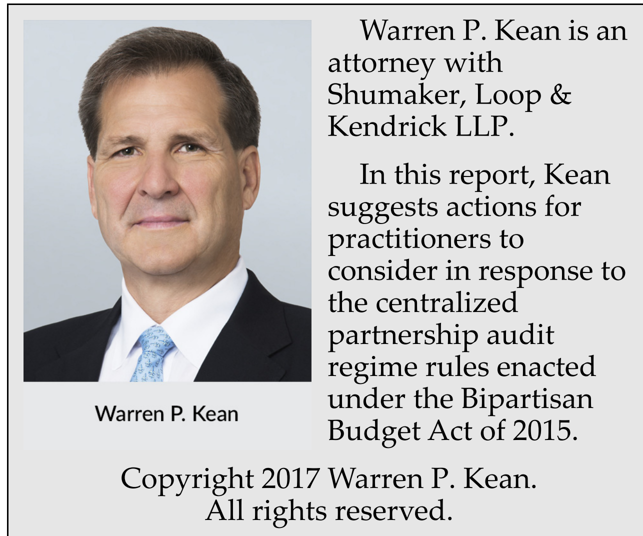
What to Know and Do About the New Partnership Audit Rules Now

by Warren P. Kean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In this report, Kean suggests actions for practitioners to consider in response to the centralized partnership audit regime rules enacted under the Bipartisan Budget Act of 2015.

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The Bipartisan Budget Act of 2015 (BBA)[1] was enacted on November 2, 2015, and amended on December 18, 2015, by the Protecting Americans From Tax Hikes Act of 2015[2] and was proposed to be further amended by the Tax Technical Correction Act of 2016.[3] The 2016 technical corrections bill, even though bipartisan and introduced on a bicameral basis, was not passed by Congress before the second session of the 114th Congress expired on January 3, 2017, but it is expected to be reintroduced in the current session.

Effective for tax years beginning after December 31, 2017, section 1101 of the BBA (the BBA rules) repeals (1) the unified partnership audit and litigation rules[4] enacted as part of the 1982 Tax Equity and Fiscal Responsibility Act[5] and (2) subchapter D of chapter 63 and Part IV of subchapter K of chapter 1, concerning the audit and litigation rules for electing large partnerships. The BBA rules replace the TEFRA rules with a new centralized partnership audit regime for all partnerships[6] other than eligible partnerships that elect out of that regime under new section 6221(b), in which case neither the centralized partnership audit regime rules nor the TEFRA rules will apply (that is, the pre-TEFRA partnership audit and litigation rules will apply).

[1]P.L. 114-74.

[2]P.L. 114-113.

[3]H.R. 6439 and S. 3506.

[4]Subchapter C of chapter 63, sections 6221-6234.

[5]P.L. 97-248, as amended and in effect before being superseded by the BBA rules.

[6]References in this report to "partnerships" include limited liability companies and other unincorporated business entities classified as partnerships for federal tax purposes, and references to "partners" also refer to members and other owners of equity interests in those entities. The agreements governing those entities are referred to collectively as "partnership agreements."

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On January 18 the IRS issued a notice of proposed rulemaking (REG-136118-15) on the centralized partnership audit regime rules. Because the notice had not been published in the *Federal Register* by January 20, when the Trump administration's freeze on new and proposed federal rulemaking went into effect, it was withdrawn until being reissued with only a few changes on June 18.

REG-136118-15 is 277 pages long, comprising a 157-page preamble and 120 pages of proposed regulations. While reasonably comprehensive, it reserves for later guidance such important concepts as how the application of these new rules will affect partners' bases in their partnership interests and their capital account balances[7] and how the push-out election under new section 6226 is to be applied to passthrough partners[8] and partners that are foreign entities.[9] REG-136118-15 also does not incorporate the changes that would have been made by the 2016 technical corrections bill; however, it interprets and applies the BBA statutory provisions consistently with those proposed amendments.

While the BBA rules (both the statute and regulations thereunder) likely will continue to be debated and amended and otherwise revised for some time, practitioners need to know how to advise their clients now. This report suggests immediate actions to consider taking in response to the new rules.

