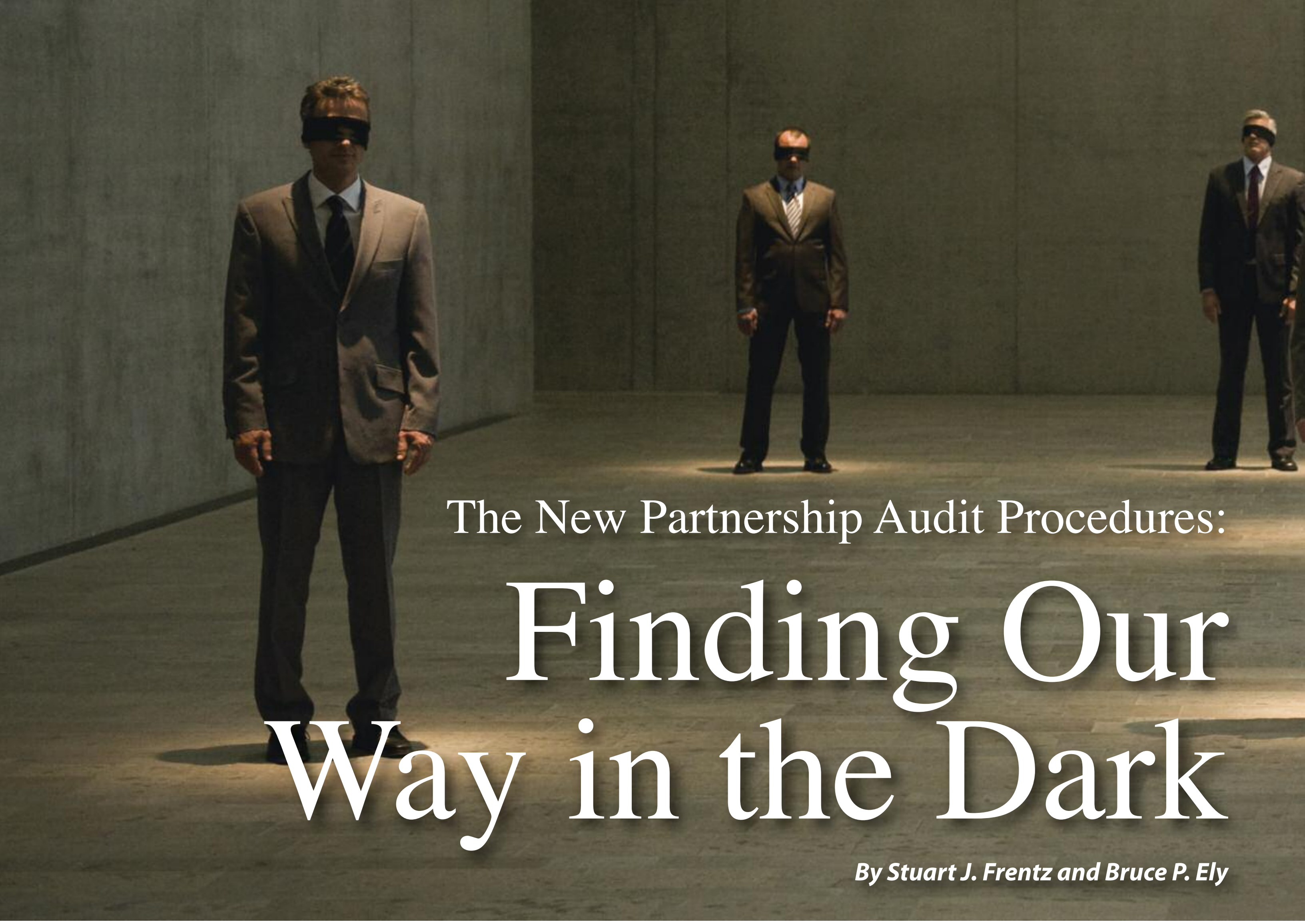


The New Partnership Audit Procedures:

Finding Our Way in the Dark

By Stuart J. Frentz and Bruce P. Ely

The Door in the Dark

In going from room to room in the dark
I reached out blindly to save my face
But neglected, however lightly, to lace
My fingers and close my arms in an arc.
A slim door got in past my guard,
And hit me a blow in the head so hard
I had my native simile jarred.
So people and things don't pair any more
With what they used to pair with before.

