THE NEW CENTRALIZED PARTNERSHIP AUDIT REGIME: AN OVERVIEW

I. WHERE ARE WE NOW? THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 ("TEFRA")

A. 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.

1. Pre-TEFRA, IRS had to audit each individual partner separately.

2. This led to inconsistent reporting and tax results for partners in the same partnership.

B. TEFRA shifted the audit of "partnership items" from each individual partner to the partnership level by mandating that the tax treatment of any partnership item must be determined at the partnership level.

C. What are "partnership items"? They are those tax items required to be taken into account for the partnership's taxable year, including:

1. A partner's distributive share of the partnership's income, gain, loss, deduction, or credit;

2. Partnership liabilities; and

3. Guaranteed payments.

D. While audits and adjustments of "partnership items" happen at the partnership level, any resulting assessment and collection of tax is pursued at the partner level.

E. Audits of "non-partnership items" and corresponding adjustments to individual partners' tax liability are made at the partner level.

F. Generally, TEFRA applies to all partnerships unless an exception applies. For example, "small partnerships" of ten or fewer partners are exempt from the TEFRA rules; however, such small partnerships may "opt-in" to TEFRA.

G. Under TEFRA, the "Tax Matters Partner" ("TMP") is the partnership's designated point-person during partnership audits.

1. Must be a partner with authority to bind the partnership. As such, the following persons can be a TMP:

a. In a General Partnership → Any member;

b. In a Limited Partnership → A general partner; and

c. In a Limited Liability Company → A member-manager or, if there is no member-manager, any member.

d. NOTE: Non-members in LLC or limited partners in limited partnership are <u>not</u> eligible to serve as TMP.

2. The TMP has the duty/authority to:

a. Be the partnership's liaison to the IRS during audits and the partnership's single representative in litigation.

b. Keep other partners informed of the audit and other administrative tax proceedings.

c. File a lawsuit or a refund claim on behalf of the partnership.

d. Extend the statute of limitations on behalf of the partnership.

3. Despite having a designated TMP, all individuals or each partner generally have the right to notice of the audit of the partnership, as well as the right to participate in partnership audit proceedings.

II. THE CENTRALIZED PARTNERSHIP AUDIT REGIME ("CPA")

A. Introduced as part of the Bipartisan Budget Act of 2015.

B. In January 2016, IRS issued proposed regulations that provided guidance with respect to CPA. Those proposed regulations were withdrawn, then re-proposed in June 2017 with minor changes.

C. What are the big differences between TEFRA and CPA?

1. The IRS may now assess an "imputed underpayment" directly against a partnership.

   a. If, during an audit of the partnership, the IRS makes adjustments that result in an increase of the partnership's tax liability, the IRS will issue a "Notice of Proposed Partnership Adjustment" ("NOPPA") setting forth such adjustment and treating such additional tax liability as an "imputed underpayment" that is assessed directly against, and must be paid by, the partnership itself.

   b. Generally, the imputed underpayment will be equal to the net of all audit adjustments multiplied by the highest then applicable tax rate.

   c. Assessment of imputed underpayment will generally be applied against the "adjustment year" (the year in which the audit occurs), not the "reviewed year" (the tax year being audited), meaning that the adjustment year partners, rather than the reviewed year partners, will indirectly bear the burden of paying such imputed underpayment.

2. The "Partnership Representative" replaces the "Tax Matters Partner".

a. Who can be a Partnership Representative ("PR")?

   i. 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.

   ii. Does not need to be a partner. Can be a non-member manager.

   iii. Partnership can appoint an entity as PR; however, if the partnership appoints 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.

   iv. If the partnership fails to appoint a PR, the Secretary of the Treasury may select one.

b. Differences between PR and TMP?

   i. 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.

   ii. PR must be designated each year on the partnership's tax return.

   iii. PR generally has no duty to notify the partners of a partnership adjustment.

iv. IRS will not recognize limits to PR's authority set forth in the partnership agreement, meaning that the PR can exceed the authority granted to it and bind the partnership.

D. PR may request to have an imputed underpayment "modified" within 270 days of the IRS's mailing of a NOPPA. Code Section 6225(c)(7); Proposed Reg. Section 301.6225-2(c)(3)(i).

1. The purpose of a modification is to reflect the tax due as closely as possible to the tax due if the partnership and the partners had correctly reported and paid (i.e., not at the highest rate).

