Why Partnerships Should Implement the new Centralized Audit Rules by December 31, 2017

by

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Introduction

While the world waits to see if the United States Congress will actually pass tax legislation in this year, legislation previously passed as part of the Bipartisan Budget Act of 2015 (the ***"BBA"***) will become effective for partnership taxable years beginning after December 31, 2017. The BBA repeals current partnership entity-level audit and adjustment rules under TEFRA.

The new partnership audit rules are problematic for several reasons.

- They change the passthrough nature of partnerships. Under the BBA the tax liability arising from an adjustment of items reported on Form 1065 is imposed on the partnership and not its partners.
- Since an examination of the Form 1065 will occur after (perhaps several years after) the year under examination, the identity of the partnership's partners may have changed.
- Partners are required to report items of partnership income gain, loss, deduction, and credit in a manner consistent with the reporting on Form 1065 or notify the IRS when an inconsistent return position is taken. Failure to give notice allows the Internal Revenue Service to treat inconsistent reporting on the partner's individual return as a math error, meaning that no examination occurs before the additional

income taxes penalties and interest are assessed and the taxpayer has no appeal rights.

- The BBA rules apply to items and information related to or derived from a partnership, including items at the partner level. For example, the BBA rules apply to adjustments with respect to disguised sales between partners and partnerships under section 707(a)(2)(b), transactions between the partnership and partners acting in a capacity other than as a partner, and related party transactions subject to loss disallowance or ordinary income recharacterization, as well as computation of partners' outside bases.
- Audit adjustments are grouped in ways that will prevent netting of certain adjustments which reduce partnership income against other adjustments which increase partnership income.
- Each partnership must have a "Partnership Representative".
- If the partnership fails to select a Partnership Representative the IRS will select one.
- The Partnership Representative can bind the partnership and has no obligation to involve partners in decisions or actions taken by the Partnership Representative.
- Unlike under TEFRA, partners have no right to participate in tax audits, appeals, or litigation, no right to opt out, and no partner-level defenses.

For the foregoing reasons, among others, we are recommending that partnerships eligible to elect out of the new partnership audit rules do so. The election out may only be made by the

Partnership Representative. Designation of the Partnership Representative is made on the

partnership's Form 1065.

The election out must be made each year on a timely filed partnership return. The election out must disclose the identity of all recipients of schedules K-1 for the year in which the election out is made. In the case of a K-1 provided to an S corporation, the election out must disclose the identity of the shareholders of the S corporation.

The election out is available only to partnerships issuing one hundred or fewer schedules K-1. In order for a partnership to be eligible to elect out of the partnership audit rules the partnership can have no partners who are disregarded entities, other partnerships, or trusts.

Whether the partnership decides to submit to the new partnership audit rules or elect out, partnership agreements will need to be changed to address the many issues created by the new partnership audit rules including:

- Selection (or a process by which selection will be made) of a Partnership Representative;
- Actions the Partnership Representative is required to take;
- Decisions the Partnership Representative is required to submit to the partners for their consent;
- Decisions which the Partnership Representative may make without the consent of the partners;
- Procedures for designation of successor Partnership Representatives;
- Obligations of departing partners arising from the IRS's examination of prior years' partnership returns;
- Obligations of the partnership to give effect to partners' amended returns;

- Obligations of the partnership to make "push out elections" to pass-through underpayment obligations to its partners; and
- Restrictions on transfers of partnership interests to entities which would prevent the partnership from electing out of the new partnership audit rules.

Please contact us if you have questions regarding the new partnership audit rules adopted by the BBA or if your clients require assistance in amending partnership or operating agreements (in the case of limited liability companies taxed under subchapter K of the Internal Revenue Code).

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