The Push-Out Election of IRC §6226

By Sean Di Ciolli[1]

The Bipartisan Budget Act of 2015 replaced the TEFRA unified audit rules for tax partnerships. Previously, the IRS audited partnerships at the partnership level, but any underpayment was assessed or collected at the partner level. Partnerships having ten (10) or fewer partners (or LLC members) were not subject to these rules, allowing the IRS to contest partnership items during an audit of an IRS Form 1040. Additionally, certain large partnerships could elect to be subject to alternative, streamlined procedures. The new "Centralized Audit Regime" rules change this basic framework and generally require that the partnership now directly pay any underpayments. These new rules require different considerations, in that current partners may now bear the economic cost of tax underpayments imputed by the IRS under IRC §6221 even if he, she or it did not own interests in the partnership during those reviewed years. The push-out election in IRC §6226 is expressly intended to address this situation.

This article will present the relevant code sections tax practitioners should be aware of when considering the push-out election under IRC §6226. Those sections include:

- IRC §6221 – Determination of adjustments, tax, and penalties at the entity level
- IRC §6223 – Partnership representative binds the partnership
- IRC §6225 – IRS adjustments at the partnership level (and its imputed tax)
- IRC §6226 – Push-out election

The following provides guidance on the effects of IRC §6225 and how IRC §6226 can shield partners from taxes imputed for review periods in which they were not partners in the audited partnership. The election under IRC §6226 requires careful consideration and is not a "one-size-fits-all" solution.

I. <u>IRC §6221 – Determination of Adjustments, Tax and Penalties at the Entity Level</u>

Adjustments to "partnership-related items" (a term broadly defined in IRC §6241(2)(b)) and eligible penalties are determined at the partnership level. A partnership is eligible to opt out of the new Centralized Audit Regime if it has 100 or less partners and no partner is a partnership, trust, or disregarded entity. A partnership that makes the opt-out election is subject to the standard partnership audit procedures that were applicable to non-TEFRA partnerships.

Additionally, if one of the partners is an S corporation, then analysis under IRC §6221(b) needs to account for the number of shareholders of the S corporation partner. The number of partners for IRC §6221(b) eligibility in that case includes the corporation, its shareholders and the other partners.[2] Hence, a two-shareholder S corporation would count as three (3) partners for

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[2] *See* Treas. Reg. §301.6221(b)-1(b)(2)(ii).

the sake of determining eligibility to elect out of the audit rules under IRC §6221.[3] The IRC §6221(b) election must be made every year on a partnership's IRS Form 1065.

II IRC §6222 – Partnership Representative Binds the Partnership

Whereas partnerships previously had a "tax-matters partner" responsible for communicating tax-related issues to the IRS, IRC §6222 now requires a "partnership representative." This representative has the power to bind the partnership in agreement with the IRS regardless of whether he, she or it is a partner in the partnership. This representative has significant power over the partners since this person may bind the partnership (and thus partners) to imputed tax, eligible penalties and interest. If necessary, the IRS now has the authority to appoint a representative on the partnership's behalf if the partners failed to do so, even appointing itself as partnership representative if it so chooses.

III. IRC §6225 – IRS Adjustments at the Partnership Level (and its imputed tax)

IRS adjustments (and the imputed tax underpayments) are imposed at the partnership level. A reviewed year's adjustments will be netted together pursuant to an intricate system set forth in the regulations.[4] Reallocations between partners will not be netted against each other to reduce imputed underpayments under IRC §6225(b)(2). The resulting imputed underpayment will be taxed at the highest marginal tax rate applicable to corporate or noncorporate taxpayers in the reviewed year. For 2018, the highest rate of tax applicable to corporate taxpayers is 21%, and the highest rate of tax applicable to noncorporate taxpayers is 37%. Thus for 2018, the individual rate is generally applied to compute the underpayment because it is the higher of the two rates. A partnership may, however, apply a reduced rate if it demonstrates that a portion of the imputed underpayment is allocable to a C corporation partner or attributable to capital gains or qualified dividends allocated to an individual partner.[5] The partnership as an entity is directly liable for the imputed amount. Under IRC §6225(c)(2), however, reviewed year partners may report the adjustments and pay their share of the partnership's imputed tax in one of two ways:

- File amended returns for the reviewed year (the tax year being audited) taking into account the adjustments under IRC §6225(c)(2)(A), or

- The partners may, in lieu of filing amended returns, pay the imputed tax due with current-year returns, taking into account the effect the changes would have occurred had those returns been filed (basis adjustments as appropriate), and provide the needed information for the IRS to verify the information (the "pull-in procedure") under IRC §6225(c)(2)(B). Partners using this option, however, forfeit the ability to contest the IRS' determination.

