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# Preparing for a Brave New World: The Centralized Partnership Audit Regime


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INTRODUCTION

# Growth of Partnerships

- Partnerships have become an increasingly popular way to structure business arrangements, including:
  - Businesses for which the pass-through of certain tax attributes is important (e.g., historic structure rehabilitation credits);
  - Joint ventures between two or more entities;
  - Investment partnerships; and
  - Professional services partnerships.
- From 2002 to 2011, “the number of large partnerships with 100 or more direct and indirect partners as well as $100 million or more in assets more than tripled to 10,099 – an increase of 257 percent.” GAO 2014 Report.

# Problems with TEFRA

- TEFRA is burdensome for the IRS and taxpayers and, even 35 years after its enactment, there are fundamental uncertainties about its implementation.
  - Identifying the Tax Matters Partner can be difficult and result in audit delays.
  - Passing adjustments to the partners is a complex and time-consuming process.
  - Ambiguity between partnership items and affected items has generated significant litigation.
- There are few audits of large partnerships.
  - The audit rate for large partnerships was 0.8 percent in 2012, compared with 27.1 percent for large corporations. GAO 2014 Report.

# The Repeal and Replacement of TEFRA

- In 2015, Congress repealed TEFRA and established a new centralized partnership audit ("CPA") regime.
  - Section 1101 of the Bipartisan Budget Act of 2015 (P.L. 114-74), signed into law November 2, 2015.
  - Technical changes under the PATH Act of 2015 (P.L. 114-113), signed into law December 18, 2015.
- The new CPA regime is <u>effective</u> for partnership taxable years beginning after December 31, 2017, and <u>electable</u> for partnership taxable years beginning after November 2, 2015 and before January 1, 2018.

# The CPA Proposed Regulations

- On January 18, 2017, the Treasury Department and IRS announced proposed regulations ("Proposed Regulations") to address implementation of the CPA regime. (Notice of Proposed Rulemaking, REG-136118-15.)
- On January 20, 2017, the Proposed Regulations were withdrawn, pending review and approval by the Trump Administration.
- On June 13, 2017, the Proposed Regulations were re-released in substantially similar form.

# THE CPA REGIME

# The Scope of the CPA Regime

- The scope of the CPA regime is expansive.
  - Absent certain elections, adjustments to and assessments of "items of income, gain, loss, deduction, or credit," as well as penalties, additions to tax, or additional amounts related to such adjustments, and any partner's distributive share thereof, are determined and collected at the partnership level.
  - The Proposed Regulations define the term "items of income, gain, loss, deduction, or credit" broadly.
    - Includes all items and information required to be shown on the partnership's return for the taxable year and all information included in the partnership's books and records.
- TEFRA's distinctions between partnership items and affected items are eliminated.

# Electing Out of the CPA Regime

- Certain "eligible partnerships" may elect out of the CPA regime and follow pre-TEFRA rules.
  - Eligible partnerships are those with 100 or fewer "eligible partners."
    - "Eligible partners" are limited to individuals, C corporations, S corporations, eligible foreign entities, and estates of deceased partners.
    - Generally, an eligible partnership is required to furnish 100 or fewer Schedules K-1 for the entire taxable year, including any Schedules K-1 that must be furnished by any partners that are S corporations.
- Ability to elect out is reserved for simple partnership structures.
  - Importantly, <u>tiered partnership structures</u> and partnerships with direct partners that are <u>disregarded entities</u> may not opt out of the CPA regime.



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# Electing Out of the CPA Regime (cont'd)

- Election out must be made on the partnership's timely filed return (including extensions) for the relevant taxable year.
  - Partnerships must provide the IRS with the name and TIN of each partner and each person to whom an S corporation partner is required to furnish tax statements.
  - Each partner must be notified of the election within 30 days of making the election.
- Once made, the election out is binding on all partners unless the IRS determines that the election is invalid.
  - Valid elections can be revoked only with the consent of the IRS.

# Partnership Representative

- Under the CPA regime, all partnerships are required to designate a partnership representative for each taxable year.
  - Designations must be made on the partnership return for the partnership taxable year to which the designation applies.
- The partnership representative has the sole authority to act on behalf of—and bind—the partnership and all partners in examinations and other tax proceedings involving the partnership.
  - For example, only the partnership representative may determine whether to extend the statute of limitations, seek resolution of a dispute in Appeals or litigation, settle a dispute, or raise penalty defenses.
  - This is true even if the partnership representative acts in violation of the partnership agreement or applicable state law.

# Representative Eligibility

- Unlike the TMP under TEFRA, the partnership representative does not need to be a partner of the partnership.
  - This change may make it easier to find a qualified and willing partnership representative.
  - The new rule also reduces the chance that the partnership representative will be later disqualified for lack of proper partner status.
- A partnership may designate <u>any</u> individual, or an entity, to serve as partnership representative as long as they meet specified eligibility requirements.

