Bloomberg BNA

Tax Management
Real Estate Journal™

The New Partnership Audit Rules: Proposed Answers to Tough Questions

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The Bipartisan Budget Act of 2015 (BBA)[1] introduced a new centralized audit regime to be applied to all entities taxed as partnerships. Under the new regime, unless a partnership is able to elect out and affirmatively makes that election, the default rule is that audit, adjustment, *assessment*, and *collection* occurs at the entity level. The new rules significantly change the partnership audit process and, quite possibly, the amount of tax liability paid and the persons ultimately bearing the economic consequence of that liability.

The new rules are effective for audits of returns filed for tax years beginning on or after January 1, 2018. Under limited circumstances, a partnership may elect an early opt-in to the new rules.

The rules, as promulgated in the BBA, arguably contain more questions than answers. On December 6, 2016, Congress introduced the Tax Technical Corrections Act of 2016,[2] which addressed a number of the provisions of the centralized partnership audit regime. However, Congress has not passed this legislation. The legislation may be reintroduced this year and attached as a rider to a tax bill, but that remains to be seen.

In January 2016, the IRS issued proposed regulations that provided guidance with respect to many of the questions that have arisen since the new audit rules were enacted. Those proposed regulations were withdrawn and then reproposed on June 14, 2017, with minor changes.

This article uses a Q&A format to highlight many of the questions that exist with respect to the new centralized audit regime and explain the way in which the proposed regulations address those questions, if they do. Although these proposed regulations help navigate what is absolutely a sea change with respect to partnerships audits, there are still many important questions left unanswered, as discussed throughout this article. There is also no doubt that new questions will arise as practitioners work through these proposed regulations against the backdrop of an already complex area of tax law.

The article ends with a discussion of the challenges that exist for practitioners who are trying to address these rules as they negotiate and draft partnership agreements for entities taxed as partnerships.

QUICK SUMMARY OF THE CENTRALIZED AUDIT PROCESS UNDER THE PROPOSED REGULATIONS

- Putting aside the early opt-in, which could apply to tax years beginning before 2018, on its 2018 partnership return, the partnership either elects out of the centralized audit regime (if the election out is available) or designates a partnership representative for that taxable year. The partnership might want to consider designating a partnership representative even if it makes the election out, in case that election is defective for any reason. Otherwise, if the IRS determines that the election is defective, the IRS can designate the partnership representative.
- If the partnership elects out, it notifies each of its partners of that election within 30 days of making it.

If the partnership does not elect out, the centralized audit process applies as follows:

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[1] Pub. L. No. 117-74, §1101.

[2] H.R. 6439, S. 3506.

- The partnership may request an administrative adjustment request (AAR) under the new rules for any partnership taxable year beginning on or after January 1, 2018 (within the prescribed period of limitations).
- If the IRS audits a taxable year (referred to as the ''reviewed year''), the partnership representative will receive a notice of administrative proceeding from the IRS. The default rule under the centralized audit regime is that adjustments will be determined, assessed, and collected at the partnership level. The partnership representative is not statutorily required to notify the partners of receipt of the IRS notice or any other aspect of the audit.
- The proposed adjustments to partnership items will be grouped and subgrouped to calculate the imputed underpayment. All penalties, additions to tax, and additional amounts will be determined at the partnership level. The audit may result in multiple imputed underpayment(s).
- Once the IRS mails the notice of proposed partnership adjustment (NOPPA) to the partnership representative, the partnership will have a prescribed period of time (generally 270 days, although an extension is available) to request modifications to the imputed underpayment(s) pursuant to the regulatory rules and procedures. There are several types of modification available, including having the reviewed partners file amended returns.
- If the partnership wishes to make an election to ''push out'' adjustments to its reviewed year partners (''push-out election''), it must do so within 45 days of the date that the IRS mails the notice of final partnership adjustment (FPA) (with no permissible extensions). If the partnership makes the push-out election, it must furnish statements to the reviewed year partners no later than 60 days after the date the partnership adjustments become finally determined (which is the later of (1) the expiration of the time to file a petition for readjustment with the Tax Court (or in some cases, the U.S. District Court or Claims Court) under §6234 (BBA) or, (2) if a petition is filed under §6234 (BBA), the date when the court's decision becomes final).[3]
- If the partnership wishes to file a petition under §6234 (BBA), it must do so within 90 days of the date that the IRS mails the FPA.
- If the partnership makes a push-out election, the reviewed year partners who are subject to the election will be required to pay the additional reporting year tax, the partner's share of any penalties, additions to tax, additional amounts, and any interest.
- The partnership does not have to make the push-out election with respect to all reviewed year partners; it may elect to push out only one or more specific imputed underpayments. If there is a remaining ''general imputed underpayment,'' the partnership will be responsible to pay that amount.
- If the partnership does not make a push-out election, the partnership is responsible to pay the imputed underpayment(s) (plus interest) at the partnership level in the adjustment year.

THE SCOPE OF THE NEW AUDIT RULES

The statute provides that the new audit rules apply to ''items of income, gain, loss, deduction, or credit of a partnership. . . and any partner's distributive share thereof.''[4] TEFRA defined items subject to partnership-level audit as ''any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations . . . provide that . . . such item is *more appropriately determined at the partnership level* than at the partner level.''[5] The current regulations under TEFRA contain an extensive list of ''partnership items,'' the first of which is ''items of income, gain, loss, deduction, or credit of a partnership.''[6]

The statute left open the question of how the scope of the new centralized audit regime compares with the scope of the TEFRA rules.

> *What is the relationship between the language in the BBA and the language in the current regulations? Is the scope of the new regime limited to only the first item listed as a partnership item in the current regulations? What about everything else on that list (e.g., debt allocations, optional basis adjustments, etc.)?*

The Preamble to the proposed regulations makes it clear that the scope language in the BBA was *not* in-

[3] Unless otherwise indicated, references in this article to ''§'' or ''Section'' are to provisions of the Internal Revenue Code (the ''Code''), and references to ''Reg. §'' are to provisions of the Treasury regulations issued thereunder. References to Code sections followed by ''(BBA)'' are to those sections as amended by the BBA. If ''(BBA)'' does not appear, then the Code reference is to a TEFRA provision.

[4] §6221(a) (BBA).

[5] §6231(a)(3).

[6] Reg. §301.6231(a)(3)-1(a)(1)(i).

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tended to limit the scope of a partnership audit under the centralized audit regime to ''a more limited set of items to be adjusted at the partnership level than the items included in the broad definition of partnership items under the TEFRA regulations.''[7] Thus, even though the language in the statute mirrors only the first item in the current regulatory list, the proposed regulations provide that the phrase *items of income, gain, loss, deduction, or credit* means all items and information required to be shown, or reflected, on a return of the partnership under §6031 (BBA), the regulations thereunder, and the forms and instructions prescribed by the IRS for the partnership's taxable year, and any information in the partnership's books and records for the taxable year.[8] The regulations go on to broadly and specifically further define ''*items of income, gain, loss, deduction, or credit*'' as well as ''*factors that affect the determination of items of income, gain, loss, deduction, or credit*'' and ''*partner's distributive share.*''[9]

What role does settled law on partnership vs. partner items play in the centralized audit regime? Is the concept of an ''affected item'' still relevant under this regime?

The General Explanation of Tax Legislation Enacted in 2015 provided that ''unlike prior law, distinctions between partnership items and affected items are no longer made'' in the centralized audit regime.[10] The concept of an ''affected item'' is no longer relevant. Under the new regime, the IRS will not determine each partner's share of an adjustment and then assess and collect separate adjustments from each partner. All adjustments will be made at the partnership level, and the partnership itself will be liable for any imputed underpayment. The partnership will use the modification procedures to correct any overstatements. The new centralized process eliminates the need for the concept of ''affected items'' and, according to the IRS, eliminates all of the controversy that existed under TEFRA with respect to the definitions of partnership items, affected items, computational adjustments, and non-partnership items.

Is the IRS able to separately examine the partnership or its partners outside the centralized partnership audit regime in order to determine and assess taxes other than tax imposed by chapter 1 of Subtitle A of the Code?

Yes. The proposed regulations answer this question by specifically providing that the term ''tax'' for purposes of the centralized audit regime means only the tax imposed by chapter 1 of Subtitle A.[11] Thus, taxes imposed by other chapters (e.g., the self-employment tax) or other subtitles (e.g., the employment tax) are not subject to the centralized audit regime. The IRS is, therefore, able to separately examine the partnership or its partners outside the centralized partnership audit regime in order to determine and assess taxes imposed under other chapters or subtitles.

The IRS may rely on determinations regarding items covered by the centralized partnership audit when making determinations regarding taxes imposed outside of chapter 1 of Subtitle A. In addition, the IRS may use all of the procedures available to it under the centralized audit regime (e.g., obtaining the books and records of the partnership) to make determinations regarding items covered by the centralized partnership audit regime solely for purposes of taxes not covered by chapter 1. The Preamble to the proposed regulations uses, as an example, a determination under the centralized audit regime that a particular partner has additional unreported ordinary income. The IRS may examine the partnership or that partner in a separate proceeding (outside of the centralized audit regime) to determine additional employment and/or self-employment taxes owed.[12]

THE ELECTION OUT OF THE CENTRALIZED REGIME

Is the election out available if any of the partners are entities taxed as partnerships? What about disregarded entities?

Section 6221(b) (BBA) provides that in order to elect out of the centralized audit regime, (1) a partnership must have 100 or fewer partners during the year (i.e., it is required to furnish 100 or fewer statements under §6031(b) during the taxable year for which the partnership makes the election) and (2) each partner must be an ''eligible entity,'' which includes:

- an individual;
- a deceased partner's estate;

[7] Preamble, REG-136118-15, 82 Fed. Reg. 27,334 (June 14, 2017).

[8] Prop. Reg. §301.6221(a)-1(b)(1)(i).

[9] *See* Prop. Reg. §301.6221(a)-1(b)(1), §301.6221(a)-1(b)(2).

[10] Joint Committee on Taxation, JCS-1-16, *General Explanations of Tax Legislation Enacted in 2015* (''JCT Bluebook'') at 57 (2016).

[11] Prop. Reg. §301.6221(a)-1(b)(3).

[12] Preamble, REG-136118-15.

