Partnership Audit Rules Are Changing in 2018
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You Should Consider How Best to Amend Current and Draft Future Partnership Agreements

Background

In October 2015, Congress enacted the Bipartisan Budget Act of 2015 (“the Act”), which contains changes to the IRS partnership audit techniques. These changes were in response to a growing concern that the IRS was unable to effectively and efficiently audit partnerships due to various cumbersome rules and procedures, especially as they relate to multi-tiered partnerships. See the full text of the Act at https://www.congress.gov/114/bills/hr1314/BILLS-114hr1314eah.pdf.

In 2012, only 0.8% of “large” partnerships were audited as compared to more than 27% of “large” corporations. The Act drastically changes the audit rules that apply to partnerships from a regime that passed through the partnership adjustments to collect the tax and any applicable penalties and interest from the partners, to a regime that allows for collection directly from the partnership. Projected revenue to be collected over ten years from these new rules exceeds $9 billion.

Current Rules

Prior to the Act, most partnerships with 10 or more partners were audited under the unified audit rules created by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Under the TEFRA audit rules, the IRS conducts a single administrative proceeding at the partnership level to determine any adjustment. If an adjustment has been determined, then the IRS recalculates the tax liability for each individual partner in the partnership attributable to the partner’s share of the overall adjustment and seeks collection from each partner.

Before the adoption of the Act, partnerships with 100 or more partners (“large partnerships”) could elect to be audited under separate, more streamlined rules. This meant, for example, that the IRS determined the necessary adjustment at the partnership level which then flowed through to the partners in the year the adjustment became effective, instead of affecting prior year returns. However, many large partnerships refused to elect such treatment for audit purposes, resulting in very few audits of these partnerships because calculating each individual partner’s tax liability under TEFRA was often complicated and extremely time-consuming. To promote more audits of large partnerships and the easier collection of tax, penalties, and interest, Congress passed the Act.

New Rules

Under the Act, which becomes effective for tax returns filed for tax years beginning after December 31, 2017 (although an election can be made to apply the new rules sooner), all partnership adjustments to income, gain, loss, deductions, and credits continue to be calculated at the partnership level. Most importantly, all tax liability resulting from such adjustments is assessed and collected directly from the partnership. Certain small partnerships, however, may elect out of this new audit regime. Small partnerships generally include those that (1) have fewer than 100 partners, (2) have only individuals, estates, C corporations, or S corporations as partners, and (3) follow certain other procedural requirements. If a qualified election is made, the partnership would be audited under the current TEFRA rules.

The amount of tax partnerships are required to pay is the “imputed underpayment.” The imputed underpayment is defined as the net of all adjustments multiplied by the highest individual or corporate tax rate with 39.6% being the highest individual rate. Partnerships may request that the IRS reduce the imputed underpayment, including under any of the following scenarios:

- All or a portion of the imputed underpayment is allocable to a partner who is a tax-exempt entity (and thus, tax might not be owed).
- All or a portion of the imputed underpayment is ordinary income and would be allocable to a C corporation, or all or a portion of the imputed underpayment is capital gain or dividend income and is allocable to an individual partner.
- One or more of the partners filed an amended return reflecting the amount of the underpayment for the tax year being reviewed.

Under the Act’s default regime, the partnership (rather than the partners) is required to pay the imputed underpayment. This means that the economic burden of the underpaid tax of prior tax years would be borne by the current partners. However, the Act provides that partnerships may choose an alternative mechanism for payment of the imputed underpayment by the partners. If the partnership chooses this alternative upon receiving a notice of final partnership adjustment, the partnership must then provide a statement reflecting the partner’s share of the adjustment to each partner who was a partner during the year reviewed. The partnership must elect the alternative mechanism for payment no later than 45 days after the date of the notice of final partnership adjustment.
In addition to changing who the IRS collects the tax from, another major change from the TEFRA rules is the transition from the old “tax matters partner” role to the new “partnership representative.” Simply put, the partnership representative has significantly more authority to bind the partnership and all of its partners in the audit, resulting in no appeal rights for a partner if the partnership representative agrees to the IRS adjustments at the audit level.

This is only a brief summary of some of the new partnership audit rules contained in the Act. Many issues and questions remain unresolved about how the Act applies under certain scenarios. Recently, the IRS requested guidance from the industry on many issues, so IRS regulations should be forthcoming to flesh out many of the nuances resulting from these new audit rules.

**Next Steps**

Although the Act does not become effective until 2018 (unless an election is made to opt in early), you should consider how these new audit rules affect existing operating agreements and partnership agreements for your company or any company in which you are an investor and how they impact any new operating agreements or partnership agreements you enter into. You should be thinking about the following:

- Whether the operating/partnership agreement should contain a mandatory election out of the Act and back into the TEFRA rules if the partnership is eligible?

- Who should be the “partnership representative” who now has much more authority than the “tax matters partner” under the TEFRA rules? To that end, can the operating/partnership agreement somehow limit the partnership representative’s authority and/or allow some participation by limited partners in the audit process? Should the partnership representative be obligated to notify all of the partners of the audit? How about requiring cooperation among all the partners to reduce the “imputed underpayment” calculation?

- If the partnership pays tax assessed pursuant to an audit (which is the default payment rule), thus, affecting current partners financially, should and how would, the partnership collect from former partners that were partners in the year reviewed but not partners in the year the tax is paid? Should the operating/partnership agreement contain some type of indemnity or reimbursement provision? Should there be some type of special allocation of the expenses and fees resulting from dealing with the audit?

- Who decides and how is it decided whether to elect out of the default payment regime and issue amended Schedule K-1s to the partners in the reviewed year (if they are no longer partners in the year of payment) to pay the tax? Should this election be mandatory and with or without a materiality threshold? Does the partnership have cash flow problems?

If you would like additional details about the Act and how its provisions may affect you, including, for example, whether to amend existing partnership agreements and how best to draft future partnership agreements, please do not hesitate to contact Chris Nuss, Bill Brown, or your BrownWinick attorney.

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