Tax

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Tougher than TEFRA: Congress Takes the Partnership Audit Rules in a Different Direction

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In search of revenue in the Bipartisan Budget Act of 2015 (P.L. 114-74, the ***Act****)*[1] *and reacting to calls to eliminate impediments to the ability of the Internal Revenue Service (the* ***IRS****) to audit large partnerships efficiently, Congress has repealed the TEFRA and Electing Large Partnership audit provisions for tax years beginning after December 31, 2017, replacing them with what is generally viewed (at least from the perspective of the IRS) as a "simplified" audit regime.*[2] *Partnerships and their tax advisors will need to consider the significance and effect of these changes, including the development of strategies for dealing with the new rules, and the possible consequences of those choices.*

The new regime (the ***New Audit Rules***) enacted by section 1101 of the Act redistributes the burdens of the audit process between partnerships and partners on the one hand and the IRS on the other, while also eliminating many rights that individual partners might previously have had in the audit process. But perhaps more troubling, the New Audit Rules create the possibility that absent careful attention and planning, the economic burden of partnership tax adjustments will both increase and be redistributed among the partners, both past and present, in a manner that does not reflect their economic agreement. As a result, it will be important for all partners and partnerships, whether newly formed or "old and cold," to evaluate their partnership agreements and consider how to address the New Audit Rules so that they do not alter the economic arrangement among the partners. Additionally, partners joining or exiting existing partnerships will need to consider potential tax liabilities in a new way. Partners and partnerships that do nothing to prepare for the New Audit Rules will find themselves at risk of surprising results.

[1] The partnership audit changes of the Act are projected to raise $9.3 billion.

[2] The Act repeals (i) the existing TEFRA audit regime contained in sections 6221 through 6234 of the Internal Revenue Code of 1986 (the ***Code)*** and (ii) the special rules for Electing Large Partnerships contained in sections 771 through 777 and sections 6240 through 6242 of the Code. The repealed provisions are replaced with new sections 6221 through 6241 of the Code.

Under the New Audit Rules, the IRS will audit the partnership and make adjustments to the partnership's items of income, gain, loss, deduction, credit and distributive shares for a particular year (the ***Reviewed Year***). Any adjustments to the partnership's items from the Reviewed Year are taken into account by the partnership in the year that the audit or judicial review is completed (the ***Adjustment Year***).

1. In a fundamental change to the way the income tax system has historically treated partnerships, if the net adjustments resulting from the audit establish that there was an "imputed underpayment" of taxes relating to the Reviewed Year, the partnership, and not the partners, is liable for paying the imputed underpayment (together with any interest and penalties).[3] The amount of the imputed underpayment is determined at the partnership level based on the ***net adjustments*** to items of income, loss, gain, deduction and credit at the partnership level for the Reviewed Year regardless of whether the partnership would otherwise have had income in the Reviewed Year, and calculated assuming the highest tax rates under sections 1 and 11 of the Code in the Reviewed Year. However, where an adjustment reallocates the distributive share of any item from one partner to another, the decrease in income or gain or increase in deduction, loss or credit of a partner is disregarded.

2. If the net adjustments made in a Reviewed Year do not give rise to an imputed underpayment, the net adjustments either (i) decrease the partnership's income in the Adjustment Year, or (ii) increase the partnership's losses in the Adjustment Year. These adjustments then flow through on Schedules K-1 to the partners who are partners in the Adjustment Year (not the Reviewed Year).

The New Audit Rules are effective for returns filed for partnership taxable years beginning after December 31, 2017, and they apply to any partnership that does not elect out of the rules (either because the partnership chooses not to elect out or because the partnership fails to qualify to elect out of the rules).[4] The election out is an annual election and can be made by a partnership that (i) is required to furnish no more than 100 Schedules K-1 for the year and (ii) has as partners for the year only individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations and estates of deceased partners.[5] If a partnership elects out, then the partnership and the partners will be audited for that year under the general pre-TEFRA rules, and each partner is subject to potentially different outcomes.

In repealing the TEFRA rules, Congress also eliminated the role of the "tax matters partner." For partnerships that do not elect out of the New Audit Rules, Congress has created the concept of the "partnership representative" in place of the tax matters partner. Where the tax matters partner had to be a partner of the partnership, the ***sole*** qualification for the partnership representative is that the person have a substantial presence in the United States. He, she or it need have no relationship with the partnership or the partners (other than contractual, presumably). Where before there were statutory limits on the ability of the tax matters partner to bind the partners, the partnership representative will now have the sole authority to act on behalf of the partnership and has the authority to bind the partnership ***and the partners*** to any

[3] This is a significant deviation from the principle that a partnership is merely a tax reporting entity, and that only the parties who were partners during a particular taxable year are accountable for their shares of the partnership's items of income, gain, loss, deduction and credit.

[4] A partnership can "elect in" to the New Audit Rules for any return of the partnership filed for partnership taxable years beginning after the date of enactment of the Act (November 2, 2015).

[5] Thus, a partnership may *not* elect out of the new regime if it has, as a member, a trust, another partnership, or a limited liability company or other similar entity treated as a partnership. It is not clear how disregarded entities (i.e., single member LLCs or grantor trusts) will be treated for this purpose. Treasury has been granted regulatory authority to allow partnerships with other partnerships and, if necessary, disregarded entities to elect out of the New Audit Rules. The number of Schedules K-1 required to be furnished by an S corporation partner is treated as required of the partnership for purposes of the 100 Schedules K-1 limit.

actions required to be taken by the partnership under the New Audit Rules and to any final decision in a proceeding brought under the New Audit Rules. Because Congress also repealed the general statutory participation rights of partners as well as the role and rights of "notice partners" that were set out in the TEFRA rules, the partnership representative is the sole person with whom the IRS is obligated to interact.