–Robert Frost

Alabama lawyers who are trying to understand the new partnership audit procedures scheduled to be effective after 2017 should identify with Robert Frost. The statutes rushed into enactment late last year as part of the Bipartisan Budget Act of 2015[1] leave many questions unanswered, with several gaping holes to be filled with guidance from the Treasury Department and the IRS. And opportunities for confusion will multiply as Alabama and other states develop their own separate responses to the federal changes.[2] The challenges posed for those of us drafting partnership agreements

and related ownership transfer documents in the absence of guidance are a bit like trying to traverse a furniture-filled room in pitch darkness.

In this article, we'll first take a look at what we *do* know about the new audit procedures based primarily on the statutes enacted and amended late last year and the joint committee's Bluebook, which is as close as we get to legislative history. Then we'll list some of the important things we *do not* know, and *will not* know until regulations and other procedural guidance trickle out of Washington.[3] Finally, we'll offer a few suggestions for what practitioners might consider doing to avoid figuratively smacking their heads into doors in the dark or tripping over furniture with regard to drafting partnership or operating agreements while waiting for the Treasury and the IRS, and perhaps Congress, to start turning on the lights.

Some Things We Know (or Think We Know) Until Things Change[4]

The current TEFRA audit[5] are repealed prospectively, and the new rules will apply to tax years beginning after 2017–which, as of the date of this publication, is only a little over a year away. Partnerships can elect to opt in under the new rules early, although there are not likely to be many takers.[6]

Congress projected the new procedures to generate more than *$9.3 billion* in new revenue over a 10-year period.[7] Many states are considering adopting all or part of these procedures for their own income tax codes and to enhance their budgets. Arizona has already enacted partial conforming legislation.[8]

There are a couple of defined terms we need to keep in mind. "Reviewed Year" means the tax year of the partnership under audit, and "Adjustment Year" means the year in which partnership return adjustments are finally determined.[9]

The new default rule under the Budget Act requires the IRS to assess the partnership on the "imputed underpayment" if filing errors are detected during an audit. The assessment is made in the Adjustment Year, so the financial burden of a payment by the partnership will fall on the partners in the Adjustment Year, even if some or all of them were not partners in the Reviewed Year. *Law firms that operate as partnerships, especially those with a large number of partners, should consider how these rules will apply to your own partners and partnership.*

The partnership's imputed underpayment is computed by netting all adjustments as finally determined and multiplying that by the highest rate of tax applicable to individuals or corporations–*i.e.*, 39.6 percent based on 2016 rates. In an especially taxpayer-unfriendly twist, adjustments that reallocate items from one partner to another (e.g., a disregarded special allocation of interest expense or gain) are not netted; the portions of the adjustment that increase items of loss or deduction or decrease items of income or gain are disregarded in determining the partnership's imputed underpayment.[10] So, for example, if a partnership is found to have allocated to partner A $100,000 of income that should have been allocated to partner B in the Reviewed Year, the partnership would have a $39,600 imputed underpayment in the Adjustment Year, even if A or B or both have departed and are no longer partners in that year.

If the partnership can show that an item of adjustment is allocable to a tax-exempt partner or to a partner that would be taxable at a lower rate (i.e., capital gains rate for individuals or a C corporation taxable at 35 percent), the partnership's imputed underpayment can be reduced accordingly.[11] An imputed underpayment can also be reduced to the extent that partners for the reviewed year file amended returns to reflect their shares of the audit adjustments and pay the additional taxes due.[12]

