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Legal Update
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Treasury and IRS Announce Proposed Regulations on Implementation of New Centralized Partnership Audit Regime

The increasing use of partnerships has posed administrative challenges for the Internal Revenue Service ("IRS"). In an attempt to combat these challenges, Congress enacted section 1101 of the Bipartisan Budget Act of 2015 ("BBA"), which repealed longstanding TEFRA audit rules for partnerships and replaced them with a new centralized partnership audit regime.[1] On January 18, 2017, the US Treasury Department ("Treasury") and the IRS announced proposed regulations ("Proposed Regulations") to address the implementation of section 1101 of the BBA. (Notice of Proposed Rulemaking, REG-136118-5.)

The new regime and associated Proposed Regulations are intended to decrease the administrative burden on the IRS by allowing it to assess and collect tax at the partnership level, rather than at the partner level. By increasing the efficiency of the adjustment, assessment, and collection processes, the IRS anticipates that the new regime will enable it to undertake additional partnership audits.

On January 20, 2017, the Trump Administration announced a freeze on all new and proposed federal rulemaking, pending review and approval by the Administration. As a result, the Proposed Regulations were withdrawn; however, we anticipate that they will be reissued with limited changes sometime during 2017 to enable taxpayers to more fully understand and prepare for the new regime.

This Legal Update offers a brief overview of the key changes to the partnership audit rules introduced in the BBA, summarizes the most significant procedural elements of the Proposed Regulations, and presents critical considerations for taxpayers to bear in mind as the new regime unfolds. Key events and deadlines under the new regime are summarized in the attached Appendix.

Background

Section 1101 of the BBA repealed the partnership audit rules established in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), as well as the rules applicable to "electing large partnerships," and replaced them with a centralized partnership audit regime effective for returns filed for partnership taxable years beginning after December 31, 2017, and electable for returns filed for partnership taxable years beginning after November 2, 2015, and before January 1, 2018.

Under the TEFRA regime, the IRS is generally required to adjust so-called "partnership items" at the partnership level but make computational adjustments to items affected by partnership items ("affected items") and impose tax related to those affected items at the partner level. Under TEFRA, the IRS communicates during administrative proceedings with a partnership's tax matters partner, but certain other partners are entitled to notice regarding those proceedings and all partners are entitled to participate in them. Under this structure, the

IRS has had difficulty auditing and collecting additional tax related to large partnerships.

Under the centralized partnership audit regime (new sections 6221 through 6241 of the Internal Revenue Code ("IRC")), administrative proceedings are generally conducted, adjustments made, and tax liability imposed at the partnership level, unless certain elections are made. Moreover, unlike under TEFRA, the new regime provides that all partnership elections and administrative proceedings are handled by the partnership representative, without notice and participation rights for partners.

Proposed Regulations

The Proposed Regulations address the scope of the centralized partnership audit regime and establish procedures related to its implementation, including regarding:

- Electing out of the centralized partnership audit regime;
- Designating and replacing a partnership representative;
- Determining a partnership adjustment and imputed underpayment;
- Modifying an imputed underpayment;
- Electing an alternative to the partnership's payment of the imputed underpayment; and
- Challenging partnership adjustments.

SCOPE OF THE CENTRALIZED PARTNERSHIP AUDIT REGIME

The Proposed Regulations reflect the view that the scope of the centralized partnership audit regime is expansive. Accordingly, adjustments to "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 at the partnership level. Similarly, any tax attributable to an adjustment of items of income, gain, loss, deduction, or credit is assessed and collected at the partnership level absent applicable elections.

The Proposed Regulations define the term "items of income, gain, loss, deduction, or credit" very broadly. In particular, the Proposed Regulations explain that the term includes not only all items and information required to be shown on the partnership's return for the taxable year, but also all information included in a partnership's books and records. This also includes items relating to transactions between a partnership and a partner, including disguised sales and transactions in which a partner is acting in a third-party capacity with respect to the partnership.

ELECTING OUT OF THE CENTRALIZED PARTNERSHIP AUDIT REGIME

In general, the centralized partnership audit regime applies to all partnerships. "Eligible partnerships," however, are permitted to elect out of the regime. By electing out, partnerships will subject themselves to pre-TEFRA audit procedures, under which the IRS must separately examine each partner and assess tax pursuant to general deficiency procedures.

An eligible partnership is a partnership with 100 or fewer "eligible partners" for the partnership's entire taxable year. Eligible partners are limited to individuals, C corporations, S corporations, eligible foreign entities, and estates of deceased partners.

