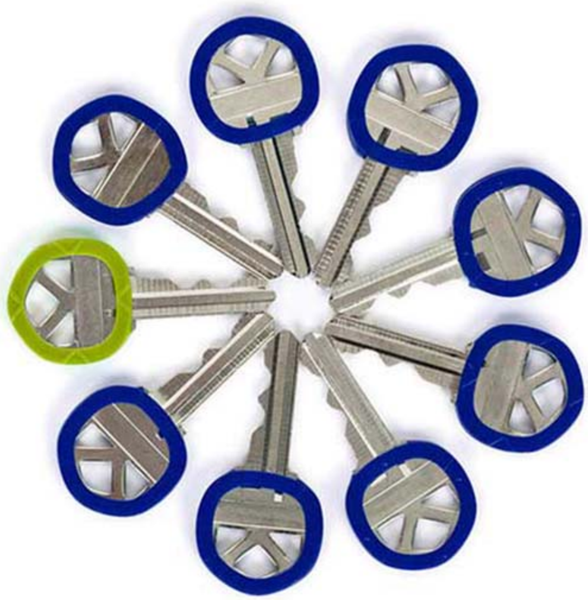
**IRS Insights**
**A closer look.**
May 2018



**In this issue:**



## Recent Update to the Partnership Audit Rules: Technical Corrections Act of 2018

On March 23, 2018, the Consolidated Appropriations Act, 2018 was enacted, which includes the Tax Technical Corrections Act of 2018 ("Act"). [1] The Act contains corrections to the centralized partnership audit regime enacted in section 1101 of the Bipartisan Budget Act of 2015 ("BBA Regime").[2] The BBA Regime replaces the Tax Equity Fiscal Responsibility Act ("TEFRA") and Electing Large Partnership ("ELP") rules with one set of partnership-level audit rules that apply to all partnerships, subject to an election out by certain partnerships. The BBA Regime is generally effective for tax years beginning after December 31, 2017. Some key corrections contained in the Act are highlighted.

[1] H.R. 1625 (March 23, 2018)
[2] Public Law 114-74.

**Background – BBA Regime**[3]

On November 2, 2015, the BBA Regime was enacted and repealed the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). Under the BBA Regime, unless a partnership is qualified to elect out and timely files such an election, the IRS will examine partnership items for a particular year ("reviewed year"), and any adjustments will be taken into account by the partnership in the year of the audit (the "adjustment year"). Generally, pursuant to the BBA rules, a partnership is responsible for paying any tax related to any adjustments ("imputed underpayment"), plus applicable penalties and interest. This is a significant change from the TEFRA provisions as it shifts any adjustment to the adjustment year partners rather than flowing the adjustments through to reviewed year partners who benefitted from the prior treatment.

The IRS will generally calculate the imputed underpayment by netting partnership adjustments and then multiplying these items by the highest rate of any of the partners, adjusted by applicable credits. Partnerships may request modification of a proposed imputed underpayment to more accurately reflect the tax due if the partnership and partners reported correctly on their respective returns. The modification procedures allow reviewed year partners to take adjustments into account and the IRS will remove the partner's portion of the underpayment from the partnership's imputed underpayment. Modification can be accomplished in a variety of ways, including: reviewed year partners amending prior year tax returns to reflect adjustments to tax and tax attributes (reducing the total netted partnership adjustments); allocating partnership adjustments to tax exempt partners; or the partnership demonstrating a portion of imputed underpayment is allocated to a partner with a lower tax rate.

As an alternative to paying the imputed underpayment, a partnership may elect to "push out" adjustments to its reviewed year partners, rather than paying the imputed underpayment ("push-out election"). If a partnership makes a valid push-out election, then the partnership is no longer liable for the imputed underpayment. A partnership making a push-out election must furnish statements to the reviewed year partners on the partner's share of the adjustments, as well as file those statements with the IRS. Under the push-out election, the reviewed year partners pay any additional tax, penalties and interest with their return for their share of the partnership adjustment in the year in which the statement was furnished.

