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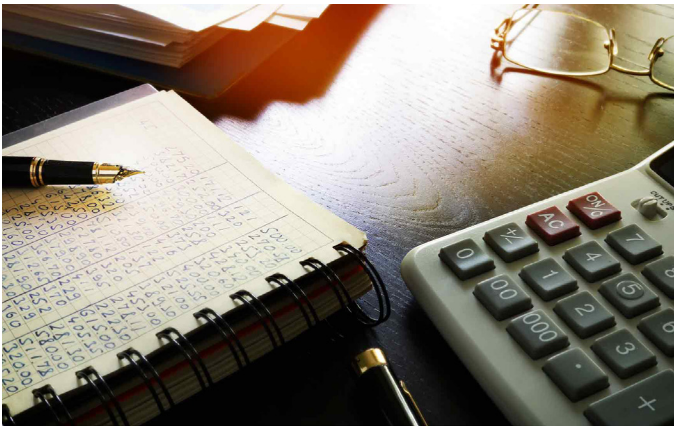
NEW CENTRALIZED PARTNERSHIP AUDIT REGIME TAKES EFFECT



In late 2015, Congress passed the Bipartisan Budget Act of 2015 (as amended, the "BBA"). The BBA established a new centralized partnership audit regime, applicable to partnership tax years beginning after December 31, 2017, and repealed prospectively the TEFRA partnership audit rules. These new federal partnership income tax audit rules will have significant implications for partnerships (and multi-member limited liability companies) and their partners.

In January 2017, the IRS issued proposed regulations (reissued in June 2017) that implement the BBA's centralized partnership audit regime. With the exception of final regulations published January 2, 2018 that implement rules related to "opting out" of the new audit rules (as explained in more detail below), the proposed regulations have not been finalized.

The new audit rules apply to all partnerships and to entities that elect for income tax purposes to be treated as partnerships (i.e., multi-member limited liability companies). As explained below, certain small partnerships (100 or fewer partners) that have only "eligible partners" can elect to opt out of the new audit rules.

For those partnerships that do not opt-out, the IRS will audit a partnership's tax items and the partners' distributive shares for a particular year, and any resulting adjustments will be made at the partnership level and taken into account by the partnership in the year the audit or judicial review is completed. If an audit results in a tax deficiency, the "imputed underpayment" will be assessed against and collected from the partnership rather than the individual partners, unless the partnership makes a "push-out" election, as described below. One big effect of the new audit rules is that they shift the burden of payment onto current partners, rather than those who were partners during the year under audit. Also, subject to possible modification, the tax is assessed at the highest federal income tax rate, regardless of the potentially lower rates that may otherwise apply.

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For purposes of this summary, references to a "partnership" include a limited liability company ("LLC") that is treated as a partnership for tax purposes, references to a "partner" include an LLC member that is treated as a partner for tax purposes, and references to a "partnership interest" include an interest in an LLC that is treated as a partnership for tax purposes.

Opting Out

Partnerships that are required to furnish 100 or fewer Schedules K-1 and whose partners are all "eligible partners" can elect to opt-out of the new audit rules. Partnerships that opt-out of the new audit rules will be subject to pre-TEFRA audit procedures under which the IRS must separately assess any tax to the partners under deficiency procedures.

Under the new audit rules, "eligible partners" are individuals, C corporations, certain tax exempt entities, certain eligible foreign entities, S corporations, and estates of deceased partners. Explicitly excluded from the definition of "eligible partner" are partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities (i.e., single-member LLCs), persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner. The exclusion of these types of entities will greatly limit the number of partnerships that are eligible to "opt out".

When counting the number of Schedules K-1 issued by a partnership with one or more S corporation partners, the partnership must count each shareholder of an S corporation partner separately. Additionally, partners who are married are counted as two separate partners.

The opt-out election must be made annually on the partnership's timely filed return (including extensions) for the year to which the election relates. When making the election, the partnership must provide the IRS with the names and TINs of all partners and, if the partnership has an S corporation partner, the names and TINs of the S corporation partner's shareholders. The partnership must also notify each of its partners of the election within 30 days of making such election. An election to opt out may only be revoked by the partnership with the IRS's consent.

It is important to note that even partnerships that opt out of the new audit rules must appoint a partnership representative.

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The Partnership Representative

The new audit rules replace the concept of the "tax matters partner" with a "partnership representative," who has the sole authority to act on behalf of the partnership with respect to the IRS. Unlike the tax matters partner, the partnership representative need not be a partner; however, the partnership representative must have a "substantial presence" in the United States. If the partnership representative is an entity, the partnership then must also designate an individual with a substantial presence in the United States as the sole person to act on behalf of the partnership representative. Partnerships must designate a partnership representative (and, if applicable, a designated individual) each tax year. The designation is done on the partnership's timely filed federal income tax return for that year. If a partnership fails to designate a partnership representative, the IRS is allowed to select any person with a substantial presence in the United States as the partnership representative, which selection by the IRS cannot be revoked without the IRS's consent.

