In 2014, the U.S. General Accountability Office reported that in 2012, the IRS only audited eight-tenths of one percent (0.8 percent) of large partnerships compared to 27.1 percent of large corporations.\(^1\) In early 2015, Commissioner John Koskinen testified before the Senate Finance Committee. In discussing the President’s fiscal year 2016 budget related to tax administration, his written testimony supported the administration’s proposal to simplify large partnership audits. The Commissioner stated: “… having to follow the TEFRA procedures is now more of a burden for the agency than a help.”\(^2\)

The Bipartisan Budget Act of 2015 (the BBA) amended the Code\(^3\) repealing both the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audit rules\(^4\) and the electing large partnership rules for tax years beginning after December 31, 2017.\(^5\) Partnerships, however, have the ability to elect current application of these new rules for tax years beginning after the date of enactment.\(^6\) The legislation is rather complex and gives a substantial amount of regulatory authority to the IRS to work out the “details.” It is not clear that the partnership audit and collection legislation was actually ready for “prime time,”\(^7\) but the revenue estimate of $9.3 billion from partnership audits and adjustments\(^8\) may have carried the day. In the future, the IRS will deal exclusively with a single representative of the partnership who will have the exclusive right to take action with respect to partnership audit, litigation and settlement, and, unless certain elections are made, individual partners will not have the ability to challenge the results of the audit or to enter into individual settlements.

Partnership audits, the computation of partnership tax deficiencies and potentially who pays the tax resulting from audits are fundamentally changing for tax years beginning after December 31, 2017. The IRS is not interested in chasing down individual partners to make adjustments and seek payment. The thrust of the new rules is IRS convenience for audit, computation and collection. Rather than precision in computing tax deficiency, the new rules provide for an overstated approximation of the tax with the burden on the partnership to demonstrate the appropriate amount, or, if an alternative election is made, determine the adjustment applicable to each partner. Assessment and collection of tax, interest and penalties may take place at the partnership level unless the partnership makes certain elections. These new rules, when effective, will make it easier to assess and collect, but it will not make the actual audit of the partnerships any easier.

J. LEIGH GRIFFITH is a Partner at Waller Lansden Dortch & Davis, LLP, in Nashville, Tennessee.
A partnership will still be able to file a request for an administrative adjustment (amended return), but such a request may not be filed after a notice of an administrative proceeding with respect to the tax year is mailed by the IRS. The new partnership audit rules also introduce new terminology. “Reviewed year” is the term for the partnership tax year to which the item being adjusted relates. “Adjustment year” is the partnership year in which (i) the notice of final partnership adjustment is mailed; (ii) the court decision establishing the adjustment becomes final; or (iii) an administrative adjustment request is made by the partnership, as applicable. Surprisingly, however, as discussed later herein, a large percentage of the partnerships will be able to opt out of the new rules, and the IRS will be stuck with auditing such partnerships and then making individual adjustments to each partner, with each partner having the ability to oppose.

As under pre-BBA law, partners are required to treat partnership items consistent with the treatment of the item on the partnership return. In the event the partner is treating an item inconsistently with the partnership return, the partner is required to disclose such inconsistency. The failure to disclose an inconsistency is subject to penalty, and the inconsistency is treated as a math error permitting the IRS to immediately adjust and assess. The tax deficiency from a partner’s undisclosed inconsistent position cannot be challenged in Tax Court. If a partner takes an inconsistent identified position, any proceeding to which the partnership is not a party is not binding on the partnership.

Each partnership, in the manner prescribed by the Secretary, shall designate a “partnership representative” who need not be a partner but must have a substantial presence in the United States. If the partnership fails to designate a partnership representative, the Secretary may do so. The partnership representative has the sole authority to act on behalf of the partnership under Subchapter C, but does not have the authority to sign the partnership return unless such partnership representative is a partner, as the Code and regulations require a partner to sign a return. All partners are bound by actions of the partnership (i.e., the partnership representative) and any final decision in a proceeding with respect to the partnership. The new partnership audit rules provide a matrix of partnership administrative choices for which the partners should develop the mechanisms to make choices and decisions in a timely manner.

**Default Rule**

The default rule for the new audit procedures is that the IRS will audit, assess and collect the tax, penalties and interest from any partnership adjustments at the partnership level. The result is those partners in the adjustment year bear the economic consequences of the audit adjustments. These partners may be different from the partners of the reviewed year who received the benefit. The IRS will determine the tax attributable to partnership adjustments by netting all audit adjustments for each reviewed year and multiplying that amount by the highest tax rate in effect for either individuals or corporations for the reviewed year (presently 39.6 percent). If an adjustment is a reallocation of income or loss among the partners, rather than netting (as the net adjustment would be zero), the adjustment is the positive amount, i.e., if income or gain is involved, the amount of income or gain that is reallocated to another partner is the adjustment or if losses or expenses are reallocated, the amount of such loss or expense becomes a positive adjustment. For example, if a partnership allocates a $100 loss to partner A and a $50 loss to partner B, and the IRS determines the loss should be allocated $75 to each, the allocation adjustment will be $25 on which tax and interest will be computed.

