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AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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FEDERAL TAX

SUBJECT

NEW PARTNERSHIP AUDIT REGIME SUBSTANTIVELY CHANGES EXISTING RULES AND MAY RESULT IN PARTNERSHIP-LEVEL PAYMENT OBLIGATIONS

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SUMMARY

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015 ("the Act").[1] The Act repeals both the partnership audit rules under the Tax Equity and Responsibility Act of 1982 (TEFRA) and the special rules for electing large partnerships ("ELP"). The TEFRA rules are replaced with a completely new regime for auditing partnerships. Under the new regime, tax adjustments resulting from partnership audits will generally be assessed at the partnership level. This enables the Internal Revenue Service ("IRS") to collect tax due on partnership adjustments at the entity level, thereby, effectively imposing an entity-level tax on partnerships.

The new regime generally applies to all partnerships regardless of size or number of partners unless the partnership is eligible to elect out and does so in a timely manner. The new procedures are effective for tax returns filed for partnership taxable years beginning after December 31, 2017, unless the partnership elects to have the new procedures apply sooner.

DETAILS

Partnerships to Which the New Regime Applies

Unlike the TEFRA rules, the new regime applies to all partnerships regardless of size or number of partners unless the partnership is eligible to elect out and does so in a timely manner.

An election out of the new procedures is available only to partnerships which have 100 or fewer partners and only if each of the partners is an individual, a

[1] P.L. 114-74(2015)

C corporation, any foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner.

The election out must be made on an annual basis with a timely filed return for such taxable year. The election must include a disclosure of the name and taxpayer identification number of each partner of the partnership and each partner of the partnership must be notified of the election. The Act instructs Treasury to provide procedures describing the manner in which the partners must be notified.

If a partner is an S corporation, special rules apply. The partnership must disclose the name and taxpayer identification number of each S corporation shareholder for the taxable year of election, and each S corporation shareholder will count toward the 100 partner rule.

Determination at the Partnership Level

Under the new regime, the IRS will audit items of income, gain, loss, deduction, or credit of the partnership at the partnership level. Any taxes, interest, or penalties relating to the adjustments will also generally be assessed and collected at the partnership level.

If the IRS determines that there are adjustments to a partnership return, the partnership will pay the "imputed underpayment" with respect to such adjustment in the year of adjustment. An adjustment that does not result in an imputed underpayment is taken into account by the partnership in the year of adjustment as a reduction in non-separately stated income or as an increase in non-separately stated loss. If the adjusted item is a credit, the adjustment is treated as a separately stated item.

An imputed underpayment is calculated by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest tax rate in effect for the reviewed year under Section 1 or 11. Any net increase or decrease in a loss is treated as a decrease or increase in income and any adjustment to a credit is treated as an increase or decrease in the imputed underpayment.

The law applies the highest tax rate in effect for the year reviewed for individuals and corporations regardless of the type of partners in the partnership. Under the current law, the tax rate used to calculate the initial imputed underpayment would be 39.6 percent. However, if sufficient information is provided to the IRS within 270 days of the notice of proposed adjustment, the imputed underpayment can be modified for the following:

- If one or more partners file returns which reflect the adjustments determined by the IRS for the reviewed year and pay the applicable tax increase, such adjustments are disregarded in determining the amount of the imputed underpayment;[2]
- To the extent that the partnership demonstrates that a portion of the adjustment is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity; and
- Taking into account a lower rate of tax to the extent that the partnership demonstrates that a portion is allocable to a partner which:
    - Is ordinary income, in the case of a C corporation, or
    - Is capital gain or qualified dividend income in the case of an individual or an S corporation.

The Act authorizes the Secretary to issue regulations to provide for additional procedures to modify imputed underpayment amounts based on other factors as determined necessary or appropriate.

Interest on the imputed underpayment amount will be determined based on interest that would be calculated by treating the imputed underpayment as an underpayment of tax imposed in the adjustment year. Penalties on the imputed underpayment amount will be determined by applying Section 6651(a)(2) to such failure to pay, and by treating the imputed underpayment as an underpayment of tax. Section 6651(a)(2) assesses a 0.5 percent penalty per month (or fraction thereof) up to a maximum of 25 percent.

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[2] For adjustments that reallocate the distributive share from one partner to another, this adjustment shall only apply if amended returns are filed by all of the affected partners.

The partnership is required to pay the imputed underpayment by the due date of the partnership's tax return. No deduction is allowed for any payment required to be made by a partnership under the new regime. This appears to include interest as well as the imputed underpayment and any penalties. The non-deductibility of the interest portion of the payment would be in contrast to a C corporation's ability to deduct interest on an underpayment of tax.

