Bipartisan Budget Act Requires Partnerships to Share a Portion of the Audit Burden

November 18, 2015

On November 2, 2015, President Barack Obama signed into law the Bipartisan Budget Act of 2015 (the “Act”), a law that raises the U.S. debt ceiling through March 2017 and defers the next federal budget battle until after the 2016 elections. Notably, Title XI of the Act – “Revenue Provisions Related to Tax Compliance” – includes fundamental changes to partnership audit rules for all entities treated as partnerships and provides clarification on gifted partnership interests. The Government Accountability Office recently issued a report stating that partnerships have been 33 times less likely to face an audit than similarly sized C corporations, in part because examining large partnerships is difficult due to the adjustments that must be made for each partner. Under the Act, a greater share of the administrative tax burden rests at the partnership level rather than at the level of the individual partners. The Congressional Budget Office estimates that these audit streamlining provisions will raise $9 billion over the next 10 years.

Partnerships filed more than 3 million tax returns for the 2013 tax year, representing more than 27 million partners and roughly $1.5 trillion in revenue.

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2 It should be noted that many securitization vehicles are, or have the risk of being treated as, partnerships for tax purposes, and thus are potentially subject to these rules. There may also be an effect on the securitization entity known as a REMIC. See Internal Revenue Code of 1986, as amended (the “Code”), §860F(e).
5 Which include, for purposes of this article, entities treated as partnerships for U.S. federal income tax purposes.
in total income.\(^6\) Partnerships are required to file an annual Form 1065, which shows the partnership’s items of income and loss. Partnerships are not taxed directly; instead, the partners report their share of partnership items of income and loss on their respective returns. In a recent report, the Treasury Inspector General for Tax Administration found that the full extent of partnership tax compliance was unknown.\(^7\)

Due to the complex nature of partnerships, the IRS has had difficulty evaluating the effect of partnership audits on the tax liability of partners. Thus, even though partnership audits “have resulted in billions of dollars in adjustments, the IRS does not know how much additional tax is ultimately assessed to the taxable partners as a result of the adjustments made to the partnership returns.”\(^8\)

**Partnership Audits and Adjustments**

**Current Audit Process**

Prior to the enactment of the Act, partnerships faced three separate audit regimes:

- For partnerships with up to 10 partners, the IRS generally applied the audit procedures for individual taxpayers, auditing the partnership and each partner separately.\(^9\)

- For partnerships with more than 10 partners, under the TEFRA rules,\(^10\) the IRS conducted a single administrative proceeding to resolve audit issues.\(^11\) Once the audit was completed and the adjustments determined, the IRS recalculate the tax liability of each partner for the particular audit year.

- Partnerships with 100 or more partners that elected to be treated as Electing Large Partnerships (“ELPs”) for reporting and audit purposes were treated differently.

Unlike the TEFRA audit rules, in which adjustments take effect for the year under audit, ELP audit rules dictate that partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect.\(^12\) Therefore, partners’ shares of current-year items of income and loss are adjusted to reflect partnership adjustments relating to a prior-year audit. The adjustments generally do not affect prior-year returns of any partners (except in the case of changes to any partner’s distributive share).

**New Legislation**

The partnership provisions of the Act are based on the proposed Partnership Audit Simplification Act of 2015, which aimed to revise audit rules for partnerships by repealing the TEFRA and ELP audit rules,\(^13\) and which was based on Representative David Camp’s proposed Tax

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\(^8\) Id.


\(^10\) TEFRA is an acronym for the Tax Equity and Fiscal Responsibility Act of 1982.

\(^11\) The Budget Summary at 13.

\(^12\) Id.