I. Effective Date: January 1, 2018

The BBA rules go into effect for partnership tax years beginning after December 31, 2017.[10] That means the following:

- Audits and controversies concerning 2017 partnership tax years (those beginning at any time during 2017) and prior years will be governed by the current TEFRA rules. A partnership, however, may elect for tax years beginning after November 2, 2015, and before January 1, 2018, to have the centralized partnership audit regime rules apply if it files that election within 30 days after the IRS issues a notice that the partnership's return for the year has been selected for examination.[11]
- Audits and controversies concerning 2018 and later partnership tax years (those beginning at any time during 2018 and all subsequent years) will be governed by the new BBA rules. Partnerships eligible to elect out of the centralized partnership audit regime rules under new section 6221(b) for the partnership's 2018 tax year will need to make that election on their 2018 federal income tax return.[12] All other partnerships will need to designate their partnership representatives for their 2018 tax year on their 2018 federal income tax returns. Calendar-year 2018 federal partnership income tax returns are to be filed by March 15, 2019, unless extended, in which case they must be filed no later than September 15, 2019.[13]
- New partnership agreements should account for these rules and their potential application.
- Transactions involving the sale of limited liability company and partnership interests that close on or after January 1, 2018, need to account for and provide for these rules.
- Because the BBA rules become applicable for partnership tax years beginning after December 31, 2017, existing partnership agreements should be reviewed to determine if they should be amended before the end of 2017 to account for the new rules. However, partnerships that do not have a change in owners or owner profit-loss sharing percentages during 2018 effectively have until their 2018 federal income tax returns are filed (that is, September 15, 2019, at the latest for calendar-year partnerships) before having to determine whether they adequately accommodate compliance,

[7] Prop. reg. sections 301.6225-4 and 301.6226-4.

[8] Prop. reg. section 6226-3(e).

[9] Prop. reg. section 6226-3(f).

[10] BBA section 1101(g)(1).

[11] Reg. section 301.9100-22T(b)(1) and (d)(1).

[12] Form 1065, "U.S. Return of Partnership Income."

[13] Sections 6072(b) and 6081 and section 2006(b)(1) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41.

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participation, and planning regarding these rules and, if not, to amend them.

II. Reasons to Amend Partnership Agreements

A. Designation of Partnership Representative

Each partnership subject to the centralized partnership audit regime rules must designate a partnership representative, in the manner prescribed by the IRS, who will have the sole authority to act on behalf of the partnership regarding federal partnership income tax adjustments and related matters.[14] The rules provide that each partnership must have a partnership representative (which no longer must be a general partner or even a partner in the partnership) for each of its tax years.[15] The proposed regulations require a partnership to designate its personal representative for each of its tax years on the partnership's federal income tax return filed for that year.[16] Also, if the partnership representative is an entity, the partnership (rather than partnership representative entity, surprisingly) must (1) appoint an individual "through whom the partnership representative will act for all purposes" under the centralized partnership audit regime rules (the designated individual) and, apparently, (2) identify that person as the designated individual on each of the partnership's federal income tax returns in conjunction with the designation of the partnership representative.[17]

The proposed regulations place some restrictions on a partnership's ability to change the designation of its partnership representative for a particular tax year. The partnership may revoke the designation for a tax year only after the IRS mails a notice of administrative proceeding to the partnership and the partnership representative.[18] The revocation is made by the partnership delivering written notice to that effect to both the partnership representative and the IRS and designating a new partnership representative for the applicable tax year, but the revocation does not become effective until 30 days after delivery of the notice.[19]

A seemingly easier process is to have the partnership representative resign and to appoint a new partnership representative.[20] Compare "may not revoke" in prop. reg. section 301.6223-1(e)(2)(i) with "may resign" in prop. reg. section 301.6223-1(d)(2), with the latter suggesting that a partnership representative "may," but is not required to, wait until the issuance of a notice of administration proceeding before resigning. Accordingly, the partnership agreement should give the partnership the power to require the personal representative to resign and to designate in the notice of resignation the successor personal representative selected by the partnership. The partnership representative's resignation will become effective 30 days after the partnership representative delivers notice of resignation to the IRS.[21] The IRS must notify the partnership and the new partnership representative of its receipt of the resignation notice.[22]

B. Duties and Liabilities of Partnership Reps

Before designating a partnership representative (and, if the partnership representative is an entity, before appointing the designated individual) or a designee accepts being so designated, both the partnership and the designee will want to ensure that the duties and liabilities of the partnership representative (and the designated individual, if applicable) are agreeably set out in the partnership agreement or other applicable agreement. The partnership representative (and presumably the designated individual) may bind the partnership, the partners, and "any other person whose tax liability is determined" under the centralized partnership audit regime rules regardless of any limitation on that authority under the company's partnership agreement (or other agreement) or applicable state law.[23] Accordingly, the

[14] New section 6223(a).

[15] New section 6223 and prop. reg. section 301.6223-1(a) and -1(c).

[16] Prop. reg. section 301.6223-1(c)(2).

[17] Prop. reg. section 301.6223-1(b)(3).

[18] Prop. reg. section 301.6223-1(e)(2).

[19] Prop. reg. section 301.6223-1(c)(1).

[20] Prop. reg. section 301.6223-1(d).

[21] Prop. reg. section 301.6223-1(d)(1).

[22] *Id.*

[23] New section 6223(b); and prop. reg. section 301.6223-2.

