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IRS EXAMINATIONS AFTER THE INFLATION REDUCTION ACT

Presented to: NAREC 2023 Annual Financial & Tax Conference

June 29, 2023

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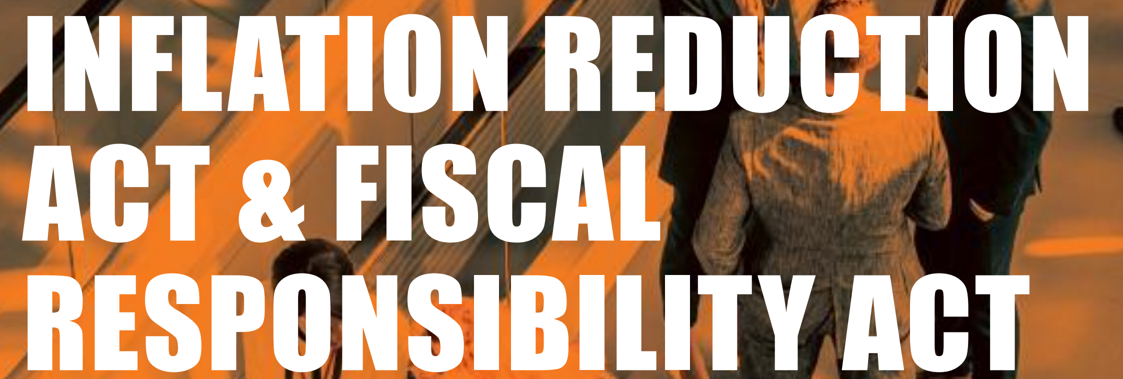
AGENDA

- IRA and FRA
- Audit Steps
- Partnerships Audits
- Individual Audits
- International Audits
- QOF/QOZB Audits
- Nonprofit Audits
- Summary
- Questions *(time permitting)*



INFLATION REDUCTION ACT & FISCAL RESPONSIBILITY ACT

INFLATION REDUCTION ACT – AUG. 16, 2022

- On August 16, 2022, President Biden signed into law the *Inflation Reduction Act of 2022* (IRA).
- $80B in new funding for the IRS.
- Over half of the $80B ($45B) funding aimed at enforcement efforts, nearly doubling the IRS's current enforcement budget.

FISCAL RESPONSIBILITY ACT – JUNE 3, 2023

- On June 3, 2023, President Biden signed into law the *Fiscal Responsibility Act of 2023* (FRA).
- Rescinded $1.39B and reallocated $20B that was provided to the IRS pursuant to the IRA ($10B to be repurposed in 2024, and $10B to be repurposed in 2025).

AUDIT STEPS

AUDIT STEPS (GENERALLY)

1. Taxpayers are notified by mail that they were selected for an audit.
2. Taxpayer appoints tax professional as power of attorney to give them the ability to handle the audit.
3. Audit is conducted by mail or through in-person interview to review taxpayer records.
4. IRS will produce an IDR (this may occur before prior step).
5. Once IDR is received, the taxpayer and tax professional work together to accumulate the requested information.

PARTNERSHIPS AUDITS

OVERVIEW

- Deficiency procedures and math errors
- Audit Steps as Applied to the BBA
- Opting out of the BBA: a Comparison
- Bonus depreciation
- 163(j) electing real property trade or business
- *Practitioners' Perspective: Audit - Section 751*

DEFICIENCY PROCEDURES AND MATH ERRORS

- General rule is that under Section 6213(a), if the IRS believes a deficiency assessment should be made against a taxpayer, the IRS must issue a notice of deficiency to the taxpayer, and the taxpayer typically has 90 days to petition the Tax Court for a redetermination of the deficiency.

- Section 6213(b)(1) creates an exception to the normal deficiency procedures for math errors under which a taxpayer “shall have no right to file a petition with the Tax Court based on such notice”. The only recourse would be to pay the assessment and to afterwards file a refund suit in district court or Court of claims.

