CPAs & BUSINESS ADVISORS

TAX REFORM: THE CURRENT STATE OF AFFAIRSFOR INDIVIDUALS & SMALL BUSINESSES

ADAM SWEET, J.D., LL.M., Principal

TODAY'S PRESENTER

Adam Sweet

Principal

Eide Bailly

National Tax Office

asweet@eidebailly.com

(509) 252-4019

DISCLAIMER

These materials, and the accompanying oral presentation, are for educational purposes only and are not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

This information is of a general nature and based on authorities that are subject to change.

EideBailly®

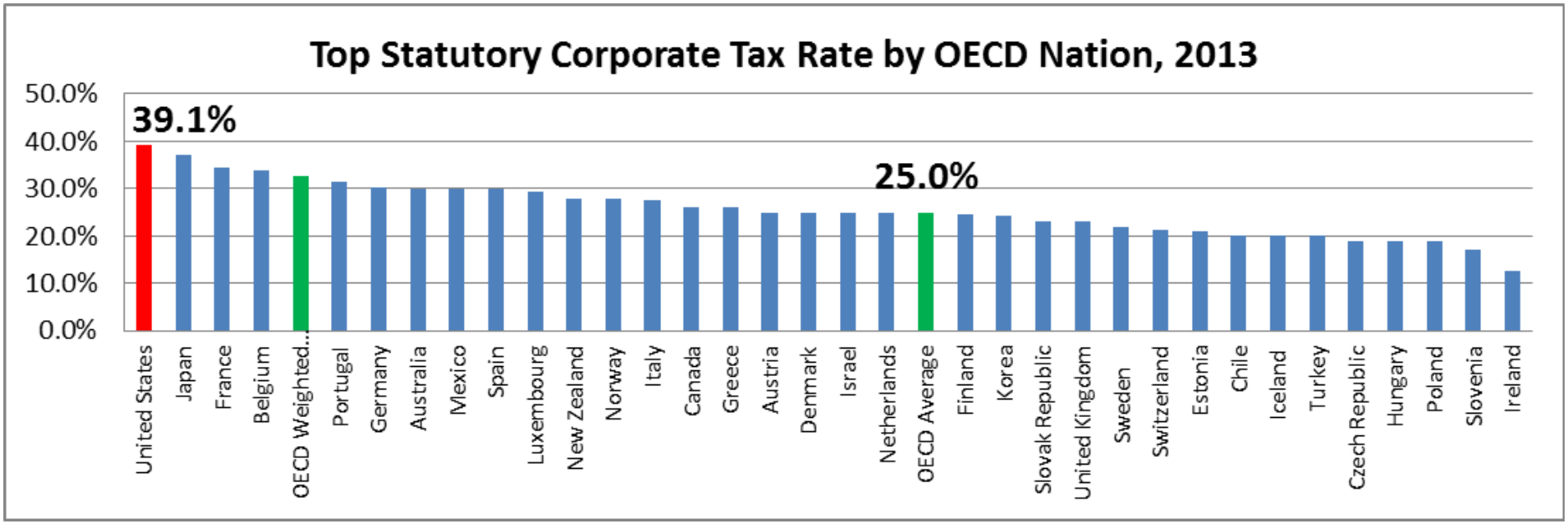
CPAs & BUSINESS ADVISORS

AGENDA

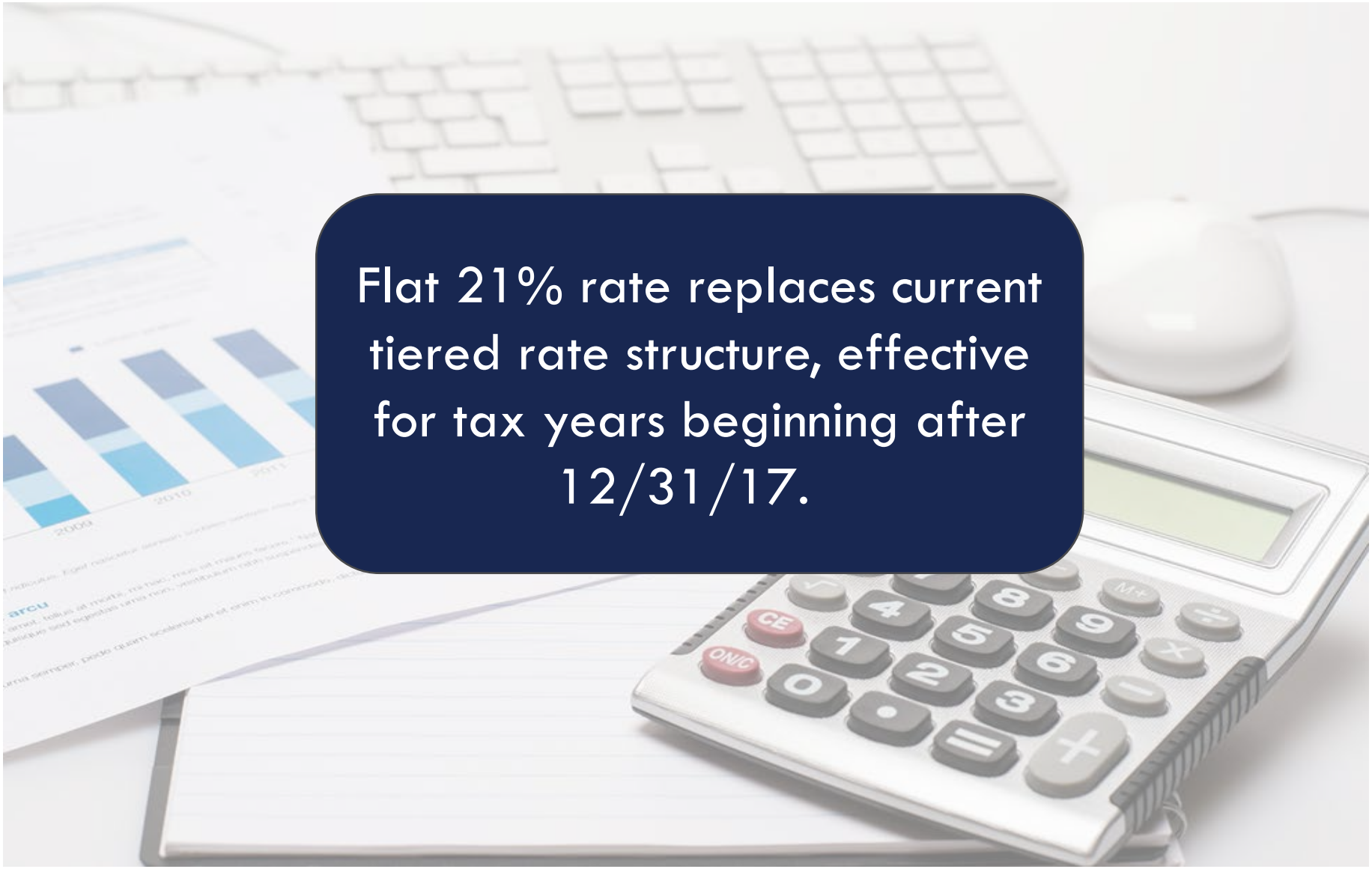
- Section 199A and qualified business income
- Individual and estate planning considerations under tax reform
- The new partnership audit rules

NEW SECTION 199A- THE 20% “PASS-THROUGH” DEDUCTION

US CORPORATE TAX RATE BEFORE ACT



CORPORATE RATE CUT



TAX REFORM'S ANSWER FOR PASS-THROUGH BUSINESSES

20% "pass-through" deduction (sec. 199A)

Sec. 199A provides deduction of 20% of "qualified business income."

For taxpayers with taxable income above the "threshold amounts," the deduction can be limited.

The deduction is available for trade or business income taxable on 1040s, whether from a K-1, Schedule C, Schedule E, or Schedule F.

Sole Proprietors, Partners, S corporation shareholders all may qualify.

Potentially applicable to both "active" and "passive" taxpayers.

ELIGIBLE INCOME

- Qualified business income is made up of income and expense items of a qualified trade or business during the year. It also includes "qualified REIT dividends" and qualified publicly-traded partnership income.

- A qualified trade or business excludes "specified services," which are:

  any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, **and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.**

- This restriction doesn't apply when income is below a "threshold amount," discussed later. Also doesn't apply to architects/engineers.

NON-QUALIFYING INCOME

Qualifying income excludes:

- Capital gains and losses.
- Dividends (other than qualified REIT dividends).
- Interest, other than trade or business interest (financial institution interest income does qualify).
- Commodity gains, other than trade or business income.
- Non-hedging currency and derivative gains.
- Annuity income.

“Rental Income" not included in list of exclusions.

No differing treatment of active and passive taxpayers?

It appears that 1231 gains also do not qualify. The Conference Report says qualifying income does not include “any item **taken into account** in determining net long-term capital gain or net long-term capital loss” (Conference explanation, page 30).

