© 2018 Thomson Reuters. Originally appeared in the Winter 2017 issue of Real Estate Finance Journal. For more information on that publication, please visit legalsolutions.thomsonreuters.com. Reprinted with permission.

# What REITs Need to Know About the New Partnership Audit Rules

*Edward L. Glazer, Mark D. Kirshenbaum, and H. Neal Sandford**

**This article focuses on the impact of new Internal Revenue Service partnership audit rules on real estate investment trusts, and issues for a REIT to consider.**

The Bipartisan Budget Act of 2015 fundamentally changes the rules and procedures governing Internal Revenue Service ("IRS") audits of partnerships for taxable years beginning on or after January 1, 2018. These new rules are contained in new Sections 6221 to 6235 and 6241 of the Internal Revenue Code of 1986 (the "Code"). This article focuses on the impact of these rules on real estate investment trusts ("REITs"), and issues for a REIT to consider.

The new rules are designed to facilitate partnership audits and collections by resolving the audit and assessing any resulting deficiency entirely at the partnership level. A partnership representative, or if the partnership representative is an entity, a designated individual appointed by the partnership, has exclusive authority to represent the partnership, and bind the partners, in connection with an audit of any partnership item. Any assessment resulting from the audit becomes a current liability of the partnership, unless further action is taken by the partnership. Partners will not have the right (as they do under current law) to opt out of a partnership-level settlement and pursue a separate proceeding with the IRS; they will be bound by whatever resolution is reached between the partnership representative and the IRS.

REITs with an umbrella partnership real estate investment trust ("UPREIT") structure or that otherwise invest through partnerships, such as joint ventures, downREITs and commingled clubs or funds, may find that the existing provisions of their operating partnership agreement ("OP Agreement") and subsidiary partnership agreements, as well as contribution agreements and related tax protection agreements, do not adequately address the new rules and may expose the REIT to bearing a share of its partners' tax liabilities. These rules also may lead to fundamental changes in structuring and negotiation of M&A transactions involving partnerships.

*Edward L. Glazer (eglazer@goodwinlaw.com), of counsel at Goodwin Procter LLP, is a member of the firm's Tax Practice and Real Estate Capital Markets Group, focusing his practice on structuring and implementing tax-oriented commercial transactions of all types. Mark D. Kirshenbaum (mkirshenbaum@goodwinlaw.com) is a partner in the firm's Tax Practice concentrating on the tax and structuring aspects of commercial transactions and investment vehicles. H. Neal Sandford (nsandford@goodwinlaw.com) is a partner in and chair of the firm's Tax Practice, specializing in structuring tax-sensitive commercial transactions.


© 2018 Thomson Reuters

Congress did not grant a last-minute delay of the effective date of this new partnership audit regime, as proposed by a number of organizations.

## Overview of the New Regime

The statute passed by Congress in 2015 could kindly be called a work in process. Many crucial details were left to be fleshed out in regulations. While Treasury has proposed regulations that address many issues, these regulations have not yet been finalized, and several key questions remain unanswered. This summary is based on the statute and the proposed regulations.

If the IRS audits a partnership taxable year starting in or after 2018 (the "reviewed year"), and the partnership is not able to opt out of the new regime, the partnership representative (or designated individual) will receive a notice of administrative proceedings setting forth the IRS's proposed adjustments and the resulting tax liability known as the imputed underpayment. The imputed underpayment is generally the hypothetical tax resulting from applying the highest possible rate (currently the highest individual tax rate) to the adjustments.

The partnership will have a prescribed number of days to request modifications to the imputed underpayment. Permitted modifications include:

- for a REIT partner (in the UPREIT structure typically the largest partner), a modification based on making a deficiency dividend pursuant to Code Section 860;
- a reviewed year partner (or indirect partner) files an amended return that takes into account a partnership adjustment and pays its share of any resulting tax liability;
- a modification based on the tax-exempt status of a reviewed year partner; and
- a modification which changes the tax rate applied to a portion of the total partnership adjustment allocable to a reviewed year partner who is a C corporation or an individual with respect to capital gains and qualified dividends.

The IRS then reduces the imputed underpayment amount by the modifications with which it agrees and issues a notice of final partnership adjustment.

