

MEMO# 30744

June 15, 2017

IRS Reissues Proposed Partnership Audit Regulations; Comments Requested

[30744] June 15, 2017 TO: Tax Committee RE: IRS Reissues Proposed Partnership Audit Regulations; Comments Requested

The Internal Revenue Service (“IRS”) and the Treasury Department have reissued [proposed regulations](#) implementing the new partnership audit regime that was enacted as part of the Bipartisan Budget Act of 2015 (“BBA”). The BBA substantially reformed the procedures for auditing partnerships by repealing the TEFRA partnership audit rules in Chapter 63 and the Electing Large Partnership rules in Subchapter K and replacing them with a single, simplified regime.

In general, under new section 6225, any adjustments for a partnership tax year are taken into account by the partnership (not the individual partners) in the year that the audit is completed. An alternative audit procedure is available under new section 6226, in which the partnership may elect to furnish to each reviewed-year partner a statement setting forth each such partner’s share of any partnership adjustments. The new rules apply to returns filed for partnership taxable years beginning after 2017, though partnerships may elect to apply the new rules to returns filed for partnership taxable years beginning after November 2, 2015 (the date of enactment of the BBA).

Prior to issuing proposed regulations, the IRS and Treasury Department requested comments on the new regime in [Notice 2016-23](#). The Institute provided recommendations on several issues of importance to regulated investment companies (“RICs”).^[1] Specifically, the Institute urged the government to clarify the application of the deficiency dividend procedures under section 860 for RICs when a RIC is a partner in a partnership that is subject to the new audit rules. We asked the IRS and Treasury Department to confirm that RICs may use the existing deficiency dividend procedures with respect to their allocable share of the applicable adjustment to partnership income, gain, loss, or deduction, and take any deficiency dividend paid into account in (1) the filing of a return by a RIC in accordance with new section 6225(c); or, (2) the calculation of the RIC’s adjustment to tax under new section 6226(b).

The Institute also recommended that the government (i) specify the “determination date” for purposes of section 860 when a partnership is audited; (ii) confirm that a RIC that pays a deficiency dividend will be charged interest only under section 860 (and not also under section 6226); (iii) provide that a RIC (or other partners) will be subject to penalties only to the extent that it has any tax liability under section 6226 resulting from its share of an

adjustment under that provision; and (iv) permit tiered partnerships to use the alternative audit procedures under section 6226.

The government initially released the proposed regulations on January 19, 2017; however, the Trump Administration issued a memorandum on January 20 ordering a freeze of all regulations not yet published in the Federal Register as of that date, including proposed and final tax regulations. The reissued proposed regulations are, for the most part, the same as those initially released in January.

Proposed Regulations

Deficiency Dividend Procedures

The proposed regulations incorporate several of the Institute's recommendations. Importantly, the proposed regulations would clarify the availability of the deficiency dividend procedures when a RIC is a partner in a partnership that is subject to audit under new section 6225 or 6226.

Under new section 6225, a partnership's imputed underpayment amount may be reduced by taking into account the impact of the underlying adjustments on the partners' reviewed year returns. A RIC that is a partner thus could amend the reviewed year return to reflect the new amount of income allocable to it and pay any tax due. The proposed regulations would provide that a partnership may request a modification of its imputed underpayment under section 6225 if partners that are "qualified investment entities" ("QIEs") described in section 860 (RICs and regulated investment trusts ("REITs")) have distributed a deficiency dividend in accordance with section 860(f).^[2] The proposed regulations clarify that such modification would be available only to the extent that the deficiency dividends take into account adjustments pursuant to section 6225 that also are adjustments within the meaning of section 860(d)(1) or (2) (whichever applies).

The IRS and Treasury Department note in the preamble to the proposed regulations that a notice of proposed partnership adjustment (NOPPA) is not a final amount, as the partnership may still challenge it. Once a deficiency dividend has been paid and the QIE has submitted a claim for that amount, however, the QIE will not have an opportunity to change its position if the partnership later obtains a more favorable result. The IRS and Treasury Department thus have asked for comments on whether this provision adequately allows QIEs to use the modification process.

