Partnership and LLC Agreements Require Changes by 2018

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Partnership and LLC Agreements Require Changes by 2018

By Stephen A. Frost

Executive Summary

To date, partnerships and multiple-member limited liability companies ("LLCs") taxed as partnerships generally do not pay income taxes at the partnership level. As a result of federal tax law changes for tax years beginning after 2017, partnerships and multiple-member limited liability companies taxed as partnerships may be obligated to pay federal income tax audit assessments at the partnership level. Why worry about this? Many partners and LLC members may be negatively affected by the federal law change unless steps are taken to mitigate the impact of the new law. Every existing partnership agreement and LLC operating agreement should be reviewed now in light of the new partnership audit rules. It is likely that every agreement will require at least some amendments. At a minimum, every existing partnership agreement and LLC operating agreement should be amended to appoint a partnership representative before December 31, 2017.

Existing Federal Partnership Audit Rules — TEFRA

Partnerships with less than ten (10) partners generally do not have to follow the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") audit rules under the current tax laws unless the partners choose to do so.[1] If no election to apply the TEFRA audit rules is made, audits are performed at the partner level and taxes are collected at the partner level.

Partnerships with (a) ten (10) or more partners; (b) partners that are pass through entities; or (c) less than ten (10) members who elect TEFRA treatment, are subject to the TEFRA rules.[2] The TEFRA rules generally provide that (a) partners are audited at the partnership level; (b) all partners have to report partnership items consistently; (c) settlements with the IRS bind all partners to the partnership items; (d) a tax matters partner controls the audit process, but notice is required when there are 100 partners or less, and some partner involvement is allowed; and (e) the IRS collects against the individual partners.[3] Almost every partnership agreement and LLC agreement includes provisions regarding audits of the partnership. Most partnership agreements and LLC agreements have TEFRA audit provisions and identify a tax matters partner. The IRS no longer wants to use the TEFRA rules because the IRS is having a difficult time collecting taxes from partners and members after auditing partnerships and LLCs—particularly multi-tiered entities.

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[1] Internal Revenue Code of 1986, as amended ("Code") § 6231(a) as applicable prior to 2018.
[2] Id.
[3] Code § 6221 *et seq.* as applicable prior to 2018.

The New Partnership Audit Rules Eliminate the Need to Collect Taxes at the Partner or LLC Member Level

The new partnership rules were enacted under the Bipartisan Budget Act of 2015 ("BBA") on November 2, 2015, at §1101 of P.L. 114-74. The new process is called the "centralized partnership audit regime". Centralized partnership audit regime is intended to make it easier for the IRS to audit partnerships and collect taxes related to partnership income. For tax years beginning after 2017, federal income taxes (including interest and penalties) resulting from an IRS audit will generally be assessed at the partnership level, not the partner level.[4] Federal income taxes will be assessed on audit as an "imputed underpayment" for the "adjustment year" (i.e., the current tax year), not the "reviewed year" (i.e., the tax year to which the adjustment relates).[5] In other words, the partners in the year of assessment (i.e., the "adjustment year") may be required to subsidize the partners from the audited year (i.e., the "reviewed year") in whole or in part whenever the partners or their ownership percentages have changed during the interim. It is also likely that the general centralized partnership audit regime audit approach will result in higher taxes being assessed than when the various partnership adjustments had been reported separately at the partner level. Further, the centralized partnership audit regime may also reallocate economic costs to innocent parties.

Effective Date of Centralized Partnership Audit Regime

Centralized partnership audit regime is effective for tax years beginning after December 31, 2017, *i.e.*, 2018 for calendar partnerships.[6] (A partnership may elect to apply the new rules after 2015, but it is not clear why anyone would want to do so.[7]) Centralized partnership audit regime may affect a large number of partnerships and LLCs. Large partnerships in particular, including hedge funds, will likely to be subject to more audits as soon as centralized partnership audit regime is effective. The anticipated impact will be so significant that Congress has allowed taxpayers almost two years to transition to the new system.

IRS Procedures Require That Three Notices Will Be Issued During the Course of an Audit

The IRS will issue three notices during the course of the audit. First, it will issue a "notice of administrative proceeding" when partnership audit started.[8] Second, a "notice of proposed partnership adjustment" will be issued when the audit is completed.[9] The issuance of the notice of proposed partnership adjustment starts the 270-day clock for the period of modification, which is described below.[10] Finally, the IRS will issue a "notice of final partnership adjustment" 270 days after the notice of proposed partnership adjustment is filed.[11] The issuance of the notice of final partnership adjustment will start the

[4] Code § 6221.
[5] Code § 6225(a).
[6] P.L. 114-74 § 1101(c)(1).
[7] P.L. 114-74 § 1101(g)(4).
[8] Code § 6231(a)(1).
[9] Code § 6231(a)(2).
[10] Code § 6225(c)(7).
[11] Code § 6231(a)(3).

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45-day clock on the "push out" exception described below.[12] If the case is to be litigated, the partnership representative must file in the Tax Court, the appropriate U.S. district court, or the Court of Federal Claims 90 days after the notice of final partnership adjustment is issued.[13] If litigation is not timely filed, the IRS may assess income taxes 90 days after issuing the notice of final partnership adjustment.[14]

Once the notice of final partnership adjustment is filed, the imputed underpayment will be known. The taxpayer may challenge the assessment at appeals and in court. If the imputed underpayment is not challenged or is otherwise finally determined, the imputed underpayment will be paid by the partnership unless it is pushed out as described below.

Netting of All Adjustments Occurs When the Imputed Underpayment Is Calculated

Generally, all positive and negative adjustments under a centralized partnership audit regime audit are netted into a single number.[15] Netting of all income, gain, loss, and deductions occurs regardless of the nature of adjustments.[16] In other words, the centralized partnership audit regime approach nets all ordinary, capital, passive, active, qualified dividends, etc., items into a single adjustment. Credits are also taken into account.[17]

The netting approach described in Code § 6225 does not distinguish by character or holding period.[18] Therefore, the approach could benefit the partners when ordinary income is netted with capital losses. The approach could be detrimental when capital gains are netted with ordinary losses. Fortunately, the centralized partnership audit regime does grant the IRS authority to adopt modification procedures whereby the partnership can submit evidence as to the character of various partnership items (e.g., a capital gain or a qualified dividend) which should cause the proposed tax assessment to be decreased.[19]

Code § 6226 is silent at to the application of the net investment income tax under Code § 1411 *et seq.* and the self-employment tax under Code § 1401 *et seq.*

Unbelievably, the new audit process does not net changes in the partners' distributive shares when the IRS reallocates such shares upon audit.[20]

Changes to the Partners' Distributive Shares Are Not Netted When the Imputed Underpayment Is Calculated

When adjustments are made to the partners' distributive shares on audit, one would think that the adjustments should wash because the adjustments would simply move income or deductions between partners. However, changes to partners' distributive shares are not netted when calculating the imputed

[12] Code § 6226(a).
[13] Code §§ 6226(d) and 6234(a).
[14] Code § 6232.
[15] Code § 6225(b).
[16] Id.
[17] Id.
[18] Id.
[19] Code § 6225(c).
[20] Code § 6225(b)(2).

underpayment.[21] The centralized partnership audit regime only considers increases in income and decreases in deductions when the partners' distributive shares are reallocated on audit.[22] This will result in phantom income to the partnership unless the imputed underpayment is pushed out as discussed below. Further, because the statute of limitations for refunds may lapse before the audit process is completed, the partner whose experiences the offsetting decreases in income and increases in deductions must timely file a protective refund claim in order to avoid the lapse of the statute of limitations and thereby lose the refund.

