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Session 7: Ahead of the Curve: Preparing for Changes to Partnership Audit and Tax Collection Rules

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Title XI of the Bipartisan Budget Agreement of 2015 ("BBA") enacted new IRS procedures for partnership audits and collection processes for tax years beginning January 1, 2018. In particular, the BBA allows the IRS to audit and collect taxes directly from partnerships rather than from the partners in many situations, in order to streamline the IRS's collections efforts. Smaller partnerships may have the ability to elect out of these rules, but only if their ownership structures meet certain guidelines. This presentation will examine the new rules coming down the track and discuss what tax advisers should be doing to help their clients prepare.

I. Current Partnership Audit Rules (TEFRA, Electing Large Partnerships, and Exempt Small Partnerships)

Partnership audits are currently conducted under one of three different procedures. Most partnerships audits are subject to procedures that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The TEFRA rules apply to all partnerships except (1) electing large partnerships and (2) certain small partnerships, which are partnerships that have ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or a deceased partner's estate. Small partnerships may elect to have the TEFRA procedures apply to them.

a. TEFRA. Under the TEFRA rules (IRC §§ 6221 - 6252), 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.

   i. Assessment Against Partners. Tax deficiencies, penalties, and interest resulting from adjustments to partnership items or affected items are then assessed against the individual partners for the year under audit, via a "Notice of computational adjustment" to partners.

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

iii. 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.

iv. Final Partnership Administrative Adjustment. If, after auditing the partnership, IRS concludes that adjustments to the return are needed, it will issue a notice of final partnership administrative adjustment (FPAA), which must be sent to the TMP and all of the partnership's notice partners. The FPAA is the partnership equivalent of a statutory notice of deficiency, or "90-day letter."

v. Settlement Agreements. IRS may enter into a settlement agreement with the TMP of a partnership or with one or more other partners in the partnership. If the TMP enters into a settlement agreement with IRS with respect to partnership items, the agreement only binds nonnotice 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.

b. Electing Large Partnerships. ELPs are partnerships that have at least 100 partners and that elect to be treated as ELPs. *See IRC § 771 – 777*. Very few partnerships elect to be treated as ELPs.

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i. ELP Audit Procedures. Simplified audit procedures apply to electing large partnerships (ELPs). The character of fewer partnership items passes through to the partners and the calculation of partnership items is made under specific rules applicable to ELPs. As with a TEFRA partnership, tax is assessed at the partner level, but audits and contests over the treatment of partnership items and affected items are determined at the partnership level.

ii. Diversion from TEFRA. A distinguishing feature of the ELP audit rules is that, unlike the TEFRA audit rules, partnership 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. Also, the partnership, not the individual partners, is liable for interest and penalties assessed for any underpayment as a result of any adjustments. Also, 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.

c. Small Partnerships. TEFRA does not apply to partnerships with 10 or fewer partners, all of which are individuals who are US citizens or resident aliens, estates of deceased partners or C corporations. If any partner is a nonresident alien, nominee, S Corporation, partnership, any type of trust (even a grantor trust), or even a disregarded entity (such as a single-member LLC), the small partnership exception will not apply, and the partnership will be subject to TEFRA.

i. Partner-Level Audits. Small partnerships exempt from TEFRA are examined at the partner level. The partnership return is audited, but adjustments are proposed for each partner separately, requiring separate audits to be opened by the IRS for each partner.

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II. 2015 Bipartisan Budget Act

The BBA repeals both TEFRA (IRC §§ 6221 – 6234) and the Electing Large Partnership rules (IRC §§ 771 – 777; 6240 – 6250), effective for tax years starting after December 31, 2017. The new partnership audit rules will be codified at IRC §§ 6221 – 6241. Following the effective date of the new rules, all partnerships will either be subject to the BBA rules or partner-level audits, if the partnership qualifies under the small partnership exception and affirmatively elects out of BBA.

a. Effective Date. The new BBA Procedures are generally effective for taxable years beginning on or after January 1, 2018. However, a partnership can elect to apply the new rules to a taxable year beginning before January 1, 2018.

