S Corporation Corner

Predicting How the New Partnership Audit Rules Will Affect S Corporations and Their Shareholders

By Stuart J. Frentz

This column has three focal points: S corporations (of course!), the new partnership audit procedures and Jeanne Dixon. Yes, that Jeanne Dixon—the self-professed psychic who claimed to have predicted the assassination of President Kennedy, met with Presidents Roosevelt and Nixon and for a time was one of Nancy Reagan's astrologers.[1] What is Jeanne Dixon doing in this S Corporation Corner?

Well, it is about predicting the future. And it is about making enough predictions based on educated guesses that one or two of them may actually come true—or at least close enough to claim they came true. Unlike Jeanne Dixon, I do not claim other-worldly inspiration for the predictions I make later in this column. My prognostications are based on the newly enacted statutes themselves, previous bills, certain governmental reports and other generally available information, and I will reveal the reasoning behind each one.

That the new partnership audit provisions elicit predictions of how they will develop is due in large part to the conditions under which they were drafted. While negotiating the budget bill last October, the Obama administration and congressional leadership at some point decided to repeal and replace TEFRA as a revenue raiser. The choice is not surprising; there was common interest in reforming the partnership audit regime, albeit little agreement as to how it should be done. The President's 2013 and 2016 budgets proposed to "streamline" the audit and adjustment procedures for large partnerships, and several bills had been introduced in Congress to the same end. The congressional tax-writing committee staffs had to produce language for inclusion in the budget bill, and for a starting point they turned to a bill that had been introduced a few months earlier by Congressman James Renacci: H.R. 2821, the Partnership Audit Simplification Act.[2]

The Renacci bill provided for underpayments of tax determined on partnership audits to be assessed and collected at the partnership level, and the conferees accepted this approach. But the bill had several features that had prevented it from progressing toward enactment. It did not provide a workable method for partnerships to shift liability for audit deficiencies back to their partners. Worse, the bill imposed joint and several liability for a partnership's imputed underpayment on its past and present partners—regardless of their status.[3] Commentators protested

STUART J. FRENTZ is a Partner with Bradley Arant Boult Cummings LLP in Birmingham, Alabama.

that investors would be deterred from investing in real estate partnerships if they would risk buying into joint and several liability for past filing errors, and the consequences could be devastating to the real estate industry.[4]

Despite the Renacci bill's shortcomings, it became the starting point for drafting what became section 1101 of the Bipartisan Budget Act of 2015 (BBA).[5] The drafters fixed the most serious problems. They added new Code Sec. 6226, which does permit partnerships to shift the liability for an imputed underpayment back to its partners from the reviewed year, and they eliminated joint and several liability of partners. However, with risks of default on U.S. debt obligations and a government shut-down looming, the drafters had little time to further fine tune their changes.

We can thank the Capital Hill staffs for making the partnership audit provisions enacted with the BBA a vast improvement over the Renacci bill, but they clearly could have benefited from a few more drafting sessions and getting comments from the public. The rules as enacted leave many important questions unanswered, including how partnership audit adjustments will flow through tiers of partnerships, and with respect to our present topic, how they will flow through to the shareholders of S corporation partners.

In the January–February 2016 issue of the Journal, Don Susswein and Tom Lenz examined the new provisions and the issues they will pose for investment funds and their investors, pointing out technical corrections and regulatory clarifications that may be needed to fill in gaps and uncertainties in the law.[6] If you have not yet read Don and Tom's piece, it would be a good idea to do that before you proceed with this column. Then come back and resume with the additional background set forth in the next section.

