Hughes Hubbard & Reed

Preparing for the New IRS Partnership Audit Regime

Client Advisories

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September 8, 2017 - As part of the Bipartisan Budget Act of 2015 (the "BBA") enacted in November 2015, the rules governing IRS audits of partnerships (including limited liability companies and other entities treated as partnerships for tax purposes) were radically changed, effective for tax years of partnerships beginning on or after January 1, 2018. Unless a partnership is eligible to “elect out” of the new regime and chooses to do so, the "partnership representative" designated by the partnership has the sole power to represent the partnership in audits and litigation, and its decisions are binding on all partners. Notwithstanding the long-standing principle that partnerships are pass-through entities that are not themselves subject to tax, additional taxes resulting from audits under the BBA rules generally are imposed on the partnership.

Regulations providing detailed rules implementing the BBA audit regime were initially proposed on January 18, 2017. As a result of the change in administration, the proposed regulations were withdrawn, but they were re-proposed in substantially the same form on June 14, 2017. While in an ideal world it would be advisable to wait for final rules, it is not too soon for taxpayers to start planning for the new rules in light of the rapidly approaching effective date. It is especially important for partnerships to consider whether they are eligible to elect out of the application of the new rules and, if they are not eligible, whether they are able to restructure in order to become eligible. In addition, partnership agreements should be reviewed to determine whether they should be amended to add appropriate contractual provisions to govern conduct of audits under the new regime.

CHANGES MADE BY THE BBA

General Rules

The so-called "TEFRA" rules currently govern the conduct of IRS audits of partnerships that have 10 or more partners or that have partners other than individuals, C corporations, and estates of deceased partners. Under the TEFRA rules, audits are conducted at the partnership level, with the partnership represented by a partner that it designates as the "tax matters partner." However, any taxes resulting from adjustments to partnership income, deduction, or credits are imposed at the partner level. Partners (other than certain partners with small interests) generally have the right to receive certain information in the course of the audit and to opt out of settlements reached by the tax matters partner and to contest the adjustments separately.

Under the BBA, a partnership is generally liable to the IRS for an "imputed underpayment" based on audit adjustments using an assumed tax rate equal to the highest marginal rate applicable to individuals or corporations. The BBA audit rules are extremely complex, and their details are beyond the scope of this alert. However, several key points should be noted:

- Items within the scope of the rules include not only items of partnership income, loss, and credit, but items relating to transactions between a partnership and one of its partners (e.g., a partner's gain on a disguised sale).
- The imputed underpayment for which the partnership is liable can substantially exceed the additional tax liability the partners would have had if they had filed their returns correctly.
- Where liability for an imputed underpayment is imposed on the partnership, absent contractual arrangements among the partners, the economic burden of the tax will be borne by the persons who are the partners at the time of the adjustment (the "adjustment year" partners), who may be different from the partners whose tax liability was underreported in the year being audited (the "reviewed year" partners).
- Where items of income, loss or credit are reallocated from one partner to another, the imputed underpayment (with interest) is imposed based on the adjustment to items allocable to the partner whose income is increased (or whose loss or credits are decreased), but the reduction in income (or increased loss or credits) allocable to the other partner is generally only reflected in the partnership's return for the year that the adjustment is finalized.

The statute and proposed regulations do provide some relief, e.g., by permitting the partnership to reduce the imputed underpayment by establishing that some of its partners are tax-exempt, as well as providing an election to "push out" adjustments so that liability is imposed on the reviewed year partners, rather than on the partnership. However, these provisions are in many cases cumbersome to apply and not fully effective in eliminating the financial disadvantages of the BBA audit regime to partners and partnerships. For example, the push-out election does not permit pushing out adjustments that would result in a reduction in a partner's tax liability, and the government has not decided whether it will be available to tiered partnerships.

Election Out of BBA Rules

A partnership can elect to be excluded from the BBA audit rules if the partnership has 100 or fewer partners, each of which is an individual, a C corporation, an S corporation, or the estate of a deceased partner. Where a partner is an S corporation, the partner and each of its shareholders counts toward the 100 partner limit. If a partnership makes a valid election out, audits are conducted and liability is imposed at the partner level.

Under the statute, a partnership is not eligible to make an election out if any of its partners is a partnership, regardless of the total number of taxpayers who are direct or indirect partners. In addition, if any partner owns its interest through a nominee or is a disregarded entity, such as a limited liability company, or a grantor trust with a single owner, the partnership is not eligible to make an election out, even if it could have done so if the owner had held its partnership interest directly.

Although the statute gives the government the authority to expand the types of eligible partners to include partnerships, nominees, disregarded entities, and grantor trusts, the Treasury Department and IRS declined to do so in the proposed regulations. Although the government may change its position in response to comments when the regulations are finalized, this possibility is at best uncertain.

WHAT TO DO NOW

Eligibility for Election Out

Electing out of the BBA audit rules is in most cases likely to be beneficial for partnerships that are eligible to do so. It is therefore important for partnerships to determine their eligibility prior to the effective date of the BBA rules. Partnerships that have no more than 100 direct or indirect partners, some of whom are ineligible, may be able to restructure in order to be eligible to elect out. For example:

- A partner that is a single member limited liability company or other disregarded entity can transfer its partnership interest to its owner if the owner would be an eligible partner.
- A partner that is a disregarded entity or grantor trust owned by an individual can transfer its partnership interest to an S corporation.
- Where a partnership's partners include a partnership, the upper-tier partnership can transfer its interest in the lower-tier partnership to its partners if they would be eligible partners.

Provisions for Inclusion in Partnership Agreements

It is important to include provisions in partnership agreements that address how audits under the BBA will be handled. These provisions should be tailored to the needs of the particular partnership and its partners. The following are examples of provisions that can be addressed:

- Designation of the partnership representative, as well as whether other partners will have a contractual right to approve actions that the partnership representative proposes to take.
- Whether to make an election out of the BBA rules (if the partnership is eligible to do so) or a push-out election.
- Provisions prohibiting partners from transferring their interests to related or unrelated parties that would result in ineligibility to elect out.
- Requirements that partners provide the partnership representative with information about the partners that could reduce any imputed underpayment that might be owed by the partnership.
- Provisions requiring partners to indemnify the partnership for any imputed underpayment attributable to their interests, including imputed underpayments paid by the partnership after a partner is no longer a partner.

It is especially important to consider amendments to existing partnership agreements that do not address the BBA rules (e.g., because they were entered into prior to enactment of the BBA). In addition, although many agreements entered into after the BBA include provisions that address how the partnership will deal with the BBA provisions, it is advisable to review these provisions in light of the proposed regulations and any subsequent developments.

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