

Passthrough Entities

IRS Proposes Rules for Foreign Issues in Partnership Audits

BNA Snapshot

- International rules cover foreign tax credits, withholding on foreign persons
- Tax attorney says government could have been more “taxpayer-friendly”



By Allyson Versprille

The IRS proposed regulations on how it will treat some foreign tax credits, tax treaty-related issues, and foreign-corporation issues in the context of the forthcoming centralized partnership audit regime.

The proposed rules (REG-119337-17) issued Nov. 29 will be integrated into partnership-audit rules (REG-136118-15) released in June when both the regulations are made final, the Internal Revenue Service said. The newly proposed rules are scheduled to publish in the Federal

Register Nov. 30.

Both sets of regulations offer guidance on how the government will implement the new audit regime, created by the Bipartisan Budget Act of 2015, that will take effect Jan. 1, 2018. The BBA auditing approach will replace the current partner-by-partner audit system with a centralized audit approach that, in general, assesses and collects tax at the partnership level.

John P. Warner, a shareholder at Buchanan Ingersoll & Rooney PC, said there are several areas in the new proposed regulations where the IRS and Treasury Department could have been more “taxpayer-friendly.”

The proposal addresses how certain international rules operate in the new centralized audit regime, including rules relating to tax withholding on foreign persons, withholding to enforce reporting on certain foreign accounts, and treatment of a partnership's *creditable foreign* tax expenditures.

Warner told Bloomberg Tax in an email that the government could have taken a more amicable approach to certain issues regarding withholding taxes and creditable foreign tax expenditures.

Withholding Taxes

In the proposed regulations, the IRS addresses withholding and reporting requirements under Chapters 3 and 4 when a partnership makes a push-out election under tax code Section 6226, thus transferring tax liability to the partners. Chapter 3 deals with withholding taxes on foreign persons and corporations, and Chapter 4 covers taxes to enforce reporting on certain foreign accounts.

The IRS said a partnership making the push-out election must pay the amount of tax required to be withheld under Chapters 3 and 4 on any audit adjustment allocable to a reviewed year partner that would have been subject to withholding in the reviewed year.

A partnership that is required to pay withholding tax can reduce that amount “to the extent that the reviewed year partner provides valid documentation to establish that it is entitled to a reduced rate of tax” under Chapters 3 and 4.

However, the rules don't allow the partnership to reduce the amount of withholding tax due based on partner-level items as provided in special rules under Treasury Regulations Section 1.1446-6. Those rules permit a partnership to consider partner-

level deductions and losses to reduce the withholding tax due on a foreign partner's share of effectively connected income.

The limitation is "less taxpayer-friendly" than it could be, Warner said.

However, it isn't "the end of the world" because the partner's loss and deduction information can probably get plugged in during the process under the BBA for modifying audit adjustments, "but it does put some pressure on the modification process and the IRS's receptiveness to it," Warner said.

'Heads-We-Win, Tails-You-Lose'

The proposed regulations also address the treatment of adjustments to creditable foreign tax expenditures (CFTEs) made in an administrative proceeding under the centralized partnership audit regime.

Under the rules, "if the amount of CFTEs is decreased on audit, the proposed regulations treat the item as if the partners had reduced their U.S. tax by that amount and, therefore, increase the imputed underpayment by the amount of the CFTE reduction," the agency said.

"Conversely, if the amount of CFTEs is increased on audit, the proposed regulations treat the item as if the foreign tax credit limitation would prevent use of the increased credit and, therefore, do not reduce the imputed underpayment," the IRS said. The amount of foreign tax credit allowed against a taxpayer's U.S. tax in a given year is limited to the amount of pre-credit U.S. tax on the taxpayer's foreign source income.

Warner said this is another area where the government was a bit harsher than it needed to be.

The rule assumes, for purposes of calculating the imputed underpayment amount, that the partnership must pay with respect to adjustments under Section 6225, "that a decrease in CFTEs increases the partners' U.S. tax liability by an equal amount, but assumes that an increase in CFTEs does not decrease the partners' U.S. tax liability at all," Warner said. This is a "heads-we-win, tails-you-lose" type of approach, he said.

"Again, it appears that in the modification process the partnership (and its partners) can make a case that an increase in CFTEs will in fact decrease the partners' U.S. tax liability, but that again will put some pressure on that process and the IRS's receptiveness to the evidence provided to it," Warner said.

More to Come

The international regulations are the first of several proposed rules on the centralized audit regime expected over the next few weeks.

The regulations were one of the five partnership audit projects listed on the IRS's most recent priority guidance plan. Other projects include guidance on tiered push-outs, administrative and judicial reviews, and adjustments to basis and capital accounts. A Treasury official recently said the goal is to issue proposed regulations on all five areas before the new auditing procedures become effective.

"We are pleased to see the IRS beginning to issue additional guidance related to the Centralized Partnership Audit Regime," said Jonathan Horn, senior manager for tax policy and advocacy at the American Institute of CPAs.

"We look forward to further guidance coming from them in the near future on the treatment of tiered partnership structures, as well as the impact of audit adjustments on capital accounts and partner basis," he told Bloomberg Tax in an email.

Horn said the AICPA continues to believe Congress should delay the effective date of the centralized audit regime by one year.

To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bloombergtax.com

To contact the editor responsible for this story: Meg Shreve at mshreve@bloombergtax.com

For More Information

Text of REG-119337-17 is in TaxCore.