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Section 6226 -- Partnership Court Review

ABSTRACT: In news analysis, Marie Sapirie discusses some of the possible changes in store for partnerships and the IRS as the new partnership audit regime takes effect.

SUMMARY: Published by Tax Analysts(R)

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As preparations begin for the new partnership audit regime, the IRS hopes that the rules will streamline audits, while taxpayers are looking for guidance on the role of the partnership representative, the option to elect out of the new regime, and the mechanics of tiered structures.

The new rules, enacted in the Bipartisan Budget Act of 2015, P.L. 114-74 (Doc 2015-23743), may not be as helpful for the IRS as Congress intended. The existing 1982 Tax Equity and Fiscal Responsibility Act requirements proved cumbersome for the IRS and were generally regarded as a disincentive to auditing partnerships. The new statute is meant to streamline audits from the perspective of the IRS, but a number of features in the law, including the opportunity to elect out for partnerships with 100 or fewer partners and the lack of joint and several liability, may cause complications. "The new rules are going to create new administrative nightmares for the IRS," said Larry A. Campagna of Chamberlain, Hrdlicka, White, Williams & Aughtry.

New guidance will be necessary before the regime is operational. "I expect to see action at the IRS to figure out how to implement these rules," said Michael J. Desmond of the Law Offices of Michael J. Desmond. That guidance might take time to develop, as Treasury and the IRS already have other partnership guidance items on their agenda.

The full impact of the partnership audit changes won't be felt for a number of years, but when the regime is fully implemented, it may have features that lawmakers did not necessarily contemplate as they rushed to enact the budget agreement.

Trend Toward Smaller Adjustments?

One probable effect of the new rules is implicit in the estimate that the changes will lead to the collection of $ 13.4 billion in tax revenue over 10 years. Some of it may come from correcting the procedural hurdles the IRS had difficulty surmounting in large partnership audits, which were identified by the Government Accountability Office in September 2014 (Doc 2014-22794), but some may come as a result of partnerships adapting to changes in IRS strategy. The framework of the new audit regime may give the IRS more incentive to reduce the size of adjustments. "I think you will see more partnership audits that have smaller amounts of adjustments and situations where the partnership just pays the tax," said Desmond. With less money on the line, the cost of issuing Schedules K-1 and the administrative headache of dealing with the partners may make cutting a check to the IRS the more appealing option, he said. A trend toward smaller adjustments may mean that they are more readily collectible if partnerships decide it is better to pay at the partnership level than to push the tax out to the partners.

Payment and assessment issues are another area in which more guidance may be needed. For partnerships that elect to issue adjusted Schedules K-1, there will be questions about what happens if a partner receives the K-1 but does not file a return reflecting the tax.

Partnership Representatives

The new regime eliminates the tax matters partner (TMP) and substitutes a new liaison with the IRS known as the partnership representative. This change is generally welcome in that it allows partnerships to designate a partner or non-partner with a substantial presence in the United States to be the point of contact with the IRS, but this simplification for the IRS may result in more snarls for partnerships. Allowing non-partners and non-U.S. persons to hold this role is a significant change from the TMP rules, which require that the TMP be both a partner and, if one is eligible, a U.S. person.

In another notable change from the TMP rules, *section 6223(b)* gives binding effect to the actions of the partnership representative. Whereas under TEFRA the TMP is primarily an information source, the partnership representative has considerable authority to act on behalf of the partnership. The new rules provide that the partners and the partnership are bound by any final decision in a proceeding regarding the partnership. This is a heavy responsibility for a representative who might not -- if not also a partner -- be able to sign the partnership return. Despite the partnership representative's responsibilities, in many cases it may be advantageous to have a representative who is not a partner because it eliminates some of the potential for conflict, said Desmond.

The statute leaves it for the IRS to explain how to designate the partnership representative. A likely starting point for this guidance is *reg. section 301.6231(a)(7)-1*, regarding the designation of the TMP, particularly on the question of how the IRS will designate a partnership representative if the partnership fails to do so. The existing provisions on how to designate an alternate TMP, revoke a designation, and address the resignation of a TMP could be imported into the new regime fairly seamlessly with minor editing. But the IRS and Treasury will likely need to redraft the rules on how the IRS will appoint a representative when there is no designation. The default option under the TMP rules is the general partner with the largest profits interest, but the IRS now has potentially more attractive default options, such as a tax director, if one exists.

