Hot Topics for Closely Held Businesses

Friday, January 31, 2020

Sponsored by the ABA Closely Held Businesses Committee

Agenda

- BBA Regulations
- *Boyle* in the Electronic Age
- IRC Section 451(b)
- Passport Revocation Update
- IRC Section 401(k) hardship distribution requirements
BBA Opt-Out

- We are quickly entering the time where BBA will be the default governing regime for partnership audits
  - The IRS is ramping up guidance, including a recent memo to Appeals employees (AP–08–1019–0013, October 18, 2019)
- Section 6221 provides a mechanism for partnerships with fewer than 100 partners to opt out of BBA
  - The partnership must be required to furnish fewer than 100 K-1s
  - The partnership may not be a second-tier or below partnership. Only partnerships with partners who are individuals, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner are eligible.
BBA Regulations

• Regulations promulgated in late 2017 make clear that partnerships with partners who are themselves partnerships, trusts, disregarded entities, foreign corporations that would not be treated as C corps, estates other than those of deceased partners, and “[a]ny person that holds an interest in the partnership on behalf of another person” are not eligible. Treas. Reg. 301.6221(b)-1.

• The regulations further clarify that opt-out elections bind the partnership and all partners unless the IRS finds that the election is invalid.
Heightened Emphasis on Partnership Agreements

• Under TEFRA, partners were entitled to notice regarding various IRS proceedings and notice partners could reject a settlement agreement with the IRS.

• Under BBA, the partnership representative (PR) has the authority to bind the partnership and all partners, including with respect to statute of limitations extensions and settlements, with other partners having no notice rights.

• The broad authority of the PR under the BBA regime means that the partnership agreement is now the avenue for partners to agree on audit matters, including opting out of BBA, the requirement to provide notice, and who is responsible for deficiencies.
Boyle in the Electronic Age

• Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions of time for filing) will be subject to a penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late.
  – This penalty will accrue up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect. (IRC § 6651(a)(1), (b)(1)).
  – For the taxpayer to avoid the penalty by showing there was a reasonable cause, the taxpayer must have exercised ordinary business care and prudence. (Treas. Reg. § 301.6651-1(c)(1)).

• The issue of Boyle’s (U.S. v Boyle, 469 U.S. 241 (1985)) non-delegable duty applicability to electronic returns is a novel legal question that has not been addressed squarely by the federal courts.
Boyle in the Electronic Age

- In *Haynes v. United States*, 760 F. App'x 324, 326 (5th Cir. 2019), the Fifth Circuit noted the possibility of an exception to Boyle for e-filed returns but did not address the issue, remanding the case on other grounds.

- In *Intress v. United States*, 3:18-cv-00851 (D. Tenn. 2019), the district court rejected a married couple's claim that they were entitled to a refund and abatement of interest and penalties for late filing of their return because their tax preparer mistakenly failed to transmit their request for a filing extension.

- The National Taxpayer Advocate’s 2018 annual report to Congress
IRC Section 451(b)

• TCJA added a new income recognition provision in section 451(b), requiring taxpayers to recognize revenue for tax purposes no later than when the taxpayer recognizes the revenue for book/financial statement purposes

• The new rule applies only to taxpayers with an “applicable financial statement”

• When combined with new financial reporting standards (and the repeal of the 451-5 regulations), taxpayers may now recognize income much earlier
Section 451(b) Proposed Regulations

- Proposed regulations were released in September 2019
- They make clear that the new rule under section 451(b) applies only to accrual taxpayers, not taxpayers using a “special method of accounting”—when the Code requires income recognition in a year other than when the all-events test is satisfied
  - Examples include installment sales, long-term contracts, qualified returns, prepaid subscription income, etc.
- The proposed regulations also expand the list of applicable financial statements and provides rules for when a taxpayer’s financial statement year is different than its tax year
- The Preamble also generally denies an accelerated cost offset/COGS for accelerated income (i.e., economic performance must still be satisfied before a deduction corresponding to the income inclusion is allowed), creating the potential for larger mismatches
Passport Revocation Update

• TIGTA’s September 19, 2019 Report highlights whose tax debts the IRS has targeted for passport revocation, how many have been revoked, and what has happened after the sending of the revocation

• The new IRM guidance also provides some updates to the reversal of certification of seriously delinquent tax debt as well as expedited decertification. The expedited decertification can shorten the processing time by 2-3 weeks, but the taxpayer must meet all three of the following conditions:
  1. The taxpayer meets a condition in 5.1.12.27.8 Reversal of Certification;
  2. The taxpayer states that they have foreign travel scheduled within 45 days and can provide proof of travel OR the taxpayer lives outside of the US; and
  3. The taxpayer has a pending application for a passport or renewal, has received notification their passport was denied or revoked, and provides a denial letter from the State Department (read: not the CP508-C).
Passport Revocation Update

- The updates to the IRM made proof of travel necessary in 2. and a copy of the State Department denial letter necessary in 3.
- There is an exception for taxpayers residing out of the United States who do not have imminent travel plans. If the taxpayer meets the conditions outlined in IRM 5.1.12.27.3 or IRM 5.1.12.27.4 and expresses an urgent need for decertification the IRS is supposed to request expedited decertification.
- According to a recent memo from Acting Taxpayer Advocate Advocate Bridget Roberts (TAS-13-0819-0014), effective July 25, 2019, all open TAS cases with a certified taxpayer will be decertified and new TAS taxpayer cases will also be systemically decertified until further notice. This is something for which former NTA Nina Olson advocated prior to leaving office.
The New IRS Hardship Distribution Regulations
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- The Treasury Department and the IRS recently finalized the new hardship distribution regulations.
- The final regulations are substantially the same as the November 2018 proposed regulations, with some limited clarifications and more definitive effective dates. The following summarizes the key features of the final regulations and applies to both 401(K) and 403(b) plans unless otherwise noted.
Mandatory Changes
Effective January 1, 2020