**Modification of Rate to Determine Imputed Underpayment by Partnership**

For the computation of the tax deficiency at the partnership level, the imputed tax rate starts with the highest rate applicable to individuals or corporations in effect for the reviewed year. This rate can be lowered if the partnership can demonstrate under rules to be promulgated by the Secretary that the tax due should be lower because of partner-specific information for the reviewed year and the Secretary approves. This will require the partnership to establish the amount and character of income to specific partners and the highest tax rates applicable to such partners on such income or gain. If the adjustment involves more than one item and any partner’s distributive share is not the same with respect to all such items, the portion of the underpayment to which the lower rate will be applied is determined by reference to the amount that would have been the partner’s distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the partnership’s reviewed year. As alluded to above, however, the lower rate will not be less than the highest possible rate applicable to the nature of the taxpayer (individual or C corporation), which is applicable to the character of the income (capital gains, dividends, ordinary income). For this purpose, S corporations are considered individuals.
The Secretary’s procedures are to provide for determining imputed underpayments reduced by the portion the partnership demonstrates is attributable to a tax-exempt entity as defined in Code Sec. 168(h)(2), which would not owe tax as a result of the income allocated to it. Code Sec. 6225(c)(5) as amended by the Protecting Taxpayers from Tax Hikes Act of 2015 provides for the publicly traded partnership’s use of certain passive activity losses to which Code Sec. 469(k) applies in the computation of the default rule’s imputed underpayment amount. The passive activity loss permitted must be attributable to specified partners. The amount of such loss is the lesser of the amount generated in the taxable year of each such partner in which or with which ends (i) the reviewed year or (ii) the adjustment year. The passive activity losses used which are attributed to specific partners, however, will reduce the passive activity loss carryover for each such partner. The tax, interest and penalties are then collected from the partnership, thereby burdening the current partners, who could be somewhat or totally different from the partners of the reviewed year. If the partnership is unable to pay the tax and the partnership is a general partnership, each partner would be 100 percent liable for all of the tax, interest and penalties since each general partner has joint and several liability. If a limited partnership is involved, the general partner would have personal liability for the tax, interest and penalties if the partnership was unable to pay. If a limited liability company is involved, no member would have personal liability for the tax solely by virtue of being a member.

Reduction of Partnership’s Underpayment Amount

In accordance with procedures to be established by the Secretary, the imputed underpayment amount of the partnership may be reduced if one or more partners (even if the statute of limitations has run) file amended returns for the tax year of such partner(s) that include the end of the partnership’s reviewed year. Each such partner’s amended return must include (i) all adjustments allocable to such partner for the reviewed year; (ii) the effect of the adjustments on tax attributes for all subsequent tax years of the partner prior to the filing of the amended return; and (iii) payment of any tax due with the filing of such return. The imputed underpayment amount for the partnership would then be determined without regard to the portion of the adjustments taken into account on such amended returns. For reallocation adjustments at the partnership level, the imputed underpayment amount will not be modified unless all partners affected by such adjustment file amended returns and pay the tax as provided above. The default rule concept of accounting for the subsequent-year tax attributes and including such aggregate adjustment in a single return is new and, as discussed later herein, is also found in Code Sec. 6226. This approach moves the subsequent year(s) complexity for the post-reviewed year corresponding adjustments through the adjustment year due to the audit adjustment from the IRS to the taxpayer.

Presumably, most former partners and potentially a large number of the current partners will not file amended returns and pay tax unless the partnership agreement has legally bound them to do so. The affected partners and former partners must amend returns and pay the tax within 270 days of the partnership receiving the notice of proposed adjustments for the partnership tax liability to be reduced. For adjustments involving a reallocation of distributive shares of any item from one partner to another, returns by all partners affected must be filed for the partnership to obtain credit. All information required to be submitted to the Secretary to reduce the tax rate or to reflect amended returns of the partners must be submitted no later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed unless the Secretary consents to an extension of time.

It is worth noting that the tax, interest and penalty that is calculated by the partners for the partnership to be able to reduce its understatement and liability for the amounts and items reported on the amended tax returns of its former partners is calculated on the reviewed-year income. This would use the rates and actual tax attributes of the partners in such year and not of the year in which the adjustment is made or the partnership distributes the information to the partners. Interest appears to be calculated at the normal underpayment interest rate. The statute
of limitations for each such filing partner’s reviewed year will presumably run in the same manner as if the taxpayer partner filed any other amended return.

The Code is silent as to how the partners filing such returns obtain credit with the partnership and among the partners as a result of the partnership having a lower tax liability because of partnership information provided by the partners that lowers the tax-rate default rules or as a result of some (but not all) partners filing amended returns and paying the tax within the prescribed periods. These are business matters for the partners. Special allocations and distribution adjustments should be provided in the partnership agreement to appropriately allocate the benefits to the partners that generate the benefit. Partners may consider requiring past partners to file tax returns and pay the tax or be liable to the partnership for the tax, interest and penalties attributable to the partner’s share of items and allocations adjusted by the IRS.

Alternative to Payment of Imputed Underpayment by a Partnership

Irrevocable Election to Pass the Adjustments and Liability to the Partners

Pursuant to rules to be promulgated by the Secretary, a partnership may irrevocably elect within 45 days after the date of the notice of final partnership adjustment the application of Code Sec. 6226.30 This is an elective alternative to the default rule and appears to be applicable to all partnerships. Under this section, the partners for the reviewed year, not the partnership, will be liable for the tax, interest and penalties. The partnership through this election passes down the entity-level adjustments to the partners of the reviewed year who are liable for the tax. The partnership must furnish to each such partner and to the Secretary, at such time and manner as the Secretary provides, a statement (presumably a form of an adjusted K-1) of the partner’s share of any adjustment to income, gain, loss, deduction or credit (as determined in the notice of final partnership adjustment), and each partner must take such adjustment into account in the tax year, which includes the date the statement was furnished.31 In essence, the partnership and not the IRS has the burden of pushing the adjustment down to and among the partners. Clifford Warren, special counsel, IRS office of Associate Chief Counsel (Passthroughs and Special Industries), characterizes this as a “vast improvement”32 because the partnership, not the IRS, has to do the work of identifying the partners and determining how the adjustment should be spread among the partners. How this push down will work in the case of passthrough entity partners is not presently clear.