The partnership representative has the sole authority to represent the partnership in a federal income tax audit or tax proceeding, and the partnership and all partners are bound by any actions or decisions of the partnership representative. The partnership representative also has the authority to make a "push-out" election (explained below) on behalf of the partnership. In addition, only the partnership representative may raise defenses to penalties, including defenses that may be available to some partners but not others. Any defense not raised by the partnership representative is waived, and defenses will not be considered if raised by a person other than the partnership representative. No partner other than the partnership representative has a right to notice of any audit, proceeding or partnership adjustment, and no partner other than the partnership representative may participate in an audit or tax proceeding without the consent of the IRS. Under the new audit rules, there is no legal obligation for the partnership representative to keep partners updated on the status of the audit or even to notify the partners of the audit.

The partnership representative's authority to bind the partnership and the other partners cannot be limited by state law, the partnership agreement, or any other document or agreement. While partnership agreements could require the partnership representative to provide partners with copies of notices, keep them informed of the progress of any audit or tax proceeding, or obtain consent before agreeing to an extension of the statute of limitations, a settlement, or making an election, such provisions do not limit the power of the partnership representative to bind the partnership and its partners in dealing with the IRS.

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Computation and Payment of Taxes

Under the new audit rules, the IRS will examine a partnership's tax return for a particular year (the "reviewed year"), and if an assessment results, the partnership itself (absent a "push-out" election) will be responsible for any adjustments, to be made the year the audit is completed or any judicial proceeding relating to the audit becomes final (the "adjustment year"). This is a significant change because partnerships have until now not been required to pay tax at the partnership level. It is also significant because a partner who benefitted from tax position taken during the reviewed year, but who leaves the partnership before the audit takes place, will not (absent a "push-out" election) have to pay their share of any resulting assessment. Instead, the current partners will be responsible for the tax liability, since it will be paid out of partnership assets in the adjustment year.

Also, any adjustments that reallocate the distributive share of any tax item from one partner to another will take into account only the upwards adjustment, disregarding the corresponding decrease in income or gain. This rule greatly increases the stakes involved when the focus of an audit is on the proper allocation of income or loss.

The tax resulting from the audit adjustment is referred to as the "imputed underpayment" and is calculated by multiplying the adjustment by the highest rate of federal income tax in effect for the reviewed year under Sec. 1 (individual rates) or 11 (corporate rates). Because of the manner in which the imputed underpayment is calculated, using the highest tax rate, the partnership's tax liability may very well be overstated compared to what the partners would have paid if the partnership had properly reported originally.

To deal with the potential overstatement issue, a partnership may request modification to adjust the imputed underpayment amount down to the correct amount of tax. The request for modification must be made within 270 days after a notice of proposed partnership adjustment is mailed by the IRS, and in connection with the request the partnership representative must provide such documents and other information needed substantiate the modification request, including, for example, tax returns, partnership operating documents, and certain certifications.

The IRS will deny a request for modification if support for such modification is not timely provided.

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Push-Out Elections

As explained above, under the new audit rules, absent a push-out election the partnership must make any imputed underpayment. The partnership's tax liability may be overstated, and absent an indemnity obligation from the partners in the reviewed year in favor of the partners in the adjustment year, the burden of such taxes will fall on persons who are partners in the adjustment year.

However, the partnership may elect to "push out" tax liabilities to the reviewed-year partners. A "push-out" election must be made by the partnership representative. A push-out election must be made no later than 45 days after the date a notice of final partnership adjustment is mailed to the partnership by the IRS and may not be revoked without the consent of the IRS.

If a push-out election is made, the reviewed-year partners must pay, and the partnership is not required to pay, the imputed underpayment (including any penalties and interest) in the year of the final partnership administrative adjustment. The interest rate applicable in connection with push-out elections is computed from the due date of the return year creating the adjustments and computed at the short-term federal rate plus five percent, rather than at the short-term federal rate plus three percent.

Other Provisions of the New Audit Rules

Consistency Requirements

The new audit rules require each partner to report each item of income, gain, loss, deduction, or credit attributable to a partnership in a manner that is consistent with the treatment of such item on the partnership's return. If a partner fails to comply with this requirement, any underpayment of tax resulting from such failure may be assessed and collected as if such underpayment were on account of a mathematical or clerical error appearing on the partner's return (that is, the IRS may collect such amount without relying on the deficiency procedures). To avoid this treatment, the partner must notify the IRS of the inconsistent treatment, or the inconsistency must result from the partner having received incorrect information from a partnership, so long as the treatment of the item on the partner's return is consistent with the treatment of that item on the incorrect statement or schedule furnished to the partner by the partnership.