- **Removal of 6-month Contribution Suspension:** Under the prior safe harbor, plans were required to suspend a participant’s contributions for 6 months following a hardship distribution. Effective January 1, 2020, plans may not suspend participant contributions following a hardship distribution. Under the proposed regulations, this change was optional as of the first day of any plan year beginning on or after December 31, 2018.
Mandatory Changes
Effective January 1, 2020

• **Removal of 6-month Contribution Suspension:** Under the final regulations, this change is mandatory for all hardship distributions made on or after January 1, 2020. For hardship distributions made prior to January 1, 2020, plans have the option to continue administering the suspension through the end of the 6-month period (even if this period ends on or after January 1, 2020) or to lift the suspension as of an earlier date, regardless of the fact that the suspension has not lasted the full 6 months.
• **New Immediate and Heavy Financial Need Standard:** Prior hardship distribution regulations applied a “facts and circumstances” test to determine whether a hardship distribution was necessary to satisfy a participant’s financial need. Effective January 1, 2020, the facts and circumstances test is replaced by a new standard requiring that:
  
  – The participant obtain all other currently available distributions under the plan and all other deferred compensation plans of the plan sponsor and its affiliates;
  
  – The participant provide a written representation (including electronically or on a recorded telephone line) that the participant has insufficient cash or other liquid assets reasonable available to satisfy the need; and
  
  – The plan sponsor does not have actual knowledge that is contrary to the participant’s representation.
Mandatory Changes
Effective January 1, 2020

• The final regulations also clarified two points related to this new standard.
• First, the final regulations clarify that the second requirement is not intended to mean that the participant does have any cash or assets available, but that the participant does not have any cash or assets available that are not earmarked for payment of another obligation in the near future (such as rent).
• Second, the final regulations clarify that the third requirement does not impose a duty on a plan sponsor to inquire into the financial condition of an employee, and only applies in very limited circumstances in which the plan sponsor has actual knowledge that an employee’s representation is not true.
Optional Changes

• **Elimination of Requirement to First Take Plan Loans**: Participants were previously required to take all available loans under a plan and all other employer plans before taking a hardship distribution.

• Plans are now permitted (but not required) to remove this requirement and allow participants to take hardship distributions even if they have not taken all available loans under the plan and all other employer plans.
Optional Changes

- **Expansion of Hardship Distribution Sources**: Prior hardship regulations did not permit the withdrawal of earnings on deferral contributions, or the withdrawal of funds in qualified non-elective contribution (QNEC), qualified matching contribution (QMAC), or employer safe harbor contributions accounts.

- Plans are now permitted (but not required) to allow hardship distributions from these sources. However, for 403(b) plans, earnings on elective deferrals cannot be part of a hardship distribution, and the plan can only permit QNECs and QMACs hardship distributions if the 403(b) plan is not in a custodial account.
Optional Changes

• **Addition of New Safe Harbor for Federally-Declared Disasters:** The final regulations added a new safe harbor event for losses incurred by a participant due to a federally declared disaster. At the time of the disaster, the participant’s principal residence or principal place of business must be within the area designated for individual assistance by the Federal Emergency Management Agency (FEMA). Plans are permitted (but not required) to permit hardship distributions based on this safe harbor event. The final regulations state that the Treasury Department and the IRS expect this new safe harbor event to replace the prior practice of publishing separate disaster-relief announcements, and that this change is intended to eliminate any delay or uncertainty regarding access to plan funds that might otherwise occur following a major disaster. In contrast to historical disaster-relief announcements, however, this new safe harbor event considers only expenses and losses of an employee (and not of the employee’s relatives and dependents).
Operational Changes and Participant Communications

- Plan sponsors should ensure that they update plan administration for the mandatory new hardship distribution rules beginning January 1, 2020, as well as any optional changes that they will make. Plan sponsors should also ensure that they promptly communicate changes to employees. The new rules generally make hardship distributions easier for employees to obtain, so employees will want to know about the changes sooner rather than later. In addition, sponsors of safe harbor 401(k) plans, who are required to issue annual safe harbor notices in advance of each plan year, should ensure that they update their notices to reflect hardship distribution changes.
Plan Amendments

• Although some of the hardship distribution changes must be implemented effective January 1, 2020 (and may be implemented earlier), plan amendments are not immediately required for individually designed 401(k) plans. The deadline is based on when the IRS includes the changes in its annual required amendment list and will be, at the earliest, December 31, 2021, for calendar year individually designed plans.
• The regulations confirm that this deadline applies to both the mandatory and optional hardship changes. However, if a plan sponsor chooses not to add an optional hardship change as part of an amendment reflecting the final regulations, but then chooses to add it at a later date, an amendment to reflect such change would need to be adopted by the end of the plan year in which the amendment is first effective.
Plan Amendments, cont.

• For individually designed 403(b) plans, the current plan remedial amendment deadline is March 31, 2020. However, the Treasury Department and the IRS state in the final regulations that they are considering publishing separate guidance that would provide for a later 403(b) amendment deadline for amendments relating to the final regulations.
Plan Amendments, cont.

• Different amendment deadlines may apply to pre-approved 401(k) and 403(b) plans, and sponsors of other types of plans should consult with legal counsel to ensure the applicable amendment deadlines are met.