June 20, 2017

IRS Reissues Proposed Regulations for Centralized Partnership Audit Regime

The new rules represent a complete overhaul of partnership audit, assessment, and collection procedures. Taxpayers should review and potentially amend partnership agreements before the new rules are scheduled to take effect on January 1, 2018. Participants in M&A transactions involving partnerships should also consider the potential impact of the new rules.

On June 13, 2017, the Internal Revenue Service ("IRS") re-released proposed regulations (the "Proposed Regulations")[1] implementing the centralized partnership[2] audit regime enacted into law under the Bipartisan Budget Act of 2015[3] (the "Budget Act").[4] The Proposed Regulations are nearly identical to regulations proposed in January of this year (the "January Proposed Regulations"), which were withdrawn as part of a regulatory freeze by the Trump administration.[5]

For partnership taxable years beginning in 2018, the Budget Act rules will replace the current regime for partnership audits ("TEFRA") with a system in which, by default, audits and assessments will occur at the partnership level. However, in certain circumstances, taxpayers are eligible to make an affirmative election to opt out of the general "default" regime.

Under the current partnership audit rules, audits occur at the partner or partnership level, generally depending on the number and types of partners and the type of tax item at issue. In addition, any tax liability resulting from such audits are reflected on the returns of, and paid by, individual partners. In contrast, the Budget Act rules generally default to both conducting audits and imposing assessments at the partnership level. The Budget Act rules therefore represent an audit and assessment model that is more like the model used for corporate taxpayers and that seeks to centralize the administration of the audit process at the entity level.

This Alert covers the highlights of the Proposed Regulations and discusses the impact of the Budget Act rules and the regulations to partners and their partnerships. As noted at the end of this Alert, taxpayers should start planning now for the implementation of the new Budget Act rules and consider whether they should amend certain provisions of their existing partnership agreements. Please feel free to contact one of the members of the

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[1] NPRM REG-136118-15. The Proposed Regulations can be found in the Federal Register, available at https://www.gpo.gov/fdsys/pkg/FR-2017-06-14/pdf/2017-12308.pdf.

[2] The rules apply to any entity that is treated as a partnership for federal income tax purposes whether the entity is, under local law, a general or limited partnership, a limited liability company or some other type of entity.

[3] Pub. L. 114-74, available at https://www.congress.gov/bill/114th-congress/house-bill/1314/text?overview=closed.

[4] For more information relating to the Bipartisan Budget Act of 2015 please see our prior Client Alert available at https://media2.mofo.com/documents/151106congresspartnershiptaxrules.pdf

[5] On January 20, 2017, President Trump's Chief of Staff, Reince Priebus, sent a memorandum to all heads of executive departments and agencies instructing, among other things, that all regulations released but not yet published in the Federal Register be immediately withdrawn for review and approval. As the January Proposed Regulations had not yet been published in the Federal Register, the regulatory freeze applied to them.

Morrison & Foerster LLP federal tax group listed at the end of this Alert for more information and to discuss whether changes to your existing partnership agreement may be advisable.

I. Highlights of the Proposed Rules

a. *Scope of the Centralized Partnership Audit Regime*

The Budget Act audit rules define their scope by stating that adjustments to any item of "income, gain, deduction, loss, or credit" are determined at the partnership level.[6] The Proposed Regulations take an expansive view of the scope of these Budget Act rules, stating that all items required to be shown or reflected on a partnership's return and information in a partnership's books and records related to a determination of such items, as well as factors that affect the determination of items of income, gain, loss, deduction, or credit, are subject to review and adjustment at the partnership level. The Proposed Regulations also provide that the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment, and any defenses thereto, are determined at the partnership level. Such scope is meaningfully broader than the scope of "partnership items" covered by partnership level proceedings under TEFRA.

b. *Election Out of the Centralized Partnership Audit Regime*

Under the Budget Act and the Proposed Regulations, a partnership that has 100 or fewer "eligible" partners during the year may elect out of the Budget Act rules. The Preamble to the Proposed Regulations states that the IRS intends to carefully review a partnership's decision to elect out of the Budget Act rules "to ensure that the election out rules are not used solely to frustrate IRS compliance efforts."

Section 6221(b)(1)(C) of the Code and the Proposed Regulations define an "eligible partner" as an individual, a C corporation, any foreign entity that would be treated as a corporation, an S corporation, and an estate of a deceased partner. The Proposed Regulations clarify that a C corporation is an entity defined in Section 1361(a)(2) of the Code, including a regulated investment company ("RIC") under Code Section 851 and a real estate investment trust ("REIT") under Code Section 856.

