The New Partnership Audit Rules:  
How Will They Impact Privately-Owned Businesses and Family Partnerships?

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Guidance Needed

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PARTNERSHIP AUDIT RULES

TAX PRACTITIONERS AWAIT NEEDED GUIDANCE AFTER THE REPEAL AND REPLACEMENT OF THE PARTNERSHIP AUDIT RULES

The new rules “streamline” the unified partnership audit rules by replacing the TEFRA provisions with “consolidated” audit, assessment, and collection rules, including rules for administrative and judicial review.

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The Bipartisan Budget Act of 2015 (the “Budget Act”),1 which the President signed into law on November 2, 2015 (as modified by the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”)2), fundamental changes how the 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”) 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 centralized or consolidated partnership audit regime.3 While the new rules may have had a specific purpose in mind, the language and principles in the new legislation may suffer from several defects, some of which are major.4

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.5 Generally, TEFRA audit rules applied to a partnership with 11 or more partners at any one time during the partnership’s tax year. Many partnerships with ten or fewer eligible partners have been able to avoid the TEFRA audit rules and be subject to audit on a partner-by-partner basis.

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 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, entity and partner-level deficiency (and tax refund) procedures, were to be applied. For example, different statutes of limitations applied, one at the partnership level and one at the partner level.6

For years in which the issue was the proper allocation of income, for example, the adjustments did not yield a positive revenue to the Service. These years would simply yield a refund for those partners receiving an excessive allocation of income for a particular year and a deficiency in tax for those partners required to pay tax on the underpayment in tax to account for the erroneous allocation of income. The Service collected tax at the partner level and would have to pursue each partner’s several liability for the years that resulted in an assessment in tax. For multi-member partnerships, this could prove to be a multi-jurisdictional collection project. TEFRA, while resolving some of the problems under the “open audit” approach of auditing partners in partnerships, still suffered from defects from a tax administration standpoint. This was primarily attributable to the fact that even under the unified audit rules, any resulting assessments in tax were not payable at the entity level, but only at the partner level. The partnership TEFRA audit could yield no “tax revenue” fruit if the Service could not collect the resulting tax liability.

TEFRA had many issues in practice. The Service often had difficulty dealing with complicated statute of limitation issues under TEFRA. There was added concern about the ability to collect taxes from partners’ deficiencies after adjustments had been determined. Again, multi-tiered partnerships having hundreds (or more) of partners 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 The Service encountered administrative difficulties under TEFRA when working with large partnerships with many partners and when working with tiered partnerships. The IRS notoriously audits a very small proportion of large partnerships (about 0.8% annually). It presumably will have to increase its audit activity for partnerships if the new audit rules are to realize their promised potential of dramatically raising revenues.9 The new rules “streamline” the unified partnership audit rules by replacing the TEFRA provisions with new “consolidated” audit, assessment, and collection rules, including rules for administrative and judicial review.10

Legislative Reform

The IRS went to Congress for relief and it responded by enacting a new audit regime for large partnerships. In addition to reforming the rules, the new scheme is intended to be a substantial source of increased revenues.11

6 See Section 6229 (statute of limitations for partnership audit does not expire until three years after the original due date of the partnership return or the date the return is filed, whichever is later). A six-year period was possible for substantial understatements under the more than 25% rule, and there was 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 Section 6501 or the partnership statute. See Rhone-Poulenc Surfactants & Specialties L.P., 114 TC 533 (2000) (reviewing the issue and siding with the Service’s position); AD Global Fund LLC, 67 Fed. Cl. 657 (2005) (discussing the interaction of Sections 6229 (TEFRA) and 6501 and the related case law).

7 As discussed below, the rules can result in excessive taxation by treating improper allocations of income for a reviewed year as a separate adjustment in computing the “imputed underpayment” without an offsetting reduction to account for the partner who essentially overpaid its tax in the reviewed year. This phenomenon is referred to as the “one-way up” adjustment.

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

9 Government Accounting Office, “Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency,” GAO-14-732 (Sept 18, 2014). The GAO found that in the 2012 fiscal year, the Service audited just 4% of large partnerships, while it audited 27.1% of similarly sized corporations (non-S corporations).


