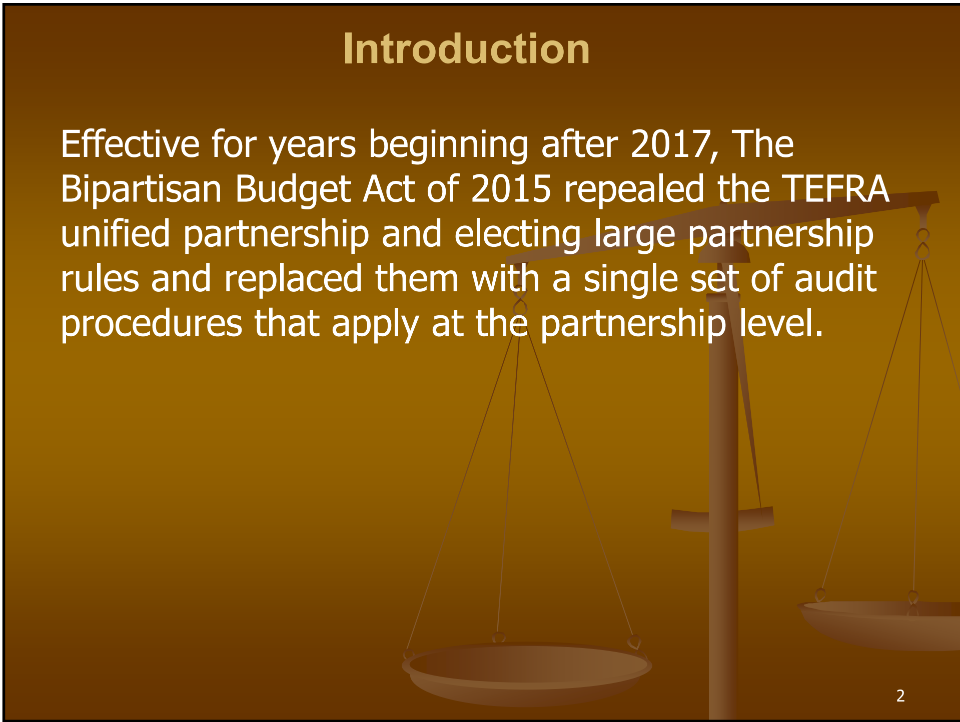
The Centralized Partnership Audit Rules
Planning Considerations


Introduction
Effective for years beginning after 2017, The Bipartisan Budget Act of 2015 repealed the TEFRA unified partnership and electing large partnership rules and replaced them with a single set of audit procedures that apply at the partnership level.
2

Two Significant Changes

The Budget Act made two significant changes to the rules covering audits of partnerships and their partners:

1. It replaced the TEFRA tax matters partner (TMP) with a partnership representative.
2. Audit adjustments are (subject to some elections) generally taken into account at the partnership level in the year the audit is completed (or a judicial proceeding is final), rather than being passed through to partners in the year(s) under audit.
   - Consequently, the results of the audit adjustments generally affect the partners in the year the audit adjustments are final rather than the partners in the year(s) under audit.

3

Planning Considerations

Two issues to address immediately:

1. Identification of the partnership representative, and the extent of and limitations on, the representative's authority, and
2. Whether and when the partnership will make one of the elections available under the centralized audit regime.

4

The Partnership Representative Overview

The partnership representative generally replaces the TEFRA tax matters partner (TMP), but has substantially more authority; e.g.:

- The TMP could bind the partnership in matters before the IRS, but not the other partners,
  - Partners other than the TMP had certain notification rights, the right to participate in proceedings with the Service, and the right to contest certain actions taken by the TMP,
- The partnership representative has sole authority to bind the partnership and all of its partners in matters before the IRS, and
- Partners no longer have statutory notification and participation rights.

5

The Partnership Representative Eligibility and General Rules

The partnership representative can be any person (including a disregarded entity or the partnership itself) with a substantial presence in the United States.

- The TEFRA TMP had to be a partner.

A partnership subject to the centralized regime must designate a partnership representative each year on its partnership return.

- The designation is made separately for each year and is effective only for the year for which it is made.
- Once named, the partnership representative generally can be changed only after the partnership has been notified that it has been selected for audit, or has made an administrative adjustment request.

6

The Partnership Representative Definitions and Special Rules

A substantial presence in the United States is defined as being available to meet in person with the IRS in the U.S., at a reasonable time and place, and having:

- A street address in the U.S.,
- A telephone number where the representative can be reached during normal business hours, and
- A U.S. taxpayer identification number.

