Temporary regulations issued on early election of new partnership audit rules

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The Bipartisan Budget Act of 2015 (BBA) provided for new partnership audit rules that significantly change the way IRS partnership audits will be handled. While these rules are not mandatory until January 1, 2018, partnerships can elect to be subject to the new rules now. Temporary regulations were issued last month, specifying how a partnership can elect into the new rules for IRS audits prior to the 2018 effective date. In addition to providing mechanical rules for early use of the new audit provision, these regulations give some insight into issues that the IRS is beginning to identify as the effective date approaches.

The new audit rules will allow the IRS in most cases to assess any additional tax resulting from the audit against the partnership itself – eliminating the need to proceed against the individual partners.

The new regulations provide for the following requirements to make the election to adopt the BBA rules prior to their effective date:

- The election must be made within 30 days of the date the partnership is notified, in writing, that a return of the partnership has been selected for examination by the IRS.
- The partnership makes the election by providing a written statement, with the words “Election under Section 1101(g)(4)” written at the top, to the individual IRS personnel identified in the audit notice as the IRS contact regarding the examination.
- The statement must be in writing and be dated and signed by the tax matters partner or an individual who has the authority to sign the partnership return for the taxable year under examination. The written statement must include:
  - The partnership's name, taxpayer identification number, and the partnership taxable year for which the election is being made.

- The name, taxpayer identification number, address, and daytime telephone number of the individual who signs the statement.
- Language indicating that the partnership is electing application of section 1101(c) of the BBA for the partnership return identified in the audit notice.
- The information required to properly designate the partnership representative as defined by section 6223 as amended by the BBA, which must include the name, taxpayer identification number, address, and daytime telephone number of the partnership representative and any additional information required by applicable regulations, forms and instructions, and other guidance issued by the IRS.

The written statement must include the following representations:

- The partnership is not insolvent and does not reasonably anticipate becoming insolvent before resolution of any adjustment with respect to the partnership taxable year for which the election is being made.
- The partnership has not filed, and does not reasonably anticipate filing, voluntarily a petition for relief under title 11 of the United States Code.
- The partnership is not subject to, and does not reasonably anticipate becoming subject to, an involuntary petition for relief under title 11 of the United States Code; and
- The partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential imputed underpayment with respect to the partnership taxable year that may be determined pursuant to the audit.

Finally, the statement must contain a representation, signed under penalties of perjury, that the individual signing the statement is duly authorized to make the election and that, to the best of the individual's knowledge and belief, all of the information contained in the statement is true, correct, and complete.

A few items of note. First, the statement requires that the partnership appoint its “partnership representative”, a designation which replaces the current tax matters partner (TMP). The partnership representative has significant authority to represent the partnership; this authority is much more extensive than the authority held by the TMP. Partnerships electing to opt in early to the BBA rules should therefore consider amending their Operating Agreement or Partnership Agreement to set forth exactly what limitations the partnership representative has in representing the partnership in the audit for which the election is made or for other partnership matters in the future.

Second, the election will not be allowed if it “frustrates” the purposes of the new audit rules. Given the requirement noted above that the partnership certify that it is not insolvent, many practitioners believe that this requirement is designed to ensure that partnership does not elect into the new rules so that an insolvent partnership, rather than the solvent partners, are responsible for any audit assessment, a rule apparently designed to avoid the following: A partnership gets an audit notice in October 2016. The partnership has been struggling and an adjustment resulting from the audit would likely exceed the assets of the partnership. The partners (all of which are individually solvent) wisely determine that the BBA rule should be elected early, in order to put the burden of any IRS assessment on the partnership and not the individual partners (which would still be the default rule in 2016). By requiring the representations as to solvency set forth above, this partnership could likely not make the election to apply the BBA audit rules to a 2016 audit. The IRS is obviously focused on this issue for the early election of the BBA rules, but one must wonder how the IRS will handle these situations beginning in 2018 when the BBA rules will be the default rules and no election is necessary to put the partnership on the hook for any audit deficiency.

The new audit rules are very complex; and significant guidance is expected from the IRS prior to the effective date. This is the first real guidance since the law became effective almost 10 months ago. Practitioners are hopeful that more guidance is issued in the near future.