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 taxing entity instead of a flow-through entity.

The new partnership audit rules 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 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 regime has been greatly enlarged from the small partnership exception in Section 6231(a)(1)(B). The new rules make it easier for partnerships with between 11 and 100 partners, actually counted on a per K-1 basis, to elect out of the new audit regime. Since many partnerships will want to elect out of the centralized audit rules, undoubtedly more audits will have to be conducted at the individual partner level than under TEFRA. The result of the greatly widened election-out rule and the difficulties in auditing on a partner-by-partner basis may be that the Service has to answer to Congress for a potential revenue loss rather than a revenue gain in assessing the budget impact of the new legislation.

In addition to the “election-out” rule, the partnership may timely elect, for each reviewed year, to “push out” the proposed partnership assessment made in the adjustment year to the partners for the reviewed years. It is not clear how many partnerships will elect to push out partnership-level adjustments to the partners with respect to one or more reviewed year audits, with the comitant obligation to pay the taxes and additions to tax due.15 There is the issue, of course, of whether the states will adopt the new partnership audit rules. Some states that automatically adopt the TEFRA unified audit rules under the “small partnership exception” (Emphasis added) Moreover all items of the partnership must be allocated among the partners by a single profit and loss sharing ratio. See Harrell, 91 TC 242 (1988); Z-Trom Computer Research & Development Program, 91 TC 258 (1988). A partnership is not an eligible partner if any of its partnerships is a partnership, S corporation, trust or estate (other than an estate of a deceased partner), or a nonresident alien individual. Reg. 301.6231(a)-1(a)(3). Buchsbaum, TC Memo. 2002-138 (small partner exception not applicable since form K-1 identified trusts as partners). Alternatively, a partnership may elect to “opt in” or otherwise structure its ownership to meet the definition of a partnership subject to TEFRA under Section 6231(a).

Effective Date

The repeal of the TEFRA partnership audit rules is effective, in general, for partnership years beginning after December 31, 2017. As mentioned, the repeal of the TEFRA partnership audit rules includes the repeal of the electing large partnership provisions. That means that the current TEFRA rules, regulations, and pertinent case law remain in effect until the applicable statutes of limitation on assessment in tax, as well as claims for refunds for overpayments in tax (at either the partnership or partner levels) for all prior tax years have expired. Partnerships may, however, elect to apply the new rules with respect to tax years beginning after November 2, 2015. Even in such instance, the TEFRA rules continue to apply until the applicable sunset date is reached as to all open years.

Early Election-In

The Service published temporary and proposed regulations, on electing into the new partnership audit rules by a partnership for a tax year beginning after November 2, 2015 (the date of enactment) and before January 1, 2018. The ability to make an “early” election into the new centralized audit rules is authorized under section 1101(g)(4) of the Budget Act. As previously mentioned, the new centralized audit rules. Some states may not adopt the new audit rules at all.

12 See Wadsworth, TC Memo. 2007-46.
13 Under the TEFRA rules, Section 6231(a)(1)(B) provides that a partnership “having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner” is not subject to the TEFRA unified audit rules under the “small partnership exception” (Emphasis added) Moreover all items of the partnership must be allocated among the partners by a single profit and loss sharing ratio. See Harrell, 91 TC 242 (1988); Z-Trom Computer Research & Development Program, 91 TC 258 (1988). A partnership is not an eligible partner if any of its partnerships is a partnership, S corporation, trust or estate (other than an estate of a deceased partner), or a nonresident alien individual. Reg. 301.6231(a)-1(a)(3). Buchsbaum, TC Memo. 2002-138 (small partner exception not applicable since form K-1 identified trusts as partners). Alternatively, a partnership may elect to “opt in” or otherwise structure its ownership to meet the definition of a partnership subject to TEFRA under Section 6231(a).
14 Section 6226(b).
15 Section 6226(b).
16 Based on the obvious need for much published guidance from Treasury and the Service and the accumulating list of errors, inconsistencies, and perhaps unintended consequences attributable to the statutory language, it is possible that Treasury may con-