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Article

Never Say Never: Preparing for the Reintroduction of the Withdrawn Centralized Partnership Audit Regulations

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On January 18, 2017, the US Internal Revenue Service (the "IRS") released 277 pages of proposed regulations and accompanying explanations to implement the centralized partnership audit ("CPA") regime effective for partnership taxable years beginning after December 31, 2017. *See* Notice of Proposed Rulemaking REG-136118-15 (the "Proposed Regulations"); Prop. Treas. Reg. §301.6221-1(e)(1). Two days later, the new Trump administration announced a freeze on all new and proposed federal rulemaking, and the IRS withdrew the Proposed Regulations. The Proposed Regulations would have implemented the new statutory scheme for auditing partnerships.[2] Accordingly, it is likely that rules substantially similar (if not identical) to the Proposed Regulations will be re-proposed after the freeze is lifted.[3] Thus, it is worth examining the Proposed Regulations to begin to understand how the statutory changes will be implemented by the IRS.

Brief Background

Under the TEFRA audit regime, the IRS has been required to determine "partnership items" at the partnership level, but seek to impose the federal tax due on such items at the partner level. Sections 6221 and 6225 of the Internal Revenue Code of 1986, as amended and in effect prior to the enactment of P.L. 114-74 (the "Pre-CPA Code"). The TEFRA audit rules required the IRS to communicate with the tax matters partner, but certain other partners were entitled to notice of proceedings and all partners have been entitled to participate in them. See Pre-CPA Code §§ 6223(a) and 6224(a). The requirement that the IRS seek the payment of any taxes due from the partners as a result of a partnership audit has been a hindrance to IRS audits of partnerships. REG-136118-15, § 2(A). In a nutshell, the CPA regime was enacted to address this situation by making the partnership itself directly liable for the payment of any taxes assessed during an audit. The CPA regime applies to all partnerships unless a partnership is an eligible partnership and effectively elects out of the rules. REG-136118-15, § 2(B).

Scope of the CPA Regime

ADJUSTMENTS

The CPA regime treats the adjustment of items of income, gain, loss, deduction, credit and penalties attributable to partnership items, and any partner's share of any of these items, as "partnership adjustments" that are determined at the partnership level. Section 6221(a) of the Internal Revenue Code of 1986, as amended (the "Code"); Prop. Treas. Reg. § 301.6221(a)-1(a). Partnership adjustments also include changes to character, timing, source and amount. Prop. Treas. Reg. § 301.6221(a)-1(b). In a major shift,

partnership adjustments also include transactions between a partnership and a partner, a partner's basis in its partnership interest and whether the partnership is a sham. Prop. Treas. Reg. § 301.6221(a)-1(b)(i)(H); Prop. Treas. Reg. § 301.6221(a)-1(b)(ii)(e). This broad definition is intended to eliminate the distinction among partnership items, computational adjustments and affected items that existed under TEFRA. REG-136118-15, § 2(A), quoting the Joint Committee on Taxation, *General Explanations of Tax Legislation Enacted in 2015*, p. 57 (JCS-1-16).

An item is a partnership item if all information related to the item is included in the partnership's books and records or its tax returns. Transactions between a partner and the partnership in which the partner is acting as a third person, such as disguised sale transactions, also are treated as partnership items. Prop. Treas. Reg. § 301.6221(a)-1(b)(2). Even in this case when a transaction is between a partner and the partnership, the tax due is assessed and collected at the partnership level.

Importantly, penalties are determined at the partnership level and no partner individually will have a right to assert any defenses to penalties. Prop. Treas. Reg. § 301.6221(a)-1(c). The partnership representative must raise all defenses that the partnership, and individual partners may have to the imposition of penalties. Prop. Treas. Reg. 301.6221-1(c)(2)(Ex. 1); REG-136118-15, Explanation of Provisions, § 1.

REPORTING

In general, a partner (including an upper-tier partnership) must treat a partnership item consistently with the way that the partnership reported such item. Prop. Treas. Reg. § 301.6222-1(a)(1). If the partnership files an amended return, the partner is bound to report the items in accordance with the amended return. Prop. Treas. Reg. §301.6222-1(a)(5)(Ex. 4). If a partner treats a partnership item differently than the partnership did without following the procedures for flagging inconsistent treatment, and the inconsistent treatment results in an underpayment of tax by the partner, the underpayment is treated as a mathematical or clerical error subject to immediate assessment by the IRS. Code § 6222; Prop. Treas. Reg. § 301.6222-1(b)(2). Unless a taxpayer has flagged the inconsistent treatment to the IRS on its filed tax returns by including a statement noting the inconsistent treatment on an item-by-item basis, the taxpayer may not request abatement of a mathematical or clerical error assessment for a partnership item. Code §§ 6662(b), (c). As a result, the IRS may immediately assess and collect tax on the underpayment. No inconsistent reporting is permitted for items that are reflected in a push-out statement filed by the partnership under Code § 6226 (described below). Prop. Treas. Reg. §301.6222-1(c)(2). A Section 6226 statement relieves the partnership of liability for an understatement and requires the partners to pay the assessment.

