In brief

A provision of the Bipartisan Budget Act of 2015 (the “Budget Act”), which is expected to be signed into law by the President in the coming days, amends the Internal Revenue Code to make significant changes to the audit and adjustment procedures that apply to partnerships. In general, the Budget Act repeals present-law audit and adjustment procedures for partnerships (commonly referred to as TEFRA) and electing large partnership (ELP) rules and replaces them with new audit and adjustment procedures that apply by default to all partnerships. Under the new provisions, adjustments to partnership items are determined at the partnership level and any addition to tax (along with penalties and interest) is assessed and collected at the partnership level, unless the partnership elects to pass the adjustment through to its partners. Removed is the provision contained in a prior version of the legislation that would have made partners jointly and severally liable for the tax liability assessed at the partnership. Recognizing the significance of the changes, Congress delayed the provisions’ effective date for two years, so that they apply to tax returns filed for partnership tax years beginning after December 31, 2017.

In detail

**Highlights of the Budget Act Provision on Partnership Audit and Adjustment Procedures**

**Applicability of New Rules**

The new audit and adjustment rules under new IRC section 6221 apply to all partnerships with an exception. Partnerships with 100 or fewer partners, each of whom is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an S corporation, the estate of a deceased partner, or other types of partners designated by the Secretary of the Treasury, are eligible to elect out of the new rules. In the case of a partner that is an S corporation, owners of the S corporation are counted as partners for purposes of making the 100-or-fewer-partners determination.

**Observation:** Without further guidance from Treasury, a lower-tier partnership in a tiered partnership structure will not be eligible to elect out of the new rules, regardless of the number of partners it has, because having a partner that is a partnership precludes the lower-tier partnership from qualifying for the 100-or-fewer-partners exclusion.

**Designation of Person to Act on Partnership’s Behalf in Examination Proceedings**

New IRC section 6223 requires every partnership to designate a person (or other person) with a substantial presence in the United States as the partnership representative that will have sole authority to act on behalf of the partnership with respect to audit and adjustment proceedings. It also permits the Secretary to select such a person if the partnership has not made the required
The partnership and all partners (including those partners who held an interest in the partnership during the year under examination but disposed of that interest prior to the current year) are bound with respect to any actions undertaken by the partnership as part of the examination and all final decisions in the proceeding.

**Observation:** Considering the importance of the designated representative under the new procedures, affected partnerships should review the provisions of their current partnership agreements regarding audit procedures, which likely were designed for TEFRA-type proceedings, to ensure that the appropriate parties will have the ability to designate a representative and that the representative will have the authority to act as needed under the new rules.

**Consistency Requirement**

New IRC section 6222 requires partners to treat partnership items on their returns in a manner that is consistent with the partnership’s treatment of such items. A partner’s deviation from the partnership’s treatment of an item is treated as if it were a math error on the partner’s return. Nevertheless, a partner’s treatment of an item may be inconsistent with the partnership’s treatment, provided the partner files a statement with the IRS identifying the inconsistency. The same filing requirement applies if the partnership has not filed a return, but the partner reports the item.

**Observation:** As a practical matter, many partnerships (upper-tier partnerships), including publicly traded partnerships and large funds, regularly file a Notice of Inconsistent Treatment (Form 8082) with their returns as a result of using estimates for income and loss from a lower-tier partnership in which they hold an interest. Estimates are typically used because the lower-tier partnership has not delivered a K-1 by the time the upper-tier partnership is required to file its tax return. Historically, absent a material adjustment, the estimated amounts are generally trued-up in the upper-tier partnership’s subsequent tax year. While the Budget Act does not directly address this common administrative practice, the consistency requirement makes it even more important to make the proper disclosures in the upper-tier partnership’s tax returns.

**Tax on Imputed Underpayments Generally Assessed and Collected at the Partnership Level**

In the event an examination results in an adjustment to a partnership’s income that creates an “imputed underpayment,” new IRC section 6225 requires the partnership to pay tax on the imputed underpayment (absent an election by the partnership to report the adjustment to the partners as described below). If the partnership does not elect to pass the adjustment through to its partners, the tax is calculated by multiplying the imputed underpayment amount by the “applicable highest tax rate,” which is the highest individual or corporate rate in effect for the year under review. Under procedures to be provided by the Secretary, the imputed underpayment amount is reduced to reflect any payments made by a partner on an amended return that properly reflects the adjusted items for the year under review. In addition, the underpayment amount can be reduced to the extent it is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity.

