The IRS recently re-released proposed regulations (REG-136118-15) implementing the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015, P.L. 114–74. These proposed regulations were initially released in January 2017, but were halted by the Trump Administration’s regulatory freeze. While the regulations appear at first glance to provide meaningful relief to taxpayers, a more careful analysis reveals many remaining pitfalls. The reissued regulations contain minor changes, as compared to the originally proposed regulations. However, major questions still remain regarding how the proposed regulations will relate to tiered partnerships, partnership M&A and partnerships in the private equity setting. The Treasury sought commentary on the proposed regulations through August 14 and the public hearing is scheduled for September 18. Given that the new audit regime goes into effect for partnership tax years beginning after December 31, 2017, this is a tight timeline for partnerships and their tax advisors to fully digest regulations that impose significant changes on the partnership audit regime.

BIASED AGAINST TAXPAYERS FOR THE CONVENIENCE OF THE IRS

The proposed regulations establish a new audit regime in which tax is assessed and collected at the partnership level, rather than on a partner by partner basis as is the current law under TEFRA. This is a complete change to one of the foundational concepts in subchapter K that makes a partnership a pass-through entity. The default rule under the proposed regulations allows the IRS to assess tax upon a partnership for the reviewed year and have the partnership pay that tax in the year of assessment. The federal tax is assessed at the highest marginal tax rate and is considered a nondeductible expense to the partnership.

The proposed regulations are widely viewed as unduly biased against taxpayers in order to make the collection of tax more convenient for the IRS. The most criticized aspect of the proposed regulations is the potential mismatch between the reviewed year and the year in which the partnership is liable for the tax that is ultimately assessed. A mismatch between the reviewed year and the year when the tax is enforced and collected could potentially shift the tax burden to partners who were not partners during the reviewed tax year. This is particularly significant for investment funds and publicly traded partnerships that typically purchase existing partnerships or see a high turnover in their own partner makeup. This potential exposure to open tax items in years where a taxpayer was not a partner in a partnership will at least cause taxpayers to pursue costly due diligence when entering into a new partnership deal that slows down the pace of partnership M&A transactions; at worst, it could create material economic friction in the market for partnership interests. The proposed regulations give the partnership the option to make a push-out election which allows the partnership to make an election to have each partner from the reviewed year pick up the assessed tax liability on their individual returns. This push out election corrects this mismatch between the partners that should bear the economic burden of assessment and potential new partners, however this comes at a cost to the ultimate taxpayer due to the increase in interest charge.

Also, the Treasury has not yet determined how the push–out election applies in the context of a tiered partnership, which is a common structure in the private equity sector. If the lower-tier partnership makes the push–out election but the election is unavailable to the partnership in the tier above, the same mismatch issue between the partners may exist at the next level. The bill for the Tax Technical Corrections Act of 2016 touched on this issue by stating that the push–out election must be available to tiered partnerships. However, Congress did not pass that bill, and Treasury explained their reservation of allowing the application for tiered partnerships due to the administrative burden placed on the IRS to track an adjustment through to the

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 ultimate owner. There is some hope that the Treasury will provide a solution for this issue given that it reserved this issue in the proposed regulations and asked for additional commentary. Until then, however, taxpayers will be forced to comply with the rules as written — without a push-out election option for tiered partnerships. Given that a multi-tiered push-out could undermine the stated intent of the rules to make life easier for the IRS, we have our doubts as to whether a change is likely. Because of the breadth of the changes to the partnership audit regime in January, we recommend that investors in partnerships give the issue careful thought, and consider adjusting their partnership agreements accordingly.

KEY PROVISIONS

Election Out: Seems Helpful, but Hard to Qualify

The proposed regulations contain an option to elect out of this new regime on an annual basis, on a return filed on time (including extensions). However, the requirements were designed to allow only a small number of partnerships to elect out of the new regime. These are partnerships with fewer than 100 partners (including indirect S corporation owners) — with partner types limited to individuals, estates of a deceased partner, S corporations, C corporations, or foreign entities that would be treated as a C corporation.

