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ALERT

Tax

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New Partnership Audit Regulations Released as Permitting Push-Out Election Through Tiered Partnerships

In a trilogy of releases in the last six weeks, the Department of Treasury ("Treasury") provided much-needed guidance on the implementation of the partnership audit rules in the Bipartisan Budget Act of 2015 (the "BBA Rules"). On the eve of the BBA Rules coming into effect (for tax years beginning after December 31, 2017), Treasury has clarified that tiered partnerships generally will be permitted to push adjustments through to indirect partners under the new Internal Revenue Code (the "Code") Section 6226, a welcome clarification that had been broadly requested by practitioners and taxpayers.

Additionally, some key aspects of the set of regulations include the following:

- As part of the new rules permitting adjustments to be pushed out through tiered partnership structures, interim pass-through partners will be permitted to calculate and pay an imputed underpayment amount (but only based on modifications approved by the IRS during the audit of the source partnership) or elect to push adjustments out to their own partners.

- Removal of the tax "safe harbor" amount (previously proposed by Treasury in proposed regulations issued in June 2017). The prior proposal would have required partnerships electing to "push-out" adjustments to provide partners with an amount equal to that partner's share of the imputed underpayment (plus interest and penalties) that the partner could pay in lieu of calculating its own amounts of tax, interest and penalties.

- Proposed rules for coordination of withholding on foreign partners and the payment of imputed underpayments, including to ensure that any applicable withholding tax is collected only once.

- Proposed rules for calculating foreign tax credits as part of the imputed underpayment that are, by default, highly unfavorable to partners—creating another incentive to ensure cooperation between partners and partnerships during the modification process or to utilize the push-out election.

- Final rules for the opt-out regime for small partnerships (with fewer than 100 partners), confirming that partnerships with disregarded entities or partnerships as partners will not be permitted to opt out of the new centralized audit procedures.

The latest proposed regulations also address certain administrative and procedural aspects of the BBA Rules. Each of the above provisions, and selected other changes are described in more detail below. Our coverage of previously issued regulations can be found at the following links: New Partnership Audit Regulations Released as Effective Date Draws Near, Treasury Releases Proposed Rules Implementing Partnership Audit Regime; Awaiting Publication in the Federal Register and Partnership Audit Reform Passed into Law.

Push-Out Election Permitted for Tiered Partnership and Other Pass-Through Structures

Under the BBA Rules, a partnership is generally required to pay an imputed underpayment with respect to adjustments to the partnership's items of income, gain, loss, deduction or credit at the partnership level. However, under Code Section 6226, a partnership may elect to "push-out" partnership adjustments to its reviewed-year partners rather than pay tax at the partnership level (the "Section 6226 election"). When a partnership makes the "push-out"

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election, it must furnish statements to each reviewed-year partner, and those reviewed-year partners are then required to take the adjustments into account on their personal returns. Under the proposed regulations, provided certain requirements are met, each pass-through partner in a tiered partnership structure is permitted to push out such adjustments through each tier to the ultimate taxpaying owners. "Pass-through partners" are defined as partnerships, S corporations and certain trusts and estates.

The new rules provide for an iterative application of the "push-out" election rules for tiered partnership structures. Specifically, upon an audit of an underlying partnership, each pass-through partner in such a tiered structure must either (1) make a "push-out" election and timely furnish the required statement to its reviewed-year partners or (2) take any adjustment reflected in the statement received by such pass-through partner into account itself by paying an amount calculated similarly to an imputed underpayment on the adjustments plus any applicable interest or penalties. If the pass-through partner chooses to make a payment itself (or fails to take any action at all), the amount required to be paid is calculated in the same manner that an imputed underpayment amount is calculated with respect to the partnership under audit (that is, by treating the amount of the adjustment as an adjustment for the first affected year, then making separate calculations for each intervening year between the adjusted year and the year of payment and taking into account any available modifications that were approved by the IRS with respect to the pass-through partner, including with respect to any of its partners, in the course of the audit of the underlying partnership).

► Practice Tip ◄

The requirement that interim partnerships only take into account modifications that had been approved by the IRS during the audit of the source partnership puts a higher premium on cooperation and coordination during any audit of a partnership with pass-through partners.

► Practice Tip ◄

Timing may be tight in a tiered partnership structure with many levels of pass-through partners between the source partnership and the ultimate individual or corporate partner who owes the tax. This means that care will need to be taken in promptly notifying partners of "push-out" elections and their share of any adjustments in order to allow adjustments to be pushed all the way through a complex structure.

The proposed rules also address the timing requirements for filing and furnishing the statements to partners of a pass-through partner that take into account the fact that such partners are not receiving the statements directly from the source partnership. Specifically, there is a single time period for all pass-through partners in a tiered partnership structure to make an election to continue pushing out adjustments—the deadline is based on the extended due date of the tax return of the source partnership for the year in which the push-out election is made.

In addition, the proposed regulations include corresponding changes applicable to the administrative adjustment request ("AAR") procedures under Code Section 6227.

Removal of Safe Harbor Tax Amount in a Push-Out Election

The proposed regulations remove a provision in the previously proposed regulations that provided for a safe harbor tax and interest amount, which partners could pay in lieu of computing amounts owed as a result of a "push-out" election. The prior proposal would have required partnerships notify partners of their allocate share of any imputed payment, which partners could then elect to pay (plus interest and penalties) in lieu of running their own calculations. The IRS explained that requiring that partnerships calculate the safe harbor amount created an additional administrative burden and that partners would be unlikely to use the safe harbor amount in most circumstances.

