

Ahead of the Curve: Preparing for Changes to Partnership Audit and Tax Collection Rules

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### Current Partnership Audit Rules

Partnership audits are currently conducted under one of three different procedures:

- Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")
- Electing Large Partnerships
- Exempt Small Partnerships

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Under the TEFRA rules, tax items are divided into partnership items, nonpartnership items, and affected items.
- Audits and other disputes with the IRS as to the tax treatment of partnership items and affected items are resolved at the partnership level in a unified proceeding.
- Assessment Against Partners. Tax deficiencies, penalties, and interest resulting from audit are assessed against the individual partners for the year under audit, via a "Notice of Computational Adjustment"

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Tax Matters Partner. A tax matters partner ("TMP") is designated by the partnership to act on behalf of the partners in a TEFRA audit proceeding.
- The TMP is required to keep the other partners informed of all administrative and judicial proceedings regarding partnership items.
- In addition to the TMP, any partner in a partnership, including an indirect partner, may participate in any partnership-level administrative proceeding relating to partnership items.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Notice Partners. IRS must send notice of the beginning of an administrative proceeding (NBAP) with respect to a partnership item to the TMP as well as to the partnership's "notice partners."
- All partners in a partnership with 100 or fewer partners are notice partners.
- In a partnership with more than 100 partners, partners with a 1% or greater interest in the partnership are notice partners

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Notice of Proposed Partnership Adjustment. Under TEFRA, the IRS typically provides a Notice of Proposed Partnership Adjustment to the TMP, also known as a "60-day letter," which gives the TMP notice and a chance to request a reconsideration or an appeal before a final adjustment is issued.
- The NPPA is not a statutory requirement under TEFRA, but is rather a creature of the Internal Revenue Manual.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Final Partnership Administrative Adjustment. After expiration of the NPPA 60-day period (and following any administrative appeals or other extensions), adjustments are issued via a notice of final partnership administrative adjustment (FPAA).
- FPAA is the TEFRA equivalent of the "Notice of Deficiency" or "90-day letter."
- IRS must send the FPAA to the TMP and all notice partners.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- Assessment to Partners. Once the 90-day period runs on the FPAA (or following the conclusion of any judicial proceedings contesting the FPAA), IRS will issue assessments pro rata to the individual partners via a "Notice of Computational Adjustment" for the years and with respect to the partnership items and affected items under audit.
- Any penalties and interest are determined at the partner level
  - For example, 25% gross understatement penalty determined based on partner's personal income, not at the partnership level.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- **Statutes of Limitations:** Period of limitations for assessment of partnership items against partners directly is tolled by issuance of FPAA to partnership under TEFRA, and during any judicial contest of the FPAA.
- SOL of Nonpartnership items not effected by TEFRA proceeding.
- Bankruptcies and criminal investigations of partners cause partnership items to be treated as nonpartnership items, meaning the period of limitations for that partner no longer tied to TEFRA proceeding.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- **Settlement Agreements.** If the TMP enters into a settlement agreement with IRS with respect to partnership items, the agreement only binds non-notice partners with respect to partnership-level determinations.
- For example, a TMP could bind partners with less than a 1% interest in a more-than-100-partner partnership. A nonnotice partner doesn't waive any other restriction on assessment or partner-level defenses.

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## Current Partnership Audit Rules

TEFRA (IRC § § 6221 - 6252):

- **Notice of Inconsistent Treatment.** TEFRA Procedures provide for partners to file a Notice of Inconsistent Treatment (Form 8082) if their share of partnership profit, loss or other items differs from what is reported by the partnership or on the partners Form K-1.

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## Current Partnership Audit Rules

Electing Large Partnerships (IRC 771 – 777):

- Electing Large Partnership (ELPs) are partnerships that have at least 100 partners and that elect to be treated as such.
- Very few partnerships elect to be treated as ELPs.
- Simplified Audit Procedures. The character of fewer partnership items pass through to the partners and the calculation of partnership items is made under specific rules applicable to ELPs.
- As with TEFRA, tax is assessed at the partner level.

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## Current Partnership Audit Rules

Electing Large Partnerships (IRC 771 – 777):

- Unlike the TEFRA audits, ELP adjustments flow through to the adjustment year partners, i.e., those that are partners in the year in which the adjustment takes effect, rather than the audited year partners.
- The partnership, not the individual partners, is liable for interest and penalties assessed for any underpayment.
- A partner in an ELP (unlike a partner in a TEFRA partnership) isn't permitted to treat partnership items on its return inconsistently with the partnership return, even if it notifies IRS of the inconsistency.

