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Partnership Audit Procedures Under the Bipartisan Budget Act of 2015

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INTRODUCTION

The Internal Revenue Service ("IRS") currently audits most partnerships under rules enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").[1] Those rules require the IRS to make adjustments at the partnership level, compute any tax due, and then individually assess each affected partner. The IRS has audited very few partnerships in recent years and has asserted adjustments in only two-thirds of the audits that have occurred.[2] In many cases where deficiencies were owed, the IRS was unable to locate the partners and collect the tax due. Tiered partnership structures (*i.e.*, partnerships with partnerships as partners) exacerbate these issues.[3]

The Bipartisan Budget Act of 2015 (the "BBA") repealed the TEFRA rules and replaced them with new partnership audit rules that constitute a paradigm shift in partnership taxation.[4] Under the default procedures, a partnership's partners in the tax year under audit (the "reviewed-year partners") are not liable for any deficiency that results from an IRS adjustment. Rather, the partners in the tax year during which the IRS adjustment becomes final (the "adjustment-year partners") bear the economic burden of the adjustment (the "imputed underpayment") even though the adjustment-year partners may not have benefited from the reviewed-year underpayment. In addition, only a single representative of the partnership (the "partnership representative") speaks for the partnership and its partners and decides what IRS adjustments will be accepted or contested.[5] The BBA's partnership audit rules are effective for tax years beginning after December 31, 2017,[6] but partnerships may elect to apply the rules to tax years beginning after November 2, 2015.[7]

Congress held no hearings before the BBA's partnership audit rules were enacted, and both taxpayers and the IRS have asked for legislative changes to make the rules more administrable. On December 6, 2016, the House Ways and Means Committee and the Senate Finance Committee introduced the Tax Technical Corrections Act of 2016 (the "Technical Corrections bill") in the House of Representatives[8] and Senate,[9] respectively. The Technical Corrections bill would significantly change the BBA's partnership audit rules. However, the Technical Corrections bill currently remains only a proposal and seems unlikely to be addressed before Congress enacts substantive tax legislation in the current session of Congress.[10]

On June 14, 2017, the IRS issued proposed Treasury regulations (the "Proposed Regulations") that would, if finalized, provide guidance on how the IRS will implement the BBA's partnership audit rules.[11] While the Proposed Regulations do not reflect all of the proposed changes in the Technical Corrections bill, the Proposed Regulations would generally interpret the BBA consistently with the Technical Corrections bill. This article discusses the partnership audit rules enacted by the BBA and the proposed changes to and interpretations of those rules by the Technical Corrections bill and the Proposed Regulations, respectively.

SCOPE OF THE BBA'S PARTNERSHIP AUDIT RULES

The BBA's partnership audit rules apply to "partnership adjustments," which are any adjustments in "the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof."[12] The Proposed Regulations would interpret the BBA broadly and define "items of income, gain, loss, deduction, or credit" to mean all items and information required to be shown or reflected on a partnership tax return and any information in the partnership's books and records.[13] The Technical Corrections bill would reach a similarly broad result by redefining "partnership adjustment" to mean any adjustment to a "partnership-related item" and defining "partnership-related item" to mean (1) any item or amount with respect to the partnership (without regard to whether such item or amount appears on the partner-ship's tax return and including any item or amount relating to any transaction with, basis in, or liability of, the partnership) which is relevant in determining any person's tax liability and (2) any partner's distributive share of any such item or amount.[14]

ELECTING OUT OF THE BBA'S PARTNERSHIP AUDIT RULES

A partnership with 100 or fewer partners may elect out of the BBA's partnership audit rules if each partner is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or a decreased partner's estate (each an "eligible partner").[15] Each shareholder of an S-corporation partner is counted when determining whether the partnership has 100 or fewer partners.[16] A trust (including a grantor trust), partnership, or disregarded entity (*e.g.*, a single-member limited liability company) is not an eligible partner.