Maximum Income Tax Rates Are to Be Applied to the Partnership Item Adjustments

In order to avoid disputes as to what tax rates should be applied to an adjustment, Code § 6225(b)(1)(A) applies a simplistic approach with regard to tax rates. If federal taxes are assessed against a partnership upon audit under centralized partnership audit regime, the tax rate applied to the net partnership adjustment will generally be the highest individual income tax rate or the highest corporate income tax rate, whichever is greater.[23] Currently, the highest individual rate on Code § 1 is 39.6% and the highest corporate rate under Code § 11 is 35%. The higher of the two rates is currently 39.6%, i.e., the highest individual income tax rate.

The centralized partnership audit regime does grant the Secretary of the Treasury ("Secretary") authority to adopt procedures whereby the partnership can submit evidence as to why a lower income tax rate is applicable due to the status of the partner (e.g., a tax exempt entity or a C corporation) or due to the character of the partnership item (e.g., a capital gain or a qualified dividend).[24]

Modifications to Imputed Underpayment Are to Be Allowed Under Code § 6225(c)

In order to mitigate the possible harsh results that could be caused by the general approach under Code § 6225(b), Code § 6225(c)(1) provides that the Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with the requirements of Code § 6225. The goal of the modification procedures is to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.[25]

Code § 6225(c) anticipates that there will be several different ways to modify the imputed underpayment, but defers to the Secretary to flesh out the details.

First, a modification of the imputed underpayment will be allowed when one or more of the <u>reviewed year partners</u> amend their reviewed year tax returns, amend all of their subsequent years' tax returns to reflect

[21] Id.
[22] Id.
[23] Code § 6225(b)(1)(A).
[24] Code § 6225(c)(4).
[25] "General Explanation of Tax Legislation Enacted in 2015" as prepared by the staff of the Joint Committee on Taxation ("Bluebook") (JCS-1-16) at pp. 65-66.

the ongoing tax attributes resulting from the audit, and pay all of the resulting taxes, interest, and penalties, within 270 days after the partnership receives a notice of proposed partnership adjustment.[26] The payments received will then reduce the imputed underpayment.[27]

Second, a modification of the imputed underpayment will be allowed when the partnership can show that one or more partnership interests are held by a tax exempt entity.[28]

Third, a modification of the imputed underpayment that considers tax rate adjustments and character of income adjustments (e.g., capital gains) will be allowed.[29] Such procedures shall also provide for taking into account a rate of tax lower than the rate of tax described in subsection Code § 6225(b)(1)(A).[30] For example, with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to a partner which the taxpayer is a C corporation will use the highest corporate income tax rate.[31] Such procedures shall also provide for taking into account a rate of tax lower than the rate of tax described in subsection Code § 6225(b)(1)(A) with respect to capital gains or qualified dividends when the partner is an individual.[32]

Fourth, in the case of a publicly traded partnership (as defined in Code § 469(k)(2), the modifications to such procedures shall provide for (a) for determining the imputed underpayment without regard to the portion thereof that the partnership demonstrates is attributable to a net decrease in a specified passive activity loss which is allocable to a specified partner, and (b) for the partnership to take such net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which such net decrease relates.[33]

Finally, the Secretary may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes of this Code § 6225(c).[34]

All information supporting a modification must be submitted to the Secretary not later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed to the partnership under Code 6231—unless such period is extended with the consent of the Secretary.[35] However, any modification may only be made upon the approval of the Secretary.

In lieu of the general centralized partnership audit regime approach or the modifications available under Code § 6225(c), the partnership can elect to “push out” the partnership adjustments to the reviewed year partners.

[26] Code § 6225(c)(2).
[27] Id.
[28] Code § 6225(c)(3).
[29] Code § 6225(c)(4).
[30] Id.
[31] Code § 6225(c)(4)(A)(i).
[32] Code § 6225(c)(4)(A)(ii).
[33] Code § 6225(c)(5).
[34] Code § 6225(c)(6).
[35] Code § 6225(c)(7).

A Partnership May Elect to "Push Out" All Partnership Adjustments to the Reviewed Year Partners and Thereby Avoid Taxation at the Partnership Level

A partnership may elect to "push out" all partnership adjustments to the reviewed year partners and thereby avoid taxation at the partnership level.[36] If push out election is timely made under Code § 6226(a), the partnership shall no longer be responsible for paying the imputed underpayment for the relevant year.

The "push out" election is made by the partnership.[37] The partnership will issue a "statement" (essentially an amended Schedule K-1) to each of the <u>reviewed year</u> partners (i.e., the prior year partners).[38] The statements must be sent within 45 days of the date that the notice of final partnership adjustment is issued.[39] Each reviewed year partner will then have to report the audit adjustments on the partner's next filed return.[40] Each reviewed year partner will also have to account for additional tax liability for years between the reviewed year and the adjustment year related to the adjustments to tax attributes contained in the push out statement.[41] In other words, each reviewed year partner will recalculate its taxes, interest and penalties related to the review year and all intervening years affected by the audit, and pay all amounts due on its current year income tax return. All taxes, penalties and interest will be collected at the partner level.[42] Interest will be charged at a rate that is two percent (2%) higher than the interest rate to be applied had the partnership paid the interest at the partnership level.[43] Unless the partner is the partnership representative, a reviewed partner will have no ability to challenge the reviewed year assessment or any related interest or penalties.[44] Further, a reviewed year partner may not even have notice of the assessment until a statement arrives on the partner's doorstep.

As stated above, it is not yet clear whether a partner will be subject to net investment income taxes under Code § 1411 *et seq.* and the self-employment tax under Code § 1401 *et seq.* However, because all partnership items would be reflected on the push out statement and the new items are to be considered on the reviewed partner's individual return, these taxes would seem to apply to the reviewed partner when a push out election is made.

The centralized partnership audit regime is silent as to what happens when an upper-tier partnership receives a statement from a lower-tier partnership. The Bluebook provides that the upper tier partnership is treated as an individual and must pay the tax related to the push out statement that it received from the audited partnership.[45]

It is likely that many partnerships will use the push out option if they cannot elect out of the centralized partnership audit regime altogether. Under the push out approach, the reviewed year partners would bear

[36] Code § 6226.
[37] Id.
[38] Code § 6226(a)(2).
[39] Code § 6226(a)(1).
[40] Code § 6226(b).
[41] Code § 6226(b)(3).
[42] Code § 6226(c).
[43] Code § 6226(c)(2)(C).
[44] Code § 6223(b).
[45] Bluebook (JCS-1-16) at p. 70.

the economic costs of the audit. However, whenever that is possible, partnerships may try to elect out of the centralized partnership audit regime altogether.

