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Recent Developments In The IRS Partnership Audit Regime

By **David Blair and Teresa Abney**
(January 18, 2019, 5:44 PM EST)


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In the last two weeks of December, there was a flurry of activity surrounding the implementation of the centralized partnership audit regime. Release of the final partnership regulations on Dec. 21, the government shutdown and, hopefully, holiday celebrations may have overshadowed two important announcements. First, on Dec. 19, 2018, the U.S. Tax Court issued new proposed rules implementing the new partnership regime. Second, on Dec. 20, 2018, the Internal Revenue Service announced its intention to issue new proposed regulations on two new topics related to implementation of the new centralized partnership audit regime. If you missed either announcement, below is a discussion of the new court rules and the to-be-proposed regulations.

U.S. Tax Court Proposes New Rules for Partnership Cases


Teresa Abney

On Dec. 19, 2018, the Tax Court announced[1] interim and proposed amendments to its rules of practice and procedure, reflecting the new centralized partnership audit regime. The rules are similar to the proposed amendments the Tax Court previously announced on March 28, 2016, but with some revisions based on comments the court received. The deadline for any proposed comments to the new amendments is Jan. 18, 2019. It is unknown how the government shutdown will affect this date.

The new rules essentially follow the structure of the Tax Court rules for partnership actions under the Tax Equity And Fiscal Responsibility Act, or TEFRA. However, the new rules address matters specific to the centralized partnership audit regime, including jurisdictional requirements, the content of the petition with respect to the imputed underpayment and the partnership representative, and the Tax Court's authority with respect to the partnership representative.

Jurisdictional Requirement in Partnership Actions

The Tax Court's jurisdictional rules reinforce the importance of the partnership representative — the rules reflect that only the partnership representative can file a petition on behalf of the partnership.

Under Tax Court Rule 255.1(c), the Tax Court has jurisdiction only if: (1) the IRS has mailed a notice of final partnership adjustment, or FPA, and (2) the partnership representative files a petition for readjustment within 90 days of the date the FPA is mailed.

Petitions in Partnership Actions

The rules have specific requirements for petitions filed pursuant to the new centralized partnership audit regime. First, any petition in a partnership action must be entitled "Petition for Partnership Action Under BBA Section 1101."[2]

Second, the petition must include, among other things:

- The partnership representative's (1) name, (2) state of legal residence — or principal place of business if the partnership representative is not an individual — and (3) mailing address;[3]

- A separately numbered paragraph stating that the partnership has designated that individual or entity as its partnership representative — or that the IRS selected that partnership representative;[4]

- The amount of the imputed underpayment as determined by the IRS;[5]

- The approximate amount of the taxpayer's asserted imputed underpayment — if different than the IRS' imputed underpayment;[6] and

- Any proposed modifications of the imputed underpayment that the IRS rejected and any facts supporting the proposed modifications.[7]

As with TEFRA petitions, the petition must include statements of each error petitioner alleges the IRS made in the FPA, a statement of the facts supporting the assignments of error, and copies of the FPA, any relevant statement accompanying the FPA and any relevant notice referenced in the FPA or relevant accompanying statement.[8]

If a partnership receives multiple FPAs, it can file one petition seeking redetermination for all the FPAs.[9] However, the court may sever the case if it will further convenience, avoid prejudice or will be conducive to expedition or economy.[10] Each partnership must file its own petition; there cannot be one petition for FPAs received by separate partnerships.[11]

Partnership Representatives

The rules give the Tax Court the power to identify or remove a partnership representative.[12] The court said this power stems from its inherent supervisory authority.[13]

If the petition does not identify the partnership representative, the Tax Court is permitted to take action to establish the identity of the partnership representative.[14]

As noted above, the rules permit the Tax Court to remove the partnership representative.[15] The partnership representative may be removed only for cause and after notice and opportunity to be heard.[16] If the Tax Court removes a partnership representative, the partnership must designate a new representative within a time period to be provided by the court.[17]

It is unclear whether the Tax Court has the power to appoint a partnership representative. The Tax Court's explanation of the rule explicitly states that it is not taking a position on that issue.[18]

IRS Announces Intent to Issue New Proposed Regulations

On Dec. 20, 2018, the IRS announced[19] its intention to issue proposed regulations on two matters related to implementation of the new centralized partnership audit regime.[20] The first matter involves audits of a person other than the partnership that require an adjustment to a partnership-related item. The second matter involves special rules for electing out of the regime for partnerships with qualified subchapter S subsidiary, or QSub, partners.

