

Scope Of Final Partnership Audit Regs May Invite Lawsuits

By Vidya Kauri

Law360 (January 15, 2019, 8:53 PM EST) -- A new scheme for auditing partnerships was aimed at reducing lengthy lawsuits, but the IRS' final regulations to implement it may have misfired with an imprecise definition of amounts that can be audited.

In its definition of partnership items or transaction amounts that can be audited, the Internal Revenue Service restricted such items to those that are shown on the partnership's tax return or that are required to be maintained in the partnership's books and records.

However, the tax law isn't always clear on what partnerships must maintain in their books and records, and the IRS could find itself in a bind if taxpayers dispute the agency's jurisdiction over audited items.

A key difference between the new and old audit regimes is that the statute of limitations is no longer automatically extended at the partner level. This means that if the IRS makes an adjustment to an item after auditing a partnership, and then a taxpayer successfully challenges its authority to do so, the deadline to make an adjustment at the individual partner level could run out while the partnership audit results are being disputed, according to Diana Wollman, a tax attorney at Cleary Gottlieb Steen & Hamilton LLP.

"I'm troubled because I think they're going to have more and more litigation about this," Wollman said. "I think it gives the taxpayer a tool to whipsaw the IRS by waiting until the partner-level statute of limitations has expired and then raising the issue."

The final regulations, contained in nearly 420 pages and released on Dec. 21, implement the audit regime that Congress passed in the November 2015 Bipartisan Budget Act to assess and collect tax at the partnership level instead of at the level of individual partners.

The BBA essentially repealed the Tax Equity and Fiscal Responsibility Act of 1982, under which the IRS had to pass a partnership's audit adjustments on to the ultimate partners — a process that became time-consuming, costly and burdensome when there were potentially thousands of partner returns, including tiers of partners that were themselves partnerships. The change reflected a shift in how



business entities are increasingly being structured, toward partnerships and away from C corporations, and a recognition from Congress and the U.S. Department of the Treasury that the number and complexity of partnerships had grown.

The new audit regime dropped certain terms from the old law, such as “affected items,” “computational adjustments” and “nonpartnership items,” that were the source of much litigation, according to the IRS. A new term, “partnership-related item,” is used to determine the scope of transactions and amounts that can be included in an audit at the partnership level.

Wollman noted that items outside the scope of the BBA audit regime can be adjusted only at the partner level in a non-BBA audit. She said that the IRS could potentially try to minimize its risks by opening up partner-level audits at the same time it opens up partnership audits, and then asking partners to extend the statute of limitations voluntarily.

“I think that if the IRS takes that approach, it’s going to be very controversial,” she said.

While some may argue that the ambiguity of TEFRA rules has crept into the new partnership audit regulations, Kat Saunders Gregor, a tax lawyer at Ropes & Gray LLP and co-founder of the firm’s tax controversy group, said that TEFRA had a “robust body of case law” behind it that could help resolve future disputes around what a partnership-related item is.

“For better or for worse, I view it as a positive,” Gregor said. “Since we’re not starting from ground zero ... we will have 30 years of guidance to rely on from courts on what that means and what the lines are.”

One example in which practitioners are unsure whether a matter would fall into the scope of a BBA partnership audit is a partner-to-partner disguised sale that might indirectly affect the partnership’s tax return. It is unclear how to determine if such transactions that occur outside the partnership are required to be reported, even though they affect the partnership’s return.

Another example where the regulations may be ambiguous is when a non-U.S. entity sells its interest in a partnership engaged in a U.S. trade or business, according to Wollman. The Tax Cuts and Jobs Act, which overhauled federal tax laws in December 2017, obliges the partnership to withhold tax from distributions to the new partner if the selling partner didn’t pay tax, which means the partnership is required to keep records about the sale, making the transaction a BBA item, Wollman said.

“I do not think that is what they intended when they wrote this,” Wollman said. “I think it’s a perfect example of the ambiguity.”

The IRS did not respond to a message for clarification on how the regulations would apply in these circumstances.

Jennifer Breen, a tax attorney at Morgan Lewis & Bockius LLP, said that it was natural to “experience some growing pains” as the IRS begins its partnership audits under the new regime, and that the agency had actually come a long way in accomplishing its goal of making adjustments and tax collection easier, with less administrative work.

It is now up to partnerships and partners to fully understand how the IRS’ new rules will work, Breen said.

“I really do think that we have to just get in there and have audits and experience the impacts of these rules on partnerships and the IRS,” she said. “We may see a tweak to the regulations based on that.”

The regulations may evolve, and the IRS could potentially issue new guidance and instructions requiring items to be reportable on a partnership’s tax returns once audits begin and disconnects become evident.

“While this language was really helpful and gives a bit more of a framework around what is an item with respect to a partnership and what is an item with respect to a partner,” Breen said, “I think this is an area that will still be confusing for partners and partnerships, and I think we’ll see this play out as audits begin.”

--Editing by Robert Rudinger and John Oudens.