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- a C corporation (allowed to be a RIC or REIT);
- a foreign entity that would be required to be a C corporation if it were domestic; and/or
- an S corporation (if certain informational requirements are met) — each S corporation shareholder counts as one partner.

The fact that an entity is not allowed to elect out of the centralized audit regime if one of its owners is an ineligible entity (e.g., is a partnership, a trust, a disregarded entity, a partner who uses nominees, an estate of a person other than a deceased partner) has been the subject of much practitioner angst and commentary since the new rules were promulgated. Nevertheless, Treasury and the IRS chose not to expand the list of eligible entities in the proposed regulations.[13] The concern in expanding the election out is the increased burden it places on the IRS when it then has to examine and assess tax at the partner level. The IRS is willing to consider additional comments on this subject but wants those comments to address this additional burden as opposed to focusing on how expansion of the election out eases taxpayer burden.

With respect to a disregarded entity owned by an otherwise eligible entity (e.g., a single-member LLC owned by a C corporation), the JCT Bluebook stated that ''guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole member, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer statements criterion is met.''[14] However, the proposed regulations do not take this position. A disregarded entity remains an ineligible entity under the proposed regulations regardless of whether the ultimate owner is an eligible entity.[15]

Interestingly, Prop. Reg. §301.6221(b)-1(b)(3) provides that an S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not eligible partners. Thus, there is some flexibility, albeit limited, to circumvent the limitations on eligible partners by using an S corporation. Of course, this flexibility is limited by the restrictions on eligible S corporation shareholders (e.g., a partnership cannot be an S corporation shareholder). However, with respect to an entity that is eligible to be an S corporation shareholder but ineligible for purposes of the election out (e.g., certain trusts), Prop. Reg. §301.6221(b)-1(b)(3) does offer a possible solution to ineligibility.

For purposes of the 100-partner threshold for the election out, are a husband and wife treated as a single partner?

Under the TEFRA audit rules, a husband and wife were treated as a single partner for purposes of determining whether the partnership had 10 or fewer partners (the TEFRA small partnership exception). However, §6221(b) (BBA) does not contain similar language and, therefore, the general principles in §6031(b) (BBA) apply. If a husband and wife each own a partnership interest (which means that the partnership is required to furnish a separate K-1 to each spouse), they are counted separately for purposes of determining whether the partnership is able to elect out of the centralized audit regime.[16] If, under the rules of §6031(b) (BBA), the partnership is required to furnish only one spouse with a K-1 (i.e., because only that spouse owns a partnership interest), then only that spouse is counted for purposes of the election out.[17]

Will the IRS treat an organization that is determined to be, or claims to be, exempt from tax under §501(a) and is classified as a corporation under §7701(a)(3) as a C corporation for purposes of the election out of the centralized audit regime?

Yes. The Preamble to the proposed regulations states that Treasury and the IRS intend to continue to treat this type of organization as a C corporation consistent with Rev. Rul. 2003-69. This rule will not extend, however, to §501(a) organizations that are classified as other than C corporations (e.g., trusts).[18]

If a partnership files its tax return after the due date (including extensions), is the election out available?

No. A partnership must elect out on a *timely filed* tax return (including extensions). Thus, *a late return precludes election out*.[19]

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[13] *See* Prop. Reg. §301.6221(b)-1(b)(3).

[14] JCT Bluebook at 60 (2016).

[15] Prop. Reg. §301.6221(b)-1(b)(3)(ii).

[16] *See* Prop. Reg. §301.6221(b)-1(b)(2)(iii) *Ex.* 1.

[17] *See* Prop. Reg. §301.6221(b)-1(b)(2)(iii) *Ex.* 2.

[18] Preamble, REG-136118-15.

[19] *See* Prop. Reg. §301.6221(b)-1(c)(1).

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Is a partnership required to notify each partner if it makes an election out of the centralized audit regime?

Yes. A partnership must notify each of its partners of an election out within 30 days of making the election.[20] This is one of the only instances under the new rules in which the partners have a notification right. Under the centralized audit regime, the partners generally do not have notification or participation rights. In the case of an election out, the centralized audit regime does not apply.

If a partner that is itself a partnership (referred to in the regulations as a "partnership-partner") makes a valid election out of the centralized audit regime, does that election out have any effect on the application of that regime to the partnership in its capacity as a partner in another partnership?

No. The proposed regulations clarify that the centralized partnership audit rules apply to all partners in the partnership, including a partnership-partner that has made a valid election out on its tax return.[21] The regulation provides that "the provisions of subchapter C of chapter 63 that apply to partners in *a partnership that has not made an election under this section* apply, to the extent provided in the regulations under subchapter C of chapter 63, to partners that are themselves partnerships that have made an election under this section in their capacity as partners in the other partnership." [Emphasis added.] It is unclear why the italicized phrase is included, because if a partnership has a partnership-partner, then it is not eligible to make the election out.

The 100-partner threshold is fairly high. Practically speaking, does this mean that the IRS will rarely audit partners in large partnerships that elect out?

Not according to the Preamble to the proposed regulations. The Preamble states that "the IRS intends to increase the number of partnership audits for *both* partnerships that are subject to the centralized partnership audit regime and partnerships that have elected out of the partnership audit regime." [Emphasis added.] If this is true, might some larger partnerships that are able to elect out determine that it is easier to stay in than to subject each partner to a separate deficiency proceeding?

In addition, the IRS will be carefully reviewing an entity's decision to elect out in order to ensure that the election out is not being used "solely to frustrate IRS compliance efforts." The Preamble fleshes this out a little, by providing that the IRS will carefully review whether partners have been accurately identified, paying particular attention to whether the partners are nominees or agents for a beneficial owner. In addition, the IRS will be analyzing the economic substance of certain types of arrangements to determine whether the election out is truly appropriate (i.e., if two or more partnerships have elected out but have, in substance, created a constructive or de facto partnership, or if two or more parties claim to be co-owners of a venture but not partners). Note here that if the IRS recasts an arrangement as a partnership, that entity will be subject to the centralized audit regime because it will not have filed a partnership return and, therefore, will not have made a timely election out.

What happens if a partnership makes an invalid election out? Can the partnership and/or the IRS rely on the election out?

Yes, the IRS can rely on the election unless and until it determines that it is invalid, and the partnership can rely on the election unless and until the IRS challenges it.[22]

THE CONSISTENCY REQUIREMENT

A partner's treatment of each item of income, gain, loss, deduction, or credit attributable to a partnership must be consistent with the treatment of those items on the partnership return, including treatment with respect to the amount, timing, and characterization of those items.

What is considered "an item on the partnership return" for purposes of the consistency requirement?

According to the proposed regulations, the phrase "an item on the partnership return" includes not only the treatment of an item on the partnership's return filed under §6031(a) (BBA) but also any amendment or supplement to that return (e.g., an administrative adjustment request filed under §6227 (BBA)) and the treatment of an item on any statement, schedule, or list, and any amendment or supplement thereto, filed

[20] §6221(b)(1)(E) (BBA); Prop. Reg. §301.6221(b)-1(c)(3).

[21] Prop. Reg. §301.6221(b)-1(d)(1).

[22] Prop. Reg. §301.6221(b)-1(e).

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by the partnership with the IRS, including statements filed pursuant to §6226 (BBA).[23]

If a partner fails to satisfy the consistency requirement, is the IRS allowed to assess and collect any resulting underpayment in the same manner as if the underpayment was due to a mathematical or clerical error appearing on the partner's return?

Generally, yes.[24] There is an exception to this rule, however, if the partner identifies the inconsistency in a statement to the IRS attached to the partner's return on which the item is treated inconsistently.[25]

Does the exception for notification of inconsistent treatment apply to a partner's treatment of an item reflected on an administrative adjustment request (AAR) under §6227 (BBA) or a push-out statement under §6226 (BBA) filed by the partnership?

No. Section 6223 (BBA) provides that the partnership and all partners are bound by the actions taken by the partnership under the centralized audit regime as well as any final decision in a proceeding with respect to the partnership. Thus, the partners are bound by the adjustments in an AAR or push-out statement. If a partner takes a position on a return that is inconsistent with an item reflected on an AAR or push-out statement, the IRS is allowed to assess and collect any resulting underpayment in the same manner as if the underpayment was due to a mathematical or clerical error, regardless of whether the partner identifies the inconsistency with the return.[26]

THE PARTNERSHIP REPRESENTATIVE

What does a "substantial U.S. presence" mean when it comes to choosing a partnership representative? Is the relevant test the substantial presence test in §7701(b)(3)?

No. Regarding eligibility to be a partnership representative, the proposed regulations do not adopt the substantial presence test in §7701(b)(3). According to the IRS, the goal of that test, which is to determine whether an individual alien should be treated as a resident alien for federal tax purposes, is different from the goal of the substantial presence test in the audit context, which is to make sure that the IRS is able to easily communicate with the partnership representative. The proposed regulations provide that a person has substantial presence in the United States for purposes of the audit rules if: (1) the person is available to meet in person with the IRS in the United States at a reasonable time and place, as is necessary and appropriate, as determined by the IRS; (2) the person has a street address that is in the United States and a telephone number with a United States area code where the person can be reached during normal business hours; and (3) the person has a United States taxpayer identification number.[27]

Can a partnership designate an entity as its partnership representative?

Yes, a partnership can designate an entity as its partnership representative, but under the proposed regulations, if a partnership designates an entity as its partnership representative (referred to as an "entity partnership representative"), it must also identify and appoint an individual (referred to as the "designated individual") to act on the entity's behalf.[28] If the partnership fails to do so, the IRS can essentially ignore the partnership representative designation; that is, the IRS can determine that there is no designation in effect.

Interestingly, Prop. Reg. §301.6223-1(b)(3)(i) describes the "designated individual" as "the sole individual through whom the partnership representative will act" but do not provide that this individual must have any particular relationship to the entity partnership representative. In fact, in one of the examples, the entity partnership representative is a C corporation and the designated individual is described as "unaffiliated with [the entity] and . . . not an officer, director, or employee of [the entity]."[29]

Query why a partnership would designate an entity as its representative and then appoint an individual completely unrelated to that entity as the designated individual. The designated individual has the authority to bind the entity partnership representative and the partnership. Because a partnership representative can be any person (i.e., does not need to be a partner), if the partnership wishes to vest authority to act on its behalf to an individual wholly unrelated to the entity

[23] Prop. Reg. §301.6222-1(a)(4).
[24] §6222(b) (BBA).
[25] §6222(c) (BBA).
[26] Prop. Reg. §301.6222-1(c)(2).
[27] Prop. Reg. §301.6223-1(b)(2).
[28] Prop. Reg. §301.6223-1(b)(3)(i).
[29] Prop. Reg. §301.6223-2(d) *Ex.* 3.