Although the CPA regime applies to partnership taxable years beginning after December 31, 2017, a partnership may elect to apply the regime to any partnership return for a taxable year beginning after November 2, 2015. In August 2016, the IRS released temporary regulations allowing taxpayers to make the election to apply the CPA regime before 2018. See Temp. Treas. Reg. § 301.9100-22T.

Election Out of the CPA Regime

Certain partnerships, referred to as "eligible partnerships," may elect out of the CPA regime. If an eligible partnership does elect out of the CPA regime, partnership items will be subject to the pre-TEFRA audit procedures, under which the IRS must separately examine and assess each partner. REG-136118-15, § 2(B). Given the difficulty that this will pose for the IRS, the IRS has stated that it "intends to carefully review a partnership's decision to elect out of the CPA

regime." REG-136118-15, Explanation of Provisions § 2(C).

An eligible partnership is a partnership with 100 or fewer "eligible partners" at all times during the taxable year. Prop. Treas. Reg. § 301.6221(b)-1(b). The IRS has stated that it may combine two or more partnerships if the facts warrant in determining if a partnership has more than 100 partners. The 100 partner test is made with reference to the number of Schedule K-1s that the partnership is required to have issued during the taxable year, not the number actually issued. Eligible partners are limited to individuals, C corporations (including RICs, REITs and tax-exempt entities other than trusts) and S corporations, estates of deceased partners and foreign entities treated as corporations. Code § 6221(b)(1)(C); Prop. Treas. Reg. § 301.6221(b)-1(b)(3)(iii). If, however, an S corporation is an eligible partner, the 100 or fewer test is determined by looking through the S corporation and counting each person who receives a Schedule K-1 from the S corporation as a partner. Code § 6221(b)(2)(A); Prop. Treas. Reg. § 301.6221(b)-1(b)(3)(ii). A partnership with a direct partner that is a nominee, disregarded entity, partnership or a trust is not an eligible partnership. Prop. Treas. Reg. § 301.6221(b)-1(b)(3)(ii).

The fact that an S corporation does not disqualify a partnership from being an eligible partnership, but a partnership-partner does, is likely to discourage the use of general partners that are themselves partnerships. It is much more likely that partnerships that are otherwise eligible to opt out of the CPA but for the fact that their general partner is a partnership will convert their general partners to S corporations if possible.

The election by an eligible partnership to elect out of the CPA regime is made by the partnership with its timely filed tax return (including extensions). Code § 6221(b)(1)(D)(i); Prop. Treas. Reg. §301.6221(b)-1(c)(1). The election must include the TIN and name of each partner (and if an S corporation is a partner, the S corporation shareholders). Code § 6221(b)(1)(D)(ii). The partnership must notify its partners of the election within 30 days of the date that the election is made. Prop. Treas. Reg. § 301.6221(b)-1(c)(3). The election may be revoked only with IRS consent. Code § 6221(b)(1)(E).

The Partnership Representative

The CPA regime requires a partnership to have a "partnership representative" who is designated as such on the partnership's tax returns. Code § 6223(a); Prop. Treas. Reg. § 301.6223-1(a). A different partnership representative may be appointed for each partnership taxable year. A designation does not automatically continue to be in effect. Each year's tax return must designate the partnership representative for that year. Prop. Treas. Reg. § 301.6223-1(c)(1).

The partnership representative has the sole authority to act on behalf of the partnership during an audit or other proceeding involving the partnership. Prop. Treas. Reg. § 301.6223-2(c)(1). Its actions are binding on the partnership and its partners. Prop. Treas. Reg. § 301.6223-2(a). No other person may participate in a partnership proceeding without prior IRS consent. The decisions of the partnership representative are binding on all partners, even if the partnership representative acts outside of the authority conveyed to him by the partnership agreement. Code § 6223(b). In other words, the acts of a partnership representative are binding on a partnership even if the partnership agreement attempted to curtail the authority of the partnership representative. A partnership representative may bind a partnership even if its acts are outside of the authority that exists under state law. Prop. Treas. Reg. § 301.6223-1(c)(1).

The partnership representative may be an entity or an individual and need not be a partner in the partnership. Prop. Treas. Reg. § 301.6223-1(b)(1). In all events, the partnership representative must have a "substantial presence

in the United States." Prop. Treas. Reg. § 301.6223-1(b)(2). This means that the partnership representative must:

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 (a "TIN"); and
3. Be available to meet with the IRS in the United States.

Id. If an entity is appointed as a taxpayer representative (an "entity partnership representative"), an individual point of contact (the "designated individual") must be identified. Prop. Treas. Reg. § 301.6223-1(b)(3). The individual must also meet the substantial presence test. Even if a partnership representative does not meet the substantial presence test, the designation of such person remains valid until the representative resigns, the designation is revoked by the partnership or the IRS determines that the designation is invalid.