If the partnership representative is not an individual, the partnership must designate an individual to act on behalf of the representative.

If the partnership fails to designate a partnership representative or designated individual, the IRS can appoint any person to serve in that capacity.

7

The Partnership Representative Some Considerations

- Since it is possible that a partner could have a conflict of interest when acting on behalf of the partnership before the IRS, consider designating a non-partner.
- Consider requiring the representative to notify the partners of specified events (e.g., the commencement of an audit, the receipt of a proposed assessment, etc.).
- Consider adding provisions to the partnership agreement or contract with the representative requiring approval by the partners for certain actions (e.g., whether and when to make elections, settle with the IRS or litigate, etc.)
  - Operating agreement provisions and contracts are not binding on the IRS, but would constitute contractual obligations for the representative.

8

Application at the Partnership Level Audit Adjustments

Audit adjustments are generally taken into account by the partnership (not the partners) in the year during which the audit or judicial review is completed (the "adjustment year"), rather than in the year under examination (the "reviewed year").

- Additional tax and other amounts due generally are paid by the partnership in the adjustment year.
- Adjustments that would otherwise result in a refund generally pass through to the partners in the adjustment year.

9

Net Positive Adjustments

The tax on additional income (the "imputed underpayment") is generally calculated using the highest rates in effect for the reviewed year.

- A partnership can reduce its liability by demonstrating that a lower amount is appropriate based on partner-level information (e.g., where some partners are tax-exempts, or where there are adjustments to ordinary income properly allocated to C corporations or adjustments to capital gains and/or qualified dividends properly allocated to individuals).
    - However, the highest rates are not reduced simply because some partners are in lower tax brackets.

10

Net Negative Adjustments

Adjustments that do not result in a deficiency generally are treated as an adjustment to the partnership’s non-separately stated income or loss, or, in the case of credits, as separately stated items in the adjustment year.

11

Adjustments Between Distributive Shares

When an adjustment reallocates shares from one partner to another, the positive adjustment is taken into account, but the negative adjustment is disregarded.

- The result is an increase in the imputed underpayment, even though the net effect on partnership income is zero.

12

Elections

Three possibilities:

- Section 6221(b) Election Out
  - Election to be completely excluded from the centralized audit rules
- Section 6226 "Push-out" election: Pass audit adjustments through to reviewed year partners
- Section 6225(c) "Pull-in" procedure: Pass their shares of the audit adjustments through to some or all of the reviewed year partners.

13

Section 6221(b) Election Out Eligibility

No more that 100 partners

- Generally measured by the number of schedules K-1 required to be issued to partners.
- Includes S corporation partners' K-1s required to be issued to shareholders.

Only eligible partners

- Generally individuals, C or S corporations, eligible foreign entities (i.e., that would be C corporations if they were domestic) and estates of deceased partners.
- Not partnerships, estates other than of deceased partners, trusts, disregarded entities, nominees or ineligible foreign entities.

14

Section 6221(b) Election Out Other Requirements

The election out must be made annually on a timely-filed partnership return.

The partnership must:

- List names and TINs of each partner, and of each shareholder of an S corporation partner (Schedule B-2 of Form 1065), and
- Notify its partners of the election out within 30 days of the date of the election.

Once made, the election out is irrevocable except with Service consent.

15

Update: Notice 2019-6

Issued on December 20, 2018. IRS intends to issue regs.

Two issues:

- Centralized regime will not apply to certain adjustments of partnership-related items on a return other than the partnership's when a person other than the partnership is under audit.
- QSUBs are eligible partners for purposes of the section 6221(b) election out.

16

Notice 2019-6
QSUB Partners

For purposes of the fewer-than-100-partners requirement, a partnership with a QSUB partner must count the schedule K-1 it issues to the QSUB and each K-1 the QSUB's S corporation owner issues to its shareholders.

- The IRS intends the regs. to be applicable to years beginning after 2017 if they are final by September 23 22, 219 or, in any case, years ending after December 20, 2018.

However, there is no reference to QSUB eligibility or provision for the expanded reporting requirement on Form 1065, Schedule B-2 or their instructions.

17

Section 6221(b) Election Out
Observations

General consensus is that the election out is usually advantageous.

- How many excluded partnerships elected to be covered under TEFA?

A lower tier partnership in a tiered structure can, if it is otherwise eligible, make the elect out under section 6221(b).

It may be possible to eliminate ineligible partners (most likely unnecessary single member LLCs).

- Too late for 2018 or 2019, but could allow an election out for 2020 and beyond.