At this point the partnership representative (or designated individual) can:

(1) pay the imputed underpayment set forth in the notice of final partnership adjustment with interest as part of the partnership's return for the adjustment year return (not the audited reviewed year);

(2) make a push-out election pursuant to Code Section 6226 to the partners in the reviewed year which requires those partners to include their share of the final imputed adjustment on their return for the adjustment year with interest (not by filing an amended return for the audited reviewed year), although as discussed below, the proposed regulations do not permit a push-out election to be made to an indirect partner; or

(3) litigate all or a portion of the imputed adjustment which delays the eventual choice between alternative (1) and (2) if


© 2018 Thomson Reuters

there is a remaining adjustment at the end of the litigation.

Partnerships with 100 or fewer partners, all of which are individuals, C corporations (including REITs), S corporations, or estates of deceased partners, may opt out of the new regime. Note that if in a tax year there are partners who are partnerships, trusts, disregarded entities[1] or nominees, the partnership may not opt out in that year. We anticipate that many public UPREITs will not be eligible to opt out. Further note that subsidiary partnerships, including joint ventures, in which the OP is a partner will not be eligible to opt out. The opt-out election is made on the partnership's tax return for that year and is a year-by-year election. The IRS has indicated that it intends to audit partnerships which make opt-out elections.

## Items Covered

The new partnership audit regime is not limited to understatements of income by a partnership. Rather, the proposed regulations provide that the following partnership-related matters (among others) will all be resolved using the new procedure:

(A) the character, timing, source and amount of the partnership's income, gain, loss, deductions and credits, including whether an item is deductible, tax-exempt, or a tax-preference item;

(B) the character, timing and source of the partnership's activities, including whether the partnership's activities are passive or active;

(C) contributions to, and distributions from, the partnership, including the value, amount and character of those contributions and distributions (for example, for purposes of Sections 704(c), 721(b), 721(c), 737, and 751(b));

(D) the partnership's basis in its assets, the character and type of the assets, and the value (or revaluation) of the assets; including any effect the character or value of the partnership's assets has on the sale or exchange of an interest in the partnership;

(E) the amount and character of partnership liabilities, including whether a liability is recourse or nonrecourse and any changes to those liabilities from the preceding tax year;

(F) any elections made by the partnership and the consequences or effects of those elections, including a Section 754 election, any election referenced in Section 703(b), a Section 761 election, and an election under Sections 6221(b) or 6226(a);

(G) items related to transactions between a partnership and any person including disguised sales, guaranteed payments, Section 704(c) allocations and transactions to which Section 707 applies;

(H) any item resulting from a partnership terminating under Section 708(b)(1)(A);

(I) items and any effects from a technical termination under Section 708(b)(1)(B);

(J) partner capital accounts, including the release of a partner from a deficit restoration obligation;

(K) whether a person is a partner and whether the entity is a partnership; and

(L) any penalty defenses.


© 2018 Thomson Reuters

## Open Questions[2]

### *Multi-Tier Push-Outs*

As currently drafted, the 6226 push-out election only goes one tier up: the partnership makes the election, and all of the partnership's direct partners must pay the tax on their share of the adjustment. There is no mechanism for a partner that is itself a partnership to push the adjustment out to its own partners. The preamble to the proposed regulations states that the IRS is reviewing whether to allow this kind of tiered push-out. This is of particular interest to UPREITs where the OP invests in subsidiary partnerships, such as joint ventures. If multi-tier push-outs are not allowed, an audit of the joint venture could result in a push-out to the OP with no way to further push out the adjustment to the partners in the OP, including the REIT.

### *Correlative REIT Adjustments*

The extent to which a REIT partner is bound by the results of the partnership audit for purposes of determining REIT qualification or REIT-specific taxes is unclear. For example, if an imputed underpayment arises from an adjustment which would produce or reduce either qualifying or non-qualifying income for purposes of the REIT income tests, does the REIT have to recompute its compliance for its income tests? It should be the case that the question of whether the income is qualifying or non-qualifying and its impact on REIT qualification is made only through an audit of the REIT and not through a partnership audit. Likewise, while the question of whether partnership property is held for sale, rather than investment, is ordinarily made at the partnership level, any imposition of the 100 percent prohibitive transaction tax or any challenge to the application of the prohibitive transaction safe harbor provision of the Code should be made through a REIT audit and not through a partnership audit.