Background and Recap of the New Rules

The IRS's problems with partnership audits have gotten a lot of attention over the past several years. In testimony to a Senate Subcommittee in 2014, the Government Accountability Office (GAO) noted that IRS examinations of large partnerships yield "minimal audit results."[7] GAO attributed the audit program's ineffectiveness to challenging administrative tasks required by TEFRA and the overwhelming complexity of large, tiered partnership structures. A few months later, GAO issued a follow-up report that cited IRS officials stating that "the process of determining each partner's share of the adjustment is paper and labor intensive. When hundreds of partners' returns have to be adjusted, the costs involved limit the number of audits IRS can conduct."[8]

The new audit procedures are Congress' and the administration's first real response to the GAO findings. They are designed to shift most of the administrative burden associated with TEFRA audit procedures to partnerships and their partners. Under TEFRA, the IRS had to follow a long and winding trail through multi-layered partnership structures to track down the individuals or entities ultimately liable for income taxes based on partnership audit adjustments. After the BBA changes go into effect, the agency will issue notices of proposed and final adjustments to the partnership, and at each stage the partnership and its partners will have opportunities—and ultimate responsibility—to sort out among themselves how they will handle the resulting tax bill. The IRS will deal with a single point of contact—the partnership representative. Only the partnership representative will be able to challenge the IRS adjustments—administratively or in litigation—and the partnership and all its partners will be bound by the ultimate outcome. If partners wish to have any say at all in partnership tax matters, they will have to negotiate for those rights under the partnership agreement.

The default rule will require the partnership itself to pay when audit adjustments result in a tax deficiency (an "imputed understatement"). There are two ways a partnership can shift part or all of the tax burden back onto its partners. First, when a partnership receives a notice of proposed partnership adjustment, the partnership can seek to have the imputed underpayment modified (*i.e.,* reduced). One path to modification will require that the partners file amended returns taking into account their shares of the partnership adjustments for earlier years and pay all additional taxes due with the amended returns.[9]

The second opportunity to shift the burden to its partners arises when a partnership receives a notice of final partnership adjustment. Within 45 days of the notice's mailing,[10] the partnership may elect under new Code Sec. 6226 to furnish a statement to each partner for the reviewed year[11] showing the partner's (or former partner's) share of any adjustments to income, gain, loss, deduction or credit as determined in the partnership audit. These statements will affect the recipient's income taxes for the tax year during which the statement is furnished,[12] and they will be issued to persons who were partners during the partnership year under audit, whether or not they are partners in the adjustment year. Because these statements will sometimes be issued to persons who are not partners in the year of issuance, they may have little or no relationship to Schedule K of the partnership's Form 1065 for

that year. Nevertheless, they will serve a purpose similar to Schedules K-1,[13] so this column will refer to them as "Adjustment K-1s."[14]

The new audit procedures contemplate that when the IRS puts a partnership on notice that additional taxes are due, the partnership will either pay the tax directly or will take the steps necessary to cause the partners to pay some or all of the deficiency. One observer summed up the new rules by saying they "can be said to focus on IRS convenience at the expense of precision."[15] For the most part, the rules' imprecision errs on the side of the government, selecting taxpayers based on their accessibility and assessing them at higher tax rates, and higher interest rates, than would otherwise apply under the law.[16]

Under new Code Sec. 6225(a), the partnership must pay any imputed underpayment with respect to those adjustments, and the adjustments that produce underpayments are not passed through to the partners—not even as a reduction in partnership income resulting from the partnership's payment of the tax.[17] Adjustments that do not result in an imputed underpayment *are* passed through to the adjustment year partners as a reduction in nonseparately stated income or as an increase in nonseparately stated loss.[18] If the partnership elects to use the Adjustment K-1 procedure under new Code Sec. 6226, the adjustments giving rise to an imputed underpayment are required to be reported to the partners on Adjustment K-1s and must be taken into account by the partners in the manner specified in new Code Sec. 6226(b).[19] When the Adjustment K-1 procedures are used, the new Code Sec. 6222(a) consistency requirement appears to apply only to partnership adjustments that do not result in imputed underpayments. Those favorable adjustments will be reflected on the partnership's return for the adjustment year and should be reflected in the regular K-1s issued to the partners for that year.