# Representative Eligibility (cont'd)

- Representative must have a "substantial presence in the United States."
  - Substantial presence requires: U.S. street address, U.S. telephone number, U.S. taxpayer identification number, and the ability to meet with the IRS in person in the U.S. at a reasonable time and place.
- Representative must have the "capacity to act" as representative.
  - No capacity to act in the event of death, incarceration, a court order adjudicating that the person is incapacitated, liquidation or dissolution of an entity partnership representative, or any "similar situation."
- If an entity is designated, an individual associated with the entity, with a substantial presence in the United States and the capacity to act as partnership representative, must be designated ("designated individual").

# Replacement of Representative

- Partnership representative designations are effective until:
  - Resignation by the partnership representative, or
  - Revocation of a designation.
- In general, resignation or revocation of the partnership representative requires written notice to the IRS (and to the representative in the case of a revocation) and can only be submitted when filing an administrative adjustment request for the year in which the designation was in effect or at any time after the partnership receives a Notice of Administrative Proceeding.

# Replacement of Representative (cont’d)

- The IRS may determine that a partnership representative designation is not in effect because:
  - Partnership failed to make a valid designation on its timely filed tax return,
  - Partnership failed to designate a successor after a valid resignation,
  - The designated representative lacks a substantial presence in the U.S. or capacity to act, or
  - Multiple revocations have been made within a 90-day period.

# Replacement of Representative (cont'd)

- If the IRS determines that a partnership representative designation is not in effect, the IRS will notify the partnership and provide the partnership with an opportunity to designate a successor representative within 30 days.
- If the partnership does not designate a partnership representative within 30 days of the notification, the IRS will designate a representative.
- The IRS will also immediately designate a representative in the event there are multiple revocations.

# The Partnership Audit

- Under the new CPA regime, the examination itself will be conducted under the same principles generally applicable to examinations.
- A partnership audit will begin with the IRS sending a Notice of Administrative Proceeding.
- Following this notice, the IRS will work with the partnership representative to set a schedule for IDR requests and partnership responses.
- Unlike under TEFRA, under the CPA regime, partners are not entitled to notice regarding the start of an audit or any developments throughout the audit or Appeals processes.

# The Partnership Audit (cont'd)

- The IRS will generally inform the partnership representative of transactions or issues identified during audit that will be included in the Notice of Proposed Partnership Adjustment ("NOPPA").
- The limitations period for issuance of the NOPPA is generally three years after filing of the partnership return, but may be extended.
- The Proposed Regulations confirm that partnerships may challenge proposed imputed underpayments in the IRS Office of Appeals but do not establish the procedures for transferring the case to Appeals.

# The Partnership Audit (cont'd)

- Managing the audit and, if necessary, the Appeals process will be a key function of the partnership representative.
  - The Proposed Regulations are silent as to whether a partnership representative may delegate day-to-day management of an audit.
- The NOPPA will identify any "imputed underpayment," which is the additional tax liability resulting from a proposed partnership adjustment for any taxable year ("reviewed year") that must be paid by the partnership.
- The concept of an imputed underpayment that may be collected directly from the partnership is one of the ways that the CPA regime seeks to avoid the difficulties in collecting the tax due under TEFRA.



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# Computing an Imputed Underpayment

- The "imputed underpayment" is calculated using a grouping and netting mechanism set forth in the Proposed Regulations.
- Any positive adjustment remaining after application of the grouping and netting mechanism is multiplied by the highest income tax rate in effect for the reviewed year (and any negative adjustments are ignored).
  - Use of the highest tax rate is a departure from TEFRA, which utilizes the separate partners' tax rates.
- The resulting number is adjusted by any net increase or decrease in credits resulting from the partnership adjustments to arrive at the "imputed underpayment."

# Modifying an Imputed Underpayment

- On or before 270 days after the date the NOPPA is mailed (unless an extension is granted), a partnership may request a modification of any proposed imputed underpayment.
  - The partnership representative is responsible for determining whether a modification request will be made.
- The CPA regime's modification provisions are intended to determine, as closely as possible, the amount of tax that would be due if the partners and the partnership had correctly reported and paid the tax due.
- Once approved by the IRS, a modification can increase or decrease an imputed underpayment by affecting the extent to which adjustments factor into the calculation of the imputed underpayment or by affecting the tax rate.

# Types of Modifications

- The Proposed Regulations identify eight types of modifications:
  - Amended return filed by a reviewed year partner;
  - Adjustments for tax-exempt partners;
  - Reduction of tax rate below the highest applicable rate;
  - Certain passive losses of publicly traded partnerships;
  - Adjustments to the number and composition of imputed underpayments;
  - Adjustments for partners that are mutual funds or REITs;
  - Adjustments to reflect partner closing agreements; and
  - Other modifications.

# The "Push-Out" Election

- A partnership may elect to push out to reviewed year partners one or more of the imputed underpayments identified in the FPA.
  - The election deadline may not be extended.
  - The partnership representative is responsible for determining whether a push-out election will be made.
- Following a valid election of this alternative, the reviewed year partners are liable for any tax, penalties, and additions to tax in accordance with their respective shares of the partnership's total imputed underpayment.
  - Reviewed year partners must report and pay any amounts owed on their returns for the taxable year that includes the date the partnership properly notified them of their respective shares of the partnership adjustment.

