Tax Assessments

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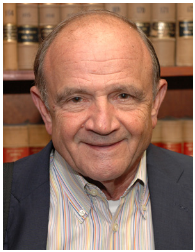
The Chair's Comments



Paul G. Topolka

"The difference between death and taxes is death doesn't get worse every time Congress meets." - Will Rogers

The above quote might be embodied in the recent news that capping off a record setting year, the fourth quarter of 2015 saw 1,110 individuals expatriate from the United States, bringing the annual total to 4,355 and smashing the previous yearly high. The IRS on February 5 released the notice listing the names of the expatriates for the quarter ending December 31, 2015, as required under Section 6039G. The 2015 total is 27 percent higher than the previous expatriation record of 3,417 set in 2014. Could the recent legislation and burdensome reporting requirements/penalties in the Federal Account Tax Compliance Act (FACTA), effective July 31, 2014, be a contributing cause? Did Congress overreach in its zeal against tax evaders holding foreign accounts and assets? Surely, it was not intended that law-abiding American citizens living overseas would be the target of such legislation? In any event, some of the unintended consequences are these citizens are now without access to everyday financial tools such as bank accounts, mortgages, insurance policies and pension funds in those affected countries.

Back here in North Carolina, I want to mention a few items that have occurred so far during my term as Chair of the Tax Section and some of the events scheduled over the next few months. On November 13 we had a joint meeting with representatives of the IRS and members of the Tax Committee of the North Carolina Association of Certified Public Accountants. The meeting was held at the Elon Law School in Greensboro and gave us an opportunity to hear from the IRS representatives concerning current issues and

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The New Partnership Tax Audit Regime: 20 Takeaways

By Galina Petrova

1. The new partnership audit regime

Signed into law on November 2, 2015, the **Bipartisan Budget Act of 2015** repeals the current partnership audit regime of the Tax Equity and Fiscal Responsibility Act of 1982 ("**TEFRA**") (Sections 6221 through 6234) and the electing large partnership rules (Sections 771 through 777 and 6240 through 6255). Title XI of this legislation sets forth new rules on tax examination, collection, and dispute resolution (new Sections 6221 through 6241). The new rules will impact all partnerships and entities that elect to be treated as partnerships for tax purposes — for example, limited liability companies ("**LLCs**") (hereinafter collectively referred to as "**partnerships**" and their owners as "**partners**").

The new regime will be effective for returns filed for partnership tax years beginning after December 31, 2017 (on or after January 1, 2018). New Section 6241(g)(1). In the interim, TEFRA and the electing large partnership rules will continue to apply to returns filed for partnership tax years beginning on or before December 31, 2017. Nevertheless, a partnership may elect to apply the new rules sooner. *See* New Section 6241(g)(4). Treasury and the IRS are yet to issue regulations and other interpretative guidance to chart out the specifics of the new rules.

A prominent feature of a partnership is its flow-through status, which subjects partners to only a single level of taxation at the partner level. Under the new regime, the IRS will assess and collect tax, penalties, and interest at the partnership level, and the liability for making these payments will reside with the partnership. This change will indirectly shift to the partnership the

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IRS's current burden of flowing audit adjustments to the partners. In reality, this new model of partnership-level assessments will deny the present benefits of a partnership's single-level taxation.

2. TEFRA as an IRS audit challenge

Congress passed this new legislation in an effort to alleviate a burden on the IRS. The proliferation of the entities classified as partnerships and the growing complexity of large partnership structures, combined with TEFRA's framework, have impeded the IRS's ability to audit large partnerships. The new regime resulted from previous proposals to allow the IRS to centralize its audit, assessment, and collection functions by determining tax liabilities at the partnership level. Senator Carl Levin and Congressman David Camp introduced these initiatives in 2014 as the Tax Reform Act of 2014 (H.R. 1) and the Partnership Auditing Fairness Act (S. 3018), and in 2015 as the Partnership Audit Simplification Act (H.R. 2821).

TEFRA has posed a challenge when the Service is seeking to do more with less, allocating limited resources funded through a shrinking budget. When first enacted, TEFRA brought administrative and judicial efficiency, as well as uniformity in tax administration. It introduced a single consolidated partnership-level examination and a single partnership-level judicial proceeding in place of various partner-level proceedings. TEFRA established unified administrative procedures for the treatment of items at the partnership level instead of at the partner level. TEFRA's current rules permit the IRS to complete audit adjustments to a partnership return in one consistent partnership-level administrative proceeding before it begins to assess partner-level tax. *See* **AD Global Fund, LLC v. United States**, 481 F.3d 1351, 1355 (Fed. Cir. 2007). Once the IRS determines partnership-return adjustments for the audited tax year to which the adjustment relates ("**audit year**"), it must flow them through to the taxpayers who were partners during the audit year ("**audit-year partners**"). Section 6221. The audit-year partners are ultimately assessed and pay any tax due under the deficiency proceedings that apply to individuals (Sections 6211 through 6216).

