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TAX UPDATE

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Todd B. Reinstein
October 2, 2015
CCH Tax Day

"Recent Regulations Address Partnerships with Corporate Partners that Seek to Avoid General Utilities Repeal, IRS Official Says"

QUOTED

Kevin M. Johnson
November 9, 2015
Tax Notes

"Possible Technical Corrections And Regs for Partnership Audits"

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The Game Has Changed: Congress Enacts Changes to IRS Partnership Audit Rules That Could Force Partnerships to Pay Tax

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THE BIPARTISAN BUDGET ACT WILL ALLOW THE IRS TO COLLECT TAXES ASSOCIATED WITH AUDIT ADJUSTMENTS AT THE PARTNERSHIP LEVEL, RATHER THAN PASSING ADJUSTMENTS THROUGH TO THE INDIVIDUAL PARTNERS, EFFECTIVELY IMPOSING ENTITY-LEVEL TAX ON PARTNERSHIPS THEMSELVES.

The recently enacted Bipartisan Budget Act of 2015 (H.R. 1315) is set to overhaul how the Internal Revenue Service (IRS) audits and collects tax from partnerships.

The new law repeals the partnership audit rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the electing large partnership rules. The new legislation will allow the IRS to collect taxes associated with audit adjustments at the partnership level, rather than passing adjustments through to the individual partners. The Bipartisan Budget Act effectively imposes entity-level tax on partnerships themselves.

Although the new law will not go into effect until January 1, 2018, partnerships will undoubtedly feel its repercussions much sooner. It may have a significant impact on how partnership interests are valued, transferred and protected. Partnerships and partners should start planning early to ensure their interests are protected.

The new partnership audit regime applies to all partnerships, regardless of size. Partnerships with 100 or fewer partners may elect out of the new audit rules only if the partners are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or estates of deceased partners (Small Partnerships). If any partner is another partnership or a trust, the partnership may not elect out. Further, if a partner in the partnership is an S corporation, each of the S corporation's shareholders is treated as a partner of the partnership for the purposes of determining whether the partnership has 100 or fewer partners.

Even if a Small Partnership meets the eligibility criteria for electing out of the new audit rules, the opt-out process is burdensome and requires the following:

- The Small Partnership must elect the opt-out on its partnership return each year.
- The Small Partnership must inform each of its partners of the election.
- The Small Partnership must submit the names and taxpayer identification numbers of each of its partners, including S corporation shareholders treated as partners, to the IRS.

Entity-Level Tax

Rather than assessing individual partners, the IRS will assess the partnership for "imputed underpayment," which will be subject to the individual or the corporate tax rate. However, the law allows the IRS and the Department of the Treasury to implement rules that could adjust this rate if a partnership can prove that certain partners are subject to a lower tax rate.

The new law requires the IRS to assess the partnership in the year of adjustment, rather than the year under audit. Thus, it is possible for current partners to be liable for tax reporting that benefited former partners.

To compensate for this possibility, the new law allows for two possible exceptions that can transfer partnership-level tax liabilities back to prior-tax-year partners.

Exception 1

If a partner pays what is owed based on partnership-level adjustments, the partnership's imputed underpayment is reduced accordingly. To take advantage of this exception, persons who were partners for the year under audit, the reviewed year, must file amended tax returns reporting their distributive shares of partnership adjustments and pay all applicable taxes within 270 days of receiving notice of a proposed partnership adjustment. This exception may be difficult to meet, as it requires the partnership to:

- Assess the effects of a series of proposed adjustments.
- Provide conforming statements of adjustment to each partner.
- Persuade the partners, including former partners, to file amended tax returns and applicable payments reflecting the newly issued K-1s, including years indirectly affected by the K-1s.

Exception 2

The second exception requires very prompt action from the partnership. Within 45 days of getting a final notice of a partnership adjustment, the partnership is permitted to elect to issue statements to the partners who were partners during the reviewed year reflecting the distributive share of partnership items as adjusted by the IRS (essentially, issue-amended K-1s for the reviewed year). If this election is made, the partners pay tax in the year that the revised statement (K-1) is issued, but they are charged interest on the underpayment of tax from the year of the adjustment at a rate equal to the "hot interest rate" set forth in Internal Revenue Code section 6621(c).

Partnership Representative

The new law requires partnerships to appoint a person or entity with substantial presence in the United States to serve as the partnership's representative (PR) before the IRS. The PR has the sole authority to act on behalf of the partnership. If the PR is a trust, estate, partnership, association, company or corporation, a responsible person, such as a corporate officer, partner or trustee, must act on behalf of the PR. If a partnership fails to appoint a representative, the IRS is authorized to appoint the PR.

