REPRINT

risk & compliance

IRS ON THE HORIZON: PARTNERSHIP AUDIT REFORM IN THE UNITED STATES

REPRINTED FROM:

RISK & COMPLIANCE MAGAZINE

JAN-MAR 2016 ISSUE

www.riskandcompliancemagazine.com

Visit the website to request
a free copy of the full e-magazine

ROPES & GRAY

Published by Financier Worldwide Ltd
riskandcompliance@financierworldwide.com

PERSPECTIVES

IRS ON THE HORIZON: PARTNERSHIP AUDIT REFORM IN THE UNITED STATES

BY **KATHLEEN SAUNDERS GREGOR AND BRITTANY CVETANOVICH**
> ROPES & GRAY LLP

In recent years, the number of large businesses organising partnerships has increased dramatically and Congress and others have expressed concern about the IRS's ability to effectively audit these often complex organisations. In testimony before the Senate Permanent Subcommittee on Investigations, the GAO identified administrative challenges and associated costs of conducting partnership audits as a reason the IRS audits relatively few partnerships with assets in excess of $100m. In response to such concerns, the Obama administration and members of Congress (both Democrat and Republican) have proposed legislation to reduce or eliminate such impediments.

On 2 November, president Obama signed the Bipartisan Budget Act of 2015 (BBA) into law, effecting sweeping changes to the rules governing audits of entities treated as partnerships for US federal income tax purposes. The new rules are expected to increase partnership audit rates by simplifying how the IRS conducts audits and collects tax. Most notably, this includes imposing, by default, an entity-level tax on the audited partnership.

Although the legislation provides an overall framework for partnership audits, it leaves many questions in this complex area unanswered, including how the new rules may apply to non-US partners and partnerships. And while the legislation directs the US Treasury to iron out critical details in regulations, there is no specific deadline for the delivery of such additional guidance making it unclear whether (or when) clarifying guidance will follow.

> **"It is the partnership's primary responsibility to ensure that tax, interest and penalties are paid."**

The problems with existing partnership audit rules

Under existing US rules, partnerships could be subject to any of three different audit regimes, depending largely on the number and structure of their partners. The most common set of provisions, the 'TEFRA rules', require partnership-level proceedings, followed by the IRS passing audit adjustments through to each (direct or indirect) taxable partner through a complicated 'computational adjustment' process. Particularly in the case of tiered partnership structures where partnership adjustments often spread across hundreds or thousands of partners, IRS resources expended in collection efforts could theoretically exceed the tax to be collected. Other cumbersome rules add to the complexity of (and time necessary for) performing and completing partnership audits, such as requiring notice to many partners of proceedings, permitting partners to opt out of the partnership's settlements with the IRS and allowing partners to participate in judicial proceedings.

Effective for tax years beginning after 31 December 2017, the BBA repeals the TEFRA rules (as well as another regime for certain large partnerships) and creates a new audit regime applicable to all partnerships. Under the new rules, any adjustment to items of partnership income, gain, loss, deduction or credit, and any partner's distributive share thereof, is determined at the partnership level. In addition, the new rules give partnerships some flexibility in determining how (and against whom) audit adjustment-related tax is calculated and ultimately assessed, but with the common thread that it is the partnership's primary responsibility to ensure that tax, interest and penalties are paid.

Highlights of the new regime: partnership's new role in tax collection

Congress addresses issues related to the collection of partnership audit adjustments in the BBA by requiring an audited partnership to pay tax (at potentially inflated rates) or to effectively assist in the collection effort by calculating which of their partners is required to pay the resulting tax.

Default rule: partnership pays tax at maximum statutory rate. As a default, the 'imputed underpayment' – the tax deficiency arising from a partnership-level adjustment with respect to an audited partnership tax year – is calculated using the maximum statutory income tax rate and is assessed against and collected from the partnership in the year that an audit (or any judicial review) is completed. The partnership is also directly liable for any related penalties and interest. The default rule is likely to lead to more tax owed than the aggregate tax the partners would otherwise pay. This is particularly the case where an adjustment is a mere reallocation of income: the imputed underpayment takes into account increases, but not decreases, in allocable share.

