May 16, 2018

Ms. Allison R. Carmody
Attorney
Office of Associate Chief Counsel
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Ms. Meghan M. Howard
Attorney
Office of Associate Chief Counsel
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations Regarding the Centralized Partnership Audit Regime: Adjusting Tax Attributes (REG-118067-17)

Dear Mses. Carmody and Howard:

The American Institute of CPAs (AICPA) offers the following comments and recommendations related to the proposed regulations on adjusting tax attributes under the Centralized Partnership Audit Regime (the "Regime") issued February 2, 2018 by the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS). The proposed regulations provide rules addressing how and when partnerships and their partners adjust tax attributes to reflect audit adjustments under section 6225[1] of the Regime. They also update certain provisions of the proposed regulations regarding the overall operation of the Regime which were issued on June 14, 2017 (REG-136118-15).

Caplin & Drysdale, Chartered

Background

The Regime, under section 6225, generally provides that a partnership is liable for the net increase in tax (the "imputed underpayment") resulting from adjustments to items of income, gain, loss, deduction, or credit of a partnership during the year under audit (the "reviewed year"). The partnership becomes liable for the imputed underpayment in the year during which such amount is final (the "adjustment year"). A partnership may request a reduction of the imputed underpayment through the application of various modifications under rules detailed in section 6225 and the related proposed regulations. Alternatively, a partnership may elect under section 6226 to have its reviewed year partners report the partnership's adjustments made by the IRS and pay any additional tax (the "push-out option").

Under the proposed regulations, when a partnership pays the imputed underpayment under the rules of section 6225, an exclusive list of tax attributes ("specified tax attributes") requires adjustment for adjustment year partners. Pursuant to Prop. Reg. § 301.6225-4(a)(2) specified tax attributes are defined as "the tax basis and book value of a partnership's property, amounts determined under section 704(c), adjustment year partners' bases in their partnership interests, and

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

adjustment year partners' capital accounts determined and maintained in accordance with § 1.704-1(b)(2)."

Proposed Reg. § 301.6225-4, and the proposed amendments to Treas. Reg. § 1.704-1, Treas. Reg. § 1.705-1, and Treas. Reg. § 1.706-4 establish rules for partnerships and their partners to adjust these specified tax attributes related to the following:

a) the adjustment of partnership asset basis and book value, along with the creation and allocation of notional items for purposes of affecting partner-level specified tax attributes;

b) address situations in which reviewed year partners are not also adjustment year partners through a set of "successor" rules; and

c) provide for the allocation and treatment of any partnership expenditure (such as additional tax, interest and penalties) related to the imputed underpayment.

Summary of Recommendations

The AICPA provides the following recommendations related to the proposed regulations:

1) Provide a flexible procedure for applying audit adjustments to the tax attributes of audited partnerships and their partners.

2) Provide audited partnerships an elective "simplified tax attribute adjustment procedure" (STAAP) under certain conditions. Only partnerships that accept limitations on the type of section 6225 modifications that could reduce their imputed underpayment would qualify for the STAAP.

3) Provide audited partnerships an elective "enhanced STAAP" which would expand the types of section 6225 modifications allowed. Only audits resulting in proposed imputed underpayments (before any modifications) below a threshold amount would qualify for the enhanced STAAP.

4) Allow an allocation of an adjustment to property of similar character following the allocation rules set forth in Treas. Reg. § 1.755-1(c) in cases where adjustments apply to specified tax attributes of partnership property held in the reviewed year, but no longer held in the adjustment year.

5) Allow any reasonable method of applying successor rules for mergers and divisions occurring between the reviewed year and the adjustment year.

6) Treat the remittance by a former partner to the partnership under a reimbursement or indemnification agreement of an allocable share of tax, interest and penalties paid by the

Caplin & Drysdale, Chartered

> partnership under section 6225 as a tax-free receipt by the partnership; reduce the partnership's section 705(a)(2)(B) expense by the amount of the payment and allocate that reduction in full to the former partner's successor; and provide that the payment by the former partner is treated as a nondeductible expense by that partner.

Recommendation

The IRS should provide a flexible procedure for applying audit adjustments to the tax attributes of audited partnerships and their partners.

Analysis

When an audited partnership pays an imputed underpayment resulting from an audit, the proposed regulations provide mechanical rules to apply adjustments to specified tax attributes of the partnership and its partners to prevent the double taxation of income and ensure that the economic effect of the audit adjustment is properly reflected in the books and records of relevant taxpayers. The underlying premise of the proposed regulations – partnership adjustments made to the reviewed year's tax return result in the applications of adjustments to specified tax attributes to the adjustment year's accounts – does not always result in basis adjustments that benefit the appropriate partner or reflect the true economic impact of the changes. These issues are pronounced when partners from the reviewed year are no longer partners in the adjustment year or a significant shifting in the capital account allocations of the partners has occurred. Transactions involving property or partnership interests occurring in the intervening years between the reviewed year and the adjustment year result in further complications. The proposed regulations can become burdensome and inaccurate in the adjustment of basis and other specified tax attributes.