Impact on Partnership Governance and Partnership Agreements

In light of the new audit regime, partnerships should consider including the following in their partnership agreements:

- Rules for electing a PR and restrictions on actions that may be taken by the PR.
- Rules requiring the partnership to notify the partners when an IRS audit commences and to keep them informed about the progress of the audit and any proposed IRS adjustments.
- Information about whether the partnership agreement requires an election out of the entity-level assessment.
- Escrow and indemnification provisions for when partners sell their interests.
- Opt-out provisions for qualifying small partnerships.
- Provisions regarding partner-amended returns.
- Information-sharing provisions to allow partnerships to determine if the ultimate owners are:
    - Corporations
    - Individuals entitled to lower capital gain and dividend tax rates
    - Tax-exempt entities.
- Allocation of tax payments.

The Bipartisan Budget Act will have deep consequences regarding tax planning for partnerships. It is essential to work with a knowledgeable tax attorney to develop optimal strategies that take into account the new audit rules.

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'Facts and Circumstances Mean Everything in Tax' – Separating Transaction and Ordinary Business Costs

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DETAILED RECORDKEEPING AND DOCUMENTATION ASSEMBLING A FACTUAL AND BUSINESS NARRATIVE RELATING TO THE RELEVANT SERVICES AND ASSOCIATED FEES ARE IMPORTANT TO THE ALLOCATION OF COSTS.

For many decades, taxpayers and the Internal Revenue Service (the Service) have worried about how to allocate costs incurred by a business as either "ordinary and necessary" costs, which are deductible under section 162, or costs that must be capitalized. Taxpayers have preferred, in most instances, to categorize a cost as an "ordinary and necessary" expense for a business such that the amount should be viewed as currently deductible by the taxpayer. In determining if specific costs can be treated as "ordinary and necessary" expenses, the Service and the courts have looked to the "origin of the claim" and other factual analyses to determine the specific tax treatment of a specific expense.[1] This concept of examining the origin of an expense and reviewing what the relevant payer received in exchange for its fee is a consistent approach taken in allocating costs between deductible and capitalized categories for federal income tax purposes.[2]

In a recent private letter ruling, Priv. Ltr. Rul. 2015-18-012 (Jan. 26, 2015), the Service addressed the specific issue of whether payments made by a taxpayer pursuant to a termination agreement entered into by the parties of a management agreement were required to be capitalized. In the management agreement, the contemplated services included, in general, ongoing monitoring and business advisory services provided to the taxpayer in an effort to turn around the taxpayer's business and make it profitable. The contract was terminated, and the service recipient was required to make a payment to the service provider. In discussing the origin and the nature of the payment made to terminate the existing management agreement, the Service discussed how the management agreement arose, which service providers were providing the monitoring and business advisory services, and if the termination fees arose because of a corporate transaction.[3] In addition, the Service reviewed information as to whether any of the fees were required to be paid because of work performed in furtherance of a contemplated IPO.

In concluding that the termination payments were not required to be capitalized under section 263, the Service focused on several key facts:

- The management agreement listed several business operational activities that were to be provided to the taxpayer during the term of the agreement.
- The agreements were extended when the original terms expired.
- The agreements were not exclusive, such that the taxpayer was freely able to hire similar third-party advisors as the need arose to provide the same or similar services.
- In arriving at the termination fee, the taxpayer provided comparable information from similar providers undergoing similar transactions and utilized the services of an advisory firm in setting the fee for the termination payment.
- The termination payment was not dependent on a successful IPO because, if the IPO did not occur, the parties could have continued the existing management arrangement or entered into a renegotiated termination agreement.

- The manager did not provide services that were considered to be generally related to an IPO.

- The services were provided in advance of the IPO and related exclusively to “turning around” the taxpayer’s business.

- The taxpayer objectively demonstrated that the turnaround of the business occurred in advance of the IPO.

- Even though the termination payment was made out of proceeds from the IPO, the taxpayer had other funds to pay the amount.

- Specific representations were made by the taxpayer as to the scope, timing and value of the services provided by the manager to the taxpayer; the financial statement treatment of the termination payment and the monitoring payments; and the ability to engage third-party vendors for similar management services.

