Major Changes to Tax Audit Procedures to Impact Most Partnerships

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Contributing Partner

Armando Gomez
Washington, D.C.

Counsel

Paul Schockett
Washington, D.C.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

Legislation enacted in November 2015 will fundamentally change the way the Internal Revenue Service (IRS) examines entities treated as partnerships for U.S. federal tax purposes, including how it assesses and collects tax underpayments. The new rules reflect the IRS' interest in auditing more partnerships more thoroughly. Many partnerships may need to amend certain tax and economic provisions of their governing documents to adjust to the new regime. The new rules create the potential for a shift in the liability for an underpayment of federal income tax with respect to a partnership — a sea change that will affect due diligence, negotiation and drafting in transactions involving the acquisition of interests in partnerships.

Importantly, Congress left many significant details of the new rules to the Treasury Department to establish in the future but did not provide a deadline by which Treasury must promulgate those procedures. As a result, key details of the new regime are not yet known and likely will be developed over the next few years.

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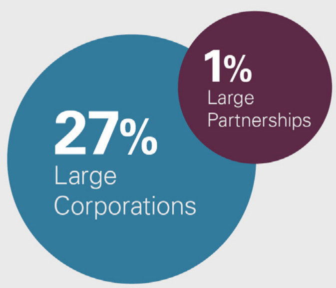

Background

Under rules enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (commonly referred to as the TEFRA unified partnership audit procedures), partnerships generally are subject to IRS audit in a proceeding at the partnership level controlled by a "tax matters partner" and subject to certain rights of "notice partners," but any resulting underpayment of tax is assessed and collected separately at the partner level. However, as partnerships (and entities taxable as partnerships, such as multimember limited liability companies) have become more numerous, this complex system of partnership-level audit/partner-level assessment has proven to be difficult for the IRS to administer. In 2014, the Government Accountability Office (GAO) presented testimony that in 2011, there were more than 10,000 large partnerships, a majority of which had more than 1,000 direct/indirect partners (many with more than 100,000) and more than five tiers of partnership ownership. Also, in 2012, less than 1 percent of large partnerships were audited, compared with more than 27 percent of large corporations; of those partnership audits, approximately two-thirds resulted in no change to net income and the other one-third averaged less than $2 million in adjustment. GAO cited the requirements of the TEFRA unified partnership audit procedures and the complexity of tiered partnership structures as contributing to the lack of meaningful partnership audits.

New Procedures

As part of the Bipartisan Budget Act enacted on November 2, 2015, the TEFRA unified partnership audit procedures were repealed effective for partnership taxable years beginning after December 31, 2017. In their place will be a new regime intended to simplify the IRS' audit function and ability to assess and collect tax underpayments from partnerships, including several novel provisions that may require amendments to many partnerships' governing documents before those partnerships file their 2018 tax returns. Several provisions of the new law are unclear and will require substantial guidance, if not statutory clarification, before the law takes effect. (Several technical corrections were enacted on December 18, 2015, as part of the Consolidated Appropriations Act, 2016. Further technical corrections are likely to be required before the new regime takes effect.)

Opting Out

Certain partnerships with 100 or fewer members/partners will be able to opt out of the new regime. However, pending the Treasury regulations, partnerships whose partners include another partnership (*i.e.*, tiered partnerships) will not. When partnerships opt out, the IRS will have to make any adjustments through audits of the partners rather than through an entity-level proceeding.

Imputed Underpayments

Under the new regime, the IRS can assess and collect any underpayment of taxes with respect to a partnership from the partnership itself rather than from the partners separately. Although the imputed underpayment will be computed based on income, gain, loss, deduction or credit of the partnership for a past year (the "reviewed year"), the assessment of the imputed underpayment will be in the current year (the "adjustment year"), potentially shifting the economic burden of the tax from former to current partners. Further, no payments the partnership makes under the new procedures (including interest) will be deductible. Under procedures to be issued, imputed underpayments can be reduced if a partner amends its reviewed year return and pays its share of the tax, or if the partnership proves that all or part of the adjustments are allocable to tax-exempt entities or, in limited circumstances, are eligible for a lower rate of tax. Alternatively, the new rules include a special election whereby the partnership may pass the imputed underpayment onto the "reviewed year" partners. However, if such an election is made, the underpayment interest rate is increased by 2 percentage points.

Partnership Representative

The new rules replace the concept of the "tax matters partner" with a "partnership representative," a position with significantly more power over the tax affairs of the partnership. The partnership representative will have the sole authority to act for the partnership with regard to the new rules. The partnership representative can be any person, not necessarily a partner, but must have a "substantial presence in the United States." If no partnership representative is chosen by the partners, the government will select one. There are no "notice partner" or similar provisions under the new rules.

Conclusion

Significant questions remain about the income tax effects of the new rules, the state and local tax consequences, and the financial accounting treatment for partnership tax liabilities, among other concerns. Amid the uncertainty, and while Treasury develops details of the new rules, many existing partnership agreements will need to be amended, and future partnership agreements and M&A transactions with respect to entities treated as partnerships will need to address the application of these new rules.