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The New Partnership Audit Rules: Electing Out

By **Elizabeth McGinley and Steven Lorch** (April 24, 2018, 3:37 PM EDT)

This is the first of two articles by Bracewell LLP attorneys Elizabeth McGinley and Steven Lorch, discussing the practical implications to partners and partnerships of the new partnership audit rules under the Internal Revenue Code and the related proposed and final Treasury regulations.

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On Nov. 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for tax purposes. The new rules, effective for audits of partnership tax years beginning on or after Jan. 1, 2018, generally allow the IRS to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level.

Under the new rules, a partnership's imputed underpayment is calculated by multiplying the net positive audit adjustment to taxable income of the partnership by the highest marginal federal income tax rate — individual or corporate, as applicable — in effect for the tax year under audit, the "reviewed year." Since any underpayment liability is applied at the partnership level, the partners in the year the audit is concluded and the assessment is made, the "assessment year," must bear the economic burden of the liability when the underpayment is satisfied. The partnership can reduce its liability by requesting modifications to the imputed underpayment, including by demonstrating that reviewed year partners have amended their reviewed year tax returns to include their share of the audit adjustments and paid the related tax due. Alternatively, the partnership can elect to push the audit adjustments out to the partners in the reviewed year — the "push-out election" — which requires each reviewed year partner to include its share of the audit adjustments in its assessment year tax return and pay any resulting increase in tax.

The new rules include a special election — the "election out" — that allows certain partnerships to choose not to be subject to the new rules. If a partnership makes the election out, any federal audit of the partnership would be conducted at the partner level, on a partner by partner basis, under the audit procedures otherwise applicable to each partner. With a valid election out, the partnership would not be subject to audit adjustments or the imputed underpayment regime of the new rules. As a result, the partnership would avoid any risk that a federal audit liability would be imposed at the partnership level, and also would be free of the administrative burden associated with pursuing partners, and perhaps former partners, either to make amendments to their reviewed year tax returns or possibly fund the

payment of the partnership-level assessment.

An eligible partnership must make a separate election out for each taxable year by making the election on its timely-filed federal income tax return. In addition, the electing partnership must provide to the IRS, for each person or entity that was a partner — and each person that was a shareholder in a Subchapter S corporation partner — at any point during the taxable year, such person's name, U.S. tax classification and taxpayer identification number, along with a statement that each partner is an "eligible partner," as defined below. The partnership also must notify each partner within 30 days after making the election. Practitioners expect that the IRS will take steps to invalidate an election out if any of the required information relating to a partnership's eligible partners is missing or incomplete, but the IRS is not expected to invalidate the election if the partnership fails to provide the proper notification to each partner.

The new rules provide that a partnership is eligible to make the election out for any taxable year if, at all times during the year, the partnership has 100 or fewer partners and all of such partners are eligible partners. An eligible partner is any individual, C corporation (including certain foreign entities that would be treated as C corporations if domestic), S corporation or an estate of a deceased partner. For purposes of the 100 partner limitation, the partnership is required to count each partner to which the partnership is required to send a Schedule K-1, plus, in the case of any S corporation that is a partner, each shareholder to which such S corporation is required to send a Schedule K-1.

Under the new rules, partnerships and disregarded entities are not eligible partners for purposes of the election out. Accordingly, this would exclude many partnerships from making the election, from partnerships in complex structures with multiple tiers of partnership owners to relatively simple partnerships with even a single partner that is not an eligible partner. The new rules, however, have given the U.S. Treasury Department authority to issue future regulations to expand the types of entities that qualify as eligible partners. This initially fueled great optimism among practitioners that the definition of eligible partner would be broadened to include partnerships and disregarded entities, and therefore would make the election out available to a larger population of partnerships. To many commentators, it seemed particularly reasonable to permit the election out if the sole regarded owner of a disregarded partner was, itself, an eligible partner, or if a first-tier partner was a partnership with only eligible partners.

The Treasury Department and the IRS, however, chose not to expand the scope of the definition of eligible partner in final regulations issued on Jan. 2, 2018. In the preamble to the final regulations, the Treasury Department explained that an expansion of this definition ultimately would result in fewer partnerships being subject to the new rules and, therefore, would require the IRS to perform more audits at the partner level, which the IRS considers to be less efficient than audits under the new rules. The Treasury Department added that it is willing to consider changes to this definition after the Treasury Department and the IRS gain experience implementing the new rules. Under current guidance, however, partnerships with even a single partner that is not an eligible partner for any taxable year should expect to be subject to the new rules for such year.

Partnerships have taken a wide variety of drafting approaches with respect to the new rules since they were enacted in 2015. For instance, partnership agreements have taken different positions on the authority of the partnership representative to make audit-related decisions, whether the reviewed year partners are required to amend their reviewed year tax returns if requested by the partnership representative, and whether the push-out election is required in all instances without consultation of the partners. With respect to the election out, however, partnership agreements almost uniformly

include a covenant that the partnership representative will make the election, if available, without seeking the consent of, or any consultation with, the partners. The prevailing view is that opting out of the new rules would, on balance, be beneficial to partnerships in nearly all scenarios. This market view is not expected to change, regardless of whether the definition of eligible partner is eventually broadened through future regulatory guidance.

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