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Investment management tax alert
November 5, 2015

Changes to IRS audits of partnerships
Bipartisan Budget Act

On Monday, November 2, 2015, the Bipartisan Budget Act of 2015 (the Budget Act) was enacted, which includes, among other items, significant rule changes for partnership audits and adjustments. These provisions are effective for returns filed for partnership taxable years beginning after December 31, 2017.

Issue

The Budget Act completely replaces the current Tax Equity and Fiscal Responsibility Act (TEFRA) procedural rules for partnership audits and adjustments.

Current rules for partnership audits and adjustments

In 1982, Congress passed TEFRA, which established unified audit rules for partnerships with more than 10 partners, and required that the tax treatment of all partnership items be determined at the entity level for these partnerships. In 1997, Congress added rules to allow partnerships with more than 100 partners (an electing large partnership or ELP) to elect into a simplified reporting regime, which included streamlined audit and adjustment procedures.

President Obama included proposals in some of the administration's previous budget packages to mandate the ELP system of streamlined audit and adjustment procedures for partnerships with 1,000 or more partners, but these proposals were never taken up in Congress. In February 2014, Rep. Dave Camp, R-Mich., who was then chairman of the House Ways and Means Committee, released the draft of a comprehensive tax reform plan that included a proposal to streamline the audit process in a manner similar to the ELP rules but applicable to partnerships with more than 100 partners. The Obama administration subsequently incorporated Camp's proposal into its fiscal 2015 and 2016 budget blueprints. On June 18, 2015, Rep. James B. Renacci, R-Ohio, and Rep. Ron Kind, D-Wis., both members of the House Ways and Means Committee, introduced the Partnership Audit Simplification Act to reform the partnership audit rules. This Act was similar in many respects to the tax reform plan introduced by Camp.

Changes to rules for partnership audits and adjustments

The Budget Act is modeled largely on the Renacci proposal. The Budget Act repeals the current TEFRA and ELP rules, including the simplified reporting aspects, and replaces them with one set of partnership-level audit rules that will apply to all partnerships, subject to an election out by certain partnerships with 100 or fewer partners. Under these streamlined audit rules, the IRS will examine partnership items for a particular year (the "reviewed year"), and any adjustments will be taken into account by the partnership at the partnership level in the year the audit or judicial review is completed (the adjustment year). This is a significant change from the current TEFRA provisions as it shifts the cost of any adjustment to the partners in the adjustment year rather than flowing the adjustments through to the partners who benefitted in the reviewed years.

Partnership-level tax

Under the Budget Act, the partnership will pay the tax, interest, and penalties on underpayments. The tax due is calculated by multiplying the net of the adjustments 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. The amount of the underpayment at the partnership level could be reduced by (i) the tax reported on the underpayment by partners filing amended returns, (ii) the tax attributable to tax-exempt partners, and (iii) the tax rate differential due to a lower corporate tax rate or lower capital gain/dividend rate.

Election for partners to pay tax

Alternatively, partnerships may elect to 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 a simplified amended return process. Those partners would calculate the additional tax owed for the reviewed year and then pay the tax (and interest and penalties) from that prior year with the tax return for the year when they receive the statement of adjustments. The partnership isn't required to ensure that each of its reviewed-year partners actually take the adjustments into account and pay any tax due. Once this election is made, it may only be revoked with the consent of the Secretary.

Statutes of limitations

The statute of limitations for assessments is determined based upon when the partnership's return was filed and considers extensions between the IRS and the partnership, rather than taking into account partners' individual assessment statutes of limitations. The statute of limitations for filing partnership refund claims is based solely on when the partnership return was filed, and cannot be extended by agreement.

Opt-out for small partnerships

Small partnerships with 100 or fewer qualifying partners are allowed to elect out of the new rules, and those partnerships and partners are subject to the general rules that apply to auditing individual taxpayers. To qualify to elect out, the partners must all be individuals, C corporations, foreign entities that would be treated as C corporations if domestic, S corporations, estates of deceased partners, or others if the Secretary prescribes in guidance. Thus, partnerships with partners that are partnerships or trusts are unable to elect out absent further guidance. The provision also contains several consent and election rules with special rules for certain partners, such as S corporations. The election to opt out is made for a particular year with a timely filed return for that taxable year.

Other changes

Audits will be handled by a designated partnership representative, who can be a partner or non-partner with a substantial presence in the U.S. The partnership representative is granted broad authority to resolve any partnership audit and any such resolution would be binding on all partners.

Under the Budget Act, partners are not subject to joint and several liability for liabilities determined at the partnership level.

Effective date

The provisions 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. According to the Congressional Budget Office, the partnership audit and adjustment provisions will increase federal receipts by approximately $9 billion over 10 years as a result of improved tax compliance and the use of a streamlined process for auditing complex partnerships.

Contacts

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