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partnership representative, why not simply designate that individual as the partnership representative?

The general need to identify an individual through whom an entity partnership representative will act makes sense; the IRS wants to know with whom it will be communicating. The entity partnership representative, who is vested with significant responsibility, will want to make sure that the designated individual is someone who has the authority to act on its behalf, which in most cases will be an executive officer or manager (or majority owner or key employee). The example in the regulations is arguably unrealistic and was likely included to drive home the point that the actions of the designated individual are binding regardless of the relationship (or lack thereof) between the entity partnership representative and the designated individual.

Is an "entity partnership representative" required to have a substantial presence in the United States?

The answer appears to be "yes." The Preamble provides that "[t]he proposed regulations require that both an entity partnership representative and the designated individual have substantial presence in the United States."[30] The regulatory language is arguably less clear. The substantial U.S. presence requirement is found in Prop. Reg. §301.6223-1(b)(2). Prop. Reg. §301.6223-1(b)(1) provides that any "person" may be designated as the partnership representative as long as that person meets certain requirements, including the substantial U.S. presence requirement and the entity partnership representative requirements, "*as applicable*." [Emphasis added.] Prop. Reg. §301.6223-1(b)(3), which contains the rules applicable to an entity partnership representative provides that "[a] person who is not an individual may be a partnership representative only if an individual who meets the requirements of (b)(2) and (4) of [Prop. Reg. §301.6223-1] is appointed by the partnership as the sole individual through whom the partnership representative will act." Thus, clearly, the designated individual must have a substantial U.S. presence, but must the entity itself also meet this requirement?

If the purpose of the substantial U.S. presence test is to "ensure ease of communication so the audit process can proceed smoothly,"[31] and the designated individual must have a substantial U.S. presence then is it necessary that the entity partnership representative also meet this requirement? Regardless of the answer, the IRS does seem to be taking the position that both the entity and the designated individual must have a substantial U.S. presence.

Is a partnership required to designate a partnership representative separately for each taxable year?

Yes. The partnership must designate a partnership representative on the partnership return for the partnership taxable year to which the designation applies and must include all of the information required by forms, instructions, and other guidance.[32] The fact that a partnership is required to designate a representative for each taxable year and is able to designate a different partnership representative for each year could create practical issues for the IRS if and when it audits multiple years. As an example, if an IRS sends a notice of administrative proceeding for each of three taxable years, it is conceivable that it would be sending each notice to a different partnership representative and would be interacting throughout the audit with three different people.

What if a partnership does not designate a partnership representative for a particular taxable year? Does the partnership representative from the prior year continue to fulfill that role?

No. A partnership representative designation for one partnership taxable year is not effective for any other taxable year.[33]

What if the partnership agreement expressly states that a particular partner is the "partnership representative"? If the partnership fails to make a designation for a given tax year, will the IRS rely on the partnership agreement?

No. Regardless of whether or not the partnership agreement appoints a partnership representative, the partnership must designate a partnership representative separately for each taxable year on the partnership return for the partnership taxable year to which the designation applies. If a partnership does not make such a designation, the IRS will not rely on the partnership agreement. It will determine that a designation is not in effect.

Although the IRS is not bound or limited in any way by the designation of a partnership representative

[30] Preamble, REG-136118-15.

[31] Preamble, REG-136118-15.

[32] Prop. Reg. §301.6223-1(c).

[33] Prop. Reg. §301.6223-1(c)(1).

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in a partnership agreement, it still makes sense and is important for the partners to discuss the designation of a partnership representative (in a general manner) when negotiating a partnership agreement and come to an agreement regarding who the partnership intends to designate as its partnership representative with its tax return each year. As an alternative, the partnership could grant the authority to designate the partnership representative to a particular partner or a majority of the partners. The partners should also consider including provisions in the partnership agreement regarding processes for making a change in the designation of the partnership representative.

Once a partnership representative has been designated for a taxable year, is a partnership able to change that designation at will?

No. Unlike the TEFRA rules which allow a partnership to designate a new tax matters partner at any time after the filing of the initial partnership return by simply submitting a new designation to the IRS, the new audit rules do not allow a partnership to change its designation of a partnership representative (through resignation or revocation) until and unless the IRS issues a notice of administrative proceeding to the partnership or the partnership files a valid AAR pursuant to §6227 (although the partnership may not file an AAR *only* to change the partnership representative).[34] Thus, once a partnership representative is designated for a given partnership taxable year, that representative is not allowed to resign that position (and the partnership is not allowed to revoke the designation) until and unless the IRS issues a notice of administrative proceeding for that year or the partnership files an AAR for that year.

An obvious practical issue with this approach is what happens if a partnership representative no longer has the capacity to act (in particular, has died or is otherwise incapacitated) at the time that the IRS issues a notice of administrative proceeding. The fact that the partnership representative no longer has the capacity to act renders the representative ineligible under the proposed regulations, but the representative remains eligible until the IRS determines otherwise and the partnership is not allowed to revoke the designation until the IRS issues a notice. How does a partnership know that the IRS has initiated an audit if the notice is sent to a partnership representative has either died or is incapacitated? Perhaps the partnership should be allowed to revoke a designation of a partnership representative if that representative no longer has the capacity to act. Treasury and the IRS are willing to consider other situations in which a partnership should be allowed to change its partnership representative and requested comments on this issue.

Who has the authority to revoke a partnership representative designation (once revocation is allowed)?

Under the proposed regulations, a revocation must be signed by a person who was a general partner at the close of the taxable year for which the partnership representative designation is in effect as shown on the partnership return for that taxable year.[35] If each general partner eligible to sign the revocation is either no longer a partner or no longer has the capacity to act, then any reviewed year partner may sign the revocation. With respect to LLCs taxed as partnerships, the proposed regulations provide that for purposes of determining who is allowed to sign a revocation, a member-manager is treated as a general partner and a member of an LLC who is not a member-manager is treated as a partner other than a general partner.[36] A ''member-manager'' is defined as an LLC member who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. If there are no elected or designated member-managers of the LLC, each member is treated as a member-manager.[37]

Does the IRS have to approve the revocation of a partnership representative designation?

It depends. If a partnership designates a partnership representative and later wishes to revoke that designation (and revocation is allowed because either the IRS has issued a notice of administrative proceeding or the partnership is filing an AAR), the partnership may revoke the designation and the revocation is effective 30 days after the date that the partnership sends the notice of revocation to the IRS. IRS consent is not necessary. *However*, if the IRS has appointed the partnership representative, the partnership cannot revoke that designation without IRS approval.[38] This is an especially harsh result if the partnership has inadvertently neglected to designate a partnership representative.

[34] Prop. Reg. §301.6223-1(d)(2) (resignation), §301.6223-1(e)(2) (revocation).

[35] Prop. Reg. §301.6223-1(e)(3)(i).

[36] Prop. Reg. §301.6223-1(e)(3)(ii)(A).

[37] Prop. Reg. §301.6223-1(e)(3)(ii)(B)(3).

[38] Prop. Reg. §301.6223-1(e)(4).

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What happens if more than one partner attempts to revoke a partnership representative designation within a short period of time?

It is conceivable that due to conflict or lack of communication (or both) between partners, more than one partner may try to revoke the partnership representative designation and appoint someone who they believe better represents their interests. Prop. Reg. §301.6223-1(e)(3)(iii) requires that a notification of revocation sent to the IRS include a statement signed under penalties of perjury that the partner signing the revocation is authorized by the partnership to revoke the designation and has provided a copy of the revocation to the partnership and partnership representative. The fact that any partner attempting to revoke a designation is required to sign such a statement should help prevent multiple revocations from occurring.

However, there is little doubt that circumstances will arise in which partners are no longer working together and/or are unclear as to whether a particular partner has the authority to sign a revocation. In any event, if this type of confusion exists — if, for whatever reason, the IRS receives multiple revocations or subsequent designations within a 90-day period — the IRS may determine that a partnership representative designation is not in effect. If the IRS makes that determination, the proposed regulations authorize the IRS to designate a new partnership representative (and, as discussed above, the partnership will not be able to revoke that designation without IRS approval).[39] To make matters worse, the proposed regulations provide that if the IRS has determined that there is no partnership representative designation in effect because there were multiple revocations, although the IRS has to notify the partnership of this determination, *it does not have to afford the partnership an opportunity to designate a partnership representative*.[40] Normally, under the proposed regulations, a partnership has 30 days within which to designate a partnership representative when the IRS has determined that no designation is in effect.[41] However, the 30-day period does not apply in this circumstance. The IRS can make the designation immediately, and it is effective beginning on the day the IRS mails the notification to the partnership. Moreover, if the IRS designates a representative that is not a partner, that person is not bound by any terms of the partnership agreement that are intended to protect the partners.

This is not a situation that any partnership wants to find itself in. It is extremely important, especially in the context of conflict between partners, that the lines of communication remain open regarding who is representing the partnership in the audit proceedings because that person has such unfettered authority to bind both the partnership and the partners. No one is served by inadvertently abdicating the right to choose the partnership representative to the IRS.

Can a partnership or a partner challenge the actions taken by a designated partnership representative on the basis that the designation is invalid?

No. Even if a partnership representative technically does not meet the statutory requirements (e.g., the partnership representative does not have a substantial U.S. presence), the partnership representative's actions and decisions are binding and the designation remains effective until and unless:

(1) there is a resignation or revocation pursuant to the procedural guidance in Prop. Reg. §301.6223-1(d) or Prop. Reg. §301.6223-1(e); or

(2) the IRS determines that the partnership representative is ineligible and, therefore, there is no designation in effect pursuant to Prop. Reg. §301.6223-1(f).

It is clear that the focus of the regulations is to make it as easy as possible for the IRS to identify the person with whom it should be communicating, communicate with that person, and unequivocally rely on that person's actions and decisions. The IRS cannot be adversely affected by a subsequent determination that a designation is ineffective or a person is ineligible to serve as the partnership representative.

