The Final Partnership Audit Regulations

What's New and Where Do We Go From Here

Federal Bar Association
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Overview

- Overview of the Centralized Partnership Audit Regime
- IRS Process
- Election Out
- Scope of the Regime
- Partnership Representative
- Modification of the Imputed Underpayment
- Push Out
- Tax Court Jurisdiction and Rules

General Rules of New Centralized Audit Regime

- Audits are conducted at the partnership level
  - Penalties determined at the partnership level but partnership defenses to penalties must be raised during partnership proceeding or in refund suit
  - Only partnership-level statute of limitations is relevant
- Regime applies to all partnerships unless they elect out
  - No small partnership exception
- The partnership must pay the IU unless it elects to "push out" the adjustments to the reviewed year partners

General Rules of New Centralized Audit Regime

- Partnerships must select an eligible PR who has sole authority to act on behalf of the partnership for purposes of the partnership audit regime
- All partners and the partnership are bound by the actions taken in and the results of the partnership-level proceeding
  - Unlike TEFRA, partners do not have the right to participate in the proceeding or receive notice of the proceedings from the IRS

IRS Process

- Overview
- Early Election into BBA
  - As of the end of January, 2019, the IRS has received 104 early elections
    - LBI – 21 elections
    - SBSE – 83 elections

Appeals

- IRS will provide an opportunity to go to Appeals and will provide further guidance on the role of Appeals in the partnership audit regime.

- Preamble also notes procedures will provide the partnership an opportunity to resolve any issues with respect to the adjustments made during the exam with Appeals prior to the mailing of the NOPPA.

  - Partnerships will therefore know which adjustments are agreed or unagreed at the time of any modification request.

Election Out

- Who can elect out?
  - Partnerships with 100 partners or less all of whom are eligible partners
  - ***Counting Partners***. Partnership has 100 or fewer partners if required to furnish 100 or fewer K-1s for the taxable year
    - Any K-1s furnished to an S corporation shareholder are counted for purposes of the 100-partner test
  - ***Eligible Partners***. Partners must be individuals, C Corporations (including any foreign entity that would be treated as a C corporation if domestic), S Corporations, or estates of deceased partners
    - A partnership, trust (including a grantor trust), disregarded entity, nominee or agent are not eligible partners
  - If an election is made, the IRS must open an audit of each partner and assess/collect from each partner individually

Notice 2019-6

- IRS intends to propose regulations under the "special enforcement matters" provision in section 6241(11) to address partnerships with a QSub as a partner.
- Notice provides that the rules will provide that
  - A partnership with a QSub as a partner cannot elect out of the new audit regime unless the partnership meets certain requirements set forth in the regulations.
  - Notice states that the rules will provide that partnerships with QSubs as partners may elect out of the regime under rules similar to that of S corporations
    - For purposes of determining whether the partnership has 100 or fewer partners, the partnership must count the statement furnished to the QSub and all statements required to be furnished by the S corporation parent of the QSub to its shareholders

Election Out

- **How to elect out?**
  - Election is made on timely filed partnership return (line 25 of Schedule B on Form 1065) by the partnership.
  - Partnership must provide the names, TINs and federal tax classifications of all partners and, if there is an S corporation partner, all of its shareholders.
    - See Appendix for Schedule B-2 (Form 1065), Election Out of Centralized Partnership Audit Regime
  - Partnerships must notify each partner of the election out within 30 days of the election.

Is Election Out the Right Answer?

Election Out	No Election Out
Most of the audit burden on the partners	Burden on the partnership rather than the partners
Partnership not subject to potential tax liability	The partnership retains control of the audit and resolution
The tax liability accurately reflects each partner's circumstances	BBA reduces the likelihood of partners having different tax consequences for the same item or transaction
More complex for IRS to have separate deficiency audits of each partner	BBA reduces redundant requests for partnership information
Audit rules more familiar and settled	BBA has mechanisms to have the tax liability accurately reflect each partners circumstances if there is no election out

Scope and Partnership-Related Items

- The new centralized partnership audit regime only applies to "partnership-related items" under chapter 1 of subtitle A.
  - Partnership-related item defined as any item or amount with respect to the partnership that is relevant in determining the income tax liability of any person.
  - The new centralized audit regime does **not** apply to taxes imposed by other chapters (e.g., self-employment taxes and net investment income taxes) although partnership adjustments are taken into account to determine these taxes.

