Preliminary observations about JCT “Bluebook” description of partnership audit reforms

The staff of the Joint Committee on Taxation (JCT) earlier this week released the “General Explanation of Tax Legislation Enacted in 2015”—known as the “Bluebook.” The Bluebook includes technical explanations of tax legislation enacted last year, including the partnership audit reform provisions that were enacted in November 2015 as part of the Bipartisan Budget Act of 2015 (the “Budget Act”) and that were amended by the Consolidated Appropriations Act in December 2015.

16 March 2016

The Bluebook contains considerable additional information about the partnership audit reform law and clarifies some issues about which questions have been raised. Although the Bluebook does not constitute official legislative history, the IRS and Treasury Department can be expected to look to the Bluebook as they draft regulations and other administrative guidance implementing the new regime.

The following discussion provides some background information regarding the new partnership audit reform rules and then presents some preliminary observations regarding the Bluebook’s explanation of the partnership audit provisions.

New partnership audit regime—overview

Generally effective for returns filed for partnership tax years beginning after 2017, the Budget Act repealed the unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the simplified rules for electing large partnerships (ELPs) and replaced them with a single system of centralized audit, adjustment, and collection of tax that generally applies to all entities classified as partnerships that are required to file federal income tax returns. The new rules are extremely complex and address a host of issues. Administrative guidance will be needed to flesh out many of the details of the new partnership audit regime.

Very generally, with respect to underpayments, the IRS will be able to impose liability at the partnership level if it determines, on audit, that a partnership (or partner) reported too little income in the audited year (the “reviewed year”). More specifically, if the partnership **understated** income or gain (or overstated losses or deductions) in the reviewed year, the IRS determines the amount of tax required to be paid—the “imputed underpayment”—and mails the partnership and the “partnership representative” a notice of proposed partnership adjustment. The imputed underpayment is determined using a formula that serves as a simplified proxy for what the IRS might be owed as a result of an understatement of partnership income, without attempting to determine how much

actual tax the reviewed-year partners should have paid on understated income based on the particular facts. However, the initial computation can be adjusted in some circumstances, reducing or even eliminating the partnership-level assessment.

The new statutory rules, however, provide an alternative mechanism (the “Alternative Method”) under which an audited partnership may elect to “push out” an adjustment to those who were partners in the reviewed year, instead of paying a partnership-level tax. If the partnership elects to push out the adjustment, each reviewed-year partner must take its share of such adjustment into account on its current year tax return (using a formula to determine the amount by which to increase its current-year tax liability). Although the reviewed-year partners do not need to file amended returns, they must pay a higher interest rate on their shares of the underpayment than the typical underpayment rate and perform potentially complex calculations to determine how much to adjust their current-year tax liability.

Further, some partnerships may be able to “elect out” of the new regime. These partnerships must be required to file 100 or fewer Schedules K-1 and must meet other requirements, including having no partnerships as partners (absent IRS guidance to the contrary).

Changes made by PATH Act

A couple months after the Budget Act was enacted, changes to several of the partnership audit reform rules were enacted as part of the “PATH Act” title of the Consolidated Appropriations Act. In December 2015, the staff of the JCT issued a technical explanation of the PATH Act (the “JCT PATH Explanation”) that included a brief description of both the new partnership audit rules and the changes made by the PATH Act.*

The JCT PATH Explanation clarifies a few aspects of the partnership audit rules. For example, for purposes of computing the imputed underpayment, the JCT PATH Explanation indicates that netting of income, gain, and deductions items is done “taking into account applicable limitations, restrictions, and special rules under present law.”

*”Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029,” prepared by the Staff of the Joint Committee on Taxation, JCX-144-15 (December 17, 2015).

KPMG observation—preliminary observations

The Bluebook contains significant additional technical detail about the partnership audit rules. It also includes examples illustrating how the rules apply in various situations. Some of the additional information is described below. The following sets forth preliminary observations concerning the Bluebook descriptions of the partnership audit rules.