   i. Early Opt-In. In accordance with procedures under Treas. Reg. § 301.9100-22T, a partnership may opt-in to the BBA procedures for any tax years that begin after November 2, 2015 and before January 1, 2018. 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.

b. Partnerships Covered. The BBA procedures apply to all entities filing a partnership returns, except certain partnerships with 100 or fewer partners that elect out.

   i. Partnerships Eligible to Elect Out. A partnership that does not desire to be covered by BBA must affirmatively elect out. An election must be made separately for each tax year of the partnership. To be eligible to elect out, the partnership must meet the following requirements:

      1. The partnership must furnish 100 or fewer K-1s during the tax year in question; and

      2. Each partner must be an individual, a C Corporation (or certain foreign corporations that would be a C Corporation under US rules), an S Corporation or an estate of a deceased partner.

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ii. Partnerships with Trusts, Partnerships and LLCs as Partners not eligible to Elect Out. The definition of an eligible partner for purposes of the BBA procedures closely mirrors the eligible partner definition under the TEFRA procedures for the small partnership exception. Since the language is similar, it is expected that a partnership would be ineligible for the election out if any partner is itself a partnership, grantor trust, or disregarded entity (such as a single-member limited liability company). However, Regulations have not been finalized and the IRS may provide additional clarification on this subject.

iii. S Corp Partners. A significant difference between the BBA rules and the small partnership definition under TEFRA is that S corporation partners are allowed. To be eligible for the election, however, the partnership must include a Schedule K-1 disclosure of the name and taxpayer identification number of every person to whom the S corporation must furnish a Schedule K-1. Each S corporation shareholder is then counted as a partner to determine if the 100 partner limitation is satisfied.

iv. Procedure for Election Out. The language in §6221 indicates that the election out is made separately with respect to each filed return. To make a valid election, the partnership must:

1. Make the election with a timely-filed partnership return;

2. Include the name and taxpayer identification number of each partner in the partnership; and

3. Notify each partner of the partnership election.

v. Effect of Election Out. If a partnership elects out of BBA, the partnership is audited under traditional rules applicable to non-TEFRA small partnerships whereby the IRS audits the tax return of each partner separately. Under TEFRA, the partnership-level procedures apply to partnerships of more than ten partners. Under the BBA procedures, a partnership with 95 qualifying partners that

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elects out would require the IRS to open an audit to make adjustments on the 95 separate partner returns.

vi. <u>**Practice Tip**</u>**: For Tax years beginning after 12/31/17, each partnership that qualifies to elect out of BBA must decide whether it wishes to do so, and if so, make an affirmative election to opt out on EVERY annual partnership tax return. Tax return preparers should be prepared to identify eligible partnership clients and advise them on the benefits and burdens of opting out of BBA.**

c. <u>Assessment of Partnership Adjustments</u>. The central purpose of the BBA procedures is to avoid the need to make the assessments of tax at the partner level for a tax year under audit. Instead, the BBA provides for assessment against the partnership directly and provides alternate procedures to allow partnerships to elect for the assessment made against the partners of for individual partners to amend their returns and report and pay their share.

i. <u>Assessment Against Partnership</u>. The default mechanism under the BBA procedures is to assess any "imputed underpayment" against the partnership directly in the "adjustment year." The adjustment is first made via a Proposed Partnership Adjustment ("PPA"), which is the equivalent of a Notice of Proposed Partnership Adjustment, or 60-day letter, under TEFRA.

1. <u>Adjustment Year Assessment</u>. Under BBA, any adjustment resulting in an "imputed underpayment of tax" 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 (1) the decision of a court in a proceeding brought under §6234 becomes final; (2) an administrative request under §6227 is made; or (3) notice of the final partnership adjustment is mailed.

