Partnership Audit Regime Shakeup

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The recent Bipartisan Budget Act of 2015 (the "Act") sets forth a new tax audit regime for partnerships (and limited liability companies taxed as partnerships) that will have far-reaching consequences. The new audit procedures will become applicable for partnership tax years beginning on or after January 1, 2018 (though it is possible for partnerships to opt into the new procedures earlier).

The new regime clearly is designed to make it easier for the IRS to audit partnerships and replaces the former partnership audit procedures (known as "TEFRA"). The new procedures allow the IRS to determine any audit adjustment at the partnership level and to assess and collect tax from any such adjustment at the partnership, rather than the partner, level. This is a significant change in partnership tax law as it subjects the partnership itself to potential direct federal income tax liability. In addition, the new procedures will severely limit the ability of partners to participate in and influence audit proceedings with respect to partnerships, unless they have negotiated for those rights in the partnership agreement.

We believe that the new regime will require updating existing partnership agreements and will affect the drafting of new partnership agreements. Currently, however, the appropriate scope of changes to be made to partnership agreements is uncertain, pending additional guidance and regulations from the IRS. While some guidance is expected in the coming months, the regulations may not be issued for some time.

Limited Opt-Out for Certain Partnerships

The Act does allow for certain smaller partnerships with "eligible partners" to opt-out of the new regime on a year-by-year basis. Specifically, partnerships with 100 or fewer eligible partners during a tax year may elect out of the new regime for that year by making an election with the partnership's timely filed tax return for the year. Eligible partners include individuals, C corporations, S corporations, and estates of deceased partners. The IRS also has the ability to add to this list of eligible partners through the still-to-be-issued regulations.

Notably absent from the list of eligible partners are other partnerships, removing the possibility of opting-out for the lower tiers of any tiered partnership. In addition, if an S corporation is a partner, each of its shareholders is counted as a partner in determining whether the partnership has 100 or fewer partners.

Default Rules for Partnership Tax Years Beginning On or After January 1, 2018

In a material change from TEFRA, under the new regime's default rules, partners do not have the right to participate in an IRS audit of partnership tax years beginning on or after January 1, 2018. Instead, a partnership must designate a "partnership representative" to act as the sole representative of the partnership for purposes of an IRS audit.

In addition, any tax liability resulting from a partnership audit will be a partnership tax liability. This is a significant change from the current TEFRA regime, which assesses tax at the partner, rather than the partnership, level.

Under the Act, the tax liability resulting from a partnership audit, referred to as the "imputed underpayment of tax," is determined by netting all adjusted tax items and multiplying this net amount by the highest tax rate in effect for the tax year subject to the audit, referred to as the "reviewed year." The imputed underpayment of tax can be reduced if one or more partners file amended tax returns and pay the corresponding tax. The partnership can also have the imputed underpayment of tax reduced by demonstrating partner specific information - for example, by demonstrating that a certain amount is allocable to tax-exempt partners. While these procedures could be helpful, currently it is not clear what partner-specific information will be required to support a reduction of the partnership's tax liability, which could be further complicated if any partners have exited the partnership since the reviewed year. Much of how these procedures will work in practice still needs to be fleshed out by the IRS through regulations or other guidance.

Alternative Procedure Under the New Regime

To avoid tax liability at the partnership level, a partnership can elect an alternative procedure under the new regime. Such an election is made after the final IRS audit adjustment has been made. If a partnership makes this election, the partnership must furnish to the IRS, and to each of its partners for the reviewed year, a statement likely similar to a K-1, allocating the audit adjustment among the partners. The partner would then be responsible for calculating and paying the resulting tax liability in the year the statements are furnished, taking into account any tax attributes such partner had during the reviewed year. If this alternative procedure is elected, the underpayment interest rate is increased by two percentage points, adding to the cost borne by the partners.

This alternative procedure is similar to TEFRA in the sense that partners now become liable for the tax liability that results from an IRS audit of a partnership. However, a fundamental difference from TEFRA is that the partnership, not the IRS, is responsible for determining the allocation of liability among the partners. This relieves the IRS from having to determine the appropriate allocation of partnership tax items among partners, placing this burden on the partnership itself.

Conclusion

As noted above, much of the implementation of the new audit procedures will depend on future guidance and regulations from the IRS. The Act gives the IRS great flexibility to both interpret and add to the new audit procedures through regulations. We believe the IRS will issue certain limited guidance in the coming months, but is unlikely to issue proposed regulations until much later. We will continue to monitor and evaluate future developments.

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