New Partnership Tax Audit Rules
By Michael J. Donohue

I. Introduction

A. Existing Rules. Currently, federal tax audits of partnerships (and their partners) for tax years after 1982 are subject to one of the following procedural rules: (i) partnerships with more than 100 partners that elect the large partnership audit rules of Sections 6240 through 6255 and Sections 771 through 777 of the Internal Revenue Code of 1986, as amended ("IRC"), are subject to electing large partnership tax rules, (ii) partnerships that are not electing large partnerships and have more than ten partners are subject to IRC Sections 6221 through 6234, which were enacted as part of the Tax Equity and Fiscal Responsibility Tax Act of 1982 ("TEFRA") (the "TEFRA Audit Rules"), and (iii) all other partnerships (those with 10 or fewer partners that have not elected the TEFRA Audit Rules) are subject to the general audit rules, whereby the tax treatment of an adjustment to partnership items of income, gain, loss, deduction, or credit is determined for each partner in separate administrative and judicial proceedings.

B. New Rules. The enactment of Section 1101 of the Bipartisan Budget Act of 2015 (the "2015 Act") on November 2, 2015 drastically changed the rules relating to federal tax audits of partnerships. The new audit rules, which are effective for partnership tax years beginning after December 31, 2017 and apply to all partnerships, completely overhaul the partnership tax audit procedures and raise numerous difficult questions regarding application of the provisions of the 2015 Act. Effective for partnership returns for tax years beginning after December 31, 2017, these sweeping new rules (i) repeal the TEFRA Audit Rules and the electing large partnership rules, (ii) replace the "tax matters partner" provisions of IRC Section 6231(a)(7) with different "partnership representative" rules, and (iii) provide new procedures for determining and collecting partnership tax assessments. The 2015 Act seeks to streamline the procedures relating to IRS audits of entities taxed as partnerships, thus increasing the number of...
partnership audits, which historically had been very low due in part to the cost and complexity of dealing with numerous partners.  

For simplicity and administrative convenience, the 2015 Act introduces a radically new mechanism that imposes the collection of tax, interest, and penalties resulting from the audit adjustments directly on the partnership. Under the new audit rules, tax from partnership audits is assessed and collected at the partnership level at the highest individual income tax rate, unless the partnership qualifies for and elects special procedures that either reduce such tax rate or shift the payment of tax to its partners. Significantly, such tax is imposed on the partnership during the year the audit is resolved, rather than for the year being audited, thus indirectly burdening those persons who are partners for the year the audit is resolved (even though the adjustments relate to partners for the year being audited).  

A partnership can reduce the partnership tax to the extent it demonstrates that all or part of the tax adjustment is attributable to a tax-exempt partner or subject to a capital gain or C corporate tax rate. As an alternative to the partnership’s payment of the underpayment, the partnership may elect to furnish a special Schedule K-1 statement to each partner of the partnership for the year being audited, who is then required to pay tax attributable to such partner’s shares of the partnership adjustment. Certain so-called “small” partnerships are permitted to elect out of the partnership audit rules. Under the new audit rules, partners no longer have the right to be notified of or participate in partnership audits.  

As noted, the new partnership audit rule generally apply after 2017, but a partnership generally is permitted to elect to apply the new audit rules to partnership returns filed for

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7 A government report issued in 2014 stated that, according to IRS data for fiscal year 2012, IRS closed only 84 large partnership field audits - an 0.8% audit rate that is well below the 27.1% audit rate of C corporations with $100 million or more in assets for the same period. See U.S. Government Accountability Office, GAO-14-732, “Large Partnerships: With Growing Number of Partnership, IRS Needs to Improve Audit Efficiency” (9/18/2014). The report determined that TEFRA’s requirement to shift audit adjustments to the partners (unless the partnership makes an election to the contrary, which generally is rare) sharply limits the number of IRS audits due to the significant time incurred in, and cost of, adjusting returns of a large number of partners IRS. The Joint Committee on Taxation estimated the net revenue effect of the partnership audit provisions to produce $9.325 billion in additional revenue over the period 2016 through 2025. See Staff of the Joint Committee on Taxation, Estimated Revenue Effects of the Tax Provisions Contained in H.R. 1314, the Bipartisan Budget Act of 2015, JCX-135-15 (10/28/2015).

8 The 2015 Act breaks new ground since previously IRS generally collected tax underpayments attributable to partnership audit adjustments from the partners.

9 The partnership-level tax is calculated based on the higher of the maximum individual income tax rate (currently 39.6%) and the maximum corporate income tax rate (currently 35%).

10 IRC Revised Section 6221(a). References to “IRC Revised Section” and “IRC Amended Section” refer to the Sections of the IRC, as amended by the 2015 Act.

11 IRC Revised Section 6225(c)(3), (4).

12 IRC Revised Section 6226.

13 IRC Revised Section 6221(b).
partnership tax years beginning after November 2, 2015 and before January 1, 2018 in the manner prescribed by IRS.\textsuperscript{14} Although not effective until 2018, the new audit provisions will force most partnerships to closely review their partnership agreement and likely make conforming amendments thereto.

II. Pre-2015 Act: Summary of TEFRA Partnership and Electing Large Partnership Audit Rules\textsuperscript{15}

A. TEFRA Partnership Unified Audit Rules.

(1) TEFRA Overview. In 1982, TEFRA established unified audit rules, requiring the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are appropriately determined at the partnership level, rather than at the partner level, as provided by regulations.\textsuperscript{16} Under TEFRA, IRS audits a partnership by conducting a single administrative proceeding to resolve issues with respect to all partners. Upon completing the audit, IRS calculates each partner’s tax liability for the year being audited.

The TEFRA Audit Rules were enacted because the "[d]etermination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult."\textsuperscript{17}

The TEFRA Audit Rules provide that collection of tax deficiencies occurs at the partner (rather than the partnership) level, although a settlement agreement with respect to partnership items generally binds all parties to the settlement.\textsuperscript{18}

\textsuperscript{14} Section 1101(g)(4) of the 2015 Act. It is not expected that many partnerships will elect to adopt the new partnership audit rules for this period.

\textsuperscript{15} See generally, Joint Committee on Taxation, Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Dec. 18, 2015) (the “2015 Technical Explanation”).

\textsuperscript{16} IRC Section 6231(a)(3).

\textsuperscript{17} See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 268 (JCS-38-82) (December 31, 1982). Additional reasons for the 1982 change include problems of duplication of administrative and judicial effort, inconsistent results, difficulty of reaching settlement, and inadequacy of prior-law filing and recordkeeping requirements for foreign partnerships with U.S. partners.

\textsuperscript{18} IRC Section 6224(c).
(2) **TEFRA Tax Matters Partner.** The primary representative of a partnership in TEFRA proceedings is the “tax matters partner”, who is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no tax matters partner is designated, and it is impractical to apply the largest profits interest rule, IRS may select any partner as the tax matters partner. The tax matters partner generally is required to keep the other partners informed of all administrative and judicial proceedings relating to adjustment of partnership items at the partnership level.