NON-QUALIFYING INCOME

- Wages: reasonable compensation for a S corporation
- Guaranteed payments: not subject to same reasonable compensation standards
- Incentive to reclassify employees as independent contractors?
- IRS: if change classification in reaction to section 199A, still treated as employee

LIMITS ON THE SEC. 199A DEDUCTION

For taxpayers with taxable income above the "threshold amounts," the deduction is limited to the greater of:

- 50% of W-2 wages included in trades or businesses of the taxpayers, or

- The sum of 25% of W-2 wages and 2.5% percent of the taxpayer's unadjusted basis immediately after acquisition (UBIA) in "qualified property"

"Qualified property" is depreciable property held by the business at the end of the taxable year whose depreciation life has not expired by the end of the taxable year. For this purpose, the depreciable life of the property is the property's regular tax life, but not less than 10 years

Additional tracking and reporting requirements

LIMITS ON THE SEC. 199A DEDUCTION

W-2 Wage limitation

- Rev. Proc. tracks former section 199 (DPAD) rules
- Can use wages paid by another person or entity if those wages are properly allocable to a specific trade or business (a common law employee standard)
- Also aggregation rules will allow for W-2 wage sharing- will follow the wage expense

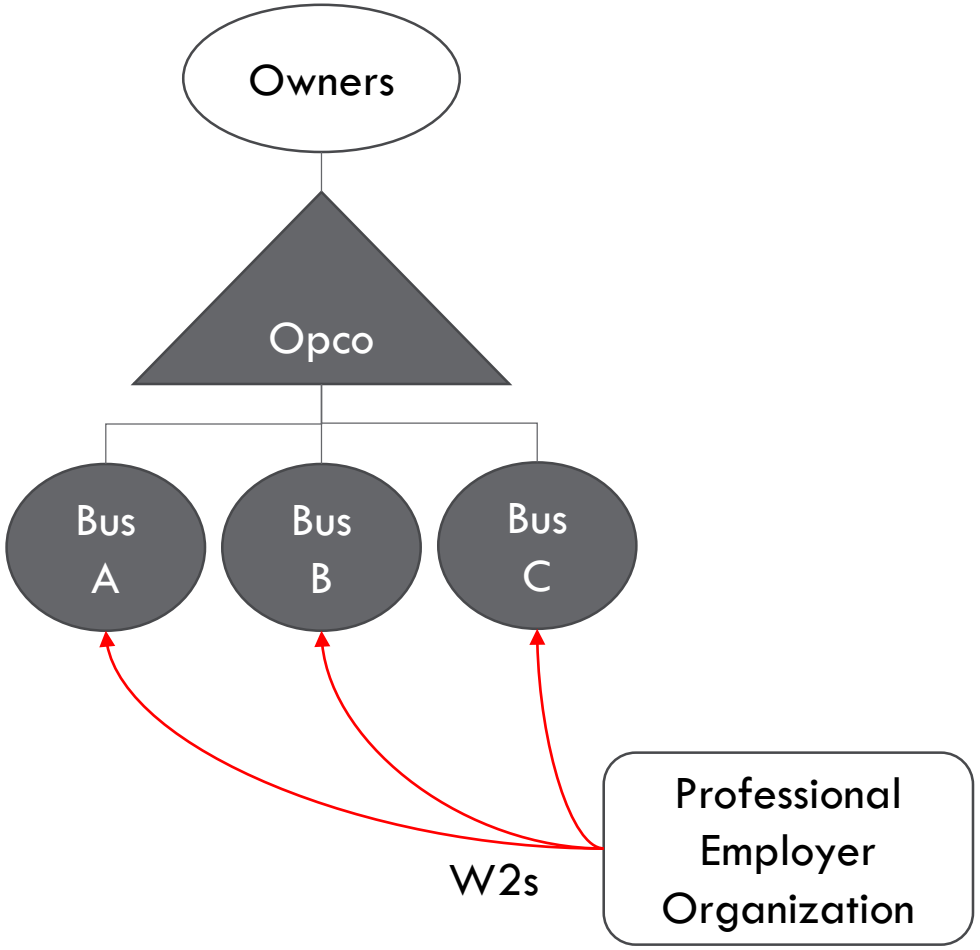
LIMITS ON THE SEC. 199A DEDUCTION

W-2 Wage Sharing Example

Opco owns 3 businesses but uses 3rd party PEO for payroll processing

W2's issued by PEO for common law employees of respective businesses

Businesses can report respective share of W-2 wages up to Opco owners even though those businesses do not issue any W-2s



LIMITS ON THE SEC. 199A DEDUCTION

- Don't forget about the overall 20% of taxable income limitation (net capital gains and qualified dividends are backed out for purposes of this limitation)

For example:

- A, a single filer filing head of household, has $100,000 of QBI producing a tentative $20,000 deduction
- A has $10,000 of other income, and A claims only the standard deduction ($18k), resulting in $92k of taxable income
- 20% of $92k=$18,400
- Overall QBI deduction limited to $18,400

SPECIAL ELIGIBILITY AT LOWER INCOME LEVELS

The restrictions on "specified service income" and W-2/Capital Base ceilings on the deduction are waived for income below "threshold amounts." These are:

- Unmarried taxpayers and married separate filers: Adjusted taxable income of up to $157,500, phasing out over the next $50,000 of income

- Joint filers: Adjusted taxable income up to $315,000, phasing out over a the next $100,000

These income tests are applied at the individual level for partners and S corporation shareholders

SECTION 199A AND RENTAL INCOME

199A AND RENTAL INCOME

- Likely a "know it when you see it" determination on whether an activity rises to the level of a trade or business for section 199A purposes, except for income from a rental trade or business

- Proposed regulations advised taxpayers to look to existing guidance for whether rental income stems from a "trade or business" and is thus QBI

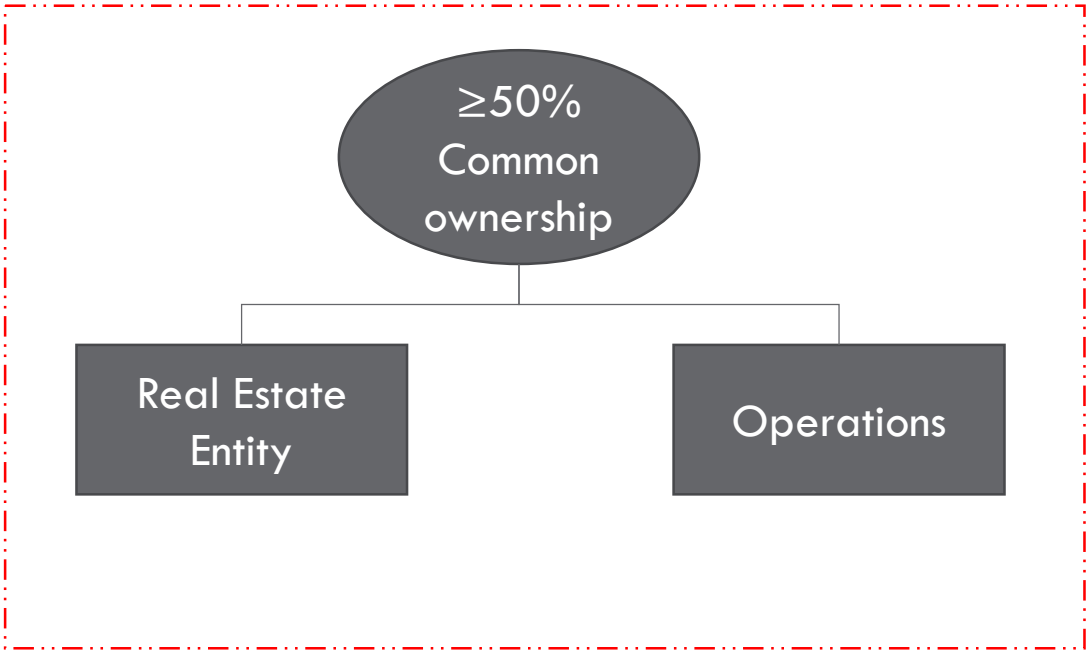
- Existing guidance= not at all clear, and sometimes contradictory

199A AND RENTAL INCOME

- Comes down to a "facts and circumstances analysis"
  - Scale, time, commercial vs residential, books and records, and many others
- The determination of a rental trade or business under section 199A does not relate to the section 469 passive activity rules
- Lots of commentary on the proposed regulations' lack of guidance concerning rental income
- Final regulations offer a bit more clarity in the form of a safe harbor

