

Partnership Tax Audits for Dummies

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In this article, the authors discuss the basics of a partnership audit and offer some lessons for tax practitioners.

We wrote this article for all tax practitioners, because when it comes to the tax audits of partnerships, we are all dummies. Just when you thought it was safe to go back into the office and TEFRA is all but a bad memory, the Bipartisan Budget Act of 2015 or “BBA” went into effect and we have a new set of rules and procedures to learn!¹ With the first BBA audits now wrapping up, this article endeavors to walk you through the basics of a partnership audit under the current invention of Congress and the Treasury with some of the lessons we have gleaned along the way.

LONG AND TORTURED HISTORY

Before 1982, the Internal Revenue Service (IRS) audited a partnership on a partner-by-partner basis. As partnerships became sophisticated business structures with growing numbers and types of partners (e.g., private equity funds), Congress recognized the need for a centralized system for auditing and adjusting partnerships. As part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress enacted a unified partnership audit regime.²

Central to TEFRA was the differentiation be-

tween a “partnership item” and a “partner item.” The TEFRA rules did analytic gymnastics to differentiate those tax issues that the IRS must examine at the partnership level and those at the partner level. As the IRS and the courts got into the weeds of TEFRA, it became clear that TEFRA was neither efficient nor effective for auditing partnerships, and many times added more complexity than it solved.

In 2015, Congress once again went back to the drawing table and came up with the BBA, which repealed TEFRA and completely overhauled the procedures for examining partnership returns and collecting tax deficiencies. The BBA applies for partnership returns filed for the taxable years beginning after December 31, 2017.

SO WHAT MAKES BBA DIFFERENT?

Central to the BBA’s core is taxation of the partnership at the partnership level and no longer can partners get directly involved in the audit. Under the BBA, the audit of a partnership looks more like the audit of any other tax entity, like a corporation or trust.³ Only the partnership representative can act on behalf of the partnership, whose actions and deci-

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sions bind the partnership and the partners.⁴ Control of an audit of a partnership is now vested in the “partnership representative” who does not have to be a partner and can be an entity.⁵ Any individual can serve as the partnership representative as long as they have a substantial presence in the United States.⁶ If an entity is designated as the partnership representative, the entity must appoint an individual with a substantial U.S. presence to be the sole individual through which the entity representative will act for purposes of the BBA.⁷

The BBA rules are mandatory for partnerships with more than 100 partners or that have a partner that is a partnership or disregarded entity for federal tax purposes.⁸ Other partnerships can elect out of the BBA rules,⁹ which forces the IRS to audit those partnerships on a partner-by-partner basis under pre-TEFRA rules.

PASS THROUGH TAX TREATMENT NO MORE

All aspects of a partnership audit are now in the hands of the partnership representative. Partners have no ability or right to participate in the audit.¹⁰ Any IRS audit adjustment to a “partnership-related item” is made at the partnership level for the “reviewed year.”¹¹ Unlike under the TEFRA rules, any imputed underpayment is assessed and collected in the partnership taxable year in which the adjustment becomes final, rather than retroactively in the year under audit.¹² As a result any taxes, penalties, and interest are asserted, assessed, and collected directly from the partnership, not the partners.¹³

Interestingly, the BBA only applies to taxes under Chapter 1 of the Code (essentially, reg-

ular income tax liability).¹⁴ Other taxes are excluded from the BBA’s procedures. For example, self-employment taxes under the Self-Employment Contribution Act (SECA)¹⁵ are commonly relevant to partners but are not subject to the BBA rules. The IRS has recognized this limitation of the BBA and prescribes special procedures where BBA audits involve SECA or similar taxes.¹⁶ A detailed description of the special procedures is beyond the scope of this article, but the special procedures typically apply in addition to, rather than instead of, the general BBA procedures discussed herein.