Under the consistent filing rule of new Code Sec. 6222(a), S corporation partners will have to file returns for an adjustment year reflecting partnership adjustments that do not produce imputed underpayments (*i.e.,* adjustments that either increase partnership nonseparately stated income or reduce partnership nonseparately stated loss). Those adjustments will be reported on the S corporation's regular K-1 from the partnership for the adjustment year and will be reflected on the S corporation's Schedule K on its Form 1120-S for that year. The consistency requirement under Code Sec. 6037(c) will require the S corporation shareholders to file their returns consistently with the S corporation's return, so their individual returns should reflect the favorable partnership adjustments.

But partnership adjustments giving rise to imputed underpayments will be reported to the S corporation partner only on an Adjustment K-1, not on a regular K-1, and the S corporation will take those adjustments into account under the provisions of new Code Sec. 6226(b). The S corporation will increase its Chapter 1 taxes for the adjustment year, but will not (under the provisions as currently enacted) reflect any of those adjustments on its adjustment year tax return for purposes of passing them through to its shareholders. It is not clear to this observer whether the consistent filing requirements and summary assessment provisions of new Code Sec. 6222 will apply to items reported on an Adjustment K-1 to an S corporation partner.

My prognostications will be based on the newly enacted statutes themselves, previous bills, certain governmental reports and other generally available information, and I will reveal the reasoning behind each one.

Although the new statutes are filled with references to "partner" and "partners," those terms are not specially defined. H.R. 2821—the pending bill that was marked up to become section 1101 of the BBA—did define partner, and did so broadly:

The term "partner" means—

A. A partner in the partnership, and
B. Any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly income, gain, deduction, or loss of the partnership.

Because that definition was deleted from the final bill, the new law leaves us with the basic definition of partner contained in Code Sec. 7701(a)(2):

> Partnership and partner. The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation, and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

The term "partner" apparently means only direct partners, and the new law does not treat a partner in an upper-tier partnership as a partner in the lower-tier partnership for any purpose. That is what the statutes say, and it also seems to be what the drafters intended when they marked up H.R. 2821 by deleting the broad definition of "partner" that included indirect partners.

The statute does not appear to reach through an S corporation partner to its shareholders to impose the tax effects of an Adjustment K-1 on them.

The Predictions

In this section I am going to make several bold (and not so bold) predictions about how the rules *should* develop and affect S corporations and their shareholders over the next several years. My first and foremost goal is to provoke thought about the new law and how it may work. My secondary, tongue-in-cheek goal is not to fall below Jeanne Dixon's career standard of accuracy, which sets a very low threshold. Skeptics (I am among them) discount Dixon's trademark claim of having predicted the Kennedy assassination. If at least one of my predictions turns out to be accurate in four or five years (giving myself enough time for the new statutes to actually operate for a year or two), I will feel that I accomplished my second goal. Even if none of them pan out, though, I still hope to hit the primary target.

PREDICTION #1:

Congress will enact technical corrections to new Code Sec. 6226 that will require S corporations to do one of two things when the S corporation receives an Adjustment K-1 from a partnership: (1) the S corporation can pay the imputed underpayment resulting from the Adjustment K-1, or (2) the S corporation can issue its own Adjustment K-1s (a new S corporation variety) to the persons who were its shareholders during the reviewed year, requiring the S corporation shareholders to take the amounts reported into income on their returns for the adjustment year.

Corollary: Congress will add a fourth corporate-level tax to the three that currently apply to S corporations.

