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TAX ALERT

New Centralized Partnership Audit Regime Impacts All Partnerships and Multimember LLCs

By Christopher M. Armstrong

In late 2015, Congress passed the Bipartisan Budget Act of 2015 (BBA), which established a new federal partnership audit regime and prospectively repealed the partnership audit rules set forth in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The BBA significantly enhanced the IRS's ability to audit partnerships (including multimember LLCs). As a result, the new federal partnership audit rules, which are effective as of January 1, 2018, will have significant implications for partnerships and their partners and for multimember LLCs and their members.

The following Q&A helps explain the new partnership audit regime and the steps that all owners of partnerships and multimember LLCs need to consider immediately, if they haven't done so already.

Who should be concerned about the new partnership audit rules?

All owners of partnerships (i.e., partnerships and multimember LLCs) need to be concerned with the new partnership audit regime.

I have a three-person partnership that has always qualified for the "small partnership" exception under TEFRA. Why should I worry about this?

Although the TEFRA partnership rules didn't apply to small partnerships that came within the small partnership exception (i.e., those with 10 or fewer partners consisting only of U.S. persons, resident aliens, C corporations or estates of deceased partners), the new partnership audit regime applies to partnerships of *all* sizes and even if a partnership qualifies to "opt out" (as discussed below) the partnership needs to make an annual election (compared to a small partnership under TEFRA which didn't have to do anything to be exempt from the TEFRA rules).

Ok, so I should care — what really changed?

In general, under TEFRA, audits were conducted at the partnership level (meaning the partnership is the subject of the audit as opposed to the individual partners), any adjustments were paid at the partner level (meaning the partners are responsible for paying any assessment), and

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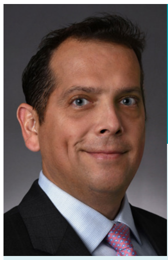

who's who

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partners were granted statutory information and participation rights in the audit and appeals process.

Under the BBA, audits will occur at the partnership level and all adjustments (subject to certain limited exceptions) will be calculated and paid by the partnership in the year of assessment (not the tax year under review as was the case under TEFRA). In addition, unlike the prior TEFRA rules, *partners are not granted information or participation rights in the audit or appeals process.*

Who controls the audit?

Under TEFRA, the "tax matters partner," a partner designated by the partnership, coordinated the audit and any judicial proceedings relating thereto but the other partners in the partnership had notice rights and had the right to participate in any audit or judicial proceeding (including the right to settle with the IRS separately).

Under the BBA, the partnership must designate a partnership representative — or PR — for each tax year. If the PR is an entity, the partnership is required to select a "designated individual" who will be the only person authorized to deal with the IRS on behalf of the PR and the partnership. The PR has the statutory right to control all aspects of the audit and any appeal, and is the only person empowered to deal with the IRS (individual partners may not participate in the audit).

The PR does not need to be a partner in the partnership, unlike under TEFRA where the "tax matters partner" had to be a partner. Additionally, if a partnership fails to designate a PR, the IRS can select *any person* for the role.

How is an audit adjustment paid?

In general, the partnership will be responsible for paying any income tax, interest and penalties that arise from an IRS audit for any tax year beginning on or after January 1, 2018. However, the partnership may elect to "push out" any final partnership adjustment to the partners of the "reviewed year" (i.e., the year that is the subject of the audit) if the election is made within 45 days of the issuance of a final partnership adjustment. This prevents the current partners from bearing the economic burden of paying for a tax liability that is properly attributable to former partners.

I have heard I can "opt out" of these rules. Is that true?

In order to "opt out" of the new partnership audit rules, a partnership must have 100 or fewer partners and the partners must either be individuals, S corporations, C corporations, eligible foreign entities (i.e., foreign entities that would be treated as C corporations if they were domestic) or an estate of a deceased partner. The majority of tax advisers have concluded that if a partnership can "opt out" of the new audit rules, then it should. The "opt out" election must be made *each year* with a timely filed partnership tax return and the partnership must disclose *each year* the names, correct TINs, and federal tax classifications of all partners of the partnership and, if there is an S corporation partner, the names, correct TINs, and federal tax classifications of all persons to whom such S corporation partner is required to furnish a Schedule K-1.

Given these new partnership audit rules, what changes should I consider making to my partnership or operating agreement?

Given that a PR has the sole authority to represent the partnership in an audit and that the partnership and all partners are bound by the PR's decisions, there are a number of changes to partnership or operating agreements, as applicable, that should be considered as a result of the new partnership audit rules. For all new or existing partnership or operating agreements, consider provisions for:

1. Appointing a PR.
2. Removing a PR.
3. Appointing a "designated individual" if the PR is an entity.
4. Requiring the PR to give all partners notice of any audit (under the BBA there are no notice requirements).
5. Contractually limiting the PR's authority to bind the partnership and the partners, including consent rights to any election or settlement. (Note that this will not be respected by the IRS, but it will provide the partners with some say in how an audit is handled and what the recourse will be in the event the contractual limitation is breached.)
6. Requiring the PR to make the 45-day "push out" election.
7. Requiring the partnership to "opt out" of the new partnership audit rules.
8. Restricting transfers of interests to entities that are not eligible partners (for those that "opt out" of the new partnership audit rules).
9. Indemnifying the PR, and reimbursement for expenses.
10. Duties of the PR.
11. Duties of the partners to provide the PR with any information regarding their individual tax returns and liabilities that may be relevant to an audit.
12. Duties of the partners to inform the partnership if they take positions on their individual tax returns relating to partnership items that are inconsistent with the partnership's tax return.
13. Duties of partners that are S corporations to annually provide the partnership with the shareholder information required for the "opt out" election.
14. Recourse against former partners for tax assessed for a year during which they were a partner.

Conclusion

The Q&A above highlights some of the major changes to the partnership audit rules and in no way represents a comprehensive analysis. It should be clear, though, that the new partnership audit rules require more than a simple tweak to a partnership agreement or operating agreement to appoint a PR. Careful consideration should be given to several elements of the partnership agreement or operating agreement and the partnership's specific facts and circumstances to deal with the new partnership audit rules and their impact on the partnership and all of the partners.

Please feel free to contact a member of our Tax group to discuss the best ways to deal with the new partnership audit rules in your partnership agreement or operating agreement.