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CLIENT ALERT

**NEW PARTNERSHIP AUDIT RULES:
THE IMPACT ON EXISTING PARTNERSHIP AND LIMITED LIABILITY
COMPANY AGREEMENTS**

The new partnership audit rules adopted as part of the Bipartisan Budget Act of 2015 (the “New Rules”) make significant changes to the manner in which partnerships and limited liability companies (“LLCs”) taxed as partnerships will be audited by the Internal Revenue Service (the “IRS”), and the manner in which tax will be assessed in the event that the IRS requires an adjustment for an underpayment. All partnership agreements and the operating or other organizational agreements of LLCs taxed as partnerships should be reviewed and revised to reflect the New Rules. LLCs taxed as corporations, and single member limited liability companies, should not be impacted by the New Rules.

Following is a summary of some of the key changes made by the New Rules:

The Partnership Representative

The New Rules replace the position of “Tax Matters Partner” with a “Partnership Representative” and endow the Partnership Representative with significantly more independence and authority to act on behalf of the partnership or LLC taxed as a partnership in IRS audit proceedings, than the Tax Matters Partner had.

- Under the New Rules, only the Partnership Representative will receive notice from the IRS of audit proceedings. In contrast, under prior law, all partners or members (“Notice Partners”) with a 1% or greater profits interest, and all partners or members in an entity with one hundred or fewer members, were entitled to notice.

- Under the New Rules, the Partnership Representative has exclusive control over IRS audit proceedings. In contrast, under prior law, the Notice Partners were generally entitled to contest IRS audit proceedings if the Tax Matters Partner failed to do so, and to participate in any contested proceeding initiated by the Tax Matters Partner.

If a partnership or LLC taxed as a partnership fails to appoint a Partnership Representative, the IRS may do so. Accordingly, all partnership agreements and the agreements of LLCs taxed as partnerships should be revised to appoint a Partnership Representative in a manner agreed upon by the partners or members. In order to maintain more oversight by the partners and members, the agreements of partnerships and LLCs taxed as partnerships might also impose notice, consultation and consent requirements on the Partnership Representative. For example, the Partnership Representative might be required to forward copies of IRS notices to other partners and members, to keep them informed of IRS proceedings, and to consult with or obtain the consent from the partners or members before taking specified actions.

Partnership Audit Adjustments

Calculation of Underpayment Liability: Under the New Rules, liability for IRS adjustments to tax (including interest and penalties) lies with the partnership or LLC taxed as a partnership, unless certain elections or other steps are taken. The underpayment liability will generally be calculated by netting all audit adjustments and multiplying the net underreported income by the highest marginal U.S. federal income tax rate (currently 39.6%), regardless of the actual tax rates applicable to the partners and members. No adjustments in tax are made to reflect adjustments to the distributive shares of partners or members resulting from the IRS assessment.

Responsibility for Underpayment: Under the New Rules, the payment is made for the tax year of the IRS adjustment (the “adjustment year”), rather than the tax year under review (the “reviewed year”). This means that the economic burden of an IRS adjustment will fall on the parties who are partners and members during the adjustment year, rather than on those who were partners and members during the reviewed year.

Elections and Options

Opt-Out Election: Certain partnerships and LLCs taxed as partnerships may elect out of the New Rules entirely. Opt-out elections are made annually, on the entity's partnership tax return. The opt-out election is only available to entities with one hundred or fewer partners or members, if each partner or member is an individual or the estate of a deceased partner, a subchapter C corporation, or a foreign entity that would be treated as a C corporation if domestic, or a subchapter S corporation if each subchapter S corporation shareholder is identified to the IRS and counted toward the one hundred partner or member limit.

Push-Up Election: Within forty-five (45) days of the date of an IRS notice of final partnership adjustment, a partnership or LLC taxed as a partnership may also make a "push-up" election and issue adjusted K-1s to the partners or members. This will have the effect of transferring the IRS underpayment liability from the partnership or LLC taxed as a partnership to the partners or members.

Alternative to Push-Up Election: The New Rules require the United States Department of the Treasury to establish procedures that will relieve a partnership or LLC taxed as a partnership of liability if the partners or members file amended tax returns for the reviewed year and pay what is owed within two hundred seventy (270) days of the IRS notice of proposed partnership level adjustment, based on adjusted K-1s issued by the partnership or LLC to the partners or members.

Treasury Procedures and Regulations

The New Rules require Treasury procedures to be adopted in a number of other areas, including adjustments to IRS underpayment assessments that might be permitted in order to reflect the tax-exempt status of income allocable to tax-exempt partners and members. Other Treasury procedures and regulations implementing the New Rules may also be issued.

Effective Date

The "Tax Matters Partner" provisions of the Internal Revenue Code were repealed with the adoption of the New Rules. The remainder of the New Rules will generally apply to IRS audits of partnership tax returns for 2018 and subsequent tax years. However, partnerships and LLCs taxed as partnerships may affirmatively elect to have the New Rules apply for the 2015-2017 tax years.

Going Forward

Existing agreements of all partnerships and LLCs taxed as partnerships should be reviewed and revised to reflect the New Rules. In order to understand the impact of the New Rules and the manner in which agreements should be revised, feel free to contact Elka Sachs (ETS@kb-law.com), or the Krokidas & Bluestein LLP attorney who assists you with your partnership or LLC.