IRS Issues Guidance to Partnerships Opting-In to New Partnership Audit Regime

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The Internal Revenue Service (IRS) issued temporary regulations on August 4, 2016, providing the time, form and manner for partnerships to elect to apply the new partnership audit regime enacted by the Bipartisan Budget Act of 2015 (BBA). In the absence of an election, these rules will not be effective until January 1, 2018.

While partnerships and LLCs should consider whether there are any benefits to applying the new regime early, we believe that it will likely be better to take no action at the present time; however, clients should consider revising their partnership and LLC operating agreements to take into account the anticipated provisions of the new regime.

New Partnership Audit Regime Background

The majority of partnerships and LLCs are currently audited by the IRS under rules enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) or the rules issued in 1997 for Electing Large Partnerships (ELP). Under these rules, the IRS audits partnerships at the entity level, but must pass any partnership-level audit adjustments through to each of the partners by way of separate assessment and collection actions. As a likely consequence, large corporations are at least 10 times more likely to be audited than partnerships.

The BBA replaces the current partnership audit regime for tax years beginning on or after January 1, 2018. The purpose of the new regime is to make it easier for the IRS to raise revenue from audit adjustments.

Default Method

Under the default method which will be in effect as of January 1, 2018, the IRS will determine any deficiency and assess and collect any tax, penalties, and interest at the partnership level. In other words, the partnership becomes the taxpayer for purposes of assessment and collection in the "adjustment" year (i.e., the year in which the audit is concluded). The deficiency will be determined by multiplying net partnership-level audit adjustments by the highest effective tax rate applicable to the "reviewed" year (i.e., the year under audit). While a partnership will be able to reduce the amount of the liability by demonstrating that either (i) there is partner-specific information reducing the liability (e.g., exempt partners or beneficial character differences) or (ii) a particular partner has filed an amended tax return based on the partnership-level adjustment and paid the tax due, there is a limited period of time to demonstrate the appropriate reduced liability to the IRS and the means of obtaining information or requiring actions from partners will have to be set forth in a separate agreement between the partnership and its partners.

Opt-Out for Small Partnerships

Partnerships with 100 or fewer partners consisting of individuals, estates of deceased partners, C corporations, S corporations, and certain foreign entities can make an annual election out of the new regime and, thus, apply the TEFRA/ELP regimes for tax years beginning before January 1, 2018, and the pre-TEFRA/ELP regimes for tax years beginning on or after January 1, 2018.

We anticipate that most eligible taxpayers will opt-out. For partnerships that do not or cannot opt-out, either the "default" method or an elective alternative "push-out" method will apply.

Alternative Elective Method

Under the alternative elective method, a partnership is not required to pay the liability and, instead, can push-out audit adjustments and the resulting tax due to the partners in the reviewed year. The election by the partnership to apply the push-out method must be made within 45 days of the issuance of a notice of final partnership adjustment by the IRS.

While many partnerships may prefer not to pay the tax liability resulting from an audit adjustment because, perhaps, the composition of the partners has changed since the reviewed year, the push-out method comes with a steep price. Under the push-out method, the partnership is required to track down all of the review-year partners and issue revised Schedules K-1 and the interest rate on underpayments is 2 percent higher than under the default method. In addition, the total tax liability may be higher under the push-out method because a partnership applying the default method is not subject to the net investment income tax that might apply to any additional income allocated to the partners.

Opting-In to the New Audit Regime

The Temporary Regulations permit partnerships to apply the new regime to partnership years beginning after November 2, 2015, and before the new regime becomes effective on January 1, 2018. Under the temporary regulations, partnerships have 30 days after notification of any audit by the IRS to decide whether to opt into the new regime and, if a partnership opts in, it will have an additional 30 days to file an administrative adjustment request with the IRS.

We see limited (if any) benefit from opting into the new rules, for most taxpayers, because opting-in early makes it easier for the IRS to audit a partnership and collect any tax deficiency. Further, under the temporary regulations, a partnership that elects to apply the new regime may not apply the small partnership exception. In addition, an election to apply the new regime cannot be revoked without consent of the IRS. Finally, a partnership opting-in to the new regime will be required to designate a "partnership representative" with sole authority to act on behalf of the partnership.

Current Actions

Before the new regime becomes applicable, partners and partnerships (including LLCs) should evaluate whether their partnership agreements and LLC operating agreements appropriately protect their interests and provide for their desired audit regime. General Partners of partnerships or managers of LLCs should contact Neal Gerber Eisenberg to discuss amending their operating agreements, especially if the partnerships or LLC are already amending their agreements to make non-tax changes.

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This alert was authored by Scott J. Bakal (312-269-8022, sbakal@ngelaw.com), Jeffrey S. Shamberg (312-269-8492, jshamberg@ngelaw.com) and Eric M. McLimore (312.269.5215; emclimore@ngelaw.com).
If you have any questions related to this article or would like additional information, please contact your attorney at Neal Gerber Eisenberg, any attorney in the Taxation practice group, or the authors.
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