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Administrative Adjustment Requests

If a partnership discovers errors on a prior-year return, the partnership may file an administrative adjustment request (an "AAR") to correct those errors. Any adjustment requested in an AAR is taken into account for the partnership taxable year in which the AAR is made. A partnership has three years from the later of the filing of a partnership return, or the due date of a partnership return (excluding extensions), to file an AAR for that taxable year. However, a partnership may not file an AAR for a taxable year after the IRS has mailed a notice of an administrative proceeding with respect to that taxable year.

If the adjustment results in an imputed underpayment, either the partnership can determine and take the adjustment into account for the taxable year in which the AAR is filed (under rules similar to the imputed underpayment rules), or the partnership and the partners can determine and take the adjustment into account (under rules similar to the push-out election rules).

Dissolved Partnerships

Under the new audit rules, if a partnership 'ceases to exist' before a partnership adjustment takes effect, the "former partners" must take any partnership adjustment into account as if the partnership had made a push-out election. In general, a partnership ceases to exist if the partnership terminates (within the meaning of the applicable section of the Internal Revenue Code) or does not have the ability to pay, in full, any amount that the partnership owes.

The new audit rules define "former partners" as the partnership's adjustment-year partners. If there are no adjustment-year partners, the partners of the partnership during the last taxable year for which a partnership return was filed are considered to be the former partners.

Other Impacts of New Audit Rules

Buying and Selling Partnership Interests

Responsibility for tax liability under the new audit rules will be an issue whenever there is an assignment of a partnership interest. An assignee of a partnership interest could become indirectly responsible for an assignor's tax liabilities if such liabilities are paid at the partnership level, or if the partnership requires the then-current partners to shoulder the burden of the tax liabilities through making additional capital contributions. As a result, buyers should enhance their tax due diligence process.

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Because a push-out election shifts the burden of taxes and penalties to persons who were partners in the reviewed year, persons who buy or sell a partnership interest may want assurances as to whether a push-out election will be made or an indemnity for taxes depending on whether the a push-out election is made. Similar considerations will be important in M&A transactions involving partnerships.

State Tax Audits

The extent to which states will adopt the centralized partnership audit regime is unclear. To the extent that a state does not adopt similar rules, state level audits would be conducted under very different rules than federal income tax audits, and the amount of tax, penalties and interest owed by each partner could differ significantly from the federal level.

Amending Partnership Agreements

Partnerships should review and amend their partnership agreements as necessary to take into account the new audit rules. Unfortunately, there is no "one size fits all" language. The types of provisions that a partner will want will depend, among other factors, on the nature of the partnership's activities, whether the partner has management control over the entity, and whether the partner will be, or will control, the partnership representative. In addition, it is important the partnerships identify and appoint a partnership representative for taxable years beginning after December 31, 2017. Issues that should be considered when amending partnership agreements or drafting new agreements include:

- how the partnership representative will be designated and may be removed;
- how the designated individual, if applicable, will be designated and may be removed;
- what partner consent will be required, if any, for making elections or settlements by the partnership representative, including opt-out and push-out elections;
- determining whether and when the partnership will "pay" (perhaps under a specified dollar amount), "push out" or "opt out";
- reimbursement of the partnership representative for the cost of obtaining professional assistance and other expenses;
- appropriate indemnifications for the partnership representative;
- if a partnership intends to opt-out if eligible, restrictions on transfers of partnership interests to entities that are ineligible partners;

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- the ability for management to make capital calls to cover the partnership's tax liabilities;
- the ability to further amend partnership agreements to deal with changes or updates to the new audit rules or state tax audit rules;
- obligations on the part of partners to provide information and otherwise cooperate with the requests of the partnership representative;
- partners' notice and participation rights in connection with IRS or state audits;
- indemnification obligations and/or "claw-back" rights with respect to prior partners; and
- if the partnership "pushes out," the ability to contact former partners.

Conclusion

The new audit rules are a dramatic departure from the prior partnership audit rules. For the first time, partnerships are required to pay taxes and penalties rather than pass them along to the partners. The new audit rules are not simply a retooling of the way the IRS handles partnership audits – they are a revenue raiser. They are designed to create efficiencies for IRS auditors, who no longer have to devote so much time to pushing entity-level income and expense audit adjustments down to numerous partners, and assessing and collecting the additional tax from each one of those partners. As a result, it is expected that the number of partnership audits will increase.

The new centralized partnership audit regime will affect every partnership – even those that opt out must designate a partnership representative and make an opt-out election each year. Clients need to review their operating agreements and partnership agreements, and amend them as necessary, to ensure that they contain proper language addressing the issues raised by the new audit rules. Partnerships will also need to help their partners understand the impact of these new rules. Finally, there may be changes to the proposed regulations as they are finalized, which may raise additional issues or necessitate further revisions.

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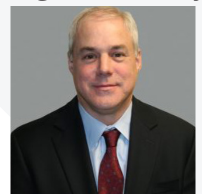

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