Scope and Partnership-Related Items

- An item or amount is a partnership-related item if it is:
  - With respect to the partnership
    - The item or amount is shown or reflected, or required to be shown or reflected, on a return of the partnership or is required to be maintained in the partnership's books or records.
    - An item or amount shown or required to be shown on a return of a person other than the partnership (or in that person's books and records) that results after application of the Code to a partnership-related item based upon the person's specific facts and circumstances is not an item or amount with respect to the partnership.
  - Relevant in determining any person's chapter 1 liability
    - An item or amount with respect to the partnership is relevant in determining the tax liability of any person under chapter 1 without regard to the application of subchapter C of chapter 63 and without regard to whether such item or amount, or an adjustment to such item or amount, has an effect on the tax liability of any particular person under chapter 1.

Notice 2019-6

- Notice 2019-06 provides that the IRS intends to propose regulations that provide that:
  - The centralized partnership audit regime will not apply where an adjustment during the examination of a person other than the partnership requires a change to a partnership-related item. Specifically, the new regime will not apply where:
    - The examination being conducted is of a person other than the partnership;
    - A partnership-related item must be adjusted, or a determination regarding a partnership-related item must be made, as part of an adjustment to a non-partnership-related item of the person whose return is being examined; and
    - The treatment of the partnership-related item on the return of the partnership under section 6031(b) or in the partnership's books and records was based in whole or in part on information provided by, or under the control of, the person whose return is being examined.

Partnership Representative

- The partnership representative has the **sole** authority to act on behalf of the partnership and binds both current and former and direct and indirect partners
  - Includes the authority to extend the statute of limitations, enter into a settlement, agree to partnership adjustments, and make an election to push-out the adjustments to the reviewed-year partners
  - Authority for federal tax purposes may not be limited by state law or agreement (including the partnership agreement)
    - The PR can, however, agree with its partners that decisions will not be made unless certain procedures are followed.
    - Partnerships should carefully consider the impact of local law on actions taken by the partnership and the PR (e.g., potential claims by partners).
    - Consider separate agreement between PR and partnership

Who can be the Partnership Representative?

- In order to be the partnership representative, the person must have a substantial presence in the United States.
  - Unlike TEFRA, the partnership representative does not have to be a partner.
- A person has a substantial presence in the United States if the person:
  - makes themselves available to meet in person with the IRS at a reasonable time and place;
  - has a U.S. street address and telephone number; and
  - has a U.S. taxpayer identification number.

Who can be the Partnership Representative?

- If the partnership representative is an entity, the partnership must identify an individual that can act on the entity's behalf that satisfies the eligibility requirements. The final regulations permit a disregarded entity or the partnership itself, in certain circumstances, to serve as partnership representative.
- **Note**: Actions taken by an ineligible partnership representative are valid and designation remains in effect until terminated (by resignation, revocation, or IRS determination).

Designating the Partnership Representative

- Partnership designates the partnership representative on its return each year (line 25 of Schedule B on Form 1065).
  - This means that in a multi-year audit the partnership may have a different partnership representative for each year under audit.
  - Partnership cannot notify the IRS of a change the partnership representative until the IRS issues a notice of selection for examination or a notice of administrative proceeding or the partnership files an AAR.
    - An AAR cannot be filed solely to change the partnership representative
    - Avoids unnecessary paperwork for IRS to process changes that have no impact because the partnership is not under audit.
  - No need to designate a partnership representative if the election out is made

Resignation and Revocation of the Partnership Representative

- Partnership representative may resign by notifying the partnership and the IRS in writing (after the notice of administrative proceeding is issued).
  - The final regulations removed the ability of a resigning partnership representative to designate a successor or resign on an AAR.
- Partnership can revoke a designation of the partnership representative.
    - The revocation must be signed by a partner for the year in which the designation was in effect (i.e., the reviewed year).
    - Revocation must include a statement under penalties of perjury that the partner is authorized by the partnership to revoke the designation.
  - In the case of revocation, the partnership must designate a successor partnership representative.
- A partnership representative's resignation or revocation is generally effective immediately upon receipt by the IRS. When there is a revocation of a partnership representative designated by the IRS, the final regulations provide that the revocation is effective the date the IRS sends notification.

