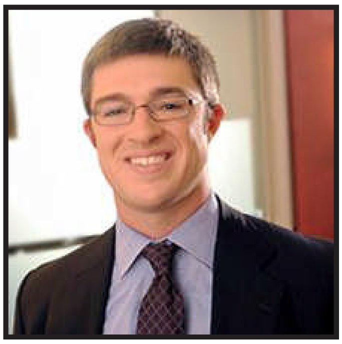
The Repeal of TEFRA and Upcoming Procedural Changes to Partnership Audits

By Brandon N. Mourges



On November 2, 2015, as part of the Bipartisan Budget Act of 2015 (P.L. 114-74) ("the BBA"), Congress repealed and replaced significant provisions of the Internal Revenue Code ("I.R.C.") regarding partnership audit procedures. The amended versions of I.R.C. §§ 6221 through 6241, the prior versions of which were passed with the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), will significantly alter tax examinations for many partnerships after December 31, 2017. If elected by the partnership, the amended provisions can be applied even earlier, to tax years beginning after November 2, 2015.

While TEFRA was intended to streamline partnership audits, mitigate the potential for disparate results between partners, and fight abusive tax shelters, many of its provisions became unworkable or unnecessary over time. Although intended to centralize most examinations at the partnership level, TEFRA did not apply to many partnerships, which consisted of 10 or fewer partners. Further, it was often too difficult for the Internal Revenue Service ("IRS") to administer the audit procedures where complex multi-tiered partnerships were selected for audit. Complicating matters further, the IRS was in some cases forced to deal with varying statutes of limitation between partners, engage in battles with different partners over the same or similar items flowing from the partnership, and navigate the classification of items as partnership items, affected items, and partner-level items. At least anecdotally, the TEFRA provisions failed to streamline partnership audits and instead led to a reduction in the number of large partnership audits as their resolution was cumbersome. Significant legislative efforts in the last five years has finally resulted in a solution to these issues.

How the BBA Addressed These Issues

Unlike TEFRA, which excepted small partnerships and certain electing partnerships from its provisions, the BBA presumptively applies to every entity taxed as a partnership. Partnerships may still elect out of the BBA if there are less than 100 partners, but must choose so affirmatively. Assuming the partnership cannot or does not elect out of the coverage of the BBA, all of its partners will be bound by the actions of the partnership, which is controlled by a single representative with respect to its tax matters. No longer will the IRS be required to provide notice of the beginning and completion of administrative proceedings to each and every partner – only the tax representative will receive such notifications. These changes will make it simpler for the IRS to conduct its audit process.

The BBA also borrows principles from corporate audits in order to assess tax. The IRS will be able to impose an entity-level tax in order to collect adjustments resulting from partnership audits. Currently, pursuant to TEFRA, additions to tax could only be assessed against a partner if either the partnership's or the partner's statute of limitations for assessment had not expired. The application of the BBA does not require such an inquiry; instead, the BBA only requires a determination of the partnership's statute of limitations. Further still, the BBA does not require the IRS to look through to the partners in order to make assessments flowing from the audit proceedings.

Previously, under TEFRA, the IRS would often be required to determine how a given partnership item either passed through or affected a partner's tax return (e.g., whether an item affected basis, amounts at-risk, or affected other tax attributes of the partner); however, BBA procedures permit the IRS to assess an entity-level tax on the partnership at the highest individual rate for understatements of income by the partnership. If the partnership so chooses, it may avoid the entity level tax by issuing adjusted Schedules K-1 to each of its partners. To avoid potential issues involving the statute of limitations, any adjustments flowing from the Schedules K-1 will be treated as tax due in the year that the adjusted Schedules K-1 are issued. The partnership may also avoid an entity-level tax to the extent it can prove that its partners, in the year where the adjustment arose, were subject to a lesser tax rate or were tax-exempt. These changes will make it simpler for the IRS to assess and collect tax stemming from partnership audits.

Preparing Partnerships for Application of the BBA

Entities taxed as partnerships must review their current governing documents in light of the BBA. The typical verbiage regarding the "tax matters partner" and its responsibilities under TEFRA will no longer suffice. Partnership agreements should be revised to address notice provisions under the BBA and should address the decision-making authority of the partnership's tax representative. Many partnerships with 100 or fewer partners will need to consider whether it is appropriate to opt out of the coverage of the BBA;

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however, they should also plan for the possibility that they may become subject to the BBA in the future, perhaps due to the addition of new partners. If the partnership opts out of the BBA, all partners need to be aware that they will be responsible for addressing future tax matters before the IRS on their own. Partnerships should also consider whether it is appropriate to fast-track application of the BBA by making an early election.

Perhaps most significantly, partnerships should address the procedural changes regarding how adjustments are made. In many (but not all) cases, a partnership will want to avoid the entity-level tax that can arise under the BBA by issuing adjusted Schedules K-1 to its partners. This may help to avoid potential liquidity issues if large adjustments arise from a partnership audit. In some cases though, where an adjustment is insignificant, it may be less costly to pay the entity-level tax. Such a decision may be further complicated by potential issues related to timing mismatches between current and historical partners. For example, for partners no longer involved with the partnership, there will be an incentive to have the current partners bear the tax burden through an entity-level tax. Finally, partners should be made aware that adjustments to prior years' Schedules K-1 will affect their tax liability in the years that they are issued, even though the underlying tax will be computed based upon the year of the adjusted partnership return.

While the new procedures may bolster efficiency for partnership audits, their exact application remains unclear and the changes will have a significant effect. Partnerships should closely monitor this changing environment as implementing regulations, interpretations, and administrative guidance continue to develop.

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for payment; as a result, an IRS suit to collect estate tax filed 11 years after the notice and demand was necessarily brought too late.

The IRS website was revised to indicate that confirmation that an estate tax return has been accepted as filed is available by requesting a transcript online; IRS ceased issuing estate tax closing letters except on request for all returns filed after May 31, 2015.

BUSINESS

Public Law 114-74, the Bipartisan Budget Act of 2015, abolishes the TEFRA partnership audit rules effective 2018 tax years and makes them optional for years commencing after enactment and creates new rules under which partnerships with 100 or fewer partners can opt out; adjustments to covered partnerships will be made at the entity level in the year of completion of the audit or judicial review or, alternatively, at the individual level through a simplified amended return process.

Public Law 114-113, the Protecting Americans from Tax Hikes Act of 2015:

- Makes "permanent" the five-year lookback on C to S conversions, the 100 percent exclusion on "small business stock" with no creation of a preference item, and the 15 year recovery period for qualifying leasehold improvements, restaurant property and retail improvement property.

- Makes "permanent" the current first year expensing limits and rules but adds indexing, removes the separate qualified real property limitation and adds expensing of air conditioning and heating units effective 2016.

- Makes "permanent" the research tax credit including the ability by eligible small businesses to offset alternative minimum tax and allows a business with gross receipts of less than $5 million and in its first five years to elect annually to claim any or all of the credit against payroll tax liability up to a $250,000 maximum effective 2016.

- Makes "permanent" the 20 percent differential wage credit for employers who pay workers called to active duty but makes it available to employers of any size effective 2016.

- Extends bonus depreciation through 2019 but reduces the percentage for 2018 to 40 percent and for 2019 to 30 percent.

- Extends the added first year depreciation for business vehicles through 2019 but reduces the amount for 2018 to $6,400 and for 2019 to $4,800.

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