An Overhaul Of Partnership Audit, Litigation Procedures

Law360, New York (November 4, 2015, 1:00 PM ET) -- On Nov. 2, 2015, President Barack Obama signed into law the Bipartisan Budget Act of 2015.[1] The act overhauls the partnership audit and litigation rules in the Internal Revenue Code, repealing both the provisions that were enacted under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the "electing large partnership" rules enacted in 1997. A key feature of the new rules is that tax adjustments resulting from partnership audits will now be assessed at the partnership level unless the partnership elects otherwise, thereby having the effect of imposing an entity-level tax on partnerships. The new procedures will apply to returns filed for partnership taxable years beginning after Dec. 31, 2017. Importantly, Congress left many significant details of the new rules to the Treasury Department to establish in the future but did not provide any deadline by which the Treasury must promulgate those procedures. As a result, key details of the new partnership regime are not yet known and will be developed by the Treasury over the next two years.

As discussed below, the changes in how partnerships are audited, and how any adjustments are assessed by the Internal Revenue Service, generally apply to all partnerships. Investors and sponsors of partnerships should review their existing agreements to determine what changes may be appropriate in light of the provisions of the act, particularly with a view toward how the economic effects of any future audit adjustments are borne and whether existing indemnity arrangements are sufficient to address potential adverse consequences to current partners that relate to periods before they acquired their interests in the partnership.

The New Partnership Procedures Generally Apply to All Partnerships

Under the act, all partnerships are subject to the new partnership audit and litigation rules. However, certain partnerships with 100 or fewer partners can elect out of the procedures if each of those partners is an individual, C corporation (or a foreign entity that would be treated as a C corporation if it was domestic), an estate of a deceased partner or an S corporation. The Treasury is required to establish procedures by which the name and taxpayer identification number of each partner in the partnership electing out of the new rules must be disclosed to the IRS.

The election-out procedures reflect three significant changes from the current TEFRA rules. First, under present law, a "small partnership" is limited to one with 10 or fewer partners. Second, the current TEFRA rules do not permit a partnership with an S corporation partner to be treated as a “small partnership.”[2] Third, and perhaps most importantly, under TEFRA, a “small partnership” is automatically excluded from the unified audit and litigation procedures unless it affirmatively elects into those rules. Under the new act, a “small partnership” must file a timely election to avoid the application of the new rules.

If the new partnership rules apply to a partnership, then each partner is required to file its returns consistently with the return filed by the partnership. A partner can file a notice of inconsistent position, however. Unless a partner files such a notice, it does not appear that a partner can ever mount its own defense of the tax position at issue.

The Act Vests Significant Power in the "Partnership Representative"

The act replaces the concept of a “tax matters partner” with a new role — the “partnership representative” — that is vested with significant power over the tax affairs of the partnership. The partnership may designate as the partnership representative a partner or any other person with a substantial presence in the United States, pursuant to procedures that will be established by the Treasury. In the absence of a designation by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership, subject to forthcoming procedures. The act currently has no limitations on the IRS’s ability to designate a partnership representative, although presumably the IRS could not designate someone who does not have a meaningful relationship to the partnership.

Under the act, the partnership representative is the only person with authority to act on behalf of the partnership. The partnership and each of its partners are bound by actions taken by the partnership representative on behalf of the partnership during any audit or litigation proceeding.

Assessments Made at the Partnership Level

Perhaps the most significant change from the prior TEFRA audit and litigation procedures is that any additional tax or penalties resulting from a partnership audit will be assessed and collected at the partnership level in the year that the audit or any judicial review is completed (the adjustment year). This has the effect of shifting the economic burden of the additional tax liability from those persons who were partners for the year under audit (the reviewed year) to the current partners in the partnership. Note, however, that partners will not be held jointly and severally liable for the liability of the partnership.[3]

When the audit is completed, the IRS will issue a notice of proposed partnership adjustment describing the adjustments for the reviewed year, which will be taken into account by the partnership in the adjustment year. All adjustments of income, gain, loss, deduction or credit resulting from the audit generally will be netted, and an “imputed underpayment” for the adjustment year will be calculated by applying the “highest rate of tax in effect for the reviewed year under section 1 or 11.”

An exception applies in the case of adjustments that have the effect of reallocating items between partners: the “imputed underpayment” will be calculated in such circumstances by including any increase in income or decrease in deductions but will disregard the offsetting allocations, thereby resulting in the same income being taxed twice. The partnership representative and partners then have 270 days in which to provide the IRS certain partner-specific information that would result in the modification of the amount of this imputed underpayment before the issuance of the notice of final partnership administrative adjustment (FPAA).

