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# Navigating the Partnership Audit Proposed Regulations: A Bumpy Ride

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SPECIAL REPORT

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**The centralized partnership audit regime proposed regulations attempt to simplify the process of collecting taxes in connection with partnership audits.**

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On 6/14/17, proposed regulations[1] were published regarding implementation of the centralized partnership audit regime contained in section 1101 of the Bipartisan Budget Act of 2015. The centralized audit regime was intended by Congress to streamline the process by which the IRS can audit partnership tax returns and collect any resulting tax liabilities. As is discussed in detail in the preamble to the proposed regulations, the centralized audit regime was put into place in order to address the complexity and difficulty of collecting tax in connection with partnership audits under the current partnership audit regime.[2] As noted by the Government Accountability Office, the current partnership audit "process for passing audit adjustments through to partners is costly and very time consuming."[3] As a consequence, while the audit rate for large corporations was 27.1% in 2012, the audit range for large partnerships was only 0.8%.[4] The centralized audit regime attempts to accomplish this goal by centralizing the partnership audit process so that: (1) all determinations are made at the partnership level with a single individual interfacing with the IRS on behalf of the partnership and (2) subject to an alternative procedure described in Section 6226 (the "push out" election) partnership assessments are made at the partnership level. The Joint Committee on Taxation estimates that the centralized audit regime will generate an additional $9.325 billion in federal revenue over the course of 2016 – 2025.[5]

The proposed regulations provide a framework for the implementation of the centralized audit regime and details as to how partnership audits will be conducted under the centralized audit regime. The purpose of this special report is to examine certain elements of the proposed regulations that could result in significant (and, in some cases, distorted) tax consequences for taxpayers who are partners in partnerships. To that end, Part I of this special report provides an overview of certain key elements of the audit process under the centralized audit regime as described in the proposed regulations and notes various "traps for the unwary" that arise as a result of these processes. Part II of this special report suggests ways in which partnership (and ancillary) agreements might be modified and constructed to protect against some of these traps. Part III of this special report examines certain policy concerns around the proposed regulations.

# The Audit Process

## The Partnership Representative

Under the centralized partnership audit regime, the partnership representative represents the partnership in administrative proceedings and the partnership representative's actions are binding on all of the other partners.[6]

### Eligibility to Serve As Partnership Representative

Unlike the "tax matters partner" under TEFRA, a partnership representative need not be a partner.[7] Instead, in order to be eligible to serve as "partnership representative," a person need only: (1) have a "substantial presence in the United States" and (2) have "capacity to act." If an entity is designated as a partnership representative, an individual must be designated as the sole individual through whom the partnership representative will act (a "designated individual") in order for the designation to be respected by the IRS.[8]

1 REG-136119-15.

2 Under current law, partnerships are audited under three possible regimes: (1) for small partnerships with ten or fewer direct partners, partnership audits require separate audits and deficiency procedures for each partner; (2) under the more consolidated regime put into place by the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 8/19/82 (TEFRA) a "tax matters partner" is largely responsible for conducting partnership audits on behalf of a partnership, subject to certain notice requirements to other partners and the ability of partners to elect out of the consolidated proceeding or (3) for large partnerships, the Electing Large Partnership regime, which generally provides for a more streamlined and consolidated partnership-level audit procedure than TEFRA. The Preamble to the proposed regulations provides a helpful summary of the ways in which the centralized audit regimes differs from these prior audit regimes. Although the Code and the proposed regulations do provide for situations in which certain partnerships may elect for the centralized audit regime not to apply, this article will not discuss the "election out" procedures, focusing instead on those partnerships that are subject to the new rules.

3 "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency," (GAO-14-732, 9/18/14) p. 30.

4 Id at p. 19.

5 Estimated Revenue Effects of the Tax Provisions contained in H.R. 1314, Fiscal Years 2016 – 2025 JCX-135-15 (10/28/15).

6 Section 6223.

7 Compare Section 6231(a)(7) (as in effect for tax years beginning before 1/1/18) with Section 6223(a) (as in effect for tax years beginning after 12/31/17) and Prop. Reg. 301.6223-1(b).

8 Prop. Reg. 301.6223-1(b). It has been suggested by some commentators that a partnership could be designated as its own "partnership representative." Doing so would effectively eliminate the significance of the designation and render the "designated individual" the effective partnership representative.