Each partner’s tax for the tax year in which the statement from the partnership reflecting the audit adjustments is issued (not the reviewed year’s taxes) will be impacted. In essence, this becomes a current-year tax with an interest component from the due date of the taxpayer’s return in which or with which the reviewed year ends. Such partner’s tax will be increased by the aggregate of the adjustments taxed under Chapter 1 of the Code for the partner’s tax year that includes the reviewed year plus the amount by which the tax imposed under Chapter 1 would increase by the effect of the adjustments in subsequent tax years through the year the statement was furnished.33

The partners shall be liable for any penalties, additions to tax or additional amounts as provided under Code Sec. 6621. The interest rate on any underpayment is computed from the due date of the return in which or with which the partnership’s reviewed year ended to the year the statement is issued by the partnership to the partner. The interest rate is the Code Sec. 6621(a)(2) underpayment rate of the federal short-term rate plus five percent rather than the normal three percent.34

The Code provides that tax attributes that would have been affected if the adjustments were taken into account in the reviewed year shall be taken into account for the reviewed year and subsequent tax years. Presumably, this includes adjustments to basis for increased income and gains or decreased for allocation of losses. For a partner who has disposed of his partnership interest prior to the issuance of the partnership’s statement reflecting the IRS adjustments, it is likely the IRS adjustment will increase the tax basis of the former partner’s interest in the partnership. Hopefully, the Secretary’s rules will address this situation and permit the reduction of gain or recognition of loss as a result of the disposition to be part of the subsequent tax attribute adjustment.

Under this election, the partner must take the adjustment into income in the year the partnership issues the statement.35 Therefore, the IRS has a new statute of limitations to audit the correctness of the reported adjustment. The IRS may well have the ability to impose a new set of penalties with respect to the reporting of the adjustment and payment of tax since it appears in a new tax year. It will be interesting how this situation is handled in the rules and regulations the Secretary develops.

The complexity of implementation is on the partnership and its partners and not the IRS. This alleviates a major source of the difficulty the IRS faces when auditing large partnerships under the TEFRA rules and places the burden
on the partnership and partners. It is the partnership and the partners that must flow the audit adjustments through to the partners. The failure of the partnership to timely and correctly flow the audit adjustments through to the taxpayer partners may well permit the IRS to utilize the default method and impose the tax on the partnership itself. For partnerships in which there are no pass-through partners, this computation and flow through may not be too difficult for the partnership. At a minimum, each partner will have a more complicated return in the year the partnership issues the statements. The magnitude of the increased complexity will largely depend not only on the computation of the adjustments for the reviewed year, but also on the attribute ramification of the adjustments and the number of years that subsequent adjustments must be factored into the computation of the tax, along with interest and penalties. The partnership and per-partner compliance cost may be significant—possibly more than the tax deficiency. In addition, the taxpayer will be subject to a higher interest rate than is normal for tax deficiencies. For many partnerships and partners, this may be a complicated and labor-intensive task. Some partners may disagree with the partnership’s determination as to how the adjustment flows, but such partner will be bound by the adjustment or must disclose the inconsistent position. Either the partnership agreement has a mechanism for the partners to approve or otherwise agree internally to the computations and audit adjustment flow or the decision appears to be up to the partnership representative. Presumably, the failure to timely issue the statements will, under rules prescribed by the Secretary, void the election and cause the default rules to apply.

Under this election, the statute of limitation problems the IRS had under TEFRA largely disappear as the liability for the adjustments is a current-year liability of the year the partnership issues the statement to the partners, even though the adjustment passes through to the partners from the reviewed year.

Provisions When a Partnership Has Ceased to Exist Prior to the Issuance of an IRS Partnership Adjustment

The new statute more or less “punts” when addressing the audit and collection procedure when a partnership has ceased to exist prior to the IRS’s partnership adjustment. The statute states: “If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.”

Until regulations are issued, taxpayers and their advisors will not know if “former partners” means the partners when the partnership ceased being a partnership or the partners in the reviewed year(s). Does this provision apply if a partnership has undergone a technical termination? Does this provision apply if the number of members of an LLC taxable as a partnership is reduced to one making the LLC a disregarded entity for tax purposes? Does this provision apply if the partnership checked the box to become taxable as a corporation?

Small Partnership Exception on Steroids

Pre-BBA law provided that a small partnership composed of 10 or fewer individuals (none of whom are nonresident aliens and a husband and wife are treated as one), C corporations or estates of deceased partners are automatically excepted from the TEFRA audit procedures unless such partnership affirmatively elects to be included. While the IRS was focused on large partnerships and the difficulty of auditing and processing those adjustments, with the expansion of the number of partnerships that can opt out of the new rules, the IRS may not be totally pleased with the new partnership audit rules and the simplification they actually make for the IRS.

The new partnership audit and collection rules expand this exemption in the form of an annually elected option for partnerships that are required to issue 100 or fewer statements under Code Sec. 6031(b) (not 100 or fewer partners) and expand the persons who may be partners to include foreign entities that would be treated as C corporations if they were domestic and S corporations. For purposes of determining whether there are 100 or fewer partners, an S corporation partner is “looked through” and each of the S corporation shareholders is counted as a partner. The author anticipates the regulations will look at the number of S-corporation shareholders over the course of the tax year of the S corporation ending with or within the partnership’s tax year to determine if the partnership is permitted to opt out.

The statute specifically restricts who may be a partner in a partnership that is eligible to opt out of the new partnership rules. Although the statute provides that all partners must be individuals, estates or C corporations, it provides that an S corporation is treated as an individual for this purpose. The statute does not classify single-member LLCs or grantor trusts as eligible or ineligible partners. Will there be a look through of the single-member LLC or the grantor trust to see the identity of the member or grantor? Given the IRS’s difficulty dealing with tiered partnerships, it is almost surprising the statute does not expressly prohibit...
a look-through of partners that are themselves partnerships, but this situation is left up to the Secretary. The Secretary is given the authority to prescribe rules similar to the S corporation rules with respect to partners who are not specifically identified partners.\(^a\) Presumably, the draftsmen were thinking of at least some of these sorts of entities, but until regulations or other authority is issued providing for such treatment, they would not appear to be eligible partners.

