Significant Changes Made to Partnership Tax Audit Procedures Will Require Modifications to Partnership Agreements and Operating Agreements

By Steven E. Grob and John A. Abbo

Introduction

On November 2, 2015, President Obama signed the Bipartisan Budget Act of 2015 (the "Act"),[1] which significantly changed the procedures for tax audits of partnerships. The Act, which generally will be effective for tax years beginning after December 31, 2017, will replace the audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The sweeping changes in the realm of partnership tax audits will likely require revisions to most partnership agreements and operating agreements, and introduce new considerations when entering or leaving a partnership.

Current Partnership Audit Procedures and Reasons for a Change

Currently, partnerships and limited liability companies ("LLCs") taxed as partnerships (both are generally referred to as partnerships in this article) are subject to audit procedures adopted under TEFRA more than 34 years ago. The primary procedures under TEFRA are:

- The IRS conducts a single examination of the tax treatment of partnership items at the partnership level.
- When the IRS makes an adjustment for a year under audit, the partners associated with the partnership for that audited year are separately responsible for paying any taxes due.
- Each partnership must have a designated tax matters partner ("TMP"). The TMP must be a partner of the entity and will represent the partnership in dealings before the IRS, manage audit investigations, and provide tax information to other partners.
- Certain partners are designated as "notice partners." Partners, who qualify as "notice partners" have the right to petition the Tax Court for an adjustment, receive notices of adjustments from the IRS, and begin proceedings if the TMP has not done so.

In practice, the IRS found the TEFRA procedures to be cumbersome, and they were regarded as a disincentive to auditing partnerships. In particular, the IRS did not have the capability to efficiently audit large partnerships and multi-tiered partnerships because of the complexity of allocating adjustments to ultimate partners and assessing the tax. Because the new procedures are expected to result in more partnership audits and more effective audits, the Joint Committee on Taxation has estimated that they will increase tax revenues by $9.324 billion over a 10-year period.

Partnership Audits Under New Procedures

The new partnership audit procedures are contained in Internal Revenue Code ("IRC") Sections 6221-6241 and generally become effective January 1, 2018 (a partnership can elect to apply them earlier to tax years beginning after November 2, 2015). These procedures will apply to all entities that are treated as partnerships for federal income tax purposes, primarily partnerships and LLCs. The IRS encouraged adoption of the new procedures with the intent that the rules will streamline audits of partnerships.

Some key features under the new audit regime are:

- The IRS will assess tax adjustments from audits at the partnership level rather than at the partner level. The new entity-level tax of the partnership will have adverse consequences on persons who are partners in the year that the audit (or any judicial review) is completed (the "Adjustment Year").

- The procedures provide for an alternative method under which the partnership can elect to impose the liability of the underpayment on the partners for the tax year to which the adjustment relates (the "Reviewed Year").
- The new procedures replace the TMP with a "partnership representative" who has different rights and responsibilities.
- Partnerships with 100 or fewer qualifying partners may opt out of the new partnership procedures.

"Opt Out" Election

Under IRC 6221(b) of the new procedures, certain partnerships with 100 or fewer qualifying partners during a tax year can make an "opt out" election for that tax year. Generally, to be eligible to make this election the partnership must meet the following requirements:

- Each of the partners of the partnership must be either an individual, a C corporation (or a foreign entity that would be treated as a C corporation were it domestic), an S corporation, or an estate of a deceased person. It is unclear whether a partnership with a disregarded entity partner can elect out.
- No partner may be an entity taxed as a partnership.
- The partnership must furnish 100 or fewer Schedules K-1 with respect to its partners.

If the partnership is eligible to "opt out" under the new procedures and makes the election on a timely filed tax return, the partnership and its partners will likely be audited under the general rules applicable to individual taxpayers. The "opt out" election applies only with respect to the tax year for which it is made and, therefore, must be made every year where desired. If the partnership cannot or does not elect to "opt out" then one of the following partnership level assessment methods will apply.

Partnership Level Assessment—Default Method

Under the default method, the IRS will assess and collect tax adjustments at the partnership level in the year that the audit is completed (the Adjustment Year). The default method will place the economic burden of the additional tax liability on the current partners in the partnership instead of on those persons who were partners for the year under audit (the Reviewed Year).

The IRS will determine the additional tax liability attributable to a partnership level adjustment by netting all adjustments and multiplying the net non-favorable adjustments by the highest tax rate in effect for the Reviewed Year (currently 39.6 percent), regardless of the tax status of the partners. However, the partnership can provide information to support a lower tax liability (for example, the presence of a tax-exempt partner or individual partners subject to a lower capital gains tax rate).

