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Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

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FEBRUARY 7, 2018

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

Christopher C. Scarpa

Kristin M. McKenna

IRS Issues Proposed Regulations on Centralized Partnership Audit Regime

The IRS has issued proposed regulations (https://www.federalregister.gov/documents/2018/02/02/2018-01989/centralized-partnership-audit-regime-adjusting-tax-attributes) on the new centralized partnership audit regime, which went into effect last month. The new proposed regulations would provide guidance on how partnerships and their partners adjust tax attributes to take into account partnership adjustments under the new regime. The regulations also would provide guidance in a number of areas that were "reserved" in proposed regulations issued in June 2017 and would make a number of amendments to those regulations.

The proposed regulations provide rules that would govern a partnership adjustment that is taken into account in the determination of the imputed underpayment, including rules for adjusting partnership asset basis and book value, rules for the creation of "notional" items (referred to as such because their sole purpose is to affect partner-level specified tax attributes, and thus they are not considered to be items for purposes of adjusting other tax attributes), rules for allocating these notional items under Section 704(b) (section references are to the Internal Revenue Code of 1986, as amended (the Code)), and successor rules for situations in which reviewed-year partners are not adjustment-year partners. The proposed regulations also provide rules for the allocation of any partnership expenditure related to the imputed underpayment, as well as guidance in the case of a partnership adjustment that does not give rise to an imputed underpayment.

Highlights of the proposed regulations include:

- **Adjustments where partnership adjustment results in imputed underpayment.** Under the proposed regulations, when there is a partnership adjustment, the partnership and its adjustment-year partners generally would be required to adjust their "specified tax attributes." Specified tax attributes are the tax basis and book value of a partnership's property, amounts determined under Section 704(c) (generally, allocations by a partnership of income, gain, loss and deductions for property contributed by a partner to take into account variations between the property's adjusted tax basis and its fair market value at the time of contribution), adjustment-year partners' bases in their partnership interests, and adjustment-year partners' capital accounts determined and maintained in accordance with Treasury Regulation Section 1.704-1(b)(2).

  In the case of a partnership adjustment that results in an imputed underpayment, the adjustments to specified tax attributes would need to be made on a partnership-adjustment-by-partnership-adjustment basis (i.e., without regard to their summation as part of the determination of the total netted partnership adjustment).

- **Adjustment of specified tax attributes.** A partnership would be required to first make appropriate adjustments to the book value and basis of property to take into account any partnership adjustment. Amounts determined under Section 704(c) also would have to be adjusted to take into account the partnership adjustment, but would require no adjustments of the book value or basis of partnership property with

respect to property that was held by the partnership in the reviewed year but is no longer held by the partnership in the adjustment year.

Under Proposed Regulation Section 301.6225-4(b)(3), notional items would then be created with respect to the partnership adjustment, and these notional items would be allocated according to the rules described below. In the case of a partnership adjustment that is an increase in income or gain, a notional item of income or gain would be created in an amount equal to the partnership adjustment. Similar rules would apply in the case of a partnership adjustment that is an increase of an expense or a loss. In the case of a partnership adjustment that is a decrease of income or gain, however, a notional item of expense or loss would be created in an amount equal to the partnership adjustment, with similar rules applying in the case of a partnership adjustment that is a decrease of an expense or a loss.

Based on the preamble to the regulations, these rules would have the effect of reversing the reviewed-year allocation to the extent necessary to reflect the partnership adjustment (i.e., an adjustment-year partner would increase its outside basis for notional income that is allocated to it, and a partnership that determines and maintains capital accounts would adjust capital accounts for notional items). There are also a limited number of situations under the proposed regulations where notional items are allocated to a partner but a corresponding basis adjustment is disallowed, including situations involving transfers of a partnership interest from a tax-exempt partner to a taxable partner.