Because the new rules could have the effect of (i) increasing the overall tax burden on the partnership's income by utilizing the highest marginal tax rates to determine the amount of any imputed underpayment, and (ii) shifting the economic benefits and burdens of tax adjustments between the partners in the Reviewed Year and the partners in the Adjustment Year, partnerships can take advantage of several mitigating provisions in the New Audit Rules to reduce the amount of any imputed underpayment or to shift the burden of the imputed underpayment back to the partners of the Reviewed Year.

1. If a partner in the Reviewed Year (a) files an amended return for its tax year including the Reviewed Year, (b) takes into account all the partnership level adjustments for the Reviewed Year allocated to that partner (and for any other taxable year with respect to which any tax attribute is affected by reason of such adjustments) on the amended return, and (c) pays any tax due with the amended returns, then the partnership's liability for the underpayment is calculated by excluding the portion of the adjustment included in the partner's amended returns. Where an adjustment reallocates the distributive share of an item from one partner to another, both partners must file amended returns for this provision to apply. (This provision has the potentially beneficial effect of subjecting a partner's share of the partnership's adjustment to that partner's actual tax rate rather than a potentially higher deemed rate applicable at the partnership level, although this is only the first of several options for avoiding this deemed maximum deemed tax rate.)

2. If the partnership can demonstrate within 270 days of the receipt of a proposed partnership adjustment the portion of the imputed underpayment that is allocable to tax-exempt partners (as defined in section 168(h)(2) of the Code), the amount of the imputed underpayment may be reduced by that portion of the underpayment.

3. If the partnership can demonstrate within 270 days of the receipt of a proposed adjustment that a portion of the underpayment is allocable to (i) in the case of ordinary income, a C corporation, or (ii) in the case of capital gain or a qualified dividend, an individual, the partnership can calculate the amount of the underpayment assuming the lower rates applicable to such income.

4. The partnership can make an election within 45 days of the notice of final partnership adjustment to have the partners that were partners in the partnership during the Reviewed Year take the adjustments into account on their own returns and pay tax resulting from those adjustments, together with any penalties and interest, in the Adjustment Year. The partnership must send a statement to the IRS and each partner for the Reviewed Year setting forth the partner's share of any adjustments (as determined in the notice of final partnership adjustment). Each partner's tax for the Adjustment Year (not the Reviewed Year) is increased by the increase in tax arising from the adjustments in the Reviewed Year and succeeding years, plus interest at the regular underpayment rate ***plus two percentage points***.

Some of these provisions are self-implementing, while others will require detailed Regulations or other administrative guidance to make them work in a manner that is efficient and avoids unintended, and potentially abusive, shifting of income recognition or tax liability. Much of the commentary published since the New Audit Rules were enacted also suggests that Congress fully anticipates that there will be a need for technical corrections. Accordingly, it may be premature for partners and partnerships to begin binding themselves to specific positions. It is clear even from a high level review of the New Audit Rules, however, that partners and partnerships will need to carefully evaluate these new rules to put themselves in the position to make informed decisions at the appropriate time.

Given the ability to elect out of the New Audit Rules or to select paths within the rules that could lead to vastly different results both in terms of the size of the overall tax burden and the identity of bearer of the tax burden, it will be important to establish the partners' expectations up front and to craft provisions in the governing documents to insure that those expectations can be realized. For example:

1. Do the partnership and the partners want the partnership to elect out of the New Audit Rules, with each partner proceeding independently? Who should decide? What role will the interests of third parties (i.e., lenders) have in the decision? What provisions need to be included in the partnership agreement to insure that the election out is both available and, if desired, made? Does the partnership need to add additional transfer restrictions?

2. Who should be the partnership representative and what restrictions should be placed on the partnership representative's authority to act? What are the procedures for removing or replacing a partnership representative? Whose interests should the partnership representative represent—the partners in the Reviewed Year or the partners in the Adjustment Year? What notice obligations should be imposed on the partnership representative? Should certain actions require the consent of the partners? If so, which partners—the partners in the Reviewed Year or the partners in the Adjustment Year?

3. What actions should partners be required to take? Should partners from a Reviewed Year be required to file amended returns and pay taxes so that the partnership's underpayment liability will be reduced? Should partners in the Adjustment Year be required to provide partner-level information to the partnership so the partnership can prove it is entitled to use lower tax rates to determine the underpayment?

4. How will the partnership's tax payments be shared among the partners? Are they treated as nondeductible expenditures and allocated under section 704(b) of the Code? Or are they treated as advances on distributions to the partners under a distribution waterfall? If they are treated as deemed distributions, should the deemed distributions be subject to claw-back provisions?

5. What should the remedies be for violation of any of these provisions?

The information presented is only of a general nature, intended simply as background material, is current only as of its indicated date, omits many details and special rules, and accordingly cannot be regarded as legal or tax advice.

If you have any questions about the content of this alert, please contact one of the authors, the Pillsbury attorney with whom you regularly work, or one of the attorneys below.

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