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## Current Partnership Audit Rules

Exempt Small Partnerships:

- TEFRA does not apply to partnerships with 10 or fewer partners if all partners are individuals are US citizens or resident aliens, estates of deceased partners, or C corporations.
- Cannot have partners that are S Corporations, partnerships, any type of trust (including grantor trusts), or even a disregarded entity.
- Partner-Level Audits. Small partnerships exempt from TEFRA are examined at the partner level. The partnership return may be audited, but adjustments are proposed for each partner separately, requiring separate exams to be opened by the IRS for each partner.

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## 2015 Bipartisan Budget Act

- The 2015 Bipartisan Budget Act (the "BBA") repeals both TEFRA and the Electing Large Partnership rules.
- The new partnership audit rules will be codified at IRC § 6221 – 6241.
- Following the effective date of the new rules, the BBA procedures will apply to all entities taxed as partnerships, unless the partnership qualifies under the new BBA small partnership exception and affirmatively elects out of BBA.

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## 2015 Bipartisan Budget Act

- Effective Date. The new BBA procedures are effective for taxable years beginning on or after January 1, 2018.
- Early Opt-In. A partnership can elect to apply the new rules to any tax years that begin after November 2, 2015 and before January 1, 2018.
  - Procedures for early opt-in under Treas. Reg. § 301.9100-22T.
  - Partnerships currently under a TEFRA proceeding are not eligible.
  - The election is made by providing a written response requesting the election within 30 days of the receipt of a NBAP for an eligible year.

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## Electing Out of BBA Procedures

Certain small partnerships are eligible to elect out of BBA. To be eligible to elect out of BBA:

- The partnership must have furnished 100 or fewer K-1s during the tax year in question, and
- Each partner must be an individual, a C Corporation (or equivalent foreign corporation), an S Corporation or an estate.

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## Electing Out of BBA Procedures

Certain small partnerships are eligible to elect out of BBA. To be eligible to elect out of BBA:

- Partnerships with trusts, partnerships and LLCs as partners are not eligible to elect out.
- Regulations have yet to be issued confirm that, like TEFRA, disregarded entities will cause the partnership to be disqualified to elect out.
- Unlike TEFRA, S Corps are allowed to be partners, but each S Corp shareholder is counted toward the 100-partner limit.

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## Electing Out of BBA Procedures

Procedure for electing out of BBA:

- The election to opt out of BBA for eligible partnerships must be made EVERY YEAR on the partnership's timely-filed partnership return.
- Statutes don't provide guidance on whether it can be made on an amended return, but it may be clarified in forthcoming Regulations
- Each partner must be notified of the election out (notice sent with K-1s presumably).

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## Electing Out of BBA Procedures

Effect of electing out of BBA:

- If a partnership elects out, the partnership and the partners are subject to the same rules as small partnerships currently exempt from TEFRA, i.e., each partner will be audited independently.
- Although the partnership return may be examined, there would be no unified proceeding to make adjustments to each partner's return.
- The IRS must initiate an examination of each partner's return and abide by separate statutes of limitations for each.

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## BBA Audit Procedures

The central purposes of the BBA procedures:

- Simplifies the IRS's notice requirements
- Allows IRS to assess and collect from the partnership directly, unless the partnership elects out or makes certain other elections to shift the assessment to the partners.

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## BBA Audit Procedures

Simplified Notice and Correspondence:

- Under BBA, the concept of a Tax Matters Partner has been replaced with a "Partnership Representative." The PR is the only person with whom the IRS is required to communicate during an audit or judicial proceeding.
- BBA has eliminated the concept of "Notice Partners" under TEFRA.
- Notice of Audit Proceeding. NAP sent to the address of record for the partnership and the PR. Replaces the NBAP sent to the TMP and all Notice Partners under TEFRA.

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## BBA Audit Procedures

Assessment Against the Partnership:

- The default mechanism under the BBA procedures is to assess any "imputed underpayment" against the partnership directly in the "adjustment year."
- Similar to TEFRA, a proposed adjustment is issued via a Proposed Partnership Adjustment ("PPA"), which replaces the NPPA, or 60-day letter, under TEFRA.

