BUSINESS LAW TODAY

# Dig into the New Partnership Tax Rules

By Betty J. Boyd

The stodgy world of partnership audit and tax collection is headed for a seismic change! Get ready to say bye-bye to the current Tax Equity and Responsibility Act of 1982 (TEFRA) and Electing Large Partnerships (ELP) rules and hello to Title XI of the Revenue Provisions Related to Tax Compliance of the Bipartisan Budget Agreement (BBA).

As part of a larger congressional budget compromise, the BBA was enacted on November 2, 2015, and takes effect for tax years beginning January 1, 2018, and thereafter. Although the BBA rules may be applied for tax years beginning November 2, 2015, and before January 1, 2018, this author believes that, in most situations, it is not a good option for partnerships.

Title XI of the BBA was created to raise revenue—without increasing taxes—by streamlining the IRS's partnership audit and collection process. Limited Liability Companies (LLCs) that have elected to be taxed as partnerships have proliferated, in part, because they offer their members limited liability, while avoiding both the inherent double taxation of C-Corporations and the severe ownership restrictions of S-Corporations.

As an asset protection vehicle, it is common to find LLCs as members to other LLCs, in a multitiered or multilayered partnership structure. These complex partnership structures, consisting of two or more layers of LLCs, protect the ultimate business owners, because the lower-tier LLCs may be comprised of nothing more than a membership interest (an "empty filling"). Thus, these complex partnership structures make it more challenging for the IRS (and other creditors) to dig through the various layers to reach the ultimate business owners and their assets.

Congress's response to this growing complexity is set forth in Title XI of the BBA, which facilitates the IRS's tax collection process, regardless of whether the ultimate partners can be easily identified. This article briefly reviews the current rules and then examines the highlights and ramifications of the new rules. Next, this article presents a few examples, with a flowchart; and finally, it looks into a few practice tips, in preparation for these new rules.

## Scratch the Surface of the Current Partnership Tax Rules: A Quick Review

Under the current rules, partnerships may be audited in one of three ways:

### *Small Partnerships*

First, partnership audits with 10 or fewer qualified partners (e.g., no flow through entities, like LLCs, as partners) are conducted at the partner level (unless the partnership elects to be audited under TEFRA). In other words, the IRS examines the partnership's return, but audit determinations are ultimately made at the partner level. Each partner has the right to participate in his or her specific audit (but is not allowed to participate in another partner's audit). Although there is no required coordination among the partners within the audit process, partners may privately attempt to coordinate efforts among themselves to ensure consistent results. The IRS makes adjustments to each partner's return, after recalculating each partner's distributive share. At the conclusion of the audit, the IRS will issue a separate notice of deficiency to each partner. This means that each partner is responsible for initiating his or her own judicial proceedings (e.g. in tax court) to challenge any IRS determinations. Finally, the IRS must collect any unpaid income tax liability from each partner. The IRS cannot collect income taxes from the partnership.

### *Medium and Large Partnerships*

Second, partnership audits with 11 or more partners (or fewer partners, if there is a nonqualified partner such as an LLC) are audited under the TEFRA rules. Enacted in 1982, TEFRA streamlined audits of partnerships. If there are adjustments to be made on the partnership's return, TEFRA allows the IRS to conduct one audit (at the partnership-entity level) and issue one notice (a Final Partnership Administrative Adjustment or FPAA) to the partnership (and copies to certain "notice" partners). TEFRA also allows the IRS to deal with a single tax matters partner (TMP) who can bind all the partners (although partners may have the right to participate in administrative or judicial proceedings). TEFRA, however, did nothing to streamline the collection process. Assessment and collection are still done at the partner level. That is, if there are any changes to the partnership's return, the IRS must collect any resulting tax underpayment from the separate partners.

### *Only Large Partnerships*

Third, large partnerships, with at least 100 partners, have the option to elect the ELP rules. However, these rules provide less participation rights under TEFRA and are rarely elected.

