Proposed Regulations on New Partnership Audit Rules

Before the inauguration of President Trump and in advance of the winter meeting of the American Bar Association's Section of Taxation, the Treasury Department and Internal Revenue Service (IRS) released proposed regulations to implement the partnership audit rules enacted as part of the Bipartisan Budget Act of 2015 and generally effective for taxable years beginning after 2017. On Inauguration Day, President Trump instructed that all regulations and proposed regulations submitted to the Federal Register and not yet published be withdrawn. Although the proposed regulations on the centralized partnership audit regime (Proposed Regulations) will not be published until the Trump Administration's moratorium on regulations is lifted, they provide useful insight into the IRS's thinking on the new partnership audit regime and may affect the drafting of partnership agreements.

This publication highlights provisions of the 277-page notice of proposed rulemaking (NPRM) that may have significant planning implications for new partnerships and individuals and entities becoming partners in partnerships.

Overview

The Proposed Regulations provide comprehensive rules for opting out of the new partnership audit regime, implementation of the regime and elections under the regime. They recognize the complexity of new partnership audit regime by providing detailed guidance on some matters and reserving, raising issues and seeking comments in other areas. In some cases, the preamble to the proposal reveals the IRS's position on open or reserved matters.

The Proposed Regulations reflect the IRS's strong desire to discourage partnerships from opting out of the new regime and to have partnerships, rather than partners, pay tax on imputed underpayments.

Opting Out of the Centralized Partnership Audit Regime

The preamble and Proposed Regulations look unfavorably on the option for certain partnerships to opt out of the centralized audit regime. They do not provide any leeway beyond what the statute provides for opting out: (i) the issuance of 100 or fewer K-1 Schedules and (ii) the requirement that each of the partners be an individual, 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. In addition, the Proposed Regulations interpret the law in ways that make it more difficult to meet the statutory requirements.

For example, in applying the 100-partner limitation when a partnership has an S corporation as a partner, the Proposed Regulations count both the Schedule K-1 issued to the S Corporation and the Schedules K-1 issued to shareholders. Schedules K-1 issued to spouses count as two K-1s even though they are a single partner for certain other tax law purposes. The preamble indicates that the 100-partner rule focuses on the literal identity of partners. Therefore, partnerships, trusts, disregarded entities, nominees and other similar persons that hold an interest on behalf of another person would not be considered eligible partners. A nonprofit corporation exempt from tax under Internal Revenue Code section 501(a) would be an eligible partner.

The preamble sends a message that the additional complexity will not make it less likely that an opted-out partnership will be audited. The preamble also cautions that the IRS will audit elections to opt out to make sure that they are valid and "carefully scrutinize" whether two closely related partnerships that have opted out should be considered a single partnership under general federal income tax principles. This could raise issues for parallel funds that seek to opt out.

Partnership Representatives

The Proposed Regulations give partnerships great freedom in selecting a partnership representative. The representative can be an individual partner or an entity with a substantial presence in the US. The NPRM indicates that the partnership representative does not need to be a partner. An entity representative must designate an individual with a substantial US presence with whom the IRS can interact. To satisfy the substantial presence requirement, the designated individual must have a street address in the US and a telephone number with a US area code, as well as a US taxpayer identification number. These requirements could cause foreign partnerships subject to these rules to look outside the partnership to identify a partnership representative.

Under the proposed regulatory scheme, the decision as to whom to appoint as partnership representative on a partnership's tax return should not be taken lightly. The representative can resign or be replaced only after the IRS files a notice of administrative proceeding with the partnership or when the partnership files an administrative adjustment request (AAR). A partnership representative can select his or her own replacement. The process for a partnership to replace a partnership representative who does not voluntarily resign is complicated. Partnership representatives will have full authority vis-à-vis the IRS to make tax-related decisions on behalf of the partnership.

These decisions will be binding on the partners, even if a partnership representative fails to comply with a provision in a partnership agreement that limits his or her authority to take certain tax-related actions without partnership consent.

As a result of the power and responsibility given to them, partnership representatives are likely to look for indemnification and insurance. On the other hand, partners may prefer that a partnership representative have personal liability for any breach of an obligation to (i) make a particular election under the audit rules or (ii) obtain partnership consent before taking certain actions.

Strong Consistency Rules

The Proposed Regulations include strong rules requiring partners to file consistently with their partnership returns unless they disclose the inconsistency. The IRS can treat undisclosed inconsistencies as mathematical errors and make adjustments without the ordinary due process that applies to other types of adjustments. The NPRM looks to the Schedules K-1 for consistency; supplemental information provided by a partnership that is inconsistent with K-1 reporting could lead to adjustments for inconsistency.

