AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

BDO KNOWS: PARTNERSHIP TAXATION

SUBJECT

PROPOSED REGULATIONS ADDRESSING NEW PARTNERSHIP AUDIT RULES

SUMMARY

To the surprise of many practitioners and taxpayers, substantial changes were made to the way partnerships will be audited by the Internal Revenue Service for returns filed for taxable years beginning after December 31, 2017. The Bipartisan Budget Act of 2015 repeals existing procedural rules, including those under TEFRA, and introduces a regime in which partnerships may, as an entity, be subject to additional tax, interest and penalties.

Many of the operational details of these new rules have been delegated to the Treasury Department. Proposed regulations, which were initially released in January 2017 and withdrawn as part of a regulatory freeze by the Trump administration, have been re-released in substantially identical form on June 14, 2017. While the proposed regulations are not yet final or effective, partnerships must understand the guidance in order to be prepared to address future final regulations. This Alert contains a high level summary of the proposed regulations and identifies some issues that remain unresolved.

DETAILS

Key Considerations

Partnerships will need to analyze and evaluate a number of issues when evaluating the new audit rules. Some key considerations include:

- Whether the partnership is eligible to elect out of the new rules and, if so, whether such an election is advisable.
- If a push-out election should be considered when a partnership cannot elect out of the new rules and, if so, whether the partnership will be able to provide the necessary partner statements.
- Whether a partnership that has not opted out may calculate imputed underpayment modifications to reduce any potential exposure and, if so, beginning the information gathering process.

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- With respect to audited financial statements, consideration of ASC 740 and whether audited financial statements may need to disclose a partnership's financial responsibility for any uncertain positions associated with imputed underpayment obligations.
- Whether the partnership must amend its operating agreement to take into account the new partnership audit rules.

Partnership Agreement Considerations

The new partnership audit rules will require partnerships to take certain measures to come into compliance with the new rules, some of which may be addressed in the partnership agreement:

- **Designating a Partnership Representative.** The proposed regulations require a partnership to designate a Partnership Representative ("PR") for tax years beginning after 2017 (or, if the new regime is elected earlier, then at that time). Similar to the Tax Matters Partner ("TMP") under the TEFRA rules, a PR is the point of contact between the entity and the IRS. Also like the TMP, a PR may bind the partnership. Unlike the TMP, however, a PR may bind all partners to the conclusions of an audit proceeding. Moreover, unlike a TMP, a PR may be a non-partner, as long as the PR has a substantial U.S. presence. If a partnership fails to designate a PR, IRS may do so on its own initiative. Therefore, a partnership should designate a PR or, at a minimum, determine the procedures for designation.
- **Preparing for an Opt-Out Election.** For those eligible partnerships that prefer to opt out of the new audit rules, an election must be made annually with the filing of the partnership return. In such case, the partnership may consider specifying in the partnership agreement its intent to make the election. In drafting such a provision, the partnership may consider the impact of S corporation partners and the need to secure their agreement. Moreover, any agreement may be set up to avoid ownership by those which would make the partnership ineligible to opt out, such as other partnerships, trusts, disregarded entities and nominees. Partnerships currently ineligible to opt out because of their structure may consider whether to restructure their ownership.
- **Preparing for a Push-Out Election.** Partnerships that either cannot opt out or prefer not to opt out of the new rules may elect to push adjustments out to its reviewed-year partners. In such a case, it may be advisable for the partnership agreement to specify such intent and direct the PR to make a push-out election. A partner entering or exiting a partnership should consider the tax implications of any existing and future tax liability resulting from the partnership's election to push out any imputed underpayment.
- **Preparing to Modify the Imputed Underpayment.** A partnership that makes neither an opt-out nor push-out election may want to modify any imputed underpayment amount as permitted under the proposed regulations. In such case, it may be desirable to specify in the partnership agreement that impacted partners will provide any necessary documentation or file amended returns as needed.

Detailed Overview of the New Rules

One of three different regimes will apply to adjustments to partnership items, once the new rules take effect:

1. The default rules provide that underpayments of tax, interest and penalties generally be determined and paid by the partnership as an entity for the year of the audit. The partners to whom such underpayments relate may have no direct liability for any additional tax, interest, or penalties if they are not partners at the time these amounts are paid.

