An Update on the New Partnership Audit Rules Under BBA

by William E. Sigler

It is hard to believe that it was the Bipartisan Budget Act of 2015 ("BBA") that created a new audit regime to replace the procedures under the 1982 Tax Equity and Fiscal Responsibility Act. Where has the time gone? Lawmakers, of course, have no sense of timing. They introduced the Tax Technical Corrections Act of 2016 to make clarifications to the BBA, but the bill did not pass in the last Congress and has yet to be reintroduced in the new one.

The IRS, on the other hand, has been hard at work. They published partnership audit regulations on January 18, 2017, but then they were withdrawn by the IRS in response to the January 20, 2017, White House memorandum ordering a freeze on all regulations. The proposed regulations were released again on June 13, 2017. The new version of the proposed regulations contains only a handful of changes from the version released in January.

The preamble and proposed regulations both look unfavorably on the option for certain partnerships to opt out of the centralized audit regime. They do not provide any leeway beyond what the statute provides for opting out, i.e., (i) the issuance of 100 or fewer K-1 Schedules and (ii) the requirement that each of the partners be an individual, a 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. More generously, the proposed regulations give partnerships great freedom in selecting a partnership representative. The representative can be an individual partner or an entity with a substantial presence in the US. The partnership representative does not need to be a partner.

Reflecting the IRS' underlying reasons for pushing for the new audit regime, the proposed regulations include strong rules requiring partners to file consistently with their partnership returns unless they disclose the inconsistency. The IRS can treat undisclosed inconsistencies as mathematical errors and make adjustments without the ordinary due process that applies to other types of adjustments. The

consistency rules plus the rules for administrative adjustment requests put a high premium on getting the original partnership return correct. A partnership will not be able to simply file an amended return and provide amended Schedules K-1 to correct an error.

Not surprisingly, the procedures for obtaining a modification to an imputed underpayment based on special tax positions of direct and indirect partners are complex. A partnership representative seeking a modification may have to furnish the IRS a detailed description of the structure, allocations, ownership, ownership changes of the partnership, its partners and, if relevant, indirect partners for each taxable year relevant to a request.

Under Section 6226, a partnership can elect to push out all adjustments to partners who were partners in the reviewed year. The proposed regulations are “reserved” on the ability of a pass-through partner to further push out adjustments to its partners/shareholders/beneficiaries. However, the preamble sets forth the IRS’ position that a second-level push-out should not be allowed. The proposed regulations reserve on the issue because a technical corrections bill would have allowed a pass-through partner to push through adjustments to its partners. If the IRS’ position is followed, the pass-through partner would pay full tax on amounts that, if reported correctly on original returns, would have passed through to tax-exempt or foreign partners (or partners with NOLs or NOL carryovers) who otherwise would have paid little or no tax on the additional income.

However, the proposed regulations include a voluntary safe harbor provision under Section 6226, if a partnership elects to push out adjustments to reviewed year partners. It allows a reviewed year partner to pay an amount of additional tax and interest stated in a notice from the partnership in lieu of recomputing its tax liability for the reviewed year and other affected years. The safe harbor amount is calculated in the same manner as the tax on imputed underpayments, which appears to be an amount computed using the highest marginal tax rates for the portion of the understatements allocated to the partner.

The proposed regulations also provide extensive guidance on partnerships that “cease to exist.” Under the proposed regulations, a partnership would “cease to exist” if the partnership terminates within the meaning of Section 708(b)(1)(A) or does not have the ability to pay in full any amount the partnership owes under the new audit regime. The rules give the IRS discretion in determining whether and when a partnership ceases to exist. The proposed regulations say that the IRS will

not treat a partnership as ceasing to exist solely by reason of a technical termination (a 50% change in ownership in a 12-month period). As a general rule, if a partnership is treated as ceasing to exist, the partnership's adjustment year partners are the partners at the time the partnership ceases to exist. The tax, interest and penalty liability determined at the partnership level then gets taken into account by the adjustment year partners.

The proposed regulations "clarify" that taxes, penalties and interest paid under the new audit rules are not deductible. When paid by a partnership, they are to be treated as Section 705(a)(2)(B) payments, i.e., amounts that reduce capital accounts and basis of the partners.

Finally, the IRS Large Business and International and Small Business/Self-Employed divisions have recently issued interim guidance on initial contact with taxpayers in partnership examinations and elections into the Bipartisan Budget Act's centralized partnership audit regime for tax periods between November 2, 2015, and January 1, 2018.

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