The new regime is intended to allow the IRS to handle partnership audits with improved efficiency. Under TEFRA, the burden of payment falls on the partners. The burdens of identifying the affected audit-year partners and flowing the adjustment through to them fall on the IRS. Identifying the affected audit-year partners is a serious challenge for the IRS in TEFRA audits. For example, if the IRS makes an adjustment of $200,000 to a partnership with 200 partners, the IRS could potentially have to assess and collect tax attributable to $1,000 of income from 200 different taxpayers. Unlike the rising audit rate for large C corporations, the IRS audit rate for large partnerships has remained low due to structural complexities growing exponentially from partnership size, partnership tiers, and the multiplicity of partners. The number of large partnerships with 100 or more direct partners and assets of $100 million or more has tripled to over 10,000 in the past decade. *GAO, Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732 (Sept. 18, 2014). Almost two-thirds of these large partnerships have more than 1,000 direct and indirect partners, $1 billion or more in assets, and six or more tiers, with many operating as investment funds. *Id.* The IRS has faced obstacles reaching the ultimate partners, particularly where it has to flow adjustments up through several tiers. As the number of partnership tiers grows, so does the complexity of the IRS collection efforts. Commentators have suggested that funding allocated to IRS technology could resolve the IRS's issue of flowing partnership adjustments through complex structures and achieve comparable improved efficiency.

3. Flow-through of tax liability under the new regime

As under TEFRA, the new rules require the IRS to conduct a single examination at the partnership level. As under TEFRA, the IRS will determine the treatment of, and impose adjustments to, typical partnership-level items of income, gains, loss, deduction, or credit at the partnership level. New Section 6221(a). However, under the new default rule, the partnership, and not the partners, will bear the economic burden of satisfying any tax liability attributable to audit adjustments. The IRS will determine, assess, and collect tax, penalties, and interest at the partnership level instead of at the partner level. New Section 6221(a). This is a notable divergence from the current TEFRA audit procedures, under which tax, penalties, and interest are assessed and collected from the partners. Section 6221. If the IRS makes an adjustment to the audit year — the "reviewed year" — the IRS will assess and collect any tax, penalties, and interest from the partnership in the "adjustment year." New Section 6225(a), (d)(1). An adjustment year is the year (i) in which a court's decision becomes final, (ii) when an administrative request is made, or (iii) when an IRS notice of final partnership adjustment is mailed. New Section 6225(d)(2). For example, if the IRS completes the audit of a partnership's items from tax year 2018 in calendar year 2020, the partnership's payment of tax on adjustments to items from tax year 2018 would be due in 2020 when the IRS mails the notice of final partnership adjustment.

Because payment is due from the partnership in the adjustment year, the adjustment-year partners may become responsible for tax benefits reaped erroneously by former audit-year partners. Unlike a prior proposal, partners will not be subject to joint and several liability for tax on partnership-level adjustments. *See* H.R. 2821, 114th Cong. § 2(c) (2015) (proposed Section 6241(d)(1)). That proposal sought to impose joint and several liability not only on the partnership, but on all direct and indirect partners during the audit year, as well as all direct and indirect partners during the adjustment year. If that proposal had become law, limited liability protection under state law would have been negated to the extent a partner's joint and several tax liability exceeds the partner's total capital contribution.

4. Tax liability computation under the new regime

The new rules appear to be modeled partly after the electing large partnership rules. An "electing large partnership" is a partnership with at least 100 direct partners during the preceding tax year that elects to apply Part IV of Subchapter K. Section 775. Instead of passing any adjustments directly through to its partners, an electing large partnership may elect to pay an "imputed underpayment" of tax at the partnership level. Section 6242(a)(2). An imputed un-

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derpayment is computed by netting all adjustments, treating any resulting net increase in income as an underpayment of tax, and multiplying it by the highest rate of tax in effect for individuals or corporations for the audit year. Section 6242(b)(4). Similar to the electing large partnership rules, the IRS will assess the additional tax due — the imputed underpayment — by netting all audit adjustments for the audit year and multiplying the net amount by the highest tax rate in effect for individuals or corporations for the audit year. New Section 6225(b)(1)(A). Unlike these rules, the new regime is mandated for all partnerships that do not elect out.

5. TEFRA's reach: Small partnership exception

Unless qualifying for an exception carved out for certain small partnerships, all partnerships are currently subject to TEFRA. The deficiency procedures applicable to individuals apply to these small partnerships excluded from TEFRA and allow their partners to act independently to resolve audit adjustments. *See, e.g.*, Section 6213. A partnership must requalify for the exception annually. Treas. Reg. 301.6231(a)(1)-1(a)(3). Nevertheless, if it so wishes, an excluded small partnership may elect into TEFRA. Section 6231(a)(1)(B)(ii). Once a partnership is subject to TEFRA, it cannot elect out.

This exception excludes from TEFRA's reach only partnerships with 10 or fewer eligible partners. Section 6231(a)(1)(B)(i). Eligible partners are individuals (other than nonresident aliens), C corporations, and estates of deceased partners. A husband and wife, and their estates, are treated as one partner. Section 6231(a)(12). A partnership does not qualify for the exception if any of its partners is a pass-through entity — another partnership, an S corporation, estate, or trust. Section 6231(a)(9). Hence, a small partnership with 10 or fewer direct partners one of whom is a pass-through entity is not excluded from TEFRA's reach.

