

Major Changes to Partnership Audit Liability

Tax Alert
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The Bipartisan Budget Act of 2015 (the Act)¹ that was signed into law on November 2, 2015, dramatically changes the rules for Internal Revenue Service (IRS) audits of partnerships and in particular who is liable for any additional tax resulting from partnership audit adjustments. The Act repeals the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Electing Large Partnership rules and replaces them with an entirely new regime.

The Act establishes the general rule that tax deficiencies attributable to adjustments of partnership items are collected from the partnership in the year the audit adjustment becomes final (the adjustment year), rather than from the partners during the tax year to which the adjustment relates (the reviewed year), based on the highest tax rate in effect for the audit year. Certain partnerships may, however, elect out of this new regime. These new rules, which apply for audits of tax years beginning in 2018, affect all partnerships regardless of size, and require a close examination of partnership agreements.

General Rule - The Partnership Pays Tax

On audit, any adjustment to the tax items of a partnership, including any penalties and interest, "shall be assessed and collected . . . at the partnership level."² The partnership must pay any "imputed underpayment," which is generally determined by multiplying the net increase in income or gain (or decrease in loss or deduction) by the highest tax rate in section 1 or 11³. This "imputed" amount serves as a proxy for the amount of additional tax that would be paid by all of the partners of the partnership. However, because this imputed amount would not take into account the differing tax positions of the partners, the U.S. Department of the Treasury (Treasury) is instructed to enact regulations to reduce the imputed amount if the partners file amended returns paying some of the additional tax, are exempt from federal income tax or are subject to a lower rate of tax on such income.⁴

The imputed underpayment, penalties and interest must be paid in the year the audit or any judicial review is completed.⁵ Thus, the adjustment year partners will bear the economic burden of the adjustment, even if they were not partners in the reviewed year.

Each partnership is required to designate a "Partner Representative," which is any partner or other person with a substantial U.S. presence to act on behalf of the partnership on audit and with respect to any elections.⁶ No longer will a partnership have a "Tax Matters Partner," although the new Partner Representative will serve essentially the same function. In addition, each partner must treat all partnership items consistently with the partnership (unless the partner files a notice of inconsistent treatment), and generally will be bound by actions taken by the Partnership Representative on behalf of the partnership.⁷

Elections for Certain "Small" Partnerships

A partnership with no more than 100 partners may elect out of the new rules and have partnership items audited at the partner level only if each of its partners is an individual, an S corporation, a C corporation (or the foreign equivalent thereof) or the estate of a deceased partner.⁸ The opt-out election is made annually on the partnership's timely filed Form 1065.⁹

Election to Avoid Partnership Level Tax and Shift Tax Burden to the Audit Year Partners

A partnership subject to the general rule may elect, within 45 days of a notice of final partnership adjustment, to have its reviewed year partners pay their distributive share of the adjustment, plus interest.¹⁰ The tax impact in the adjustment year is then increased,

but not decreased, by any adjustments attributable to years between the reviewed year and the adjustment year.¹¹ In addition, interest on the underpayment is accrued at a rate 200 basis points above the normal rate.¹² This is apparently the "toll charge" for electing out of the entity level tax regime.

Key Issues

1. Existing partnership agreements must be reviewed and new partnership agreements must be drafted to address aspects of the new rules, including to: (a) designate a partnership representative, if necessary; (b) specify any elections with respect to partnership audits that the partnership representative will make; (c) provide for the potential payment of entity-level tax and (possibly) (d) limit the types and numbers of partners.
2. Those who plan to acquire a partnership interest will need to consider their potential share of the partnership's liability with respect to any of the partnership's previously filed tax returns if the partnership is not able to elect out of the new regime.
3. The statute provides only an outline of the new rules, with significant open questions and a vast grant of regulatory authority to the IRS to make the new regime work. This occurs at a time when IRS resources are severely limited. Treasury and the IRS are already seeking input.
4. Payments made by the partnership under these provisions, including any interest owed on the imputed underpayment amount, are explicitly non-deductible.¹³ While as a general rule individuals are unable to deduct interest on federal income tax deficiencies, corporations generally can. Thus, this rule will affect corporate partners from deducting their distributive share of interest on the underpayment amount.¹⁴

This new legislation imposes an entity level tax on partnerships -- an entity which itself is not subject to tax. The legislation was passed without hearings and the collateral consequences of subjecting partnerships to tax are still being considered.

We will continue to keep you informed.

1. P.L. 114-74 (2015).
2. Section 6621. All section references are to the Internal Revenue Code of 1986 unless otherwise noted, as amended by the Act and other legislation.
3. Section 6625.
4. Section 6625(c).
5. Section 6221(a); section 6225(a).
6. Section 6223(a).
7. Section 6222; section 6223.
8. Section 6221(b).
9. Section 6221(b)(1)(D).
10. Section 6226.
11. Section 6226(b)(3).
12. Section 6626(c)(2).
13. Section 6241(4).
14. *See* Section 163(h).

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