Imminent changes to tax partnership audit rules: action steps

US Tax Alert

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To more easily audit and assess tax against entities taxed as partnerships (which includes most limited liability companies, or LLCs), Congress passed the Bipartisan Budget Act of 2015 (the “BBA”). The BBA completely overhauled the rules for auditing tax partnerships (the “BBA Rules”), effective for tax years beginning on or after January 1, 2018, which is less than five months from now.

The IRS recently issued proposed regulations implementing the BBA Rules. Because these new rules are likely to cause an increase in the number of partnership audits, we urge tax partnerships, and their partners or members, to consider the effect of the BBA Rules and amend their partnership/operating agreements as necessary before the rules become effective.

This alert provides a high-level summary of the changes effectuated by the BBA Rules and outlines some of the implications of these changes for entities taxed as partnerships.

First significant change: assessment of tax at the partnership (not partner) level

- **Current law.** Under current law, an IRS examination of “partnership items” takes place at the partnership level. However, once the IRS makes an adjustment to a partnership item, the IRS must proceed against the individual...
partners that held an interest in the partnership in the year under review, and collect any tax liability (including interest and penalties) from the affected partner(s).

- **Changes under the BBA Rules.** Under the BBA Rules, the IRS will continue to examine partnership items and make any adjustments at the partnership level. However, under the BBA Rules, if the adjustment results in an underpayment of tax (an "imputed underpayment"), the IRS will assess and collect the imputed underpayment (including interest and penalties) from the partnership itself (and not the individual partners). This is a significant change because partnerships have never before been required to pay federal tax at the partnership level. Moreover, while any IRS adjustments and imputed underpayment will relate to the tax year being reviewed (the "reviewed year"), the imputed underpayment is actually assessed and collected from the partnership in the year that such audit is completed (the "adjustment year"). The BBA Rules therefore result in partners during the adjustment year bearing the economic burden of the assessment, not those who were partners during the reviewed year, unless the partnership agreement reallocates that burden.

- **Options for reducing amount of imputed underpayment.** A partnership can reduce the amount of imputed underpayment it must pay to the extent (i) a partner files an amended return for the tax year at issue reflecting its share of the partnership level adjustments, and the resulting tax is paid by the partner, or (ii) the partnership can demonstrate that part of the underpayment is allocable to a tax-exempt partner, a C corporation (which generally pay a lower rate of tax on ordinary income than individuals), or individuals (in the case of capital gains subject to reduced rates of tax).

- **Limited options for avoiding application of the BBA Rules.** A very limited exception from the BBA Rules permits certain "small" partnerships to elect annually to opt out of the BBA Rules entirely (the "opt-out election"). A "small" partnership must have 100 or fewer partners, and must be composed entirely of individuals, C-corporations, S-corporations, foreign entities treated as a C-corporations, or estates of deceased partners. The opt-out election is unavailable to a partnership that has a flow-through entity as a partner (such as another partnership or LLC). It is important to note that even partnerships making the opt-out election must appoint a partnership representative (discussed below). A second election, the "push-out election," permits a partnership that has not made the opt-out election to avoid paying the imputed underpayment by transferring that liability to its partners. A partnership making the push-out election must furnish a statement to both the IRS and each of the partners during the reviewed year that reflects such partner's distributive share of any resulting adjustment from the partnership audit. In effect, the push-out election transfers the imputed underpayment to its historic partners.

**Second significant change: “partnership representative” replaces the “tax matters partner”**

- **Current law.** Under the current rules, a partnership must appoint a partner to serve as the partnership's "tax matters partner." The tax matters partner has very limited authority to act on a partnership's behalf, and other partners continue to have the right to participate in partnership audit proceedings before the IRS.

- **Changes under the BBA Rules.** The BBA Rules replace the tax matters partner and require each partnership to appoint a "partnership representative." The partnership representative has wide authority to act on behalf of the partnership before the IRS. The partnership representative (i) may bind the partnership and the partners with respect to partnership audits and other proceedings, including the authority to extend the statute of limitations, to proceed to litigation, or to make the push-out election on behalf of the partnership, but (ii) has no legal obligation to notify partners of an audit or to keep partners updated on the status of an audit. Importantly, the partnership representative need not to be a partner of the partnership. If a partnership does not designate a partnership representative the IRS may select any person as the partnership representative.

**Addressing the BBA Rules in partnership agreements: consider these action steps**

The changes made to the partnership audit regime under the BBA Rules are significant. Entities that are taxed as partnerships should consider whether to make changes to their partnership or operating agreements to address these changes (and newly formed entities should consider adopting similar provisions at the outset), including:

- Establishing how, whether, and under what circumstances to make the opt-out election or push-out election, and where such an election is not made, providing for indemnification from historic partners for tax, interest, or penalties that may arise in a reviewed year. Presumably these decision should not be left in the hands of the partnership representative by default.

- If a partnership decides to make the opt-out election or wants to maintain its eligibility for that election in the
future, the partnership agreement should consider restrictions on transfers of partnership interests to non-qualifying partners (such as other tax partnerships).

- As noted above, imputed underpayments are collected in adjustment years, but relate to adjustments arising in reviewed years, which means that the tax burden relating to an audit could be imposed on partners who were not partners during the reviewed year. Partnership agreements should consider providing recourse against former partners for tax assessed for a year during which they were a partner.

- Given the wide authority of the partnership representative, the partnership agreement should set out how the partnership representative is elected and removed, and should consider limitations on the partnership representative, for example, (i) requiring the partnership representative to give notice of audits and assessments, or (ii) limiting the partnership representative’s discretion in settling an audit or extending the statute of limitations, potentially by requiring that a certain percentage of the partners agree to those actions before they are taken.

**Election available to apply BBA Rules earlier**

While the BBA Rules generally are effective for tax years beginning on or after January 1, 2018, the BBA does allow partnerships to elect to apply the BBA Rules to any partnership returns filed for tax years beginning after November 2, 2015, and before January 1, 2018 (a “BBA-eligible tax year”). This election may be made either on IRS Form 7036 or on a written statement prepared by the partnership meeting certain requirements.

If the IRS informs a partnership that it is being audited for a BBA-eligible tax year, the partnership and its partners should consider whether an election to apply the BBA Rules would be beneficial, and if so, confirm whether the partnership agreement permits such an election and who has the authority to make the election.

The BBA Rules represent a sea change in the partnership audit regime. As you consider the implications of the BBA Rules, questions will inevitably arise. Those questions may be addressed to Tom Geraghty or Stacy Paz.

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