BRACEWELL

INSIGHTS

The New Partnership Audit Rules, Part 7: What Lies Ahead

July 20, 2018

By: **[Elizabeth L. McGinley]**

This is the seventh 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.

Since the New Rules were enacted, the IRS and Treasury Department have issued several rounds of proposed regulations, which include regulations covering the ***push-out election***, including in the context of tiered partnerships, the roles and responsibilities of the ***partnership representative***, adjustments to tax basis and capital accounts of partners in connection with partnership audit adjustments, and certain international aspects of the New Rules, and final regulations providing general guidance under the New Rules and guidance with respect to the ***election out***. In addition, Congress provided various statutory changes to the New Rules in the Technical Corrections Act of 2018, which added a new ***pull-in procedure*** and provided new rules for making the push-out election through multiple tiers of partnerships.

Despite the IRS and Treasury Department's commendable efforts to issue guidance under the New Rules, several open questions remain. Commentators and practitioners are optimistic, however, that the balance of final regulations under the New Rules, which are expected to be released by the end of 2018, will provide clarity on these issues.

First, practitioners and commentators still are awaiting final regulations addressing partnership representatives, which has been listed as a priority project under the IRS's 2017-2018 Priority Guidance Plan (the Plan). The Treasury Department has received many comments concerning the scope of the partnership representative's authority, including with respect to a partnership representative's right to appoint a successor. There is an emerging view in the market that a partnership representative should not have the authority to appoint a successor under the New Rules if it would not otherwise have such authority under the partnership agreement (for instance, if it were the general partner or managing member), particularly because resignations of partnership representatives and revocations of partnership representative designations are likely to arise in the context of a dispute between the partnership representative and some or all of the partners.

Similarly, commentators and practitioners are awaiting final regulations concerning the new pull-in procedure, which also has been listed as a priority project under the Plan. As we have discussed in a ***previous installment***, the pull-in procedure, which was included as part of the Tax Technical Corrections Act of 2018, generally was received as a more efficient and administrable option for reducing a partnership's imputed underpayment than the push-out election or the amendment of reviewed year tax returns by current and former partners. In fact, many practitioners believe that the pull-in procedure will essentially eliminate the need for the push-out election and the amendment procedure. To achieve this result, however, the Treasury Department must issue clear, workable and efficient regulations for the procedure.

Practitioners, particularly transactional tax practitioners, also are awaiting guidance as to the meaning of a partnership ceasing to exist. As we discussed in a ***previous installment***, if the IRS determines that a partnership has ceased to exist, the IRS can push out the imputed underpayment to the partners for the year the assessment is made (or, if there are no such partners, the partners for the last year for which a partnership tax return was filed), as if the partnership itself made a push-out election. The proposed regulations do not specify, however, whether certain transactions, including the acquisition of all of the outstanding equity of a partnership, as described in Revenue Ruling 99-6, or the merger of one partnership into another, would result in a partnership ceasing to exist for purposes of the New Rules. As a result, practitioners have been left to speculate as to when the IRS will have discretion to cause a push-out and when this decision will be left to the partners.

Although the regulations concerning the election out of the New Rules are final, practitioners are increasingly optimistic that the IRS and Treasury Department will revisit these regulations and make the election out available to a greater number of partnerships. These regulations, which were finalized in early 2018, permit a partnership to elect out of the New Rules only if it has 100 or fewer eligible partners. An eligible partner is an individual, C corporation or S corporation, but not a partnership or disregarded entity. As a result, a partnership with even a single partner that is a partnership or disregarded entity would not be eligible to make the election out, which generally eliminates the application of the election out to partnerships with complex ownership structures, including multiple tiers of partnerships. In the legislative history, however, the IRS and Treasury Department expressed willingness to expand the definition of eligible partner for purposes of the election out after the IRS and Treasury Department gain experience implementing the New Rules.

There also is consensus growing among practitioners that the IRS and Treasury Department should simplify a variety of procedures and processes under the New Rules. For example, the American Institute of CPAs has made various recommendations for the IRS and Treasury Department to streamline the process of adjusting the tax attributes of an audited partnership and its partners, including an elective simplified procedure for such adjustments. Commentators have also suggested that the IRS and Treasury Department consider simplifying the proposed regulations related to basis and capital account adjustments following audit adjustments.

Finally, many state taxing authorities are grappling with a response to the New Rules and, in particular, are considering whether, and to what extent, to align their partnership audit procedures with the New Rules. Various organizations are in the process of drafting recommendations and model provisions for state-level partnership audit procedures, which will inform states as they begin the process of revising, or replacing, their current audit procedures. At this point, it is expected that most states will develop an entity-level partnership audit procedure that mirrors, or is similar to, the federal procedure.

Looking ahead, we will continue to provide updates concerning any new IRS or Treasury Department guidance with respect to the New Rules in the Bracewell Tax Report.