Client Update
Proposed Partnership Audit Regulations Liberalize Push-Out Rules

With all the tax reform discussions occurring late last year, culminating in the enactment of the Tax Cuts and Jobs Act, the flurry of additional IRS guidance on the centralized partnership audit regime that came out in November, December and January has received less attention. Nevertheless, certain aspects of the additional guidance are noteworthy, especially since the new regime takes effect for taxable years starting in 2018. The statutory regime and prior IRS guidance are summarized in our prior client update. In perhaps the most important policy shift in this area that is sure to be welcomed by all taxpayers, the IRS has made the so-called "push-out election" more feasible. However, much of the additional guidance continues to reflect the IRS's general caution about being overly taxpayer-friendly.

PUSH-OUT ELECTIONS AND TIERED PARTNERSHIPS

- Under the new regime, instead of paying tax at the partnership level, a partnership may elect to have partners in the reviewed year (the year audited by the IRS) take into account the adjustments made by the IRS (the "push-out election"). The tax due from each partner in the reviewed year is based on any increase in tax in the reviewed year (and any increased tax for each year between the reviewed year and the current taxable year) resulting from the adjustments. The resulting tax includes any interest and penalties and is payable as part of the current taxable year. The toll charge for making a push-out election is that interest on the underpayment for all partners is computed at the higher rate applicable to corporations, rather than the rate applicable to individuals.
- The IRS originally reserved on the application of the push-out election to tiered partnership structures, citing administrative burdens. However, the latest proposed regulations now allow partnerships with partners that are other partnerships, S corporations, and certain trusts or estates to make push-out elections to pass through audit adjustments to their partners, shareholders or beneficiaries.
- If the partnership makes a push-out election, each pass-through partner must decide whether to continue pushing adjustments out to the next tier of affected partners in the chain or to pay the tax resulting from the adjustment in a manner similar to the rules that

apply to a partnership audit at that level. If a pass-through partner does not take action, the imputed tax will be due by the pass-through partner (and additional penalties may apply for failure to timely pay the imputed tax).

- A partnership will also be able to correct prior years' tax returns (in lieu of amending) by pushing adjustments requested through an Administrative Adjustment Request initiated by the partnership to its pass-through partners.

NO SAFE HARBOR FOR PUSH-OUT ELECTIONS

- The latest proposed regulations remove a safe harbor option in the original proposed regulations that required partnerships to provide partners with information enabling them to pay a safe harbor amount rather than determining their actual tax liability. The IRS acknowledged that mandating partnerships to supply safe harbor amounts would add administrative complexity and would not likely be used by partners.

PUSH-OUT ELECTIONS AND WITHHOLDING ON FOREIGN PARTNERS

- The proposed regulations provide that a push-out election does not absolve a partnership from its obligations to withhold tax on FDAP, FATCA or ECI resulting from an adjustment.
  - Consistent with the withholding rules, if the partnership has valid IRS W-8 forms from a foreign partner to establish that a lower rate applies (*e.g.*, the foreign partner is entitled to a treaty rate), the partnership may reduce its rate of withholding on that partner. The partnership can use forms that were valid with respect to the reviewed year or obtain new forms from the foreign partner with a signed affidavit attesting to the entitlement with respect to the reviewed year.
- Because withholding applies only to tax and not interest and penalties, the IRS's current position is that a push-out election will require each foreign partner that is subject to withholding to file a U.S. income tax return.
  - Filing U.S. income tax returns can be avoided by foreign partners if the partnership pays the imputed tax rather than elects the push-out. The IRS noted that a partnership may request a bifurcated approach and pay imputed tax in respect of its foreign partners and push out imputed tax in respect of U.S. partners.
  - The IRS is also considering other methods to eliminate these filing obligations, including allowing the partnership to pay interest and penalties as part of the withholding provisions.

ELECTION OUT

- The Treasury has finalized regulations on electing out of the centralized partnership audit regime for certain partnerships. Partnerships having only 100 or fewer "eligible partners" during a taxable year may elect out of the regime for such taxable year. In these cases, the IRS will be required to audit the partners individually.

- The final regulations declined to expand the definition of eligible partners. Partnerships, disregarded entities and trusts are not eligible partners.
- An S corporation is an eligible partner, but the S corporation plus its shareholders are counted towards the 100-partner limit. However, an S corporation is eligible even if it has shareholders that would not be considered eligible partners. For example, a disregarded entity may be the shareholder of an S corporation, which in turn is a partner of a partnership that opts to elect out.
- Both the transferee and transferor in a mid-year transfer will count towards the 100-partner limit. Under the Tax Cuts and Jobs Act, a partnership taxable year will no longer terminate when more than 50% of a partnership's interests are transferred. Partnerships that intend to elect out will need to carefully scrutinize their partners and transfers.

FOREIGN TAX CREDIT

- Adjustments to creditable foreign tax expenditures ("CFTEs"), which allow each partner to take into account a pro-rata portion of foreign taxes paid by the partnership for foreign tax credit purposes, are addressed in the proposed regulations. The IRS noted that whether a partner benefits from CFTEs generally depends on facts at the partner level. Consistent with the general sub-grouping approach in the proposed regulations, an adjustment that decreases CFTE will increase the partnership's imputed tax (on the assumption that partners fully benefited from the CFTE) but an adjustment that increases CFTE **will not** generally decrease the imputed tax (on the assumption that partners would not benefit from the CFTE).
    - In the preamble, the IRS acknowledged that this approach can be unfavorable to the taxpayer and suggested using the modification process available under the new partnership audit regime. It remains to be seen whether the modification process will prove effective in addressing this distortion.

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Please do not hesitate to contact us with any questions.

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