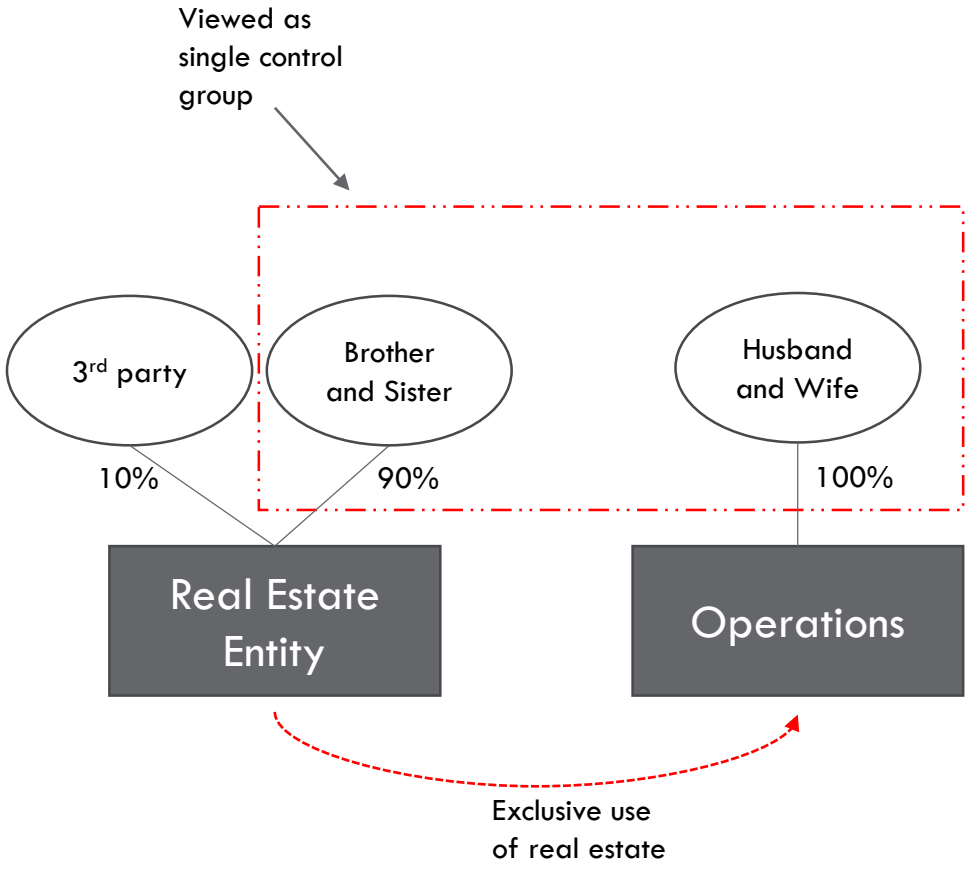
199A AND RENTAL INCOME

- Viewed as single business, even if triple net lease
- Common ownership uses the section 707(a) and 267(b) related party rules
  - Includes: siblings, spouse, ancestors, and lineal descendants



199A AND RENTAL INCOME

- Through attribution, deemed to have 100% common ownership between real estate entity and Operations
- Appears to produce QBI for brother and sister, and 3rd party, even though they do not hold an interest in the operating entity



199A AND RENTAL INCOME

Notice 2019-07

- IRS intends to issue a Rev. Proc. providing a **safe harbor** allowing a "rental real estate enterprise" to "be treated as a trade or business for purposes of section 199A" if certain requirements are met

- Real estate enterprise is "defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties"

- The individual or Relevant Passthrough Entity ("RPE") relying upon the safe harbor must hold the interest directly or through a disregarded entity

199A AND RENTAL INCOME

Notice 2019-07

- "Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents…as a single enterprise"
- **Commercial and residential real estate cannot** be part of the same enterprise
- Note that failing to meet this safe harbor **does not necessarily mean** rental income is not QBI
- **Three general requirements** for Safe Harbor
- Once rental income is treated as trade or business income for section 199A purposes, the IRS says it should be treated as trade or business income **for all other purposes of the code** (i.e., Form 1099 filing requirements, etc.)

199A AND RENTAL INCOME

Notice 2019-07 Requirement #1

- **250 hours of qualifying services** are performed each taxable year with respect to the enterprise (taxable years beginning after December 31, 2022, this can be met in any 3 out of 5 taxable years)
  - Services can be performed by owners, employees, and independent contractors
    - Examples of qualifying services include: maintenance, repairs, collection of rents, payment of expenses, provision of services to tenants, and efforts to rent the property
    - Examples of non-qualifying services (purportedly performed in the role of an "investor") include: arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or contracting long term capital improvements, and traveling to and from the real estate
- Need to keep contemporaneous records (but not for the 2018 tax year)

199A AND RENTAL INCOME

Notice 2019-07 Requirement #2

- Maintaining **separate books and records** (and separate bank accounts) for the rental real estate enterprise

199A AND RENTAL INCOME

Notice 2019-07 Requirement #3

- **Triple Net Leases do not qualify,** and the subject property cannot be used by the taxpayer as a personal residence

- A triple net lease, for purposes of section 199A, generally includes a lease agreement that requires the tenant to

  - Pay all or a portion of the taxes, fees and insurance, and

  - Be responsible for all or a portion of the maintenance activities in addition to rent and utilities.

199A AND RENTAL INCOME

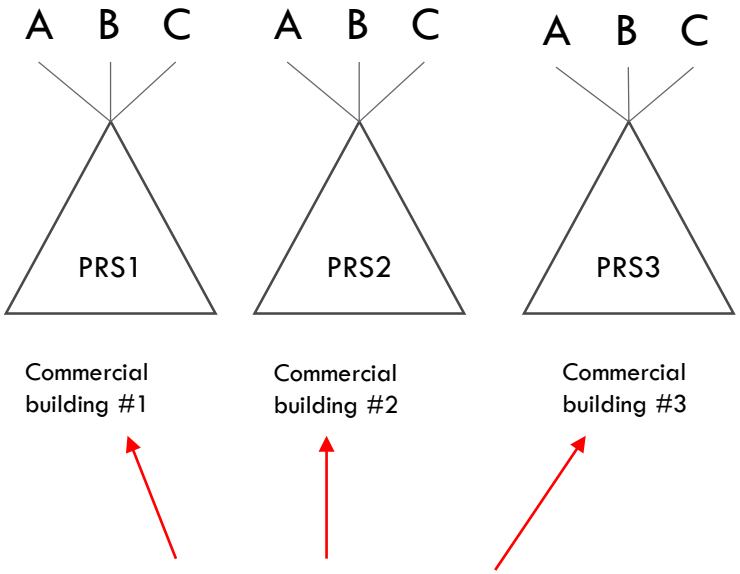
Is failure to meet the safe harbor significant?

- Not necessarily a bad thing if safe harbor requirements are not met
- Many businesses generating rental income may qualify for the section 199A deduction without meeting the safe harbor requirements
- But safe harbor does provide useful factors to consider
  - Separate books and records
  - Need some time- but can be time from owner, employee, 3rd parties, etc.- contrast to the section 469 material participation rules
  - Make it look like a business- file forms 1099
  - Triple net leases may garner extra scrutiny, but consider the effects of scale and commercial vs residential

199A AND RENTAL INCOME

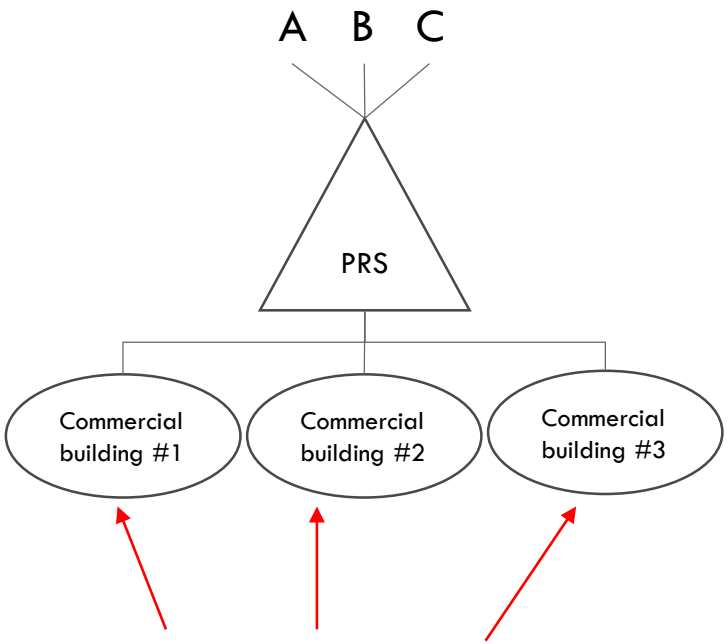
Consider these two examples, assuming identical facts (except for structure): landlord pays for maintenance, 250 hours of qualifying service (in the aggregate) in regards to the buildings, proper books and records, etc.

Example #1



Three separate trades or businesses, none of which on its own satisfies the safe harbor?

Example #2



One single trade or business satisfying the safe harbor?

