HUNTON& WILLIAMS

Client Alert

November 2015

New Partnership Audit Rules Will Require Changes to Existing and Future Partnership Agreements

The President recently signed into law the Bipartisan Budget Agreement of 2015, which includes a complete overhaul of the procedures that apply to IRS audits of partnerships (including LLCs) and their partners. Although the new law will apply to taxable years beginning after December 31, 2017, we recommend that clients consider amending their existing partnership (and LLC) agreements and modifying the tax audit provisions of future agreements to address the new partnership audit procedures.

The Current Rules for Partnership Audits

Under the current rules, partnerships are generally subject to a single administrative proceeding to resolve audit issues at the partnership level (unless the partnership elects out). The tax liability for "partnership items" (a term subject to interpretation under current law) is determined at the partnership level, but any adjustments determined by the IRS flow through the partnership and are taken into account by the individual partners. Additionally, existing law requires certain partners to be notified of major developments in a partnership audit. Partnership-level audits are not necessarily binding on partners.

The New Rules for Partnership Audits

Significant aspects of the new rules include the following:

- The IRS will conduct its examination at the partnership level for "all items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year," but partners are no longer required to be notified regarding audit developments and partners will be bound by the determinations made at the partnership level. The power to manage these determinations on behalf of the partnership belongs to a "partnership representative," which generally should be designated by the partnership agreement.

- If the IRS makes an audit adjustment, the partnership itself will generally be liable for the tax due.

    - This represents a significant change to established principles that partnerships are "flow-through" entities that generally are not subject to entity-level tax.

- The tax is assessed to the partnership in the year that the audit or judicial review is completed. In other words, it does not relate back to the year in which the item was reported on the tax return, which is called the "reviewed year." Thus, a new partner may bear the burden of an audit assessment for years preceding the partner's admission to the partnership.

- A partnership may electively avoid partnership-level taxation on audit adjustments by issuing "adjusted information returns" (i.e., adjusted Schedule K-1s) to the reviewed-year partners. This election would allow the partnership to shift the tax liability from the entity-level to the partners for the reviewed year. Those partners would be required to take the adjustments into account in the adjustment year through a simplified amended return process.

- There is an "opt-out" election for partnerships with 100 or less partners. To qualify for the election, each of the partners of the partnership must be an individual, C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner. The opt-out election is not available to partnerships with another partnership as a partner unless Treasury issues future guidance extending the election in such circumstances. This is an annual election and is made on a timely filed partnership tax return.

What Changes Should You Consider?

Although it is likely that the IRS will issue guidance addressing certain aspects of the new rules before their delayed effective date, members of existing partnerships and LLCs and those entering into new partnerships and LLCs should consider amending their existing agreements and modifying the typical partnership audit provisions of future agreements, respectively, to address the new partnership audit rules. Below are some issues that partnerships (and LLCs) may want to address.

- If an opt-out election is available, should the partnership opt out of the new rules? If an opt out is not available but is desirable, can changes be made to the partnership to make an opt out available?

- Should the partnership restrict transfers of interests to partners that would preclude an opt-out election?

- Should the partnership be obligated to issue "adjusted information returns" following an audit to avoid an entity-level tax?

- To what extent should partners be entitled to notifications of partnership audit developments and have the ability to influence those audits?

Members of the Hunton & Williams Tax & ERISA Team listed below are available to discuss the new rules and their implications for existing and future partnerships and LLCs.

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