### *Foreign Partners*

The proposed regulations do not address how the new regime will apply to foreign partners. The preamble to the proposed regulations notes that the IRS intends to issue regulations on this subject

### *Adjustments to Capital Accounts and Tax Basis*

An audit of a partnership and the payment of additional tax, either at the partnership level or through a Section 6626 push-out, ought to result in corresponding adjustments to the partnership's basis in and book values of its assets, the partners' basis in their partnership interests, and/or their capital account balances, as applicable. The proposed regulations do not specify how to make these necessary adjustments. The IRS plans to issue separate regulations in the future to address this issue.

### *Additional Proposed Regulations*

The IRS is drafting additional proposed regulations which could include: (a) the treatment of tax-exempt partners, (b) appeals procedures which would permit a partnership to go to appeals during an audit to challenge certain positions that the IRS is taking, (c) the ability of a partnership to change its partnership representative prior to the issuance of a notice of administrative proceedings, and (d) certain timing mismatches.


© 2018 Thomson Reuters

## Preparing for the Implementation of the New Audit Regime

### *Determine if You Can Opt Out and Whether it is Desirable to Opt Out*

As noted, partnerships with 100 or fewer partners, all of which are individuals, C corporations (including REITs), S corporations, or estates of deceased partners, may opt out of the new regime. You should determine whether your partnerships are eligible to opt out, or if you can revise your structure to eliminate or modify partners who are not eligible, to allow opting out. We anticipate that many public UPREITs will not be eligible to opt out, and in any event subsidiary partnerships of the OP will not be eligible to opt out.

### *Review Your OP Agreement and Subsidiary Partnership Agreements*

As described more fully below, several provisions of a typical OP agreement will affect the conduct of an audit under the new regime and the consequences of an adverse determination. Your current language may or may not be sufficient to protect your interests; you should review your existing agreements and determine whether any amendments are necessary.

### *Withholding From Current Partners*

You should review your partnership agreement to determine whether (and to what extent) it allows you to allocate the economic cost of the imputed underpayment to the appropriate partners. In many, but not all, cases the tax withholding provisions of existing partnership agreements are sufficiently broad to allow the partnership to recover the costs of imputed underpayments from the appropriate partners (or, stated differently, to allow the partnership to pass the savings of modifications on to those partners who generated the modifications—such as passing the savings of a deficiency dividend modification to the REIT partner). Sufficiently robust withholding or similar provisions could eliminate or reduce the need for a push-out election, which may not always be available.

### *Former Partners — Transfers and Redemptions of Partnership Interests*

You should review your withholding, transfer and redemption provisions to determine whether they are broad enough to require former partners to pay their share of such an adjustment without the requirement of making a push-out election.

### *Designating a Partnership Representative and Designated Individual; Tax Elections*

A partnership designates a partnership representative for each year on its tax return for that year. A partnership representative must be appointed every year, and it can, but need not be, the same each year. The partnership representative does not need to be a partner. In the typical UPREIT structure we expect that the REIT will designate itself as the partnership representative.

If the partnership representative is an entity, as would be the case if the REIT is so designated, the partnership must name a designated individual who will be the sole individual through whom the partnership representative will act for all purposes. The designated individual has sole authority to bind the partnership representative and the partnership for all purposes.


© 2018 Thomson Reuters

You should review your partnership agreement to determine whether the REIT has the power to elect itself partnership representative and name a designated individual and make push-out elections without the consent of the other partners. This may be found in the provision of your partnership agreement dealing with tax elections, the provision dealing with the current tax matters partner regime or elsewhere.

If you have joint ventures structured as subsidiary partnerships, your joint venture partners in those subsidiary partnerships may have more consent rights than those contained in the OP agreement.

### *Tax Contests*

Your partnership agreements (or as discussed below your tax protection agreements) may have a provision specifically addressing the conduct of audits and other tax disputes and give minority partners certain rights to participate in such audits and tax disputes. These rights may be inconsistent with the new partnership audit regime which provides that only the partnership representative (or the designated individual) is entitled to participate directly in discussions with the IRS. There is no longer any right or opportunity under the new rules for a minority partner to elect out of a partnership-level settlement and pursue a separate proceeding with the IRS. To be clear, the Section 6626 push-out election occurs only after the final amount owed has been determined with no further appeal by an affected partner. The push-out election is solely a method for collecting the tax, interest and penalties owed.

