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A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

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NEW RULES AFFECTING PARTNERSHIP AND LLC AUDITS

by Katie Lepore, CPA, J.D., LL.M., Taxation

The Bipartisan Budget Act of 2015 (the “Act”) changed the rules relating to audits of partnerships for tax years beginning after December 31, 2017 and with it, Internal Revenue Code Sections 6221 to 6241. The Act replaces the existing audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). The new rules affect all entities that are taxed as partnerships, including limited liability companies, or “LLCs,” so long as they are taxed as partnerships and not as disregarded entities.

The Act allows the IRS to collect any deficiency in taxes at the partnership level rather than having to collect the tax from all the individual partners. In a large partnership, collecting from all the partners can be a daunting task, possibly requiring partners to amend their individual returns if amended K-1s are issued.

The Act allows any tax deficiency to be collected at the highest marginal rate, despite the partners themselves possibly having lower income tax rates. This also means that current partners in the year of audit will shoulder the burden of the tax, even though these may not be the same partners as in the year that caused the adjustment to arise.

However, the Act is only applicable for tax years beginning after December 31, 2017. That means there are still open tax years subject to audit for which the Act does not apply. Partnerships may elect to apply the Act for any tax years between the enactment of the Act (November 2, 2015) and January 1, 2018, which should encompass all open tax years, barring an extended statute of limitations.

Partnership Representative

The TEFRA “tax matters partner” has now been replaced with a “Partnership Representative,” a title with much broader powers than a tax matters partner, or “TMP.” The Partnership Representative does not have to be a partner and is the sole person the IRS needs to alert about an audit. The Partnership Representative has sole decision-making authority with regard to various elections during the audit. That means the Partnership Representative has the authority to extend the statute of limitations, settle a dispute, or agree to an adjustment, without having to receive the consent of the partners. Since the Partnership Representative does not need to be a partner, partnerships can now have a management company or investment advisor serve as Partnership Representative.

There is no automatic conversion of a TMP into a Partnership Representative, though the partnership may choose to appoint the same person. If the partnership agreement does not include provisions for appointing a Partnership Representative, the IRS can appoint a Partnership Representative for a given audit and the appointment is final. At a minimum, partnerships should consider amending their agreements to appoint a Partnership Representative and to add provisions for appointing and/or removing a Partnership Representative.

It appears that partners will have limited rights to challenge the decisions of the Partnership Representative unless the partnership agreement says otherwise and the Partnership Representative is bound by the terms of that agreement. Therefore, it may be wise to amend partnership agreements to give the partners greater rights and control over the audit and the Partnership Representative. Recommended changes include (1) requiring the Partnership Representative to give notice to the partners of a partnership audit, and (2) requiring majority or unanimous partner approval before certain decisions can be made during an audit.

If you anticipate serving as a Partnership Representative, you may also want to ensure that the partnership agreement or other agreement indemnifies you from any actions taken in good faith while serving as Partnership Representative.

Whether a partnership agreement is amended or not, the IRS will require the partnership to name a Partnership Representative on the partnership's 2018 tax return, which will be filed for most partnerships on or around March 15, 2019, unless extended.

Pushing Out the Tax

The partnership agreement can be drafted in such a way as to allow a Partnership Representative to elect to "push out" the tax deficiencies to the partners who were owners in the tax year under audit pursuant to Internal Revenue Code Section 6226. This allows the partnership to avoid paying tax at the highest marginal rate. However, making such an election would require all the partners to amend their tax returns. Making the election to push out the tax also carries with it the penalty that any underpayment interest due will be two percentage points higher than any interest assessed at the partnership level. It also likely will cause the partners to pay an additional 3.8% net investment income tax on any additional income on an amended K-1.

The election to push out the tax must be made within 45 days of the date of the notice of final partnership adjustment from the IRS. The decision to push out the tax should include a weighing of the overall tax to be paid, versus the burden it casts on the partners. It may be wise to include a provision to indemnify the Partnership Representative for his or her decision with regard to the election after weighing such alternatives.

