CONGRESS ENACTS SWEEPING NEW PARTNERSHIP AUDIT RULES

Authors
Philip R. Hirschfeld
Nina Krauthamer

Tags
Audit
Corporate Tax
Partnerships
Partnership Tax

Partnerships owning real estate or other assets sometimes take aggressive tax positions that may invite I.R.S. scrutiny.[1] However, I.R.S. efforts to challenge such positions are hampered by the fact that the partnership itself is not the taxpayer.

Back in 1982, Congress enacted the Tax Equity and Financial Responsibly Act ("T.E.F.R.A."),[2] which provides for a unified partnership audit. However, the I.R.S. must still assess any resulting tax deficiency against each partner, which becomes increasingly difficult when the number of partners becomes significant. In the recently enacted Bipartisan Budget Act of 2015 (the "Act"),[3] Congress updated the partnership audit rules for all partnerships so as to allow for a unified partnership audit for any partnership, as well as collection of any resulting tax deficiency from the partnership.[4] While the new law will take effect for partnership taxable years starting on or after January 1, 2018, planning should begin now in order to determine the full impact of the new law and what steps may be taken to reduce any adverse consequences.

BACKGROUND

A partnership is an odd creature under the tax law: It resembles a business "entity" in that it files a partnership tax return on Form 1065 and makes certain elections, but it also resembles an "aggregate" of separate partners who each have to file their own tax returns and either pay tax on their shares of the partnership's income or report their shares of partnership loss. For the I.R.S., this entity/aggregate distinction has caused concern on audits of partnerships. Until 1982, the I.R.S. had to audit both the partnership and each partner, individually, in order to assess a tax deficiency against each partner. The resulting administrative burden made partnerships far less susceptible to audits as compared to corporations or individuals.

In 1982, Congress adopted T.E.F.R.A. to respond to this concern. The heart of T.E.F.R.A.'s unified partnership audit rules is Subchapter C (Tax Treatment of Partnership Items) under Chapter 63 (Assessment) of the Code, which encompasses Code §6221 through §6234. The key ingredients of these rules lie in Code §6221, which provides that the tax treatment of any partnership item is determined at the partnership level, and Code §6222(a), which requires all partners to report their

---

[1] For example, partnerships may try to deduct expenses that are not properly deductible or a partnership may specially allocate tax losses to one partner, which tax allocations lack substantial economic effect under Code §704(b) and thus, that should not be allowed. See, *e.g.*, Philip Hirschfeld, "Deciphering Tax Allocation Provisions in a Partnership Agreement," *Probate & Property*, (forthcoming).

[2] P.L. 97–248, 96 Stat. 324, enacted September 3, 1982.

[3] P.L. 114-74, 114th Cong., 1st Sess. (Nov. 2, 2015)(adopting H.R. 1314).

[4] Act, §1101.

respective distributive shares of partnership items consistently with the partnership tax return filed on Form 1065. If there is a partnership audit that determines a partnership item to be changed, then that adjustment should be binding on all partners. After partnership-level adjustments are made, the I.R.S. then needs to pursue collection from each partner, which also takes into account each partner's own overall tax situation. For example, a partnership-level adjustment that reports added taxable income to a partner may be offset by tax losses of that partner so that no tax currently due by that partner.

T.E.F.R.A. divided the world of partnership audits into three categories:

1. Small partnerships are exempt from these unified partnership audit rules. Two requirements must be met in order to qualify for this exception:

    a. the partnership must have ten or fewer partners

    b. all partners must be individuals who are U.S. citizens or resident aliens, estates of deceased partners, or C Corporations[5]

    A small partnership may elect to be covered by the T.E.F.R.A. procedures by attaching a statement to the partnership return for the first year in which the election is to be effective.[6]

2. Partnerships with 100 or more partners can elect to become electing large partnerships ("E.L.P.'s").[7] Code §§6240-6255, which is Subchapter D of Chapter 63 of the Code, provides special audit procedures for E.L.P.'s. The E.L.P. audit rules differ from the rules that otherwise apply under T.E.F.R.A. A major distinction is that for an E.L.P., any partnership audit adjustment made for an earlier taxable year does not require each partner to have to adjust its taxable income for that prior year. Rather, the partnership can take that adjustment into account in reporting each partner's share of taxable income for the year in which the adjustment is made.[8] For example, if the 2012 partnership taxable year is under audit and an I.R.S. adjustment is made in 2015 that results in $100 of added taxable income for each partner, the partnership can report that $100 taxable income as added income allocable to each of the partners for 2015; the I.R.S. does not have to chase each partner to make sure they filed an amended 2012 tax return. An E.L.P. can be liable for the unpaid tax if it elects not to include such income in the current year, or under certain other situations.[9]

3. A partnership that is not a small partnership or an E.L.P. is subject to the general T.E.F.R.A. audit rules. These rules allow the partnership to resolve matters with the partnership, but the I.R.S. must then pursue each partner to collect the tax, which can be very burdensome for the I.R.S., especially for large partnerships with many partners. This burden on the I.R.S. has translated into lost tax revenue, and as a result, these new partnership audit rules are intended to serve as a revenue raiser within the Act.

---

[5] Code §6231(a)(1)(B)(i).

[6] Treas. Reg. §301.6231(a)(1)-1(b).

[7] Code §775.

[8] Code §6242(a)(1).