In order to have "substantial presence within the United States," a person must be: (1) available to meet in person with the IRS in the U.S. at a reasonable time and place, as is necessary and appropriate, as determined by IRS; (2) have a street address and telephone number in the U.S. where the person can be reached during normal business hours and (3) have a U.S. taxpayer identification number.[9] A partnership representative will cease to have "capacity to act" in the event of: (1) death; (2) a court order adjudicating that the person does not have the capacity to act and is therefore ineligible to serve as partnership representative; (3) a court order enjoining the person from acting on behalf of the partnership (or in the case of a designated individual, acting on behalf of an entity that is designated as partnership representative); (4) incarceration; (5) liquidation or dissolution of an entity partnership representative or (6) any similar situation where the IRS reasonably determines the person may no longer have capacity to act.[10]

## Designation of the Partnership Representative

Under the proposed regulations, each partnership must designate a partnership representative for each tax year. Designation of the partnership representative for a tax year will remain in effect until that designation is terminated by: (1) a valid resignation by the partnership representative; (2) a valid revocation of the partnership representative's designation or (3) a determination by the IRS that no valid designation is in effect.[11]

The designation of the partnership representative is made on the partnership tax return for the partnership tax year for which the designation applies and is effective on the date the partnership tax return is filed.[12] The designation is effective for only the tax year for which it is made. Thus, a new designation must be made each year. The proposed regulations make clear that where a partnership representative is appointed for a year (the "reviewed year") and another partnership representative is appointed for a subsequent year in which an audit of the reviewed year occurs, then subject to the resignation and revocation procedures described below, the partnership representative for the reviewed year will be the partnership representative for purposes of the audit.[13] Thus, a person who has ceased to be affiliated with the partnership could still be the partnership representative for a partnership tax year up until the time that a proceeding is actually commenced with respect to that year.

## Resignation and Revocation of Partnership Representative

A partnership representative (or designated individual) may resign by notification in writing to the IRS.[14] Any such resignation may include a designation of a successor representative for the year for which the designation was in effect. If a successor is designated, the IRS will notify the partnership, the resigning partnership representative and the newly designated successor on its receipt of the notification. If no successor is designated, the IRS will determine that there is no effective partnership representative designation in effect for the applicable tax year and will notify the partnership (and the most recent partnership representative for that tax year)[15] that no designation is in effect, whereupon the partnership will have the opportunity to designate a new partnership representative.[16] If the partnership fails to designate a new partnership representative during the 30-day period following the mailing (rather than its receipt) of the notice from the IRS, then the IRS will appoint a successor partnership representative for that year.[17]

A partnership representative may resign in connection with only: (1) the filing of an administrative adjustment request (AAR)[18] or (2) the commencement of an audit of the partnership tax year. Any attempt of a partnership representative to resign outside of the context of an AAR or audit will be ineffective.[19]

9 Prop. Reg. 301.6223-1(b)(2).
10 Prop. Reg. 301.6223-1(b)(4). Notably, the proposed regulations do not provide any specific means for challenging the reasonableness of a determination by the IRS in this regard.
11 Prop. Reg. 301.6223-1(a).
12 Prop. Reg. 301.6223-1(c).
13 Prop. Reg. 301.6223-1(c)(3).
14 Prop. Reg. 301.6223-1(d)(1).
15 Presumably, this refers to the resigning partnership representative, though the proposed regulations are not clear on this point.
16 Prop. Reg. 301.6223-1(d)(1). In the case of a designated individual, failure to designate a successor will cause the IRS to determine that no effective designation of the partnership representative is in effect, such that a new partnership representative and a new designated individual will have to be designated.
17 Prop. Reg. 301.6223-1(f)(1).
18 This would generally arise in connection with a partnership's claim for adjustments that would give rise to refunds. The proposed regulations specify that an AAR may not be filed solely for the purpose of allowing the resignation or revocation of the partnership representative for a tax year. (Prop. Regs. 301.6223-(1)(d)(2) and 301.6223-1(e)(2)).
19 Prop. Reg. 301.6223-(d)(2).

In addition to resignation, the designation of a partnership representative (or designated individual) can also be revoked at the time of an AAR or commencement of an audit. The Preamble makes clear that resignation and appointment of a successor is the preferred method for a partnership to change its partnership representative but that "there may be circumstances where the partnership would like to change the designation, and the partnership representative or designated individual will not resign."[20] A revocation of a designation as partnership representative or designated individual must be signed by a person who was a general partner at the close of the year for which the partnership representative designation is in effect as shown on the partnership tax return for that year unless every general partner in that year is no longer a partner or no longer has capacity to act.[21] If a revocation of the designation of a partnership representative does not name a successor, the revocation will be ineffective.[22] Additionally, if within a 90-day period, the IRS receives more than one revocation of a designation of a partnership representative for the same partnership tax year signed by different persons, the IRS may determine that no partnership representative designation is in effect, in which case, as noted above, the IRS will notify the partnership (and the most recent partnership representative for that tax year) that no designation is in effect, whereupon the partnership will have the opportunity to designate a new partnership representative during the 30-day period following the mailing of the notice.

In the case of a resignation and designation of a successor partnership representative or a revocation of a partnership representative (which necessarily includes a designation of a successor partnership representative), the change in partnership representative becomes effective 30 days after receipt by the IRS of the notice designating the new partnership representative.[23]

There are several ways in which the designation and resignation/revocation of a partnership representative can go wrong for partnerships (and partnership representatives) under this regime. In particular, it should be noted that there is no requirement under the proposed regulations that a purported partnership representative consent to, or even be informed of, its designation at the time of appointment. Indeed, while perhaps unlikely, it is possible that the first an individual learns of its status as the "partnership representative" of a partnership is on its receipt of a notice of administrative proceeding from the IRS. Consider the following example:

**Example 1:** Shayna is an employee (but not a partner) of partnership ABC, whose principal place of business is in New York, New York. Unbeknownst to her, Shayna is designated as the partnership representative on ABC's 2018 tax return. In 2020, Shayna resigns from ABC and moves across the country to California. In 2021, Shayna receives a notice that ABC is being audited for the 2018 tax year and that she is the partnership representative.