Is a partnership able to limit the authority of a partnership representative through provisions in the partnership agreement or any other agreement? What about state law limitations — Can state law limit the authority of the partnership representative to make binding decisions?

The authority of the partnership representative is in sharp contrast to the authority of the Tax Matters Partner (''TMP'') under TEFRA. The partnership representative (which includes a designated individual in the case of an entity partnership representative) has the sole authority to act on behalf of the partnership and those actions are binding on the partnership, all of the partners, and any other person whose tax liability is determined in whole or in part by taking into ac-

[39] Prop. Reg. §301.6223-1(e)(5).

[40] Prop. Reg. §301.6223-1(f)(4).

[41] Prop. Reg. §301.6223-1(f)(1).

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count (directly or indirectly) adjustments made under the centralized audit regime.[42]

The centralized audit regime does not include any statutory right to notice of, or participation in, a partnership audit for any person other than the partnership and the partnership representative.[43] No partner (or other affected person) is able to contest the results of an examination or other proceeding involving a partnership.

The proposed regulations specifically state that no state law, partnership agreement, or other document or agreement is able to limit the authority of the partnership representative as described in §6223 (BBA).[44] The regulations contain an example in which a partnership representative consents to an extension of the period for adjustments under §6235(b) (BBA). The partnership agreement expressly requires the partnership representative to consult with an identified managing group of partners before taking any action with respect to an IRS administrative proceeding. Nevertheless, the partnership representative's consent to extend the time period is valid. The contractual provision has no effect on the partnership representative's ability to bind the partnership. The partners may have a cause of action for breach of contract, but for purposes of the IRS administrative proceeding, the partnership representative's actions are binding.

Does a partnership representative's resignation affect the binding nature of any actions taken before that resignation?

No.[45] The proposed regulations include an example in which a partnership representative agrees to an extension of the period of adjustment under §6235(b) (BBA) and then resigns. The example makes it clear that the resignation does not affect the extension; it remains valid and binding.[46]

Are there any parameters with respect to an IRS designation of a partnership representative?

Section 6223(a) (BBA) provides that the IRS may appoint *any person* as the partnership representative if a designation is not in effect. The IRS received a significant number of comments related to the IRS designation of a partnership representative. In response to these comments and in an effort to balance the needs of the partnership and the government, the proposed regulations provide that in designating a partnership representative the IRS *will* consider whether there is a suitable partner of the partnership, either from the reviewed year or at the time the partnership representative designation is made and *may* consider additional factors listed in the regulations, including:

- The views of the partners having a majority interest in the partnership regarding the designation;
- The general knowledge of the person in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership; and/or
- Whether the person is a U.S. person (within the meaning of §7701(a)(30)).[47]

Thus, although the proposed regulations provide that the IRS may appoint ''any person'' as the partnership representative, the regulations require the IRS to consider the reviewed year and/or current partners, which suggests that if one of those partners is eligible to act as the partnership representative, the IRS should and will designate that partner. The Preamble provides that the IRS may ''designate any person *after first considering partners from the reviewed year or at the time the designation is made*.''[48] The concept of a ''suitable partner'' is not further fleshed out in the regulations so, ultimately, it may prove difficult to challenge an IRS designation of a partnership representative.

Does a partnership representative designated by the IRS have to have the authority under state law to bind the partnership?

No. State law is essentially irrelevant under the new centralized audit regime. The authority of the partnership representative is derived from federal tax law, and that authority is binding regardless of the application of state law. This is true whether the IRS designates the partnership representative or the partnership makes the designation.[49] As discussed above, the authority of the partnership representative to bind the partnership and the partners is not affected by state law or any provision in the partnership agreement or any other document or agreement.

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[42] Prop. Reg. §301.6223-2(a).

[43] Prop. Reg. §301.6223-2(c)(1).

[44] Prop. Reg. §301.6223-2(c)(1).

[45] Prop. Reg. §301.6223-2(b).

[46] Prop. Reg. §301.6223-2(d) *Ex.* 1.

[47] Prop. Reg. §301.6223-1(f)(5).

[48] Preamble, REG-136118-15.

[49] *See* Preamble, REG-136118-15.

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CALCULATING THE IMPUTED UNDERPAYMENT

The proposed regulations introduce "grouping" of adjustments with respect to the calculation of the imputed underpayment. How are adjustments grouped?

The proposed regulations provide for the following four groups of adjustments:[50]

1. Reallocation Grouping — adjustments that reallocate items among the partners.
2. Credit Grouping — adjustments to items that are claimed or could be claimed as a credit by the partnership on the partnership's return.
3. Creditable Expenditure Grouping — adjustments to creditable expenditures.
4. Residual Grouping — all remaining adjustments.

There is a paragraph reserved in the proposed regulations for further guidance regarding the creditable expenditure grouping.

The regulations provide for further subgrouping within each of these groups. If there is a reallocation of a partnership item, that reallocation is treated as two adjustments — an increase and a decrease. Those two adjustments are *not* netted to zero. Instead, each of the adjustments is grouped in its own reallocation subgroup.[51]

Once the adjustments are grouped, how is the imputed underpayment calculated?

With respect to the reallocation grouping and the residual grouping, the following steps apply to calculate the "netted partnership adjustment:"[52]

Step One: The IRS nets all of the adjustments within each group or subgroup. In netting the adjustments, increased gain is treated as increased income, decreased gain is treated as decreased income, increased loss is treated as decreased income, and decreased loss is treated as increased income. Each group or subgroup will end up with either a net positive adjustment or a net nonpositive adjustment (as defined in Prop. Reg. §301.6225-1(d)(3)(ii)(B) and §301.6225-1(d)(3)(ii)(C)).

Step Two: Any netted amount that is a net nonpositive adjustment is disregarded for purposes of computing the imputed underpayment.

Step Three: The net positive adjustments in the residual grouping and the net positive adjustments in the reallocation grouping are added together to arrive at the total netted partnership adjustment.

After these steps are applied, the following steps apply to compute the imputed underpayment:[53]

Step One: The total netted partnership adjustment is multiplied by the highest rate of federal income tax in effect for the reviewed year under §1 or §11.

Step Two: The IRS nets the adjustments in the credit grouping and increases or decreases the product calculated in Step One by any net adjustment to credits.

Step Three: If the result in Step Two is a net positive adjustment, the resulting amount is the imputed underpayment. If the result is a net nonpositive amount, the result is an adjustment that does not result in an imputed underpayment.

For purposes of computing the imputed underpayment, how will the IRS treat adjustments that are, or could be, reported by the partnership as expenditures that may be treated as a credit by a partner (creditable expenditures)?

The proposed regulations do not address this issue but do reserve a paragraph to provide special rules applicable to certain creditable expenditures. Treasury Department and the IRS are seeking comments on the appropriate treatment of these items.

For purposes of computing the imputed underpayment, how should a partnership group credits, and is there a particular order in which a partnership should apply credits?

There is no additional guidance in the proposed regulations regarding how credits should be grouped and whether or not credits should be applied in any particular order. Treasury Department and the IRS have requested comments on these issues.

In computing the imputed underpayment, will the IRS net adjustments from one tax-

[50] Prop. Reg. §301.6225-1(d)(2)(i).

[51] Prop. Reg. §301.6225-1(d)(2)(ii).

[52] Prop. Reg. §301.6225-1(c)(3), §301.6225-1(d)(3).

[53] Prop. Reg. §301.6225-1(c)(1).

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able year against adjustments from a different taxable year?

No. Even if these adjustments would otherwise be part of the same subgrouping (e.g., they are both adjustments to ordinary income), the IRS will not net an adjustment from one taxable year against an adjustment from another.[54]

Is either the IRS or the partnership allowed to allocate partnership adjustments for the same partnership taxable year such that there are multiple imputed underpayments?

Yes. Under the proposed regulations, there are two types of imputed underpayments — a general imputed underpayment and a specific imputed underpayment.[55] The general imputed underpayment is calculated based on all adjustments (other than adjustments that do not result in an imputed underpayment) that are not taken into account to determine a specific imputed underpayment. There can be only one general imputed underpayment in an administrative proceeding. A specific imputed underpayment is an imputed underpayment with respect to adjustments to an item or items that were allocated to one partner or a group of partners that had the same or similar characteristics or that participated in the same or similar transaction.

The proposed regulations allow the IRS (or the partnership through the modification process) to create multiple ''specific imputed underpayments'' with respect to the same taxable year.[56]

MODIFICATION OF THE IMPUTED UNDERPAYMENT

Once the IRS issues a NOPPA, does the partnership have any procedural options to request changes to the imputed underpayment other than the modification procedures?

No. The Preamble makes it clear that before the issuance of the NOPPA, there is an expectation that the IRS and the partnership representative will work together to resolve issues and the partnership will be responding to IDRs, etc. However, once the NOPPA is issued, the modification procedures are the only ''formal route'' to request changes to the imputed underpayment.[57]

Is a partnership allowed to request an extension of the time within which to request modification?

Yes. Generally, the partnership representative must submit all necessary documentation with respect to a request for modification to the IRS on or before 270 days after the date the NOPPA is mailed. The partnership may request an extension of this 270-day period, subject to IRS approval.[58] The partnership representative and IRS may also agree, in writing, to waive the 270-day period.[59] A partnership may consider this if it does not agree with the NOPPA and wants to receive the FPA earlier and litigate the adjustments or does agree with the NOPPA and wants to make the push-out election.

Section 6225(c) (BBA) provides for three types of modifications but also provides that regulations may provide for additional means of modification. Did the proposed regulations add additional modification procedures?

Yes. Section 6225(c) (BBA) provides for the following four types of modifications:

- Partner amended returns.[60]
- Tax-exempt partners.[61]
- Adjustment to the rate of tax.[62]
- Modification based on certain passive losses of publicly traded partnerships (allocable to a specified partner).[63]

The proposed regulations add three additional types of modifications:[64]

- Modification of the number and composition of imputed underpayments (the partnership may request that the IRS group adjustments a certain way and create specific imputed underpayments).
- Modification based on deficiency distributions distributed by a partner that is a qualified investment entity.
- Modification based on partner closing agreements.