If a partnership fails to designate a partnership representative, the IRS may choose one. Code § 6223(a). In addition, the IRS may reasonably determine that a partnership representative is ineligible to act as such. Prop. Treas. Reg. § 301.6223-1(b)(1). In this event, the partnership has 30 days to designate a replacement. Prop. Treas. Reg. §301.6223-1(f)(4). If the IRS chooses a replacement partnership representative, such person cannot be replaced without IRS approval. Prop. Treas. Reg. § 301.6223-1(f)(3)(iii).

A partnership representative may resign only at specified times in order to save the IRS the burden of changing the listed representative for a partnership that may never be audited. Specifically, a partnership representative may resign simultaneously with the filing of a administrative adjustment request (an "AAR") for a year during which the designation was in effect, any time after the partnership has received a notice of administrative proceeding or at another time identified by the IRS. Prop. Treas. Reg. § 301.6623-1(d)(2). A partner representative may resign by notice to the general partner of the partnership, but the resignation is effective at the same time as a resignation tendered to the partnership and the IRS.

Proposed Treasury Regulation § 301.6223-1(d) provides procedures pursuant to which a partnership may terminate a partnership representative and appoint a replacement. As with other replacements, a partnership representative may not be replaced prior to the issuance of a notice of administrative proceeding or the filing of an AAR. In general, any general partner may sign a notice of revocation. Prop. Treas. Reg. § 301.6223-1(e)(3)(i). For limited liability companies, member-managers may sign a notice of revocation. Prop. Treas. Reg. § 301.6223-1(e)(3)(ii).

Partnership Adjustments and Imputed Underpayments

The heart of the CPA regime lies in the liability for tax assessments. Under the CPA rules, unless the partnership is no longer in existence, the partnership itself will be liable for any "imputed underpayment" resulting from a partnership adjustment for any taxable year (a "reviewed year"). Code § 6225(a)(1); Prop. Treas. Reg. § 301.6241-1(a)(8). The tax, however, is imposed and paid by the partnership in year assessed (the "adjustment year"). Thus, unless a push-out election is made, the tax liability for a reviewed year will be borne by adjustment year partners. If the partnership has ceased to exist (or cannot pay the liability), the adjustment is taken into account by the adjustment year partners directly. Prop. Treas. Reg. § 301.6241-3(d)(1)(i). The payment of a partnership adjustment is not deductible. Prop. Treas. Reg. § 301.6241-4.

Certain positive and negative adjustments are netted and are treated as items of non-separately stated loss under Code § 702(a)(8). Code §

6225(a)(2)(A)-(B); Prop. Treas. Reg. § 301.6225-1(c) – (d). As described below, however, certain adjustments are placed into separate groupings, which are not netted. Thus, the ability to achieve a tax arbitrage upon audit is curtailed. If a particular grouping has a net negative adjustment, it does not reduce the net positive adjustments from another grouping. Prop. Treas. Reg. § 301.6225-1(c)(2). In addition, if an adjustment results in taxable income that is reversed in another year, such other year decrease is ignored. Prop. Treas. Reg. § 301.6225-1(c)(4); Prop. Treas. Reg. § 301.6225-1(f)(Ex. 5) (deductions claimed in 2019 that should have been claimed in 2020 result in an imputed underpayment in 2019 without consideration of the offset). As a result, an imputed underpayment may result in an amount that approximates gross income. The IRS expressly rejected a rule that would limit partnership adjustments to the net amount of underpaid tax. See Prop. Treas. Reg. § 301.6225-1(a)(2).

The net positive adjustment is then multiplied by the highest rate of tax applicable to individuals or corporations for the reviewed year. Code § 6225(b)(1)(A); Prop. Treas. Reg. §301.6225-1(c). The resulting tax liability is then adjusted to reflect partnership tax credits. Code § 6225(c). The partnership adjustment and resulting tax liability is treated as arising in the year in which the liability is fixed (referred to as the "adjustment year"). An imputed underpayment must be paid in the adjustment year. If the partnership does not pay the adjustment, adjustment year partners are liable for the underpayment. Prop. Treas. Reg. § 301.6241-3(c).

Separate rules are provided for negative adjustments. Prop. Treas. Reg. § 301.6225-3. In general, negative adjustments are treated as non-separately stated items of income and loss. If, however, the net negative adjustment relates to a separately stated item, it adjusts that item. If the negative adjustment relates to an amount that is reallocated among partners, only those partners (or their successors) take the item into account. Prop. Treas. Reg. § 301.6225-3(a)(4). If successor partners cannot be identified, the reallocated item is allocated to all partners based upon their distributive share. If the partnership has made a push-out election, re-allocated items are taken into account directly by the affected partners. Prop. Treas. Reg. § 301.6225-3(a)(6).