The consistency rules plus the rules for administrative adjustment requests put a high premium on getting the original partnership return correct. A partnership will not be able to simply file an amended return and provide amended Schedules K-1 to correct an error.

Tiered Partnerships

Under the position taken by the IRS in the preamble to the Proposed Regulations, tax-exempt, foreign and other no or low tax rate partners that invest through tiered partnerships will not be able to reduce the audited partnership's tax liability through a push-out election. Instead, they will have to rely on one of the approaches for modifying the imputed understatement of tax.

Under section 6226, a partnership can elect to push out all adjustments to partners who were partners in the reviewed year. The Proposed Regulations are "reserved" on the ability of a pass-through partner to further push out adjustments to its partners/shareholders/beneficiaries. However, the preamble sets forth the IRS's position that a second-level push-out should not be allowed and the reasons for that conclusion. The Proposed Regulations reserve on the issue because a technical corrections bill would have allowed a pass-through partner to push through adjustments to its partners. If the IRS position is followed, the pass-through partner would pay full tax on amounts that, if reported correctly on original returns, would have passed through to tax-exempt or foreign partners (or partners with NOLs or NOL carryovers) who otherwise would have paid little or no tax on the additional income.

Under section 6225(c)(2), a partnership's imputed underpayment amount will be reduced by amounts that reviewed year partners take into account in amended returns filed for the reviewed year and all affected years. The Proposed Regulations permit the direct pass-through partner to file the amended return and pay the tax under the safe harbor rules described below – essentially using maximum marginal tax rates and the pass-through entity (as opposed to its partners or shareholders) must pay the tax.

The Proposed Regulations also allow the pass-through partner to essentially push out adjustments to its partners. If those partners file returns and pay the required tax and interest, the adjustments pushed out to them will not be taken into account in determining the imputed underpayment amount on which the audited partnership must pay tax.

It may also be possible to reduce the imputed underpayment to take into account tax-exempt and foreign entities that invest through tiered entities. A partnership may seek IRS permission to modify the imputed underpayment that it would be required to pay to take into account the tax-exempt status of some of its partners in the reviewed year. By defining tax-exempt entities by cross reference to Code section 168(h)(2), the Code allows foreign persons and entities to be treated as tax-exempt entities and, therefore, their tax status to be taken into account in the modification process. The Proposed Regulations allow for the possibility of looking through to indirect partners if the pass-through partner in the audited partnership and the indirect partners provide appropriate information to the audited partnership.

Under both modification provisions described above, the Proposed Regulations allow for modifications with respect to "indirect partners." The Proposed Regulations define an "indirect partner" as "any person who holds an interest in a partnership through their interest in one or more pass-through partners." A "pass-through partner" is a pass-through entity that holds an interest in a partnership. These definitions can be read to treat as an "indirect partner" a person who holds an interest through multiple tiers, but that reading is not free from doubt.

As a result of the NPRM, pass-through entities that are partners in another partnership should be cautious about requiring the partnership to make a push-out election. Similarly, partners should be cautious about requiring a partnership to require any partnership of which it is a partner to make a push-out election. Technical corrections may eventually allow for a multi-level push-out, but technical corrections legislation is often delayed. IRS or Treasury Department opposition to a proposed technical correction can cause it to be deleted from legislation.

Rules for Modifications

The procedures for obtaining a modification to an imputed underpayment based on special tax positions of direct and indirect partners are necessarily complex. A partnership representative seeking a modification may have to furnish the IRS a detailed description of the structure, allocations, ownership, ownership changes of the partnership, its partners and, if relevant, indirect partners for each taxable year relevant to a request. A partnership seeking modification based on the tax-exempt status of a partner must demonstrate that the tax-exempt partner would not have been subject to tax (e.g., as additional unrelated business taxable income) with respect to the adjustment had it been allocated to the partner in the reviewed year.

Push-Out Election Safe Harbor

The proposed regulations include a voluntary safe harbor provision if a partnership elects, under Code section 6226, to push out adjustments to reviewed year partners. It allows a reviewed year partner to pay an amount of additional tax and interest stated in a notice from the partnership in lieu of recomputing its tax liability for the reviewed year and other affected years. The safe harbor amount is calculated in the same manner as the tax on imputed underpayments, which appears to be an amount computed using the highest marginal tax rates for the portion of the understatements allocated to the partner.

