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The New Partnership Audit Rules, Part 5: The Pull-In Procedure

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This is the fifth installment of Bracewell Tax Report articles describing the new rules applicable to partnership audits under the Internal Revenue Code and the related proposed and final Treasury regulations. Each installment focuses on certain aspects of these rules and the practical implications to partners and partnerships, particularly as they relate to negotiating and drafting partnership agreements.

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for federal income tax purposes (the New Rules). The New Rules, effective for audits of partnership tax years beginning on or after January 1, 2018, generally allow the IRS to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level. Click ***here*** for a general description of the New Rules.

As we have discussed in previous installments, if the IRS assesses an imputed underpayment on a partnership, absent an ***election*** to push out the adjustments to the partners (the Push-Out Election) in the year subject to audit (the Reviewed Year), the partnership must remit the underpayment to the IRS. If paid by the partnership, the imputed underpayment will be economically borne by the partners in the year the audit concludes and an assessment is made (the Adjustment Year). The New Rules, however, permit a partnership to reduce its imputed underpayment by requesting certain modifications, including by demonstrating that some or all of the Reviewed Year partners have amended their Reviewed Year tax returns to reflect their share of the audit adjustments and have paid any resulting increase in tax (the Amended Return Adjustment). By utilizing the Amended Return Adjustment, partnerships can effectively shift the audit liability to those partners in the Reviewed Year that amend their returns, rather than the partners in the Adjustment Year, without making a Push-Out Election.

When the New Rules were enacted, practitioners had mixed views on the value of the Amended Return Adjustment. If all Reviewed Year partners cooperate in the amendment process, the partnership could eliminate its imputed underpayment and shift the burden to the Reviewed Year partners. But, such cooperation may be difficult to achieve for large partnerships or partnerships with frequent trading in their interests. Further, the Reviewed Year partners may resist the partnership’s request to amend their tax returns in the Reviewed Year, and possibly all subsequent years, as too burdensome, and may wish to avoid the potential increased risk of further audit adjustments on account of the amendment restarting the statute of limitations for any affected tax years.

Fortunately, the Tax Technical Corrections Act of 2018, which was signed into law by President Trump on March 23, 2018, as a component of the Consolidated Appropriations Act, 2018 (the Corrections Act), simplified partnerships' ability to reduce their imputed underpayment and shift all or part of the liability to their Reviewed Year partners without requiring such partners to file one or more amended tax returns. The Corrections Act provides that, in lieu of a Reviewed Year partner amending its prior year returns, a Reviewed Year partner may, no later than 270 days after the date on which the proposed partnership adjustment is mailed to the partnership, simply (i) pay the amount of tax due with respect to its share of the partnership audit adjustments, (ii) agree to reflect the resulting adjustments to such partner's tax attributes, and (iii) provide such additional information as the Secretary may require in connection with such reduction in the partnership's imputed underpayment (the Pull-in Procedure). The partnership representative, or a third party, such as an accounting firm or law firm, may serve as a coordinator to collect such payments and information and remit them to the IRS on behalf of the Reviewed Year partners. The Pull-in Procedure is not expected to cause the statute of limitations to be reopened for the affected tax years, although this is subject to confirmation in future guidance.

When drafting or amending partnership agreement provisions with respect to the New Rules, partners should consider binding Reviewed Year partners to participate in reducing any imputed underpayments by amending their prior year returns, or agreeing to participate in the Pull-In Procedure, in lieu of such amendments, whenever reasonably practicable. Partnerships and partners generally should prefer the Pull-in Procedure, as it generally should be less burdensome on Reviewed Year partners and also should provide the partnership with more control over the process of reducing the underpayment than relying on Reviewed Year partners to act independently. In the event that all Reviewed Partners are willing to participate in the Pull-in Procedure, the final result should be similar to the result under a Push-Out Election, except that the Reviewed Year partners would not be required to bear the additional 200 basis point charge. For this reason, Reviewed Year partners should prefer the Pull-in Procedure to the Push-Out Election. However, the partnership also must compare the cost and administrative burden of allocating audit adjustments as well as collecting taxes and information from Reviewed Year partners and acting on their behalf with the IRS, or engaging a third-party representative to do the same, pursuant to the Pull-in Procedure, versus preparing and distributing statements to its Reviewed Year partners for purposes of the Push-Out Election.

Our next installment will focus on the impact of the New Rules on acquisitions and divestiture transactions.