The imposition of tax liability on the partnership itself will pose challenges to partnerships that experience redemptions, sales of partnership interests and issuances of new partnership interests in between the time that a reviewed year closes and the partnership settles IRS adjustments for such taxable year because, to such extent, the adjustment year partners may not be the same persons who were partners during the reviewed year. Accordingly, it will be important to include an indemnity or similar contractual arrangement for former partners in partnership agreements for partnerships subject to the CPA regime if the push-out election is not made by the partnership.

The regulations reserve on the thorny issue on how capital accounts and outside basis should be adjusted if a reviewed year partner has redeemed his interest in the partnership prior to the adjustment year. In all other cases, however, the capital account of the adjustment year partner (whether or not such partner had acquired the partnership interest after the reviewed year) is adjusted to take into account the partnership adjustment.

GROUPINGS

The IRS, under the Proposed Regulations, will group various items together in one of three categories in determining the imputed underpayment. Prop. Treas. Reg. § 301.6225-1(d). Although a group may have net additional deductions or less income, these adjustments are not netted against the adjustments made with respect to another group (or subgroup) that result in additional income or fewer deductions.

See Prop. Treas. Reg. § 301.6225-1(f)(Ex. 4). Accordingly, while the aggregate of partnership adjustments can be taxpayer-favorable or even neutral, the partnership will still owe tax on the net positive adjustments within a grouping or sub-grouping.

Adjustments that reallocate items among partners are one category. Prop. Treas. Reg. §301.6225-1(d)(2)(ii). The debits and credits are placed into separate subcategories so they do not net to zero. *Id*. If an adjustment re-allocates a partnership item from one partner to another, the adjustment is considered on a gross basis, that is the increase in income to a partner is treated as an imputed underpayment but the corresponding decrease in income to the other partner is ignored. Code § 6225(b)(2); Prop. Treas. Reg. § 301.6225-1(d)(2)(ii). The net negative adjustments are disregarded.

Partnership-generated tax credits are in the second grouping. The net credit adjustment may be netted against positive adjustments in the other categories notwithstanding the general rule that net positive adjustments within one grouping are not netted against net negative adjustments in other categories.

All remaining items are placed into the third category. The regulations envision that there will be subgroups here as well, such as an ordinary item subgroup and capital (gain and loss) subgroup. Prop. Treas. Reg. § 301.6225-1(d)(3). Long-term capital gains are placed into a separate subcategory from short-term capital gains and losses. Adjustments within one subcategory are not netted against the items in another subcategory. *Id*. A grouping with a negative adjustment is ignored in determining the imputed underpayment. Prop. Treas. Reg. §301.6225-1(d)(3)(ii)(A).

Partnership adjustments are further categorized into one of two types: (i) general imputed underpayments and (ii) specific imputed underpayments. Prop. Treas. Reg. § 301.6225-1(e)(2)(i). A general imputed underpayment is based upon all adjustments not relating to specific imputed underpayments. Both positive and negative adjustments are taken into account (other than re-allocations among partners), and the final amount can be negative, that is, result in a net increase in deductions or decrease in partnership income. Prop. Treas. Reg. § 301.6225-1(f)(Ex. 1). As noted above, negative partnership adjustments do not lessen the amount that must be paid in respect of positive partnership adjustments. Specific imputed underpayments relate to specific transactions. Prop. Treas. Reg. § 301.6225-1(e)(2)(iii). In example 5 of Proposed Treasury Regulation § 301.6225-1(f), however, the IRS reserved the right to categorize items into specific imputed underpayments based upon the character of such items.

ALLOCATIONS OF PARTNERSHIP ADJUSTMENTS

The CPA regime was not accompanied by any guidance on how partnership adjustments and imputed underpayments should be allocated among partners. In the Preamble to the Proposed Regulations, the IRS stated that it intends to issue regulations that will treat positive partnership adjustments as items of nontaxable income for capital account and basis purposes. This treatment would ensure that positive partnership adjustments are not double taxed. Concomitantly, negative partnership adjustments will be treated as non-deductible charges to a partner's capital accounts. In addition, the Preamble states that the IRS has determined that it is appropriate to adjust the partners' outside basis in their partnership interests and the book value of partnership property when an adjustment affects the tax attributes of the property. No rules have been promulgated for this purpose yet although the Preamble states:

> Outside bases and capital accounts should be adjusted to what they would have been if the adjustments were made in the review year to reviewed year

partners and property and then modified to take into account all intervening events.

The Preamble recognizes that if a partner acquired its partnership interest in a taxable transaction in an intervening year, no adjustment may be appropriate to the basis in the partnership interest because the basis would be determined with reference to the consideration paid by the acquiring partner.

