IRS Issues Proposed Regulations on New Tax Audit Rules for Partnerships

On June 13, 2017, the United States Internal Revenue Service (IRS) re-released proposed regulations (the Proposed Regulations) that were originally circulated in unofficial form on January 19, 2017 (the Unofficial Proposed Regulations), on the new partnership audit rules enacted by Congress in 2015 (the New Audit Rules). These new rules apply to partnership taxable years beginning on or after January 1, 2018. The Proposed Regulations clarify the broad scope of the New Audit Rules and provide, among other things, procedures for opting out of these rules, for designating the partnership representative, for determining amounts owed by the partnership or partners attributable to adjustments and for pushing out the adjustments to the partners. The Proposed Regulations and their Preamble are essentially identical to the Unofficial Proposed Regulations.

Background – the New Audit Rules

On November 2, 2015, the New Audit Rules were enacted, effective for partnership taxable years beginning on or after January 1, 2018. These rules significantly changed the existing rules by requiring the partnership (domestic or foreign), rather than the partners in the year being audited, to pay any tax deficiencies and by limiting the rights of the partners to participate in the audit proceedings. The amount of any tax deficiency (the Imputed Underpayment) will generally be computed based on the highest tax rate applicable to an individual, but a partnership may claim a reduction in the tax rate based on certain types of income (e.g., capital gains and qualifying dividend income) and each partner’s status (e.g., tax-exempt). Certain partnerships with fewer than 100 partners may elect to opt out of these rules (the Opt Out Election), and partnerships that are subject to these rules are permitted to elect to push out the tax deficiency and tax payments to the partners that were partners in the taxable year that was being audited, thus saving the current partners from having to bear the cost of such tax. The New Audit Rules also no longer require the person representing the partnership in the audit proceedings before the IRS to be a partner in the partnership but permit the partnership to designate any person with substantial U.S. presence as its representative (replacing the old term “Tax Matters Partner” with the new term “Partnership Representative”). The Partnership Representative is given the sole authority to resolve any partnership audit and any such resolution will be binding on all partners. The Proposed Regulations provide much needed guidance on how these New Audit Rules will be applied.
Scope of the New Partnership Tax Audit Rules

The Proposed Regulations state that the scope of the New Audit Rules is intended to be very broad (including both partnership items and items affected by a partnership item), but clarify that the New Audit Rules apply only to income taxes. Therefore, they do not apply, for example, to social security taxes, self-employment tax and excise taxes, which the IRS may separately examine outside the scope of these rules.

Election to Opt Out of the New Audit Rules

Eligibility

The Opt-Out Election may only be made by a partnership with 100 or fewer “eligible partners.” The Proposed Regulations do not expand the types of partners that are “eligible partners,” restricting the Opt-Out Election to only individuals, C corporations, foreign corporations, S corporations or estates of deceased partners as its partners. For purposes of this rule, “C corporations” include regulated investment companies (RICs) and real estate investment trusts (REITs), along with certain tax-exempt entities classified as corporations under the Internal Revenue Code. Partnerships, trusts, disregarded entities, nominees and other similar persons that hold an interest on behalf of another person are not eligible partners (i.e. no election is available for partnerships having other partnerships or disregarded entities as their partners). Furthermore, only partnerships that are required to provide 100 or fewer K-1 statements for the applicable tax year may make an Opt-Out Election. Any statement required to be furnished by any partner that is an S corporation to its shareholder is counted for this purpose.

Making the Opt-Out Election

Under the Proposed Regulations, the partnership may make the election on a timely-filed partnership return if it discloses the names, TINs and tax classifications of each partner (along with the shareholders of each S corporation partner) and the partnership notifies its partners of the election within 30 days after making the election.

Due to the additional administrative burden on the IRS, the IRS intends to carefully scrutinize a partnership’s Opt-Out Election.

Partnership Representative

Eligibility to Serve as Partnership Representative

The Proposed Regulations provide procedures for designating the Partnership Representative for any audit proceedings. Generally, a partnership may designate any person (including an entity) to be the Partnership Representative, provided the designee has a substantial presence in the United States. The Proposed Regulations set forth a three-part test to determine whether a person has a “substantial presence” in the U.S.:

- First, the person must be able to meet in person with the IRS in the United States at a reasonable time and place as is determined by the IRS;
• Second, the Partnership Representative must have a U.S. address and phone number where the Partnership Representative can be reached during normal business hours; and

• Third, the partnership representative must have a U.S. taxpayer identification number.

If the partnership appoints an entity as the Partnership Representative, the partnership must also designate, at the same time, a designated individual who meets the substantial presence test described above to act on behalf of the entity.

**Designating the Partnership Representative**

The Proposed Regulations provide that the Partnership Representative is designated on the partnership’s tax return for the taxable year. A separate designation must be made for each taxable year. If there is no designation of a Partnership Representative, the IRS may, after a 30-day notice period, select any person to serve as Partnership Representative. The IRS will consider whether there is any suitable partner and any other relevant factor, and may consider a number of factors described in the Proposed Regulations when choosing a designee, including the views of the partners having a majority interest, the person’s knowledge of 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 U.S. person.

**Authority of the Partnership Representative**

The actions of the Partnership Representative are binding on the partnership and its partners, including any settlement agreement or final partnership adjustment to which the Partnership Representative agrees.

