# Client Update
# Government Insights into the New Partnership Tax Audit Regime

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On January 18, the Treasury Department and the Internal Revenue Service released proposed regulations under the partnership audit regime created by the Bipartisan Budget Act of 2015 (the "BBA Regime"). (We discussed the BBA Regime in our November 3, 2015 Client Update.) However, the legal status of the proposed regulations is uncertain. They have not been formally published in the Federal Register, likely due to the Trump administration's "freeze" on pending regulations. Even if not officially proposed, the regulations offer valuable insight into Treasury's and the IRS's views on how the BBA Regime should be implemented.

Regardless of the fate of the proposed regulations, partnership agreements should be drafted with appropriate provisions dealing with the BBA Regime. For example, partnership agreements should address designation of the partnership representative for dealing with the IRS and the scope of its authority, control of audits, collection of information from partners, and how any taxes paid by the partnership are borne by current and former partners.

## ELECTION OUT FOR CERTAIN SMALL PARTNERSHIPS

- Under the BBA Regime, partnerships having only 100 or fewer "eligible partners" may elect out of the new rules. An election out would require the IRS to audit partners individually.
- The proposed regulations define eligible partners narrowly. Partnerships and trusts are not eligible partners. Surprisingly, a disregarded entity is also not an eligible partner, even if its owner would be an eligible partner. Where a partner is an S corporation, the proposed regulations clarify that its shareholders must also be counted as partners for the 100 partner threshold.

## PARTNERSHIP REPRESENTATIVE

- Under the BBA Regime, each partnership must designate a partnership representative. The proposed regulations provide that if a partnership fails to adequately select a partnership representative, the IRS may select one. The partnership representative does not need to be a partner.

- The partnership representative binds the partnership and the partners in its dealings with the IRS, even if its actions exceed its authority under the partnership agreement. **This feature of the proposed regulations has attracted considerable attention, given the broad authority of the IRS to select the partnership representative if the partnership does not.**

## PARTNERSHIP ADJUSTMENTS INITIATED BY THE IRS

- Under the proposed regulations, the IRS segregates audit adjustments relating to items having different tax attributes into separate groups. The adjustments in each group are netted together to determine whether there is a "net positive adjustment" (*i.e.*, one that gives rise to tax due) or a "net non-positive adjustment" (*i.e.*, one that does not) for that group. All net positive adjustments are added together, **and all net non-positive adjustments are ignored**, for purposes of determining the partnership's "total netted partnership adjustment."

- The total netted partnership adjustment is then multiplied by the highest rate of federal income tax for individuals or corporations in effect for the reviewed year and then adjusted to reflect any net increase or decrease in credits resulting from the adjustments. The resulting amount is the "imputed underpayment."

- The imputed underpayment is treated as a tax imposed for the current taxable year and is subject to interest and penalties. Any adjustment that was ignored is taken into account in the current taxable year.

  For example, if the IRS determines that a partnership failed to report ordinary income and capital loss for the reviewed year, the partnership's imputed underpayment for such year will equal the unreported ordinary income multiplied by 39.6%. **The capital loss does not reduce the imputed underpayment**, even if the partnership has capital gains in the reviewed year for the capital loss to offset. Instead, the capital loss is taken into account by the partnership in the current taxable year.

## MODIFICATIONS TO IMPUTED UNDERPAYMENTS

- A partnership representative can request a modification to an imputed underpayment within 270 days of receiving notice. Under the proposed regulations, there are several ways that an underpayment can be reduced. For example, the underpayment will be reduced to the extent partners in the reviewed year amend their prior years' returns to reflect the adjustments and pay any resulting tax.

- The underpayment can also be reduced to the extent of any imputed underpayment attributable to tax-exempt and non-U.S. partners, and partners taxable at lower rates (*e.g.*, applying capital gains rates to capital gain adjustments for individual partners). The proposed regulations make clear that the modifications for tax-exempt status or lower rates are based on the partners in the reviewed year, something the statute left unclear.

## PUSH OUT ELECTION

- Instead of paying the tax at the partnership level, a partnership may elect to have partners in the reviewed year take into account the adjustments made by the IRS (the "push out election"). Under the proposed regulations, the tax due from each reviewed year partner is based on any increase in tax in the reviewed year (and any year between the reviewed year and the current taxable year) resulting from the adjustments.
- Only net increases in tax for a given year are taken into account in determining the amount of tax owed. While the proposed regulations indicate that negative adjustments are to be taken into account by the reviewed year partners, the process for doing so is unclear.
- **The proposed regulations reserve on the application of the push out election in tiered partnership structures.** The preamble to the proposed regulations notes that Treasury and the IRS have concerns with the administrative burden of allowing pass-through partners to push out adjustments, given the complexity of tiered partnership arrangements.
- The statute itself is not clear on this point, and some of the legislative history implies that pass-through partners cannot push out adjustments received from lower-tier partnerships. On this issue, it is worth noting that a draft technical corrections bill in Congress would clarify that an upper-tier partnership that receives a push out adjustment can further push out the adjustment to its partners.

## PARTNERSHIP ADJUSTMENTS INITIATED BY THE PARTNERSHIP

- A partnership may file for an administrative adjustment request on its own to correct a previous year's tax return without amending it. In this case, the partnership is subject to a more lenient process than the procedures that apply to adjustments initiated by the IRS.

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Please do not hesitate to contact us with any questions.