To: Partnership Work Group

From: MTC Staff

Re: Evaluation of the "Push-Out" Election in its Current Form

Updated: November 29, 2016

At its meeting on November 15, 2016, the Partnership Work Group asked MTC staff to provide additional analysis into a key provision of the new federal Bipartisan Budget Act audit and adjustment rules—the "push-out" election in Section 6226. This memo summarizes that analysis as well as important developments that occurred after the work group meeting.

Summary of the Push-Out Election

Under the Bipartisan Budget Act of 2015, after the IRS audits a partnership under the new audit and adjustment rules and computes a final imputed underpayment (tax amount), a partnership has 45 days to elect to "push out" the audit adjustments to the partners[1] or must pay the tax itself. To make the push-out election, the partnership must furnish to the IRS and to each reviewed-year (audit year) partner of the partnership a statement of each partner's distributive share of any adjustment to income, gain, loss, deduction, or credit.[2] (The form for this statement is yet to be developed by the IRS.) If the partnership provides this statement, then it is relieved of liability, and instead, each partner must take the adjustments into account.[3] Each reviewed-year partner must, in the adjustment year (the year in which they receive the statement), increase their adjustment-year tax appropriately for the aggregate of the adjustment amounts.[4] That increase in tax includes tax that would have been due in the reviewed year had the adjustments been taken into account in that year,[5] as well as the tax that would have been due years subsequent to the reviewed year as a result of the related adjustments of the partner's tax attributes.[6]

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[1] Sec. 6226(a)(1).
[2] Sec. 6226(a)(2).
[3] Sec. 6226(a)(2).
[4] Sec. 6226(b)(1).
[5] Sec. 6226(b)(2)(A).
[6] Sec. 6226(b)(2)(B) and (C).

Additional Analysis

Staff has worked with the group members and others to develop a working draft of a state issue list for purposes of directing our efforts in drafting model language for states to use to impose notice and filing requirements for partners and partnerships that are subject to federal audit adjustments.[7] This list makes certain assumptions about how the federal push-out election will work. More importantly, this list of issues assumes that the push-out election *can* work in the form in which it appears to have been enacted.

While the IRS has not yet issued regulations and there are unanswered questions about the process it will put in place for the push-out election, we have analyzed some of the potential issues that the election appears to create. We considered various sources of information for this analysis including comments made to the IRS as part of the regulatory process, analysis done by practitioners and others, and public statements by the IRS about the push-out election in particular or about the new audit and adjustment rules in general.

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[7] 1. Will the state allow the partnership to push out the state tax amount related to the federal audit adjustments if the partnership makes a federal push-out election?

- a) If so, will the state require the partnership to provide additional state-related information (such as apportionment information) so that the state tax owed by the partners can be properly calculated?
- b) Will the relevant apportionment information be that related to the reviewed year (and subsequent years) in order to avoid constitutional concerns?
- c) How will the state handle the partner who was a state resident in the reviewed year but is now a nonresident or no longer a partner? And vice versa? What jurisdictional issues are presented?

2. If the state normally requires withholding for nonresident partners, will the state require the partnership to withhold on nonresident partners for their tax liabilities? (see question above)
3. If the state normally allows or requires a composite return for nonresident partners to be filed by the partnership, will it allow an amended composite return, or a current year composite return that includes reviewed year adjustments, in this situation? What jurisdictional issues are presented?
4. Will states permit partnerships to file withholding or composite returns for resident partners or will they each be required to file amended returns? If they are allowed to be included, how will their liability be computed?
5. Can the composite return include corporate partners who were not included on the originally filed composite return? If they are allowed to be included, how will their liability be computed.
6. If the partnership elects to push out the federal adjustments, will the state allow it to pay the state-related tax at the partnership level, without pushing that liability out to the partners? In other words, if a federal push-out election is made, will the state allow the partnership to opt-out of that election for a particular state and remain liable for the tax?
7. Conversely, if a partnership does not make a federal push-out election, may it nevertheless do so at the state level? Under what conditions?

Simple Example

To provide context for this analysis, consider the following simple example:

A and B are partners in AB.

In YR1, AB files a 1065 showing $1 million of business revenues and $800,000 or ordinary business expenses. It files schedule K-1s allocating 80% of the $200,000 of ordinary net income ($160,000) to A and 20% ($40,000) to B.

