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ALERT
Tax

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Partnership Audit Reform Passed into Law

On Monday, November 2, President Obama signed the Bipartisan Budget Act of 2015 (the "BBA") into law, effecting sweeping changes to the rules governing audits of entities treated as partnerships for U.S. federal income tax purposes. The new rules can be expected to increase partnership audit rates by making audits and related tax assessments more efficient for the IRS, including by imposing an entity-level tax on the partnership on audit adjustments, absent an election (described below) to shift tax liability to partners. The new rules constitute a stark change from existing law and, pending additional guidance from the Treasury, leave many important questions unanswered.

Current Audit Regimes

Currently there are three different partnership audit regimes.

- Most commonly, the "TEFRA" rules provide unified audit procedures that determine the tax treatment of all "partnership items" at the partnership level, after which the IRS may assess each audited-year partner individually based on such partner's share of any such adjustment. The TEFRA rules also include procedures for notice to and participation by partners.
- A partnership with more than 100 partners can elect application of a simplified set of audit rules (the "electing large partnership" rules) under which partnership-level adjustments generally also flow through to partners, but to those partners who are partners in the year the adjustment takes effect (not, as under the TEFRA rules, in the earlier audited year).
- For certain small partnerships not subject to the foregoing, adjustments to partnership items of income, gain, loss, deduction or credit are determined in separate proceedings for each partner under generally applicable audit procedures.

Repeal and Replacement of TEFRA and Electing Large Partnership Rules

Effective for tax years beginning after December 31, 2017, the BBA repeals both the TEFRA and electing large partnership rules and replaces them with a new partnership audit regime applicable to all partnerships. A narrowly defined category of small partnerships is eligible to elect out of the provisions for a given taxable year, with the result that any adjustments to such a partnership's items can be made only at the partner level. This election may be made only by partnerships with 100 or fewer partners, each of which is an individual, a C corporation, an S corporation[1] or an estate of a deceased partner. Thus, for example, any partnership having another partnership as a partner is not eligible to elect out of the new audit regime.

Partnership-Level Audit Determinations under the BBA

Under the new rules, any adjustment to items of partnership income, gain, loss, deduction or credit, and any partner's distributive share thereof, are determined at the partnership level. Thus, the BBA in general does not make distinctions (of critical importance under the TEFRA rules) among partnership items, non-partnership items and items affected by partnership items.

[1] In addition, for purposes of applying the 100-partner limit, the shareholders of any S corporation partner count as partners of the partnership.

Default Rule: Partnership-Level Tax at Maximum Statutory Rate

The new rules provide partnerships flexibility in determining how (and against whom) audit adjustment-related tax is calculated and ultimately assessed. Notably, specific factual circumstances such as the various partners' tax profiles or changes in partner interests between the audited year and a subsequent adjustment could significantly impact both the total amount of tax collected and the portion that various partners (whether current or former) bear.

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 such audit (or any judicial review) is completed. In addition, the partnership is directly liable for any related penalties and interest, calculated as if the partnership had been originally liable for the tax in the audited year.

These default rules are subject to two primary exceptions:

- **Potential Reduction in Partnership Liability**. A partnership’s imputed underpayment may be reduced to the extent partners voluntarily file amended tax returns and pay any tax due for the audited year, or if the partnership demonstrates that partnership items are allocable to partners either not subject to tax (in the case of a tax-exempt entity) or taxed at reduced corporate or capital gain rates.

  Treasury is delegated with implementing procedures to take into account these and other partner-specific reductions, but the scope of any additional reductions is unknown (including the extent to which a partner’s non-U.S. status will be a permitted basis to apply reduced tax rates, and whether partners filing amended returns must pay any associated interest and penalties). Based on the legislation itself, most partner-specific characteristics (such as the existence of net operating losses) would not reduce the imputed underpayment. Nor does the legislation contemplate how the IRS would adjust partnership items otherwise determined solely with respect to individual partners (such as percentage depletion or partner-specific basis adjustments).

- **Partnership Elects to Shift Liability to Partners**. Alternatively, partnership-level assessment may generally be avoided altogether if the partnership elects to issue adjusted information returns to each of the audited-year partners and the IRS, with such partners taking any adjustment into account on their individual returns in the year in which they receive the adjusted information return. Under this alternative, the audited-year partners (rather than the partnership) are liable for any related penalties and interest, but with deficiency interest calculated at an increased rate and running from the audited year.

Procedural Changes

The BBA also effects significant changes to procedural aspects of partnership audits:

- **“Partnership Representative” granted considerable power**. The “tax matters partner” role under prior law is replaced with an expanded “partnership representative” role. The 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.
- **Partner rights significantly curtailed**. The IRS is no longer required to notify partners of partnership audit proceedings or adjustments, and partners are bound by determinations made at the partnership level. Partners no longer have rights to participate in partnership audits or related judicial proceedings, nor standing to bring a judicial action if the partnership representative does not challenge an assessment.
- **Partnership deposit required**. Partnerships challenging an assessment in a District Court or the Court of Federal Claims are required to deposit the entire amount of the partnership’s imputed liability (in contrast to existing rules that only require a deposit of the petitioning partner’s liability).

- **Single statute of limitations**. The statute of limitations for adjustments will be calculated solely with reference to the date the partnership filed its return.

Practical Implications for Partners and Partnership Sponsors

The BBA's new partnership audit regime applies for partnership taxable years beginning after December 31, 2017, affording partners, partnership sponsors and other interested parties much-needed time to consider the potential impact of the new rules on new and existing partnerships and partnership agreements. The BBA's broad sweep and uncertain scope are expected to cause widespread changes. While it is possible that Treasury will issue clarifying guidance before the new rules are effective, interested parties are likely to take steps before the release of such guidance. These may include:

- Negotiation over which regime the partnership will elect for paying any tax due: partnership-level payment, amended statements to partners, or amended partner returns. Note the choice of election may implicitly involve a choice as to which partners or former partners should bear tax and the amount of tax each such person should bear.
- New contractual agreements regarding the extent to which partners will provide information and take actions that may reduce or eliminate any partnership-level tax liability.
- Adjustment to existing tax audit administration and governance provisions, including contractual agreement to any non-statutory duties of the partnership representative.
- Revision of partnership agreement provisions addressing the sharing among the partners of any partnership-level tax and related items.
- Development of options for reducing and allocating tax liability in multi-tier partnership structures, including the application of adjustments from lowest-tier partnerships to ultimate partners.
- Attention to contractual provisions relating to responsibility for tax obligations in acquisitions of partnership interests and mergers involving partnerships.
- Consideration of non-tax rules; for example, whether FIN 48 tax accruals may now apply at the partnership level.

Please contact a member of Ropes & Gray's tax or tax controversy practice with any questions relating to these major developments.

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