IRS Seeks Comments to Promulgate Regulations for New Tax Examination and Collection Regime for Partnerships and LLCs

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Late last year, Congress completely overhauled the rules by which the Internal Revenue Service ("IRS") examines partnerships and limited liability companies ("LLC") (please see our client alert dated December 10, 2015). With the stroke of a pen, Congress repealed over three decades of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") rules relating to the tax examination of partnerships, the so-called unified audit and litigation procedures. In its place the Bipartisan Budget Act of 2015 ("BBA") installed a set of rules to simplify, for the IRS, the examination of partnerships and LLCs and the collection of any tax resulting from such examination.

The new rules (1) create a very powerful "partnership representative" to replace the "tax matters partner;" (2) strip partners of notice and participation rights (with respect to any partnership-level examination and litigation); and (3) default to a collection procedure, of any additional tax and penalties, at the partnership level (instead of at the partner level). In light of the new legislation, partnerships and partners should now evaluate the current provisions of their partnership and LLC agreements and make fundamental changes to the tax representation and procedure provisions.

While the concepts and policy goals for the new rules were brewing for some time, the actual drafting of the law was done fairly quickly. Accordingly, Congress had to enact technical corrections, 45 days later, in the Protecting Americans from Tax Hikes ("PATH") Act of 2015. But the PATH Act did not catch many of the technical problems and certainly did not solve any of the statutory ambiguities.

For example, a partnership with 100 or fewer partners can elect out of the BBA tax examination and collection regime. However, those 100 or fewer partners must be comprised of only individuals, C corporations, foreign entities that would be treated as C corporations, estates of deceased partners, or S corporations. Even though certain entities, like grantor trusts and single member LLCs, are treated as individuals for tax purposes, the plain language of the statute appears to throw any partnership with a grantor trust or single member LLC partner into the BBA regime, without any ability to elect out. It appears that the IRS would prefer to adopt this hard-line, exclusive interpretation of the statutory provision. Regulations could fix that.

In public forums, IRS executives have stated that they will move quickly to promulgate regulations to "fill in the gaps" in the legislation. On March 4, 2016, the IRS issued Notice 2016-23 to solicit comments regarding implementation of the BBA regime. This is the first chance to provide comments directly to the Treasury Department and the IRS's regulation-writing staff and is an important part of the regulatory process under the Administrative Procedures Act. There will be very few opportunities to participate in the process involving these complex and high-stakes statutory provisions.

Some of the IRS's specific requests for comment include:

1. For the partnership representative:

- Any limitations on who may be designated as a partnership representative?
- The definition of "substantial presence" in the United States.
- Designation of the partnership representative by the IRS in cases where the partnership fails to designate a representative or the designation is not in effect.

2. For purposes of calculating the partnership level tax:

- How character changes, restrictions, and limitations under the Internal Revenue Code are taken into account.
- The effect of unrelated business taxable income of a tax-exempt entity on the modification procedure relating to tax-exempt partners.
- Any other issues and factors that should be considered when formulating the modification procedures?

3. With respect to the revised K-1 or "push out" procedures:

- How to make the election, the time for providing information to the IRS, the information that should be required to be included with the election, and the form and content of the statement of adjustments to be provided to the partners and the IRS.
- How tax attributes should be taken into account for intervening years between the reviewed year and the adjustment years.

4. With respect to a partnership level administrative adjustment request ("AAR"):

- What steps the IRS should take upon receipt of an AAR?
- What opportunities the partnership has for review of IRS actions taken with respect to an AAR?

5. With respect to general procedural rules:

- What information will the notices of proceedings and adjustment contain?
- What are the rules regarding assessment, collection, and payment of the imputed underpayment?
- How penalties and interest are computed?
- What judicial review of partnership adjustments is available?

The new partnership tax audit and collection regime under the BBA will create a good deal of confusion and uncertainty in the marketplace. Partnerships and LLCs have been favored as business and investment vehicles due to their flexible structures and pass-through nature for purposes of federal and state income taxes. The BBA has certainly chipped away at both of those favorable attributes. Providing comments to the Treasury Department and IRS as part of the regulation process may ameliorate some of the concerns.

If you have any questions about these new statutory provisions or the regulatory process, please contact Charles M. Ruchelman at cruchelman@capdale.com / 202.862.7834.

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