Partnership Audit Regime Shakeup

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THE RECENT Bipartisan Budget Act of 2015 (the "Act") sets forth a new tax audit regime for partnerships (and limited liability companies taxed as partnerships) that will have far-reaching consequences. The regime is expected to substantially increase the number of partnership audits and to generate billions of dollars in additional tax revenue. The new audit procedures will become applicable for partnership tax years beginning on or after January 1, 2018 (though it is possible for partnerships to opt into portions of the new procedures earlier).

The new regime clearly is designed to make it easier for the Internal Revenue Service (the "IRS") to audit partnerships and replaces the audit procedures that were established by the 1982 Tax Equity and Fiscal Responsibility Act ("TEFRA"). The new procedures allow the IRS to determine any audit adjustment at the partnership level and to assess and collect tax from any such adjustment at the partnership, rather than the partner, level. This is a significant change in partnership tax law as it subjects the partnership itself to potential direct federal income tax liability. In addition, the new procedures will severely limit the ability of partners to participate in and influence audit proceedings with respect to partnerships, unless they have negotiated for those rights in the partnership agreement. The new regime likely will require updating existing partnership agreements and will affect the drafting of new partnership agreements. Some drafting considerations are discussed below; however, the full scope of changes to be made to partnership agreements is uncertain, pending the issuance of guidance and regulations by the IRS. While

some guidance is expected in the coming months, regulations may not be issued for some time.

LIMITED OPT-OUT FOR CERTAIN PARTNERSHIPS • The Act does allow for certain smaller partnerships with "eligible partners" to opt-out of the new regime on a year-by-year basis. Specifically, partnerships with 100 or fewer eligible partners during a tax year may elect out of the new regime for that year by making an election with the partnership's timely filed tax return for the year. Eligible partners are limited to individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, and estates of deceased partners. The IRS also has the ability to add to this list of eligible partners through the still-to-be-issued regulations.

Notably absent from the list of eligible partners are other partnerships, removing the possibility of opting out for the lower tiers of any tiered partnerships. In addition, if an S corporation is a partner, each of its shareholders is counted as a partner in determining whether the partnership has 100 or fewer partners. It is currently unclear whether a single-member LLC that is disregarded for tax purposes could be an eligible partner for these purposes.

Depending on the circumstances, partnerships may wish to mandate or preclude this election to opt-out of the new regime in their partnership agreements. If a partnership intends to make this election on an annual basis, it may also want to allow transfers of partnership interests only to persons who would be eligible partners, in order to ensure the partnership's continuing eligibility for the election.

DEFAULT RULES FOR PARTNERSHIP TAX YEARS BEGINNING ON OR AFTER JANUARY 1, 2018 • In a material change from TEFRA, under the new regime's default rules, partners do not have the right to participate in an IRS audit of partnership tax years beginning on or after January 1, 2018. Due to this change, partners may wish to seek contractual rights in their partnership agreements similar to the statutory rights that partners had under TEFRA, such as rights to notice and participation in these audit proceedings. Under the Act, a partnership must designate a "partnership representative" to act as the sole representative of the partnership for purposes of an IRS audit. This concept is similar to the "tax matters partner" under TEFRA, but there are significant differences. For example, the partnership representative does not have to be a partner in the partnership. Partnership agreements should address how the partnership representative is to be selected and removed.

In another significant change from the current TEFRA regime, any tax liability resulting from a partnership audit will be a partnership tax liability. Because audits under the new regime will determine liability at the partnership level, new partners could be responsible for a partnership tax liability that relates to a tax period that ended before those partners entered into the partnership. To address this issue, partners should consider including provisions in their partnership agreements that specify how the burden of potential partnership tax liabilities will be allocated among current and former partners. Partners may also want indemnification provisions in partnership agreements, binding on current and former partners that address responsibility for such liabilities. Further, transferor and transferee partners may wish to include in their transfer documents provisions that address the allocation between them of responsibility to the partnership for any potential partnership tax liability.

Under the Act, the tax liability resulting from a partnership audit, referred to as the "imputed underpayment of tax," is determined by netting all adjusted tax items and multiplying this net amount by the highest tax rate in effect for the tax year subject to the audit, referred to as the "reviewed year." The imputed underpayment of tax can be reduced

if one or more partners file amended tax returns and pay the corresponding tax. The partnership may wish to address this in its partnership agreement by either requiring partners to file, or preventing partners from filing, such amended returns.

The partnership can also have the imputed underpayment of tax reduced by demonstrating partner specific information—for example, by demonstrating that a certain amount is allocable to tax-exempt partners. Thus, partnership agreements should require the partners' cooperation in providing such information to the partnership. While these procedures under the Act could be helpful, currently it is not clear what partner-specific information will be required to support a reduction of the partnership's tax liability. This process could be further complicated if any partners have exited the partnership since the reviewed year. Much of how these procedures will work in practice still needs to be fleshed out by the IRS through regulations or other guidance.

ALTERNATIVE PROCEDURE UNDER THE NEW REGIME • To avoid tax liability at the partnership level, a partnership can elect an alternative procedure under the new regime. Such an election is made not later than 45 days after the date of the notice of final partnership audit adjustment. If a partnership makes this election, the partnership must furnish to the IRS, and to each of its partners for the reviewed year, a statement (likely similar to a K-1) that allocates the audit adjustment among the partners. The partner (or former partner) would then be responsible for calculating and paying the resulting tax liability in the year the statements are furnished, taking into account any tax attributes such partner (or former partner) had during the reviewed year. If this alternative procedure is elected, the underpayment interest rate is increased by two percentage points, adding to the cost borne by the partners. As with the opt-out election discussed above, partners may wish to mandate or preclude this election in their partnership agreements.

This alternative procedure is similar to TEFRA in the sense that partners now become liable for the tax liability that results from an IRS audit of a partnership. However, a fundamental difference from TEFRA is that the partnership, not the IRS, is responsible for determining the allocation of liability among the partners. This relieves the IRS from having to determine the appropriate allocation of partnership tax items among partners, placing this burden on the partnership itself.

STATE TAX CONSIDERATIONS • Because most states' tax laws conform to the Internal Revenue Code for purposes of determining taxable income, but not for purposes of administrative procedures, the impact of the Act on state tax laws could be significant and complex. For example, it is currently unclear how the default rules, which can create a partnership-level tax liability that is placed on current year partners (even though the liability relates to partnership allocations from prior years), would interact with state tax laws. Ultimately, there could be a disconnect between how the IRS and state revenue departments collect taxes from partners and partnerships. States, therefore, may need to enact new legislation or regulations, or be unable to effectively react to the Act.

CONCLUSION • As noted above, much of the implementation of the new audit procedures will depend on future guidance and regulations from the IRS. The Act gives the IRS great flexibility to both interpret and add to the new audit procedures through regulations. The IRS is expected to issue limited guidance in the coming months, but is unlikely to issue proposed regulations until much later. Nevertheless, careful consideration should be given now to how existing and new partnership agreements should be amended or drafted.