2. Different types of modification include:

a. Amended Returns – one or more reviewed year partners file amended returns and calculate and pay the tax attributable to the adjustment allocable to that partner.

b. Tax-Exempt Partners – upon proof that one or more partners is tax-exempt, the IRS may modify the imputed underpayment disregarding the portion of the partnership adjustment allocable to the tax-exempt partner(s).

c. Rate Modification – the partnership may provide proof that some items treated as ordinary income should have been treated as capital gains.

E. 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).

1. This mechanism helps to avoid issue of "new partners" paying tax liability of partners who have since left the partnership.

2. Election must be made by PR within 45 days after the partnership receives a Notice of Final Partnership Adjustment ("FPA").

3. If a "push out" election is made, the partnership is no longer liable for the imputed underpayment, and the reviewed year partners are liable for tax, penalties, additions to tax, and additional amounts, as well as interest on such amounts. Each reviewed year partner will have to calculate the additional tax related to the adjustment for the reviewed year and all intervening years. Any additional taxes must be paid on the partner's current year income tax return.

4. If push out election is made, a reviewed year partner will have no ability to challenge the assessment or any related interest or penalties.

5. NOTE: "push out" is mandatory if the partnership has ceased to exist or cannot otherwise pay the adjustment.

F. CPA will be effective for tax years beginning after December 31, 2017 unless an eligible partnership "opts-out". REG-136118-15, Section 2(B). Partnerships can elect to "opt-in" to CPA before January 1, 2018.

1. What partnerships are eligible to opt-out? A partnership with 100 or fewer "eligible partners" at all times during the subject tax year.

2. Per Proposed Reg. Section 301.6221(b)–1(b)(3)(i) "Eligible Partners" are:

a. Individuals;

b. C corporations (including regulated investment companies, real estate investment trusts, and tax-exempt entities other than trusts);

c. S corporations;

d. Estates of deceased partners; and

e. Foreign entities treated as corporations.

3. Per Proposed Reg. Section 301.6221(b)–1(b)(3)(ii), "Ineligible Partners" are:

a. Partnerships;

b. Trusts;

c. Disregarded entities; and

d. Estates that are not estates of a deceased partner.

4. The partnership must notify its partners of the election to opt-out within 30 days of the date the election is made.

5. Even if the partnership elects to opt-out of CPA, the partnership should still designate a PR in the event that the IRS determines the election is defective or untimely filed.

6. The effect of opting out is that the partnership will be subject to pre-TEFRA audit procedures.

G. Some states are beginning to implement similar provisions in their state taxation statutes.

1. Arizona law now requires partnerships that receive an imputed underpayment under CPA to file a state return for the reviewed year that shows the adjustments to income or the gain, loss or deduction upon which the federal imputed adjustment was based. If the adjustment results in a net increase in Arizona taxable income, the partnership would be required to file a return and pay the tax on the adjustment within 90 days at the highest Arizona individual rate. If the adjustment results in a net reduction in

Arizona taxable income, the partnership is not authorized to claim a refund for amounts not actually paid by the partnership. Instead, the partnership must notify the partners of the adjustment within 90 days and each partner must file an amended return to claim a refund.

2. Multistate Tax Commission and other groups are working on model provisions for use at state level.

III. RECOMMENDATIONS FOR OUR CLIENTS WHO ARE PARTNERSHIPS

A. Partnership agreements should be reviewed and amended to address CPA.

B. Items to be addressed in an amendment to the partnership agreement:

1. Designation and removal of PR.

2. Requirement to opt-out of CPA.

3. Requirement for PR and partners to obtain and provide information that may reduce partnership's liability for imputed underpayment.

4. Restrictions on number of partners and on transfers of partnership interests to entities that are ineligible partners (this is especially important for partnerships that wish to opt-out of CPA).

5. Obligation for PR to seek to lower partnership's tax rate.

6. Indemnification provisions for current and former partners and PR, perhaps even a clawback provision.

7. Voting rights for partners on tax matters. For example:

a. Should partnership make a push out election?

b. Should PR elect to extend statute of limitations?

c. Should partnership petition for readjustment?

C. Until regulations are final and full extent of CPA's impact are known, partnerships should:

1. Elect to opt-out of CPA. Partnerships that make such an election will remain subject to pre-TEFRA regulations.

2. If the partnership is ineligible or otherwise decides not to opt-out of CPA, the partnership should elect to "push out" any adjustments to the "reviewed year" partners.