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Congress Overhauls the Partnership Tax Audit Rules

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On November 2, 2015, President Obama signed the Bipartisan Budget Act of 2015 (the "Bill"),[1] which repeals the TEFRA Unified Audit Procedures[2] and replaces them with a radically modified "corporate" model for partnership tax audits. The new rules are designed to help fund the Bill[3] by replacing the current three-tiered regime for partnership audits with a uniform system in which audits and assessments occur at the partnership level, subject to some options to elect out of that "default" rule. The current audit regime will remain in place for returns filed for partnership taxable years up until December 31, 2017, after which the new rules will take effect. While the new rules potentially simplify the partnership audit procedures from the perspective of the Internal Revenue Service ("IRS"), they create significant concerns and uncertainty for partners, as many of the most important aspects of the new rules have been left to be determined in future Treasury Regulations.

I. CURRENT LAW (INCLUDING THE TEFRA UNIFIED AUDIT PROCEDURES)

The current partnership[4] audit rules consist of three different audit regimes depending on the number of partners in a partnership. First, the Internal Revenue Service ("IRS") audits partnerships with ten or fewer partners under general audit procedures for individuals, auditing the partnership and the individuals separately. Second, partnerships with more than ten partners are audited under the TEFRA rules,[5] which allow for a single administrative proceeding by the IRS at the partnership level. After the partnership level audit is completed, each partner's tax liability for the taxable year under audit is adjusted according to the results of the partnership level proceeding. Third, under the electing large partnership provisions,[6] partnerships with 100 or more partners can elect to be treated under an audit regime that is similar to the TEFRA rules in that a partnership level audit is conducted. However, rather than the partners making adjustments to their tax returns in the year under audit, any adjustment is made to a partner's tax return in the year the audit is completed.

II. NEW RULES IN BIPARTISAN BUDGET ACT OF 2015

The Bipartisan Budget Act of 2015 repeals the three-tiered audit system for partnerships and replaces it with one set of rules, with some elective exceptions.[7] This default rule, a radical departure from current law, provides that

[1] Pub. L. 114-74, available at https://www.congress.gov/bill/114th-congress/house-bill/1314/text?overview=closed.

[2] TEFRA is the Tax Equity and Fiscal Responsibility Act of 1982. Pub. L. 97-248. See IRC §§ 6221-6234.

[3] The Joint Committee on Taxation estimates that these provisions will increase revenues by $9.3 billion over a 10-year period.

[4] The rules apply to an entity treated as a partnership for federal income tax purposes whether the entity is, under local law, a general or limited partnership, a limited liability company or something else.

[5] IRC §§ 6221-6234.

[6] IRC §§ 6240-6255.

[7] By repealing Subchapter C of Chapter 63 of the Internal Revenue Code, Congress also repealed IRC §6234, which allowed the IRS to adjust items in a taxpayer's "oversheltered" tax return, i.e., a return that shows no income and a loss from partnership items.

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the IRS will conduct audits and assess tax at the partnership level. The tax is payable by the partnership 90 days after the IRS sends a notice of final partnership adjustment or, if the partnership challenges the assessment, when a court decision becomes final. The new rule therefore represents a "corporate" like audit and assessment model.

When an adjustment is made at the partnership level, the tax is assessed by netting all adjustments of income, gain, loss or deduction for the taxable year and multiplying the net amount by the highest corporate or individual tax rate on ordinary income. In the case of such an "imputed" underpayment, the Treasury Secretary is directed to establish procedures whereby a partnership can show that the adjustment would be lower if it were based on partner-level information (*e.g.*, a partner is tax-exempt)[8] from the year under audit. However, depending on what information will need to be provided to the IRS, these procedures may not be available to certain partners for which confidentiality is a significant concern. If a partnership does avail itself of these procedures and pays a reduced assessment as a result, partners may insist that the partnership agreement have special provisions to ensure that the benefit of the reduction is recognized by the partners that are not subject or subject to a reduced rate of U.S. tax.

A "partnership representative," which need not be a partner but which must have a "substantial presence in the United States," will participate in the audit on behalf of the partnership, and the partners will have no automatic rights to participate in or opt out of the proceedings.[9] As a result, partners that want the right to participate in the audit process will need to build those rights into the partnership agreement.

Because adjustments take place in the year that the adjustment occurs rather than the year in which the liability arose, the partners that had the "benefit" of the challenged position in a prior taxable year may not be required to include amounts in income in the year of assessment if the partners in a partnership change from year to year. Partners should consider amending partnership agreements to contain indemnification provisions to address this potential inequity. Moreover, the audit procedures and tax liability therefore likely will be an important part of the negotiation process for sales or redemptions of partnership interests.

There are two exceptions to assessment of tax at the partnership level. First, similar to the current regime, partnerships with 100 or fewer qualifying partners can opt out of the new rules and be audited under the rules applicable to individual taxpayers. Any adjustments would be taken into account at the partner level but would be applicable to the year being audited rather than the year the audit is completed. However, this election is not available for partnerships that have a partnership as a partner, including most funds that have a general partner that is treated as a partnership for U.S. tax purposes.

Second, within 45 days after the IRS notice of a final partnership adjustment, a partnership can opt to have the partners pay the tax. In this case, the partnership furnishes the IRS and each partner who was a partner during the audited year with a statement of each partner's share of any adjustment to income, gain, loss, deduction or credit. Those partners must then take their share of the adjustment into account on their individual returns in the year that the statement was furnished by the partnership, not the year under audit.

[8] Other information that would reduce the partnership level "imputed" underpayment of tax would include that the partner filed an amended return and has paid the tax, the tax rates applicable to specific types of partners and the type of income subject to the adjustment.

[9] The new rules thus do away with a partner's right under current law to participate in audit proceedings, to form a group of partners having at least a 5% interest in the partnership to receive notices relating to the partnership audit and to form a group of partners having at least a 5% interest in the partnership that can file a petition for readjustment of partnership items.

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In order to head off adjustment and assessment at the partnership level or where a partnership decides to change an item on its previously filed tax return, the new rules allow partnerships to file requests for administrative adjustments when they believe an additional payment will be due (or an overpayment was made). The partnership can elect to make any adjustment at either the partnership or the partner level. An adjustment will be determined and taken into account for the partnership taxable year in which the administrative adjustment request is made with the result that there may be more interest payable on the assessed amount.

If a partnership wants to challenge a final partnership adjustment, then it can file a "readjustment" petition with the Tax Court, the U.S. district court where the partnership's principal place of business is located or the Claims Court. To file a petition in U.S. district court or the Claims Court, the partnership must pay the imputed underpayment shown in the final partnership adjustment. The petition must be filed within 90 days after the final partnership adjustment is mailed.

III. LOOKING AHEAD

As noted, the new rules will only take effect for returns filed for partnership taxable years beginning after December 31, 2017. A partnership can elect to have the new rules apply for taxable years beginning after November 3, 2015, and before 2018.

Going forward, as discussed above, partnership agreements will need to contain architecture taking into account the new rules. In particular, moving the focus of audits to the year they occur, rather than the year in which the tax items were recognized, is certain to raise issues as the partners in a partnership change over time. Therefore, even existing partnership agreements will need to be revised to account for the new rules.

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