(3) **Partner TEFRA Audit Rules.** Partners are required to report partnership items consistently with the partnership's reporting, unless the partner notifies IRS of inconsistent treatment. Tax attributable to an adjustment of a partnership item is assessed against each of the partners in the year in which the understatement of tax liability arose. A partner has the right to participate in administrative proceedings relating to the determination of partnership items at the partnership level, and can request an administrative adjustment (or refund) for the partner's separate individual tax liability. If a settlement is reached as to partnership items, all partners are entitled to consistent treatment.

The TEFRA Audit Rules apply to partnership tax items, which are categorized as partnership items, non-partnership items, and affected items. IRS adjustments of partnership items and affected items are resolved at the partnership level in a unified proceeding, while adjustments to non-partnership items are determined and resolved in separate proceedings with the individual partners. Tax deficiencies, penalties, and interest are assessed at the partner level.

Any partner, including an indirect partner, has the right to participate in any partnership-level administrative proceeding relating to the determination of the partnership items. IRS is required to send notice of the beginning of an administrative proceeding relating to partnership items to the tax matters partner and each the “notice partners.” IRS is required to issue a notice of final

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19 With respect to a limited liability company taxed as a partnership for federal tax purposes, Treasury Regulation (“Reg.”) §301.6231(a)(7)-2(a) provides that each “member-manager” is treated as a general partner, and all other members are considered non-general partners. A member-manager is one “who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed.” Reg. §301.6231(a)(7)-2(b)(3). If there are no elected or designated member-managers of the limited liability company, each member is treated as a member-manager for purposes of these rules.

20 IRC Section 6231(a)(7).

21 IRC Section 6231(a)(7).

22 IRC Section 6224.

23 A partnership item is any item that must be taken into account for the partnership's tax year, if regulations provide the item is more appropriately determined at the partnership level than at the partner level. IRC Section 6231(a)(3). A non-partnership item is an item that is not a partnership item. IRC Section 6231(a)(4). The term “affected item” means any item to the extent that item is affected by or dependent on a partnership item. IRC Section 6231(a)(5).

24 All partners in a partnership with 100 or fewer partners are notice partners. In a partnership with more than 100 partners, partners with a 1% or greater interest in the partnership are notice partners. IRC Sections 6231(a)(8) and 6223(b).
partnership administrative adjustment, which sets forth the partnership adjustments, to the tax matters partner and all notice partners.  

(4) TEFRA Settlements. IRS may enter into a settlement agreement with the tax matters partner of a partnership or with one or more other partners of the partnership. The tax matters partner may execute a settlement agreement with IRS with respect to partnership items, including partnership-level penalties, additions to tax, or additional amounts relating to adjustments to partnership items. All partners are bound by the agreement to the extent the agreement so provides, except for notice partners, members of a five percent notice group, and partners who have filed a statement not to be bound by settlement agreements between IRS and the tax matters partner. If IRS settles with any partner with respect to partnership items for any partnership tax year, IRS generally must offer consistent settlement terms for that partnership tax year to all other partners.

B. Electing Large Partnerships.  

A partnership with at least 100 partners is permitted to elect simplified audit procedures that apply to electing large partnerships. These audit procedures, which differ significantly from the TEFRA Audit Rules, generally are intended to ease the partnership’s reporting responsibilities of tax items allocated to its partners. Similar to the TEFRA Audit Rules, disputes relating to the tax treatment of partnership items and affected items are determined at the partnership level and tax is assessed at the partner level. But, a partner in an electing large partnership must treat all partnership items on its return consistently with the partnership return, even if it notifies IRS of the inconsistency. Further, under the electing large partnership rules, IRS is not required to furnish notice to individual partners of the commencement of an administrative proceeding or the issuance of a final administrative adjustment. Also unlike the TEFRA Audit Rules, the electing large partnerships rules allocate partnership adjustments to partners for the year the adjustment become final.

An electing large partnership is permitted to challenge IRS’s administrative adjustment in the Tax Court, the federal district court for the district in which the partnership’s principal place of business is located, or the Court of Federal Claims. The electing large partnership is permitted to elect to pay the imputed tax on the adjustment instead of passing the adjustment through to its partners. The electing large partnership is generally liable for any interest and penalties that result from a partnership adjustment.

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25 The final partnership administrative adjustment is the partnership’s equivalent of a statutory notice of deficiency (90-day letter).
26 Such settlement agreement binds non-notice partners only with respect to partnership level determinations.
27 It has been reported that very few partnerships have elected to apply these rules.
28 IRC Section 6241(a).
29 IRC Section 6247(a).
30 IRC Section 6242(a)(2)(A).
III. New Partnership Audit Rules Under Bipartisan Budget Act

A. **Overview.** Effective for partnership returns for tax years beginning after 2017, the 2015 Act replaces the TEFRA Audit Rules (including the tax matters partner provisions) and the electing large partnership provisions with a system that generally requires the partnership (rather than the partners) to pay income tax attributable to partnership audit adjustments. Tax imposed at the partnership level is calculated on at the highest rate of income tax pursuant to §1 (applicable to individual taxpayers) or §11 (applicable to corporate taxpayers) for the year in which the tax adjustments are finalized. Thus, partners during the year the audit is resolved (including through judicial proceedings) indirectly bear the partnership tax liability, even though the tax adjustments are attributable to tax items allocated to partners for the prior year being audited. Because of this potential unfairness, partnerships are permitted to shift the obligation to pay the tax those who were partners for the year being audited (i) by issuing revised Schedule K-1s to its partners for the year being audited, or (ii) to the extent that a partner files an amended return (for the year being audited) reflecting the partner’s share of the partnership tax adjustment and pays the additional tax. Further, a partnership with no more than 100 partners (none of whom are trusts or taxed as partnerships) can elect out of the new audit rules altogether on a year-by-year basis, thus shifting the resolution and collection of the tax to its partners.31

The 2015 Act also amends the procedural rules relating to partnership audits and related judicial proceedings, including limitation periods applicable to partnership adjustments and tax assessments, IRS notice rules, administrative adjustments requested by partnerships, interest and penalty provisions, and judicial review. As noted, the 2015 Act provides the partnership representative, who is not required to be a partner, with the sole right to control partnership tax audits and judicial proceedings and bind the partners. Thus, commencing in 2018, partners will no longer have the right pursuant to the IRC to receive notice of, or to participate in, tax exams and proceedings at the partnership level.

