// THE ELITE QUARTERLY – Taxation //

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Thank you for your ongoing support of *The Elite Quarterly*. Please refer to pages 22 and 23 for details of all of our subscription packages for 2018 in case you wish to purchase prior quarterly newsletters and course bundles. Testing online at our website is more convenient than ever. CPElite will be announcing some exciting changes for 2019 so please stay tuned for a future announcement! Thank you for being a customer – we appreciate your business! We would like to wish you and your family a very Happy Holiday from all of us at CPElite!

What's Inside This Issue

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Instructions, Content Level, & Learning Objectives

Read the content on pages 1-17, the exam questions on pages 18-20, and the exam instructions on page 21. Select the best answer for each exam question and record the answers either on the answer sheet on page 21 or online at www.cpelite.com. This edition of the *Elite Quarterly* addresses a number of IRS regulations issued in 2018. We are also devoting significant attention on the topic of the Centralized Partnership Audit Regime which, in our estimation, has garnered little attention given the magnitude of these changes. The content level for this course material is "Update" and field of study classification is "Taxation". A general understanding of federal income taxation is the prerequisite for this course. No advance preparation is required. The ***Learning Objectives*** for this course are:

1. Recall the calculation of the "imputed underpayment" in accordance with CPAR.
2. Identify eligible and non-eligible partners for opting out of the Centralized Partnership Audit Regime.
3. Recall the powers that a Partnership Representative has.
4. Recall recordkeeping requirements associated with the Earned Income Tax Credit.
5. Recall the deductibility limits for meal and entertainment expenses upon passage of the TCJA.
6. Identify court cases impacting nexus issues for taxpayers with multi-state physical presence.

Key Terms in This Issue of *THE ELITE QUARTERLY*

[Item 1] *Eligible Partner:* Any person who is an individual, C corporation, eligible foreign entity, S corporation, or an estate of a deceased partner in connection with elections out of CPAR.

[Item 1] *TEFRA:* Tax Equity and Fiscal Responsibility Act of 1982.

[Item 1] *Push-Out Method*: Alternative to the imputed underpayment calculation of the Centralized Partnership Audit Regime in which the partnership communicates all audit adjustments at the partner level and then all partners would compute the extra tax for the audit year in question. Additionally the tax would be reported in the tax year the adjustment is received and not the audit tax year subject to the adjustment.

[Item 3] *Additional Child Tax Credit:* A refundable child tax credit generally calculated using the "earned income formula" up to a maximum of $1,400 per qualifying child.

[Item 4] *Qualified Opportunity Fund (QOF):* An entity treated as a partnership or corporation for Federal tax purposes and organized in any of the 50 states, D.C. or five U.S. territories for the purpose of investing in qualified opportunity zone property.

[Item 5] *__Backup Withholdings:__* Tax levied on income at an established rate to ensure that governments are able to receive tax owed to them from taxable income.

[Item 6] *__Entertainment Expense:__* In the context of Section 1.274-2(b)(1)(i) of the income tax regulations provides that the term "entertainment" means any activity which is of a type generally considered to constitute entertainment, amusement, or Recreation

[Item 8] *__Due Process:__* the administration of justice to safeguard from arbitrary denial of life, liberty, or property by a government outside the sanction of law

[ITEM 1] Centralized Partnership Audit Regime

Practitioners who work closely with partnerships should note that final and proposed regulations have been issued during 2018 which will impact clients and practitioners on a grand scale. The Centralized Partnership Audit Regime (CPAR) materially changes the method by which partnerships will be taxed in the event of an audit. We will devote substantial time in this newsletter analyzing these new regulations: Proposed Reg 136118-15 – Centralized Partnership Audit Regime, Final Reg TD 9829 - Election Out of the Centralized Partnership Audit Regime, and Final Reg TD 9839 - Partnership Representative Under the Centralized Partnership Audit Regime and Election To Apply the Centralized Partnership Audit Regime.

__Legislative History of CPAR__

The proposed regulations (136118-15) affect partnerships for taxable years beginning after December 31, 2017, as well as partnerships that make the election under the Bipartisan Budget Act of 2015 (BBA), to apply the centralized partnership audit regime to partnership taxable years beginning on or after November 2, 2015 and before January 1, 2018.

The BBA overhauled the manner in which partnerships are audited and how any resulting tax liability is computed, assessed and collected. Before the BBA, a partnership audit generally was conducted in accordance with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which did not provide any statutory mechanism for collecting income tax at the entity level. Rather, the IRS generally had to seek payment of underpaid tax directly from the partners that would have owed such tax had the partnership properly reported the items on its tax return. The BBA adopted a new regime that allows for assessment and collection of tax at the partnership level under centralized audit procedures, along with a number of other changes to the partnership audit process.

These new proposed regulations withdraw, to the extent not already finalized, the proposed regulations issued in June 2017, November 2017, December 2017 and February 2018. Nonetheless, the IRS states that the "Explanation of Provisions" sections of the withdrawn proposed regulations remain relevant, and the new proposed regulations incorporate them by reference to the extent not inconsistent with the rules therein or with rules otherwise already finalized.

Final Reg TD 9829 - Election Out of the Centralized Partnership Audit Regime is effective Jan 2, 2018 and contains final regulations regarding the implementation of certain portions of section 1101 of the Bipartisan Budget Act of 2015 (BBA), which was enacted into law on November 2, 2015. Section 1101 of the BBA repeals the current rules governing partnership audits with CPAR. These final regulations address electing out of the centralized partnership audit regime, and affect partnerships for taxable years beginning after December 31, 2017.

Final Reg TD 9839 - Partnership Representative Under the Centralized Partnership Audit Regime and Election To Apply the Centralized Partnership Audit Regime addresses the designation and authority of the partnership representative under CPAR. These final regulations also affect partnerships for taxable years beginning after December 31, 2017. This document also contains final regulations and removes temporary regulations regarding the election to apply the centralized partnership audit regime to partnership taxable years beginning after November 2, 2015 and before January 1, 2018 under section 1101(g) (4) of the BBA. These final regulations affect partnerships for taxable years beginning after November 2, 2015 and before January 1, 2018."

We'll break down the elements contained in these proposed and final regulations and step through examples of common issues we will encounter this tax season. First, we'll answer the question of IRS and Congressional intent. For years, the IRS has experienced impactful budget cuts and according to John Koskinen, former IRS commissioner, expressed that the IRS "….will do less with less". Data from a study conducted in 2012 revealed that the IRS had audited 27% of large corporations but only .8% of partnerships. What is driving this difference? On balance, partnership tax returns are very complicated and consume significant time and resources during an audit. Coupled with the results of this study was Congressional distaste for raising taxes. Respective leaders from each party convened to devise a solution which evolved into the Centralized Partnership Audit Regime (CPAR).

So what is CPAR? Simply stated, in the event of a partnership audit (and audit deficiency) a tax is applied at the partnership level at the *highest tax rate* much like an audit of a C Corporation. The tax applied at the partnership level is called the "Imputed Underpayment". The audit deficiency adjustment is not passed thru to individual tax partners. CPAR is projected to allow more audits of partnerships and bring an additional forecasted increase of over $9 billion in tax revenue (with altering tax rates). The burden of work shifts from the IRS to the tax practitioner and to the client. The IRS benefits from fewer forms and administrative proceedings (one partnership versus individual audits of each partner).

Practitioners and partnerships should look to opt out of CPAR and avoid these imputed underpayments (we'll discuss these alternatives to CPAR momentarily). Several compelling reasons include:

- Tax is applied at the highest rate versus tax occurring at lower nominal rates for each partner.
- The Qualified Business Income Deduction (Section 199A) is not allowed to be applied to this Imputed Underpayment under CPAR.
- Consider that approximately 50% of partnership tax returns are either real estate or leasing companies. These partnerships typically have many passive investors who may have suspended passive losses. Suspended losses at the partner level cannot be used to offset audit adjustments under CPAR at the partnership level.
- Similarly capital losses and carryovers at the partner level cannot be used to offset capital gain income that may result from an audit adjustment at the partnership level.