MATH ERRORS UNDER THE BBA RULES

- Partner consistency requirement:
  - Under the centralized partnership audit regime, partners generally must treat each partnership-related item consistently with the partnership's treatment of that item. IRC Sec. 6222.
  - Any underpayment of tax by a partner due to failure to comply with this consistency requirement is treated as a math error, which means the IRS can immediately assess any tax deficiency against the partner under IRC Sec. 6213(b)(1).
  - Section 6213(b)(2), which normally allows a taxpayer to request an abatement of those math error assessments, is not available under the BBA rules (Section 6222).
  - So, the IRS can move to collect the tax from the partner without issuing a Notice of Deficiency, and the partner cannot challenge the assessment in court, as previously noted.

FORM 8082 IMPACT ON MATH ERROR RULES

- However, if the partner notifies the IRS of the inconsistent treatment, then (generally) the math error assessment will not apply (Section 6222(c)(1), effective for partnership tax years after Dec. 31, 2017).
- The Form used to notify the IRS of this is Form 8082.
- Similarly, the Budget Act allows a partner that receives incorrect information from the partnership to elect and demonstrate to the IRS's satisfaction that the treatment of the item on the partner's return is consistent with the treatment of the item on the Schedule K-1 (Sec. 6222(c)(2), effective for partnership tax years after Dec. 31, 2017). The election procedure is set forth in the regulations. The election must be provided to the IRS within 60 days of receiving an IRS notice stating that an inconsistent position was identified.

FORM 8082 REQUIREMENTS

- In order for the Form 8082 to "count" by the IRS, it must be completed as per the Form's instructions, as they relate to notifying the IRS of an inconsistency.

- The partner should file this form when either:
  - The partnership has filed a return but the partner's treatment of the item is (or may be) inconsistent with the partnership's treatment, or
  - The partnership has not filed a return.

DEFICIENCY PROCEDURES AND MATH ERRORS

- Example: Filing Form 8082 to report inconsistent treatment
- Maye owns a 10% interest in ABC Partnership. In December of Year 1, she bought an additional 5% interest from another partner. Maye receives a Sch. K-1 for Year 1 showing her share of the partnership's ordinary loss as $10,000. she reports her share of loss on Sch. E as $15,000 because she believes Sch. K-1 does not reflect the additional ownership interest she bought in December of Year 1. Since Maye is reporting a partnership-related item inconsistently with its treatment on the Sch. K-1, she files Form 8082 with her tax return. This prevents the IRS from immediately assessing any tax due as a math error to conform Maye's treatment of the loss to the loss reported on Sch. K-1.

TIPS TO AVOID BBA MATH ERRORS

- Tips in avoiding partnership-partner disagreements:
  - Communication with partners/investors
  - Partnership to provide draft K-1s to partners/investors with ample time before filing (see next point)
  - EXTEND. Operating agreements sometimes provide for the partnership to file the partnership return by 3/15. Consider amending or negotiating this point so that the partnership has the option to extend (best practice!) and provide estimates instead for interim informational purposes.
  - If you are eligible to do so consider electing out of BBA

AUDIT STEPS AS APPLIED TO THE BBA

Publication 5388 (7-2021) (irs.gov)

Bipartisan Budget Act (BBA) Roadmap for Taxpayers

CENTRALIZED PARTNERSHIP PROCESS

FILING/AUDIT SELECTION

Taxpayer Files Original Return
- For all tax years beginning 01/01/2018 and forward, partnerships are automatically BBA unless taxpayer meets the criteria and "Elects Out of BBA" on a timely filed return
- Partnership Representative (PR) is designated on the filed return and will have sole authority to act on behalf of the partnership

AAR
- If filed, must be filed prior to issuance of NAP

Return Selected For Examination
- Verification of PR by exam team

AUDIT PROCESS

Examination
- Examination steps to complete the audit issues generally remain unchanged under BBA procedures