For example, the partnership could demonstrate that one or more partners is tax-exempt, that one or more partners is a C corporation (and thus subject to a lower tax rate on ordinary income, at least under present law), or that a portion of the increase is attributable to capital gains or qualified dividends (and thus subject to a lower tax rate for individuals, at least under present law). The imputed underpayment also could be reduced to the extent that individual partners file amended returns for the reviewed year taking into account their allocable share of the additional tax liability.[4]

Though this modification process is described conceptually in the act, the entire implementation has been left to the Treasury to develop. Interest and penalties resulting from the final FPAA would be determined at the partnership level. Notably, the act does not appear to provide for any partner-level defenses to penalties, which marks another significant departure from current law.[5]

As an alternative to this default process, the act provides for the issuance of adjusted Schedules K-1 by the partnership to all reviewed year partners within 45 days of the receipt of an FPAA. The partnership's election to use this alternative is irrevocable without the consent of the IRS. The reviewed year partners would be required to take the adjustments into account on their individual returns but would do so in the current adjustment year. Interest would be determined at the partner level at the federal short-term rate plus 5 percentage points, which is 200 basis points higher than otherwise would apply. Thus, the partners in a partnership that elects to issue adjusted Schedules K-1 will incur a penalty in the form of a higher interest rate on any understatement of tax.

As under current law, the act permits a partnership to file an administrative adjustment request (AAR) for a reviewed year, except that any adjustments resulting from the AAR would default to being taken into account by the partnership in the year in which the AAR is filed. If the AAR results in a refund, the partnership must issue adjusted Schedules K-1 to all reviewed year partners reflecting the refund. Although the act does not specify the procedures for such partners to obtain their refunds, presumably each reviewed year partner would be required to file an amended return to seek payment of their allocable share of any refund.

The act specifies that any payments required to be made by a partnership are not deductible. This is another change, at least with respect to corporate taxpayers, in that interest on tax deficiencies will not be deductible under the new regime.

Judicial Review of Partnership Determinations

As with the TEFRA procedures, the act permits a partnership to file a petition for readjustment with respect to a partnership taxable year in the Tax Court, a district court or the Court of Federal Claims within 90 days of receiving an FPAA. However, it appears that any such action could be filed only by the partnership representative; there is no provision for a partner other than the partnership representative to file an action for judicial review. Further, the entire amount of the partnership's imputed underpayment must be made as a jurisdictional deposit in order to pursue the action in a refund.

Statute of Limitations Determined by Reference to the Partnership

In accordance with the shift to assessing tax on the partnership instead of the partners, the statute of limitations will now be based off the partnership return and can be extended by agreement between the partnership representative and the IRS.

Notably, the statute of limitations will not start to run until the partnership files its return. For "small partnerships," this is a significant change from current law, and thus there will be a heightened importance in ensuring that partnerships timely file their returns.

With respect to an AAR, a separate statute of limitations applies such that a partnership may not file the AAR more than three years after the later of (1) the date on which the partnership return for the year was filed, or (2) the last day for filing the partnership return for such year (determined without regard to extensions). It is unclear whether this period of limitations can be extended by agreement between the partnership representative and the IRS.

Observations

The act contains an outline for the new partnership audit and litigation regime envisioned by Congress; however, many significant details remain unknown. Many key provisions of the act require the Treasury to promulgate implementing procedures, and there are many questions about the content and timing of those administrative procedures. Notably, the act does not impose any deadline for the Treasury to promulgate those administrative procedures, nor does it require the Treasury to promulgate regulations to implement its provisions. It is therefore unclear whether such administrative procedures will be subject to the same level of deference as would regulations promulgated pursuant to the Administrative Procedure Act. Interested taxpayers and other stakeholders will need to identify specific issues of interest and engage with the Treasury and the IRS over the next two years before the provisions of the act come into effect.[6]

In addition, the changes in the act — specifically the introduction of a partnership representative instead of a tax matters partner, the shift of the tax burden to the current partners by default and the inability of any partner other than the partnership representative to seek judicial review — necessitate a review of all existing partnership agreements and any planned partnership agreements to evaluate the changes that may be required to account for the new regime. Moreover, potential acquirers of partnership interests will need to undertake heightened due diligence reviews with respect to tax returns filed by the partnership in light of the shift in the economic burden from former partners to current owners of a partnership under the act.

Finally, partners and partnerships will need to carefully analyze the potential effects of proposed audit adjustments. The "imputed underpayment" rules under the act can create whipsaw situations for taxpayers, with reallocations of income resulting in additional tax that can only be avoided if all partners file amended returns consistent with the reallocation. And if a partnership elects to issue amended Schedules K-1 to its partners to avoid the entity-level assessment of tax contemplated by the act, the partners will be subject to a higher rate of interest on underpayments than otherwise would apply. These changed dynamics could dramatically alter the calculus for how investors approach partnerships under this new regime.

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[1] P.L. 114-74 (2015).

[2] Notably, each shareholder of the S corporation must be counted for purposes of determining whether the partnership is treated to have 100 or fewer partners.

[3] However, if the partnership has liquidated by the time of the adjustment year, the IRS

can collect from the former partners under regulations to be prescribed by the Treasury.

[4] This appears to be the only way that the act contemplates that partners can avoid the whipsaw effect of reallocated tax items between partners in a partnership.

[5] While Congress granted the Treasury the authority to provide for additional procedures to modify imputed underpayment amounts as “necessary or appropriate to carry out the purposes of this subsection” through regulations or guidance, it is not clear whether such procedures could provide for partner-level penalty defenses.

[6] The act permits partnerships to elect to apply the new rules to any return filed for taxable years beginning after the date of enactment of the act.