

# **TEFRA Repealed in Favor of Entity-Level Partnership Tax**

## **The Beginning of the End for Pass-Through Entities?**

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Tax

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The Bipartisan Budget Act of 2015 (H.R. 1315) (the "Act"), signed into law Monday, wholly revamps how the Internal Revenue Service ("IRS") will audit and collect tax from partnerships.

Effective for partnership tax years beginning after December 31, 2017, Section 1011 of the Act repeals both the partnership audit rules of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") (i.e., Code sections 6221 through 6234) and the electing large partnership rules (i.e., Code sections 771 through 777 and 6240 through 6255). But, for those who have worked with TEFRA (and its limitations), this is not an occasion to rejoice. The Act replaces the TEFRA provisions with new Code sections 6221 through 6241, which, among other things, allow for the IRS to assess and collect taxes associated with audit adjustments at the partnership level, rather than flowing adjustments through to individual partners. The changes will have a significant effect on planning strategies, tax controversies, and the case law that has developed around TEFRA partnerships over the past several decades.

Although law, the Act leaves many questions unanswered and will require significant guidance (or outright amendment) to fill the gaps inherent in the legislation. In effect, the Act imposes an entity-level tax on partnerships themselves, and thereby introduces a new set of problems for partnerships and their current, former, and prospective partners. And, although the Act is not set to be effective for tax years beginning before December 31, 2017, its repercussions will likely be felt sooner because of its potential impact on how partnership interests are valued, transferred, and protected. As with most significant changes to the tax law, early planning will be essential to safeguard the interests of those owning or acquiring partnership interests.

Set forth below is a discussion of some of the more significant changes imposed by the Act and issues that taxpayers will soon face.

### **Partnerships Captured by the New Rules**

The Act generally imposes the new partnership audit procedures on all partnerships, regardless of size. An exception is made for partnerships (or limited liability companies treated as partnerships) that have 100 or fewer partners. Such a partnership may elect out of the new audit rules, but only if the 100 or fewer partners are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or estates of deceased partners. If any of the partners is another partnership, a trust, etc., the opt-out election cannot be made. Additionally, although the existence of an S corporation as a partner does not preclude the opt-out election, each of the S corporation's shareholders is treated as a partner of

the partnership for purposes of determining whether there are 100 or fewer partners. Moreover, Congress has granted the IRS and Treasury the authority to promulgate rules similar to the S corporation “look through” rule with respect to other types of entities.

Even if a partnership meets the eligibility requirements to opt out of the new audit procedures, the process is not a simple one. First, the partnership must timely file, on an annual basis, the opt-out election on its partnership return. Second, the partnership must notify each of the partners that the election has been made. Finally, the partnership must supply to the IRS the names and taxpayer identification numbers of each of its partners, including information with respect to each S corporation shareholder treated as a partner. This last requirement could potentially be the most unwieldy and troubling for partnerships as it requires near-real time information concerning the number and identities of potentially unrelated S corporations and their shareholders.

In short, if desired, opting out of the new audit rules will require careful structuring around partnership ownership and strict adherence to the related annual election and information reporting requirements.

### **Partnership-Level Tax**

Significantly, the Act requires, as a default rule, that the partnership itself bear the economic burden of any audit adjustments made by the IRS. Specifically, under the new Code section 6225, rather than flowing through audit adjustments and assessing individual partners, the IRS will assess the partnership for what the Act terms the partnership’s “imputed underpayment.” Because the tax is imposed at the partnership level, the Act adopts a form of “rough justice” to compute the amount of tax owed. Thus, the imputed underpayment is made subject to the highest corporate or individual rate in the Code during the tax year at issue. Although the Act calls upon the IRS and Treasury to adopt regulations that could adjust this rate where a partnership can prove that certain partners are exempt from or subject to a lower rate of tax (e.g., by providing the tax returns of individual partners for the years at issue), it is difficult to imagine an administrable set of regulations that can achieve a perfect or even near-perfect match. This may be especially true in the context of foreign partnerships with a trade or business in the U.S., particularly large domestic partnerships, and publicly traded partnerships.

Equally as important, under the new rules, the IRS will assess the partnership in the year of adjustment, not the year to which the adjustments relate. For example, if the IRS completes the audit of a partnership’s 2018 tax year in 2022, the rules impose the liability for any adjustments made to the 2018 tax year on the partnership (and in effect its partners) in 2022. This means that current partners may be liable for erroneous tax benefits garnered by former partners.

Recognizing this, the Act allows for two possible exceptions that can shift partnership-level tax liability back onto the prior tax year partners. First, the computation of the partnership’s imputed underpayment may be adjusted by disregarding the portion of adjustments that individual partners take into consideration and for which they pay associated taxes. To benefit from this exception, within 270 days of receiving a notice of a proposed partnership adjustment, partners must file amended tax returns reporting their distributive shares of the partnership adjustments and pay all related taxes. Stated differently, if a partner pays what is owed based on the partnership-level adjustments, the imputed underpayment is reduced accordingly.

