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WHAT LAW FIRMS NEED TO CONSIDER

The Centralized Partnership Audit Regime

AN ARMANINO WHITE PAPER

OVERVIEW

Near the end of 2015, Congress passed the Bipartisan Budget Act of 2015 (BBA), sections of which replaced the partnership audit rules in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The new rules, known as the centralized partnership audit regime (CPAR), apply to tax years that begin after 2017.

The new rules no longer require the IRS to determine each partner's share of adjustments made to partnership items. Further, the IRS is no longer required to make a separate adjustment computation for each partner to determine the correct tax due based on the partnership audit. Under the CPAR, the partnership is liable for any imputed underpayment based on the adjustments made at the partnership level. As a result, the onus is now on the partnership to determine how to properly distribute the adjustments and to compute the imputed tax due from each partner as a result of the adjustments.

All partnerships should opt out of the CPAR, if able, and should also amend their partnership agreement to account for the new rules.

OPTING OUT

A partnership may opt out of the CPAR if it has 100 or fewer partners (determined by the number of K-1s issued) and all partners are “eligible partners” as defined by Treasury Regulation §301.6221(b)-1(b)(3). To opt out, the partnership must make an affirmative election on the eligible partnership’s timely filed return (including extensions) and provide certain partner information. The partnership must also notify each of its partners of the opt-out within 30 days of making the election. Any foreign partners must have a valid U.S. taxpayer identification number (TIN) for the partnership to successfully opt out of the CPAR. It is important to highlight that the opt-out election must be made every year; thus it is possible that a partnership could be subject to different audit rules in different years. If the partnership successfully opts out of the CPAR, partners will be separately audited and will need access to the partnership’s books and records, even after they leave the partnership.

It is highly preferable to opt out of the CPAR, if possible, because then the IRS must make adjustment for each partner, individually. It seems likely that a partnership that has opted out of the CPAR could reduce its chance of being audited because of the added cost and complexity of sustaining audits on individual partners. The IRS has refuted this assumption and claims that it will closely scrutinize any partnership’s opt-out election, including whether proper procedures were followed. History has shown, however, that partnerships have a lower audit rate than any other business entity because of the increased complexity.

AMENDING THE PARTNERSHIP AGREEMENT

Every partnership agreement should include provisions that address the CPAR rules. Even if a partnership expects to be able to opt out, it is prudent to include contingencies for how to deal with the CPAR in the event of a disqualified opt-out.

Especially important issues to address include: who will be “partnership representative,” whether the partnership will “pull in” or “push out” adjustments, and whether former partners will be required to make a contribution in the event of an IRS adjustment.

Partnership Representative

Partnerships must now appoint a partnership representative (PR), who takes the place of the tax matters partner (TMP) under the TEFRA. The PR has significantly more power than the TMP, so new provisions must be included in the partnership agreement to dictate the scope of those powers. For example, the PR has exclusive authority to represent the partnership in IRS audits, appeals, litigation, etc. Further, the PR has the power to bind all partners to audit adjustments without separate signatures from each partner. It is important to note that the PR need not be a partner or an individual. However, an entity PR must appoint and identify an individual to act on the entity’s behalf. To be eligible, the designee must be a person with substantial U.S. presence and have a U.S. TIN. If a PR is not designated by a partnership, the IRS will select one for the returns under examination.

Partnerships should consider how they will control the actions of the PR. The partnership agreement should dictate the parameters of the PR’s power and indicate when the PR may act independently, and when other processes would be required. The partnership agreement must outline the procedures and include the course of action if the procedures are not followed, up to and including removal of the PR.

Adjustments

The CPAR allows the IRS to make adjustments to all "partnership-related items" and is not limited to items on the partnership return. Partnerships must decide whether they will pull in or push out any adjustments. The decision will hinge on whether the partnership wants the burden or benefit of adjustments to impact reviewed-year or adjustment-year partners.

Reviewed Year vs. Adjustment Year. The reviewed year is the tax year of the return being examined by the IRS. The adjustment year is the year in which the IRS examines the partnership return and makes any adjustments. For all intents and purposes, the adjustment year means the current year.

Pull-In. Adjustment "pull-in" is the default method of accounting for adjustments. Pulled-in adjustments will impact adjustment-year partners. It is important to note that a partnership's payment on a liability is considered a nondeductible partnership expense. Pulled-in adjustments can be handled in two ways. The first is that the partnership can pay the liability, and the payments will be reflected in partners' capital. Capital adjustments will result in partners having capital accounts that differ from their economic deal, and will often require corrective allocations, which will add complexity to the partnership books.

Alternatively, the partnership could require reviewed-year partners to reimburse the partnership on a pro rata basis to cover the liability. Requiring reimbursement would reduce the burden of bookkeeping complexity. Partnerships electing to require reimbursement should frame it as a "mandatory capital contribution" rather than a true reimbursement to avoid taxable income to the partnership.

It is important to note that any taxes imposed on the partnership will be imposed at the highest marginal rates, without taking the tax attributes of the partners into account. Thus, the liability imposed on the partnership will often exceed the liability that would have been imposed directly on the partners.

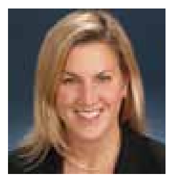
Push-Out. Adjustments can be "pushed out" by partnership election. After a final partnership adjustment notice from the IRS, the partnership has 45 days to make a push-out election. First, the partnership must calculate the individual liability for each partner. Then, the partnership will pass that liability on to the reviewed-year partners. To account for the adjustments, partners must redetermine their reviewed-year tax and any intervening years following proper procedures. Reviewed-year partners will also be liable for any interest that accrues on underpaid taxes.

Under the CPAR, successor partners will step into the shoes of the succeeded partners, meaning that a tax liability could be imposed on a partner who was not a partner in the reviewed year. Since the burden of any adjustments may be imposed on non-adjustment-year partners and non-current partners, those affected by any adjustment should be granted access to the partnership's books and records.

CONCLUSION

Regardless of whether a partnership will be subject to the new CPAR rules or whether it can opt out, partnerships must act to address the implications of the new system. No choices are inherently right or wrong, but will instead depend on the particular circumstances and desires of each partnership.

To discuss how the new CPAR rules will affect your business, contact the Law Firm Services team.



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