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The New Partnership Audit Rules, Part 1: The Basics

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This is the first of several installments of Bracewell Tax Report articles describing the new rules applicable to partnership audits under the Internal Revenue Code, and related proposed and final Treasury regulations. Future installments will focus on various aspects of these rules and practical implications to partners and partnerships, particularly as they relate to negotiating and drafting partnership agreements.

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for tax purposes (the "New Rules"). The New Rules, effective for audits of partnership tax years beginning on or after January 1, 2018, are a dramatic departure from the prior rules, known as the TEFRA rules (the "TEFRA Rules"). Under the TEFRA Rules, the IRS is required to allocate any partnership audit adjustments among the partners in the year subject to audit, and assess and collect any underpayment of tax at the partner level. Accordingly, audits under the TEFRA Rules require substantial IRS resources, causing audits of large partnerships, with hundreds, or even thousands, of partners extremely difficult and time consuming for the IRS. In contrast, under the New Rules, the IRS is permitted to impose any underpayment directly against the partnership. The burden of allocating the adjustments or underpayment among the partners therefore is shifted to the partnership. Accordingly, with the potential for increased efficiency conducting partnership audits under the New Rules, it is anticipated that the IRS will more vigorously pursue large partnership audits.

Under the New Rules, the imputed underpayment is calculated by multiplying the net positive audit adjustment to taxable income of the partnership by the highest marginal federal income tax rate (individual or corporate, as applicable) in effect for the tax year subject to audit (the "Reviewed Year"). The partnership, however, can request modifications of the imputed underpayment computed by the IRS including by demonstrating that (i) partners in the Reviewed Year amended their tax returns including the Reviewed Year to reflect their share of the adjustments and paid the related tax due, (ii) a portion of the adjustments are properly allocable to a partner not subject to tax or (iii) a portion of the adjustments are allocable to a corporate partner or properly treated as capital gain or qualified dividends allocable to an individual partner, in each case, subject to tax at a lower rate.

The imputed underpayment, adjusted for any modifications approved by the IRS, is assessed on the partnership, so the partners in the year the assessment is made bear the economic burden of the underpayment. Such result may be inequitable if the ownership interests of one or more partners in the partnership in the Reviewed Year differ from their interests in the partnership in the year the audit concludes and the assessment is paid. As an alternative to the partnership bearing the imputed underpayment in the year the audit concludes, the partnership can elect to push the audit adjustments out to the partners in the Reviewed Year (the "Push-out Election"). When the Push-out Election is made, each Reviewed Year partner is required to include its share of the audit adjustments in its current year tax return and pay any resulting increase in tax.

The New Rules also replace the designation of a tax matters partner under the TEFRA Rules with the designation of a partnership representative. Unlike the tax matters partner, the partnership representative need not be a partner in the partnership. Moreover, the New Rules grant the partnership representative broader authority to act on behalf of, and bind, the partnership and its partners than the tax matters partner. Accordingly, the other partners may seek restrictions in the partnership agreement on the partnership representative's ability to make decisions binding on the partners as part of the audit process.

Finally, a partnership can elect to be excluded from the application of the New Rules (the "Election Out") if it has 100 or fewer eligible partners. Pursuant to final regulations recently issued by Treasury, individuals, C-corporations and S- corporations are eligible partners for this purpose, but partnerships and disregarded entities are not. As a result, any partnership with even a single partner that is a disregarded entity or partnership will be subject to the New Rules.

Our next installment will focus on partnership's ability to make the Election Out, including tax planning and drafting techniques allowing partnerships and partners to permanently avoid the application of the New Rules.