Notice of Preliminary Partnership Examination Changes

Notice of Proposed Partnership Adjustment (NOPPA)
- Final imputed underpayment (IU) is determined

Taxpayer Can File an Appeal
- Partnership can not appeal an issue/matter more than once

POST AUDIT**

Modification
- Modification requests may be submitted to reduce the IU amount shown on the NOPPA
- The partnership is responsible for providing all required information to the IRS for review and approval of the request

Final Partnership Adjustment (FPA)

PARTNERSHIP PAY OR PUSHOUT*

PAY

PUSHOUT*

CLOSING PROCEDURES

***Pushout Responsibilities**
- Partnership is no longer liable for the IU
- Partnership will provide statements to its partners, and the IRS, on what adjustments and amounts, are being pushed out

TIMEFRAMES

30 DAYS
Issuance of NAP must be at least 30 days after date of L2205D

270 DAYS
Issuance of the NOPPA starts the 270 day modification request period

45/90 DAYS
Issuance of FPA starts:
- 45 days to elect pushout
- 90 days to petition court

TAXPAYER NOTIFICATIONS

- Notice of selection for examination **Letter 2205D**
- Notice of administrative proceeding (NAP) **Letter 5893/5893A**
- Notice of preliminary partnership exam changes and IU (summary report package) **Letter 5895 Form 14791/886A**
- BBA 30-day letter **Letter 5891 Form 14791/886A**
- Notice of proposed partnership adjustment (NOPPA) **Letter 5892/5892A Form 14792/886A**
- Modification determination package **Letter 5975 Form 15027**
- Notice of final partnership adjustment (FPA) **Letter 5933/5933A Form 15027/886A**

** For information about mandatory registration and electronic filing of Post Audit forms, see https://www.irs.gov/BBAeSubmit

Publication 5388 (Rev. 7-2021) Catalog Number 73720B Department of the Treasury **Internal Revenue Service** www.irs.gov

IRS

OPTING OUT OF THE BBA - COMPARISON

BBA	Opt Out
Partnership files an AAR to self-correct	Partnership files an amended return
Partnership may pay any additional tax due on unfavorable changes (imputed underpayment)	Partnership does not pay any tax – the partners must pay
Partnership may elect to push out changes to partners (must push out favorable changes)	Changes are automatically taken into account by the partners
Pushed out changes are reported on Form 8986 and are taken into account by the partners with their returns for the year the AAR is filed or year of the audit	Partners get an amended K-1 and file an amended return for the year of the adjustment
Favorable changes that reduce tax in the year of the change effectively result in a nonrefundable credit (see next slide for more detail).	Favorable changes may result in a refundable overpayment
Cannot retroactively opt-out	The Opt Out election may be revoked only with IRS permission (Form 15288)
Audits: Partnership level audit results binding on all partners. (1) pay imputed underpayment, (2) push-out, (3) have partners file amended returns	Audits: Partners subject to separate assessment

BBA PARTNERSHIP AUDIT

Nonrefundable credit issue

- Favorable changes (i.e. decrease in revenue or increase in deductions) result in a *nonrefundable* credit when pushed out to the partners. This means that if the partner does not otherwise have sufficient taxable income to be offset, the favorable change is effectively wasted.
- There is currently proposed legislation to fix this issue by making the credit a refundable credit.
- Potential fix for non-audit related changes - partners file notices of inconsistent treatment on Form 8082 and claim the “proper” income for the taxable year in question.

BONUS DEPRECIATION

- Bonus depreciation rate reduces by 20% starting in 2023
  - 100% bonus deprecation begins to phase out for assets placed into service in tax years beginning 2023.

Year	Bonus Depreciation Allowable %
2023	80%
2024	60%
2025	40%
2026	20%
2027	0%

BONUS DEPRECIATION

- Eligible property: generally, MACRS property with a recovery period of 20 years or less (both new and used assets)
  - Personal property, land improvements, computer software, water utility property, qualified film/television production property, qualified improvement property
- Audit Outlook:
  - Audit risk where IRS disagrees as to when an asset was placed into service and acquired.