The alternative procedures under new Code Sec. 6226 may be preferred by partnerships as predicted by many commentators, including Susswein and Lenz in the January–February 2016 issue of the Journal, but they are also the provisions of the new law most in need of technical correction. By focusing narrowly on Chapter 1 taxes paid by direct partners, this section leaves gaps in coverage and omits taxes that should be collected. In addition, new Code Sec. 6226 does not include a broad grant of regulatory authority like that in new Code Sec. 6225(c)(6), so a technical correction bill will likely be necessary in order for new Code Sec. 6226 to work as Congress seems to have intended.[20]

Under new Code Sec. 6226, a partnership can avoid paying an imputed underpayment if it elects (within 45 days of the date of a notice of partnership adjustment) to furnish to each person that was a partner in the reviewed year a statement of that person's share of the audit adjustments. The recipient of the statement must compute the amounts by which its Chapter 1 taxes (*i.e.,* those imposed under Code Secs. 1 through 1400) would have increased for the reviewed year and for each subsequent tax year up to—but not including—the year in which the statement is received. The partner or former partner's tax for the adjustment year is increased by the aggregate of those amounts.

The provisions' narrow focus on direct partners' Chapter 1 tax liabilities seemingly leaves S corporation shareholders largely out of the picture. As we discussed earlier, the statutes as enacted use the term "partner" to mean direct partners only, so when an S corporation partner receives an Adjustment K-1 from a partnership, the person whose Chapter 1 taxes will be increased is the S corporation itself. In many cases, an S corporation partner will not be liable for any federal income taxes under Chapter 1. Except when the built-in gains tax, the excess passive investment income "sting" tax or investment tax credit recapture applies, an S corporation will not pay federal income taxes under Chapter 1.[21] The statute does not appear to reach through an S corporation partner to its shareholders to impose the tax effects of an Adjustment K-1 on them.

Had partnership items adjusted in an audit been properly reported on the partnership's original return for the reviewed year, they would have flowed through to the S corporation partner and would have been reflected on the S corporation's own return. Thus, the adjustments would have both increased the S corporation's Chapter 1 taxes for that year (if any), and increased the amounts reported to the S corporation's shareholders on Schedules K-1 issued by the S corporation for that year. It seems that the new partnership audit procedures should reproduce

approximately the same results in the adjustment year when a partnership with an S corporation partner elects to issue Adjustment K-1s under new Code Sec. 6226.

The drafters of new Code Sec. 6226 probably did not intend for S corporation shareholders to be treated more favorably than other taxpayers owning indirect interests in a partnership, such as through another partnership. The new legislation is so clearly aimed at making it easier for the IRS to collect income tax liabilities attributable to partnership reporting errors, it should not open a loophole for a partnership to avoid paying taxes merely by shifting them to an S corporation partner that is not itself required to pay those taxes.

With regard to passthrough entities other than S corporations, the drafters seem to have wanted lower-tier partnership adjustments to flow upward through any number of higher tiers until either they reach a partnership that elects to pay the imputed underpayment under the default rule, or they reach the ultimate partners required to take them into account as adjustments to their Chapter 1 taxes for the adjustment year. As Susswein and Lenz point out, the statutory language does not automatically produce cascading Adjustment K-1s from one tier to the next in a tiered partnership structure. They suggest a technical correction may be necessary to provide that a partnership's receipt of an Adjustment K-1 from a lower-tier partnership's election under new Code Sec. 6226 should be treated as receipt of a notice of final partnership adjustment for purposes of both new Code Sec. 6225 and new Code Sec. 6226. Each successive upper-tier partnership would have to either pay the tax or push it out to the next level of partners by issuing its own Adjustment K-1s.

I foresee parallel technical corrections coming for S corporations. In order to match the treatment of shareholders of an S corporation partner to the treatment expected for the partners of the ultimate top-tier partnership in a tiered partnership structure, a single-tier cascading rule should be sufficient. Under this rule, an S corporation partner that receives an Adjustment K-1 would be treated in the same way a top-tier partnership that receives an Adjustment K-1 from a lower-tier partnership would be treated under the technical correction proposed by Susswein and Lenz. By default, the S corporation could pay the imputed underpayment in a manner consistent with new Code Sec. 6225(a)(1). An S corporation's payment of an imputed underpayment under a provision analogous to new Code Sec. 6225(a)(1) would be added to the list of corporate-level income taxes payable by S corporations. *See* the Corollary to Prediction 1.