6. New regime's optionality: Electing in early

Partners may consider whether an early application of the new rules is favorable. A partnership may elect to have the new rules apply to its returns filed for tax years beginning after November 2, 2015 and before January 1, 2018. New Section 6241(g)(4). The timing of any roll-out of corresponding new rules at the state level may result in state tax arbitrage impacting the partners of partnerships that elect in early. These timing issues could occur in states where an IRS audit adjustment to a partnership's return under the new rules would not give rise to adjustments to partner's return under state tax law. Most likely the only partnerships seeking to elect in, whether before the new regimes takes effect, will be those that currently have elected to be subject to the electing large partnerships regime.

7. New regime's optionality: Electing out

While applicable to all partnerships regardless of their characteristics, the new regime allows certain partnerships to elect out. Notably, electing into the regime early and then electing out to escape TEFRA would not be an option because the opt-out will be available only for tax years beginning after December 31, 2017 when TEFRA will no longer exist. New Section 6241(g)(4). The exclusion granted by this opt-out is broader than TEFRA's exception in terms of both number and type of eligible partners. Electing out shifts the partnership's assessment and collection burden back to the IRS in a pre-TEFRA regime or a possible new regime when TEFRA is no longer in effect. When it makes an adjustment to the return of a partnership that has elected out, the IRS must issue a separate audit report to each partner and conduct partner-level proceedings. Each partner can then act independently to challenge its own audit report. Partnerships willing and eligible to elect out should structure partnership ownership carefully and observe strictly the related annual election and information reporting requirements. Because of the restrictions on partner eligibility, however, many small partnerships will not be permitted to elect out.

A partnership seeking to opt out must have 100 or fewer eligible partners. New Section 6221(b)(1). Eligible partners are individuals, estates of deceased partners, S corporations, C corporations, and foreign entities that would be treated as C corporations were they domestic. New Section 6221(b)(1)(C). Unlike TEFRA's exception, this opt-out opens the door to S corporations and foreign corporations as eligible partners. Each shareholder of an S corporation is treated as one partner in determining whether the partnership is below the 100-or-fewer-partners eligibility ceiling. New Section 6221(b)(2)(A). Congress reserved the right for Treasury and the IRS to permit additional groups of eligible partners that are not specifically identified in the statute. New Section 6221(b)(2)(C).

As under TEFRA, a partnership cannot elect out of the new rules if any of its direct partners is a partnership. Having a pass-through partner other than an S corporation or an estate of a deceased partner — a partnership, trust, or estate of a non-partner — would cause an otherwise qualified partnership to become ineligible to elect out. Section 6231(a)(9); New Section 6221(b)(1)(C). Hence, the new rules subject pass-through business entities to dichotomous treatment because they favor partnerships with S-corporation partners while precluding from electing out similarly situated taxpayers with partnerships as partners. Although they target greater IRS audit efficiency with respect to large partnerships with more than 100 partners and more than $100 million in assets, the new rules sweep in significantly smaller partnerships for which an opt-out is impossible because at least one direct partner is a partnership. Unlike a prior proposal, real estate investment trusts and regulated investment companies are not addressed and are not specifically excluded as eligible partners. *See* H.R. 2821, 114th Cong. § 2(c) (2015) (proposed Section 6221(b)(3)).

8. Procedure for electing out from the new regime

While TEFRA's exception for small partnerships operates without requiring any action, the new rules require partnerships desiring to elect out to follow specific procedures.

I. <u>File election annually with partnership return</u>. First, the partnership must make the opt-out election on its timely filed partnership return for each qualifying tax year. New Section 6221(b)(1)(D)(i). A partnership must requalify for the election annually just as a small partnership would for the TEFRA exception.

II. <u>Report partner information to the IRS</u>. Second, the partnership must provide to the IRS the name and taxpayer identification number of "each partner of such partnership." New Section 6221(b)(1)(D)(ii), (2)(A)(i). This information reporting require-

ment appears to apply to the partners in the tax year subject to the opt-out election. New Section 6221(b)(2)(C). Because each shareholder of an S corporation is treated as one partner, the partnership must also provide to the IRS the name and taxpayer identification number of the shareholders of an S corporation that is a partner.

Under TEFRA, the partnership is required to provide to the IRS the name, address, profits interest, and taxpayer identification number of each audit-year partner only upon receipt of IRS notice of the beginning of an administrative proceeding. Section 6230(e), 6223(a)(1). Schedules K-1 for Form 1065 (partnership) and Form 1120-S (S corporation) already incorporate fields for the names and taxpayer identification numbers of partners and S corporation shareholders. However, reporting the name and taxpayer identification number of each shareholder of an S-corporation partner could be an arduous task because it requires near real-time information on the number and identities of potentially unrelated S corporations and their shareholders.

Regulatory guidance should be forthcoming on the alternative identification of foreign partners that do not have taxpayer identification numbers. New Section 6221(b)(2)(B). Most foreign partners in existing partnerships likely already have IRS individual tax identification numbers ("**ITINs**"). Foreign partners must obtain ITINs to file U.S. federal income tax returns and tax refund claims. Treas. Reg. 301.6109-1(a)(1)(ii)(B), -1(b)(2). Partnerships must use ITINs to report withholding tax on foreign partners' allocable share of (i) income effectively connected with a U.S. trade or business and (ii) U.S. source passive income that is not effectively connected with the partnership's U. S. trade or business. Section 1441 (nonresident aliens), 1443 (foreign corporations), 1446 (foreign partners); Treas. Reg. 301.6109-1(c).