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## BBA Audit Procedures

Assessment Against the Partnership:

- Imputed Underpayment: The tax amount that will be assessed against the partnership, computed by:
  - (1) netting all adjustments of items of income, gain, loss or deduction;
  - (2) multiplying the net amount by the highest rate of tax in effect for the reviewed year under § 1 or § 11;
  - (3) treating any net increase or decrease in loss as a decrease or increase, respectively, in income; and
  - (4) adding or subtracting any credit adjustments.
- Adjustments that result in a net decrease in partnership income are taken into account by the partnership in the "adjustment year" and passed through to the adjustment year partners.

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## BBA Audit Procedures

Assessment Against the Partnership:

- Adjustment Year Assessment. The "imputed underpayment" is assessed against the partnership in the "adjustment year," rather than in the tax year under audit.
- The "Adjustment year" is defined as the partnership taxable year in which notice of the final partnership adjustment (FPA) is mailed.
- If final adjustment is determined by the decision of a court proceeding, the adjustment year is the year in which the decision becomes final.

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## BBA Audit Procedures

Modifications to the Imputed Underpayment:

- An important concept under BBA is the ability of a partnership modify an imputed underpayment set forth in a PPA.
- Under BBA, the Partnership has 270 days from the date of the PPA to request a modification.
- Under TEFRA, partnership only has 60 days following NPPA to request a reconsideration or appeal of the proposed adjustments.

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## BBA Audit Procedures

Modifications to the Imputed Underpayment:

- Modification by Amended Return of Partners:
  - The BBA allows "reviewed year partners" to file amended returns during the 270-day PPA period to report their share of the imputed underpayment and pay the corresponding tax due.
  - The amount of adjustment reported on the amended return is eliminated from the imputed underpayment of the partnership.
  - If the amended returns relate to a reallocation of distributive shares among the partners, all affected partners must file amended returns.

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## BBA Audit Procedures

Modifications to the Imputed Underpayment:

- Modification by Amended Return of Partners:
  - Allocation of Remaining Imputed Underpayment: If some but not all partners file an amended return during the PPA period, the remaining imputed underpayment is assessed against the partnership in the adjustment year.
  - The BBA statutes do not address allocation of the remaining imputed underpayment to the adjustment year partners, which may or may not be the same as the reviewed year partners. Commenters expect this issue to be addressed in forthcoming regulations.

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## BBA Audit Procedures

Modifications to the Imputed Underpayment:

- Modification by Amended Return of Partners:
  - Practice Tip: Until Regulations are finalized, it may be necessary to provide the allocation of imputed underpayment in partnership agreements among non-amending partners, or to require all partners to file amended returns.

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## BBA Audit Procedures

Modifications to the Imputed Underpayment:

- Allocation to Tax-Exempt Partners: The partnership may request a modification of the Imputed Underpayment to the extent that the adjustment would flow through to one or more tax-exempt partners.
- Modification to Reduce Tax Rate: The partnership may reduce the imputed underpayment tax rate if:
  - A C Corp partner is subject to a lower tax rate, or
  - The adjustment would result in long-term capital gains to individual partners.

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## BBA Audit Procedures

Partner Assessment Election:

- BBA provides an alternative to the partnership assessment procedure in which the partnership can elect to have the reviewed year partners assessed instead.
- Reviewed Year Partners. Similar to current procedures under TEFRA, the partnership assessment election would allocate the assessment among those that were partners in the partnership during the year under audit, i.e., the "reviewed year partners."

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## BBA Audit Procedures

Partner Assessment Election:

- Timing and Manner of Election. The election must be made not later than 45 days after the Final Partnership Adjustment ("FPA") has been issued. In other words, this decision may be made after the 270 day PPA period.
- The partnership must issue a statement to each reviewed year partner and the IRS that reflects the allocation of the adjustments in the FPA.

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## BBA Audit Procedures

Partner Assessment Election:

- Reported in Election Year if Partner Election Made. The reviewed year partners' assessment is applied in the taxable year in which the election is made.
- This timing issue could be problematic if the FPA is contested in tax court because the allocation and assessment would be required before the final assessment amount is known.
- The regulations may allow the partnership to defer the election until after the FPA adjustments have become final in a judicial proceeding.