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partnership will want to designate a partnership representative (and a designated individual, if applicable) in whom it has trust and confidence. The partnership (or those who manage the partnership, such as one or more of the partnership's managers or its board of directors, depending on the partnership's management structure) also likely will want to make the partnership representative (and, if applicable, the designated individual) subject to its control and direction as well as subject to specified consequences if that person acts other than as authorized or directed.

The partnership representative or designated individual will be confronted with potentially conflicting or competing interests between the partnership, its current members (adjustment-year partners), its former members (persons who were partners for the partnership tax year under audit — reviewed-year partners and their partnership interests for that year), and the partner or partners during the year the partnership is deemed to cease to exist under prop. reg. section 301.6241-3. Hence, the partnership representative or designated individual will want to know the exact scope of their duties, to whom those duties are owed, and the liability and other consequences that may be imposed if those duties are not met or fully satisfied. Those considerations likely will be made in light of more general standards in the partnership agreement (including the duties of the manager(s) or board of directors regarding that person's selection, retention, supervision, and direction), and the centralized partnership audit regime rules pertaining to partnership representatives may cause the partners or the partnership's management to reconsider those standards. Entities that are partnership representatives will have similar considerations and concerns regarding the designated individual appointed by the partnership to interface with the IRS.

If a partnership fails to designate or otherwise does not have a partnership representative (or valid designation of a partnership representative) for a particular tax year, the IRS will designate one for the partnership.[24] Whether an IRS-designated partnership representative is to have different (that is, greater) duties or be subject to different (that is, higher) standards of liability for breach of those duties is something else to consider when drafting or amending the partnership agreement to account for the BBA rules. It may be difficult to find someone who is willing to serve as a partnership representative if that person's duties and exposure to liabilities are not limited or otherwise adequately refined.

C. Scope of Centralized Partnership Audit Regime

TEFRA is limited to partnership items (that is, those items more appropriately determined at the partnership level than at the partner level), with any related deficiencies being assessed at the partner level.[25] The centralized partnership audit regime rules, at least as reflected in the proposed regulations, go further and apply to (1) all items and information required to be shown or reflected on the partnership's federal income tax returns, (2) any information in the partnership's books and records for the tax year, and (3) all factors needed to determine or allocate the tax treatment of those items.[26] Under the 2016 technical corrections bill, the rules would be amended to apply to "partnership-related items" in lieu of "items of income, gain, loss deduction or credit of a partnership for a partnership taxable year," with partnership-related items to be defined in new section 6241(2)(B)(i) to include "any item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return and including any item or amount relating to any transaction with, basis in, or liability of, the partnership) which is relevant . . . in determining the [federal income] tax liability of any person."

Specifically mentioned as items within the reach of the proposed regulations are the determination of whether a purported partnership is a partnership for federal income tax purposes or is a sham and, if a partnership, who its members are and the tax and economic contours of their relative interests, including the

[24] Prop. reg. section 301.6223-1(f)(2).

[25] Sections 6231(a)(3), 6225, and 6230, and the regulations thereunder.

[26] Prop. reg. section 301.6221(a)-1(b)(1).

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adjusted basis of each member's interest in the partnership.[27] Also captured by the proposed regulations and the 2016 technical corrections bill is the federal income tax treatment of transactions and imputed transactions (for example, disguised sales and guaranteed payments) between the partnership and any of the partners, for which any additional taxes that might otherwise be owed by a transacting partner will be determined, assessed, and collected at the partnership level.[28]

TEFRA also grants partners who are not the tax matters partner the right to receive specific notifications and to participate in the administrative proceedings concerning the federal income taxation of partnership items.[29] Under the centralized partnership audit regime rules, partners other than the partnership representative (there may be only one partnership representative) have no such statutory rights.[30] Thus, a partner will have only those notice, information, and participation rights regarding these new procedures provided in the partnership agreement or other agreement or accommodation by those who control the partnership. Even then, the proposed regulations instruct the IRS (except to the extent the IRS permits a partner or other person to participate in an administrative proceeding) to deal only with the partnership representative and, effectively, to disregard any contractual or state statutory rights partners may have or that may otherwise limit the partnership representative's authority.[31]

D. Economic Consequences to Partners

The partnership agreement should provide (1) who is to directly or indirectly bear the tax and related costs of adjustments to partnership-related items (including any imputed underpayment derived under new section 6225 to be paid with respect to those adjustments), and (2) how those costs are to be borne, such as by having the partnership bear those costs (and, thereby, have the current adjustment-year partners indirectly bear those charges) or have the reviewed-year partners bear those charges under any of the alternative procedures of new section 6221(b), 6225(c)(2), or 6226, or by the terms of the partnership agreement. These considerations will require careful review and likely modification or supplementation of the economic and tax accounting provisions of the partnership agreement[32] to ensure that the appropriate, or at least the agreed, persons directly or indirectly bear in the proper proportions the liabilities and costs that emanate from or are related to the application of the centralized partnership audit regime rules.