The opt out of the new partnership audit and collection rules for an eligible partnership is made annually on a timely filed partnership return.\(^b\) The election must include (in the manner prescribed by the Secretary) the name and taxpayer identification number of each partner of such partnership (and each shareholder of an S corporation partner for the applicable tax year), and the partnership must notify each such partner of the election in the manner prescribed by the Secretary.\(^c\) The Secretary may provide for alternative identification of any foreign partners. The failure to timely file a partnership tax return will result in the application of the new default partnership audit rules. Unless regulations provide otherwise, the traditional small partnerships of 10 or fewer eligible partners apparently will now need to file a tax return as they are no longer automatically exempt from the entity-level audit and collection rules. It is unknown whether the IRS will update Rev. Proc. 84-35\(^d\) for certain small partnerships as having a presumed reasonable cause to avoid penalties for failure to file or file timely provided that all partners properly report their shares of income, deduction and credits of the partnership.\(^e\) Unless there is a specific applicable update, traditional small partnerships should assume that penalties for failing to file will apply when the provisions of the BBA are applicable. Given the increased size of partnerships that can opt out, the author would be surprised if Rev. Proc. 84-35 is updated to reflect the new Code section. Presumably, since the Code Sec. 6226 alternative is an election made after the final administrative adjustment occurs, if a partnership is found to have unsuccessfully attempted to opt out, the Code Sec. 6226 election can be made.

For taxpayer partners involved in a large number of partnerships with complex financial and reporting situations, the opt out may put the IRS in a difficult position. If the partnership’s return is audited and the partner refuses to agree with the adjustment, the IRS is faced with the decision of whether to make an adjustment to the partner’s tax return. An adjustment as a result of one audit of a partnership return will give the taxpayer the option to go to Tax Court. Once in Tax Court, the court’s decision, which will only involve the issues in the proposed adjustment, will generally close the tax year of the partner. This puts the IRS examiners in the position of choosing to not issue a deficiency notice and let the partnership adjustment go or issue the notice knowing that they may in effect be giving taxpayers complete passes on the remainder of their tax returns. The result is apt to be partnership adjustments to the partner’s return shortly before the statute of limitations would otherwise run if the IRS can develop, maintain and monitor the potential pending partnership adjustments and each taxpayer’s running of the statute of limitations.\(^f\)

**Partnership Adjustment Requested by the Partnership**

A new Code Sec. 6227 (replacing pre-BBA Code Sec. 6227) is added, which permits the partnership to request an administrative adjustment in the amount of one or more items of income, gain, loss, deduction or credit for any partnership tax year. The adjustment shall be computed using rules similar to those of Code Sec. 6225 or 6226 except the enhanced interest rate does not apply. Such request must be made not more than three years after the later of the date the partnership return was filed or the last day for filing the partnership return without extensions but cannot be made after a notice of an administrative proceeding with respect to the tax year is mailed under Code Sec. 6231.\(^g\) An amended return after the due date of the partnership information return cannot be filed except under rules prescribed by the Secretary.\(^h\) Hopefully, rules prescribed by the Secretary will provide a mechanism for adjustments initiated by the partnership to be handled in the audit. If the partnership adjustment requested by the partnership would result in additional tax being due, the additional tax must accompany the request. As discussed infra under “Period of Limitations on Making Adjustments,” the filing of a partnership adjustment request will extend the statute of limitations to the date that is three years from the filing of the administrative adjustment request.

Regulations permitting the individual partners to report the adjustment in their own returns are likely to be complicated as the partnership is supposed to remit the tax due when it files the request for administrative adjustment.\(^i\) This may indicate that requests for administrative adjustments will be under the default rules.

**Partner Participation in IRS Audit Process Will Be Restricted**

Unless the partnership is a small partnership and has opted out of the new rules, it does not appear that each of the partners has a right to contest the adjustment at the
partnership level. If the partnership representative does not initiate a contest at the partnership level, it appears there will be no challenge to adjustments at the partnership level. If the partnership pays the tax, interest and penalties, there is no obvious way for a partner to contest the substantive adjustment. There does not appear to be the ability for a partner to independently settle with the IRS under the new rules, whereas under the TEFRA rules a notice partner had such ability. Even if the partnership elects the Code Sec. 6226 alternative providing for the partnership to issue statements to each partner reflecting the adjusted items of income, gain, loss and deduction allocated to the partner and for assessment and collection to take place at the partner level, it does not appear that the partner has the ability to challenge the underlying partnership adjustments.

Entity That Is Not a Partnership Filing a Partnership Return May Be Treated as a Partnership Under Regulations

If it is determined that the filer of a partnership return is not a partnership or there is no entity of any kind for tax purposes, then to extent provided in regulations, the provisions discussed in this column will, nevertheless, apply to such nonentity or nonpartnership and to persons holding an interest in such entity.51

IRS Notices and Assessment

The Secretary is only required to mail notice of any administrative proceeding initiated at the partnership level, notice of any proposed partnership adjustment and notice of any final partnership adjustment to the partnership and the partnership representative.52 The Secretary is not required to send any notice of such actions to any other partner! This appears to be the case even if the partnership has opted out of the new rules with respect to the audit of the partnership, but then the IRS will have to make adjustments to each partner’s return and presumably open an audit on each partner’s return. For partnerships that have not opted out of the new rules, the mailing to the last known address of the partnership representative or the partnership shall constitute notice even if the partnership has ceased to be in existence. Any notice of a final partnership adjustment shall not be mailed prior to 270 days after the date on which the proposed partnership adjustment is mailed.53

Generally, no assessment or other collection action can be undertaken before the close of the 90th day after the date a notice of final partnership adjustment is mailed. If a petition is filed under Code Sec. 6234 with respect to a final partnership notice, until the decision of the court has become final, no assessment or collection action can be taken. Code Sec. 6234 provides for judicial review of partnership adjustments. Notwithstanding the above, an adjustment on account of a mathematical or clerical error may be made in a manner similar to that provided in Code Sec. 6213(b) which permits prompt assessment and collection unless the taxpayer objects within 60 days in which case the normal process for adjustments will be followed.54

Assessment and collection of tax, interest and penalties may take place at the partnership level unless the partnership makes certain elections.

If a partnership has properly elected out of the new rules under Code Sec. 6221(b), it appears that the IRS will have to assess each partner, and each partner will have the right to separately challenge the validity of any partnership adjustment. As was the case prior to TEFRA, there may be inconsistent results among the partners and the statute of limitations may run for one partner and not for others.

