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New Partnership Audit Procedures May Dramatically Affect the Assessment and Collection of Taxes Relating to Partnership Activities

The Bipartisan Budget Act of 2015 (the “BBA”), which was signed into law in November 2015, includes sweeping changes to the rules governing federal tax audits of entities treated as partnerships for US federal income tax purposes. The new rules replace the long-standing regimes for auditing partnerships under the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) and the Electing Large Partnership (“ELP”) rules. The new rules allow the Internal Revenue Service (the “IRS”) to deal with only a single “partnership representative,” similar to the tax matters partner under TEFRA, during an audit and any related court cases. Unless a partnership elects out, the new rules impose an entity-level tax on the partnership at the highest rate of tax in effect for the reviewed year (subject to potential reduction) for any understatements of partnership income. The entity-level tax can be avoided, however, if the partnership elects to “push out” the adjustment to its partners by providing them with adjusted Schedule K-1s reporting their allocable share of any partnership-level audit adjustments. The purpose of the new rules is to streamline partnership audits under a single set of rules and to make it easier for the IRS to assess and collect tax after a partnership audit. Importantly, the new audit regime will apply only to partnership tax returns filed for taxable years beginning after December 31, 2017 unless a partnership elects to apply them to an earlier taxable year. The BBA contains profound changes affecting both partnerships and partners. Consequently, a review of partnership agreements to analyze how these rules will affect existing partnerships is advisable.

Background

The TEFRA regime, which generally remains in place until the BBA’s audit provisions become effective, provides for unified audit procedures to determine the tax treatment of all “partnership items” at the partnership level, after which the IRS can assess each audited-year partner individually based on the partner’s allocated share of the adjustments. The TEFRA rules also include procedures for notice to, and participation by, partners in audits and any related litigation. The BBA audit provisions will replace both the TEFRA regime as well as the rarely-used tax provisions and audit procedures for ELPs (electing partnerships with more than 100 partners). Partnerships that elected to be treated as an ELP were subject to a unified audit under which any adjustments were generally reflected on the partners’ current year return rather than on an amended prior-year return. The ELP rules were adopted to make audits of large partnerships less burdensome. But most large partnerships did not elect ELP treatment, and the IRS found the ELP regime to be underutilized. Under the BBA’s audit provisions, partnerships with more than 100 partners will be governed by the new rules as no election to opt-out is permitted.

Application of the New Partnership Audit Procedures

All partnerships will be subject to the new audit procedures provided for in the BBA unless they are permitted to elect out. Thus, partnerships with as few as two individuals will be covered by default under the BBA. Partnerships with more than 100 partners may not elect out of the BBA provisions.

A partnership with 100 or fewer partners can elect out of the new rules for a taxable year if all of its partners are individuals, C corporations (including entities treated for tax purposes as real estate investment trusts or regulated investment companies), foreign entities that would be treated as C corporations if they were domestic, or estates of deceased partners. A partnership with an S corporation partner may elect out of the new rules if all of the S corporation's shareholders are identified to the IRS. In that event, each of the S corporation's shareholders counts as a partner for purposes of the "100 or fewer partners" test. Partnerships with other types of partners, such as partnerships, trusts, or certain tax-exempt entities, cannot elect out of the new audit procedures. Accordingly, tiered partnerships cannot elect out of the BBA audit procedures.

To elect out of the new rules with respect to a taxable year, a partnership must:

- include the election with its timely-filed income tax return for that year;
- disclose the names of all of its partners and their tax identification numbers to the IRS; and
- provide its partners with notice of the election.

If a partnership with 100 or fewer partners elects out of the new rules, the general non-partnership assessment and collection rules will apply. As a result, partners in a partnership, where the partnership has filed the partnership return and disclosed the election out of the BBA, may take inconsistent positions regarding partnership items reported on their Schedule K-1s, without providing notice to the IRS of the inconsistent position. In the case of a partnership that elects out of the BBA, the IRS still may audit the partnership, but it must make all tax adjustments at the partner level (*i.e.*, the partnership cannot settle issues on behalf of partners), and the partnership cannot extend the statute of limitations for the partners. Accordingly, in such a case, the IRS would need to timely issue 30-day letters or notices of deficiency to the individual partners.