In the alternative, the S corporation partner could elect to issue its own Adjustment K-1s to the persons who were its shareholders during its tax year that included the partnership's reviewed year (which we will refer to as the S corporation's reviewed year). The recipients of the S corporation's Adjustment K-1s would increase their Chapter 1 taxes for the adjustment year by the amounts by which their Chapter 1 taxes would have increased in the S corporation's reviewed year and in the intervening years if the applicable adjustments had been made in the reviewed year. In other words, provisions mirroring new Code Sec. 6226 would apply to S corporation partners and their shareholders.

PREDICTION #2:

Some partnership agreements will be revised and some new ones drafted to require S corporation partners to provide annually to the partnership an accurate list of the names and TINs of the S corporation's shareholders (*i.e.,* the persons to whom the S corporation is required to issue Schedules K-1 for the year).

Corollary: Some partnership agreements will provide that S corporation partners must indemnify the partnership and its other partners against either: (i) partnership-level income taxes the partnership is required to pay but could have avoided had the S corporation provided the information necessary for the partnership to elect out of the entity-level audit provisions on a timely basis, or (ii) the costs to the partnership of making an election under new Code Sec. 6226.

This prediction is founded on one of the few provisions of the new law that explicitly mentions S corporations. New Code Sec. 6221(b) allows certain partnerships having 100 or fewer partners to elect out of the new audit procedures. The election out is made separately for each tax year. Most partnerships that are eligible to elect out will probably want to do so. Having an S corporation partner does not prevent a partnership from electing out, but a special rule under new Code Sec. 6221(b)(2)(A)(i) says an S corporation will be treated as a qualifying partner *only* if the partnership discloses the name and TIN of each person to whom the S corporation is required to furnish a K-1 for its tax year ending with or within the year for which the election out is made. In order to elect out for a tax year, a partnership with an S corporation partner must obtain accurate information about the S corporation's shareholders in time to submit that information as part of a timely election.

As is the case with several aspects of the new law, procedures for making these disclosures are to be prescribed by

the Secretary. Until those procedures are developed, we will not know how much time a partnership and S corporation partner will have to gather and review the information or how much leeway they will have to correct or supplement the information after submission. But the language clearly states that a partnership with an S corporation partner shall be treated as meeting the requirements for electing out *only* if it discloses the S corporation shareholder information in connection with its election.

A partnership is eligible to elect out only if it has 100 or fewer partners, each of which is an individual, a C corporation,[22] an S corporation or the estate of a deceased partner. If an eligible partnership fails to make a valid election out and that year is audited by the IRS, the partnership could become liable for an imputed underpayment of tax under New Code Sec. 6225. A partnership tagged for an entity-level tax that could have been avoided if an S corporation partner had furnished the information necessary for the partnership to elect out may want to be indemnified by the S corporation partner for part—or even all—of the entity-level tax. At a minimum, the S corporation should be responsible for the portion of the partnership's tax bill allocable to the S corporation partner's share of the partnership adjustments.

Of course, a partnership in this position could avoid paying tax at the partnership level by electing under new Code Sec. 6226. An S corporation partner that impeded the partnership's election out might still be required to indemnify the partnership for the administrative costs of making the election (*i.e.,* handling the partnership-level audit, dealing with the IRS, preparing and issuing Adjustment K-1s, *etc.*) and the other partners for increases in their tax liabilities under new Code Sec. 6226 relative to what they would have been had the partners been audited separately. All these factors will be subject to negotiation, and some partners and partnerships may want to take strong measures to insure they can elect out of the new audit procedures if they are otherwise eligible to do so.

Readers of this column are well aware that S corporations and their shareholders often enter into agreements to preserve the S election. Many such agreements include liquidated damages provisions to deter shareholders from unilaterally terminating the S election. I predict we will see partnership agreements in the future contain analogous provisions aimed at protecting the partnership's eligibility to elect out of the new audit procedures.