An election out of the BBA's partnership audit rules must be made annually on a timely filed tax return for the tax year to which the election relates.[17] The partnership must also notify its partners at the time of the election[18] and disclose each partner's name and taxpayer identification number to the IRS.[19]

If a partnership elects out of the BBA's partnership audit rules, there is no centralized audit regime and the IRS has to audit each partner separately. To minimize those situations, the Proposed Regulations would narrowly interpret the election-out rules. For example, the Proposed Regulations would provide that an election out by an upper-tier partnership has no effect on the application of the BBA's partnership audit rules to the upper-tier partnership in its capacity as a partner in a lower-tier partnership.[20] In addition, the Proposed Regulations would require the partnership to disclose its partners' federal tax classifications and, if any partner is an S corporation, the name, taxpayer identification number, and federal tax classification of each of the S corporation's shareholders.[21]

THE PARTNERSHIP REPRESENTATIVE

As noted above, under the BBA's partnership audit rules, a partnership must designate a partnership representative ("PR") to represent the partnership in any IRS audit.[22] The Proposed Regulations require the partnership to designate a PR for each tax year.[23] Unlike the TEFRA rules,[24] neither the BBA's partnership audit rules nor the Proposed Regulations require the PR to communicate with the partnership's partners regarding developments during an IRS audit and the partners have no right to participate in the audit.

If a partnership does not designate a PR, the IRS may do so.[25] The Proposed Regulations would provide that a partnership may not change the IRS's designation without the IRS's permission.[26] Additionally, under the Proposed Regulations a PR for a tax year could not resign, nor could a partnership revoke a PR designation, before the partnership receives a notice of administrative proceeding from the IRS or files an administrative adjustment request with the IRS with respect to the tax year.[27]

The PR does not have to be a partner in the partnership but must have "a substantial presence in the United States."[28] The Proposed Regulations would interpret the phrase "substantial presence" to require the PR to be able to meet in person with the IRS in the United States at a reasonable time and place, to have a U.S. street address and phone number where the PR can be reached, and to have a taxpayer identification number.[29] The Proposed Regulations would also clarify that the PR can be an individual or an entity,[30] but if the PR is an entity, the partnership would be required to appoint a "designated individual" with a substantial presence in the United States through whom the PR will act.[31]

The PR has sole authority to act on the partnership's behalf[32] and partners may not participate in or contest the results of a partnership audit. A settlement agreement entered into by the partnership, a notice of final partnership adjustment that is not contested, or a court's final decision with respect to a notice of final partnership adjustment that is contested bind the partnership and its partners.[33] The Proposed Regulations would provide that neither state law nor the partnership agreement can limit the PR's authority to act on the partnership's behalf.[34]

THE "DEFAULT RULE"

1. Introduction

If adjustments during a partnership audit result in an "imputed underpayment," then the partnership must pay that imputed underpayment in the year the adjustments are finally determined (*i.e.*, the adjustment year).[35] This simplifies the collection process because the IRS collects the entire imputed underpayment from one source. However, it also means that adjustment-year partners rather than reviewed-year partners bear the economic burden of reviewed-year adjustments. Similarly, if adjustments during a partnership audit produce a taxpayer-favorable result, then the adjustment-year partners account for the adjustments in the adjustment year.[36]

2. Determining the Imputed Underpayment

The BBA provides rules for determining the imputed underpayment for the reviewed year.[37] The imputed underpayment is determined by netting adjustments to items of income, gain, loss, or deduction for the reviewed year and then multiplying that amount by the highest tax rate in effect for the reviewed year under Internal Revenue Code Section 1 or Section 11.[38]

Under the BBA, adjustments to partners' distributive shares are not netted.[39] If an adjustment reallocates the distributive share of any item from one partner to another, then the adjustment is accounted for by disregarding any decrease in any item of income or gain and any increase in any item of deduction, loss, or credit.[40] Self-employment taxes, the net investment income tax, and withholding taxes under Internal Revenue Code Sections 1441–1474 also are not specifically mentioned in determining the imputed underpayment.[41] The preamble to the Proposed Regulations, however, provides that partnership adjustments would be considered in determining those other taxes, but the assessment and collection of those taxes would be done outside of the BBA's partnership audit rules.[42] The Technical Corrections bill would confirm that interpretation.[43]

