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Audits of Partnerships That Cease To Exist Could Have Odd Results

by Eric Yauch

Partners who were owners of an entity just before it ceased to exist could be on the hook for adjustments related to other partners who exited the scene earlier, under the centralized audit regime.

A rule on adjustments could create gaming opportunities, according to one practitioner.

"It's a very odd rule that can not only have the incidence of tax change, but actually whether it's taxed could change," Steven R. Schneider of Baker McKenzie said September 10 at a District of Columbia Bar Taxation Community event.

As an example, Schneider said, assume ABC partnership has three general partners — A, B, and C — and one tax-exempt limited partner, D. If A and B exit the partnership and the IRS seeks to audit the partnership that it determined now ceases to exist, partners C and D could be stuck with the adjustments, he said.

Schneider pointed to section 6241(7) as well as reg. section 301.6241-3, which says the adjustments are taken into account by the applicable former partner — the adjustment-year partner — rather than the reviewed-year partners. In the above example, C and D could receive adjustments from the audit.

> ***'For example, if two partners leave and the partnership also terminates as part of a merger, the ordering of the partner redemptions versus partnership merger could arguably affect which partners inherit the adjustment when the partnership ceases to exist,' Schneider said.***

D, as a tax-exempt entity, might receive the adjustment in the form of more income. On the plus side, if it's not unrelated business taxable income, it wouldn't be taxable because partner D is exempt, Schneider said.

Jennifer Breen of Morgan, Lewis & Bockius LLP asked whether that rule could open the door to taxpayer mischief if a partnership planned to terminate, so it had most of its partners exit and leave only the tax-exempts in place. Schneider said there are common law principles that might address mischief, but that this result could occur without mischievous intent.

"There can be multiple events, although related, that require the picking of an order," Schneider said. "For example, if two partners leave and the partnership also terminates as part of a merger, the ordering of the partner redemptions versus partnership merger could arguably affect which partners inherit the adjustment when the partnership ceases to exist."

"But I do have to pick an order, so it's going to raise a lot of practical questions," Schneider added.

The centralized partnership audit regime was created in the Bipartisan Budget Act of 2015 and is effective for the 2018 tax year. The new regime allows the government to audit partnerships at the entity level, resolving an issue the IRS had struggled with for decades.

Final rules implementing the various aspects of the regime have been released over the past year, including rules on selecting the partnership representative (PR) (T.D. 9839) and on using the push-out election that sends adjustments determined at the entity level to partners.

Last-Minute Scramble

One of the biggest changes to the way partnerships are audited is the power granted to the PR and the designated individual. The PR or designated individual has the sole authority to bind the partnership in an audit and is named on the partnership tax return every year.

Breen said one reason some partnerships hadn't amended their agreements to reflect the audit regime just days before the September 15 return due date for those who filed an extension is that it could open up the entire agreement to scrutiny. That could require getting the general counsel involved, as well as other departments aside from just the tax department. ■

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