2. <u>Imputed Underpayment</u>. The "imputed underpayment" is the tax amount that will be billed to the partnership, computed by "(1) netting all adjustments of items of income, gain, loss or

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deduction; (2) multiplying the net amount by the highest individual 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." **In other words, the amount assessed against the partnership is the tax due with respect to any increased adjustment, determined at the highest individual or corporate tax rate for the year under audit.**

3. Negative 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.

ii. Modifications to Imputed Underpayment. A new and important concept under BBA is the ability of a Partnership to request a modification to an imputed underpayment set forth in a Proposed Partnership Adjustment ("PPA"). Although the general guidelines for modification are set out in § 6225(c), the statute reserves in the Secretary the establishment of specific procedures by Regulations.

1. Timing of Modification Request. The partnership has 270 days following receipt of a PPA to request a modification to the imputed underpayment. This time period replaces the 60-day period reserved under TEFRA for contesting a NPPA. The 270-day period can be extended by agreement.

2. Modifications: Amended Partner Returns. The first potential modification allows reviewed-year partners to file amended returns and pay the corresponding tax due. If this occurs, the amount of adjustment reported on the amended return is then eliminated from the imputed underpayment computation. If the amended returns relate to a reallocation of distributive shares among the partners, all affected partners must file the amended returns.

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a. **<u>Practice Tip</u>: Although not set forth in the BBA statutes, commenters expect the Regulations to provide for automatic allocation of the imputed underpayment to the reviewed-year partners that do not file an amended return and pay their share of tax during the modification period. It may be necessary to provide for such allocation in partnership agreements until the Regulations are finalized.**

3. <u>Modifications: Allocation to Tax-Exempt Partners</u>. For partnerships with one or more tax-exempt partners, the partnership may request a modification of the Imputed Underpayment to the extent that the adjustment would flow through to the tax-exempt partner.

4. <u>Modifications: Reduced Tax Rates</u>. Partnerships have a limited ability to request a modification of the applicable tax rate used to determine the Imputed Underpayment. The rate may be lowered only where a C Corporation partner establishes that it is subject to a lower tax rate, and with respect to individual partners, where the allocated adjustment would be subject to a reduced rate for long-term capital gains. Individual partners may not request modification by establishing that his or her overall tax rate is lower than the imputed rate against the partnership.

iii. <u>Partner Assessment Election</u>. BBA provides an alternative to the partnership assessment procedure in which the partnership can elect to have the reviewed year partners assessed instead.

1. <u>Reviewed Year Partners</u>. Similar to current procedures under TEFRA, the election would allocate the assessment among those that were partners in the partnership during the year under audit, i.e., the "reviewed year."

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2. Timing and Manner of Election. The reviewed year partner assessment 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 expiration of 270 days following the issuance of the PPA (and after any modifications to the PPA are requested via amended returns, etc.). The partnership must issue a statement to each reviewed year partner and the IRS that reflects the allocation of the adjustments in the FPA with respect to each item of income, gain, loss, deduction or credit to each reviewed year partner. The statute directs the IRS to issue regulations concerning the time, manner and information needed for this statement.

3. Reported in Election Year if Partner Election Made. If the partnership elects to have the assessment made against the partners directly, the "reviewed year" partners' tax is increased by the relevant adjustment amounts in the taxable year in which the election is made. This is not necessarily the same as the "adjustment year," since the election must be made within 45 days after the FPA and the partnership has 90 days after the FPA to file a petition in Tax Court contesting the FPA, meaning the election can be made well before the partnership adjustments become final.

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If it is known the FPA will not be contested, there should be sufficient time for the final adjustments to be incorporated in the statement provided pursuant to the partner assessment election. This timing issue is problematic if the FPA is contested, however. The allocation is required before the amount of the adjustments is known. The regulations to be implemented under this section may allow the partnership to defer submission of the allocation computations until after the FPA adjustments have become final in a judicial proceeding. Since no regulations have yet been issued, the timing of the statement is currently subject to question.