**Technical Corrections Act**

**Scope of BBA Regime:** The Act clarifies the scope of adjustments subject to the BBA Regime, as set forth in Section 6241(2). Under the updated provisions, a partnership adjustment is "any adjustment to a partnership-related item", which is further defined as any item or amount with respect to the partnership which is relevant in determining the tax liability of any person and any partner's distributive share. Previously, these provisions referenced specific items of adjustment to partnership income, gain, loss, deduction, or credit. Accordingly, the Act clarifies that the BBA Regime could apply to a broad range of partnership items.

**Imputed Underpayment:** The Act also updates several aspects of calculating the imputed underpayment including IRS netting of potential adjustments, as well as procedures for partnerships submitting information to reduce the imputed underpayment under Section 6225(c). As noted, under the BBA Regime, the IRS will generally calculate any imputed underpayment by netting partnership adjustments and then multiplying these items by the highest rate of any of the partners, adjusted by applicable credits. The Act amends Section 6225(b) to clarify that adjustments to distributive shares cannot be netted, and adjustments must be separately netted by character. For example, different types of losses, such as ordinary and capital, cannot be netted.

Additionally, the Act further defines the procedures for partnerships requesting modification to the IRS' calculation, pursuant to reporting by its partners of any adjustments. Originally, partners were required to file amended returns and pay tax due to allow the partnership to request an adjustment to the imputed underpayment. However, the Act amends Section 6225(c)(2) to provide specific requirements for partners filing amended returns, as well as an alternative method ("pull-in procedure"). Generally, under the pull-in procedure, the partners must provide certain information to the IRS, pay any tax and adjust attributes, but are not required to file an amended return.

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[3] I.R.C. Section 6221 – 6234. For additional background on the BBA provisions, see IRS Insights, *Changes Made to Partnership Audits and Adjustments*, January 2016 edition.

**Push-Out Election:** As noted above, under Section 6226, a partnership may elect to have its reviewed year partners pay any imputed underpayment by pushing out the items of adjustment. The Act amends Section 6226(b) to address the push-out election in tiered partnership structures. If a pass-through partner receives a statement from a partnership, pursuant to a push-out election by that partnership, the pass-through partner must file a partnership adjustment tracking report with the IRS reflecting certain identifying information on its partners. Pursuant to the updated provisions, the pass-through entity may pay the imputed underpayment or push out the adjustments to its partners, under rules similar to of Sections 6225 and 6226. If a pass-through partner fails to properly make a push-out election, then it is responsible for paying the tax, interest and any penalties at the entity level.

**Assessment Statute of Limitations:** In addition, the Act contains clarifications to many procedural items, such as assessment statute of limitations under Section 6235 for adjustments related to partnership items. In contrast to the TEFRA provisions, the BBA Regime require only an evaluation of the partnership's assessment statute of limitations and does not contemplate any statute of limitations related to the partners.

The Act modifies Section 6235 for a number of items including providing the requisite timing for a notice of proposed adjustment. In addition, the Act amends the provisions to clarify that Section 6235 will not expire prior to time frames set forth in Section 6501(c)(8)[4] and Section 6501(c)(10)[5], if applicable. Further, the Act clarifies the BBA Regime does not alter the period of limitations set forth in Section 905(c).[6]

Payment of Tax: Lastly, the Act also amended Section 6232 to generally provide that if a partnership fails to pay the imputed underpayment, then the IRS may assess on each partner of the partnership (determined as of the close of the adjustment year). Alternatively, if the partnership has ceased to exist, then the IRS may assess upon former partners pursuant to the procedures set forth in the Act.

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## IRS Large Business & International Division Announces Five New Campaigns

On March 13, 2018, the IRS announced an additional five compliance campaigns as areas of focus for the Large Business & International Division ("Announcement").[7] Of the five newly identified campaigns, three focus on partnership issues, including treatment of certain items by partners, with the remaining two campaigns focus on costs to facilitate I.R.C. Section 355 transactions and partial dispositions of buildings under I.R.C. Section 168, respectively.

