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New Tax Audit Regime Constitutes a Sea Change for Partnerships

Legislation impacts tiered partnerships and M&A transactions. Existing partnerships should review operating agreements before new rules take effect.

The Bipartisan Budget Act of 2015 (the Act), which President Obama signed on November 2, upends the way the Internal Revenue Service (IRS) conducts partnership audits, with potentially far-reaching effects. The new audit procedures apply at the partnership level and the partnership must pay the tax deficiencies resulting from any audit adjustments, unless the partnership affirmatively elects to pass the adjustments on to its partners. The new rules apply to all partnerships (including limited liability companies taxed as partnerships) with more than 100 partners, and to partnerships with 100 or fewer partners if any of the partners is itself a partnership or a trust. Other partnerships may elect out of the regime, in which case audits and adjustments relating to partnership items would take place at the partner level.

The new audit rules will be effective for taxable years beginning on or after January 1, 2018, although partnerships may elect to apply them sooner. The delayed effective date allows partnerships time to adjust and, since a number of the Act's provisions will require the IRS and the Treasury Department to fill gaps in the statute, the delay will also provide those agencies with time to draft regulations or other guidance.

Background

The enactment of the new regime appears motivated by Congress' desire to make it easier for the IRS to conduct partnership audits and to collect any resulting tax liability. Current audit rules generally require the IRS to allocate the partnership tax liability to, and collect it from, the ultimate partners, which can consume substantial resources. In recent years, as partnerships have mushroomed in number, size and complexity, many observers believe the IRS — shorn of much of its funding and personnel — simply cannot keep up. The result has been a minuscule audit rate for partnerships, compared to that for C corporations, with attendant concerns about the practical inability to detect noncompliance.

The Act aims to streamline the three existing partnership audit regimes, the application of which depends on the size and composition of the partnership. Under the current audit regimes:

- **Partnerships composed of more than 10 partners** are subject to audit under rules introduced by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The TEFRA regime establishes a category of "partnership items" for which the tax treatment must be determined at the partnership level. A TEFRA audit focuses on those partnership items, and passes through any audit adjustments to the partners in the year under review. A partnership subject to TEFRA designates one of its partners as the "tax matters partner" to act for the partnership in proceedings with the IRS, although

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all partners have certain information and notice rights and may participate in the proceedings. The TEFRA regime also applies to partnerships with 10 or fewer partners if any partner is a partnership or trust.

- **Small partnerships composed of 10 or fewer partners**, each of whom is an individual (other than a nonresident alien), a C corporation or an estate of a deceased partner, are subject to audit under the same procedures that apply to individual taxpayers, unless the small partnership elects to be subject to TEFRA.

- **Electing large partnerships composed of at least 100 partners** generally are subject to a simplified version of the TEFRA audit regime which, among other things, generally affords partners considerably lesser participation rights than under a regular TEFRA audit.

Congress reportedly incorporated the new partnership audit provisions into the budget bill as potential revenue-raisers. If the IRS can conduct these audits more easily, the reasoning goes, it will conduct more of them and collect more taxes. In fact, after the Act's passage, press reports cited an IRS official as stating the agency plans to train examiners to identify and handle partnership issues. Other recent tax reform proposals generally endorsed the audit reform approach reflected in the Act, as did President Obama's fiscal year 2016 budget proposal, which counted streamlining audit and adjustment procedure for large partnerships as a deficit-reduction measure.[1]

Key Aspects of New Regime

The Act creates a new default audit regime that applies to all partnerships unless a partnership is eligible to elect out of the regime and makes the election. Under the new default audit regime, the IRS generally will conduct audits and make any resulting adjustments at the partnership level, and if the IRS finds a deficiency, it will impose tax on the partnership itself (rather than on the partners) at the highest individual or corporate tax rate in effect for the year under examination. The Act authorizes the IRS to prescribe rules that will allow a partnership to reduce the liability by demonstrating, for example, that some of its partners are subject to a lower rate or are tax-exempt. Audit adjustments that do not result in a deficiency generally are required to be taken into account by the partnership as an adjustment to its bottom-line taxable income or loss in the year of the adjustment, rather than amending returns for prior years.

As an alternative to partnership-level liability, the partnership may elect to furnish adjusted Schedules K-1 to each person who was a partner in the reviewed year and to the IRS, stating such partner's share of any partnership adjustments. Those partners would then take the adjustments into account on their own returns in the year in which they receive their adjusted Schedules K-1 (rather than by amending their returns for the reviewed year), using what has been described as a simplified amended-return process. The Act leaves it to the IRS to draft the precise contours of this election, including the time and manner of furnishing the adjusted Schedules K-1, although the Act specifies that the partnership must elect this alternative method within 45 days after the notice of final partnership adjustment.