The BBA does not explain how to net partnership adjustments when computing an imputed underpayment.[44] The Proposed Regulations would require partnership adjust-ments to be grouped and subgrouped before they are netted.[45] Adjustments that reallocate items among partners would go in a "reallocation grouping," adjustments to the partnership's credits would go in a "credit grouping," and all other adjustments would go in a "residual grouping."[46] Each grouping could have subgroupings based on character, source, limitations, and other restrictions.[47]

For example, assume that during an audit the IRS increases ordinary income by$200 and long-term capital gain by $75, and decreases capital loss by $50, a depreciation deduction by $30, and a tax credit by $2. Under the Proposed Regulations, the adjustment to the tax credit would go in the "credit grouping" and the other adjustments would go in the "residual grouping." Within the residual grouping, the adjustment to ordinary income and the depreciation deduction would go in an "ordinary" subgrouping, which sums to $230 of additional income, and the adjust-ments to long-term capital gain and loss would go in a "long-term capital" subgrouping, which sums to $125 of additional income. The two subgroupings sum to a total netted partnership adjustment of $355, which would then be multiplied by the highest tax rate in effect (assumed to be 40 percent) to yield $142. Finally, the $142 would be increased by the $2 credit grouping to equal a $144 imputed underpay-ment.[48]

3. Modifying the Imputed Underpayment

The BBA provides procedures for modifying the imputed underpayment.[49] The procedures aim "to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners."[50] This is essential to preserve the treatment of a partnership as a fiscally transparent entity rather than as a taxpayer. The BBA does not provide for modification procedures when partnership adjustments produce a taxpayer-favorable result rather than an imputed underpayment because the adjustments just flow through the partnership to the partners.[51]

The imputed underpayment is reduced to the extent reviewed-year partners file amended tax returns for the reviewed year which account for all adjustments properly allocable to such partners, including tax attributes affected in other tax years, and those returns include the payment of any tax due.[52] If all reviewed-year partners file amended tax returns and pay the tax due, then the imputed underpayment as modified equals zero. Otherwise, the partnership must pay the balance of the imputed underpayment not paid by the partnership's reviewed-year partners.

The imputed underpayment is also reduced by the proportionate amount attributable to tax-exempt partners (*e.g.*, foreign persons or entities or organizations exempt from federal tax)[53] and by applying a lower tax rate to any portion of an adjustment that is allocable to a C corporation or, in the case of capital gain or qualified dividend income, to an individual.[54] The imputed underpayment of a publicly traded partnership also may be reduced by its partners' passive activity losses.[55] The BBA gives the IRS authority to issue regulations or guidance providing for other modifications.[56] Under the Proposed Regulations, closing agreements entered into by partners and the attributes of indirect partners could also give rise to modifications to the amount of the imputed underpayment.[57]

The Technical Corrections bill proposes a new "pull-in" procedure that would reduce the imputed underpayment to the extent reviewed-year partners: (1) pay the tax that would be due with amended tax returns; (2) make binding changes to affected tax attributes for subsequent years; and (3) provide the IRS with information necessary to substantiate that the tax was correctly computed and paid.[58] The Technical Corrections bill does not specify how binding changes to affected tax attributes would be memorialized (*e.g.*, a closing agreement or other form signed by a partner). The pull-in procedure would be available for both direct and indirect partners.