III. Notify partners. Third, the partnership must notify each partner whose information it has provided to the IRS that the partnership has made the election. New Section 6221(b)(1)(E). This information reporting benefits the partners, as they will likely prefer to know the election is in effect. Not every partnership though may be willing to undertake this information reporting.

9. Alternative procedure election for passing adjustments to partners under the new regime

An alternative procedure under the new rules allows any partnership to elect to flow the partnership-level adjustments through to the audit-year partners so they bear the associated tax liabilities. By making this election, partnerships can avoid the potential economic injustice of having tax liabilities imposed on adjustment-year partners for the lapses of audit-year partners. Partnerships can also achieve TEFRA-like results because partners become individually responsible for the associated tax liabilities. Unlike TEFRA, the alternative procedure requires the partnership, rather than the IRS, to flow the adjustments through to the partners. While this alternative procedure still burdens the partnership administratively with flowing through the adjustments, it eliminates the partnership's burdens of dispute resolution and payment of any tax liabilities.

The partnership has a mere 45 days from the IRS's mailing of the notice of final partnership adjustment to make this irrevocable election. New Section 6226(a). The IRS must mail the notice not earlier than 270 days after mailing the notice of administrative proceeding, which gives the partnership some warning and time to formulate its approach. New Section 6231(a). Once it has made the election, the partnership is not subject to the imputed underpayment. New Section 6226(a). Rather, each partner pays tax, interest, and penalties directly to the IRS on that partner's share of any adjustments and affected tax attributes at that partner's tax rate. New Section 6226(b). The partnership must issue to each audit-year partner a "statement" (likely similar to a Schedule K-1) reflecting the partner's share of any adjustment to income, gain, loss, deduction, or credit as determined in the notice of final partnership adjustment. *See* New Section 6226(a)(2). The partnership must also provide copies of these statements to the IRS. *Id.* An affected partner must take the adjustments into account on its tax return for the year of actual receipt of the statement from the partnership. New Section 6226(b). Regulatory details on these statements will likely be forthcoming.

Demanding swift action on behalf of a partnership, the 45-day deadline for making the election invites grim repercussions. Should a partnership wish to obtain judicial review, it would likely lose the opportunity to shift the tax liability to the audit-year partners. Instead, the partnership will be assessed the imputed underpayment directly. The decision to pursue this alternative procedure may depend on the number of statements the partnership would have to issue, the complexity of preparing them, the extent of partner turnover, and the magnitude of the tax, penalties, and interest the partnership would bear if the imputed underpayment were to apply. Because the partnership, and not the IRS, must determine how to flow the adjustments through to the partners, the partnership gains flexibility in how to approach the entire process. If a partnership elects the alternative procedure, interest on each audit-year partner's tax liability will accrue at the federal short-term rate plus five percent, a rate two percentage points higher than the usual underpayment rate. New Section 6226(c)(2)(C); Section 6621(a)(2), (c).

10. Reducing partnership-level tax liability under the new regime

The IRS may reduce the amount of the imputed underpayment if the partnership presents partner-specific information. The partnership must complete the process within 270 days of the IRS's mailing of a notice of a proposed partnership adjustment and any extension. New Section 6225(c)(1), (7), 6235(c)(2). The 270-day period may be extended only with IRS consent. New Section 6225(c)(2)(C). This time limit is an improvement over the Levin and Camp proposal, which suggested only 180 days.

I. Option A: Reduced tax rates. One mechanism for a partnership to reduce the imputed underpayment is by showing specific audit-year partners and their distributive shares of allocable adjustments should be subject to lower rates. A partnership can provide information on the tax rate applicable to a specific partner — an individual, a C corporation, or an S corporation (treated as an individual) — and the specific type of income arising from to the adjustment — for example, ordinary income, qualified dividends, or capital gains. New Section 6225(c)(4). Regulatory guidance should be forthcoming on procedures for a partnership to establish part-

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ner-specific tax rates. New Section 6225(c)(1), (5).

II. Option B: Disregarded audit adjustments. Another mechanism for a partnership to reduce the imputed underpayment is by presenting information for the IRS to disregard adjustments allocable to specific audit-year partners from the computation of the imputed underpayment. The IRS will consider disregarding adjustments allocable to two types of audit-year partners:

a. Partners with amended returns. First, a partnership can establish that an audit-year partner (i) has filed an amended tax return reflecting the partner's distributive share of all partnership-level adjustments properly allocable to that partner and (ii) has paid any resulting tax due. New Section 6225(c)(2)(A). A partner must file amended returns for all audit years. *Id.* The amended returns must include all of the partner's properly allocable adjustments for these audit years and any indirectly impacted tax years with respect to which tax attributes are affected by the adjustments (for example, carryovers and section 481 adjustments). *See id.* If the IRS is satisfied, it should reduce the partnership's imputed underpayment for that partner's share of adjustments. If an adjustment reallocates one partner's distributive share to another, the IRS will disregard the portion of adjustments allocable to the first partner only if both partners file amended returns. New Section 6225(c)(2)(B). Thus, a partnership should coordinate with the partners on both sides of the equation if it desires to obtain a reduction in its imputed underpayment. Affected audit-year partners must file amended tax returns and pay all associated taxes within 270 days of the IRS's mailing of a notice of a proposed partnership adjustment and any extension. New Section 6235(c)(2).