While the ability to elect out of the new partnership audit regime may be useful in certain cases (such as closely-held partnerships among sophisticated partners), the election-out provisions may be of limited utility because, as a practical matter, most investment funds and widely-held partnerships are unlikely to satisfy the requirements for electing out.

Partnership Level Assessments and Collections – The Default Rule

Under the BBA, the IRS will audit the partnership's items of income, gain, loss, deduction, credit and partners' distributive shares for a particular year of the partnership at the partnership level (like under TEFRA), which is now called the "reviewed year." Except as described below, any adjustment, assessment and collection of tax, interest and penalties will be made at the partnership level and taken into account by the partnership in the year that the audit or any judicial review is completed. The year in which an audit becomes final is called the "adjustment year." If the IRS determines that any adjustments are required, the partnership generally will be required to pay the imputed underpayment of tax, plus interest and penalties. The imputed underpayment is determined by adding together or

“netting” all adjustments to items of income, gain, loss and deduction and multiplying the result by the *highest* tax rate in effect for the reviewed year under section 1 (individuals) or section 11 (corporations) (*i.e.*, under current law, the relevant rate would be 39.6%). The imputed underpayment is calculated without regard to the nature of the adjustments; all positive or negative adjustments to capital gains and losses, whether long or short term, items of ordinary income or other types of income or loss, are netted. Nor does it appear to matter that items might be subject to restrictions on deduction at the partner level such as the “at risk” or “passive activity” limitations.

A partnership’s imputed underpayment may be reduced to the extent partners voluntarily file amended tax returns and pay any tax due for the audited year, or if the partnership demonstrates that partnership items are allocable to partners that are either not subject to tax (*i.e.*, tax-exempt entities), or taxed at a reduced corporate tax rate or, in the case of an individual, a reduced capital gain rate or qualified dividend income rate. The BBA directs Treasury to establish procedures under which the imputed underpayment “may be modified” to specifically account for (i) adjustments to reflect amended returns filed by partners, (ii) adjustments to exclude income allocable to tax-exempt partners, (iii) adjustments to reflect the applicability of rates of tax lower than the highest rate to income or gains allocable to C corporation partners and capital gains or qualified dividend income allocable to individual partners and (iv) other factors as the Secretary “determines are necessary or appropriate.” The scope of any additional reduction under such procedures is not yet known.

Partner Level Assessments and Collections – The Alternative Rule (*i.e.*, the Push-Out Election)

As an alternative to the general rule that an imputed underpayment is assessed and collected at the partnership level, a partnership that receives notice of a Final Partnership Administrative Adjustment (“FPAA”) will be permitted to elect that, instead of the tax being assessed against the partnership, any adjustments are pushed out to its partners for the reviewed year through the issuance of adjusted Schedule K-1s. If this election is made, the reviewed year partners’ tax for the adjustment year will be increased to reflect the adjustment amount. In addition, the tax will include any tax that would have resulted from those adjustments in the years after the reviewed year and before the adjustment year. The effect of this election is similar to a TEFRA adjustment, but instead of actually imposing tax with respect to the earlier years (which would require the filing of amended tax returns), the tax is reported on and paid with the partners’ return for the adjustment year. Under this alternative, the reviewed year partners (rather than the partnership) are liable for the tax. In addition to the tax, the reviewed year partners will be liable for interest running from the due date of the return for the earlier years(s) that generated the liability and any penalties, and the interest rate used to calculate the amount of interest is increased by a “toll charge” of two percentage points above the typical underpayment rate. All tax attributes, such as basis, will be affected by these adjustments. In order to avail itself of the push-out election, a partnership must elect to issue adjusted Schedule K-1s no later than 45 days after the issuance of the FPAA. If it timely makes the election and furnishes the adjusted Schedule K-1s, the partnership will not be liable for any underpayment.

The decision whether the partnership should pay the imputed underpayment at the partnership level or elect to push out the adjustment to its reviewed year partners has important implications. Unless the partnership agreement provides otherwise, under the general partnership tax rule, paying tax at the partnership level places the economic burden on the persons who are partners during the adjustment year. This could impose part of the economic

burden of the adjustment on particular partners who were not partners in the partnership (or had a lower percentage interest in the partnership) in the reviewed year.