Unless and until future guidance is provided, a partnership subject to a partnership adjustment can allocate the adjustment in accordance with the percentage interests in the adjustment year or as an effective Section 704(c) adjustment to those partners who were partners in the reviewed year. In most cases, it would seem that the imputed partnership tax liability should be allocated in the same way that the partnership adjustment was determined. An interesting corollary issue is the effect that an imputed partnership underpayment should have on a carried interest. A case can be made that the imputed partnership underpayment is a below-the-line item that should not affect the carried interest. On the other hand, when the tax is being borne by persons who were not partners in the reviewed year, the case that the imputed partnership underpayment should be treated as a loss that is counted in determining the amount of the carried interest seems persuasive.

Modifying an Imputed Underpayment

As noted above, the underpayment is computed using the highest rate of federal income tax. A partnership representative is permitted, however, to request the IRS to modify a proposed imputed underpayment identified in a Notice of Proposed Partnership Adjustment (a "NOPPA") provided by the IRS within 270 days of the NOPPA mailing date. Code § 6225(c)(7); Prop. Treas. Reg. § 301.6225-2(c)(3)(i). (The IRS may extend the 270-day period. Prop. Treas. Reg. § 301.6225-1(c)(3)(ii).) The purpose of a modification request is to reflect the tax due as closely as possible to the tax due if the partnership and the partners had correctly reported and paid. REG-136118-15, § 2(A). Accordingly, all modifications are made with respect to the tax aspects of reviewed year partners even though the liability will be borne by adjustment year partners. The Preamble notes that the modification rules mirror the results that would have obtained under TEFRA, without requiring the IRS to pursue individual partners. *Id.* Accordingly, a modification only affects the imputed underpayment, not the partnership adjustment.

Specifically, the partnership can have the proposed imputed underpayment reduced to reflect the following items:

1. Amended returns filed by partners to reflect the total proposed imputed underpayment allocable to such partners (provided such returns are accompanied by payment of the additional tax due);

2. Tax-exempt partners (whether tax-exempt as a section 501 organization or exempt from tax as a non-US person);

3. Partners who are subject to a tax rate lower than the highest applicable rate on particular types of income, such as qualified dividend income or long-term capital gains (no benefits of graduated rates are taken into account);

4. In the case of publicly traded partnerships, net decreases in passive activity losses (not in excess of suspended PAL carryovers) allocable to individuals and closely held C corporations;

5. Number and composition of imputed underpayments;

6. Partners that are regulated investment companies or real estate investment trusts that will pay deficiency dividends to their shareholders;

7. Partner closing agreements; and

8. Other modifications.

Code § 6225(c). These modifications are defined as "tax attributes." Prop. Treas. Reg. § 301.6241-1(a)(10).

Each of the accepted reasons for a modification of an imputed underpayment comes with specific requirements. See Prop. Treas. Reg. § 301.6225-1(b)(4). In order to receive a modification for an amended return, if no refund is requested, the tax year for the amended return must be open when modification is requested. Prop. Treas. Reg. §301.6225-2(d)(2)(v). In practice, this may be a challenge. An amended return filed by an upper-tier partnership must include payment of the tax liability, that is, the upper-tier partnership must pay the tax due in order for the lower-tier partnership to be able to claim a modification with respect to the tax attributes of the upper-tier partnership. Prop. Treas. Reg. § 301.6225-2(d)(2)(vii). A partner who has filed an amended return that leads to a modification of an imputed underpayment may not later file another amended return claiming a refund of that amount. Prop. Treas. Reg. § 301.6225-2(d)(2)(vii)(B).

Furthermore, in order to claim a modification for one or more partners filing amended returns, the partnership representative must provide affidavits from the partners that the partners filed the returns and paid the tax due. Prop. Treas. Reg. §301.6225-2(d)(2)(iii). The affidavit eliminates the need for affected partners to provide their amended returns to the partnership. If there is a reallocation adjustment, all affected partners must file an amended return in order for the partnership representative to claim a modification based upon amended returns. If an amended return requesting a refund is filed outside of the statute of limitations period for the original return, a partner may request a refund only for items related to the partnership proceeding and correlative adjustments. Prop. Treas. Reg. § 301.6225-2(d)(2)(v)(B).

If an adjustment reallocates a partnership item among partners, it will be eligible for modification treatment only if all affected partners have filed amended returns. Prop. Treas. Reg. § 301.6225-2(d)(2)(vi). (Otherwise, modifications can be granted when less than all affected partners file amended returns.) In addition, a partnership may request a modification of an adjustment only if the partnership has an imputed underpayment. Prop. Treas. Reg. § 301.6225-2. The imputed underpayment need not relate to the item for which a modification is sought, but the existence of an imputed underpayment is a condition precedent before a modification can be sought.

A partnership representative can waive the 270-day period during which to request a modification of an imputed underpayment. Prop. Treas. Reg. §301.6225-2(c)(3)(i). A partnership would agree to this waiver if it wanted to proceed to litigation and not request a modification or make the election to push-out the responsibility to pay the tax to its partners.