PREDICTION #3:

The Treasury will issue regulations or other guidance allowing a partnership's imputed understatement to be modified (*i.e.,* reduced) to the extent the partnership can show that a portion of the imputed understatement is attributable to adjustments that are attributable to an S corporation partner with an ESOP owner. Any such modification will be limited to the ESOP's ownership share of the S corporation.

New Code Sec. 6225(c)(4)(A) is the only other provision of the new law besides new Code Sec. 6221 that mentions S corporations. The reference appears in a subsection that directs Treasury to establish procedures to permit a partnership's imputed underpayment of tax to be modified (*i.e.,* reduced) on the basis of the specific circumstances of, or actions taken by, certain partners. This section defers procedural rule-making to the Secretary.

When a partnership is required to pay an imputed underpayment at the entity level, the deficiency is computed by applying the highest rate of tax in effect for individuals or corporations for the reviewed year. If this rule were in effect for 2016, for example, the applicable rate would be 39.6 percent.[23] Among the procedures Treasury is charged with developing are rules that will allow the applicable rate to be reduced if the partnership demonstrates that a portion of an adjustment giving rise to an imputed underpayment consists of capital gain or qualified dividend income allocable to an individual taxpayer. For this purpose, new Code Sec. 6225(c)(4)(A) provides that an S corporation partner will be treated as an individual. The Treasury must also establish procedures that will determine a partnership's imputed underpayment without regard to the portion shown by the partnership to be allocable to a partner that would not owe tax because it is a tax-exempt entity as defined in Code Sec. 168(h)(2).[24]

S corporations with ESOP shareholders will not be happy with a rule that treats S corporations as fully taxable individuals without exception. S corporation income passed through to an ESOP generally escapes income taxation altogether.[25] ESOPs are tax-exempt entities within the meaning of Code Sec. 168(h)(2),[26] and the tax-exempt entity modification rule would apply if the ESOP were a direct partner of the partnership.

I predict the Secretary will use the authority granted by new Code Sec. 6225(c)(6) to issue regulations or other guidance allowing a partnership's imputed underpayment to be determined without regard to the portion thereof that the partnership demonstrates to be allocable to an ESOP-owned S corporation partner, to the extent of the ESOP's ownership of the S corporation.

PREDICTION #4:

The Treasury will issue regulations providing that in order for an imputed underpayment to be modified

under new Code Sec. 6225(c) for any partnership that has an S corporation partner, the partnership must show that the shareholders of the S corporation partner filed amended returns and paid the taxes due on those returns.

Corollary: Partnerships with S corporation partners will rarely use this procedure.

A partnership that receives a notice of proposed audit adjustments will, in theory, be able to have its imputed underpayment modified (*i.e.,* reduced) if partners (or former partners) file amended returns for affected years taking their shares of the adjustments into account and pay the taxes due on those returns. Procedural rules for obtaining such reductions are left to Treasury, of course. The statute gives the partnership 270 days—subject to extension—after the notice of proposed adjustments is mailed to submit "anything required to be submitted" under those procedures. The required items will almost certainly include proof that amended returns were filed, certification that the returns took the proper amount of adjustments into account and evidence that the resulting tax deficiencies were actually paid along with any applicable penalties and interest.

The statute also provides that modifications can be made *only* upon approval by the Secretary of Treasury. In other words, there will be no appeal, judicial review or other opportunity to challenge the IRS's denial of a request for modification. It will be interesting to see how high Treasury and the IRS set the bar for obtaining modifications based on partner-amended returns and payments of tax. It will be even more interesting to see whether *any* partnerships ever try to take this route to modification of an imputed underpayment.

The Treasury may find it difficult to develop procedures that will be very attractive to tiered partnerships. The law seems to envision procedures under which partnerships would do the kind of "paper and labor intensive work" the IRS has complained about in TEFRA audits[27] and then hand over proof sufficient to satisfy the IRS that all relevant taxes have been paid. The burden may be set so high that few partnerships will seek modifications. Accepting a partnership-level assessment will not commit the partnership to paying the imputed underpayment; it can still avoid doing so by electing to issue Adjustment K-1s to its partners under new Code Sec. 6226.