Certain Partnerships May Elect Out of the Centralized Partnership Audit Regime under Some Circumstances

Certain partnerships may be able to elect out of the centralized partnership audit regime under some circumstances.[46] A partnership that has (a) one hundred (100) or less direct or indirect partners; (b) all of the partners are individuals, C corporations, S corporations, foreign corporations treated as C corporations, or deceased partners' estates; (c) a timely election is made; and (d) the partnership has notified the partners of the election, may elect out of the centralized partnership audit regime.[47]

If a partnership has fewer than 100 "statements", it may be able to elect out of the new rules.[48] Therefore, correctly counting "statements" will be quite important. Generally, there will be one statement for each partner. Look through rules apply to each S corporation partner.[49] The S corporation and each of the S corporation's individual shareholders will also count as a statement.[50]

The partners in a partnership that wants to elect out must be individuals, C corporations, S corporations, foreign corporations, or deceased partners' estates.[51] Trusts (including grantor trusts), partnerships, and limited liability companies taxed as partnerships are notably absent from the list. This would seem to preclude all tiered partnerships from electing out of the centralized partnership audit regime. However, centralized partnership audit regime does grant the IRS the authority to identify additional allowable partners.[52] The Joint Tax Committee's Bluebook anticipates that provisions will be made for trusts (including grantor trusts) and other partnerships.[53] The Bluebook also provides that a REIT taxed as a C corporation is an eligible partner.[54]

Because partnerships having trusts (including grantor trusts), partnerships, or limited liability companies taxed as partnerships as partners are not currently eligible to elect out of the centralized partnership audit regime treatment, many partnerships—including many small partnerships—will be precluded from electing out of the centralized partnership audit regime.

The election to elect out of the centralized partnership audit regime will be made annually on a timely filed partnership income tax return.[55] The election is only valid for one year.[56] Therefore, a partnership will have to decide each year whether or not to elect out of the centralized partnership audit regime treatment. If the partnership fails to timely file its income tax return, it will subject to centralized partnership audit regime for that year. The relevant partnership income tax return must disclose the name and taxpayer

[46] Code § 6221(b).
[47] Code § 6221(b)(1).
[48] Code § 6221(b)(1)(B).
[49] Code § 6221(b)(2).
[50] Bluebook (JCS-1-16) at p. 59.
[51] Code § 6221(b)(1)(C).
[52] Code § 6221(b)(2)(C).
[53] Bluebook (JCS-1-16) at pp. 60-61.
[54] Bluebook (JCS-1-16) at p. 58.
[55] Code § 6221(b)(1)(D).
[56] Id.

identification number of each partner.[57] The partnership must also disclose the name and taxpayer identification number of each shareholder in any S corporation that is a partner.[58]

If the partnership elects out of the centralized partnership audit regime, the pre-TEFRA rules will then apply. In other words, each partner will be audited separately. Each partner may then bear the cost for the audit personally and may not be subject to the same adjustments as the other partners, if any. This could be an administrative burden which would cause a small partnership to not make the election. Rather, the small partnership would utilize the centralized partnership audit regime and make a push out election.

A Partnership May File an Administrative Adjustment Request Whenever a Centralized Partnership Audit Regime Audit Results in a Decrease of Income or an Increase in Deductions

An imputed underpayment anticipates that there will be additional income taxes assessed. However, not every audit results in a tax assessment. Therefore, centralized partnership audit regime also provides for the possibility that a partnership adjustment may reduce the amount of income or increase the amount of deductions initially reported by the audited partnership. A partnership may file an administrative adjustment request ("AAR") whenever a centralized partnership audit regime audit results in a decrease of income of an increase in deduction reported.[59] An individual partner may not file an AAR.[60] The IRS will consider the changes as made in the year the AAR is filed.[61] The AAR must be filed within three years of filing the reviewed year partnership tax return (without extensions) or three years from the date that the reviewed year partnership tax return was actually filed.[62]

In other words, after centralized partnership audit regime become effective, a partnership will no longer file amended income tax returns or issue amended Schedules K-1 to partners who must then file their own amended income tax returns.[63] (Note, however, the push out "statements" appear to be similar to Schedules K-1 despite the difference in nomenclature.) If an imputed underpayment occurs as a result of filing the AAR, the partnership will pay the resulting tax.[64]

Strong Consistency Rules Still Apply to All Partners

TEFRA provided for strong consistency rules which required partners to file their respective tax returns consistently with the relevant partnership return or notify the IRS of the inconsistency. Strong consistency rules still apply under the new centralized partnership audit regime.[65] Inconsistent positions taken by

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[57] Code § 6221(b)(1)(D)(ii).
[58] Code § 6221(b)(2).
[59] Code § 6227.
[60] Id.
[61] Code § 6227(b).
[62] Code § 6227(c).
[63] Bluebook (JCS-1-16) p. 82.
[64] Id.
[65] Code § 6222.

partners on their individual tax returns must be reported and may treated as math errors and may be corrected without challenge.[66]

The Appointment of a Partnership Representative under Code § 6223 Will Be a Critical Decision

One of the most important aspects of the centralized partnership audit regime is the creation of a "partnership representative".[67] Every partnership should have one, even when the partnership intends to elect out of the centralized partnership audit regime treatment. If the partnership does not designate a partnership representative, the IRS may select one.[68]

All communications to and from the IRS will go to the partnership representative. Unlike a "tax matters partner" under TEFRA, a partnership representative will have complete authority vis-a-vis the IRS.[69] If centralized partnership audit regime applies, the partnership representative will have the sole and exclusive authority to act on behalf of the partnership and to bind all partners.[70] Under Code § 6223, partners will not be allowed to participate in audits and are not required to receive notice. Because of the partnership representative's total control over the audit process, the partners will want to be very careful in who they select and may want to list duties and obligations owed to the partners under the relevant partnership agreement.

A partnership representative may be an individual or an entity.[71] A partnership representative need not be a partner.[72] The partnership representative must have substantial presence in the United States.[73]

Technical Corrections Act of 2016 Introduced But Not Enacted

After the BBA was passed, it became clear that Congress intended to make changes to it. The Technical Corrections Act of 2016 ("Technical Corrections Act")[74] was introduced on December 6, 2016, but was not enacted before the end of the legislative cycle. It is anticipated that the technical corrections ("Technical Corrections") will be re-introduced in the current Congress in 2017.

The Technical Corrections Act makes several key changes. First, the definition of "partnership adjustment" under Code § 6241(2)(B) would be broadened to include "partnership-related items". "Partnership-related items" would mean any item or amount with respect to the partnership which is relevant in determining the income tax liability of any person and any partner's distributive share.[75] The

[66] Id.
[67] Code § 6223(a).
[68] Id.
[69] Code § 6223(b).
[70] Id.
[71] Code § 6223(a).
[72] Id.
[73] Id.
[74] H.R. 6439 (114th).
[75] Technical Corrections Act of 2016, H.R. 6439 (114th), § 201 (amending Code § 6241(2)(B)).

definition would include any transaction with, basis in, or liability of the partnership.[76] The term would apply without regard to whether or not such item or amount appears on the partnership's return.[77]

Second, the imputed underpayment calculation would be changed so that items of different character (e.g., capital v. ordinary) would not be netted together in calculating the imputed underpayment.[78] The imputed underpayment calculation would be changed so that any decrease in the amount of the imputed underpayments which is subject to an additional limitation (e.g., passive loss limitations) shall not be considered except to the extent provided in future regulations.[79]

Third, the Technical Corrections Act adds a "Pull In" alternative under Code § 6225(c)(2)(B).[80] In lieu of a modification involving amended partner tax returns, the revised Code § 6225(c)(2)(B) would allow partners to simply substantiate the taxes that would be due if they had file amended returns provided that they pay their taxes and adjust their tax attributes (e.g., net operating losses) for subsequent years.[81] No amended returns need be filed by the reviewed year partners.[82] The reviewed year partners would still pay the taxes due, make the corresponding changes to subsequent years, and provide information to the IRS that their taxes were accurately paid.[83] If the partners' distributive shares are changed, all affected partners must follow these procedures.[84]

Fourth, Technical Corrections Act would amend Code § 6226(b) to allow upper tier partnerships to make a "push put" election.[85] Each upper tier partnership must file "partnership adjustment tracking report" with the IRS.[86] Upon receiving a push out notice from a partnership, the upper tier partnership must pay its share of the imputed underpayment or provide push out statements to its partners.[87] Under this approach, it would possible to push out the imputed underpayment all the way through the various tiers to the ultimate taxpayers.[88] Note that a tracking report is not an amended tax return.[89] It is not clear how the 45-day period related to the issuance of the original notice of final partnership adjustment would apply.