IRS Designation of the Partnership Representative

- If there is no partnership representation designation in effect, the IRS may select **any person** and will consider the following factors:
  - Whether there is a suitable partner for the reviewed year or the time the selection is made
  - The views of the partners having a majority interest
  - General knowledge of tax matters and the partnership's administrative operations
  - Access to the partnership's books and records
  - Whether the person is a U.S. person
  - In the case of a partner, the profits interest of the partner
- The IRS will generally provide the partnership with an opportunity to designate a partnership representative before the IRS designates one.
  - If multiple revocations in a 90-day period results in an IRS determination that a partnership designation is not in effect, the partnership will not be given the opportunity to designate.
- Once designated, the partnership cannot revoke the IRS designation without IRS consent.
- Unless unavoidable, the IRS will not designate an IRS employee, agent, or contractor as a partnership representative.

Imputed Underpayment

- The IU is a tax imposed on the partnership
  - It is assessed and collected in the same manner as a tax under subtitle A of the Code except deficiency procedures do not apply
  - The IU is a nondeductible expense allocated to adjustment year partners
- Determination of the IU
  - All adjustments are appropriately netted and multiplied by the highest rate in Section 1 or 11 for the reviewed year
  - Changes in credits are taken into account as an increase or decrease in the IU, as appropriate under the circumstances

Modification Procedures

- **Who?** Only the partnership representative may request a modification and the modification must be approved by the IRS
- **When?** Within 270 days of the NOPPA all necessary information to substantiate the request must be submitted
  - 270-day period can be waived or extended by agreement
- **How?** Procedures expected in forms and instructions
  - Request must be substantiated to satisfaction of IRS
  - Must provide detailed description of the structure, allocations, ownership and ownership changes, and relevant partners (e.g., including any indirect partners if modification related to them)
  - Documents and information may vary based type of modification
  - Necessary documents and information may include tax returns, partnership operating documents, certifications

Modification of Imputed Underpayment

- Types of Modifications that the IRS will consider:
  1. Amended Return (and Pull-in)
  2. Tax-Exempt Partner
  3. Rate Modification (corporate or individual partner)
  4. Passive Activity Losses of PTPs
  5. Closing Agreements
  6. Deficiency dividends for RICs and REITs
  7. Tax Treaty Modifications
  8. Other Modifications

Amended Return Modification

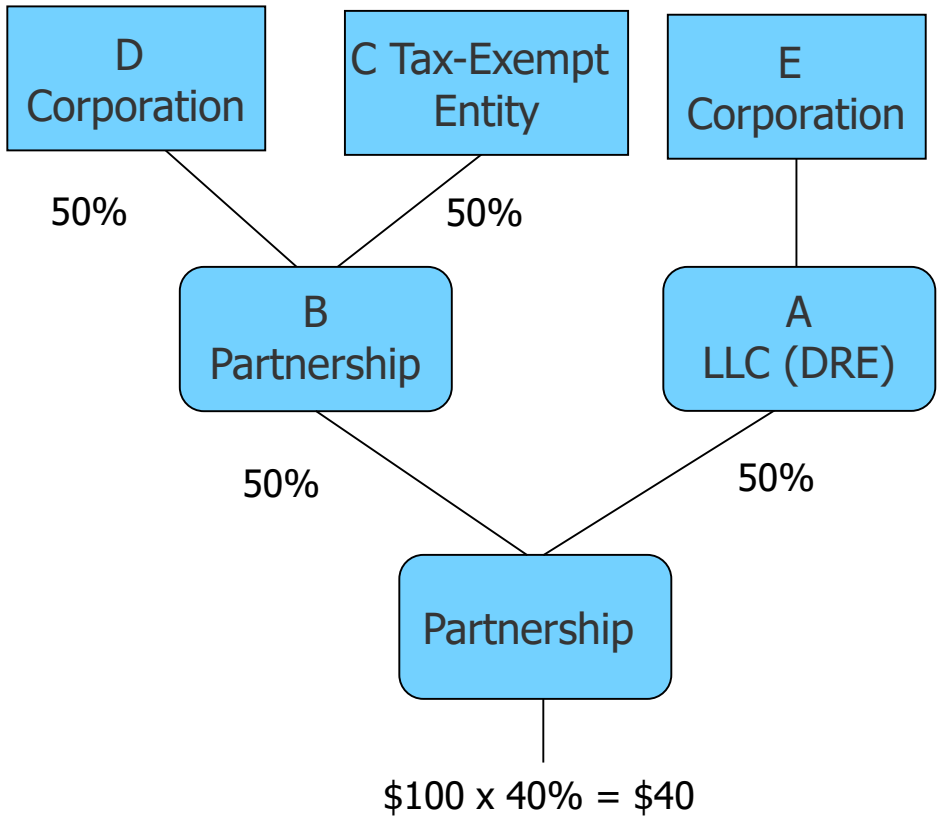
- The IU is reduced by the allocable share of adjustments taken into account by a reviewed year partner on an amended return filed for the reviewed year and all intervening years and the partner pays the applicable tax, interest and penalties
  - The partnership representative must provide affidavits from each partner that partner filed amended returns and paid tax due
  - In a reallocation adjustment, all partners affected must file amended returns unless the adjustment is taken into account by some other type of modification
  - After filing amended return, partner cannot file additional amended returns with respect to partnership adjustments unless partner receives IRS permission.
  - A pass-through partner may file an amended return taking into account the adjustments and pay an amount equal to an imputed underpayment calculated on the adjustments allocated to the pass-through partner
  - Indirect partners can file amended returns.

