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Alerts

All Partnerships Need to Adapt to the New Partnership Audit Rules Now

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Hinshaw Alert

Historically, partnerships and multiple-member limited liability companies ("LLCs") taxed as partnerships generally have not had to pay income taxes at the partnership level. As a result of federal tax law changes effective after 2017, partnerships and multiple-member limited liability companies taxed as partnerships may be obligated to pay federal income tax audit assessments at the partnership level. Partners and LLC members could be negatively affected by the federal law change unless steps are taken to mitigate the impact of the new rules. Every existing partnership agreement and LLC operating agreement should be reviewed now in light of the new partnership audit rules. Each agreement will require at least some amendments.

The New "Centralized Partnership Audit Regime"

New partnership audit rules were enacted under the Bipartisan Budget Act of 2015 ("BBA") on November 2, 2015, at §1101 of P.L. 114-74. The new process is called the "centralized partnership audit regime." Under the centralized partnership audit regime, federal income taxes assessed against a partnership on audit will be treated as an "imputed underpayment." Generally, the imputed underpayment will equal the net of all audit adjustments times a tax rate of 39.6%. Credits are considered separately. As a result, the new audit approach will often result in higher taxes being assessed than would have occurred had the various partnership adjustments been reported separately at the partner level.

To add insult to injury, the assessment against the partnership will generally be applied against the "adjustment year" (*i.e.*, the current tax year), not the "reviewed year" (*i.e.*, the tax year to which the adjustment relates). In other words, the partners in the year of assessment (*i.e.*, the "adjustment year") may be required to subsidize the partners from the audited year (*i.e.*, the "reviewed year") in whole or in part whenever the partners or their ownership percentages have changed during the interim. As a result, the new approach may also reallocate economic costs to the adjustment year partners.

Fortunately, there are several approaches which can avoid or mitigate undesirable outcomes.

Modifications To Imputed Underpayment Allowed Under Code § 6225(c)

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In order to mitigate potentially harsh results under the centralized partnership audit regime, Internal Revenue Code of 1986, as amended ("Code") § 6225(c) provides that the Secretary of the Treasury ("Secretary") shall establish procedures under which the imputed underpayment amount may be "modified" under some circumstances.

- First, a modification of the imputed underpayment will be allowed when, within 270 days after the partnership receives a notice of proposed partnership adjustment, one or more of the reviewed year partners amend their reviewed year tax returns, amend all of their subsequent years' tax returns to reflect the ongoing tax attributes resulting from the audit, and pay all of the resulting taxes, interest, and penalties. The payments received will then reduce the imputed underpayment.
- Second, a modification of the imputed underpayment will be allowed when the partnership can show that one or more partnership interests are held by a tax exempt entity.
- Third, a modification of the imputed underpayment that considers tax rate adjustments and character of income adjustments (*g.*, capital gains) will be allowed. Such procedures shall provide for taking into account a rate of tax lower than 39.6% with respect to any portion of the imputed underpayment that is allocable to a partner which is a C corporation. Such procedures shall also take into account a rate of tax lower than 39.6% with respect to capital gains or qualified dividends when the partner is an individual.
- Finally, the Secretary may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the Secretary determines are necessary or appropriate.

Unless such period is extended with the consent of the Secretary, all information supporting a modification must be submitted to the Secretary not later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed to the partnership.

In lieu of the modifications available under Code § 6225(c), the partnership can elect to "push out" the partnership adjustments directly to the reviewed year partners.

First Tier Partnership May Elect to "Push Out" All Partnership Adjustments to the Reviewed Year Partners and Thereby Avoid Taxation at the Partnership Level

A first tier partnership may elect to "push out" all partnership adjustments to the reviewed year partners and thereby avoid taxation at the partnership level. The "push out" election is made by the partnership representative. Because the election must be made within 45 days after the partnership receives an assessment, the partnership agreement will need to have a specified procedure for making the "push out" election promptly. When a "push out" election is made, the partnership will issue a "statement" (essentially an amended Schedule K-1) to each of the reviewed year partners (*i.e.*, the prior year partners). Each reviewed year partner will then have to calculate the additional tax related to the partnership audit adjustments for the reviewed year and all intervening years. The additional taxes must then be reported and paid on the partner's current year income tax return. Tax, penalties and interest are also collected at the partner level. Unless the partner is also the partnership representative, a reviewed year partner will have no ability to challenge the assessment or any related interest or penalties.

