The New Partnership Audit Rules—An Executive Summary

Congress recently enacted the Bipartisan Budget Act of 2015 (the "Act"), which includes major changes in the way the IRS will audit entities that are classified as partnerships for federal income tax purposes. The new rules repeal the current regime of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and generally apply to tax years beginning after December 31, 2017. Although certain eligible partnerships may elect out of the regime on an original timely filed return, partnerships that are required to furnish more than 100 Schedule K-1s or that have a partner that is a trust or a partnership (as is common in many organizational structures) are ineligible to make this election. Accordingly, as discussed below, taxpayers need to understand and consider the new rules today.

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Default Regime—Partnership Pays

Under the Act, the IRS can assess an entity-level tax on an imputed underpayment (generally calculated at the higher of the maximum corporate or individual income tax rate) against a partnership in the adjustment year (e.g., the year a notice of the final partnership audit adjustment ("FPAA") is mailed). Therefore, under the new rules, if the audit of a partnership's 2018 return is concluded in 2020 and results in a tax assessment, the economic cost of the tax assessment will be indirectly borne by the partners in 2020, who may differ from the partners in 2018. The payment of any tax, interest, and penalties by the partnership is treated as a non-deductible payment.

The imputed underpayment is determined by netting all adjustments for the year under audit (the "reviewed year"). It is important to note that, in the case of a reallocation of items among partners, the Act provides that only the positive adjustments are taken into account. Thus, future audits could focus both on the determination of taxable income and the manner in which those items were allocated among the partners.

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The imputed underpayment may then be subject to modification—for instance, to eliminate the portion allocable to a partner that is tax-exempt and to adjust for a lesser rate of tax in the case of a corporate partner or in the case of capital gains and qualified dividends in the case of an individual partner.

Observation: Under the default regime, there are currently no rules that address the extent to which the imputed understatement may affect other items, such as a partner's basis in its assets or a partner's basis in its partnership interest. Absent corresponding adjustments, it is possible that the new regime could result in unexpected tax consequences.

Alternate Regime—Partnership Elects to Push Out

Partnerships subject to the Act will have the option to elect, within 45 days of the notice of an FPAA, to pass the underpayment adjustment to the partners of the reviewed year, which will effectively shift the tax burden to those partners. The partners of the reviewed year then must redetermine their tax for the reviewed year, the year the adjustment was furnished (the "statement year"), and all intervening years (making appropriate adjustments to tax attributes) and increase these partners' tax in the statement year.

It is unclear how the alternative regime applies to tiered structures. The Act currently has no mechanism for a partnership (or S corporation) that receives notice of adjustment to correspondingly push that adjustment out to its partners (or shareholders) in the reviewed year, leading to questions regarding if and how adjustments can be pushed through to the partners of the reviewed year.

Goodbye Tax Matters Partner, Hello Partnership Representative

The repeal of TEFRA means that under the new regime there will no longer be a tax matters partner. Rather, the new rules require a partnership to designate a partnership representative that has the sole authority to act on behalf of the partnership. The partnership representative no longer has to be a partner but will have broad authority under the Act and should be selected carefully.

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Summary

The above is intended to be a very high-level summary of the new rules. There are numerous unanswered questions that will hopefully be resolved through technical corrections, regulations, or other guidance in the future. In the meantime, there are a number of issues that are important to taxpayers:

- How will the new rules affect organizational structures? For example, will structures be revised to manage potential exposure to a partnership level tax liability?
- How will the new rules affect partnership agreements? At a minimum, changes will be required to address the repeal of TEFRA and the selection of the partnership representative. However, it is anticipated that the impact could be much greater as partnerships will now need to consider whether they will "pay or push" any potential tax burden. If they chose to pay, consideration will need to be given to how the payment will be borne by the current partners. If they chose to push, it may become more important to be able to reach former partners and to consider mechanisms to determine that obligations are met.
- How will the new rules affect financial statements and disclosures?
- How will the states respond to the new rules?
- Lastly, how might due diligence procedures change with respect to partnership acquisitions? It will become more important to identify any potential issues that could result in an imputed underpayment and to more closely review the partnership agreement to consider whether the partnership can elect out, can make an election to push the obligation out to the former partners, or will be obligated to pay any tax liability with partnership assets.

Impact Today

Although the new rules generally are effective for returns filed after December 31, 2017, the changes should be considered by taxpayers in connection with:

- Drafting or amending partnership documents to properly take into account the potential impact of the rules on allocations, distributions, and responsibilities in connection with a partnership audit assessments;

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- Evaluating financial reporting and risk disclosure obligations;
- Formulating approaches to mitigate potential tax and business risks; and
- Performing tax due diligence when acquiring an interest in a partnership, which should address tax risks specific to partnerships, including the risk of non-compliance with the complex rules regarding partnership allocations. This partnership-specific due diligence is in addition to the traditional tax due diligence.

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