Push-Out Election and Partners Subject to Withholding

The Proposed Regulations reserve on rules that would apply when statements that a partnership provides as part of a push-out election are provided to foreign partners and certain domestic partners that may be subject to withholding at the source. In the preamble, the IRS states that income to such a partner that was not accounted for in the reviewed year should be subject to withholding in the adjustment year.

Partnerships That Cease to Exist

The Proposed Regulations provide extensive guidance on partnerships that "cease to exist." Under the Proposed Regulations, a partnership would "cease to exist" if the partnership terminates within the meaning of Code section 708(b)(1)(A) or does not have the ability to pay in full any amount the partnership owes under the new audit regime. The rules give the IRS discretion in determining whether and when a partnership ceases to exist. The proposed regulations say that the IRS will not treat a partnership as ceasing to exist solely by reason of a technical termination (a 50% change in ownership in a 12-month period).

As a general rule, if a partnership is treated as ceasing to exist, the partnership's adjustment year partners are the partners at the time the partnership ceases to exist. The tax, interest and penalty liability determined at the partnership level then gets taken into account by the adjustment year partners.

These rules may affect the perceived limited liability of limited partners and members of a limited liability company treated as a partnership for tax purposes. An individual who joins a failing firm as a partner or member could become liable for a significant share of tax associated with past understatements of income or improper pass-through of tax credits or tax-credit attributes by the partnership or company.

These rules do not specifically address partnership mergers and whether the surviving partnership (for tax purposes) becomes liable for the tax attributable to pre-merger imputed underpayments imposed on the terminated partnership.

Economic Burden of Adjustments When Taxes Paid at Partnership Level

The Proposed Regulations clarify that taxes, penalties and interest paid under the new audit rules are not deductible. When paid by a partnership, they are to be treated as section 705(a)(2)(B) payments, i.e., amounts that reduce capital accounts and basis of the partners. The Proposed Regulations do not provide guidance on how adjustments to income, gain, loss or deduction that result in an imputed underpayment should be allocated for purposes of determining capital accounts and basis. The NPRM indicates that the IRS intends to allocate the adjustments to the adjustment year partners and to provide rules for adjustment to inside basis.

Comments

In addition to allowing comments on all aspects of the proposed rulemaking, the NPRM seeks comments on a variety of specific issues. While the 90-day comment period will not be triggered until proposed regulations are published in the Federal Register, partners and partnerships that may be affected by items on which comments are requested or invited should begin to think about positions that can be taken in comments. Some significant areas in which the NPRM seeks or welcomes comments are:

- Expansion of the opt-out election **if** the comments address the additional burdens on the IRS from a proposed expansion.
- Circumstances allowing a partnership or partnership representative to change a partnership representative designation, other than as provided in the Proposed Regulations.
- Special rules relating to the treatment of certain creditable expenditures in determining imputed underpayments.
- Modifications in computing imputed underpayments where a partner is a foreign person and may be subject to gross basis taxation or where a direct or indirect partner is entitled to a modified rate of tax under the Code or as a resident of a country that has an income tax treaty with the US.
- Whether guidance is needed under ERISA, excise tax rules or private inurement/private benefit rules relating to a partnership's decision to request or not request a modification when a partnership has a partner subject to one of those rules.
- Whether the modification rules proposed for section 860 entities that use "deficiency dividends" adequately allows such entities to use the modification process.
- The method of allocating adjustment items to partners.
- How adjustments relating to the foreign tax credit should be taken into account within the framework of the audit regime, including possible ways to account for adjustments to items sourced or calculated at the partner level, such as interest expense and deemed paid cost.
- Potential issues arising with respect to tax-exempt entities as the result of a push-out election and ways to resolve issues, e.g., the effect of increased investment income on the public support calculation.
- Issues relating to the payment of withholding tax when income that would be subject to withholding is pushed out.

Future of the Proposed Regulations

The Proposed Regulations are not the type of proposed regulations that the Trump Administration is seeking to stop. They are a step in providing guidance that the IRS, partnerships and partners will need when the audit regime becomes effective. We expect that the Proposed Regulations will be published, largely as released, in the Federal Register and become official proposed regulations. The publication delay could cause the IRS to change the date for the public hearing on the Proposed Regulations and may enable the IRS to expand the Proposed Regulations to include proposed language on some matters on which the preamble advises readers of the IRS's tentative position, but that are not specifically addressed in the Proposed Regulations.

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