Partnership agreements should be reviewed to determine if the partnership wants to give the Partnership Representative the option to push out the tax to the partners. Additionally, if such an election is included in the partnership agreement, there should also likely be language regarding the process of collecting the tax from the partners and issuing new K-1s. The partners responsible for the tax would then be the partners who were partners in the year to which the adjustment relates, rather than the current partners.

In addition to including a provision allowing the Partnership Representative to push out the tax, the partnership agreement could also include a requirement that a former partner remains liable for such taxes for prior years, and if such partner is no longer living or otherwise no longer exists (such as due to an entity dissolution), the person receiving those interests receives them subject to this duty to indemnify the partnership for any tax it is required to pay on behalf of the former partner.

There are other considerations to pushing out the tax as well, such as how it may affect a partner's basis in his partnership interest, particularly if that partner has since transferred or sold his interest in the partnership. This may also be a good way to protect newer partners, who may be younger generations in a family business, from the burden of a tax liability that does not relate to their time as partner.

Electing Out of the Act

Fortunately, the Act allows "small partnerships" to elect out of the new audit provisions. A small partnership is defined in the Act as one with fewer than 100 partners, all of which are either individuals, C-corporations, S-corporations, or an estate of a deceased partner. Partnerships that have as a partner an entity which is taxed as a partnership, such as a partnership itself or an LLC, and those that have a trust as a partner, whether it be a revocable grantor trust or an irrevocable trust, are not eligible to be treated as small partnerships. The election to opt out must be made on a timely filed partnership tax return (including extensions), and each partner must be notified within 30 days of making such an election. This means the partnership must decide whether to opt out before the audit even arises or the nature of the adjustment is known. Please note, to qualify as a small partnership, the partnership must have only qualifying partners for the entire calendar year.

Conclusion

The IRS is not requiring partnerships to amend their partnership agreements at this time to name a Partnership Representative, but as outlined above, it may be prudent to do so before an audit arises, and especially before tax filing season for the 2018 tax year when a Partnership Representative must be named. This is especially important for partnerships where there may be different partners from year to year, therefore changing who may shoulder the burden of an adjustment, or for partnerships that wish to limit the powers of the Partnership Representative.

PROPOSED NEW LAWS WOULD SIGNIFICANTLY AFFECT RENTAL PROPERTIES

By DeEtte L. Loeffler, J.D., LL.M., Taxation

Landlords may want to take notice of a series of bills currently under consideration in California which could impose greater burdens on landlords. These bills are primarily aimed at assisting renters in the current tight rental market.

AB 2343. This bill would increase the notice and response times for landlords seeking to evict tenants. First, the 3-day period for eviction of a tenant for nonpayment of rent/nonperformance of a duty under a lease would increase to 10 days. Second, the landlord would be required to provide specific information to the tenant about the duty and how to cure it, and to notify the tenant of a right to request "reasonable accommodations" for any disability affecting the tenant's ability to perform the duty.

In addition, the current 3-day period for evictions for waste, nuisance or unlawful acts would increase to 5 days. Also, the current 5-day period to respond to a complaint for possession would increase to 14 days, and if the tenant failed to appear, the court clerk would not be permitted enter a default for an additional 14 days. Finally, the bill would expand the non-retaliatory eviction rules to include tenants who engage with an organization advocating tenant rights.

AB 2364. This bill would close the "loophole" in the Ellis Act which permits landlords to evict tenants in order to remove a property from the marketplace. Some landlords have allegedly used the law to do mass evictions before re-

renting these properties on a piecemeal basis. The bill would prohibit re-renting such properties following such a mass eviction. In addition, the bill would require 12 months advance notice to tenants, not the current 120 days.

Yet another bill, expected in late February, would impose statewide "just cause" restrictions on landlords who wish to evict tenants. These restrictions would only permit evictions for specific listed reasons, such as nonpayment of rent. Such laws are already in effect for the cities of Oakland, Berkeley, San Francisco and San Jose.