## Get the Scoop on the New Partnership Tax Rules

### *The Default Rules*

BBA picks up where TEFRA left off. The BBA establishes new streamlined default rules for both the examination of partnership returns and for the collection of partnership taxes. These new rules target complicated partnership ownership structures (e.g., partnership interests held by flow through entities other than S-Corporations), by allowing the IRS to collect taxes from the partnerships. Small partnerships, consisting of 100 or fewer partners, can elect out of the new rules, if their ownership structure is simplified (e.g. the partners are limited to only individuals, estates of deceased partners, S-Corporations, C-Corporations, or foreign corporations, which would be taxed as C-Corporations under U.S. law).

Under the new rules, partners will no longer have the right to participate in a partnership audit or judicial proceeding. Partners will not even have the right to receive notice of partnership audits or be able to raise partner defenses. The IRS will deal with one designated partnership representative who may bind all the partners in an administrative or judicial proceeding (but who, unlike the TMP, does not need any special relationship to the partnership to qualify). This simplifies the audit process for the IRS. It lessens the burden of identifying "notice partners" and shifts the burden of actually keeping these partners informed from the IRS to the partnership representative. In addition, the IRS can focus on a single partnership representative, whether he or she is a partner. This can give the IRS increased confidence that the partnership representative will not be "disqualified" because he or she does not have the correct partner status.

More significantly, as mentioned above, the IRS will now be able to collect the imputed tax underpayment and any related penalties and interest—*directly* from the partnership, if the underpayments are the result of the partnership's imputed tax deficiencies (e.g. the partnership returns understate income/gains or overstate deductions/losses). This is a substantial departure from the current rules, in which the IRS does not collect tax underpayments, penalties, and interest, directly from the partnership; but, instead, must collect, from the separate partners—based on what those partners owe (unless the partners enter a Form 906 Agreement allowing the IRS to collect from the partnership entity). Under the new rules, the tax collected will not even be computed at the separate partners' tax rates—but at the *highest* individual rate (currently 39.6 percent) with few exceptions.

Thus, the new rules shift the burden of tax collection from the IRS to the separate partners. No longer will the IRS have to "chase" the separate partners to collect their share of taxes. Rather, the IRS will simply take the money directly from the partnership (which presumably will have assets associated with a business or investment activity), leaving the partners to battle over who must contribute funds to the partnership to make it whole. What's more? The new rules shift the burden for the payment of these taxes—from the partners in the audited year (or year under audit) to the partners in the years the taxes are collected. That's correct! Current partners may be stuck with a larger tax bill, even if they were not partners in the audited year (and thus did not benefit from the partnership's underreporting of taxable income). This means that current partners may have to battle with the former partners, to get them to contribute money to the partnership to make it whole (even though the former partners are no longer involved with the partnership). Good luck!

### *The Section 6221 ("Small Partnership") Election*

The BBA allows certain partnerships to elect out of the new rules, thereby, avoiding the hammer of tax collection at the partnership-entity level. However, this carrot comes at the price of simplifying the partnership ownership structure making it easier for the IRS to see who ultimately owes the unpaid tax liability (making collection easier for the IRS). The BBA allows small partnerships to elect out of the default rules if it has 100 or fewer qualifying partners (i.e., no flow through partners, other than S-Corporations and estates of deceased partners, and no foreign entities unless they would be C-Corporations under U.S. law). This small-partnership election is set forth in new Internal Revenue Code (IRC) Section 6221(b) and requires the partnership to notify each partner of this election (as prescribed by the IRS). This election must be made annually—with a timely filed return, and the partnership must provide the IRS with all the partners' names and tax identification numbers (TINs) as well as the TINs of any indirect partners who are shareholders in an S-Corporation. Thus, this "Section 6221 election" requires partnerships to simplify their ownership structure (e.g. no LLCs or trusts) and to provide the IRS with the tools they will need to track down the partners who will be required to pay the tax.