A BBA AUDIT BEGINS WITH A NOTICE

When the IRS selects a partnership for examination, it sends Letter 2205D “Notice of Selection for Examination” to the partnership (not the partnership representative).¹⁷ The notice gives the partnership 30 days to file an administrative adjustment request (AAR). An AAR is similar to an amended return. The AAR gives the partnership representative¹⁸ a chance to clean up any issues before the audit begins.¹⁹ A partnership cannot file an AAR more than three years after the later of: (1) the filing date of the partnership return for the reviewed year, or (2) the due date for filing such return (determined without regard to extensions).²⁰ The IRS has three years to examine an AAR; that is, filing an AAR effectively restarts the three-year statute of limitations on any issues raised in the AAR.²¹

Any time after thirty days of sending out the examination notice, the IRS will send the partnership representative a notice of administrative proceeding (NAP).²² The NAP notifies the partnership that the IRS will examine the

partnership's returns for all years covered by the NAP (reviewed years).²³

The IRS will use its typical examination techniques in the examination, e.g., the issuance of Information Document Requests, interviews, site visits, etc. Any resulting "imputed underpayments"²⁴ for the reviewed year must be paid by the partnership (with interest) in the partnership year during which the BBA proceeding becomes final (the adjustment year).²⁵ The interest rate applied to imputed underpayments is the standard underpayment rate provided in IRC Section 6621(a)(2), and is increased by 2 percent if the partnership fails to pay within ten days of the date that the IRS provides notice and demand.²⁶ Deposits may be made to suspend the accrual of underpayment interest.²⁷ Notably, the IRS does not award overpayment interest in the event the partnership overpaid.

This is a vast departure from TEFRA under which adjustments flowed back to the tax year in which the item reviewed occurred, which caused all sorts of statute of limitations on assessment questions and issues. For example, if the IRS opens an audit in 2025 for the 2022 partnership tax year and determines an adjustment is warranted, under the BBA, the additional tax would be required to be paid by the partnership in 2025, the adjustment year. Likewise, any partnership-favorable adjustments to a reviewed year are effective in the adjustment year.²⁸ This change can have enormous repercussions to partners who join the partnership after a reviewed year. Careful planning by partners is highly suggested as they join and leave partnerships.²⁹

THE END OF THE BBA AUDIT IS NEAR

The partnership examination ends when the

IRS issues either a "no change" letter or adjustments to partnership related item(s). The IRS agent will issue a Summary Report Package to the partnership representative that summarizes all of the substantive adjustments and determinations and includes a preliminary imputed underpayment amount.³⁰ The Summary Report Package includes three documents: Letter 5895, Preliminary Partnership Examination Changes and Imputed Underpayment; Form 14791, Preliminary Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts; and Form 886-A, Explanation of Adjustments, for each substantive issue, each penalty (if applicable), and the imputed underpayment amount.³¹ The Summary Report Package must be issued no later than 14 months prior to the statute of limitations date under IRC Section 6235(a)(1).³² If the partnership wants to discuss the audit results, the partnership representative may request a conference with the auditor no later than two weeks from the issuance of Letter 5895.³³

If a partnership intends to protest the proposed adjustment and imputed underpayment and wants to seek review by the IRS Independent Office of Appeals (IRS Appeals), the IRS agent will prepare a "30-Day Letter Package" instead of the "Summary Report Package."³⁴ The 30-Day Letter Package includes three documents: Letter 5891 (30-Day Letter), Form 14791, and Form 886-A.³⁵ If a partnership requests to go to IRS Appeals, there must be at least 18 months remaining on the statute of limitations when the case is transferred to IRS Appeals.³⁶

The partnership can request to go to IRS

Appeals and protest a proposed adjustment on a substantive issue, any penalty associated with such adjustment, and the imputed underpayment amount.³⁷ The appeal is handled by IRS Appeals under the same processes as any other taxpayer protest.

Near the end of the audit, the IRS agent will issue the partnership representative a “notice of proposed partnership adjustment” (NOPPA).³⁸ Note that a partnership can go to Appeals prior to the mailing of the NOPPA. The NOPPA must be mailed no later than the statute of limitations. Under IRC Section 6235, the IRS has three years from the latest of the date on which the partnership tax return was filed, the return due date, or the date on which the partnership filed the AAR to propose an adjustment. The period of limitations can also be extended by agreement.³⁹

The NOPPA indicates the IRS’s “imputed underpayment” - the amount of additional tax that the IRS determined the partnership owes for the reviewed tax year. The calculation of the imputed underpayment can be very complicated, but it follows specific ordering rules. The IRS:

- (1) Groups the partnership adjustments;
- (2) Nets the adjustments;
- (3) Calculates the total net partnership adjustment; and
- (4) Applies the highest marginal rate of tax in effect for each reviewed year to calculate the amount of the imputed underpayment for the adjustment year.⁴⁰

After the IRS has determined the adjustments to the partnership items, the partnership representative can request modifications

to the imputed underpayment that may reduce the imputed underpayment.⁴¹ Modifications to the imputed underpayment can result from partner-specific attributes (e.g., if a partner is tax exempt⁴² or is taxed at a lower rate⁴³) or a partner can make a so-called “pull-in election” by filing amended returns for the adjustments made in the reviewed year and paying the associated tax.⁴⁴ Generally, the partnership has 270 days from the date that the IRS mails the NOPPA to request a modification of the imputed underpayment.⁴⁵

A partner subject to a lower tax rate may file an amended return and pay his share of adjustment based on correct tax calculation.⁴⁶ Not all partners are required to file an amended return. In this case, the partnership’s proposed imputed underpayment is recomputed to exclude that partner or partners’ share of adjustments. The amending partner(s) must pay any required tax before the IRS will modify the partnership’s imputed underpayment.⁴⁷ A similar process is available for reviewed-year partners (i.e., those who were partners in the year of the audit), but reviewed-year partners pay any tax due without filing amended returns.⁴⁸ Any related modifications to the proposed imputed underpayment are subject to IRS approval.⁴⁹ The major difference between a pull-in election and the amended return procedures is that partners cannot receive refunds under pull-in procedure.⁵⁰

After reviewing the request for modification of imputed underpayment, the IRS issues a determination package which includes a Letter 5975 (Notice of Modification Request Determination) and Form 15027 (Partnership Summary of Approved Modifications and the Imputed Underpayment). If the IRS rejects the

modification request, the partnership can appeal the denial of modification to IRS Appeals. Note this is separate from an appeal of any adjustments after receiving the 30-Day Letter Package and only the denial of modification is before Appeals.

After all of the modifications, the IRS may issue a notice of “final partnership adjustment” (FPA) imposing the imputed tax underpayment on the partnership for the reviewed year.⁵¹ The IRS cannot issue the FPA before the 270-day period provided for by the NOPPA,⁵² and the IRS must generally issue an FPA within 330 days of the date of the NOPPA.⁵³ This period can be extended by agreement with the IRS.⁵⁴

After the FPA is sent to the partnership representative, the partnership may elect to “push-out” the reviewed-year adjustments to the reviewed-year partners.⁵⁵ This election shifts the tax liability from the partnership to the partners at the time of the reviewed tax year. The push-out election must be made within 45 days of the date of the FPA, and no extensions are available.⁵⁶

To make a valid push-out election, the partnership representative must provide all information required by the IRS. This includes the IRC Section 6226 election form, which is made on a Form 8988, Election to Alternative to Payment of the Imputed Underpayment. A partnership that makes a push-out election must also furnish each reviewed-year partner a separate Form 8986, Partner’s Share of Adjustment(s) to Partnership-Related Item(s), statement (IRC Section 6226 Statement) containing specified information about the partner’s share of the adjustments underlying the imputed underpayment the partnership has elected to push out.⁵⁷ The partnership repre-

sentative must also provide the IRS with a Form 8985, Pass-Through - Statement Transmittal/Partnership Adjustment Tracking Report, which summarizes and transmits the IRC Section 6226 Statements. The partnership representative has 60 days from when the audit matters (issues or adjustments the IRS identified in the audit) become final to submit push-out statements to its partners and to the IRS.⁵⁸

The push-out election is binding on the partnership and all partners and cannot be revoked without permission from the IRS.⁵⁹ Under the push-out procedures, partners self-assess additional tax, and report and pay in the year partners receive the new Schedules K-1.⁶⁰ Partners are responsible for the underpayment on interest at a rate two percent higher than the ordinarily-applicable rate.⁶¹ Depending on the complexity of the partnership structure, this can present practical problems where partners are themselves pass-throughs and the pass-through partners need to push-out the payments to their respective partners.