Pull-In Modification Procedure

- The requirements for amended return modification is satisfied if the partnership submits, on behalf of a partner, all information and payment of any tax, penalties, and interest that would have been required if the partner had filed an amended return. The partner must agree to take into account adjustments to any tax attributes of the partner.
  - Statute provides that the IRS can require that information be provided on an amended return
- A partner can file an amended return or use the pull-in procedure even if the statute of limitations is closed for assessment
  - Amended return can result in refunds; pull-in cannot

Modification of Imputed Underpayment

Example 1 – Multiple Modifications (Amended Return and Tax-Exempt Entity)

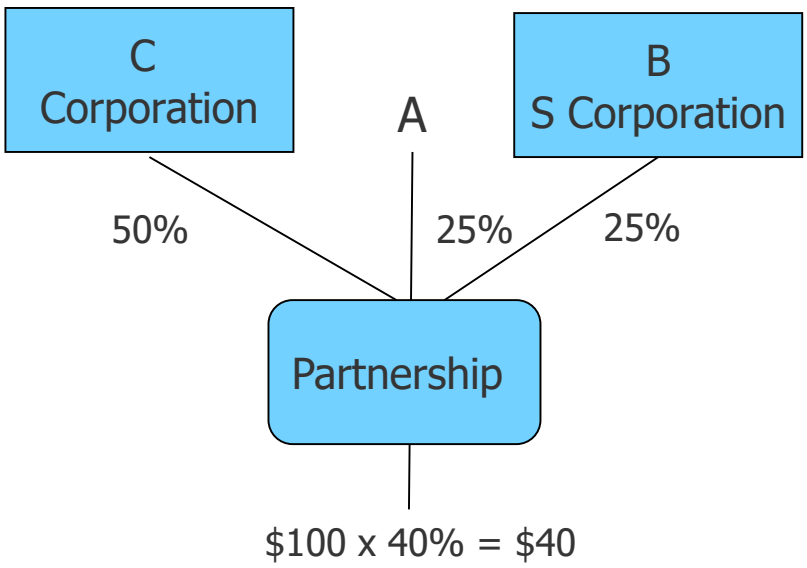


NOPPA shows $100 increase in ordinary income resulting in $40 imputed underpayment.

- Partnership can submit evidence that C owns an indirect 25% interest in Partnership and is a tax-exempt entity. No tax on C's $25 share, reducing imputed underpayment to $30.
- Can D also file an amended return reporting D's $25 share? Yes
- A cannot file an amended return reporting A's share because A is a disregarded entity.
- E can file an amended return since E is a relevant partner.
- B **can** file an amended return reporting B's share.

Modification of Imputed Underpayment

Example 2 – Rate Modification (Capital Gains)



For 2018 tax year, NOPPA shows $100 increase in long-term capital gain resulting in $40 imputed underpayment.

- Partnership can submit evidence to reduce the imputed underpayment as follows:
  - C's share = $50 x 21% = $10.50
  - A's share = $25 x 20% = $5
  - B's share = $25 x 20% = $5
- Total tax burden reduced from $40 to $27.50.