To obtain the benefits of any reduction of the imputed underpayment, a partnership must complete a series of arduous steps on a 270-day timeline. While the new regime does not prescribe specific steps, a partnership would need to coordinate the following actions: (i) analyze the proposed adjustments to determine impacted tax years and partner-specific allocations; (ii) issue some form of statements to all affected audit-year partners to allocate their distributive shares of each adjustment; (iii) compel these partners to file amended tax returns consistent with the partnership's allocation of adjustments for all audit years; and (iv) ensure the IRS receives tax payments along with the partners' amended returns, whether the partners or the partnership are filing them. This time-sensitive process may be particularly challenging for partnerships with complex structures and difficult-to-reach partners. Publicly traded partnerships, large domestic partnerships, and foreign partnerships with a trade or business in the United States may pose logistical issues because of numerous dispersed partners, frequently changing ownership, and partner residence in jurisdictions outside the United States. Because the obligation to pay the imputed underpayment is imposed on the partnership, little, if any, incentive exists for an audit-year partner to act unilaterally, especially a partner that has already exited the partnership. Obligating contractually current and former partners could help a partnership ensure the partners' accurate and timely filing of amended returns and payment of associated taxes.

b. Tax-exempt entity partners. Second, a partnership can establish that a portion of the adjustments is both properly allocable to a partner that is a "tax-exempt entity," as defined in section 168(h)(2), and attributable to that partner's income that would not subject to tax. New Section 6225(c)(3). A "tax-exempt entity" broadly encompasses: exempt organizations governed by Subchapter F (except section 521 farmers' cooperatives); foreign persons or entities (except foreign pass-through entities and foreign partnerships); and Indian tribal federal, state, and local government entities. Section 168(h)(2)(A), (C). The partnership must establish the tax-exempt entity status of a partner within the 270-day deadline.

Regulatory guidance should be forthcoming on procedures for establishing a partner's tax-exempt entity status and information to be provided for the IRS to reduce an imputed underpayment. New Section 6225(c)(3)(5). Commentators have proposed partner-level tax attributes known by a partnership, such as passive activity losses, be applied to reduce imputed underpayments. *See* 161 Cong. Rec. S7637 (daily ed. Oct. 29, 2015) (statement of Sen. Orrin Hatch). While regulatory guidance may allow the IRS to reduce the imputed underpayment where a partnership can prove that certain partners are exempt from or subject to a lower rate of tax, its practical implementation may be problematic due to administrative complexities. For example, partner-specific information may be difficult to obtain in certain contexts. In a tiered partnership structure, the lowest-tier partnership may not be familiar with or be able to obtain the identity of the highest-tier partners. Likewise, a partner may not wish to reveal its tax circumstances to the partnership or other partners.

11. IRS notices

The new rules require partners to give up certain TEFRA rights to control the audit and make partners' participation more challenging. For example, receiving a notification from the IRS about a partnership-level proceeding can assist a partner in determining whether to participate. Under TEFRA, the IRS must mail a notice of the beginning of a partnership-level administrative proceeding and a notice of the final partnership administrative adjustment to each partner whose name and address are provided to the IRS ("**notice partner**"). Section 6223(a). Yet not all partners of a TEFRA-governed partnership are notice partners and entitled to IRS notice. A partner having less than 1 percent interest in the profits of a partnership with more than 100 partners is not entitled to IRS notice ("**non-notice partner**"). Section 6223(b)(1). However, a group of non-notice partners with an aggregate interest of five percent or more in the partnership's profits ("**notice group**") can designate a partner to whom the IRS must give notice. Section 6223(b)(2). Under TEFRA, if the IRS fails to give the requisite notice, a partner may elect to have the adjustments determined at the partner level. Section 6223(e).

Under the new rules, only the partnership representative (discussed herein supra) and the partnership will receive IRS notices at their last known addresses. New Section 6231(a). Thus, no partner will receive notices from the IRS unless the partner is the partnership representative. Likely because the partnership representative and the partnership will be the only notice recipients, the new rules

do not address the effect of an IRS failure to provide the requisite notice. The new rules require: (i) a notice of administrative proceeding initiated at the partnership level; (ii) a notice of proposed partnership adjustment; and (iii) a notice of final partnership adjustment. New Section 6231(a)(1), (2), (3). To rescind any notice already mailed to the partnership, the IRS must obtain the partnership's consent. New Section 6231(c). While the statute is silent on consent requirements for IRS rescission of notices mailed to the partnership representative, analogous treatment would likely apply to require the partnership representative's consent.