2. The partnership may elect to pass any adjustments on to the individual partners – or former partners – to whom the adjustments relate. Upon making a "push-out" election, those partners will then be required to pay any additional tax, interest and penalties.

3. Partnerships may "opt out" of the new audit rules on an annual basis, in which case any additional tax must be assessed against the partners on a partner-by-partner basis.

Each alternative has its own complex requirements and procedures for, among other things, determining eligibility, computing amounts due and reporting. The proposed regulations provide some guidance on how these rules will work in practice but leave even more questions unanswered. It is clear, however, that partnerships will have many decisions and elections to make, some of which will have to be addressed long before any audit actually begins. Addressing the new rules may also necessitate amending partnership agreements. Thus, it is important that the principals of every partnership understand the new rules prior to their effective date.

The Default Rules

Under the new partnership audit rules the partnership itself must generally pay any "imputed underpayment" calculated for a taxable year. Under the proposed regulations, the imputed underpayment is calculated by multiplying the "total netted partnership adjustment" by the highest rate of federal income tax in effect for any type of taxpayer for the year to which the adjustment relates. The result is then increased or decreased by any adjustment made to the partnership's credits. In determining the total netted partnership adjustment, all adjustments to partnership items are first grouped together:

- Any adjustment that reallocates an item from one partner to another is treated as two adjustments, a positive adjustment (an increase in taxable income) to one partner and a non-positive adjustment (a decrease in taxable income) to another. Each adjustment is grouped in its own reallocation subgroup to prevent the two adjustments from netting to zero. Only positive adjustments are considered in calculating the imputed underpayment.
- All adjustments to items that the partnership claimed or could have claimed as a credit on the partnership's return are included in the credit grouping.
- The third grouping is the residual grouping, which includes all other adjustments. These adjustments are further sub-grouped according to character and based on any limitations that may apply. An adjustment that re-characterizes an item (e.g., from capital gain to ordinary income) is treated as two separate adjustments, one adjustment decreasing the amount of the item as reported by the partnership and a second adjustment increasing the amount of the item as re-characterized by the IRS.

After all adjustments are grouped, items within the same grouping or subgrouping are netted so that each grouping or subgrouping has either a net positive or net non-positive adjustment. The total netted partnership adjustment is the sum of all net positive adjustments in the "residual grouping" and the "reallocation grouping" as described above. Any grouping with a net non-positive adjustment is disregarded for the purpose of calculating the imputed underpayment.

Non-positive adjustments that are disregarded in determining the imputed underpayment described above are not lost but are taken into account by the partnership as non-separately stated income or loss, not for the year under audit (the "reviewed year") but for the year in which the adjustments are determined (the "adjustment year").

The proposed regulations allow a partner to request that the amount of the imputed underpayment otherwise payable by the partnership be adjusted. For example:

- If a reviewed year partner files an amended return reflecting its share of all adjustments, and pays in full any addition to tax plus applicable penalties and interest, the partnership may request that such partner's share of adjustments be excluded in calculating the imputed underpayment. To qualify, the partner must also file amended returns for any other years affected by the adjustment (e.g., because of changes to carryover losses), and the statute of limitation must generally be open with respect to all years for which an amended return is filed. If the adjustment relates to a reallocation of partnership income, all partners affected by the adjustment must file amended returns. If the partner filing an amended return to satisfy these requirements is a pass-through entity (partnership or S corporation), it cannot further pass the adjustments through to its members but must compute and pay any taxes, penalties and interest itself.
- If adjustments are allocable to a tax-exempt entity that would not owe tax by reason of that status, the partnership may request that such adjustments be excluded in computing the imputed underpayment.
- A partnership may request modification of the imputed underpayment to account for lower tax rates to which the partners affected by such adjustment would have been subject. For example, if a partner to which an adjustment is allocable is a corporation, the partnership may request that the imputed underpayment be calculated based on the maximum corporate tax rate rather than the maximum tax rate attributable to individuals. Likewise, if the adjustment relates to capital gains or qualified dividends allocable to individuals, the partnership may request modification based on the lower maximum rate of tax attributable to such income.

