KOSTELANETZ & FINK, LLP TAX ALERT

Congress Repeals the TEFRA Partnership Audit Rules and Enacts a New Set of Rules Which Includes the Assessment of Income Taxes at the Partnership Level

As part of The Bipartisan Budget Agreement of 2015, which the President signed into law on November 2, 2015, Congress repealed the complex and much-criticized partnership entity-level audit ("ELA") rules under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),[1] including the electing large partnership rules. The new law replaces the ELA rules with a set of "streamlined" entity-level audit ("SELA") rules designed to enhance the IRS's ability to audit more large partnerships and increase tax collections.[2]

The repeal of the TEFRA partnership audit rules is effective, in general, for partnership returns filed for taxable years beginning after December 31, 2017, but the "old" ELA rules will continue to apply under the sunset rule for partnership tax years starting before 2018, subject to certain exceptions. A partnership may elect, however, to have the provisions of the bill apply to returns filed for tax years beginning after November 2, 2015 and before January 1, 2018.

The central and most controversial feature of the new SELA rules is to shift the obligation to pay additional income tax assessed in a partnership audit from the partners in the years in issue, to the partnership (or limited liability company). The assessment with respect to prior years' partnership items, a/k/a the "imputed underpayment," is taken into account in the year in which the partnership receives an administrative adjustment, not in the tax year at issue. This means that current partners may end up with the burden of paying for the income tax liabilities of former partners unless special elections are made with the IRS on an annual basis.

The new rules will have a substantial impact on tax partnership audits and litigation against the IRS. Legal and tax counsel will need to inform clients who are partners in partnerships about the need to revise partnership and limited liability company agreements. The new SELA regime will also have a major impact on the due diligence undertaken by a prospective purchaser of a partnership interest, or a successor in interest to a partner, such as a former spouse who obtains an interest through a property settlement incident to a divorce. The IRS will address many technical issues and problems with integrating the new rules with forthcoming formal guidance and regulations.

Background of TEFRA ELA Rules

Prior to enactment of the entity-level audit rules in TEFRA, partnership audits were conducted by the IRS examination division at the partner level because a partnership, as a flow-through entity, is not subject to payment of federal income tax. Prior to TEFRA, the IRS would have to

[1] Pub. L. 97-248, §1101.

[2] The TEFRA ELA rules were set forth in §§ 6221 thru 6234. The electing larger partnership rules were contained in §§771 thru 777 and 6240 thru 6255.

audit each individual partner separately. The individual audit approach handicapped the IRS from effectively auditing partnerships. The partner-by-partner audit approach proved particularly unworkable and inefficient for auditing tax shelter partnerships organized during the 1970's and early 1980's. When partner level audits were conducted in different jurisdictions or IRS districts, there was always the chance that the audit results, settlements, and litigation outcomes would not be consistent. [3] The potential for inconsistent outcomes increased when a tax shelter promotion involved many individual investors, or was warehoused in large investment partnerships, making partner audits under pre-TEFRA rules a challenging, uphill climb for the IRS.

The TEFRA ELA rules were designed to address these difficulties[4] by adopting a single unified procedure for auditing partnerships, and by creating a separate framework for conducting the audit, administrative appeal, and tax litigation (including tax refund suit) of a TEFRA partnership.

The main characteristics of the TEFRA ELA rules (which continue to apply until taxable years beginning after 2017) may be summarized as follows:

1. Partnership items or issues are addressed in a unified partnership level proceeding for audit, appeal, and administrative purposes, as well as in instituting judicial proceedings, including refund litigation;

2. The "tax matters partner" ("TMP") generally represents the partnership and its partners. The partnership could designate the TMP, or, if not, the IRS could designate the TMP pursuant to certain criteria;

3. The statute of limitations for all partners' partnership items generally (but not exclusively) is determined based on the filing date of the partnership return. The TMP may extend the statute of limitations with respect to partnership items and certain "affected items" by executing a partnership-level extension agreement, which

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[3] Under the Tax Court's rule of administrative convenience, the Tax Court will follow a Court of Appeals decision which is squarely on point where appeal from the case lies with that Court of Appeals based on the taxpayer-petitioner's residence, even if the Tax Court would apply a different rule to cases subject to review in different circuits. *Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[4] For more explanation of the background and problems encountered with the TEFRA partnership audit rules see August, "Entity-Level Audit Rules Continue to Pose Challenges for Partners," Parts I and II, Business Entities (RIA WG&L)(Nov/Dec 2014 and Jul/Aug 2015); Comments on Partnership Tax Audit and Litigation Regime Revisions," American Bar Association Section of Taxation (Nov. 2, 2015). http://pdfs.taxnotes.com/2015/2015-24250-1.pdf

is effective for all partners, even if the partners do not individually agree to an extension for their individual tax return year(s);

4. The IRS makes proposed audit adjustments in a final partnership adjustment notice ("FPAA") which starts the time period for the partnership to seek judicial review of contested items;

5. The IRS is required to send to each "notice partner" notice of important actions such as the commencement of an audit and the issuance of a FPAA;

6. In general, a "notice partner" has the right to participate in the audit, administrative appeal, or judicial proceeding involving a TEFRA partnership;

7. Each partner has the right to a settlement consistent with any settlement agreement the IRS enters into with another partner;

8. On completion of the audit and administrative proceedings, each partner has the right to contest the proposed adjustments in court, i.e., the Tax Court, a federal district court in which venue lies, or the Court of Federal Claims; and

9. After there has been a final partnership-level determination on one or more partnership items, either through a final court decision or settlement, the IRS makes computational adjustments and issues assessments to the partners At this point, a partner can challenge only the computation itself and not the merits of any partnership level adjustment.

