

# A REVIEW OF THE NEW CENTRALIZED PARTNERSHIP AUDIT REGIME

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## Learning Objectives

- Understand the current partnership audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”).
- Grasp the key differences between the TEFRA audit rules and the new Centralized Partnership Audit (“CPA”) rules.
- Learn key drafting points for preparing new, and amending old, partnership agreements and operating agreements.

## Where Are We Now?

# *The Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”)*

## TEFRA Audit Rules

- The Tax Matters Partner is the partnership's point person in an audit.
- Audits at the partnership level only address "Partnership Items" which include, without limitation, the partnership aggregate, and each partner's share of, income, gain, loss, deduction or credit.
- Resulting assessments are made at the individual partner level.

## Pre-TEFRA Audit Rules

- Prior to TEFRA, partnership audits were conducted by the IRS examination division at the partner level because a partnership, as a flow-through entity, is not subject to payment of federal income tax.
  - Pre-TEFRA, IRS had to audit each individual partner separately.
  - This led to inconsistent reporting and tax results for partners in the same partnership.

# Centralized Partnership Audit Regime (“CPA”)



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## Major Differences Between TEFRA and CPA

### TEFRA

- Tax Matters Partner is partnership's designated tax representative.
- Audits at partnership level may result in assessment at partner level against the partners individually.

### CPA

- Partnership Representative is partnership's designated tax representative.
- Audits at partnership level may result in "imputed underpayment" assessment against partnership itself.

## CPA Terminology

- “Reviewed Year” – Partnership tax year or return under audit.
- “Adjustment Year” – Year in which the adjustment for the reviewed year is made.
- “Partnership Representative” – Party selected to represent the partnership before the IRS and to make tax decision on behalf of the partnership.
- “Imputed Underpayment” – Net non-favorable adjustments to the partnership tax year multiplied by the applicable tax rate(s).

## **WHAT'S THE BIG DEAL?: Key Drafting Points**

- Opting out of the CPA.
- Making a “Push Out” election to reviewed year partners in the event of an imputed underpayment.
- Modifying an imputed underpayment.
- Defining scope of partnership representative’s duties and obligations.

## Opting Out of the CPA

- A partnership with 100 or fewer “eligible partners” at all times during the subject tax year may elect to opt out of the provisions of CPA.
- Per Proposed Reg. Section 301.6221(b)–1(b)(3)(i) “Eligible Partners” are: Individuals, C corporations (including regulated investment companies, real estate investment trusts, and tax-exempt entities other than trusts), S corporations, estates of deceased partners, and foreign entities treated as corporations.
- Per Proposed Reg. Section 301.6221(b)–1(b)(3)(ii), “Ineligible Partners” are: partnerships, trusts, disregarded entities, and estates that are not estates of a deceased partner.
- Effect of opting out is that pre-TEFRA audit rules apply (partner level audits).

## Sample Opt-Out Provision

“The Members agree to make the election provided in Code Section 6221(b)(1) for each taxable year of the Company for which the Company is eligible to make such election. The Manager is authorized to make the disclosure required under Code Section 6221(b)(D)(ii) and the Members hereby agree to provide their names and taxpayer identification numbers to the Manager for this purpose.”

## Making a “Push Out” Election

- Partnership may elect to “push out” any assessed adjustment to the “reviewed year” partners. Section 6226(a)(1); Proposed Reg. Section 301.6226-1(a).
- Helps to avoid issue of “new partners” paying tax liability of partners who have since left the partnership.
- If a “push out” election is made, each reviewed year partner will have to calculate the additional tax related to the adjustment for the reviewed year and all intervening years.

## Sample Push Out Provision

“The Members agree to make the election provided in Code Section 6221(b)(1) for each taxable year of the Company for which the Company is eligible to make such election. The Manager is authorized to make the disclosure required under Code Section 6221(b)(D)(ii) and the Members hereby agree to provide their names and taxpayer identification numbers to the Manager for this purpose.”

## Modification of Imputed Underpayments

- An imputed underpayment may be “modified” within 270 days of the IRS’s mailing of a notice of proposed partnership adjustment (NOPPA). Code Section 6225(c)(7); Proposed Reg. Section 301.6225-2(c)(3)(i).
- Reviewed year partners file amended return and pay the tax attributable to the adjustment allocable to that partner.

## The Partnership Representative

- Who can be a Partnership Representative (“PR”)?
  - A person with substantial presence in the United States, meaning someone who is available to meet with the IRS in the United States, who has a United States street address and telephone number, and has a United States taxpayer ID number.
  - Does not need to be a partner. Can be a non-member manager.
  - Partnership can appoint an entity as PR, it must also appoint a “designated individual” to be the sole individual through whom the partnership representative will act. If the partnership fails to name a designated individual, the IRS may simply disregard the PR designation.

## Differences Between Tax Matters Partner and Partnership Representative

- PR can bind the partnership and its partners to an adjustment or settlement in an IRS audit or in a related court proceeding. No other partner may participate without the consent of the IRS.
- PR must be designated each year on the partnership's tax return.
- PR generally has no duty to notify the partners of a partnership adjustment.
- PR's authority to bind the partnership cannot be limited by the partnership agreement.

## The Partnership Representative: Key Drafting Considerations

- Designation and removal of PR;
- Requirement for PR and partners to obtain and provide information that may reduce partnership's liability for imputed underpayment;
- Liability for PR who acts outside scope of authority granted in partnership agreement; and
- Indemnification provisions for current and former partners and PR, perhaps even a clawback provision.

## Sample Provision: Designation and Removal of PR

- “Regardless of whether or not the Partnership “opts-out” of the CPA Rules (as hereinafter defined), \_\_\_\_\_ is designated the “Partnership Representative” for the Company for each fiscal year within the meaning of Code Section 6223 and Proposed Treasury Regulation Section 301.6223-1. In the event that the Company at any point designates an entity to be the Partnership Representative, then the Company’s Manager shall also designate a “Designated Individual” of such entity for each fiscal year within the meaning of Proposed Treasury Regulation Section 301.6223-1(b)(3). The Manager may replace the Partnership Representative and/or Designated Individual in its sole and absolute discretion.”

## Sample Provision: Cooperation by Members

- “Each Member agrees to cooperate with the Manager and Partnership Representative with respect to any request by the Company to request a modification of an imputed underpayment and to provide, and certify to, such information as the Manager determines is necessary or appropriate for the Company to request such a modification.”

## **Sample Provision: Reviewed Year Partners' Liability**

- “Persons who were Members in a reviewed year but cease to be Members prior to the assessment of an imputed underpayment required to be paid by the Company agree to pay to the Company for their share of the imputed underpayment as determined by the Manger no less than five (5) business days prior to the date that the Company is required to pay such imputed underpayment. The Members agree that this provision shall survive any Member’s withdrawal from the Company.”

## The Upshot

- New Partnership (Operating) Agreements should address CPA provisions; old agreements should be amended.
- Partnerships should opt-out of the CPA's coverage if eligible.
- If partnership cannot opt-out of the CPA, then the partnership should elect to push out.

## Questions?

