New Final Partnership Audit Regulations

On December 21, 2018, IRS and Treasury issued final regulations implementing the partnership audit regime (T.D. 9844). The final regulations largely adopt, with some changes, the proposed regulations issued in August 2018. By issuing almost 200 pages of preamble, the final regulations provide extensive discussion of which comments were incorporated and why others were not. Likely, IRS is thinking ahead to litigation over the validity of the regulations by issuing such broad discussions of the comment process. The most significant changes to the proposed regulations are changes to the definition of partnership-related items and changes allowing administrative adjustment of partnership-related items.

Changes to Definition of Partnership-Related Items

The final regulations more narrowly define the term "partnership-related item" than did the proposed regulations. The final regulations clarify that "partnership-related item" include only items or amounts that are (1) shown (or required to be shown) on the partnership's return or (2) required to be maintained in the partnership's books and records. "Partnership-related items" do not include items or amounts that would have been affected items or computational adjustments under the previous partnership audit regime, the Tax Equity and Fiscal Responsibility Act ("TEFRA").

► Practice Tip ◄
Practically, partnerships will be able to look to the existing doctrine of case law under TEFRA to inform their analyses of what is covered by the new rules.

The IRS intends for this definition of "with respect to the partnership" to preserve the centralized nature of the proceeding around the partnership. The final regulations note that IRS adjusts items at the partnership level based on the information to which the partnership has access (*i.e.*, items that are reported by the partnership on its return or items that are used for the purposes of completing the return).

What is in and what is out? Here are some key examples:

- Because disguised sales affect a partnership's books and records, the IRS appears to continue to treat disguised sales as within the scope of the new rules.
- Partner-level items that are dependent upon partners' adjusted gross income (i.e., limitations on charitable contributions) should be excluded from partnership-level proceedings under the final regulations.
- Partner-level loss limitations are also affected items under existing TEFRA rules—partners will need to utilize amended returns or other mechanisms to pull partner-level characteristics into partnership proceedings where the IRS is adjusting losses that were suspended at the partner level.

Considerations Related to Consistency Between Partner and Partnership Returns

The final regulations make it clear that partners must treat partnership-related items consistently with partnership treatment, on both original and amended returns, and on any included statement, schedule, list, amendment, or supplement.

The final regulations provide one exception to this consistency requirement, stating that if a partner treats a partnership-related item on an amended return inconsistently with the partnership's treatment, then the partner is deemed to have filed an AAR. The partner must also notify IRS of this inconsistent treatment. This changes the rule in the proposed regulations, which did not permit partners to request AARs.

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There are limitations to a partner's ability to file an AAR of a partnership item: The final regulations provide that a partner may not notify IRS that the partner is treating an item inconsistently with the partnership return for a taxable year *after* a notice of administrative proceeding ("NAP") has been mailed to the partnership. In other words, the partner may not adjust a partnership-related item outside of the administrative proceeding, once initiated by the IRS, by taking an inconsistent position. Rather, any adjustment to a partnership-related item at that point must be determined within the administrative proceeding. This is consistent with the proposed regulations, which had stated (consistent with section 6227(c)) that an administrative adjustment request cannot be filed by the partnership, after an NAP had been mailed to the partnership (with an exception related to withdrawal of a notice of administrative proceeding).

► Practice Tip ◄
Permitting partners to trigger an AAR through an amended tax return (and notice to the IRS) provides a concession to partners to counter-balance the otherwise broad powers granted to partnership representatives.

If a partnership has not filed a return, any partner's return is no longer treated as *per se* inconsistent (as per proposed regulations). The final regulations clarify that where a partnership has failed to file a return, any treatment of a partnership-related item on a partnership's return may be removed and IRS may determine any underpayment of tax resulting from such adjustment.

Timing of Push-Out Elections

IRS declined to provide an exception to or an extension of the 45-day period (following the receipt of a final partnership adjustment ("FPA")) to make a push-out election, even in the case of a judicial challenge. Rather, a partnership will remain required to elect push-out adjustments within 45 days of the FPA, even if they later file a request for judicial review (which must be filed within 90 days of the FPA).

Access to IRS Appeals Office

The preamble to the final regulations contemplate that the IRS will provide the opportunity for partnerships to challenge determinations prior to receiving a "notice of proposed partnership adjustment ("NOPPA") with the Office of Appeals. While granting partnerships access to the IRS Appeals process is welcome, as a practical matter, only the substantive adjustments to partnership items would be reviewed at that stage of the proceeding. In other words, at this time there is no clear path to bringing a challenge to the calculation of an imputed underpayment to Appeals. Treasury has, however, indicated that guidance expanding upon these procedures is forthcoming.

Other Notable Changes

Other changes to the proposed regulations include the following:

- Administrative adjustment requests ("AARs") can contain more than one imputed underpayment.
- IRS may not invalidate AARs based on errors in statements provided to partners, if a partnership corrects those errors in a timely manner.
- If a partnership has multiple imputed underpayments, it can choose to settle some and push-out others to its partners.
- Provisions governing interest on underpayments are now consistent with interest-related provisions of the code.
- IRS has included special rules for publicly traded partnerships ("PTPs") and partners that are regulated investment companies ("RICs") and real estate investment trusts ("REITs").
- The final regulations have excluded partner level penalty defenses from partnership level proceedings, with a resulting process requiring partners to pay the penalties first and sue for refund.

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- The final regulations provide guidance on when a partnership ceases to exist.

Finally, Treasury and IRS are continuing to look at additional guidance for reserved issues, including how to treat partner-level debt and how to incorporate adjustments to creditable foreign taxes in either a partnership audit or AAR proceeding.

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