B. **Exemption for Electing Small Partnerships**

(1) **General Requirements.** IRC Amended Section 6221(b) allows certain so-called “small partnerships” to elect out of the new partnership audit rules. Pursuant to this election, the partnership and its partners become subject to the pre-TEFRA Audit Rules that require IRS to deal separately with the partnership and each partner. This election is available on an annual basis if the following requirements are met for each specific election year (i) the partnership affirmatively elects out of the new audit rules32 on a timely filed partnership return for such year and discloses to IRS the name and taxpayer identification numbers of each partner,33 (ii) each partner is an individual, a C corporation, a foreign entity that would be treated

31 If a purported partnership is later determined not be a partnership for tax purposes, the new provisions nevertheless apply to the entity and its owners as provided in future regulations. IRC Amended Section 6241(8).
32 A separate election is required by the partnership for each year the election is to be effective.
33 Pursuant to IRC Revised Section 6221(b)(2)(B), IRS may provide for alternative methods of identifying foreign partners.
as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner,34 (iii) the partnership has one hundred or fewer partners for such tax year,35 and (iv) the partnership notifies each partner of the election (in a manner prescribed by IRS).36 Thus, absent guidance, a partnership having a partner that is a trust37 or an entity taxed as a partnership may not elect out of the new audit rules.

(2) S Corporation Partners. For purposes of the small partnership election, special rules apply to a partnership that has an S corporation partner.38 First, the partnership must disclose to IRS the name and taxpayer identification number of each shareholder to whom the S corporation is required to furnish an S corporation K-1 for the tax year of the S corporation ending with or within the partnership election year. Second, in determining if the partnership has more than 100 partners, the shareholders of the S corporation partner are treated as partners of the partnership.39 IRC Revised Section 6221(b)(2)(C) authorizes IRS to issue appropriate guidance similar to these S corporation rules for partners that otherwise cause the partnership to be ineligible to make the election.

C. Tax Matters Partner Replaced with Partnership Representative. The 2015 Act provides that each partnership is responsible for designating a person to be the “partnership representative.”40 The designation must occur in a manner determined by IRS. If the designation is either not made or not effective, IRS is permitted to name the partnership representative.41 The partnership representative must be a person with a substantial presence in the U.S. but, unlike the tax matters partner designated under the TEFRA Audit Rules, the partnership representative is

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34 Partnerships intending to make this election should consider (i) prohibiting the issuance or other transfer of partnership equity to an ineligible partner and (ii) requiring all partners (including S corporation partners discussed below) to furnish the requisite information to the partnership to qualify for the election.

35 This rule is satisfied if the partnership is required to issue 100 or less Schedule K-1s to its partners pursuant to IRC Section 6031(b).

36 IRC Revised Section 6221(b)(1)(C).

37 Apparently, a grantor trust is not an eligible partner for purposes of the election-out provision. It is not clear if the election is available to a partnership with a partner that is a disregarded entity under Reg. §301.7701-2 or a qualified subchapter S subsidiary (QSub) within the meaning of IRC Section 1361(b)(3)(B). IRS apparently intends to adopt a narrow view of the type of partner (other than those listed in IRC Amended Section 6221(b)(1)(C)) that should be eligible to permit the partnership to elect out of the new audit rules. See Leniency Not IRS's Goal in Partnership Audit Elect-Out Option, 48 Daily Tax Report at G-5 (Mar. 11, 2016) (quoting Clifford Warren, special counsel in IRS's Office of Chief Counsel (Pass-through and Special Industries) as stating that, although a final decision has not yet been reached, it is likely that IRS will not be overly accommodating to expand the type of partners for purposes of electing out of the 2015 Act beyond those set forth in IRC Amended Section 6221(b)(1)(C)).

38 IRC Revised Section 6221(b)(2)(A).

39 It is not clear if an S corporation partner with an eligible S corporation shareholder that is a trust disqualifies the partnership from electing out of the new partnership audit rules. Although an S corporation shareholder that is a trust is counted for purposes of the 100 partner limit, the 2015 Act does not otherwise have “look-through” rules.

40 IRC Revised Section 6223(a).

41 Questions surround the partnership representative rules, including how a person terminates its designation, how successor partnership representatives are named, and whether the bankruptcy or other events impacting a partnership (or impacting the partnership representative) cause loss of partnership representative status.
not required to be a partner of the partnership.\textsuperscript{42} Interestingly, the partnership representative may be a person who is not authorized to sign the partnership’s tax return.\textsuperscript{43} The 2015 Act grants the partnership representative significant rights in connection with a tax audit of the partnership and related judicial proceedings, including broad power to bind the partnership and its partners.\textsuperscript{44} Accordingly, a partner who is not the partnership representative (or affiliated with the partnership representative) should strongly consider seeking (in the partnership agreement or otherwise) notification, participation, approval, veto and similar rights with respect to a partnership audit and partnership tax adjustments.\textsuperscript{45} Likewise, the partnership representative should seek indemnification by the partnership and partners for expenses and losses arising from fulfilling its role as the partnership representative.\textsuperscript{46}

D. Calculation and Collection of Partnership Imputed Underpayment.

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(1) Default Rule - Tax Underpayment Collected at Partnership Level.

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(a) Net Unfavorable Partnership Adjustments. IRC Amended Section 6221 generally provides that partnership tax adjustments, and a partner's distributive share thereof, is determined at the partnership level. To the extent the net adjustments increase partnership income (i.e., unfavorable adjustments), any underpayment of tax (referred to as an "imputed underpayment")\textsuperscript{47} resulting therefrom generally is assessed and collected at the partnership level (the "default rule").\textsuperscript{48} Interest accrues at the applicable underpayment rate from the day after the due date of the partnership return for the audit year.

Under the default rule, partnership tax assessments generally are made for the year in which the audit is resolved, rather than the year being audited. Significantly, because the partnership is responsible (subject to various exceptions) for payment of the tax liability, the liability is indirectly borne by those who are partners during the year in which the adjustment

\textsuperscript{42} If a partnership representative is an entity, it is unclear who can act on behalf of such entity and fulfill the partnership representative responsibilities.

\textsuperscript{43} Presumably, the partnership representative will need access to sensitive partnership information, including the partnership tax return and Schedule K-1 information of the partners.

\textsuperscript{44} In this regard, judicial review of a partnership adjustment must be filed solely by the partnership. IRC Amended Section 6223.

\textsuperscript{45} Such provisions may lead to conflicts and lawsuits between the partnership representative (who the 2015 Act grants absolute power to deal with partnership tax matters) and partners who may disagree with the decisions of the partnership representative.

\textsuperscript{46} Any rights provided to, and restrictions placed on, the partnership representative in the partnership agreement (or otherwise) should be carefully considered and potentially will result in heated negotiations between the partnership representative and the partners. Similarly, to the extent that the partnership agreement requires (or permits) the partnership representative to elect one or more alternative audit procedures or modifications under the 2015 Act, the partners should be required to furnish any requisite information to the partnership, and otherwise cooperate with the partnership representative.

\textsuperscript{47} IRC Revised Section 6225(a)(1).