In January 2017, the IRS launched its campaign initiative with an initial 13 compliance campaigns and subsequently conducted webinars to discuss the specific campaigns and campaign process.[8] In November 2017, the IRS released an additional 11 campaigns with the majority of campaigns focusing on international issues.[9] The Announcement notes

[4] I.R.C. Section 6501(c)(8) provides if a taxpayer fails to provide notification to the IRS of certain foreign transfers, then the assessment statute of limitations does not expire until three years after the information is furnished. If the failure is due to reasonable cause, then the extended statute of limitations will only apply to items related to the failure.
[5] I.R.C. Section 6501(c)(10) provides that if a taxpayer fails to include information for a listed transaction, then the assessment statute of limitations for the transaction shall not expire until one year after the earlier of the date the information is furnished to the IRS, or the date that the material advisor meets the requirements of Section 6112 pursuant to a request by the Secretary relating to the transaction.
[6] I.R.C. Section 905(c) requires that a taxpayer notify the IRS for redetermination of tax in instances whose accrued taxes differ from amounts claimed as credit, accrued taxes are not paid before two years after the close of the taxable year to which the taxes relate, or any tax is refunded in whole or in part.
[7] IRS Announces Rollout of Five Large Business and International Compliance Campaigns (March 13, 2018), located at: https://www.irs.gov/businesses/irs-announces-rollout-of-five-large-business-and-international-compliance-campaigns, updated March 28, 2018.
[8] For more information related to the initial campaigns, *see* IRS Insights, *IRS Large Business & International Division Releases Initial Campaigns*, March 2017 edition;
[9] For more information related to the second 11 campaigns, *see* IRS Insights, *IRS Large Business & International Division Announces New Campaigns: Seven International Campaigns and Four Domestic Campaigns*, January 2018 edition.

that the IRS continues to move towards issue-focused examinations and a compliance campaign process to effectively allocate resources.

The five campaigns in the Announcement were identified using the same methods as the prior campaigns, including IRS data analysis and suggestions from employees. The newly announced campaigns are as follows, by practice area:

- **Pass Through Entities and Northeastern Compliance**
  - Self-Employment Contributions Act (SECA) Tax
  - Partnership Stop Filer
  - Sale of Partnership Interest
- **Enterprise Activities**
  - Costs that Facilitate an IRC Section 355 Transaction
- **Eastern Compliance**
  - Partial Disposition Election for Buildings

**Pass through Campaigns**[10]

Three out of the five new campaigns relate to partnership issues and reporting of certain items by partners. The first pass-through campaign will focus on whether partners potentially subject to the Self-Employment Contributions Act (SECA) tax are properly reporting and paying tax. The Announcement notes that unless a partner qualifies as a "limited partner" for self-employment tax purposes,[11] then a partner's distributive share from the partnership is subject to SECA tax. The Announcement further details that some individual partners, including limited liability entities, may be improperly claiming this exclusion. Treatment streams for this campaign will be issue-based examinations, as well as outreach programs to not only practitioners but also software providers and vendors.

The second pass-through campaign, Partnership Stop Filer, will evaluate partnerships that previously filed tax returns; however, discontinued filing returns. The Announcement notes that these types of partnerships may still have economic transactions, thus the campaign will focus on whether these situations are being properly reported by the partnership or respective partners. For this campaign, the IRS will use issue-based examinations, soft letters to encourage self-correction and stakeholder outreach.

The last of the pass-through campaigns is the Sale of Partnership Interest campaign, which will focus on the proper treatment and reporting of a gain or loss of a partnership interest by the partners. The Announcement notes that generally sales of partnership interests result in a capital gain or capital loss; however, the reporting can vary based upon the duration (such as long-term capital gain) or a portion of the gain or loss may be ordinary gain or loss if the partnership had inventory or unrealized receivables. The IRS will use a variety of treatment streams for this campaign, which may include examinations, practitioner and taxpayer outreach, vendor outreach, tax form and publication change, or soft letters when appropriate.

