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ALERT

Tax

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Treasury Releases Proposed Rules Implementing Partnership Audit Regime; Awaiting Publication in the Federal Register

On January 18, 2017, the Department of Treasury ("Treasury") released proposed regulations (REG-136118-15) (the "Proposed Regulations") implementing the partnership audit provisions of the Bipartisan Budget Act of 2015 (the "BBA Rules"). The BBA Rules created a new regime for auditing partnerships, repealing the Tax Equity and Fiscal Responsibility Act ("TEFRA") rules that have been in place since 1982. The BBA Rules are intended to facilitate audits of large and tiered partnership structures by the Internal Revenue Service (the "IRS") by permitting the IRS to collect tax directly from partnerships, rather than collecting tax from each individual partner as provided under TEFRA. The BBA Rules, codified under sections 6221 to 6231 of the Internal Revenue Code (the "Code"), will be effective for tax returns filed with respect to tax years beginning after December 31, 2017. For prior coverage of the BBA Rules and related Temporary Regulations issued in 2016 that address early election into the BBA Rules, see here and here.

As described further below, the Proposed Regulations provide much-needed guidance on a number of issues. They (1) specify a narrow set of partnerships that are permitted to opt out of the BBA Rules; (2) broaden the powers of the "partnership representative" (the party with delegated authority to act on behalf of the partnership); (3) greatly expand the scope of tax to be collected in a partnership proceeding; (4) set out detailed mechanics for calculating the amount of tax payable by the partnership on behalf of its partners (referred to in the BBA Rules as the "imputed underpayment"); and (5) create innovative rules for partnerships that wish to "push out" adjustments from the partnership, making individual partners liable for any additional tax under section 6226 of the Code. Notably, the Treasury and the IRS reserved on, and requested comments in, several critical areas, giving taxpayers and practitioners an opportunity to influence further rule making.

Although Treasury submitted the Proposed Regulations to the Federal Register for publication, they were not published before President Trump froze all unpublished regulations to enable further review by the Office of Management and Budget (the "OMB"). Until publication, the Proposed Regulations will not be official, and the period for comments and the date for public hearing will be unknown. Moreover, it is possible that Treasury will modify the regulations prior to their eventual release. Nonetheless, the Proposed Rules provide partnerships with critical insight into the potential application of the BBA Rules scheduled to come into effect in less than a year.

Overview of the Material Aspects of the Proposed Regulations

1. Opting Out

> *► Practice Tip ◄*
> *Treasury has made clear that partnerships should not assume that opting out means less likelihood of audit.*

Under section 6221(b), certain eligible partnerships may make an election out of the new regime, which would cause partners of those partnerships to become subject to separate audit procedures. However, eligibility for the election is extremely limited. The Proposed Regulations would limit the range of partnerships that are eligible to elect out to partnerships with: (i) 100 or fewer partners during the year (based on the number of Schedule K-1s issued); and (ii) only partners that are all "eligible partners." The list of eligible partners is narrow: individuals, C corporations (including regulated investment companies ("RICs") and real estate investment trusts ("REITs")); "eligible foreign entities" that are classified or elect to be treated as corporations for U.S. tax purposes; S corporations; estates of deceased partners; and tax-exempt organizations classified as corporations. The

Proposed Regulations expressly exclude from the definition of "eligible partners," partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees or other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner.

> ► *Practice Tip* ◄
> *Although an election out of the BBA Rules is valid until a partnership is notified otherwise by the IRS, partnerships should consider engaging in significant diligence into the status of partners, and should consider adding contractual provisions requiring notice of changes in entity classification to ensure successful opt-outs.*

To ensure that the opt-out rules are not abused, the IRS intends to carefully scrutinize opt-out decisions, particularly where (1) two or more partnerships could be recast as having formed one or more constructive or *de facto* partnerships; (2) profits or losses of one partnership are determined in whole or in part by reference to the profits or losses of another partnership; and (3) taxpayers allege a structure other than a partnership was created (for example, the co-ownership of property).