<u>Calls for Reform Including Outright Repeal of the TEFRA ELA Rules</u>

Over thirty years have passed since the TEFRA ELA rules went into effect. During this period, the individual tax shelter industry has greatly diminished in size with the exception of the capital loss or partnership basis plays that were prevalent during the mid-1990's through the mid-2000's. During recent years, the growth of large partnerships has been driven by rates of economic return, and many hundreds of investors have funded large investment pools, including hedge funds and private equity funds.[5]

As reflected in published reports, the IRS lacks resources to audit more than a few large partnerships, and even when large partnerships are audited, the audits frequently result in small

[5] The GAO reported in September, 2014, that the number of large partnerships has more than tripled to 10,009 from 2002 to 2011. Almost two-thirds of large partnerships had more than 1,000 direct and indirect partners, and had six or more tiers and/or self-reported as being in the finance and insurance sector, with many being investment funds. The GAO, in its report, recommended that Congress should impose taxes on audit adjustments at the partnership level with respect to large partnerships. United States General Accountability Office, Report to Congressional Requestors, "*Large Partnerships: With Growing Numbers of Partnerships, IRS Needs to Improve Audit Efficiency*," GAO-14-732 (Sept. 2014) (the "GAO Report").

increases in tax. The IRS simply does not have the resources to engage in a broader audit function of large partnerships.

Because of these problems with partnership audits, which also posed traps for the unwary taxpayer-partner, many in Congress were concerned that "large partnerships" may not be subject to the proper level of audit review, fueled in some part by the complex ELA provisions, and that reform in this area was needed. The perception was that the IRS needed a major statutory overhaul to increase the number of audits, increase the adjustments in tax, and increase collections in tax for large partnerships.[6] Congress's response is the repeal of the ELA rules and enactment the new SELA rules in the Bipartisan Budget Act of 2015.

<u>The "Basics" of the New SELA Rules</u>

The new rules apply to all partnerships. Partnerships, including limited liability companies treated as partnerships for federal income tax purposes, with 100 or fewer partners may elect out of the new SELA rules, provided all partners are individuals, C corporations, foreign entities that are treated as corporations under the check-the-box regulations, S corporations having certain types of shareholders, or estates of deceased partners. When any partner is a partnership, trust, or even a single member LLC or defective entity, the partnership cannot elect out of the new SELA rules. The partnership must comply with important notification requirements both to the IRS and to the partners in order to elect out of the SELA rules. This election out must be made annually.[7]

Unless an election out is made, the the partnership will bear the economic cost of any assessments resulting from a partnership adjustment. In such instance, the IRS will assess against the partnership for the "imputed underpayment," which is to be calculated at the highest corporate or individual rate during the tax year at issue, and not for the year or years in which the partnership level adjustments are attributable. Presumably, regulations will allow for adjustment in computing the "imputed underpayment" where a partnership can prove that certain partners are exempt from tax or subject to a lower rate of tax for the years at issue. This "pay tax as you go" approach not only reflects a paradigm shift in the taxation of flow-through entities, but also for the first time imposes the tax assessment against partnerships as entities, much like corporations. The procedure for making or contesting tax payments at the partnership level will resemble the procedures for making or contesting tax payments for C corporations. There also may be income tax consequences to the partners whose tax liabilities for prior years are paid by the partnership in a later year.

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[6] Also under TEFRA, unless the large investment partnership elected to be taxed at the entity level (which few do), the IRS must pass audit adjustments through to the ultimate partners. When hundreds of partners' returns have to be adjusted, the costs involved limit the number of audits IRS can conduct. Adjusting the partnership return instead of the partners' returns would reduce these costs but, without legislative action, the IRS's ability to do so was limited.

[7] The partnership is required to supply to the IRS the names and taxpayer identification numbers of each of its partners, including information with respect to each S corporation shareholder who is a partner.

In addition to the election-out feature described above, the new law creates two exceptions that can shift the partnership-level tax liability back to the partners for the years in which the adjustments relate. The first exception reduces the "imputed underpayment" required to be paid by the partnership for the current year under audit when the partners file amended returns and pay their individual shares of the partnership level adjustments within 270 days of receiving a notice of proposed adjustment. The second exception to the partnership level "imputed underpayment" provides that within 45 days of receiving a notice of partnership adjustment, a partnership may elect to issue a statement of each partner's share of such adjustment(s) to the partners and the IRS. Thereafter, each partner, and not the partnership, is responsible for payment of the adjustment amounts. If the partnership challenges the proposed adjustments in court, any resulting deficiency in tax will be assessed against the partnership.

A revised statute of limitations for assessment creates a single partnership limitation period.[8] Under new Section 6235, an adjustment to the partnership cannot be made more than 3 years after the later of: (i) the date on which the partnership filed its return; (ii) the due date for the return; or (iii) the date on which the partnership filed an administrative adjustment request. The statute of limitations may be extended or waived on consent.

The concept of TMP has been eliminated, and under the new law, every partnership must designate a "partnership representative," *i.e.,* a partner or other person having a "substantial presence" in the United States who has sole authority to act on behalf of the partnership. If the partnership fails to make this designation, the IRS may select any person as the partnership representative.

This "new world" of partnership income tax procedure, which will go into effect for partnership taxable years beginning after 2017, will have a profound impact on professionals advising clients on the need to revise partnership and LLC operating agreements. In the same fashion, professionals will need to advise clients on the enhanced due diligence required when a client considers an investment in a partnership or LLC.

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[8] Under current law, Section 6501, the general statute of limitations for a partner, controlled, but could be extended or held open by application of Section 6229 under TEFRA ELA rules.