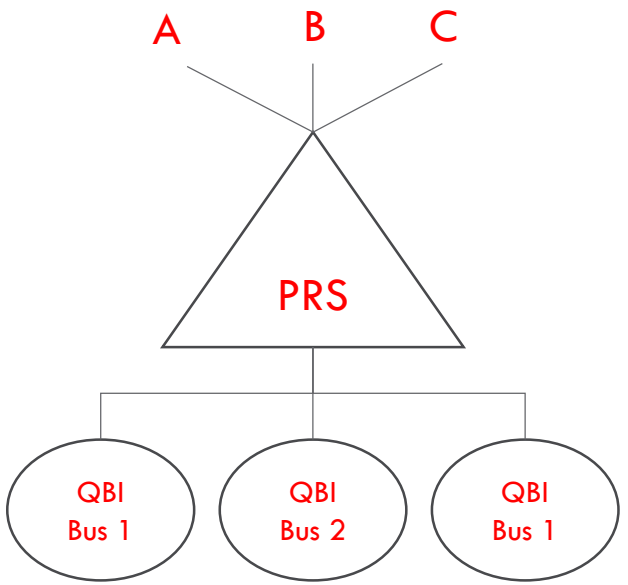
AGGREGATION

AGGREGATION

- Business aggregation permitted but not required
  1. Must be trade or business and not a service business
  2. Need majority common ownership
  3. Need to establish 2 of 3 factors
     - Common products and services (gas station and car wash, restaurant and food truck)
     - Shared facilities or shared centralized business elements (personnel, back office functions, HR, IT, etc)
     - Businesses operated in coordination with or reliance upon other businesses in aggregated group (supply chain interdependencies)
- Aggregation election can be made at individual or entity level
- There is a duty of consistency once an aggregation election is made and a disclosure must be made on the relevant tax return

AGGREGATION

- A, B, and C could individually decide whether to aggregate under the proposed regulations
- PRS can choose to aggregate under the final regulations
- Why aggregate: efficiencies, maximize section 199A deduction, ease compliance burden
- SSTB's can not be aggregated



Assume common products and services and that the businesses share certain interdependencies

SEPARATE TRADES OR BUSINESSES

SEPARATE TRADES OR BUSINESSES

- The section 199A deduction is first computed on a "trade or business" by "trade or business" basis
- A single entity can have multiple trades or businesses
- Final regulations suggest looking to the **accounting methods guidance under section 446** - a separate trade or business generally should be eligible to choose a different method of accounting
- Factors can include
  - Complete and **separable** books and records (including bank accounts)
  - Separate employees
  - Geography
  - Many others

WHY SEPARATE TRADES OR BUSINESSES?

Consider the "Cliff Effect", affirmed in the final regulations

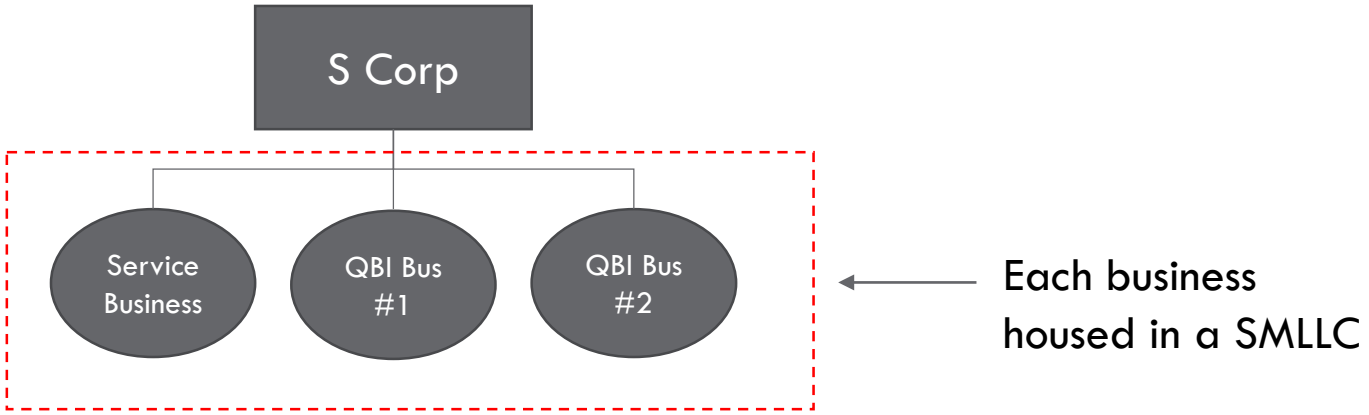
- In a single business, "tainted" gross revenue from certain services can **disqualify** entire business from 199A benefits

- Gross Receipts of $25 million or less, 10% or more
- Gross Receipts over $25 million, 5% or more

SEGREGATING INCOME FOR UNDER 199A

What to do if a business crosses the 5 or 10% threshold?

- Possible to argue that the service income represents a separate trade or business
- Separate tracking of expenses, apportioning of wages, distinct employees, treating as separate business lines in financials, and use of SMLLCs
- Ultimately a facts and circumstances analysis- pay attention to the "crack and pack" rules and make sure the service business is not providing products/services to other businesses



SPECIFIED SERVICE TRADES OR BUSINESSES

SSTB AND HEALTH SERVICES

- Reminder that not all trades or businesses necessarily produce QBI
- Disqualifying businesses include businesses
  - "…involving the performance of services in the fields of: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services"
  - "…where the principal asset of such trade or business is the 'reputation or skill' of one or more of its employees or owners"
  - "…the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities"
- SSTB rules only apply to taxpayers with taxable income above the taxable income thresholds of $315k MFJ and $157,500 Single, indexed for inflation
- Remember the "Cliff effect" of having even a small amount of SSTB income

SPECIFIED SERVICE TRADES OR BUSINESSES

"…and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners."

Proposed and final regulations adopt a narrow definition:

- Income from endorsing products or services
- Licensing or receiving income from use of individual's name/likeness
- Appearance fees

Proposed regulations: "Congress enacted section 199A to provide a deduction from taxable income to trades or businesses" that are not conducted in the C corporation form

SPECIFIED SERVICE TRADES OR BUSINESSES

- Adopt the "commonly" accepted definition of specified businesses and look to existing section 448 guidance

- Look for continuing IRS guidance specific to certain industries

SSTB AND HEALTH SERVICES

- The final regulations remove the proposed regulation's requirement that "medical services be provided directly to a patient", **meaning indirect services** could now be considered to be part of a SSTB

- This could expand the types of services considered to be health services

- For example, what about a technician working in a clinic who operates an MRI machine?

NEW EXAMPLES

- In response to commentary, the final regulations (through language in the preamble and new examples) recognize that certain businesses related to the healthcare industry, but not directly involved in healthcare services, can potentially produce QBI

- Important point: the IRS often uses "clean" facts to illustrate a point, and real world situations often deviate from these "clean" facts, so taxpayers should take caution when relying upon these examples

SURGICAL CENTERS

- Is common to have medical professionals invest (along side other non medical professionals) into ambulatory and surgical centers
  - Capital is used to purchase real estate, equipment, fund operations
- The medical professionals may perform certain services at the center, but as employees or owners of another entity
- There is case law and guidance recognizing, with the right facts, that the medical professional's investment is separate and apart from the professional's provision of medical services

SURGICAL CENTERS

- Consider the "clean" facts of the example contrasted with the reality of industry practice
  - Most surgical centers employ some health care professionals, like nurses, and may be required to do so under state law
  - If the surgical center must employ these health care professionals, can it rely upon the example in the final regulations

ASSISTED LIVING FACILITIES

Non-medical residential services

Medical services (doctors, nurses)

Customers

- Again, like the surgical center example, real world facts may differ

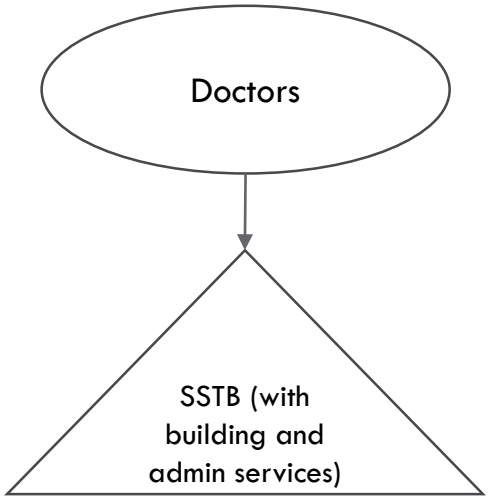
ANTI-ABUSE RULES

"CRACK AND PACK RULES"

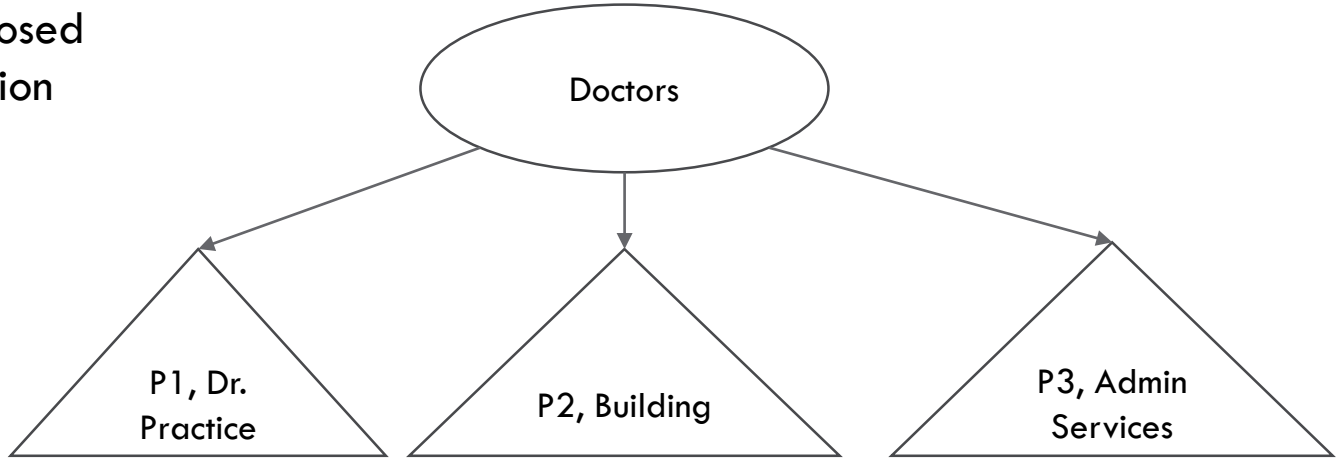
- Some commentators (before the issuance of the proposed regulations) speculated that a SSTB could "crack" itself open, pull out certain component parts that are not direct SSTBs, and generate QBI from those component parts