**Enterprise Campaign – Section 355 cost**[12]

In this campaign, the IRS will evaluate whether taxpayers are properly capitalizing costs related to transactions that qualify as a tax-free distribution under IRC Section 355. In order to qualify for tax-free treatment under Section 355, the transaction must meet specific requirements.[13] The Announcement specifies that this campaign will focus on whether costs related to these transactions are being properly capitalized.[14] The sole treatment stream for this campaign is issue-based examinations.

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[10] *Supra 7.*
[11] *See* I.R.C. Section 1402.
[12] *Supra 7.*
[13] See I.R.C. Section 355 and the regulations thereunder.
[14] Pursuant to I.R.C. Section 263 and the regulations thereunder, specifically Treas. Reg. § 1.263(a)-5(a), a taxpayer generally must capitalize the amount paid to facilitate certain transactions including distributions of stock described in I.R.C. Section 355.

**Eastern Compliance – Partial Disposition Election of Buildings**[15]

Lastly, the Partial Disposition Election for Buildings campaign, will focus on whether taxpayers are properly recognizing gain or loss pursuant to an election under IRC Section 168, and the regulations thereunder, on a partial disposition of a building. The Announcement notes that in order to make an election, a taxpayer must be able to substantiate the following:

- Disposal of a portion of the modified accelerated cost recovery system (MACRS) asset;
- Identification of the asset that was partially disposed;
- Determination of the placed-in service date of the partially disposed asset;
- Reduction of the adjusted basis of the asset by the disposed portion.

This campaign will evaluate whether taxpayers have properly recognized the gain or loss on the partial disposition of a building, including structural components. The treatment streams for this campaign include not only issue-based examinations, but also changes to IRS publications, including IRS forms and supporting instructions.

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## IRS Releases Data Book and Enforcement and Service Results for Fiscal Year 2017

On March 29, 2018, the IRS released the *Internal Revenue Service Data Book, 2017* ("Data Book"), which provides specific information about the activities conducted by the IRS during the period beginning October 1, 2016 and ending September 30, 2017 ("FY 2017"). These activities include receipt of returns, collection of tax, issuance of refunds, examinations, information reporting and verification enforcement activity, Collections and Appeals activity, assessment and abatement of penalties, and taxpayer assistance. In addition, the Data Book captures some statistics related to the IRS's budget and workforce. The IRS also recently released the *FY 2017 Enforcement and Service Results* report ("Enforcement Report"), which provides further insight into current IRS operations and trends over the past ten years in the enforcement, examination, collection and taxpayer service areas. A few key topics covered in these publications are summarized below.

**IRS Revenue Figures and Enforcement Trends**

During FY 2016, the IRS collected a net of almost $3 trillion in tax revenue. This is a slight increase from the net collections recorded for FY 2016. The IRS collected enforcement revenue of $56.91 billion during FY 2017, which is an increase of approximately $2.6 billion from FY 2016. Examination revenue increased by $2.2 billion over the prior year.

There was an increase in enforcement revenue collected in Appeals; during FY 2017, the IRS collected $2.97 billion through Appeals enforcement, up from $2.1 billion in FY 2016. The $2.97 billion collected in FY 2017 is still relatively low, compared to the amount collected from FY 2007 through FY 2015. The revenue collected through the IRS's Document Matching program, which includes amounts collected through the Information Reporter Program and the Automated Underreporter Program, increased by approximately $300 million in FY 2017, as compared to FY 2016.

In general, enforcement actions continued to decline in FY 2017, and the IRS reported the lowest number of liens and levies in ten years. In fact, the number of levies issued by the IRS decreased by 32% from FY 2016 to FY 2017. The number of seizures also decreased in FY 2017, as compared to FY 2016.

**Examination Coverage Rates and Trends**

Overall, there were fewer returns examined in FY 2017, as compared to each year of the prior decade.