Additional issues arise in the case of a liquidation of a partner's entire interest in the partnership during or subsequent to the reviewed year. As stated in Prop. Reg. § 1.704-1(b)(4):

> *"the determination of the extent to which the Adjustment Year Partners are treated as successors under this section must be made in a manner that reflects the extent to which the Adjustment Year Partners' interests in the partnership increased as a result of the liquidating distribution (considering all facts and circumstances)."*

We believe that the language of this proposed rule is vague and will prove difficult to implement in many circumstances.

We recognize the difficulties involved in developing mechanical rules to determine the appropriate application of basis adjustments following completion of an audit under the Regime. A major contributor to the complexity involved is the myriad of relevant transactions that can occur between the reviewed year and the adjustment year. Instead of attempting to apply static mechanical rules which may result in unfair and illogical results, we recommend providing a flexible procedure that recognizes the potential need for unique adjustments in each situation.

Caplin & Drysdale, Chartered

Specifically, we recommend that as part of the modification process, the Partnership Representative should propose to the IRS examiner, adjustments to tax attributes (including, but not limited to, "the tax basis and book value of a partnership's property, amounts determined under section 704(c), adjustment year partners' bases in their partnership interests, and adjustment year partners' capital accounts determined and maintained in accordance with § 1.704-1(b)(2)") of the audited partnership and its partners. The proposed adjustments to these tax attributes should properly reflect the audit adjustments, minimize the potential for double taxation or double allowance of a deduction and represent a reasonable attempt to allocate the economic effects of the audit to the proper reviewed year partner or their successor.

We support the method proposed by the IRS of using notional items to accomplish the allocation of adjustment items to the appropriate partners. Such a system will permit the necessary adjustments to partnership and partner tax attributes, while avoiding further tax complications under subchapter K.

The IRS examiner would approve or recommend changes to the proposal as part of the modifications approval process. Both the examiner and the Partnership Representative would need to approve in writing any original or modified proposal. If no agreement was reached prior to the issuance of the Notice of Final Partnership Adjustment ("FPA"), then the partnership would by default use the push-out option for any adjustments related to the remaining imputed underpayment amounts.

A flexible procedure to apply audit adjustments to the tax attributes of audited partnerships and their partners would provide the IRS and the partnership the ability to account for any unique circumstances or adjustment types without the restrictions inherent in a strict mechanical rule, as described in the proposed regulations.

Recommendations

The IRS should provide audited partnerships an elective STAAP under certain conditions.

Under this procedure, a partnership could apply the audit adjustments and non-deductible payment of tax, interest and penalties to the tax attributes of the adjustment year partners based upon their capital accounts.

To qualify for this procedure, only audited partnerships that accept limitations on the type of section 6225 modifications that could reduce their imputed underpayment would qualify.

The AICPA also recommends that the IRS provide audited partnerships an elective "enhanced STAAP" which would expand the types of section 6225 modifications allowed. Only audits resulting in unmodified imputed underpayments below a threshold amount would qualify for the enhanced STAAP.

Caplin & Drysdale, Chartered

Analysis

In cases where a partnership has only minor audit adjustments to apply to its partners' tax attributes, a simplified method is preferable. We recommend that the IRS establish an elective "simplified tax attribute adjustment procedure" STAAP, as well as an "enhanced STAAP" for partnerships meeting specified criteria.

In order to qualify for the STAAP election, a partnership could not request modifications to the proposed imputed underpayment other than the rate modifications for corporate partners or for long-term capital gains and qualified dividends adjustments. Under this procedure, a partnership would then allocate the audit adjustments and non-deductible payment of tax, interest and penalties to the tax attributes of the adjustment year partners based upon the end of the adjustment year's section 704(b) capital account percentages.

The enhanced STAAP would allow an audited partnership to request any of the available modifications to the proposed imputed underpayment (such as, amended returns or a tax-exempt partner). In order to qualify for the enhanced STAAP election, the proposed imputed underpayment amount (as determined on the Notice of Proposed Partnership Adjustment (NOPPA)) could not exceed $2,500,000 provided that no adjustment year partner is a tax-exempt partner as defined in section 168(h)(2). If any adjustment year partner is a tax-exempt partner as defined in section 168(h)(2), then the limitation amount is reduced to $500,000. The partnership would allocate any remaining audit adjustments and non-deductible payments of tax, interest and penalties to the tax attributes of the remaining adjustment year partners. Remaining adjustment year partners would consist of those partners (or their successors) for which a modification was not made resulting in the reduction of any portion of a proposed adjustment amount on the FPA.