The IRS also asked Congress asked for one partnership representative. This individual is known as the Partnership Representative (PR) and as we will show in detail later in this discussion, that this person has greater powers and responsibilities than a partnership Tax Matters Partner (TMP).

Congress, however, has incorporated relief in this new regime realizing that this new set of rules could provide issues for taxpayer. As such taxpayers can explore one of three options available.

- Option 1 - Electing out of CPAR entirely.
- Option 2 - Amending tax returns (pull-in procedure)
- Option 3 - "Push out" election.

Before we examine these options, let's look at the following examples which illustrate the calculation of the Imputed Underpayment within CPAR.

Example – Florida Condo LLC is a rental real estate LLC. In 2018, the partnership is audited and assessed a rental income deficiency of $50,000. Under CPAR this LLC would pay a tax of $18,500 (top tax rate of 37%) plus interest and penalty. Consider the outcome if one of these individual partners had substantial passive loss carryovers totaling the amount of the income deficiency assessed? They would owe no additional tax and avoid interest and penalties if CPAR did not apply.

Example – The Crusty Crab LLC is a restaurant and audited in 2018. Income was increased by $100,000 as a result of the audit. If the LLC is subject to CPAR, then the LLC would owe $37,000 (top tax rate) + interest, and penalty. However, let's assume that the individual partners are in the 24% tax bracket. Additionally, the Qualified Business Income Deduction (Sec. 199A) could be utilized to offset the additional income resulting from the audit (20% deduction). If this additional audit income flowed thru to each individual partner, the result tax would only be $19,200 ($100,000 x 24% x 80% (net after QBID) = $19,200). The difference is striking. Nearly half of the tax could be avoided by opting out of CPAR.

What about the Net Investment Income tax (NIIT) and Self Employment Tax (SE)? Are these taxes paid at the partnership level? The answer is no, but according to the IRS (§6241(a)(9)(A) and JCX-6-18, the IRS has the authority to pursue individual partners for NIIT and SE tax.

Absent any changes in these regulations, prevailing wisdom dictates that taxpayers will want to opt out of CPAR. We'll now take a look at the options available to avoid CPAR.

<u>Option 1 - Electing out of CPAR entirely</u>

Section 301.6221(b)–1 outlines the rules regarding the ability of a partnership to elect out of the centralized partnership audit regime, including prescribing the time, form, and manner for making the election. A partnership is eligible to elect out of the centralized partnership audit regime if the partnership has:

- 100 or fewer partners for the taxable year, and
- All of the partners are eligible partners.

A partnership is deemed to have 100 or fewer partners for the taxable year if it is required to furnish 100 or fewer statements under section 6031(b). Section 6031(b) generally requires a partnership to furnish a statement to each person that is a partner in the partnership during the partnership taxable year regarding that partner's interest in the partnership for such year. Also note that if you have, for example, an S corporation as a partner, you would count the K-1's the S corporation issues to shareholders and you would have to count all shareholders in the S-Corporation.

What if a pass-through entity or disregarded entity is a partner in the partnership? The partnership is then required to furnish a statement to that pass-through entity or disregarded entity. Additionally, if two individuals are partners in a partnership, the partnership is required to furnish a statement under section 6031(b) to each of those individuals, regardless of whether they are married to one another.

Eligible Partners for purposes of electing out of CPAR would include:

- Individuals
- C corporations
- Foreign entity that would be treated as a C corporation if it were a domestic entity
- S corporations
- Estate of a deceased partner

Partners who would not be eligible and invalidate the CPAR opt out election include:

- Partnerships
- Trusts
- Disregarded entities (i.e. Single Member LLC)
- Nominees or other similar persons that hold an interest on behalf of another person
- Estates other than the estate of a deceased partner

Having just one partner considered as an ineligible partner would prevent the partnership from making this opt out election.

Example – LLC has 75 partners, 74 of which are individuals and 1 is an S-Corp. The S-Corp has 10 shareholders. All shareholders are considered "eligible". For purposes of this elect out calculation, the partnership (LLC) is deemed to have 85 partners. 75 partners are direct partners and 10 shareholders from the S-Corp. This entity could elect out of CPAR since all partners are "eligible" and the total is less than 100 partners.

Example – Trio LLC has 3 members. Two of the members are individuals and one is a disregarded entity. The disregarded entity is a single member LLC. Trio LLC would not be able to elect out of CPAR because the single member LLC is an ineligible partner.

Example – Boardwalk LLC has 2 members. An individual and a grantor trust (living trust). The grantor trust would make the LLC ineligible to make the-opt out election.

The regulations provide that an election out of the centralized partnership audit regime must be made with the eligible partnership's timely filed return, including extensions, for the taxable year to which the election applies, and, once made cannot be revoked without the consent of the IRS. Also, amending the tax return before the due date (including extensions) would qualify. This election is made with each year's tax filing. Tax forms and instructions are not yet available to indicate how this would appear in practice. The assumption is that a "check the box" option on the Partnership tax return will exist to invoke this option.

Example – Lastminute, LLC files for extension until Sept, 15, 2019 to file its 2018 partnership tax return. The LLC files its Form 1065 on May 2, 2019. During August of 2019, the LLC realizes that it did not make the opt out election. The LLC files an amended tax return before 9/15/19 and has successfully made the opt out election.

The election must include each partner's name, correct U.S. TIN, and Federal tax classification. If the election is being made by a partnership that has an S corporation as a partner, than the election must also include each S corporation shareholder's name, correct U.S. TIN, and Federal tax classification. Worth noting is the fact that the S Corporation may have a disregarded entity as a partner, and still have the partnership (in which the S Corporation is a partner) be eligible for this opt out option. Practitioners may want to consider extending additional partnership tax returns in the coming year to keep this option open for clients, particularly in this first year.

These rules also provides that the election must include an affirmative statement that the partner is an eligible partner. Again, tax software will invariably be updated to provide for this election and generate the statements necessary under this option. If a partnership makes an election under section 6221(b), the partnership must notify its partners of the election within 30 days of making the election. It would appear reasonable to assume that the K-1 will be the vehicle by which this notification to partners are made, however, partnerships have discretion on the method to notify partners. S Corporation partners of a partnership do not require that each S-Corp shareholder receive notification, simply that the S-Corporation receive the notification.

The major highlight in the final regulations is that a partnership will not be eligible to elect out of the new partnership regime if it has a partner that is itself a partnership or a disregarded entity, such as a disregarded single-member limited liability company (LLC) or a grantor trust. It is also important to note that all eligible foreign partners — even those with no U.S. filing requirements — must apply for and obtain a valid U.S. TIN for the partnership to file a valid election. In addition, a partnership that is interested in electing out and is eligible to make this election may want to consider restricting the number, type of partners, and the ability of its partners to change tax status.

Audit Treatment after Electing Out

If electing out, and a subsequent audit commences, then the IRS would proceed by making assessments against all of the partners in separate partner-level proceedings. Thus, if a partnership proceeds to make the election out, its partners should confirm that they will have sufficient access to the partnership's books and records if they need to substantiate the amounts allocated by the partnership in an IRS audit. A more crucial aspect is the fact that if a partnership makes a valid election out, the applicable statute of limitation for assessment of tax will be determined at the partner level and is further determined separately for each partner. In such a case, the old rules would apply (pre TEFRA, 1982). Each partner would be entitled to separate appeals conference and deficiency treatment. Penalties would be imposed on actual tax and not based on the imputed payment. No consistency reporting requirements would be required.

Example - Elle LLC decides to elect out of the CPAR requirements. Ralph and Judy are the 2 members of the LLC (equal members). Each member represents itself during the audit. The LLC has a $100k long term capital gain deficiency, $50k of which is reportable by each member as a result of the audit. Ralph has an individual $75k capital loss carryover which can be utilized to offset the additional $50 in capital gains resulting from the audit resulting in no tax for Ralph. Judy has no other income for the audit year. No tax would apply to Judy upon recognition of this additional $50,000 of Capital Gain (0% bracket applies). In this scenario no additional tax is owed as a result of the opt out. Alternatively, the imputed tax under CPAR would have totaled $20,000 (highest capital gain tax rate of 20% x $100k).

