A Review of the Centralized Partnership Audit Regime

By Lauren N. Page

With the flurry of discussion following the passage of the Tax Cuts and Jobs Act in late 2017, it is easy to forget that a major change in partnership taxation is also taking effect this year: the new centralized audit regime. This new regime, which became law as part of 2015’s Bipartisan Budget Act, presents a major shift in partnership audits from handling adjustments and payments at the partner level to handling them at the partnership level. The new regime applies to tax years beginning after Dec. 31, 2017. Now is the time to consider the new rules and how they may affect your partnership and LLC clients.

Introduction

The passage of the centralized partnership audit regime in the Bipartisan Budget Act of 2015 marks Congress’s second major attempt at creating a more efficient process for auditing partnerships. Previously, the Internal Revenue Service was required to audit each individual partner’s return for the year(s) in question if it wanted to audit a partnership due to the fact that partnerships are pass-through entities. The passage of the TEFRA rules was an attempt to simplify partnership audits by handling the adjustment of some items at the partnership level. The Service describes in June, 2017 proposed regulations to the centralized partnership audit regime the difficulties even after the enactment of the TEFRA rules in auditing partnerships due to their increasing size and complexity. The creation of the centralized partnership audit regime is Congress’s latest attempt to streamline the auditing of partnerships.

The law itself was passed on Nov. 2, 2015 and amended on Dec. 18, 2015 and March 23, 2018. It repeals the TEFRA rules and replaces them with the centralized partnership audit regime for entities taxed as partnerships for tax years beginning after Dec. 31, 2017. Throughout this article, the term “partnership” is used in place of “entities taxed as partnerships” and the use of “partnership” herein includes LLCs which are taxed as partnerships. The centralized partnership audit regime applies to all partnerships unless they qualify to and do elect out of the regime as described below. The Service issued proposed regulations pertaining to the centralized partnership audit regime on June 14, 2017. Further proposed regulations dealing specifically with international entities, tiered partnerships, and partnership adjustments since have been released. Final regulations regarding an entity’s option to elect out of the centralized partnership audit regime were issued on Jan. 2, 2018. Final regulations mostly relating to the partnership representative rules were issued on Aug. 9, 2018. The new rules are reviewed first, followed by a discussion of the option to elect out of them.

Rules of the centralized partnership audit regime

The audit of all partnerships will be governed by the new rules unless a partnership cannot elect out or has chosen not to elect out of the centralized partnership audit regime. The audit will be conducted at the partnership level, and any adjustments assessed on the partnership must be paid at the partnership level, with a significant exception described below. The partners’ tax returns and the partnership’s tax return must consistently treat partnership-related items, which are defined as any item or amount with respect to the partnership which is relevant in determining the tax liability of any person and any partner’s distributive share of any such item or amount. The Service may assess one or more imputed underpayments on a partnership. A general imputed underpayment affects all partners, whereas a specific imputed underpayment affects only a certain partner or partners. These rules do not apply to taxes imposed outside of Chapter 1 of Subtitle A of the Tax Code, such as payroll taxes, self-employment taxes, and sales tax.

The partnership is required to be represented before the Service by a “partnership representative.” The partnership representative replaces the tax matters partner previously designated under TEFRA. The partnership representative has significant authority in an audit. The Service is only required to give notices to and communicate with the partnership representative. The partnership representative’s actions are binding on the partnership and its partners. The partners have no rights in terms of communication to and from the Service, or involvement in the audit proceedings. The partnership representative’s authority may not be limited by state law or a partnership agreement. This is a significant change from the role of tax matters partner, where he or she had authority with regard to the partnership, but not with regard to other partners, and he or she was required to provide notice to partners in certain cases. As the comments to the proposed regulations explain, previously, a partner who was not the tax matters partner still had certain notification and participation rights, whereas partners under the centralized partnership audit regime have no such rights.

The partnership representative may be any person or entity with a “substantial presence” in the United States. “Substantial presence” means that the person must be available to meet with the Service at a reasonable time and place, in the Service’s discretion, and that the person has a United States address, telephone number, and taxpayer identification number. The partnership representative does not have to be a partner (a departure from the rules regarding the tax matters partner). It may be desirable in certain circumstances for a non-partner manager or other individual with significant information about the partnership to serve as the partnership representative. If a partnership chooses an entity, including itself, to serve as its partnership representative, a “designated individual,” who is the sole individual through whom the partnership representative will act, must also be selected. The Service wants one individual it can contact with regard to the partnership, and it does not want to hunt that individual down.

The partnership representative must be designated on the partnership’s timely filed tax return, and must be designated each year. A partnership representative so designated only has authority to act
for adjustments related to the tax year for which he or she was designated. Although it is common practice to designate a representative in the partnership agreement, a designation of a partnership representative in the agreement without also making the designation on the tax return will have no effect on the Service. If a partnership representative is not designated on the partnership’s tax return, the Service will notify the partnership. The partnership generally has 30 days from the mailing by the Service of such notification to designate a successor partnership representative. The Aug. 9, 2018 final regulations provide specific rules regarding when a partnership representative may resign or when the partnership representative’s designation may be revoked by the partnership. The Service has also released a new Form 8979 relating to a partnership representative’s revocation and resignation. The final regulations also allow a partnership representative to designate an agent through which it may act. If no successor is designated, the Service will choose a partnership representative. The instructions for IRS Form 2848, Power of Attorney and Declaration of Representative, have been updated to include new directions for powers of attorney related to the centralized partnership audit regime.