In order to obtain these modifications, the partnership will need access to the tax information of its partners because a request for a modification must contain sufficient facts for the IRS to assess its correctness. If the partnership has an upper-tier partnership as a partner, additional information about the reporting of the partnership items at the upper-tier partnership must be provided to the IRS upon request. Accordingly, partnership agreements should be amended to include a provision requiring partners to supply this information if and when the partnership receives a NOPPA.

The Proposed Regulations contain three circumstances in which partnership adjustments do not result in an imputed underpayment. First, an adjustment that results in a disregarded reallocation does not result in an imputed underpayment. Second, if the net adjustment is negative, no imputed underpayment arises. Third, if the imputed underpayment is zero or

less than zero, no imputed underpayment is considered to exist. In general, these adjustments are treated as non-separately stated items for the year in which the adjustment is made. Prop. Treas. Reg. §301.6225-3(b)(2). If, however, the adjustment results from an item that would be separately stated under Code § 702, it is treated as such. Prop. Treas. Reg. §301.6225-3(b)(3). In any event, these items cannot be re-allocated back to the partners from whom they were allocated away. Prop. Treas. Reg. § 301.6225-1(c)(2)(i).

The Alternative to the Partnership Payment of an Imputed Underpayment

The CPA regime allows partnerships to push out liability for imputed underpayments (including penalties) to the persons who held an interest in the partnership at any time during a reviewed year ("reviewed year partners"). Code § 6226(a)(1); Prop. Treas. Reg. § 301.6226-1(a). The push-out regime is mandatory for partnerships that have ceased to exist or cannot pay a partnership adjustment but, in that case, the adjustment is paid by the adjustment year partners instead of the reviewed year partners. Prop. Treas. Reg. § 301.6241-3(e)(2)(ii). A partnership that makes the election to push out the tax liability to its partners is not also liable for the tax. The partnership may elect this alternative within 45 days of its receipt of a Notice of Final Partnership Adjustment (an "FPA") to make this election. Prop. Treas. Reg. §301.6226-1(c)(3). If the election is made, reviewed year adjustments that do not result in an imputed underpayment are also taken into account by the partners, not the partnership. Prop. Treas. Reg. § 301.6225-1(c)(2)(i). A partnership that is a partner is liable for its share of the underpayment even if the partnership-partner has elected out of the CPA regime. Prop. Treas. Reg. § 301.6221(b)-1(d)(1). A partnership may make the push-out election with respect to some, but less than all, adjustments.

The election must meet a number of requirements, including providing both of the IRS and the reviewed year partner with information regarding the partner's share of partnership adjustments. The statement to partners must be provided within 60 days of the date on which the adjustment is finally determined. The statement may not be folded into a Schedule K-1. Accordingly, if a partnership seeks judicial review of an FPA, it may be years between the filing of the election and the date on which the statements are sent to partners. The push-out election does not preclude the partnership from challenging the adjustment. Prop. Treas. Reg. § 301.6226-1(e).

Partners who become liable for a tax deficiency as a result of the push-out election must include and report the deficiency in their incomes for the taxable year in which the partnership provided the required notice to its partners (the "reporting year"). Code § 6226(b)(2); Prop. Treas. Reg. § 301.6226-3(a). Affected reviewed year partners are not permitted to take positions inconsistent with the final adjustment. Prop. Treas. Reg. §301.6226-3. In addition, the push-out election requires the partners to pay tax on any increased tax liability for all intervening years as well. Prop. Treas. Reg. § 301.6226-3(b)(3). This additional liability is determined on a year-by-year (as opposed to an aggregated) basis. Interest, which is not deductible, is imposed on the tax liability (at the underpayment rate plus five percent) from the year (reviewed year or intervening year) in which the additional tax was determined. Prop. Treas. Reg. § 301.6226-3(d). In contrast, if no push-out election is made, interest is determined at the regular underpayment rate plus three percent.

The fact that the deficiency is treated as an additional liability in the adjustment year alleviates statute of limitation issues that could arise if the deficiency were reportable in the year in which the deficiency arose. In addition, the amount to be paid is adjusted by the differences

in taxable income in the intervening years that would have occurred if the item had been properly reported in the first affected year. Code § 6226(b)(3). Penalties follow the allocation of the partnership adjustment. Prop. Treas. Reg. § 301.6226-2(f)(3).

Under the Proposed Regulations, upper-tier partnerships are liable for the tax due with respect to a push-out election, determined as if the upper-tier partnership were an individual. The upper-tier partnership is not treated as an aggregate for this purpose. Although a Technical Corrections bill was introduced to reverse this result, it is opposed by the IRS.

