THE BIPARTISAN BUDGET ACT of 2015, Pub. L. No. 114-74, Act § 1101 (the “Budget Act”), which the President signed into law on November 2, 2015, (as modified by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113 (the “PATH Act”)) makes fundamental changes in how the Internal Revenue Service (“Service”) will conduct audits of partnerships. The Budget Act repeals the partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)1 and electing large partnership regimes and replaces them with a new set of rules for partnership audits and judicial review of partnership audit adjustments under a new centralized or consolidated partnership audit regime.2

The new centralized partnership audit rules are generally applicable to all partnerships. While the Service will audit the partnership under the revised entity-level audit rules, the default rule contained in Section 6225, will, for the first time, make the partnership responsible to make payment of any resulting imputed underpayment.

from one or more partnership adjustments for the reviewed year or years. There is a major exception, and that pertains to certain partnerships that have 100 or fewer partners. Under new Section 6221(b), a partnership having “100 or less” partners (actually 100 K-1s or fewer) may elect out of the new audit rules for any tax year, provided that all partners are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic entities under the check-the-box regulations, and S corporations having certain types of shareholders or estates of deceased partners. There are important notification provisions that must be made by the partnership representative to the IRS and the partners in qualifying for the election out of the partnership audit rules under SELA. The election out must be made annually.\(^3\) With respect to any tax year of the partnership where any partner is a partnership, trust, or even a single member LLC or defective entity, the election out provided in Section 6221(b) cannot be made.

When an eligible partnership elects out, the partners will be subject to the pre-TEFRA partnership audit rules with respect to such year, which will require that the IRS separately audit each partner as well as the partnership. It is somewhat ironic that the IRS’ motivation in obtaining the legislation was to enhance the audit and assessment of partnerships but the legislation in fact opens the door for making auditing partners who reside in different states and countries even more difficult than before.

When an election out is not made or is otherwise ineffective, the new law requires that the partnership will be subject to the general rule under Section 6221(a) and must directly bear the economic cost of proposed assessments in income tax resulting from the partnership audit in the year of adjustment, and not the “reviewed years” to which the partnership adjustments were attributable. The “partnership adjustment” is defined in new Section 6225. In such instance, the IRS will assess federal income tax against the partnership for the “imputed underpayment,” resulting from aggregate net increase in taxable income (or aggregate decrease in taxable loss) attributable to the partnership adjustments with respect to the “reviewed” years. The imputed underpayment is calculated at the highest corporate or individual rate during the tax year(s) at issue.\(^4\) Appropriate guidance will be forthcoming on the computation of the imputed underpayment by IRS notice and then in final regulations. The amount of the imputed underpayment can be mitigated by timely presentation of particular tax profiles of the partners to which the adjustments are allocable (for the reviewed years) or by reference to a particular tax provision in the Code, such as long-term capital gain, or qualifying dividend income, that will reduce part of the resulting imputed underpayment. Indeed, the partners can reduce the imputed underpayment amount by timely remitting amended returns and making the required tax payments for their respective shares of the imputed underpayment amount.

A single partnership limitation period is set forth under a revised set of statute of limitations rules, in particular new Section 6235, replacing Section 6229. Under Section 6235, adjustments to the partnership cannot be made more than three years after the latest of: (a) the date on which the partnership filed its return; (b) the due date for the return; or (c) the date on which the partnership filed an administrative adjustment request. Of course, the law allows for the parties to agree to an extension or waiver of the statute of limitations. There are other important procedural rules set forth in the new provisions that again will be the subject of an extensive set of rules and exceptions to be published by the Service as guidance, proposed regulations, and then in final regulations. A

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\(^3\) See new § 6231(a) (notices of audit (administrative proceeding), proposed partnership adjustment and final partnership adjustment). Section 6231(a) (flush language provides that “[N]otice of a final partnership adjustment shall not be mailed earlier than 270 days after the date on which the notice of the proposed partnership adjustment is mailed. Such notices shall be sufficient if mailed to the last known address of the partnership representative or the partnership (even if the partnership has terminated its existence). The first sentence shall apply to any proceeding with respect to an administrative adjustment request [or AAR] filed by a partnership under § 6227. See also § 6245(b)(1) (“notice of partnership adjustment”) which is deleted under the new rules).