Option 2 – Amended Tax Returns and Pull-In Procedure

The second option available to circumvent CPAR requirements would involve amending tax return or employing a Pull-In Procedure. These are somewhat similar in function. Amended tax returns would involve some or all partners actually filing amended tax returns with the IRS. Partners filing these amended tax returns would then pay any tax due (plus interest/penalties) with their respective filing. In a Pull-In procedure, amended tax returns are not filed, instead information is provided to the IRS concerning the increase in tax along with inclusion of payment. The benefit of this approach would be that the process of calculating this additional tax and payment can be centralized. In short, one practitioner or office can coordinate the details of this process.

Worth noting is the impact that amending tax returns or employing this Pull-In procedure would have on other tax years. If carryover losses are utilized in an audit year, then other filing years in which the losses were previously used may be affected.

Example – LLC is audited for tax year 2018. As a result of the audit, the income has increased by $100,000. Abe (a 50%) partner files an amended tax return for 2018. Abe, on his original 2018 tax return, had reported a $10,000 passive loss carryover. As a result of the amended return, Abe recognizes $40,000 of income ($50,000 for his share of income less $10,000 of passive loss). Abe has already filed his 2019 individual tax return of which he applied $7,000 of this passive loss carryover to reduce his tax in 2019, and $3,000 of this loss carryover was rolled forward into 2020 (which has not been filed yet). Abe must now file an amended tax return for 2019 and adjust his 2020 carryforward loss to reflect the adjustment made as a result of his 2018 amended tax return (utilization of the loss in 2018).

To the extent that a partner files an amended tax return and pays the related tax, then the partner filing the amended tax return must also file an affidavit declaring that they have amended the tax return and paid the tax associated with the adjustment. This declaration must be made within 270 days of the Notice of Proposed Partnership Adjustment issued by the IRS. The IRS in some circumstances may extend this deadline. In either case, the IRS must agree to accept the modification in connection with an amended tax return filing or Pull-In procedure.

One issue resulting from the filing of an amended tax return in this instance results in the event of a change to the Notice of Proposed Partnership adjustment (NOPPA). Note that a NOPPA is a preliminary notice of amounts due issued by the IRS. A situation may occur where the tax assessed is reduced, however one of the partners may have filed an amended tax returns and paid tax based on this notice.

Another issue which arises results from one partner who files an amended tax return, while another partner takes no action resulting in an imputed underpayment.

Example – AB LLC does not elect out of CPAR. The LLC contains two equal members (Jim and Jeff). The LLC has underreported income of $100k and Jim has decided to file an amended tax return and pay the additional tax (assuming in his case a 25% tax bracket), interest and penalties based *on his proportionate share ($50k). Upon audit, the LLC is assessed a tax, however this amount is adjusted down by half since Jim has filed an amended tax return to recognize half of the unreported income. The partnership then pays the imputed underpayment (Jeff's share) at the highest tax rate. This outcome is not fair to Jim. Partnership agreements may need to be revisited to provide remedy for these occurrences.*

<u>Option 3 – Push-Out Election</u>

The third option available to circumvent CPAR requirements is called the Push-Out method. This procedures involves the partnership providing information similar to an adjusted K-1's to ALL partners. ALL partners would then compute the extra tax at the partner level for the tax year (audit year) in question. Interest associated with payment of the additional tax would equal the regular interest rate for underpayment PLUS 2% plus penalties. Additionally, this additional tax would not be reported in the tax year being audited, instead the tax would be reported on the tax year you receive the statement.

Example – LLC has underreported income of $100,000 in 2018. The LLC elects the "Push-Out" Method. A 20% partner receives an adjusted K-1 in 2021 (relating to 2018, the "reviewed year"). Assuming the partner is in the 25% bracket in 2018, the additional tax (based on the 2018, the "reviewed year") would equal $5,000 ($100,000 underreported income x 20% partner x 25% tax bracket), plus interest charged from 4/15/19 (filing deadline, 2018) at the regular interest rate plus 2% plus penalties if applicable. This additional tax would be reported on the 2021 tax return. It is assumed that tax forms will include an additional line item to recognize this additional tax.

The structure of this calculation and payment of tax runs contrary to common procedure. Tax is reported in the year recognized, however it is based on the audit year (the "reviewed year"). Tax practitioners will have to pay careful attention in these calculations and consider any impact of carryover losses and other tax attributes impacting the review year, the year the tax is reported and any intervening year. This is consistent with the IRS approach of pushing additional work down to tax practitioners.

In the event that a partner has amended a tax return and subsequently receives an adjusted K-1 during the course of a Push-Out election, the partner with the amended tax return would still need to include the tax in the reportable year, however it would receive an offsetting credit because tax had been paid previously thru the previously filed amended tax return.

What occurs in the event that one of the partners is an S-Corp or a Partnership? Partnerships that employ the Push-Out election and have this occurrence can select one of two options.

- The pass through partners may make their own Push-Out Election and provide Push-Out statements to their partners. This would involve an additional level of reporting to the IRS. A partnership adjustment tracking report would be required according to the regulations (§6226(b)(4)).
- Alternatively, the pass through partners can simply pay the imputed underpayment similar to the regular underpayment rules under CPAR.

<u>Calculation of the tax – Imputed Underpayments</u>

Taxpayers not employing one of the three opt out options would be required to calculate the Imputed Underpayment. Let's review this calculation and available modifications.

Entities subject to CPAR and the imputed underpayment would pay tax at the top rate (i.e. 37% individual, 21% C Corp). The net investment income tax and the Self Employment tax are disregarded in this calculation, but as mentioned earlier, the IRS will pursue individual partners for these amounts. Partnerships would pay tax in the year of adjustment. Interest would be calculated from the due date of the "review year".

Taxpayers can request modifications to reduce this imputed underpayment, some examples include:

- Reduction for partners who have previously filed amended tax returns and paid tax.
- Proportionate share of income related to tax-exempt partners.
- C-Corporate partners who are entitled to use a lower tax rate.
- If income resulting from an audit adjustment is dividend income or long term capital gain, then a lower tax rate can be used (20%).

To the extent that the partnership is unable to pay any imputed underpayment, then the partners would be obligated to pay (within 10 days of the notice and demand letter). In such an event, the applicable interest rate applied to the tax would increase by 2%. Additionally, partners would be obligated to pay even if the partnership ceases to exist (§6241(a)(7)).

<u>Partnership Representatives</u>

Under the Centralized Partnership Audit Regime, we have a newly created designation, the Partnership Representative. This individual is granted greater powers then the "Designated Tax Matters Person" and, as such, careful consideration must be undertaken when selecting this individual.

We'll address the concerns and considerations taxpayers must take when selecting an individual. First, practitioners should note that taxpayers who are able to and elect out of CPAR do not have to address this issue. There is no requirement to select a Partnership Representative when an entity elects out of CPAR.

Partnerships Representatives have the authority to make elections (for example, the Push-Out Election). Additionally they can sign settlement agreements with the IRS and bind the partnerships to these agreements even if the partnership has a contractual understanding amongst the partners that prevent this. Regardless of any agreement between the partners, this would not impact any settlement agreement with the IRS. The Partnership Representative is also the sole individual who can represent the partnership in any proceedings with the IRS.

Example – A partnership designates James to be the Partnership Representative. The partnership and James enter into a written agreement which includes language stating that James must advise the partners of any potential settlement with the IRS before executing any settlement with the IRS. James signs a settlement agreement with the IRS for $2 million. James does not communicate with the partners with respect to this IRS settlement. The IRS settlement entered into by James is binding on the partnership regardless whether the amount of tax is wrong and the partnership can show otherwise.

Example – The partnership designates Gloria to be the Partnership Representative. Upon audit and notice of proposed adjustment, the partners instruct Gloria that she must make the Push-Out Election. The final partnership adjustment is received and Gloria neglects to make the election and does not inform the partners. The result is that the partnership would be responsible for the "imputed underpayment".