Finally, Technical Corrections Act would authorize the Secretary to issue separate regulations related to foreign partnerships.[90] Foreign partnerships will eventually have their own special rules.[91]

The provisions of the Technical Corrections Act are not yet law. However, the adoption of such provisions is still expected in 2017. Until such changes are enacted, however, the current situation remains murky, particularly regarding multi-tiered partnerships.

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[76] Id.
[77] Id.
[78] Technical Corrections Act of 2016, H.R. 6439 (114th), § 202 (amending Code § 6225(b)).
[79] Id.
[80] Technical Corrections Act of 2016, H.R. 6439 (114th), § 203 (amending Code § 6225(c)).
[81] Id.
[82] Id.
[83] Id.
[84] Id.
[85] Technical Corrections Act of 2016, H.R. 6439 (114th), § 204 (amending Code § 6226(b)).
[86] Id.
[87] Id.
[88] Id.
[89] Id.
[90] Technical Corrections Act of 2016, H.R. 6439 (114th), § 206 (amending Code § 6241(10)).
[91] Id.

Proposed Regulations Explaining Centralized Partnership Audit Regime Were Issued and Then Withdrawn in January 2017

The Secretary drafted 277 pages of proposed regulations[92] ("Proposed Regulations") explaining centralized partnership audit regime. The Proposed Regulations were sent to the Federal Register on January 18, 2017, but were withdrawn on January 20, 2017, in conformance with President Trump's executive order. The Proposed Regulations were re-issued on June 13, 2017, and published in the Federal Register on June 14, 2017.

The Proposed Regulations Take a Broad View of What Will Be Subject to Audit under Centralized Partnership Audit Regime

Prop. Reg. § 301.6221(b)-1 provides that all items on a partnership income tax return; all information in a partnership's books and records related a determination of the items on such tax returns; and all factors that affect the determination of items of income, gain, loss, deduction or credit (including elections and capital accounts), are subject to determination and adjustment at the partnership level under the new regime.

Imputed Underpayment Calculations Are Clarified under Prop. Reg. § 301.6225-1

Code § 6225(b) provides that an imputed underpayment is computed by: (a) netting all adjustments of income, gain, loss or deduction, and (b) multiplying such net amount by the highest rate of tax in effect for the reviewed year under Code § 1 or § 11. After netting the changes and applying the highest tax rate, the IRS will then consider the net credits.[93] Each imputed underpayment is considered year by year, even when the audit involves more than a single year.[94]

Prop. Reg. § 301.6225-1 addresses how the netting process is to occur under Code § 6225(c). Adjustments will first be separated into one of four groupings.[95] Adjustments that involve reallocating items among partners will be included in the "reallocation grouping".[96] Adjustments related to credits will be included in the "credit grouping".[97] Creditable expenditures will be included in the "creditable expenditure grouping".[98] All other adjustments will be consolidated into the "residual grouping".[99]

The residual grouping may be further divided into subgroupings according to any limitations or restrictions such as character or holding period.[100] In other words, capital items will be separated from ordinary

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[92] REG-136118-15.
[93] Prop. Reg. § 301.6225-1(c).
[94] Prop. Reg. § 301.6225-1(c)(4).
[95] Prop. Reg. § 301.6225-1(d).
[96] Id.
[97] Id.
[98] Id.
[99] Id.
[100] Id.

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income items; qualified dividends should be separated from other dividends, and long-term items will be separated from short-term items. Once each grouping or subgrouping is netted, the net adjustment will be positive or negative. If the net adjustment is positive, the balance will multiplied by the highest applicable tax rate and become an imputed underpayment.[101]

With regard to the reallocation grouping, if a change in distributive shares occurs, the imputed underpayment calculation will only consider the increases, not the decreases.[102] This approach puts the partner whose taxes would be reduced in a precarious position. Because the statute of limitations may close on the partner's potential refund, such partner should immediately file a protective refund claim before the statute of limitation period expires. Note that modifications do not help in situations where partners' distributive shares are changed. However, if a partnership elects to push out all of the partnership adjustments to the reviewed year partners, including any changes in distributive shares, the partners can avoid such troublesome mismatches.

If the rules described above are not sufficiently complex, imputed underpayments will also be separated between "specific" and "general" imputed underpayments.[103] A "specific" imputed underpayment relates to an item that was allocated to a partner or partners with similar characteristics or participated in a similar transaction.[104] A partnership may have more than one specific imputed underpayment.[105] The "general" imputed underpayment is the aggregate of all adjustments that were not considered when computing the "specific" imputed understatement or understatements.[106] The various treatments and elections will be applied separately to each imputed underpayment independently, regardless of whether it is a specific or general imputed underpayment.[107]

The Proposed Regulations do not address adjustments to partners' outside bases, partners' capital accounts, the partnership's basis in property, or the partnership's book value in property.[108] This lack of direction will undoubtedly cause significant anxiety when preparing tax returns until these issues are resolved.

If a partnership "ceases to exist", the adjustment year partners will be the partners at that time.[109] The term "ceases to exist" means terminates or does not have the ability to pay in full any amount that partnership owes under centralized partnership audit regime.[110]

Any adjustment which does not result in an imputed underpayment is taken into account by the partnership year in the adjustment year—not the reviewed year.[111] This can obviously result in an unfair mismatch of adjustments between the reviewed year and adjustment year partners.

The Proposed Regulations also further clarify the modification provisions under Code § 6225(c).[112]

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[101] Prop. Reg. § 301.6225-1.
[102] Prop. Reg. § 301.6225-1(c)(2).
[103] Prop. Reg. § 301.6225-1(e)(2).
[104] Id.
[105] Id.
[106] Id.
[107] Prop. Reg. § 301.6225-1(e).
[108] Prop. Reg. § 301.6226-4.
[109] Prop. Reg. § 301.6241-3.
[110] Id.
[111] Prop. Reg. § 301.6225-1(b).

The Proposed Regulations Expand on the Modification Rules Described in Code § 6225(c)

The issuance of a notice of proposed partnership adjustment starts the 270-day clock for the period of modification.[113] Extensions of the 270-day period to modify an imputed underpayment will be possible with IRS' consent.[114]

The partnership representative may request any type of modification.[115] Only a partnership representative can request a modification.[116] The partnership representative may also request multiple types of modifications.[117] In order to utilize modifications, the partnership must substantiate the facts supporting each request for a modification.[118] The partnership must timely provide information that the IRS deems necessary to substantiate the modification or the IRS will deny the modification.[119] The IRS must approve the modification before the modification will be considered.[120]

In no event may a modification based on a tax rate be lower than the highest rate with respect to the respective type of income or partner.[121]

Tax exempt partners must show that they are not subject to unrelated business taxable income treatment in order to get tax exempt treatment under the modification rules.[122]

Modifications based on amended returns filed by reviewed year partners are only allowed when amended returns for reviewed year and all modification years have been filed and all related taxes have been paid.[123] The partnership representative must then file an affidavit with the IRS under penalties of perjury that such returns have been filed and paid within the 270-day statutory period.[124] The partnership representative will obviously need written proof of filing and payment before the partnership representative is willing to execute an affidavit under oath.