[9] Code §6242(a)(2).

SUMMARY OF THE NEW LAW

The Act repeals the T.E.F.R.A. unified partnership audit rules under Subchapter C, as well as the E.L.P. rules under Subchapter D,[10] and replaces them with a new unified partnership audit regime applicable to all partnerships – with some ability to elect out.[11] The existing T.E.F.R.A. rules still apply for all partnership taxable years that begin before January 1, 2018.[12] So, for the time being, the T.E.F.R.A. rules still remain relevant.

"The Act repeals the T.E.F.R.A. unified partnership audit rules under Subchapter C, as well as the E.L.P. rules under Subchapter D, and replaces them with a new unified partnership audit regime applicable to all partnerships – with some ability to elect out."

The new streamlined partnership audit rules create a single set of audit rules for all partnerships. In a major departure from the current law, any adjustments would be taken into account by the partnership (and not each partner). The partnership would pay any tax that is then due at the highest rates of tax in the year the audit is completed or upon expiration of any judicial review.[13]

Partnerships with 100 or fewer partners may elect out of this new law provided that each of the partners is an individual, a C Corporation, any foreign entity that would be a C Corporation were it domestic, an S Corporation, or an estate of a deceased partner.[14] Regulations need to be issued giving further guidance. The reference to individuals is not limited to U.S. citizens or resident alien individuals; in that case, Code §1446 partnership withholding on effectively connected income would still apply. Therefore, the partnership may still be liable for any unpaid tax allocable to any foreign partner.

Partnerships that pay the tax deficiency have the ability to show that the tax liability should be lower if it was based on actual partner-level information from the year under audit rather than imputed amounts determined solely on the partnership's information for such year.[15] I.R.S. guidance on this important option is needed. Such adjustment could be based on amended returns of partners who choose to file, the status of tax exempt partners who may be exempt from tax on such income, or showing a lower tax rate applicable to a partner.[16]

Partnerships have the option to elect out of being personally liable for the added tax if the partnership files an election within 45 days after the date of the final notice of partnership adjustment.[17] The tax burden then shifts to the partners who were partners for the "reviewed year" (*i.e.*, the year under audit). In that case, the partnership will issue adjusted information returns on Form K-1 to those "review year" partners, but the K-1 will be issued for the year in which the "adjustment" is made; the K-1 is then subject to a simplified amended return process rather than a more cumbersome process that would apply if an amended K-1 was issued for the earlier year. While the adjusted K-1 may be for the current year, interest (at higher rates)

---

10 Act §§1101(a), (b).

11 Act §1101(c).

12 New Code §6241(g).

13 New Code §6221(a), Determination at Partnership Level, and §6225(a)(1), Partnership Adjustment by Secretary.

14 New Act §6221(b). Note that partnerships and trusts are not listed.

15 New Code §6225(c), Modification of Imputed Underpayment.

16 New Code §§6225(c)(2), (3), and (4).

17 New Code §6226, Alternative to Payment of Imputed Underpayment by Partnership.

and penalties are due as if the tax was owed from the prior year.[18] The I.R.S. needs to issue guidance on this election.

The Act also allows a partnership to initiate an adjustment for a reviewed year with the adjustment taken into account in the adjustment year.[19] This election also needs I.R.S. guidance.

BUYER BEWARE: CONCERNS FOR NEW PARTNERS

The new rules will impose tax liability on the partnership. If the current partners are the same as those that were partners in the earlier year under audit, then this procedure should not be harmful to any partner. However, if a person buys a partnership interest from an existing partner or acquires a partnership interest directly from the partnership and there is an audit for a year prior to their admission, then the new rules will expose the new partner to *indirectly* paying partnership tax liabilities that do not truly relate to them (*i.e.*, the partnership bears that expense, therefore reducing the amount of current partnership cash available for distribution to the partners and the value of the partnership interests). New partners need to assess the potential tax exposure for prior years. A new partner may desire to seek indemnification for any past due tax from either the person who sold the partnership interest or from the partnership itself, if the interest was purchased directly.

PARTNERSHIP REPRESENTATIVE REPLACES TAX MATTERS PARTNER

Under current law, a tax matters partner ("T.M.P.") represents partnerships before the I.R.S. in audit proceedings.[20] The Act replaces the T.M.P. with a Partnership Representative ("P.R.").[21] A major difference between the T.M.P. and the P.R. is that a T.M.P. had to be a partner, whereas the partnership can designate as a P.R. who is "a partner (or other person) with a substantial presence in the United States." If the partnership fails to appoint a person as a P.R., then the I.R.S. can appoint "any person" to act as a P.R. I.R.S. guidance is needed to clarify the role of the P.R. Partnership agreements should also be updated to appoint a P.R. and clarify his or her role.

CONCLUSION

The newly enacted partnership audit rules create a major change in tax audits by exposing the partnership to liability for any tax deficiency. Despite the two-year delay in implementation of these new rules, partnerships and partners should begin to analyze the full impact of the new law now and determine whether partnership agreements will need to be amended to reflect these changes. All partnerships and L.L.C.'s should determine whether the new small partnership rules will apply, or if not, whether the partnership or L.L.C. should make the opt-out election mandatory.

---

18 New Code §6226(e).

19 New Code §6227, Administrative Adjustment Request by Partnerships.

20 Code §6231(a)(7).

21 New Code §6233(a).