PUBLICATION

New Act Significantly Alters Partnership Audit Procedures

Authors: Allen Brooks Blow
December 09, 2015

The recently enacted Bipartisan Budget Act of 2015 repeals the current Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Electing Large Partnership (ELP) partnership audit regimes and replaces them with a new regime. The new rules require tax adjustments to be made at the partnership level (not the partner level) following a partnership audit, which would result in an entity level tax on the partnership. These new audit rules will apply to taxable years beginning after December 31, 2017; however, partnerships may elect to have the new regime apply to any taxable year beginning after November 2, 2015. Based on this recent legislation, existing partnership agreements and operating agreements may need to be reviewed and potentially revised in order to address these new audit procedures. Moreover, consideration of these new audit procedures will affect how future partnership agreements and operating agreements are prepared.

Audits Under Current Procedures

Under the current TEFRA audit procedures applicable to most partnerships, the IRS conducts audits of all "partnership items" at the partnership level. The IRS then individually assesses each partner for his or her share of any resulting adjustment. The TEFRA rules provide procedures for giving notice to the partners and for the partners to participate in a limited fashion in the audit proceedings. Similarly, under the ELP rules applicable to certain large partnerships which elect to have those rules apply, audits are conducted at the partnership level and assessments are made at the partner level.

Audits Under the New Act – Underpayment Determinations

Under the new audit procedures, the IRS will audit items of partnership income, gain, loss, deduction, credit and partners' distributive share at the partnership level. In a significant change from the current audit procedures, if the audit results in any adjustments for tax liabilities, such adjustments will be assessed and collected at the *partnership* level, not the individual *partner* level. Interest and penalties will also apply at the partnership level for any underpayment of tax. In addition, these tax liability adjustments will be taken into account in the year that the audit is complete.

The general rule under the new procedures provides that tax liability for any underpayment of tax is calculated by multiplying the underpayment by the highest applicable tax rate, without considering the unique tax characteristics of each partner. However, partnerships will have the option to submit information to the IRS within 270 days of receiving a notice of final partnership adjustment, showing that the underpayment should be reduced due to partner-specific tax characteristics such as a tax-exempt partner or a partner subject to a lower income tax rate.

Because tax liability adjustments will be taken into account at the partnership level and will be assessed currently against the partnership, certain partners who were not a partner in the audited year may bear the tax burden for those who are no longer partners. Congress did, however, provide a mechanism under the new Act whereby a partnership may, within 45 days of receiving a final notice of partnership adjustment, elect to shift the burden of the assessed underpayments to the partners who were partners during the taxable year to which the assessed underpayments relate, by issuing new K-1s to such partners. If this election is made, the partners

who will be required to pay the tax will also be required to pay interest on the underpayments at a rate that is two percent higher than the normal underpayment interest rate.

When the tax is calculated at the partnership level, the new rules do not appear to take timing differences or net overall effect to partners into account. For example, if a partnership loss is reduced, the partnership will be taxed on the amount of the reduction even if partners have not been able to use the loss due to various limitations, such as the deferral of the loss under the passive activity rules. Also a reallocation of income from one partner to a second partner may result in a net tax to the partnership even if there is no overall net tax change because the reduction of the taxable income of the first partner is not taken into account.

Audits Under the New Act – Overpayment Determinations

The new audit rules provide that overpayments of tax are also taken into account at the partnership level in the year an audit concludes. However, the IRS will not pay any imputed overpayment to the partnership. Rather, the partnership takes the overpayment into account in the year the audit concludes by reducing its non-separately stated income or increasing its non-separately stated loss, as applicable. Unlike the rules pertaining to imputed underpayments, the new audit procedures do not provide a mechanism for the partnership to shift the benefit of an overpayment to those who were partners in the year of overpayment but who are not partners in the year an audit concludes. This is significant, because it may deprive a partner who overpaid tax in a prior year, but who left the partnership between the overpayment and the conclusion of the audit, from receiving the benefit of such overpayment.

Electing to Opt Out of the New Act's Audit Procedures

While the new audit procedures apply to all partnerships, certain small partnerships will be eligible to opt out of the new procedures. If this election is made, such partnerships will be audited under the audit rules applicable to individual taxpayers, with any adjustments being made and assessed at the partner level. To be eligible to elect out of the new procedures, a partnership must have 100 or fewer partners and all partners must be individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or the estates of deceased partners. Notably absent from the list of "qualifying partners" are partnerships and trusts. The Treasury Department is permitted to provide rules under which a partnership with a partnership or a trust as a partner would be eligible to opt out of the new regime, but it is unclear whether the Treasury Department will exercise this discretion.

Partnership Representatives Under the New Act

The new procedures dispense with the concept of a "tax matters partner" and replace it with the new role of "partnership representative." The partnership representative has the authority to act on behalf of the partnership and the partners are bound by the acts of the partnership representative during any audit or litigation. Notably, the partnership representative need not be a partner. The new audit procedures vest significant authority in the partnership representative and significantly restrict any other partners' rights to participate in any audit or tax litigation relating to the partnership.

Statute of Limitations Under the New Act

Another important feature of the new audit procedures is that the statute of limitations will not begin to run until the partnership has filed its Form 1065. This puts a premium on partners ensuring that their partnership timely files its tax return.

Regulations Potentially to be Issued

While Congress provides a basic framework in the Act for the new audit procedures, the Treasury Department has significant discretion in implementing the new audit procedures. Therefore, tax payers may not fully understand how the new audit procedures may affect them until the Treasury Department releases regulations. However, in the interim it is advisable to review your partnership agreement or operating agreements in light of the Act's new procedures.

Please remember that advice and counsel regarding your particular tax-related issues, including the potential impact of the developments above on you, your business or organization, depend on your specific facts and circumstances. For more information about how these issues may affect your business, or related matters, contact the co-authors of this alert, Allen Blow and Adam Province, or any member of the Firm's Tax Group.