Bypassing the Centralized Regime in Nonpartnership Audits

The IRS intends to propose regulations that will allow it to directly audit a partner without applying the centralized partnership audit regime. Under the to-be-proposed regulations, the IRS can decide that the centralized regime does not apply to an adjustment of a partnership-related item if:

- The item does not arise in an audit of a partnership;
- The partnership-related item adjustment is made as part of an adjustment to a non-partnership-related item; and
- The treatment of the partnership-related item is based on information from the person under examination.[21]

According to the IRS, this regulation will enable the IRS to effectively and efficiently focus on a single partner or a small group without "unduly burdening the partnership and avoiding procedural concerns about the appropriate level at which such items must be examined."[22]

Special Elect-Out Rules for Partnerships with QSubs

Under Internal Revenue Code Section 6221(b), certain partnerships may elect out of the centralized partnership audit regime. The IRS intends to propose regulations that would generally bar any partnership with a QSub partner from electing out.

To be eligible to elect out of the centralized partnership audit regime, the partnership, among other things, must have 100 or fewer partners for a year.[23] The number of partners is determined by counting the number of Schedule K-1s that the partnership is required to issue and all the Schedule K-1s any direct S corporation partners are required to issue.[24]

A QSub is a domestic corporation that is 100 percent owned by an S corporation that has elected to treat the corporation as a QSub.[25] Generally, a QSub is disregarded and all of its assets, liabilities and items of income, deduction and credit are treated as the assets, liabilities and items of income, deduction and credit of the S corporation parent.[26]

The IRS said it needs to ban partnerships with QSub partners from electing out of the centralized regime, because otherwise if a partnership has a QSub partner, the partnership could elect out of the regime but have more than 100 ultimate partners.[27] Without the ban, the IRS would face "significant enforcement concerns" and the efficiencies introduced by the centralized partnership regime would be frustrated.[28]

However, the IRS said there will be an exception in the forthcoming regulations that allows a partnership with a QSub partner to elect out of the regime if certain requirements are met.[29] The IRS also said that the regulations will include a rule similar to the rule for S corporation partners in Section 6221(b)(2)(A).[30] That section requires partnerships with S corporations seeking to elect out of the regime to disclose the name and taxpayer identification number of each person to whom the S corporation is required to issue a Schedule K-1.[31]

The forthcoming proposed regulations will also have a new rule for counting partners for partnerships with a QSub partners. When counting partners, the partnership must include the Schedules K-1 for each QSub partner and each S corporation shareholder.[32]

Authority for the Regulations

Both regulations will be issued pursuant to Section 6241(11), which gives the IRS the authority to exclude special enforcement matters from the centralized partnership audit regime and issue special rules governing those matters. Special enforcement matters include failure to comply with the rules regarding push-out statements to tiered partners, termination and jeopardy assessments, criminal investigations, indirect methods of proof of income, foreign partners or partnerships and other matters that the IRS determines by regulation.[33]

Timing of the Regulations

The IRS and U.S. Department of the Treasury plan to issue these proposed and final regulations by Sept. 23, 2019 — 18 months after the Consolidated Appropriations Act which contained technical corrections to the centralized partnership audit regime. If they promulgate final regulations by then, the regulations may be applicable to all partnership taxable years beginning after Dec. 31, 2017. If the regulations are not finalized by then, the IRS intends for the regulations to be applicable to partnership taxable years beginning after Dec. 31, 2017, and ending after the Dec. 20, 2018 — the date of notice.[34]

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[1] https://www.ustaxcourt.gov/press/121918.pdf.

[2] Tax Ct. R. 255.2(b).

[3] Tax Ct. R. 255.2(b)(1).

[4] Id.

[5] Tax Ct. R. 255.2(b)(5).

[6] Id.

[7] Tax Ct. R. 255.2(b)(5), (6), (7).

[8] Tax Ct. R. 255.2(b)(6), (7), (10), Tax Ct. R. 241(d)(1).

[9] Tax Ct. R. 255.2(c)(1).

[10] Tax Ct. R. 255.2(c)(2).

[11] Tax Ct. R. 255.2(c)(1).

[12] Tax Ct. R. 255.6.

[13] Explanation to Tax Ct. R. 255.6.

[14] Tax Ct. R. 255.6(a).

[15] Tax Ct. R. 255.6(b).

[16] Id.

[17] Id.

[18] Explanation to Tax Ct. R. 255.6.

[19] https://www.irs.gov/pub/irs-drop/n-19-06.pdf

[20] I.R.S. Notice 2019-06, 2019-03 I.R.B. 353.

[21] Id.

[22] Id.

[23] I.R.C. 6221(b)(1)(B).

[24] 26 C.F.R. Section 301.6221(b)-1(b).

[25] I.R.C. Section 1361(b)(3).

[26] I.R.C. Section 1361(b)(3)(A).

[27] I.R.S. Notice 2019-06.

[28] Id.

[29] Id.

[30] Id.

[31] I.R.C. Section 6221(b)(2)(A).

[32] I.R.S. Notice 2019-06.

[33] I.R.C. Section 6241(11)(B).

[34] I.R.S. Notice 2019-06.