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[3] *See* Treas. Reg. §301.6221(b)-1(b)(2)(iii).
[4] *See* Prop. Reg. §301.6225-1.
[5] *See* IRC 6225(c)(4)(A)(ii).The lower applied rate cannot be less than the highest rate applicable to the relevant income for the relevant taxpayer.

Adjustments paid by the taxpayer will be subtracted from and reduce the imputed underpayment due from the partnership.[6]

The general statute of limitation rules do not apply to underpayments paid by partners under either of these options.[7] In order for an S corporation partner to take advantage of the above options under IRC §6225, additional information would need to be provided. Lastly, adjustments that would be allocable to a non-profit partner result in a reduction of the partnership's imputed underpayment if and only if the partnership provides evidence that the partner actually qualifies as a non-profit entity.

IV. IRC §6226 – Push-out Election

The "push-out" election under IRC §6226 allows the partnership to transfer or push out responsibility for an underpayment to its individual partners. The partnership as an entity does not pay the assessed underpayment as it normally would under IRC §6225. This is significant because it ensures that partners pay their share of an underpayment if they owned an interest in the partnership during the reviewed year. Former partners having owned interests during the reviewed years will receive statements advising of their share of the imputed tax, to be collected by the IRS from the partner rather than the partnership. If the election is made, all partners must include their portion of the imputed underpayment and penalties on their current- year returns.

At first glance, the push-out election appears to be a no-brainer, in that partners will pay the underpayments only for the periods they owned interests in the partnership. Imagine that Mike, Matt, Steve and Partnership X each owned twenty-five percent (25%) interests in partnership Y during the reviewed year. Between the reviewed year and the year in which the audit is conducted, Steve transferred his interest in Partnership Y to Sarah. Absent the push out election, Sarah is effectively required to pay a portion of the underpayment even though she was not a partner during the reviewed year. A push-out election effectively forces Steve to pay his share of the underpayment and any corresponding penalties.

The tax rate applicable to the imputed underpayment will remain the highest marginal rate. Additionally, the interest rate for which past tax and penalties are to be collected will be the corporate rate, rather than the individual rate, regardless of the type of partner.[8] This interest rate will be calculated as the short-term applicable federal rate plus five percent (5%) (versus the three percent (3%) used for individuals). This additional interest expense can make a push out election comparatively more expensive than electing out of the new partnership rules altogether, amending returns or opting for the pull-in procedure.

The push-out election requires written notice to be filed within forty-five (45) days of the final partnership adjustment (FPA). The FPA becomes final at the expiration of time to file a petition for court review (within 90 days of FPA issuance) or upon a court's final decision.[9]

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[6] *See* Treas. Reg. §301.6225-2.
[7] *See* IRC 6225(c)(2)(D).
[8] *See* Treas. Reg. §301.6226-3(c).
[9] *See* IRC 6234.

Treas. Reg. §301.6226-1 sets forth the mechanics of making this election. The contents of this election must contain:

- Name, address, and taxpayer ID for the partnership
- Taxable year to which election relates
- Copy of the final partnership adjustment
- Name and taxpayer ID number for each partner in reviewed year along with current or last known address.
- Additional requirements as contained in forms, instructions, or other guidance.

The IRS determines an election's validity. However, denial cannot be based purely upon secretarial errors in election filings. Should one of these errors be discovered, the service has thirty (30) days to inform the partnership. Correction of these errors must be completed within the guidelines provided in the regulations.

Treas. Reg. §301.6226-2 provides guidance for the statements furnished to the partners and also filed electronically with the IRS. These statements must be issued and filed within sixty (60) days of the FPA. Secretarial errors alone in these statements cannot be used to deny the push-out election.

If a pass-through entity (PTE) receives a statement furnished under Treas. Reg. §301.6226-2, the procedures under Treas. Reg. §301.6226-3(e) must be considered. The PTE must file an IRS partnership adjustment tracking report under (3)(iii) of the aforementioned subsection by its extended due date for annual tax filing in the adjusted year. Additionally, statements must be furnished to the partners and filed with the IRS consistent with the requirements of Treas. Reg. §301.6226-3(e) within the timing requirements under Treas. Reg. §301.6226-2. If the PTE fails to make this election, then under Treas. Reg. §301.6226-3(e)(4) the entity must pay the imputed underpayment by the extended due date of its annual income tax filing.

V. <u>Conclusion</u>

In conclusion, the push-out election should gain traction with partnerships that: (i) have not elected out of the new partnership audit rules (or are ineligible to do so), (ii) face a large imputed underpayment, and (iii) have a large number of reviewed-year partners who no longer own an interest in the partnership. The increased interest rate applied to underpayments, however, will require partnerships to weigh the benefits of the push-out election against the pull-in procedure.