[54] Prop. Reg. §301-6225-1(c)(4).
[55] Prop. Reg. §301.6225-1(e)(2)(i).
[56] Prop. Reg. §301.6225-1(e)(2)(iii), §301.6225-2(d)(6).
[57] Preamble, REG-136118-15.
[58] Prop. Reg. §301.6225-2(c)(3)(ii).
[59] Prop. Reg. §301.6225-2(c)(3)(iii).
[60] §6225(c)(2) (BBA).
[61] §6225(c)(3) (BBA).
[62] §6225(c)(4) (BBA).
[63] §6225(c)(5) (BBA).
[64] Prop. Reg. §301.6225-2(d).

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In addition, the proposed regulations provide that a partnership may request a type of modification that is not specifically described, in which case the IRS will determine whether the modification is accurate and appropriate.[65] The IRS may also issue guidance allowing additional types of modification.

Is modification available with respect to adjustments that do not result in an imputed underpayment?

According to the proposed regulations, the answer to this question depends on whether the partnership also has an imputed underpayment that is eligible to be modified under Prop. Reg. §301.6225-2 (i.e., the partnership has an imputed underpayment that is set forth in the NOPPA). If it does, then the partnership may request modification with respect to an adjustment that does not result in an imputed underpayment.[66] However, if the NOPPA does not set forth an imputed underpayment, the partnership is not allowed to request a modification with respect to adjustments that do not result in an imputed underpayment. This is problematic as the IRS could be making incorrect adjustments and the partnership does not appear to have the ability to modify merely because those adjustments do not result in an imputed underpayment.

If the IRS approves modification of a partnership's imputed underpayment based on an adjustment in a partner's amended return, is the IRS still allowed to examine that amended return in a separate proceeding with respect to that partner?

If the IRS makes a determination with respect to a modification request under §6225 (BBA), §7605(b) does not preclude the IRS from initiating an administrative proceeding with respect to that partner.[67] Even in the case of a push-out election (where an approved modification may affect the amount of an adjustment that a partner takes into account), nothing in the regulations prohibits the IRS from re-examining the partner's return.

Is the amended return modification process available to pass-through partners?

Yes. The proposed regulations provide that for purposes of the amended return modification process, a pass-through partner (or indirect partner that is a pass-through partner) is allowed to file an amended return and pay an amount calculated in the same manner as the ''safe harbor amount'' applicable with a push-out election (discussed below).[68] For purposes of this rule, the term ''pass-through partner'' includes a (1) partnership, (2) S corporation, (3) trust (other than a trust wholly owned by one person that reports the owner's information to payors under Reg. §1.671-4(b)(2)(i)(A)), or (4) decedent's estate that holds an interest in a partnership. The term ''pass-through partner does not include a disregarded entity.[69]

If a pass-through partner files an amended return, the applicable tax rate is determined by substituting the total net income of the pass-through partner for the taxable year (as adjusted) for taxable income in §1(c) (determined without regard to §1(h)).[70] If a pass-through partner files an amended return, the partnership may not also request modification with respect to any amended return filed by direct or indirect partners of that pass-through partner (or indirect pass-through partner).[71]

With respect to modification of the imputed underpayment, what happens if the §6501 period of limitations on assessment has expired? Can a reviewed year partner still file an amended return?

The proposed regulations provide that the IRS will generally not accept modification with respect to any amended return if the period of limitations on assessment under §6501 with respect to the partner's taxable year for which the amended return is being filed has expired.[72] However, §6225(c)(2)(A)(i) (BBA) provides that partners may file amended returns, *notwithstanding §6511*. Thus, if a partner is filing an amended return claiming a refund (for example, if there has been a reallocation of a distributive share), the return may be filed after the expiration of the period of limitations. However, this exception is available only if all partnership adjustments allocated to the partner (or indirect partner) filing the amended return are taken into account on the amended return, the only items reported on the amended return are items attributable to the partnership adjustments, and the partner files all

[65] Prop. Reg. §301.6225-2(d)(9).
[66] Prop. Reg. §301.6225-2(a).
[67] Prop. Reg. §301.6225-2(c)(1).
[68] Prop. Reg. §301.6225-2(d)(2)(vii)(A).
[69] Prop. Reg. §301.6241-1(a).
[70] Prop. Reg. §301.6225-2(d)(2)(vii)(B).
[71] Prop. Reg. §301.6225-2(d)(2)(vii)(C).
[72] Prop. Reg. §301.6225-2(d)(2)(v)(A).

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amended returns required under the proposed regulations.[73]

A partnership that receives a notice of administrative proceeding may want to discuss with reviewed year partners the possibility of agreeing to extend the period of limitations for the reviewed year before its expiration under §6501 to keep open the possibility of using the amended return modification process upon receipt of the NOPPA. In addition, as discussed below, the proposed regulations provide an alternative to the amended return process in the form of a closing agreement, which a reviewed year partner is able to take advantage of if the period of limitations on filing an amended return has expired.

It is important to note that, under the proposed regulations, if a partner files an amended return claiming a refund as part of the modification process after the expiration of the §6511 period, that partner may claim a refund only for adjustments that are a direct result of the partnership-level audit. In addition, the proposed regulations provide that once a partner has filed an amended return under the modification procedures, it is not allowed to file a subsequent amended return for that taxable year without IRS approval.[74]

Are all reviewed year partners required to file amended returns in order for the partnership to request amended return modification?

Generally, no. However, if there has been a reallocation adjustment, the IRS will approve a modification only if all partners affected by the adjustment file amended returns or the IRS determines that this requirement is satisfied because the affected partners took into account their allocable share of the adjustment through other types of approved modifications.[75]

Is the amended return process available if the partnership intends to make a push-out election?

Yes. There was some question about this among practitioners based on the language in the statute, but the provisions in the proposed regulations related to the push-out election specifically address the possibility of a reviewed year partner having amended its return pursuant to the modification procedures.[76] Clearly the IRS expects that there will be circumstances in which a reviewed year partner will amend a return pursuant to the modification procedures and the partnership will later push out adjustments to that partner.

Do the proposed regulations require the partnership to receive copies of amended returns from individual partners in order to request a reduction of an imputed underpayment?

No.[77] Instead, the regulations require that the partnership representative provide the IRS with an affidavit from the partner (or indirect partner) signed under penalties of perjury that the amended return was filed (and the date of filing) and that the full amount of tax, penalties, additions to tax, additional amounts, and interest was paid (and the date of payment).

Is a partner who is filing an amended return as part of the modification process required to pay the tax owed with the return, or are the other IRS administrative collection processes available to that partner?

Section 6225(c)(2)(A)(iii) (BBA) specifically states that ''payment of any tax due'' must be ''included with such return.'' Even though the statutory language does not seem to allow any flexibility, the IRS is seeking comments with respect to whether and how it could allow more flexibility to reviewed year partners to pay tax due with an amended return. The IRS needs to balance the desire to allow flexibility with the need to ensure that the reviewed year partners are committed to taking into account the adjustments.

With respect to modification of the imputed underpayment, is there an alternative way for the reviewed year partners to pay tax related to adjustments without filing amended returns?

Yes. The proposed regulations allow the IRS to approve a modification based on the contents of a closing agreement between the IRS and a reviewed year

[73] Prop. Reg. §301.6225-2(d)(2)(v)(B).

[74] Prop. Reg. §301.6225-2(d)(2)(vii)(B) of the second Prop. Reg. §301.6225-2(d)(2)(vii). *Editor's Note:* In an apparent typographical error, the proposed regulations under REG-136118-15 contain two different consecutive provisions, both designated as Prop. Reg. §301.6225-2(d)(2)(vii). The Prop. Reg. §301.6225-2(d)(2)(vii)(B) referenced in this footnote should be redesignated as Prop. Reg. §301.6225-2(d)(2)(viii)(B).

[75] Prop. Reg. §301.6225-2(d)(2)(vi).

[76] *See* Prop. Reg. §301.6226-1(b)(1) (''A modification approved by the IRS under §301.6225-2 is taken into account by the reviewed year partners in accordance with §301.6226-2(f)(2).'')

[77] Prop. Reg. §301.6225-2(d)(2)(iii).

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partner.[78] However, it is important to note that modification occurs after the NOPPA but before the imputed underpayment is final. If a reviewed year partner enters into a closing agreement and the partnership challenges the partnership adjustments in the IRS Office of Appeals or in court, the existence of that agreement may limit the partnership's ability to challenge adjustments taken into account in that agreement.

With respect to modification based on applicable tax rates, is a partnership allowed to request a modification based on the status or tax attributes of the current partners?

No. Modification based on rate reduction is available only with respect to adjustments that are attributable to a reviewed year partner (or indirect partner) that is a C corporation and adjustments with respect to capital gains or qualified dividends that are attributable to a reviewed year partner (or indirect partner) who is an individual.[79] The partnership is not allowed to request modification based on the status or tax attributes of current year partners. One of the reasons for this is that although the adjustment year partners may ultimately bear the economic burden of the imputed underpayment, the partners at the time of the modification request may not also be adjustment year partners. Modification is requested after the NOPPA is issued, which will not always be the ''adjustment year.''

With respect to the new modification procedure in the proposed regulations related to qualified investment entities and distributed deficiency dividends, what happens if an entity makes a distribution, modification is sought based on that distribution, but the underpayment is later changed by the IRS Office of Appeals or in court?

The proposed regulations allow a partnership a special modification related to partners who are qualified investments entities that distribute deficiency dividends in compliance with §860 (and the accompanying regulations).[80] However, the distribution and modification occurs after the NOPPA is issued, but before the imputed underpayment is final. What happens if the amount of the final underpayment is different? Treasury and the IRS have requested comments on this issue and whether, because of the lack of finality, this type of modification is adequate as currently provided.

If the IRS does not approve a modification, does the partnership have any recourse before the issuance of the FPA?

No. There is nothing in the statute or the proposed regulations that allows a partnership to appeal an IRS decision with respect to modification before the issuance of the FPA. The rules provide only that the IRS must approve all modifications. They do not require the IRS to provide the partnership with anything similar to a 30-day letter. They also do not provide any specific time frame within which the IRS must respond to a modification request. However, the FPA has to be issued within 330 days after the NOPPA, subject to an extension of the 270-day period. So, the IRS would have to make some decision during that 60-day period.