There will be no role for a "tax matters partner" or "tax matters member" for years after 2017. Instead, the new and greatly empowered "partnership representative" ("PR") will be the sole contact person for the IRS auditor and will be authorized under the law to make all decisions regarding how to handle the audit, whether to appeal the assessment, settle or litigate, and whether the partnership will "push out" the assessment to the former partners or pay the assessment itself. The partnership and all its partners will be bound by actions taken by the PR in connection with partnership audits, while (so far) having no rights to participate. And the PR need not be an individual, or even a partner.[13]

Certain partnerships will be permitted to opt out of the new audit procedures.[14] Those that opt out will fall back into the pre-TEFRA audit procedures, under which the IRS must audit, assess and collect tax deficiencies from each ultimate partner, separately. We think that change is near the top of the Treasury's wish list for a technical corrections bill. The first step in determining whether the opt-out election is available is based on a head count.[15] A partnership can opt out only if it has 100 or fewer partners, all of which must be individuals, S corporations, C corporations or estates of deceased partners.[16] And if the partnership has an S corporation partner, it must count each of its shareholders against the 100-partner limit.[17] Unless the IRS issues guidance to the contrary, if even *one* partner is another partnership, or a disregarded single-member LLC or a grantor trust or any other type of trust, the partnership will be thrown irretrievably into the new regime–no opt-out.[18]

Opt-out elections will be effective for one taxable year only. An eligible partnership that desires to get out from under the new audit procedures must file opt-out elections every year, on a timely filed return. We cannot expect the IRS to extend much grace in that regard.

Thankfully, partnerships that can't opt out of the new procedures, or fail to timely do so, can avoid having to pay an imputed underpayment by making a so-called "push-out" election under I.R.C. section 6226, which will shift the burden of audit adjustments back onto the Reviewed

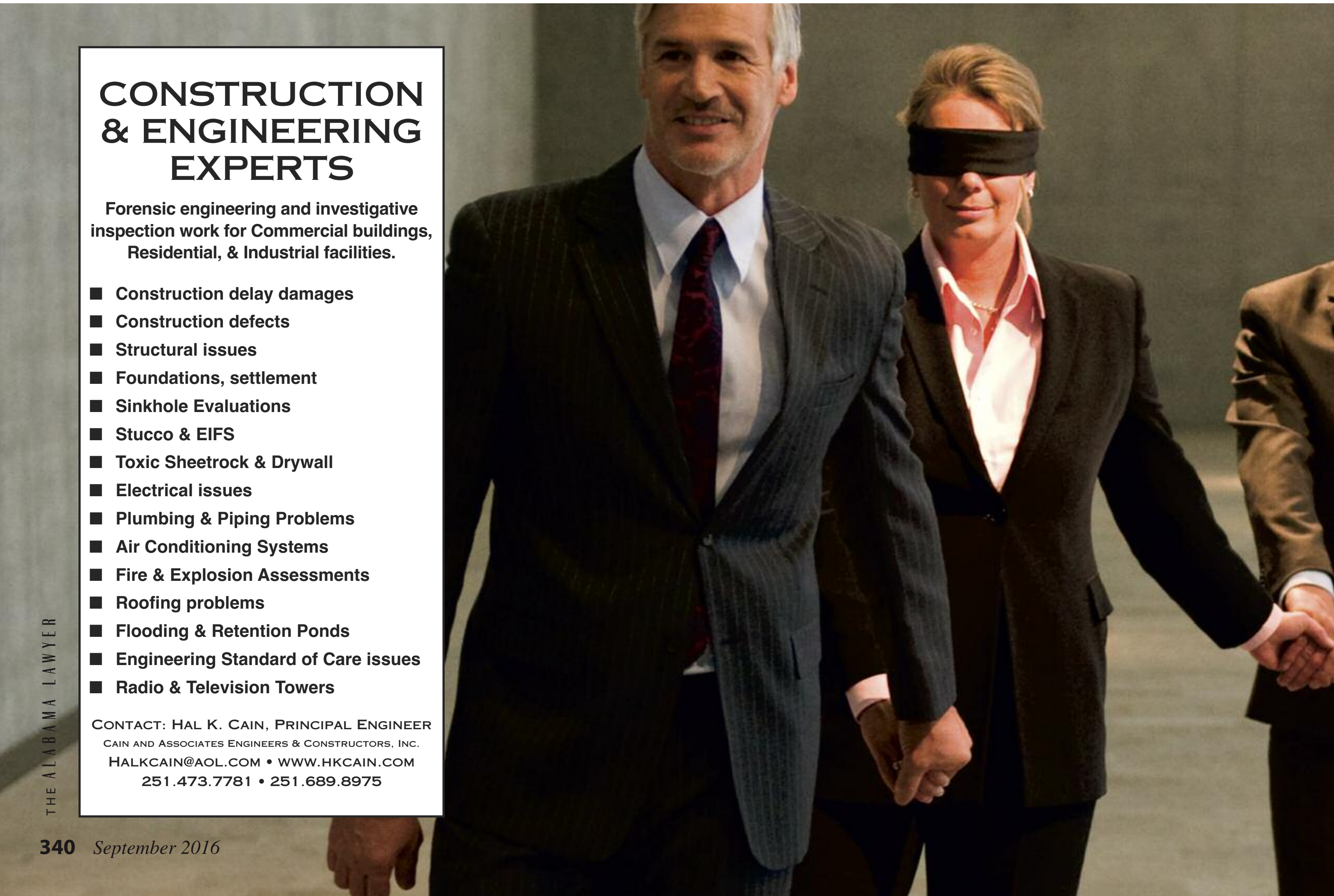
Year partners. The PR (we think) must make this election within 45 days of receiving a notice of final partnership adjustment closing out the audit. The partnership must then furnish "statements" (commonly referred to as "Adjustment K-1s"), reporting to each partner for the Reviewed Year and to the IRS the partner's allocable share of the partnership adjustments. A partner who receives an Adjustment K-1 is required to pay the additional taxes for the Adjustment Year (i.e., the current year), but the amount of tax due is computed by determining the amount by which the partner's federal income tax would have increased in the *Reviewed Year* had the adjustments been properly taken into account in that year, plus the amount by which the partner's tax would have increased in *any intervening year* as a result of changes in tax attributes caused by the adjustments. Only *increases* in tax are taken into account; adjustments to tax attributes that reduce taxes are ignored. In addition, interest is charged from the date the original returns were due, at a rate two percent higher than is normally charged as deficiency interest.[19]