\textsuperscript{48} Likewise, under the default rule, imposition and collection of penalties, additions to tax or additional amounts relating to such adjustments occurs at the partnership level.
becomes final (referred as the “adjustment year”), \(^{49}\) rather than those who were partners during the year being audited (referred to as the “reviewed year”). \(^{50}\) This represents a significant and drastic change from the TEFRA Audit Rules. Importantly, a person acquiring an interest in a partnership (whether from the partnership or a partner) should seek to obtain indemnity protection through the partnership agreement (or otherwise) from understatements of partnership tax attributable to pre-acquisition periods of the partnership for which the new partner may indirectly become liable.

(b) **Net Favorable Partnership Adjustments.** If the net partnership adjustment reduces partnership income or otherwise does not result in an imputed underpayment tax (i.e., constitutes a net favorable adjustment), the partnership treats such favorable adjustment in the year the audit is resolved as a reduction in the partnership's non-separately stated income (or an increase in any non-separately stated loss) pursuant to IRC Section 702(a)(8). \(^{51}\) Importantly, under the default rule, the partners for the year the audit becomes final are allocated the benefit of the net favorable adjustments, rather than the partners for the year being audited who initially suffered the detriment that gave rise to the favorable adjustments. Thus, the default rule does not permit the prior year partners to claim a refund with respect to favorable tax adjustments arising from the year being audited.

(c) **Maximum Tax Rate Imposed on Net Unfavorable Partnership Adjustments.** Generally, an imputed underpayment of a partnership is calculated by netting all adjustments of items of income, gain, loss, or deduction for the audit year. Any resulting net income or gain of the partnership (i.e., an unfavorable adjustment) is multiplied by the highest tax rate in effect for the year being audited pursuant to IRC Section 1 or 11. \(^{52}\) Currently, the highest tax rate for IRC Section 1 is 39.6% (applicable to individual taxpayers) and for IRC Section 11 is 35% (for corporate taxpayers). Thus, the highest rate presently is 39.6%. A net adjustment amount that results in an increase (or decrease) in a partnership loss is treated as a decrease (or increase, respectively) in partnership income. \(^{53}\) Although the partnership is assessed tax only on a net unfavorable adjustment, under the default rule the partnership is not entitled to a tax refund with respect to a net favorable adjustment. The legislative history states that netting

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\(^{49}\) IRC Amended Section 6225(d)(2). The “adjustment year” is defined as: (i) if the adjustment is pursuant to a court decision in a proceeding brought under the rules, the partnership tax year in which the decision becomes final (IRC Revised Section 6225(d)(2)(A)); (ii) when the adjustment is under an administrative adjustment request, the partnership tax year in which the administrative adjustment request is made (IRC Revised Section 6225(d)(2)(B)); or (iii) otherwise, the partnership tax year in which notice of the final partnership adjustment is mailed (IRC Revised Section 6225(d)(2)(C)). With respect to the 2015 Act, references herein to the year the audit is resolved or the year in which the adjustments become final refer to the “adjustment year.”

\(^{50}\) IRC Amended Section 6225(d)(1).

\(^{51}\) IRC Revised Section 6225(a)(2)(A). An adjustment to a partnership credit is treated as a separately stated item. IRC Revised Section 6225(a)(2)(B).

\(^{52}\) IRC Amended Section 6225(b)(1)(A). Adjustments to credits are treated as an increase or decrease, as applicable, to the tax imposed on the imputed underpayment. IRC Amended Section 6225(b)(1)(C).

\(^{53}\) IRC Amended Section 6225(b)(1)(B).
of the adjustments is applied based on applicable limitations, restrictions, and special rules under present law.\footnote{See 2015 Technical Explanation. It is not clear how such limitations, restrictions, and special rules under present law apply in this context. Presumably this rule requires for example that, prior to netting, partnership items be separately categorized based on the character of the tax item (e.g., capital loss and ordinary income).}

\begin{itemize}
  \item[(d)] \textbf{Reallocation Adjustments Among Partners.} The default rule provides that when an adjustment merely reallocates the distributive share of a partnership tax item from one partner to another partner (resulting in no net aggregate adjustment for all affected partners), the partnership determines the imputed underpayment by disregarding the favorable adjustments (i.e., ignoring (i) any decrease in any item of income or gain,\footnote{IRC Amended Section 6225(b)(2)(A).} and (ii) any increase in any item of deduction, loss, or credit).\footnote{IRC Amended Section 6225(b)(2)(B).} Thus, in that event, the amount on which the partnership must pay tax is determined solely with respect to each partner’s share of the unfavorable adjustments, rather than the aggregate net adjustments of the affected partners.\footnote{Presumably, the partnership would reduce non-separately stated partnership income (or increase partnership loss, as appropriate) pursuant to IRC Section 702(a)(8) with respect to the favorable adjustments. The partnership agreement should address how to specially allocate those favorable adjustments to the partner(s) whose allocation caused the favorable adjustment.}

  \item[(e)] \textbf{Partner Liability for Partnership Tax.} Imposing liability to fund the imputed underpayment tax on the partnership for the year the audit is resolved may cause significant issues as to how the partnership pays the tax, especially if it does not have the funds.\footnote{The partnership agreement should consider requiring current partners to make capital call contributions or loans to the partnership to fund the partnership tax (and also consider requiring prior year partners to indemnify the partnership for their share of this partnership liability attributable to the audit year during which they were partners).} Importantly, legislative history to the 2015 Act provides that partners are not subject to joint and several liability for any tax liability determined at the partnership level.\footnote{Bipartisan Budget Act of 2015: Section-by-Section Summary, U.S. House of Representatives (2015), at 13-14, http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf.}

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(2) \textbf{Modifications.} IRC Amended Section 6225(c)(1) directs IRS to establish procedures permitting the partnership to modify (i.e., reduce) the amount of the imputed underpayment tax.\footnote{IRC Amended Section 6225(c).} In addition to the imputed underpayment modifications described below, IRS is authorized to permit additional adjustments to the calculation of imputed underpayment amounts through regulations or other guidance consistent with the purpose of the new audit rules.\footnote{IRC Amended Section 6225(c)(6).} All modifications to a partnership’s imputed underpayment must be approved by IRS.\footnote{IRC Amended Section 6225(c)(8).}

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  \item[(a)] \textbf{Partner Amended Returns.} If a person, who was a partner during the year under audit, files an amended return \textit{for that year that reflects} the partner’s share of partnership adjustments and the partner pays the resulting tax, the partnership is permitted to
reduce the imputed underpayment by the corresponding portion reported by the partner.\textsuperscript{63} For this purpose, a partner may file an amended return even if the IRC Section 6511 statute of limitation period for the amended return has expired.\textsuperscript{64} This alternative\textsuperscript{65} not only transfers the tax obligation from the partnership to the partners filing amended returns, but effectively shifts the tax responsibility from those who are partners for the year the audit is resolved to the audit year amending partners.\textsuperscript{66}