Notably missing from the list of acceptable partners are other partnerships, disregarded entities, and trusts (including grantor trusts). This is a severe limitation in the partnership realm given the common use of tiered partnership structures and the flexibility to have any type of partner. These restrictions will also directly affect estate planning techniques commonly used by family limited partnerships (including the use of DREs and grantor trusts).

The Treasury has received numerous comments on this limitation, but stated in the preamble to the proposed regulations that the limited scope of the election out was intentional. The new audit regime is intended to lessen the burden that TEFRA has imposed on IRS audits of large partnerships. It is expensive and time-consuming for the IRS to assess tax on partnership-level issues on a partner by partner basis. If a majority of partnerships, especially large partnerships, were able to elect out of the new regime, the process would remain cumbersome for the IRS and may not be an improvement from the Treasury’s perspective. Treasury states in the preamble to the proposed regulations that this issue will be the subject of other proposed regulations to be published in the near future; and it encourages the submission of additional comments.

Partnership Representative: Serious Issues of Responsibility and Indemnity

If the partnership does not make the annual election out of the new audit regime, the partnership must declare a partnership representative. The partnership representative replaces the previous concept of the tax matters partner, but this represents a significant change because there would now be few limitations on who can serve in this role. The only restriction is that the partnership representative must have a substantial presence in the U.S. If the partnership fails to designate a partnership representative, the IRS has the authority to choose the partnership representative. The representative does not have to be a partner in the partnership (as the tax matters partner had to be). The lifting of restrictions is beneficial to both the IRS and the partnership because it allows the designation of someone who is familiar with the partnership business without the requirement of being a partner (e.g., someone from the partnership management company). However, partners should beware — the partnership representative has the authority to act on behalf of the partnership and may bind the partnership and partners in IRS audits as well as court proceedings. Designation of a partnership representative removes the right of all other partners to protest an assessment before the IRS. The proposed regulations specifically state that no state law, partnership agreement or other document is able to limit the authority of the partnership representative. The scope of the partnership representative’s authority raises the question: What should be included in the partnership agreement to hold them accountable?

IRS Assessment Mechanism: So Who Pays What?

Once the IRS determines that there is a deficiency at the partnership level, an “imputed underpayment” will be calculated by applying the highest marginal tax rate — currently the individual rate of 39.6 percent. The default imputed underpayment does not take into account different characters of income that may be subject to lower rates, or even that some partners may not be subject to tax. There is a provision in the regulations that allows a taxpayer to request a modification of the amount of tax assessed, but this shifts the burden of determining the proper tax amount onto the partnership. Under the old rules, the IRS was required to determine the deficiency based on a partnership-level item at the partner level — taking into account the various tax attributes of each partner. The new regime gives the IRS the authority to apply a blanket rate to the entire deficiency and puts the burden of petitioning to reduce this amount on the partnership itself. The proposed regulations outline five limited
modifications that will be considered: amended returns filed by a partner, tax-exempt status of partners, rate modification based on types of income, certain passive losses of publicly traded partnerships, and an “other” category to be defined later.

After tax has been assessed on the partnership and all requested modifications have been accepted or denied, the IRS will provide the final partnership adjustment. Under the default rule, this amount is the partnership’s responsibility. Accordingly, the proposed regulations place the cash tax burden on the assessment—year partners, which may be different from the reviewed—year partners. This is particularly troubling for partnerships that regularly have changes in their partner makeup. Future partners may bear the tax costs of mistakes made before they had any interest in a partnership. This liability allocation places a major burden on the due diligence process, will be cumbersome to new investors, and will reduce the speed at which deals can close. New partners will need to inquire about all potential areas of tax risk to make an educated decision on whether to invest in a partnership. To reduce these costs of the new regime, existing partnerships and buyers of partnership interests may want to consider adding indemnification provisions for exiting partners.