The number of business returns examined by the IRS in FY 2017 decreased by 8%, compared to FY 2016. For the purposes of the Enforcement Report, business returns include: large corporation returns, small corporation returns,

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[15] *Supra 7.*

Subchapter S returns and partnership returns. During FY 2017, the IRS examined only 46,989 business returns, the fewest number examined in the past ten years, from FY 2008 through FY 2017. Relatedly, FY 2017 had the lowest overall coverage rate recorded in the last ten years, of only 0.44%. The coverage rate for large corporate returns (filed by corporations with assets of $10 million and higher) decreased from 9.53% in FY 2016 to 7.86% in FY 2017. The coverage rate for S corporations also decreased, from 0.34% in FY 2016 to 0.28% in FY 2017. The coverage rate for small corporations decreased from 0.80% in FY 2016 to 0.69% in FY 2017. In these three areas (large corporation returns, S corporation returns, and small corporation returns), the FY 2016 coverage rates are the lowest rates recorded in the prior ten years. The coverage rate for partnership returns remained at the same rate for FY 2017 as for FY 2016, 0.38%.

With respect to large corporate returns, the Enforcement Report breaks this category down further into asset classes, as detailed below:

| Large Corporation – Asset Class | Returns Examined (FY 2017) | Coverage (FY 2017) |
|---|---|---|
| $10 million < $50 million | 1,676 | 3.95% |
| $50 million < $100 million | 930 | 10.17% |
| $100 million < $250 million | 897 | 9.93% |
| $250 million and higher | 2,606 | 15.20% |

The FY 2017 coverage rates for each asset class have decreased, as compared to the coverage rates reported in FY 2016.

The number of individual returns examined in FY 2017 also decreased, as compared to FY 2016, and the coverage rates decreased, as follows:

| Individual – Income Category | Coverage (FY 2016) | Coverage (FY 2017) |
|---|---|---|
| Income under $200,000 | 0.65% | 0.59% |
| Income $200,000 and higher | 1.70% | 1.28% |
| Income $1 million and higher | 5.83% | 4.37% |

The number of both field examinations and correspondence examinations conducted in FY 2017 decreased from the prior year, for all categories of individual taxpayers. The overall coverage rate of individuals was 0.62%, which is the lowest coverage rate recorded in the prior ten years.

### IRS Funding and Expenditures

For FY 2017, IRS funding remained at approximately the same level of funding as for FY 2016, $11.2 billion. The FY 2017 funding level, after adjusting for inflation, was lower than the funding level for each of the seven years prior to FY 2015. IRS funding has dropped by $600 million between FY 2010 and FY 2017. Meanwhile, in general, the number of tax returns and other forms filed has increased each year (with the exception of FY 2014).

### IRS Enforcement Staffing Statistics and Trends

Overall, the total number of IRS employees has declined by 17,879 employees over the past seven years (since FY 2010), and the number of permanent IRS employees has decreased by nearly 20% over the same time period. The staffing for the IRS's primary enforcement operations (i.e., revenue agents, revenue officers, and special agents) has continued to decrease, and the staffing levels for these roles are the lowest measured in the past ten years. Specifically, there were approximately 43% fewer revenue officers employed during FY 2017, as compared to FY 2010. Similarly, revenue agent positions have decreased by almost 30% and special agent positions have decreased by almost 22% since FY 2010. These staffing level changes translate to an overall reduction in enforcement personnel of 7,353 from FY 2010 to FY 2017, a decrease of approximately 32%.

### Taxpayer Assistance Program Statistics and Trends

The Data Book and Enforcement Report also reported taxpayer service statistics for FY 2017, which included data on the following items: telephone level of service, toll-free assistance customer satisfaction rate, toll-free tax law accuracy, webpage visits on irs.gov, and online refund status checks.

After a significant drop-off during FY 2015 to 38%, and an increase to 53% during FY 2016, the telephone level of service improved to 77% during FY 2017; this is the highest level of assistor service recorded during the past ten years. As for the toll-free assistance customer satisfaction rate, this has remained relatively steady in recent years, and has only ranged from 87% to 94% over the past ten years. Over time, there has been a slight, gradual improvement in the accuracy of toll-free telephone tax law assistance and, in FY 2017, the percentage of tax law questions answered accurately was 97%, the highest recorded in the prior ten years.