### *The Section 6226 ("the Alternative") Election*

For those large partnerships who cannot elect out (e.g. more than 100 partners) or for those partnerships with disqualifying partners (e.g. LLC as a partner), the BBA offers another alternative to the default rule, where the partnership pays the tax. New IRC Section 6226 allows the partnership to elect that all the partners from the audited year pay the tax underpayment, if this election is made within 45 days from the date of the notice of final partnership adjustment ("FPA," which is BBA's new acronym, not to be confused with TEFRA's FPAA terminology). Under this "Section 6226 election," the partnership must issue a statement of the partner's share of adjustment to income, gain, loss, deduction, or credit (i.e., adjusted Schedule K-1) to the IRS and to each partner of the audited year (or partnership taxable year, under audit, to which the item being adjusted relates). Each of these partners, in turn, is required to pay the adjusted tax with their current return (determined by the calendar year the adjusted K-1 is issued).

Notice that, under the alternative election, the IRS still does not need to chase the separate partners; the onus is on the partnership to identify and to ensure that each partner of the audited year pays the tax underpayment. Also, notice that the adjusted Schedule K-1 is included with each partner's return for the year it is issued and not for the audited year. Thus, the IRS will, generally, have three years from the date the aforesaid return is filed to verify that each partner properly reported their recalculated distributive share (consistent with the FPA issued to the partnership for the audited year).

### *The Section 6225 ("Lower the Imputed Tax") Option*

But what if a partnership is ineligible to elect out or does not want to simplify itself, in an effort to appease Uncle Sam? Or, what if the partners from the audited years refuse to cooperate? Do not despair! There is yet a third option to reduce the imputed tax underpayment that the IRS will be able to collect at the partnership level—at the highest individual tax rate. New IRC Section 6225(c) requires the IRS to take into account the correct tax liability of the partners (when computing the imputed tax underpayment) where

1. at least one partner from the audited year files an amended return consistent with the FPA adjustments and pays the tax in full;
2. at least one partner from the audited year is tax exempt; or
3. a lower rate should apply because the partner is a C-Corporation or because the adjustment is made to a qualified dividend or a capital gain.

This "Section 6225 option" is not a removal from the new rules—as any imputed tax underpayment can still be collected from the partnership. However, it does offer some relief to partnerships unable or unwilling to make the Sections 6221 or 6226 elections, from being taxed at the highest individual rate of 39.6 percent.

### Plow into Three Examples, with the New Partnership Tax Rules Flowchart

How will you know if the new audit and collection rules will apply to your partnership? Let us apply the new rules to the following three hypothetical partnerships, comprising of two partners (each of whom hold a 50 percent interest):

1. the Green Partnership, consisting of two individual partners;
2. the Yellow Partnership, consisting of one individual partner and one S-Corporation that has 100 members; and
3. the Red Partnership, consisting of one tax-exempt C-Corporation partner and one LLC partner.

Flash-forward! Suppose the current year is 2020, and all three partnerships are under audit, regarding their 2018 taxes. What rules apply to each of these partnerships? See the gray diamond (Partnership Adjustment) in Flowchart No. 1.

### *The Green Partnership: "Green Light, Go!"*

First, let us examine the Green Partnership. Suppose the Green Partnership elected out of the BBA rules, when it timely filed its 2018 return (and Schedule K-1s), and it provided the required partner information (e.g. the names and the taxpayer identification numbers, or TINs, of both separate partners) to the IRS; as well as notify both partners of this Section 6221 election. If this were the case, the IRS will need to follow the old (or current 2016) audit rules. The IRS will make any partnership adjustments, through separate audits of each partners' individual returns (Form 1040s), and issue a separate notice of deficiency to each partner. Finally, the IRS will assess and collect any tax underpayment directly from the partners. See the green-shaded shapes in Flowchart No. 1, which breaks the rules down into a basic, graphic format.

Notice, in this scenario, that none of the BBA rules applied, and the Green Partnership, a small and simple partnership, had the "green light" to proceed with the old rules, because it made the election prior to the audit (back in 2019, when it timely filed its 2018 tax return and Schedule K-1s). Thus, partners should know these BBA rules, before the return for an audited year is filed (or they may face unintended consequences).