12. Partnership representative and tax matters partner

The new rules require a partnership to designate a "partnership representative." New Section 6223(a). Unlike a "tax matters partner" ("**TMP**") under TEFRA, the partnership representative does not have to be a partner. Section 6231(a)(7). TEFRA requires the TMP of a state-law partnership to be a general partner and the TMP of an LLC to be a member with management authority. Treas. Reg. 301.6231-1, -2. A partner or any other "person" can be the partnership representative, so long as the designee has a substantial presence in the United States. New Section 6223(a). By definition, a "person" includes an individual, trust, estate, partnership, association, company, or corporation. Section 7701(a)(1). Regulatory guidance will likely be forthcoming on the manner of a partnership's designation of a partnership representative.

Under the new rules, the partnership representative has the sole authority to act on behalf of the partnership. No partner has the authority to represent the partnership or intervene on its behalf in a partnership-level proceeding unless the partner is the partnership representative. This is a significant departure from the way a TMP and other partners interact with the administrative and judicial system under TEFRA. The TMP is a statutory representative designated to act solely as a liaison between the partners, the IRS, and the federal courts:

(a) The TMP's role is to participate in administrative and judicial proceedings and to inform the partners of partnership-level adjustments. Section 6223(g).

(b) The TMP has the authority to determine the time and place for all administrative proceedings. Treas. Reg. 301.6224(a)-1. However, each partner, including each indirect partner, has the right to participate in any phase of an administrative proceeding. Section 6224(a); Treas. Reg. 301.6224(a)-1. A partner may waive this right by filing a signed written waiver with the IRS. Section 6224(b).

(c) The TMP may enter into a binding settlement agreement with the IRS. Section 6224(c)(1). A settlement agreement entered into by a TMP is binding on notice partners that are parties and all non-notice partners. Section 6224(c)(1), (c)(3)(A). However, a non-notice partner may file a statement with the IRS to opt out of the TMP's representation. Section 6224(c)(3)(B).

(d) The TMP may file a readjustment petition for judicial review of the results of the administrative proceeding. Section 6226(a). If the TMP does not file the petition within 90 days of the notice of a final partnership administrative adjustment, any notice partner and any notice group have the right to initiate judicial proceedings. Section 6226(b)(1).

The IRS has cited difficulties with the timely identification and qualification of the TMP as one of its serious challenges in auditing large partnerships particularly where the TMP is an entity and not an individual. *GAO, Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits, GAO-4-746T* (July 22, 2014). Under TEFRA, if a partnership fails to designate a TMP or the designation is ineffective, the TMP is determined by applying the largest profits interest rule under the regulations. Treas. Reg. 301.6231-1(a). If the application of this rule is impractical, the IRS may select any partner as the TMP, including an indirect partner or a limited partner. Treas. Reg. 301.6231(a)(7)-1(n). Under the new rules, if a partnership fails to designate a partnership representative or the designation is ineffective, the IRS may select any "person" as the partnership representative. New Section 6223(a). An ineffective designation or an omission to designate a partnership representative leaves this selection in the hands of the IRS, which can lead to the partnership and its partners having diminished control over administrative proceedings. Without regulatory guidance to delineate the universe of potential designees, conflicts of interest can arise. For example, a conflict of interest could arise if the IRS selects as the partnership representative a former partner that has not been replaced after exiting the partnership. If the former partner is one of the audit-year partners, the former partner may be unwilling to make an election for the alternative procedure to apply for adjustments to flow from the partnership to the audit-year partners.

13. Statute of limitations

Under TEFRA, the IRS has the authority to assess a tax liability on adjustments to a partnership's separately stated items only after the close of a partnership's administrative proceeding and before the applicable statute of limitations on the assessment of tax has expired. With respect to a partner, TEFRA provides a three-year statute of limitations measured from the filing date of the partner's return. Section 6501(a). With respect to a partnership, the statute of limitations for the assessment of tax on separately stated items is three years after the later of: (i) the filing date of the partnership's return or (ii) the last day for filing the partnership return (determined without regard to extensions). Section 6229(a). Either of these three-year assessment periods becomes six years when the return of a partner or a partnership omits a substantial amount of gross income (more than 25 percent). Section 6501(e).

Although the interplay between a partner's (Section 6501) and a partnership's (Section 6229) statutes of limitations under TEFRA is not entirely clear, courts have construed them to prescribe a single limitations period when read together. **Prati v. United States**, 603 F.3d 1301, 1307 (Fed. Cir. 2010); **Andantech L.L.C. v. Comm'r**, 331 F.3d 972, 977 (D.C. Cir. 2003), *aff'g* T.C. Memo. 2002-97. Therefore, even if the statute of limitations on a partner's assessment period has expired, the IRS can extend it with the partner's consent, so long as the partnership's statute of limitations is still open.

Because the TMP is the recipient of the notice of a final partnership administrative adjustment, the TMP can petition a court, and the TMP's actions can unfavorably extend the statute for the partnership and all affected partners. Under TEFRA, the filing of

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a court petition on behalf of a partnership suspends the running of the statute of limitations for one year after a court decision becomes final. Section 6229(d). If a partner files a court petition on its own behalf, the running of the statute of limitations is suspended for 60 days after a court decision becomes final. Section 6503.