Tiered partnerships and the "Alternative Method": The statutory language of the new partnership audit rules does not specify how the Alternative Method applies in the case of tiered partnerships. For example, if a lower-tier partnership is audited and elects to use the Alternative Method to push out an adjustment to its reviewed-year partners, can an upper-tier partnership that receives a share of the adjustment use the Alternative Method to pass its share of the adjustment through to its past-year partners?

The Bluebook suggests that, in such a situation, the upper-tier partnership might not be able to use the Alternative Method, but

instead pays tax on its share of the adjustment as if it were an individual at the entity-level—even though there are no statutory rules providing for a partnership that is not itself audited to pay federal income tax at the entity level. The Bluebook also appears to contemplate that an upper-tier partnership might use indemnification agreements to ensure that past-year partners, rather than the current partners, bear the economic burden of the upper-tier partnership’s share of the adjustment. Specifically, the Bluebook provides, in relevant part:

In the case of tiered partnerships, a partnership that receives a statement from the audited partnership is treated similarly to an individual who receives a statement from the audited partnership. That is, the recipient partnership takes into account the aggregate of the adjustment amounts determined for the partner’s taxable year including the end of the reviewed year, plus the adjustments to tax attributes in the following taxable years of the recipient partnership. ***The recipient partnership pays the tax attributable to adjustments with respect to the reviewed year and the intervening years, calculated as if it were an individual (consistently with section 703), for the taxable year that includes the date of the statement.*** *The recipient partnership, its partners in the taxable year that is the reviewed year of the audited partnership, and its partners in the year that includes the date of the statement, may have entered into indemnification agreements under the partnership agreement with respect to therisk of tax liability of reviewed year partners being borne economically by partners in the year that includes the date of the statement. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible. [Emphasis added.]*

Some have suggested that an upper-tier partnership might be able to use the administrative adjustment request (AAR) provisions in the new partnership audit regime to push out to its past-year partners its share of an adjustment from a lower-tier partnership that elected the Alternative Method. Absent administrative guidance, it is not clear precisely how this approach would work. The Bluebook does not directly address this possibility, but can be read as leaving open the possibility of such an approach.

The Bluebook includes general language explaining how an upper-tier partnership may choose to file an AAR with respect to its share of an adjustment from a lower-tier partnership. Although this language might be focused on situations in which a lower-tier partnership files an AAR and pushes an adjustment through to an upper-tier partnership, it also might be intended to address situations in which a lower-tier partnership that is audited uses the Alternative Method to push an adjustment through to an upper-tier partnership. The Bluebook states, in relevant part:

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for a partnership taxable year. Following the filing of the administrative adjustment request, the partnership may apply most of the procedures for modification in a manner similar to modification of an imputed underpayment under new section 6225(c). Like the partnership audit, tax resulting from the adjustment may be paid by the partners in the manner in which a partnership pays an imputed underpayment in the adjustment year under new section 6225. Alternatively, the adjustment may be taken into account by the partnership and partners, and the tax paid by reviewed year partners upon receipt of statements showing the adjustments, similar to new section 6226. . .

In the case of tiered partnerships, a partnership’s partners that are themselves partnerships may choose to file an administrative adjustment request with respect to their distributive shares of an adjustment. The partners and indirect partners that are themselves partnerships may choose to coordinate the filing of administrative adjustment requests as a group to the extent permitted by the Secretary.

Nonetheless, even if upper-tier partnerships that receive shares of adjustments from lower-tier partnerships that use the Alternative Method could use the AAR mechanism to pass adjustments through to past-year partners, a number of questions and issues could be raised depending upon how administrative guidance implemented the use of such a mechanism. For example:

- The new rules only allow a partnership to file an AAR for a tax year within three years of the date on which it filed its partnership return for such year (or three years of the date on which such return was due, excluding extensions, whichever is later) and, in no event, can a partnership file an AAR after it has received a notice of administrative proceeding. Given that the exam process for a lower-tier partnership may take significant time, it might be difficult for an upper-tier partnership to satisfy the timing requirements for filing an AAR with respect to the year to which the adjustment relates. Thus, query whether there could be some situations in which an upper-tier partnership might be precluded from using an AAR as a mechanism to push an adjustment from a lower-tier partnership out to past-year partners.