As noted, however, under the default rule, a person who was a partner during the year under audit, but is not a partner when the audit become final, does not bear (directly or indirectly) the burden of a partnership-level tax payment. Accordingly, a partner who departs the partnership prior to the year in which the partnership tax assessment is finalized may not have an incentive to file an amended return.\textsuperscript{67} For that reason, partnerships should consider including language in their partnership agreement requiring (if requested by the partnership) persons who terminate their partner status (i) to promptly file (upon request by partnership representative) amended returns for the partnership years being examined, and (ii) to reasonably cooperate with the partnership representative to comply with the amended return requirements and furnish adequate information and documentation to the partnership.\textsuperscript{68}

(b) Reductions of Partnership Tax Based on Character of Income or Tax Status of Partner. A partnership is permitted to reduce the imputed underpayment by the portion of the partnership adjustment that the partnership establishes is not subject to tax due to a partner’s status as a tax-exempt entity.\textsuperscript{69} Further, to calculate the imputed underpayment tax, a

\textsuperscript{63} IRC Amended Section 6225(c)(2). With respect to a partnership adjustment resulting from a reallocation of a partnership tax item from one partner to another, this provision applies only if all affected partners file such amended returns reflecting their distributive share of the adjustment. IRC Amended Section 6225(c)(2)(B).

\textsuperscript{64} IRC Amended Section 6225(c)(2)(A)(i). The amended return extends the statute of limitations for all items on the partner’s tax return for the year being audited.

\textsuperscript{65} Apparently, this alternative is available only with respect to partnership audit adjustments that result in a tax liability to the audit year partner who files an amended return (i.e., unfavorable adjustments). Thus, it appears that if an amending partner’s share of the partnership tax adjustment decreases the amending partner’s tax, such partner apparently is not permitted to claim that benefit on the partner’s individual return. Rather, this benefit presumably is treated as a current partnership deduction that is allocated to those who are partners for the year the audit is finalized. A partner that leaves the partnership should seek to be compensated by the partnership for this lost benefit to the extent it arises.

\textsuperscript{66} If less than all of the partners file amended returns for the year being audited, complexities may arise as how the allocations of the amount of the modification should be made to the current partners (e.g., should such benefit be allocated solely to any successor of the amending partner?).

\textsuperscript{67} If an amending partner owns equity in the partnership during both the audit year and the subsequent year in which the audit is resolved, and the partnership pays the reduced imputed underpayment, the share of the partnership tax expense allocated to the amending partner should be reduced. This should be addressed in the partnership agreement.

\textsuperscript{68} Such a partnership agreement provision presumably would require partners to furnish their amended returns to the partnership, which may raise confidentiality issues.

\textsuperscript{69} IRC Amended Section 6225(c)(3). For this purpose, a “tax-exempt entity” is defined in IRC Section 168(b)(2) and includes a foreign partner (other than a partner that is a foreign partnership).
partnership is permitted to use the lower tax rate\textsuperscript{70} applicable to the portion of the imputed underpayment attributable (i) to a partner that is a C corporation (since the maximum corporate tax rate is less than the maximum individual rate)\textsuperscript{71} or (ii) to capital gain or an IRC Section 1(h)(11)(B) qualified dividend.\textsuperscript{72} The partnership has the burden to establish facts supporting the lower rate applicable to (i) tax exempt and C corporate partners and (ii) capital gain and qualified dividend income allocated to individual partners.\textsuperscript{73} Accordingly, the partnership agreement should require partners to provide the partnership with the requisite supporting information relating to such lower tax rates.

The portion of the imputed underpayment to which a lower rate applies\textsuperscript{74} will be calculated by reference to the partners' distributive share of items to which the imputed underpayment relates.\textsuperscript{75} If a lower rate applies, the partnership agreement should address how the expense\textsuperscript{76} allocation attributable to the reduced partnership tax payment will be made to the partner who causes the reduction of the imputed underpayment. If the imputed underpayment is attributable to the adjustment of more than one partnership item, and any partner's distributive share of the items is not the same for all the items, the portion of the imputed underpayment to which the lower rate applies is determined based on the amount that would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the partnership’s year being audited.\textsuperscript{77}

\begin{enumerate}
\item[(c)] Passive Losses of Publicly Traded Partnership. IRS modifications will permit a publicly traded partnership to reduce an imputed underpayment by the portion it demonstrates is attributable to “specified passive activity losses”\textsuperscript{78} that are attributable to a “specified partner.” The amount of the specified passive activity loss is correspondingly decreased, and the partnership accounts for the decrease in the year the audit becomes final with respect to the specified partners to which the decrease relates.
\end{enumerate}

\textsuperscript{70} This lower tax rate cannot be less than the highest rate applicable to the relevant income for the relevant taxpayer. IRC Section 6225(c)(4)(A).
\textsuperscript{71} IRC Amended Section 6225(c)(4)(A)(i). Currently, the highest corporate tax rate is less than the highest individual tax rate.
\textsuperscript{72} IRC Amended Section 6225(c)(4)(A)(ii). Such income and gain currently is subject a maximum income tax rate lower than both the IRC Section 1 and Section 11 rates. For this purpose, an S corporation is treated as an individual. IRC Amended Section 6225(c)(4)(A).
\textsuperscript{73} Based on the statutory language, it is unclear if these modifications apply to partners for the audit year or the year in which the audit is resolved (although IRC Amended Section 6225(c)(4)(B)(ii) refers to the year being audited).
\textsuperscript{74} It is unclear if a partnership, which has a partner that is a partnership, will be allowed to establish that the equity owners of the pass-through partner are tax exempt, C corporations and individuals eligible for favorable federal income tax rates on allocable partnership capital gain and qualified dividend income. IRC Amended Section 6225(c)(4)(B)(ii) limits these special rules to a “partner” (rather than a partner of a partner).
\textsuperscript{75} IRC Amended Section 6225(c)(4)(B)(i).
\textsuperscript{76} The amount of a partnership’s imputed underpayment should be treated as a nondeductible partnership expense in the year when the tax audit is resolved.
\textsuperscript{77} IRC Amended Section 6225(c)(4)(B)(ii).
\textsuperscript{78} For this purpose, a passive activity loss is defined in IRC Section 469(k).
A specified passive activity loss for any specified partner of a publicly traded partnership is the lesser of the passive activity loss of such partner for the partner's taxable year (i) during which the audit year of the partnership ends, or (ii) during which partnership year in which the audit becomes final. A specified partner is one who, for the period commencing with the partner's taxable year relating to the partnership year being audited and ending with such partner's taxable year relating to the partnership year when the audit becomes final (i) is a partner of the publicly traded partnership; (ii) is an individual, estate, trust, closely held C corporation, or personal service corporation; and (iii) has a specified passive activity loss with respect to the publicly traded partnership.