"CRACK AND PACK RULES"

Original Structure



Proposed Solution



"CRACK AND PACK RULES"

- Not surprisingly, the IRS disagreed with this strategy
- Income from a non-SSTB is treated as SSTB income if:
  - There is common ownership between the two businesses (50% or more including related party rules)
  - And the non-SSTB provides property or services to the SSTB
- So in the previous example, the result is the same regardless of structure
- What about C corporations

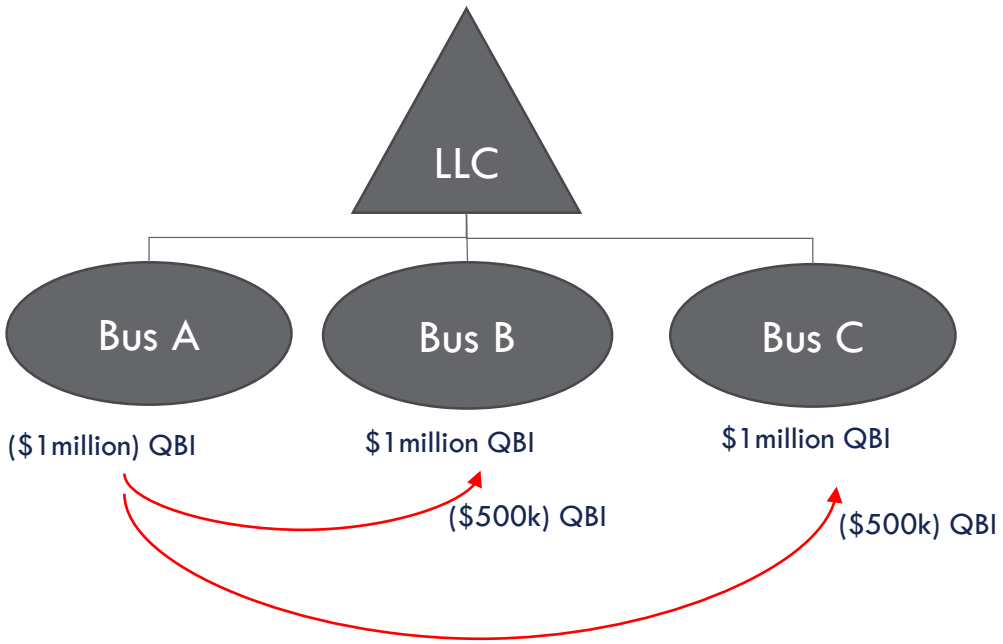
MISC. CONSIDERATIONS

QBI LOSS FROM ONE BUSINESS

($500K) of the loss from Bus A is apportioned to each of Bus B and C

None of the Bus A wages or UBIA goes with the loss

Reduces Bus B and Bus C QBI to $500k, respectively



199A DEDUCTION PARTICULARS

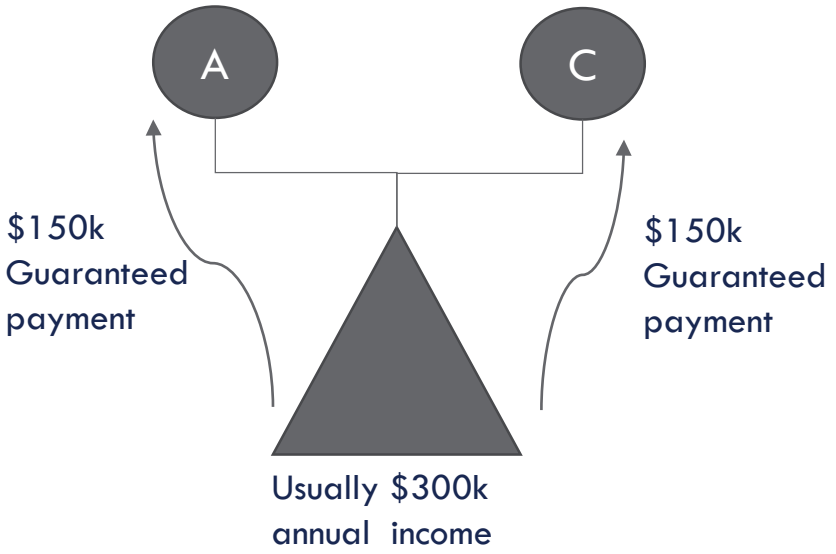
- The section 199A deduction does not reduce basis
- The section 199A deduction does not reduce SE Tax
- The section 199A deduction is allowed for AMT
- The section 199A deduction does not reduce net investment income for purposes of the section 1411 tax
- Enhanced accuracy related penalty reduced to greater of $5,000/5%

FISCAL YEAR ENTITIES

- Fiscal Year S Corp or Partnership with year straddling 12/31/2017 will generate QBI for whole year
- Example: partnership with tax year beginning 5/1/17 and ending 4/30/18
  - Assuming partnership generates QBI, 100% of QBI listed on K-1 could qualify

GUARANTEED PAYMENT

- What if re-categorize to net income allocation (not guaranteed)
- Can work even if SSTB (*ie* law firm) if A and C have taxable income between $315k-$415k (MFJ)
- Use of priority allocations
- State tax considerations



TRUST QUALIFICATION

While estates and trusts were excluded from Sec. 199A benefits under the House and Senate bills, they do qualify for the deduction under the Act.

- This is a big deal for "Electing Small Business Trusts" owning S corporation stock.
- It also affects many family trusts owning inherited business and farm property.

TRUSTS AND SECTION 199A REGULATIONS

- Grantor Trust
  - Deduction computed by grantor
- Nongrantor Trust
  - Allocation between beneficiary and trust/estate based on proportion of DNI
  - DNI is calculated without 199A deduction
  - Separate share rule applies
  - If no DNI – 100% to trust/estate