## States Likely To Follow

This new regime is a part of the federal Internal Revenue Code and therefore only affects audits of federal tax returns. It remains to be seen how states will respond to this change. Some states likely will adopt similar procedures at the state level. It is likely that not all states will reach the same conclusion on these questions,[3] so your state tax considerations may become significantly more complex. You should keep this in mind in making any needed amendments to your current partnership agreements.

## Bring on the Litigators

Minority partners, including joint venture partners and OP unitholders who contribute appreciated property, may successfully negotiate contractual limitations on the partnership's ability to resolve audits without the minority partner's involvement or consent. The proposed regulations make it clear that (1) no partner, or any other person, may participate in an examination or other proceeding involving the partnership without the permission of the IRS, (2) no state law, partnership agreement or other document or agreement may limit the authority of the partnership representative (or designated individual) in dealing with the IRS, and (3) the actions of the partnership representative (and designated individual) bind the partnership and all partners for all purposes. The failure to consult with the minority partners, as required under the OP agreement or tax protection agreement, does not limit the authority of the partnership representative (or designated individual) to bind the partnership. The sole remedy of the minority partners is to bring on the litigators and sue the partnership, the partnership representative


© 2018 Thomson Reuters

and/or the designated individual for damages. Questions may also arise as to the continuing effectiveness, as a matter of contract law, of participation/consent rights that reference the now repealed "tax matters partner" regime.

## Partnerships That Cease to Exist

If a partnership ceases to exist before a partnership adjustment takes effect (which is defined to be the time when all amounts due from the partnership as a result of the audit are fully paid), the former partners of the partnership become liable for the partnership's obligations. The IRS may, but is not required to, determine that a partnership does not exist if (1) it has terminated pursuant to Section 708(b)(1)(A), or (2) it does not have the ability to pay the amount owned. Only the IRS can determine that a partnership has ceased to exist. A technical termination under Section 708(b)(1)(B) does not cause a partnership to cease to exist.

If a partnership is determined to have ceased to exist, the partnership itself is no longer liable and the persons who were partners in the year the audit concluded (the adjustment year) must take into account on their tax returns their share of the partnership adjustments. If there are no adjustment-year partners (i.e., the partnership terminated in a previous year), the persons who were partners in the last year that the partnership existed must bear their share of the partnership adjustments. The amount each such partner must include in income in the adjustment year is determined in a manner similar to that used to calculate the 6226 push-outs. If the partnership ceased to exist before it could make a 6226 push-out election, there does not seem to be any way for the former partners to make such an election on behalf of the partnership. It is unclear why this burden falls on the partners in the adjustment year or in the last year the partnership existed rather than the partners in the reviewed year (the year under audit).

Similar rules apply to upper-tier partnerships. For example, if an adjustment year partner of a partnership that ceased to exist is itself an upper-tier partnership that ceased to exist, or if the partnership under audit makes a 6226 push-out election but one of its partners in the year under audit was a partnership that has ceased to exist, the liability for the former upper-tier partnership shifts to the former adjustment year partners of the upper-tier partnership.

You should keep these rules in mind whenever a partnership in your structure ceases to exist (including cases where it ceases to exist for tax purposes because it has become a disregarded entity). Whatever persons were partners in the partnership last year may have significant liability exposure. Persons acquiring a partnership interest from another partner also will need indemnification to protect them against this risk.

## Contribution Agreements, Tax Protection Agreements — New Negotiations Ahead

Many UPREITs have entered into contribution agreements and related tax protection agreements, under which contributors transfer appreciated real estate to the OP and receive in exchange OP units. These transactions are structured to be tax free under Code Section 721; if the contributor has a "negative capital account" the OP typically agrees to provide a negotiated amount of debt protection pursuant


© 2018 Thomson Reuters

to the rules of Code Section 752. The contributor also often negotiates to require the OP to make certain elections which will benefit the contributors as OP unitholders. As indicated above, the determination of whether a transaction complies with Code Section 721 or is treated as a disguised sale will be made at the partnership level starting in 2018. Likewise, allocations of debt under Code Section 752 and tax elections will now be made at the partnership level starting in 2018.

