Partnership Audit Changes

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DRAFT

CohnReznick
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BIPARTISAN BUDGET BILL OF 2015

- Signed into law by President Obama November 2, 2015.
- Applies to partnership tax years beginning after December 31, 2017.
- Partnerships may elect to apply the new rules to any returns filed for tax years beginning after November 2, 2015.

LAW PRIOR TO CHANGE– TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 "TEFRA"

A partnership may be audited under three different audit regimes:

- Partnerships with 100 or more partners, that elect to be governed by the Electing Large Partnerships (ELP) rules, are subject to simplified audit procedures
- For partnerships with more than 10 partners, the IRS conducts a single administrative proceeding under TEFRA
- For partnerships with 10 or fewer partners, each of which is an individual U.S. resident, C Corporation or estate, the IRS applies the audit procedures to partnership and partner separately

NEW LAW

- Repeals both TEFRA and ELP rules.
- Implements a streamlined system for auditing partnerships and their partners at the partnership level.
- Eliminates the tax matters partner and substitutes a new liaison with the IRS known as the partnership representative.
  - The partnership representative does not have to be a partner.
  - The partnership representative can bind the partnership and partners to the final decision in a proceeding.

NEW LAW

- Removes joint and several liability for the partners for partnership liabilities.
- Any adjustments, including penalties, are taken into account by the partnership, not the individual partners in the year the audit is completed.
- The partnership would be required to pay the net of all adjustments to the partnership return for the year under review, multiplied by the highest individual or corporate rate.

NEW LAW

Partnerships would have the option of demonstrating that the adjustment would be lower if it were based on certain partner-level information, for example:

- If a partner is opting to file an amended return taking into account his or her adjustment
- If the applicable tax rate should be different for a particular type of partner
- If the type of income (ordinary, dividends, capital gains) would have a different applicable rate

ELECTION OUT OF PARTNERSHIP LEVEL ADJUSTMENT

- The partnership can make an election to issue adjusted K-1s to the partners who would be obligated to file amended returns for the reviewed year through a simplified amended return process.
- The election has to be made no later than 45 days after a notice of final partnership adjustment and can only be revoked with the IRS's consent.
- Partnership provides a statement to each partner in the reviewed year showing that partner's share of adjustment; partner then adjusts current year income/loss.

OPT-OUT FOR SMALL PARTNERSHIPS

- Partnerships with 100 or fewer qualifying partners can opt-out of the new audit system.
- Qualifying partners are:
  - Individuals,
  - C Corporations,
  - Foreign entities that would be treated as C Corporations if domestic
  - S Corporations
  - Estates
- Those that opt-out will be audited under the general rules applicable to individual taxpayers.

ISSUES WITH NEW LAW

- A new partner may find the partnership is subject to tax liability resulting from an adjustment prior to when he or she was a partner.
- Not clear what happens if a partner receives a revised K-1 and does not file an amended return reflecting the tax.
- Tiered partnerships – law is not clear on how to handle election out of partnership level adjustment.
- Provision that prevents netting of adjustments to partners' distributive shares could cause partnership income to be taxed more than once.

ISSUES WITH NEW LAW

- Not clear how the IRS will designate a partnership representative if the partnership fails to do so.
- Not clear how much authority the partnership representative has and what options a partner has if he does not agree with the representative's decision.
- Under TEFRA, rules for extending the statute of limitations for partnership and partners were simple; now IRS will need to separately obtain extensions from each partner.