III. The Three Alternative Regimes

A. Opt Out by Eligible Partnerships

Some eligible partnerships may elect out of the centralized partnership audit regime rules and have the pre-TEFRA audit rules apply to adjustments of partnership tax items.[33] The election must be made annually on the partnership's timely filed federal income tax returns. Partnership agreements should be reviewed, and possibly revised, to ensure that the partnership is eligible to make the election and to determine who has the authority to make the election or how that authority may be exercised by others — understanding that for tax years beginning after December 31, 2017, partnerships will no longer have a tax matters partner under section 6231(a)(7). If the partnership is eligible to make the election, it likely will want to make sure the election is timely made for the 2018 tax year and each of the partnership's subsequent tax years. Once this election is made for a partnership tax year, it may not be revoked without the IRS's consent.[34]

To be eligible to make the election, the partnership may have as partners only individuals, corporations (including S corporations and foreign entities that would be

[27] Prop. reg. section 301.6221(a)-1(b)(1)(ii)(C), (D), (E), and (H).

[28] Prop. reg. section 301.6221(a)-1(b)(1)(i)(H).

[29] Sections 6223(a) and 6224(c).

[30] Prop. reg. section 301.6223-1.

[31] Prop. reg. section 301.6223-2.

[32] These are provisions concerning allocations, distributions, capital contributions, and capital account maintenance.

[33] New section 6221(b).

[34] Prop. reg. section 301.6221(b)-1(c).

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classified as corporations if they were domestic), and estates of deceased individuals.[35] It, therefore, may not have as a partner any partnership, disregarded entity described in reg. section 301.7701-2(c)(2)(i), foreign entity that would not be classified as a corporation if it were organized under domestic law, estate of an individual other than of a deceased partner, nominee or similar person that holds an interest on behalf of another person, or trust.[36] Also, the partnership must not be required to furnish more than 100 statements under section 6031(b) (partnership Schedules K-1) for the tax year, which includes for this purpose all statements under section 6037(b) (S corporation Schedules K-1) that each partner that is an S corporation must furnish for its tax year ending with or within the partnership's tax year.[37]

To make the election, the partnership must disclose to the IRS the following information about each of its partners and each of the shareholders of any of its partners that are S corporations: name, taxpayer identification number, federal tax classification, and an affirmative statement that the partner is an eligible partner for this purpose.[38] Of course, to timely provide that and other information to the IRS requires cooperation from the partners, particularly any partner that is an S corporation, and that obligation to cooperate should be set out in the partnership agreement. Whether an eligible partnership should make this election on its federal income tax returns (in most cases it likely should) is a subject the partnership will want to discuss with its tax advisers before filing its federal income tax return for 2018 and, perhaps, for subsequent years.

The BBA rules may (and often should) prompt discussions about whether the partners that prevent the partnership from being eligible to elect out of the centralized partnership audit regime rules should reorganize, restructure, or liquidate themselves to allow the partnership to be eligible to make the election beginning with its 2018 tax year. That discussion, of course, should take place as far before the filing of the partnership's 2018 tax return as possible.

B. Pull-In Procedure

New section 6225(c)(2) (as proposed to be amended by the 2016 technical corrections bill) and prop. reg. section 301.6225-2(d)(2) allow a partnership to reduce or otherwise modify (and even eliminate) the partnership adjustments on which its imputed underpayment is determined by having one or more reviewed-year partners[39] file amended returns (or, under the 2016 technical corrections bill, reviewed-year partners paying the tax due, adjusting affected tax attributes, and providing required information to the IRS without having to file amended returns) taking into account their shares of the partnership adjustments for both the reviewed year and any of the partner's other tax years for which any tax attribute[40] is affected by those adjustments. The 2016 technical corrections bill would add a new subparagraph (B) to new section 6225(c)(2) to allow for a simplified alternative under which reviewed-year partners may pay the tax due, adjust affected tax attributes, and provide prescribed information to the IRS without having to file amended returns. The Joint Committee on Taxation, in its technical explanation of the 2016 technical corrections bill,[41] refers to this modification as the "pull-in" procedure.

The amended returns under section 6225(c)(2)(A), together with full payment of all related taxes and other charges,[42] must be filed and paid within 270 days after the date the IRS

[35]Prop. reg. section 301.6221(b)-1(b).

[36]One of many curious aspects of the proposed regulations is that a permitted trust under section 1361(c)(2) may be an indirect partner of an eligible partnership through an S corporation but may not be a direct partner. *See* prop. reg. section 301.6221(b)-1(b)(3)(i): "An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not an eligible partner."

[37]Prop. reg. section 301.6221(b)-1(b).

[38]Prop. reg. section 301.6221(b)-1(c).