Partnership Representative

The BBA requires partnerships to designate a “partnership representative” with a role similar to that of the “tax matter partner” under TEFRA. The partnership representative can be any person (and not necessarily a partner) that has a “substantial presence in the United States.” (Until guidance is issued, it is unclear what level of US presence is required to act as a partnership representative.) The partnership representative has the sole authority to act on behalf of the partnership in an examination (including extending the statute of limitations and settling issues raised on audit), and decisions made by the representative are binding on the partnership and all of its partners. Partners retain no rights in administrative proceedings and will be unable to challenge IRS determinations separately from the partnership. Partners do have the right to file inconsistently with the partnership return (unless and until the partnership representative reaches an agreement with the IRS to finalize an audit) with notification to the IRS. If a partnership does not designate a partnership representative, the IRS is free to designate anyone it chooses. Additionally, the IRS is no longer required to notify partners of partnership audit proceedings or adjustments.

Statute of Limitations

The BBA provides that an adjustment generally must be made by the IRS (presumably “assessed”) within three years from the later of:

- the date the partnership return for the reviewed year was filed,
- the due date for such partnership return, and
- the date the partnership filed an Administrative Adjustment Request for the year.

An adjustment made within three years of any of these dates is timely. If, however, the amount of unreported income exceeds 25 percent of the gross income of the partnership for the reviewed year, the IRS has six years (rather than three years) to make the adjustment. Moreover, if the partnership did not file a return or filed a fraudulent return, there is no limitation period. In addition, as noted above, the partnership representative can agree to extend the time to make the adjustment.

The period for adjustment also will remain open (i) in the case of any imputed underpayment modification, for 270 days after the date that everything required to be submitted to the IRS is submitted and (ii) in the case of any proposed partnership adjustment, for 270 days after the date of the notice. The 270-day period gives the partnership time to produce documentation supporting lower tax rates for some or all of an imputed underpayment. The IRS must wait 90 days after issuing the FPAA before assessing the deficiency and, if the partnership timely files a petition in Tax Court, the IRS must wait until the court’s decision is final before making an assessment. Petitions in Tax Court do not require pre-payment, but a partnership filing in district court or the Claims Court must first pay the asserted imputed underpayment.

Planning Ahead

The BBA brings some long-needed reforms to a complex area of the tax code. Absent an election to apply the new rules before 2018, the BBA will not affect any partnership audits before 2019 (when returns for the 2018 taxable year can first be audited). However, it is not too early for affected taxpayers to consider the potential impact of these new rules on new and existing partnerships and partnership agreements. The new partnership audit rules represent a dramatic change from existing law and will likely have a significant impact on partnership transactions. Considering the breadth of guidance the IRS will need to issue and the IRS's discretion in deciding how the elections and underpayment calculations will operate, partnerships may have to act quickly to respond once rules are effective. Partnerships, both existing and new, should consider steps now to prepare for potential audits under the new rules and should begin evaluating their partnership and operating agreements and consider whether changes will be needed to address a variety of issues, including:

- Whether the partnership should consider electing out of the new partnership audit regime (if the partnership is eligible to make such election);
- Whether to agree in advance that the partnership will elect to push out any adjustment to its partners;
- Whether to include a provision placing the burden of an adjustment on persons who were partners during the reviewed year, rather than those who are partners during the adjustment year;
- Who to designate as the "partnership representative" and how future replacement partnership representatives will be selected; and
- Whether and how partners should receive notice of any tax proceeding.

Anyone joining a partnership also should review existing agreements closely for implications under the new rules. Under the default entity-level payment procedures, new partners can be exposed to effective liability for tax positions taken before they entered the partnership, and new partners may wish to request mechanisms, such as indemnities or a requirement for the partnership to make the push-out election, to reduce or eliminate their potential exposure.

Finally, we note that the new partnership audit regime is viewed by the government as a “work in progress” and, as a result, it would not be surprising if significant changes were made to the regime before it becomes effective.

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