(d) Time to Submit Supporting Information to IRS. IRC Amended Section 6225(c)(7) requires that information required to support an imputed underpayment modification (discussed above) must be submitted to IRS no later than 270 days after the notice of the proposed partnership adjustment is mailed pursuant to IRC Amended Section 6231 (unless IRS consents to an extension).79

E. Partnership Election to Shifting Tax Responsibility to Partners.

(1) General. Pursuant to the 2015 Act, a partnership has another alternative to transfer the obligation of paying tax on partnership tax deficiencies to those who were partners of the partnership during the year being audited.80 This important procedure, which is expected to be widely used, allows a partnership to elect to furnish, to IRS and to each person who was a partner for the year under audit, a statement (a special Schedule K-1 statement) of the partner's share of the partnership tax adjustment, as determined in the notice of final partnership adjustment.81 The statements must be prepared and issued in the manner determined by IRS.

(2) Election. The election, which is irrevocable and is available to all partnerships,82 must be made by the partnership within 45 days of receipt of the final partnership adjustment.83 This alternative procedure (i) relieves the partnership from liability to pay the imputed underpayment and (ii) precludes IRS from collecting the tax imposed on a partner's share of the partnership tax adjustments from other partners. The election, which apparently is

79 The 270-day period may expire prior to a decision by the partnership to pursue judicial review of any proposed partnership adjustment.
80 If the partnership makes this election, query if the partnership agreement should require those who were partners during the audit year to reimburse the partnership for the cost the partnership and partnership representative incur to resolve the audit and related judicial proceedings.
81 IRC Amended Section 6226(a)(2). It may become typical for a partnership’s lender to require the partnership to elect this alternative (or, alternatively, to require the partnership to elect out of the provisions of the 2015 Act under the small partnership exemption discussed above) to the extent the partnership is eligible.
82 IRC Amended Section 6226(a).
83 IRC Amended Section 6226(a)(1). Of course, the short 45-day period in which to make the election may place significant time constraints on the partnership and partnership representative to properly weigh the pros and cons of such election. Also, although the election is unilaterally made by the partnership representative, if the partners have contractual rights to approve whether such election is made, prompt coordination with such partners will be critical.
available only to the extent the partnership audit increases partners’ tax liability (i.e., only applies to the partnership’s net unfavorable partnership adjustments), subjects each person (who was a partner during the audit year) to tax liability for the year during which the partnership issues the statement. Thus, under this alternative the partner does not file an amended return for the year being audited, but rather pays its increased tax for the year in which the audit is finalized. But, the partner’s tax is calculated as if the tax adjustments occurred for the year under audit. The partner also must compute and pay any tax increase for years subsequent to the year being audited that results from adjustments to tax items and attributes that would have been affected if the partnership adjustments occurred during the audit year.

(3) Increased Partner Interest Rate. Significantly, interest on the partner’s additional tax is determined at the partner level and calculated from the due date of the return for the year under audit at the underpayment rate pursuant to IRC Section 6621(a)(2) based on the applicable federal short-term rate plus by five percentage points (instead of normal three percentage point increase set forth in IRC Section 6621(a)(2)(B)). Thus, a disadvantage of the alternative of the issuing special K-1 statements is the partners are exposed to a higher interest cost. This election also requires the audit year partner to become liable for any penalties, additions to tax, or additional amounts imposed on the partner’s share of the partnership tax assessment.

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84 Partners whose tax liability from the partnership tax adjustment would decrease for the audit year generally obtain no benefit, rather the partnership apparently would claim a net deduction for the year the audit is resolved and such deduction would be allocated to those who are partners for that year.

85 IRC Amended Section 6226(b)(1). The ramifications are unclear if a partner receives a statement from the partnership but does not file an amended return or pay the corresponding tax.

86 IRC Revised Section 6226(b)(2)(A). In essence, a partner’s increased tax is calculated by increasing the income for the year being audited as if the partner’s share of the tax adjustment had been properly reflected on the original Schedule K-1 for the year being audited, but tax is reported and paid on the partner’s return for the year the special K-1 is issued. The partner is liable for the additional tax even if the statute of limitation has expired for the partner’s return for the year being audited.

87 IRC Revised Section 6226(b)(2)(B). Tax items and attributes of the partner must be adjusted for tax years after the year being audited and before the year the audit becomes final, and thereafter for later tax years. IRC Revised Section 6226(b)(3)(A) and (B). Note that if a partner experiences a post-audit year reduction in tax as a result of reporting the special K-1 adjustments for the audit year, such benefit is not taken into account.

88 IRC Amended Section 6226(c)(2).

89 The special K-1 statement election may also put pressure on the partnership representative to resolve the audit promptly to minimize the increased interest cost. Other possible disadvantages of the special K-1 statement alternative (that would not occur absent the special K-1 statement election) include (i) subjecting the partner to taxes (and interest and penalties) for post-audit years resulting from the special K-1 adjustments for the audit year, and (ii) possibly imposing the 3.8% Medicare tax under IRC Section 1411 on the special K-1 adjustments of partners who are not C corporations.

90 IRC Amended Section 6226(c)(1). Those tax items continue to be determined at the partnership level.
(4) Tiered Partnerships. Numerous partnerships have tiered partnership structures whereby the partnership (the “lower-tier partnership”) has one or more partners that are taxed as a partnership (an “upper-tier partnership”). It is not clear how the special K-1 statement election, if made at the lower-tier partnership level, affects an upper-tier partnership. Tiered structures will likely raise complex issues as to how the lower tier partnership’s imputed underpayment tax flows up to (and through the upper-tier partnership to the owners of the upper-tier partnership) as a result of the upper-tier partnership receiving a special K-1 statement from the lower tier partnership. In this regard, if the lower-tier partnership makes the election and issues a special K-1 statement to the upper-tier partnership, it is unclear if the upper-tier partnership has the discretion to either pay the tax attributable to the special K-1 statement or instead shift that payment obligation to the partners of the upper-tier partnership by itself issuing special K-1 statements to its partners. Moreover if, upon receiving a special K-1 statement from a lower-tier partnership, the upper-tier partnership is permitted in turn to issue special K-1 statements to the partners of the upper-tier partnership, does the upper-tier partnership obtain an additional 45 days to elect the special K-1 alternative. Also if, under IRC Amended Section 6221(b)(1), the upper-tier partnership has elected out of the provisions of the 2015 Act for the year being audited, what impact (if any) does such election have on the upper-tier partnership issuing special K-1 statements in this context. Answers to many issues arising from tiered partnership structures likely will not be answered until IRS issues future guidance.

F. Termination of the Partnership. IRC Amended Section 6241(7) provides that if a partnership ceases to exist before the partnership adjustments are finalized (or even prior to a partnership audit commencing), the adjustments are taken into account by the “former” partners as determined under future regulations. Because the new audit rules generally do not impose joint and several liability for partnership tax on the partners, it is not entirely clear what rights IRS has to collect partnership tax directly from the partners if the terminated partnership has insufficient funds and one or more “former” partners do not pay their share of tax.

