New Partnership Examination Procedures Designed to Simplify Will Cause Complications and Additional IRS Scrutiny of Large Partnerships

By Steven Toscher and Jonathan Kalinski

Steven Toscher and Jonathan Kalinski examine the new partnership examination procedures.

In a time when tax reform seems to be much talked about but out of reach, the federal budget process has given us a major reform of the rules governing the IRS partnership examinations. As part of the Bipartisan Budget Act of 2015 (BBA),[1] Congress passed and President Obama signed legislation that causes a seismic shift in the way that partnerships are audited and taxes collected. Perhaps the most dramatic change is that partnerships, historically flow-through entities not liable for the income taxes on partnership income, can now be liable for the income taxes arising out of adjustments to partnership income asserted by the IRS.

The Tax Equity and Fiscal Responsibility Act (TEFRA) rules and Electing Large Partnership (ELP) rules[2] are repealed and in their place are a new set of rules designed to simplify audits of partnerships, particularly large partnerships.

Prior to TEFRA's passage in 1982, all partners needed to be audited. With the rise of partnerships and tax shelters using partnerships as the shelter vehicle, the TEFRA rules allowed the IRS to audit the partnership and determine income, loss, *etc.,* at the partnership level in one administrative proceeding. The ultimate adjustments, however, still needed to be made at the partner level, requiring substantial resources for the IRS to apply the partnership adjustments, determine the amount of tax due from a partner and assess and collect the tax.

In 1997, Congress passed the ELP rules, which were designed to streamline the procedures for partnerships with 100 or more partners. Partnerships

STEVEN TOSCHER is a Principal at Hochman, Salkin, Rettig, Toscher and Perez, where the specialize in civil and criminal tax controversy.

JONATHAN KALINSKI is an Associate at Hochman, Salkin, Rettig, Toscher and Perez, where the specialize in civil and criminal tax controversy.

needed to elect into this regime, and few partnerships made this election.

Reasons for Change

Many of us who represent partnerships in examinations and litigation before the IRS recognize and have had to deal with the complexity of the TEFRA rules that have been with us for over 30 years. But that was not the driving force behind this legislation. Rather, it seems, the new procedural rules are a reaction to the IRS's inability to effectively examine larger partnerships and the Congressional Budget Office's estimate that the change in partnership examination procedures will increase revenue collections by more than $11 billion over the next 10 years.[3]

Perhaps the most dramatic change is that partnerships, historically flow-through entities not liable for the income taxes on partnership income, can now be liable for the income taxes arising out of adjustments to partnership income asserted by the IRS.

In 2014, the Government Accountability Office (GAO) released a report highlighting the growth of large partnerships and its extremely low audit rate.[4] From 2002 to 2011, the number of large partnerships tripled.[5] The growth was attributed in part to the fact that many large partnerships are hedge funds and other investment funds where the investors are considered partners.[6] In 2011, there were more than 10,000 large partnerships, with a majority having more than 1,000 direct and indirect partners and six or more tiers.[7] Hundreds of partnerships had over 100,000 direct and indirect partners.[8]

Needless to say, this created an administrative nightmare for the IRS. Even following a partnership examination where adjustments are asserted by the IRS, the actual determination and collection of additional tax liabilities would take thousands of hours of man power from an agency already suffering from limited resources. The IRS audited only 0.8 percent of large partnerships in fiscal year 2012 compared to 27.1 percent of large corporations.[9] Moreover, the large-partnership audits that the IRS conducted resulted in relatively small adjustments. Approximately two-thirds resulted in a no change with the remaining one-third having an average adjustment to net income of $1.9 million.[10] The GAO cited the TEFRA rules and the complexity of tiered partnerships as a main reason for the low audit rate.

There is no question that the TEFRA rules presented significant administrative hurdles to the IRS in applying the results of the partnership examinations to the individual partners, but that really does not explain the low examination rates or the paltry results of the audits that were undertaken. One has to wonder whether the problem lies in the complexity of substantive partnership taxation law rather than the procedural mechanism of collecting additional taxes. If the substantive tax adjustments are not present or the IRS agents are unable to find them, providing a simplified method of applying those adjustments if and when found is not likely to add much to the federal coffers.

Partnership-Level Tax

The new rules dramatically change the current system. The assessment and payment of additional income taxes determined in an examination will now be made at the partnership level. The new rules are effective for partnership returns filed for tax years beginning after December 31, 2017, so the first year they will be applicable will be 2018. Significantly, and addressed below, the new rules provide an opt-out provision and ways for the partnership to avoid liability for the additional taxes instead pushing these liabilities to the partners.