\(^4\) See new § 6225(b)(1).
six-year period will apply for substantial omissions from the partnership’s gross income and, when no return is filed by the partnership or it involves civil fraud, there will be no statute of limitations.\(^5\)

**THE PARTNERSHIP AUDIT RULES PRIOR TO AND AS A RESULT OF TEFRA** • Prior to the enactment of the TEFRA rules, all partnership audits were conducted at the partner level as part of the audit of one or more partners. The Service determined that this was an unsatisfactory method to audit partnerships although non-partnership issues would still be determined at the partner level.\(^6\)

Some partnerships could elect out of TEFRA, such as a partnership with 10 or fewer eligible partners, in which case the IRS would have to audit each partner separately. There also were rules whereby electing large partnerships, i.e., partnerships with 100 or more partners, could elect into a special set of rules they would centralize the audit process.

The TEFRA entity level audit rules mixed both entity and aggregate theories into a complex web of procedural rules and protocols that were supposed to supersede the normal set of procedural rules applicable to taxpayers in general. This dual system for auditing partnerships had a well-intended design but generated much complexity and uncertainty in how the two sets of rules were to be applied. For example, there were different statutes of limitations applicable, one at the partnership level and one at the partner level.\(^7\)

In instances in which the TEFRA audit rules applied, the Service encountered administrative difficulties in timely locating the tax matters partner as well as all notice partners that the IRS was required to notify at the commencement of the audit and in issuing a final set of proposed partnership adjustments (FPAA). There were also thorny technical or legal issues generated from the two-track system of statutes of limitations, and in identifying whether particular adjustments were to be labeled as “partnership items,” “affected items,” etc. The election-out mechanics are contained in Treas. Reg. § 1.761-2(b). The election out would also negate application of the entity-level audit rules under TEFRA and presumably under the BBA, subject to the issuance of regulations.

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\(^5\) See new §§ 6235(c)(1)-(4).

\(^6\) Certain investment entities, joint extraction, or production arrangements that are joint undertakings for profit under may still elect out of partnership status in accordance with the regulations to § 761, in which case such enterprise is also not treated as a partnership under the TEFRA audit rules. Treas. Reg. § 1.761-2. See § 7701(a)(2); Powell v. Commissioner, 26 T.C.M. (CCH) 161 (1967); Rev. Rul. 68-344, 1968-1 C.B. 569; Rev. Rul. 82-61, 1982-1 C.B. 13. But see Bentex Oil Corp. v. Commissioner, 20 T.C. 565 (1953); Madison Gas & Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980). See also, WB Acquisition, Inc. v. Commissioner, 633 F.2d 512 (7th Cir. 1980), aff’d, 803 F.3d 1014 (9th Cir. 2015) (profit cap found to be indicative of a contingent compensation arrangement); Historic Boardwalk Hall, LLC, v. Commissioner, 694 F.3d 425 (3d. Cir. 2012), rev’d and remanding 136 T.C. 1 (2011) (investor in vehicle to transfer historic tax credits not a bona fide partner); Chief Couns. Adv. 20124002F (Aug. 30, 2012) (applying participation analysis to treat tax equity investor’s interest in partnership as debt). The regulations describe an “investing partnership” that may “elect out” of partnership status as one in which: (a) The partners own the property as co-owners (b) Each owner reserves the right to separately take or dispose of their shares of any property acquired or retained; (c) the owners do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for a period of up to one year. Under Treas. Reg. § 1.761-2(a)(3), a group may elect out of Subchapter K where the participants enter into an operating agreement for the joint production, extraction, or use of property in which: (a) the participants own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights; (b) the participants reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used; and (c) the participants do not jointly sell services or the property produced or extracted.