4. Failure to Pay the Imputed Underpayment

As noted above, under the default rule the partnership is liable for the imputed underpayment.[59] Under the Technical Corrections bill, if a partnership fails to pay the imputed underpayment within ten days of notice and demand from the IRS, then the IRS would have two years to assess each adjustment-year partner for its proportionate share of the imputed underpayment (*i.e.*, no joint and several liability), including interest and penalties.[60]

THE "PUSH-OUT" ELECTION

1. Overview

As an alternative to the default rule, a partnership may "push out" the imputed underpayment to reviewed-year partners by making an election and providing each reviewed-year partner (and the IRS) with a statement showing the partner's share of the partnership adjustments, as determined in the notice of final partnership adjust-ment.[61] A partnership must make the election within forty-five days after the date of the notice of final partnership adjustment and, once made, the election is revocable only with the IRS's consent.[62] The BBA's partnership audit rules do not provide reviewed-year partners with a right to administrative or judicial review of the imputed underpayment that a partnership pushes out to them.[63] This again highlights the PR's authority in the partnership audit process.

Each reviewed-year partner's tax liability for the adjustment year is adjusted to account for any increases to the partner's tax liability for the reviewed year and any increases to the partner's tax liability for years after the reviewed year and before the adjustment year attributable to the pushed out amount.[64] Adjustments that would decrease the partner's tax liability and changes to a partner's liability for self-employment tax, net investment income tax, and withholding taxes under Internal Revenue Code Sections 1441–1474 are not taken into account.[65] Under the Technical Corrections bill, reviewed-year partners would be required to adjust their adjustment-year tax liability to account for both increases and decreases in tax liability for prior years.[66]

2. Tiered Partnership Structures

According to the Joint Committee on Taxation's explanation of the BBA, an upper-tier partnership is treated like an individual partner for purposes of the push-out election.[67] Thus, if a partnership makes a push-out election, a partner that is a partnership may not elect to push out its share of the imputed underpayment to its partners or use its partners' tax attributes to reduce the allocated share of the imputed underpayment. Because many partnerships are owned in whole or in part by other partnerships, this interpretation severely limits the use of the push-out election.

In contrast, under the Technical Corrections bill an upper-tier partnership that is a partner in a lower-tier partnership that makes a push-out election would be allowed to either pay the upper-tier partnership's share of the imputed underpayment under rules similar to those under the default method or issue push-out statements to the upper-tier partnership's partners.[68] Multiple tiers of partnerships could make the push-out election provided that all push-out statements required to be issued to partners are filed with the IRS by the due date (including extensions) for the audited partnership's tax return for the year of the final determination.[69]

The Proposed Regulations reserve on the availability of a push-out election through tiers of partnerships, but the preamble to the Proposed Regulations states that the IRS is considering an approach "that will be the subject of other proposed regulations to be published in the near future."[70]

DEADLINES DURING THE AUDIT

After receiving a notice of proposed partnership adjustment, a partnership has 270 days to provide information or make payments to the IRS to modify the imputed underpayment under the default rule.[71] The IRS may extend this period.[72] The IRS may not issue a notice of final partnership adjustment until 270 days after the IRS issues a notice of proposed partnership adjustment.[73] The Technical Corrections bill would allow the partnership to waive this limitation.[74] After receiving a notice of final partnership adjustment, the partnership has forty-five days to make a push-out election.[75]

ADMINISTRATIVE ADJUSTMENT REQUESTS

In lieu of filing an amended tax return, a partnership may request an adjustment to one or more items of income, gain, loss, deduction, or credit for a tax year only by filing an administrative adjustment request.[76] If the administrative adjustment request results in an imputed underpayment, then the partnership must either pay the imputed underpayment or push the imputed underpayment out to the partners.[77] If the administrative adjustment request does not result in an imputed underpayment, then the partnership must push the adjustment out to the partners.[78]

A partnership may not file an administrative adjustment request for a tax year more than three years after the later of the date on which the partnership tax return for such tax year was filed or the last day for filing the partnership tax return for such tax year (determined without regard to extensions).[79] In no event may a partnership file an administrative adjustment request after the IRS mails a notice of an administrative proceeding (*i.e.*, a notice of the commencement of a partnership audit) to the partnership.[80]