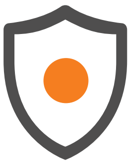
In this scenario, it is safe to assume that many people in Shayna's position will simply ignore the notice. In most cases, ABC will, on its receipt of the notice, take steps to revoke Shayna's designation. However, if ABC fails to revoke the designation, the IRS could be in a position where it is forced to deal with a nonresponsive partnership representative. The IRS can determine that no effective partnership representative designation is in effect only if: (1) the partnership failed to make a proper designation, (2) the partnership representative does not have substantial presence in the U.S. or lacks capacity to act,; (3) the partnership failed to appoint a designated individual (in the case of an entity partnership representative) or (4) in the case of a resignation or revocation without designation of a successor.[24] In this case, the best chance that the IRS will have of being able to appoint a responsive partnership representative would be to claim that Shayna lacks "substantial presence" on the basis of her not being "available to meet in person with IRS in United States at a reasonable time and place, as is necessary and appropriate, as determined by IRS." (However, it is unclear whether this language is intended to encompass U.S. residents who may be available, but unwilling, to meet with the IRS or who are available and willing to meet an auditor from the New York field office, but only in California.) This could create an untenable situation where the IRS is effectively unable to obtain sufficient information to conduct its audit and is left either: (1) imposing and attempting to collect tax liabilities from ABC that are spun from whole cloth or (2) being administratively stymied in its attempt to examine ABC.

20 Preamble at 4.b. (p. 58).
21 Prop. Reg. 301.6223-1(e)(3)(i) . For this purpose, a member-manager of a limited liability company is treated as a "general partner," as is every member of a member-managed limited liability company. (Prop. Reg. 301.6223-1(e)(3)(ii) ).
22 Prop. Reg. 301.6223-1(e)(1).
23 Prop. Regs. 301.6223-1(d)(1) and 301.6223-1(e)(1).
24 Prop. Reg. 301.6223-1(f)(2).

Perhaps, however, one should assume that Shayna will be responsible and respond to the notice of administrative proceeding. As partnership representative for an entity that she is no longer affiliated with, Shayna's most likely course of action will be to resign as partnership representative. If she so desires, she could also designate a successor partnership representative. It should be noted that if Shayna's parting with ABC was acrimonious, her ability to designate a successor could result in significant mischief. She might, for example, designate one of ABC's competitors as her successor partnership representative. In that case, even if ABC subsequently revokes the designation, the competitor could have up to a 30-day period during which it will have access to ABC's tax returns and the ability to take actions on ABC's behalf in the audit process.

Moreover, if Shayna resigns and appoints a successor, there can be no assurance that ABC will not, simultaneously, revoke her designation and appoint a different successor. The proposed regulations do not address what happens if a resignation and a revocation occur at the same time (which could be especially problematic if they appoint different successors). As noted above, the Preamble suggests that resignation and appointment of a successor is preferred to revocation, such that perhaps the IRS would take the view that the successor appointed by Shayna should be the partnership representative (whereupon the partnership could revoke that designation and appoint a successor).[25] If Shayna does not resign, the partnership would still likely revoke her designation and appoint a successor. However, in either case that revocation would not be effective for 30-days, during which Shayna would have exclusive control over the partnership audit (and could potentially take actions that are damaging to the partnership if she were so inclined or simply indifferent).

These are but a few of the myriad problems that could arise as a result of: (1) the ability of a partnership to designate a partnership representative without notification or acceptance, and (2) the inability of a partnership to change that designation outside of the context of an audit. The Preamble argues that allowing changes only in the context of an administrative proceeding "avoids the resource drain created by processing unnecessary resignations, revocations, and subsequent designations."[26] However, preventing a partnership from changing its designated partnership representatives at the same time that the associated business relationship changes itself can result in an even greater resource drain given the mobility of the modern workforce.

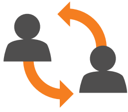


## Authority of the Partnership Representative

One of the hallmarks of the centralized audit regime is the significant amount of authority vested in the partnership representative. The partnership representative has the sole authority to act on behalf of the partnership in a proceeding, and no other partner is permitted to participate.[27] The proposed regulations even go so far as to provide that "[n]o state law, partnership agreement or other document or agreement may limit the authority of the partnership representative."[28] Indeed, unlike under TEFRA, the proposed regulations do not provide the partnership representative with any duty to notify partners of significant developments in administrative proceedings or to permit partners to participate in those administrative proceedings.[29]

Notwithstanding the expansiveness of this language, it does not appear that the proposed regulations intend to limit the state law remedies that might be available vis-a-vis a partnership representative that breaches an obligation set forth in a partnership agreement to exercise its discretion subject to oversight by other partners or managers of the partnership. Rather, it appears aimed at ensuring that even if a partnership representative acts contrary to state law or the partnership agreement, its actions on behalf of the partnership in an administrative proceeding remain binding on the partnership.[30] As a result, where a partnership representative missteps in conducting an audit and acts in a manner that is contrary to the partnership agreement (or any other agreement binding it as partnership representative) the partners' only recourse would be to pursue the partnership representative personally based on a breach of contract or tort claim.

