



BBA AUDITS AND RECENT EXAM TRENDS

Key Developments and Recent Experiences

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Today's Speakers



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Mark is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, digital assets, insurance products, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Mark frequently works the clients addressing Internal Revenue Service inquiries and controversies. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then at Weil Gotshal.



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Miri Forster is a Partner and National Leader of the Tax Controversy & Dispute Resolution practice at Eisner Advisory Group LLC. Miri specializes in providing tax dispute resolution services to public and private corporations, partnerships and high net worth individuals on a wide range of technical and procedural issues. Miri represents businesses and high net worth individuals before the IRS Examination and Appeals Divisions on complex domestic and international tax issues. She also obtains private letter rulings from the IRS National Office, including 9100 relief requests for missed elections. Miri consults on the Centralized Partnership Audit Regime, assists clients with voluntary disclosures of inadvertent income, international information return, withholding, and payroll tax compliance errors, obtains penalty abatements and refunds, resolves IRS account issues, and advises on a broad range of IRS practice, procedure and dispute resolution matters. Prior to joining the firm, Miri was a Tax Controversy Principal at a Big 4 firm. Miri also previously served as an Attorney-Advisor at the United States Tax Court in Washington, D.C.

IRS AUDIT ACTIVITY OF PARTNERSHIPS IS INCREASING

The IRS Seeks to Increase Partnership Audit Adjustments



- Historically, 4 of 5 large partnership audits end with no change
- In October 2023, LB&I Commissioner Paz announced that the IRS is seeking to conduct “more productive exams” that will find a greater number of partnership items for adjustment
- LB&I has created a dedicated team for auditing large partnerships.

LB&I Has Created a Task Force to Audit Large Partnerships



- IRS will audit the 75 largest partnerships filing US federal income tax returns
- Compliance letters will be sent to 500 large partnerships with “balance sheet discrepancies”
- To implement this new initiative, LB&I has formed the “mega passthrough organization” unit
- Clifford Warren IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) has warned about IDR noncompliance

LB&I Has Updated Its Audit Procedures for BBA Audits



- LB&I-04-0223-001 updates the Internal Revenue Manual (4.31.10) for audits of partnerships subject to the BBA (BBA Exam Field Support Operation Procedures)
- Guidance provides rules for obtaining information, statute of limitations extensions and issuing NOPAs
- Audit procedures also apply to Chapter 2 (NESE & NIIT) assessments.
- In practice, we're seeing demands for very extended SOL extensions issued or threats of assessment

IRS Reorganization



New leadership structure in early 2024

- Updates existing organizational structure in place since 2000
- New structure has one deputy commissioner + 4 chief executives to report to IRS Commissioner Werfel. Positions to serve across all divisions
 - Chief, Taxpayer Services
 - Chief Taxpayer Compliance Officer
 - Chief Information Officer
 - Chief Operating Officer

Enforcement is in the IRS Crosshairs

NESE Statutory Scheme

- Code § 1402(a)(13) provides an exception from all 3 components of the net earnings from self-employment (NESE) for limited partners.
- Total tax burden is 3.8%.
- In 1997, the IRS proposed a functional analysis test to determine if a partner should be treated as a limited partner.
- Congress imposed a one-year moratorium on these regulations and the IRS never attempted to re-propose them.

Enter the NIIT



- Effective in 2013, Net Investment Income Tax (NIIT) picks up where the NESE leaves off.
- 3 Categories of income subject to NIIT:
 - Dividends, interest & rents unless derived in trading securities or commodities or a business that is a passive activity
 - Other income derived in trading securities or commodities or a passive activity
 - Gain from the disposition of property if derived in trading securities or commodities or a passive activity

IRS Audit Campaign on LP Exception



- In 2018, the IRS began audit campaign against LPs claiming the LP exception.
- Monique Gabel of LB&I stated that new audits had ceased in September 2023 as existing cases wound their way through the courts
- IRS selected hundreds of partnerships for SECA audits, with a particular focus on those operating in the asset management, financial services, private equity, and hedge fund industries.
 - Soroban Capital Partners LP (Dkt. Nos. 16217-22)
 - Denham Capital Management LP (Dkt. No. 9973-23),
 - Point72 Asset Management LP (Dkt. No. 12752-23).