Period of Limitations on Making Adjustments

Generally, the statute of limitations for an adjustment for a partnership tax year is the date which is the later of (i) three years after the latest of (a) the date the partnership return was filed, (b) the return due date for the tax year, or (c) the date on which the partnership filed an administrative adjustment with respect to such partnership tax year; (ii) in the case of a partnership modifying the amount of an imputed underpayment under Code Sec. 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted55; (iii) in the case of a proposed partnership adjustment under Code Sec. 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under Code Sec. 6225(c)(7))56 after the date of such notice.57 Such period for assessment may be extended by agreement entered into prior to the expiration of the period of adjustment.58 If a notice of a final partnership adjustment is mailed prior to the running of the statute, the statute is extended for the period a court action may
be brought (and if a court action is brought until the decision of the court becomes final) plus one year.\(^5\) If there is a substantial omission from gross income as described in Code Sec. 6501(e)(1)(A), six years is substituted for three years.\(^6\) The running of the statute of limitations is suspended for assessment or collection during the period that the Secretary is prohibited by reason of a Title 11 case from making the adjustment or assessment plus 60 days or for taking collection steps plus six months. Adjustments may be made at any time in the case of a false or fraudulent return with intent to evade tax or the failure to file a partnership tax return.\(^6\)

If an eligible partnership has timely elected out of the new rules, the statute of limitations for each partner appears to be the relevant statute of limitations for the specific partner.

**Assessment of Tax**

For partnerships that are unable to or failed to opt out of the new rules, any imputed underpayment is assessed and collected in the same manner as if it were a tax imposed for the adjustment year (i.e., the year of assessment, not the reviewed/audited year). In the case of an administrative adjustment request by a partnership, the underpayment shall be paid when the request is filed.\(^6\) The Secretary’s regulations will need to set forth the assessment rules when a Code Sec. 6226 election is made, as the assessment will be with respect to each partner with the partnership having computed the adjustment for each partner (as opposed to the IRS).

Generally, neither an assessment or deficiency nor a proceeding in court for collection may be made before the close of the 90th day after the date of the notice of final partnership adjustment or if a petition is filed under Code Sec. 6234, until the decision of the court becomes final.\(^6\) A partnership may waive this restriction by a written waiver and permit a quicker assessment.\(^6\) If no judicial review is timely filed with respect to a final partnership adjustment, the amount for which the partnership will be liable shall not exceed the amount of the final adjustment.\(^6\)

Adjustments arising out of math or clerical errors appearing in the partnership return shall be assessed in the same manner as similar errors on other returns under Code Sec. 6213(b). In the case of tiered partnerships, any failure to comply with the requirements of Code Sec. 6222(a) (duty to report consistent with the lower tier partnership’s return or adjustment) shall be deemed to be a math or clerical error.\(^6\)

If the partnership has properly elected out of the new rules, the assessment is made at the partner level. The partner will then have to bring an action challenging the specific partner’s adjustment. This can be very expensive with multiple actions on essentially the same facts.

**Interest and Penalties**

Except for the increased interest rate under Code Sec. 6226(c), if the partnership elects application of Code Sec. 6226, interest is determined for the partnership adjustment for the period beginning on the return due date for the reviewed year and ending on the return due date for the adjustment year (or if earlier, the payment date). Penalties are determined at the partnership level as if the partnership were an individual for the reviewed year and the imputed underpayment was an actual underpayment or understatement for such year.\(^6\) Except as provided in Code Sec. 6226(c), the partnership shall be liable for penalties and interest computed as if the imputed underpayment was an underpayment of tax imposed in the adjustment year if it does not pay such amount timely.\(^6\) If the alternative of Code Sec. 6226 is elected, the partners are liable for the penalties and interest (at a higher than normal rate) computed at the partner level.\(^6\) Code Sec. 6226 makes the adjustment a current-year reporting and tax payment item and the failure to properly report such on the return for the year in which the statement is received can give rise to separate penalties and interest cost to the partner.

**Judicial Review of Partnership Adjustment**

Unless the partnership is an eligible partnership that properly opted out of the new partnership rules, the partnership may file for judicial review within 90 days of the notice of a final partnership adjustment in the Tax Court, the district court in the district in which the partnership’s principal place of business is located, or the Court of Claims. For other than the Tax Court, the partnership filing the petition must deposit with the Secretary on or before the date the petition is filed the amount of the imputed underpayment as of the date of the filing of the petition. The court may order that the jurisdictional requirements are satisfied where there has been a good faith attempt to satisfy such requirement and any shortfall of the amount required to be deposited is timely corrected.\(^\) Such deposit is not treated as a payment of tax. The court has the authority to determine all items of income, gain, loss, deduction or credit of the partnership for such tax year and the proper allocation of such items among the partners, as well as the application of penalties or additions to tax for which the partnership may be liable.\(^\) If an action is dismissed other than by reason of a rescission under Code Sec. 6231(c),
such dismissal shall be considered a decision that the final partnership adjustment is correct.\textsuperscript{72}

If an eligible partnership has opted out of the new partnership rules, each partner who desires to contest the adjustment applicable to such partner must file a petition for judicial review within 90 days of the notice of final partnership adjustment in the Tax Court, the District Court or the Court of Claims. Note, if the partnership opts out, it is likely the IRS will want to audit other areas of the partner’s return prior to assessing for a specific partnership adjustment. If the partnership has not opted out, if the partnership files an action in district court, it must be in the district in which the partnership’s principal place of business is located.\textsuperscript{73}

**No Deduction for Any Payment Required to Be Made by a Partnership**

If the partnership is required to make a payment of tax, interest or penalty under Chapter 63, Subchapter C, no deduction shall be allowed.\textsuperscript{74} If an eligible partnership opts out of the new rules, this flat prohibition of no deduction for any amount paid will not apply, but the normal rules will continue to apply.

**State Tax Potential Ramifications**

The concept that the partnership may be liable for tax, interest and penalties on a net adjustment basis is something that current state tax law does not contemplate. Most states do not tax the entities but rather tax the partners. Under the default rule, the adjustment is not passed down to the partners.

