Butterfield + Co.
CPAs, Inc.

December 3, 2018

To our Clients and Friends,

We hope that you're enjoying a happy and successful year so far!

The proliferation of partnership and tiered partnership structures over the last couple of decades along with the limitations on the IRS's ability to audit partnerships under the current audit rules has resulted in a perceived enforcement deficiency and the passage of the Centralized Partnership Audit Rules (CPAR).

We wanted to specifically address those changes with you in order to allow for sufficient time for review, assessment, and amendment of your partnership operating and other agreements, as necessary.

New Partnership Centralized Audit Regime

The 2015 Bipartisan Budget Act (BBA) repealed the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audit procedures and the electing large partnership rules. These new rules are effective for returns filed for tax years beginning after 2017 and for any partnerships that elect application for tax years beginning after November 2, 2015 and before January 1, 2018. Under the new approach, adjustments to a partnership's items of income, gain, loss, deductions, and credits will be made at the partnership level. (As a result, the current partners are indirectly responsible for the additional tax instead of the reviewed year partners.) Any additional tax, penalty, or other amount related to the tax will also be determined and collected at the partnership level unless the partnership elects the alternative process known as a push-out election.

Underpayments in prior years (i.e., reviewed years) will be borne by the partnership. Specifically, any proposed and resulting deficiency in tax will be assessed against and paid by the partnership in the adjustment year (i.e., the year the assessment is made). The assessment against the partnership is with respect to the imputed underpayment amount, which is generally the net of all adjustments for the year under audit multiplied by the highest individual or corporate tax rate in effect for that year. However, partnerships that can show that the underpayment would be lower if it were based on certain partner-level information can pay the lower amount. The information needed to show that a lower underpayment amount should apply could include amended returns of partners, the tax rates applicable to specific types of partners (e.g., individuals, corporations, or tax-exempt organizations), and the type of income subject to the adjustments.

Under the new audit rules, partners generally must treat each item of income, gain, loss deduction, or credit attributable to a partnership consistently with the partnership's treatment of the item. Any underpayment of tax by a partner due to failure to comply with this consistency requirement will be treated as a mathematical or clerical error (which means that the IRS can immediately assess any tax deficiency against the partner). This consistency rule will not apply if the partner files a statement with the IRS identifying the inconsistency. For this purpose, an inconsistency can occur either when (a) the partnership has filed a return but the partner's treatment of the item is (or may be) inconsistent with the partnership's treatment or (b) the partnership has not filed a return.

Please note that the current TEFRA rules, regulations, and pertinent case law remain in effect until the applicable statutes of limitation on assessment in tax, as well as claims for refunds for overpayments in tax (at either the partnership or partner levels) for all prior tax years have expired.

Electing to Apply the New Audit Rules Early

Partnerships can elect to apply the new audit rules for tax years beginning after November 2, 2015, and before 2018. Electing into the new audit rules might be attractive for partnerships that would prefer not to have to issue amended Schedules K-1 to their partners in the event an adjustment to partnership income is made.

Push-Out Election

If a partnership is assessed an imputed underpayment for one or more reviewed years, it can elect out of making the tax payment if, not later than 45 days after receiving a notice of final partnership administrative adjustment, it furnishes to each partner who was in the partnership in the year under audit (the reviewed-year partners) and to the IRS, a statement of the partners' share of any adjustment to income, gain, loss, deduction, or credit for the reviewed year(s). Those partners would then take the adjustments into account in the year the statement was furnished (and any subsequent years to the extent that any tax attributes are affected by the adjustment). If the partnership elects this alternative payment process also called a push-out election, the reviewed-year partners will pay interest on any underpayment at a rate that is 2% higher than the normal interest rate.

When a push-out election is made by the partnership, the statute of limitations at the partner level for the reviewed (audited) year is not applicable since the assessment in tax is imposed with respect to the current year.

Partnership Representative

The new audit rules do not provide for a tax matters partner (TMP). Instead, partnerships will designate a partnership representative (PR). The IRS will no longer send correspondence about any audit proceedings to the partners. Instead, the PR will receive all correspondence and will have broad authority to bind the partners. The PR does not have to be a partner in the respective partnership, but must be a person having a "substantial presence" in the U.S. A person who is not an individual can be a PR only if an individual who meets the substantial presence test and has the capacity to act is appointed by the partnership as the sole individual through whom the PR will act.

The PR has the authority to act on the partnership's behalf, and to bind the partnership and the partners without their direct knowledge or involvement. The PR also has sole authority to act on behalf of the partnership in all federal tax assessment matters. No state law, partnership agreement or other agreement can limit the authority of the PR. This means that the PR can:

- choose whether to extend the limitations period for reviewed years;
- bind the partnership and the partners to an adjustment or settlement in an IRS audit or in a related court proceeding;
- decide whether to seek judicial review of an IRS determination, and what court in which to do so; and
- choose whether to push out the underpayment liability to the reviewed year partners.

A PR is designated on the partnership's tax return. Partnerships must designate a PR separately for each tax year. The PR designation remains in effect until it is terminated by resignation or revocation. If the IRS determines that a PR designation is not in effect it will notify the partnership and the most recent PR for that tax year. Once the notification is made, the partnership has 30 days to appoint a successor PR. If the partnership does not designate a successor PR with 30 days, the IRS will appoint one.

Criteria for Election Out of CPAR

Eligible partnerships with 100 or fewer eligible partners can elect out of the new audit rules for any tax year. If the election out is made, the partnership and its partners will be audited under the general rules for individual taxpayers.

The election out must be made with a timely filed return (including extensions) for the tax year for which the election applies. It must include the name and taxpayer identification number (TIN) of each partner. The partnership must also notify each partner of the election out in a manner to be prescribed by the IRS.

Eligible Partners. Generally, the election out is only available for partnerships in which the partners are eligible and include —

- individuals,
- C or S corporations,
- foreign entities that would be treated as C corporations if they were domestic, and
- estates of deceased partners.

An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not an eligible partner. A partnership that has a partner that is an S corporation must, in its election out, furnish the names and TINs of each S corporation shareholder that received a Schedule K-1 from the S corporation for the S corporations tax year that ended in the partnership year in which the election out is being made. Also, each of the S corporation shareholders must be counted as a partner for determining the 100 partner threshold.

Ineligible Partners. Partners that would prevent a small partnership from being able to elect out of the new partnership audit rules include —

- partnerships,
- trusts,

- foreign entities that would not be treated as C corporation if they were domestic,
- disregarded entities,
- nominees or other similar persons that hold an interest on behalf of another person, and
- estates of individuals that are not deceased partners.

California Conformity

On September 24, 2018, Governor Brown signed SB 274, which generally conforms to CPAR. Under SB 274, partnerships must report each partnership item change or correction to the California Franchise Tax Board within 6 months of the date of each final federal determination if the partnership is issued an adjustment or makes a push-out election as part of an IRS partnership level audit.

How Best to Prepare

There are several agreements that should be reviewed and amended, as necessary, in light of CPAR including partnership agreements, LLC operating agreements, buy sell agreements, contribution agreements, redemption and dissolution agreements, merger agreements, disclosure documents and loan agreements. Each partnership should identify and designated a partnership representative and determine the applicability of the elections under CPAR. Please note that several of these items will need to be addressed in conjunction with your attorney.

Conclusion

The information contained in this letter is a good way to get you started in your preparation for CPAR and the related provisions. Please don't hesitate to call us with questions or for additional guidance on preparing for CPAR. We'd be glad to set up a meeting or assist you in any way that we can.

Very truly yours,

Butterfield + Co. CPAs, Inc.

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