HARRIS ▪ WINICK ▪ HARRIS LLP

December 2, 2015

CLIENT ALERT

NEW PARTNERSHIP AUDIT RULES: THE IMPLICATIONS FOR PARTNERSHIPS AND THEIR ADVISORS

Overview

The Bipartisan Budget Act of 2015 (the "Act") was signed into law on November 2, 2015, and among other provisions, includes new partnership audit rules intended to make it easier for the IRS to collect tax liabilities resulting from partnership audits.

The new partnership audit rules fundamentally change the manner in which the IRS conducts audits of partnerships and collects resulting tax liabilities. Historically, partnerships (including limited liability companies taxed as partnerships) have been treated under the Federal income tax law as flow-through entities. Accordingly, a partnership does not directly incur tax liability and instead items of partnership income, gain, loss, deduction and credit flow through to, and are taxed in the hands of, the partners. This has been true not only for items reported on the partnership's originally filed and amended tax returns, but also for audit adjustments of partnership items as determined by the IRS.

The new partnership audit regime changes the historic treatment of partnerships under the Federal income tax law, and imposes liability for tax resulting from audit adjustments directly on the partnership. Because the persons owning interests in a partnership may have changed between the year in which the partnership items were first reported (the "reviewed year") and the year in which the items are finally adjusted (the "adjustment year"), the new partnership audit regime may significantly impact the economic position of former and current partners. As discussed below, unless an eligible partnership makes an election to opt-out of the new partnership audit regime, the new rules in general shift the economic burden of audit adjustments of partnership items from the partners who were originally allocated and reported the items on their returns to those partners who own the partnership at the time of the adjustment. In addition, because the audit rules create the potential for partnership level tax liabilities with respect to prior year audit adjustments, parties in the merger and acquisition context will now have to consider who bears economic responsibility for pre-closing period partnership liabilities, as well as who controls proceedings with respect to prior periods and related issues.

Importantly, the new partnership audit rules are effective for tax years commencing on or after January 1, 2018 unless the partnership affirmatively elects to apply the new rules sooner. This means that partnerships and their advisors should have the necessary time to consider the impact of the new audit procedures and, as appropriate, amendment of existing partnership agreements to address the economic and procedural implications of the new rules.

Background—Existing Audit Regimes

Effective for tax years commencing on or after January 1, 2018, the Act repeals the existing audit procedures for partnerships and replaces them with a single unified standard. Under prior law, three different regimes existed for auditing partnerships:

- *TEFRA Rules.*

For partnerships with more than 10 partners, the IRS conducted a single audit proceeding under TEFRA (the Tax Equity and Fiscal Responsibility Act of 1982). Under the TEFRA rules, the IRS determined the tax treatment of so-called "partnership items" at the partnership level, but was then required to assess each audited year partner based on the partner's share of the adjustment. A partnership subject to TEFRA designated a tax matters partner to act as its representative in the IRS proceedings; however, partners of the partnership also had certain notice and participation rights with respect to the proceeding.

- *Electing Large Partnership ("ELP") Rules.*

A second audit regime applied to partnerships with 100 or more partners that elected to be treated as so-called electing large partnerships for reporting and audit purposes. Under the ELP rules, unlike the TEFRA rules, partnership audit adjustments generally flowed through to the partners for the year in which the adjustment took effect, rather than the year under audit. Thus, under the ELP regime (in contrast to the TEFRA rules), adjustment of partnerships items did not generally affect the prior year returns of any partners.

- *Rules Governing Certain Small Partnerships.*

In the case of certain small partnerships not subject to the TEFRA or the ELP rules, i.e. partnerships with 10 or fewer partners, adjustments to partnership items were determined in separate proceedings for each partner under the same IRS audit procedures that apply generally to individuals.

The Act's New Partnership Audit Regime

Default Rule: Partnership Level Tax Determined at the Maximum Statutory Rate

Under the Act, partnerships are subject to a default audit regime unless the partnership is eligible to elect out of the regime and timely makes the election as further described below. Under the new default audit rules, the IRS will conduct audits, and determine adjustments to items of partnership income, gain, loss, deduction or credit, at the partnership level. There is no distinction between partnership items and non-partnership items as under TEFRA.