In tiered situations, modifications related to tax returns filed "indirect partners" will be considered whenever the indirect partners file amended returns for the reviewed year and all modification years and pay the related taxes.[125] "Indirect partners" who are tax exempt or foreign persons will also be eligible for modification for tax exempt partners.[126]

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[112] Prop. Reg. § 301.6225-2.
[113] Code § 6225 and Prop. Reg. § 301.6225-2(c)(3).
[114] Id.
[115] Prop. Reg. § 301.6225-2(a).
[116] Id.
[117] Prop. Reg. § 301.6225-2(d)(1).
[118] Prop. Reg. § 301.6225-2(c)(2).
[119] Id.
[120] Prop. Reg. § 301.6225-2(b)(1).
[121] Prop. Reg. § 301.6225-2(d)(4).
[122] Prop. Reg. § 301.6225-2(d)(3).
[123] Prop. Reg. § 301.6225-2(d)(2).
[124] Id.
[125] Prop. Reg. § 301.6225-2(d)(2)(C)(vii).
[126] Id.

In addition to clarifying the modification rules, the Proposed Regulations expand on the push out election rules under Code § 6226.[127]

The Proposed Regulations Expand on the Push Out Rules Described in Code § 6226

Prop. Reg. § 301.6226-1 addresses the issues related to the push out election. The push out election is made by the partnership representative.[128] However, the Preamble provides that no second level push out election is allowed.[129] An upper tier partnership may only use modifications at the upper tier level. This will be a major issue with multi-tiered partnerships.

The push out election must be filed within forty-five (45) days after the notice of final partnership adjustment is mailed.[130] The filing deadline may not be extended.[131]

If a push out election is timely made, the partnership is no longer liable for the imputed underpayment to which the election applies.[132]

The push out statements will provide an adjustment-by-adjustment description of the partnership items.[133] The push out statements sent by the partnership to the reviewed year partners are binding.[134] The push out statements must be furnished to the reviewed year partners within sixty (60) days after the partnership adjustments finally determined.[135] The push out statements are to be mailed to the last known address of reviewed year partners.[136] If a statement is returned as undelivered, the partnership must be reasonably diligent about finding an updated address.[137] A partnership can send corrected push out statements if the statements are sent within sixty (60) days after the partnership adjustments finally determined.[138] After sixty (60) days, corrected push out statements may only be issued with the IRS' consent.[139] However, the IRS may require that corrected push out statements be issued whenever the IRS discovers an error.[140]

In addition to providing each reviewed year partner with a statement, the partnership must provide each partner with a "safe harbor" tax obligation and interest calculations computed in accordance with Prop. Reg. § 301.6225-1.[141] Each partner may elect to pay the safe harbor tax and interest in lieu of recalculating its tax and interest liabilities after considering the information provided on its push out

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[127] Prop. Reg. § 301.6226-1.
[128] Prop. Reg. § 301.6223-1(c)(4).
[129] Prop. Reg. Preamble at pp. 125-129; and Bluebook (JCS-1-16) at p. 70.
[130] Prop. Reg. § 301.6226-1(c)(3).
[131] Id.
[132] Prop. Reg. § 301.6226-1(a).
[133] Prop. Reg. § 301.6226-2.
[134] Prop. Reg. § 301.6226-1(b) and (d) .
[135] Prop. Reg. § 301.6226-2(c).
[136] Prop. Reg. § 301.6226-2(b)(2).
[137] Id.
[138] Prop. Reg. § 301.6226-2(d)(2)(i).
[139] Prop. Reg. § 301.6226-2(d)(2)(ii).
[140] Prop. Reg. § 301.6226-2(d).
[141] Prop. Reg. § 301.6226-2(g).

statement.[142] This election may appeal to a partner whose safe harbor amounts are less than the costs of preparing amended income tax returns for the reviewed year and all intervening years.

The Proposed Regulations Try to Limit the Number of Partnerships That Are Eligible to Elect Out of the Centralized Partnership Audit Regime

The IRS is clearly hostile to partnerships who want to elect out of the centralized partnership audit regime.[143] The IRS states specifically that electing out will not change likelihood of audit.[144] Further, the IRS will carefully review a partnership's decision to elect out of the centralized partnership audit regime to ensure that the elect out election is not being used solely to frustrate IRS compliance efforts.[145] For example, the IRS is not expected to allow splitting off new partnerships in order to reduce the number of partners in each partnership to an acceptable number. The IRS may also treat sister partnerships as a single entity.[146]

Although the Joint Tax Committee Bluebook anticipates that provisions will be made to allow trusts and other partnerships to become eligible partners, Prop. Reg. § 301.6221(b)-1(b)(3)(ii) provides that partnerships, LLCs taxed as partnerships, trusts, foreign entities that are not treated as C corporations, certain disregarded entities, estates that are not estate of a deceased partner (e.g., bankruptcy estates), and nominees ARE NOT ELIGIBLE PARTNERS. Further, when an upper tier partnership receives a push out statement, the upper tier partnership must report the partnership adjustments and pay the resulting taxes, interest and penalties at the partnership level—even when the upper tier partnership has elected out of the centralized partnership audit regime.[147]

Prop. Reg. § 301.6221(b)-1(c) provides the time, form and manner for electing out of the centralized partnership audit regime treatment. The election is made on a timely file partnership income tax return (including extensions).[148] All of the requirements must be met for the election to be valid.[149] The partnership must notify each partner within thirty (30) days of making election.[150] The form of the notice is not mandated.[151] When an S corporation is a partner, information related to each S corporation shareholder must also be provided with the election.[152] Once an election to elect out is made, the election cannot be revoked without IRS consent.[153]

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[142] Prop. Reg. § 301.6226-3(c).
[143] Prop. Reg. Preamble at pp. 44-45.
[144] Id.
[145] Id.
[146] Id.
[147] Prop. Reg. § 301.6221(b)-1(d).
[148] Prop. Reg. § 301.6221(b)-1(c).
[149] Id.
[150] Id.
[151] Id.
[152] Id.
[153] Id.

Prop. Reg. § 301.6222-1 Underscores That Consistency Rules Stay in Place

The Proposed Regulations reinforce the proposition that the rules that require consistency in reporting will still apply.[154] Inconsistent positions filed by partners may be treated as math errors and can be corrected without challenge.[155] Consistency in reporting among the partners will continue to be maintained.[156]

Prop. Reg. § 301.6227-1 Expands on the Rules Related to Administrative Adjustment Requests

Only the partnership may file an AAR.[157] The AAR must filed by the partnership representative.[158] If the partnership adjustments included in the AAR do not result in an imputed underpayment, the partnership must issue a statement to the reviewed year partners.[159] The reviewed year partners must then take into account their shares of the partnership adjustments.[160] Whenever the partnership adjustments results in an imputed underpayment, the partnership must pay the resulting tax unless a push out election is made under Prop. Reg. § 301.6227-1.[161]

Prop. Reg. §§ 301.6223-1 and 301.6223-2 Enhance the Importance of the Partnership Representative

A partnership representative has sole authority to deal with the IRS on behalf of the partnership.[162] No partner may participate in an audit or other proceeding involving the partnership.[163]

The partnership representative can bind the partnership and all of the partners without any input from any partner.[164] The partnership representative's decisions are final with respect to IRS audits.[165] Such decisions include settlement agreements, extending the statute of limitations by agreement, waiving defenses changes (including penalties), and failing to contest a notice of final partnership adjustment.[166] Only a partnership representative may request a modification under Prop. Reg. § 301.6225-2(a).[167] Only a partnership representative my make the push out election.[168]

[154] Prop. Reg. § 301.6222-1(a)(1).
[155] Prop. Reg. § 301.6222-1(b).
[156] Prop. Reg. §§ 301.6222-1(c) and 6223.
[157] Prop. Reg. § 301.6227-1(a).
[158] Id.
[159] Prop. Reg. § 301.6227-1(d).
[160] Prop. Reg. § 301.6227-1(f).
[161] Prop. Reg. § 301.6227-1(a).
[162] Prop. Reg. § 301.6223-2.
[163] Id.
[164] Id.
[165] Id.
[166] Id.
[167] Id.
[168] Id.