[39]Including owners of passthrough partners, as defined in prop. reg. section 301.6241-1(a)(5). These persons are referred to as "indirect partners" in prop. reg. section 301.6241-1(a)(4).

[40]Defined in prop. reg. section 301.6241-1(a)(10) to mean "the amount or timing of an item of income, gain, loss, deduction or credit . . . or that can affect the amount of tax due in any taxable year."

[41]JCT, "Technical Explanation of the Tax Technical Corrections Act of 2016," JCX-91-16, at Part B, 11-13 (Dec. 6, 2016).

[42]*E.g.*, penalties, interest, and additions to tax.

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mails the notice of proposed partnership adjustment to the partnership, unless the IRS grants the partnership an extension of that deadline.[43] However, in no event will an extension be granted past the date on which the IRS issues a notice of final partnership adjustment.

Moreover, the partnership representative must provide the IRS an affidavit from each of those partners that shows that they have filed the required amended returns and paid the related taxes and other charges.[44] The affidavit must also state the dates on which the amended returns were filed and on which the taxes and other charges were paid.[45] A partner who files amended returns and pays the related taxes and other charges under the pull-in procedure may not file a subsequent amended return without the IRS's permission.[46] According to the preamble of the proposed regulations, the pull-in procedure is intended to effectively replicate the result under TEFRA for the participating partners: "Where all partners amend their returns taking all of the adjustments into account, the IRS, the partnership and its partners have effectively mirrored the result of a TEFRA audit, including the final partner-level computational adjustments."

Partners (including indirect partners) who pay less than the highest rate of tax in effect for the reviewed year may prefer to adjust their tax returns and pay any additional associated taxes and other charges under this pull-in procedure to establish the true tax cost of their share of the partnership adjustments. To avoid effectively having to pay twice, those partners will want to ensure that the partnership agreement excludes them from having to indirectly bear the economic costs of any centralized partnership audit regime liabilities the partnership may have to pay for the partners who do not pick up their full shares of the partnership adjustments under the pull-in procedure.

Further, those who control the partnership may prefer to have the partners and indirect partners instead of the partnership account for the adjustment of partnership items and pay the related taxes and other charges. Accordingly, partnership agreements likely will need to be revised to give them that right and ability.[47] Moreover, each partner's (and indirect partner's) tax return preparer will need to be able to promptly prepare the required amended returns (or make the calculations required under the 2016 technical corrections alternative pull-in procedure). To do that, the preparers will need access to information that the partnership (or passthrough partner) should be required under the partnership agreement (or shareholders' agreement) to compile, prepare, maintain, and make available to partners for this purpose.

C. Push-Out Procedures

Instead of, or in addition to, the partners filing amended returns and paying their adjusted tax liabilities under the pull-in procedure or the partnership (and thereby indirectly the adjustment-year partners) paying imputed underpayments under the default centralized partnership audit regime rules, the partnership may elect to have the reviewed-year partners (including passthrough partners) include their shares of the positive partnership adjustment amounts for the reviewed year or other first affected year and each of the intervening years in determining their federal income tax liabilities and picking up their shares of interest and penalties as provided in new section 6226(c) in the reporting year (as defined below).[48] A modified push-out procedure is mandatory for partnerships deemed to cease to exist under prop. reg. section 301.6241-1.[49] That modification compels those who were partners for the tax year during which the partnership is deemed to cease

[43] Prop. reg. section 301.6225-2(c)(3) and (d)(2)(iii).

[44] Prop. reg. section 301.6225-2(d)(2)(iii).

[45] *Id.*

[46] Prop. reg. section 301.6225-2(d)(2)(viii)(B). The June 18 proposed regulations have the same typographical error as the January 20 proposed regulations in designating this subparagraph as subparagraph "(vii)" when there already is a subparagraph (vii), instead of designating it as subparagraph "(viii)."

[47] Corresponding amendments to partnership agreements, shareholders' agreements of partnership, and S corporation passthrough partners will also likely need to be made.

[48] New section 6226. These are referred to as the "push-out" procedures in the preamble to the proposed regulations and by the JCT (JCX-91-16, *supra* note 41, at Part B, 13-14), with adjustment amounts being defined in new section 6226(b)(2) and prop. reg. section 301.6226-2(f).

[49] This includes partnerships that the IRS determines are unable to fully pay an imputed underpayment.

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to exist to adjust their tax liabilities, instead of the reviewed-year partners.