25 As noted above, it would be critical that the second revocation be signed by the same "general partner" who signed the first revocation in order for it to be accepted.
26 Preamble at 4.B (p. 57).
27 Prop. Reg. 301.6223-2(c) .
28 Id.
29 Preamble at 4.F (p. 66). Query whether partners' inability to participate in administrative proceedings that adjudicate their personal liability for taxes could be challenged on the basis of the "due process" clause of the Fifth and Fourteenth amendments to the U.S. Constitution.
30 See Preamble at 4.E. ("Any action taken by the partnership representative with respect to the centralized partnership audit regime under the Code and federal tax regulations is valid and binding on the partnership for purposes of tax law regardless of any other provision of state law, partnership agreement or any other document or agreement" (emphasis added); Prop. Reg. 301.6223-2(d), Example 1.



# Partnership Level Tax Payment

Perhaps the most radical change from current law reflected in the centralized audit regime is the idea that tax resulting from the audit can be collected from the partnership — notwithstanding its status as a passthrough entity. The proposed regulations create a complex multi-step system for imposing this tax with a stated goal of "determin[ing] the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid."[31] While in some cases, the proposed regulations will achieve this goal, the complexity of the process and requirement of partner cooperation (particularly in connection with the modification procedures) may in many cases result either in: (1) more aggregate tax being collected than would have been had the partnership and partners correctly calculated and paid the tax in the reviewed year and/or (2) the wrong taxpayers bearing the payment of taxes that should have been paid in the reviewed year.[32]

## The Notice of Proposed Partnership Adjustments — the Imputed Underpayment

After completing its audit, the IRS will mail to the partnership representative a "notice of proposed partnership adjustments" (NOPPA) setting forth its audit findings and calculating an "imputed underpayment" of tax, for which the partnership will be responsible.[33]

The imputed underpayment is calculated using a complex set of formulae, which intend to capture the maximum amount of additional tax that may be due as a result of the adjustments made in the audit. (As is discussed below, this initial "imputed underpayment" can be subsequently adjusted through the "modification" process to arrive at a more accurate estimate of actual tax deficiency.)

## Initial Calculation of the Imputed Underpayment

The imputed underpayment set forth on a NOPPA will be equal to the "total netted partnership adjustment" multiplied by the highest federal income tax rate then in effect and then will be further adjusted for changes in applicable tax credits. The complexity arises in the calculation of the "total netted partnership adjustment."

The "total netted partnership adjustment" calculation relies on a set of grouping and netting rules that attempt to: (1) ensure that income and loss only offset one another to the extent that they are of the same character and not subject to limitation and (2) ensure that changes in allocations from one partner to another do not offset one another. This is accomplished through the following process:

First, all adjustments are assigned to one of three "groupings:" (1) the "reallocation grouping," (2) the "credit grouping"[34] and (3) the "residual grouping." The "reallocation grouping" contains each partnership adjustment that reallocates a distributive share of an item of income. (That is, for example, if in an audit, the IRS determines that a $1,000 capital gain allocated to partner A should instead have been allocated to partner B, that $1,000 reallocation adjustment would be placed in the "reallocation grouping.") Any partnership adjustment that is not assigned to the credit grouping or the reallocation grouping is assigned to the "residual grouping."[35]

Next, the proposed regulations require that within each "grouping" the adjustments be further divided into "subgroupings." Within the reallocation grouping, a separate subgrouping is established for each adjustment for a particular partner. Thus, using the example above where a $1,000 capital gain is reallocated from partner A to partner B, the reduction in the capital gain allocated to partner A will be assigned to one subgrouping, and the increase in capital gain allocated to partner B will be assigned to a separate subgrouping.[36] Within the residuary grouping, a separate subgrouping is established to "account for limitations or restrictions such as character or holding period."[37]

31 Preamble at 1 (p. 13).

32 Prop. Reg.301.6241-4 provides that amounts paid by the partnership as an "imputed underpayment" are to be treated as nondeductible expenses described in Section 705(a)(2)(B). However, the proposed regulations currently reserve on the effect such payments will have on the bases and capital accounts of the partners. Prop. Reg. 301.6225-4.

33 Section 6231; Prop. Reg. 301.6225-1(a).

34 A fourth grouping is the "creditable expenditure grouping" for expenditures reflected on a partnership tax return for which credits are separately calculated on the tax returns of the partners. The proposed regulations reserve on this grouping. Prop. Reg. 301.6225-1(d)(2)(iv).