2. Partnership Representative

The Proposed Regulations define the BBA's requirement that a partnership representative have a "substantial presence" in the United States and the capacity to act on behalf of the partnership. A person has a substantial presence in the United States if they are able to meet in person with the IRS in the United States at a reasonable time and place, have a street address in the United States and a telephone number with a United States area code where they can be reached, and have a U.S. taxpayer identification number ("TIN"). Unlike under TEFRA, the partnership representative need not be a partner in the partnership. The partnership may appoint a legal entity as the partnership representative, including the partnership's management company, so long as that entity identifies and appoints an individual with a substantial presence in the United States to act on its behalf.

> ► *Practice Tip* ◄
> *The new rules will make it difficult to change the partnership representative in the absence of an IRS audit. Consideration should be given to contractual provisions requiring a partnership representative or designated individual to tender its resignation when an audit commences.*

> ► *Practice Tip* ◄
> *Partners have significantly fewer regulatory protections under the BBA compared to the TEFRA regime. Accordingly, partners may place a higher premium on contractual provisions providing for notice of an IRS audit and opportunity to participate in the audit process.*

A partnership must designate a partnership representative on its return for each taxable year. A designation for a partnership taxable year remains in effect until the partnership representative resigns, the partnership revokes the designation, or the IRS determines that the designation is not in effect. The Proposed Regulations provide that a partnership representative may not be changed (either by resignation or revocation) until the IRS issues a notice of administrative proceeding to the partnership, or the partnership files a valid administrative adjustment request for a valid purpose other than changing the partnership representative.

If a partnership representative has not been designated, the IRS may select any person to serve as a partnership representative, and will take into consideration whether the person is a partner in the partnership, either in the reviewed year or at the time the designation is made. The IRS may also consider the views of the partners having a majority interest in the partnership, the general knowledge of the person in tax matters and the administrative operation of the partnership, the person's access to the books and records of the partnership, and whether the person is a United States person.

> ► *Practice Tip* ◄
> *Given the seemingly unfettered authority of the partnership representative, partnerships should consider contractually protecting themselves vis-à-vis a partnership representative that ceases to be a partner, employee, or officer of the partnership.*

In a significant departure from TEFRA, the new rules also broaden the powers of the partnership representative. All partners, including indirect partners, are bound by the actions of the partnership representative and by any final decision in proceedings brought under the new audit regime. Unless the IRS consents, only the partnership representative may participate in an examination or other proceeding involving the partnership. The partnership representative has the power to (1) agree to a settlement with the IRS, (2) accept a notice of final partnership adjustment ("FPA"), (3) make a push-out election under section 6226, and (4) request an extension of the period for adjustments under section 6235.

► Practice Tip ◄
Since, unlike TEFRA, the BBA Rules do not impose any notice requirements on the partnership representative, partnership agreements should incorporate such provisions.

There are limited opportunities for partnerships to modify these powers. The Proposed Regulations provide that any action taken by the partnership representative is valid and binding on the partnership for purposes of tax law regardless of any other provision of state law, partnership agreement, or any other document or agreement.

3. Scope

The Proposed Regulations adopt an expansive definition of the tax that may be collected from the partnership. Section 6221 requires that any tax attributable to "any adjustment to items of income, gain, loss, deduction or credit of a partnership (and any partners' distributive share thereof)" be determined at the partnership level. The Proposed Regulations interpret "items of income, gain, loss, deduction, or credit" to mean all items and information required to be shown, or reflected, on a partnership return and any other forms required for the applicable taxable year, and any information in the partnership's books and records for such taxable year, including, among other things

- the character, timing, source and amount of the partnership's income, gain, loss, deductions, and credits;
- the character, timing and source of the partnership's activities;
- the value, amount, and character of partnership contributions;
- the partnership's basis in its assets and the character, type, and value thereof;
- the amount and character of partnership liabilities, including whether a liability is recourse or nonrecourse;
- any elections made by the partnership, and the consequences or effects of those elections; and
- partner capital accounts.

A partner may treat these items inconsistently. However, absent a final binding action under the BBA Rules, they must first notify the IRS, or they could be subject to an automatic assessment of additional tax in the same manner as a mathematical or clerical error. Self-employment taxes, Medicare taxes on unearned income, foreign withholding taxes, taxes on foreign accounts, and taxes reported on consolidated returns are excluded from the new rules, but determinations pursuant to an audit conducted under the new regime can be relied upon by the IRS for purposes of making determinations with respect to such other taxes. The Proposed Regulations also clarify that any defenses to penalties or other additions to tax must generally be raised by the partnership representative at the partnership proceeding, prior to a final determination with respect to the applicable items.