Reform Act of 2014.\textsuperscript{14} The Act repeals the TEFRA and ELP rules and enacts a set of rules for auditing partnerships and their partners at the partnership level.\textsuperscript{15} Partnerships with 100 or fewer partners generally retain the ability to opt out of the new rules, in which case the partnership and its partners would be audited under the general rules applicable to individual taxpayers.\textsuperscript{16}

To qualify as having 100 or fewer partners, each partner must be an individual, a C corporation, a foreign entity that would be treated as a C corporation were it domestic, an S corporation\textsuperscript{17} or the estate of a deceased partner.\textsuperscript{18} A partnership will not qualify for this opt out if it has even one trust or partnership as a partner. To opt out of these audit provisions, a qualifying partnership must disclose to the IRS the name and taxpayer identification number of each S Corporation shareholder during the taxable year.\textsuperscript{19}

Under the Act, the IRS first examines the partnership’s treatment of income, gain, loss, deduction, and credit attributable to a specific partnership tax year (the “reviewed year”). If a partnership adjustment is made, the partnership, not the individual partners, pays any imputed underpayment of tax in the year the final determination is made (the “adjustment year”).\textsuperscript{20} From a practical standpoint, the additional tax is determined by increasing the income in the reviewed year, though the adjustment to tax is in the adjustment year. Partners are not subject to joint and several liability for any liability determined at the partnership level.\textsuperscript{21}

Adjustments that do not result in an imputed underpayment generally are to be taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss, or in the case of an item of credit as a separately stated item.\textsuperscript{22} Imputed underpayments are calculated using the higher of the highest corporate or individual tax rate in effect for the reviewed year.\textsuperscript{23}

\textsuperscript{14} H.R. 1, 113\textsuperscript{th} Cong. (2014). The Tax Reform Act of 2014 did not become law.
\textsuperscript{15} The Act applies to all partnerships, including foreign partnerships, unless excluded from a U.S. partnership filing requirement under Treasury Regulations Section 1.6031(a)-1(b) because (i) the partnership had no effectively connected income during its tax year, (ii) the partnership had U.S. source income of $20,000 or less during its tax year, (iii) less than 1% of any partnership item of income, gain, loss, deduction, or credit was allocable in the aggregate to direct U.S. partners at any time during its tax year, and (iv) the partnership is not a “withholding foreign partnership.”
\textsuperscript{16} Code §6221(b), as added by the Act. Hereinafter, unless otherwise indicated, every reference to a Code section is to the Code, as amended by the Act.
\textsuperscript{17} For this purpose, each shareholder in an S corporation would be considered a partner.
\textsuperscript{18} Code §6221(b)(1)(C). The Partnership Audit Simplification Act of 2015 had provided that partnerships with one or more REITs or RICs as members could not elect to opt out of the audit rules. This exclusion is not in the Act.
\textsuperscript{19} Code §6221(b)(2)(A)(i).
\textsuperscript{20} Code §6225(d)(2). The term “adjustment year” refers to the partnership taxable year in which (a) in the case of an adjustment pursuant to the decision of a court in a proceeding, such decision becomes final, (b) in the case of an administrative adjustment request, such administrative adjustment request is made, or (c) notice of the final partnership adjustment is mailed.
\textsuperscript{21} The Budget Summary, at 14.
\textsuperscript{22} Code §6225(a)(2)(A) and (B).
\textsuperscript{23} Code §6225(b)(1)(A). Regulations might attempt to increase the tax assessed to partnerships by the 3.8% Medicare tax in §1411, though this would seem to be beyond the scope of the statutory language.
Upon a proper showing to the IRS, partnerships may reduce the adjustment on account of certain partner level information from the reviewed year, such as the portion that is attributable to tax-exempt partners or individual partners who pay tax on capital gains or dividends at lower rates. This effectively puts the burden of showing that the tax is less on the partnership.

The 6226 Election

The Act includes a provision that could, depending on how regulations interpreting the Act are written, significantly weaken its simplifications and burden shifting. Partnerships of all sizes may elect to push an adjustment through to each partner, rather than pay the tax resulting from an audit adjustment at the partnership level. To do this, a partnership would issue an adjusted Form K-1 to the reviewed year partners, and those partners would take the adjustment into account on their individual returns in the adjustment year through a simplified amended-return process. This is an adjustment of income, gain, loss, deduction or credit, not tax. Each partner would then pay any additional tax due as a result of the adjustment. Even if this election is made, penalties would be determined at the partnership level, and each partner for the reviewed year would be liable for the additional amount. Interest would be assessed at the partner level at the short term applicable federal rate plus an additional 5% (not the standard 3%). This election to pass through the liability to the partners must be made within 45 days after the date of the notice of final partnership adjustment. If the election is made, the partnership must furnish the IRS and each partner for the reviewed year a statement of the partner’s share of any adjustment to income, gain, loss, deduction or credit.