For certain types of partnership adjustments (e.g., ones that do not derive from items that would have been allocated in the reviewed year under Section 704(b)), notional items would not be created, but specified tax attributes would nonetheless be adjusted for the partnership and its reviewed-year partners (or their successors) in a manner consistent with how the partnership adjustment would have been taken into account under the partnership agreement in effect for the reviewed year.

- **Allocation of notional items.** Under the proposed regulations, the allocation of a notional item would not have substantial economic effect, but it would be deemed to be in accordance with the partners' interests in the partnership if it were made in the manner in which the corresponding actual item would have been allocated in the reviewed year under the Section 704 regulations. Additionally, the allocation of a notional item of expense or loss or a notional item of income or gain must be allocated to the reviewed-year partners that were originally allocated that excess item in the reviewed year (or their successors, which are treated as reviewed-year partners under the proposed regulations).

- **Successors.** A reviewed-year partner's successor generally would be defined either as a transferee that succeeds to the transferor partner's capital account under Proposed Regulation Section 1.704-1(b)(2)(iv)(1) or, in the case of a complete liquidation of a partner's interest, as the remaining partners to the extent their interests increased as a result of the liquidated partner's departure. The proposed regulations also modify the June 2017 proposed regulations to provide that if a partnership cannot determine the transferee for a partnership interest under Proposed Regulation Section 1.704-1(b)(1)(viii)(b)(2), the successor is deemed to be those partners in the adjustment year that were not also partners in the reviewed year or otherwise identifiable as successors to reviewed-year partners, in proportion to their respective interests in the partnership.

- **Accounting and allocation of certain expenditures.** A partnership's expenditure arising from an imputed underpayment would be taken into account by the partnership and its partners under the rules at Proposed Regulation Section 301.6225-4(c). The expenditure would be allocated under Section 704(b) and its regulations. The IRS noted, in the preamble to the proposed regulations, that under existing rules, a partnership's payment of an imputed underpayment under Section 6225 has the effect of converting what would have been a nondeductible partner-level expenditure into a nondeductible partnership-level expenditure. The proposed regulations provide that allocation of the nondeductible expenditure would be considered "substantial" only if the partnership allocates it in proportion to the notional item to which it relates.

  The proposed regulations also would provide that in order for an allocation of an expenditure for interest, penalties, additions to tax or additional amounts as determined under Section 6233 to be substantial, it would have to be allocated to the reviewed-year partner in proportion to the allocation of the related imputed underpayment, the related payment made by a pass-through partner under Proposed Regulation Section 301.622-3(e)(4) or the related notional item to which it relates (whichever is appropriate), taking into account modifications under Proposed Regulation Section 301.6225-2 attributable to that partner.

- **Adjustments that do not result in imputed underpayments.** Proposed Regulation Section 1.704-1(b)(4)(xii) expands upon the June 2017 proposed regulations to provide that an allocation of an item arising from a partnership adjustment that does not result in an imputed underpayment, as defined in Proposed Regulation Section

301.6225-1(c)(2), would not have substantial economic effect, but it would be deemed to be in accordance with the partners' interests in the partnership if it were allocated in the manner in which the item would have been allocated in the reviewed year under the Section 704 regulations, taking into account the successor rules, described above.

- **"Pushed-out" items.** The proposed regulations would provide that the reviewed-year partners or affected partners, as described in Proposed Regulation Section 301.6226-3(e)(3)(i), must take into account items of income, gain, loss, deduction or credit with respect to their share of the partnership adjustments as contained in the statements described in Proposed Regulation Section 301.6226-2 (pushed-out items) in the reporting year, as defined in Proposed Regulation Section 301.6226-3(a). Similarly, partnerships would adjust tax attributes affected by reason of a pushed-out item in the reviewed year. In the case of a reviewed-year partner that disposed of its partnership interest prior to the reporting year, that partner would be able to take into account any outside basis adjustment under the proposed regulations in an amended return to the extent otherwise allowable under the Code.