Recommendation

The AICPA recommends allowing an allocation of an adjustment to property of similar character following the allocation rules set forth in Treas. Reg. § 1.755-1(c) in cases where adjustments apply to specified tax attributes of partnership property held in the reviewed year, but no longer held in the adjustment year.

Analysis

Proposed Reg. § 301.6225-4(b)(2) provides that a partnership must adjust the book value and tax basis of a partnership's property to reflect any partnership adjustment taken into account in determining the imputed underpayment under Prop. Reg. § 301.6225-1(c). It also indicates that no adjustments are made 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.

When the property that gave rise to an imputed underpayment that was held by the partnership in the reviewed year is no longer held by the partnership in the adjustment year, the AICPA

Caplin & Drysdale, Chartered

recommends that the adjustment is appropriately made to property of similar character in the same manner as the rules outlined in Treas. Reg. §1.755-1(c).

Example 1:

A, B, and C form partnership PRS in 2019. Each partner contributes $100 for a total of $300 and agree to a one-third sharing in PRS's profits and losses. PRS uses the cash to purchase land (Asset 1) and two pieces of machinery (Assets 2 and 3) for $100 each. On its 2019 tax return, PRS claims a deduction of $300 under the section 168(k) 100% bonus depreciation provision on all three assets. In 2021, PRS sells Asset 1 for $150 and recognizes $150 of gain on its tax return since the tax basis in Asset 1 was $0. The depreciation recapture provisions of section 1245 result in PRS recognizing $100 of the gain as ordinary income and the remaining $50 as capital gain. PRS allocates the income and capital gain amounts proportionately to partners A, B, and C.

In 2022, an examination of PRS's 2019 tax return results in a positive partnership adjustment of $100 since Asset 1 was not qualified property under section 168(k). Since PRS no longer holds Asset 1, PRS is unable to allocate the $100 adjustment to the now disposed of property.

Our recommendation would allow the allocation of the adjustment to Assets 2 and 3 under the rules outlined in Treas. Reg. § 1.755-1(c).

In 2022, the adjusted basis and fair market value of PRS's assets prior to the audit adjustment are as follows:

	Adjusted Tax Basis	Fair Market Value
Asset 2	$ 0	$ 90
Asset 3	$ 0	$ 60
Total	**$ 0**	**$ 150**

Following the rules outlined in Treas. Reg. §1.755-1(c), the $100 adjustment is first allocated between the ordinary income property class and capital gain asset class. The adjustment relates to property that under the "duty of consistency doctrine" is considered ordinary income property under section 1245. Assets 2 and 3 are both ordinary income property subject to section 1245 depreciation recapture (since the inherent gain in each property does not exceed the depreciation previously deducted). The $100 adjustment is allocated between the ordinary income assets (Asset 2 and Asset 3) in proportion to the excess of the fair market value and the adjusted tax basis of each asset. The fair market value of Asset 2 exceeds its adjusted basis by $90. Therefore, the basis of Asset 2 is increased by $60 ($100 multiplied by $90 divided by $150). The fair market value of Asset 3 exceeds its adjusted basis by $60. Therefore, the basis of Asset 3 is increased by $40 ($100 multiplied by $60 divided by $150).

Following the application of the audit adjustments, the adjusted basis and fair market value of PRS's assets are as follows:

Caplin & Drysdale, Chartered

	Adjusted Tax Basis	Fair Market Value
Asset 2	$ 60	$ 90
Asset 3	$ 40	$ 60
Total	**$ 100**	**$ 150**

Recommendation

The AICPA recommends that the IRS allow any reasonable method of applying successor rules for mergers and divisions occurring between the reviewed year and the adjustment year.

We urge the IRS to permit maximum flexibility and approve any reasonable method proposed by a partnership for applying the successor rules in the context of mergers and divisions which may have occurred between the reviewed year and the adjustment year.

Recommendation

The AICPA recommends treating the remittance by a former partner to the partnership (under a reimbursement or indemnification agreement of an allocable share of tax, interest and penalties paid by the partnership under section 6225) as a tax-free receipt by the partnership.

We also recommend that the payment reduce the partnership's section 705(a)(2)(B) expense and that the partnership should allocate the reduction in full to the former partner's successor.

In addition, we recommend that the payment by the former partner is treated as a nondeductible expense by that partner.