The Push Out Election

- Rather than pay the IU, the partnership can elect to push out adjustments to reviewed year partners
  - A valid push out election means the partnership is no longer liable for the IU
  - Push out results in correct tax being paid by correct partners
- Valid election = Election + Statements
  - A push out election is valid until the IRS determines it is not. If the IRS determines the push-out election is invalid, the IRS will notify the partnership representative within 30 days
  - If the IRS determines the push out election is invalid, the partnership is liable for the imputed underpayment as if no push out election was made. The partnership is also liable for any applicable penalties and interest on the imputed underpayment.

The Push Out Election

- Partnership must make the election within 45 days of the date the FPA was mailed, though statements not due until 60 days after the 90-day period to go to court has lapsed or the court determination of adjustments is final
  - The partnership may still challenge the FPA in court following a push out election because the statements are due 60 days after the final court determination
- A push out election must include the following information:
  - the name, address and TIN of the partnership;
  - the taxable year to which the election relates;
  - a copy of the FPA to which the election relates;
  - if the FPA includes more than one imputed underpayment, identification of the imputed underpayment(s) to which the election applies;
  - each reviewed-year partner's name, address, and correct TIN; and
  - any other information prescribed by the IRS in forms, instructions, and other guidance.

The Push Out Election

- The statement must include each reviewed year partner's share of various partnership-related items, its share of adjustments and modifications as finally determined and the applicability of any penalties, additions to tax and additional amounts
- A reviewed year partner must pay additional chapter 1 tax on the return for the year the statement is received equal to the aggregate of the "correction amounts," plus penalties and interest
  - The correction amounts are any changes in taxes payable for the reviewed year and all intervening years had the adjustments been properly reported
- Interest on the tax due is two percentage points higher than the normal underpayment interest rate

Push Out Election in Tiers

- Adjustments can be pushed out through the multiple tiers of ownership to the ultimate owner.
- Pass-through partner must furnish statements to its partners (the affected partners). If the pass-through partner does not furnish statements, the pass-through partner must pay an imputed underpayment.
  - Pass-through affected partners can elect to push or pay.
  - A pass-through partner is a partnership, S corporation, non-grantor trust, or estate
  - In the case of a wholly-owned grantor trust or disregarded entity, the owner is treated as the affected partner

Push Out in Tiered Partnerships

- Each partner that is a pass-through partner must:
  - Furnish statements with allocable share of adjustments to each partner/shareholder/beneficiary
    - File copy of statements with IRS
    - Statements must be furnished by the extended due date of the audited partnership's adjustment year return
  - Must pay IU if fail to timely furnish and file statements
- Each pass-through partner paying or pushing must file a partnership adjustment tracking report with IRS

Pay or Push – Statement Recipients

Pay	Push
Eliminates burden from upper tier partnership and S corporation partners	Correct tax paid by correct reviewed year partners
Avoids cost/burden of statements	Partners (and former partners) may be contacted years later about an unknown tax liability
Avoids compressed time to issue statements	Compressed time to issue statements gets more compressed as statements go up the tiers
May make sense if the per partner liability is low, regardless of the total tax liability	Cost/burden imposed on reviewed year partners to compute additional tax due

Judicial Review

- Suit may be brought by the Partnership Representative within 90 days of when an FPA is mailed in
  - Tax Court
  - District Court in which the partnership's principal place of business is located; or
  - The Court of Federal Claims
- Court has jurisdiction to determine:
  - Adjustments
  - Modifications
  - The proper allocation of items among partners; and
  - Penalties, additions to tax and other amounts for which the partnership may be liable
- It is unclear what the standard of review is for modification

Tax Court Rules

- The Tax Court announced interim and proposed amendments to its rules, Rules 255.1 through 255.7, on December 19, 2018
  - Includes rules applicable to partnerships subject to the centralized partnership audit regime and explanations of those rules
  - Tax Court requested comments with a due date of January 18, 2019
  - Rules generally track the structure of the provisions in place for partnership actions subject to TEFRA

Tax Court Rules

- Rule 255.2(b)(5) – Contents of Petition
  - Rules contemplate that the Tax Court has judicial review over:
    - Determinations with regard to the imputed underpayment
    - Proposed modifications to which the Commissioner did not consent
- Rule 255.6 – Identification and Removal of Partnership Representative
  - At the commencement of a case, if the PR is not identified, Tax Court will take such action as necessary to establish the identity of the PR
  - After the commencement of a case, the Tax Court may remove PR for cause and if a PR' status is terminated for any reason, the partnership shall designate a successor PR as the Tax Court may direct
  - Tax Court explained it was not taking a position on whether it could appoint a PR

Questions?