If the partnership representative changes, the succeeding partnership representative cannot invalidate the prior partnership representative's decisions.[169] A partnership representative may name his or her own replacement.[170]

A partnership representative may an entity.[171] If an entity is designated, the entity must then appoint a designated individual to act on behalf of the entity partnership representative.[172] The designated individual must meet the same requirements as a personal representative.[173] The designated individual must be appointed at the same time as the entity partnership representative is designated.[174] The failure to appoint a designated individual may cause the IRS to find that the partnership representative designation is not in effect.[175]

If a partnership fails to timely appoint a partnership representative, the IRS may designate any person to be the partnership representative.[176] However, the IRS will consider whether the person is partner in the partnership and other factors listed in Prop. Reg. § 301.6223-1(f)(ii) before appointing a partnership representative.[177]

With respect to the IRS, the authority of a partnership representative may not be limited by state law or contractual agreement.[178] In other words, state law fiduciary duties to partners and any restrictions on the partnership representative under the relevant partnership agreement or LLC operating agreement will not be binding on the IRS. If the personal representative breaches the partnership agreement or the LLC operating agreement, the partnership representative may be accountable to his or her partners. However, the actions taken by the partnership representative vis-à-vis the IRS remain valid and enforceable by the IRS.[179]

The personal representative is designated on a year by year basis.[180] The designation is made on the partnership's annual tax return and is effective on the date that the tax return is filed.[181] A designation remains in effect until a valid resignation occurs, a valid revocation occurs, or a determination is made the IRS that a designation is not in effect.[182] A partnership representative may only resign or be replaced after (a) the issuance of notice of administrative proceeding, (b) the filing of an AAR, or (c) as otherwise prescribed by the IRS.[183]

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[169] Id.
[170] Prop. Reg. § 301.6223-1.
[171] Prop. Reg. § 301.6223-1(b).
[172] Prop. Reg. § 301.6223-1(b)(3).
[173] Id.
[174] Id.
[175] Id.
[176] Prop. Reg. § 301.6223-1(f).
[177] Id.
[178] Prop. Reg. § 301.6223-2(a).
[179] Id.
[180] Prop. Reg. § 301.6223-1(c).
[181] Id.
[182] Prop. Reg. § 301.6223-1(a).
[183] Prop. Reg. § 301.6223-1(d).

A partnership representative who does not have “capacity” becomes ineligible to act.[184] A partnership representative or designated individual lacks “capacity” to act if he or she (a) is dead, (b) has been adjudicated so by a court, (c) has been enjoined from acting by a court order, (d) is incarcerated, (e) has been liquidated or dissolved under state law, or (d) has been reasonably determined by the IRS to lack capacity.[185]

Each partnership representative must have a U.S. mailing address, a U.S. telephone number, and a U.S. taxpayer identification number (“TIN”).[186] Each partnership representative must be able to meet with IRS in the U.S.[187]

Although Comprehensive, the Proposed Regulations Do Not Address Many Issues

Many key issues are not addressed by the Proposed Regulations. For example, the issues of outside basis, capital accounts, net investment income taxes, self-employment taxes, withholding taxes, and international implications are not yet addressed.[188]

The Impact of the Centralized Partnership Audit Regime on the States Is Not Clear

Like partnerships, states are unsure what centralized partnership audit regime may mean. Some states will conform to the federal rules or piggyback on the federal audit changes. Some states may address the situation through legislation. Some states have their own partnership audit rules. The Multistate Tax Commission has opened a project to address conformity issues, but no results have yet been issued. Hopefully, the Multistate Tax Commission will address the following issues, among others:

1. Will a separate partnership representative be appointed for each state?
2. How would an imputed underpayment be calculated at a state level?
3. Will it be possible to modify the imputed underpayment on a state by state basis?
4. With regard to the push out election, what happens when a partner changes its residence between the reviewed year and adjustment year?
5. What happens if the partnership filed a composite tax return in the reviewed year?
6. What happens when no state tax return was originally filed by the partnership?
7. Will states allow amended tax returns or piggyback on federal AARs?

[184] Id.

[185] Id.

[186] Prop. Reg. § 301.6223-1(b)(2).

[187] Id.

[188] Prop. Reg. Preamble at pp. 34-35.

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Implications of New Audit Rules

It is absolutely clear that all existing partnership agreement and LLC operating agreements will need to be amended, at least in part, before January 1, 2018. It is also absolutely clear that practitioners must revise their drafting terms on a prospective basis. A blanket approach to drafting will not be available going forward.

TEFRA Provisions Will Need to Remain in Partnership Agreements throughout the Transition Period

The centralized partnership audit regime does not apply until a partnership tax year begins after 2017.[189] The standard statute of limitations period related to a partnership's income tax return is three years.[190] Therefore, a partnership that reports income taxes on a calendar year basis and timely files an extended 2017 federal tax return will continue to use the TEFRA rules until as late as 2021. This means that the TEFRA provisions in a partnership agreement or LLC operating agreement will need to remain in place until the statute of limitations for the final TEFRA year expires. However, the relevant agreement will need to sunset the TEFRA provisions under the relevant partnership agreement or LLC operating agreement.

A True Up Mechanism Will Be Needed When Taxes Are Paid at the Partnership Level

If a partnership pays an imputed underpayment, the payment is treated as a non-deductible expense of the partnership.[191] Presumably the payments will be attributed to the partners in accordance with their partnership percentages. However, what happens if the percentages have changed between the reviewed year and the adjustment year? What happens when there is a waterfall of allocations which makes it impossible to simply allocate the payments to the adjustment year partners on a pro rata basis? A true up mechanism will need to carefully considered and even more carefully drafted.

What happens when the imputed underpayment is modified in accordance with Code § 6221(c)? A true up mechanism will be even more important when an imputed underpayment is modified. The benefits of the various modifications will need to be specially allocated to the partners who were responsible for such modifications. For example, no portion of an imputed underpayment should be allocated to a tax-exempt entity so long as it is not unrelated table business income.

A Special Contribution Provision May Be Needed When Taxes Are Paid at the Partnership Level

If a partnership is assessed with an imputed underpayment, the payment of the resulting taxes must come from the partnership. When the partnership has insufficient liquid resources with which to pay the taxes, it will need to borrow the money or demand additional contributions from its adjustment year partners. Who will decide whether to borrow or raise capital? If the general partner or LLC manager

[189] P.L. 114-74 § 1101(c)(1).
[190] Code § 6229 applicable prior to BBA; Code § 6235.
[191] Prop. Reg. § 301.6241-4.

