Are You and Your Clients Ready for the New Partnership Audit Rules?

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(September 2018) - The new partnership audit rules are important to all partnerships including, of course, CPA firms and their partnership clients. The new rules apply to partnership returns filed for partnership taxable years beginning after Dec. 31, 2017. As such, returns due in 2018 will come under the new audit rules. Here are a few important items CPAs may want to note as we get closer to that date.

General Rules under Section 6225

The *Bipartisan Budget Act of 2015*, Pub. L. No. 114-74, as amended by the *Protecting Americans from Tax Hikes Act of 2015*, Pub. L. No. 114-113, established new rules for IRS audits of partnerships and other entities taxed as partnerships for federal income tax purposes, including many limited liability companies. Generally, under IRC Section 6221(a), any additions to tax, penalties and interest resulting from an audit will be imposed at the partnership level instead of flowing through to the various partners and will apply to the year the adjustments are made rather than the year under examination. The statute bases the partnership-level adjustment on the highest tax rate in effect for the year under review, but adjustments will be permitted to the extent the audit adjustments relate to capital gains or dividends or are allocable to certain partners (such as where a partner in the reviewed year is a tax-exempt organization).

Has the Partnership Agreement Been Amended?

All partnership agreements should be reviewed and amended to address several matters depending on the partners and partnership's particular situation. Some matters the partners may want to address in the agreement include:

1. who should act as the partnership representative and how that selection process should occur;

2. how transfers of partnership interests should be handled in light of the new rules;
3. whether the partnership should opt out of the new partnership audit rules and whether restrictions on its ownership should be implemented so the partnership remains eligible for the opt-out election; and
4. whether the partnership should be required to make a “push-out” election.

Partners should also understand that, depending on the elections made or not made, their partnership could be liable for audit adjustments applicable to years before they became a partner. That possibility makes it particularly important for partners to understand the scope of the partnership representative’s authority, how that representative is chosen and the various options available to the partnership under the new rules.

Who Should be Designated as Partnership Representative on the Partnership Return?

In addition to amending the partnership agreements to address the partnership representative, the partnership will need to designate the representative on its tax return. Once the designation has been made on a partnership return, the partnership representative can only be changed in one of three instances:

1. the partnership representative could resign;
2. his/her status as partnership representative could be revoked by the partnership; or
3. the IRS could determine that the partnership representative’s designation is not in effect.

However, any such resignation or revocation is only effective if an Administrative Adjustment Request (AAR) is filed or a Notice of Audit has been issued. Given the limited ability to revoke a designation, a CPA will want to carefully consider the person designated as partnership representative to ensure it reflects the will of the partnership.

Should the Partnership Opt Out of the New Partnership Audit Rules?

Qualifying partnerships with 100 or fewer partners may want to consider the Section 6221(b) opportunity to elect out of the new partnership audit rules. The election is unavailable if the partnership in the reviewed year had another partnership, a limited liability company, a trust, or disregarded entity as a partner. A married couple is considered two partners for this purpose if they each receive a separate Schedule K-1. Where the partnership has an S corporation partner, all

shareholders of the S corporation and the S corporation itself are included in the count. The election must be made annually with a timely filed tax return and requires notification to the partners and disclosure of the partners to the IRS.

Should a Partnership Make a Push-Out Election Following an Audit?

IRS audits under the new partnership audit rules are not expected to occur until about the year 2020. However, CPAs should be familiar with some key aspects of the new audit rules, given the importance and short deadlines associated with some elections. For example, partnerships that experience a change in partners between the year under examination and the year of the examination may want to consider making a push-out election under Section 6226 at the conclusion of an audit. Section 6226 allows a partnership to make an election that would push out the audit adjustments to its partners for the year under examination. However, even under the election, penalties apply at the partnership level and the election must be made within 45 days after the date of the final adjustment.

If a push-out election is made, the partnership must provide statements to each partner and the IRS detailing the adjustments affecting each partner, and a higher rate of interest applies to the resulting partner-level underpayments. The partners will have a very short time frame to make any applicable payment to the IRS. The IRS proposed regulations provide that, for tiered partnerships, the IRS will not impose any additions to tax under Section 6651 if an affected partner who is not a pass-through partner reports and pays any additional reporting year tax within 30 days of the extended due date for the return for the adjustment year of the partnership that made a push-out election (Prop. Treas. Reg. Section 301.6226-3(e)(3)(iv)).

Should the Partnership Request Modification of the Imputed Underpayment Amount?

Another avenue available to partnerships to reduce partnership-level tax on IRS adjustments is to request modification of its imputed underpayment. Under the modification procedures, the partnership representative has 270 days from the issuance of a Notice of Proposed Partnership Adjustment (NOPPA) to provide the IRS with information sufficient to show that the partnership-level tax should be reduced. For example, the modification procedures permit a reduction in partnership-level tax where an examination year partner files an amended return related to the adjustments and pays his/her share of tax. Moreover, the modification procedures permit reductions in partnership-level tax where the partnership has a tax-exempt partner or the adjustments may cause varying tax rates, such as a capital gains or qualified dividend income adjustment.

Effective Date

Although the new audit procedures are generally effective for tax years beginning after 2017, partnerships may elect to apply the new rules for 2016 and 2017 returns.

TSCPA's Federal Tax Policy Committee continues to monitor and serve as the voice of our members on the centralized partnership audit rules:

https://www.tscpa.org/docs/default-source/comment-letters/federal-tax-policy/2018/partnership-audit-provisions-fed-tax-policy.pdf?sfvrsn=f201feb1_4

https://www.tscpa.org/docs/default-source/comment-letters/federal-tax-policy/2018/letter-to-irs-on-tiered-partnerships-march-2018.pdf

https://www.tscpa.org/docs/default-source/comment-letters/federal-tax-policy/2017/tscpa-request-to-testify-irs-centralized-partnership-audit-regime.pdf?sfvrsn=2

https://www.tscpa.org/docs/default-source/comment-letters/federal-tax-policy/2017/irs-partnership-audit-regime-letter.pdf