In general, a partnership has 100 or fewer partners if it is required to furnish 100 or fewer Schedules K-1 for the partnership's taxable year. If any of the partners is an S corporation, computation of the number of Schedules K-1 required to be furnished by the partnership will also include the number of Schedules K-1 that the S corporation is required to furnish to its shareholders.

To elect out of the centralized partnership audit regime, an eligible partnership must make an election on its timely filed return, including any extensions, for the taxable year to which the election applies. In addition, the eligible partnership must include with its election all information required by the IRS, including

information regarding its partners. This information is designed to facilitate auditing individual partners, if necessary.

Any eligible partnership that elects out of the centralized partnership audit regime must notify its partners within 30 days of making the election.

Once made, an election out of the centralized partnership audit regime is binding on all partners unless the IRS determines the election was invalid. A valid election can only be revoked with the IRS's consent.

The Preamble to the Proposed Regulations makes clear that the IRS intends to increase partnership audits, including for those partnerships that have elected out of the centralized partnership audit regime. Whether the IRS will be successful in doing so is questionable given the practical difficulties of auditing and assessing tax against numerous partners.

DESIGNATING AND REPLACING A PARTNERSHIP REPRESENTATIVE

Under the centralized partnership audit regime, all partnerships are required to designate a partnership representative for each taxable year. The partnership representative has the sole authority to act on behalf of the partnership, including through participation in an examination or other proceeding involving the partnership. The Proposed Regulations explicitly state that no other partner or person may participate in an audit of a partnership unless the IRS permits. While one would expect the IRS to be reasonable in giving its permission, it is not clear that a high-level decision maker chosen as the partnership representative would be able to delegate day-to-day management of the audit to a subordinate. The Proposed Regulations also note that the partnership representative's actions are binding for all partners in the partnership even if the representative acts in violation of the partnership agreement; i.e., the partnership representative's actions are binding even if those actions contradict limits placed on the representative in the partnership agreement. Hence, designation of a partnership representative is a critical element of the centralized partnership audit regime and an important decision for taxpayers.

In general, a designation must be made on the partnership return for the partnership taxable year to which the designation applies and must include all of the information required by the IRS. If the partnership fails to designate a partnership representative, the IRS may select one.

The Proposed Regulations require that the partnership representative be a person with whom the IRS can actively work to conduct and resolve an audit. Unlike the "tax matters partner" under TEFRA, the partnership representative may be either a partner or a non-partner. In addition, the partnership representative may be either an individual or an entity. In any event, the partnership representative must have a "substantial presence in the United States," such that they (1) have a street address in the United States and a telephone number with a US area code, (2) have a US taxpayer identification number, and (3) would be available to meet with the IRS in person in the United States.[2] In addition, the partnership representative must have the "capacity to act" in that role. Although Treasury and the IRS heeded comments requesting that entities be permitted to serve as partnership representatives, the Proposed Regulations insist that, even in such circumstances, an individual point of contact must be identified. In particular, if the partnership representative is an entity ("entity partnership representative"), an individual with a substantial presence in the United States and a capacity to act as partnership representative must be designated as the sole individual through whom the entity partnership representative will act under the centralized partnership audit regime ("designated individual").

Partnership representative designations are effective until terminated by a valid resignation, a valid revocation, or a determination by the IRS

that a designation is not in effect. A partnership representative may resign by submitting written notice to the partnership and the IRS. However, the Proposed Regulations limit the timing for resignations to avoid the IRS processing changes in designation for partnerships that may never be audited. In particular, a partnership representative is permitted to resign simultaneously with filing a valid administrative adjustment request ("AAR") for the partnership taxable year for which the designation was in effect, any time after receiving a notice of administrative proceeding for the partnership taxable year, or at any other time identified by the IRS.

Separately, a partnership representative designation may be revoked through written notice provided to the partnership representative and to the IRS from a general partner (or other partner, if no general partners exist or have the capacity to act) of the partnership. For this purpose, a member-manager of a limited liability company is treated as a general partner. Like a resignation, a revocation may take place only when the partnership files a valid AAR for the partnership taxable year for which the designation was in effect, or any time after receiving a notice of administrative proceeding.

The Proposed Regulations contain additional requirements regarding the designation of successor partnership representatives, including circumstances in which the IRS may designate a partnership representative.