The IRS examination begins with the IRS notifying the partnership and the "Partnership Representative" of the audit.[11] The rules eliminate the Tax Matters Partner (TMP) and notice partners in favor of the Partnership Representative.[12] Because the IRS believed that identifying the TMP was time consuming in many cases, the new rules require partners to designate a representative that may or may not be a partner. Many large partnerships are hedge funds and other private investment funds and allowing a nonpartner to function as the representative allows fund managers to coordinate the audit. This is consistent with what occurs in and formalizes present practice.

Under TEFRA, for partnerships with 100 or fewer partners, all partners identified on the return were "notice partners,"[13] and had certain rights to participate in the examination proceedings. For partnerships with greater than 100 partners, those with an interest of less than one percent of the profits were not notice partners. Unlike in TEFRA proceedings, under the new regime, partners have no right to participate in the audit and have no mechanism for judicial review. For example, TEFRA allowed notice partners to file Tax Court petitions if the TMP did not file one.[14] This places an even greater role on the representative than the TMP previously had. Partners are at the mercy of the Partnership Representative with no rights before the IRS or the Court in resolving the tax dispute if the Partnership Representative does not act in the manner desired by the partner(s). Disputes will need to be dealt with in the context of state law rights under the partnership agreement.

Additionally, partner returns must be consistent with the partnership return.[15] Any underpayment resulting from a difference will be treated as a math error and can be assessed outside of regular deficiency procedures.[16] A partner can take an inconsistent position and avoid the automatic assessment if it notifies the IRS.[17]

The Income Tax Burden on the Partnership

Shifting the burden of paying the tax to the partnership creates a number of potential problems. First and foremost, partners of the partnership at the time the additional tax liability is determined bear the additional liability rather than the partners of the tax year that the additional liability was determined. If partners have changed during this period of time—a real likelihood—there can be a significant economic cost that will now have to be addressed in the partnership agreement.

Recognizing the payment of the tax at the partnership level may cause a number of issues and the new law provides a mechanism to "push down" or shift the liability back to the partners. Under new Code Sec. 6226, the partnership can elect within 45 days of the Notice of Final Partnership Adjustment (NFPA) to issue amended K-1s to the partners for the examination or "reviewed year."[18, 19] With the election, partners become liable for the tax, penalties and interest attributable to the adjustment.

It is important to note that with the election, interest is calculated at a higher rate adding a cost and an inducement not to push the liability down to the partners.[20] Once the election is made, it can only be revoked with the Secretary's permission.[21] The election provisions contemplate regulations that will provide further details.

For example, assume the total adjustments asserted in the NFPA increased income to the partners by $1 million. This could create a tax at the partnership level of approximately $390,000 (assuming a maximum rate of 39 percent), which would have to be paid by the partnership unless the election was made and amended K-1s issued to those persons who were partners in the year of examination.

The effect of these amended K-1s will be to allow the IRS to assess the additional liabilities against the partners. The partners will have no ability to contest the additional liability.

This push-down procedure appears limited to those circumstances where the IRS and the partnership are in agreement with the adjustments since the push-down election must be made within 45 days of the issuance of the NFPA. If the partnership wanted to contest the NFPA in court, this procedure does not appear to be available absent some provision in the regulations or a technical amendment to the statute. This could have the effect of severely limiting the utility of the election.

Another manner to shift the tax away from the partnership is if within 270 days of the mailing of the Proposed Notice of Partnership Adjustments, one or more partners file amended returns taking into account *all* adjustments and pay the tax with the return.[22] Under this scenario, the imputed underpayment is determined without regard to the portion of the adjustments taken into account on the amended returns.[23] Again, as with the push-down election, the ability to shift the tax liability away from partnership and back to the partners is limited to those circumstances where the adjustments are not going to be contested.

Computing the Entity-Level Tax

Because a partnership is generally not a tax-paying entity but will be serving as a proxy for the tax due by the individual partners, the legislation had to come up with a new tax creature—the so-called "imputed underpayment." The "imputed underpayment" is determined by netting the adjustments and multiplying the amount by the *highest rate* in effect for the reviewed year.[24] Again the new rules allow for regulations to adjust the applicable highest rates. If the partnership demonstrates that a portion of the imputed underpayment is allocable to a C-corporation partner, the highest C-corporation rate applies.[25] Also, if a portion is attributed to individual capital gains or qualified dividends, those highest rates apply.[26] S corporations are treated as individuals for this purpose.

The new provisions contain detailed rules for providing information and determining the imputed underpayment.

Opt-Out Provisions for Certain Partnerships with Less Than 100 Partners

The new rules target all partnerships, but it remains to be seen how many will actually be affected. Partnerships with fewer than 100 partners whose partners are individuals, C corporations, foreign entities that that would be treated as a C corporation if domestic, S corporations[27] or estates of deceased partners can opt out of the new rules by making an election with a timely filed return.[28] Partnerships that have other partnerships or trusts as partners are not eligible for the opt-out provisions.