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makes the decision, does the partnership representative need to coordinate with that person if they are not the same individuals? When should notice be given to the adjustment year partners? What happens when an adjustment year partner fails to timely contribute money or fails to contribute money altogether? Because the imputed underpayment must be "trued up" among the partners, the contribution percentages will need to reflect the same "true up" percentages, too.

Provisions Related to Modifications of the Imputed Underpayment Will Be Needed Unless a "Push Out" Election Is Mandated in the Agreement

Not only will the partnership representative negotiate the imputed underpayment, the partnership representative will decide what modifications, if any, should be utilized to decrease the exposure of the adjustment year partners. If the partnership representative decides that modifications are appropriate, information and actions will be needed from the various partners. The partnership agreement or LLC agreement will need to create a duty to cooperate and provide for consequences if such cooperation is not forthcoming in a timely fashion. The partners should also be subject to a best efforts obligation to provide the needed information or actions. When reviewed partners are not partners in the adjustment year, the partnership agreement or LLC operating agreement must provide that such obligations survive until the applicable statute of limitations has expired (including extensions agreed to be the partnership representative). In return, the partners are going to want notice and perhaps vote on which modifications are desired. What votes are appropriate, when, and after what notice? How will you count votes when adjustment year partners and reviewed year partners are each affected?

One modification choice allows the reviewed year partners to file amended tax returns and pay the resulting tax within 270 after a notice of proposed partnership adjustment has been issued. Such payments then reduce the imputed underpayment. In order to support an offset for an amended tax return, the partnership representative will need to be provided with a copy of the amended return, proof of its filing, and proof of payment. The partnership or LLC agreement can require such information, but what partner wants to share its own tax return with its partner or partners? Who pays the imputed underpayment when one or more of the partners fails to timely cooperate? It would appear that the "true up" of the taxes related to the imputed underpayment will then need to be adjusted.

Similar issues may apply with regard to modifications based on tax rates. However, tax exempt partners and C corporation partners will be less shy about providing support for proof of their respective tax statuses and highest applicable income tax rates.

In lieu of such provisions, would it be better to for the partnership agreement or LLC operating agreement to simply provide that the partnership representative must elect to "push out" the partnership adjustments to the reviewed year partners on a mandatory basis?

The "Push Out" Election Provisions Will Need to Be Included in the Agreement

One way to ensure that the reviewed year partners bear the economic burden of the imputed underpayment is to elect to push out the partnership adjustments to the reviewed year partners. The first question raised is whether or not the push out election should be mandatory. In some years, the imputed adjustment may be sufficiently small that it would be more cost effective to pay the imputed

underpayment at the partnership level. Therefore, should a *de minimus* exception to the mandatory rule be included in the partnership agreement or LLC operating agreement?

Note that a push out election is not currently available to an upper tier partnership that receives a push out statement from the lower tier partnership. This may change if the Technical Corrections provisions are signed into law.

When there is a change in the partners' distributive shares between the reviewed year and the adjustment year, the push out election should be mandatory. This provision is necessary because the imputed underpayment calculations only consider increases, not decreases, in the partnership adjustments.[192]

Assuming that the push out election is made, do the adjustment year partners and reviewed year partners get prior notice? When?

Everyone knows that cash is king. When a push out election is made, will the partnership agreement or LLC operating agreement provide for a tax distribution? At what tax rate or amount? If a reviewed year partner has partnership obligations which survive its exit from the partnership, will the partnership's obligation to make tax distributions to the reviewed year partner also survive?

The push out election must be made within forty-five (45) days after the Notice of Final Adjustment is issued. What are the consequences when the personal representative fails to timely make the election? Would it make sense to include the modification provisions discussed above in the partnership agreement or LLC agreement just in case such event occurs?

Electing Out of the Centralized Partnership Audit Regime May Not Be That Simple

When a partnership is composed of eligible partners, it may elect out of the centralized partnership audit regime if it would issue less than 100 statements.[193] Should the election out be mandatory or on a year-by-year basis. If the decision is to be made annually, who will make the decision? If the partners vote, what percentage of the partnership interests is appropriate? Will the partnership representative be bound by the decision? What happens should the partnership representative fail to abide by the decision? Will the personal representative be bound by the vote for purposes of personal liability?

When a partnership has less than the maximum allowed statements and is composed of eligible partners, will the partnership agreement or LLC operating agreement limit transfers to ineligible partners and/or limit the total number of partners needed to remain under 100 statements.

Whenever an election out of the centralized partnership audit regime is made, the partnership or LLC operating agreement must bind the partners to timely provide the partnership representative with the required information needed to make the election out, including information about the shareholders of each S corporation that is a shareholder. Each partner must have a duty to cooperate and to use its best efforts to provide such information. Consequences must occur if an election out fails to occur because a partner fails to provide the necessary information timely.

[192] Code § 6625(b)(2) and Prop. Reg. § 301.6225-1(d)(2)(ii).
[193] Code § 6221(b).

If a partnership elects out of the centralized partnership audit regime, the IRS may audit one or more of the partners individually. The partners may want to impose a duty to cooperate and shares information among the partners and the partnership in such situations in order to minimize the costs related to such audits and maximize the consistency of results among the audited partners.

A Partnership May File an Administrative Adjustment AAR Rules

As noted above, a partnership will no longer file an amended return under centralized partnership audit regime.[194] Who will decide when to file an AAR and under what circumstances? Will the general partner or the LLC manager make the decision? Will the partnership representative make the decision? If the partners are going to vote, what percentage of the partnership interests is appropriate? Will the partnership representative be bound by the decision? What happens should the partnership representative fail to abide by the decision? Will the personal representative be bound by the vote for purposes of personal liability?

As you can see, the role of the personal representative will be critical in each partnership and LLC taxed as a partnership.

Partnership Representative Provisions Need to Be Included in All Agreements Now

It would be prudent to included partnership representative provisions in every partnership agreement or LLC operating agreement now. This is true even when the partners and partnership anticipate electing out of the centralized partnership audit regime every year. First, the partnership may inadvertently fail to make an election to timely elect out of the centralized partnership audit regime. Remember that the election is made annually. It is possible that a partnership's income tax return is not filed timely. Second, the IRS may challenge the partnerships elect out election.

With regard to a partnership that cannot or does not elect out of the centralized partnership audit regime, the role of partnership representative will be absolutely critical. The partnership representative defends the partnerships tax returns; negotiates the imputed underpayment; decides whether to argue before the IRS appeals division; determines whether or not to litigate the matter; decides whether to extend the statute of limitations; determines what, if any, modifications will be considered; and decides whether or not to elect to push out the partnership adjustments to the reviewed year partners. When a partner's partnership interest is changed, it will be particularly important to notify any partner that will need to file a protective refund claim.

Should the partnership representative take any action or omit any action in contravention of the partnership agreement or LLC operating agreement, the IRS still believes that the partnership representative's decisions are binding on all partners.[195] Therefore, the partners are putting a lot of trust in one person.

Obviously, the partnership agreement or LLC operating agreement must appoint an initial partnership representative or provide a mechanism for appointing a partnership representative. The appointment can be year to year or until the partnership representative is replaced. Provisions for the resignation and

[194] Code § 6227.
[195] Code § 6223 and Prop. Reg. § 301.6223-2(a).

replacement of the partnership representative will also be needed. Remember that the IRS does not intend to allow a partnership representative to resign or be replaced until the notice of administrative proceeding is issued.[196] This may cause the relevant agreement provisions to be inconsistent with the Proposed Regulations. When an entity is named as the partnership representative, similar rules will need to be provided for naming the designated individual. Often, the general partner or LLC manager may be expected to concurrently act as the partnership representative.