Under the new rules, the IRS may assess tax only after an audit adjustment becomes final, which occurs either when a court's decision becomes final or 90 days after the IRS mails a notice of final partnership adjustment. New Section 6232(b). The new rules replace TEFRA's statute of limitations regime and related judicial precedent with a single partnership statute of limitations of three years after the latest of: (i) the filing date of the partnership's return; (ii) the partnership return's due date; or (iii) the date on which the partnership filed an administrative adjustment request. New Section 6235(a)(1). The IRS may extend this assessment period before its expiration with the partnership's consent. New Section 6235(b). As under TEFRA, the filing of a court petition on behalf of a partnership suspends the running of the statute of limitations for one year after a court decision becomes final. New Section 6235(d). TEFRA's extension of the assessment period to six years continues to apply under the new rules to any omission of a substantial amount of gross income. New Section 6235(c)(2). The statute remains open indefinitely for false or fraudulent partnership returns and a partnership's failure to file a return. New Section 6235(c)(1), (3).

14. Administrative adjustment requests

Under TEFRA, an administrative adjustment request initiates a procedure allowing the IRS to adjust a partner's tax liability directly. Section 6227. A TMP may file a request on behalf of the partnership. Section 6227(c). Likewise, any partner may file a request on its own behalf. Section 6227(d). An administrative adjustment request must be accompanied by the filer's amended return.

Under the new rules, as under TEFRA, a partnership may file a request not more than three years after the later of: (i) the filing date of the partnership's return or (ii) the last day for filing the partnership return (determined without regard to extensions). New Section 6227(c); Section 6227(a). Yet the new rules alter the period for the filing of administrative adjustment requests in two ways. First, a request may no longer be filed after the IRS mails a notice of administrative proceeding to the partnership. New Section 6227 (flush language). TEFRA allows a partner to file a request at any time before the IRS mails a notice of final partnership administrative adjustment to the TMP. Section 6227(a)(2). TEFRA also permits the filing of a request for six months after the expiration of a partnership's extended statute. Section 6227(b). Second, under the new rules, the extension of a partnership's statute of limitations does not concurrently extend the filing period for a request. New Section 6227. Construed together, these two changes restrict considerably a partnership's ability to file administrative adjustment requests.

15. IRS settlements

TEFRA applies a most favored nation principle to IRS settlements. If the IRS enters into a settlement agreement with a partner with respect to partnership-level adjustments, the IRS must offer the same terms to any other partner who requests them. Section 6224(c)(2). Further, an IRS settlement agreement is binding on the IRS and all partners that are parties. Section 6224(c)(1). An indirect partner is bound by a settlement agreement entered into by its pass-through partner unless the indirect partner has been specifically identified to the IRS by name, address, and interest in the partnership's profits. Section 6224(c)(1), 6223(c)(3). Under TEFRA, a partner may enter into a settlement agreement with the IRS even when other partners choose not to join. Section 6224(c). In contrast, only the partnership may settle with the IRS under the new rules outside of the alternative procedure. The framework of the new regime precludes a partner from settling with the IRS on behalf of the partnership unless that partner is acting as the partnership representative. New Section 6223(a).

16. Judicial review

Under TEFRA, the TMP has the authority to initiate judicial proceedings by filing a readjustment petition in court (within 90 days of mailing of the notice of final partnership adjustment). Section 6226(a). If the TMP does not, a notice partner or a notice group may petition a court, and the TMP has the right to intervene. Section 6226(b)(1), (2), (3), (6). In contrast, the new rules provide that only the partnership may petition for judicial review of a partnership-level adjustment. New Section 6234(a), (g).

TEFRA favors the Tax Court and a first-in-time claimant. It specifies that if two or more actions are brought, the first action brought in Tax Court will go forward and the rest will be dismissed. Section 6226(b)(2). If two or more actions are brought in federal district court or the Court of Federal Claims, or both, only the first action will go forward. Section 6226(b)(3).

The new rules do not establish an order of priority because only the partnership may petition for judicial review and bring a single action. New Section 6234(b), (d). The new rules continue certain TEFRA statutory mandates on judicial review: (i) the jurisdictional requirement to deposit the amount of the disputed tax liability; (ii) the scope of judicial review; (iii) the reviewability of a decision as final; and (iv) a dismissal's effect of affirming the accuracy of a final notice. Section 6226(e), (f), (g), (h); New Section 6234(b), (e), (d), (e).

17. Finality and binding effect

Under the new rules, a final decision in a proceeding brought with respect to the partnership and actions taken by the partnership are binding on the "partnership and all partners of such partnership." New Section 6223(b). Either the binding effect imposed on the partners is rather inclusive or the meaning of the phrase "all partners" is unclear. Does "all" include all past, present, and future partners? A narrow interpretation would impact only the audit-year partners that a proceeding or a partnership action would implicate. An exception is made for a proceeding involving a partner's return that is inconsistent with the partnership's position; then, the partnership would not be bound by a final decision in a proceeding to which the partnership is not a party. New Section 6222(c), (d). The new rules continue TEFRA's leniency allowing a partner to file a tax return inconsistent with the partnership's tax return where the partner reports the inconsistency to the IRS. New Section 6222(c)(1)(B); IRS Form 8082. If the partner shows having reported on its return consistently with the Schedule K-1, the IRS

would treat that partner as having reported the inconsistency to the IRS, recognizing any discrepancy must have arisen from receiving inaccurate information. New Section 6222(c).