Whatever procedures Treasury does develop are unlikely to permit a lower-tier partnership to reduce its imputed underpayment merely by showing that an immediate upper-tier partnership (*i.e.,* its direct partner) filed amended returns, if that upper-tier partnership did not pay tax by virtue of being a passthrough entity. I would expect those modification procedures to require the requesting partnership show that the audit adjustments resulted in tax revenues actually paid into government coffers before the modification will be allowed. After all, the new rules are aimed at enhancing the IRS's ability to collect income taxes when it audits partnership returns and discovers errors producing underpayments.

By the same token, the procedures-to-come are not likely to allow a partnership to reduce its imputed underpayment solely on the basis that an S corporation partner filed amended returns and paid whatever corporate-level taxes may have been due on those returns. What the new law seems to be after in this situation is a convenient, one-stop method of collecting all the taxes that the S corporation partner, and its shareholders, would have been required to pay had the partnership's original return properly reflected the adjustments made on audit.

New Code Sec. 6225(c)(6) authorizes the Secretary to "by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes of this subsection." One purpose of subsection (c) of new Code Sec. 6225 certainly appears to be insuring that a partnership is relieved of its obligation to pay an imputed underpayment only if, and to the extent that, one or more partners actually pay the full amount of taxes resulting from a partnership adjustment.

I also predict that such modifications will rarely be sought. The reasons should be obvious. If a partnership's S corporation partner has more than a few shareholders, marshaling all the components necessary to obtain a modification will not be worth the effort. Multiple amended K-1s and amended returns would have to be filed, and taxes and interest would have to be paid, all within a limited period of time. The partnership would have to gather proofs of filing and payment or otherwise equip itself to satisfy whatever procedural requirements may be established under new Code Sec. 6225(c)(2). The burden will ratchet up according to the number of shareholders an S corporation partner has. The degree of difficulty will increase exponentially if persons who were shareholders of an S corporation partner during the partnership reviewed year have ceased to be shareholders by the time the notice of partnership adjustments comes through. Convincing former S corporation partner shareholders—or in some cases their estates—to file and pay taxes voluntarily when they are not legally required to do

so would be a monumental challenge. Such a partnership should take the path of least resistance and make an election under new Code Sec. 6226.

There you have them. Four predictions and three corollaries made forthrightly for readers of this column to judge their accuracy.

ENDNOTES

[1] *See* Former Treasury Secretary Donald Regan's memoir For the Record: From Wall Street to Washington (Harcourt Trade Publishers, 1988).

[2] H.R. 2821, Partnership Audit Simplification Act of 2015, introduced in the House on June 18, 2015, by Rep. James B. Renacci. H.R. 2821 was nearly identical to a partnership audit proposal included in the Tax Reform Act of 2014, H.R. 1, introduced by former Ways and Means Chair Dave Camp on December 10, 2014.

[3] The bill provided: "The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto," and "[a] person shall be treated as a partner of the partnership if such person is a partner of such partnership at any time during the reviewed or adjustment year."

[4] *See* Donald B. Susswein and Ryan P. McCormick, *Fixing the Partnership Audit Process*, Tax Notes, Oct. 5, 2015. *Also see* Donald B. Susswein and Thomas C. Lenz, Private Equity & Hedge Fund Corner, New Partnership Audit Rules Pose Issues for Investment Funds and Their Investors, J. Passthrough Entities, Jan.–Feb. 2016, at 19.

[5] Bipartisan Budget Act of 2015 (P.L. 114-74), Act Sec. 1101.

[6] Susswein and Lenz, *supra* note 4.

[7] Highlights of GAO-14-746T (Washington, D.C., July 22, 2014), a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate.

[8] Highlights of GAO-14-732 (Washington, D.C. Sept. 14, 2014), a report to congressional requesters.