The proposed regulations provide for additional targeted modifications with respect to publicly traded partnerships and allocations to regulated investment companies and real estate investment trusts, and for appropriate adjustments not specifically described in the regulations.

Modifications must be requested within 270 days of the issuance of the notice of final partnership adjustment ("FPA"), but the form of the request has not yet been specified. Likewise, a partnership requesting modification will be required to substantiate the facts supporting the request, but no guidance has yet been issued on the specific means of substantiation that will be required.

The Push-Out Rules

As an alternative to the Default Rules, a partnership may elect to "push out" adjustments to its reviewed year partners rather than paying the imputed underpayment itself. A partnership may make a push-out election with respect to one or more imputed underpayments identified in an FPA. For example, where the FPA includes a general imputed underpayment and one or more specific imputed underpayments, the partnership may make an election with respect to any or all of the imputed underpayments. If a valid push-out election is made, the reviewed year partners of the partnership are liable for tax, penalties and interest on their respective shares of any partnership adjustments that have been pushed-out.

For this purpose interest is calculated using the federal short-term rate plus five percentage points. That rate is two percent higher than the rate normally applicable to underpayments of tax. Thus, there is effectively a two percent interest rate surcharge for the use of the push-out method.

The election must be made within 45 days of the date the FPA was mailed by the IRS. The time for filing the election may not be extended. The election must be signed by the PR and must include the name, address and correct taxpayer identification number ("TIN") of the partnership; the taxable year to which the election relates; the imputed underpayment(s) to which the election applies (if there is more than one imputed underpayment in the FPA); each reviewed year partner's name, address and correct TIN and any other information required by forms, instructions and other guidance. All reviewed year partners are bound by the election and each reviewed year partner must therefore take the adjustments on the statement into account and report and pay additional tax, penalties and interest.

A partnership making the push-out election must furnish statements to the reviewed year partners with respect to the partner's share of the adjustments and file those statements with the IRS. The statements must be filed and furnished separate from any other statements required to be filed with the IRS and furnished to the partners for the taxable year, including any Schedules K-1. Therefore, the partnership may not include the partnership adjustments that are to be taken into account by the reviewed year partners on any Schedule K-1 required to be furnished to the partner for the year. Similarly, the partnership must furnish separate statements for each reviewed year at issue and cannot combine multiple reviewed years (if any) into a single statement. The statements must be furnished to the reviewed year partners no later than 60 days after the date the partnership adjustments become finally determined.

The statements must include the name and correct TIN of the reviewed year partner; the current or last address of the reviewed year partner that is known to the partnership; the reviewed year partner's share of items originally reported to the partner; the reviewed year partner's share of the partnership adjustments and any penalties, additions to tax, or additional amounts; modifications attributable to the reviewed year partner; the reviewed year partner's share of any amounts attributable to adjustments to the partnership's tax attributes in any intervening year resulting from the partnership adjustments allocable to the partner; the reviewed year partner's "safe harbor amount" and "interest safe harbor amount" (as described more fully below); the date the statement is furnished to the partner; the partnership taxable year to which the adjustments relate and any other information required by forms, instructions, or other guidance.

A reviewed year partner that is furnished a statement is required to pay any additional tax (additional reporting year tax) for the partner's taxable year, which includes the date the statement was furnished to the partner (the reporting year) that results from taking into account the adjustments reflected in the statement. The additional reporting year tax is either the "aggregate of the adjustment amounts," or at the election of the partner, the "safe harbor amount." In addition, the reviewed year partner must also pay the partner's share of any penalties, additions to tax or additional amounts reflected in the statement, and any interest on such amounts.