Will the states ultimately adopt the federal approach or a variation thereof? With respect to partnerships doing business in a state, the shift by a state to imposing a tax on the partnership for audit adjustments will have minimal revenue impact for the state if it presently imposes and enforces withholding or the filing of composite returns with respect to nonresident partners. Between the tax on the resident partners and the withholding or composite returns for the nonresident partners, such states are already substantively collecting tax on the partnership. However, the assessment of tax at the partnership level will mean that states in which partners live or are domiciled but in which the partnership itself if not engaged in business will not have nexus to tax the partnership. If the default rule applies, the partners may not even have the information as to how the adjustment flows down to their income tax returns. In addition, the state may not receive information concerning any allocation of income to a resident or domiciled partner if the partnership is being assessed and paying the tax as the IRS will not necessarily develop or receive such information.

The state tax treatment may cause some partners not to want the partnership to opt out of the new rules even if the partnership would be permitted to do so. For example, California partners in a tax year in which the partnership did not do business in California may not want the partnership to opt out of the new rules for such year and attempt to avoid California’s high taxes on any future adjustment. Later, if there is an audit adjustment for such a year, such California partners are likely to also be opposed to the partnership electing the alternative of Code Sec. 6226 as that would provide the information to the taxpayer and presumably to California of the partner’s individual adjustment. From these partners’ perspective, the high tax rates of California may make it much more economical for the partnership to pay the federal tax at the highest levels.

States will consider changing their laws to seek to impose tax at the partnership level on an apportioned share of audit adjustments, especially to those partnerships to which the default rules apply. The mix of different state laws and the federal tax law is apt to add greater complexity and may effectively pose double taxation on some partners—the partnership paying tax on all of its income to one or more states and the partner paying tax on such partner’s share of such income. For early speculation on what the new partnership audit rules will mean for the states, see News Analysis: What Do the IRS Partnership Audit Changes Mean for States?\textsuperscript{75}

**Implications for Partnerships and Partners**

**2018 Returns and Partnerships That Elect in Early**

It is anticipated that for tax years beginning on or after January 1, 2018, more large partnerships will be audited and it will be easier for the IRS to collect tax, interest
and penalties with respect to all partnerships other than those that are able to and do opt out of the new partnership audit and collection rules. The assessment and collection improvements do not mean the actual audit will be easier for the IRS. Complex partnership rules must be understood and applied to the facts by the auditor and that requires trained auditors and a thorough audit. The convenience of the IRS to permit audits of large partnerships was the primary purpose of the amendments and the reason for the revenue estimates of increased collections of $9 billion over the next 10 years. For partnerships opting out of the new rules, it is likely to be more difficult for the IRS to process the audit results and may be more expensive for the partners to challenge proposed adjustments. The statute of limitations may well run on some partners, and there may be some differences in the results of litigation and settlement of similarly situated partners.

Attorneys Drafting Disclosure Documents

The tax discussion of partnership offerings will need to include a discussion of the new partnership audit and collection rules and any provisions in the partnership for dealing with the new rules.

Attorneys Drafting Partnership Agreements

Although presumably not applicable until tax years beginning in 2018, counsel should now begin considering what modifications to new partnership agreements are prudent even prior to the issuance of regulations. The naming of a partnership representative and whether the tax matters partner and the partnership representative should be the same person or entity should also be considered. If the partnership representative is someone other than a partner, who determines what partner signs the partnership’s tax return? What indemnity is appropriate for the partnership representative and, if applicable, the partner that executes the partnership information return?

Since the IRS will not be providing notice to partners that the partnership will be under audit, how the audit is progressing and the results of the audit, new partnership agreements need to be drafted that provide for the timely information flow to the partners. The partnership agreement should provide whether any partner has the right to participate as an observer or otherwise in the audit and, if applicable, audit settlement process.

New partnership agreements should also include a method of selecting the partnership representative and if such person is not a partner, then a method for determining what partner will execute partnership information returns and execute other partnership tax returns.

Rules and Process for Making New Audit Rule Elections

As discussed supra, there are several potential choices for partnerships to make. Should agreements being drafted today provide a mechanism for making the elections that will bind partners and require partners (and those who were partners in the reviewed tax year) to undertake certain activities timely or be liable to the partnership?

1. What action, if any, is required for the partnership to decide to opt out of the new rules if the partnership is eligible to do so each year? Will partners that are entities be required to provide information as to the identity of their owners? What happens if a partner refuses to provide such information?

2. If the partners are generally inclined for the partnership to opt out of the new rules, should there be restrictions on the transfer of partnership interests so that the number of partners (K-1s) over the course of the year is less than 100 (including for this purpose the shareholders of any S corporation partners and no transfers to ineligible parties)? Not all transfers are voluntary. For example, since an agreement cannot prevent an individual from dying, the partnership’s maximum number of K-1s prior to the prohibition of additional transfers should have some “headroom” for a few transfers after the partnership agreement’s ceiling is met.

3. If the partnership is unable or fails to opt out the new rules:

   a. Are the partners required to provide information that would allow the partnership to reduce the partnership’s tax liability? To the extent partners provide the information and any documentation the Secretary requires to reduce the tax rate used in determining the tax deficiency of the partnership, is there a mechanism for giving the economic benefit of such information and documentation to the partners that provide it? Is there a mechanism to “charge” partners that fail to provide the needed information?

   b. Is there an obligation and a mechanism for requiring those who are partners in the reviewed year to timely file amended returns, pay the tax and provide the information the Secretary requires for the Partnership’s tax liability to be avoided. If a partner in the partnership for the reviewed year is required to do so and does not, what is the partnership’s
remedy? If some partners timely amend returns and pay the tax and others do not, do those amending partners receive preferential distributions to reflect the savings to the partnership?

