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The New Partnership Audit Rules, Part 2: The Election Out

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This is the second of several installments of Bracewell Tax Report articles describing the new rules applicable to partnership audits under the Internal Revenue Code and the related proposed and final Treasury regulations. Each installment focuses on certain aspects of these rules and the practical implications to partners and partnerships, particularly as they relate to negotiating and drafting partnership agreements.

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for tax purposes (the New Rules). The New Rules, effective for audits of partnership tax years beginning on or after January 1, 2018, generally allow the IRS to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level. Click ***here*** for more background on the New Rules.

The New Rules include a special election (the Election Out) that allows certain partnerships to choose not to be subject to the New Rules. If a partnership makes the Election Out, any federal audit of the partnership must be conducted at the partner level, on a partner-by-partner basis, under the audit procedures applicable to each partner. With a valid election, the partnership would not be subject to audit adjustments or the imputed underpayment regime of the New Rules and, therefore, would avoid any risk that a federal audit liability would be imposed at the entity level.

A partnership is permitted to make the Election Out for any taxable year if, at all times during the year, the partnership has 100 or fewer partners and all of such partners are eligible partners. An eligible partner is any individual, C-corporation (including certain foreign entities that would be treated as C-corporations if domestic), S-corporation or an estate of a deceased partner. For purposes of the 100 partner limitation, the partnership must count each partner to which the partnership is required to send a Schedule K-1, plus, in the case of any S-corporation that is a partner, each shareholder to which such S-corporation is required to send a Schedule K-1. Partnerships and disregarded entities are not eligible partners for purposes of the Election Out. Accordingly, many partnerships—from partnerships in complex structures with multiple tiers of partnership owners, to relatively simple partnerships with even a single partner that is a partnership or disregarded entity—would be unable to make the Election Out. The New Rules give authority to the Treasury Department, however, to issue future regulations to expand the types of entities that could qualify as eligible partners.

The Treasury Department and the IRS issued final regulations concerning the Election Out on January 2, 2018 (the Final Regulations). Prior to the release of the Final Regulations, commentators suggested that the definition of eligible partner be broadened to include partnerships and disregarded entities, which would greatly expand the population of partnerships that could make the Election Out. Some commentators also made the request to include disregarded entities that are owned by persons or entities that would otherwise be eligible partners under the New Rules. The Treasury Department and the IRS, however, chose not to expand the scope of the definition of eligible partner. In the preamble to the Final Regulations, the Treasury Department explained that an expansion of this definition would ultimately result in fewer partnerships being subject to the New Rules and therefore require the IRS to perform more audits at the partner level, which the IRS considers to be less efficient than audits under the New Rules. The Treasury Department, however, expressed that it is willing to consider changes to this definition after the Treasury Department and the IRS gain experience implementing the New Rules. Under current guidance, however, partnerships with even a single ineligible partner for any taxable year should expect to be subject to the New Rules for such year.

A partnership must make the Election Out separately for each taxable year by claiming the election on its timely-filed federal income tax return. In addition, the electing partnership must provide to the IRS, for each person or entity that was a partner (and each person that was a shareholder in an S-corporation partner) at any point during the taxable year, such person's name, U.S. tax classification and taxpayer identification number, along with a statement that each partner is an eligible partner, and the partnership must notify each partner within 30 days after making the election. Commentators expect that the IRS will take steps to invalidate an Election Out if any of the required information relating to a partnership's eligible partners is missing or incomplete, but they are not expecting the IRS to invalidate the election if the partnership fails to provide the proper notification to each partner.

Partnerships have taken a wide variety of drafting approaches with respect to the New Rules since they were enacted in 2015. With respect to the Election Out, however, partnership agreements almost uniformly include a covenant that the partnership representative will make the election, if available, without the consent of, or any consultation with, the partners. The prevailing view is that opting out of the New Rules would, on balance, be beneficial to the partnership in nearly all scenarios. In addition, partnership agreements generally include a covenant requiring all partners to cooperate with the partnership representative to effectuate the Election Out.

Our next installment will focus on the push-out election under the New Rules, which permits a partnership to allocate any partnership-level adjustments to its partners in the year under review, rather than cause the assessment to be borne at the partnership level.