The aggregate of the adjustment amounts is the aggregate of two "correction amounts," one for the partner's taxable year, which includes the reviewed year of the partnership (first affected year), and a second correction amount for the partner's taxable years after the first affected year and before the reporting year (intervening years). These correction amounts cannot be less than zero, and any amount below zero does not reduce any correction amount, any tax in the reporting year, or any other amount. The correction amount for the first affected year is the amount by which the reviewed year partner's federal income tax would increase for the first affected year by taking into account the adjustments reflected in the statement provided to the reviewed year partner. The aggregate correction amount for all intervening years is the sum of the correction amounts for each intervening year determined on a year-by-year basis. The correction amount for each intervening year is the amount by which the reviewed year partner's federal income tax would increase by taking into account any adjustments to any tax attributes.

In lieu of computing and paying an aggregate adjustment amount, a partner that is furnished a push-out statement can elect to pay the safe harbor amount. The election is made on the partner's return for the reporting year. The safe harbor amount for each reviewed year is calculated in the same manner as a partnership calculates and imputes underpayment except that only the adjustments allocated to the partner on the statement are taken into account. However, no modifications to the underpayment amount are allowed except for approved modifications for adjustments that have been taken into account by the partner on an amended return.

In addition to the safe harbor amount, a partnership making the push-out election must calculate an interest safe harbor amount for partners who are individuals and who have a calendar year taxable year. The rate of interest is calculated using the federal short-term rate plus five percentage points.

The Opt-Out Rules

Eligible partnerships may elect not to be subject to the centralized partnership audit regime. The election is effective only for the taxable year in which it is made, so a partnership wishing to elect out of the regime must make a valid election each year. Partnerships that elect out for a taxable year will be subject to pre-TEFRA audit procedures under which the IRS must separately assess tax with respect to each partner. Those procedures are burdensome and complex to administer and will generally make it more difficult for the IRS to examine electing partnerships. It is expected that the majority of eligible partnerships will elect out.

There are two conditions that must be met for a partnership to be eligible to elect out of the centralized partnership audit regime. First, a partnership must have 100 or fewer partners during the year. This requirement is met only if the partnership is required to furnish 100 or fewer Schedules K-1 to partners for the year regardless of how many Schedules K-1 are actually issued. For example, if a partnership furnishes two separate Schedules K-1 to a partner who holds both a general and limited partnership interest, the partnership is treated as having furnished a single Schedule K-1 to that partner because only one Schedule K-1 is required. If a husband and wife each own an interest in the same partnership they are treated as two partners for purposes of this rule.

The proposed regulations include a special rule for partnerships that have S corporation partners: Any Schedules K-1 required to be furnished by the S corporation to its shareholders for the taxable year of the S corporation ending with or within the partnership's taxable year are taken into account in determining whether the partnership is required to furnish 100 or fewer Schedules K-1 for that taxable year. For example, if an S corporation with 50 shareholders is a partner in a partnership, in addition to the statement the partnership is required to furnish to the S corporation, the 50 Schedules K-1 that the S corporation is required to furnish to its shareholders are counted in determining whether the partnership is required to issue 100 or fewer Schedules K-1 to its partners.

The second requirement for eligibility is that at all times during the year all the partners must be eligible partners. Eligible partners include only individuals, C corporations, eligible foreign entities, S corporations and estates of deceased partners. For this purpose C corporations include regulated investment companies, real estate investment trusts and tax exempt corporations (but not tax exempt trusts). Eligible foreign entities include foreign entities that are classified as corporations under Treas. Reg. sections 301.7701-2 and 301-7701-3, whether because they are per se corporations, have defaulted to corporate status, or have elected to be classified as a corporation. Notably, a disregarded entity is not an eligible partner, nor is a nominee or other person holding an interest on behalf of another.

An eligible partnership may make an election only on a timely filed partnership return (including extensions) for the partnership taxable year to which the election relates. Once made, the election may only be revoked with the consent of the IRS. The electing partnership must disclose the names, taxpayer identification numbers and federal tax classifications of all partners of the partnership. If the partnership has an S corporation partner the partnership must disclose this information with respect to each shareholder to whom the S corporation is required to provide a Schedule K-1. The form of the disclosure has not yet been prescribed.

A partnership that elects out of the centralized partnership audit regime must notify each of its partners of the election within 30 days of making the election. The proposed regulations do not mandate the form of the notification.

Finally, if an electing partnership (the upper-tier partnership) is itself a partner in another partnership (the lower tier partnership), the election has no effect on the application of the centralized partnership audit regime to items attributable to the lower-tier partnership.