The adjustments to be reported to partners take into account both the positive tax adjustment for the reviewed year and positive tax adjustments for years after the adjustment year and before the reporting year (intervening years). Prop. Treas. Reg. § 301.6226-3(b). Negative (whether correlative or not) adjustments are not taken into account. The aggregate correction is the sum of these amounts. Prop. Treas. Reg. § 301.6226-3(b)(3). Since negative adjustments are not taken into account, a push-out election could result in significant tax burdens in excess of the actual tax liability associated with a partnership adjustment.

In general, a partner will determine the additional tax liability for the adjustment year by recomputing the reviewed year tax liability taking into account the partnership adjustment. See Prop. Treas. Reg. § 301.6226-3(g)(Ex. 1). Partnerships utilizing the push-out election, however, are permitted to provide partners with a safe-harbor amount to pay. Prop. Treas. Reg. §301.6226-2(g). The safe-harbor amount is the share of the imputed underpayment applicable to the partnership. Prop. Treas. Reg. § 301.6226-2(g)(2). The safe-harbor amount may be adjusted by amounts paid by the affected partner under a closing agreement or amended return filed with respect to the partnership items. The safe-harbor must include an interest charge (at the underpayment rate plus 5 percent) determined from the reviewed year to the reporting year. Prop. Treas. Reg. § 301.6226-3(d)(4).

RICs, REITs and CFCs

The Proposed Regulations permit regulated investment companies ("RICs" or mutual funds) and real estate investment trusts ("REITs") to utilize the existing deficiency dividend procedures for their share of an imputed underpayment that is pushed out to them. Proposed Treasury Regulation §301.6226-3(d) permits a RIC and a REIT to claim a deduction for the amount of any imputed deficiency pushed out to them that is included in a deficiency dividend. REITs and RICs remain liable for interest and penalties on the imputed underpayment.

The IRS is studying how the CPA should work in the case of a controlled foreign corporation ("CFC") (the direct partner) that would not have a tax liability on a partnership adjustment, but the owners of the CFC (the indirect partners) would have subpart F income or other income arising from the adjustment.

Amended Returns

The new CPA regime contains specific rules for amended partnership returns. Pursuant to Code § 6227(a), a partnership may file an amended return (referred to as an administrative adjustment request or AAR) to correct errors on an already-filed return. Prop. Treas. Reg. § 301.6227-1(a). The amended return must be filed within three years of the due date (including extensions) of the original return. Code § 6227(c); Prop. Treas. Reg. § 301.6227-1(b). An amended return may not be filed if the IRS has mailed a notice of an administrative proceeding to the partnership with respect to that year. All partners are bound by the positions taken by the partnership in the AAR. Prop. Treas. Reg. §301.6222-1(f). The IRS may audit positions taken in an AAR within three years of

the filing of the AAR. Prop. Treas. Reg. § 301.6227-1(g).

The partnership must determine whether the AAR adjustment results in an imputed underpayment. Prop. Treas. Reg. § 301.6227-1(a). The imputed underpayment may be reduced by allocations to tax-exempt partners, modifications related to certain PALs of publicly traded partnerships and certain other enumerated items, without prior IRS approval. Prop. Treas. Reg. § 301.6227-2.

If an amended return results in an imputed underpayment, the partnership may address it in one of two ways. First, the partnership can utilize the rules in Code § 6225 to take the underpayment into account and pay additional tax itself. Alternatively, the partnership and the partners can utilize the push-out rules of Code § 6226 to take the underpayment into account in the reporting year (not the reviewed year). Code § 6227(b); Prop. Treas. Reg. § 301.6227-2(c). If the amended return does not result in an imputed underpayment, the partners take the adjustment into account on their own returns (essentially utilizing the push-out method). In contrast to the rules for the regular push-out election, AAR adjustments may be negative. Prop. Treas. Reg. § 301.6227-3(b)(1). These negative amounts may be used to reduce taxable income and tax payable in the adjustment year. Prop. Treas. Reg. §301.6227-3(b)(2). If the partner is a partnership, however, it is not entitled to a refund and must allocate the negative adjustments among its partners. Prop. Treas. Reg. § 301.6227-3(b)(1).

Challenging Partnership Adjustments

Partnerships may challenge deficiencies asserted in a NOPPA in the IRS Appeals Office. If a proposed imputed underpayment cannot be resolved without reference to litigation, the partnership may challenge the deficiency asserted in an FPA within 90 days after the FPA is mailed by filing a petition in the US Tax Court, or a complaint in the Court of Federal Claims or a US district court. If the partnership chooses to file a complaint in the Court of Federal Claims or a US district court, the partnership must deposit with the IRS the total amount of the imputed underpayment. This is a marked change from the TEFRA rules under which an individual partner could challenge an adjustment by only paying his share of the assessment. The partnership remains the sole party who can challenge an FPA, even if the partnership has elected to push out the imputed underpayment under the alternative method described above.

