon be obsolete?
- The new role of partnership representative is more expansive than the prior role of tax matters partner
  - Question: Does the partnership/operating agreement contractually limit the authority of the partnership representative to curb the otherwise broad powers given to the partnership representative by the BBA?

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Company Representative Options

Company Representative

See TEFRA Repeal: Essential Changes To Partnership Agreements And Operating Agreements for more information

Must the Company Representative be a Member?
(•) Yes ( ) No

Must the Company Representative obtain approval of the Members before taking binding action in connection with any Internal Revenue Service proceeding?
(•) Yes ( ) No

What percentage of the Members must approve the action?
Supermajority

Impose fiduciary duties on the Company Representative?
(•) Yes ( ) No

Who will serve as Company Representative?
A specific Member named in the Agreement

Select the Company Representative:
Sherlock Holmes

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Sample Company Representative Language

Section 2.02 Company Representative

The Company must designate a Member with a substantial presence in the United States to serve as the Company representative within the meaning of Code Section 6223 (*Company Representative*). The Company Representative must be a Member. The Company Representative has the sole authority to act on behalf of the Company in connection with Internal Revenue Service audits and adjustments. Sherlock Holmes is designated to serve as the Company Representative. If Sherlock Holmes is or becomes unwilling or unable to serve for any reason, the Managers shall promptly appoint a Member to serve as Company Representative in accordance with Code requirements.

(a) Obligations and Discretion as to Tax Matters

The Company Representative shall notify all of the Members upon receipt of any notice regarding any examination by any federal, state, or local authority about the Company's tax compliance. The Company Representative must obtain the approval of a Supermajority Vote of the Members before taking any binding action in connection with any Internal Revenue Service proceeding. Upon obtaining this approval, the Company Representative may:

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Opting Out of Partnership-Level Taxation

- There are specific requirements that must be satisfied before a partnership or LLC can opt out of partnership-level taxation under Section 6221(b).
  - Question: Does the partnership/operating agreement provide guidance in this area?
- Transfers to ineligible owners could forfeit the ability to elect out of partnership-level treatment.
  - Question: Does the partnership/operating agreement restrict these transfers?

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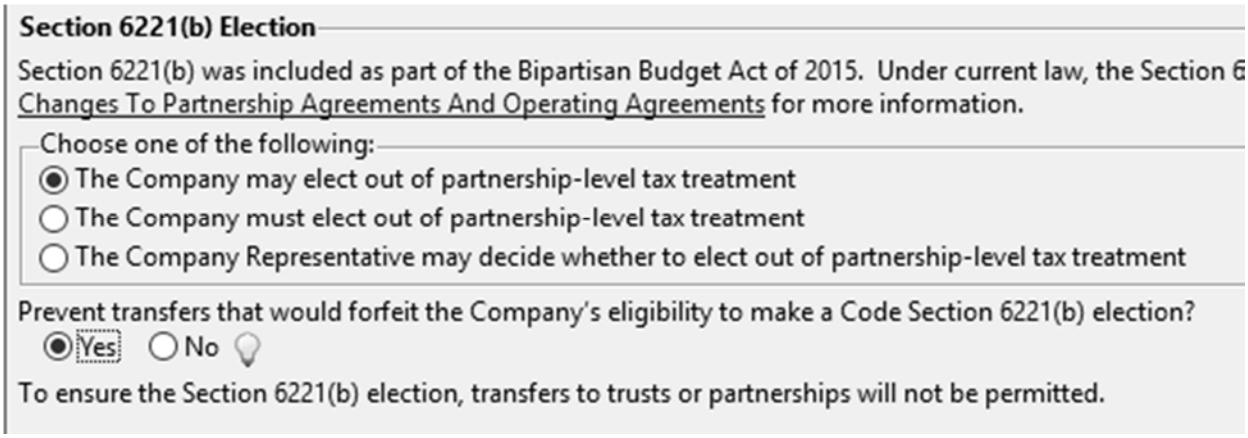
Business Docx® Section 6221(b) Options



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Sample 6221(b) Language

Section 2.04 Election under Code Section 6221(b)

The Company may elect for Code Section 6221(b) to apply for any taxable year that the Company meets the requirements to elect out of Company-level treatment under Code Section 6221(b). The election must be made with a timely filed return for that taxable year. The election must include the name and taxpayer identification number of each Member. The Company must notify each Member of the election in the manner prescribed by the Secretary of Treasury.

Section 2.05 Consistent Treatment

Each Member shall, on the Member's income tax return, treat each item of income, gain, loss, deduction, or credit attributable to the Company in a manner consistent with the treatment of the income, gain, loss, deduction, or credit on the Company income tax return.

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Allocating Tax Liability to Prior-Year Partners

- The Section 6225 option requires participation of the partners from prior years (file amended returns and pay tax within 270 days of receipt of notice of proposed adjustment).
  - Question: Does the partnership/operating agreement provide a means to compel this participation?
- The 6226 election requires a statement to be issued to the partners within 45 days from the partnership's receipt of notice of final judgment.
  - Question: Does the partnership/operating agreement provide guidance in this area?

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Future Adjustments – Sample Language 1 of 3

Section 2.06 Adjustment in Future Tax Years

If any tax proceeding results in adjustment in the amount of any item of income, gain, loss, deduction, or credit of the Company—or any Member's distributive share thereof—for a prior year, the Company may take corrective action. If the Company elects to apply Code Section 6226 within 45 days from the date of the notice of final partnership adjustment, the Company may issue the statement described in Code Section 6226(a)(2) to the Internal Revenue Service and to each Member that held an interest in the year in question. The statement must describe the Member's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment issued by the Internal Revenue Service). Upon receipt of the statement, each Member must take the adjustments described on the statement into account as provided in Code Section 6226(b).

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Future Adjustments – Sample Language 2 of 3

Alternatively, the Company may require each Member that held an interest in the Member during the prior year file to file an amended tax return reporting the Member's distributive share of the tax adjustments and to pay any taxes resulting from the adjustments in accordance with Code Section 6225(c). Each Member must submit the amended returns and pay all related taxes not later than 270 days from the date on which the notice of a proposed partnership adjustment is mailed to the Company.

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Future Adjustments – Sample Language 3 of 3

This Section and the Member's obligations under Section 2.05 survive the Company's termination, dissolution, liquidation, and winding up and the Member's withdrawal from the Company or transfer of its Interest.

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Flexible Effective Date

- Partnership could be governed by the BBA for any tax year beginning after November 2, 2015
- Partnership will be governed by the BBA on January 1, 2018
- Questions:
  - Are your partnership/operating agreements drafted in such a way as to provide for both regimes?
  - Will your partnership/operating agreements drafted between now and December 31, 2017, need to be amended after the BBA's mandatory effective date?

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Business Docx® Solution

- Replace Tax Matters Partner provisions with provisions relating to Partnership Representative
- Add transitional language to cover interim period

Section 2.03 Coordination with TEFRA Audit Rules

If any audit or adjustment of the Company is governed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit rules, the Company Representative designated under Section 2.02 shall serve as the *tax matters partner* within the meaning of Code Section 6231(a)(7).

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Business Docx® Templates with TEFRA Changes

- Operating Agreement
- General Partnership Agreement
- Limited Partnership Agreement
- Buy-Sell Agreement

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Wealth Docx® Templates with TEFRA Changes

- Buy-Sell Agreement
- Family Limited Partnership Agreement
- LLC Operating Agreement

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Questions

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