IRC SEC. 163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

- The TCJA limits a taxpayer's deduction of business interest expense (BIE) in a taxable year to the sum of:
  - The taxpayer's business interest income (BII) for the tax year;
  - 30% of the taxpayer adjusted taxable income (ATI) for the tax year; and
  - The taxpayer's floor plan financing interest for the tax year.

- Section 163(j) provides that business interest means any interest paid or accrued on indebtedness properly allocable to a "trade or business."

IRC SEC. 163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

- "Trade or business" for purposes of Section 163(j) generally means a trade or business within the meaning of Section 162, except that it does not include the following, each of which is an "excepted trade or business":
  - The trade or business of performing services as an employee;
  - An electing real property trade or business ("ERPTB") (as described in Section 163(j)(7)(B);
  - An electing farm business (as described in Section 163(j)(7)(C)); or
  - Certain regulated utility trades or businesses

IRC SEC. 163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

- Under Section 163(j)(7)(B), an electing real property trade or business is:
  - A trade or business that is a real property trade or business, as described in Section 469(c)(7)(C) and Reg. Sec. 1.469-9(b)(2), or
  - Real property trades or businesses conducted by real estate investment trusts, as described in Reg. Sec. 1.163(j)-9(g) . . .

- that makes the election to be a real property trade or business under Section 163(j)(7)(B) and Reg. Sec. 1.163(j)-9.

IRC SEC. 163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

- Practitioner Perspective:
  - Confirm partnership calculated limitation correctly.
  - The IRS may look at whether the entity was eligible to make the election: whether it qualifies as a real property trade or business.
  - If partnership elected out of Sec. 163(j), ensure it correctly uses ADS depreciation on certain real property assets.

PRACTITIONERS' PERSPECTIVE: AUDIT

SECTION 751 HOT ASSETS

- Auditor requested workpapers from partnership to support taxpayer's Sec. 751 (hot asset) calculation for the sale of a partnership interest.
  - There are two categories of hot assets that trigger ordinary income upon the disposition of a partner's interest: unrealized receivables and inventory items.
  - These are essentially items that would generate ordinary income if sold.
  - Common items include cash basis receivables and Section 1245 depreciation recapture.
- Take Home: IRS is digging deeper.

INDIVIDUAL TAXPAYER AUDITS

OVERVIEW

- Real estate professional
- Aggregation Election
- Material Participation
- Passive activities
- Debt-financed distributions and interest tracing rules
- Activities – grouping entities

REAL ESTATE PROFESSIONAL

- The general rule regarding rental activities is that they are per se passive activities. IRC Sec. 469(c)(2).
- In order for a taxpayer’s income or loss from a rental activity to be classified as nonpassive, the taxpayer must be a real estate professional (defined in IRC Sec. 469(c)(7)) and must satisfy at least one of the material participation tests.
- In other words, in order to avoid the per se passive rule related to rental activities, a taxpayer must be a real estate professional.

REAL ESTATE PROFESSIONAL

- A taxpayer is a real estate professional if
  - More than 50% of the personal services that the taxpayer performs in trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates; and
  - the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

MATERIAL PARTICIPATION

- Material Participation Decision Tree
  - Is the taxpayer a material participant in a business activity?
  - If answer to any one is yes, losses are excepted from the passive loss limitations and generally fully deductible.
    - Did the individual participate in the activity for more than 500 hours during such year?
    - Did the individual's participation in the activity for the taxable year constitute substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year?
    - Did the individual participate in the activity for more than 100 hours during the taxable year, and was such individual's participation in the activity for the taxable year not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year?
    - Was the activity a significant participation activity for the taxable year, and did the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours?
    - Did the individual materially participate in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year?
    - Was the activity a personal service activity, and did the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year?
    - Based on all of the facts and circumstances, did the individual participates in the activity on a regular, continuous, and substantial basis during such year?

