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Financial Reporting Alert 18-6

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Contents

Financial Statement Implications of the New Partnership Audit Rules

Background

On November 2, 2015, the Bipartisan Budget Act of 2015 (the "Budget Act") was signed into law. The Budget Act includes, among other items, significant changes to the rules for partnership audits and adjustments. The new rules supersede the current Tax Equity and Fiscal Responsibility Act (TEFRA) procedural rules for partnership audits and adjustments and will apply to all partnerships, although an opt-out election is available to certain qualifying partnerships. These provisions of the Budget Act are effective for returns filed for partnership taxable years beginning after December 31, 2017. A partnership may elect to apply the new rules to any partnership return filed for partnership taxable years beginning after the date of enactment and before January 1, 2018.

Under these streamlined audit rules, the IRS will examine partnership items for a particular year (the "reviewed year") and the partnership will take any adjustments into account at the partnership level in the year in which the audit or judicial review is completed (the "adjustment year"). This is a significant change from the TEFRA provisions since it shifts the cost of any adjustment to the partners in the adjustment year rather than flowing the adjustments through to the partners who benefited in the reviewed years.

In addition, under the Budget Act, the partnership may pay the tax, interest, and penalties on underpayments. The tax due is calculated by multiplying the appropriately netted partnership adjustments for tax positions causing underpayments by the highest statutory corporate or individual rate in place. Any adjustments not causing underpayments will then flow through to the partners in the year of the adjustment. If the partnership remits the payment, partners are not subject to joint-and-several liability with respect to this payment.

Partnerships may, however, make a "push-out" election or issue adjusted information returns to the reviewed-year partners, who would then take the adjustments into account on their individual returns in the adjustment year through an amended return process. In this case, the partners would remit the payment to the IRS. Once the push-out election is made with respect to the reviewed year, it may only be revoked with the consent of the secretary. If the partnership elects to push out, the partnership is not subject to joint-and-several liability with respect to the payment.

For more information about the changes to the partnership audit rules, please join us on May 2, 2018, for our *Dbriefs* webcast *Quarterly Federal Tax Roundup: A Pass-Throughs Update*.

Financial Statement Implications

In March 2018, the AICPA released TIS Section 7200.09,[1] which addresses the financial statement implications of the new partnership audit rules. TIS Section 7200.09 states, in part:

> How should a partnership account for amounts it pays to the IRS for previous underpayments of tax, interest, and penalties?[1] Said another way, does the underpayment represent an income tax of the partnership or the partners?
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> *Reply* — In accordance with paragraphs 226–229 of FASB ASC 740-10-55, if income taxes paid by the entity are attributable to the entity, they should be accounted for under the FASB ASC 740, Income Taxes, accounting model. If, however, the income taxes paid by the entity are attributable to the owners, they should be accounted for as a transaction with the owners. The determination of attribution should be made for each jurisdiction where the entity is subject to income taxes. Attribution is determined on the basis of laws and regulations of the jurisdiction.
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> In the case of the IRS partnership audit regime, the collection of tax from the partnership is merely an administrative convenience on the part of the government to collect the underpayment of income taxes from the partners in previous periods. Accordingly, the income taxes on partnership income, regardless of when paid, should continue to be attributed to the partners and, therefore, the partnership would not apply the FASB ASC 740 accounting model to account for amounts it pays to the IRS for previous underpayments of tax, interest, and penalties. Rather, a payment made by the partnership under the IRS partnership audit regime should be treated as a distribution from the partnership to the partners in the financial statements of the partnership.
>
> [1] This Technical Question and Answer does not address whether or, if so, when the partnership would recognize a liability.

Accordingly, under U.S. GAAP, in a manner consistent with the excerpt above, any payment by the partnership under the Budget Act would not be reflected as an income tax expense of the partnership but would, instead, be recorded through equity.

While footnote 1 of TIS Section 7200.09 indicates that it "does not address whether or, if so, when the partnership would recognize a liability," we believe that an entity would generally be required to recognize a liability, through equity, for a future dividend payment *once declared*. An entity will need to exercise judgment when determining the declaration date and whether a liability has been incurred as of the reporting date. This determination would include an analysis of the specific facts and circumstances, including, but not limited to, the partnership's intent or obligation to pay the underpayment of taxes. Alternatively, if the partnership has elected to push out the adjustments or is required to do so under the partnership agreement, a liability would generally not be recorded in the partnership's financial statements for the additional taxes the partners would owe in connection with the underpayments.

[1] AICPA Technical Practice Aids, TIS Section 7200.09, "Tax Accounting Considerations Under Partnership Audit Regime."

To maintain transparency for financial statement users, management should carefully consider providing appropriate disclosures as a result of the new partnership audit rules, including disclosures related to the partnership's established or intended policy to pay or push out the underpayments.