Defining the scope of the partnership representative's authority will be a critical element of future guidance. Although the IRS could recycle the TMP rules on some nominal points, it will have to address substantive questions that the TMP rules did not because the TMP has primarily informational duties and the partnership representative has the power to bind the partnership.

As a result, resolution of disputes involving an alleged violation of the partnership agreement by a partnership representative will also differ from cases governed by TEFRA. Violations of agreements will be more important under the new rules because of the partnership representative's increased authority, said Desmond. "That will increase the tension in situations where that person doesn't act in conformity [with the agreement], and there may be situations where it's not clear whether they have or not," he said.

The legislation seems designed to keep the IRS out of disputes between the partnership and the representative by removing almost all the rights that partners previously had. However, there is reason to doubt whether this strict divide will remain absolute. According to the statutory language, "there appears to be no method for a minority view to be expressed by a partner," said Campagna. "I am not sure that the Tax Court or any other court will allow a partner to intervene in any partnership proceeding to express a different view about the tax issues because the new rules seem to authorize the partnership representative to bind the partnership, and there is no mechanism for the appeals office or exam team to hear from a partner who does not agree with the partnership representative's point of view," he said. It is clear that Congress intended to prevent the IRS from having to deal with multiple partners, as it did under the TEFRA regime, but making civil litigation among partners the only recourse for partners that do not agree with the partnership representative may be draconian. The regulations may instead provide room for some communication from partners to the IRS.

Tiered Partnerships

Tiered partnerships were a challenge under TEFRA, and although the new regime is somewhat incomplete regarding the treatment of these partnerships, it makes computations easier for the IRS by putting the onus on the partnership and partners, said Desmond. "It should be easier for the partnership and partners to do [the calculations of adjustments] because they generally have more information," he said. "I think that was a big part of the problem with the TEFRA rules -- the nuances of affected items and statutory notices of deficiencies should go by the wayside." He added that complications may arise in multitiered partnerships in which there are dissolved or foreign partnerships because it could be difficult to figure out who should get information and be responsible for paying the tax.

The mechanical rules governing how adjustments flow through multitiered entities will be an important component of guidance under *section 6226* regarding the alternative to payment of the imputed underpayment by the partnership. "There are a lot of uncertainties as to how exactly the tax flows through the tiers," said Mary A. McNulty of Thompson & Knight LLP. And there could be unpleasant surprises for partners who receive adjusted partner statements as a result of the audits of lower-tier partnerships, she said. She added that while the removal of joint and several liability for the partners for partnership liabilities is taxpayer favorable, it might cause problems for the government, particularly with tiered entities. "The partnership being audited can issue adjusted partner statements to their partners, but if you cannot find a partner somewhere along the way, or they don't pay, there are going to be enforcement issues," she said.

One solution to the problems created by the lack of joint and several liability might be for the government to adopt a hybrid approach that would allow some portion of the tax to be paid by the partnership and some to be paid by the partners, said McNulty. The change would have to come legislatively, because the statute does not currently allow this type of approach, she said.

Electing Out

Partnerships with 100 or fewer partners can elect out of the new regime under *section 6221(b)*. But eligible partnerships might not want to be too quick to make the election. "Most people expect that eligible partnerships will elect out, but partnerships might be hesitant to require an election out under the partnership agreement" because it could be hard to predict whether the election will be advantageous, McNulty said.

Campagna said the option for partnerships with 100 or fewer partners to elect out is a necessary consequence of the sea change in the default rule regarding who owes when there is an imputed underpayment. He noted that because large partnerships function more like a public entity, it may make sense to have the entity pay the liability, but for smaller partnerships, that model may be unfair when there have been changes in ownership.

Section 6221(b) prescribes the general conditions for electing out. However, "it is not clear whether a partnership with a disregarded entity as a partner can elect out," said McNulty. Guidance should explain whether the disregarded entity is looked through or if the existence of the entity automatically renders the partnership ineligible to elect out.

Some of the issues arising under the new regime can be easily addressed in guidance, but others will require deeper consideration by either the IRS or partnerships. Partnerships have already started to feel the impact of the changes, as new partnership agreements are being drafted with the flexibility to accommodate possible regulations and advisers are examining existing agreements in light of the new rules. But the impact on the IRS is less certain and may not be as positive as Congress hopes.