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FEDERAL TAX Insights



IRS Finalizes Regulations for Opting Out of Centralized Partnership Audit Regime

Ross D. Cohen, Partner
Co-Chair – Federal Tax
RCohen@bgdlegal.com
Ross's Bio

Mark A. Loyd, Partner
Chair, Tax Department
MLoyd@bgdlegal.com
Mark's Bio

Bailey Roese, Attorney
BRoese@bgdlegal.com
Bailey's Bio

Stephanie Bruns, Attorney
SBruns@bgdlegal.com
Stephanie's Bio

On January 2, 2018, the IRS issued final regulations providing guidance on the requirements and mechanisms by which a partnership may opt out of the new centralized partnership audit regime, which is effective for IRS audits of partnerships (including LLCs taxed as partnerships) for tax years beginning after December 31, 2017. These regulations closely follow those that were initially proposed on June 14, 2017.

The centralized partnership audit regime was introduced in the Bipartisan Budget Act of 2015 ("BBA"). Significantly changing the procedures for partnership audits, the BBA provides for the assessment and collection of tax at the partnership level rather than with the individual partners.

The new regulations provide that a partnership may opt out of the centralized audit regime if it both qualifies as an eligible partnership and makes a valid election on a timely filed tax return. Partnerships that make a valid election will not be audited at the partnership level under the centralized regime. Rather, any adjustment relating to the partnership's return would be made through an audit of any or all of the partners in separate partner-level proceedings.

Eligible Partnership

Only an eligible partnership may make an election to opt out of the centralized audit regime. To be an eligible partnership, the partnership must (1) have 100 or fewer partners and (2) all partners must be eligible partners at all times during the taxable year.

Brett J. Miller, Partner
Co-Chair – Federal Tax
BMiller@bgdlegal.com
Brett's Bio

Charles Lavelle, Partner
CLavelle@bgdlegal.com
Chaz's Bio

Maggie Hayes, Attorney
MHayes@bgdlegal.com
Maggie's Bio



100 or Fewer Partners

Whether a partnership has 100 or fewer partners is determined by the number of statements (Schedules K-1 (Form 1065)) the partnership is required to furnish under the Internal Revenue Code of 1986, as amended ("Code"). To illustrate, at the beginning of the taxable year, a partnership has three partners – all of whom are individuals – each owning a separate partnership interest. During the course of the year, one partner dies and his partnership interest becomes an asset of his estate. The same year, another partner sells his partnership interest to another individual who holds the interest for the remainder of the taxable year. At the end of the taxable year, the partnership is required to furnish five statements: one to each of the three initial individual partners, one to the deceased partner's estate, and one to the new individual partner. Thus, for purposes of opt-out eligibility, the partnership has five partners for the taxable year.

A special rule applies for partnerships having an S corporation as a partner. In such a case, the partnership must take into account each statement (Schedule K-1 (Form 1120S)) the S corporation must furnish to its shareholders. Thus, a partnership with 50 individual partners and one S corporation partner having 50 shareholders would have 101 partners for purposes of opt-out eligibility. The Code requires the partnership to furnish statements to each of its 50 individual partners and to the S corporation partner. Although the partnership has only 51 partners, counting the 50 statements the S corporation must also furnish to its shareholders renders the partnership ineligible to opt-out of the centralized audit regime.

Eligible Partners

An eligible partner is defined as any person who is an individual, C corporation, "eligible foreign entity," an S corporation, or an estate of a deceased partner. The regulations specifically exclude the following from the definition of eligible partners: other partnerships, trusts, foreign entities that are not "eligible foreign entities," single member LLCs, estates that are not estates of a deceased partner, and any other person that holds an interest on behalf of another person. Eligible foreign entities are defined as foreign entities that would be treated as a C corporation if it were a domestic entity under existing guidance.

Valid Election

An election to opt-out of the centralized partnership audit regime must be made on the eligible partnership's timely filed return, including extensions, for the taxable year to which the election applies. Once made, the election may not be revoked without the consent of the IRS.

The eligible partnership must also include all information required by the IRS in forms, instructions, or other guidance. The final regulations specifically require disclosure of information about each



person that was a partner at any time during the taxable year of the partnership to which the election applies. This information includes each partner's name, correct U.S. taxpayer identification number, each partner's Federal tax classification, and an affirmative statement that the partner is an eligible partner. If a partner is an S corporation, the partnership must disclose the same information for each of the S corporation's shareholders. If the required information is not disclosed, the election will be considered invalid.

Key Implications

The regulations' narrow eligibility requirements will limit the number of partnerships (including LLCs taxed as partnerships) that are able to opt out of the centralized partnership audit regime. In the final regulations, the IRS intentionally declined to expand the class of partnerships eligible to opt out on the basis that the centralized regime's intended benefit of efficient tax administration would be undermined by expanding the group of partnerships that would be eligible to elect out of it.

Additionally, partnerships eligible to opt out of the centralized regime should still consider the collateral consequences of the election. If an election is made, partnerships will be constrained by partner eligibility requirements and should consider modifications to partnership or operating agreements to restrict the number and type of partners.

The enactment of the centralized partnership audit regime is recent. There are still a number of proposed regulations relating to the BBA that have yet to be finalized and the IRS is expected to continue to issue additional proposed and final regulations on the new regime throughout the year. Partnerships should consult with an attorney to determine eligibility, evaluate the costs and benefits of filing an election, and modify their partnership and operating agreements to address collateral matters.

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