The very detailed and comprehensive review of the documents and the facts demonstrated that the Service engaged in a taxpayer-specific evaluation in determining whether the payment of the termination fee was required to be capitalized. This detailed taxpayer specific-evaluation is extremely helpful to taxpayers in other situations that are facing the decision of whether a specific fee is deductible or must be capitalized. It indicates that not every fee paid on or around a corporate transaction must be viewed as related to the transaction, but can be explained as a routine expense if, in fact, the services provided to the taxpayer (or others) were for the benefit of the taxpayer’s ongoing business. In the private letter ruling, the Service did not merely look at the present transaction, an IPO, and the source of the payment for the termination fee, *i.e.*, the proceeds from the IPO. Rather, the Service took a significant amount of time reviewing agreements, third-party documentation and the taxpayer’s unique situation and factual descriptions to step away from a “knee jerk” reaction of capitalization because it was close in time with an IPO, and found that the facts supported deductibility. The taxpayer was able to demonstrate that the termination fee was associated with its ordinary business operations and, thus, was eligible for deductibility under section 162.

Pepper Perspective

Private letter ruling 2015-18-012 validates the long-held judicial doctrine of “origin of the claim,” which continues to have specific applicability as taxpayers and the

Service seek to allocate costs incurred in and around corporate transactions as deductible or capitalizable. Therefore, detailed recordkeeping and documentation assembling a factual and business narrative relating to the relevant services and associated fees are important to the allocation of costs. Such detailed recordkeeping and information will assist taxpayers in identifying costs that can be deducted, regardless if they are paid in or around a corporate transaction.

Endnotes

1 *United States v. Gilmore*, 372 U.S. 39, 49 (1963). *See also Ellis Banking Corp. v. Comm'r*, 688 F.2d 1376 (11th Cir. 1982) (holding accounting fees incurred to investigate the financial condition of a corporation in preparation for a proposed stock acquisition to be capital expenditures, while the costs associated with the performance of the taxpayer's regular audit functions were deductible).

2 *Id.*

3 In analyzing the fees and the taxpayer's documentation, the Service reviewed the capitalization regulations, Treas. Reg. §§ 1.263(a)-4, 1.263(a)-5, and discussed the rule as to allocation in general by citing *A.E. Staley Manufacturing Co. v. Commissioner,* 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995).

Pepper Hamilton Private Funds

Joan C. Arnold recently spoke at the "Pepper Hamilton Private Funds" event hosted in the firm's New York office. Ms. Arnold's presentation covered "Select Cross Border Tax Issues in Funds: U.S. Sponsored Funds Investing in Europe, Non-U.S. Persons Investing in U.S. Funds." A copy of the PowerPoint is available at http://www.pepperlaw.com/events/pepper-hamilton-private-funds-event-2015-11-16/.

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California Court Upholds Payroll Tax Withholding on Back Pay and Front Pay Judgment

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THE OPINION ADOPTS WELL-ESTABLISHED FEDERAL LAW AND OVERTURNS A 22-YEAR-OLD CALIFORNIA CASE THAT HELD THAT WITHHOLDING WAS NOT REQUIRED.

Everyone knows that, when an employer pays wages to an employee, the employer must withhold federal and state income taxes and social security (FICA). But what happens when a terminated employee receives an amount from the employer as a result of a lawsuit involving wrongful termination or discrimination? Does it matter if the lawsuit involves back pay or front pay? Is there a difference if the payment is the result of a settlement or a judgment? What if state law clashes with federal law?

These questions have been fairly well settled under federal law for a number of years, and withholding is required. However, California only recently adopted the federal law in *Cifuentes v. Costco Wholesale Corp.*[1] There, the Court of Appeals of California overturned the lower court and declined to follow a 22-year-old California case that had held that withholding was not required.

In *Cifuentes*, a dispute between Costco and its former employee Carlos Cifuentes resulted in a judgment in favor of Cifuentes after a jury trial. The dispute stemmed from Cifuentes' report to his supervisor that he observed a manager hugging a female employee. Six months later, the manager reported that he saw Cifuentes sipping a beverage sold by Costco without paying for it. Costco fired Cifuentes for violating its policy against food consumption. Cifuentes sued for wrongful termination/breach of contract.

At trial, the jury awarded him $28,125 for past wages and $273,253 for future wage loss. When Costco paid the judgment, it withheld $116,150.84 in payroll taxes from the $301,378 attributed to lost wages. Costco informed Cifuentes that it had fully satisfied the judgment and demanded that Cifuentes acknowledge full satisfaction. Cifuentes disputed the withholding, claiming that Costco should have paid him the full judgment amount, issued Form 1099, and allowed him to pay any taxes due directly to the taxing authorities. The amount in controversy was reduced when Cifuentes received tax refunds from the Internal Revenue Service (IRS) and from California. At that point, Costco again demanded that Cifuentes acknowledge satisfaction of the judgment, which Cifuentes refused to do. Costco then asked the court for an acknowledgement of the satisfaction of judgment.