To be effective, the push-out election must be filed within 45 days after the date the final partnership adjustment is mailed by the IRS, and that filing period may not be extended.[50]

The election must include the name, address, and correct TIN of each of the reviewed-year partners and a copy of the final partnership adjustment to which the election relates. Also, the partnership must furnish to each reviewed-year partner and file with the IRS a statement of the reviewed-year partner's share of the partnership adjustments, other modifications, adjustments of tax attributes related to the partnership adjustments, penalties, and the amount of safe harbor interest and other charges. Those statements must be furnished no later than 60 days after the date all of the partnership adjustments to which the statement relates are finally determined (including after the partnership's right to judicial review has been exhausted, with the year during which the statements are filed being the reporting year).[51]

The downside of this election includes the interest rate on underpayments being assessed at 2 percentage points higher than what it otherwise would be[52] and penalties being based on the partnership's imputed underpayment amount, which likely will be higher than the penalties that would otherwise be imposed were the underpayment amount instead determined at the partner level.[53] Further, because the correction amounts for the first affected year and each succeeding intervening year must be positive to be taken into account, it is possible (if not likely) that the combined amount of tax to be paid bye the partners under new section 6226 will be greater than the combined tax that would have been paid by the partners had the partnership correctly reported its items of income, gain, loss, deduction, and credit for the reviewed year.[54]

[50]New section 6226(a)(1); and prop. reg. section 1.6226-1(c)(3).

[51]Prop. reg. section 301.6226-2(b) and -3(a).

[52]New section 6226(c)(2)(C).

[53]New section 6226(c)(1).

[54]Prop. reg. section 301.6226-3(b)(1)-(3). *See* prop. reg. section 301.6226-3(g), Example 4.

IV. Default Centralized Partnership Audit Rules

If none of the above elections are made, or if only the pull-in election of new section 6225(c)(2) is made by only some of the partners, the default rules and procedures of the centralized partnership audit regime will apply. Those standard or default rules include the following.

A. The Partnership Pays the Tax

The partnership must pay the imputed underpayment(s) and related interest and penalties.[55] This means the current, adjustment-year partners must effectively pay (that is, bear the economic cost of) the imputed underpayment and related charges, based on their current, adjustment-year profit and loss sharing ratios, unless the partnership agreement or other agreement requires indemnification or reimbursement by others or requires that those liabilities effectively be redirected and economically borne by the partners based on their reviewed-year profit and loss sharing ratios or in some other agreed-on manner. Those make-whole obligations and consequences should be considered in connection with the drafting and amending of partnership agreements.

B. Inflated Imputed Underpayments

A partnership's imputed underpayment is determined by multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year under section 1 or 11 and then adjusting that amount by any increases or decreases in applicable federal income tax credits.[56] The BBA rules contain many rules of convenience in favor of the IRS that will likely cause the partnership's imputed underpayment to exceed the collective underpayments of the partners were the partners instead to include the partnership adjustments in determining their federal income tax liabilities for the reviewed year. Because the interest and penalty charges are predicated on the underpayment amount, the additional taxes that the partnership must pay on imputed

[55]New sections 6225(a)(1) and 6232.

[56]Prop. reg. section 301.6225-1(c)(1).

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underpayments also will inflate the interest and penalties imposed on those amounts.[57]

In the preamble to the proposed regulations, the IRS acknowledges that "the imputed underpayment calculation may, for some partnerships, overstate the amount of tax due had the partnership and partners reported the partnership adjustments properly."[58] The preamble further states the IRS, in applying the centralized partnership audit regime in conjunction with the modification rules under new section 6225, should exercise its discretionary authority to correct "potential overstatements" of the partnership's imputed underpayments.[59] The preamble reflects the IRS's observation that the intent of the modification provisions of section 6225 is to "determine the amount of tax due as closely as possible to the tax due if the partnership and parties had correctly reported and paid while at the same time implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners."[60] Some of the reasons why the partnership's imputed underpayment likely will be higher than what would be the collective underpayments of the reviewed-year partners, unless so modified or mitigated, are discussed below.

1. Applying the maximum federal income tax rate instead of the partners' actual marginal income tax rates.

The proposed regulations provide procedures for reducing the imputed (maximum) tax rate.[61] However, the potential modifications are limited.

The imputed federal income tax rate will not be reduced to the actual combined marginal federal income tax rates paid by the partners. For example, if for the reviewed year a partnership has two 50-50 partners, one a C corporation and the other an individual, and a total netted partnership adjustment of $200,000, the partnership's imputed underpayment would be $79,200 ($200,000 x the maximum federal income tax rate of 39.6 percent for individuals under section 1 for the reviewed year). The partnership could request that the imputed underpayment be modified to $74,600 to account for the maximum federal corporate income tax being 35 percent for the reviewed year of the corporate partner's 50 percent share of the adjustment.[62]

If the $200,000 total netted partnership adjustment was an increase in the partnership's net long-term capital gain, the partnership could request an additional adjustment to lower its imputed underpayment to $55,000 to account for the 20 percent maximum long-term capital gains rate for individuals for the reviewed year.[63]