Some Things We Won't Know Until Guidance Is Issued

- Whether partnerships having single-member LLCs, grantor trusts, other types of simple trusts or other partnerships as partners will be eligible to elect out of the new procedures under any circumstances. The new law authorizes the Treasury to issue regulations or other guidance extending treatment similar to that afforded S corporations to other types of partners, but the extent to which the Treasury and IRS may be willing to do so is unclear. If such guidance is issued, each person holding a direct *or indirect* interest in the partnership will be counted toward the 100-partner limit for electing-out, and the partnership will be required to furnish identifying information about each such person to the IRS. This may pose all sorts of practical problems.
- Will the PR be involved in opting out? The effect of an opt-out is that the new rules won't apply to the partnership for the taxable year for which the election is filed, and of course, the provisions governing PR functions are contained in those rules. Does this arrangement create a Catch-22 situation if a PR were to file an opt-out? Until guidance says otherwise, we should assume that someone other than the PR should file an opt-out–probably a manager-member, a member authorized by the board or management committee or the general partner should do so.
- How will the new procedures affect S corporations and their shareholders?[20]
  - Will all the S corporation shareholders be required to file amended returns and pay the taxes due in order for an audited partnership in which the S corporation is a partner to obtain a modification of its imputed underpayment?
  - Can a partnership's imputed underpayment be modified on the basis that one or more shareholders of a partner S corporation are tax-exempt?
  - If an S corporation receives an Adjustment K-1 from a partnership, will the S corporation be required to pay tax, or will the S corporation have an opportunity to "push out" the effects of the adjustments to its shareholders?
- How will the new procedures apply to tiered pass-through structures?
  - Will a push-out election stop at the first tier? If the first tier is itself a partnership? What if the first-tier partnership itself has elected out? Will a partnership be forced to pay a partnership-level tax due to a push-out election made by a lower tier partnership regardless of the fact that it has successfully opted out of the new procedures?
  - Conversely, how will the modification rules apply if guidance permits multi-tier pass-through? Will the ultimate taxpaying partners be required to amend their returns and pay taxes in order for a lower-tier partnership to obtain a modification of an imputed underpayment?
  - If push-out elections are allowed to cascade upward through multiple partnership tiers, will each higher-tier partnership have the option of either paying tax or filing its own push-out election?
- How will tax effects that can be determined only at the *partner* level be taken into account?
- How will penalties determined at the partnership level under