Should the Service determine that an underpayment was made by the partnership, the partnership is responsible for paying the tax, interest, and penalties owed. Further, pursuant to Code Section 6225, the tax owed is computed by applying the highest rate of tax in effect for the reviewed year under Section 1 (personal tax) or 11 (corporate tax). The exception is that a partnership may elect under Section 301.6226 to “push out” the amounts owed to the reviewed year partners. This option has been coined the “push out election.” The regulations define the term “reviewed year” as the tax year to which the item being adjusted relates. Interest due when the push out option is elected is the federal short-term rate plus 5 percentage points (the general rate in Code Section 6621 is an additional 3 percentage points).

The push out election must be made within 45 days of the Service’s mailing of a Notice of Final Partnership Adjustment, and must include addresses and taxpayer identification numbers for the partnership and its partners. The electing partnership must also provide a statement to the reviewed year partners with each partner’s share of the adjustment. These statements must be provided to the partners and filed with the Service within 60 days of the date the partnership adjustments become finally determined.

**Electing out of the centralized partnership audit regime**

So what if all of the above doesn’t sound appealing? The Service has provided the option to elect out of the centralized partnership audit regime for certain partnerships which qualify. Partnerships which elect out of the centralized partnership audit regime are audited and adjustments are assessed at the partner level.

A partnership may elect out of the centralized partnership audit regime if it is an “eligible partnership.” The regulations define an eligible partnership as one with (i) 100 or fewer partners, and (ii) each partner is an individual, a C corporation, an S corporation, an eligible foreign entity, or the estate of a deceased partner.

A partnership has 100 or fewer partners if the partnership furnishes 100 or fewer statements (K-1s) for its tax year. Special attention must be paid if a partner is an S corporation, or if married persons own partnership interests. The regulations require that each K-1 issued by the partner S corporation to its shareholders counts in determining the number of partners a partnership has for purposes of electing out. For example, if a partnership has two S corporation partners, and each S corporation has four shareholders, for purposes of electing out of the centralized partnership audit regime the partnership is considered to have eight partners. If spouses own a partnership interest jointly and one K-1 is issued with regard to that interest, they will be considered one partner. However, if spouses each own a separate interest in a partnership and the partnership issues a K-1 to each of them, they will be considered two partners even if they file their income tax return jointly.

The eligible partner rules have caused significant discussion. The final regulations specifically state who is not an eligible partner, most notably trusts. The Service notes in its comments to the Jan. 2, 2018 final regulations that it considered arguments made by commentators that entities such as trusts should be added to the list of eligible partners but ultimately declined to add them, citing the need for efficiency in audit procedures and the risk that if those entities are considered eligible partners, more partnerships will elect out, which would work against the goal of the new rules.

Estate planning attorneys frequently create entities for clients which are taxed as partnerships and owned by spouses or family members. Attorneys often advise, for various reasons, that a revocable or irrevocable trust own an interest in a partnership versus a client owning his or her interest individually. However, this planning will make a partnership ineligible to elect out of the centralized partnership audit regime. Attorneys will have to work through the decision as to whether to have a trust own an interest in a partnership with the client and his or her other advisors. The inability to elect out of the centralized partnership audit regime must be assessed against benefits of trust ownership, such as tax planning or the desire to keep interests in such entities out of probate.

A partnership elects out of the centralized partnership audit regime on its timely filed income tax return. Like the partnership representative requirement, this must be done annually on each tax return for which the partnership wants to elect out. When electing out, the partnership is also required to disclose to the Service each partner’s name, taxpayer identification number, federal tax classification, and an “affirmative statement that the partner is an eligible partner.” The partnership must also notify the partners of the election within 30 days of making it.

**Further Considerations**

The centralized partnership audit regime presents a significant change in the audit process of partnerships. Entities taxed as partnerships will want to first consider whether they are able to and want to elect out of the new rules or not. If the partners want to elect out, they will have to ensure that the partnership and the partners are all eligible. In many cases, meeting the requirement that the partnership have no more than 100 partners will not pose an issue; however, meeting the definition of an eligible partner, particularly the disallowance of a trust as an eligible partner, may require consideration. If the partnership wants to elect out, the partnership’s agreement should include provisions allowing for that, such as rules to ensure that only eligible partners, as defined by the Service, may be admitted as initial and substitute partners.

If the partnership determines that it cannot or does not want to elect out, the partnership agreement should include provisions applicable to the centralized partnership audit regime. Provisions
that may be considered include those related to the partnership representative, including nominating that person, ensuring that that nomination is made on the partnership’s tax return, and detailing the partnership representative’s responsibilities to the other partners. For example, although the partnership representative is not required to provide information to the partners under the centralized partnership audit regime rules, the partners may wish to require the partnership representative to share all information he or she receives from the Service with the partners, and refrain from settling a tax adjustment with the Service or electing to push out amounts due without partner approval. The partnership agreement can provide indemnification provisions for the partnership representative, detail costs the partnership representative may incur in handling an audit, as well as require the partners to cooperate with the partnership representative and provide information as needed.

There remains a great deal of uncertainty as to how the new rules will be put into practice once the Service commences audits under the centralized partnership audit regime. However, attorneys can act now to familiarize themselves with the new rules, educate clients regarding the rules and choices they have under them, work with clients’ tax advisors to plan for the changes, and update governing documents.

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