American Institute of CPAs
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November 17, 2016

The Honorable Orrin G. Hatch, Chairman
Senate Committee on Finance
104 Hart Office Building
Washington, DC 20510

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
301 Cannon Building
Washington, DC 20515

The Honorable Ronald L. Wyden
Ranking Member
Senate Committee on Finance
221 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sander M. Levin
Ranking Member
House Committee on Ways & Means
1236 Longworth House Office Building
Washington, DC 20515

RE: Proposed Legislative Revisions to the Partnership Audit Regime Enacted as part of the Bipartisan Budget Act of 2015

Dear Chairmen Hatch and Brady, and Ranking Members Wyden and Levin:

The American Institute of CPAs (AICPA) provides the following recommended legislative revisions to the Partnership Audit Regime ("Regime") enacted as part of the Bipartisan Budget Act of 2015,[1] ("Act"). We appreciate Congress's efforts to streamline the ability of the Internal Revenue Service (IRS) to audit, assess and collect underpayments of tax from partnerships and their partners. However, the Act contains a number of provisions that are unclear, confusing or difficult to administer in a fair and efficient manner. These suggested changes are necessary to clarify the operation of certain provisions of the Act, correct inconsistencies, improve the Regime's fairness and simplify its administration.

These comments were developed by the AICPA Partnership Taxation Technical Resource Panel and approved by the AICPA Tax Executive Committee.

Background

On November 2, 2015, Congress enacted the Act that made significant changes to the Internal Revenue Code (IRC or "Code") by creating a new centralized partnership audit regime to replace the existing regime enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (TEFRA). The Regime is generally effective for taxable years beginning after December 31, 2017.

The Regime will generally centralize the ability of the IRS to audit, assess and collect any determined underpayment of tax directly from a partnership, subject to certain available elections. The elections include allowing certain partnerships to opt-out of the Regime, as well as an election

[1] Public Law 114-74.

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for partnerships to push-out the responsibility for payment of any assessment imposed to its partners. The implementation of the Regime will require balancing a simplified assessment and collection process imposed at the partnership level with the guiding principles of fairness and equity in the tax code. There is a general expectation that tax is to be imposed at the appropriate rate of tax (as enacted in the applicable section of the IRC) and imposed *only* on (1) the appropriate taxable individual or entity and (2) the properly calculated amount of taxable income.

As enacted, Code sections 6221[2] through 6241, which establish the Regime, contain substantial procedural gaps and uncertainties that the United States Secretary of the Treasury ("Secretary") is required to address through regulations. The AICPA has previously submitted a series of recommendations to the United States Department of the Treasury ("Treasury") and the IRS for use in developing these regulations[3] and will continue to engage with them throughout their process of establishing the Regime. However, there are several issues that require Congressional action to change the language of the IRC to ensure the development of a fair, equitable and workable Regime.

Recommendations

1. *Expand Push-Out Election to Allow Affected Taxpayers to Also Push Out*

The AICPA recommends that Congress modify the Code to provide that upon receipt of an adjustment Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* an upper-tier partnership, S corporation or estate or trust is permitted to make an election to either pay any calculated additional tax or further push-out the adjustment to their partners, owners or beneficiaries.

A primary goal of the push-out election is to have the liability for any additional tax imposed on the responsible partners from the reviewed year versus the partnership. In order to ensure this outcome, it is necessary to make the push-out election available to upper-tier partnerships, S corporations, and trusts and estates owning a direct or indirect interest in the audited partnership. We believe that the IRS can develop procedures that will permit them to collect the additional tax, interest and penalties from the indirect partners in a fair and efficient manner.

2. *Revise Push-Out Election to Allow Decreases in Tax*

The AICPA recommends that Congress modify section 6226(b) to allow partners to take into account adjustments that would both increase and decrease their calculation of the correct amount of tax imposed for the reviewed year and any intervening years.

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[2] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.
[3] AICPA Comment Letter Notice 2016-23 BBA Partnership Audit Procedures dated October 7, 2016.

As currently written, section 6226(b)(2) only permits taking into account increases to the tax imposed when a partner is required to recalculate their tax liability for the reviewed or intervening tax years. There are many instances where a pushed-out statement would result in a decrease to a partner's tax in either the reviewed year or, based on affected tax attributes, an intervening year. Failure to allow a partner to apply these decreases to either reduce the total amount of additional tax due in the current year or obtain a refund is unfair or unduly punitive.