G. New Partnership Tax Assessment and Collection Procedures. Unlike the TEFRA Audit Rules permitting a “notice” partner to settle its share of partnership adjustment (regardless of whether the other partners did so), the 2015 Act generally eliminates a partner’s ability to settle partnership adjustments with IRS. Further, the new audit rules do not distinguish among TEFRA partnership items, non-partnership items, and affected items. The new regime is intended to reduce administrative challenges. Likewise, in contrast to the TEFRA Audit Rules, which under certain circumstances permit a partner to file a petition in the U.S. Tax Court, the new audit rules only permit the partnership to petition the U.S. Tax Court to challenge an IRS

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91 It is unclear how broadly the term “former” partner will be interpreted in this context and whether this provision only applies to current partners of the partnership existing when the partnership terminates (or applies to all persons who were former partners of the partnership). In this situation, it may be prudent for the partnership agreement to address how post-termination partnership tax audits will be handled and whether the partnership representative is permitted to elect to issue special K-1s to former partners of the partnership.

92 IRC Section 6224(c).

93 IRC Section 6226(b).
adjustment at the partnership level. Under IRC Amended Section 6223(b), a partnership and its partners are bound (i) by actions taken by the partnership representative and (ii) by any final decision in a proceeding brought with respect to the partnership.

(1) Consistent Partner Reporting. Similar to the TEFRA Audit Rules, the new audit rules require that a partner generally report partnership tax items consistently with the partnership. But, as with the TEFRA Audit Rules, the 2015 Act permits a partner to file a tax return that is inconsistent with the partnership’s return, provided the partner notifies IRS. If a partner fails to report in a manner consistent with the partnership and does not qualify for an exception, IRS is allowed to assess and collect the underpayment as if the underpayment were a mathematical or clerical error on the partner’s return.

(2) Limitation Period for IRS to Make Partnership Adjustments. Pursuant to IRC Amended Section 6235, the general limitations period for asserting partnership adjustments is three years after the latest of (i) the date the partnership return is filed, (ii) the partnership return due date for such year, or (iii) the date on which the partnership filed an administrative adjustment request relating to such year pursuant to IRC Amended Section 6227. This limitation period is extended (x) 270 days after any permitted partnership submission to IRS of information supporting an imputed underpayment modification pursuant to IRC Amended Section 6225, and (y) 330 days after the date of a notice of a proposed partnership adjustment under IRC Amended Section 6231(a)(2).

(3) Administrative Adjustment Requests. IRC Amended Section 6227 sets forth procedures for a partnership to file a request for an administrative adjustment to partnership tax adjustments. The request must be filed not more than 3 years after the later of (i) the date on which the partnership return for such year is filed, or (ii) the last day for filing the partnership return for such year (determined without regard to extensions). IRC Amended Section 6227(c) provides that a request may not be filed after a notice of an administrative proceeding with respect to the taxable year is mailed pursuant IRC Amended Section 6231. If the request reflects an imputed underpayment amount, the partnership must either (i) pay the amount of any imputed

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94 IRC Amended Section 6234(a).
95 IRC Amended Section 6222(a).
96 IRC Amended Section 6222(c). The partner must also comply with IRS notice requirements when the partnership fails to file a return. IRC Amended Section 6222(c)(1)(A)(ii).
97 IRC Amended Section 6222(b).
98 IRC Amended Section 6235(b) provides the partnership and IRS may extend the general limitations period by agreement entered before the expiration of such period. The period of limitations is extended to six years in the case of a substantial omission from gross income, and no period of limitation applies in cases of a fraudulent partnership return or where the partnership fails to file a return for any tax year. IRC Amended Section 6235(c).
99 Under the new audit rules, the statute of limitations is based solely on the partnership return; the expiration of a partner’s statute of limitations is no longer relevant.
100 These periods are further extended for any additional periods consented to by IRS pursuant to IRC Amended Section 6225(c)(7).
101 IRC Amended Section 6227(c)(1) and (2).
underpayment when filing the request, or (ii) issue amended K-1s to the partnership similar to the rules set forth in IRC Amended Section 6226.

(4) Notice of Adjustments; Assessments Periods. IRC Amended Section 6231 requires IRS to mail to the partnership and partnership representative (i) notice of an administrative proceeding initiated at the partnership level, (ii) notice of any proposed partnership adjustment resulting from such proceeding, and (iii) notice of any final partnership adjustment resulting from such proceeding. The notice of any final partnership adjustment may not be mailed earlier than 270 days after the date on which the notice of any proposed partnership adjustment is mailed.102 Pursuant to IRC Amended Section 6232, generally no assessment of a tax deficiency may be made (and no collection action related to such adjustments commenced) before the 90th day after the date the notice of final partnership adjustment was mailed or, if a petition is filed for judicial review of the adjustment, before the decision of the court has become final.103

(5) Judicial Review. A partnership104 may seek judicial review of the adjustments in a notice of final partnership adjustments with the Tax Court, the U.S. district court,105 or the Court of Federal Claims by filing a petition for readjustment within the 90-day period after the date on which a notice of final partnership adjustment is mailed pursuant to IRC Amended Section 6231.106 However, to sue in the district court or the Court of Federal Claims, the partnership must deposit, on or before the petition is filing date, the amount of the imputed underpayment.107 Pursuant to IRC Amended Section 6234, the court has jurisdiction to determine (i) all items of income, gain, loss, deduction, or credit of the partnership for the taxable year to which the final partnership adjustments relates, (ii) the proper allocation of items among partners, and (iii) penalties, additions to tax, and other amounts for which the partnership may be liable.

IV. Practical Application.

Although the new audit rules do not yet apply, partnerships and their partners (in consultation with their advisors) should become familiar with the provisions of the 2015 Act and determine whether to amend their partnership agreements in advance of the 2018 effective date. Partners should identify who will bear the burden or enjoy the benefit of partnership adjustments for a specific audit year by including appropriate indemnification and other provisions in their partnership agreement. Likewise, partners forming a new partnership, along with purchasers of

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102 During the 270-day period (as extended by IRS) that the partnership is permitted to seek a modification of the imputed underpayment, IRS may not issue a notice of final partnership adjustment.
103 The 2015 Act addresses interest and penalties related to a partnership adjustment in IRC Amended Section 6233.
104 A partner is not permitted to seek judicial review of the partnership tax adjustment.
105 The applicable district court is the district in which the partnership's principal place of business is located.
106 IRC Amended Section 6234(a).
107 IRC Amended Section 6234(b)(1).
interests of an existing partnership, should consider the effect of the 2015 Act in their agreements.