If the corporation is a tax-exempt organization, the partnership could request the IRS to further reduce its imputed underpayment on the net long-term capital gains adjustment of $200,000 to $20,000 to account for the fact that the tax-exempt corporation isn't subject to tax on its share of partnership income that is not unrelated business taxable income.[64]

The partnership would have imputed underpayments in the above amounts ($79,200, $74,600, $55,000, or $20,000, depending on the maximum federal income tax rates at which its reviewed-year partners' income could be taxed) regardless of their actual marginal income tax rates for the reviewed year — that is, even if each of the partners had sufficient losses from other sources to have a federal income tax liability of zero for the reviewed year — if the adjustment had been taxed to them instead of to the partnership.[65] However, depending on future IRS guidance, further modification may be possible under prop. reg. section 301.6225-2(d)(9) (other

[57] New section 6223.

[58] REG–136118-15, at 13, section 2(A).

[59] *Id.*

[60] *Id.*

[61] Prop. reg. section 301.6225-2(b)(3) and -2(d)(4).

[62] 35 percent maximum federal corporate income tax rate x the corporate partner's $100,000 share of the adjustment = $35,000 + $39,600 (39.6 percent maximum individual federal income tax rate x the individual partner's $100,000 share of the adjustment = $74,600). *See* prop. reg. section 301.6225-2(b)(3)(iii) and -2(c)(4).

[63] The corporate partner's share of the adjustment resulting in an imputed underpayment of $35,000 + $20,000 (the maximum long-term capital gains rate of 20 percent x the individual partner's $100,000 share of the adjustment). *See* prop. reg. section 301.6225-2(b)(3)(iii) and -2(c)(4). *See also* prop. reg. section 301.6225-1(f), Example 6.

[64] Prop. reg. section 301.6225-2(d)(3)(i).

[65] Prop. reg. section 301.6225-2(d)(4), -2(d)(3), and -2(b)(3). Prop. reg. section 301.6225-2(d)(4) states: "In no event may the lower rate under the preceding sentence be less than the highest rate in effect with respect to the type of income and taxpayer."

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modifications that the IRS determines to be accurate and appropriate under prop. reg. section 301.6225-2(c)(4)).[66]

2. Reallocations.

The proposed regulations include in the computation of the partnership's total netted partnership adjustment only the additional income half of reallocations of items of partnership income, deductions, and credits from one partner to another — not the reciprocal reduced share of income or increased share of losses or deductions or increased share of tax credits.[67] Those reciprocal reallocations are instead to be "taken into account by the partnership in the *adjustment year*" as provided in prop. reg. section 301.6225-3(b)(4) (emphasis added).

This rule of convenience in favor of the IRS is illustrated in Example 3 of the January 18 prop. reg. section 301.6225-1(f) (this example was deleted in the June 18 reissuance of REG-113118-15), in which $40 of net deductions that had been allocated to Partner B were determined on audit to instead be allocable to Partner A. Under prop. reg. section 301.6225-1(c)(3) the partnership's total netted partnership adjustment equals the sum of the net positive adjustments in the residual grouping under prop. reg. section 301.6225-1(d)(2)(v), and in the reallocation grouping under prop. reg. section 301.6225-1(d)(2)(ii). Under the facts of Example 3, there are net positive adjustments of $40 (the decrease in the amount of net deductions to Partner B) and "net non-positive adjustments" of $40 (the increase in the amount of net deductions to Partner A), as those terms are defined in prop. reg. section 301.6225-1(d). The net non-positive adjustments (that is, the reallocation of partnership deductions to Partner A) are then ignored in determining the partnership's total netted partnership adjustment, leaving only the net positive adjustments of the decrease in net deductions allocated to Partner B. They instead are to be reallocated among the partners in the adjustment year as provided in prop. reg. section 301.6225-3(b)(4).

Thus, the partnership's imputed underpayment under these facts is $16 (net non-positive adjustments of $40 x the highest marginal tax rate for the reviewed year, which the example deems to be 40 percent); the example in the proposed regulations contains a mathematical error when it states: "The $40 increase is then multiplied by 40 percent, which results in an imputed underpayment of $28." This is the result even if the $40 net deductions reallocated to Partner A would lower Partner A's federal income tax liability for the reviewed year by $16, and the loss of deductions to Partner B would not increase Partner B's federal income tax liability for the reviewed year because of Partner B's remaining share of the partnership's losses or losses from other sources.

3. Residual subgrouping.

Items of partnership income, gain, deduction, and loss are subject to different treatment depending on the tax classification, and other tax attributes of the different partners in the partnership (that is, items of different character) are segmented into different subgroups with only net positive adjustments being taken into account in calculating the partnership's total netted partnership adjustments.[68] The effect of this rule is illustrated in examples 3 and 4 of the June 18 prop. reg. section 301.6225-1(f).

