Anchin Alert

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January 27, 2016

New Tax Audit Rules Constitute a Radical Change for Partnerships

Late in 2015, Congress passed the Bipartisan Budget Act of 2015 (the Act), which includes a complete overhaul of the procedures that apply to Internal Revenue Service (IRS) audits of partnerships and limited liability companies (LLCs) taxed as partnerships and their partners. The Act repeals the Tax Equity and Fiscal Responsibility Act (TEFRA) audit rules which were originally enacted in 1982 and the reporting and audit procedures for Electing Large Partnerships (ELPs) in effect since 1998. It adopts new audit rules and procedures effective for partnership taxable years beginning after December 31, 2017. The purpose of these new partnership audit rules is to increase tax collections from partnership audits, and therefore, it is widely expected that the number of partnership audits will increase as well.

Under the current rules for partnership audits (TEFRA and ELP), partnerships are generally subject to a single administrative proceeding to resolve audit issues at the partnership level (unless the partnership elects out). The tax liability for partnership items is determined at the partnership level, but any adjustments determined by the IRS flow through the partnership and are taken into account by the individual partners. Additionally, the current rules require certain partners to be notified of major developments in a partnership audit and partnership-level audits are not necessarily binding on partners.

The intent of the new rules is to streamline partnership audit procedures which will impose a tax at the partnership level resulting from any audit adjustments. The new rules apply to all partnerships (including LLCs taxed as partnerships) other than partnerships with 100 or fewer partners meeting certain requirements. Partnerships and LLCs taxed as partnerships with 100 or fewer partners who are individuals or corporations may elect out of these rules provided they make an election on their tax returns and provide certain information about all partners and S corporation shareholders. Such entities that elect out of the new rules will have the audits and audit adjustments relating to partnership items take place at the partner level.

Significant highlights of the Act include:

- The IRS will conduct its examination at the partnership level for all items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year but partners are no longer required to be notified regarding audit developments and partners will be bound by the determinations made at the partnership level.

- The designated tax matters partner (TMP) under the current rules is eliminated and replaced by a "partnership representative"- who will have the power to manage these audit determinations on behalf of the partnership. The partnership representative will generally be designated by the partnership agreement and will be a partner (or other person) with a substantial presence in the United States who shall have the sole authority to act on behalf of the partnership.

- If the IRS makes an audit adjustment, the partnership will generally be liable for any "imputed underpayment" – the tax deficiency arising from a partnership-level audit adjustment with respect to a partnership tax year (a reviewed year) – calculated using the maximum statutory income tax rate and assessed against and collected from the partnership in the year that such audit is completed (the adjustment year). Adjustments to partners' distributive shares are not netted. If there is a reallocation of distributive share items between partners that results in some decreases of income and gain or increases of deductions, losses or credit, said deductions, losses and credits will be disregarded in determining the imputed underpayment. In others words, the increase items cannot be offset by the decrease items. The partnership is also directly liable for any related penalties and interest, calculated as if the partnership had been originally liable for the tax in the audited year.

- The Act directs the U.S. Department of the Treasury (Treasury) to establish procedures under which the amount of the imputed underpayment may be modified in certain circumstances. For example, if one or more partners file tax returns for the reviewed year that take the audit adjustments into account and pay the associated taxes, the imputed underpayment amount should be determined without regard to the portion of the adjustments so taken into account. Or, if the partnership demonstrates that a portion of the imputed underpayment is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity the procedures are to provide that the imputed underpayment is to be determined without regard to that portion. The Act also directs that the procedures take into account reduced corporate, capital gain and qualified dividend rates as to the portion of any imputed underpayment allocable to an applicable partner.

- The tax is assessed to the partnership in the year the audit or judicial review is completed and does not relate back to the year in which the item was reported on the tax return, or the reviewed year. Therefore, new partners may bear the burden of the partnership audit assessment for years before they were admitted to the partnership even though they did not benefit from underpayment of tax in prior years

- The partnership level assessment may be avoided by electing to issue "adjusted information returns" (i.e., amended/adjusted Schedules K-1) to all partners in the reviewed year. The election would allow the partnership to push the tax liability to the partners for the reviewed year whereby each partner would be required to take into account such adjustment at the partner level and pay additional tax for the current year based on the taxes that would have been due for prior years as a result of the adjustment, along with interest at a special increased rate and any penalties due as well. Such election must be made within 45 days of the final notice of partnership adjustment.

- In order to qualify for the annual opt-out election for partnerships with 100 or fewer partners mentioned earlier, each of the partners of the partnership must be an individual, C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation or an estate of a deceased partner. The opt-out election is currently not available to partnerships with another partnership as a partner.

- The new rules provide that the statute of limitations for making an adjustment is generally three years from the latter of the due dates of the return without regard to extensions, or the filing of the partnership's tax return. This is a positive change when compared to the current rules where the IRS applied the statute of limitations based on the last to expire of the partnership's or a partner's statute of limitations.

The new partnership audit rules constitute a significant change from existing law and will require clarification through guidance from Treasury. However, it is not too early for those affected by the changes to start to take the necessary steps to address the implications of the new rules. Discussions about modifying or adding new disclosures around these rules to fund offering documents, partnership agreements and LLC operating agreements should be taking place now.

We will continue to monitor any additional guidance and developments and stand ready as ***Your Expert Partner*** to assist you. If you have any questions, please contact your engagement partner or any member of ***Anchin's Financial Services Practice***.

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