DETERMINING A PARTNERSHIP ADJUSTMENT AND IMPUTED UNDERPAYMENT

In sharp contrast to prior law, the centralized partnership audit regime generally requires that any "imputed underpayment" resulting from a partnership adjustment for any taxable year ("reviewed year") must be paid by the partnership. The imputed underpayment amount is computed first through an adjustment grouping and netting mechanism set forth in Proposed Regulations sections 301.6225-1(c)-(d). Any adjustment remaining after the grouping and netting mechanism is thereafter multiplied by the highest rate of federal income tax in effect for individuals or corporations for the reviewed year. Finally, the product of these amounts is increased or decreased by any adjustment made to the partnership's credits.

Given that the partnership audit is likely to be completed several years after the reviewed year, the economic cost of any imputed underpayment paid by the partnership may be borne by partners different than those who were partners in the reviewed year unless an indemnity or similar contractual arrangement is in place with the former partners.

MODIFYING AN IMPUTED UNDERPAYMENT

As noted above, the general rule is that any imputed underpayment is computed using the highest rate of federal income tax. Under the centralized partnership audit regime, a partnership is permitted to request modification of any proposed imputed underpayment that was identified in a Notice of Proposed Partnership Adjustment ("NOPPA"). As acknowledged in the Preamble to the Proposed Regulations, "the intent of the modification provision is to 'determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.'"

Unless the IRS grants an extension, the partnership has 270 days from the date the IRS mailed the NOPPA to submit its modification request.

The Proposed Regulations identify seven specific types of modifications, and one general type of modification, which a partnership may request. Those modifications pertain to: (1) amended returns by partners; (2) tax-exempt partners; (3) rate of tax lower than the highest applicable tax rate; (4) certain passive losses of publicly traded partnerships; (5) number and composition of imputed underpayments; (6)

partners that are mutual funds or REITs; (7) partner closing agreements; and (8) other modifications. Obtaining modifications will require partnerships to have access to tax characteristics of their partners that was previously unnecessary.

If the IRS approves a partnership's modification request, it can increase or decrease the amount of the imputed underpayment identified in the NOPPA. The Proposed Regulations set forth requirements for determining the amount of an imputed underpayment in connection with the various types of modification requests.

Following the IRS's acceptance of a modification request, or the partnership's waiver of the 270-day requirement to file such a request, the IRS will issue a Notice of Final Partnership Adjustment ("FPA") reflecting the final adjustments.

ELECTING AN ALTERNATIVE TO THE PARTNERSHIP'S PAYMENT OF THE IMPUTED UNDERPAYMENT

As discussed above, one of the key features distinguishing the centralized partnership audit regime from TEFRA is that the former establishes partnership-level liability for imputed underpayments as a default principle. However, the Proposed Regulations also contain an "election for an alternative to the [partnership's] payment of the imputed underpayment." Under this alternative, a partnership may elect to push out an imputed underpayment to the persons who held an interest in the partnership at any time during the reviewed year ("reviewed year partners").

A partnership has 45 days from the date the IRS mailed the FPA to elect this alternative with respect to any imputed underpayment contained in the FPA. In order for the partnership's election to be valid, it must satisfy a number of requirements, including, among other things, that it provide both the IRS and each reviewed year partner with statements identifying each reviewed year partner's share of the partnership adjustments related to the imputed underpayment. Although the election must be filed within 45 days of the FPA, the statements to partners must be sent within 60 days of the date the adjustment is finally determined. If the partnership seeks judicial review of the FPA, several years may elapse between the filing of the election and sending statements to the partners.

Following a valid election of this alternative, the partnership is no longer liable for the imputed underpayment to which its election applies. Instead, the reviewed year partners are liable for any tax, penalties, additions to tax, additional amounts, and interest stemming from their respective shares of the partnership adjustments related to the imputed underpayment. The reviewed year partners must report and pay any amounts owed as a result of the push-out on their returns for the taxable year that includes the date the partnership furnished them with the required statement identifying their respective shares of the partnership adjustment ("reporting year").[3]

CHALLENGING PARTNERSHIP ADJUSTMENTS IN THE NEW REGIME

IRS Appeals

The Proposed Regulations note that the underpayment proposed in a NOPPA is not final because "the partnership may still challenge the amount in the IRS Office of Appeals," but they do not discuss how IRS Appeals will operate in the context of the new centralized partnership audit regime. Presumably, the mechanics and form of the proceedings will largely mirror those currently in use—i.e., the partnership will have a certain period, following receipt of the NOPPA, within which to file a protest with IRS Appeals; thereafter, traditional IRS Appeals procedures will likely apply.

