New Partnership Audit Law for 2018 Requires Changes to Business Agreements

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Effective January 1, 2018, the Bipartisan Budget Act of 2015 (the "Budget Act") implements new rules regarding audits of partnerships. These rules also apply to limited liability companies taxed as partnerships. For partnership tax years beginning in 2018, the Budget Act now imposes an entity level tax collected on the partnership itself to the extent the partnership is audited and the Internal Revenue Service makes an adjustment and determines that there is a tax deficiency in any audit. Prior to application of the Budget Act, audits were normally assessed and paid at the partner level by the partners rather than at the partnership level by the partnership.

As part of this new audit process, the Budget Act requires the appointment of a "partnership representative" to communicate with the IRS and bind the partners on behalf of the partnership regarding any audit matters. The partnership representative is the sole party that has the authority to interact with the IRS. The partnership representative needs to be a United States person or entity but there is no requirement that the partnership representative be a partner of the partnership. The IRS has the authority to appoint a partnership representative if the partnership has not already appointed one. Accordingly, it is critical to update your partnership agreement or operating agreement to include language regarding who your partnership will appoint as partnership representative, including the right to remove or replace the partnership representative.

The Budget Act provides certain partnerships the ability to elect out of this new audit process on an annual basis. Generally, partnerships with fewer than 100 partners, all of which are either individuals, C corporations, S corporations, certain foreign entities and estates of deceased partners are eligible to elect out of the new audit process. Election out is not permitted if any of the partners are trusts, disregarded entities, retirement plans/

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accounts or other partnerships. Your partnership agreement can address the ability or requirement to opt out of these audit rules or whether there should be any restrictions against transferring interests to an ineligible partner if it is desirable to always have the ability to opt out of these audit rules on an annual basis.

Since the tax on an audit is paid at the partnership level for those entities that do not elect out of its application, additional attention must be paid in the partnership's governing documents for how the tax is to be allocated among the partners. Any adjusted tax for a prior year tax return is assessed and paid by the partnership in the year in which the adjustment is finalized. A potential mismatch would exist if ownership of the partnership changes between the audited prior tax year and the current year when the tax is actually paid by the partnership. Therefore, it is critical for your governing documents to address which partners will be responsible for sharing in payment of the tax, as the partnership is permitted to "push out" payment of the tax to current or former partners. Additionally, provisions regarding payment of tax liabilities should also be addressed in any transactions involving the sale, redemption or other transfer of an interest in the partnership.

Please contact one of the members of our Tax Group if you would like to discuss planning opportunities, updating your governing documents and how the Budget Act will affect your partnership or limited liability company.