[9] The Treasury is charged with developing procedures under which modifications will be requested and approved. Presumably, the partnership will issue amended Schedules K-1 (or provide equivalent information) for the affected years so the partners can file their amended returns properly.

[10] The 45-day period expires only halfway through the 90-day period within which the partnership can file a petition for readjustment with the Tax Court, a federal district court, or the Court of Claims under New Code Sec. 6234(a). In order to file a timely election under New Code Sec. 6226, a partnership apparently must forgo its rights to litigate the deficiency. Under New Code Sec. 6223 the Partnership Representative has the sole authority to act on behalf of the partnership under Subchapter C, and all partners of the partnership are bound by actions taken by the partnership under that subchapter, so the partners have no separate rights to litigate their liabilities arising from partnership adjustments. The statutes should be amended (or procedures established) to give the partnership an additional 45-day period to elect under Code Sec. 6226 following a final decision in a proceeding brought under Subchapter C.

[11] As used in this column, the term "reviewed year" refers to the partnership year that is examined by the IRS under the new audit procedures. With regard to a partner, the term is used to refer to the partner's tax year that includes the end of the partnership's reviewed year.

[12] The recipient's tax year that includes the date the statement is issued is the "adjustment year."

[13] The legislative history of new Code Sec. 6226 describes the new statements as being "similar to a Schedule K-1." Joint Committee on Taxation Report-JCX-144-15, p. 248. In addition, Code Sec. 6031, as amended by the BBA and the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), Division Q of P.L. 114-113, makes no reference to new Code Sec. 6226(a)(2) statements. Perhaps the new statements will be called K-2s, honoring the 2nd highest mountain in the world after Mount Everest.

[14] Susswein and Lenz refer to these statements as "adjusted K-1s."

[15] Lee A. Sheppard, *News Analysis: Investment Fund Questions Raised by the New Partnership Audit Rules*, Tax Notes Today, Nov. 16, 2015.

[16] When a partnership pays the imputed underpayment, new Code Sec. 6225(b)(1)(A) applies the "highest rate in effect for the reviewed year under section 1 or 11." When a partner pays based on an Adjustment K-1 issued pursuant to an election by the partnership under new Code Sec. 6226, new Code Sec. 6226(c)(2)(C) adds two percentage points to the underpayment rate determined under Code Sec. 6221(a)(2)(B), *i.e.,* the federal short-term rate plus five percent rather than three percent.

[17] New Code Sec. 6241(4) provides that no deduction shall be allowed under subtitle A for any payment required to be made by a partnership under subchapter C.

[18] Adjustments to credits are treated as separately stated items. New Code Sec. 6225(a)(2)(B).

[19] New Code Sec. 6226(b) is not one of the sections that leaves procedures and rule-making to the Secretary. This section *does* establish specific rules of law.

[20] The only authorities new Code Sec. 6226 expressly grants to the Secretary are to provide for the time and manner of furnishing Adjustment K-1s to the reviewed year partners and to provide for the manner of making an election to push responsibility for an imputed underpayment out to the partners under new Code Sec. 6226(a)(1).

[21] Although LIFO recapture tax under Code Sec. 1362(d) is technically incurred in the last tax year as a C corporation when a corporation converts to S corporation status, the additional tax is payable in four equal installments. Therefore, three installments are due to be paid on the S corporation's returns.

[22] Including any foreign entity that would be treated as a C corporation, if it were domestic.

[23] The highest rate applicable to C corporations is 35 percent. Code Sec. 11(b)(1).

[24] New Code Sec. 6225(c)(3).

[25] If the ESOP arrangement runs afoul of the anti-abuse rules in Code Sec. 409(p), the S corporation may be subject to substantial excise taxes under Code Sec. 4979A.

[26] *See* Reg. §1.168(j)-1T Q&A-11.

[27] Highlights of GAO-14-732 (Washington, D.C. Sept. 14, 2014), a report to congressional requesters.