- The filing of an AAR by a partnership seemingly extends the statute of limitations for assessment of partnership items for three years after the date of the filing of the AAR. For many partnerships, extending the statute of limitations could raise investor relations, partner conflict, and other issues. Thus, using the AAR process to achieve a “push out” of adjustments to past year partners may not be feasible in some cases.
- If an upper-tier partnership pushes its share of an adjustment resulting from the audit of a lower-tier partnership to its partners under the AAR procedures, those partners apparently would not be subject to the increased interest rate that applies under the Alternative Method. Thus, those who own interests in an audited partnership directly and who are allocated amounts under the Alternative Method might pay a higher interest rate than would those who hold their interests indirectly through an upper-tier partnership that uses the AAR mechanism. The potential different treatment of direct and indirect partners could raise concerns for different partner groups.
- An AAR is intended to allow a partnership to inform the IRS of adjustments of the partnership for a tax year so that the IRS either: (1) can collect additional tax from the partnership or partners; or (2) can allow, in effect, a refund for the year in question. If the IRS already has issued a notice of final partnership adjustment (FPA) to a lower-tier partnership and the lower-tier partnership already has passed out an allocable share of the adjustment to the upper-tier partnership, the IRS is already on notice of the adjustment and filing an AAR appears to be redundant or a nullity.

REITS, RICs, and the Alternative Method: The Bluebook indicates that the IRS should provide guidance with respect to the deficiency dividend procedures when an audited partnership that elects the Alternative Method has as a partner a real estate investment trust (REIT) or regulated investment trust (RIC). Specifically, the Bluebook states:

A recipient partner that is a RIC or REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend with respect to the reviewed year. Guidance coordinating the receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary.

Partnership-level tax—basis adjustments: If a partnership pays a partnership-level tax under the new partnership audit regime, the Bluebook indicates that a partner’s basis in its partnership interest is reduced to reflect the nondeductible payment by the partnership of the tax. Likewise, the partnership’s total adjusted basis in its assets is reduced by the cash payment of the tax. Thus, both inside and outside basis are adjusted. Further, if partners, former partners, and the partnership have entered into indemnification arrangements with respect to the payment of partnership-level tax, the Bluebook indicates that both the payment of the partnership-level tax and any payments under those agreements are nondeductible.

Imputed underpayment: Like the JCT PATH Explanation, the Bluebook indicates that, in determining the imputed underpayment, netting takes into account applicable limitations, restrictions, and special rules. However, the Bluebook provides example of how the netting rule applies. It also provides examples of the rules for reallocating distributive shares of items among partners and the rules for adjusting the amount of the imputed underpayment for C corporation partners when the partners’ distributive shares differ among items.

The “election out”: The Bluebook also contains additional information regarding several aspects of the rules for electing out of the new regime. For example, the Bluebook:

- Makes clear that the fact that a partnership has as a partner a C corporation that is a RIC or REIT does not prevent the partnership from making the election out.
- Clarifies that the statutory rule for partners that are “foreign entities that would be classified as C corporations if domestic” applies to foreign entities that have elected to be, or that are, treated as *per se* corporations under the entity classification rules (i.e., it clarifies that these partners are “eligible” partners for purposes of determining if the partnership can make the election out).
- Clarifies how the determination of whether a partnership is required to issue 100 or fewer Schedules K-1 applies when a partnership has as a partner an S corporation.
- Provides examples illustrating how administrative guidance could apply when a partnership that has a disregarded entity or a trust as a partner wants to make the election out—these examples indicate that guidance could provide for looking through to the owners (and trustees or other persons, as appropriate) for purposes of the 100-or-fewer requirement.
- Makes clear that administrative guidance can provide rules permitting a partnership with other partnerships as partners to make the election out “to the extent such rules are consistent with prompt and efficient collection of tax,” provided indirect partners are identified and are counted in applying the 100-or-fewer requirement.

