The Bankler Report

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INTRODUCTION

The rules governing IRS Partnership audits were changed by the Bipartisan Budget Act of 2015 (BBA) and are effective for partnership tax years beginning on or after January 1, 2018. These rules are intended to streamline partnership audits.

Prior Law: The prior Partnership Audit rules were adopted by the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA). The main points were as follows:

1. **Audit adjustments** - The partnership would be audited, and the IRS would issue the report. After it became final (either agreed or after litigation), each partner would correct and submit their return, which would compute the proper amount of tax.

2. **Tax adjustment** – When each taxpayer recomputed the correct tax liability, they would then pay the additional tax (if the original return had paid less than the "correct" amount of tax, or receive a refund if it had overpaid the tax).

3. **Tracking the partners' audit adjustments** – The IRS would then have to monitor the various partners' tax returns to ascertain that these changes had been properly recorded. In large complicated audits, these returns required "special handling" by the IRS since they could be amending returns that, in many cases, had been filed over 10 years prior.

Current Law: The BBA has replaced those rules and can affect the following:

(a) who is liable for the additional tax,
(b) who is entitled to a favorable adjustment (i.e., audit results in a lower tax),
(c) how the additional tax is due, and
(d) how a favorable adjustment is taken into account.

1. **General rules** – The partnership is now a "taxpayer." Any audit adjustment will be paid/received by the partnership rather than having each partner correct that year's return and paying the tax at their rate. In addition, some of the major changes are:
    a. Newer partners could be suffering the consequences of the actions of partners who are no longer members of the partnership (and took the disallowed deductions).
    b. Generally, under the new regime, partners do not have previous rights under the TEFRA regime. The partnership is represented by a "Partnership Representative" who will make binding decisions in the partnership's dealings with the IRS. If the partnership fails to designate a Partnership Representative, the IRS has the power to appoint a representative.

2. **Small partnerships can "elect out" of the new regime** – Qualifying partnerships can elect out if the partnership:
    a. has 100 or fewer partners,
    b. is an eligible partner for an "eligible partnership," and
    c. makes an election out.

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3. **"Eligible partnerships"** are those partnerships whose partners are:
    a. individuals,
    b. corporations (both C and S), or
    c. an estate of a deceased partner or any foreign entity that would be treated as a C corporation were it domestic.

4. **Ineligible partnerships** include partners who are:
    a. partnerships, or
    b. disregarded entities.

    The election out must be made on a timely filed (including extension) return.

5. **Push-out election** – If the audit results in additional tax, the partnership could consider a push-out election. Essentially, the partnership makes an election to have each partner report their share of the adjustment. If a partner in the audited partnership receives a push-out election, it too may make a push-out election. However, the time constraints on the audited partnership to make the elections and distribute the partner statements are not extended to partners who are also partnerships wishing to make these same elections.

    For a partnership to make a valid election, it MUST provide all partners with the required statement. The IRS has not yet clarified the requirement if the partnership is unable to provide the required statement due to:
    a. the death of a partner,
    b. inability to locate a partner, or
    c. the partner was itself a partnership (or corporation) that has been dissolved.

Currently, a brief rule of thumb is to first elect out. If that election fails, the partnership can make a push-out election. If that fails, the audited partnership would be liable for the results of the audit.

This report is only a brief summary of this law and is not a complete discussion of all of its provisions. Please feel free to contact us with your specific questions.