Push–Out Election: An Option to Get It Right … but at a Higher Cost

The proposed regulations contain an option for the partnership to make a push–out election to have each partner from the reviewed year pick up the assessed tax liability on their individual returns. The election must be made within 45 days of the postmark date of the final partnership adjustment. This election correctly ensures that the partners who were partners during the review year bear the economic burden of the adjustment, rather than those who are partners when the assessment is made. However, this election is not free. The partnership (and its partners) must pay a premium for increasing the IRS’s administrative burden. If a partnership makes a push–out election, the applicable interest charge on the imputed underpayment increases by two percent — from short-term AFR plus three percent to short term AFR plus five percent.

As discussed above, it is unclear whether this push–out election will be available to tiered partnerships. If tiered partnerships cannot use the push–out election, that would significantly reduce the benefit of this election, even at the increased cost. If the partnership does not make a push–out election, the partnership is responsible for paying the imputed underpayment at the partnership level in the year of adjustment.

WHAT TO DO BEFORE YEAR-END

Most existing partnership agreements will need to be amended to reflect the changes imposed by these proposed regulations, and all new agreements should factor in their impact. Although questions remain on numerous items upon which the proposed regulations have remained silent, given their effective date of January 1, 2018, partnerships and their advisors should act now and consider the following non–exhaustive list of issues:

- If the partnership is eligible for an election out of the new audit regime, should the agreement be amended to require the partnership to make this annual election?
- Even if the partnership qualifies for the election, should the agreement be amended to include a partnership representative in the event that the IRS deems the election invalid?
- Should the partnership agreement put a limitation on the types of partners that an interest can be transferred to in order to protect the ability to make the opt–out election?
- What procedures should be in place for selecting a partnership representative? Given that this is an annual designation, should the partnership agreement specify that the representative will be reappointed on an annual basis to ensure this is the proper representative?
- Should the partnership agreement require that the partnership representative get approval from a majority of partners or management team members before making decisions on behalf of the partnership?
- Should the partnership agreement require that information regarding notices and audit procedures be communicated by the partnership representative to the partners prior to making decisions on behalf of the partnership?
- Do agreements need indemnity clauses or clawbacks against previous partners for a potential imputed underpayment by the partnership if there has been a change in partners?
- Should the partnership agreement require the partnership to make a push–out election so that review–year partners are liable for the imputed underpayment even though the cost to the taxpayer is higher?
- Instead of requiring a push–out election, should exiting partners agree to a three–year distribution holdback in order to
cover potential imputed underpayments?

- When acquiring a partnership interest, or a partnership in the merger and acquisition context, should the agreement include an indemnity or reimbursement provision for liabilities that arise for the period prior to the acquisition?

ALVAREZ & MARSAL TAXAND SAYS:

The IRC statute under Section 6221 through 6223 and related re–released proposed regulations, as written, provide for a substantial change to the partnership audit regime with many key questions left unanswered and a long list of items for partnerships and their advisors to consider. The IRS public hearing is scheduled for September 18, and the new audit regime goes into effect for partnership tax years beginning after December 31, 2017. Given the complexity of the changes, there is not a one–size–fits–all recommendation on updating partnership agreements, and many nuances will need to be considered in short order. Practitioners are hoping that the finalized regulations will provide clarity on several complex issues. However, given the short time frame for the Treasury to update and issue final regulations, we recommend that partnerships begin to work on updating their agreements now so that proper language is in place by the start of the new regime.

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A major focus of a private equity fund acquiring a target or a business contributing cash to a joint venture is to ensure that it receives depreciation based on the relative fair market value of its contributions to the partnership.

The Obama Administration’s Parting Gift to Gift Taxes [5]

It’s no secret that the popular estate planning mechanism of valuation discounts has been a targeted area of estate planning for many years. The Obama Administration had included recommendations to Congress in its annual proposed budget to restrict or eliminate valuation discounts for transfers of interests in family–controlled entities from 2009 to 2012.

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Proposed Regulations and New Audit Regime Create Uncertainty for Investment Funds

The second half of 2015 has been a busy period for partnership taxation. The Treasury issued proposed regulations under the long reserved IRC Section 1.707-2, and Congress passed a new law governing how large partnership audits will be performed. Unfortunately, the two changes when considered together may make life more difficult for many investment funds.

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