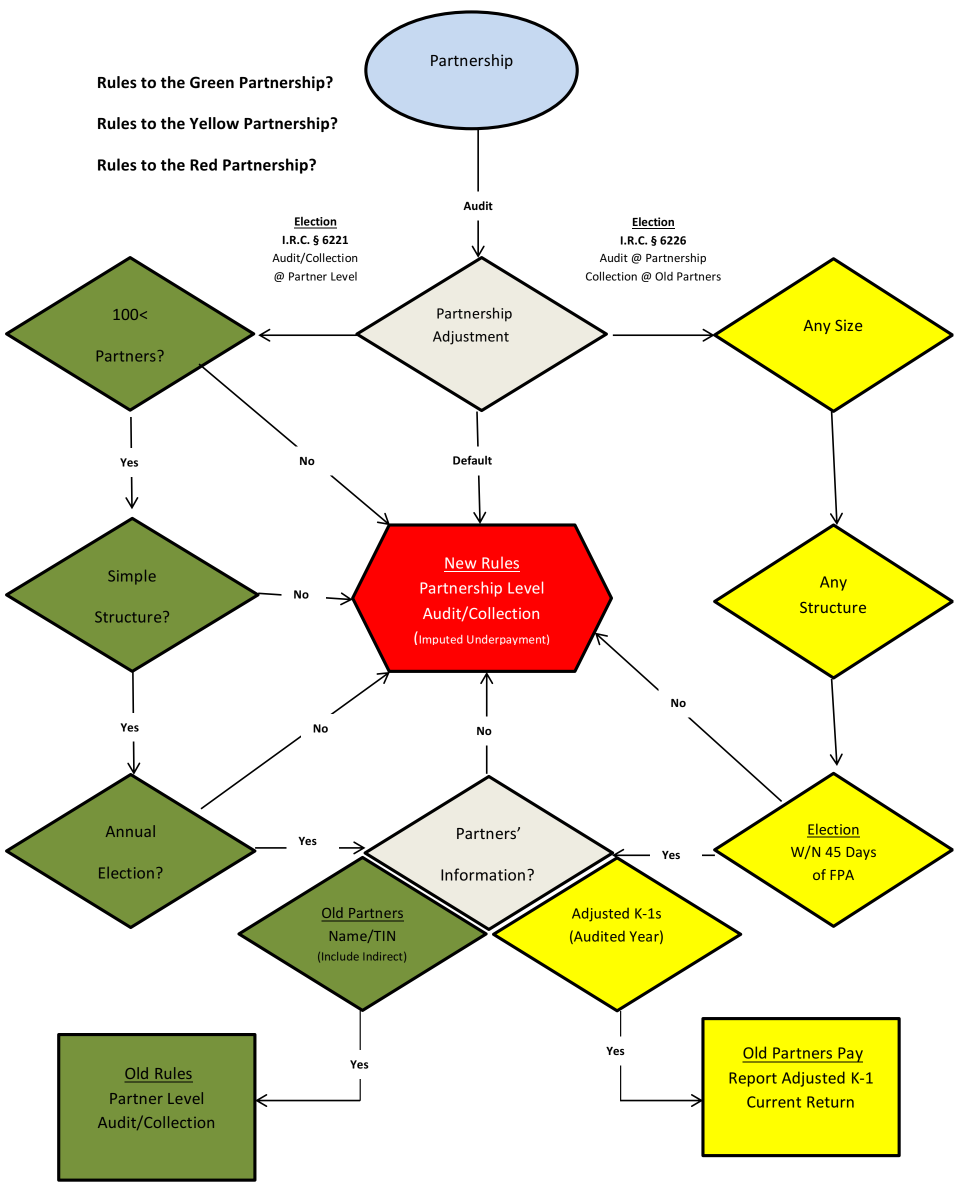
### *The Yellow Partnership: "Proceed with Caution!"*

Now, let us see what happens to the Yellow Partnership. Under the new rules, each member of the S-Corporation counts as one partner, and the maximum number of Schedule K-1s that a partnership can issue to qualify for the Section 6221 election is 100. With a total of 101 Schedule K-1s (100 members in the S-Corporation and one individual), the Yellow Partnership does not qualify to elect out of the BBA rules (under the Section 6221 election). Therefore, the BBA rules will apply to the audit of the partnership return. That is, the IRS will audit the Yellow Partnership's return (at the entity level) and make any adjustments to its return, through a single FPA.