I.R.C. section 6226(c)(1)[21] be apportioned among partners?

- Will any limits be placed on who can serve as PR? On who the IRS will be able to designate in the absence of a valid designation by the partnership?
- Will partners have any rights to participate in audits, appeals or tax litigation?
- Will there be any incentives or benefits for small partnerships *not* to opt out? If not, it's difficult to imagine a situation in which an eligible partnership and its partners would be better off under the new procedures than they would under the rules that were in effect before TEFRA was enacted in 1982. Perhaps in some situations the potential economies of scale in a unified proceeding might outweigh the disadvantages of the new procedures or the partner in charge of the tax and accounting functions of the partnership may wish to solidify that role by having itself or one of its employees appointed PR.
- Will Congress take up additional technical corrections? Don't hold your breath this election year.
- Will the effective date be delayed? It is hard to assess whether the IRS and Treasury will be able to produce workable guidance, reorganize and gear up for the new audit procedures by January 1, 2018. It is possible that we won't see truly useful guidance until well after the effective date of the Budget Act; the Treasury has said its first priority is to develop procedures for electing-*in* before the effective date.
- An important question that must be answered in litigation (and in the partnership agreement itself) and not by IRS or Treasury guidance is whether and to what extent PRs will owe fiduciary duties to the partners–and which set of partners, i.e., those in the Reviewed Year or those in the Adjustment Year.
- How often will a partnership be able to change its PR? Will a partnership be able to pull the rug out from under its designated PR if an audit, appeal or litigation does not appear to be proceeding in a way that suits the partners?



Things to Do and Think About While Awaiting Guidance

- If you're stuck in a dark and unfamiliar room filled with hazards, one way to avoid injury is simply to stay put until daylight, or until the lights come on. Similarly, if existing partnership agreements do not otherwise have to be amended, it would be wise to wait until more is known about what the Treasury and the IRS will say about the new audit procedures, before trying to draft provisions taking those procedures into account.
- However, if your client is contemplating a new business venture that will be classified as a partnership for income tax purposes (including an LLC or joint venture) or if a client needs to amend an existing agreement for other reasons, these changes should be incorporated into the new or revised agreement *immediately*, with a warning to the partnership and the prospective PR (once you decide who your client is) that detailed guidance on many aspects of the Budget Act isn't expected to be released for some length of time. We urge our fellow practitioners to monitor Treasury, IRS and Congressional efforts in this regard. The IRS has pledged that the guidance process will go forward whether or not Congress steps back in to fill legislative gaps in the Budget Act provisions.[22] Depending on how the fall elections go, a technical corrections bill may see the light of day next year. We certainly hope so.
- Partnership clients should be thinking about: (1) who the new PR should be; (2) what level of indemnification will be afforded the PR against any claims, costs or liabilities that may be incurred by acting in that role; and (3) the level of accountability they will have to the company and its partners. For example, must the PR seek advance approval of its actions or non-actions from the managing member, or board of managers, or general partner(s), or perhaps the majority owners?