Alternatively, new section 6226 provides procedures under which a partnership may send adjusted partnership statements to the partners for the reviewed year. Those partners must include in their adjustment year tax return an amount determined by calculating the amount by which their tax liability would have increased in the reviewed year, and any subsequent years, if that partner's allocable share of the adjustments had been properly taken into account in the reviewed year (the "correction amount").^[3]

The proposed regulations would coordinate the rules under new section 6226 with the deficiency dividend procedures for QIEs. The proposed regulations thus would provide that a RIC or REIT may use the deficiency dividend rules under section 860 if the partnership provides to a QIE a statement (as described in Prop. Reg. § 301-6226-2) reflecting the QIE's share of any partnership adjustments for the reviewed year.^[4]

If the partnership provides a statement under section 6226 to a QIE, and the RIC or REIT

makes a determination under section 860(e)(4) that one or more of the adjustments reflected in the statement is an adjustment within the meaning of section 860(d), the proposed regulations would permit the QIE to distribute deficiency dividends for that taxable year for those amounts.^[5] The QIE then would claim a deduction for the deficiency dividends against any correction amounts calculated under section 6226.

The proposed regulations also clarify that interest under the proposed regulations would be calculated only on any correction amount determined after deducting any deficiency dividend deduction from the adjustments taken into account by the RIC or REIT.^[6] In other words, a RIC or REIT would not be subject to interest under both section 860(c)(1) and section 6226 on the same amounts; interest under section 860(c)(1) would apply to the extent of the deficiency dividend, and interest under section 6226 only would apply to any additional correction amounts. The proposed regulations note, however, that any deduction for deficiency dividends paid would have no effect on the QIE's liability for penalties.^[7]

Other Proposed Rules Affecting RICs

Section 6221(b), as added by the BBA, permits certain eligible partnerships to elect out of the new partnership audit regime. A partnership is an eligible partnership if it has 100 or fewer partners during the year and all partners are eligible partners, as described in Prop. Reg. § 301.6221(b)-1(b)(3), at all times during the taxable year. Prop. Reg. § 301.6221(b)-1(b)(3)(i) would define an "eligible partner" as any person who is an individual, C corporation, eligible foreign entity, S corporation, or an estate of a deceased partner. The proposed regulations provide that for these purposes a C corporation would be an entity defined in section 1361(a)(2), including a RIC or REIT.

The IRS and Treasury Department noted in the preamble to the proposed regulations that they received a number of comments regarding the ability of tiered partnerships to use the alternative audit procedures under section 6226. The preamble notes that a bipartisan technical corrections bill was introduced in both the House of Representatives and the Senate in December 2016 that would have permitted a partner that is a partnership or S corporation to elect to flow the adjustments through upper tier partnerships or S corporations. The technical corrections bill ultimately was not enacted. The IRS and Treasury Department have expressed concerns with the administrability of such a rule, and the proposed regulations reserve on this issue. The government is seeking comments on how the IRS might administer section 6226 in tiered structures, including comments on information tracking and other information sharing issues. The government also is asking for comments on reducing noncompliance and collection risk in tiered structures while also limiting the administrative costs to the IRS.

Request for Comments

Please provide any comments on the proposed regulations to me (kgibian@ici.org or (202)371-5432) no later than **Tuesday, July 11, 2017**. The IRS and Treasury Department have asked for comments on the proposed regulations by August 14, 2017.

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endnotes

[1] See Institute Memorandum No. 30339, dated October 25, 2016, which can be found at: https://www.ici.org/my_ici/memorandum/memo30339.

[2] Prop. Reg. § 301.6225-2(d)(7).

[3] Prop. Reg. § 301.6226-3(b)(2).

[4] Prop. Reg. § 301.6226-2(h).

[5] Prop. Reg. § 301.6226-3(b)(4).

[6] Prop. Reg. § 301.6226-3(d).

[7] Prop. Reg. § 301.6226-3(b)(4).

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