Alternative to Payment of Imputed Underpayment by the Partnership

Since an imputed underpayment under the new regime is paid by a partnership in the year of adjustment rather than the reviewed year, the economic burden of the underpayment for a prior year can be shifted to current partners who may not have been partners in the reviewed year.

The Act provides that the partnership may within 45 days of receiving a notice of final partnership adjustment irrevocably elect to have the partners take the adjustments into account on their separate tax returns. If this election is made and the partnership properly notifies its partners of the election, the partnership will not incur an imputed underpayment and the burden of the underpayment is put on the partners who were partners in the reviewed year. This election appears to apply only to an imputed underpayment. A favorable adjustment would continue to be taken into account at the partnership level. If elected, the partnership will issue adjusted Schedules K-1 reflecting each partner's share of any audit adjustments.

If this election is made, each partner will increase its taxes owed to reflect the adjustment amount, plus any interest and penalties, in the year that the statement is furnished to the partner by the partnership. The adjustment amount is calculated by adding:

1. The amount that the partner's tax would increase for the taxable year which includes the end of the reviewed year, if the partner's share of any adjustment to income, gain, loss, deduction, or credit were taken into account for such taxable year, and
2. The amount that the partner's tax would increase for any taxable year after the taxable year that includes the reviewed year and before the adjustment year, if the partner's tax attributes would have been affected had the adjustment been made in the reviewed year.

Additionally, any subsequent year tax attribute that would have been affected if the adjustment had been made in the reviewed year would need to be adjusted for future tax years. The Act also requires that when this election is made, the partners pay an interest rate on the underpayment that is two percentage points higher the regular underpayment interest rate.

Partnership Representative

The Act requires that each partnership designate (in the manner prescribed by the Secretary) a partner (or other person) with a substantial presence in the United States as the partnership representative. The partnership representative shall have the sole authority to act on behalf of the partnership. If the partnership does not make a designation, the IRS may select any person as the partnership representative.

A partnership and all partners of such partnership shall be bound by actions taken by the partnership and by any final decision in a proceeding brought with respect to the partnership.

Administrative Adjustment Request ("AAR") by Partnership

The Act provides that a partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year. The approach is similar to underpayments in the case of an IRS exam.

Any such adjustment shall be determined and taken into account for the partnership taxable year in which the AAR is made (not the year being adjusted). The AAR adjustment can be made:

1. By the partnership (under rules similar to the new rules under which the IRS can adjust partnership items) for the partnership taxable year in which the administrative adjustment request is made, or

2. By the partnership and partners under rules similar to the new alternative payment of imputed underpayment rules (e.g. the payments are pushed to the partners).

In the case of an adjustment that would not result in an imputed underpayment, paragraph (1) shall not apply and paragraph (2) shall apply with appropriate adjustments. Where the AAR results in a refund, the partnership will be required to issue adjusted Schedules K-1 presumably enabling the partners to file a separate amended return in order to obtain the refund.

Period of Limitations on Making Adjustments

Under the Act, no adjustment may be made after the later of the date which is 3 years after the latest of:

1. The date on which the partnership return for such taxable year was filed,
2. The return due date for the taxable year, or
3. The date on which the partnership filed an AAR with respect to such year.

The period of limitations will also remain open for adjustments as indicated below:

- In the case of any modification of an imputed underpayment, the period of limitations remains open until the date that is 270 days after the date on which everything required to be submitted to the IRS, and
- In the case of any notice of a proposed partnership adjustment, the period of limitations remains open until the date that is 270 days after the date of such notice.

BDO INSIGHTS

- The Act fundamentally changes the partnership audit rules and creates the potential for imposition of an entity-level federal income tax obligation. However, partnerships will have the option to pass adjustments through to their partners to avoid entity-level tax.
- The statute contains a number of unanswered questions that will need to be addressed by the IRS and Treasury through regulations and instructions. For example, under the new regime, partnerships may be subject to tax on an “imputed underpayment” that is calculated based on the highest marginal federal tax rates. While the rules provide for certain modifications, the Act relies on Treasury regulations to determine the actual mechanics.
- Because the imputed underpayment is imposed at the partnership level, it’s possible that partners will be left to shoulder the burden of adjustments attributable to other partners’ distributive shares. Equity investors should consider the potential impact of these rules.
- Certain partnerships will be eligible to elect out of the new regime. However, whereas under the TEFRA rules certain small partnerships were automatically excluded from the unified audit rules, the new regime requires proactive steps to elect out.
- Under the Act, a “partnership representative” replaces the concept of a “tax matters partner.” The partnership representative will have the power to act on behalf of the partnership.

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