An example of language in a partnership agreement drafted to make this election by default:

The Partnership Representative shall, on behalf of the Partnership, cause all federal, state and local income and other tax returns and all tax elections not otherwise provided for in this Agreement to be timely filed by the Partnership (taking into account any applicable extensions in time for filing). In the event of an audit by the IRS, the Partnership Representative shall make, on a timely basis, the election provided by Code Section 6226(a) to treat a “partnership adjustment” as an adjustment to be taken into account by each Partner in accordance with Code Section 6226(b), provided that the Partnership Representative shall, if

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24 Code §6225(c). A tax-exempt partner includes foreign partners (other than foreign partnerships). See Code §§ 6225(c)(3) and 168(b)(2).
25 Note that the language in the Act is unclear at times, and therefore, it will be necessary for the IRS to promulgate detailed regulations.
26 Code §6226.
27 It is unclear how the penalty will be allocated among the partners.
28 The IRS issues a monthly Revenue Procedure with the relevant applicable federal rate.
29 Code §6226(c).
30 Code §6226(a). The final partnership adjustment notice is similar to a deficiency notice (although note that the IRS is required to mail a proposed partnership adjustment 270 days before mailing the final partnership adjustment notice). The election requires the partnership to “at such time and in such manner as the Secretary may provide, [furnish] to each partner of the partnership for the reviewed year and to the Secretary a statement of the partner’s share of any adjustment to income...(as determined in the notice of final partnership adjustment)....”
31 Code §6226(a)(2).
requested in writing by a majority of the Partners, not make such election.

**Other Provisions**

A partnership generally also has the option of itself initiating an adjustment for a year, such as when it believes an additional payment is due or an overpayment was made, with the adjustment taken into account in the adjustment year.\(^{32}\) The partnership generally would be permitted to take the adjustment into account at the partnership level or issue adjusted information returns to each reviewed-year partner.

The Act requires partnerships to designate a representative with a role similar to a tax matters partner under TEFRA. This representative need not be a partner, but must have a substantial presence in the United States. If a partnership does not designate a representative, the IRS may select a partnership representative of its choice.\(^{33}\)

The new rules generally apply to returns filed for partnership taxable years beginning after December 31, 2017, though partnerships may elect for the new rules to apply for an earlier taxable year.\(^{34}\) The Act also leaves considerable discretion to the IRS to issue guidance with respect to the new provisions in the Act. Partnerships likely will have limited time to amend their partnership agreements to reflect the substantive changes once guidance is issued.

**Additional Analysis**

Although the Act streamlines the complexity of the audit process, many questions remain. The Act provides that if a partnership ceases to exist for tax purposes before a partnership adjustment takes effect, the adjustment is taken into account by the former partners.\(^{35}\) However, it is unclear what will happen when the partnership has few or no assets. Of note, because the Act does not provide for joint and several liability, if the partnership has few assets, the IRS may not be able to assess the individual partners with the partnership’s tax liability, even though they may be flush with cash.

The Act provides that adjustments to a partnership’s tax liabilities as a result of an audit apply to the adjustment year, rather than to the reviewed year. Thus, if the partnership fails to elect to pass the liability on to the reviewed year’s partners or is unable to do so,\(^{36}\) partners that join a partnership could be liable for prior tax positions taken by the partnership. Partners contemplating joining a partnership should ask for an indemnity in the event of an audit, and should ensure that the partnership agreement governs how any disputes concerning the partnership’s tax returns would be resolved. By the same token, partners selling their interests in a partnership may be asked to indemnify the partnership on account of any tax positions previously taken by the partnership. Partnership agreements should also include procedures for electing and replacing the partnership representative.

Although the Act allows partnerships with fewer than 100 partners to opt out of the new provisions, not all qualifying partnerships will make this election. In particular, partnerships that are geographically dispersed – such that they are under

\(^{32}\) Code §6227.

\(^{33}\) Code §6223.

\(^{34}\) Code §6241(g).

\(^{35}\) Code at §6241(7).