The Proposed Regulations explain that the term "eligible partner" does not include partnerships, trusts, disregarded entities, nominees, other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner. In this regard, it is important to note that Taxpayers commonly invest in operating partnerships through a tiered partnership structure or through an LLC disregarded as an entity for U.S. federal income tax purposes, which, under the new rules, would limit the eligibility of such partnerships to elect out of the default Budget Act rules. The definition of "eligible partner" is limited despite the Preamble to the Proposed Regulations noting that the IRS received numerous comments to the Budget Act arguing for the expansion of the definition of "eligible entity" to include disregarded entities, trusts, partnerships, and partners whose nominees should be considered eligible partners.[7]

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[6] *See* I.R.C. Section 6221(a).
[7] Under the TEFRA audit regime, a partnership with a disregarded entity as a partner is also not permitted to use the small partnership exception. *See* Rev. Rul. 2004-88, 2004-2 C.B. 165 (2004).

The Proposed Regulations provide mechanics for determining whether a partnership has 100 or fewer partners,[8] as well as for making the election.[9] The Proposed Regulations also clarify that an election out by a partnership-partner has no effect on the application of the Budget Act rules to that partnership-partner in its capacity as a partner in another partnership. If a partnership makes an election out, the IRS may rely on that election for all purposes unless and until the IRS determines that the election is invalid. If a partnership makes an effective election out of the Budget Act rules, the IRS will audit both a partnership and its partners and be required to open deficiency proceedings at the partner level to adjust items associated with the partnership, resolve any issues, and assess and collect any tax that may result from the adjustments.

c. *Consistent Treatment*

Code Section 6222 and the Proposed Regulations provide that 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, unless the partner adequately discloses the inconsistent treatment to the IRS. The Proposed Regulations explain that the determination of whether a partner has treated items consistently with the partnership return is determined by reference to the partnership return filed with the IRS, not by reference to any schedule or other information provided by the partnership to a partner, including an IRS Schedule K-1. The Proposed Regulations also provide that the IRS may assess and collect any underpayment of tax that results from adjusting a partner's inconsistently reported item to conform that item with the treatment on the partnership return as if the resulting underpayment were on account of a mathematical or clerical error on the partner's return. Such treatment generally allows the IRS to immediately assess and collect tax, with the partner having no right to file a petition with the Tax Court and having no right to request an abatement of such an assessment.

The Proposed Regulations allow partners to identify inconsistencies to the IRS and provide mechanics for doing so.[10]

d. Partnership Representative

Code Section 6223 and the Proposed Regulations require a partnership to designate a "partnership representative." The concept is similar to the current TEFRA "tax matters partner" with which partnerships today are familiar. However, the rules regarding eligibility, designation, and authority of the partnership representative differ from those applicable to tax matters partners under TEFRA.

A partnership representative need not be a partner in the partnership and may be an entity or an individual. The only limitation is that the partnership representative must have a substantial presence in the United States and have the capacity to act.

A partnership representative is the sole representative of the partnership, and its actions and decisions with respect to the centralized partnership audit regime are binding on both the partnership and its partners.

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[8] *See* Prop. Treas. Reg. Section 301.6221(b)-1(b).
[9] *See* Prop. Treas. Reg. Section 301.6221(b)-1(c).
[10] *See* Prop. Treas. Reg. Section 301.6222-1.

Importantly, this authority may not be limited by state law or the partnership agreement.[11] Further, no other partner is permitted to participate in a partnership proceeding without the consent of the IRS.

The Proposed Regulations provide the mechanics for choosing a partnership representative.[12]

e. Imputed Underpayment and Modification of Imputed Underpayment

Code Section 6225 and the Proposed Regulations provide that if a partnership adjustment results in an "imputed underpayment," the partnership must pay the imputed underpayment in the "adjustment year." This requirement places the financial burden of any adjustments on the partnership itself in the adjustment year, meaning that the current year partners, rather than the reviewed year partners, indirectly will bear such burden. Partnership adjustments and any imputed underpayment resulting from such adjustments will be set forth by the IRS in a Notice of Proposed Partnership Adjustment ("NOPPA") mailed to the partnership and partnership representative. The Proposed Regulations provide mechanics for calculating an imputed underpayment.[13]

Additionally, Code Section 6225 and the Proposed Regulations allow partnerships to request the modification of an imputed underpayment. The Proposed Regulations provide rules for the time, form and manner in which a partnership may request a modification of an imputed underpayment[14]and enumerate seven types of permitted modifications. Modifications can be made under certain circumstances:

(a) if partners file amended returns and pay resulting taxes themselves;

(b) if there are tax-exempt partners in the audited partnership, as such partners would not be subject to the adjusted tax in the reviewed year;

(c) to change the tax rate of the imputed underpayment;

(d) for certain passive losses of publicly traded partnerships;

(e) based on partnership adjustments allocated to a reviewed year partner who is a "qualified investment entity" pursuant to Section 860 of the Code;

(f) based on partner closing agreements with the IRS; and

(g) for other forms of modification under Section 6225(c)(6) of the Code.