ADJUSTMENTS THAT DO NOT RESULT IN AN IMPUTED UNDERPAYMENT

With respect to an adjustment that does not result in an imputed underpayment, is it ever appropriate for a partnership to treat that adjustment as a reduction or increase in separately stated amounts in the adjustment year?

Section 6225(a)(2) (BBA) provides that any adjustment that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year. The ''adjustment year'' is defined as the partnership taxable year in which:[81]

- In the case of an adjustment pursuant to the decision of a court in a proceeding brought under §6234 (BBA), such decision becomes final;
- In the case of an AAR under §6227 (BBA), such AAR is made; or
- In any other case, an FPA is mailed under §6231 (BBA) or, if the partnership waives the restrictions under §6232(b) (BBA) (related to limitations on assessment), the date the waiver is executed by the IRS.

[78] Prop. Reg. §301.6225-2(d)(8).
[79] Prop. Reg. §301.6225-2(d)(4).
[80] Prop. Reg. §301.6225-2(d)(7).
[81] Prop. Reg. §301.6241-1(a)(2).

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Section 6225(a)(2)(A) (BBA) provides that the partnership treats the adjustment as a (1) reduction in non-separately stated income or an (2) increase in non-separately stated loss and any adjustment to a credit is accounted for as a separately stated item. However, the JCT Bluebook suggested that it may also be appropriate to treat certain adjustments as reductions or increases in separately stated amounts.[82] The proposed regulations provide that a partnership adjustment to an item that the partnership is required to separately state (under §702) is taken into account by the partnership as a reduction in or increase to that separately stated item.[83]

Are there specific rules with respect to partnership allocation of an adjustment that does not result in an imputed underpayment?

The statute is silent as to allocation. The proposed regulations are also generally silent on this issue but they do include guidance with respect to the allocation of an adjustment that relates to a distributive share reallocation that is disregarded. As discussed above, in computing an imputed underpayment, reallocation adjustments are grouped separately. The reallocation is treated as two adjustments — an increase and a decrease — and the two adjustments are not netted. Instead, each of the adjustments is grouped in its own reallocation subgroup. The decrease is an adjustment that does not result in an imputed underpayment. Under the proposed regulations, that adjustment is allocated to those adjustment year partners who are the reviewed year partners with respect to whom the amount was reallocated. If any reviewed year partner with respect to whom an amount was reallocated is not also an adjustment year partner, the portion of the adjustment that would otherwise be allocated to that reviewed year partner is allocated instead to the adjustment year partner or partners who are the successor or successors to the reviewed year partner. If the partnership cannot identify an adjustment year partner that is a successor to the reviewed year partner or if a successor does not exist, the portion of the adjustment that would otherwise be allocated to that reviewed year partner is allocated among the adjustment year partners according to the adjustment year partners' distributive shares.[84]

Are there circumstances in which a reviewed year partner (as opposed to the partnership) will take into account adjustments that do not result in an imputed underpayment?

Yes. As discussed above, under certain circumstances, the proposed regulations allow a reviewed year partner (or an indirect partner that holds its interest in the partnership through its interest in the reviewed year partner) to take into account an adjustment that would otherwise not result in an imputed underpayment as part of the modification process. This rule applies *if and only if* the partnership also has an imputed underpayment that is eligible to be modified. In addition, in the context of a push-out election, the reviewed year partners will take into account a partnership adjustment that does not result in an imputed underpayment if (1) the adjustment relates to a distributive share reallocation that is disregarded or (2) after grouping and netting the adjustments, the result of netting any grouping or subgrouping is a net non-positive adjustment.[85]

PUSH-OUT ELECTION

As an alternative to payment of an imputed underpayment by the partnership, under §6226 (BBA), the partnership may elect to have the reviewed year partners take into account their share of the partnership adjustments that relate to that imputed underpayment. If a partnership makes this election (referred to as a ''push-out election''), the reviewed year partners who receive a statement from the partnership are liable for any tax, penalties, additions to tax, additional amounts, and interest.[86]

Is a partnership required to notify the reviewed year partners that it has filed a push-out election?

No. The proposed regulations do not require the partnership to notify the reviewed year partners that it has made a push-out election, which is consistent with the general approach of this new centralized audit regime, which does not afford anyone other than the partnership representative notification or participation rights. There is a requirement that the partnership send a statement to the reviewed year partners (see question below) but that could occur quite a while after the partnership has filed the election. If the partners want to require the partnership representative to send notice of a push-out election, they need to address this type of communication in the partnership agreement.

[82] JCT Bluebook at 63 (2016).

[83] Prop. Reg. §301.6225-3(b)(2).

[84] Prop. Reg. §301.6225-3(b)(4).

[85] *See* Prop. Reg. §301.6225-3(b)(5), §301.6225-3(b)(6).

[86] Prop. Reg. §301.6226-1.

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If a partnership makes the push-out election, how long does the partnership have to furnish statements to the reviewed year partners?

The partnership is required to make the push-out election within 45 days of the date the FPA was mailed by the IRS (with no permissible extensions). The proposed regulations provide that the partnership must furnish statements to the reviewed year partners no later than 60 days after the date the partnership adjustments become finally determined (which is the later of (1) the expiration of the time to file a petition under §6234 (BBA), or (2) if a petition is filed under §6234 (BBA), the date when the court's decision becomes final).[87] The petition period under §6234 (BBA) is 90 days from the date that the IRS mails the FPA.

Assume, for example, that a partnership makes a push-out election 30 days after the FPA is mailed. If the partnership does not file a §6234 (BBA) petition, the partnership will have only 120 days from the date of the push-out election to send the statements to the reviewed year partners (60 days remaining on the petition period plus 60 days in Prop. Reg. §301-6226-2(b)). The statements require a number of computations that, depending on the number of reviewed year partners and the complexity of their tax situations, could be very time-consuming to determine.

If a partnership sends a push-out statement to a reviewed year partner's last known address, has the partnership satisfied this requirement?

Not necessarily. The proposed regulations provide that if a statement is returned to the partnership as undeliverable, the partnership is required to undertake reasonable diligence to identify a correct address for the reviewed year partner.[88] The regulations include an example in which a statement is returned to the partnership as undeliverable and reasonable diligence would have revealed the correct address. In that example, the partnership is treated as having failed to furnish the statement.[89]

The proposed regulations add a new concept to the push-out election — payment by the reviewed year partners of a "safe harbor" amount. What is the "safe harbor amount"?

Under the proposed regulations, the push-out statement that the partnership is required to provide to the reviewed year partner(s) and the IRS must include a "safe harbor amount" and an "interest safe harbor amount" (in addition to including the reviewed year partner's share of partnership adjustments, the reviewed year partner's share of any amounts attributable to adjustments to the partnership's tax attributes, the reviewed year partner's share of any penalties, additions to tax, or additional amounts, and several other items). The concept of a safe harbor amount was added to the proposed regulations in an effort to simplify the push-out process by affording the reviewed year partner(s) an opportunity to avoid having to calculate correction amounts for the affected year and each intervening year.

The partnership is required to calculate a "safe harbor amount" for each reviewed year partner and an "interest safe harbor amount" for each reviewed year partner that is an individual.[90] The partnership calculates the safe harbor amount the same way that it calculates the imputed underpayment except that it substitutes each reviewed year partner's share of the partnership adjustments as reported on the push-out statement for the partnership adjustments taken into account for purposes of determining the imputed underpayment.[91] Modifications to the imputed underpayment are disregarded for purposes of computing the safe harbor amount, with the exception of approved modifications based on an amended return or closing agreement relevant to the reviewed year partner.[92]

For a partner that is an individual calendar-year taxpayer, the partnership must also calculate an "interest safe harbor amount" at the rate set forth in Prop. Reg. §301.6226-3(d)(4) (which is the federal short-term rate plus five percentage points) from the due date (without extension) of the individual reviewed year partner's return for the first affected year until the due date (without extension) of the individual reviewed year partner's return for the reporting year.[93]

Under what circumstances can a reviewed year partner choose to pay the safe harbor amount instead of the "aggregate of the adjustment amounts"?

If a partnership makes a push-out election, the reviewed year partner(s) is required to pay the "addi-

[87] Prop. Reg. §301-6226-2(b).

[88] Prop. Reg. §301-6226-2(b)(2).

[89] Prop. Reg. §301-6226-2(b)(3) *Ex.* 2.

[90] Prop. Reg. §301.6226-2(g)(1).

[91] Prop. Reg. §301.6226-2(g)(2)(i).

[92] Prop. Reg. §301.6226-2(g)(2)(ii).

[93] Prop. Reg. §301.6226-2(g)(2)(iii).

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tional reporting year tax'' for the taxable year that includes the date the push-out statement was furnished by the partnership. The ''additional reporting year tax'' is either:

1. the aggregate of the adjustment amounts (see discussion below); or
2. the safe harbor amount, if elected by the reviewed year partner.

The reviewed year partner must also pay (in the reporting year) the partner's share of any penalties, additions to tax, and additional amounts as reflected in the push-out statement.[94]

The ''aggregate of the adjustment amounts'' is equal to the sum of the ''correction amount'' for the first affected year (the taxable year of the partner that includes the end of the reviewed year) plus the correction amounts for each intervening year, none of which can be less than zero.[95] The proposed regulations provide detailed guidance on how each of these amounts is computed. As an alternative to making all of these computations and essentially trying to determine what the increase in tax would have been for each of the affected years if the proper amounts had been reported on the K-1 for the first affected year, the reviewed year partner can elect to pay the safe harbor amount provided on the push-out statement. The reviewed year partner must make this election on its return for the reporting year and must pay the safe harbor amount on a timely filed return (determined without regard to extensions). If the reviewed year partner does not meet these requirements, the additional reporting year tax for the reviewed year will be equal to the aggregate of the adjustment amounts.[96]

With respect to interest, a reviewed year partner will pay interest either on the correction amounts (as determined under Prop. Reg. §301.6226-3(d)(1)) or on the safe harbor amount. If the reviewed year partner has elected to pay the safe harbor amount, the partner will either calculate interest under Prop. Reg. §301.6226-3(d)(2)(i) or, if the reviewed year partner is a calendar-year individual taxpayer, can elect to pay the interest safe harbor amount.[97] Interest on the safe harbor amount is calculated from the due date (without extension) of the reviewed year partner's return for the first affected year *until the amount is paid* whereas the interest safe harbor amount is calculated from the due date (without extension) of the individual reviewed year partner's return for the first affected year until the due date (without extension) of the individual reviewed year partner's return for the reporting year. The interest safe harbor amount is calculated based on the assumption that the individual reviewed year partner is filing a timely return for the reporting year and is paying the safe harbor amount and the interest with that return. If this requirement is not met, the election is invalid and the reviewed year partner will not be paying the interest safe harbor amount.