Analysis

Proposed Reg. § 301.6241-4(a) provides that payments made by a partnership for an imputed underpayment, interest, penalties or any addition to tax as a result of an adjustment under the Regime are nondeductible. The preamble to the proposed regulations states that when a partnership pays an imputed underpayment under section 6225, it has the effect of converting what is normally a nondeductible partner-level expenditure into a nondeductible partnership-level expenditure. The General Explanation of Tax Legislation Enacted in 2015 ("Bluebook") published by the Joint Committee on Taxation on March 14, 2016, states on page 79:

> *"Partners, former partners, and the partnership may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax liability of former or new partners being borne economically by new or former partners, respectively. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to or arising from the tax are nondeductible."*

Caplin & Drysdale, Chartered

We agree with the statement in the Bluebook and recommend that the appropriate treatment for a remittance by a former partner to the partnership under a reimbursement agreement (or indemnification) for amounts of tax, interest and penalties paid by the partnership under section 6225 is as a tax-free receipt by the partnership that reduces the partnership's section 705(a)(2)(B) expense and is a nondeductible expense to the former partner.

Proposed Reg. § 1.704-1(b)(2)(iii)(f) provides that the allocation of these nondeductible expenditures is substantial only if the partnership allocates the expenditure in proportion to the notional items to which it relates. This treatment is consistent with the flow-through nature of partnerships under subchapter K.

In instances where a former partner remits to the partnership, under a reimbursement agreement (or indemnification), for its share of any such nondeductible expenditure paid by the partnership, we recommend that the resulting reduction in the partnership's section 705(a)(2)(b) expense is allocated in full to the former partner's successor.

The following example demonstrates the application of this recommendation.

Example 2:

A and B form partnership PRS in 2019. Each partner contributes $100 for a total of $200 and agree to an equal sharing of PRS's profits and losses. In 2019, PRS received a cash payment for services of $200, which it did not record on its books. PRS reported no income or loss on its 2019 tax return. At the end of year 2019, A sells its entire interest in PRS to C, an unrelated party, for $100 (no gain or loss). At the time of the sale the balance in the assets, capital accounts and outside bases of PRS are as follows:

Partnership (PRS)					**Partners**			
						Outside		
	Basis	Book	Value			Basis	Book	Value
Cash	$ 200	$ 200	$ 200		Partner A	$ 100	$ 100	$ 100
					Partner B	$ 100	$ 100	$ 100
Total	**$ 200**	**$ 200**	**$ 200**		**Total**	**$ 200**	**$ 200**	**$ 200**

In 2021, an examination of PRS's 2019 tax return results in a positive partnership adjustment of $200 of income (cash), creating an imputed underpayment of $74 ($200 multiplied by the highest individual rate of 37%). PRS pays the $74 imputed underpayment. Immediately following the payment, the balance in the assets, capital accounts and outside bases of PRS are as follows:

Caplin & Drysdale, Chartered

Partnership (PRS)					Partners			
						Outside		
	Basis	Book	Value			Basis	Book	Value
Cash	$ 326	$ 326	$ 326		Partner C	$ 163	$ 163	$ 163
					Partner B	$ 163	$ 163	$ 163
Total	**$ 326**	**$ 326**	**$ 326**		**Total**	**$ 326**	**$ 326**	**$ 326**

Following completion of the audit, PRS is reimbursed by A (the former partner) under an indemnification agreement for A's share of the imputed underpayment of $37 ($74 multiplied by 50%). PRS allocates the entire amount of the reimbursement to C since the notional income item which gave rise to that portion of the liability was allocated to C, as the successor partner to A. As a result of this allocation, the balance in the assets, capital accounts and outside bases of PRS are as follows:

Partnership (PRS)					Partners			
						Outside		
	Basis	Book	Value			Basis	Book	Value
Cash	$ 363	$ 363	$ 363		Partner C	$ 200	$ 200	$ 200
					Partner B	$ 163	$ 163	$ 163
Total	**$ 363**	**$ 363**	**$ 363**		**Total**	**$ 363**	**$ 363**	**$ 363**

* * * * *

The AICPA is the world's largest member association representing the accounting profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our comments and welcome the opportunity to discuss these issues further. Please contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; Michael Greenwald, Chair, AICPA Partnership Taxation Technical Resource Panel, at (212) 842-7513 or MGreenwald@friedmanllp.com; or Jonathan Horn, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9204 or Jonathan.Horn@aicpa-cima.com.

Caplin & Drysdale, Chartered

Respectfully submitted,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Ms. Rochelle Hodes, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Brendan O'Dell, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Bryan Rimmke, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Ms. Kathryn Zuba, Associate Chief Counsel (Procedure & Administration), Internal Revenue Service
Mr. Clifford Warren, Special Counsel, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Ms. Jennifer M. Black, Office of Associate Chief Counsel (Procedure & Administration), Internal Revenue Service

Caplin & Drysdale, Chartered