18

Section 6226: The Push-Out Election Introduction

Allows a partnership that cannot or has not made an election out under section 6221(b) to avoid liability for its imputed underpayment by passing the audit adjustments through to its reviewed year partners.

Two-step process:

- Making the election itself and
- The provision of adjusted information returns to the partnership's reviewed year partners and the IRS.

19

Section 6226: The Push-Out Election Making the Election

Must be signed by the partnership representative, filed within 45 days of the date the IRS mailed the final notice of partnership adjustment (FPA) and include the information required by reg. 301.6226-1(c); generally:

- The partnership's name, address, and TIN,
- The year and imputed underpayment for which the election is made,
- A copy of the FPA,
- The name, current or last known address and TIN of each reviewed year partner and
- Any other information prescribed by the IRS in forms, instructions, etc.

20

Section 6226: The Push-Out Election The Provision of Adjusted Information Returns

The partnership must furnish adjusted information returns (amended K-1s?) showing their respective shares of the audit adjustments to the reviewed year partners and the IRS within 60 days of the later of:

- The expiration of the 90-day period for filing a petition for judicial review, or
- If a petition was filed, the date the court's decision is final.

See regs. at 301.6226-2 for detailed guidance on the mechanics of the provision of the adjusted information returns and note that the filing with the IRS must be done electronically.

21

Section 6226: The Push-Out Election Reviewed-Years' Partners' Computations

Each reviewed year partner's tax liability for the year in which the adjusted information return was provided (the reporting year) is increased or decreased by the aggregate of the correction amounts for the reviewed year and each year after the reviewed year and before the reporting year (the intervening years).

- The correction amount for the reviewed year is the amount by which the partner's tax liability would increase or decrease if the adjustments were taken into account in the reviewed year.
- The correction amount for each intervening year is the amount (if any) by which the partner's tax liability for the year would increase or decrease on account of adjustments of tax attributes (e.g., basis, loss carryovers, etc.).

22

The Push-Out Election Self-Reporting

Partnerships can use similar procedures to self-report adjustments for prior years by filing a request for an administrative adjustment with the Service.

The partnership can:

- Take the adjustments into account (and pay any resulting tax or adjust its non-separately stated income) at the partnership level in the adjustment year, or
- Make the section 6226 election, and furnish adjusted information returns to the reviewed year partners, who then determine and account for the adjustments under the push-out rules covered earlier.

23

The Push-Out Election Tiered Structures

If an upper-tier partnership makes a section 6226 election, lower-tier passthrough entities can:

- Account for the adjustments at the entity level or
- Make the election to push them out to their partners, shareholders or beneficiaries.
  - S corporations and trusts are treated like partnerships for this purpose.

The same rules apply in cases where an upper-tier partnership passes through self-reported adjustments under an administrative adjustment request.

24

The Push-Out Election Observations

The partnership agreement should state whether and when the election will be made before the partnership gets audited.

- Always good to have an agreement before it is needed.

It is possible for the election to be advantageous for some partners but not for others (for example, adjustments between distributive shares).

25

Section 6225(c): The Pull-in Procedure

Allows reduction of the partnership's liability to the extent that partners report and pay any amounts due on their shares of the imputed underpayment.

Three-step process:

1. Relevant partner(s) file amended returns, or report adjustments under an alternative procedure, for the reviewed year and any intervening years, and pay any amounts due.
2. Partnership requests modification of the imputed underpayment.
3. IRS approves or denies all or part of the modification.

A relevant partner is:

- Any reviewed year partner (including a passthrough entity) other than a disregarded entity or nominee
- For whom the partnership requests modification.

26

The Pull-in Procedure
Amended Returns / Alterative Procedure

Under the alternative procedure, the partnership provides the IRS with the information needed to determine that any amounts due were properly determined and paid, in lieu of partners filing amended returns.

- Apparently avoids corollary effects (e.g., extension of the assessment statute).

27

The Pull-in Procedure
Request for Modification

Must be made by the partnership representative:

- Within 270 days of the date the IRS mailed the notice of proposed partnership adjustment, and
- Include documentation demonstrating that the reviewed year partner(s) have filed amended returns, or the partnership provided information under the alternative procedure, and that any amounts due have been paid.

28

The Pull-in Procedure
Tiered Structures

Partnership and S corporation partners in tiered structures can apply the pull-in procedure at the entity level under the same rules as those that apply to partnerships generally.

The Pull-in Procedure
Observations

- Unlike the push-out election, the pull-in procedure can be applied selectively.
- Like the push-out election, may be advantageous for some partners but not for others (e.g., again, adjustments between distributive shares).
- The partnership agreement should specify the circumstances under which and partners to which it will apply.