The reviewed year partner is also liable for interest on any penalties, additions to tax, or additional amounts calculated from the due date (without extension) of the reviewed year partner's return for the first affected year until the amount is paid.[98]

If a partnership makes the push-out election, §6226 (BBA) requires the reviewed year partners to calculate adjustment amounts by determining the amount by which the partner's chapter 1 tax would ***increase*** *in the affected year and all intervening years. What about decreases in tax that may have resulted from the adjustments? Are the reviewed year partners able to offset the increases by those decreases?*

No. Because the statutory language specifically refers to the amounts by which tax would *increase*, the regulations take the position that a correction amount for the affected year and any intervening year cannot be less than zero. The reviewed year partner is not allowed to take into account any decreases in chapter 1 tax that would result for the first affected year or for any intervening year in calculating the additional reporting year tax.

If the IRS (or the partnership) has created multiple imputed underpayments, is the partnership able to push out less than all of these underpayments?

Yes. The proposed regulations allow the partnership to elect to push out one or more specific imputed underpayments to one or more partners who would be responsible for payment of the tax liability and the partnership could pay the remaining general imputed underpayment at the partnership level.

Can a partner to whom liability has been "pushed" under §6226 (BBA) raise a penalty defense (e.g., a reasonable cause defense)?

[94] Prop. Reg. §301.6226-3(a).

[95] Prop. Reg. §301.6226-3(b).

[96] Prop. Reg. §301.6226-3(c).

[97] Prop. Reg. §301.6226-3(d)(2)(ii).

[98] Prop. Reg. §301.6226-3(d)(3).

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No. The proposed regulations provide that any defense to any penalty, addition to tax, or additional amount *must be raised by the partnership* in a partnership-level proceeding. This rule applies regardless of whether the defense relates to facts and circumstances relating to a person other than the partnership (i.e., a particular partner).[99] Thus, if a partnership does not raise a defense and the adjustments become final, there is no longer any defense available to any person.

How binding is the push-out statement on the reviewed year partner?

The proposed regulations provide that unless determined otherwise by the IRS, the partner's share of the adjustments, the safe harbor amount and interest safe harbor amount (discussed above), and any penalties, additions to tax, and additional amounts as set forth in the statement are binding on the partner. The partner may not treat items reflected on the statement on the partner's return inconsistently with how those items are treated on the statement.[100]

Can a pass-through partner "push out" liability for an imputed underpayment? In other words, can tiered entities "push out" the liability to the ultimate owners?

The statute is silent on this issue but the JCT Bluebook stated that the push-out goes up only one tier and stops.[101] The Tax Technical Corrections Act would have allowed a partnership or S corporation that receives a push-out statement to either pay the liability or make a push-out election, but Congress has not passed this legislation. Treasury and the IRS have wrestled with this issue but are clearly having difficulty justifying allowing a push-out through several tiers due to administrative complexity. The Preamble states that the Technical Corrections Act's approach to this issue ''raises significant administrative concerns'' and would subject the IRS to the ''labor intensive process of tracking, validating, and reconciling adjustments and payments through countless tiers.''[102] Treasury intended the changes to the audit rules to shift the administrative audit burden to the partnership, and it is arguably difficult to see how this intent is served by allowing each tier to push out. The proposed regulations reserve on this issue.

What effect, if any, does a push-out election have on the adjustment year partners' outside bases and capital accounts and/or the partnership's basis and book value in property?

This question remains unanswered and is arguably one of the most important and complex to sort out. Regardless of the fact that it is the reviewed year partners who pay additional tax when the partnership has made a push-out election, it is still necessary in many instances to adjust the adjustment year partners' outside bases and capital accounts as well as the partnership's basis and book value in property in order to ensure that, going forward, these numbers are essentially what they would have been had there been no need for partnership adjustments. The proposed regulations reserve a section for guidance on adjustments to partners' outside bases and capital accounts as well as partnership basis and book value in property, and Treasury and the IRS have requested comments on the technical issues that arise when trying to provide guidance on these adjustments.

PARTNERSHIP PAYMENT OF IMPUTED UNDERPAYMENT

If a partnership pays an imputed underpayment, how is that payment treated for tax purposes? What is the effect of the partnership's payment on the partners' bases and capital accounts and the partnership's inside basis and book value of partnership property?

Pursuant to §6241(4) (BBA), the partnership's payment of an imputed underpayment is treated as a nondeductible expense. There is currently no additional guidance, however, in the statute or proposed regulations on how the adjustments affect the partnership or any partners. There is a section reserved in the proposed regulations to provide guidance on the effect of partnership adjustments on basis and capital accounts. According to the Preamble to the proposed regulations, Treasury and the IRS intend to adopt the position that:

(1) a partnership that pays an imputed underpayment attributable to an adjustment to an item of income, gain, loss, or deduction, allocate that item in the adjustment year to the adjustment year partners treating such items as items of income, gain, loss, or deduction as nontaxable or deductible under §705(a)(1)(B) or §705(a)(2)(B);

[99] Prop. Reg. §301.6221(a)-1(c).
[100] Prop. Reg. §301.6221(a)-1(d).
[101] JCT Bluebook at 70 (2016).
[102] Preamble, REG-136118-15.

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(2) adjustments to partners' basis and capital accounts are necessary;

(3) adjustments to the inside basis and book value of any partnership property are necessary if the partnership adjustment is a change to an item of gain, loss, amortization or depreciation; and

(4) adjustment items taken into account on an amended return in connection with a modification to an imputed underpayment should not be allocated in the adjustment year.[103]

Is the partnership required to allocate the adjustments and imputed underpayment pursuant to the provisions in the partnership agreement? Are the allocations subject to the "substantial economic effect" test?

With respect to the allocation, Treasury and the IRS are uncertain as to whether allocations should be made in accordance with the partnership agreement and subject to the existing §704 ''substantial economic effect'' requirements. Instead, they believe it may be appropriate to allocate partnership adjustments that result in an imputed underpayment only to adjustment year partners to which the partnership has allocated a portion of the §705(a)(2)(B) expense related to the partnership's payment of the imputed underpayment. They have requested comments on this approach. They have also requested comments on how to handle partnership adjustments that arise from a reviewed year allocation that is reallocated from one partner to another, as well as how to handle situations in which there are successor partners or reviewed year partners that have received liquidating distributions and are no longer partners.

ADMINISTRATIVE ADJUSTMENT REQUEST (AAR)

If a partnership files an AAR, are all of the modification procedures available to the partnership and does the IRS have to approve modification?

No, not all of the modification procedures in the statute and regulations are available to the partnership and no, the IRS does not need to approve modification. Only the following types of modification are available in the context of an AAR:

- Modification related to tax-exempt partners.
- Modification of Applicable Tax Rate.
- Modification regarding specified passive activity losses of publicly traded partnerships.
- Modification regarding certain qualified investment entities.[104]

The partnership is not required to seek IRS approval before modifying the imputed underpayment as reported on the AAR.[105]

If a partnership files an AAR that results in an imputed underpayment and elects to have the reviewed year partners take the adjustments into account, what rules apply to this type of push-out? Is the push-out handled the same way as a push-out when the IRS has initiated an audit?

Section 6227(b)(2) (BBA) provides that adjustments pursuant to an AAR that result in an imputed underpayment may be taken into account by the partnership and partners ''under rules similar to the rules in section 6226.'' Thus, a partnership may choose to pay the imputed underpayment or may push that liability out to the reviewed year partners. The proposed regulations provide detailed guidance on how the rules in §6226 (BBA) apply in the context of an AAR, and there are several significant differences:

- Modification is disregarded.
- The reviewed year partners are allowed to take into account both increases *and decreases*; in other words, the rule that the correction amount for the first affected year and any intervening year cannot be less than zero does not apply.
- The reviewed year partner may not elect to pay a safe harbor amount or interest safe harbor amount (although the IRS has requested comments as to whether these provisions should apply).
- The reviewed year partner does not pay the increased interest rate that generally applies when there is a §6226 (BBA) push-out election; thus interest is calculated at the federal short-term rate plus three — not five — percentage points.[106]

If an AAR does not result in an imputed underpayment, is the partnership able to take the adjustment into account, or are the re-

[103] Preamble, REG-136118-15.

[104] Prop. Reg. §301.6227-2(a)(2).

[105] Prop. Reg. §301.6227-2(a)(2)(i).

[106] Prop. Reg. §301.6227-3(b)(1).

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viewed year partners required to take the adjustments into account?

If the adjustments in an AAR do not result in an imputed underpayment, the reviewed year partners are required to take them into account pursuant to the rules in Prop. Reg. §301.6227-3.

What is the effect on outside bases and capital accounts and a partnership's basis and book value in property when reviewed year partners take AAR adjustments into account?

Treasury and the IRS are aware that guidance is needed with respect to this question but have not provided any as of yet. They have reserved a section in the proposed regulations for future guidance and have requested comments on these issues.

PARTNERSHIPS THAT 'CEASE TO EXIST'

Section 6241(7) (BBA) provides that if a partnership ''ceases to exist'' before a partnership adjustment ''takes effect,'' the adjustment is taken into account by the ''former partners.'' None of these phrases is statutorily defined. How do the proposed regulations define these concepts?

When does a partnership "cease to exist?"

The proposed regulations provide that a partnership ''ceases to exist'' for purposes of §6241(7) (BBA) if the partnership (1) terminates under §708(b)(1)(A) (but not under §708(b)(1)(B) (technical termination)); or (2) does not have the ability to pay, in full, any amount that the partnership owes under subchapter C of chapter 63.[107] The IRS makes the determination with respect to whether a partnership has the ability to pay, taking into account the information that the IRS has at any particular point in time with respect to collectability and without any requirement to develop additional facts.