The prudent course of action is to elect out of the CPAR rules whenever possible which in turn means that a Partnership Representative is not required. In addition to the expand powers that come with this designation, taxpayers should also consider other issues. The Partnership Representative could invariably find themselves in the middle of partnership disputes (i.e. one set of partners would wish to make the Push-Out Election, whereby others do not). Also, notices from the IRS could simply be missed (vacations, illnesses, clerical mistakes). The individual who receives this designation would always be "on alert" because a missed notice could prove disastrous.

To the extent that a Partnership Representative must be selected, then the first question is who can become a Partnership Representative. Partnership Representatives must have a "substantial presence" in the United States and are required to provide a US phone number and address. The must be able to make themselves available in the US to meet with the IRS if needed. Entities can be designated as a Partnership Representative, however, the entity must then select a "designated individual". Similarly, partnerships may elect its own partnership as the Partnership Representative, but as we just expressed, they too would need to select a designated individual.

This Partnership Representative designation would most likely be made on the partnership tax return for the year (Form 1065). This Partnership Representative status can be revoked for any tax year, but only after the IRS informs the taxpayers that the tax year is under audit. Additionally, a successor must be named during this process.

Partnership Representatives may also resign but only when the partnership receives a notice of administrative proceeding from the IRS. This restriction may prove inconvenient for partners in this position, particularly individuals who are set to retire. They are effectively "stuck". The IRS will notify the partnership that they have 30 days to name a new partnership representative upon receipt of the notice of administrative proceeding by the partnership, and receipt by the IRS from the Partnership Representative that they wish to resign. If the partnership fails to name a replacement Partnership Representative, then the IRS will select a replacement for the entity.

IRS notices and how to respond

Several notices will be received by the partnership during the course of an audit. It is important to recognize what these notices represent and important dates related to these notices. Initially, the IRS will notify the partnership that they are being audit. A Notice of Administrative Proceeding will be issued by the IRS to inform the partnership that an audit will commence. Both the partnership and the Partnership Representative would receive this notice.

Subsequent to the IRS examining data in connection with the audit, the IRS will issue the Notice of Proposed Partnership Adjustment. This notice spells out any adjustments proposed by the IRS. The entity would have 270 days from the date of this notice to propose modifications to the IRS adjustment. This would be the period of time in which the taxpayer communicates actions that have previously occurred (i.e. certain partners have filed amended tax returns, therefore proposed IRS adjustments should be reduced by these amended amounts), or other information such as the existence of C-Corporation partners in the partnership, and the need to reduce any additional tax due because of the lower tax rate afforded C-Corporations compared with individual tax rates. This would also be the period in which partners may wish to file amended tax returns if they have not done so previously.

Once the 270 day period has elapsed, then the taxpayer will receive a Notice of Final Partnership Adjustment. This notice will state the amount of imputed underpayment owed by the partnership relative to audit findings. This notice will also put the partnership on notice that it has 45 days from the date of the Notice of Final Partnership Adjustment to make the Push-Out Election, and 90 days to file an appeal, if it so chooses, with the US tax Court, District Court, or Court of Federal Claims.

Practical Considerations

As you can see, CPAR represents a seismic shift in the audit landscape for partnerships. Practitioners and taxpayers must work closely to work through these new rules. The following recap will highlight some practical considerations practitioners should employ.

- Update your checklist or annual meeting notes to discuss these new rules with clients before tax returns are due.
- Consider extending additional partnership tax returns to provide ample time to discuss these new rules with clients.
- Discuss the need for clients to update their partnership agreements and to address issues such as Push-Out Elections, Partnership Representatives, and successor elections. Updates to partnership agreements may also include the prevention of current partners to transfer their interest to ineligible partners.
- Partnership agreements may also need review to include language in connection with corrective distributions in cases where one partner amends a tax return individually upon an audit adjustment while other partners choose not to.
- Discuss the out opt election from CPAR and the possible issues with partners who would disqualify the partnership. Discuss the possibility of turning disqualifying partners into qualifying partners (i.e. liquidating a single member LLC and distributing assets to the individual).
- Include these discussions in questionnaires and notes when working with clients interested in forming a new partnership entity.
- Update engagement letters for partnership and LLC entities to address these new rules and to communicate the need for clients to provide any correspondence received by the IRS in an expeditious manner.

Practitioners should pay close attention to the instructions for Form 1065 in the months ahead to understand the specifics of how to make the above referenced elections and for any additional instructions.

[ITEM 2] Proposed regulations on charitable contributions and state and local tax credits

Proposed regulations were issued in August by the Department of the Treasury and the IRS providing rules on the availability of charitable contribution deductions when the taxpayer receives or expects to receive a corresponding state or local tax credit. These rules are designed to clarify the relationship between state and local tax credits and the federal tax rules for charitable contribution deductions.

Under the proposed regulations, a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.

Example – A state grants a 70 percent state tax credit and the taxpayer pays $1,000 to an eligible entity, and as such, the taxpayer receives a $700 state tax credit. The taxpayer must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on the taxpayer's federal income tax return.

The proposed regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction.

The proposed regulations provide exceptions for dollar-for-dollar state tax deductions and for tax credits of no more than 15 percent of the payment amount or of the fair market value of the property transferred.

Example - A taxpayer who makes a $1,000 contribution to an eligible entity is not required to reduce the $1,000 deduction on the taxpayer's federal income tax return if the state or local tax credit received or expected to be received is no more than $150.

REVIEW QUESTIONS AND SOLUTIONS

1. Which of the following is not true in connection with the Centralized Partnership Audit Regime.
   a. A tax is applied at the partnership level at the highest rate of tax.
   b. The tax applied at the partnership level is called the "Final Adjustment Underpayment"
   c. CPAR is projected to increase tax revenues.

2. The Imputed Underpayment includes which of the following taxes?
   a. Net Investment Income Tax (NIIT)
   b. Self Employment Tax (SE)
   c. None of the above.

3. Eligible Partners for purposes of electing out of the Centralized Partnership Audit Regime would include all of the following except for?
   a. Partnerships
   b. Individuals
   c. Estate of a deceased partner

4. In order to qualify as an eligible Partnership Representative (PR) under the Centralized Partnership Audit Regime, a PR ________
   a. Is provided the opportunity to meet with the IRS both in the US and on foreign soil.
   b. Cannot designate anyone other than an individual person.
   c. Must have a "substantial presence" in the United States.

5. When an LLC elects to opt out of CPAR by electing the "Push-Out Method", the tax would be reported ___________
   a. In the tax year in which the audit adjustment statement is received.
   b. For the "reviewed tax year"
   c. Equally by all partners

6. Proposed regulations were issued in August 2018 by the Department of the Treasury and the IRS providing rules on the availability of charitable contribution deductions when the taxpayer receives or expects to receive a corresponding state or local tax credit. These regulations state that taxpayers who make payments to an eligible entity to receive a tax deductible contribution must, in some cases, ______________.
   a. Increase their charitable deduction by the amount of any expected state tax credit to be received.
   b. reduce their charitable deduction by the amount of any state tax credit the taxpayer receives
   c. Must add back adjustment amounts in connection with Alternative Minimum Tax instructions.

Solutions

1. **"A" is an incorrect response**. The Centralized Partnership Audit Regime will tax partnerships in the same fashion as a C Corporation under audit.
   "B" is the correct response. The tax applied at the partnership level is called the "Imputed Underpayment"
   "C" is an incorrect response. Additional tax audits under CPAR are projected to generate billions of dollars in additional tax revenue

2. **"A" is an incorrect response**. The CPAR tax imputed underpayment does not include NIIT, however the IRS has the authority to pursue individual partners for this tax.
   "B" is an incorrect response. Similar to NIIT, the CPAR imputed underpayment does not include Self-employment tax, however, the IRS has the authority to pursue individual partners for this tax in cases where SE tax is applicable.
   "C" is the correct response. The imputed underpayment reflects tax applied to the partnership at the highest level. In some cases, the tax rate may differ depending on the underlying nature of income adjustments (i.e. ordinary income versus capital gain)

3. **"A" is the correct response.** Note that having just one partner considered as an ineligible partner would prevent the partnership from making an-opt out election from CPAR.
   "B is an incorrect response. C Corporations and S Corporation Partners would also be considered as eligible partners in this respect.
   "C" is an incorrect response. A partner who was an estate other than that of a deceased partner would not be considered an ineligible partner.