In addition to the enumerated types of imputed underpayment modification, the Proposed Regulations state that the IRS can consider alternative forms of modification.

[11] Presumably such authority can be contractually limited with indemnification as a remedy for breach. However, such indemnification would need to be enforced and pursued through the litigation process, rather than the prospective limitations that are currently put upon tax matters partners under the TEFRA regime.
[12] *See* Prop. Treas. Reg. Section 301.6223-1.
[13] *See* Prop. Treas. Reg. Section 301.6225-1.
[14] *See* Prop. Treas. Reg. Section 301.6225-2.

f. Push-Out Election

Code Section 6226 and the Proposed Regulations allow for a partnership to elect to "push-out" adjustments to its reviewed year partners rather than paying the imputed underpayment at the partnership level. If a partnership makes a valid push-out election, the partnership is no longer liable for the imputed underpayment, and the reviewed year partners of the partnership are liable for tax, penalties, additions to tax, and additional amounts, as well as interest on such amounts. The Proposed Regulations detail the mechanics for making a push-out election.[15] In addition, the Proposed Regulations provide rules for how partners who are allocated a share of an adjustment from a push-out election can calculate and pay the tax on such adjustment.[16]

The Proposed Regulations state that specific rules will apply to special types of partners in partnerships that make a push-out election. First, the Proposed Regulations under Code Section 6226 coordinate the Budget Act rules with the deficiency dividend procedures for entities subject to Section 860 of the Code.[17] Thus, if an adjustment is delivered by a partnership to a reviewed year partner that is a REIT or a RIC, such entity can make use of the deficiency dividend procedures for the adjustments on such statement, subject to certain limitations. Second, the Proposed Regulations reserve on rules that would apply to foreign partners if they were to be furnished a push-out election statement.

Finally, the Proposed Regulations reserve on the question of whether a push-out election can be made in the context of a tiered partnership beyond the first tier, an approach sought by commenters to the Budget Act rules.

As mentioned in the introduction of this Alert, the Proposed Regulations are nearly identical to the January Proposed Regulations. The only significant difference is with respect to push-out in the context of tiered partnerships. The January Proposed Regulations reserved on the issue of whether a push-out election could be made through a tiered partnership structure. The Proposed Regulations still reserve on the issue but state that this will be the topic of other proposed regulations "to be published in the near future." The Preamble to the Proposed Regulations states that the IRS is seeking comments on the information tracking and other information from a partnership (at the bottom of a tiered structure) under examination that the IRS would need for the IRS to monitor whether push-out adjustments properly flowed through the tiers. The ability to push an adjustment through the tiers of a partnership is an important one to many taxpayers and will likely be highlighted by most commenters to the Proposed Regulations.

g. Administrative Adjustment Requests

Under Code Section 6227 and the Proposed Regulations, a partnership seeking to adjust one or more items of income, gain, loss, deduction, or credit for a partnership taxable year may file an administrative adjustment request ("AAR"). To the extent that the adjustment to any tax attribute results in an imputed underpayment of tax for the reviewed year, the partnership may either pay the imputed underpayment on the date the partnership files the AAR or elect, at the time the partnership files the AAR, to have the partners who held an interest in the

[15] *See* Prop. Treas. Reg. Section 301.6226-1(c).
[16] *See* Prop. Treas. Reg. Section 301.6226-3.
[17] Generally, under Code Section 860, REITs and RICs are generally permitted to be relieved from payment of deficiencies for certain taxes by paying deficiency dividends pursuant to Section 860 of the Code.

partnership during the reviewed year take into account their shares of the adjustments requested in the AAR. If an imputed underpayment is not paid on the date an AAR is filed, such AAR may result in penalties and additional taxes. If the adjustment does not result in an imputed underpayment, the reviewed year partners must take into account their shares of the adjustments requested in the AAR to ensure that those partners benefit from any resulting refund. Reviewed year partners must take into account their shares of the adjustments in the taxable year that includes the date the AAR was filed.

The Proposed Regulations provide the mechanics for making an AAR.[18]

II. State and Local Tax Implications

State and local income tax rules often, but not always, mirror federal income tax rules. Most states do not currently have provisions allowing them to collect an audit assessment directly from a partnership operating within that state. Certain states are considering or have already passed legislation to conform to the Budget Act rules. The Multistate Tax Commission has opened a project to address conformity issues and develop model provisions for states.