The election *must be made each year* so the partnership might decide to elect one year, but not others. If the election is made, partnership examinations will be governed by the pre-TEFRA rules—that is individual-level examinations—with all applicable differences including the controlling statues of limitations.

It is likely that with the new rules and the scrutiny Congress has paid to the IRS's lack of examination activity of large partnerships, we will see a significant increase in large-partnership examinations.

Procedures

The new rules are similar to the TEFRA rules we have been dealing with for the last 30 years. The IRS must mail Notices of the Beginning the Audit, Notice of Proposed Adjustments and NFPA to the partnership and the partnership representative.[29] Any NFPA must not be mailed earlier than 270 days after the date that the notice of proposed adjustment is mailed.[30]

Imputed underpayments will be assessed and collected, under regular deficiency procedures, except in the case of an administrative adjustment request, which requires payment at the time the request is filed.

The partnership can petition the Tax Court within 90 days from the mailing of the NFPA.[31] Partnerships can also challenge the adjustments in District Court or Claims Court by depositing the amount of the imputed underpayment.[32]

Statute of Limitations

The normal three-year statutory period of limitations on additional assessments applies to the additional taxes determined under the new rules, with some exceptions. If there is any modification of the imputed underpayment under Code Sec. 6225(e), the period of limitations expires 270 days after the date that everything required to be submitted to the IRS is submitted.[33] If a NFPA was rescinded by consent, the period of limitations expires 270 days after the date of the notice.[34] The statutory exceptions for fraud and substantial omission of income also apply.[35]

More IRS Examinations Are Anticipated but Many Questions Remain

One can debate the merits and need for the new rules, but they will now be with us—beginning in 2018.[36] It is likely that with the new rules and the scrutiny Congress has paid to the IRS's lack of examination activity of large partnerships, we will see a significant increase in large-partnership examinations.

It is the shifting of the tax obligation to the partnership level that is the most significant change and presents the largest challenge to large partnerships. For those partnerships that can, opting out of the new procedures—requiring the IRS to follow pre-TEFRA individual deficiency procedures—may be the safest course of action until we get some experience with the new statute. For those partnerships that will not be able to opt out of the new provisions, the questions presented by this shift are just now beginning to be asked and will be required to be addressed. What changes in the partnership agreements will be required? How do you deal with changes in partners? How does a partnership deal with uncertain tax positions and reserves for tax liabilities—which up to now has not been an entity-level issue. Unfortunately, the new provisions seem to present more issues and complexity and less simplification and solutions, but stay tuned.

ENDNOTES

1 Bipartisan Budget Act of 2015 (P.L. 114-74).
2 These rules are currently Code Secs. 771 through 777.
3 Estimate of Budgetary Effects of the Bipartisan Budget Act of 2015 (Oct. 27, 2015).
4 "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency," GAO-14-732 (Sept. 2014).
5 Large partnerships are defined as having 100 or more direct or indirect partners and $100 million or more in assets.
6 GAO-14-732.
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.*
11 New Code Sec. 6231(a)(1).
12 New Code Sec. 6223(a).
13 Notice partners also include partners with an aggregate five-percent interest who request notice and designate a partner to receive notice and indirect partners whom the IRS has their name, address and profit interest.
14 Code Sec. 6226(a)(1), (b)(1).

[15] New Code Sec. 6222(a).
[16] New Code Sec. 6222(b).
[17] New Code Sec. 6222(c).
[18] New Code Sec. 6226(a).
[19] Under new Code Sec. 6225(d)(1), reviewed year is defined as "the partnership taxable year to which the item being adjusted relates."
[20] New Code Sec. 6226(c)(2)(B).
[21] New Code Sec. 6226.
[22] New Code Sec. 6225(c)(6).
[23] New Code Sec. 6225(c)(2).
[24] New Code Sec. 6225(b).
[25] New Code Sec. 6225(c)(4).
[26] *Id.*
[27] For S Corporation partners, the partnership is only treated as meeting the opt-out requirements if the partnership disclosed the name and taxpayer identification number of each person with respect to whom the S Corporation is required to furnish a statement under Code Sec. 6037(b) (copies to shareholders).
[28] New Code Sec. 6221(b).
[29] New Code Sec. 6231(a)(1)-(3).
[30] New Code Sec. 6231(a).
[31] New Code Sec. 6234(a)(1).
[32] New Code Sec. 6234(a)(2), (3).
[33] New Code Sec. 6235(a)(2).
[34] New Code Sec. 6231(c).
[35] New Code Sec. 6235(c)(1), (2).
[36] TEFRA will be gone from the Code but will still be with us in audits and litigation involving older years for many years to come.