In addition, the Act provides procedures for a partnership to self-report adjustments for prior taxable years. A partnership may file with the IRS a request for an administrative adjustment with respect to a prior year and take the adjustment into account in the year in which the partnership made the administrative adjustment request. The partnership generally could then either take the adjustment into account at the partnership level in the adjustment year and pay any resulting tax or furnish adjusted Schedules K-1 to the reviewed-year partners, who would then take the adjustment into account in the year in which they receive the adjusted Schedules K-1.

The Act replaces the "tax matters partner" with a partnership representative, who need not be a partner but must have a substantial presence in the United States, to assume sole authority to act for the partnership in an audit. If the partnership fails to designate a representative, the IRS may select any person to fill the role. This change resolves many unanswered questions as to who could serve as the tax matters partner for a limited liability company under existing TEFRA rules. Actions the partnership takes under the new regime, and any final decision in a proceeding under the new regime with respect to the partnership, will be binding on the partnership and its partners.

Partnerships composed of 100 or fewer partners and whose partners do not include any partnerships or trusts may elect out of the new regime. The partnership must timely make the election annually on its partnership return, and must notify all partners of the election. The rules require the partnership to report to the IRS the name and taxpayer identification number of each partner, including each shareholder of any S corporation that is a partner. Each such S corporation shareholder counts toward the 100-partner limit for the partnership to be eligible to elect out of the new audit regime. Although generally a smaller partnership may elect out of the new rules only if no partner is a partnership or a trust, the Act authorizes the IRS to issue guidance relaxing this restriction, provided the partnership can report information about the partners' owners in a manner similar to the disclosure regarding S corporation shareholders.

Impact on M&A and Tiered Partnerships

The imposition of entity-level liability for income taxes has significant implications in the context of mergers and acquisitions involving partnerships and will heighten concerns over whether an acquirer or successor to a former partnership is considered a continuation of that partnership for tax purposes. The Act contemplates that if a partnership has ceased to exist at the time of the audit, the adjustments will be taken into account by, and any resulting tax liability will be the obligation of, the partners of the partnership for the audited year. However, the implementation of this rule has been left to the IRS. Accordingly, if an acquirer is considered a continuation of the acquired partnership, then it appears the acquirer would succeed to any potential pre-closing tax liabilities of the acquired partnership. However, if an acquirer is not considered a continuation of the acquired partnership, then it appears that those liabilities would be left behind. Transaction parties will need to take account of the new audit rules when negotiating who will bear the economic cost of taxes imposed at the partnership level, who will control audits for pre-closing periods and what elections the partnership will be allowed to make.

In the context of tiered partnerships, whether upper-tier partnerships may fully avail themselves of the alternative procedure allowing a partnership to shift the tax liability from the partnership to the reviewed-year partners by issuing adjusted Schedules K-1 is unclear. The Act provides that taxes of the reviewed-year partners will be increased accordingly, in the year in which they receive their adjusted Schedules K-1. If the partnership under audit (the lower-tier partnership, or LTP) has a reviewed-year partner that is itself a partnership (the upper-tier partnership, or UTP), the statutory language suggests that UTP must take the adjustment into account in the year in which it received the adjusted Schedule K-1 from LTP. In such event, UTP's partners in that year would bear the burden of the adjustment, even though they may be different from UTP's partners in the LTP year under audit. Congress may have meant to permit "tiering up" the adjustment, such that UTP could issue adjusted Schedules K-1 to the persons who were its partners in the LTP year under audit, and so on up the chain. Congress may need to clarify its intention, or perhaps the IRS has sufficient authority under the Act to issue clarifying guidance on this question.

Conclusion

The replacement of the TEFRA and electing large partnership rules with the new partnership audit regime presents numerous challenges for partnerships. Small partnerships will have to decide whether they want to elect out of the new regime, thereby weakening the ability to control consistent partner reporting.

Partnerships that do not elect out or that are ineligible to elect out will need to ensure their operating agreements address the new procedural requirements, such as addressing whether the partnership is required to elect to pass-through audit adjustments to the partners or who will have the authority to make that decision. Partnerships that want to shift the economic liability of partnership audit adjustments to persons who were partners during the reviewed year will need to comply with an election procedure, as yet largely unwritten, within a limited time frame. In the M&A context, the new regime's default rule to impose liability on the partnership during the adjustment year rather than the reviewed year highlights the importance of indemnification provisions in partnership acquisition and investment agreements. Congress has left many details of the new regime to the IRS and may need to enact technical corrections to clarify certain aspects of the law. Partnerships, partners and their advisors will need to study carefully any future guidance from Congress or the IRS to implement the new rules.

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Endnote

[1] Of some comfort to partnerships, unlike some previous similar proposals, the Act does not impose joint and several liability on partners for liabilities determined at the partnership level.