COMPLIANCE CONSIDERATIONS

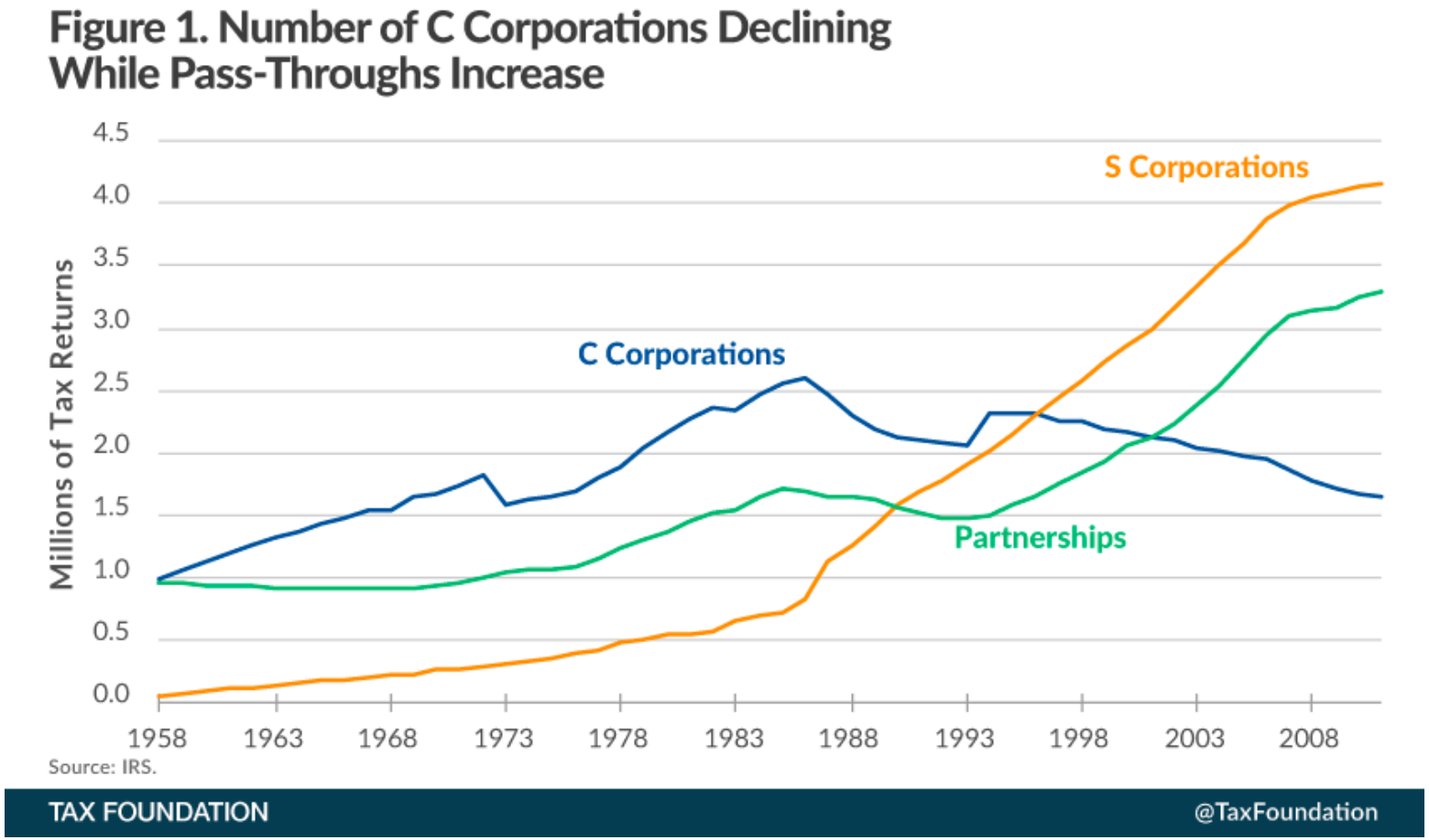
REPORTING AND COMPLIANCE

- An RPE must "separately identify or report an item of QBI, W-2 wages, or UBIA of qualified property"
- Failure to do so results in the presumption that the omitted item is zero, no matter the profile of the ultimate taxpayer
- There is no exception even if an RPE knows that all its owners have taxable income below the threshold amounts
- Note that this is a more generous rule than the proposed regulations (providing that any omitted information caused all the items to be presumed to be zero)
- Also consider heightened penalties under section 199A and the new centralized partnership audit regime

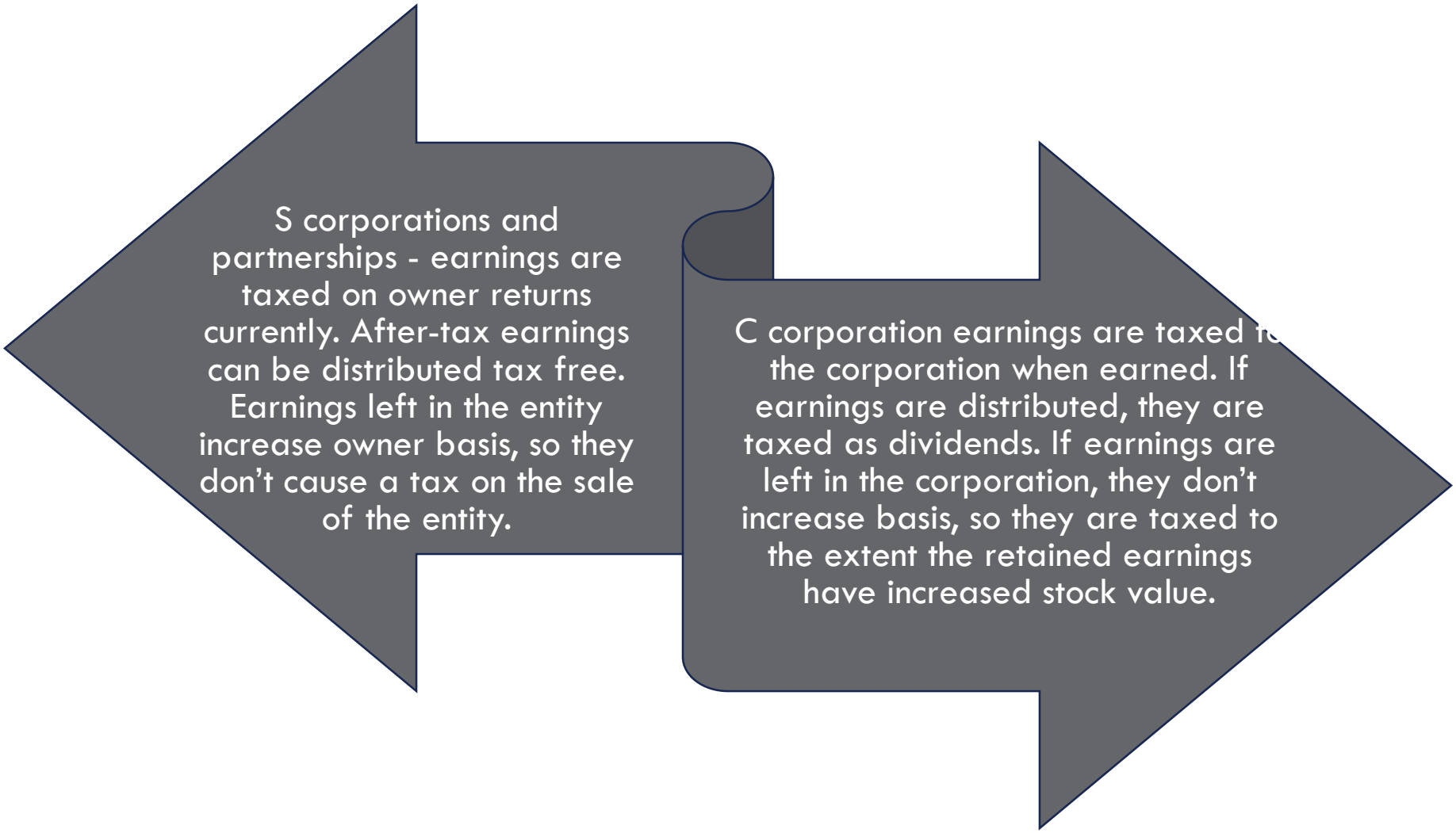
ARE C CORPORATIONS NOW THE PREFERRED FORM OF BUSINESS?

IS IT TIME TO RECONSIDER THE C CORPORATION?

C corporations have fallen out of favor under the 1986 Code



WHY? THE C CORPORATION DOUBLE TAX



RATE COMPARISONS

Entity Choice Federal Tax Rates		
Tax Rate Comparisons	**Prior Law**	**Act**
C corporation shareholder	50.47%	39.8%
Active flow-through owner with no 20 percent pass-through deductions	39.6%	37.0%
Passive flow-through owners with no 20 percent deduction	43.4%	40.8%
Active flow-through owner with 20 percent pass-through deduction	N/A	29.6%
Passive flow-through owner with 20 percent pass-through deductions	N/A	33.4%

- Note: Calculations assume the highest federal tax rates apply and all of a corporation's after-tax earnings are distributed to shareholders by way of taxable dividends subject to the 3.8 percent net investment income tax. State income taxes are ignored

PERSONAL HOLDING COMPANY TAX

20% tax on "undistributed personal holding company income."

Effect is to force distribution of investment income.

Accumulated Earnings Tax

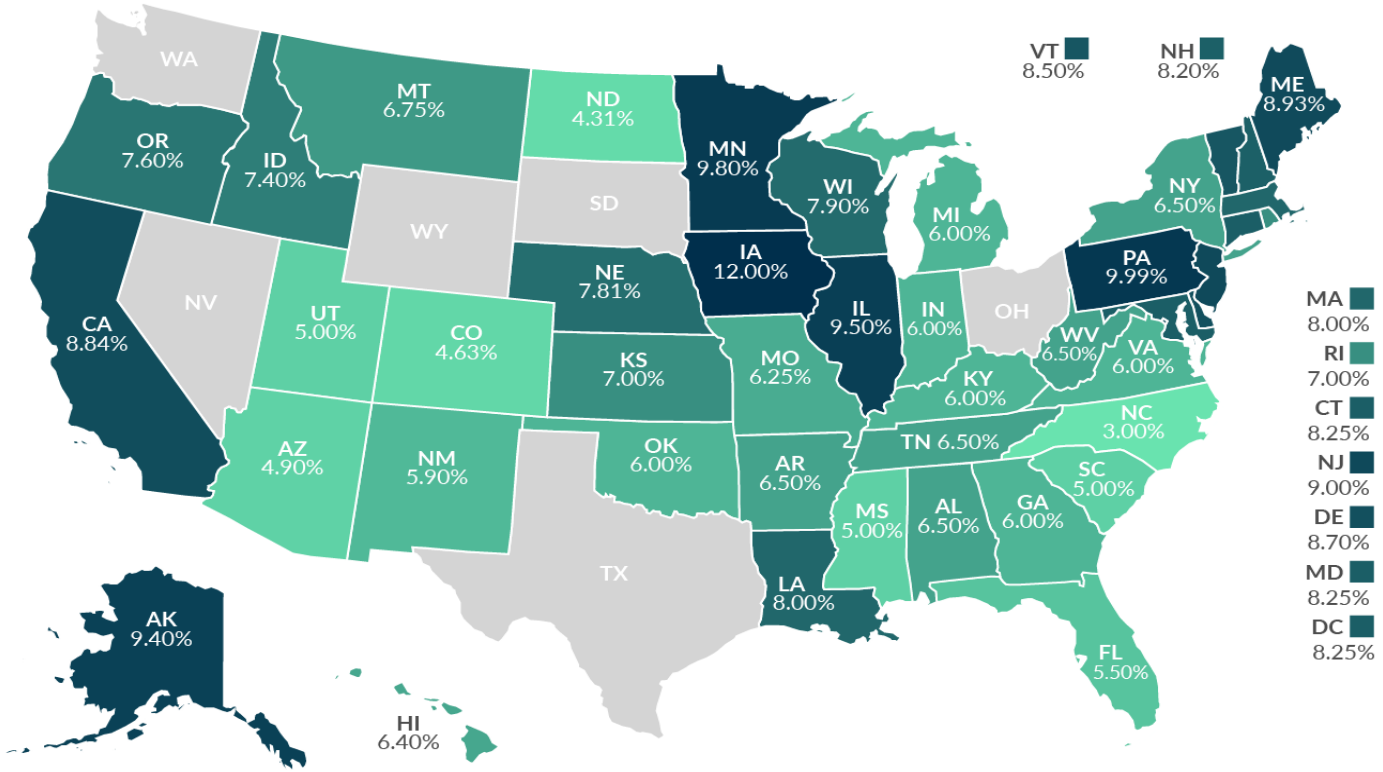
20% tax on “excess accumulated taxable income” of C corporations.