Under the default audit rules, the tax liability resulting from partnership audit adjustments will be assessed and collected at the partnership level. Specifically, the tax liability resulting from a partnership level adjustment with respect to an audited tax year (the "imputed underpayment") is (i) calculated using the maximum statutory income tax rate (i.e. the highest individual or corporate income tax rate in effect for the year under examination) and (ii) assessed against and collected from the partnership in the year that such audit (or judicial review) is completed. The partnership is also directly liable for any related penalties and interest, calculated as if the partnership had been originally liable for the tax in the audited year. In contrast to an earlier version of the Act, partners are <u>not</u> subject to joint and several liability for partnership level adjustments under the new rules.

Election Out

The new law provides that, in any taxable year, partnerships with 100 or fewer partners, all of whom qualify under the new rules, will be permitted to elect out of the default regime. If a partnership elects to opt-out of the new rules, then, as under the existing small partnership regime, audits and related judicial proceedings for such taxable year will be conducted (and any resulting assessments will be made) at the partner level, applying the same IRS audit procedures that generally apply to individuals. The election is required to be made on an annual basis on a timely filed partnership return.

For purposes of the opt-out election, qualifying partners include a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation (counting the shareholders of an S corporation partner as partners of the partnership for purposes of the 100 partner limit), and the estate of a deceased partner. Partnerships and trusts, however, are <u>not</u> treated as qualifying partners for purposes of the opt-out election. Accordingly, in a fund of funds structure, or other tiered partnership structure, any lower tier partnership with an upper tier partnership as a partner would appear not to be eligible to elect out of the new partnership audit procedures. In this regard, the Act provides that the IRS *may*, in the case of other partners (which may include partnerships) prescribe look-through rules similar to those for S corporations. Of course, until the IRS issues such guidance relaxing the requirement that an electing partnership not have any partnerships as partners, the availability of the opt-out election will be limited in the tiered partnership context.

Mechanism for Reducing Imputed Underpayment Under Default Regime

The new law authorizes the IRS to prescribe regulations that will allow a partnership to reduce the imputed underpayment amount by demonstrating that (i) partners filed amended returns and made related tax payments with respect to the reviewed year (taking into account partnership items properly allocable to such partners), (ii) a portion of the adjustment is attributable to one or more partners with reduced rates of tax (e.g. tax exempt entities), or (iii) the income subject to adjustment (e.g. ordinary income, dividends and capital gains) is subject to a lower rate of tax. The scope of the foregoing reductions, as well as the identification of other factors that may result in a decrease in the amount of the imputed underpayment, will be addressed by the Treasury in forthcoming regulations or other guidance.

It is important to note that partnership adjustments that involve a reallocation of a partnership item from one partner to another are generally not "netted" for purposes of calculating the amount of the imputed underpayment. Instead, in the case of an adjustment resulting from a reallocation of the distributive share of any item from one partner to another, the Act provides that any decrease in an item of income or gain (or any increase in an item of deduction, loss or credit) will be disregarded in computing the imputed underpayment amount. This "no netting" rule may lead to situations where income of the partnership is taxed more than once. For example, where a partnership incurs the entity level tax on an item of income or gain reallocated to a partner under the default regime, but the corresponding decrease in income or gain allocable to another partner is not taken into account (either by the partner's filing of an amended return or otherwise), the same item of income would appear to be subject to tax twice—once at the partnership level and again in the hands of the partner who reported the income on his return.

Alternative Procedure

The Act provides an alternative procedure which permits a partnership to avoid the assessment of liability at the partnership level, and instead shift the tax liability attributable to partnership audit adjustments to the partners who were partners of the partnership during the tax year to which the audit adjustment relates. Under the alternative procedure, a partnership must elect to issue adjusted Schedule K-1s to each of the reviewed year partners (and the IRS) setting forth such partners' share of any partnership adjustments. The partners must then take any such adjustment into account on their individual returns *for the year* in which they receive the adjusted Schedule K-1s. The amount of the additional tax liability of a partner will be based in general as if the adjustment had been reported on the partner's original K-1. The Act specifies that the partnership must elect this alternative procedure within 45 days after the IRS issues a notice of final partnership adjustment, and once made, any such election is revocable only with the consent of the IRS.