35 Prop. Reg. 301.6225-1(d)(2).

36 Prop. Reg. 301.6225-1(d)(2)(ii) .

37 Prop. Reg. 301.6225-1(d)(2)(v).

The partnership adjustments assigned to each subgroup are then netted together (treating any adjustment that increases gain as an increase in income, any adjustment that decreases gain as a decrease in income, any adjustment that increases loss as a decrease in income, and any adjustment that decreases loss as an increase in income) to determine whether the applicable subgroup contains a net positive adjustment or a net non-positive adjustment. The "total netted partnership adjustment" is then equal to the sum of all net positive adjustments for the groupings and subgroupings. (Net non-positive adjustments do not factor into the calculation, and thus do not reduce the "total netted partnership adjustment").[38]

The proposed regulations allow the IRS to compute more than a single imputed underpayment with respect to a tax year. That is, if an imputed underpayment can be separately calculated with respect to adjustments to an item or items that were allocated to one partner or group of partners that had the same or similar characteristics or that participated in the same or similar transaction, the IRS may treat that imputed underpayment as a "specific imputed underpayment" and record it as a separate liability from the "general imputed underpayment" applicable to the partners as a group. In Prop. Reg. 301.6225-1(f) , Example 5, the proposed regulations posit a situation in which a partnership had four partners, all of whom were individuals.[39] The partnership reported ordinary income of $100 million and capital gain of $50 million. All of the capital gain was allocated to partner E. In the NOPPA, the IRS determined that the capital gain allocated to E should have been increased to $75 million and the partnership should have recognized an additional $10 million in ordinary income. Because the capital gain was allocated to only E, the IRS could elect to separate the imputed underpayment in the NOPPA into two imputed underpayments — one specific imputed underpayment with respect to the amounts allocable to only E and a general imputed underpayment with respect to the additional ordinary income. The purpose of this separation is to provide the partnership representative with more flexibility in how it manages the imputed underpayment. By way of example, the Preamble specifies that the partnership representative may decide to make an election to "push-out" the specific imputed underpayment pursuant to Section 6226 , while paying the general imputed underpayment at the partnership level.[40]

## Modifications of the Imputed Underpayment

The initial calculation of the imputed underpayment is, in many (if not most) cases, likely to result in a tax amount that exceeds the actual tax that would have been collected had the correct amounts of income, gain, loss, deduction and credit been reported to the partners. The proposed regulations allow for partnerships to address this potential overstatement through a process by which the imputed underpayment may be "modified."

A modification may increase or decrease the amount of an imputed underpayment either by: (1) modifying the rate that is applicable to the total netted partnership adjustment or (2) modifying the extent to which a given adjustment is taken into account in the calculation of the imputed underpayment.

There are six types of modification: (1) amended returns, (2) modifications attributable to tax-exempt partners; (3) modifications as to the applicable rate of tax; (4) modifications to take into account certain passive losses of publicly traded partnerships; (5) modification of the number and composition of imputed underpayments and (6) modifications based on deficiency dividends distributed by a partner that is a regulated investment company or real estate investment trust.[41]

### Amended Returns

The calculation of an imputed underpayment may be modified if (and to the extent) that affected partners amend their tax returns for the reviewed year (and any subsequent years to the extent necessary to give effect to the impact of the adjustment on intervening years) to take into account the adjustments reflected in the NOPPA. In order for amended returns to give rise to a modification to an imputed underpayment amount, all taxes, penalties and interest arising out of the amended return must be filed within a 270-day period from the mailing of the NOPPA (and the applicable partner must provide an affidavit, signed under penalties of perjury, that the amended returns have been filed and all taxes have been paid).[42]

38 Prop. Reg. 301.6225-1(d)(3)(ii).

39 The Example states that the partnership has four "equal" partners, but the facts of the example have partner E receiving a nonequal share of the capital gain of the partnership. As such, the word "equal" should probably be removed before the proposed regulations are finalized.

40 Preamble at 5.B.ii (p.74). While the initial determination of the number and composition of imputed underpayments is made by the IRS, the partnership representative may request modification of this determination as part of the modification process discussed below.

41 Prop. Reg. 301.6225-2(d) . In the interest of brevity, this article will not discuss the modifications associated with publicly traded partnerships or regulated investment entities.