  An allocation of a pushed-out item would not have substantial economic effect under Section 704(b)(2), but it would be deemed to be in accordance with the partners' interests in the partnership if certain requirements were satisfied.

IRS Releases Practice Unit on S Corp Debt Basis Adjustments

The IRS released a practice unit (https://www.irs.gov/pub/foia/sco_c_53_04_02_02_05.pdf) on adjustments to an S corporation shareholder's debt basis in various circumstances, explaining why shareholders must track stock basis and debt basis separately.

IRS Issues 2018 Version of Circular E, Employer's Tax Guide

The IRS released the 2018 version of Publication 15, Circular E, Employer's Tax Guide (https://www.irs.gov/pub/irs-pdf/p15.pdf), updated to reflect changes made by the Tax Cuts and Jobs Act signed into law on Dec. 22, 2017.

Pennsylvania Issues Notice of Nextel Decision

The Department of Revenue published notice (https://www.pabulletin.com/secure/data/vol48/48-4/157.html) of the Pennsylvania Supreme Court decision in *Nextel Communications of the Mid-Atlantic, Inc. v. Commw*. The Pennsylvania Supreme Court held in Nextel that the flat $3 million net loss deduction carryover provision violated the Uniformity Clause of the Pennsylvania Constitution and severed the flat dollar limit provision from the law. (See our prior coverage here (https://www.stradley.com/insights/publications/2017/10/tax-insights-october-25-2017) and here (https://www.stradley.com/insights/publications/2015/tax-insights-web-versions/tax-insights-december-2-2015).) Act 43 provides amendments to the law consistent with *Nextel* but also provides that such amendments will become effective on publication of notice of the *Nextel* decision in the Pennsylvania Bulletin. The Secretary of Revenue therefore provided notice that the Pennsylvania Supreme Court has held all or a part of the Pennsylvania corporate net income tax net loss deduction limitations unconstitutional and that the amendment or addition of Pennsylvania law relating to such deduction was to take effect on the date of the publication of the notice (Jan. 27).

Pennsylvania Issues Notice on Marketplace Sales

The Pennsylvania Department of Revenue issued a notice (http://www.revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/Documents/Tax%20Bulletins/SUT/st_bulletin_2018-01.pdf) advising taxpayers that the tax collection, notice and reporting requirements of the marketplace sales provisions of Act 43 of 2017 are taking effect and will be enforced by Pennsylvania Department of Revenue (Department) in accordance with applicable state and federal law. Act 43 gives certain marketplace facilitators, remote sellers, and referrers the option to either collect and remit sales tax on sales that are taxable in Pennsylvania or elect to notify their customers that use tax may be due and report the customers' names, addresses and aggregate dollar amounts of each customer's purchases to the Department. On or before March 1, a remote seller, marketplace facilitator or referrer that had aggregate taxable sales in Pennsylvania worth at least $10,000 in the previous 12 months but does not maintain a place of business in Pennsylvania must either file an election to collect and remit sales tax going forward or comply with certain notice and reporting requirements. Only those marketplace facilitators that do not maintain a place of business in Pennsylvania are allowed to elect to collect or give notice and report. For referrers, the option to elect to collect or report applies only to sales at retail from referrals to marketplace sellers that do not maintain places of business in Pennsylvania, sales directly resulting from referrals to remote sellers, and sales of the referrer's own products (provided the referrer does not maintain a Pennsylvania place of business). A remote seller that makes more than $10,000 of taxable sales in Pennsylvania must make an election and must either collect sales tax from the seller's Pennsylvania customers or notify the customers that they may owe use tax and report all of the Pennsylvania sales to the Department. A remote seller, marketplace facilitator or a referrer that fails to make the required election is deemed to have elected to comply with the notice and reporting requirements; however, an election to provide notice and report can be switched to an election to collect, by filing a new election at any time during the fiscal year to indicate that the notice and the report election are valid.