Quite significantly, according to the proposed regulations, *only the IRS* can determine that a partnership has ceased to exist. In addition, even if a partnership technically meets the Prop. Reg. §301.6241-3(b)(2) definition of a partnership that has ceased to exist, the IRS is not required to determine that the partnership has ceased to exist for purposes of the audit rules.[108] Thus, the IRS has sole authority and significant discretion to decide when a partnership has ceased to exist. Once it makes that determination, the partnership is no longer liable for any remaining amounts owed resulting from a partnership adjustment.

When does a partnership adjustment "take effect?"

The proposed regulations provide that a partnership adjustment takes effect when the partnership has fully paid all amounts due under subchapter C of chapter 63 resulting from the partnership adjustment.[109]

Who are the "former partners"? Reviewed year partners? Partners immediately before the partnership ceased to exist?

If the IRS determines that a partnership ceases to exist, the ''former partners'' take into account the partnership adjustments. The proposed regulations provide that the ''former partners'' are the adjustment year partners of a partnership that has ceased to exist (not the reviewed year partners).[110] If an adjustment year partner is a partnership-partner and the IRS has determined that such partnership has ceased to exist, the former partners are the partners of the partnership-partner for the partnership-partner's taxable year that includes the end of the adjustment year of the partnership that has ceased to exist.[111] If there are no adjustment year partners of a partnership (which could occur if the partnership ceased to exist before the adjustment year), the former partners are the partners of the partnership (or partnership-partner) during the last taxable year for which a partnership return was filed under §6031(b) (BBA).[112]

Interestingly, many practitioners believed that the IRS would define ''former partners'' in this context as the reviewed year partners so that the result was similar to what would have occurred if the partnership had made a push-out election. However, that is not the decision that was made. The ''former partners'' do, however, take the adjustments into account as if the partnership had made a push-out election.[113] Thus, the former partners (generally, the adjustment year partners) apply the guidance in Prop. Reg. §301.6226-3 in taking into account their share of a partnership adjustment (which includes the option of paying a safe harbor amount). It is not entirely clear why the proposed

[107] Prop. Reg. §301.6241-3(b)(2).
[108] Prop. Reg. §301.6241-3(b)(1).
[109] Prop. Reg. §301.6241-3(c).
[110] Prop. Reg. §301.6241-3(d)(1)(i).
[111] Prop. Reg. §301.6241-3(d)(1)(ii).
[112] Prop. Reg. §301.6241-3(d)(2).
[113] Prop. Reg. §301.6241-3(e).

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regulations treat a partnership that ceases to exist as having made a push-out election but then define the ''former partners'' as adjustment year partners.

DRAFTING CONSIDERATIONS

Drafting for the new partnership audit rules is anything but straightforward. This section of the article discusses some of the challenges facing practitioners and lists several questions that arise when determining what aspects of the rules should be addressed in a partnership agreement. Several different approaches are already developing, ranging from minimal coverage in the agreement to highly detailed, prescriptive coverage.

One of the key points to keep in mind when determining how to handle the new centralized audit regime in a partnership agreement is that the language that a practitioner suggests will and should depend on who the practitioner is representing. As an example, the goals and concerns of a member-manager with a small minority interest in a joint venture (e.g., a developer in a real estate venture) often is very different from those of the passive majority equity investor.

The Partnership Representative:

- *Should the partnership agreement appoint the partnership representative or should it provide that the Company will appoint the representative (by majority vote)?*
- *Under what circumstances can the partnership representative be removed or replaced?*
- *What are the responsibilities of the partnership representative to the partners? Should the agreement impose affirmative requirements to notify partners of developments with respect to any tax proceeding? What types of developments? Material developments?*
- *Should the agreement limit the partnership representative's authority to act (extending statute of limitations, entering into a settlement agreement, making a push-out election, initiating judicial review, etc.) without some level of owner approval?*
- *Should the agreement specifically require other owners to cooperate with the partnership representative (e.g., furnish information when requested)?*
- *Should the agreement specifically provide that the partnership representative will be reimbursed for expenses and is authorized to expend Company funds?*
- *What type of indemnification provisions should be included?*

The centralized audit regime *affords no participation rights to partners* and *imposes no obligation on the partnership representative to give notice to the other partners* of significant developments, or even notice that the partnership is being audited. According to the Preamble to the proposed regulations, ''[w]hether and how the partnership representative communicates with the partners in the partnership is best left to the partnership to determine.''[114] It is, therefore, extremely important that the partnership agreement address (1) the responsibility of the partnership representative to provide information to the partners, (2) the type of information that the partnership representative is required to communicate, and (3) the manner in which the partners want that information conveyed. For example, the partners should consider adding language to the partnership agreement requiring the partnership representative to notify them, in writing, within a prescribed period of time upon receipt of a notice of administrative proceeding from the IRS as well as if and when the partnership representative takes certain actions (e.g., extends the statute of limitations, makes a push-out election, enters into a settlement agreement, files a petition under §6234, etc.).

It is important to explain to clients that, regardless of the protections drafted into the partnership agreement regarding the level of approval that the partnership representative must garner in order to act on the partnership's behalf during a partnership audit, the IRS considers the authority of the partnership representative to be absolute. That is, there is nothing that can be written into a partnership agreement that can limit the authority of the partnership representative vis-à-vis the IRS. Thus, the only remedy that the other partners have is a cause of action against the partnership representative for breach of contract and/or breach of fiduciary duty.

Some clients are pushing back on the idea of serving as the partnership representative where they were more than willing to serve as the Tax Matters Partner under TEFRA. This is because of the significantly increased burden and responsibility placed on the partnership representative and the potential liability for missteps or mistakes. Attorneys representing these clients should consider inclusion of indemnification provisions. They should also consider a provision protecting the partnership representative from liability except in cases of intentional misconduct or gross negligence.

Query how partners will force or even expect a partnership representative in a partnership that has since been terminated to fulfill its obligations with all

[114] Preamble, REG-136118-15.

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of the partners' best interests in mind. There may be no indemnification available to the partnership representative at that time.

Election Out:

- *Is the partnership eligible to opt out?*
- *Should it opt out? Should the agreement require the "opt out" election, or should it be within the discretion of the partnership representative (with or without some level of owner approval?)*
- *What informational requirements should be added to the agreement to be certain that the partnership has the necessary information to make this election?*
- *Should agreement limit the number and/or type of partners to ensure continued availability of the election? Transfer restrictions to ensure eligibility?*

Modification:

- *Should the agreement require the partnership representative to cause any and all actions to be taken that would modify the imputed underpayment (e.g., require partners to file amended returns for years to which an imputed underpayment relates within required time frame and provide required statement to partnership; require modification of applicable highest rates; require a determination of any portion attributable to tax-exempt partner, etc.)?*
- *Or . . . should the agreement simply give the partnership representative broad discretion to make these decisions (with or without approval rights)?*

The parties may want to include language that requires the partners to file amended returns if requested by the partnership representative. If the parties decide to address the amended return modification process in the partnership agreement, the parties should consider also requiring the partners to provide the partnership representative with the affidavit that the partnership representative is required to send to the IRS in order to receive IRS approval of the modification. In addition, the parties should discuss the possibility of requiring the partners to agree to an extension of the period of limitations for filing an amended return (if that period has not already expired) once the partnership receives a notice of administrative proceeding.

Push-Out Election:

- *Should the agreement require the partnership representative to make the election to push out liability to the reviewed year partners?*
- *If not required, who makes the push-out decision? The partnership representative (with or without owner approval)?*
- *What is the process for that approval?*

The push-out election decision is tricky. It seems like an obvious, easy solution to avoid the partnership-level liability and place the tax burden on the appropriate partners. However, it may not always be in the partners' best interests. Consider, for example, the increased interest burden imposed with the push-out election. In the case of an imputed underpayment for which the election is made, interest is determined at the partner level and the rate increases by two percentage points. Under certain circumstances, a partner may be at a disadvantage if the partnership representative elects the push-out in contrast to paying the tax at the partnership level under §6225.

So, should the partnership agreement require the push-out election? Because the benefit of the push-out decision will often be fact-specific, it may not be wise to contractually impose this requirement on the partnership representative. A determination will need to be made as to what the process should be to decide whether to make the push-out election.

AAR:

- *Should the agreement permit/require partnership representative to file an AAR? Under what circumstances? With or without some level of owner approval?*

Partnership Payment of Imputed Underpayment:

- *What provisions should be added regarding allocation of partnership adjustments and nondeductible expense?*
- *Should there be an indemnification/reimbursement provision if the adjustment year partners bear the economic burden of an imputed underpayment?*

If the partnership does not make an election to push out the liability for the underpayment to the reviewed year partners, the partners in the adjustment year are essentially paying the liability, which raises indemnification issues that should be addressed in the partnership agreement.

OTHER TYPES OF TRANSACTIONS THAT WILL TRIGGER DRAFTING ISSUES

As an example, once the new rules are effective, in the context of a sale or exchange of an interest in an entity taxed as a partnership, a practitioner should negotiate and include terms to protect the transferee from liability for imputed underpayments determined

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under the centralized audit regime for past taxable years. Even if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits, the partnership does not ''cease to exist'' for purposes of the centralized audit regime. This is true even though §708(b)(1)(B) would treat this as a technical termination of the partnership.

As another example, in the context of an M&A transaction involving an entity taxed as a partnership, there will be an increased need for due diligence to analyze past taxable years. If a new entity is/could be considered a continuation of a partnership, there will need to be indemnification/reimbursement provisions to protect new owners from past liabilities. The approaches utilized by purchasers of the stock of corporations in M&A transactions should be considered in these circumstances.

For a sale or exchange of a partnership interest or an M&A transaction that occurs before the effective date of the new rules, the parties should include a provision in the relevant agreement precluding an early opt-in.

CONCLUSION

There is little question that this level of change in the audit process will be highly impactful and will necessitate a significant level of thought, understanding, and planning on the part of entities taxed as partnerships and their advisors. The uncertainty in application and interpretation, coupled with the complexity of partnership tax law, creates a significant challenge for practitioners in educating clients, drafting agreements, and advising clients who are audited under this new regime. The proposed regulations go a long way in providing guidance on how the IRS intends to apply the new rules, but the open questions are significant. Even with detailed guidance, the first time that an entity is faced with an audit under this new regime, there will likely be much uncertainty with respect to the process, which is not only new but very complex. There are new concepts, new terms, new decisions, and new timeframes — much to be interpreted, learned, and applied.

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