However, suppose that, within 45 days of receiving the FPA, the Yellow Partnership made a 6226 election and issued adjusted Schedule K-1s to the IRS and to the 2018 partners reflecting changes in their distributive shares consistent with the FPA. Also, suppose that each 2018 partner agreed to pay any resulting underpayments in full (with interest and penalties) with their 2020 returns. If this were the case, then the collection arm of the BBA would not reach the Yellow Partnership. That's correct! See the yellow-shaded shapes, in Flowchart No. 1.

Notice that, unlike the Green Partnership, the Yellow Partnership underwent an audit incorporating the new rules, because the Section 6226 election was made at the end of the audit. Nevertheless, the Yellow Partnership had the "yellow light" to proceed with caution, to opt out of the collection arm of the BBA—by carefully following the required rules. Thus, although a large and/or complex partnership may be unable to avoid the BBA's audit rules, it may be able to avert the BBA's collection rules, under Section 6226 (an alternative to the partnership paying the imputed tax underpayment).

As explained above, it is important to note that, under this election, the adjusted Schedule K-1 is included with each partner's return for the year it is issued (2020) and not for the audited year (2018). Thus, the IRS will, generally, have at least three years from the date the partner's 2020 return is filed to review the partners return and make sure the new distributive share (resulting from the FPA) was properly reported.




### *The Red Partnership: "Stop and Think Through the Rules!"*

Finally, let us examine the Red Partnership. The Red Partnership's structure is complex, because one of its partners is an LLC. Therefore, the BBA audit rules automatically apply. Similar to the Yellow Partnership, the IRS will audit the Red Partnership, at the partnership level, and make any adjustments through an FPA. Unlike the Yellow Partnership, however, suppose that the Red Partnership did not make a 6226 election. If this were the case, then the IRS will follow the new default collection rules. See the red-shaded area in Flowchart No. 1.

So, stop and think! The IRS will assess and collect the imputed tax underpayment directly from the partnership—at the highest individual or corporate tax rate. Can the Red Partnership think of something to lower this tax rate? As mentioned above, Section 6225(c) requires the IRS to take into account the correct tax liability of the partners when, one partner is tax exempt. Fortunately, one of the Red Partnership's equal partners is a tax-exempt corporation, earning Section 501(c)(3) income. Therefore, the Red Partnership can contend that 50 percent of the imputed tax underpayment is allocable to a partner that does not owe tax; therefore, the highest rate should, accordingly, be reduced (the Section 6225 option). Therefore, although the BBA's collection hand reached the Red Partnership, its grip can be lessened; the imputed underpayment amount can be reduced, if the partnership can demonstrate this to the IRS.

### Uncover the Bottom-Line Tips Regarding the New Partnership Tax Rules

Good news: Partners still have a couple of years, to prepare for the new rules, before they take effect. So, what are the bottom-line practice tips? First and foremost, partners need to be proactive about their partnership agreements. Partners should consult with their tax professionals about the need to incorporate the new BBA terminology and rules into their agreements, while designating the sole authoritative partnership representative. Partners also need to address whether they want to include provisions concerning the 6221 election (for eligible partnerships) and the 6226 election. Remember, the 6221 election needs to be made when the return is filed, so think ahead. Second, partners (especially those contemplating purchasing a partnership interest) should vigilantly review the partnership's current and previous tax records. These records should be reviewed with a tax professional, to determine the likelihood of being liable for any imputed tax underpayment.

The new partnership rules are coming, so be ready! Dig 'em, be proactive and be vigilant!

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**ADDITIONAL RESOURCES**
**For other materials related to this topic, please refer to the following.**

**LLCs, Partnerships and Unincorporated Entities Webinars**

**Tax Terms in Plain English. Tax Terms as a Second Language (Access PDF, audio, and video here)**
An explanation of the Top Ten Tax Terms non-tax lawyers should understand.