Partnership Representative

The new partnership audit rules require each partnership to designate a person as the PR, who will have the sole authority to act on behalf of the partnership. The PR is similar in concept to a TMP under the TEFRA rules, but there are two very important differences.

First, whereas the actions of a TMP do not bind the other partners, all the partners are bound by the actions of the PR and they have no right to contradict its decisions. This broad authority cannot be limited by state law, the partnership agreement or any other document or agreement.

Second, unlike a TMP, the PR does not have to be a partner but can be any person, including an entity, as long as it has a substantial presence in the United States and the capacity to act. To have a substantial presence in the United States (1) the person must be able to meet in person with the IRS in the United States at a reasonable time and place as is necessary, (2) the person must have a street address in the United States and a telephone number with a United States area code where the person can be reached by mail or telephone during normal business hours, and (3) the person must have a U.S. taxpayer identification number. If the partnership designates an entity as the PR, the proposed regulations require that an individual be designated to act on behalf of that entity.

The proposed regulations require a partnership to designate the PR on the partnership's return filed for each taxable year. A PR may not be changed under these rules until the IRS issues a notice of administrative proceeding to the partnership or when the partnership files a valid administrative adjustment request, which cannot be filed solely for that purpose. Limited exceptions are provided in specific circumstances.

If a partnership fails to designate a PR, the partnership has 30 days to designate one once the IRS notifies the partnership that no designation is in effect. If the partnership still fails to designate a representative, the proposed regulations allow the IRS to select one. The proposed regulations provide factors the IRS must consider in selecting a PR, but once chosen the representative has the same authority as a representative chosen by the partnership and the partnership cannot revoke the designation without IRS consent.

Administrative Adjustment Requests

Like partnerships subject to the TEFRA rules, partnerships subject to the new partnership audit rules cannot file amended returns to correct errors reflected on returns that have been filed but must file an administrative adjustment request ("AAR"). Under the proposed regulations, if a partnership files an AAR and the adjustments result in an imputed underpayment, the partnership must generally compute an imputed underpayment amount under the Default Rules discussed above.

As in the case of adjustments arising from an IRS examination, the partnership may reduce the imputed underpayment for the permitted modifications discussed above. The partnership does not need to seek IRS approval for such modifications in the case of an AAR, but must notify the IRS and provide supporting documentation. In addition, the partnership may elect to be subject to the Push-Out rules rather than pay the imputed underpayment amount itself.

As with the existing rules, a partnership may not file an AAR with respect to a taxable year more than three years after the later of the date the return for that year was filed or the due date of such return determined without regard to extensions.

Unresolved Issues

Despite the considerable scope of the proposed regulations there remain a number of issues that will need to be addressed in future guidance before the new audit rules become effective.

Perhaps the most significant issue yet to be addressed is how adjustments under the new rules will affect the basis and capital accounts of the adjustment year partners, as well as the partnership's tax and section 704(b) "book" basis in its assets. The Treasury has determined generally that the adjustment year partners' outside basis and capital accounts, and a partnership's basis in its property, should be adjusted to what they would have been if the adjustments were made in the reviewed year and should then be modified to take into account how the adjustments would have effected taxes in intervening years. However, the IRS has not yet determined how to draft mechanical rules achieving appropriate results and has therefore requested public comments.

The IRS is also considering whether a pass-through partner who receives a push-out statement should be allowed to push that adjustment out to its own members. A technical corrections bill introduced in Congress in December 2016 would resolve the question and provide that a partner that is a partnership or S corporation may elect to either pay an imputed underpayment or flow the adjustments through the tiers. The IRS has requested public comment on how administer the push-out rules in tiered structures.

The IRS has also reserved on how to coordinate the push-out rules with withholding requirements for foreign and certain domestic partners; how to treat partners that are estates, trusts or foreign entities (such as controlled foreign corporations) that might not be directly subject to tax on adjustments but whose owners may be and how to treat adjustments to creditable foreign tax expenditures and other adjustments affecting the amount of foreign tax credit that might be allowable to partners.