Treatment when partnership ceases to exist: The Bluebook indicates that, if a partnership ceases to exist before a partnership

adjustment is made, regulations may provide that the adjustment is taken into account by the former partners of the partnership. A partnership that terminates within the meaning of section 708(b)(1)(A) is treated as ceasing to exist. In addition, regulations may provide that a partnership that has no significant income, revenue, assets, or activity at the time the adjustment takes effect may be treated as having ceased to exist. Further, the successor partnership in a technical termination under section 708(b)(1)(B) succeeds to the adjustment or imputed underpayment, absent regulations to the contrary.

Note that, although the Bluebook indicates that a technical termination under section 708(b)(1)(B) is not taken into account in determining whether a partnership has ceased to exist, there remain many unanswered questions involving the new partnership audit provisions and a technical termination. When there is a technical termination, a partnership is required to file a short-year return. If the IRS examines the short-year return of the partnership, does the “old” partnership or the “succeeding” partnership have the right to designate the partnership representative? This is an important matter because, if the IRS asserts an imputed underpayment for the short-year return, the partnership representative has the option: (1) of seeking judicial review; (2) of the partnership paying the tax under new section 6225, which would burden the owners of the succeeding partnership; or (3) of having the adjustment pushed out under new section 6226 to the partners of the old partnership. Future guidance may address these issues. Further, buyers and sellers of partnership interests will want to take these matters into consideration during negotiations and due diligence.

Partners’ rights or lack thereof: The Bluebook recognizes that, under the TEFRA rules, partners had certain rights of notification of the proceedings from either the IRS or the tax matters partner, while under the new centralized system, the partnership acts through its partnership representative, who has the sole authority to act on behalf of the partnership. Under the centralized system, the partnership and all partners are bound by actions taken by the partnership and partners may not participate or contest results of an examination of a partnership.

The Bluebook makes it clear that a partner has almost no rights with respect to the new audit regime. In an example, the Bluebook describes a situation in which the IRS asserts in a final partnership adjustment that a partnership had an imputed underpayment of $1,000, but the partnership chooses not to seek judicial review. The partnership elects to push out the imputed underpayment to reviewed-year partners under the Alternative Method and sends Partner A a statement that its allocable share of the adjustment is $100, which would result in an increase of $35 in taxes for Partner A. Partner A does not include this adjustment on its current year return as required. The Bluebook indicates that, prior to a levy on Partner A’s property, Partner A is entitled to a collection due process hearing, but Partner A is precluded from raising whether the $100 was properly includible in determining its share of partnership taxable income.

Other items not addressed: The Bluebook does not address a number of other questions raised by the new rules. For example, it does not address:

- Whether a partnership that enters into a settlement with the IRS (and does not receive an FPA) can use the Alternative Method
- How penalties are “shared” among partners if a partnership uses the Alternative Method (and whether tax-exempt partners could share in such penalties)

- How the mechanism for reducing the imputed underpayment when partners file amended returns and pay associated tax due applies in the case of tiered partnerships
- Whether there should be late election relief available for a partnership that inadvertently fails to elect under new section 6226 within 45 days
- How a partnership determines whether a direct or indirect partner does not owe tax by reason of being a tax-exempt entity (as defined in section 168(h)(2))
- Whether there are any corresponding adjustments resulting from the adjustments taken into account under new section 6225—for instance, if depreciation is overstated resulting in an adjustment, are the corresponding basis of the asset and the partners’ bases in their partnership interests increased for the amount of the adjustment?
- What is the definition of a “tax attribute” for purpose of new section 6226? Does it refer to only items such as passive losses and net operating losses, does it include basis consistent with the notion of a tax attribute under section 108, or does it refer to any item affected by the adjustments?

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