4. **"A" is an incorrect response**. Partnership Representatives must be able to make themselves available in the US to

meet with the IRS and provide a US phone number and address.
"B" is an incorrect response. Entities can be designated as a Partnership Representative, however the entity must then select a "designated individual".
"C" is the correct response. This Partnership Representative designation would most likely be made on the partnership tax return for the year (Form 1065).

5. **"A" is the correct response**. This additional tax would not be reported in the tax year being, audited, instead the tax would be reported on the tax year in which a taxpayer receives the statement communicating the additional tax owed.
"B" is an incorrect response. Note that any interest associated with payment of the additional tax would equal the regular interest rate for underpayment plus 2% plus penalties.
"C" is an incorrect response. The increase in additional income resulting from an audit would be allocated according to individual partner's interest relative to the partnership. Communicating these adjustments would typically include the partnership providing information similar to an adjusted K-1 to all partners.

6. **"A" is an incorrect response**. The proposed regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction.
"B is the correct response. The proposed regulations provide exceptions for dollar-for-dollar state tax deductions and for tax credits of no more than 15 percent of the payment amount or of the fair market value of the property transferred.
"C" is an incorrect response. These rules are designed to clarify the relationship between state and local tax credits and the federal tax rules for charitable contribution deductions.

[ITEM 3] IRS Regulations – Due Diligence

The IRS recently finalized proposed regulations [REG-140280-09] under Sec. 6695(g) imposing a penalty on tax return preparers who do not follow certain due-diligence requirements when preparing to file tax returns for taxpayers who are claiming head-of-household filing status, the earned income tax credit (EITC), the child tax credit, the additional child tax credit (ACTC), or the American opportunity tax credit (T.D. 9842). The IRS said it was adopting the existing proposed regulations without substantive change, other than adding some examples. It also removed the temporary regulations that were issued with the proposed regulations in 2016.

The Protecting Americans From Tax Hikes Act, P.L. 114-113, amended Sec. 6695 to apply to tax return preparers who fail to exercise due diligence when preparing a taxpayer's return with a claim for the child tax credit or ACTC under Sec. 24 or the American opportunity tax credit under Sec. 25A.

Before these changes, the due-diligence requirements and the penalties for noncompliance applied only to claims for the EITC. These new rules applied for returns or claims for refund prepared on or after Dec. 5, 2016, for tax years beginning after Dec. 31, 2015. *For tax years beginning after Dec. 31, 2017, Tax Cuts and Jobs Act added head-of-household filing status to the credits subject to the due-diligence requirements.*

Form 8867, Paid Preparer's Due Diligence Checklist, must be completed including due-diligence worksheet in Form 1040, 1040A, 1040EZ, or any other form the IRS may prescribe for each credit. The preparer must not know or have reason to know that any information the preparer used to determine eligibility for, and the amount of, each credit or head-of-household filing status, is incorrect. The preparer also must make reasonable inquiries when required, documenting those inquiries and responses contemporaneously.

Finally, the preparer must retain for three years the Form 8867, the worksheet (or alternative records), and the record of how and when the information that was used to determine eligibility for head-or-household filing status and each credit, including the identity of any person furnishing information and a copy of any document the preparer relied on in preparing the return. The regulations contain numerous examples illustrating how the penalties are to apply.

As previously discussed in this newsletter, these regulations are consistent with an ongoing shift by the IRS and Treasury Department to push additional responsibilities onto tax practitioners and to impose penalties where applicable. Client Questionnaires and taxpayer checklists should be reviewed and updated to reflect these changes.

[ITEM 4] Treasury, IRS issue proposed regulations on new Opportunity Zone tax incentive

On October 19th, proposed regulations and other published guidance for the new Opportunity Zone tax incentive was released.

Opportunity Zones, created by the 2017 Tax Cuts and Jobs Act, were designed to spur investment in distressed communities throughout the country through tax benefits.

Under a nomination process completed in June, 8,761 communities in all 50 states, the District of Columbia and five U.S. territories were designated as qualified Opportunity Zones. Opportunity Zones will retain their designation for 10 years. Investors may defer tax on almost any capital gain up to Dec. 31, 2026 by making an appropriate investment in a zone, making an election after December 21, 2017, and meeting other requirements.

The proposed regulations clarify that almost all capital gains qualify for deferral. In the case of a capital gain experienced by a partnership, the rules allow either a partnership or its partners to elect deferral. Similar rules apply to other pass-through entities, such as S corporations and their shareholders, and estates and trusts and their beneficiaries.

Generally, to qualify for deferral, the amount of a capital gain to be deferred *must be invested in a Qualified Opportunity Fund (QOF*), which must be an entity treated as a partnership or corporation for Federal tax purposes and organized in any of the 50 states, D.C. or five U.S. territories for the purpose of investing in qualified opportunity zone property.

The QOF must hold at least 90 percent of its assets in qualified Opportunity Zone property (investment standard). Investors who hold their QOF investment for at least 10 years may qualify to increase their basis to the fair market value of the investment on the date it is sold.

The proposed regulations also provide that if at least 70 percent of the tangible business property owned or leased by a trade or business is qualified opportunity zone business property, the requirement that "substantially all" of such tangible business property is qualified opportunity zone business property can be satisfied if other requirements are met. If the tangible property is a building, the proposed regulations provide that "substantial improvement" is measured based only on the basis of the building (not of the underlying land).

In addition to the proposed regulations, Treasury and the IRS issued an additional piece of guidance to aid taxpayers in participating in the qualified Opportunity Zone incentive. Rev. Rul. 2018-29 provides guidance for taxpayers on the "original use" requirement for land purchased after 2017 in qualified opportunity zones. They also released Form 8996, which investment vehicles will use to self-certify as QOFs.

[ITEM 5] The TCJA reduces to 24-percent the withholding rate applied to small businesses.

Publication 1281, Backup Withholding for Missing and Incorrect Name/TIN(s) has been updated to reflect a key change made by the Tax Cuts and Jobs Act (TCJA). As a result of this change, effective Jan. 1, 2018, the backup withholding tax rate dropped from 28 percent to 24 percent. When backup withholding applies, payers must backup withhold tax from payments not otherwise subject to withholding. Payees may be subject to backup withholding if they:

- Fail to give a Tax Identification Number (TIN)
- Give an incorrect TIN,
- Supply a TIN in an improper manner,
- Underreport interest or dividends on their income tax return, or
- Fail to certify that they're not subject to backup withholding for underreporting of interest and dividends.

Backup withholding can apply to most kinds of payments reported on Form 1099, including:

- Interest payments;
- Dividends;
- Patronage dividends, but only if at least half of the payment is in money;
- Rents, profits or other income;
- Commissions, fees or other payments for work performed as an independent contractor;
- Payments by brokers and barter exchange transactions;
- Payments by fishing boat operators, but only the portion that's in money and represents a share of the proceeds of the catch;
- Payment card and third-party network transactions; and
- Royalty payments.

Like regular federal income tax withholding, a payee can claim credit for any backup withholding when they file their 2018 federal income tax return.

[ITEM 6] - IRS issues guidance on Tax Cuts and Jobs Act changes - business expense deductions for meals, entertainment

Recently issued guidance now provides tax practitioners with much needed assistance in connection with the business expense deduction for meals and entertainment following law changes in the Tax Cuts and Jobs Act (TCJA). The 2017 TCJA eliminated the deduction for any expenses related to activities generally considered entertainment, amusement or recreation.

Taxpayers may continue to deduct 50 percent of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant. The meals may be provided to a current or potential business customer, client, consultant or similar business contact.

