

Client Alert

January 2018

IRS Issues Guidance Under Partnership Audit Rules

The effective date for the new partnership audit rules (the “New Partnership Audit Rules”) enacted by the Bipartisan Budget Act of 2015 has arrived. Unless partnerships are eligible to elect out, and do elect out, the New Partnership Audit Rules impose a new, more centralized audit regime to partnership taxable years beginning on or after January 1, 2018. Under the New Partnership Audit Rules, the tax on any audit adjustment that increases a partnership’s income is assessed and collected at the partnership level, unless the partnership elects to “push out” that adjustment.

The IRS issued final and proposed regulations addressing several issues at the end of 2017 as this deadline approached. Most importantly, on December 15, 2017, the IRS proposed regulations (the “December 15 Proposed Regulations”) that allow tiered partnerships to “push-out” audit adjustments beyond the first tier of partners. Under the December 15 Proposed Regulations, each partner in an audited partnership that is itself a partnership, S corporation, or certain trusts or estates (a “pass-through partner”) will have the option to either pay any tax resulting from audit adjustments, or further push the audit adjustments out to its partners, shareholders, or beneficiaries. If the pass-through partner fails to properly and timely push out the adjustments or pay the tax, the tax will be collected from the non-compliant pass-through partner. This compliance mechanism effectively shifts liability upward through the partnership tiers by eliminating any liability with respect to complying tiers. This method allows the adjustment to be “pushed out” to the ultimate taxpaying owners.

In addition, on November 29, the IRS proposed regulations regarding certain international issues, including coordinating the New Partnership Audit Rules with existing withholding rules to ensure that applicable tax is collected only once.

Most recently, on December 29, the IRS issued final regulations regarding the ability to elect out of the New Partnership Audit Rules (the “December 29 Final Regulations”). Consistent with the proposed regulations, only partnerships with 100 or fewer partners, all of which are “eligible partners,” may elect out of the New Partnership Audit Rules. Eligible partners include individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, or estates of a deceased partner. As in the proposed regulations, disregarded entities are not considered eligible partners, even if the disregarded entity is wholly owned by an entity that would be an eligible partner if it held its interest directly. Thus, partnerships with even one disregarded entity partner (or any other non-“eligible partner”) will not be eligible to elect out of the New Partnership Audit Rules. The preamble to the December 29 Final Regulations indicates that the Treasury Department and IRS may reconsider expanding the “eligible partner” definition after gaining experience with the New Partnership Audit Rules. An election out is made on an eligible partnership’s timely filed return, including extensions.

Additional guidance regarding the New Partnership Audit Rules is expected in 2018, including regulations addressing adjustments to bases and capital accounts and the tax and book basis of partnership property, among other things.

If you would like more information about the application of the New Partnership Audit Rules or incorporating the New Partnership Audit Rules into existing or future partnership or LLC agreements, please contact one of the attorneys listed below.

Contacts

Jeffry M. Blair
jblair@hunton.com

Cecelia Philipps Horner
chorner@hunton.com

George C. Howell, III
ghowell@hunton.com

Timothy L. Jacobs
tjacobs@hunton.com

Laura Ellen Jones
ljones@hunton.com

David S. Lowman, Jr.
dlowman@hunton.com

Alexander G. McGeoch
amcgeoch@hunton.com

Patrick E. Mitchell
pmitchell@hunton.com

Kendal A. Sibley
ksibley@hunton.com

B. Cary Tolley, III
ctolley@hunton.com