The FPA is a jurisdictional requirement, and the partnership representative has 90 days from the date of the FPA to challenge it in court.⁶² The partnership representative can file a petition in the U.S. Tax Court, the U.S. district court for the district in which the partnership has its principal place of business, or the U.S. Court of Federal Claims.⁶³ If the petition is filed in Tax Court, no amount of the underpayment must be paid in advance of the proceeding. If the petition is filed in the district court or the Court of Federal Claims, the partnership must deposit with the IRS the amount of the underpayment, penalties, and additions to tax.⁶⁴ Despite filing a push-out

election, the partnership (and not the partners)⁶⁵ can still dispute the FPA adjustments in court. Courts have jurisdiction over all partnership-related items, allocation among partners, and penalties. This presents numerous possibilities for court challenges including challenging adjustments, penalties and additions to tax, the calculation of the imputed underpayment, and the modification of the imputed underpayment, among others.

If the partnership does not file a petition in court, the IRS will assess (i.e., record a liability for the tax on IRS records) and collect the tax underpayment from the partnership or the partners, if the partnership has elected to “push out” the adjustments.⁶⁶

SOME TAKEAWAYS

The BBA forces consistency between the tax treatment of items by the partnership and its partners. If a partner fails to treat an item consistently, the IRS will treat the inconsistency as a mathematical error, and assess and collect the tax accordingly.⁶⁷ A partner does not have to agree with the reporting position taken by the partnership, and can file a statement with its return identifying the inconsistency.⁶⁸ If all of this is too much to keep track of, the IRS has published a helpful “Roadmap for Taxpayers,” which provides a broad overview of the BBA procedures.⁶⁹

NOTES:

¹Pub. L. No. 114-74, § 1101.

²Pub. L. No. 97-248, § 402.

³Congress built some optionality of partnership-level taxation into the BBA regime if the partnership makes certain elections described herein.

⁴IRC § 6223(a). See Treas. Reg. § 301.6223-2(d). Except as otherwise stated, all section references are to

the Internal Revenue Code of 1986 (the Code or IRC) as amended, and the regulations promulgated thereunder.

⁵Treas. Reg. § 301.6223-1(b)(3). The designation is made for each year on the partnership return for that year. See Treas. Reg. § 301.6223-1(c). If the partnership does not designate a partnership representative, the IRS will. IRC § 6223(a); Treas. Reg. § 301.6223-1(f).

⁶Treas. Reg. § 301.6223-1(b)(2).

⁷Treas. Reg. § 301.6223-1(b)(3)(i).

⁸IRC § 6221.

⁹See IRC § 6221(b).

¹⁰IRC § 6223.

¹¹Assuming the partnership does not elect out of the BBA. See IRC § 6221(b).

¹²IRC § 6225(d).

¹³IRC § 6221; Treas. Reg. § 301.6221-1.

¹⁴See IRC § 6241(2)(B)(i) (defining “partnership-related item” to include only items relevant “in determining the tax liability of any person under chapter 1” of the Code (IRC Sections 1 through 1400Z-2)).

¹⁵IRC §§ 1401 et seq. (Chapter 2 of the Code).

¹⁶See Internal Revenue Manual (IRM) 4.31.10 (04-04-2025) (providing special rules for BBA audits involving taxes under Chapters 2 and 2A of the Code).

¹⁷Interestingly, neither the statutes nor the regulations mention sending notice of the beginning of an examination. Instead, this procedure is self-created by the IRS. See IRM 4.31.9.7.8 (01-24-2024).

¹⁸Treas. Reg. § 301.6227-1(a).

¹⁹See IRC § 6227.

²⁰IRC § 6227(c); Treas. Reg. § 301.6227-1(b).

²¹Treas. Reg. § 301.6227-1(f).

²²IRC § 6231(a)(1).

²³IRC § 6225(d)(1).

²⁴IRC Section 6225 details the intricate calculation of the imputed underpayment. A detailed description of the calculation is beyond the scope of this article.