Cifuentes based his position on *Lisec v. United Airlines, Inc.*,[2] which held that an employer is not required to withhold payroll taxes from an award of lost wages to a former employee. Believing that it was bound by *Lisec*, the trial court ruled that the withholding was improper and denied Costco's motion for acknowledgment of satisfaction of the judgment. On appeal, the California Court of Appeals overturned the trial court. It ruled in Costco's favor that lost past wages and lost future wages are subject to withholding, in effect overruling *Lisec*.

In support of Costco's argument that the payments to Cifuentes were wages on which it had to withhold, Costco alleged that a failure to withhold could mean that it would have to pay twice by paying the judgment and also paying the taxes. The appeals court agreed, noting that an employer that fails to withhold taxes from an award of back or front pay to a former employee exposes itself to penalties and personal liability for those taxes. Therefore, the court declined to follow *Lisec* and instead adopted the prevailing federal law requiring withholding.

When *Lisec* was decided in 1992, there was limited law on the scope of "wages" for tax purposes. The plaintiffs in *Lisec* had prevailed on a wrongful termination claim and obtained an award of back and front pay. Their former employer withheld payroll taxes, claiming that the award constituted wages under federal and state law. When the plaintiffs asserted that the judgment was not satisfied, the employer moved for an acknowledgment of satisfaction of judgment. The trial court in *Lisec* denied the motion, finding that the employer lacked the authority to unilaterally reduce the judgment by withholding taxes. In affirming the decision, the court of appeals distinguished the case on the basis that the employees had not been reinstated. According to the court, as a result of failing to be reinstated, the award did not constitute remuneration for services performed and, therefore, was not wages for purpose of withholding.

The court of appeals in *Cifuentes* observed that, in the years since *Lisec*, numerous federal courts have considered whether back or front pay to a non-reinstated employee is subject to income and FICA taxation and withholding. The IRS view of wages is expansive, as is the view of the courts. In Revenue Ruling 72-572, [3] the IRS stated that remuneration for employment constitutes wages, even though the individual is no longer an employee at the time of payment. The IRS' position is that judgment and settlement payments for front and back pay (other than lost wages on account of personal injury or sickness) are subject to income and FICA tax withholding and are reportable as wages on a Form W-2, rather than as non-wage income on a Form 1099-MISC.[4] With the exception of the U.S. Court of Appeals for the Fifth Circuit in *Dotson v. United States*,[5] federal courts have adopted the broad definition of wages established in *Social Security Board v. Nierotko*.[6] There, the U.S. Supreme Court held that an award of back pay to a wrongfully terminated employee constitutes wages for social security purposes. The Court rejected the argument that the award did not qualify as wages because no services had been performed and held that the term "service performed by an employee" means not only work actually done, but the entire employer-employee relationship for which compensation is paid. In *Gerbec v. United States*,[7] for example, the U.S. Court of Appeals for the Sixth Circuit concluded that a portion of a settlement award of back and front pay in a class action brought by former employees against Continental Can Company was subject to both income and FICA taxes. [8]

Cifuentes contended that these cases were distinguishable from his case because they involved a settlement of claims, rather than a judgment. However, he could cite no case law suggesting that an award of back or front pay should be treated differently for tax purposes because it arose from a judgment rather than a settlement.

The *Cifuentes* court noted that, when Costco paid the judgment, it had two alternatives. It could follow *Lisec* and risk liability to the IRS and other taxing authorities for the amount of tax it failed to withhold plus penalties. Alternatively, it could follow the prevailing federal view by withholding and risk a judicial declaration that that judgment was not satisfied. Costco chose the latter course, and the court concluded that it chose correctly. Costco therefore had paid Cifuentes the full amount of the judgment.

Cifuentes did not demonstrate that his award of lost wages was exempt from income and FICA or that he was entitled to reimbursement of these taxes. His own financial expert testified that his award would be subject to FICA and state disability withholding. The appeals court agreed with Costco that, if the courts do not consistently apply the definition of “wages” for taxation and withholding purposes, employers and employees will have a difficult time understanding when payroll taxes must be withheld from judgments and settlements. The court noted that, by adopting the prevailing federal view, it ensures that California employers that withhold taxes from awards of lost wages are not subject to penalties. The court further pointed out that plaintiff employees have a remedy from over-withholding in the form of a refund from the taxing authorities.