c. An analysis of some of the factors that partners should consider when determining if, as a partnership agreement default rule, the partnership, if eligible, will (or will not) automatically opt out of the new rules needs to be developed and communicated to the partners or prospective partners so the appropriate mechanism can be inserted. Wealthy and perhaps institutional investor partners may well desire for the opt out as it is more likely that the statute of limitations may run before such partner is assessed or the IRS may choose not to assess the partner as a full audit of the partner has not taken place and the IRS does not want to run the risk of the taxpayer taking an action that may preclude future adjustments to the partner’s return that does not involve the specific partnership. Even if such a partner’s return is adjusted, such partner may believe his counsel and/or accountants are likely to achieve a better result for such partner than the partnership would. Other partners may not wish to be in a position that forces the IRS to look at their return and make the partnership adjustments and perhaps see other items to question in the process and therefore prefer that the partnership not opt out. The nature of the partnership and the likelihood of significant partnership adjustments should be factors in the decision to opt out. If it is unlikely that a significant adjustment will arise, the partnership’s cost of allocating the adjustments among the partners and the partners’ cost of preparing amended returns and providing the requisite information to the partnership may exceed any probable tax savings.

d. What is the mechanism for the partnership (or the partnership representative) to decide whether to timely elect the application of Code Sec. 6226?

e. To the extent partnership actions are to be determined by a vote of the partners, what is the vote necessary for authorizing or directing that an action take place? Do all actions require the same vote or do some require a higher vote?

4. CPAs and Attorneys Advising Partners in Partnerships. Historically, new partners have had limited tax exposure for prior years as it was the partners in such prior years that would be responsible for any income tax, interest and penalties attributable to adjustments for such years. However, if the new rules apply, unless the partnership is a small partnership that is able to and does opt out of the new rules, that may not be the case in the future. For tax years beginning before January 1, 2018, new partners to an older partnership may wish to determine if the partnership has or has not opted into the new rules. Clients that are presently partners in partnerships or that are contemplating becoming a partner should be informed of the future application of the new rules. This is particularly true if the partner is making an investment in a partnership and is not going to be actively involved in the operation of the partnership.

Partners in large hedge funds or private equity funds should be aware that it may be impractical for the partnership to make the Code Sec. 6226 election. Partners who leave the partnership, or perhaps partners that reduce their percentage interest, after the reviewed year and before the adjustment year will escape tax. In such case, those who are partners when the notice of final adjustment or a decision of a court is rendered will be economically burdened with the tax as the tax will be a partnership liability unless there is a tax-sharing agreement in the partnership agreement or other binding document that permits the partnership to recover the tax, interest and penalties from such former or reduced interest partners.

For tax years beginning on or after January 1, 2018, or with respect to partnerships that elect to have the new rules apply, new partners should consider negotiating for representations, warranties and indemnities regarding pre-closing tax liabilities if the partnership is not a small partnership that has elected out of the new audit and collection rules for the applicable years. This would be true even if the partnership agreement requires partners of the reviewed year to file amended returns, pay the tax and provide the information to the partnership required by the Secretary. There may be instances in which such partners are unwilling or unable to honor this obligation. Some may feel representations, warranties and indemnities should not be necessary if the partnership agreement requires the partnership to elect the Code Sec. 6226 alternative procedure in the event of an audit. Even in such case, however, there is the risk that the partnership will fail to make the timely election. There may be circumstances in which the absolute requirement to make a Code Sec. 6226 election is not wise as the administrative expense of complying can be complex and costly and an absolute requirement would mean that such costs would be incurred. Procedures short
of unanimous consent to modify the requirement to election Code Sec. 6226 would pose the risk for the new partner that the election is not made.

If the partnership qualified for small partnership status and elected each year to opt out of the new audit and collection requirements, a new partner may wish to perform due diligence to verify the election was timely and valid (i.e., only qualifying parties were partners and the number of partners for the year did not exceed 100) and that the tax return for each year with the election was made was executed by a qualified partner and the partnership representative in the manner required by the Secretary.

A general partnership may be a bit less attractive to even an active partner as the federal income tax liability from audits will be a liability of the partnership and as a general partner, such partner will be jointly and severally liable for 100 percent of the partnership’s deficiency, interest and penalty.

5. Amendment of Existing Partnership Agreements. At this time, and until the Secretary issues proposed regulations or other guidance, it is probably too early to prepare detailed amendments to existing partnership agreements—or at least partnership agreements that are not being amended for other purposes. It may be prudent, however, for partnerships to inform partners of the fact that new audit and collection rules are coming and that over the next 12–18 months, amendments to the partnership agreement will be proposed to address the new rules. Over the next 18 months or so, as IRS regulations, proposed regulations or other guidance starts to develop, existing partnership agreements that are not otherwise in need of amendment will likely need reviewing and perhaps amending for at least some, if not all, of the items described above. Annual decisions have to be made in connection with the filing of the partnership’s information return. If an audit occurs and the partnership has not opted out of the new rules, how is a quick decision reached? It will be difficult to reach a consensus if an audit is underway and even more difficult if a proposed partnership adjustment is issued. Addressing the issues while theoretical and providing for rights, remedies and a means of decision making will be infinitely easier before an audit.