Food and beverages that are provided during entertainment events will not be considered entertainment if purchased separately from the event.

Prior to 2018, a business could deduct up to 50 percent of entertainment expenses directly related to the active conduct of a trade or business or, if incurred immediately before or after a bona fide business discussion, associated with the active conduct of a trade or business.

The Department of the Treasury and the IRS expect to publish proposed regulations clarifying when business meal expenses are deductible and what constitutes entertainment. Until the proposed regulations are effective, taxpayers can rely on guidance in Notice 2018-76.

Notice 2018-76

These proposed regulations provides transitional guidance on the deductibility of expenses for certain business meals under § 274 of the Internal Revenue Code amended by the Tax Cuts and Jobs Act. As amended by the TCJA, § 274 generally disallows a deduction for expenses with respect to entertainment, amusement, or recreation. However, the Act does not specifically address the deductibility of expenses for business meals.

This notice also announced that the Treasury Department and the IRS intend to publish proposed regulations under § 274, which will include guidance on the deductibility of expenses for certain business meals. Until the proposed regulations are effective, taxpayers can rely on the guidance contained in this notice for the treatment under § 274 of expenses for certain business meals.

Background

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, § 274(a)(1), as revised by the TCJA, generally disallows a deduction for any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation.

Section 274(k) generally provides that *no deduction is allowed for the expense of any food or beverages unless (A) such expense is not lavish or extravagant under the circumstances, and (B) the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages.*

Section 274(n)(1) generally provides that the amount allowable as a deduction for any expense for food or beverages shall not exceed 50 percent of the amount of the expense that otherwise would be allowable. Prior to amendment by the Act, § 274(a)(1)(A) generally prohibited a deduction with respect to an activity of a type considered to constitute entertainment, amusement, or recreation ("entertainment expenses"). However, § 274(a)(1)(A) provided exceptions to that prohibition if the taxpayer established that: (1) the item was directly related to the active conduct of the taxpayer's trade or business (the "directly related" exception), or (2) in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the item was associated with the active conduct of the taxpayer's trade or business (the "business discussion" exception).

Prior to amendment by the Act, § 274(n)(1) generally limited the deduction of food and beverage (meal) expenses and entertainment expenses to 50 percent of the amount that otherwise would have been Allowable. Thus, under prior law, taxpayers could deduct 50 percent of meal expenses and could deduct 50 percent of entertainment expenses that met the directly related or business discussion exceptions.

The Act repealed the directly related and business discussion exceptions to the general prohibition on deducting entertainment expenses in § 274(a)(1)(A). Thus, entertainment expenses are no longer deductible. The Act also amended the 50 percent limitation in § 274(n)(1) to remove the reference to entertainment expenses. Otherwise allowable meal expenses remain deductible, subject to the 50 Percent limitation in § 274(n)(1).

Section 1.274-2(b)(1)(i) of the Income Tax Regulations provides that the term "entertainment" means any activity which is of a type generally considered to constitute entertainment, amusement, or Recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation, and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family.

The term "entertainment" may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or the customer's family. The term "entertainment" does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to an employee working overtime, (b) a hotel room maintained by an employer for lodging of employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though also used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee.

Section 1.274-2(b)(1)(ii) provides that an objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of § 274(a) and § 1.274-2 regardless of whether the expenditure for the activity can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business shall be considered. Thus, although attending a theatrical performance would generally be considered entertainment, it would not be considered entertainment for a professional theater critic attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered to constitute entertainment. In contrast, if an appliance distributor conducts a fashion show for its retailers, the fashion show generally would be considered to constitute entertainment.

Section 274(e) enumerates nine specific exceptions to § 274(a). Expenses that are within one of the exceptions in § 274(e), which may include certain meal expenses, are not disallowed under § 274(a). However, those expenses may be subject to the 50 percent limit on deductibility under § 274(n). The Treasury Department and the IRS intend to issue separate guidance addressing the treatment under § 274(e)(1) and 274(n) of expenses for food and beverages furnished primarily to employees on the employer's business premises.

Interim Guidance for Business Meals

The Act did not change the definition of entertainment under § 274(a)(1); therefore, the regulations under § 274(a)(1) that define entertainment continue to apply. The Act did not address the circumstances in which the provision of food and beverages might constitute entertainment. However, the legislative history of the Act clarifies that taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business.

The Treasury Department and the IRS intend to publish proposed regulations under § 274 clarifying when business meal expenses are nondeductible entertainment expenses and when they are 50 percent deductible expenses. Until the proposed regulations are effective, taxpayers may rely on the guidance in this notice for the treatment under § 274 of expenses for certain business meals. Under Notice 2018-76, taxpayers may deduct 50 percent of an otherwise allowable business meal expense if:

1. The expense is an ordinary and necessary expense under § 162(a) paid or incurred during the taxable year in carrying on any trade or business;
2. The expense is not lavish or extravagant under the circumstances;
3. The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
4. The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
5. *In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.* [Planning Tip: Be sure to speak with your clients concerning these new rules and the need to break out charges separately in these instances].

The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

Let's examine a few examples. For each of the following assume that the food and beverage expenses are ordinary and necessary expenses under § 162(a) paid or incurred during the taxable year in carrying on a trade or business and are not lavish or extravagant under the circumstances. Also assume that the taxpayer and the business contact are not engaged in a trade or business that has any relation to the entertainment activity.

Example - Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B. The baseball game is considered entertainment and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and *drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.*

Example: Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages. The basketball game is considered entertainment and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

Example - Assume the same facts as above, except that the invoice for the basketball game tickets separately states the cost of the food and beverages. As in the previous Example, the basketball game is considered entertainment and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

[ITEM 7] Less Regulations!

We have covered the trend of ever increasing workloads hoisted upon the backs of tax practitioners…..now we have some much needed good news. IRS proposal REG-132197-17 would remove 298 regulations from the tax code, as part of an effort to reduce bureaucracy. The proposal is in response to Executive Orders 13777 and 13789, and seeks to streamline IRS regulations. The 298 regulations are considered unnecessary because they simply do not apply to the tax code.

Early last year, President Trump issued Executive Order 13777, directing each agency to set up a regulatory reform task force. Each task force was to review existing regulations that are outdated or unnecessary, eliminate jobs or hinder job creation, cost more than the benefits they provide, are inconsistent with or interfere with regulatory reforms, are inconsistent with the Information Quality Act requirements, or are the result of prior presidents' executive orders that have been rescinded or modified.

Several months later, President Trump issued Executive Order 13789, which intended that the "Federal tax system should be simple, fair, efficient, and pro-growth" and that "[t]he purposes of tax regulations should be to bring clarity to the already complex Internal Revenue Code... and to provide useful guidance to taxpayers," according to a direct quote from the Federal Register notice. The order also called for immediate action to ease the burden of tax regulations on taxpayers, provide tax relief and "useful, simplified tax guidance."

Removing the regulations from the Code of Federal Regulations (CFR) will streamline title 26 of Federal Tax Regulations, reduce the number of regulations that taxpayers must review, and make the tax law clearer. The removal has nothing to do with the substance of rules in the regulations "and no negative inference regarding the stated rules should be made," the notice states. The removal is proposed "solely because the regulations have no current or future applicability."

The proposal also amends 79 regulations to remove cross-references to the 298 regulations. These amendments also will streamline title 26 of the CFR, reduce the volume of regulations taxpayers need to review, and increase clarity of the tax law.

The proposed removals fall into one of the following three categories:

- Regulations interpreting code provisions that have been repealed and no longer are in title 26 of the code.
- Regulations interpreting code provisions that have been significantly revised but that do not reflect statutory changes. This category refers to statutory changes that must have made the entire regulation inapplicable.
- Regulations that are no longer applicable. This includes expired temporary regulations, a code provision that only applies to returns filed before Jan. 1, 1996, or regulations providing for a transition rule applicable to transactions done between Jan. 1, 2000 and March 1, 2001.