In Example 3, $125 of the partnership's long-term capital gains is recharacterized as ordinary income by the IRS on audit. The increase in the partnership's ordinary income by $125 is characterized as a net positive adjustment, and the decrease in the partnership's long-term capital gains by $125 is characterized as a net non-positive adjustment, meaning the total netted partnership adjustment is $125, causing the partnership to have an imputed underpayment (applying a deemed maximum federal income tax rate of 40 percent) of $50, determined without regard to the amount of federal income taxes the reviewed-year partners paid on the previously allocated $125 of long-term capital gains. Instead,

[66] *See* prop. reg. section 301.6225-2(b)(3): "A modification under paragraph (d)(9) of this section (other modifications) is treated as a rate modification under paragraph (b)(3) of this section if such modification affects the rate applied with respect to any partnership adjustment or portion of a partnership adjustment that makes up the total netted partnership adjustment with respect to an imputed underpayment."

[67] Prop. reg. section 301.6225-1(c)(2)(i) and -1(d)(2)(ii).

[68] Prop. reg. section 301.6225-1(d)(2)(v) and -1(d)(3).

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these adjustments are to be taken into account by the partnership in the adjustment year as provided in prop. reg. section 301.6225-3(b).[69]

In Example 4, the partnership deducted $25 of expenses in one year that should have been deducted in the following year. The partnership would have a total netted partnership adjustment of $25 for the first year, for which there is an imputed underpayment (assuming a maximum federal income tax rate of 40 percent) of $10, and a non-positive partnership adjustment for the second partnership tax year of $25, which is disregarded in determining the partnership's tax liability for the first tax year. Again, these adjustments are to be taken into account by the partnership in the adjustment year as provided in prop. reg. section 301.6225.3(b).

V. Conclusion

The one-sidedness of the standard centralized partnership audit regime rules discussed in Section IV will cause many, if not most, partnerships to be better served by electing out of those rules under one of the three alternative regimes described in Section III. To do that, and to evaluate whether to elect into the rules for partnership tax years beginning after November 2, 2015, and before January 1, 2018, during the limited 30-day election period from the date the IRS issues a notice to the partnership of selection for examination for one or more of those years, there must be timely compliance with the requirements for the applicable elections and related rules and procedures. That compliance, and running pro formas to determine which of the alternative regimes will best serve the partnership, requires the partnership and its partners to maintain and have prompt access to up-to-date and accurate tax accounting information, including, for example, the following:

- the current names, addresses, TINs, and tax classifications of its current and former members and indirect members;
- the adjusted bases and holding periods of their partnership interests;
- the partnership's basis and holding periods in each of its assets (and those of passthrough partners);
- accurate section 704(b) and 704(c) book and tax capital account balances;
- the extent to which provisions such as the passive loss and at-risk rules apply in determining the tax liabilities of partners and indirect partners;
- each partner's federal income tax year (and the federal income tax year of each of the passthrough partners and indirect partners); and
- related accounting information and supporting work papers to properly account for the tax return positions taken and to be taken by the partnership and each of the partners and indirect partners.

Hence, to be able to timely elect into one of the alternative audit regimes for a partnership tax year and to able to file requests for administrative adjustments under new section 6227 regulations, timely access to that necessary information should be required under the partnership agreement, and that up-to-date information will need to be maintained by the partnership's accountants.

If a reviewed-year partner causes the partnership to be unable to comply with any of the three alternative procedures for determining and paying tax deficiencies and related charges attributable to adjustments made to partnership-related items, or if the partnership determines on balance that it is best to have (or, for tax years beginning after November 2, 2015, and before January 1, 2018, to elect to have) the standard centralized partnership audit regime rules apply, consideration should be given to having the partnership agreement impose the related costs and liabilities on the partner(s) who should rightfully bear those charges. That determination likely should be based on the reviewed-year partners' (including former partners and their successors in interests') proportional shares of the partnership's imputed underpayment and perhaps imposing on those partners (including former partners) any additional liabilities that must be paid because they prevented the partnership from using one or more of the alternative regimes.

[69] Prop. reg. section 301.6225-3(a).

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Lastly, because the BBA rules remain in flux, as will often be the case for the underlying facts, many, if not most, partnerships and their members will determine that they should ensure that the partnership and those responsible for managing the partnership have the appropriate flexibility to allow the partnership and the current and former partners to respond to proposed adjustments in partnership-related items in a manner they determine to be best, including by appropriately charging the applicable partners with any payments that the partnership effectively makes on their behalf.[70] In that respect, provision for the BBA rules in the partnership agreement can be made by building on related provisions that should already be in place for dealing with state composite returns and state, federal, and foreign withholding taxes. ■

[70] *E.g.*, by requiring them to make capital contributions or other payments to the partnership or reducing the amount of distributions they will then be entitled to receive from the partnership, all properly accounted for in the partners' capital accounts.

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