²⁵IRC § 6225(a)(1). The adjustment year is the year in which: (1) a court enters a decision relating to the adjustment; (2) the partnership representative makes an AAR per IRC Section 6227; or (3) a final partnership adjustment or “FPA” is mailed or the partnership waives the IRC Section 6232(b) limitation on assessments. See IRC § 6225(d)(2); Treas. Reg. § 301.6241-1(a)(1).

²⁶IRC §§ 6233(a)(2); 6232(f)(1).

²⁷IRC § 6233(c).

²⁸IRC § 6225(a)(2).

²⁹See IRC §§ 6225(c)(2)(A), 6225(c)(2)(B), 6226.

³⁰IRM 4.31.9.10.1 (01-24-2024).

³¹IRM 4.31.9.10.1(2) (01-24-2024).

³²IRM 4.31.9.10.1(6) (01-24-2024).

³³IRM 4.31.9.10.1(6)(b) (01-24-2024).

³⁴IRM 4.31.9.10.2 (10-29-2021).

³⁵IRM 4.31.9.10.2(4) (10-29-2021).

³⁶IRM 4.31.9.10.2(2) (10-29-2021).

³⁷IRM 4.31.9.10.2(1) (10-29-2021).

³⁸IRC § 6231(a)(2).

³⁹See IRS § 6235(b). There are other exceptions to this timing rule, for example if the partnership fails to file a return. See, e.g., IRC § 6235(c).

⁴⁰See IRC § 6225(a); Treas. Reg. § 301.6225-1(b), (c).

⁴¹IRC § 6225(c); Treas. Reg. § 301.6225-2.

⁴²IRC § 6225(c)(3).

⁴³IRC § 6225(c)(4).

⁴⁴See IRC § 6225(c)(2); Treas. Reg. § 301.6225-2(d)(2)(ii)(A).

⁴⁵IRC § 6225(c)(7).

⁴⁶IRC § 6225(c)(2); Treas. Reg. § 301.6225-2(d)(2).

⁴⁷Treas. Reg. § 301.6225-2(d)(2)(ii)(A).

⁴⁸Treas. Reg. § 301.6225-2(d)(2)(x).

⁴⁹Treas. Reg. § 301.6225-2(d)(2)(x).

⁵⁰Treas. Reg. § 301.6225-2(d)(2)(x)(A).

⁵¹IRC § 6231(a)(3).

⁵²IRC § 6231(b)(2)(A).

⁵³IRC § 6235(a)(3).

⁵⁴IRC § 6235(b).

⁵⁵IRC § 6226. The cost of making the push-out election is an additional 2 percent above the statutory underpayment interest rate. See IRC Section 6226(c)(2)(C). For the form and manner of making the push-out election, see Treas. Reg. § 301.6226-1(c)(3)(ii).

⁵⁶Treas. Reg. § 301.6226-1(c)(2).

⁵⁷Treas. Reg. § 301.6226-2(a). If the partnership fails to provide the IRC Section 6226 Statement it may be liable for a civil tax penalty under IRC Section 6722. See Treas. Reg. § 301.6226-2(a).

⁵⁸Treas. Reg. § 301.6241-3(e)(2)(ii).

⁵⁹Treas. Reg. §§ 301.6226-1(c)(2); 301.6226-1(c)(1).

⁶⁰See IRC § 6232(f)(1)(B).

⁶¹IRC § 6226(c)(2).

⁶²IRC § 6234(a).

⁶³See IRC § 6234(a).

⁶⁴See IRC § 6234(b).

⁶⁵Treas. Reg. § 301.6226-1(e).

⁶⁶IRC §§ 6226, 6232(b).

⁶⁷IRC § 6222(b); Treas. Reg. § 301.6222-1(b).

⁶⁸IRC § 6222(c)(1); Treas. Reg. § 301.6222-1(c)(1). Note, however, that a partner cannot file an inconsistent treatment notice for items determined in a final decision or in a push-out statement filed by the partnership. See Treas. Reg. §§ 301.6222-1(c)(2), 301.6226-1(e).

⁶⁹IRS Pub. No. 5388 (Rev. 7-2021), Bipartisan Budget Act (BBA) Roadmap for Taxpayers, <https://www.irs.gov/pub/irs-pdf/p5388.pdf>.