Examples of situations where section 6226(b) results in a skewed outcome include:

a. When a taxpayer sells some or all of their partnership interest prior to the adjustment year, changes in the reviewed year will affect their basis for gain or loss on the transaction. The basis adjustment from any additional income allocated to the partner in the reviewed year would lower their gain (or increase their loss) on disposition, resulting in an overpayment of tax in the year of disposition.

b. When changes are made to the depreciable life of an asset and/or the treatment of an asset from expensed to depreciable or vice-versa, the timing of the allowed or allowable depreciation deductions is affected. Depending on the nature of the change related to depreciation, an overpayment of tax could occur in one or more of the affected years.

c. When the partnership elects to push-out an audit adjustment which includes a reallocation rather than have the affected partners file amended returns. The partners whose allocable shares are reduced will have overpaid tax in the reviewed year and be entitled to a refund.

Section 6227 relating to Administrative Adjustment Requests (AAR) mandates the use of the push-out election in the case of an adjustment that does not result in an imputed underpayment. Section 6227 also includes the language "with appropriate adjustments" in reference to the use of the push-out method. We interpret this language as permitting the IRS to allow taxpayers to take decreases in tax into account when calculating the additional tax imposed from an AAR. If our understanding is correct, we are unaware of any reason to deny taxpayers the same ability to take decreases in income into account when an audit adjustment is pushed out. Otherwise, a partnership is unable to correct an error that resulted in its partners overpaying income tax.

3. *Allow Modifications of Imputed Underpayments for Affected Taxpayers*

The AICPA recommends that Congress modify the Code to provide that the procedures, established by the Secretary under section 6225(c)(1) to allow modifications of the imputed underpayment, also apply to affected taxpayers (indirect partners in any upper-tier partnership, owners of any upper-tier S corporation and beneficiaries of any upper-tier estate or trust).

If the partnership can provide the IRS with satisfactory proof of eligibility for a permitted modification of an imputed underpayment, we believe it is fair and equitable to allow such a modification for both direct and indirect partners of an audited partnership.

To illustrate, consider the following simplified example:

- The IRS audits Partnership X.
- Partnership X is owned 10% by an individual and 90% by Partnership Y (upper-tier partnership).
- Partnership Y is owned 50% by an individual and 50% by a tax-exempt entity.

If the audited partnership (Partnership X) elects to pay any imputed underpayment, but is unable to request a modification of the imputed underpayment based on its indirect partners, then 45% (90% multiplied by 50%) of the imputed underpayment would relate to a tax-exempt entity.

If the audit produces an increase in taxable income of $100,000, the initial imputed underpayment is $39,600 ($100,000 multiplied by highest individual rate of 39.6%). For simplicity, assume that all the direct and indirect individual partners are subject to the same 39.6% rate on their original reviewed year returns and that none of the increased income is UBTI for the tax-exempt partner.

If the partnership had reported the additional $100,000 in income on the originally filed return, the tax would have been calculated as follows:

Direct individual partner –10% share: $10,000 multiplied by 39.6% = $3,960
Indirect individual partner – 45% share: $45,000 multiplied by 39.6% = $17,820
Indirect tax-exempt partner – 45% share: $45,000 multiplied by 0% = $0
Total tax owed = $21,780

In the example, if the partnership elects to pay the imputed underpayment directly, which achieves a goal of the Regime to simplify the ability of the IRS to assess and collect adjustments from partnerships, **a significant disparity between the amount of $21,780 owed under the Code and the amount of $39,600 collected by the IRS would exist**.

Unless the partnership is permitted to request a modification based on the entity type of an indirect partner, the partnership and its partners are thus required to pay $17,820 in additional tax above and beyond what is required under the law.

4. *Amended Returns – Clarify Impact on Intervening Years*

The AICPA recommends that Congress modify the Code to indicate that partners filing amended returns under section 6225(c)(2) for the reviewed year must also file amended returns for any

intervening years (years between the reviewed and adjustment years) irrespective of any statute of limitation restrictions, if tax attributes are affected in the intervening years.

Section 6225(c)(2)(A)(ii) requires that amended returns filed because of of audit adjustments in a reviewed year, take into account allocable adjustments for the reviewed year "and any other taxable year with respect to which any tax attribute is affected by reason of such adjustments." However, section 6225(c)(2)(A)(i) only requires the filing of an amended return for the reviewed year and not for any intervening years. In addition, section 6225(c)(2)(A)(iii) requires that "payment of any tax due is included with such **return**" (emphasis added). The use of the singular "return" appears to refer to only an amended return filed for the reviewed year.