The legislation also provides that the applicable highest tax rate is reduced to account for ordinary income allocated to C corporations and capital gain and qualified dividend income allocated to individuals. In addition, the Secretary “may by regulations or other guidance” provide for
additional procedures to modify the imputed underpayment amounts on the basis of other factors. Any payment of tax by the partnership is treated as a non-deductible partnership item.

**Observations:** The “additional procedures” that the Secretary may specify in future guidance for purposes of modifying the imputed underpayment should include, for example, a procedure to reduce the underpayment to account for passive losses of the partnership to which section 469(k) applies. Because passive losses of such a partnership can only be used to offset passive income from that same partnership, they can and should be taken into consideration in determining underpayments. Senate Finance Committee Chairman Orrin Hatch specifically mentioned the passive loss example in connection with the Senate’s consideration of the legislation.

It is unclear why the applicable highest tax rate is modified only for ordinary income items allocated to C corporations. Any item allocated to a C corporation should result in a reduction of the applicable highest tax rate from the higher top individual rate to the corporate rate.

In a significant change from current practice, if the partnership does not elect to pass an adjustment through to its partners, an adjustment determined with respect to a “reviewed year”, i.e., the year under audit, would be paid by the partnership in the “adjustment year”, i.e., the year the adjustment is made by the IRS, and taken into account by the partnership in the adjustment year. Under these circumstances, adjustments will be borne by adjustment-year partners rather than reviewed-year partners.

**Election by Partnership to Pass Adjustments and Liability to Partners**

As an alternative to the partnership paying the tax assessed on the imputed underpayment, new IRC section 6226 allows a partnership to elect, not later than 45 days after the date of the notice of final partnership adjustment, to pass the adjustment through to its partners. Under this alternative, the partnership provides a statement to each person that was a partner in the reviewed year, showing that person’s share of the adjustment to the partnership’s income, gain, loss, deduction, or credit. Each person receiving such a statement is then required to increase its tax for the year in which the statement is received (i.e., the current year) by the additional tax that would have been due in the year under review and any intervening years as if the adjustment had been taken into account by the partner on its return for the reviewed year and all subsequent returns up to and including the current-year return. Tax attributes affected by the adjustment are changed accordingly. Penalties are determined at the partnership level and passed through to the partners in a manner similar to income adjustments; interest is determined at the partner level.

**Observations:** As a practical matter, we expect that in most cases partnerships will elect to pass through all material adjustments, because passing through such adjustments guarantees that the proper persons (i.e., those who were partners in the year under review) will bear the burden of any tax and will almost always result in a lower aggregate tax burden, since some partners may be taxed at less than the highest rate and may have attributes, such as net operating losses, that will reduce the tax due. In drafting partnership agreements, practitioners should consider who controls the election to pass tax adjustments through to the partners.

In the case of a tiered partnership, it is not clear whether the election to pass an adjustment through to the partners is available at each tier or whether an upper-tier partnership that receives a “statement” from a lower-tier partnership may elect to pay tax on the adjustment. New IRC section 6226 is silent on this matter. We believe that the logical way to read the new
rule is to treat any adjustment passed to a partner (including an upper-tier partnership) as additional income in the year of review for which tax is required to be paid in the year in which the statement is sent. While one would not expect the government to object to an upper-tier partnership simply paying the tax, the default rule seems to require the adjustment to be passed through to the partners of the upper-tier partnership like any other item of income. Considering the significant impact this issue could have on many partnerships, prompt clarification from Congress is needed.

Partnership Request for Adjustments to Taxable Income

New IRC section 6227 permits a partnership to file a request for an administrative adjustment, i.e., an amended return, in the amount of partnership items of income, gain, loss, deduction or credit for an open year. Adjustments that result in underpayments will either cause tax to be due at the partnership level or may be passed through to the partners under the alternative approach described above. Adjustments that do not result in underpayments must be passed through to the partners as additional deductions in the current year.

Observation: Under new IRC section 6235, the period of limitations for adjustments is three years after the later of the date the partnership return is filed, the return due date, or the date on which the partnership files an administrative adjustment request. As a result, filing an administrative adjustment request will extend the period of limitations.

Effective Date

The provisions are generally effective for returns filed for partnership taxable years beginning after December 31, 2017. Partnerships may, however, elect application for any returns filed for taxable years beginning after the date of enactment.

Observation: The two-year lead time may allow for some additional technical changes to be made, either by Congress or through administrative guidance, to a provision that was fast-tracked through the legislative process. In statements made in connection with the Senate’s consideration of the legislation, both Senate Finance Committee Chairman Hatch and Ranking Member Ron Wyden indicated that they plan to address further the problems raised by affected parties.

Let’s talk

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