**Imputed Underpayment and Modification of Imputed Underpayment**

**Calculation of Imputed Underpayment, Netting and Groupings**

Under the Proposed Regulations, the Imputed Underpayment is generally determined by dividing items into three types of “groupings” (reallocation, credit and residual) and adding together all net positive adjustments from each grouping. Special rules apply to the reallocation grouping to ensure that only upward adjustments of income (and downward adjustments of losses) are taken into account when items are reallocated, in accordance with the New Audit Rules. Other detailed rules are provided as to the exact determination of the Imputed Underpayments.

**Modification of an Imputed Underpayment**

Under the Proposed Regulations, the portion of any adjustment attributable to a partner as described further below and that is approved by the IRS will be removed from the determination of the Imputed Underpayment. Modifications may be requested by the Partnership Representative by providing the IRS with a detailed description of the structure, allocations and ownership of the partnership, along with substantiating documentation. The Proposed Regulations include several adjustments to the Imputed Underpayment the IRS will consider, including the following:

- *Amended Returns and Closing Agreements*. A partnership may request the reduction of an Imputed Underpayment if a partner (or indirect partner) files an amended return or enters into a closing
agreement that takes into account all partnership adjustments allocable to such partner and the partner pays all taxes, interest and penalties as a result of such adjustments. There is no requirement for all affected partners to file amended returns, except in the case of an item reallocated to another partner in which case the Imputed Underpayment will be reduced only if all affected partners file amended tax returns.

- **Tax-Exempt and Foreign Partners.** The Imputed Underpayment may be reduced by the portion of the adjustment that is allocable to a tax-exempt partner (which, for this purpose, includes foreign persons, but not foreign partnerships or other pass-through entities), but only for that portion of the adjustment with respect to which the tax-exempt partner would not owe any tax.

- **Rate Modification.** The partnership may request to reduce an Imputed Underpayment by modifying the taxable rate used that is allocable to a C corporation or an individual with respect to capital gains and qualified dividends.

- **Other Modifications.** The IRS will also consider other modifications, including separating an Imputed Underpayment into multiple Imputed Underpayments allocable to specific partners.

**Push-Out Election**

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Under the New Audit Rules, a partnership may elect to “push out” one or more Imputed Underpayments to its partners in the year being audited rather than pay the Imputed Underpayment at the partnership level and having the current partners bear the costs of such tax (a Push-Out Election). The Proposed Regulations set forth detailed procedures that must be followed for a valid election to be made, including the statement that must be provided to each partner in connection with the election (the Push-Out Statement). If a partnership makes a valid Push-Out Election, each reviewed year partner will be liable for Imputed Underpayment and the partnership will no longer be liable for the Imputed Underpayment. The IRS may determine an election is invalid if the procedures set forth in the Proposed Regulations are not met, in which case the partnership will remain liable for any Imputed Underpayment to which the election related. The fact that certain partners do not pay their share of the Imputed Underpayment should not make an election invalid.

**Computation of Tax Resulting from Taking Adjustments into Account**

The Proposed Regulations clarify that each reviewed year partner that is furnished a Push-Out Statement is required to take into account the items that were adjusted at the partnership level and recalculate its tax at the partner level using the adjusted items and their affect on future year taxes. The additional tax as a result of these adjustments is calculated on a year-to-year basis, without a tax reduction in one year as a result of the adjustments reducing the additional tax payable with respect to any other year (the IRS and Treasury Department explained that they lacked authority to permit such netting under the statutory language of Section 6226 of the Internal Revenue Code). Alternatively, the reviewed year partner may pay a safe harbor amount, which is the partner’s share of the partnership level Imputed Underpayment, which avoids the unduly complicated calculation at the partner level of the tax adjustments mentioned above.
Other Applications of the Push-Out Election

- **Qualified Investment Entities.** The Proposed Regulations clarify that RICs and REITs may make deficiency dividends if they receive a Push-Out Statement.

- **Foreign Partners.** The Proposed Regulations reserve on the rules that would apply to foreign partners when a partnership makes a Push-Out Election. However, if the partnership makes such an election, it is the position of the IRS and Treasury that any additional income should be subject to the general withholding rules in the adjustment year.

- **Pass-Through Partners.** The Proposed Regulations reserve on the rules that would apply to pass-through partners when a partnership makes a Push-Out Election. Congress proposed in a technical corrections bill that a partnership or S corporation partner may elect to either pay an Imputed Underpayment or push out the liability in a manner similar to the Push-Out Election. The IRS and Treasury are currently considering an approach for pushing any Imputed Underpayment beyond first tier pass-through partners, which will be reflected in future proposed regulations.

- **Adjustments to Partners’ Outside Bases and Capital Accounts and Partner’s Basis and Book Value in Property.** The Proposed Regulations reserve on rules regarding adjustments to a partner’s outside basis, capital account and other tax attributes. However, the IRS and Treasury note that it is appropriate to adjust the adjustment year partners’ outside bases and capital accounts, along with the partnership’s basis and book value in property when such attributes are affected by reason of a partnership adjustment. The IRS and Treasury believe that these adjustments should be determined by making the adjustments in the reviewed year and carrying them forward to the adjustment year.

Other Issues

The Proposed Regulations are extremely complex and address a significant number of other important issues.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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