4. Imputed Underpayment Calculation

If a partnership's allocation of liabilities to a partner is adjusted in a manner that increases the partner's tax liability, the increase is collected at the partnership level by calculating an imputed underpayment. The Proposed Regulations provide significant new guidance regarding the calculation of the imputed underpayment, including basing the amount on the application of the highest rate of federal income tax, as well as establishing all other assumptions in favor of the government. It is likely that the imputed underpayment calculation will nearly always result in an overestimation of tax due, and it will be incumbent upon the partnership representative to demonstrate that any reductions should be made.

a. Calculation of the Imputed Underpayment—Grouping and Netting of Adjustments

To calculate an imputed underpayment, partnership adjustments are grouped into categories in the following order: (1) adjustments that reallocate items among the partners (reallocation grouping), (2) adjustments to the partnership's credits (credit grouping), (3) all remaining adjustments (residual grouping). Within each grouping, partnership adjustments are further grouped into subgroupings based on preferences, limitations, restrictions, and conventions, such as source, character, and holding period. The IRS will net items within the same grouping or subgrouping for a single taxable year. For example, it will net all ordinary adjustments (assuming no other restrictions under the Code) separately from capital adjustments.

► Practice Tip ◄
The ability to specially allocate adjustments when calculating specific imputed underpayments is an innovation by the IRS and could make it easier for partnerships to calculate imputed underpayments in an equitable manner.

The IRS will then proceed to calculate a general imputed underpayment which takes into account all adjustments. It also has discretion to calculate one or more specific imputed underpayments where certain items were allocated to a single partner or subgroup of partners.

b. Modification of an Imputed Underpayment

To correct (at least partially) potential overstatements of tax due under the new regime as a result of the default imputed underpayment regime, section 6225 and the Proposed Regulations include modification procedures. The Joint Committee on Taxation observed that the intent of these procedures was to "determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners."

If a notice of proposed partnership adjustment sets forth an imputed underpayment, the partnership representative may request modification of the amount within 270 days. The partnership may not challenge adjustments that do not result in an imputed underpayment until it receives an FPA.

c. Types of Modifications

The Proposed Regulations provide seven enumerated types of modifications the IRS will consider if requested by the partnership. In general, a partnership may request any or all of the types of modification.

i. Amended Returns

► Practice Tip ◄
In the case of a tiered partnership, the imputed underpayment can be reduced if an indirect partner files an amended tax return (and pays resulting tax and penalties). However, an upper-tier partnership may want to file amended returns in order to protect attributes such as tax basis. In such a case, it must also pay the imputed underpayment amount.

A partnership may request modification of an imputed underpayment if the partnership representative provides affidavits from each relevant partner that the partner filed amended returns for the reviewed year and made appropriate payments. In the case of a reallocation adjustment, in order for the IRS to approve the modification, all partners affected by the reallocation adjustment must file amended returns related to the reallocation adjustment.

If the IRS approves the modification request based on a partner's amended return, the partner loses its ability to file, without IRS consent, further amended returns for the modification years with respect to the relevant items. This prohibition should not affect the ability of a partner to file subsequent amended returns resulting from adjustments in a proceeding for a different partnership or a different taxable year.

ii. Tax-Exempt and Foreign Partners

A partnership may request modification based on the status of its tax-exempt and foreign partners, but only to the extent that the partnership demonstrates to the satisfaction of the IRS that the tax-exempt or foreign partner would not have been subject to tax with respect to the adjustment allocable to the partner for the reviewed year.

iii. Rate Modification

A partnership may request modification of an imputed underpayment by changing the tax rate applied to the portion of the total netted partnership adjustment allocable to a C corporation or an individual with respect to capital gains and qualified dividends. Such lower rate, however, will be the highest rate applicable to the partner with respect to the type of income in question.