POLITICAL RISKS

STATE CORPORATE TAX RATES (2016)

How High Are Corporate Income Tax Rates in Your State?

Top State Marginal Corporate Income Tax Rates in 2018



Note: (*) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Arkansas has a "benefit recapture," by which corporations with more than $100,000 of taxable income pay a flat tax of 6.5% on all income, not just on amounts above the benefit threshold. Connecticut's rate includes a 10% surtax, which effectively increases the rate from 7.5% to 8.25%. Surtax is required by businesses with at least $100 million annual gross income. Illinois' rate includes two separate corporate income taxes, one at a 7.0% rate and one at a 2.5% rate.

Top State Marginal Corporate Income Tax Rate

Lower — Higher

Source: State tax statutes, forms, and instructions; Bloomberg BNA

SUMMARY: THE FUTURE OF C CORPORATIONS

Image by Hartmut Inerle under Creative Commons license

ESTATE TAX AND PLANNING IMPLICATIONS

ESTATE TAX

2017 Tax Cuts and Jobs Act

- 40% rate
- Exemption estimated to be 11.18M 2018 11.4M 2019 indexed ($5.6 M prior to enactment)
- Increased Exemption available for gift, estate and GST
- Portability
- Increased Exemption set to sunset back to 2018 rates January 1, 2026
- 2018/2019 Annual Exclusion estimated to be $15,000 per person

PORTABILITY

No change with Tax Reform.
The first spouse to pass-away can now pass his/her exemption amount to the surviving spouse without complex estate planning.

SUNSET CONSIDERATIONS FOR GIFTING

If exemption is used during life, taxpayer uses the bottom threshold first.
To take advantage of the increased exemption, one must gift over the Sunset amount of $5.6 million.

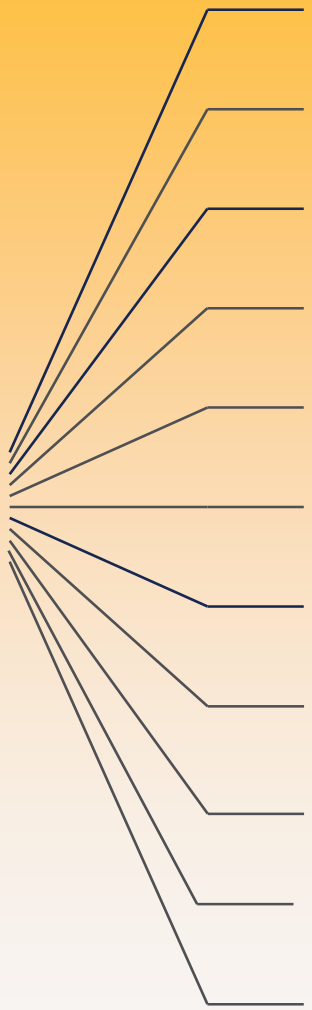
SUNSET CONSIDERATIONS FOR GIFTING

CLAWBACK

Under Proposed Reg. §20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation.

Proposed regulations would prevent Clawback of increased basic exclusion amount with respect to taxable gifts made before 2026.

Lost, limited or revised deductions: Personal



- Standard deductions
- Medical expenses
- State and local taxes
- Home mortgage interest
- Charitable donations
- Casualty and theft losses
- Miscellaneous 2% deductions
- Phase out of itemized deductions
- Child tax credit
- Alimony
- Moving expenses

PERSONAL EXEMPTIONS

- 2017 $4,050 PER PERSON
  - SUBJECT TO PHASE-OUT
- 2018 – GONE

STANDARD DEDUCTION

- Increases the standard deduction to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other individuals

- Indexes the standard deduction for inflation using the C-CPI-U for taxable years beginning after December 31, 2018

CHILD TAX CREDIT

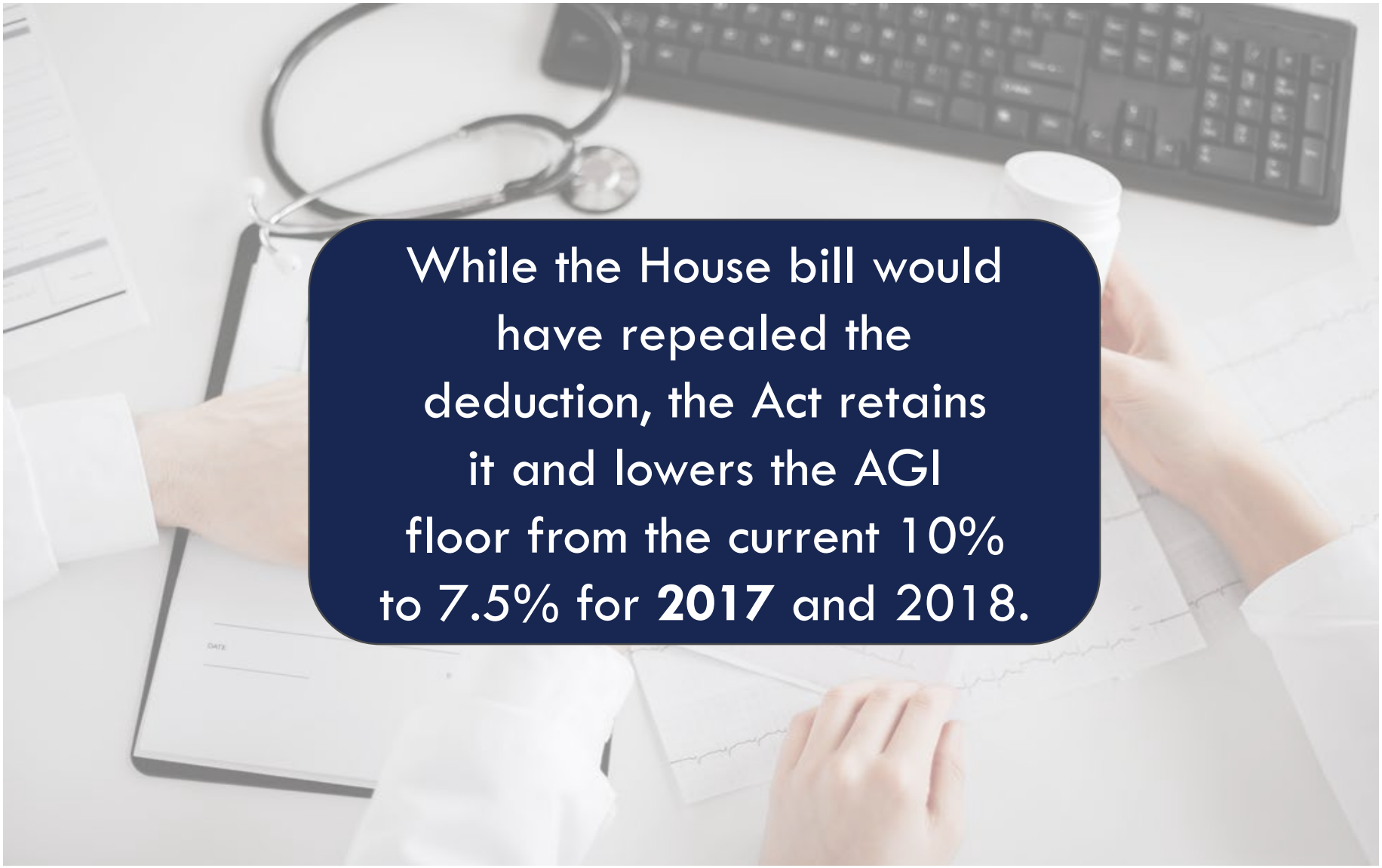
Old law: Credit of $1,000 for qualifying children under 17. Phased out starting at $110,000 for joint filers, $75,000 for single filers. Refundable to lesser of full amount or 15% of earned income exceeding $3,000.

Act: $2,000 credit. Phased out starting at $400,000 for joint filers, $200,000 otherwise. First $1,400 is refundable to extent of 15% of earned income over $2,500.

Child's Social Security number required to claim credit.

Effective: 2018-2025.