An earlier bill, SB 1506, would have repealed restrictions on the ability of cities to impose rent control requirements. That bill died in committee. However, advocates are currently gathering signatures to place the measure on the November 2018 ballot.

We will monitor these bills as they proceed and will keep you informed of any other related bills.

FEDERAL TAX UPDATE
By DeEtte L. Loeffler, J.D., LL.M., Taxation

No Business Deduction for Property Rented to Family Member at Below Market Rate. In an unpublished Memorandum, the 9th Circuit Court of Appeals affirmed the lower court's decision denying business deductions to a couple who rented their second home to their daughter for below market rent. The taxpayers sought to deduct mortgage interest, taxes, insurance, depreciation and other expenses. The Court deemed the daughter's use of the house as "personal use" by her parents for purposes of IRC Section 280A(d)(1), which limits deductions for personal use of a dwelling. *Okonkwo v. Com'r*, Tax Court No. 23496.13, filed December 11, 2017.

Bipartisan Budget Act Revises Deductions. The recently enacted Bipartisan Budget Act of 2018 revived for 2017 several tax provisions which had expired in 2016. These include the right to deduct mortgage insurance premiums as interest under IRC Section 163(h), the above the line deduction for qualified tuition and expenses under IRC Section 222, and the exclusion from gross income for debt discharged on a qualified personal residence under IRC Section 108(a)(1)(E). Certain energy incentive programs were also revived, residential credits for solar, geothermal, fuel cell and wind energy, and vehicle related fuels and alternate power. New exceptions were also introduced to exempt private foundations from excess business holdings rules and some small universities from excise taxes.

STATE TAX NEWS
by DeEtte L. Loeffler, J.D., LL.M., Taxation

Initiative Would Sharply Increase Property Taxes on Commercial and Industrial Properties. The People's Initiative to Limit Property Taxation (commonly known as Prop 13), adopted in 1978, limits property tax increases to 2.0% per year. It also excludes from property tax reassessment certain transfers of real property between parents and children (the "parent-child exclusion"). Initiative 17-0055 would eliminate these benefits for commercial and industrial properties by requiring them to be reassessed to fair market value every three (3) years. The change would not apply to properties occupied by a business owner, or to

small taxpayers (those owning a total of less than $2 million of property in California). In addition, a new property tax would apply to businesses with more than $500,000 in personal property unless the business has fewer than 50 full time employees in California and uses the property for business purposes. The Attorney General estimates the bill would raise $6-10 billion annually, net of costs, and allocate 40% to schools and 60% to local government. The initiative has not yet qualified for inclusion in the November ballot.

Homeowner Savings Account Proposed. Marc Steinorth (R) introduced AB 1758 to encourage and promote individual home ownership by allowing Californians to contribute to "homeowner savings accounts". Such accounts would be similar to IRAs, growing free of California taxes (although federal taxes would apply). Funds could be used for the purchase of the taxpayer's primary residence. Accounts would be limited to 20% of the median home price for the year in which the account is established.

Renters Tax Credit Could Double. SB 1182, introduced by Senator Steve Glazer (D), would double the renter's tax credit to $120 for those who earn $40,078 ($240 for couples with $80,156). This credit has not been increased in decades, despite a market increase in rent.

Bill to Tax Service Reintroduced. Senator Robert Hertzberg (D) has introduced SB 993, to impose a sales and use tax on services purchased by businesses after January 1, 2019, for use within California. Similar bills were introduced in 2016 and 2017 but would have also taxed services purchased by individuals. Under the bill, tax would be imposed on most services, including legal, accounting, maintenance, real estate brokerage, consulting, IT support, cloud computing, and advertising services. Certain services would be exempt from the tax, including healthcare, education, and child care services, as well as interest and insurance payments subject to the California gross premiums tax. The bill would exempt businesses with gross receipts of less than $100,000. The tax raised would be used for education costs of low and middle income taxpayers.

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