iv. Certain Passive Losses of Publicly Traded Partnerships

Publicly traded partnerships, as defined in section 469(k)(2) ("PTPs"), may request modification of an imputed underpayment in the case of a net decrease in a specified passive activity loss for specified partners. This modification is available both to partnerships that are PTPs and with respect to partners (and indirect partners) that are PTPs.

v. Other Forms of Modification

The IRS also proposed three additional methods of modification not included in the BBA Rules. First, it allows a partnership to request modification of the number and composition of imputed underpayments. Second, a special modification is allowed for partners that are RICs and REITs where they can show that they have followed the procedures for deficiency dividends laid out in section 860. Third, the IRS will allow an appropriate modification based on the contents of a closing agreement entered into under section 7121. The IRS also reserved its ability to consider alternative types of modification not discussed in the Proposed Regulations.

d. Treatment of Adjustments that Do Not Result in Imputed Underpayment

Section 6225 requires that partnership adjustments that do not result in an imputed underpayment be taken into account by the partnership in the "adjustment year," the taxable year in which the adjustment decision becomes final. However, both the BBA Rules and Proposed Regulations are silent with respect to the allocation of these adjustments, presumably leaving their allocation to the partnership agreement.

5. Push-Out Election

The BBA Rules allow a partnership, after being given an FPA, to "push-out" partnership adjustments to its partners rather than pay tax at the partnership level. Partnerships have a short window to do this and must provide their partners and the IRS an allocation of items of gain, loss, deduction, and credit among their partners. The Proposed Regulations conceive of an innovative approach to push-out adjustments, requiring that partnerships calculate a "safe-harbor" tax, interest and penalty amount for each partner in a similar manner to the calculation of the imputed underpayment. Partners may opt to pay this tax in lieu of recalculating the tax due on the reviewed year (and intervening year) returns. With the permission of the IRS during the course of an audit, partnerships may also calculate this tax regarding some, but not all, proposed adjustments.

If the IRS determines that the partnership has ceased to exist, either because it no longer conducts any business or does not have the ability to pay in full the amount owed under the Proposed Regulations, an automatic push-out goes into effect. In such a case, the partnership must furnish statements to former partners indicating their share of the adjustments, or the IRS will do so.

6. Related Proposed Legislation

In December 2016, while the IRS was already working on the Proposed Regulations, the Tax Technical Corrections Act of 2016 was introduced in Congress. That bill addresses several major issues, including clarifying the calculation for imputed underpayments, creating an alternative procedure to a partner's filing amended returns (a "pull-in" option allowing partners to demonstrate a reduced imputed underpayment taking into account individual tax attributes), and describing a "push-through" option allowing pass-through partners to push adjustments through interim partnerships up to ultimate taxpayer partners, which has now been reserved in the Proposed Regulations. The bill has currently been referred to Senate Finance Committee and in the House Ways and Means Committee.

7. Upcoming Legislation and Broad Requests for Comments

In addition to the broad request for comments, Treasury and the IRS request specific comments both on aspects of the Proposed Regulations and areas that the IRS reserved for future rulemaking, including

- whether the IRS should provide for other modifications of the imputed underpayment, including when a partner or the partnership is a foreign person, or entitled to a modified tax basis or rate;
- how to streamline the amended return process, including how filing of an amended return should be authorized by the IRS, and how the IRS could allow more flexibility regarding the required payments associated with amended returns;
- whether additional rules are necessary to allow RICs and REITs to use the modification process in light of section 860; and
- how to coordinate push-out elections with withholding rules for foreign taxpayers and accounts, tiered partnership structures, and circumstances in which direct partners are not liable for U.S. tax, but the adjustment might affect a U.S. taxpayer's liability.

In calling for specific comments, the IRS signaled in several places that it is interested in particular in solutions that do not place any further burdens on the IRS, but rather ones that improve efficiency or administrability of the partnership audit process.

Conclusion

With the BBA Rules going into effect in 2018, taxpayers would ordinarily expect to see considerable progress on the Proposed Regulations and other coordinating guidance this year. However, it is possible these regulations could be affected by President Trump's executive order requiring that at least two prior regulations be eliminated for each new regulation issued. We will be watching these developments closely.

If you have any questions regarding the Proposed Regulations, please contact your regular Ropes & Gray tax advisor.