18. Tax basis in partnership interest and other tax attributes

Under TEFRA, the following components of a partner's basis in its partnership interest are "affected items" that are determined in partner-level proceedings: the basis of contributions to the partnership; distributions from the partnership; the partner's share of nontaxable income, taxable income, losses and deductions; and the partner's share of partnership liabilities. Section 705, 6221, 6231(a)(5); Treas. Reg. 301.6231(a)(3)-1; **Nussdorf v. Comm'r**, 129 T.C. 30, 42-44 (2007).

The new rules do not directly address a partner's basis in its partnership interest. It is uncertain whether an audit-year partner will be permitted to reflect in its basis an adjustment of income or gain where the partnership is the payer of any associated tax, and what mechanism would apply to allocate any basis adjustments in the partner's interest. Further, clarity is lacking about a sale of a partner's interest after the audit year but before the payment of any additional audit-year tax. Regulatory guidance will likely provide clarity about basis adjustments.

The new rules address the reallocation of distributive shares from one partner to another, but are unclear on set-offs for special attributes. A partner's tax-exempt status is a special attribute that can lead to tax savings if the partnership were to be liable for the imputed underpayment. If a partnership uses a partner's special attributes to reduce its partnership-level tax, it is unclear how that partner will obtain the full benefit of the partnership's tax reduction. One possibility is having the partnership agreement provide for a special allocation to a partner whose special attributes reduce the partnership-level tax resulting from an adjustment. However, this solution could be unhelpful where the partner no longer is a partner when an adjustment becomes final and the partnership's tax payment is due.

19. Treatment when the partnership ceases to exist

Under the new rules as under TEFRA, if a partnership ceases to exist before the IRS makes a partnership-level adjustment, the "former partners" will take the adjustment into account "under regulations to be prescribed by the Secretary." New Section 6241(7); Section 6255(d). The statutory language is unclear on whether the phrase "former partners" means the partners in the year to which the adjustment relates or the partners in the year in which the partnership ceases to exist. Under TEFRA, adjustments flow up directly to the audit-year partners, and no question arises as to who the former partners are. It appears that adjustments will reside with the "former partners" where a partnership ceases to exist by disposition of its assets and a complete liquidation. However, the tax law to date leaves it uncertain whether this provision would apply where a partnership becomes a disregarded entity, elects to be taxed as a corporation, or undergoes a technical termination under Section 708(b). Future regulations or other guidance may clarify these points.

20. Partnership arrangements going forward

The new rules will simplify partnership audits for the IRS and will allow it to streamline the collection of tax, penalties, and interest attributable to partnership-level adjustments. Accordingly, the IRS audit rate of partnerships will increase for tax years beginning on or after January 1, 2018, and so will the amounts the IRS ultimately collects from these audits. The Joint Committee of Taxation estimates resulting revenue of $9.3 billion through 2025. Joint Committee of Taxation, Estimated Revenue Effects Of The Tax Provisions Contained In H.R. 1314, The "Bipartisan Budget Act of 2015," JCX-135-15, Oct. 28, 2015. From an implementation perspective, this new legislation leaves many questions unanswered and will require significant guidance to fill the gaps. From a transactional perspective, partnerships and their partners may wish to assess the tax provisions of their existing partnership and revise them to address the onset of the new rules. Substantive revisions should await the authoritative guidance of Treasury and the IRS.

Partnerships that experience high partner turnover or anticipate events leading to significant changes in ownership may benefit from evaluating tax procedure arrangements. Under TEFRA, new partners have limited risk of inheriting any historic tax liabilities attributable to prior years because prior-year adjustments flow to the partners in those years. Under the new rules, however, a new partner could be forced to bear a share of such historic tax liabilities indirectly if the partnership chooses to pay them instead of to pursue the alternative procedure and pass them to the audit-year partners.

To avoid a mismatch of historic tax benefits and burdens, partnerships should consider revising existing partnership agreements to articulate whether the partnership intends to:

(a) bear tax liabilities attributable to partnership-level audit adjustments by applying the default rule (for tax years beginning after December 31, 2017 or after November 2, 2015 if electing in early),

(b) shift historic partnership-level tax liabilities to the audit-year partners by electing out if eligible (on an annual basis),

(c) shift historic partnership-level tax liabilities to the audit-year partners by electing irrevocably the alternative procedure (within 45 days after the end of an administrative proceeding),

(d) collect and provide partner-specific information to the IRS (within 270 days after the beginning of an administrative proceeding) for (i) reduced tax rates to apply and/or (ii) audit adjustments to be disregarded from the amount of the partnership-level tax liability for audit-year partners who (A) have filed amended returns and paid tax or (B) are tax-exempt, or

(e) evaluate the handling of IRS audit adjustments on a case-by-case basis.

New partners will likely prefer the protection of the alternative procedure to ensure historic tax liabilities attributable to prior tax years are borne by partners in those years. The 45-day deadline for a partnership to allocate adjustments and issue statements to audit-year partners under the alternative procedure may deter existing partners from following this route. If a partnership does not commit to pursuing the alternative procedure, a new partner should ask for extensive representations, warranties, and indemnities as to pre-closing tax liabilities.

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