We are concerned that the wording may lead some partnerships to contend that their partners must only file amended returns for the reviewed year and pay any additional tax resulting from the reviewed year changes. We do not believe that is the intent of this section. We believe that the intent is for a partner to file amended returns for the reviewed year and any intervening years (in which a tax attribute was affected), as well as pay the additional tax due for all the affected tax years. We believe clarifying language is necessary to preclude any uncertainty or disputes on this issue.

5. *Allow Affected Taxpayers to Amend Returns*

The AICPA recommends that Congress modify the Code to allow affected taxpayers (partners of an upper tier partnership, owners of an S corporation and/or beneficiaries of an estate or trust that receive an amended Schedule K-1 or equivalent statement because of an audit) to file amended returns under section 6225(c)(2) for affected years, notwithstanding section 6511. The same limitations on an extended or reopened statute of limitations discussed in our previous recommendation would apply here as well.

Often, the partners of an audited partnership electing to file amended returns to claim a reduction of an imputed underpayment are another partnership, an S corporation, an estate or a trust. In these cases, responsibility for paying the additional tax is the responsibility of the partners, owners or beneficiaries of the entity and not an entity that is a direct partner.

In order to ensure that the indirect partners are entitled to file amended returns, particularly in cases involving a potential refund due to a reallocation of distributive shares, we recommend that Congress provide specific authority in the Code.

6. *Provide Convenient Option for Tax-Exempt Partners to Verify Tax Status (Upon Reallocation of Distributive Share)*

The AICPA recommends that for purposes of section 6225(c)(2)(B), Congress modify the Code to allow a partnership to provide the Secretary with proof of a partner's tax-exempt status in lieu

of requiring such partners to file amended returns in the case of a reallocation of a distributive share to or from that partner. This provision should apply only if the reallocation does not affect unrelated business taxable income (UBTI).

Code section 6225(b)(2) considers only those items that increase taxable income for purposes of calculating the imputed underpayment for adjustments involving the reallocation of a partnership's distributive shares. In order to request a modification of the imputed underpayment from such a reallocation, the Code requires that all partners affected by the reallocation of distributive shares file amended returns.

We presume this provision is intended to ensure that before the IRS allows a modification of the imputed underpayment, the partners, whose allocable shares have increased, file amended returns and pay the additional tax owed. However, a tax-exempt partner, unless the reallocation involves UBTI, will not owe any additional tax. Instead of requiring a tax-exempt partner to file an amended return, the Code should provide an exception to allow the partnership to provide the IRS proof of the partner's tax-exempt status. This simpler method of achieving the same goal would facilitate efficient tax administration without requiring the preparation and processing of an unnecessary tax return.

7. *Clarify Limitations on NOLs*

The AICPA recommends that Congress modify the language in the Code to prevent a taxpayer from receiving a double benefit from a net operating loss (NOL) when they must recalculate their tax for the reviewed year under the push-out method and had previously carried back an NOL from the reviewed year to earlier tax years.

To illustrate our recommendation, consider the following example:

A partner reports a NOL in the amount of $20,000 on their original reviewed year return. The partner carried back $10,000 of the NOL to their prior year's tax filing and carried forward the remaining, unused NOL of $10,000 to the subsequent tax year. If the partner's allocable share of increased income resulting from an audit of the reviewed year is $20,000, a recalculation of their reviewed year return will result in net income of zero.

Under the Code as currently written, the partner is required to recalculate their tax for the subsequent tax year. In the example, the $10,000 NOL carryforward is no longer available in the subsequent tax year due to the increase in income of $20,000 as a result of the audit, resulting in the imposition of tax on the $10,000 of income. There is no provision in the Code requiring a partner to recalculate the tax imposed due to a change in a tax attribute for any tax year prior to a reviewed year. Therefore, the $10,000 that was carried back to a year prior to the reviewed year is never recovered. As a result, the partner will only have additional tax imposed on $10,000 of the $20,000 increase in income allocated to them.

In the example, a taxpayer could receive a double benefit from any portion of the reviewed year's NOL that was carried back. To prevent this occurrence, we recommend requiring a taxpayer to increase their taxable income or decrease their taxable loss by the amount of any NOL previously carried back when recalculating the tax imposed for the reviewed year.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; Michael Greenwald, Chair, AICPA Partnership Taxation Technical Resource Panel, at (212) 842-7513 or MGreenwald@friedmanllp.com; or Jonathan Horn, Senior Technical Manager – AICPA Tax Policy & Advocacy, at (202) 434-9204 or jhorn@aicpa.org.

Respectfully submitted,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable Mark Mazur, Assistant Secretary for Tax Policy, Department of the Treasury
Mr. Thomas C. West, Tax Legislative Counsel, Department of the Treasury