The partnership or LLC operating agreement will need to clearly lay out the personal representative's duties. Duties of loyalty and due care would be expected. The partnership representative may be obligated to keep the partners reasonably informed, provide timely notice of the commencement of an audit, all notices issued by the IRS, and the imputed underpayment calculations; consult with the partners before making decisions, particularly with regard to elections; provide timely notice of all elections; and abide by the partnership agreement regarding the scope of the partnership representative's authority (particularly with regard to elections, settlements, and litigation. Similar rules would need to apply to the designated individual. Consequences would need to be defined whenever the partnership breaches the duties provided or fails to abide by the partnership agreement. Complete exoneration may be called for whenever a partnership representative acts in good faith and has not failed due to a negotiated standard such as negligence, gross negligence, willful disregard, or intentional act.

Need to include penalties in partnership agreement since IRS not bound if partnership representative fails to give notice, etc. Prop. Reg. § 301.3223-2.

Because of the numerous risks associated with acting as the partnership representative, every party acting as personal representative will want to see expansive exculpation and indemnification provisions in the partnership agreement or the services agreement if the partnership representative is not a partner. A designated individual will want similar language in the relevant agreement. A partnership representative and a designated individual may also want insurance coverage up to a negotiated limit. A partnership representative may also want to be compensated for its time and expertise.

Transfer Provisions Affecting Partnership and LLC Interests Will Need to Be Amended

Any party acquiring an interest in a partnership or an LLC taxes as a partnership will need to consider how Centralized partnership audit regime will be applied. If the partnership or LLC has elected out of the centralized partnership audit regime or has a mandatory push out provision in its partnership agreement or LLC operating agreement, the acquiring party (including the partnership itself) will understand that the risk of audit will remain on the reviewed year partners. However, unless a partnership properly elects out of the centralized partnership audit regime or the partnership elects to push out the partnership adjustments, the adjustment year partners may bear the economic costs associated with an audit. This has particular significance when partnership interests are transferred.

Unless the partnership agreement or LLC operating agreement provisions survive a transfer, a reviewed year partner will face no consequences related to a partnership audit. This is particularly important when a partner exits a partnership or changes its partnership interest percentage between the reviewed year and the adjustment year. A buyer, donee, or legatee may end up with an unexpected contingent liability

[196] Prop. Reg. § 301.6223-1(d).

under such circumstances. That is why these issues will now need to be addressed in partnership agreements (including abandonment and dissolution provisions); LLC operating agreements (including abandonment and dissolution provisions); purchase agreements; redemption agreements; and all other types of assignment documents. Indemnification provisions may be desired in such documents so that the reviewed year partner always remains responsible for taxes related to the reviewed year. The representations contained in such agreements may also need to be altered. Additional indemnification provisions should also be expected when an acquiring party is unwilling to assume the risks of audit for prior years.

Centralized Partnership Audit Regime Do Not Appear to Change the Rules Code § 704(b) and the Related Treasury Regulations

Every partnership must follow the capital account and allocation rules under Code § 704(b) and the related Treasury Regulations. Depending on the situation, the partnership adjustments and related imputed underpayment payments will affect the capital accounts of the adjustment year partners and/or the reviewed year partners. The Code § 704(b) capital account and allocation provisions in every partnership agreement and LLC agreement will need to be reviewed. Most will need to be amended to consider the implications of the centralized partnership audit regime.

Centralized Partnership Audit Regime Do Not Appear to Change the Rules Related to Outside Basis

Like the Code § 704(b) rules discussed above, centralized partnership audit regime do not appear to change the outside basis rules under Code §§ 723 and 737. The partnership adjustments and related imputed underpayment payments will affect the outside basis of the adjustment year partners and/or the reviewed year partners. Gains, losses, and depreciation may need to be recalculated as a result of the audit. It would appear that partners affected will report the changes to their respective outside bases and adjust their respective tax returns accordingly. Remember that income taxes paid by the partnership will be treated as a non-deductible expense.[197]

Conclusion

Simple fairness would seem to dictate that the reviewed year partners should bear the cost of an audit related to the reviewed year. Generally, this can only be accomplished by electing out of the centralized partnership audit regime or electing to push out partnership adjustment to the reviewed year partners. However, an upper tier partnership can apparently only accomplish this goal by electing out of the centralized partnership audit regime.

My first reaction to hearing about the centralized partnership audit regime was to say that most of my partnership clients will elect out of the centralized partnership audit regime. The partnerships that I represent are well within the statement limit. However, most of the partnerships that I represent are owned by grantor trusts, complex trusts, partnerships, and LLCs taxed as partnerships. Therefore, electing out of the centralized partnership audit regime will not be available to many partnerships owned by relatively small numbers of partners. I do not think that my experience is in any way unique.

[197] Code § 6241(4) and Prop. Reg. § 301.6241-4.

Therefore, my first reaction was incorrect. Most partnerships may not be able to elect out of the centralized partnership audit regime.

Even when a partnership may elect out of the centralized partnership audit regime treatment, it may still want centralized partnership audit regime to apply in anticipation of making a push out election. Centralized partnership audit regime allows for centralization of administration, consistency of tax treatments, and cost sharing at the partnership level. By electing push out treatment, the reviewed year partners will still bear the economic costs of the audit adjustments.

When a partnership is ineligible to elect out of the centralized partnership audit regime, electing to push out the partnership adjustments to the reviewed year partners is the only way to ensure that the reviewed year partners pay the additional taxes related to the reviewed year. Unfortunately, unless Congress changes the rules, this approach only works successfully for the first tier partnership. To avoid an unfair result related to changes in distributive shares, the partnership should elect to push out the partnership adjustments to the reviewed year partners, including any changes in distributive shares.

The Technical Corrections provisions seem to address some of the unfairness under centralized partnership audit regime, particularly with regard to multi-tiered partnership. Hopefully, such provisions will be included in the much anticipated 2017 comprehensive tax act, but hope is not a strategy. However, it will be important to keep an eye on this issue as the sausage in being made this year.

It appears that the Proposed Regulations will eventually be issued in their current form. Many of the provisions provided clarity and are quite helpful. However, the IRS' hostility to multi-tiered partnerships will hopefully be tempered by Congressional action. Not only is this a question of fairness, but multi-tiered partnerships are essential for raising capital. Raising capital is still essential for creating businesses and jobs, and we do not want to burden the creation of capital more than is absolutely necessary.

Finally, centralized partnership audit regime essentially reverses the roles of the IRS and partners. Centralized partnership audit regime provide a simplified approach which allows the IRS to assess taxes on partners through their partnerships—including innocent partners—at an arbitrary rate of tax. The partners (through the first tier partnership) must now prove what the correct amount of tax should have been had all of the adjustments been paid by the appropriate parties in the reviewed year. (Unfortunately, multi-tiered partnerships can never achieve that goal under the current system.) Further, in some situations, the actual tax must be paid before the imputed underpayment can be modified. The burden of the audit has now shifted to the partners in a very heavy handed manner. The new system is so heavy handed that it will reinforce the public's belief that the system is not a fair one. Hopefully, Congress will relieve some of this burden so that the reviewed year partners (regardless of whether they are tiered partnerships) will ultimately bear the cost of partnership audits.

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