III. Impact of the Proposed Regulations and Next Steps

a. *Partnership and LLC Agreements*

Partnerships (including LLCs taxed as partnerships) and their partners should reconsider tax matters provisions in their partnership (and LLC) agreements in light of the threat of entity-level taxation and the possibility of increased IRS audit activity reflected in these Proposed Regulations. Tax matters provisions negotiated under the TEFRA rules may need to be reconsidered given the sole and exclusive authority granted to the partnership representative without any notice or participation rights given to partners.

At a minimum, existing partnership and LLC agreements should be amended to designate the partnership representative for taxable years beginning no later than January 1, 2018.

Topics that may be desirable to address in partnership and LLC agreements include the following:

- *Procedural Matters*
    - Establishing qualifications for the partnership representative;
    - Establishing terms for removal of and resignation by the partnership representative;
    - Addressing the obligations of the partnership representative and partners (direct and indirect) to seek or provide partner tax attributes and other information that may reduce the partnership's imputed underpayment under the default Budget Act rule;
    - Addressing the obligations of the partnership representative, former partners, and partnerships to cooperate with respect to reviewed years in which the former partners were partners;

[18] *See* Prop. Treas. Reg. Section 301.6227-1.

  - Limiting the ability of the partnership representative to make elections or settle audit issues without partner participation;
  - Providing authority to amend provisions of the partnership agreement relating to audit rules and requiring the partnership representative and partners to cooperate in good faith when the IRS issues additional guidance or amendments are made to the underlying statute; and
  - Considering potential complications in tiered partnership structures.
- *Choices Regarding Application of Budget Act Rules*
  - Ensuring that the election to opt out of the default Budget Act rule is available and protected whether or not the partnership makes the election;
  - Deciding whether and when an eligible partnership elects out of the default Budget Act rule and, in the event of an election out, establishing procedures and rules for cooperation and information sharing between the partners and the partnership;
  - Requiring the default Budget Act rule to be applied for imputed underpayments under a specified dollar amount and requiring the push-out election to be made for imputed overpayments at or over that specified amount;
  - Addressing the level of diligence the partnership representative must exercise to identify partner tax attributes than can reduce an imputed underpayment;
  - Addressing whether and when partners are required to file amended returns; and
  - Establishing timing and diligence requirements for partners to respond to the partnership representative's reasonable requests for information.
- *Funding and Allocating Tax Liability*
  - Addressing the manner in which a partnership tax liability under the default Budget Act rule will be funded, i.e., processed and collected from the partners;
  - Allocating that liability, by indemnification or otherwise, among the partners in various circumstances; and
  - Extending indemnification obligations to survive for a period of time after a partner sells its partnership interest.
- *Other Considerations*
  - Providing for some level of diligence regarding material, uncertain tax positions, including a minimal level of comfort (e.g., substantial authority, more likely than not) and a minimal level of documentation.

b. *Acquisitions of Partnership Interests and Mergers & Acquisitions*

Acquirers of partnership interests and participants in merger and acquisition transactions may need to account for additional considerations relating to the new Budget Act rules.

- *Issues for Sellers*
  - Understanding who controls the push-out election for any year in which the seller was a partner and, at minimum, negotiating for notice and participation rights for those reviewed years;
  - Reconsidering and revisiting uncertain tax positions taken in the past in light of the new federal audit rules in anticipation of possibly increased IRS audit activity; and
  - For tax-exempt partners, negotiating to require the partnership representative to make the push-out election for all material adjusted partnership items and/or, for partnership items not pushed out, negotiating to ensure such partners realize the benefit of any reduction in the imputed underpayment attributable to their tax-exempt status.
- *Issues for Buyers*
  - Conducting diligence regarding potential liability for prior-period income taxes;
  - Reviewing the partnership or LLC agreement to identify how the new Budget Act rules will be applied and evaluating the potential impact on buyer;
  - Identifying potential sources of additional tax burden, such as if the partnership representative fails to make a contractually obligated push-out election, which subjects the partnership to entity-level taxation under the default rule; and
  - Considering whether and to what extent an acquired partnership is considered a continuation of the partnership for tax purposes.

c. *UPREITS*

In an UPREIT structure, a REIT conducts most of its operations through an operating partnership. The more general points above would also apply to a REIT partner in these structures. However, REIT partners have specific considerations under the Proposed Regulations as well, including the following:

- *Electing Out*
  - Considering whether it is possible to elect out of the Budget Act rules (i.e., if non-REIT partners are either disregarded entities or partnerships for U.S. federal income tax purposes).
- *Deficiency Dividends*
  - Considering whether to pay deficiency dividends for imputed underpayments at the partnership level after receipt of a NOPPA if no push-out election is made; and

- ○ Considering whether to pay deficiency dividends to cover final partnership adjustments for which a push-out election is made.

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