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Technical Corrections to Partnership Audit Rules

In 2015, the Bipartisan Budget Act of 2015 (BBA) was signed into law and introduced a new federal partnership tax audit regime, which replaced the previous partnership audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Under these new partnership audit rules, taxes and penalties due as a result of a partnership audit are assessed at the partnership entity-level, rather than individually at the partner level. These new partnership audit rules became effective Jan. 1, 2018. The Consolidated Appropriations Act (P.L 115-141), also known as the omnibus appropriations bill, was signed into law by President Trump March 23, 2018, and provides clarifying provisions and corrections to the partnership audit rules. These corrections have clarified the congressional intent of the partnership audit rules and have given the IRS more authority to draft regulations and guidelines. This GT Alert describes some important changes to the audit rules and explains their relevance to practitioners and taxpayers.

1. Alternative Procedure for Filing Amended Returns (Pull-In Procedure)

If the IRS audits a partnership for a particular year (the "reviewed year"), the amount which the IRS determines that the partnership owes is referred to as an imputed underpayment. The amount owed by the partnership can be reduced, however, if and to the extent that the partners agree to file amended returns and pay their share of the tax themselves. Any tax paid by a partner with the amended return is a credit against the tax owed by the partnership. Under a new option, referred to as the "pull-in" procedure, partners may pay the tax that would be due under the amended return filing procedure without having to file an amended return. The partnership can reduce the imputed underpayment by the amount paid by the partner or partners who follow this procedure. Under the pull-in procedure, payment is due by the same deadline for filing amended returns, i.e., within the period ending 270 days after the notice of proposed partnership adjustment was mailed. The partner is required to provide necessary information to the IRS to substantiate that the tax was correctly paid, but the partners do not file amended returns. Therefore, there are no corollary effects on the partner's tax returns, except the effects on tax attributes, such as the partner's basis in his partnership interest. The pull-in procedure does not require the participation of all direct and indirect partners. Finally, to make the process easier to administer, the partnership representative or the partnership's accounting firm may collect all the information and payments from the partners who choose to use the pull-in procedure. This allows for centralized tracking of the partners' information and addresses privacy concerns of partners who may not want to share information with the partnership representative. This addition to the partnership audit rules is largely seen as taxpayer-friendly as it provides yet another option for taxpayers and reduces the administrative burden on partners.

2. Push-Out Treatment of Pass-Through Partners in Tiered Structures

The partnership audit rules provide a mechanism whereby the partnership can elect not to pay the tax and to require the persons who were the partners in the reviewed year to pay the tax. This is referred to as a "push-out" election and will have the effect of pushing the audit adjustments out to the partners. As a result, the partnership itself will not be required to pay the tax, and, instead, the partnership will send a statement of the adjustments (similar to an amended Schedule K-1) to each of the reviewed year partners. The reviewed year partners will pay the tax that is attributable to their share of the adjustments. Previously, the availability of this election was uncertain in situations where an audited partnership had other partnerships or S corporations as direct or indirect partners. The bill clarifies that tiered partnerships may make push out elections at each tier, so that the tax is paid by the ultimate owners. Each partner that is a partnership (a "pass-through partner") must file a partnership adjustment tracking report and must furnish statements (similar to an amended Schedule K-1) to its partners. This same procedure must be followed at each successive level of pass-through ownership. The due date for the furnishing of partner statements and the filing of the partnership adjustment tracking report is the return due date (including allowable extensions) for the adjustment year of the audited partnership. That is, the partnership adjustment tracking report must be filed with the IRS, and the statements furnished to partners or S corporation shareholders, no later than the due date for the adjustment year of the audited partnership. If such statements are not timely provided, the partnership (or any pass-through partnership) must pay its imputed underpayment. Therefore, partnerships with multiple tiers must act quickly to issue adjusted partner statements at lower tiers so that the upper tier partnership can meet the deadline. The expanded clarity in this area is favorable to taxpayers and is consistent with prior interpretations of the law. This may make the push-out election more desirable in a broader range of situations. However, upper-tier partnerships or S corporation partners should be cognizant of the relevant deadline for properly making push-out elections.

3. Treatment of Positive and Negative Adjustments in a Push-Out Election

As mentioned above, a partnership can make a push-out election as an alternative to paying the imputed underpayment itself in the adjustment year. Prior to the bill, only adjustments that would increase a partner's tax were taken into account. In an important change, the new law provides that, in determining a partner's tax liability when a push-out election is made, items that both increase and decrease the partner's tax liability can be taken into account. Therefore, the partner's tax liability for the taxable year that includes the end of the reviewed year takes into account any increase or decrease in the partner's share of adjustments for that year. The partner's share of tax liability for any other taxable year (such as intervening years) would take into account any increase or decrease of the partner's share of adjustments as well. Thus, the tax payable by the reviewed year partners will more closely reflect the tax increase or decrease that would have resulted if the adjustments were taken into account in the reviewed year. This change is generally viewed as making a push-out election more attractive to partners.

4. Expanded Scope of the Partnership Audit Rules

As mentioned above, the partnership audit rules replace the former TEFRA audit rules. The TEFRA rules provided for a centralized audit at the partnership level of all partnership items that have an effect on the partners. On the other hand, the new audit rules that became effective in 2018, originally applied only to partnership profits and losses. Responding to concerns that the new audit provisions were not as broad as the former TEFRA rules, the bill clarifies that the partnership audit rules apply to all "partnership-related items" which are defined as any item or amount with respect to the partnership that is relevant in determining the tax liability of any person, without regard to whether the item or amount appears on the partnership's return. This includes an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of the partnership. Therefore, the determination of items or amounts with respect to (i) transactions between a partner and partnership, (ii) the basis of a partner's partnership interest or of partnership property, and (iii) liabilities of a partnership and the partners' share of such liabilities, are within the scope of review. Furthermore, the bill makes it clear that the partnership audit rules do not apply to self-employment taxes, net investment income taxes, and withholding taxes on non-resident alien individuals or foreign corporations. Although the new audit rules do not apply to a partnership's withholding taxes on non-US partners, the bill explains that following a partnership audit, any additional withholding tax is due and payable in the adjusted year. For example, if the audit results in an increase in the partnership's effectively connected income allocable to foreign partners, the additional withholding tax must be paid by the partnership in the adjustment year.

5. Manner of Netting Items to Determine Imputed Underpayment

A partnership's imputed underpayment is determined by (a) allocating the various adjustments to groups or subgroups, (b) netting the positive and negative adjustments in each group or subgroup, and (c) taking into account only netted amounts that <u>increase</u> the tax for the reviewed year. The total netted adjustments are multiplied by the highest rate of tax that was in effect during the reviewed year. The bill clarifies that items of different character (e.g., capital and ordinary) may not be netted together in computing the imputed underpayment. If it is determined that there is no imputed underpayment and there is a taxpayer-favorable adjustment (such as additional depreciation) then that adjustment would not impact an imputed underpayment, but would rather be taken into account by the partnership and passed through to the partners in the form of a deduction in the adjustment year.

In the case of partners' distributive shares, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any part of the adjustment that results in a decrease in the amount of an imputed underpayment. For example, this rule may disregard any reallocation of deduction, loss, or credit that would result in a decrease in the amount of an imputed underpayment. Adjustments to items of credit are separately determined and netted, then taken into account as an increase or decrease in determining the amount of an imputed underpayment. The clarifications described above may result in greater imputed underpayments and may encourage the use of the push-out or pull-in procedures.

While the above technical corrections (and various other changes not discussed here) provide guidance regarding some crucial areas of the centralized partnership audit regime, some uncertainty remains as practitioners await final regulations.

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