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Regulations Reveal IRS' Views On Partnership Audit Regime

By **Elizabeth McGinley and Steven Lorch** (March 6, 2019, 10:53 AM EST)

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On Dec. 21, 2018, the U.S. Department of the Treasury and the Internal Revenue Service released final regulations[1] implementing the federal audit regime for partnerships and entities classified as partnerships for federal income tax purposes, enacted under the Bipartisan Budget Act of 2015. The new rules, effective for audits of partnership tax years beginning on or after Jan. 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.

The regulations adopt portions of the proposed regulations issued in August 2018, with limited revisions in response to the scores of written comments received by the Treasury Department and statements made in public hearings. In addition, the regulations and the preamble to the regulations provide insight into the IRS' view on several aspects of topics previously discussed in the new rules, including the election pursuant to Code Section 6226(a) (the push-out election), the alternative procedure for filing amended returns (the pull-in procedure) and the IRS' authority to determine when a partnership ceases to exist for purposes of the new rules.

Push-Out Election

The Treasury Department and the IRS received extensive comments concerning the timing and mechanics of the push-out election. Commenters advocated for an extension of the 45-day election period, including a recommendation that a partnership not be required to make the push-out election until after a final determination of the partnership adjustments, and a recommendation that the regulations permit an extension of the election period, either automatically or by request of the partnership. Commenters also recommended that partnerships should have the flexibility to revoke a push-out election in the event of a change in circumstances after the election is made, including the settlement of an imputed underpayment.

The Treasury Department and the IRS, however, declined to modify the period for making the push-out election, which will remain the 45-day period after the final partnership adjustment is mailed to the partnership. The preamble states that this 45-day period was established by statute and therefore would not be modified by the regulations. Accordingly, the regulations defer to Congress to make any substantive changes to the election period. Further, the Treasury Department and the IRS declined to adopt comments requiring the IRS to notify a partnership of an invalid election and declined to adopt Tax Court review of a determination that an election is invalid.

Commenters also recommended that the push-out election be mandatory in two circumstances to mitigate a partnership representative's potential conflict of interest: (1) if the partnership representative is both a partner in the reviewed year and the adjustment year, and the partnership representative's interest during the adjustment year is less than in the reviewed year and (2) if the aggregate partnership interest of any adjustment year partner, or partner group, holding a 20 percent or greater interest in the partnership, is 20 percent or greater than the interest held by the same partner, or partner group, in the reviewed year.

The preamble explains that such comments are inconsistent with the elective nature of the push-out election under the code, and therefore were not adopted. Notably, by rejecting this comment, the Treasury Department declined to extend mandatory push-out elections beyond situations where a partnership ceases to exist, as discussed below, and, consistent with the general structure of the new rules under the Bipartisan Budget Act of 2015 and associated regulations, refused to insert itself into potential disputes among partners, which instead will be governed by the provisions of the applicable partnership agreement.

Pull-In Procedure

The Treasury Department and the IRS received several comments concerning the pull-in procedure, which was introduced in the Technical Corrections Act of 2018 as an alternative to modifying an imputed underpayment by partners amending their reviewed year tax returns. One commenter recommended that partners participating in the pull-in procedure be permitted to communicate directly with the IRS exam team during the partnership audit, rather than communicating through the partnership representative or its agent, and thereby avoiding sharing the details of their respective financial affairs with the partnership representative or the partnership.

The preamble declined to address this comment in the regulations, but noted that the procedures for gathering partners' information for purposes of the pull-in procedure were still forthcoming and such processes may permit partners to provide certain information directly to the IRS.

In addition, in response to comments that partners should be able to claim a refund in connection with the pull-in procedure, the Treasury Department and the IRS responded that the pull-in procedure, in contrast to modification by amendment, was intended to be a streamlined process available only to partners that make a payment, or owe no tax, with respect to an imputed underpayment. Partners may utilize the pull-in procedure if they have been allocated negative adjustments, but only if those adjustments would offset other positive adjustments, and otherwise must file an amended return in order to claim a cash refund.

Partnership Ceasing to Exist

The August 2018 proposed regulations provided that if the IRS determines, in its sole discretion, that a partnership ceases to exist before partnership adjustments take effect, the adjustments must be taken into account by former partners as if a push-out election had been made for the reviewed year. Under the August proposed regulations, the IRS could, but was not required to, determine that a partnership ceased to exist if no business, financial operation or venture of the partnership continued to be carried on by any of its partners in a partnership — a Section 708(b)(1) termination — or if the partnership does not have the ability to pay, in full, any amount due under the new rules for which the partnership is or becomes liable. A Section 708(b)(1) termination presumably would include the partners' sale of 100 percent of their partnership interests to an unrelated buyer for cash.

Practitioners were concerned that such broad discretion would make it difficult to predict whether, following various types of sale, merger or other transformative partnership transactions, partners should expect to be subject to a mandatory push-out election or whether they would be free to choose another method under the new rules. In response to this comment, the regulations provide greater certainty to taxpayers by requiring the IRS to determine that a partnership ceased to exist in the event of a Section 708(b)(1) termination or if the partnership is unable to pay amounts due under the new rules. The IRS would retain complete discretion in other situations, however, including the partners' sale of all or substantially all of their partnership interests.

Tax Return Consistency

The August proposed regulations were unclear as to whether a partner may file an amended return to take a position inconsistent with the filed partnership tax return. Commenters requested that the regulations confirm that such an inconsistent position on an amended tax return is permitted, provided that the tax amended return include a statement identifying the inconsistent treatment, and the Treasury Department and the IRS accepted this comment.

Effective Date

The regulations apply to partnerships for taxable years beginning after Dec. 31, 2017, and ending after Aug. 12, 2018, as well as partnerships that make the election to apply the new rules to partnership taxable years beginning on or after Nov. 2, 2015, and before Jan. 1, 2018.

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