You should anticipate that contributors will negotiate for consent rights and limited tax audit participation rights (to the extent they are permissible under the new audit regime) particularly with respect to audit adjustments that solely or disproportionately adversely impact the contributors. Many of these adjustments, if agreed to, would benefit the REIT and other partners since they could produce a stepped-up tax basis in the contributed property, provide more debt that can be allocated to other partners and/or reduce the amount of taxable income allocated to the REIT and other partners.

We are already seeing this issue raised in 2017 contribution agreements. It becomes much more important for those transactions which close in 2018 or after. It is not too early to focus on how you want to address this issue in future transactions. More fundamentally, existing tax protection agreements will need to be reviewed to assess whether indemnity provisions will continue to operate as intended.

## Effects on M&A Transactions

We expect the new partnership audit regime to have a significant impact on how partnerships are acquired in mergers and acquisitions. Prior to this new partnership audit regime, the purchaser of a partnership interest assumed minimal federal income tax risk. If the partnership were ever audited for a pre-acquisition year, only the selling partners and not the partnership itself or the purchasing parties would be liable for any resulting assessment of tax. Because the legal liability fell on the sellers to begin with, there was no need for a broad tax indemnity or significant tax diligence. That will change under these new partnership audit rules starting in 2018. Pursuant to the new regime, if a partnership is audited for a prior tax year, including a year prior to the acquisitive transaction, the partnership itself will be required to pay the imputed underpayment if it cannot make a push-out election to the partners in the year under audit (the reviewed year).

One would expect that buyers will want to perform a much larger amount of tax diligence to ascertain any potential audit issues. In addition, under certain circumstances in non-public transactions tax indemnities which survive the closing may be sought. Buyers will want to make sure that prior partnership representative and designated individual elections can be terminated either by resignation or revocation so that they can make the Code Section 6226 push-out election.

This new regime will likely cause buyers beginning in 2018, where possible, to desire to acquire assets (or interests in disregarded entities that own the assets) rather than partnership interests. This may have adverse consequences to sellers who now need to deal with the rules which apply to partnerships that cease to exist.


© 2018 Thomson Reuters

## Observations

All of this assumes that starting in 2018, there will be a significant amount of audit activity involving UPREITs or subsidiary partnerships owned by REITs which justifies doing all of this work. Be prepared in case this does happen, and be grateful if this turns out not to be the case.

This new partnership audit regime is quite complex and will only work successfully from the taxpayers' point of view and from the IRS' point of view, if the partnership representative is dealing with an IRS agent who is knowledgeable in both how these rules work and Subchapter K (the partnership rules). Whether there are and will be enough knowledgeable persons in the IRS to handle these audits is a real concern. If not, it will make the job of the partnership representative and designated individual very difficult.

New tax insurance policies for partnership items may develop to cover partnership M&A transactions, contribution agreement/tax protection agreement transactions and more aggressive positions taken by a partnership in 2018 or after. Who should own and pay the premiums on such policies will be a matter subject to negotiation.

## Conclusion

There are several additional points that should be mentioned.

First, Congress did not grant a last minute delay. These partnership audit rules are now in effect for 2018 audits.

Second, final regulations were issued in December 2017 and finalized as of January 2, 2018 which, among other things, did not expand the list of eligible partners for purposes of determining whether a partnership may opt out of the new partnership audit regime.

Most important: New proposed regulations were issued on December 15, 2017 which permit all pass-through entities (partnerships, S corporations, certain types of trusts and estates) to make a push out election pursuant to Section 6226 through the tiers of ownership to the ultimate taxpaying owners.

Next, the new proposed regulations also address the rules for seeking judicial review of partnership adjustments and provide rules regarding assessment and collection, penalties and interest, and period of limitations under the new centralized partnership audit regime.

Finally, an additional set of proposed regulations were issued in November 2017 which provide rules addressing how certain international rules operate in the context of the centralized partnership audit regime, including rules relating to withholding of tax on foreign persons, the treatment of creditable foreign tax expenditures and other foreign tax credit issues, and modifications of an imputed underpayment based on the status of a foreign partner and other treaty issues.

**NOTES:**

[1]At a public hearing held on September 18, several practitioners who spoke at the hearing asked the IRS to expand the list of eligible partners to include disregarded entities.

[2]As noted under "Conclusions," certain of these open issues have been addressed in proposed regulations issued after the preparation of this article.

[3]A coalition of tax groups has updated its proposed model state statute to better link to this new federal partnership audit regime.


© 2018 Thomson Reuters