Pepper Takeaways

In any employment tax dispute, employers should consider the amount subject to payroll tax withholding. In a settlement, this subject should be negotiated before a settlement figure is reached to avoid disputes about whether the settlement amount was net of withholding. The parties’ agreement should be documented in a settlement agreement. It may be appropriate to allocate some portion of the settlement to non-wage categories, *e.g.*, pain and suffering or attorneys’ fees, in which case that amount of the settlement will be reported on Form 1099 and will not be subject to withholding. Withholding is required whether the payment is received as a result of a settlement or as a judgment. If there is a misunderstanding about withholding, the parties may need to go to court again to wrangle over withholding tax, which certainly should be avoided.

Endnotes

1 No. B247930, 2015 Cal. App. LEXIS (June 26, 2015).

2 10 Cal App. 4th 1500 (1992).

3 1972-2 CB 535.

4 Office of Chief Counsel IRS Memorandum, UILC: 61.00-00, 3101.00-00, 3111.00-00, 3402.00-00, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (Oct. 22, 2008).

5 78 F.3d 682 (5th Cir. 1996).

6 327 U.S 358 (1946).

7 164 F.3d 1015 (6th Cir. 1999).

8 The Fourth and Eighth circuits reached the same conclusion in two other Continental settlement cases. *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997); *Mayberry v. United States* 151 F.3d 855, 860 (8th Cir. 1998).

AUTHORED

Kevin M. Johnson
November 3, 2015
ABA Tax Section to IRS
"Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Partnership Audit and Legislation Reform"

INTERVIEW

Jennifer A. O'Leary
November 30, 2015
Law360
"Pepper Hamilton Nabs Klehr Harrison Tax Pro in Philly"

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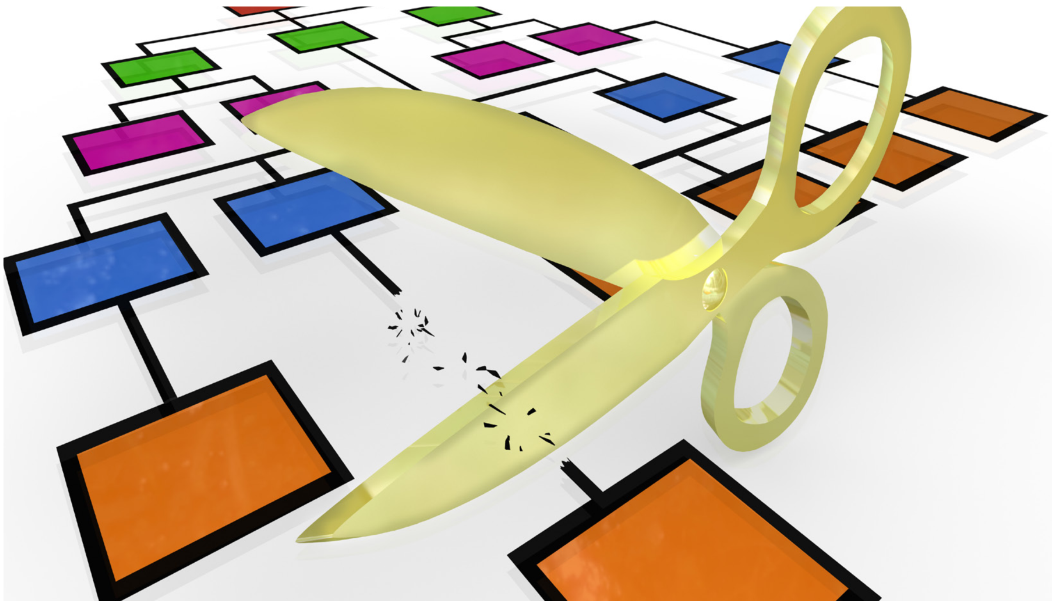
IRS Restructuring LB&I Division and Audit Process Again



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THE CHANGES INCLUDE A MOVE TOWARD MORE ISSUE-FOCUSED AND EFFICIENT AUDITS, WHICH SHOULD BENEFIT BOTH THE IRS AND ITS TAXPAYERS.

It seems like the Internal Revenue Service (IRS) reorganizes its Large Business and International (LB&I) Division every few years, changing its audit priorities and the manner in which its revenue agents are expected to conduct audits.