The push out election is problematic for multi-tiered partnerships. A first tier partnership may make the push out election. However, an upper tier partnership may not then push out the pushed out partnership adjustments to its upper tier partners. Although the statute is silent, the Joint Committee on Taxation's "Bluebook" provides that the upper tier partnership is treated as an individual and must pay the tax related to the push out statement that it received from the audited partnership. The upper tier partnership must pay the tax resulting from the adjustments on the first tier partnership's push out statement, although modifications may be allowed. Congress is expected to address this issue under a technical corrections bill or as part of the anticipated 2017 tax reform package. However, until such a correction occurs, a cascade of push out elections does not currently seem to be possible.

Under the push out approach, the reviewed year partners bear the assessment and the economic costs of the audit. The reviewed year partners will also bear the economic costs of the audit when the partnership had elected out of the centralized partnership audit regime altogether.

Certain Partnerships May Be Able to Elect Out of the New Audit Rules Altogether

Certain partnerships may be able to elect out of the centralized partnership audit regime. A partnership that has (a) one hundred (100) or less direct or indirect partners; (b) all of the partners are individuals, C corporations, S corporations, foreign corporations treated as C corporations, or deceased partners' estates; (c) a timely election is made; and (d) the partnership has notified the partners of the election, may elect out of the centralized partnership audit regime. In determining the number of direct and indirect partners, each shareholder of an S corporation which is a partner is treated as a separate partner. The S corporation itself is also counted as a partner.

Note that only partnerships composed of certain types of partners are eligible to elect out of the centralized partnership audit regime. A partnership which wants to elect out of the centralized partnership audit regime must be composed solely of individuals, C corporations, S corporations, foreign corporations, or deceased partners' estates. Trusts (including grantor trusts), partnerships, and limited liability companies taxed as partnerships are notably absent from the list of allowed partners. This precludes all multi-tiered partnerships from electing out of the centralized partnership audit regime. The Secretary has been given the authority to identify additional allowable partners, but the Secretary of the Treasury declined to do so in the Proposed Regulations that were issued and withdrawn in January 2017.

Because partnerships having trusts (including grantor trusts), partnerships, or limited liability companies taxed as partnerships as partners are not currently eligible to elect out of the centralized partnership audit regime, many partnerships (including small partnerships) will be precluded from electing out.

Electing out of the centralized partnership audit regime will be done annually on a timely filed partnership income tax return. The election out is only valid for one year. Therefore, a partnership will have to decide each year whether or not to elect out of the centralized partnership audit regime. If the partnership fails to timely file its income tax return, it will subject to the centralized partnership audit regime for that year. When an election is made, the relevant partnership income tax return must disclose the name and taxpayer identification number of each partner. The partnership must also disclose the name and taxpayer identification number of each shareholder in any S corporation that is a partner.

When a partnership elects out of the centralized partnership audit regime, the pre-TEFRA rules will apply. In other words, each partner will be audited separately. Each partner may then bear the cost for the audit personally and may not be subject to the same adjustments as the other partners. Note that, according to the IRS, electing out of the centralized partnership audit regime will not diminish a partnership's risk of audit.

The Partnership Representative Designation Will Be Critical

One of the most important aspects of the centralized partnership audit regime is the creation of a "partnership representative." Every partnership should have one, even when the partnership intends to elect out of the centralized partnership audit regime. When the partnership fails to designate a partnership representative, the IRS may select one.

A partnership representative may be an individual or an entity. A partnership representative need not be a partner. The partnership representative must have substantial presence in the United States.

All communications to and from the IRS will go through the partnership representative. Unlike a "tax matters partner" under TEFRA, a partnership representative will have complete authority vis-a-vis the IRS. When the centralized partnership audit regime applies, the partnership representative will have the sole and exclusive authority to act on behalf of the partnership and to bind all partners. Except for a partner acting as the partnership representative, partners will not be allowed to participate in audits and will not receive any notices from the IRS regarding the audit. Because of the partnership representative will have total control over the audit process, the partners will want to be very careful whom they select and may want to list the duties and obligations owed by the partnership representative to the partners under the relevant partnership agreement or LLC operating agreement.

Recommended Action Steps

There are several actions steps which should be considered immediately:

1. Every partnership and LLC taxed as a partnership should appoint a partnership representative. The partnership agreement or LLC operating agreement should consider the appointment, resignation and replacement of the partnership representative. It should also consider the partnership representative's duties and obligations to the partners and the partners' obligations to the partnership representative. Remember that the IRS does not believe that it is bound by any partnership agreement or LLC operating agreement provisions when dealing with the partnership representative.
2. Determine whether or not the partnership is eligible to elect out of the centralized partnership audit regime. If it is eligible, consider what provisions are necessary to keep it eligible. If it is not eligible, does the partnership want to require a change of its partners so that it can become eligible to elect out of the centralized partnership audit regime?
3. Determine whether or not the partnership will want to require that a push out election be made. