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# Enhanced Partnership Tax Audit Rules: New Challenges that Require Consideration

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In the past, IRS efforts to audit partnerships have been thwarted by the need to chase every partner on audit or for collection of taxes due. The result has been IRS inaction in many situations. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101, 129 Stat. 584 (Nov. 2, 2015), enacted by Congress late last year ("Budget Act"), changes that situation by totally revamping how partnership tax audits will be conducted. These changes start with taxable years beginning on or after January 1, 2018, unless a partnership makes an election to apply these new rules earlier. The most dramatic change is that the IRS will be able to collect any unpaid tax directly from the partnership rather than having to pursue each partner.

These tax changes are important because real estate is commonly owned by a limited partnership or an LLC that is treated like a partnership for tax purposes. Partnerships are not taxable entities; their taxable income and loss flow through to their partners, who then report their share of the income or loss on their own tax returns and pay any resulting tax liability. Reduction of taxes flowing from partnership activity is of great importance. Planning to minimize taxes permeates nearly every real estate partnership, but such planning may be in gray areas in which the IRS and the partnership may disagree. One situation that routinely occurs is the decision on how much of the purchase price of a building is allocable to the land, the building itself, and its personal property components. This fact-dependent decision affects the depreciation deductions that can be claimed by the partnership and the tax liability of all partners, a determination with which the IRS may disagree.

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More than three decades ago, Congress last tried to help the IRS deal with partnership audits by enactment of the Tax Equity and Financial Responsibly Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (Sept. 3, 1982) (TEFRA), which permits the IRS to conduct a unified partnership audit. Pre-Budget Act IRC §§ 6221–6234. Despite those efforts, the IRS must still assess any resulting tax deficiency against each partner, which becomes increasingly difficult with greater numbers of partners. In the Budget Act, Congress updated the partnership audit rules for all partnerships to allow for both a unified partnership audit for any partnership and collection of any resulting tax deficiency from the partnership itself. Although the new law will take effect for partnership taxable years starting on or after January 1, 2018, planning should start now to determine the full effect of the new law and what steps must be taken to reduce any potential adverse effects. This planning should include a review and update of existing partnership and LLC agreements.

**The TEFRA Rules**

Until 1982, the IRS had to audit both the partnership and each partner to assess a tax deficiency against each partner. The resulting administrative burden made partnerships far more likely to escape audits compared to corporations or individuals.

TEFRA responded to these concerns by dividing the world of partnerships into three categories: small partnerships, "electing large partnerships" (ELPs), and all other partnerships. All partnerships other than small partnerships or ELPs are subject to the general TEFRA audit rules. Under these rules, the IRS can pursue the audit at the partnership level. The tax treatment of any partnership item of income, gain, loss, deduction, or credit is determined at the partnership level, and all partners are required to report their shares of partnership items consistently with the partnership tax return, which is filed on Form 1065. Pre-Budget Act IRC §§ 6221, 6222(a). Any adjustment made at the partnership level by the IRS is binding on all partners, but the IRS needs to pursue collection from each partner.

IRS collection efforts under TEFRA must take into account each partner's overall tax situation so that a partnership adjustment that increases taxable income allocable to a partner can be offset by tax losses of that partner resulting in no tax due. The need for the IRS to pursue each partner for collection of the tax due is very burdensome and has meant that some potential audits do not proceed or are cut short early; as a result, tax that may be owed is not collected. The Budget Act actually treated the new partnership audit rules as a revenue

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raiser because Congress felt that the IRS has not been able to collect all the tax due under the TEFRA rules.

Small partnerships (those with 10 or fewer partners that meet certain other criteria) are exempt from the unified TEFRA partnership audit rules unless the partnership made an election to be covered by these rules. Pre-Budget Act IRC § 6231(a)(1)(B); Treas. Reg. § 301.6231(a)(1)-1(b). In this case, the IRS still needs to pursue each partner separately. The Budget Act enlarged the scope of small partnerships that are exempt from its new rules, so more entities may be able to opt out of a partnership level audit.

A partnership with 100 or more partners can elect to become an ELP. Pre-Budget Act IRC § 775. ELPs are subject to special audit procedures, which are different from the general TEFRA rules. Pre-Budget Act IRC §§ 6240–6255. For an ELP, any partnership audit adjustment made for an earlier taxable year does not require each partner to adjust its taxable income for that prior year. Rather, the partnership can take that adjustment into account in reporting each partner's share of taxable income for the year in which the adjustment is made. Pre-Budget Act IRC § 6242(a)(1). For example, if the 2013 partnership taxable year is under audit and an IRS adjustment is made in 2016 that results in $1,000 of added taxable income for each partner, the partnership can report that $1,000 taxable income as added income allocable to each of the partners for 2016; this procedure eliminates the need for the IRS to pursue collection for old tax years from each partner. An ELP is liable for the unpaid tax if it elects to not include such income in the current year or under certain other situations. Pre-Budget Act IRC § 6242(a)(2).

**Effective Date of New Rules and Election to Be Covered Earlier**

Effective for taxable years that start on or after January 1, 2018, the Budget Act repeals the TEFRA unified partnership audit rules as well as the ELP rules and replaces them with a new unified partnership audit regime applicable to all partnerships with some ability to elect out. Budget Act §§ 1101(a), (b), (c). The existing TEFRA rules, however, are still relevant because they will continue to apply to all partnership taxable years beginning prior to January 1, 2018. IRC § 6241(g). Budget Act § 1101(g).

A partnership can make an election to apply the Budget Act rules to its taxable year beginning after November 2, 2015, and before January 1, 2018. Id. But, until the IRS issues detailed guidance for these new rules, a partnership should be reluctant to make such an election because the partners cannot fully assess the effect of this election. More importantly, as discussed below, the new rules

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take certain liberties in computing the tax due, which may exceed the actual tax owed by all partners, so the new law may be more costly than present law. Lastly, if a partner from a year under audit is no longer a partner at the time of the tax audit, then the new rules shift that former partner's tax burden for the year under audit to the present partners because the new law imposes the liability to pay that tax on the partnership (subject to some important modifications, also discussed below). As a result, the election to opt into the new rules may not be advisable for many partnerships, especially those that have undergone an ownership change.

**New Partnership Audit Rules and the Taxpayer Representative**

The new streamlined partnership audit rules create a single set of audit rules for all partnerships, enabling certain partnerships with 100 or fewer partners to elect out. In a major departure from the TEFRA rules, any adjustments would be taken into account by the partnership (and not each partner), and the partnership would then pay any tax that is then due in the adjustment year, which is the year the audit is completed or, if later, the expiration of any judicial review. IRC §§ 6221(a), 6225(a)(1), (d)(2).

The partnership will have sole control over the examination and assessment process, which is to be handled by a newly-created person called the partnership representative. Under TEFRA, a tax matters partner (TMP) represented the partnership before the IRS. Pre-Budget Act IRC § 6231(a)(7). Under the Budget Act, the TMP is replaced by the partnership representative, who has much more power than the TMP and is the sole person representing the partnership before the IRS. The partners have no statutory rights to participate in the audit process or even get notice of the audit. IRC § 6223(a). Partners desiring to get notice of or be involved in an audit need to have the partnership agreement or other governing document mandate such involvement because the Code offers them no assistance.

The Budget Act allows any person to be appointed the taxpayer representative even if he is not a partner. This is a beneficial change compared to the TEFRA rules, which required the general partner or the managing member of an LLC that is treated as a partnership to serve as the TMP. Treas. Reg. §§ 301.6231(a)(7)-1(b)(1), -2 (in effect before any changes made by the Budget Act). Under the Budget Act, the only requirement is that the partnership representative must have a "substantial presence in the United States." IRC § 6223(a). This substantial presence requirement is not yet defined in the Code or any regulations. If the partnership fails to designate a partnership representative, then the IRS has the power to designate someone. As a result,

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partnerships need to update their partnership agreements to designate who will serve as the partnership representative.

The new law also allows a partnership to initiate an adjustment for a reviewed year with the adjustment taken into account in the adjustment year. IRC § 6227. This election also needs IRS guidance.

**Collection of Tax Due— Three Choices**

After the IRS concludes the audit, the IRS will issue a final partnership adjustment (FPA) that reports the required adjustments (for example, added taxable income or loss of tax deductions). The new law then provides three different methods for how taxes owed as a result of the adjustments will be determined and collected.

The first payment method is a basic default rule that provides that the partnership, and not the partners, pays the tax in the adjustment year. IRC § 6225(a). As a general matter, the IRS will determine the tax due, first by netting all adjustments made in the audit and, next, by determining the imputed underpayment of tax on the resulting net income by multiplying the net income by the highest tax rate in effect for any type of partner (that is, corporate or individual) for the reviewed year. IRC § 6225(b)(1). If the audit served to reallocate an item among the partners (for example, a loss allocated to one partner is reallocated to another partner), these rules take a harsh approach by providing that the imputed underpayment should disregard decreases in income or gain and increases in deductions, losses, or credits. IRC § 6225(b)(2).

In practice, this imputed underpayment will be different from the total tax due if tax liability was determined at the partner level because the imputed underpayment assumes a maximum rate of tax and ignores the specific tax status of each partner. This difference may be material and may work to the detriment of the partners. To remedy this situation, within 270 days of the issuance of the FPA, the partnership should file a request with the IRS to lower the imputed underpayment by showing that a lower tax rate applies to certain partners (for example, individuals get favorable treatment for long-term capital gains). IRC §§ 6225(c)(4), (7). If applicable, the partnership may also request lowering the imputed underpayment by showing that a partner may not owe any tax because of its status as a tax-exempt entity. IRC § 6225(c)(3). The IRS is given the power to issue regulations to add other factors that can be taken into account in determining its imputed underpayment, but no final regulations have yet been issued. IRC § 6225(c)(6). Despite these adjustments, it is still

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likely that the imputed underpayment will overstate the tax that would have been due if the tax burden were determined at the level of each partner.

The second payment method allows the partnership to push out the tax liability arising from the FPA to the reviewed year partners (that is, the partners actually affected by the earlier tax return filed by the partnership, and not the current partners). IRC § 6226(b). This option must be chosen by the partnership within 45 days after issuance of the FPA. In this case, the partnership will issue adjusted information returns on Form K-1s to those reviewed year partners, but the K-1 will be issued for the year in which the "adjustment" is made. That K-1 is then subject to a simplified amended return process rather than a more cumbersome process that would apply if an amended K-1 were issued for the earlier year. Although the adjusted K-1 may be for the current year, interest and penalties are due as if the tax were owed from the prior year. IRC § 6226(c). Such partner then must pay interest on the tax owed at a higher interest rate, which is 5% above the IRS-published short-term applicable federal rate (AFR), rather than the normal 3% above such AFR amount. IRC § 6226(c)(2). The IRS needs to issue guidance on this election.

The third payment method modifies the basic default rule if (1) any partner from the reviewed year chooses within 270 days after issuance of the FPA to file an amended income tax return for the reviewed year that takes into account the partner's allocable share of the partnership adjustments and (2) that partner pays the additional tax due. If this method is chosen, the imputed tax underpayment owed by the partnership is reduced to take into account that partner's share of that income. IRC §§ 6225(c)(2), (7). If every partner for the reviewed year files an amended return and pays the additional tax, the partnership will have no liability for unpaid tax.

If the partnership does not agree with the FPA, then the partnership representative can contest the FPA in court. The petition must be filed by the partnership representative within 90 days of the FPA. Although TEFRA allowed the TMP an additional 60-day period to file, no such extension exists under the Budget Act.

**Election Out of New Rules for Partnerships with 100 or Fewer Partners**

The Budget Act allows certain partnerships with 100 or fewer partners to elect out of the new rules. IRC § 6221(b). By contrast, the exemption to the TEFRA rules discussed above was narrower in scope; TEFRA did not apply to partnerships with 10 or fewer partners, and, then, only if all the partners were natural persons or estates and if each partner's share of any partnership item of

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income, gain, loss, and deductions was identical to its share of every other item. Pre-Budget Act IRC § 6231(a)(1)(B). The Budget Act's expansion of the 10-partner threshold to 100 partners and the relaxation of who can be an eligible partner results in this election being available to many more partnerships than allowed under TEFRA.

If a partnership elects out of the new audit rules, then the partnership is subject to the pre-TEFRA rules and avoids the partnership level audit rules of both the Budget Act and TEFRA. In the case of an electing-out partnership, IRS audit adjustments must be made at the level of each partner, and an audit adjustment made for one partner is not binding on any other partner. As a result, an election out will increase the burden on the IRS substantially and may discourage audits of these partnerships. The bottom line is that an election out may be more beneficial to the partnership and its partners.

The ability to elect out is available only if each of the partners is (1) an individual, (2) a C corporation (that is, a U.S. corporation subject to corporate level tax), (3) an S corporation (that is, a U.S. corporation meeting certain requirements that can result in the corporation generally not being subject to corporate tax, in which case its shareholders currently pay tax on their share of the S corporation's income), (4) the estate of a deceased partner, or (5) a foreign entity that would be a C corporation if it were a U.S. corporation. IRC § 6221(b)(1)(C). The reference to individuals is not limited to U.S. citizens or resident alien individuals; however, if a non-U.S. individual is a partner, then partnership withholding on effectively connected income or income from the sale of U.S. real estate would still apply; as a result, the partnership may be liable for any unpaid tax allocable to any foreign partner. IRC §§ 1445, 1446. If a partner is an S corporation, then each of its shareholders is counted for purposes of applying the 100-partner limitation. IRC § 6221(b)(2)(A). If a partner is itself a partnership, then that partner is not an eligible partner unless the Treasury exercises its regulatory power to allow that situation (such as for a tiered partnership discussed below); the Treasury has not yet exercised that power. IRC § 6221(b)(2)(C). Unlike TEFRA, there is no requirement that the partnership have simple allocation provisions that are identical for every item.

An important procedural requirement is that the election must be made on the partnership's timely filed Form 1065. The election out cannot be delayed until an audit starts. IRC § 6221(b)(1)(D)(i).

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### Buyer-Beware Concerns for New Partners

As discussed above, the new rules will impose tax liability on the partnership unless actions are taken to shift that burden. If the current partners are the same as those that were partners in the earlier (audited) year and there has been no admission of new partners or change in the partnership agreement since the audited year, then the tax burden resulting from the audit will generally fall on the partners whose income is being adjusted in the audit, regardless of when payment may be due.

Consider, however, what happens if (1) a person ("New Partner") buys a partnership interest from an existing partner or from the partnership, (2) there is an audit for a year prior to the admission of the New Partner, and (3) the audit is concluded and the partnership currently pays the tax due. The new rules generally require the partnership to currently pay the tax liability, which will decrease current partnership cash flow or assets that belong to the New Partner and the other current partners. As a result, the New Partner is indirectly paying other people's tax liabilities because these tax liabilities relate back to either the person the New Partner purchased the partnership interest from or the other partners who were partners during the year under audit. A New Partner needs to assess the potential tax exposure for prior years, and any New Partner may desire to seek indemnification for any past due tax from either the person who sold him the partnership interest or the partnership itself if he bought the partnership interest from the partnership.

### Tiered Partnerships

A tiered partnership is a structure in which one or more partners in a partnership (the "upper-tier partnership") are partners in another partnership (the "lower-tier partnership"). Although a tiered partnership may evoke images of complex partnership structures, many partnerships whose business operations are not complex can have some partners who are partnerships and thus are tiered partnerships. A tiered partnership involved in a partnership audit can greatly complicate the audit process and has frustrated the IRS's ability to audit these tiered partnerships.

The Budget Act shifts many of the complexities in dealing with these tiered partnership audits from the IRS to the affected partnership, which must pay the tax owed once an audit is complete. Even if a lower-tier partnership has fewer than 100 partners, the election-out option discussed earlier is not an option for a lower-tier partnership because a partnership is not an eligible partner unless the Treasury exercises its regulatory power to allow that to occur, as discussed

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above. IRC § 6221(b). IRS guidance is needed to assist in determining the mechanics of the audit process.

## Partnerships That Cease to Exist or Have Insufficient Assets

The theory behind the Budget Act is that the partnership is an easy party for the IRS to pursue for collection so that tax revenues can be collected more quickly. Sometimes, however, life complicates matters. But what happens if a partnership no longer exists? The Budget Act answers that question by stating that if a partnership should cease to exist before a final partnership audit adjustment is made, then such adjustments shall be taken into account by the "former partners" of the partnership. IRC § 6241(7). The IRS should provide guidance in identifying the former partners and how this adjustment will be applied.

What happens if the partnership still exists but has insufficient assets to pay the tax due? Under IRC § 708(b)(1)(A), a partnership will terminate when no part of any business, financial operations, or venture continues to be conducted by the partners in the partnership. In that case, the IRS should be able to pursue the partners for payment. If the partnership is still in business, but has insufficient assets to pay the IRS in full, then no specific authority addresses how the IRS will proceed. Again, further guidance is needed.

## Conclusion

The newly-enacted partnership audit rules create a major change in tax audits by exposing the partnership to liability for any tax deficiency. Despite the delay in implementation of these new rules, partnerships and partners should start now to analyze the full effect of this new law and determine the need to amend partnership agreements to reflect these changes.

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