

Congress enacts new tax examination and collection regime for partnerships

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One by-product of the Bipartisan Budget Act of 2015 is a fundamental change to the rules by which partnerships, and entities that elect to be treated as partnerships for tax purposes (collectively, 'partnerships'), interact with the Internal Revenue Service (IRS) with respect to the tax examination, litigation and collection process. The Bipartisan Budget Act repealed what was known as the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership regime and replaced it with an entirely new set of rules.⁽¹⁾ While the new regime has similarities to the TEFRA regime, there are significant changes that will require careful review of and revisions to certain tax provisions of partnership agreements. In light of the new legislation, partnerships and partners should evaluate the current provisions of their partnership agreements and make fundamental changes to the tax procedure provisions.

The Bipartisan Budget Act substantially changed:

- the ability of the IRS to collect an underpayment of tax, penalties and interest from the partnership itself;
- current partners' exposure to tax liabilities of prior partners; and
- the powers entrusted in the partnership's designated liaison with the IRS (formerly known as the 'tax matters partner').

Also, Congress provided the Treasury Department with broad regulatory authority to implement the goals of the statutory revisions. Therefore, partnerships should pay attention to the issuance of new Treasury regulations in the coming months.⁽²⁾

Statutory revisions affecting partnership agreements

New tax terms and concepts

The new regime repeals well-known TEFRA terms (eg, 'tax matters partner') and creates completely new legal terms and concepts, including 'partnership representative', 'imputed underpayment', 'reviewed year' and 'adjustment year'.⁽³⁾ To synchronise with the new Internal Revenue Code requirements, these terms and concepts should be incorporated into partnership agreements. Reviewing and revising the partnership agreements now will allow for an orderly process if and when the IRS examines a partnership tax return, makes tax adjustments or requires payments of additional tax, penalties or interest. Further, revisions to the partnership agreements will clarify the rights and obligations of the partnership and partners.

Tax underpayments to be collected from partnership

As under TEFRA, tax adjustments will continue to be made at the partnership level.⁽⁴⁾ However, unlike under TEFRA, unless a partnership is eligible to make an annual election and does in fact make the election, the tax attributable to an adjustment – and related interest and penalties – will be

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collected, subject to certain possible adjustments, at the partnership level.(5)

When the IRS makes a tax adjustment the partnership's current partners (the 'adjustment year' partners) will effectively pay the tax for the partners that were in place in the tax year for which the adjustment was made (the 'reviewed year' partners).(6) The tax to be paid is based on another new concept, a calculation called the imputed underpayment.(7) Generally, the imputed underpayment is calculated at the highest tax rate for the reviewed year. This change in the law may require parties to consider or review indemnification provisions in the partnership agreement.

Ways to modify or avoid tax collection at partnership level

The imputed underpayment collection process can be avoided or modified in one of three ways:

- Elect out on timely filed return - if a partnership has no more than 100 partners and no partner is itself a partnership (or an entity that has elected to be treated as a partnership such as a limited liability company), the partnership can make an annual opt-out election on a timely filed tax return.(8) To preserve this option, a partnership agreement could be amended to limit the number of partners to 100 and restrict the ability of other partnerships to join the partnership as a partner. If a partnership elects out of the new regime, the partnership and partners will be examined under the rules applicable to individual taxpayers.(9)
- Reviewed year partner pays tax with current year individual return - within 45 days of receiving a notice of final partnership adjustment, any partnership – regardless of size – may elect out of the imputed underpayment process, so long as it provides the IRS with "a statement of each partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment)".(10) Under this procedure, reviewed year partners calculate their share of additional tax due based on the statement described above (ie, as for an amended Schedule K-1) and pay the additional amount with their respective current year individual tax returns.(11) However, an election under this provision increases the applicable underpayment interest rate by two percentage points.(12) The new statute requires fast action by the partnership (ie, 45 days) to perform computations and send the proper notices. Therefore, a procedure should be put in place to accomplish this procedural route.
- Modify imputed underpayment where reviewed year partner files an amended reviewed year tax return - a partnership can reduce the amount of the imputed underpayment if one or more of the reviewed year partners files an amended return and pays the tax attributable to the adjustment allocable to that partner. To implement this, the partnership must submit information to the IRS sufficient to modify the imputed underpayment amount within 270 days of the notice of proposed adjustment.(13) Verifying that an amended tax return has been filed by a reviewed year partner may raise certain privacy concerns. Thus, a partnership may wish to establish a method that allows for the implementation of this alternative, rather than undergo the imputed underpayment procedure.

Powerful new partnership representative

The Internal Revenue Code now mandates that the partnership designate a partnership representative instead of a tax matters partner.(14) The partnership representative will "have *sole* authority to act on behalf of the partnership" and the "partnership and *all* partners shall be bound by actions taken...by the partnership".(15) This controlling entity need not be a partner in the partnership. Further, the new rule significantly curtails the ability of other partners to participate in an IRS examination or litigation with the IRS. Therefore, partnership agreements may need to be adjusted to provide contract rights to other partners that once existed as a statutory matter under TEFRA. For example, a partnership might consider whether the partnership representative has unbridled power to settle a case or extend the statute of limitations without approval from the other partners. This new regime obviates the need for the IRS to chase each and every partner to sign a Form 870-PT (Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts) or sign a Form 906 (Closing Agreement On Final Determination Covering Specific Matters) in order to implement an examination's adjustments or a settlement. Partnership agreements should be revised to reflect this new, critical designation. If there is no partnership designated representative, the Internal Revenue Code gives the IRS the authority to designate one; partnerships and partners will not want to relinquish that selection right to the IRS.(16)

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The new rules apply to partnership tax years beginning after December 31 2017. However, a partnership may elect to have the new rules apply to partnership tax years beginning after the date of enactment and before January 1 2018.⁽¹⁷⁾ Given the many new legal terms and concepts, and the potentially significant shift of the benefits and burdens of post-adjustment tax items, existing partnerships and partners should review and modify their partnership agreements. New partnership agreements should accommodate the new partnership tax audit and collection regime.

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Endnotes

- (1) The Tax Equity and Fiscal Responsibility Act of 1982 originally enacted the unified partnership examination provisions.
- (2) The Bipartisan Budget Act also changed the statute of limitations for partnership assessments. Under the new law, the statute of limitations starts to run only when the partnership's tax return is filed and no longer takes into consideration the filing date of the individual partner's return. Section 6235(a) of the Internal Revenue Code of 1986 as amended (26 USC).
- (3) Sections 6623(a), 6625(b), 6625(d)(1) and 6625(d)(2), Internal Revenue Code.
- (4) *Id* at Section 6621(a).
- (5) *Id* ("any tax attributable thereto shall be assessed and collected...at the partnership level pursuant to this subchapter.")
- (6) *Id* at Section 6225(a).
- (7) *Id* at Section 6225(b).
- (8) *Id* at Section 6221(b).
- (9) *Id* at Section 6225(d)(1).
- (10) *Id* at 6226(a)(1) and (2).
- (11) *Id* at Section 6226(b)(1).
- (12) *Id* at Section 6226(c)(2)(C).
- (13) *Id* at Section 6225(c)(6).
- (14) *Id* at Section 6223.
- (15) *Id* at Sections 6223(a) and (b).
- (16) *Id* at Section 6223(a).
- (17) *Id* at Section 6241(g)(4).