iv. Increased Interest. A potentially major drawback to the partner assessment election, a two percent (2%) increased interest amount is charged against the partners as the cost for making the election. Rather than applying the normal underpayment rate that is three percentage points over the Federal short-term rate specified in §6621, two additional percentage points (for a total of 5 percentage points) are added. This interest is computed from the due date of the reviewed year return with respect to the initial additional tax. The interest is assessed and collected at the partner level.

v. Penalties. The applicability of any penalties is determined at the partnership level, regardless of whether the partner assessment election is made. If the partner assessment election is made, the penalties are assessed against the partners pro rata.

d. **Practice Tip - Deciding whether to Make the Partner Assessment Election. Under the default partnership assessment procedures, the Imputed Understatement will likely be calculated at a higher tax rate than the aggregate rates of the individual partners. It is also possible that, for partnerships that have admitted new partners since the year under audit, deciding not to make a partner assessment election may shift the economic burden to the new partners, since the assessment is made against the partnership in the "adjustment year." On the other hand, there is a 2% increased interest burden if the partner assessment**

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election is made. The best option for many partnerships may be to require the partners to file amended returns and pay their share of the tax due the under the Imputed Understatement issued in the PPA. Doing so will allow each partner to report and pay the tax based on its own tax rate without imposition of the increased interest burden.

III. **New Terminology and Concepts under BBA**

a. Tax Matters Partner now the "Partnership Representative". Under the BBA, the concept of the TMP has been retained, but the name has been changed to the Partnership Representative (PR). The PR is given even more powers than the TMP. In fact, the PR is the only person who may act on behalf of the partnership. *See IRC § 6223(a).*

i. Authority to Bind All Partners. The BBA procedures give the PR statutory authority to bind all partners with respect to all actions taken by the partnership in the BBA administrative proceeding and in any judicial proceeding. Since the PR is the exclusive party to act on behalf of the partnership, the PR may also bind all partners to extensions of the statute of limitations, settlements and available elections.

ii. Eligibility. The eligibility rules for the PR are much simpler than the rules concerning the appointment of the TMP. The only statutory requirement is that the PR must have "a substantial presence in the United States." The PR need not be a partner, need not have a stake in the outcome, and is not subject to termination for events such as bankruptcy or criminal investigation. If the partnership does not designate a PR, the IRS may select any person as the partnership representative.

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iii. Elimination of "Notice Partners", etc. By giving all rights to the PR to act on behalf of the partnership, the need to define other categories of partners has been eliminated. Notice partners, pass-through partners, indirect partners and participating partners essentially do not exist. These categories are necessary under TEFRA because they have differing rights. None of these categories have any rights or responsibilities under the BBA procedures. The only meaningful categories under the BBA procedures are the PR and everybody else.

b. Partnership and Nonpartnership Items. The concept of "partnership items" under the TEFRA procedures applies with the same force and effect under the BBA procedures. Section §6221(a) indicates that the BBA procedures apply to "any adjustment to the items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof). . ." These are the "partnership items" that are determined in the partnership proceeding.

c. Affected Items Eliminated. The affected item category that exists under TEFRA is not necessary under the BBA procedures. The BBA procedures contemplate either a partnership-level proceeding with the tax paid by the partnership or an election out with the entire examination at the partner level. In neither of these circumstances is it necessary to deal with "affected items" as defined under TEFRA. In addition, the "partner assessment election" applies to the year the determination is made and therefore does not require the coordination of partnership items and non-partnership items to compute the partner's tax in the audited year.

d. Notices and Timing under BBA. In general, the BBA procedures retain the TEFRA partnership-level notices but effectively eliminate all partner-level notice requirements of the IRS.

