What Practitioners Need to Know about the New Partnership Audit Rules

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As you've surely heard by now, the Bipartisan Budget Agreement of 2015 ("BBA") enacted new IRS procedures for partnership audits for tax years beginning on or after January 1, 2018. The new audit rules allow the IRS to collect taxes directly from most partnerships rather than from their partners, subject to several exceptions and elections. Partnerships are looking to their advisors for guidance on a range of issues, from selecting the right Partnership Representative and amending their governing agreements, to deciding whether to elect out of the new procedures altogether. Practitioners are in turn looking to Congress and the IRS for guidance on several issues left open by the BBA and proposed regulations.

The BBA, enacted in 2015, provides the framework for the new audit rules. The IRS issued proposed regulations in 2016, which helped clarify some, but not all, of practitioners' concerns. A "technical corrections" bill was introduced in the 2016 Congressional Session, but was not passed and has not been re-introduced this year. The IRS has not yet issued final regulations, and may likely be waiting to see if Congress passes corrective legislation before the end of the year. With the January 1, 2018, implementation date fast approaching, practitioners should not wait on the IRS or Congress to implement the final details before advising clients about the impact the new rules may have on their partnership.

Audit and Collection Framework

Under the BBA's default rule, partnership audits are conducted solely at the partnership level, and the partnership is taxed directly for any "imputed underpayment," at the highest individual or corporate tax rate then in effect. The procedures allow for a "modification" to the partnership-level assessment for each partner that amends its reviewed-year return and pays all associated tax due. The partners are allowed 270 days from the issuance of a Notice of Proposed Partnership Adjustment to amend their returns, and this period may be extended upon request.

If some or all partners are in a lower tax bracket, modifying the imputed underpayment by amending returns will have a lower overall tax effect than paying the tax at the partnership level. However, the practical implications and costs of each partner amending its tax returns could be daunting for even the simplest partnership structures. Further, if less than all partners choose to amend, or if there are current partners that were not partners during the reviewed year, allocating the remaining imputed underpayment can be difficult.

Alternatively, the partnership may elect to flow through, or "push out," the imputed underpayment to the reviewed-year partners. If the partnership makes the push-out election, the partnership will be required to report the adjusted partnership items to each reviewed year partner. The push-out election requires the reviewed-year partners, rather than the adjustment-year partners, to bear the tax liability for the reviewed year. However, the push-out election comes at a cost, in the form of a two percent increase to the interest rate charged on the underpayment due from the partners.

The proposed regulations also leave open the issue of pushing out an underpayment to the partners of upper-tier partnerships. The 2016 Technical Corrections Bill proposed to require upper-tier partnerships to push out any lower-tier adjustments by filing a partnership adjustment report with the IRS. However, the Bill was not passed and has not been reintroduced this session. The proposed regulations asked for public comment on this topic, and it is expected to be addressed in the final regulations.

Even though several questions about the new procedures remain unanswered, practitioners should advise their partnership clients to consider including provisions in their partnership agreements to prepare for the new rules. For example, some partnerships may want to require all partners to file an amended return, and set forth the parameters for allocating the imputed underpayment to any reviewed-year partners that do not pick up their share of the adjustment (the proposed regulations provide a similar framework, but have not been finalized). Further, partnership agreements could require that the Partnership Representative either make or not make a push-out election, depending on whether the partners wish to pay the additional 2 percent interest, or pay the higher tax rate at the partnership level (this decision could also be left to the discretion of the Partnership Representative on a case-by-case basis). Some commenters have also suggested including an indemnification of each partner to the other partners and the partnership in the event a partner leaves the partnership prior to an audit adjustment, and otherwise fails to file an amended return to pay its share of a reviewed-year adjustment.

Partnership Representative Decisions

Under the BBA and the proposed regulations, the “Partnership Representative” replaces the current role of the “tax matters partner.” The Partnership Representative, which is not required to be a partner, is designated on the partnership tax return each tax year. Unlike the current “tax matters partner” role, the Partnership Representative has the sole authority to act on behalf of the partnership and communicate with the IRS during an audit. The Partnership Representative may unilaterally extend statutes of limitation, settle or accept audit adjustments, and cause the partnership to make the push-out election. Neither the IRS nor the Representative is required to give notice to any other partner regarding the audit.

Partnerships should consider amending their existing partnership agreements to, at a minimum, designate a Partnership Representative. Practitioners should also discuss with their partnership clients whether to include provisions for limiting the Representative’s authority, requiring that the Representative keep the partners informed of the audit findings, removing the Representative and electing a successor.

Opting In/Electing Out

Although the new rules are effective for tax years beginning after January 1, 2018, the BBA allows partnership to opt-in to the new rules for earlier tax years beginning after November 2, 2015 and before January 1, 2018. The opt-in election is made within 30 days of the date the partnership receives notice of an audit, by providing a statement to the IRS agent. The election statement requirements are set forth at Treas. Reg. § 301.9100-22T. Opting in to the BBA procedures may be advantageous for larger partnerships in that it provides streamlined audit procedures, including a single point of contact between the IRS and the partnership and an option for the partnership to pay the tax directly. However, until the final regulations are issued or corrective legislation is passed, there may be too much uncertainty regarding the new procedures to warrant advising clients to opt in early.

Advisors should also discuss their partnership clients’ eligibility to elect out of the BBA for tax years after 2018, and the merits of doing so. Currently, partnerships that issue no more than 100 K-1s, and whose partners are all individuals, C Corporations, S Corporations, or the estate of a deceased partner are eligible to elect out of the new audit procedures. Partnerships are ineligible to elect out if any partner is itself a partnership, a grantor trust or disregarded entity. The proposed regulations note that the IRS is considering proposals to allow partnerships with disregarded entity partners to elect out. At a IRS public hearing on the proposed regulations on September 18, 2017, several practitioners requested that

partnerships with disregarded entity partners be allowed to elect out if the partnership provides the names and TINs of the disregarded entity and its owners.

Advisors should also carefully consider whether an eligible partnership should elect out of the BBA procedures. The current TEFRA audit regime will be repealed for all tax years beginning on January 1, 2018, meaning for partnerships that elect out of the new procedures, each partner will be audited separately for their partnership items. While electing out of the BBA rules may be desirable for some partnerships with only a few individual or corporate partners, it will likely create higher aggregate administrative costs to the partners than allowing the IRS to conduct a single partnership audit under the BBA procedures. Doing so could also open up each partner's returns for examination beyond partnership items. In the event a partnership does elect out, the partnership agreement could require the partnership to provide all information and cooperation necessary in the event individual partners are audited for partnership items, and should restrict the transfer of partnership interests to ineligible partners.