# Partnership Audit Reform

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# Background

- The Bipartisan Budget Act of 2015 was signed by the President on November 2, 2015.

- Repealed the existing partnership audit regime under the 1982 Tax Equity and Fiscal Responsibility Act (“TEFRA”).

- Complete reworking of the audit rules for partnerships (including LLCs) and their partners.

- Changes are effective for tax years beginning after December 31, 2017.

# Current Law Under TEFRA

- Partnerships are generally subject to a single administrative proceeding to resolve audit issues at the partnership level.
- Tax liability for "partnership items" determined at partnership level.
- Adjustments determined by the IRS at the partnership level flow through to the individual partners.
- Notification of major developments required for certain partners.
- Individual partners are not necessarily bound by determinations made at the partnership level.

# New Law Overview

- Examination is conducted at the partnership level and includes "all items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year."

- IRS can also examine and adjust allocable share of partners.

- Partnership itself is directly liable for tax due following adjustment.

- Opt-out election for partnerships with 100 or less partners.

# General Rules

- Partnership appoints a “Partnership Representative”—generally should be designated by the partnership agreement.
- Partners are not required to be notified of audit developments.
- Individual partners are bound by determinations made at the partnership level.
- Statute of limitations—no adjustment after 3 years from the later of:
  - The date the partnership tax return was filed; or
  - The date the partnership tax return was due.

# Audit Mechanics

- "Imputed underpayment"—determined by netting all adjustments of income, loss, or deduction and multiplying by the highest tax rate in effect for the audit year.

- Tax is assessed to the partnership in the year the audit (or judicial review) is completed (the "adjustment year")—does not relate back to the year in which the item was reported (the "reviewed year").

- Imputed underpayment may be reduced if:
    - One or more partners files amended returns for the reviewed year and pays associated tax
    - Partnership demonstrates that one or more partners are a tax-exempt entity
    - Partnership demonstrates that a lesser tax rate applies to one or more partners

# Audit Mechanics

- The partnership may alternatively elect to issue “adjusted information returns” (i.e. adjusted Schedule K-1s) to the reviewed year partners.
- Reviewed year partners would then be required to take the adjustments into account in the adjustment year through a simplified amended return process.
- Election would effectively shift the tax liability from the partnership level to the partner level.

# Opt Out Election

- The partnership may opt out of the new audit rules if it has less than 100 partners.
- The partners of an electing partnership will instead be “audited under the general rules applicable to individual taxpayers.”
- Each of the partners must be an individual, C corporation, a foreign entity that would be treated as a C corporation if domestic, an S Corporation, or an estate of a deceased partner.
- Election is made annually on the partnership return.
- The opt out is not currently available for partnerships that have another partnership as a partner.

# Takeaways

- Implementation of partnership level liability departs significantly from established principles of “flow through” entity taxation.
- Assessment of an “imputed underpayment” in the adjustment year instead of the reviewed year leaves open the possibility that new partners may bear the burden of tax attributable to years preceding admission.
- Individual partners will be bound by adjustments made at the partnership level but will not be required to be notified of significant audit developments.
- The partnership has the ability to shift liability to the partner level by issuing timely information returns.

# Key Questions

- Should the partnership opt out if such an election is available?
- If unavailable, can the partnership modify its structure to make an opt out election available?
- Should the partnership be obligated to issue “adjusted information returns” to avoid partnership level tax?
- How and to what extent should individual partners be included in the audit process?
- What effect do partnership level adjustments have on the outside bases of the individual partners?
- Will individual partners be subject to liability in instances where the partnership itself is insolvent?
- What additional issues are left open and what will the associated regulations clarify?

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