All partners are bound by the final resolution in the partnership level proceeding. Unlike TEFRA, partners do not have the right to participate in the audit or receive notice of the proceedings from the IRS. However, the new partnership audit procedures retain the TEFRA provision that a partner has the right to file a notice of an inconsistent position. If the partner fails to file the notice, the IRS may treat any resulting underpayment as a mathematical error and thus may assess and collect the tax without issuing a deficiency notice. Furthermore, all penalties are determined at the partnership level. There are no partner level defenses to penalties. Only the partnership level statute of limitations applies. The statutes of limitation for individual partners (which could be shorter or longer) are irrelevant. For example, the IRC 6501(e) six-year statute of limitations for substantive omissions of income is determined at the partnership level.

> The sweeping changes in the realm of partnership tax audits will likely require revisions to most partnership agreements and operating agreements, and introduce new considerations when entering or leaving a partnership.

Partner Level Assessment—Alternative Method

As an alternative to the default method, the partnership may elect out of the partnership level assessment and shift the tax liability to the partners during the tax year to which the adjustment applies. This can be accomplished by issuing adjusted Schedules K-1 to the those persons who were partners during the Reviewed Year within 45 days after the IRS issues a notice of final judgment. Under this method, each Reviewed Year partner would then take the adjustment into account in calculating its tax liability. A drawback to electing the alternative method is that interest is determined at a rate that is 2 percent higher than the normal deficiency rate. Interest will accrue from the due date of the tax return for the taxable year at issue.

Partnership Representative Replaces the Tax Matters Partner

The new rules eliminate the designation of a TMP and instead require each partnership to select a partnership representative ("PR"). It is unclear when a partnership must designate a PR or how a partnership can change its PR. Unlike the TMP under TEFRA, the PR does not need to be a partner. The only prerequisite is that the PR has "a substantial presence in the United States." An entity can be designated the PR, in which case a responsible person (such as a corporate officer, partner, or trustee), will act on behalf of the PR. If the partnership fails to select a PR, the IRS has the authority to do so. Furthermore, the new rules eliminate the concept of a "notice partner." As a result, the PR's actions will bind the partnership and all its partners. The PR's exclusive right to resolve partnership audits and disputes may create serious tensions if the PR's rights are not specified in the partnership agreement. While the TMP under TEFRA is primarily an information source, the PR is granted significantly more authority to act on behalf of the partnership. The IRS will need to issue guidance on how to appoint a PR when there is no designation in the partnership agreement (under TEFRA, the default rule is the general partner with the largest profits interest).

Implications

Commentators believe that these new audit procedures will lead to an increase in the number of partnership audits. Existing and new partnership agreements should be reviewed and in most cases revised to address various aspects of the new rules. Key issues for current and new partners to consider in amending a partnership agreement (or an LLC operating agreement) include the following:

- Potential revisions to existing partnership agreements:
  - Designate a partnership representative and specify how the PR can be removed and replaced.
  - Specify the authority, duties, and liabilities of the partnership representative.
  - Determine whether to "opt out" (if eligible) or elect the alternative method if the "opt out" election is not available.
  - Include provisions that prevent partners from assigning interests to any entity treated as a partnership for U.S. tax purposes.
  - Partners may want to include rights similar to those they had under TEFRA, such as notice rights and rights to participate in proceedings.
  - Specify whether former partners are required to pay to the partnership their share of the audit liability.
  - Add special allocation provisions to equitably allocate audit adjustments absorbed at the partnership level among Adjustment Year partners, and comply with capital account maintenance.
- Considerations for potential acquirers of partnership interests:
  - Perform additional due diligence regarding the partnership's prior tax returns in consideration of the shift of liability from former partners to current partners under the new audit regime.
  - Potentially request representations, indemnities and escrows from the seller of the interest with respect to any pre-closing taxes or penalties.

Lender Reactions

Some lenders have become concerned that the tax audit liability, which previously was a partner responsibility, might now become a partnership liability thus impairing the value of the partnership assets they are relying on when making a loan to a partnership. Accordingly, such lenders are requiring that, where possible, a partnership borrower elect out of paying any audit deficiencies at the entity level.

IRS Seeks Input

The IRS is requesting comments to help it develop guidance regarding the implementation of the new partnership audit regime. Notice 2016-23 lists 12 issues in particular on which the U.S. Treasury Department and the IRS request comments, including the "opt out" election, the designation of the PR under IRC 6223, determination and modification of the imputed underpayment, and the effect of adjustments on the basis of the partners and the partnership.

Conclusion

The IRS has successfully persuaded Congress to adopt radically different partnership audit procedures to make its audits of entities taxed as partnerships much easier. These changes will not only increase the number of partnership and LLC audits, but will create new tensions among existing and former partners that will result in various new considerations in drafting partnership agreements and operating agreements, as well as documents regarding transfers of partnership and member interests.

NOTES

1. Pub L No 114-74, __ Stat __ (2015).

Steven E. Grob, a member of Dykema, Detroit, focuses his practice on federal and state tax law, including tax planning for corporations, partnerships and limited liability companies, estate planning, IRS audits, federal and state tax litigation, and general corporate and real estate matters.

John A. Abbo is an associate in the Bloomfield Hills, Michigan office of Dykema. Mr. Abbo focuses his practice on taxation and estates.