[ITEM 8] South Dakota v. Wayfair

We would be remiss if we did not touch upon, what could be, one of the most significant legal decisions impacting practitioners in 2018. South Dakota v. Wayfair will invariably impact many clients with multi-state tax presence for years to follow. E-commerce is here to stay, and the Wayfair decision is a reflection of evolving law concerning interstate and internet commerce.

Before we discuss the present, let's review the quick history concerning this topic. Over 50 years ago the U.S. Supreme Court held that the states could not impose on out-of-state mail-order sellers the obligation to collect and remit sales taxes for sales made to customers in states where those sellers had no stores, warehouses, or other physical presence. The Court held that both the dormant Commerce Clause and the Due Process Clause prohibit the states from taxing remote sellers without a physical presence within the state.

In 1992, the Court had a chance to reconsider its earlier ruling in a case called Quill v. North Dakota. The Quill Court reiterated its earlier conclusion that a physical presence is required to impose a sales tax collection-and-remittance obligation on out-of-state sellers. The Court based its conclusion solely on the Commerce Clause, explicitly inviting Congress—which has the power under the Constitution to regulate interstate commerce—to intervene and to write the rules for how and under what circumstances states can tax remote sellers. That action never came and the Quill decision became the de-facto law of the land.

Fast forward to 2018 and the Supreme Court issued its opinion in South Dakota v. Wayfair and eliminated the physical presence requirement, thereby opening the door for states to impose sales tax collection-and-remittance obligations on remote sellers.

Why the reversal? Pressure had been building against the physical presence rule from two sources: states needing revenue, and traditional brick-and-mortar sellers who, because they had to collect and remit sales tax, complained they were put at an unfair disadvantage compared to remote sellers. In 1992, remote sales totaled about $180 billion, with an estimated sales tax shortfall—aggregate uncollected tax obligations—of between $0.5 and $3.3 billion. Only about 2 percent of households had Internet access when Quill was decided.

By 2017, e-commerce sales totaled more than $450 billion, with total remote sales in excess of $500 billion. The sales tax shortfall had grown to between $8 billion and $33 billion, and more than 85 percent of households had Internet access.

Base on comments from the Supreme Court to reconsider Quill, South Dakota went on the offense and enacted a law that directly challenged the Court's physical presence test. The South Dakota law required an out-of-state seller without a physical presence in South Dakota to collect and remit sales taxes to South Dakota customers if the seller annually sold more than $100,000 of goods and services into South Dakota or engaged in 200 or more transactions within the state.

Enter Wayfair, an online retailer of furniture and home goods, who lacked a physical presence in South Dakota, but had sales in excess of the statutory amount. Wayfair did not bend to the new law and refused to collect the tax. South Dakota sought a declaratory judgment in state court, while Wayfair sought summary judgment relying on the Supreme Court's earlier decision in Quill. The South Dakota trial court granted Wayfair's motion, and the state's highest court affirmed. South Dakota appealed to the Supreme Court.

In a 5-4 opinion written by Justice Kennedy and joined by Justices Clarence Thomas, Ruth Bader Ginsburg, Samuel Alito, and Neil Gorsuch, the Court overturned its earlier precedents and rejected the physical presence requirement. The Court explicitly reversed its earlier decisions, which it said had been wrongly decided. The Court said that the physical presence rule creates cross-border "distortions" because it discourages out-of-state sellers from having an in-state physical presence and encourages customers to buy from out-of-state vendors.

According to the majority, the physical presence rule is also "arbitrary" and "formalistic," which runs counter to the Court's preference for a more nuanced approach that is responsive to the facts. In response to remote sellers' arguments that they had made investments in reliance of not having to collect and remit sales taxes, the majority rejected those arguments because the sellers' reliance was predicated on the customers not paying use tax, which they are required to pay but rarely do.

Writing in dissent, Chief Justice John Roberts—joined by Justices Stephen Breyer, Sonia Sotomayor, and Elena Kagan—agreed with the majority that the Court's earlier decisions imposing a physical presence test were "wrongly decided," but argued that the Court still should have adhered to precedent because Congress could override the Court's earlier decisions. The Chief Justice was also concerned with the potentially heavy compliance costs that remote sellers would face because they will now have to deal with the shifting and disparate tax regimes of 50 states and numerous localities.

Ultimately, although the Court overruled Quill by confirming that physical presence was not a constitutional prerequisite to imposing a sales tax collection-and-remittance obligation on remote sellers, the Court did not clearly articulate what nexus a business must have with a state before it bears obligations for collecting sales taxes for that state. The Court approved the South Dakota law at issue as "clearly sufficient" to establish the required nexus, but questions remain about how low the threshold can go before a business cannot be obligated to collect sales taxes. The Court said only that a sufficient nexus arises when the collector "avails itself of the substantial privilege of carrying on business in that jurisdiction."

The Court's lack of clarity is problematic because the majority opinion in Wayfair confirmed that there remains a difference between the nexus needed to satisfy the Due Process Clause versus the nexus needed under dormant Commerce Clause analysis. Based on prior precedents, the dormant Commerce Clause nexus threshold is higher; no one knows, though, exactly how much higher.

REVIEW QUESTIONS AND SOLUTIONS

7. Which of the following credits was not addressed with recent proposed regulations issued under Sec. 6695(g) reflecting the imposition of preparer penalties in cases where due diligence requirements are not followed.
   a. The Child Tax Credit
   b. The Excess FICA Payments Credit
   c. The Earned Income Tax Credit

8. In addition to all 50 States, Opportunity Zones created by the 2017 TCJA include communities' located in___________.
   a. In the District of Columbia
   b. Each of the five US Territories
   c. Both a & b

9. Backup withholdings apply to many kinds of payments reported on Form 1099 including __________
   a. Dividend payments
   b. Partner distributions
   c. Mortgage interest payments

10. After passage of the Tax Cuts and Jobs Act of 2017, taxpayer's ______________ of the food and beverage expense associated with operating their business.
    a. May deduct 25%
    b. May not deduct any
    c. Generally may continue to deduct 50%

11. One of the objectives of Executive Order 13789 was to _______________.
    a. Ease the burden of tax regulations on taxpayers
    b. Increase the level of complexity of the Federal system of taxation.
    c. Increase the scope and detail of tax guidance.

12. In 1992, a court decision in ______________ ruled that a physical presence is required to impose a sales tax collection and remittance obligation on out of state sellers.
    a. South Dakota v. Wayfair
    b. Quill v. North Dakota
    c. Harley v. Davidson

Solutions

7. **"A" is an incorrect response**. Before these changes reflected in these regulations, the due-diligence requirements and the penalties for noncompliance applied only to claims for the Earned Income Tax Credit.
   "B" is the correct response. These regulations address taxpayers who are claiming the earned income tax credit, the child tax credit, the additional child tax credit, or the American opportunity tax credit.
   "C" is an incorrect response. Tax preparers must retain for three years information that was used to determine eligibility for the Earned Income Tax Credit.

8. **"A" is an incorrect response**. Opportunity Zones also include communities located in each of the five US territories.
   "B" is an incorrect response. Under current law, the Opportunity Zone tax incentive will retain their tax advantaged status through December 31, 2026.
   "C" is the correct response. Opportunity Zones, created by the 2017 Tax Cuts and Jobs Act, were designed to spur

investment in distressed communities throughout the country through tax benefits.

9. **"A" is the correct response.** Recent regulations concerning backup withholdings are located in Publication 1281.
"B is an incorrect response. Information concerning partner distributions would be found on Form K-1.
"C" is an incorrect response. Information related to mortgage interest payments would be found on Form 1098.

10. **"A" is an incorrect response.** Taxpayers may continue to deduct 50 percent of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant.
"B" is an incorrect response. The meals may be provided to a current or potential business customer, client, consultant or similar business contact.
"C" is the correct response. Food and beverages that are provided during entertainment events will not be considered entertainment if purchased separately from the event.