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\(^7\) See § 6229(statute of limitations for partnership audit does not expire until 3 years after the original due date of the partnership return or the date the return is filed, whichever is later). A 6 year period was possible for substantial understatements under the more than 25% rule as well as no statute of limitations for fraudulently reported partnership items. Each partner’s statute of limitation was to be determined as the later in time of the normal statute of limitations on assessments under I.R.C. § 6501 or the partnership statute. See Rhone-Poulenc Surfactants & Specialties LP v. Commissioner, 114 T.C. 533 (2000) (reviewing the issue and siding with the Internal Revenue Service’s position); AD Global Fund LLC v. United States, 67 Fed. Cl. 657 (2005), aff’d, 481 F.3d 1351 (Fed. Cir. 2007) (discussing the interaction of §§ 6229 (TEFRA) and 6501 and the related case law).
or “non-partnership items.” The case law under TEFRA reveals that the courts were somewhat ill-equipped to handle these unique and at times perplexing legal questions that had to be sorted out with judicial candor and clarity. This was not always easy.

The Service often had further difficulty dealing with complicated statute of limitation issues under TEFRA. There was added concern with the ability to collect taxes from partners’ deficiencies after adjustments had been determined. Again, the multi-tiered partnerships having hundreds of partners (or more) in an investment fund situated in different parts of the U.S., as well as in foreign countries, posed formidable collection burdens for the IRS.8

Congress Agreed with the Service and Treasury that Legislative Reform of the Partnership Procedural Rules and Collection Process Was Required

The IRS went to Congress for relief. Congress responded by enacting a new audit regime for large partnerships generally effective for partnership taxable years beginning after 2017. The new scheme also is intended to be a substantial source of increased revenues.9

The general rule under the consolidated audit approach is that underpayments in prior years, i.e., reviewed years, with respect to partner income taxes in a partnership, would be borne by the partnership. Under the new law, the audit would still focus on the prior tax years (the “reviewed year audits”). The proposed and resulting deficiency in tax would be assessed against and paid by the partnership in the “adjustment year.” The partnership assessment becomes final, subject to a set of complex payment rules and exceptions. This fundamental change in federal tax procedure to assess and collect federal income tax in “open” years against the partnership entity appears to be a paradigm shift in treating a partnership for federal income tax purposes as a separate taxable entity instead of a flow-through entity, at least for assessment and collection purposes.10

The new partnership audit rules, which are generally effective for partnership taxable years beginning after December 31, 2017,11 replace both the TEFRA audit rules and the electing large partnership rules. The hallmark of the new rules is that the partnership itself will be liable for any imputed underpayment in tax for one or more “reviewed year audits.” This is what the Treasury and the Service clearly wanted Congress to do in order to facilitate audits of large partnerships, including funds of funds and multi-tiered partnerships. The ability to elect out of the new centralized audit

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8 See, however, §§ 1441 (non-resident FDAP), 1442 (foreign corporation FDAP), 1445 (FIRPTA), 1446 (foreign ECI), 1471-1474 (FATCA).


10 As discussed below, in Notice 2016-23, 2016-13 I.R.B. 490 the IRS issued notice requesting comments under the new partnership rules in issuing guidance. The regulations projects will be quite important in understanding the scope and breadth of the new statutory language. The Congress, as it typically is prone to do in the area of tax legislation, left much of the detail on the new reforms to be defined by regulation and other forms of guidance. In fact, it has been reported that the IRS was not asked by Congress to report on the legislation prior to its enactment.

11 Based on the obvious need for much published guidance from the Treasury and the IRS and the accumulating list of errors, inconsistencies and perhaps unintended consequences attributable to the statutory language, it is possible that the Treasury may convince Congress to postpone the effective date of the new rules or otherwise promulgate, under rule-making authority, a delay in effective date. I.R.C. § 7805(b).