In general, the number of visits to irs.gov has increased steadily over the past ten years; however, from FY 2016 to FY 2017, the number of visits decreased by approximately 5.8 million visits or 1%. In addition, the IRS has observed slightly decreased traffic on its "Where's My Refund" webpage from FY 2016 to FY 2017, where taxpayers can visit to check the status of their refunds; specifically, the use of the IRS's online refund status check tool decreased by 7% from FY 2016 to FY 2017.

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## IRS Office of Chief Counsel Issues Notice to Chief Counsel Attorneys Handling Passport Actions Under IRC § 7345

On April 5, 2018, the IRS Office of Chief Counsel issued Notice CC-2018-055 ("Notice"), providing guidance to Chief Counsel attorneys handling passport actions under Internal Revenue Code ("IRC") § 7345.

The Fixing America's Surface Transportation ("FAST") Act, enacted in 2015, requires the State Department to deny a passport application by any individual that the IRS certifies as having a "seriously delinquent tax debt." In addition, the FAST Act authorizes the State Department to revoke the passport of any individual that the IRS certifies as having a "seriously delinquent tax debt." IRC § 7345(b)(1) defines "seriously delinquent tax debt" as an unpaid, legally enforceable federal tax liability of an individual, and provides that the liability must be assessed and the total liability (including assessed penalties and interest) must exceed $50,000 (indexed for inflation). IRC § 7345(b)(1)(C) further provides that the IRS must have filed a notice of federal tax lien under IRC § 6323 (and the taxpayer's collection due process ("CDP") rights have lapsed or been extinguished) or the IRS must have made a levy under IRC § 6331 with respect to the liability.

IRC § 7345(b)(2) identifies certain liabilities that are excluded from the definition of "seriously delinquent tax debts," including: a liability paid timely pursuant to an installment agreement under IRC § 6159 or an agreement under IRC § 7122 (e.g., offer-in-compromise); and a liability for which collection has been suspended because the taxpayer requested a CDP hearing or innocent-spouse relief. In addition, the IRS has set forth discretionary, non-statutory exclusions to the definition of "seriously delinquent tax debt" in the Internal Revenue Manual. *See* IRM sections 5.1.12.27.4 and 5.19.1.5.19.4.

The Notice clarifies that the IRS will rely on automated systems to identify every module on an individual's account with an unpaid assessed tax liability, and the system will aggregate the amount of unpaid liabilities. If the total of liabilities exceeds the statutory threshold, the IRS will input Transaction Code 971 and Action Code 641 to each module. Next, the Commissioner of the IRS Small Business/Self-Employed Division ("SB/SE") will certify that each identified individual has a seriously delinquent tax debt. The IRS will then send a list of certified individuals to the State Department. The State Department will not issue a new or renewed passport to a certified individual and it may revoke a previously issued passport. The IRS will notify individuals of their certification by issuing Notice CP508C, listing the tax liabilities giving rise to the certification.

The IRS will reverse the certification in the following circumstances: (1) if the certification is found to be erroneous; (2) if the seriously delinquent tax debt is fully satisfied; and (3) if the debt on which the certification is based ceases to be a seriously delinquent tax debt due to an exception. When a certification is reversed, the IRS will post Transaction Code 972 and Action Code 641 to the impacted modules. When all modules meet the criteria for reversal, the IRS will notify the taxpayer and the State Department that the certification has been reversed. The IRS will notify individuals of the reversal of certification by the issuance of Notice CP508R.

In accordance with IRC § 7345(e)(1), an individual who has been certified may bring a civil action in either a federal district court or the Tax Court to determine whether the certification was erroneous or should be reversed. The Notice also clarifies that there will be no judicial review of the amount of the underlying liabilities that constitute a seriously delinquent tax debt. In addition, according to the Notice, the general six-year limitations period will apply, such that an individual will have six years from the issuance of the certification notice to bring an action to determine whether a certification was erroneous when made or six years from the date that the grounds for reversal existed to bring an action challenging whether the IRS failed to reverse a certification. Judicial review will be limited to the IRS's records, and the applicable standard of review is whether agency action (i.e., the certification or the failure to reverse the certification) was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.