



## **An overview of the new partnership audit rules: The Bipartisan Budget Act of 2015 to go in effect - by Sandy Klein and David Greenspan**

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Sandy Klein,  
Shanholt Glassman Klein Kramer & Co.

The Bipartisan Budget Act of 2015 has replaced TEFRA with new partnership audit rules that will apply in 2018. Enacted by congress in 2015, these new rules generally apply starting with the 2018 partnership tax year for returns filed in 2019. Certain small partnerships (100 or fewer partners) may elect out of the new regime.

### **Overview of New Audit Rules**

Under the new streamlined audit approach, the IRS will audit the partnership's items of income, gain, loss, deduction, credit and partners' distributive shares for a particular year of the partnership (the reviewed year). Any adjustments will be made at the partnership level and taken into account by the partnership in the year that the audit or any judicial review is completed (the adjustment year.)

The IRS can assess an entity-level tax on an imputed underpayment (generally calculated at the higher of the maximum corporate or individual income tax rate) against a partnership in the adjustment year. Therefore, under the new rules, if the audit of a partnership's 2018 return is concluded in 2020 and results in a tax assessment, the economic cost of the tax assessment will be indirectly borne by the partners in 2020, who may differ from the partners in 2018. An adjustment that does not result in an imputed underpayment but rather a decrease in income generally will be taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss, or in the case of a credit, as a separately stated item.

Partnerships will have the option of modifying the imputed underpayment by following rules published in the proposed regulations. The partnership —through its partnership representative —is permitted to request that the IRS modify the imputed underpayment to account for numerous factors, including reviewed year partners' amended tax returns, amounts allocable to tax-exempt partners, lower tax rates attributable to income allocated to reviewed year partners, or adjustments allocable to passive activity losses of reviewed year partners' in a publicly traded partnership. The

partnership representative must submit a request for modification within 270 days after the date the notice of proposed partnership adjustment is mailed by the IRS.

As an alternative to the general rule that an imputed underpayment is assessed and collected at the partnership level, a partnership may elect to “push out” adjustments to its reviewed year partners, which will effectively shift the tax burden to those partners. The partnership must make this election no later than 45 days after the date of the notice of final partnership adjustment. If the partnership makes this election the imputed underpayment is paid by the reviewed year partners. This may be beneficial if the reviewed year partners have a lower marginal tax rate than the highest marginal federal income tax rate applicable to individuals or corporations in effect during the reviewed year. On the other hand the partner assessment approach could increase the total amount of taxes paid to be in excess of the amount of the partnership’s imputed adjustment.

It is important to note that if the partnership wishes to contest the proposed or final adjustments administratively or judicially and the appeals process takes longer than the 270 or 45 days, whichever is applicable, the partnership will no longer be able to modify the imputed underpayment or “push out” the adjustments to the partners, unless the IRS consents to extend the 270 or 45 day deadline.

Under the new rules, a partnership can initiate an administrative adjustment request, which it may want to do if it believes that an overpayment has been made. The adjustment would be taken into account in the adjustment year. Such a request would be in lieu of filing an amended partnership return.

#### Traditional Audit Rules for Partnerships that Elect Out

Partnerships with 100 or fewer “eligible partners” may elect out of the application of the new rules for a particular year on a timely filed return. “eligible partners” are defined as individuals, U.S. and non-U.S. C corporations, S corporations, and estates of deceased partners. Disregarded entities, trusts and partnerships are not considered eligible partners and, therefore the election out will not be available to such a partnership. Traditional audit, assessment and collection statutes of limitation will apply to the partners. Consideration should be given before the end of 2017 to restructure ownership if being able to elect out is important to the partners and the partnership. Tax-exempt partners and lenders may pressure the partnership to revisit and revise the operating or partnership agreements and elect out of the new audit rules in order to protect their economic interests.

Sandy Klein, CPA, is a partner, and David Greenspan, CPA, is a tax senior at Shanholt Glassman Klein Kramer & Co., New York, N.Y.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540