REAL ESTATE PROFESSIONAL

- Audit Outlook:
  - Substantiation: The auditor will ask for a contemporaneous activity log of time spent on the activities, which the taxpayer will likely not have. Therefore, the taxpayer will need to recreate a log, generally by making reference to their calendar.

  - Educating the auditor on the passive activity loss rules. For example, auditors will often try to overapply the “participation as an investor” rule; a rule that does not count hours for time reviewing financials *for the individual’s own use*.

ACTIVITY LOG EXAMPLE

Exhibit 4.4: Activity Log

Business/Property:__________________ Year:____________

Complete the following by day:

Date	Hours Spent	Description of Service Performed. Be as specific as possible. By each service, enter H or W for husband or wife.	If requested, how could activity be verified?

____

____

____

Under penalties of perjury, I declare that I have examined the information contained on this worksheet, including attached worksheets and statements, and to the best of my knowledge and belief, it is true, correct and complete.

__________________________________ ___________________

Signatures (both spouses, if married) ***Date***

Reg. § 1.469-5T(f)(4) provides that reasonable means for proving hours may include a statement of services performed AND approximate hours based on appointment books, calendars, etc. To meet his burden of proof under IRC 7491, the taxpayer must comply with the recordkeeping requirements of the regulations.

IRS Passive Activity Loss Audit Technique Guide (ATG)

AGGREGATION ELECTION

- If a taxpayer is a real estate professional, the taxpayer's rental activities are not considered per se passive and the taxpayer is able to demonstrate that the income or loss from those activities is nonpassive if the taxpayer materially participates in them.
- A taxpayer may make an election to treat all interests in rental real estate as a single rental activity.
- Absent this election, a real estate professional's interests in rental activity are treated as separate activities for determining whether the taxpayer materially participates in each activity.

AGGREGATION ELECTION

- If the taxpayer elects to aggregate its rental real estate activities, that aggregation election will apply for all subsequent taxable years.
- Additionally, passive loss carryovers from any of the rental real estate interests can offset current net income from the aggregated activity, regardless of which rental real estate interests within the aggregated activity produced the income or passive loss carryovers.

AGGREGATION ELECTION

- Audit Outlook:
  - Failure to make the aggregation election will likely increase taxpayer exposure. A taxpayer may fail to meet a material participation test when looking at each rental activity on its own. However, when the election is made all rental activities are counted as one activity so it is easier to attain material participation.
  - The auditor will want to see proof that the election was actually made. As such, it is advisable to periodically make the election, which is technically not required, so an election can be easily found if audited.

PASSIVE ACTIVITIES

- Schedule A – Itemized Deductions – Investment Interest, Line 13
  - Interest expense to buy rental real estate, an equipment leasing activity, or an investment in a partnership or S Corporation is not investment interest.
  - If the borrowed funds were used to buy rental real estate or equipment leasing or contributed to partnership/S corporation in which the taxpayer does not materially participate, that interest expense is passive activity interest. In the absence of passive income, it is generally not deductible.
  - Interest that is properly characterized as investment interest expense is deductible only to the extent of investment income.

DEBT-FINANCED DISTRIBUTIONS AND INTEREST TRACING RULES

- Interest expense on a debt financed distribution is subject to tracing rules.
- The burden of deductibility is up to the individual partner (not the partnership) who will be required to individually trace the expenditures made with the proceeds of such distributions to determine if such interest expense is deductible.
- Expenditures can be classified as either trade or business, personal, investment or passive activity expenditures.

DEBT-FINANCED DISTRIBUTIONS AND INTEREST TRACING RULES

- Notice 89-35 and Notice 88-20 provide interest expense allocation rules for pass-through entities.
- If a partner incurs debt to purchase a partnership interest, the debt proceeds and associated interest expense are allocated among the partnership's assets using any reasonable method, such as based on FMV, book value, or adjusted basis, in each case reduced by partnership-level debt and other partner-level debt allocated to such assets.