PENALTIES AND INTEREST

Penalties are determined at the partnership level.[81] Under the default rule, the partnership pays any penalties that are imposed, which means the adjustment-year partners bear the economic burden of those penalties.[82] Under the push-out rule, penalties are still determined at the partnership level but the reviewed-year partners pay their share of any penalties.[83]

Under the default rule, interest is determined at the partnership level using the regular underpayment interest rate (*i.e.*, the short-term applicable federal rate ("AFR") plus three percentage points).84 Under the push-out rule, interest is determined at the partner level using the "hot interest" rate (*i.e.*, the short-term AFR plus five percentage points).[85] Thus, a "toll charge" is imposed on the partnership for making the push-out election.

CONCLUSION

The BBA's partnership audit rules constitute a paradigm shift in partnership taxation because the PR has sole authority to act for the partnership and its partners during an IRS audit and, under the default rule, the partnership is liable for any deficiency that results from an IRS audit. Accordingly, existing partnership agreements should be reviewed and amended to reflect the new partnership audit rules even though uncertainties remain. In particular, each partnership should consider whether the partnership is eligible to elect out of the BBA regime and, if not, who will be the PR and what checks will the partners have on the PR's authority during an IRS audit. Additional amendments to partnership agreements may be required if and when the Technical Corrections bill is enacted and final Treasury regulations interpreting the BBA are issued.

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[1] *See* IRC §§ 6221–6234.

[2] U.S. Government Accountability Office, Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, GAO-14-732 at 19–21 (Sept. 2014).

[3] *Id.* at 16.

[4] Pub L No 114-74, § 1101, 129 Stat 584, 625. The Protecting Americans from Tax Hikes Act of 2015, Pub L No 114-113, § 411, 129 Stat 2242, 3121, amended the BBA's partnership audit rules shortly after they were enacted. In this article, all references to the "BBA" are to the BBA as amended by the Protecting Americans from Tax Hikes Act of 2015.

[5] This is analogous to the way shareholders are treated when the IRS audits a corporation.

[6] Bipartisan Budget Act of 2015, Pub L No 114-74, § 1101(g)(1), 129 Stat 584, 638.

[7] *Id.* § 1101(g)(4). Temporary and proposed Treasury regulations provide procedures for electing to apply the BBA's partnership audit rules before the otherwise applicable effective date. *See* Temp Treas Reg § 301.9100-22T.

[8] HR 6439, 114th Cong §§ 201–207 (2016).

[9] S 3506, 114th Cong §§ 201–207 (2016).

[10] The BBA's partnership audit rules amend the TEFRA Internal Revenue Code sections. This article cites the TEFRA provisions as "IRC §" and the BBA provisions as "BBA IRC §." Provisions that would result from the Technical Corrections bill's amendments to the BBA are cited as "TTCA IRC §."

[11] Centralized Partnership Audit Regime, 82 Fed Reg 27,334 (proposed June 14, 2017).

[12] BBA IRC § 6241(2).

[13] Prop Treas Reg § 301.6221(a)-1(b)(1).

[14] TTCA IRC § 6241(2).

[15] BBA IRC § 6221(b)(1).

[16] BBA IRC § 6221(b)(2)(A).

[17] BBA IRC § 6221(b)(1)(D)(i).

[18] BBA IRC § 6221(b)(1)(E).

[19] BBA IRC § 6221(b)(1)(D)(ii).

[20] Prop Treas Reg § 301.6221(b)-1(d)(1).

[21] Prop Treas Reg § 301.6221(b)-1(c)(2).

[22] BBA IRC § 6223(a).

[23] Prop Treas Reg § 301.6223-1(c)(1).

[24] IRC § 6223(g); Treas Reg § 301.6223(g)-1.

[25] BBA IRC § 6223(a).

[26] Prop Treas Reg § 301.6223-1(e)(4).

[27] Prop Treas Reg § 301.6223-1(d)(2), (e)(2).

[28] BBA IRC § 6223(a).

[29] Prop Treas Reg § 301.6223-1(b)(2).