Litigation Ensued Over Limited Partner-Like Structures



- Renkemeyer, Campbell & Weaver, LLP – attorney partners in limited liability partnership (LLP) denied limited partner status
- Howell – limited partner in LLP denied LP status even though she made a capital contribution and performed only limited bookkeeping duties
- CCA 201436049 – Members of a hedge fund GP in limited liability company (LLC) form denied LP status even though they received compensation subject to NESE and made substantial capital contributions. CCA 201640014 (same for pres of franchise restaurant)
- Hardy – Plastic surgeon member of LLC treated as an LP when he had no role in management
- Castigliola – attorney-partners in PLLC not treated as LPs despite substantial guaranteed payments subject to NESE

When Income Earned Thru an LP Interest Is Not Passive Activity Income



- Limited partners can be treated as materially participating, and therefore LP income will not be treated as passive under one of 3 tests:
 - The individual participates in the activity for more than 500 hours during such year.
 - The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.
 - The activity is a “personal service activity” and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.

Summary Judgment Decision in Soroban Capital Partners



- 2016 & 2017 before court, but court did not address NIIT issues.
- Soroban was engaged in managing an investment partnership. It had 3 limited partners (having converted from an LLC in 2015).
- Each partner received a guaranteed payment for services (& paid NESE on the guaranteed payment) and a share of partnership income through holding the LP interest.

Court Analysis of LP Exception in Soroban



- Court read legislative history as excluding “earnings that are of an investment nature.”
- Court noted that proposed regulation would have excluded LPs that worked 500 hours or more per year for partnership.
- Court ignored Senate action that enacted moratorium on proposed regulations and choose to focus on its view of the legislative history

Soroban Court Initiates Functional Analysis Test



- Taxpayers argued that since they were limited partners under state law, they were entitled to LP exception
- IRS, and court, asserted that a functional analysis must be applied.
- Court supported its position by focusing on the two words following the phrase LP: “limited partner, *as such*.”
- Court did not discuss the fact that LPs were paid reasonable compensation as guaranteed payments for their services.

Soroban Capital and the NIIT



- Decision effectively precludes social security tax relief for limited partners who have not retired
- If LP satisfies 500 hour participation rule, it is likely that LP will be subject to NESE on LP allocation, even if LP is separately compensated for services.
- If LP provides less than 500 hours of service, then LP is likely to be subject to NIIT on its distributive share of partnership income.
- Pathway may still exist for retired LPs who were subject to NESE on distributive share of income in prior years.

Other Recent IRS Exam Trends

Sale of a Partnership Interest

Sale of Partnership Interest Compliance Campaign

- Announced in 2018, addresses taxpayers who do not report the sale or do not report the gain or loss correctly
- Incorrect reporting may include the gain or loss amount or reporting the entire gain as long-term capital gain (usually 15 percent). Often, a portion of the gain is ordinary gain or taxed at the 25 percent or 28 percent long-term capital gain rates (if the partnership depreciated real property or has appreciated collectibles at the time of the sale or exchange, higher capital gain rates may apply). If the partnership has inventory items or unrealized receivables at the time of the sale or exchange, a portion of the gain or loss will be ordinary gain or loss.

Sale of a Partnership Interest (cont'd)

- IRS issues practice unit and video with comprehensive case study
- *Rawat v. Commissioner*, No. 23-1142 (D.C. Cir. 2023), which appeals the Tax Court decision in T.C. Memo. 2023-14.
 - U.S. Tax Court: Gain recognized by an NRA partner on the sale of an interest in a US partnership, that was attributable to inventory items, may be treated as U.S. source income subject to U.S. tax.

Losses in Excess of Partner's Basis

- Partnership losses in excess of partner's basis campaign announced in 2022
- Partners that report flow-through losses from partnerships must have adequate outside basis as determined pursuant to IRC § 705 to deduct the losses or else the losses are suspended per § 704(d) to the extent they exceed the partner's basis in the partnership interest.
- Partnership adjustments are subject to Centralized Partnership Audit Regime procedures



Section 457(f) and Section 1256 Contracts

- IRS audit initiatives seek to determine whether partnerships are eligible for mark-to-market election
- In depth examination of when gains are eligible for 60/40 treatment.

Centralized Partnership Audit Regime— Partnership Examinations



- NOPPA issued by centralized unit, not by the examiner.
- NOPPA starts the 270-day modification period
- Modification Requests (Form 8980)—
 - Must register to use online system, submissions are case sensitive
 - Approval of extension of 270-day period (Form 8984) must be received before expiration of the 270-day period.
- Cash deposits permitted to stop the running of interest
 - Don't forget about the +2% interest toll if an adjustment is pushed out.



Centralized Partnership Audit Regime--AARs

- Administrative Adjustment Requests
 - IRS efile system is currently closed, paper filed AAR requires different forms.
 - Due date for issuing Forms 8986 push out statement
- Modification Request by the LTP only (Form 8980)
 - Must register to use online system, submissions are case sensitive
- No +2% interest toll with push out of an AAR adjustment



Thank You!