ENDNOTES

3 Unless otherwise specifically indicated, all references to the Code are to the Internal Revenue Code of 1986 as amended by the Bipartisan Budget Act of 2015 (P.L. 114-74), 129 Stat. 584.
4 The Tax Equity and Fiscal Responsibility Act of 1982 enacted the TEFRA-centralized partnership audit system. This caused the tax treatment of all partnership items to be determined at the partnership level. Under TEFRA, a tax matters partner must be appointed to represent the partnership in TEFRA proceedings. The tax matters partner has the right to extend the statute of limitations, file for refunds and settle with the IRS. All partners (if there are fewer than 100) or all one-percent partners if there are over 100 can be notice partners and have the right to receive notices from the IRS of proceedings and adjustments and to initiate a tax contest if the tax matters partner does not. Tax matters partners generally cannot bind notice partners to a settlement agreement. A notice partner may enter into an individual settlement. While the partnership return statute of limitations is three years, the statute of limitations for a partnership item is actually the longer of the partnership’s statute of limitations or the statute of limitations applicable to the partners. See Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), 96 Stat. 325.
6 Code Sec. 6241(g).
7 Indeed, some sections have already been amended. See Act Sec. 411 of the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113), 129 Stat. 2242 (H.R. 2029 passed on Dec. 18, 2015).
9 Code Sec. 6227(c).
10 Code Sec. 6222(a).
11 Code Sec. 6222(b).
12 The correction of a math error does not constitute a notice of deficiency, and the IRS may make a summary assessment. The Tax Court does not have jurisdiction if that is the only adjustment. Code Sec. 6213(b)(1). After the tax is paid, a taxpayer can bring a refund action in District Court or the Court of Claims.
13 Code Sec. 6222(d).
14 Code Sec. 6223(a).
15 Code Sec. 6223(a). Subchapter C is comprised of Code Sec. 6221–6235. The “partnership representative” replaces the tax matters partner and has similar but different responsibilities.
16 Code Sec. 6031 requires the partnership return to be signed by a partner. Reg. §1.6031(a)-1(a)(2) also requires a partner signature on the return, as does the current Form 1065 instructions. Having a nonpartner partnership representative who has the sole authority to interface with the IRS and bind the partnership but not sign tax returns is going to create taxpayer confusion and will undoubtedly cause improperly executed partnership tax returns to be filed. Ramifications of an improperly executed partnership tax return include the potential for the IRS to say no return was filed, and as a result ignore elections thereon (such as Code Sec. 754 elections), cause no statute of limitations to run and subject the partnership to failure to file penalties.
17 Code Sec. 6223(b).
18 Code Sec. 6223(b)(1).
19 Code Sec. 6223(b)(2).
20 Code Sec. 6223(c)(1) and (7).
21 Code Sec. 6223(c)(4)(B).
22 Code Sec. 6223(c)(4)(A).
23 Id.
24 Code Sec. 6223(c)(3).
25 Such partner must be a partner described in Code Sec. 469(a)(2) of the publicly traded partnership and have a specified passive activity loss with respect to such publicly traded partnership. Code Sec. 6223(c)(5)(C) (as amended by Act Sec. 411 of the Protecting Americans from Tax Hikes Act of 2015).

33 Code Sec. 6226(b). Under a literal reading of the statute, subsequent-year adjustments before the year the statement was furnished to the partner by the partnership reflecting the audit adjustments that would decrease tax do not appear to enter into the computation of the imputed reviewed-year tax underpayment. If the statute of limitations has not run, the taxpayer may be required to file amended returns to obtain the benefit of favorable subsequent adjustments. Perhaps, the Secretary’s regulations will cure this anomaly.

34 Code Sec. 6226(c)(2).
35 Code Sec. 6226(b)(1).
36 Id.
37 Code Sec. 6241(7).
39 Commentators that the author has reviewed have generally phrased the exception as 100 or fewer partners. However, Code Sec. 6031(b) requires a statement be given to each person who is a partner at any time during the partnership’s tax year. This would seem to indicate that a husband and wife each receiving a K-1 may be treated as two partners, and the 100 refers to the total number of partners over the course of the year as each receives a K-1, not the number outstanding at any point in the year.

40 Code Sec. 6221(b)(2)(C).
41 Code Sec. 6221(b)(2)(A).
42 Code Sec. 6221(b)(2)(B).
43 Code Sec. 6221(b)(2)(A).
44 Code Sec. 6226(c)(2). The election causes Subchapter C of Chapter 63 not to apply to the partnership. Id., at (b)(1). Each partner will have to be separately assessed and will be required to independently contest any assessment. The resolution for one partner will not bind either the IRS or other partners. Presumably, the extension of the statute of limitations by the partnership (if it can be extended) will not extend the statute for the partners.

46 Rev. Proc. 84-35 states its purpose is to conform the small partnership provisions of Code Sec. 6231(a), which the BBA repeals. For a discussion of pre-BBA analysis of Rev. Proc. 84-35 and the IRS’ position on the late filing of an otherwise qualifying small partnership with respect to late-filing penalties, see J. Leigh Griffith & Jon P. Gaston, Is the IRS Mounting a New Challenge to Small Partnership Exception to Penalty for Not Timely Filing a Complete Return under TEFRA Rules? Tenn. CPA J., Sep./Oct. 2013 at 26-27.

48 Under pre-BBA Code Sec. 6227, an administrative adjustment request (i.e., an amended return) could be made at any time prior to the mailing of a final partnership administrative adjustment with respect to such tax year.

49 Code Sec. 6031(b) is amended to prohibit the amendment of a partnership information return “[e]xcept as provided under Code Sec. 6225(c), with respect to statements under Code Sec. 6226, or as otherwise provided by the Secretary ….” Code Sec. 6241(e).
50 Code Sec. 6232(a).
51 Code Sec. 6241(b).
52 Code Sec. 6231.
53 Code Sec. 6231(a).
54 Code Sec. 6232(d)(1)(A).
55 Unless regulations issued by the Secretary have a “bright line” as to when all required information is received, there may well be substantive litigation as to when the statute has run. The IRS may argue that all materials had not been received by a specified date thereby extending the statute of limitations to a date later than the taxpayers believe appropriate.

56 Code Sec. 6235(a)(3) (as amended by Act Sec. 411 of the Protecting Americans from Tax Hikes Act of 2015). The original provision would have made it difficult for the Secretary to assess as generally the statute of limitations and the earliest date for assessment were identical if three years from the later of (i) due date of the return, (ii) date the return was filed, or (iii) the date the partnership filed an administrative adjustment request.
57 Code Sec. 6225(a).
58 Code Sec. 6235(b).
59 Code Sec. 6235(c).
60 Code Sec. 6235(d).
61 Code Sec. 6235(c)(2).
62 Code Sec. 6235(c)(1) and (3).
63 Code Sec. 6232(a).
64 Code Sec. 6232(b).
65 Code Sec. 6232(d)(2).
66 Code Sec. 6232(e).
67 Code Sec. 6232(d)(1)(B).
68 Code Sec. 6226(c).
69 Code Sec. 6233(b).
70 Code Sec. 6226(c).
71 Code Sec. 6234(b).
72 Code Sec. 6234(c).
73 Code Sec. 6234(c)(2).
74 Code Sec. 6234(e).
75 Code Sec. 6234(a)(2).
76 Code Sec. 6241(4).
78 Code Sec. 6221(b).