

DuaneMorris

New Partnership Audit Rules

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Table of Contents

- Pre-TEFRA Audit Procedures
- Tax Equity and Fiscal Responsibility Act (“TEFRA”) Audit Procedures
- Bipartisan Budget Act of 2015 (“BBA”)

Pre-TEFRA Audit Procedures

- Before TEFRA, the IRS did not audit partnerships. Instead, any audit adjustment of partnership operations had to be made to an individual partner's tax return pursuant to an audit of the individual partner.
- This led to inconsistent reporting and tax results for partners of the same partnership.

Tax Equity and Fiscal Responsibility Act ("TEFRA")

- In 1982, Congress passed TEFRA.
- Partnership Level Determination
 - TEFRA shifted the audit of partnership items from each individual partner to the partnership level by mandating that the tax treatment of any partnership item must be determined at the partnership level.
- Consistency Requirement
 - TEFRA mandated that each partner's tax treatment of partnership items must be consistent with the treatment of those items at the partnership level.
- Unified Partnership Audits
 - After TEFRA, the audit of certain partnerships were unified proceedings. The IRS was required to issue formal notice of the audit directly to all partners at the start of the audit.
- Tax Matters Partner
 - TEFRA created "Tax Matters Partner" ("TMP"), a partner charged with coordinating the audit and any judicial proceeding for the partnership. Individual partners still had the right to participate in any audit or judicial proceeding and to negotiate his own settlement with the IRS.
- Final Partnership Administrative Adjustment
 - TEFRA audit concluded when the IRS mailed to the TMP a notice of final partnership administrative adjustment. Individual partners could challenge the IRS' administrative adjustment if the TMP failed to do so.
- Statute of Limitations
 - IRS had 1 year after the administrative adjustment to collect tax from individual partners.

TEFRA (continued)

- Small Partnership Exception to TEFRA
 - “Small partnerships” Excluded from TEFRA audit procedures
 - Small Partnerships Defined:
 - The partnership must have 10 or fewer partners at all times during the tax year.
 - Married couples filing jointly and their estates are treated as a single partner.
 - All partners in the partnership must be U.S. persons, resident aliens, C corporations, or estates of deceased partners.
 - Subject to TEFRA if any partner is:
 - » Another partnership
 - » An S corporation
 - » A multi-member LLC treated as a partnership
 - » A single-member LLC treated as a disregarded entity
 - » A Trust, including a grantor trust
 - » A nominee
 - » A non-resident alien

TEFRA (continued)

- TEFRA Shortcomings
 - Too much complexity over statute of limitations issues and over whether a particular item was a partnership item
 - Tax Matters Partner:
 - there was no remedy for an individual partner if the TMP failed to notify other partners of IRS audit
 - Difficulty in identifying the TMP caused difficulties in administering IRS audits
 - Too Labor Intensive for IRS

Bipartisan Budget Act of 2015 (“BBA”)

- Overview
 - Enacted on November 2, 2015
 - New rules located in Sections 6221 through 6241 of the Code
 - 3 Regimes in the BBA
 - Default Regime (Partnership liable directly for tax)
 - Small Partnership Opt Out Regime
 - Alternative Regime (Partner liable directly for tax)
 - Effective for all partnership audits for all tax years commencing January 1, 2018.

BBA - Default Regime

- Partnership Level Assessment – Section 6221(a)
 - Any adjustment to items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level pursuant to this subchapter.

BBA - Default Regime (continued)

- Consistency Requirement – Section 622(a)
 - A partner shall, on the partner's return, treat each item of income, gain, loss, deduction or credit attributable to a partnership in a manner which is consistent with the treatment of such income, gain, loss, deduction or credit on the partnership return.
 - A partner can avoid consistency requirement by filing a statement identifying the inconsistency.

BBA - Default Regime (continued)

- Partnership Representative – Section 6223
 - The partnership shall designate a “partnership representative” who has the sole authority to act on behalf of the partnership in an audit.
 - The partnership and all partners are bound by the actions taken by the partnership representative and any final decision with respect to the partnership
 - The partnership representative must be a partner (or other person) with a substantial presence in the US.
 - If the IRS fails to designate a partnership representative, the IRS can select any person.

BBA - Default Regime (continued)

- Imputed Underpayments – Section 6225
 - **The partnership must pay the amount of any imputed underpayment.**
 - The imputed underpayment is the net adjustment of income, gain, loss or deduction multiplied by the highest tax rate in effect for the reviewed year.
 - The imputed underpayment is assessed in the adjustment year not the year under review.

BBA - Small Partnership Opt Out Regime

- Small Partnership Opt Out Regime – Section 6221(b)
 - The partnership can elect to opt out of the Default Regime for any tax year that it issues 100 or fewer K-1s in the taxable year.
 - Opt Out only applies if:
 - Every partner is an individual, a C-corporation, a foreign entity that would be treated as a C-corporation if it were domestic, an S-corporation, or an estate of a deceased partner. Certain look-through rules apply for S-corporations.
 - The opt out election must be filed annually with the partnership's tax return.

BBA - Alternative Regime

- Election to Pass the Imputed Underpayment on to the Partners – Section 6226
 - The partnership can elect out of the default regime with respect to any underpayment if, within 45 days of receiving the final audit adjustment notice, the partnership elects the alternative regime and furnishes to each partner for the reviewed year with a statement of such partner's share of any adjustment.

BBA - Alternative Regime (continued)

- **The election allows the partnership to push the burden of an imputed underpayment to reviewed year partners and have such partners report additional tax on their current year return.**
 - Avoids entity level tax and shifts liability between current and former partners.
 - Shifting of burden comes at the cost of 2% higher rate than if the partnership paid the imputed underpayment directly.

BBA - Alternative Regime (continued)

- **Mechanics of Reporting Adjustment – Section 6226**
 - Tax liability for the year in which the partner receives a statement of the partner's share of any adjustment is determined as follows:
 - Calculate the hypothetical increase in tax liability for the partner's reviewed year that would occur if the partner's share of adjustments were taken into account in the reviewed year
 - Determine the effect of such hypothetical increase on all tax attributes
 - Calculate the hypothetical increase in tax liability for years between the reviewed year and adjustment year due to changes in tax attributes
 - The sum of such increase is a liability for the year in which the statement is furnished.

Further information

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