DEBT-FINANCED DISTRIBUTIONS AND INTEREST TRACING RULES

- A partner’s share of the partnership interest expense with respect to the debt-financed distribution may exceed the interest on the partnership’s debt proceeds distributed to that partner.
- In such a case, the partnership may allocate the partner’s excess interest expense using any reasonable method.
- The partnership may alternatively choose to first allocate the debt proceeds to the partnership’s other expenditures that are not allocated to any debt.

DEBT-FINANCED DISTRIBUTIONS AND INTEREST TRACING RULES

- Audit Outlook:
  - At the taxpayer level, ensure the interest expense deductions are properly traceable.
  - At partnership level, ensure partnership allocates interest to debt-financed distributions pursuant to Notice 89-35.

ACTIVITIES – GROUPING ENTITIES

- The IRS may ask whether the grouping forms an appropriate economic unit.
  - Taxpayers may group related business entities into one single activity in order to meet the 500 hour test for material participation.
  - Conversely, some taxpayers may attempt to separate inherently related activities in an attempt to create purported passive income which would trigger otherwise unallowable passive losses.
  - In abusive situations, particularly with passive income, the Government may regroup activities to prevent the taxpayer from circumventing IRC Section 469.

ACTIVITIES – GROUPING ENTITIES

- The IRS may ask at the initial appointment or first IDR if entities were grouped. They may further request statements as to how activities are grouped, which entities or undertakings are grouped, and why they form an appropriate economic unit.

ACTIVITIES – GROUPING ENTITIES

- If taxpayer did group activities, the IRS may ask <u>when</u> the grouping decision was made and request tax workpapers or other documents addressing the entities grouped.
  - The failure to provide any written documentation generated at the time of return filing (either in current or prior years) is an indicator that taxpayer did not group his activities.
  - The decision to group or not group is not made at the time of an audit. It is a decision which generally should have been made in 1994 or in the year the interest in the activity was acquired, whichever is later.
    - Treas. Reg. Sec. 1.469-4(e) contains a consistency requirement from year to year and provides that taxpayer may not regroup (unless original grouping was inappropriate or there is a material change).

ACTIVITIES – GROUPING ENTITIES

- The IRS may verify the grouping forms an appropriate economic unit based on:
  - Similarities
  - Location
  - Ownership
  - Common control
  - Interdependencies (purchase or sell goods between themselves, involve products or services that are generally provided together, the same customers, the same employees, or use a single set of books and records to account for the activities).

- Not all factors are necessary and one factor is not determinative. Instead, the appropriateness of the grouping is based on all of the facts and circumstances.

ACTIVITIES – GROUPING ENTITIES

- The IRS may scrutinize any entity that produces purported passive income, but is related or in the same line of business as other non-passive activities.
  - The IRS may look at this to ensure the grouping was not to circumvent the passive loss limitations.

- The IRS may review prior and subsequent year returns for passive and non-passive losses and income to verify the grouping has been used consistently.
  - Three or more year lookback.
  - Treas. Reg. Sec. 1.469-4(e) provides that once the taxpayer has grouped activities he cannot regroup in subsequent years unless the original grouping was clearly inappropriate or a material change makes the original grouping inappropriate.

ACTIVITIES – GROUPING ENTITIES

- The IRS may also ask whether the spouse is involved in business activities, which ones, and how much time.
  - Both spouses' time counts.
  - One spouse's participation is attributed to the other spouse.
  - Even if the spouse does nothing, if the other spouse materially participates, income and losses are non-passive.

INTERNATIONAL
TAXPAYER AUDITS

OVERVIEW

- Sale of real estate & navigating the Foreign Investment in Real Property Tax Act (FIRPTA) rules
- Form 5471/5472 and 8804/8805

ISSUE 1: SALE OF REAL ESTATE, NAVIGATING FIRPTA

- Gain is generally taxable under the *Foreign Investment in Real Property Tax Act of 1980* (FIRPTA) – See Section 897.