- Partners who won't be serving as the PR may want to specify the duties and obligations the PR will have to act in the best interest of the partners. PRs may want their decisions to be reviewed and approved by the partners so as to reduce the chances of being held personally liable for those decisions.
- Conversely, especially if you're the attorney for the prospective PR, consider provisions reimbursing the PR for expenses incurred in that role, and indemnifying the PR against claims, damages, etc. asserted against or suffered by the PR as a result of their service. Typically, a gross negligence standard has been used for TMP provisions, but that doesn't necessarily hold true for the non-PR partners who lack any right to participate in audits and litigation under the new rules, but who are bound by actions taken by the PR on behalf of the partnership. They may sue the PR if they feel the PR acted out of selfish motives and violated a fiduciary duty to the partners (especially minority partners).[23] Thus, consider expressly limiting the PR's fiduciary duties to the former or current partners–to the extent relevant state law permits. Consider potential conflicts of interest for PRs who currently are partners, or former partners. For example, what if a former partner is appointed the new PR, and later is faced with the decision whether to push out the proposed assessment to those who were partners in the Reviewed Year–which happens to include her?
- Consider including mandatory opt-out provisions for any taxable year in which the partnership is eligible to opt out. Be as specific as possible about who will be responsible for determining eligibility, gathering the necessary information and filing the election. Until guidance indicates otherwise, though, we think it best not to designate the PR to do these things (see discussion above).
- Most partnership agreements should require the partners (and former partners) to be responsible for their allocable shares of any taxes (including penalties and interest) paid by the partnership under the new procedures.
- Give consideration to how partnership-level taxes should be allocated among the partners for capital account and basis purposes. I.R.C. section 6241(4) provides that no deduction shall be allowed for any payment required to be made by a partnership under the new audit procedures. The Bluebook adds that payments by a partner under an indemnification or similar agreement are also nondeductible. Basic capital accounting rules under federal income tax regulations require that a partner's capital account be decreased by allocations of expenditures described in I.R.C. section 704(a)(2)(B), i.e., expenditures of the partnership that are not deductible in computing its taxable income and not properly chargeable to capital accounts.
- Finally, warn your client (once you decide who that is) that provisions in their partnership agreement dealing with the new audit procedures need to be revisited periodically, as and when the IRS and Congress act and the state legislatures and state departments of revenue join in.

All comments herein are those of the authors only and not necessarily their law firm, the ABA Tax Section, the Alabama State Bar or any other organization or any client with which they are affiliated. The authors thank their Huntsville partner and business entity guru, Scott E. Ludwig, for his helpful comments in the preparation of this article.

Endnotes

1. Section 1101 of Pub. L. No. 114-74 (Nov. 2, 2015) (herein, the "Budget Act"). Throughout this article we'll refer to partners, partnerships and partnership agreements but that is intended to include members, LLCs and operating agreement as well.

2. Amy Hamilton "Stakeholders Mobilizing State Response to New IRS Partnership Audit Regine," Tax Notes Today (May 9, 2016).

3. Donald Rumsfeld's widely-publicized response to a question at a DoD news briefing on February 12, 2002 seems apropos here: "As we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say, we know there are some things we do not know. But there are also unknown unknowns–the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult one." All three categories of knowledge, or lack thereof, are present with regard to the new partnership audit procedures at this point in time.

4. As of early July 2016. At this time, the only official sources of information are the statutes themselves–Subchapter C of Chapter 63, Subtitle A, consisting of I.R.C. sections 6221 through 6241–and the *General Explanation of Tax Legislation Enacted in 2015*, prepared by the staff of the Joint Committee on Taxation, JCS-1-16, March 2016 (herein, the "Bluebook"). References in this article to I.R.C. sections 6221 through 6241 are to the new provisions that are due to become effective for taxable years beginning after December 31, 2017.

5. Originally enacted by the Tax Equity and Fiscal Responsibility Act of 1982, or "TEFRA."

6. Id.

7. Section 1101 of the Budget Act did not change any substantive tax rules of Subchapter K, so this revenue projection must indicate Congress' belief that every year about $1 Billion–or likely much more–due in federal income taxes from partners under current law goes uncollected due to ineffective audit procedures.