[30] Prop Treas Reg § 301.6223-1(b)(1).

[31] Prop Treas Reg § 301.6223-1(b)(3).

[32] BBA IRC § 6223(a).

[33] Prop Treas Reg § 301.6223-2(a); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, at 62 (Mar. 2016).

[34] Prop Treas Reg § 301.6223-2(c)(1).

[35] BBA IRC § 6225(a)(1).

[36] BBA IRC § 6225(a)(2).

[37] BBA IRC § 6225(b). There are no corresponding rules that apply if partnership adjustments produce a taxpayer-favorable result because such adjustments flow through the partnership to the adjustment-year partners.

[38] BBA IRC § 6225(b)(1). The highest rate is currently the 39.6 percent individual tax rate.

[39] BBA IRC § 6225(b)(2).

[40] *Id.*

[41] BBA IRC § 6225(b)(1)(A) (referring only to tax rates in effect under IRC §§ 1 or 11).

[42] Centralized Partnership Audit Regime, 82 Fed Reg 27,334, 27,342 (proposed June 14, 2017).

[43] TTCA IRC § 6241(9).

[44] The Technical Corrections bill would require partnership adjustments to be netted separately within each category listed in IRC § 702(a). TTCA IRC § 6225(b)(3).

[45] Prop Treas Reg § 301.6225-1(d).

[46] Prop Treas Reg § 301.6225-1(d)(2).

[47] Prop Treas Reg § 301.6225-1(d)(1).

[48] Prop Treas Reg § 301.6225-1(f), Example 2. The Proposed Regulations reserve on rules for adjusting partners' outside basis and capital accounts and the partnership's basis or book value in property in the context of the default rule. *See* Prop Treas Reg § 301.6225-4.

[49] BBA IRC § 6225(c).

[50] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, at 65–66 (Mar. 2016).

[51] *See* BBA IRC § 6225(c)(1) (referring only to procedures for modifying an imputed underpayment).

[52] BBA IRC § 6225(c)(2).

[53] BBA IRC § 6225(c)(3).

[54] BBA IRC § 6225(c)(4).

[55] BBA IRC § 6225(c)(5).

[56] BBA IRC § 6225(c)(6).

[57] Prop Treas Reg § 301.6225-2(d).

[58] TTCA IRC § 6225(c)(2)(B).

[59] BBA IRC § 6225(a).

[60] TTCA IRC § 6232(f)(1).

[61] BBA IRC § 6226(a).

[62] *Id*.

[63] BBA IRC §§ 6223(a), 6234(a).

[64] BBA IRC § 6226(b)(2). The Proposed Regulations reserve on rules for adjusting partners' outside basis and capital accounts and the partnership's basis or book value in property when a partnership makes a push-out election. *See* Prop Treas Reg § 301.6226-4.

[65] BBA IRC § 6226(b)(1) (referring only to tax under Chapter 1 of the Internal Revenue Code).

[66] TTCA IRC § 6226(b)(2).

[67] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, at 70 (Mar. 2016).

[68] TTCA IRC § 6226(b)(4).

[69] TTCA IRC § 6226(b)(4)(B).

[70] Prop Treas Reg § 301.6226-3(e); Centralized Partnership Audit Regime, 82 Fed Reg 27,334, 27,365 (proposed June 14, 2017).

[71] BBA IRC § 6225(c)(7).

[72] *Id*.

[73] BBA IRC § 6231(a).

[74] TTCA IRC § 6231(b)(2)(A).

[75] BBA IRC § 6226(a)(1).

[76] BBA IRC § 6227(a).

[77] BBA IRC § 6227(b).

[78] *Id*.

[79] BBA IRC § 6227(c).

[80] *Id*.

[81] BBA IRC § 6233(a)(3).

[82] BBA IRC § 6233(a)(1)(B).

[83] BBA IRC § 6226(c)(1).

[84] BBA IRC § 6233(a)(2).

[85] BBA IRC § 6226(c)(2).