Although the alternative procedure allows a partnership to pass through adjustments to its partners in a manner similar to TEFRA, because the partnership (and not the IRS) is required under the alternative procedure to determine how the partnership audit adjustments flow through to the partners, a partnership (particularly one with many partners) electing the alternative regime may encounter the same administrative complexity and difficulty that the IRS experienced in auditing large partnerships (and which led in part to the enactment of the new partnership audit rules).

Certain Procedural Changes

Under the Act, the former "tax matters partner" designation has been repealed and is replaced with the role of "partnership representative." Existing partnership agreements will thus need to be amended to identify the person serving in this new role. A person acting as "partnership representative" does not need to be a partner in the partnership, but such person must have a substantial presence in the United States. In the event the partnership fails to designate a partnership representative, the IRS may select any person to occupy the role.

The "partnership representative" has the sole authority to act on behalf of the partnership in an audit proceeding. Actions taken by the partnership representative under the new rules will bind both the partnership and the partners with respect to the audit proceeding. Moreover, in contrast to the TEFRA rules, the IRS no longer is required to notify partners of the partnership audit and adjustments, and partners likewise no longer possess rights to participate in the partnership audit or related judicial proceedings.

Despite the extremely broad powers granted to the "partnership representative" under the Act, partners in existing and newly formed partnerships will need to consider whether the partnership agreement should provide that the "partnership representative' is required to provide notice, or obtain the consent of the partners with respect to certain decisions, before the partnership representative may act on behalf of the partnership in an IRS audit or related proceedings. Although any contractual obligation expressed in the partnership agreement would appear not to cause the partnership representative to lose the power granted under the Act to bind the partnership and the partners in the audit proceedings, it would provide the partners with potential recourse under the partnership agreement in the event the partnership representative acted in breach of his contractual obligations.

Implications of the New Partnership Audit Regime

As noted above, the new partnership audit rules are effective for tax years commencing on or after January 1, 2018 unless the partnership affirmatively elects to apply the new rules sooner. Because of the delayed effective date of the new rules, partnerships and their advisors have much needed time to consider the impact of the new audit procedures both with respect to existing and newly formed partnerships and the agreements that govern these entities.

There are a wide range of issues that partnerships and their advisors will need to focus on in light of the new partnership audit procedures, including:

- Should the partnership, if eligible, be obligated under the partnership agreement to make (or be prohibited from making) the small partnership "opt-out" election? Should the partnership agreement expressly prohibit the transfer of interests to persons who would cause the partnership to be ineligible to make the small partnership opt-out election?

- In the case of a partnership subject to the default audit regime (either because the partnership fails to elect out or is ineligible to do so), will the partnership be liable for the imputed underpayment or instead should the partnership be required under the partnership agreement to elect the alternative procedure and flow through audit adjustments to the partners on adjusted Schedule K-1s? Who has the authority to make this determination under the partnership agreement?

- If the partnership is subject to the default audit regime, and is liable for the imputed underpayment amount at the partnership level, to what extent should the partnership agreement obligate existing or former partners to provide information or take action that may reduce or eliminate partnership level tax liability? For example, should partners be required to file amended returns and pay tax resulting from their share of partnership adjustments to reduce the imputed underpayment? If the partnership agreement requires the partners to file amended returns and pay any resulting tax liability, should the partnership agreement contain an indemnity, holdback from distributions and/or other remedies to protect the partnership and its other partners from a partner's failure to comply with the partnership agreement?

- More generally, in the case of a partnership subject to the default audit regime, should the partnership agreement contractually obligate former partners, or partners whose interests in the partnership have changed, to indemnify or otherwise reimburse the partnership for the partnership level liability resulting from adjustments to earlier year returns?

- To what extent should the partnership agreement limit the power of the "partnership representative" to bind the partnership in audits and related proceedings without notice or consent of the partners?

The foregoing are only some of the many issues that should be considered in reviewing existing partnership agreements and in entering into new agreements in light of the new audit procedures.

****

If you have any questions about this Client Alert, please feel free to directly contact Ken Harris at (312)-662-4620 (kharris@hwhlegal.com) or Bob Bedore at (312)-662-4625 (rbedore@hwhlegal.com).