In YR3, AB is audited by the IRS. The IRS determines that AB took $100,000 of deductions to which it was not entitled. It also determined that the ordinary income of the partnership should have been allocated 50/50, rather than 80/20, to A and B.

At the end of YR3, C buys A's partnership interest.

In YR3, the IRS calculates an imputed underpayment as follows:

Additional ordinary income	$100,000
Additional allocation to B of the income originally reported ((50% x $200,000)-(20% x $200,000))	60,000
Total base adjustment	$160,000
Tax rate	40%
Imputed underpayment	$64,000

Note that in determining the imputed underpayment, the over-allocated amount to A is not offset against the under-allocated amount to B. (This follows the explicit requirements of the statute.)

Also note, the adjustment to ordinary income and the adjustment in allocated amounts of ordinary income from 80/20 to 50/50 should also result in adjustments to both the capital accounts and the outside basis of A and B at the end of YR1. This could also affect the gain or loss recognized on the sale of A's partnership interest to C at the end of YR3 and might affect other related provisions of Subchapter K. (What is not clear, however, as discussed further below, is whether the rationale for the reallocation would affect distributive shares or tax attributes in YR2 and YR3 or whether A can take into account the offsetting reduction in A's distributive share in YR1.)

Assume that in YR4, AB ultimately makes the election to push out the adjustments. There are things that appear to be clear about how this will work and things that appear less clear. As for the things that seem clear:

1. AB will be required to file information returns with the IRS and with A and B showing as adjustments: the $100,000 adjustment to net income allocated 50/50 to A and B; and the $60,000 under-allocated amount of the originally reported income affecting B.

2. A and B will be required to report in YR4 any tax that would have been due in YR1 on these adjustments along with additional tax that would have been due because of changes in tax attributes due to these YR1 adjustments.

As far as the things we don't know:

1. How will the over-allocated amount to A in YR1 be treated for purposes of the push-out election? If it is not taken into account, then A would owe additional tax. If it is, then A would be entitled to a refund ($50,000 - $60,000). Assuming that it is taken into account, AB would be required (or allowed) to include in the information return filed with the IRS and with A this offsetting adjustment even though it was not taken into account in calculating the imputed underpayment. Presumably, how A's tax attributes are adjusted at the end of YR1 will also be affected by the answer to this question as well.

2. If the answer to 1 is that the AB will not push-out the offsetting re-allocation adjustment to A, can A nevertheless include the offsetting over-allocated amount in A's YR4 return with the other adjustments reported by AB (subject to review by the IRS)? Does whether or not A will be entitled to a refund in this case be based on whether B eventually pays the additional tax owed on account of the re-allocation?

3. Assuming that the adjustment to the allocation of ordinary income is based on a finding that would apply to YR 2, YR3, and YR4 as well, will A and B be required to calculate the tax that would be due on any reallocation of income in those years and report that tax in YR4? If not, can A file amended returns for YR2 and YR3 claiming over-reported (over-allocated) income on the basis of the IRS audit or would this be an inconsistent tax position (since the partnership would not have allocated the income in those years 50/50)? If A can file amended returns, can the

IRS decline to grant refunds until B also files amended returns reporting the additional allocation of income B should have paid tax on?

4. Depending on the answers to 1-3, how will this affect A's capital account and A's outside basis and the potential gain/loss on the sale of A's partnership interest to C?

5. What if, in YR3, in response to the original imputed underpayment by the IRS, A filed an amended tax return taking into account A's share of the additional ordinary income and offsetting the over-allocated amount of original income ($50,000 - $60,000) and claimed a refund? (Again, would that be considered an inconsistent position at that time?)

<u>Summary of Unanswered Questions About Push-Out for Federal Tax Purposes</u>

As the simple example above demonstrates, there are a number of unanswered questions about how the push-out election will work. These questions reflect a bigger uncertainty--whether the ultimate goal is to arrive at the so-called "correct return position" so that every partner's tax returns (and the tax computed) will reflect the proper treatment under Subchapter K for that partner for all related issues and years. Or is this new audit and adjustment scheme essentially an in-lieu of tax meant to supplement the tax under Subchapter K?