- Gain from the sale of a United States Real Property Interest (USRPI) generally taxed as if:
  - Foreign seller is engaged in trade or business in the U.S. and the gain is effectively connected income (ECI)
  - Foreign sellers are taxed on gains at the same rates applicable to U.S. sellers. Gain can qualify for long-term capital gains treatment

- Definition of USRPI (Treas. Reg. Sec. 1.897-1):
  - Interest in real property:
    - Real property includes land, buildings, and other improvements

ISSUE 1: SALE OF REAL ESTATE, NAVIGATING FIRPTA

- Audit Outlook:
  - Withholding requirement provided by Section 1445
  - Buyer must withhold 15% of “amount realized” on sale
- Potential exemptions to withholding where seller provides buyer with a:
  - Non-foreign affidavit or
  - Non-US Real Property Holding Corporation (USRPHC) affidavit if seller is buying a company (discussed in Issue 2).

ISSUE 2: FORMS 5471/5472 AND 8804/8805

- Certain taxpayers are required to file the following forms and withhold tax related to certain foreign investments:
  - Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*
  - Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*
  - Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*
  - Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*

ISSUE 2: FORMS 5471/5472 AND 8804/8805

- Section 1446 requires withholding on a non-US partner's share of effectively connected income of a partnership and withholding on sale of partnerships that have effectively connected income.
- Section 1441 requires 30% withholding on fixed, determinable, annual and periodical (FDAP) income and applies those rules to income allocable by partnerships to foreign partners as well.
- Section 1445 requires 15% withholding of the gross proceeds from a sale or exchange of a US Real Property Interest (USRPI) and from certain distributions by a US Real Property Holding Corporation (USRPHC).

ISSUE 2: FORMS 5471/5472 AND 8804/8805

- Audit Outlook:
  - If taxpayer is required to file information reporting and/or withholding returns and fails to do so, can trigger automatic notice and potential large penalties

ACCOUNTING METHODS
AUDITS

OVERVIEW

- Practitioners’ Perspective: Audit – Bonus Depreciation
- Practitioners’ Perspective: Audit - *Amerisouth*

PRACTITIONERS' PERSPECTIVE: AUDIT

2018 TAX YEAR, BONUS DEPRECIATION

- IRS looked at (in connection with the cost segregation study) the placed in service date, which affected whether the taxpayer was eligible for 100% bonus versus 50% bonus.

- After working this issue through with the exam agent, the tax professional and the auditor determined that almost all of the 5- and 15-year property was eligible for 100%, but some was placed in service earlier and was subject to 50% bonus.

PRACTITIONERS' PERSPECTIVE: AUDIT

2022 TAX YEAR, *AMERISOUTH*

- Audit involving a multi-family property where the IRS raised the *Amerisouth* case.
- The IRS did not take issue with anything the tax professional treated as 15-year land improvements but wanted to deny 5-year treatment to about half of the items that the tax professional identified as 5-year property (in the cost segregation study).
- The positions the IRS raised were in line with the *Amerisouth* case.
- The tax professionals defended their position (via a memo), and the IRS ultimately allowed the taxpayer to keep 95% of the benefit.

QOF/QOZB AUDITS

OVERVIEW

- QOF/QOZB Compliance – Individual Level
- QOF/QOZB Compliance – Partnership Level

ISSUES: QOF/QOZB COMPLIANCE – INDIVIDUAL LEVEL

Generally, in order to defer tax on an eligible gain, a taxpayer must invest in a QOF in exchange for an equity interest within 180 days of recognizing the gain.

If a partner of a partnership that sold assets that generated capital gains would like to defer his capital gains by investing in a QOF, when does the 180-day investment period begin?

- The date on which the partner receives a K-1 notifying you of the eligible gain is not relevant. Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts have the option to start the 180-day investment period on any of the following dates:
  - The last day of the partnership taxable year;
  - The same date that the partnership's 180-day period begins; or
  - The due date for the partnership's tax return, without extensions, for the taxable year in which the partnership realized the eligible gain.