Alternative 1: partnership demonstrates reductions in imputed underpayment. The legislation directs the Treasury to establish procedures pursuant to which a partnership's imputed underpayment may be reduced if its partners voluntarily file amended tax returns (and pay any tax due) for the audited year

or if the partnership demonstrates that adjustments would be taxed at lower rates (or not at all) in the hands of its partners. For example, the imputed underpayment may be reduced by the portion of an adjustment allocable to a non-US investor not subject to US tax, a US tax-exempt investor, or a corporation (taxed at lower rates), or the portion allocable to individuals as capital gain (also taxed at lower rates). Unfortunately, in the absence of regulations, the requirements for obtaining any such reduction is unclear.

Alternative 2: partnership elects to shift liability back to partners. Partnership-level assessment may be avoided altogether if a partnership elects to issue a statement to each audited-year partner showing that partner's allocable share of adjustments. Each partner would then take any adjustment into account on the return for the year the statement is received (not the return for the audited year), and would pay penalties and interest directly. Because the tax would be based on the tax rates applicable to their own situation, the tax may be lower overall. However, under this alternative, interest is calculated at an increased rate (2 percent higher than the normal rate).

While this option could be the simplest way to reduce the total amount of tax paid, it may come at a cost: the rules now are unclear whether choosing this option effectively forecloses the partnership from challenging the audit results in court. This is, one hopes, an oversight, and may be handled in technical corrections by Congress, or perhaps by regulations. But the uncertainty may keep partnerships from committing to select this option.

Notably, changes in partner interests between the audited year and a subsequent adjustment, or changes in particular partners' tax profiles, could cause significant variations in each of these methods.

Procedural changes: simplification of the IRS's task but at expense of partners?

Although the BBA reduces some procedural impediments to partnership audits faced by the IRS, from a partner's perspective these 'fixes' can be seen as giving partnerships significant power and autonomy to resolve audits and court proceedings without the partners' participation – or even awareness. For example, under the TEFRA rules, the IRS is largely responsible for identifying a qualified partnership representative (the 'tax matters partner') at the outset of a partnership audit, but in practice doing so could be both difficult and time consuming. In response, under the BBA a partnership must designate a person to serve as 'partnership representative', but in any case where such designation is not in effect, the IRS may simply appoint one. Notably, however, a partnership representative is not required to be a partner, has sole authority to act on behalf of the partnership in an audit proceeding, and binds both the partnership and the partners with its actions in the audit – all giving the partnership more flexibility and control over audit proceedings than under prior law.

Similarly, the BBA relieves the IRS of the potentially costly and time-consuming tasks of identifying a partnership's direct and indirect (e.g., through multiple tiers of partnerships) taxable partners for purposes of passing through partnership adjustments, providing notice of partnership proceedings to partners, or calculating each partner's share of adjustments. But from a partner's perspective, these changes may leave partners unaware of partnership audit proceedings or adjustments, eliminate rights to participated in partnership audits or related judicial proceedings and standing to bring a judicial action if the partnership representative does not challenge an assessment.

What to do while we wait for clarification?

The BBA's broad sweep and uncertain scope can be expected to result in changes to the governing documents of both new and existing partnership arrangements, even prior to the effective date of the new law. These changes are expected to include negotiation over which regime the partnership will select for handling audit adjustments (or notice and consent rights to partners before a partnership makes a selection), how the burden of any partnership-level tax should be shared and the extent to which partners will provide information needed to reduce or eliminate any partnership-level tax liability. Some partners may seek to replicate current-law rights that will be lost under the new rules through contractual protections. In addition, acquisitive transactions involving partnerships will require particular attention to indemnification provisions, as well as contractual provisions addressing cooperation on tax matters.

Thanks to the delayed effective date – the BBA's new partnership audit regime applies for partnership taxable years beginning after 31 December 2017 – partners, partnership sponsors and other interested parties are afforded much needed time to consider the potential impact of the new rules on new and existing partnerships and partnership agreements. RC

Kathleen (Kat) Saunders Gregor
Partner
Ropes & Gray, LLP
T: +1 (617) 951 7064
E: kathleen.gregor@ropesgray.com

Brittany Cvetanovich
Associate
Ropes & Gray, LLP
T: +1 (312) 845 1211
E: brittany.cvetanovich@ropesgray.com