A Modest Proposal: Partnership Provision for the Implementation of the CPA

The CPA provision set forth below reflects choices as to which party will have responsibility for administering the CPA regime and which partners will bear responsibility for assessments. It should not be used without carefully considering the implicit judgments and allocations contained in it. The provision also uses defined terms not set forth in it that the author typically sees defined in other areas of partnership agreements. The purpose of the provision is to highlight those areas that should be addressed in partnerships for taxable years beginning in 2018 or after.

Section ____. Taxpayer Representative, Liability for Tax and Related Matters.

(a) ______________ is designated as the "partnership representative" for each Fiscal Year within the meaning of Code Section 6223 and Proposed Treasury Regulation § 301.6223-1. _____________ is the initial "designated individual" for each Fiscal Year within the meaning of Proposed Treasury Regulation § 301.6223-1(b)(3). The General Partner may replace the partnership representative and the designated individual in its sole and absolute discretion.

(b) Each audit of the Partnership by the Internal Revenue Service or other taxing authority

shall be an expense of the Partnership and the Partnership shall advance the costs and expenses of resolving the same to the partnership representative in Fiscal Years in which the Partnership is subject to the centralized partnership audit rules of Sections 6221 through 6227 of the Code, as amended by Section 1101 of the Bipartisan Budget Act of 2015, P.L. 114-74, as amended by the Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113, div. Q (collectively, the "CPA Rules").

(c) The Partnership shall timely elect out of the CPA Rules pursuant to the election provided for by Code Section 6221 in each Fiscal Year in which the Partnership is eligible to make such election.

(d) The partnership representative shall notify each reviewed year partner of an audit of the Partnership by the Internal Revenue Service under the CPA Rules. In connection with any Internal Revenue Service audit of the Partnership subject to the CPA Rules, it shall be the responsibility of each Partner to provide the partnership representative with a complete explanation of any defenses such Partner may have to the imposition of an "imputed underpayment" (within the meaning of Proposed Treasury Regulation § 301.6241-1(a)(3)) proposed by the Internal Revenue Service. The partnership representative may raise any such defenses in its sole and absolute discretion.

(e) If the Partnership does not make the election out of the CPA Rules, the partnership representative shall make the election provided by Code Section 6226 and Proposed Treasury Regulation § 301.6226-1(a) for the Partners who were Partners in the "reviewed year" (within the meaning of Proposed Treasury Regulation § 301.6241-1(a)(8)) to pay the amount of an imputed underpayment. Each Partner agrees to cooperate with the partnership representative in providing such information as is reasonably requested by the partnership representative to enable the partnership representative to make such election.

(f) Each Partner agrees to cooperate with the General Partner with respect to any request by the Partnership to request a modification of an imputed underpayment and to provide, and certify to, such information as the General Partner determines is necessary or appropriate for the Partnership to request such a modification.

(g) The General Partner shall deduct the amount of an imputed underpayment from the Partners' Capital Accounts in a manner that reasonably approximates the allocation of the "partnership adjustment" (within the meaning of Proposed Treasury Regulation § 301.6241-1(a)(6)) that gave rise to the imputed underpayment. Notwithstanding any other provision of this Agreement, if the General Partner reasonably determines that the allocation of an imputed underpayment to one or more Partners does not equitably reflect the partnership adjustment that gave rise to such imputed underpayment, the General Partner may make offsetting special allocations of Partnership taxable income, gain, loss, deduction or credit in whatever manner, and for whatever years, it determines appropriate so that, after such offsetting allocations are made, each Partner's Capital Account balance is, to the extent possible, equal to the Capital Account balance such Partner would have had if the imputed underpayment had been borne by Partners who were partners in the "reviewed year" (within the meaning of Proposed Treasury Regulation § 301.6241-1(a)(8)) in amounts that reflect such Partners' share of the imputed underpayment.

(h) Persons who were Partners in a reviewed year, but cease to be Partners prior to the assessment of an imputed underpayment required to be paid by the Partnership, agree

to pay to the Partnership for their share of the imputed underpayment as determined by the General Partner no less than five business days prior to the date that the Partnership is required to pay such imputed underpayment.

(i) Each Partner agrees that the rights and obligations of the Partners under this Section ___ shall survive the withdrawal of each Partner and the dissolution of the Partnership.

For more information about the topics raised in this article, contact the author or your regular Mayer Brown contact.

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Endnotes

[1] The author thanks Kristin M. Mikolaitis for her helpful comments and suggestions. Mistakes and omissions remain the sole responsibility of the author.

[2] Section 1101 of the Bipartisan Budget Act of 2015 (the "BBA"), P.L. 114-74, as amended by the Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113, div. Q, repealed the existing Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") audit rules and replaced such rules with the CPA rules. The IRS had not issued prior guidance on the CPA rules.

[3] See statements of Rochelle Hodes, associate tax legislative counsel in the Treasury Office of Tax Policy, made on March 5, 2017, reprinted in the Daily Tax Report (42 TRS G-1), "*Nobody should think this isn't going to happen, because right now it is.*"

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