8. Amy Hamilton, "News Analysis: Arizona Official Dives Deep into Aspects of New Partnership Audit Law," Tax Analysts Doc. No. 2016-11284 (June 7, 2016).

9. I.e., the year in which a partnership adjustment becomes final under a court decision, the year in which an adjustment is made at the partnership's initiative by filing an administrative adjustment request, or the year in which a notice of final partnership adjustment is mailed. I.R.C. section 6225(d).

10. I.R.C. section 6225(b)(2).

11. I.R.C. section 6225(c)(3) and (4).

12. I.R.C. section 6225(c)(2).

13. I.R.C. section 6223 requires only that the PR be a person with a substantial presence in the United States. The statute provides that the PR "shall have the sole authority to act on behalf of the partnership under this subchapter."

14. Procedures for the election-out are to be established by the Treasury Secretary. As of this writing, no information on what these procedures might look like is available.

15. Technically, the count is based on the number of K-1s the partnership is required to furnish to its partners for the taxable year. I.R.C. section 6221(b)(1)(B).

16. I.R.C. section 6221(b)(1)(C).

17. I.R.C. section 6221(b)(2)(A). The special rules for counting the number of shareholders for S corporation eligibility do not apply (e.g., counting husband and wife and certain members of a family as one shareholder). Instead, the number of K-1s the S corporation is required to furnish to its shareholders for the taxable year count toward the 100-partner limitation. Some S corporations may be required to furnish many more than 100 K-1s. *See* Stuart J. Frentz, S Corporation Corner: *Predicting How the New Partnership Audit Rules Will Affect S Corporations and Their Shareholders,* J. Passthrough Entities, Mar.-Apr. 2016, at 27.

18. IRS Chief Counsel William J. Wilkins warned attendees at the Texas Federal Tax Institute that, "I wouldn't be confident of your ability to elect out if you had a partner that was a disregarded entity unless and until there's guidance or a legislative change confirming that." Amy S. Elliott, "Wilkins Noncommittal on Impartial Partnership Audit Changes," Tax Notes Today (June 14, 2016).

19. I.R.C. section 6226(b) and (c).

20. For a more detailed discussion of issues for S corporations under the new audit procedures, see Stuart's article cited in fn. 17 above.

21. This section provides that notwithstanding a push-out election requiring Reviewed Year partners to pay taxes and interest due as a result of taking their shares of partnership adjustments into account, "any penalties, additions to tax, or additional amounts shall be determined as provided under section 6221 [at the partnership level] and the partners of the partnership for the reviewed year shall be liable for any such penalty, addition to tax, or additional amount."

22. Amy S. Elliott, "IRS to Give More Weight to JCT's View of Partnership Audit Rules, "Tax Notes Today (June 27, 2016).

23. In an effort to reflect the "freedom of contract" principle articulated by Delaware and other states, effective January 1, 2017, the Alabama Limited Liability Company Law and Alabama Limited Partnership Law will allow members and partners to expand, restrict or eliminate certain duties in a written limited liability company agreement or written partnership agreement; however, neither a limited liability company agreement nor a partnership agreement may eliminate the implied contractual covenant of good faith and fair dealing. It should be noted that a number of Delaware decisions have admonished practitioners to take care in drafting agreements under the "freedom of contract" principle, as the agreements themselves may create additional and unintended duties. Also, duties which arise under federal statutes may not be subject to the contractual freedoms provided by the Alabama Limited Liability Company Law and Alabama Limited Partnership Law.

Stuart J. Frentz

Stuart Frentz is a partner with Bradley Arant Boult Cummings LLP in the Birmingham office, where he has practiced federal tax law for more than 30 years. Frentz has been a columnist for the CCH Journal of Passthrough Entities *covering S corporation tax developments.*

Bruce P. Ely

Bruce Ely is a partner with Bradley Arant Boult Cummings LLP in the Birmingham office and is co-chair of a new ABA Tax Section SALT task force on the new partnership audit rules. Ely is a graduate of the University of Alabama School of Law and of the New York University School of Law's Graduate Tax Program.