ISSUES: QOF/QOZB COMPLIANCE – PARTNERSHIP LEVEL

QOF/QOZB compliance is a potential IRS area of focus.

The QOF operating agreement must contain language that it intended to be organized as a QOF, and it should be signed and dated.

- The date of the operating agreement and the date it is signed is extremely relevant for purposes of the 180-day testing rules, and in the event the taxpayer needs to request 9100 relief for failure to file Form 8996 with the QOF tax return.

Generally, ensure the taxpayer complied with all of the rules to ensure it has a good investment. This includes, for example, preparing and retaining detailed workpapers that support the following:

- 90% asset test (QOF level),
- 70% asset test (QOZB level),
- 5% nonqualified financial property (NQFP) test (QOZB level).

ISSUES: QOF/QOZB COMPLIANCE – PARTNERSHIP LEVEL

- Request the following from the client to support the internally prepared workpapers, and to use as support in the event of an audit:
  - Trial balance, to demonstrate there are no “bad assets” in the QOF.
    - For example, loan to partner on trial balance.
  - One of the requirements for qualification as a QOZB is that less than 5% of the average of the aggregate unadjusted bases of property held by the entity be attributable to NQFP.
  - The definition of NQFP does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.
  - Working capital assets may be treated as reasonable in amount.

ISSUES: QOF/QOZB COMPLIANCE – PARTNERSHIP LEVEL

Working capital assets may be treated as reasonable in amount if the following requirements are met:

1. The amounts are *designated in writing* for the development of a trade or business in a QOZ
2. There is a *written schedule* consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets.
3. The QOZB must actually use the working capital assets in a manner that is substantially consistent with the written plan and written schedule described in (1) and (2).

NONPROFIT/TAX EXEMPT
USE PROPERTY

OVERVIEW

- UBTI Reporting Requirement
- Fractions Rule

ISSUE 1: UBTI REPORTING REQUIREMENT

- Reporting requirement triggered where there is a tax-exempt partner.
- Where there is a tax-exempt partner, the partnership must disclose unrelated business taxable income (UBTI) on the partner's K-1, box 20V.
- Audit Outlook:
  - Ensure proper reporting where there is a tax-exempt partner.

ISSUE 2: FRACTIONS RULE

- Qualified organizations include educational organizations (and certain affiliates), pension trusts, tax-exempt title-holding corporations, and retirement income accounts described in Section 403(b)(9).
- The fractions rule is applied at the partnership level, not the partner level.
- The fractions rule is intended to prevent the improper allocation of gains to a tax-exempt organization and losses to a taxable organization.
- Section 514(c)(9)(E)(i) defines the fractions rule in two parts:
  - Allocation of items to a partner (the fractions part) and
  - Substantial economic effect

ISSUE 2: FRACTIONS RULE

- Under the fractions part:
  - [T]he allocation of items to any partner which is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest. Section 514(c)(9)(E)(i)(II).

- Substantial economic effect requires the partnership allocations to maintain consistency with the “underlying economic arrangement of the partners”. Treas. Reg. Section 1.704-1(b)(2)(ii)(a).

ISSUE 2: FRACTIONS RULE

- Audit Outlook:
  - If a partnership does not satisfy the fractions rule in Sec. 514(c)(9)(E)(i), the benefit of Sec. 514(c)(9) will not apply to the qualified organization partners. Overall, the determination of whether debt-financed income from real property will be classified as UBTI could depend on whether the partnership meets the fractions rule.

QUESTIONS?

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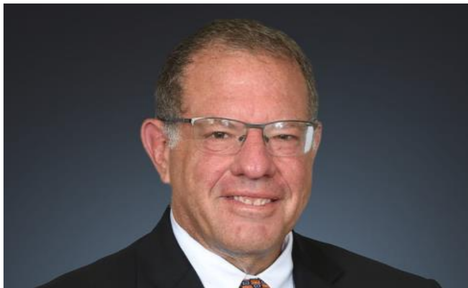

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