Client Update
Treasury Issues Regulations for Early Election into New Partnership Tax Audit Regime

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The Treasury Department and the IRS have issued temporary regulations describing how partnerships may make an early election into the new partnership tax audit regime created by the Bipartisan Budget Act of 2015 (the "BBA").

Under the BBA tax audit rules, the IRS generally will audit partnerships and make adjustments at the partnership level. The BBA rules represent a significant departure from pre-BBA rules (often referred to as the TEFRA rules), which provide for centralized partnership-level tax audit procedures, but require the IRS to collect any resulting adjustments from the partners in the audited partnership. The BBA rules include a procedure for electing to "push out" to the partners in the partnership any tax resulting from an audit adjustment. However, the details of the push-out rules and many other aspects of the BBA rules remain uncertain because the IRS has not issued any guidance regarding the application of the new rules. The BBA rules are described in greater detail in our prior Client Update.

Many unresolved issues remain in the implementation of the BBA tax audit rules. Unless the IRS addresses many of the open issues, partnerships should proceed with caution before electing into the regime early under these temporary regulations.

The early election generally is available with respect to a partnership tax return for a taxable year beginning after November 2, 2015 (the date the BBA was enacted) and before January 1, 2018 (the date on which the BBA tax audit provision go into effect). In general, an election must be made within 30 days of the date the partnership receives a notice from the IRS that a return of the partnership for an eligible taxable year has been selected for examination; no extension of time may be requested. An election may only be revoked with the consent of the IRS. Many partnerships may not know the amount at stake in the audit within the timeframe provided by the IRS for making the election.

The BBA provides that certain partnerships with 100 or fewer partners may elect out of the new partnership audit rules. Because the BBA repeals the existing TEFRA rules, an election out would likely require the IRS to audit each partner individually. The temporary regulations make clear that a partnership with 100 or fewer partners cannot take advantage of this early election provision to get out of the existing TEFRA rules by electing into the BBA rules and then electing out. It will remain to be seen how Treasury and the IRS will apply the 100-or-fewer-partner opt-out provision when the BBA goes into effect.

The regulations provide that an election into the BBA rules is not valid if it "frustrates the purposes" of the new audit regime. The preamble to the regulations goes on to say that these purposes include the collection of any imputed underpayment that may be due by the partnership. Consistent with this theme, partnerships making this election must make certain representations attesting to the partnership's solvency and that the partnership is not in or expected to enter into a bankruptcy proceeding. This requirement appears to reflect an understandable concern by Treasury that partnerships with insufficient assets may seek to shield their partners from liability under the TEFRA rules by electing to have the tax paid at the partnership level.

It is unclear whether partnerships making the early election into the BBA rules will be permitted to elect to "push out" the additional tax liability to the persons who were partners in that year. IRS Chief Counsel William J. Wilkins reportedly has warned partnerships to be cautious about electing in early, because some provisions of the new rules, including the ability to push out the adjustment to the partners, aren't available until 2018.

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Please do not hesitate to contact us with any questions.