11. **"A" is the correct response**. This executive order will streamline title 26 of Federal Tax Regulations.
"B" is an incorrect response. Some of the regulations removed as a result occurred solely because the regulations have no current or future applicability.
"C" is an incorrect response. Regulations impacted include those regulations interpreting code provisions that have been repealed, regulations interpreting code provisions that have been significantly revised but that do not reflect statutory changes, and regulations which are no longer applicable.

12. **"A" is an incorrect response**. This court decision will impact many clients with multi-state tax presence and runs contrary to the Quill v. North Dakota decision.
"B is the correct response. This case originally concluded that a physical presence is required to impose a sales tax collection and remittance obligation on out-of-state sellers.
"C" is an incorrect response. The Quill v. North Dakota case established this precedent which stood for over 25 years.

CE IRS-APPROVED CONTINUING EDUCATION PROVIDER

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******* EXAM QUESTIONS *******

*Place your answers to the following 20 Multiple Choice Questions on the enclosed answer sheet (**page 21**).*

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1. For years, the IRS has experienced impactful budget cuts and in the words of the former IRS commissioner, expressed the mantra that the IRS "….will do less with less". Data from a study conducted in 2012 revealed that the IRS had audited ____ of large corporations but only ___ of partnerships.
   a) 27%, .8%
   b) 30%, 10%
   c) 50%, 10%
   d) 15%, 5%

2. Before the Bipartisan Budget Act of 2015, a partnership audit generally was conducted in accordance with the _______, which did not provide any statutory mechanism for collecting income tax at the entity level.
   a) Provisions of TRA 1986
   b) Tax Equity and Fiscal Responsibility Act of 1982
   c) Tax Cuts and Jobs Act
   d) Centralized Partnership Audit Regime

3. Shady Location LLC is a rental real estate partnership. In 2018, the partnership is audited and assessed a rental income deficiency of $10,000. If this LLC is subject to CPAR and the imputed underpayment, this LLC would pay a tax of _________ plus possible interest and penalty.
   a) $ 2,800
   b) $ 3,000
   c) $ 3,700
   d) $ 5,000

4. Allover LLC has 95 partners, 94 of which are individuals and 1 is an S-Corp. The S-Corp has 15 shareholders. All shareholders are considered "eligible". Which his true concerning this Allover LLC's ability to opt out of the Centralized Partnership Audit Regime (CPAR) rules?
   a) They can opt out of CPAR since total direct partners exceed 100
   b) They cannot elect out of CPAR because total eligible shareholders exceed 100
   c) The number of shareholders with the S-Corp does not factor into this calculation
   d) None of the above

5. Which of the following is not an example of a tax modification which taxpayers may use to reduce the imputed underpayment in connection with CPAR?
   a) Allocate proportionate share of income in connection with the audit to the partners which are C Corporations
   b) Allocate proportionate share of income in connection with the audit to the partners which are tax-exempt partners.
   c) Reduce the amount of additional income resulting from the audit for those partners who have previously amended tax returns and recognized their proportionate share of the audit adjustment.
   d) Reduce the total imputed underpayment by the amount of Self Employment Tax included in the calculation.

6. Which of the following is not an option to avoid the imputed underpayment under CPAR?
   a) Electing out of CPAR
   b) Amending Tax Returns (Pull-in Method)
   c) File for Bankruptcy
   d) Push-Out Election

7. Which of the following powers does a Partnership Representative have under the Centralized Partnership Audit Regime?
   a) Power to sign Settlement Agreements with the IRS
   b) Power to represent the partnership in any proceedings with the IRS
   c) Power to make elections on behalf of the partnership
   d) All of the above

8. A partnership designates Adam to be the Partnership Representative in 2018. The partnership and Adam enter into a written agreement which includes language stating that Adam must advise the partners of any potential settlement with the IRS before executing any settlement with the IRS. The partnership is audited for tax year 2018 and deemed to have an underpayment of tax totaling $100,000. Adam signs a settlement agreement with the IRS for the full amount of $100,000. The partnership is __________.
   a. Bound by the agreement Adam signed
   b. Able to petition the tax court to reduce this tax liability
   c. Able to declare bankruptcy to avoid payment of tax
   d. None of the above

9. Which of the following tax notices would be received first, chronologically, in connection with an audit of a partnership.
   a. Notice of Administrative Proceeding
   b. Notice of Proposed Partnership Adjustment
   c. Notice of Final Partnership Adjustment
   d. Notice to Levy

10. Under the proposed IRS regulations issued in 2018, a taxpayer who makes payments or transfers property to a(n) _________to receive tax deductible contributions must _______ their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.
    a. Eligible entity, reduce
    b. Trust, increase
    c. Eligible entity, increase
    d. Third party, allocate

11. Form ________ must be completed including due-diligence worksheet in Form 1040, 1040A, 1040EZ, or any other form the IRS may prescribe when claiming the earned income tax credit (EITC).
    a. 6695
    b. 8867
    c. 8850
    d. 8882

12. Tax preparers must retain records of how and when information used to determine eligibility for head-or-household filing status and each tax credit for a period of no less than __________ years.
    a. Three
    b. Four
    c. Five
    d. Ten

13. In order to qualify for capital gain deferral treatment, A “Qualified Opportunity Fund” must hold at least __________of its assets in qualified Opportunity Zone property.
    a. 75%
    b. 80%
    c. 85%
    d. 90%

14. Dianne is interested in investing in a Qualified Opportunity Fund. You correctly tell her that ______.
    a. Opportunity Zones were created by the 2017 Tax Cuts and Jobs Act
    b. Opportunity Zones are limited to the 50 United States
    c. Investors may defer tax on capital gains thru 2028.
    d. None of the above

15. Which of the following is true in connection with the deductibility of meals and entertainment expenses after passage of the Tax Cuts and Jobs Act.
    a. Food and Beverages that are provided during entertainment events will be considered entertainment in every instance.
    b. Taxpayers will not be able to deduct 50% of the cost of business meals regardless of whether the taxpayer is not present and the expense is not considered extravagant.
    c. The 2017 Tax Cuts and Jobs Act eliminated the deduction for any expenses related to activities generally considered to be recreation.

d. None of the above

16. Section 1.274-2(b)(1)(i) of the Income Tax Regulations provides that the term “entertainment” means any activity which is of a type generally to include all of the following except for _________.
    a. Entertaining at night clubs
    b. Hotel rooms provided to employees on vacation
    c. Dinner money for employees working overtime
    d. Golf outings

17. Which of the following would be true in connection with meals and entertainment expenses incurred during a business outing incurred during 2018?
    a. Cost of ticket to a sporting event would be deductible
    b. Cost of meals incurred during the sporting would be 50% deductible if they are purchased separately from the sporting event cost.
    c. Cost of meals incurred during the sporting would be 50% would not be deductible even if they are purchased separately from the sporting event cost.
    d. None of the above

18. Which of the following scenarios best exemplifies the need to consider a taxpayers trade or business and would not be considered “entertainment” for purposes of determining the deduction of expense under § 274?
    a. Expense incurred by a chef to attend a fashion show
    b. Expense incurred by a sports agent to attend a sporting event
    c. Expense incurred by a tax preparer to take dance lessons
    d. Expense incurred by a retailer to charter a boat for its vendors

19. IRS proposal REG-132197-17 would remove 298 regulations from the tax code, as part of an effort to reduce bureaucracy. These proposals fall into which of the following categories?
    a. Regulations interpreting code provisions that have been repealed and no longer are in title 26 of the code.
    b. Regulations interpreting code provisions that have been significantly revised but that do not reflect statutory changes. This category refers to statutory changes that must have made the entire regulation inapplicable.
    c. Regulations that are no longer applicable. This includes expired temporary regulations, a code provision that only applies to returns filed before Jan. 1, 1996, or regulations providing for a transition rule applicable to transactions done between Jan. 1, 2000 and March 1, 2001.
    d. All of the above

20. The South Dakota law requires an out-of-state seller without a physical presence in South Dakota to collect and remit sales taxes to South Dakota customers if the seller annually sold more than _______of goods and services into South Dakota or engaged in _____ or more transactions within the state.
    a. $50000,100
    b. $50000,200
    c. $100000,100
    d. $100000,200

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