\(^{36}\) Regulations may, in certain circumstances, restrict the ability of partnerships to elect under Section 6226, particularly if one of the partners is a partnership.
the jurisdiction of different appellate courts — or that are likely to have differing views on litigating a particular IRS position, should consider the advantages of a streamlined auditing process that would avoid the confusion inherent in numerous individual audits. Law firms with several offices are examples of partnerships that have both of the above characteristics.

Many partnerships are organized as tiered structures that include a partnership or trust. Due to the complexity of these tiered structures, problems may surface if a partnership elects under §6226 to pass the imputed underpayment through the tiered structures. Additionally, when the lower-tier partnership of a two-tiered partnership makes the election to have the items of income flow through to its partners, it is unclear whether these items of income flow directly to the ultimate partners or if flow-through liability only flows through to the lower tier partners; however, absent regulations, the better reading is that the income flows through directly to ultimate partners, because it is a current year adjustment to income and not an adjustment on the audit of any partners of the lower tier partnership. How the regulations deal with tiered partnerships will significantly affect the simplification and burden shifting effects of the Act.

The Act allows a partnership to challenge an adjustment made by the IRS within 3 years after the later of the date on which the partnership return for such year is filed or the last day for filing the partnership return for such year.\textsuperscript{37} Under §6223, a partnership and its partners are bound by actions taken by the partnership and by any final decision in a proceeding brought with respect to the partnership.\textsuperscript{38} Despite this statutory language, there is an open question whether a partner may challenge an adjustment or if they are otherwise bound by the actions taken by the partnership at various points in time (given that §6222(c) allows a partner to disagree with a partnership return if it identifies the disagreement).

**Partnership Interests Created by Gift**

The Act also clarifies the rules concerning gifted partnership interests. Generally speaking, a partnership is an unincorporated organization in which parties have joined together with the purpose of conducting an active trade or business.\textsuperscript{39} Code Section 704(e), as in effect prior to the Act, states: “A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.”\textsuperscript{40} Congress enacted this section to clarify that a family member who receives via gift a capital interest in a partnership, where capital is a material income-producing factor, should be respected as a partner in the partnership and should be taxed on the income from that partnership.\textsuperscript{41}

In *TIFD III-E, Inc. v. United States*, the Court of Appeals examined whether two foreign banks holding partnership debt qualified as partners under §704(e)(1).\textsuperscript{42} The court discussed whether §704(e)(1) changed the law so that a holding of debt could qualify as a partnership interest.\textsuperscript{43} The

\begin{itemize}
  \item \textsuperscript{37} Code §6227(c)(1) and (2).
  \item \textsuperscript{38} Code §6223(b)(1) and (2).
  \item \textsuperscript{39} The Budget Summary, at 14.
  \item \textsuperscript{40} Code §704(e).
  \item \textsuperscript{41} The Budget Summary, at 14.
  \item \textsuperscript{42} *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012).
  \item \textsuperscript{43} *Id.* at 842.
\end{itemize}
court found that the legislative history of §704(e)(1) indicated that the provision did not intend to broaden the character of interests in partnerships that qualify for treatment as a partnership interest.44 Rather, the concern behind the passage of §704(e)(1) was to reject court opinions that refused to recognize for tax purposes transfers of partnership interests because the transfers were effectuated by intrafamilial gift, as opposed to arm’s length purchase.45 Accordingly “its focus is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.”46

Some taxpayers continue to argue that the family partnership rule provides an alternative test for determining who is a partner, asserting that “if a partner holds a capital interest in a partnership, the partnership must be respected regardless of whether the parties have demonstrated that they joined together to conduct an active trade or business.”47 The Act changes the title of §704(e) from “Family Partnerships” to “Partnership Interests Created By Gift” and moves the rule concerning gifted partnership interests from §704(e) (discussing family partnerships) to the general definition of “Partner” in §761(b).48 This codifies the holding in TIFD III-E, Inc. v. United States and clarifies that Congress did not intend for §704(e) to provide an alternative test for whether a person is a partner in a partnership. The determination of whether the owner of a capital interest is a partner should be made under the generally applicable rules defining a partnership and a partner.49

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44 Id. at 844.
45 Id. at 844.
46 Id.
47 The Budget Summary, at 14.
48 §1102 of the Act.
49 §1102 of the Act.
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