Judicial Review

Although the centralized partnership audit regime generally leaves the prior judicial review framework intact, it does include some

important modifications. The new regime allows partnerships, within 90 days after the FPA is mailed, to file a petition for readjustment in the US Tax Court, the Court of Federal Claims, or a US district court. It bears emphasis that only the partnership may seek judicial review of an FPA under the new regime. In contrast, under TEFRA, any partner entitled to notice was permitted to file a petition.[4]

If a partnership elects to push out an imputed underpayment to the partnership's reviewed year partners (within 45 days of the receipt of the FPA) as discussed above, it will not affect the partnership's ability to file a petition to challenge adjustments set forth in an FPA. If, after going to court, a partnership that appropriately filed an election determines that it no longer wishes to push out the imputed underpayment, the partnership can request IRS consent to revoke its election.

Importantly, IRC section 6234(b)(1) creates a new limitation on a partnership's ability to file a petition for readjustment in the Court of Federal Claims and the US district courts. Under TEFRA, a partner filing a petition for readjustment needed first to deposit with the IRS its *proportionate share* of the adjustments set forth in the FPA. Under the new regime, however, the filing partnership must deposit with the IRS, on or before the date the petition is filed, the *total amount* of the imputed underpayment. This presents a significant practical hurdle to litigating in these refund forums and will likely pull more partnership litigation into the US Tax Court.

TREASURY'S AND THE IRS'S REQUESTS FOR TAXPAYER COMMENTS

Throughout the Preamble to the Proposed Regulations, Treasury and the IRS requested taxpayer comments regarding a number of outstanding issues, including:

- Additional circumstances that may warrant allowing a partnership or partnership representative to change the partnership representative designation;
- How best to streamline administering the amended return modification process;
- How adjustments affecting foreign tax credit calculations should be taken into account within the framework of the centralized partnership audit regime;
- How to administer the requirements of IRC section 6226 (reviewed year partners take into account the adjustments made by the IRS and pay any tax due as a result of those adjustments) in tiered structures, and how to reduce noncompliance and collection risk in tiered structures, while at the same time limiting the administrative costs of the IRS; and
- Mechanical rules to govern the adjustments to adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property.

Considerations for Taxpayers

Large partnerships have become an increasingly common vehicle for business and investment activity. The BBA has provided the IRS with tools to more effectively audit and collect tax from these partnership activities. The Proposed Regulations indicate that the IRS has embraced the use of these tools. Partnerships are likely to be subject to more frequent audit activities in the coming years.

Although most partnerships will not be covered by these rules until after December 31, 2017, partnerships should be considering incorporating appropriate mechanisms to deal with issues such as the designation of a partnership representative, partners' rights with respect to receipt of notices and information in connection with audits, how to respond to any imputed underpayment determined as a result of an audit, and how to ensure that any imputed underpayment is economically borne by the appropriate partners (or former partners).

Appendix

Summary of Key Events and Deadline

EVENT	DEADLINE	CITATION
Designating partnership representative	Return filing date	Proposed Regulation § 301.6223-1(c)(2)
Opting out of centralized partnership audit regime	Return filing date	Proposed Regulation § 301.6221(b)-1(c)(1)
Notifying partners of opt out	30 days after return filing date	Proposed Regulation § 301.6221(b)-1(c)(3)
Issuance of NOPPA (by IRS)	Generally within three years of filing return, but may be extended	N/A
Modification request	270 days after NOPPA is mailed, unless IRS grants extension	Proposed Regulation § 301.6225-2(c)(3)(i)
Electing alternative to push out imputed underpayment to partners	45 days after FPA is mailed	Proposed Regulation § 301.6226-1(c)(3)
Notifying partners of election to push out	60 days after adjustment is finally determined	Proposed Regulation § 301.6226-2(b)(1)
Seeking judicial review	90 days after FPA is mailed	IRC § 6234(a)

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Endnotes

[1] For purposes of this Legal Update, references to the BBA also include technical changes included in the Protect Americans from Tax Hikes Act of 2015 ("PATH Act").

[2] The Proposed Regulations do not adopt the substantial presence test as described in IRC section 7701(b)(3).

[3] The Proposed Regulations do not resolve the issue of whether a partner that is itself a pass-through entity may flow any pushed-out adjustment through to its owners.

[4] Under TEFRA, a tax matters partner is given 90 days following receipt of the FPA to file a petition for readjustment. If the tax matters partner fails to file a petition for readjustment within that window, a non-tax matter partner is permitted to file a petition within 60 days thereafter.

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