This first exception may prove challenging for a partnership to meet. It requires the partnership to: (i) evaluate the effects of a series of proposed adjustments; (ii) issue conforming K-1s to all affected partners; (iii) convince those partners to file amended tax returns consistent with the newly issued K-1s (including years indirectly affected by the K-1s such as in the case of carrybacks or other similar items); and (iv) ensure that payments associated with the partners' amended returns are received by the IRS along with the filing of the amended returns. Each of the foregoing steps must be completed no later than 270 days after the partnership's receipt of the notice of proposed partnership adjustment. Partnerships desiring to take advantage of this exception will likely need to contractually obligate their current and former partners, to the extent possible, to ensure the accurate and timely filing of amended returns (and the payment of any associated taxes), as there appears little incentive for a prior year partner to act unilaterally.

The second exception is simpler than the first, but still demands quick action on the part of a partnership. Under new Code section 6226, within 45 days of receiving a final notice of partnership adjustment, a partnership may elect to issue to each prior year partner and to the IRS a statement of the partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment). Thereafter, each partner is responsible for the adjusted amounts so reported, not the partnership.

### **Implications for Contesting Adjustments**

Importantly, both of the exceptions to partnership-level assessment described above require swift action by the partnership—within either 270 days of issuance of a proposed notice of partnership adjustment, or 45 days of issuance of a final notice of partnership adjustment. The timing implications of these restrictive deadlines are stark—should a partnership wish to contest an adjustment, either administratively or judicially, it will likely lose the ability to shift the assessment responsibility to the appropriate partners, and will instead be assessed directly.

For example, if the IRS issues a proposed notice of partnership adjustment that the partnership appeals administratively, and if such appeal takes longer than 270 days to resolve, the partnership will not be able to avail itself of the first exception unless the IRS consents to extend the 270 day deadline. Similarly, if the IRS issues a final notice of partnership adjustment and the partnership litigates in a pre-payment forum, then under the new rules any adverse resolution decided by a court may be assessed against the partnership, not the prior tax year partners.

### **Partnership Representative**

New Code section 6223 requires partnerships to designate a partner or other person with a substantial presence in the United States to serve as the partnership's representative before the IRS. The designee of the partnership has the sole authority to act on behalf of the partnership. To the extent that the partnership fails to designate a representative, the IRS "may select any person as the partnership representative."

Partnerships would be well-advised to pay close attention to their responsibilities to designate a representative under new Code section 6223. If the partnership has failed to designate a representative, the IRS may do so, leaving the partnership with diminished control over administrative proceedings. Moreover, if a former partner has been selected as the representative and not replaced after leaving the partnership, conflicts of interest could arise as the former partner may be unwilling to make an election under new Code section 6226 that would push adjustments from the partnership to the prior tax year partners.

## Statute of Limitations

The Act makes sweeping changes to the statute of limitations for assessments. Under prior law, the partner's assessment statute of limitations under Code section 6501 controlled, but could be held open to the extent that the period under Code section 6229 remained open (i.e., the so-called partnership statute of limitations). New Code section 6235 replaces this regime (along with decades of judicial wrangling) with a single partnership statute of limitations, providing that an adjustment under the Act's new rules cannot be made three years after the later of: (i) the date the partnership filed its return; (ii) the partnership return's due date; or (iii) the date on which the partnership filed an administrative adjustment request. This period may be extended pursuant to an agreement between the IRS and the partnership.

Similarly, the Act significantly alters the period for a partnership to file an administrative adjustment request. Consistent with current law, the Act permits a partnership to file a request for an administrative adjustment within three years after the later of: (i) the date on which the partnership return is filed; or (ii) the last day for filing the partnership return (determined without regard to extensions). The Act, however, imposes two significant changes. First, new Code section 6227 provides that an administrative adjustment request may not be filed after the IRS issues a notice of administrative proceeding to the partnership (compared to current law, which allows a request to be filed prior to the issuance of a notice of final partnership administrative adjustment). Second, and perhaps most importantly, unlike current law, the extension of a partnership's assessment statute of limitations does not simultaneously extend the period to file an administrative adjustment request. Taken together, these two revisions significantly curtail a partnership's ability to file administrative adjustment requests.

## Effective Date

The Act's new partnership audit rules generally apply "to returns filed for partnership taxable years beginning after December 31, 2017." A partnership may elect, however, to have the provisions of the Act apply to returns filed for tax years beginning after the enactment of the Act and before January 1, 2018. Accordingly, taxpayers should consider whether there are planning, controversy, or other opportunities to elect early application of the new rules.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Tax practice group:

Sean Akins	+1 202 662 5062	<a href="mailto:sakins@cov.com">sakins@cov.com</a>
Samuel Maruca	+1 202 662 5161	<a href="mailto:smaruca@cov.com">smaruca@cov.com</a>
Jeremy Spector	+1 202 662 5639	<a href="mailto:jspector@cov.com">jspector@cov.com</a>
Emin Toro	+1 202 662 5481	<a href="mailto:etoro@cov.com">etoro@cov.com</a>

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