Coordination with Withholding Tax Provisions

The newly proposed regulations clarify that a partnership's withholding tax obligations with respect to non-U.S. partners (under chapter 3 of the Code) and FATCA withholding (under chapter 4 of the Code) do not fall within the

scope of the BBA Rules. Accordingly, an audit of a partnership's compliance with its obligations under either withholding regime (and collection of any under withheld tax) may be handled in a separate proceeding not subject to the BBA Rules.

Through various examples, the newly proposed regulations provide guidance on coordinating audits of partnership income under the BBA Rules and a partnership's withholding tax obligations. Importantly, the proposed regulations would ensure that tax is collected only once, including taking into account any imputed underpayment collected from the partnership.

> ► *Practice Tip* ◄
> *The IRS has made clear that partnerships will be permitted to rely on partners' documentation, including forms W-8 and other certification, if that documentation was valid as of the reviewed year, even if such information is no longer valid or out of date as of the date of the "push-out" election.*

The newly proposed regulations also provide rules governing application of the withholding and reporting requirements under chapters 3 and 4 to a partnership that makes a Section 6226 election, pushing adjustments out to reviewed-year partners. Specifically, partnerships will be required to withhold on any adjustments allocable to a reviewed-year partner in the same manner as if the relevant partnership items had been earned in the year at issue.

> ► *Practice Tip* ◄
> *U.S. partners (including pass-through partners) may find themselves preferring "push-out" elections in circumstances where foreign partners might strongly prefer to avoid filing a tax return. In the absence of further guidance, partnerships may want to proactively seek a partial push-out election during an audit.*

Even though withholding applies with respect to the tax liability of foreign partners, partnerships that make a push-out election cannot "withhold" tax and interest. This means that foreign partners, under the current rules, will still be required to file tax returns in many circumstances when a partnership makes a push-out election. The IRS may permit partnerships to request a bifurcated approach, paying imputed tax with respect to foreign partners, but pushing out adjustments with respect to U.S. partners.

Adjustments to Foreign Tax Credits

The proposed regulations introduce rules for calculating the imputed underpayment amount when the IRS adjusts creditable foreign tax expenditures ("CFTEs"). Because the benefit of CFTEs is highly dependent on partner-level facts, the proposed regulations adopt a rule where imputed underpayment amounts are increased in the event that CFTEs are adjusted down, but the partnership receives no benefit of a reduction in the imputed underpayment if CFTEs are adjusted upward. In effect, the proposed regulations assume partners received the full benefit of any CFTEs improperly claimed (and adjusted downward), but assume partners will not benefit from any upward increase. In the preamble to the applicable proposed regulation, the IRS acknowledged that this approach can be unfavorable to taxpayers and suggested that the modification process can be used to address this and any distortive effects.

> ► *Practice Tip* ◄
> *Partnerships with foreign operations and anticipated foreign tax credits should watch the development of these rules closely. Modification procedures may prove unable to fully account for CFTEs and such partnerships may need to utilize Section 6226 elections to achieve a fair result from adjustments to CFTEs.*

Final Regulations on Opt-Out Provisions

► *Practice Tip* ◄
Partnerships hoping to opt out of the centralized audit rules may find that they are unable to control their ability to do so—for example, if a corporate partner elects to become a disregarded entity or an individual partner dies and assets pass to an estate, the partnership would cease to be eligible.

The new rules finalize regulations addressing when a partnership may opt out of the centralized partnership audit regime. The BBA Rules permit partnerships with 100 or fewer eligible partners to elect out, and the newly finalized regulations define eligible partner to exclude partnerships, trusts, disregarded entities, nominees or other similar persons that hold an interest on behalf of another person, and estates other than the estate of a deceased partner. Treasury declined, in final regulations, to require that partners notify a partnership of changes in status that would cause the partnership to become ineligible to elect out. The final regulations otherwise broadly adopt the rules previously proposed in early 2017.

Other Provisions

The proposed regulations also introduce or amend several other procedures outside of those discussed above, including:

- **Penalties in a "Push-Out" Election:** The proposed regulations amend prior regulations by requiring partner-level calculations of, and permitting partner-level defenses for purposes of calculating penalties attributable to a partnership adjustment.

- **Mathematical and Clerical Adjustments:** The proposed regulations provide that assessments attributable to mathematical or clerical errors, or failure to treat an item in a manner consistent with a partnership return, are not subject to the new partnership audit rules, and the IRS is permitted to assess tax without utilizing the centralized audit procedures.

- **Period of Limitations:** Rules are introduced that implement the period of limitations for issuing a Notice of Proposed Partnership Adjustment ("NOPPA") and a Final Partnership Adjustment ("FPA"), and clarify that, in the absence of an agreed extension, a NOPPA must be issued within the three-year limitations period set forth in the statute. Mailing a NOPPA within this period effectively tolls the limitations period for purposes of determining the amount of imputed underpayment, making certain elections and issuing a FPA.

- **Coordination with Section Code 905(c) Notice of Foreign Tax Redeterminations:** Treasury has requested comments on whether an AAR should be permitted to satisfy the notice requirements of Code Section 905(c), in effect creating a departure from the normal time limitations for filing an AAR.

If you have any questions with respect to these developments, please contact a member of Ropes & Gray's tax practice group or email PartnershipAuditReformGroup@ropesgray.com.

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