# The "Push-Out" Election (cont'd)

- The push-out election requires partners to pay any tax deficiencies for all years between the reviewed year and the adjustment year as well.
  - Interest is imposed on partners' tax liability for the reviewed year and any intervening year at the federal short-term rate plus five percent.
  - If no push-out election is made, interest is imposed at the regular underpayment rate (federal short-term rate plus three percent).
- Absent the push-out election, the ability of current partners to recover the cost of an imputed underpayment related to departed reviewed year partners will depend on contractual rights set forth in agreements with departing partners.

# The “Push-Out” Election (cont’d)

- The election to push out must occur within 45 days of the date the Final Partnership Adjustment (“FPA”) is mailed.
- The partnership representative must provide the IRS and each reviewed year partner with a statement identifying each partner’s respective share of the partnership adjustment. These statements must be furnished within 60 days after the FPA is finally determined, when the deadline to file a petition has passed, or when the reviewing court’s decision is final.
  - If the partnership seeks judicial review of the partnership adjustment, several years may elapse between the push-out election and the provision of the statement to each partner.
- The push-out election may be revoked, but only with consent of the IRS.

# Judicial Review

- The new CPA regime generally leaves the existing judicial review framework intact, although it does make three important changes.
  - Seeking judicial review. Within 90 days after the date on which an FPA is mailed, the partnership may file a petition for readjustment in the U.S. Tax Court, the Court of Federal Claims, or a U.S. district court.
    - Under the CPA regime, the partnership representative is responsible for determining whether to pursue judicial review; the partners have no ability to do so.
    - By contrast, under TEFRA, the TMP has 90 days to file a petition on behalf of the partnership. If the TMP does not file within 90 days, any partner entitled to notice is able to file a petition for readjustment.

# Judicial Review (cont'd)

– Perquisites to refund suits. Before or contemporaneously with filing a refund suit in the Court of Federal Claims and U.S. district courts, the partnership must deposit the total amount of the imputed underpayment with the IRS.
  - Under TEFRA, a partner needed only to deposit its proportionate share of the adjustments set forth in the FPA before suing for a refund. This change may result in more partnership litigation in the U.S. Tax Court.

# Judicial Review (cont'd)

– Penalty defenses. Only the partnership representative may raise defenses to penalties or additions to tax, including the partnership's defenses and any defenses that relate to individual partners.

  - Any defenses not raised at the partnership proceeding will be waived even if the partnership makes the push-out election.
  - This is a significant change from the TEFRA regime which requires partner-level defenses to be raised at a subsequent partner-level refund proceeding.
  - By requiring all penalties and additions to tax and defenses thereto to be raised at the partnership-level hearing, the CPA regime makes clear that the trial court will have jurisdiction over these items, resolving an issue that was subject to extensive litigation. *See, e.g., United States v. Woods*, 134 S. Ct. 557 (2013); *New Millennium Trading LLC v. Comm'r*, 131 T.C. 275 (2008).

# KEY CONSIDERATIONS FOR TAXPAYERS

# Key Considerations

- Partnerships, especially large partnerships, are likely to be subject to more frequent audits in the new CPA regime.
- Although simplifying audits of large partnerships was a key objective, all partnerships—including existing partnerships—will be subject to the new CPA regime unless they elect out for the year.
- Only simple partnership structures are eligible to opt out of the CPA regime.
  - No more than 100 partners inclusive of shareholders of S corporations.
  - None of the partners can be partnerships, LLCs, disregarded entities, or trusts.

# Timeline of Key Events in the CPA Regime

| Event | Deadline |
|---|---|
| Designating partnership representative | Return filing date |
| Electing out of centralized partnership audit regime | Return filing date |
| Notifying partners of election out | 30 days after return filing date |
| Issuance of Notice of Proposed Partnership Adjustment ("NOPPA") | Within 3 years of filing return, unless extended |
| Modification request | 270 days after NOPPA is mailed, unless IRS grants extension |
| Electing alternative to push out imputed underpayment to partners | 45 days after Final Partnership Adjustment ("FPA") is mailed |
| Seeking judicial review | 90 days after FPA is mailed |
| Notifying partners of election to push out | 60 days after adjustment is finally determined |

# Changes to Partnership Agreements

- The new CPA regime creates many new questions that partnerships will need to address, such as:
  - Whether the partnership will elect out of the CPA regime (if eligible);
  - Who will be designated as the partnership representative, including following resignation or revocation of a prior designation;
  - Which general partner(s) will be permitted to revoke a partnership representative designation, and why;
  - Whether appropriate structures are in place to respond to IRS audit demands;
  - Whom the partnership representative will consult in deciding how an audit should be conducted, whether a settlement should be made, and when litigation will be pursued;

# Changes to Partnership Agreements (cont'd)

- Whether the partnership will request modifications to imputed underpayments;
- Whether the partnership will make the push-out election;
- If not, which partners will bear the economic cost of imputed underpayments, and how;
- Which notices and information will the partnership representative be required to provide to partners; and
- What information will partners be required to supply in connection with modification requests and penalty defenses, and when.

• Partnerships should review their partnership agreements to ensure that these issues are properly addressed.

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