MEDICAL EXPENSES



STATE AND LOCAL TAXES

- Repeals the itemized deduction for state and local taxes, effective after 2017, with the exception of a $10,000 annual allowance

- The allowance allows a maximum $10,000 deduction for state and local non-business property and income taxes, or, at the taxpayer's option, property and sales taxes

- Same $10,000 limit for joint filers and single taxpayers

STATE AND LOCAL TAX EXAMPLE

- $5,000 Property Taxes on House
- $10,000 State Income Tax
- $13,000 State Sales Tax

2017: $18,000 deduction

2018: $10,000 deduction (cap)

State efforts to address $10,000 cap on state and local tax deductions.

HOME MORTGAGE INTEREST

- Deduction limited to interest on $750,000 principal on new home acquisition debt incurred after 12/15/17.

- Home equity debt interest deduction “suspended” from 2018 through 2025.
  - But, look to use of loan

CHARITABLE GIFTS

- Cash contribution ceiling raised to 60% of AGI
- Charitable deduction for contributions to colleges for seating rights eliminated
- The increase in the standard deduction will greatly reduce the number of people who itemize their deductions.
- Tax planning ideas:
  - 'Bunch' charitable contributions for two years into one year to exceed the standard deduction every other year
  - Set up a donor advised fund
- This will be an interesting case of behavioral economics to see if the tax deductibility will affect charitable giving

MISCELLANEOUS DEDUCTIONS

- Repeals deductions for tax preparation fees and unreimbursed employee business expenses
- Also repeals the deduction for expenses for the production or collection of income, as well as other deductions subject to the 2% floor
- Sunsets these disallowances after 2025

PHASE-OUT OF ITEMIZED DEDUCTIONS, PERSONAL EXEMPTIONS

Gone

THE NEW PARTNERSHIP AUDIT RULES

OLD LAW- A MESS

- IRS audits at the partnership level, resulting in Final Partnership Administrative Adjustment (FPAA)
- FPAA allows assessment of tax against ultimate taxpayers
- Audit process provides for IRS interaction with Tax Matters Partner, subject to specified rights of notice and participation by other partners
- Statute of limitations regime begins with statute at partner level and provides for extensions with respect to items affected by FPAA

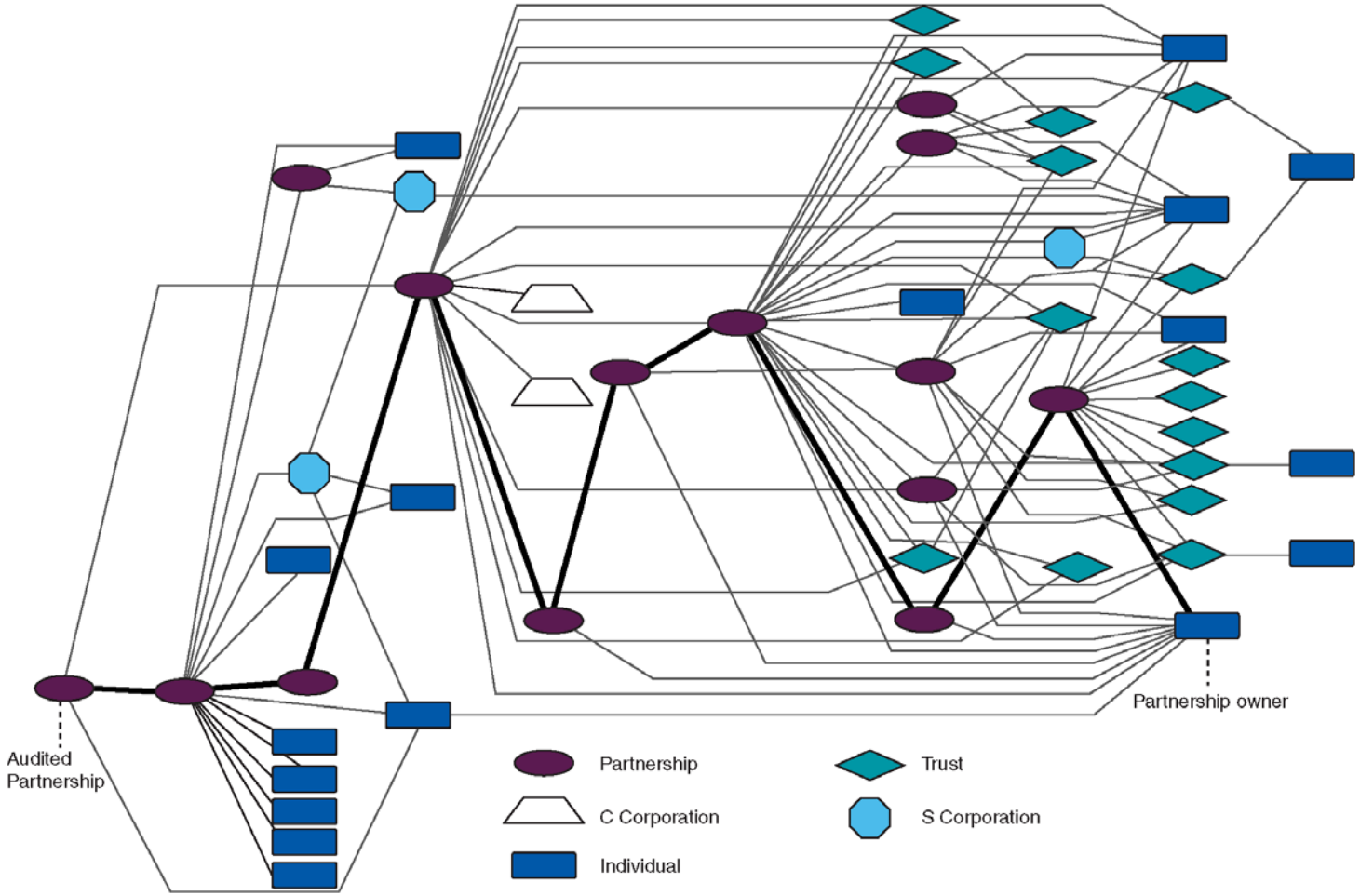
OLD LAW- A MESS

- Partnership items (adjusted at the partnership level), non-partnership items and affected items (taken into account at partner level)
- Mix of entity and aggregate
- IRS difficulties with administering the rules
- Who is TMP
- Tiered partnerships and TEFRA linkage
- What is a partnership item
- Procedural hurdles even before examine merits
- Non TEFRA Partnerships- IRS audits at partner level

OLD LAW- GAO REPORT

- The number of large partnerships has more than tripled to 10,099 from tax year 2002 to 2011
- Almost two-thirds of large partnerships had more than 1,000 direct and indirect partners, had six or more tiers and/or self reported being in the finance and insurance sector, with many being investment funds
- IRS audits few large, complex partnerships. According to IRS data, in fiscal year 2012, IRS closed 84 field audits—or a 0.8 percent audit rate
- This audit rate is well below that of C corporations with $100 million or more in assets, which was 27.1 percent in fiscal year 2012

OLD LAW- 2014 GAO REPORT



Source: GAO analysis of IRS documentation. I GAO-14-732

NEW LAW

- Applies to returns filed for partnership taxable years beginning after December 31, 2017
- TEFRA rules repealed
- Default Rule
  - Tax on "imputed underpayments" is assessed and collected at the partnership level unless partnership elects to push out adjusted items
  - Under default rule, partnership pays tax in the adjustment year and adjustment-year partners bear economic burden
- "Reviewed Year": year adjustments relate to
- "Adjustment Year": year of examination

NEW LAW

- Partnership must designate one representative (the "Partnership Representative") ("PR") to deal with IRS in audit proceedings
- Partners have no statutory right to participate in tax audits or litigation, no right to opt out, and no partner-level defenses
- PR= Czar

NEW LAW- ELECTING OUT

- Partnerships furnishing 100 or fewer statements under section 6031(b) (i.e., schedules K-1) may elect out of new provisions
- At all times during the year, all partners must be:
  - Individual, C corporation (including RIC, REIT, 501(a) corporations), S corporation (number of S corporation shareholders counts), estate of deceased partner, eligible foreign entity (per se corporations)
- Ineligible partners
  - Disregarded entities and trusts

NEW LAW- PUSH OUT ELECTION

- Partnership may elect not later than 45 days after date of the "notice of final partnership adjustment" to pass the adjustment through to its partners

- Partnership provides a "statement" to each person that was a partner in the reviewed year (i.e., the year under audit) showing that person's share of adjusted items

- Mailed to last known address, must make reasonable efforts to determine new address

NEW LAW- PUSH OUT ELECTION

- Partnership may elect not later than 45 days after date of the "notice of final partnership adjustment" to pass the adjustment through to its partners
- Partnership provides a "statement" to each person that was a partner in the reviewed year (i.e., the year under audit) showing that person's share of adjusted items
- Mailed to last known address, must make reasonable efforts to determine new address
- Higher interest rate

TAKE AWAY POINTS

- Best practice- discuss with clients and amend operating agreements
- Real world- many clients may take a wait and see approach
- Any reason not to elect out (if eligible)?
- Heightened diligence if buying into a partnership
- Possible contractual protections
- Key decisions for 2018
  - Elect out
  - Identity of PR