AND NOW FOR SOMETHING COMPLETELY DIFFERENT: NEW RULES FOR PARTNERSHIP AUDITS

Posted on **November 9, 2015** by **Jim Malone**

Suddenly, TEFRA died.

It remains to be seen if it will be missed. On November 2, 2015, the President signed the Bipartisan Budget Act of 2015, Pub. L. 114-74. Title XI of the legislation brings radical change to the world of partnership taxation.

Starting with the 2018 tax year, when a partnership audit results in adjustments, the default rule will be that the partnership pays the tax, not the partners. Consequently, someone entering a partnership may be subject to taxes that historically would have been someone else's headache. There are two ways out of that predicament, but first a bit of history is in order.

Historically, when the IRS audited a partnership, it had to go partner-by-partner. There was no centralized mechanism to evaluate partnership tax items on an aggregate basis. TEFRA, the Tax Equity and Fiscal Responsibility Act of 1982, changed all that by creating a system featuring partnership level proceedings that generated adjustments that would then flow through to the individual partners. This was a complex process, and it featured some booby-traps, including a special limitations period for refund claims.

From the government's perspective, TEFRA wasn't good enough. Speaking at the Philadelphia Tax Conference last week, Clifford Warren, special counsel to the Associate Chief Counsel for Passthroughs and Special Industries, noted that the IRS had grown increasingly frustrated with TEFRA. In the field, revenue agents, routinely had to navigate through a variety of obstacles including gamesmanship concerning the identity of the tax matters partner, a central figure in the

TEFRA regime. And when the partnership audit was complete, the process of passing the adjustment along to partners was far from straightforward.

Changes to the regime for partnership audits had been an agenda item for the IRS, but the changes enacted earlier this month came faster than anyone expected: they were adopted so quickly, no committee report is expected.

To provide an overview, the Budget Act:

- Repeals the TEFRA audit rules, I.R.C. §§ 6221-6234;
- Eliminates the electing large partnership provisions of the Code;
- Substitutes a regime in which every partnership will be audited at the partnership level and be liable for the amount of the adjustments in the absence of making an appropriate election to be treated in another way.

Pub. L. 114-74, § 1101.

Under new Section 6221 of the Code, "items of income, loss, deduction or credit" associated with a partnership will determined at the partnership level, assessed and collected at the partnership level, and "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share" will be determined at the partnership level. Pub. L. 114-74, § 1101(c)(1)(to be codified at I.R.C. § 6221(a)). Under new Section 6222, partners are required to file returns that are consistent with the partnership returns, and for good measure, they are bound by actions of the partnership and by adjustments made to the partnership's return by the IRS under new section 6223 of the Code. From the perspective of the IRS, auditing a partnership will be just like auditing a corporation. Partnerships that do not want to follow this approach have limited options.

Some partnerships will be able to opt-out of it altogether. New Section 6221(b) permits partnerships to opt-out of the new regime if they have one hundred or fewer partners, but only if the each of its partners are an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner. Pub. L. 114-74, § 1101(c)(1)(to be codified at I.R.C. § 6221(b)(1)(C)). Consequently, if a partnership includes another partnership as a partner or a trust as a partner it cannot opt-out, although there may be a possibility that the treatment of trusts will be adjusted through regulations. There are also special rules for S Corporation partners: each of their shareholders counts as a partner under new Section 6221(b)(2)(A). The election is made annually in conjunction with the filing of the partnership return.

Partnerships can also elect to have the adjustments made by their partners under new Section 6226 of the Code. This election can be made within forty-five days of the issuance of the final partnership adjustment, and it requires the partnership to send notices to the partners affected by the adjustments.

And there is a provision that will make many revenue agents happy: a partnership's ability to conceal its tax matters partner is gone. New Section 6223(a) provides that partnerships must designate a representative in a manner to be prescribed by regulation. If a partnership fails to file an effective designation, the Secretary of the Treasury may select *any* person. Pub. L. 114-74, §

1101(c)(1)(to be codified at I.R.C. § 6223(a)) (emphasis supplied).

The Budget Act provides for a radical change in the approach to partnership audits, and the scope of its impact will become clearer as regulations are issued. For now, partners should look at their partnership agreements to consider what changes are in order.

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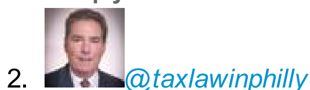
2. *@taxlawinphilly*
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