42 Prop. Reg. 301.6225-2(d)(2).

In the case of a distributive share reallocation, amended returns will give rise to modification only if all partners affected by the adjustment file the amended returns.[43] This is a critical issue since, as noted above, a distributive share reallocation will be presumed to give rise to tax for purposes of the NOPPA. Consider the following example:

**Example 2:** Avi is a partner in ABC. Avi was a partner in 2018 and remained a partner until 2020, at which point ABC's 2018 tax year is audited. The final partnership adjustment finds that $1 million of capital gain that should have been allocated to another partner, Noam, in 2018 was mistakenly allocated to Avi. Noam is no longer a partner in 2020. The NOPPA includes an imputed underpayment amount of $396,000 associated with the shifting of the distributive share from Avi to Noam (the $1 million of gain included in the reallocation subgrouping multiplied by 39.6% — the highest tax rate under Chapter 1 of the Code). Assuming that both Avi and Noam were subject to the same rate of tax in 2018, if both amend their tax returns (Avi to obtain a refund of taxes paid on the allocation and Noam to include the income mistakenly allocated to Avi and pay the taxes thereon), the $1 million adjustment will be removed from the calculation of the imputed underpayment. The partnership representative reaches out to Noam to request that he file an amended tax return.

In the absence of any contractual obligation, Noam appears to have no incentive to do so. If he files the amended tax return, he will increase his personal tax liability. If he does not file the amended tax return, that tax liability will instead be borne by the partnership (of which he is no longer a partner). If Noam refuses to amend his tax return, the partnership representative can, as is discussed below, request that the imputed underpayment associated with the reallocation be treated as a specific imputed underpayment with respect to which an election may be made to "push-out" the adjustment to Noam. However, this mechanism does not provide Avi with any means of obtaining a refund. It is not clear in the proposed regulations whether, if Avi files an amended return, but Noam does not, Avi would obtain a refund of the taxes he paid with respect to the adjusted allocation. If not, the IRS in this example would have collected more overall tax than would have been due had the correct amounts of tax been paid in the first place.[44] (Likewise, if the amounts incorrectly allocated to Avi are not treated as a specific imputed underpayment and pushed out to Noam (perhaps because the partnership representative lacks information necessary to make a valid push-out election), then the current partners, including Avi) will bear the tax liability associated with the reallocation of income away from Avi.

Pass-through entities that are partners in the audited partnership (pass-through partners) may also elect to file amended tax returns and pay the "safe harbor amount" associated with the adjustment to the pass-through partners' returns. (The "safe harbor amount" is discussed below in connection with the "push-out" election, but is essentially an imputed underpayment based solely on the items allocated to the specific partner.) Alternatively, instead of a pass-through partner amending its return, the partners of the pass-through partner (that is, the "indirect partners" of the audited partnership) may amend their own tax returns in the same manner as direct partners.[45]

## Tax Exempt Partners

A partnership representative may request modification of an imputed underpayment if it can demonstrate to the satisfaction of the IRS that the adjustment reflects an allocation of income to a tax-exempt entity (including foreign persons) that would not have given rise to tax.[46]

## Rate Modification

A partnership representative may request modification of an imputed underpayment to the extent that it can show that: (1) an item of adjustment was allocated to a C corporation and thus subject to a lower tax rate or (2) an item of adjustment consisted of long-term capital gains or qualified dividend income allocated to an individual reviewed year partner. A modified rate cannot be less than the highest rate in effect with respect to the type of income and taxpayer. Thus, the only way for a partnership to obtain the benefit of lower marginal rates that may apply to partners would be for those partners to file amended returns.[47]

43 Prop. Reg. 301.6225-2(d)(2)(vi).

44 Prop. Reg. 301.6225-2(d)(2)(v)(B) does provide that "[A]n amended return claiming a refund may be filed after the expiration of the period of limitations under 6511, provided all partnership adjustments allocated to the partner filing the amended return are taken into account on such amended return, the only items reported on the amended return are items attributable to such partnership adjustments and the partner files all required amended returns [for intervening modification years]." This would seem to indicate that refund claims are generally permitted on amended returns even if the amended return cannot be used for modification purposes (e.g., in the case of a reallocation, if only one party to the reallocation files an amended return). However, this provision of the proposed regulations modifies the general requirement that amended returns be filed prior to the closing the statute of limitations. As such, it is not clear whether the rule that all affected partners must file amended returns for a modification to be approved would operate to trump this regulation and bar a refund claim. This issue should be clarified in final regulations. The proposed regulations are, however, clear that Avi cannot file an amended return to obtain a refund outside of the modification process. Prop. Reg. 301.6225-2(d)(2)(vii).

45 Prop. Reg. 301.6225-2(d)(2)(vii).

46 Prop. Reg. 301.6225-2(d)(3).

47 Prop. Reg. 301.6225-2(d)(4).

## Number and Composition of Imputed Underpayments

As is noted above in Example 2, a partnership representative may request that an imputed underpayment described in a NOPPA be modified so as to separate from a general imputed underpayment one or more specific imputed underpayments. This may be advisable in cases where a partnership representative wishes to make a "push-out" election for certain imputed underpayments but not for others.[48]

# Push-Out Elections

The so-called "push-out" election allows a partnership to avoid entity-level liability for an imputed underpayment by furnishing to the reviewed year partners statements of their share of the partnership adjustments.[49] If the push-out election is made, interest on the past due tax liability is paid at a rate that is 2% higher than interest paid on imputed underpayments.[50]

