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New IRS Partnership Audit Procedures Coming to the United States

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The recently enacted *Bipartisan Budget Act of 2015*[1] contains major changes to future IRS partnership-level audit procedures. The Act replaces the existing rules for partnership taxable years beginning in 2018. Though the effective date is still two years away, the rules contain a number of important technical deficiencies that could have harsh and unexpected consequences and so should be considered now.

Under the new regime, all partnership audit adjustments and any resulting tax deficiencies will be determined and assessed at the partnership level. In addition, liabilities for penalties will be determined (e.g., whether there was reasonable cause for an underpayment) at the partnership level.

In contrast to existing TEFRA[2] procedures, individual partners cannot participate in the proceeding or elect out of any settlement. Instead, the partnership will designate a "partnership representative" (which replaces the "Tax Matters Partner" designation under current law) whose decisions will be binding on all partners. If the partnership representative designated by the partnership does not have a substantial presence in the United States, the IRS can choose the partnership representative.

Unless the partnership elects otherwise under revised section 6226 (as described below), the partnership itself is liable for the tax, interest and penalties with respect to any partner-level underpayments ("imputed underpayments") resulting from the partnership-level adjustments. This imputed underpayment is calculated on the highest rate applicable to the relevant item of partnership income, taking into account (though imperfectly) the type of partner to whom the income is allocable. If a partnership item is reallocated from one partner to another on audit, the imputed underpayment by the partner whose share of the partnership's income increased is determined without any netting of an imputed overpayment by the partner whose share of the income decreased or of other partner-level items.

The partnership can elect under section 6226 to pass the adjustments through to its partners instead. In that case, the partners would pick up the resulting additional tax on their returns for the year in which the adjustment notice is issued, rather than by filing amended returns for the prior years; however, interest on any underpayment would still run from the audited year.

Partnerships with fewer than 100 partners can elect out of the new rules, but the election is an annual election that must be included on the partnership's timely filed return. Under the statutory language, a partnership that has another partnership as a partner is not eligible to elect out of the rules, although regulations might expand the availability of the election to such partnerships.

The new legislation eliminates the ability of a partnership (other than a partnership that has elected out of the new rules) to amend its returns and issue amended K-1s to its partners. Instead, any amendments after the due date of the partnership return would have to be undertaken through an administrative adjustment request to voluntarily subject the partnership to section 6225 or 6226.

The congressional sponsors of a predecessor bill stated that they did not actually expect the proposal to be adopted so quickly, and so the bill did not go through the normal congressional vetting process that would have given stakeholders an opportunity to comment on the proposal. As a result, the legislation contains a number of flaws that will need to be addressed in a future legislative technical correction. (One glaring problem is that if the identity of the partnership's partners in the year in which an IRS audit is completed has changed from the year under audit, the cost of the adjustment may be borne by partners who were not present when the improper reporting occurred. The statute does not provide any mechanism for protecting the new partners or collecting the tax from the former partners, so it is hoped that the problem will be addressed by a technical correction.)

Although the new rules will not be effective for several years, it is not too soon for partners who enter into partnerships to be thinking about how they will handle future partnership audits. Points to consider addressing in partnership agreements include (1) mandatory partnership section 6221 elections out of the new rules, where possible; (2) provisions governing the designation of the partnership representative; (3) provisions governing decisions by the partnership representative (to give other partners input into those decisions); (4) provisions for mandatory elections under section 6226 (or alternatively, the right to compel a partner to file an amended return under section 6225); and (5) partner indemnities in the event that the partnership becomes liable for imputed underpayment amounts under section 6225.

[1] H.R. 1314 became Public Law 114-74, signed by President Obama on November 2, 2015.

[2] *The Tax Equity and Fiscal Responsibility Act of 1982* (Pub.L. 97–248).

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