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## BBA Audit Procedures

Partner Assessment Election:

- Increased Interest: A 2% increased interest amount is charged against the partners as the cost for making the partner assessment election. The 2% is added to the statutory 3% over the Federal short-term rate.
- This interest is computed from the due date of the reviewed year return with respect to the initial additional tax and collected from the partners.
- Penalties: Any penalties are determined at the partnership level, but if the partner election is made, they are assessed against the partners pro rata.

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## BBA Audit Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Unlike TEFRA, BBA leaves much of the decision-making in the hands of the partnerships.
- The Partnership Representative and their advisors must decide whether:
  - 1. To elect out of BBA altogether (if eligible), and if not,
  - 2. Whether to take advantage of the ability of partners to file amended returns and report the adjusted tax individually,
  - 3. Elect to have the adjustments assessed against the partners, or
  - 4. Allow the IRS to assess against the partnership directly at the highest tax bracket.

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## Electing Out of BBA Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Benefits of opting out of BBA (if eligible):
  - Each partner controls his or her own examination – no reliance on single Partnership Representative to bind each partner.
  - Avoid the higher tax rate assessed against the partnership under the default rule.
  - Avoid an assessment in the adjustment year rather than against the reviewed year partners – important if partnership makeup will change (can be alleviated by amending returns during the 270-day PPA period)
  - No increased interest as would be the case if partnership later decides to have partners assessed directly

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## Electing Out of BBA Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Reasons Not to Opt Out of BBA:
  - Requires annual opt-out election on return and notice to partners (although it will hopefully just be a box to check on the partnership tax return)
  - Requirement of multiple IRS examinations to address same issue for each partner (increased legal and accounting fees, lost productivity, etc.)
  - Assessment directly against each partner individually rather than single assessment against the partnership (may be beneficial for large professional partnerships)

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## BBA Audit Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Benefits of Filing Amended Returns.
  - Allows each partner to report and pay their share of tax based on potentially lower personal tax rate.
  - Avoids imposition of the increased interest under the partnership assessment election.

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## BBA Audit Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Reasons not to File Amended Returns.
  - Burdensome for partners - may be difficult to coordinate for larger partnerships in relatively short amount of time (270 days), although regulations may allow extension by agreement.
  - Uncertainty of allocation of imputed understatement if less than all partners file an amended return, if not directed in partnership agreement or clarified in regulations.

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## BBA Audit Procedures

Practice Tip: Advising Clients on the BBA Elections:

- Benefits of Making the Partner Assessment Election:
  - The aggregate rates of the individual partners will likely be lower than the highest rate used to calculate the Imputed Understatement to the partnership.
  - For partnerships that have admitted new partners since the year under audit, making a partner assessment assures the Reviewed Year Partners retain the economic burden of the adjustments. Otherwise it could shift the adjustment to new partners, since the assessment is made against the partnership in the "adjustment year."

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## BBA Audit Procedures

Partner Assessment Election:

- Reasons Not to Make the Partner Assessment Election.
  - 2% increased interest burden if the partner assessment election is made.
  - Administrative burden on Partnership Representative to give notice to all partners and make allocations of underpayment.

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## Conclusion

- Simplicity?: The BBA Procedures intend to simplify partnership audits for the IRS and for most partnerships.
  - The simplifications come at a cost of a potentially higher tax rate to the partnership than the aggregate individual rates of the partners.
  - Much of the details have been left to the regulations that have yet to be issued. Until Regulations are finalized, it remains to be seen whether the goal of simplification will be achieved.

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## Conclusion

- Options and Elections – Potential Traps for the ill-advised:
  - BBA gives partnerships a lot of flexibility in deciding how to navigate an audit and assessment situation, and most of the decision-making power is reserved in a single designated Partnership Representative.
  - The default rule of assessing directly against the partnership may not be the most economically beneficial option for many partnerships.
  - Most partnerships will not be eligible to elect out, and those that are may not fully understand the benefits or consequences of doing so without sound tax advice.

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## Conclusion

- Options and Elections – Potential Traps for the ill-advised:
  - Most partnerships will not be eligible to elect out, and those that are may not fully understand the benefits or consequences of doing so without sound tax advice.
  - Without knowledgeable tax advisors, Partnership Representatives may not be aware of the options under a BBA proceeding to shift the assessment burden to the partners and reduce the aggregate tax rates.
  - Knowledgeable tax advisors must help clients weigh these options at each step, and stay abreast of the procedures if/when clarifying regulations are issued.

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