A push-out election is made within 45 days of the notice of final partnership adjustment (FPA). That is, the election is made only after receipt of a NOPPA and completion of the modification process. (In some cases, the modification process may not be necessary where the partnership intends to make a push-out election). On making the election, the partnership must send to each reviewed year partner a statement showing the partner's share of any adjusted partnership item as that item was originally reported, the changes to the applicable item, the resulting changes in tax attributes (that could impact intervening years' tax liability), the partner's share of penalties, additions to tax or other amounts and the partner's "safe harbor amount."[51]

The safe harbor amount is essentially a partner-by-partner determination of the imputed underpayment amount.[52] Generally, modifications taken into account in the determination of the imputed underpayment reflected in the FPA are ignored for purposes of determining a partner's safe harbor amount. The one exception to this general rule is that where a partner has filed an amended return giving rise to a modification (such that the adjustments reflected on the amended return are excluded from the modified imputed underpayment), those adjustments will also not be taken into account in computing the partner's safe harbor amount. This prevents a partner who has filed an amended return from being subject to double tax on the same adjustment.[53]

On receipt of a statement issued by the partnership, the reviewed year partners are required to pay the "additional reporting year tax." This additional tax is determined via a fairly complex set of defined terms. The additional reporting year tax is equal to either: (x) the "aggregate adjustment amounts" or (y) if elected by the partner, the safe harbor amount.[54] The "aggregate of the adjustment amounts" is equal to the sum of the "correction amount for the first affected year" and the "correction amounts for the intervening years." The "correction amount for the first affected year" is the amount by which the reviewed year partner's tax would increase for the first affected year if the partner's taxable income for such year was recomputed by taking into account the partner's share of partnership adjustments reflected on the statement. The Proposed Regulations provide a formula for the determination of the correction amount for the first affected year, which is expressed as A - (B + C - D), where A is the chapter 1 tax that would have been imposed had the items as adjusted been properly reflected on the return for the affected year; B is the chapter 1 tax shown due on the return for the affected year; C is amounts not shown on the return but previously assessed or collected and D is the amount of any prior tax rebates.[55] The "correction amount of the intervening years" is the aggregate of correction amounts for each year between the reviewed year and the adjustment year.

It should be noted that if a correction amount for a year is less than zero (i.e., it reflects an overpayment of tax due to the impact of an audit adjustment), that loss cannot be used to reduce any other correction amount or tax due.[56] Thus, once again, unless amended returns are filed in the modification process (and gave rise to refunds), even the push-out election can result in an aggregate overpayment of tax.

The Proposed Regulations reserve on the process for making push-out elections for partners that are themselves partnerships.

48 Prop. Reg. 301.6225-2(d)(6).
49 Section 6226 . Since an entity level payment of tax would be borne by the partners in the year of the audit (the "adjustment year" partners), a push-out election will often be advisable where there has been a meaningful change in the make-up of the partners between the reviewed year and the adjustment year.
50 Section 6226(c)(2).
51 Prop. Reg. 301.6226-2(e).
52 Prop. Reg. 301.6226-2(g)(2)(i).
53 Prop. Reg. 301.6226-1(g)(ii)(B).
54 Prop. Reg. 301.6226-3(a).
55 Prop. Reg. 301.6226-3(b)(2).
56 Prop. Reg. 301.6226-3(b)(1).

# Drafting Agreements to Manage the Centralized Audit Regime

The foregoing, though dense, is actually a simplified "high-level" overview of some of the most salient provisions of the centralized audit regime. As such, partnership agreements will likely need to change to accommodate the many pitfalls of these complex rules. The following represents a list of issues that should be addressed by partnerships in preparing for implementation of the centralized audit regime.[57]

## Partnership Representative

Since the partnership representative's actions will be binding on all partners (without the notice requirements, and ability to elect out of the consolidated proceeding currently afforded by TEFRA), partnerships will have to use contractual arrangements to create any desired oversight of the partnership representative. Purported partnership representatives will likely want to be sure that they are appropriately indemnified against law suits for taking actions in their capacity as partnership representative and will want fulsome expense reimbursement provisions — particularly given that any partnership representative that is not a tax professional will likely need to retain a lawyer or accountant to manage the audit process. On the other hand, partnerships will often want a contractual ability to require that the partnership representative involve management in making decisions about partnership audits (and may wish to have contractual remedies against partnership representatives that "go rogue," resulting in additional tax liabilities for the partnership or its partners). While the contractual provisions surrounding the partnership representative will have to be discussed in every partnership (and will certainly vary from partnership to partnership), the following general contractual provisions are likely to be included in most partnership agreements:

- No person may be designated as partnership representative (or designated individual) without his or her consent
- Any person designated as partnership representative will resign at the direction of the partnership (that is, the general partner, or in the case of a limited liability company, the manager or members) and appoint such successor as the partnership (or some specific partner) directs
- In the case of a resignation and appointment of successor (or a revocation and appointment of successor), the partnership representative that has resigned or been removed will act only as directed by the person who has been appointed successor during any period prior to the effectiveness of that designation
- For partnerships whose management function is exercised by more than a single individual, the partnership representative will include the appropriate managers in all decisions concerning the conduct of an audit

Additionally, under TEFRA, it became common for many partnership agreements to provide the "tax matters partner" with authority beyond its responsibilities for conducting audits. In many cases, the tax matters partner is responsible for most tax compliance. Given that the partnership representative may not be a partner and cannot be replaced until an audit is actually commenced by the IRS, partnerships should carefully consider limiting the role of the partnership representative to management of partnership audits.