Among the many issues to consider are: ¹⁰⁸

(i) is the partnership eligible to elect out of the new audit rules and, if so, will the annual election be made to do so,

(ii) if the partnership intends to elect out, should the partnership agreement prohibit (a) transfers (including issuances by the partnership) of partnership interests to ineligible persons (e.g., trusts and entities taxed as partnerships), (b) transfers of partnership interests (including to an S corporation having more than one S corporation shareholder) that cause the partnership to have more than 100 partners within the meaning of IRC Amended Section 6221(b), and (c) S corporation partners from increasing the number of their shareholders in violation the 100-partner threshold.

(iii) who will be designated the partnership representative, what procedures will apply for a successor partnership representative, and what restrictions (if any) will be imposed by the partners on the partnership representative’s broad statutory rights, ¹⁰⁹

(iv) what contractual rights (if any) will partners acquire from the partnership and the partnership representative with respect to (a) notice of and participation in partnership audits and related judicial proceedings, (b) approval of various partnership elections under the 2015 Act, and (c) approval of resolution of partnership audit adjustments,

(v) should the partnership and partners indemnify the partnership representative for acting as the partnership representative,

(vi) will the partnership elect to transfer the payment obligation for any partnership imputed underpayment tax to its partners by issuing special K-1s to the partners, thus subjecting such partners to the increased interest rate on their portion of the tax deficiency,

(vii) how will a partnership that is an upper-tier partnership handle receipt of a special K-1 from the lower-tier partnership,

¹⁰⁸ A partnership and its partners likely will not be in a position to properly address many of these issues until future guidance is issued.

¹⁰⁹ In fulfilling its responsibilities as the partnership representative, a related issue is what duty (if any) does the partnership representative owe to those persons who were partners during the year being audited.
(viii) will partners (including former partners) be required to file amended returns and pay tax for the audit year reflecting their share of partnership tax adjustments in order to reduce the partnership imputed underpayment tax and, if so, such partners should be required to (a) promptly furnish such amended returns to the partnership representative, and (b) reasonably cooperate with the partnership representative,

(ix) if the partnership decides to pay the imputed underpayment tax, will the current partners be required to contribute or loan cash to the partnership to fund such tax if the partnership has insufficient cash.

(x) will the partnership agreement require a partner who leaves the partnership (and who thus becomes a former partner) to indemnify the partnership and its current partners for the partnership tax cost relating to partnership adjustments for audit years during which the former partner was a partner,

(xi) will lenders of the partnership require the partnership to shift the payment obligation for any partnership imputed underpayment tax from the partnership to its partners by issuing special K-1s to its partners or by electing out of the new audit rules, thus eliminating IRS as a creditor of the partnership,

(xii) what information must a partner provide to the partnership representative (for example, (a) a corporate partner’s status as a C corporation, permitting the partnership to calculate a portion of the imputed underpayment tax at the corporate tax rate, and (b) information relating to an S corporation partner and its owners and relating to an upper tier partnership and its owners),

(xiii) how will the partnership allocate partnership tax items attributable to partnership audit adjustments (and partnership tax payments) to its partners,

(xiv) what provisions should be addressed in the partnership agreement relating to the partnership audit adjustments that are made after the partnership terminates, and

(xv) what consequences occur to a partner who fails to comply with partnership provision related to the new partnership audit rules?

As noted, if the partnership does not statutorily shift liability to pay taxes to its partners, a person becoming a partner after the audit year (but before the year the audit become final) may become indirectly liable for partnership taxes for pre-acquisition periods of the partnership. A person who acquires an interest in an existing partnership should perform detailed tax due diligence on the partnership’s prior tax positions and seek an indemnity from the partnership and
its partners for any partnership tax liability that may arise for pre-acquisition tax periods. Also, the new partner should clearly understand what partner rights exist under the partnership agreement relating to tax audits of the partnership (and related judicial proceedings) and confirm that the new partner is adequately protected with respect to partnership audits (and related judicial proceedings). Likewise, if a partnership is acquired, the 2015 Act now strongly encourages the acquirer to focus on potential partnership tax liability for pre-acquisition periods and obtain tax indemnities from the partners of the partnership for such potential partnership-level federal taxes.110

V. IRS Notice 2016-23 – IRS Request for Comments on New Partnership Audit Rules.

On March 4, 2016, IRS issued Notice 2016-23, which requests comments on the new audit rules by April 15, 2016. The Notice implicitly acknowledges that the current general federal income tax system applicable to pass-through entities is not consistent with the 2015 Act default rule that imposes and collects tax at the partnership level. The Notice specifically lists 12 issues on which comments are specifically invited, including the following:

(1) **Election Out of 2015 Act.** What type of partner, in addition to those described in IRC Amended Section 6221(b)(1)(C) (i.e., individuals, C corporations, foreign entities treated as C corporations if they were domestic, S corporations, and estates of a deceased partners), should permit the partnership to elect out of the provisions of the 2015 Act (similar to the special rules applicable to S corporations);

(2) **Designation of Partnership Representative.** What limitations (if any) should be placed on the partnership representative designation; and how should “substantial presence in the United States” be defined for purposes of that designation;

(3) **Determination of the Imputed Underpayment.** How should the netting of partnership audit adjustments be calculated; and how should the general IRC provisions relating to character changes, restrictions, and limitations be applied to calculate the imputed underpayment;

(4) **Modification of the Imputed Underpayment.** How should the mechanics and timing requirements apply for requesting modification to the imputed underpayment and providing supporting documentation; what effect should a tax-exempt partner’s unrelated business taxable income have on the modification procedure; and what other criteria should be considered in applying the modification procedures;

110 Disclosure provided to a prospective new partner likewise should address the consequences of the new partnership audit rules to the new partner.
(5) **Favorable Audit Adjustments.** How should a partnership account for IRS adjustments that do not result in an imputed underpayment (e.g., net favorable adjustments that do not increase income or do not decrease loss);

(6) **Special K-1 Statements.** How should the partnership election to issue special K-1 statements to partners be made (and what information should be included with the election); when should the related information be sent to IRS and the partners; how should changes by a court proceeding to the final notice of partnership adjustment be taken into account; and what consequences (if any) occur if a partner fails to account for adjustments on the special K-1 statement (including how IRS collects the tax resulting from the special K-1);

(7) **Effect on Basis.** What effect does partnership audit adjustments have on the bases of (i) the partners’ partnership interests; and (ii) the partnership’s assets; and

(8) **Effect of Partnership Bankruptcy or Termination.** What effect does bankruptcy or termination of the partnership have on application of the new audit rules.

**Conclusion.** The 2015 Act will have a significant impact on virtually all partnerships and their current and future partners. However, many significant questions surrounding the 2015 Act will remain unanswered until the issuance of detailed regulations and other guidance by IRS. Although the 2015 Act is not yet effective, partnerships, partners and their tax advisors are well-advised to promptly commence reviewing the new audit rules, and amending their partnership agreements to address the impact of the new rules, including the various alternatives and elections provided therein.