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New Partnership Audit Rules in Effect; Partnerships and LLCs Should Consider Changes

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A new "centralized partnership audit regime" is now in effect for partnerships, including limited liability companies (LLCs) that are treated as partnerships for tax purposes (which we refer to collectively as "partnerships"). The new regime, which was enacted by the Bipartisan Budget Act of 2015, applies to all partnerships (domestic and foreign) for taxable years beginning after December 31, 2017.

The new regime replaces the provisions of the Internal Revenue Code known as the TEFRA procedures, which still govern partnership audits for taxable years beginning before December 31, 2017, and may also be applicable for audits by states that have not adopted the new federal procedures. The new regime is significantly different from TEFRA in terms of both the conduct and the consequences of a partnership audit. Partnerships need to be aware of the impact of the new audit rules and may need to make changes to their governing documents to address the new rules.

The discussion below highlights several key changes under the new audit regime and suggests actions that partnerships should consider taking. Please contact a member of the Tax Group to discuss the impact of the new regime on your partnership and what changes you should consider making to your governing documents.

Assessments Collected at Entity Level

Under the new audit regime, any taxes and penalties resulting from a partnership audit are assessed and collected at the entity level, which means the partnership itself (rather than the affected partners) is liable for the assessment. However, a partnership may be eligible to make a "push-out" election to require the affected partners (which may include former partners) to take into account the adjustments and pay any taxes due as a result of those adjustments, provided that the necessary information is provided to the IRS. In addition, the entity-level assessment may be reduced if a partner files an amended return for the reviewed year taking into account any adjustments properly allocated to such partner and paying any taxes due as a result of such adjustments.

- *Partnerships should consider including language in their governing documents to address* *the economic burden of an assessment under the new regime, including the ability of the partnership to make a "push-out" election and obligations of the partners (including former partners) to provide information to the partnership and to indemnify the partnership for assessments properly allocable to the partner.*

- *Further, purchasers of partnership interests should consider negotiating for indemnification from the transferor for assessments attributable to periods prior to the purchaser's acquisition of the partnership interest.*

Partnership Representative

Under the new audit regime, the "partnership representative" has sole authority to act on behalf of the partnership. All partners are bound by the actions of the partnership representative, and partners have no statutory right to receive notice of or to participate in the partnership-level proceedings. This is a significant change from the TEFRA procedures, under which partners generally retained notification and participation rights in partnership-level proceedings.

Unlike the tax matters partner under TEFRA, the partnership representative can be any individual or entity that has a substantial presence in the United States and need not be a partner of the partnership. Accordingly, under the new regime, partnerships have greater flexibility in selecting a partnership representative.

- *Partnerships should consider whether their governing documents should be updated to designate a partnership representative. Partnerships should carefully consider the appropriate person to serve as partnership representative.*
- *Partnerships should consider including contractual limitations on the partnership representative's actions. Although neither the partnership nor the partners can limit the ability of the partnership representative to act before the IRS, provisions in the partnership agreement can provide contractual protections for partners (such as notification and consent rights) that would allow affected partners to bring a claim for damages if the partnership representative exceeds the authority set forth in the partnership agreement.*

Eligible Partnerships May Elect Out

Partnerships with 100 or fewer partners, all of which are eligible partners (i.e., individuals, C corporations, eligible foreign entities, S corporations and estates of deceased partners), may be eligible to elect out of the new partnership audit regime. If an eligible partnership elects out of the new regime, the partnership will be subject to the pre-TEFRA audit procedures under which the IRS must separately assess any tax deficiency against each partner. Importantly, the election out of the new regime must be made on a timely filed federal income tax return of the partnership for each year for which the election is to be effective.

Partnerships with more than 100 partners or with partners that are partnerships, disregarded entities or trusts are not currently eligible to elect out. Unlike under TEFRA, small partnerships are not automatically exempt. If a partnership takes no action, the new regime will automatically apply.

- *Partnerships that wish to elect out of the new regime should analyze the status of their* *partners to ensure that the partnership qualifies to make the election and should consider whether provisions regarding the election should be included in the partnership's governing documents.*

What Now?

Partnerships should consider amending their partnership agreements to reflect the new audit regime.

- *Amending the partnership agreement solely to address the new audit regime is likely not necessary for most partnerships until an audit of the partnership is imminent or the partnership amends a federal income tax return filed for a taxable year beginning after the effective date of the new regime. However, it is advisable to amend the partnership agreement sooner rather than later so as to avoid disputes that may arise in the context of an audit or amended return and to designate a partnership representative.*
- *Partnerships that are otherwise amending their partnership agreements for non-tax reasons should consider whether to address the new audit procedures at that time.*
- *We would strongly recommend that partnerships amend their partnership agreements to address the new audit procedures prior to any (i) transfer of interests, (ii) admissions of new partners, (iii) withdrawals of existing partners or (iv) other circumstances in which the interests of partners change.*

A member of the Tax Group can assist you in evaluating the timing of amending your partnership agreement and determining the content of any amendments.

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