It is also important to note that where a person who is not a partner of the partnership is appointed as partnership representative or designated individual, partnerships must be sure that the rights and duties of the partnership representative are set out in a contract to which the partnership representative is a party.[58] This will likely require partnerships to create "partnership representative" agreements laying out the rights and duties of the partnership representative.

## Imputed Underpayment

As is described above, the imputed underpayment is assessed against the partnership as an entity. Partnership management should covenant, to the extent possible to take actions as may be necessary to cause any imputed underpayment to be borne proportionately by the partners in the same manner as the tax would have been borne had it been appropriately reported. This may include: (1) making full or partial push-out elections for imputed underpayments or (2) making allocations and distributions in such a manner so as to correct for economic distortions arising out of the payment of the imputed underpayment at the partnership level. Partners should also be required to make payments to the partnership to reflect their share of any tax payments made on their behalf by way of an imputed underpayment.

57 This article has not examined the ability of certain partnerships with fewer than 100 partners (none of which are themselves partnerships) to elect out of the centralized audit regime. Partnerships that qualify for election out of the centralized audit regime should include in their partnership agreements the necessary provisions to ensure that if a determination is made to elect out of the centralized audit regime, the partners cooperate in making any necessary filings.

58 This is an important point that can be easily overlooked in the amendment of partnership agreements due to the fact that the "tax matters partner" under TEFRA was required to be a partner.

### Modifications

As is described above, once an imputed underpayment has been established by NOPPA, the modification process can be used to minimize the extent to which tax is overpaid. However, cooperation of the partners is required to make maximal use of the modification process. As such, most partnership agreements should require that:

- Partners amend tax returns (and pay required taxes) within the required timeframe to take partnership adjustments into account if requested by the partnership representative
- Partners that are tax exempt provide such certifications of their status as may be requested by the partnership representative
- Partners take such other actions and provide such other information as may be requested by the partnership representative to modify the rate at which income is taxed or as necessary to make valid push-out elections

These obligations should survive a partner's ceasing to be a partner in the partnership.

## A Note on Policy

Despite the over 300 pages represented by the Preamble and the Proposed Regulations (to say nothing of the statute and its legislative history), it is not at all clear whether the centralized audit regime is intended to provide an alternative method for collecting taxes assessed under Chapter 1 of the Code or whether, by contrast, it is intended to impose a new tax on partnerships in certain contexts. Section 6221(a) appears to contemplate the former, referring to "any adjustment to items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined [and] any tax attributable thereto" being "collected and assessed" at the partnership level. Indeed, the centralized audit regime calculates the "imputed underpayment" by reference to the tax that would have been due under chapter 1 of the Code and makes no attempt to amend or negate Section 701 , which provides that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

However, the Proposed Regulations appear to understand the centralized audit regime as, in many cases, allowing for tax that was never due under any other provision of the Code, to be assessed without any ability on the part of partners to obtain refunds. Admittedly, if the partnership representative makes appropriate use of all available modifications and makes push-out elections as necessary, an overall overpayment of tax can, in most cases, be avoided (or at least minimized to a significant extent). However, if a partnership representative is unable, or unwilling, to manage the rules of the centralized audit regime with sufficient expertise, one can imagine many scenarios in which more tax is paid than would be due in the absence of the centralized audit regime. This is particularly glaring in the situation where a current partner of a partnership bears the tax liability associated with an audit of a year in which that person was not a partner. In that case, by what statutory mandate can the IRS collect tax without an offsetting refund or credit? At a minimum, if a current partner bears the tax liability associated with a former partner's allocation, should the payment by the new partner of the former partner's liability be given effect for tax purposes (by way of income recognition by the former partner and an offsetting deduction or increase in basis by the new partner)? If so, final regulations should specify the manner in which such amounts are to be treated.

It may be that Congress did, in fact, intend for the centralized audit regime to create (rather than just collect) additional taxes. Perhaps the "imputed underpayment" is actually a separate and distinct tax that is imposed on partnerships in certain circumstances, such that, as a tax matter, the entity is responsible for the tax (and any contractual arrangements apportioning the liability for that tax are simply given separate effect as in the case of tax sharing and allocation agreements among C corporations). However, if the centralized audit regime is indeed intended to impose such a new (oddly constructed) entity level tax, this too should be made clear in final regulations.

## Conclusions

The centralized audit regime has the potential to create a significant increase in partnership audits. Because it has the potential to create so many distortions if not managed correctly, it will be critical for partnerships to ensure that they are prepared for the sea of change it represents.

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