The questions concerning the push-out election can be generally summarized as follows:

1. If the IRS determines that partnership tax items were improperly allocated, how are offsetting under-allocated amounts treated in the push-out election?

2. How are audit findings that would apply in the same way in years subsequent to the reviewed year but prior to the adjustment year treated?

    a. Will the IRS require only that changes in the reviewed year be reflected in capital accounts, inside basis, asset basis, outside basis, etc.?

    b. Or, will the IRS require that changes in the reviewed year that would implicate reporting in the subsequent years also be taken into account—e.g. change in the proportionate distributive shares allocated to the partners?

    c. Assuming that adjustments made in the reviewed year will require some kind of adjustments (at a minimum in capital accounts and basis) in subsequent years, are any tax effects generated by those subsequent year adjustments (gain/loss on sale of partnership shares or assets) required to be reported along with the other adjustments in the adjustment year?

3. Can some partners who overpaid tax in the reviewed year or subsequent year, based on audit adjustments, file amended returns claiming refunds prior to the push-out election? (Public statements of IRS officials seem to indicate the answer to this question is, no.) Can partners file amended returns to take into account items not adjusted as part of the audit for the reviewed year or subsequent years?

4. What happens if the IRS takes issue with the manner in which the partnership pushes out the adjustments? Will the partnership owe some portion of the tax if it does not properly push out the adjustments?

5. Since the partners are required to report the tax that would have been due in the reviewed year (had the adjustments been made), but must do so by reporting that tax in the adjustment year, how exactly will this be shown on either the statement provided by the partnership or the partner's adjusted year return? (It will not be as simple as increasing distributive share of items on the partner's adjusted year return—since the tax that would have been owed in the reviewed year will also depend on other reviewed year factors such as offsetting deductions or losses from other sources and on the effective tax rate of that partner in the reviewed year.)

6. Can a partnership with partners that are pass-through entities make the push-out election provided that the partnership (as well as its partnership partners) is willing to do the work of computing adjustments for all taxable partners in whatever tier of the structure that they may be? (Section 6226 and the Blue Book's interpretation clearly indicate that the push-out method allows the adjustments to be pushed out only to a single tier of partners.) If it is the goal of the process to reach the correct return position for all partners, and if this process is to be allowed to partnerships with multiple tiers, then it will be necessary for the partners in the upper tiers (indirect partners) to disclose to the audited partnership personal tax information to understand how to properly report the adjustments.

7. The audit and adjustment process now allows partners to file amended returns for the review year and report additional tax related to audit adjustments and pay additional tax – reducing the imputed underpayment (prior to the election to push-out the adjustments). If some partners choose to do so, will this affect how the remaining adjustments are pushed out to other partners?

Recent Developments

On November 15, in a presentation to the AICPA National Tax Conference in DC, Commissioner Koskinen of the IRS is reported to have said the following: "Our hope was when the TEFRA rules were changed, that it would allow the audit to be more efficient -- both for the taxpayer and us. . . . We've been spending a lot of time trying to sort through whether [the BBA leaves the IRS] better off or not. There are some indications that this process -- if we can't get it all smoothed out -- will be worse for taxpayers and us than" TEFRA, he said. "The statute has turned out to be more complicated rather than less, and so it's a challenge."

At a meeting at the AICPA National Tax Conference in DC, representatives of the AICPA met with representatives of the IRS to express concerns about the audit and adjustment provisions and the potential regulatory solutions. AICPA representatives had a number of questions for the IRS about what kind of data sharing the IRS would be doing with the states and how the IRS would decide what data to share with which states. Those representatives also asked that whether or not the adjustments are pushed-out (that is, if the partnership pays the liability) that the effect on the partners be treated the same—that tax attributes be adjusted appropriately and that the tax paid be treated as paid on behalf of the partners. (Other discussion focused on Section 6225, rather than 6226.) The IRS gave little indication of how it would address any particular question or whether it expected that Congress might amend the related statutory provisions.

In a letter to the leadership of the House Ways & Means Committee on November 17, 2016, the AICPA made a number of observations about proposed legislative revisions to the Bipartisan Budget Act with respect to the need for those revisions generally, and the push-out election in particular, including:

- ". . . the Act contains a number of provisions that are unclear, confusing or difficult to administer in a fair and efficient manner."
- "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 6222 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."

- "... 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."
- "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."
- "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. 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."