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i. NAP Replaces NBAP. Under the TEFRA procedures, the IRS is required to send ta "Notice of Beginning of Partnership Audit Proceeding" (NBAP) to all notice partners at the beginning of the administrative proceeding. Under the BBA procedures, a "Notice of Audit Proceeding" (NAP) is required at the beginning of the administrative proceeding but the IRS must send that notice only to the partnership and the PR.

ii. PPA Replaces "60-day Letter". The concept of the 60-day letter was an administrative procedure under TEFRA, but not codified under the statutes. The Proposed Partnership Adjustment (PPA) procedure under BBA now codifies a 270-day period for requesting corrections and modifications to the PPA, which includes the filing of amended returns by partners (see above).

iii. FPA Replaces FPAA. Under the TEFRA procedures, the "Final Partnership Audit Adjustment" (FPAA) was the equivalent of a non-TEFRA notice of deficiency, or "90-day letter", which concluded the partnership proceeding and triggered the right for judicial review. Under the BBA, the FPAA continues to exist in the form of the "Final Partnership Adjustment" (FPA).

iv. Administrative Adjustment Request (AAR) Retained. An Administrative Adjustment Request, which essentially functions as a partnership amended return, remains an option under BBA, except that under BBA, the AAR implements an adjustment in the year in which the AAR is filed rather than the year to which the amendment applies.

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v. Notice of Inconsistent Treatment Retained for All Partnerships. As under TEFRA, a partner may file a notification of inconsistent treatment which allows the partner to avoid a consistency assessment if he files a return inconsistent with the partnerships' return. This requires the partner to file a notification of inconsistent treatment attached to the partner's return. Presumably *Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request*, which serves as notice under the TEFRA procedures, will be retained under the BBA procedures for this purpose.

vi. Computational Adjustment and Affected Item Procedures Eliminated. Because there is no retroactive assessment of the partnership item flow-through amounts at the partner level, the need for computational adjustment and affected item procedures are eliminated under BBA.

e. Statute of Limitations Simplified under BBA. Under TEFRA, the statute of limitations for assessing the tax attributable to partnership adjustments can be complicated. Disputes arise over whether the partnership-level statute of limitations is an independent statute of limitations based on the partnership return or merely served as one of several events that suspended the ultimate statute of limitations on assessment against the individual partners. Since the BBA procedures eliminate retroactive partner-level assessments, the statute of limitations rules under the BBA procedures are dramatically simpler.

i. SOL under BBA Partnership Procedure. If no election is made to opt out of BBA, the general 3-year SOL applies. Assessment must be made within 3 years after the later of the date the partnership return was filed or the due date for the return. The period of limitations is extended for 270 days upon the issuance of a Proposed Partnership Adjustment, and for 90 days plus one year after an FPA (same as under TEFRA).

ii. SOL upon Election out of BBA. If a partnership elects out of BBA, the examination is conducted entirely at the partner level. No special SOL is provided for such an examination and assessment.

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iii. Partner Assessment Election. In addition to the standard 3 year SOL for issuing an assessment based on the reviewed year return filing, making a partner assessment election may potentially create an extension of time to assess the adjustment against the partners. Under the partner assessment election, the assessment is made for the year the election occurs. If the partner fails to properly take into account the partner assessment amount on his election year return, the IRS would presumably have the normal three-year period of limitations in §6501 within which to make the proper assessment against the election year return. Hopefully, the regulations will clarify this point.

IV. Conclusion.

a. Simplification?: The BBA procedures intend to simplify the audit process for both the IRS and participating partnerships, and most commenters agree the BBA provides the framework for accomplishing this goal. However, much of the implementation is left to regulations that have yet to be issued. Whether or not this goal of simplification will be achieved will depend on the complexity and timing of the regulations that are issued.

b. Options and Elections: Unlike TEFRA, BBA leaves much of the procedural decision-making in the hands of the partnerships, and specifically to a single designated Partnership Representative. Although the default rule of assessing directly against the partnership in the year of adjustment may simplify the audit process for many partnerships, it may not be the most economically advantageous option. Without knowledgeable tax advisors, many smaller partnerships may simply not be aware of the option to elect out of BBA upon filing of each partnership tax return, the ability to modify the proposed assessment against the partnership by filing amended returns, or the election to allocate the assessment to the partners after the issuance of an FPA. Each of these decisions bears certain risks and benefits, and it will be incumbent on knowledgeable tax advisors to help weigh these options at each step, and stay abreast of the procedures if/when clarifying regulations are issued.

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