New Audit Rules For Partnerships

Dear Client and Friends

To the surprise of many practitioners and taxpayers, substantial changes were made to the way partnerships will be audited by the Internal Revenue Service for returns filed for taxable years beginning after December 31, 2017. The Bipartisan Budget Act of 2015 repeals existing procedural rules, including those under TEFRA, and introduces a regime in which partnerships may, as an entity, be subject to additional tax, interest and penalties.

Many of the operational details of these new rules have been delegated to the Treasury Department. While the proposed regulations are not yet final or effective, partnerships must understand the guidance in order to be prepared to address future final regulations. This letter provides a high level summary of the proposed regulations.

Key Considerations

Partnerships will need to analyze and evaluate a number of issues when evaluating the new audit rules. Some key considerations include:

- *Whether the partnership is eligible to elect out of the new rules and, if so, whether such an election is advisable.*
- *If a push-out election should be considered when a partnership cannot elect out of the new rules and, if so, whether the partnership will be able to provide the necessary partner statements.*
- *Whether a partnership that has not opted out may calculate imputed underpayment modifications to reduce any potential exposure and, if so, beginning the information gathering process.*

- *With respect to audited financial statements, consideration of ASC 740 and whether audited financial statements may need to disclose a partnership's financial responsibility for any uncertain positions associated with imputed underpayment obligations.*

- *Whether the partnership must amend its operating agreement to take into account the new partnership audit rules.*

Partnership Agreement Considerations

The new partnership audit rules will require partnerships to take certain measures to come into compliance with the new rules, some of which may be addressed in the partnership agreement:

- *Designating a Partnership Representative.* The proposed regulations require a partnership to designate a Partnership Representative ("PR") for tax years beginning after 2017. Similar to the Tax Matters Partner ("TMP") under the TEFRA rules, a PR is the point of contact between the entity and the IRS. Also like the TMP, a PR may bind the partnership. Unlike the TMP, however, a PR may bind all partners to the conclusions of an audit proceeding. Moreover, unlike a TMP, a PR may be a non-partner, as long as the PR has a substantial U.S. presence. If a partnership fails to designate a PR, IRS may do so on its own initiative. Therefore, a partnership should designate a PR or, at a minimum, determine the procedures for designation.

- *Preparing for an Opt-Out Election.* For those eligible partnerships that prefer to opt out of the new audit rules, an election must be made annually with the filing of the partnership return. In such case, the partnership may consider specifying in the partnership agreement its intent to make the election. In drafting such a provision, the partnership may consider the impact of S corporation partners and the need to secure their agreement. Moreover, any agreement may be set up to avoid ownership by those which would make the partnership ineligible to opt out, such as other partnerships, trusts, disregarded entities and nominees. Partnerships currently ineligible to opt out because of their structure may consider whether to restructure their ownership.

- *Preparing for a Push-Out Election.* Partnerships that either cannot opt out or prefer not to opt out of the new rules may elect to push adjustments out to its reviewed-year partners. In such a case, it may be advisable for the partnership agreement to specify such intent and direct the PR to make a push-out election. *A partner entering or exiting*

- *a partnership should consider the tax implications of any existing and future tax liability resulting from the partnership's election to push out any imputed underpayment.*

- *Preparing to Modify the Imputed Underpayment.* A partnership that makes neither an opt-out nor push-out election may want to modify any imputed underpayment amount as permitted under the proposed regulations. In such case, it may be desirable to specify in the partnership agreement that impacted partners will provide any necessary documentation or file amended returns as needed.

One of three different regimes will apply to adjustments to partnership items, once the new rules take effect:

1. The default rules provide that underpayments of tax, interest and penalties generally be determined and paid by the partnership as an entity for the year of the audit. The partners to whom such underpayments relate may have no direct liability for any additional tax, interest, or penalties if they are not partners at the time these amounts are paid.

2. The partnership may elect to pass any adjustments on to the individual partners – or former partners – to whom the adjustments relate. Upon making a "push-out" election, those partners will then be required to pay any additional tax, interest and penalties.

3. Partnerships may "opt out" of the new audit rules on an annual basis, in which case any additional tax must be assessed against the partners on a partner-by-partner basis.

Each alternative has its own complex requirements and procedures for, among other things, determining eligibility, computing amounts due and reporting. The proposed regulations provide some guidance on how these rules will work in practice but leave even more questions unanswered. It is clear, however, that partnerships will have many decisions and elections to make, some of which will have to be addressed long before any audit actually begins. Addressing the new rules may also necessitate amending partnership agreements.

Administrative Adjustment Requests

Like partnerships subject to the TEFRA rules, partnerships subject to the new partnership audit rules cannot file amended returns to correct errors reflected on returns that have been filed but must file an administrative adjustment request ("AAR"). Under the proposed regulations, if a partnership files an AAR and the adjustments result in an imputed underpayment, the partnership must generally compute an imputed underpayment amount under the Default Rules discussed above.

As in the case of adjustments arising from an IRS examination, the partnership may reduce the imputed underpayment for the permitted modifications discussed above. The partnership does not need to seek IRS approval for such modifications in the case of an AAR, but must notify the IRS and provide supporting documentation. In addition, the partnership may elect to be subject to the Push-Out rules rather than pay the imputed underpayment amount itself.

As with the existing rules, a partnership may not file an AAR with respect to a taxable year more than three years after the later of the date the return for that year was filed or the due date of such return determined without regard to extensions.

Please contact us for additional information about any of the items in this letter or if you have question

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