In large part, the IRS has been forced to rethink its priorities due to substantial budget cuts and increased responsibilities, including responsibilities for supervising compliance with employer health insurance mandates under the Affordable Care Act.

On September 17, 2015, Douglas O'Donnell, IRS Commissioner of LB&I, announced the latest round of changes. The IRS is attempting to redevelop its large-case audit program to perform more efficiently in an era when the IRS's resources are limited.

To that end, the IRS will be ending the Coordinated Industry Program, under which large corporations are audited for each tax return that they file in two- or three-year cycles. The IRS has indicated that the change in the program does not mean that continuous audits of large corporations will be completely eliminated, but rather that the number of such audits is likely to diminish and the focus of the IRS's examinations will change.

The IRS also indicated that it is attempting to develop more issue-focused and efficient IRS audits. Under this approach, an IRS examination team might have three or four core issues identified at the start of an audit of a large company, rather than conducting a more comprehensive review of the company's books and records to identify issues.

The IRS will restructure LB&I into an anticipated nine "practice" areas, which will be organized geographically as well as by subject matter. The practice areas will include (1) pass-through entities, (2) financial institutions and products, (3) corporate tax, (4) cross-border activities, (4) withholding and international tax compliance and (5) transfer pricing and tax-treaty compliance.

One way in which LB&I plans to create more issue-focused and limited audits is to develop audit "campaigns." It appears that LB&I, through its practice groups and the work of its revenue agents in the field, will identify areas of noncompliance and then will focus on those types of "campaign" tax issues in industries in which the issues are likely to be present.

The news that IRS LB&I exam teams will be conducting more focused and efficient IRS audits is certainly welcomed by large taxpaying entities as well as their advisors. IRS audits involving detailed examinations of a taxpayer's books and records to identify issues required a great deal of internal and external resources to manage. Companies and their tax advisors will welcome audits that are limited to a smaller number of key issues and that can be completed in more reasonable time frames.

The IRS has yet to provide, however, the details of the new program and the processes that will be used to develop the IRS LB&I campaigns. If the IRS uses its resources to develop thoughtful campaigns that identify significant tax issues, and if the LB&I "campaign" audits are limited to those companies and taxpayers that have a substantial risk of noncompliance in areas and issues identified by the IRS campaigns, LB&I's restructured organization and refocused audit strategy might help streamline the audit process for large companies and benefit both the IRS and the LB&I constituent taxpayers.

Recent Additions to Tax Practice

Jennifer A. O'Leary has joined the firm as a partner, resident in the Philadelphia office.

O'Leary's practice focuses on the federal income tax aspects of pass-throughs, private investment funds, domestic and international mergers and acquisitions, dispositions, corporate tax restructuring, real estate mortgage investment conduits, and real estate investments trusts. Prior to joining Pepper, O'Leary was a partner with Klehr Harrison Harvey Branzburg LLP, and previously was counsel at Dechert. She is chair of the Tax Section of the Philadelphia Bar Association.

O'Leary is a 1998 *summa cum laude* graduate of Villanova University School of Law, where she was associate editor of the *Villanova Law Review* and a member of the Order of the Coif. She graduated from the University of Chicago in 1990.

Annette M. Ahlers has joined the firm as of counsel in the Los Angeles office.

Ms. Ahlers rejoins Pepper Hamilton from Moss Adams LLP, where she served as a principal in the firm's National Tax Practice Group. Prior to her time at Moss Adams LLP, she spent eight years at Pepper as partner in the Tax Practice and nine years at Ernst & Young LLP in the national office and as the lead partner in charge of M&A tax services for the Mid-Atlantic area. Ms. Ahlers joined Ernst & Young after four years in the Corporate Division of the Associate Chief Counsel at the Internal Revenue Service National Office in Washington, DC.

Ms. Ahlers' practice focuses on providing guidance to large and mid-sized companies on corporate tax matters. She has experience in various areas of tax planning and advisory services, including advising companies in M&A transactions and tax structuring, determining availability of net operating losses, tax issues associated with formation and liquidation of corporations, identifying capitalization and deduction opportunities, bankruptcy tax issues and applying for and receiving private letter rulings from the IRS.

Ms. Ahlers is a graduate of Georgetown University Law Center, where she received her LL.M. In addition, she received her J.D. from California Western School of Law and B.A. from the University of Washington.

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** Ms. Klinzing is admitted to practice in Georgia (she is not admitted in Pennsylvania).*

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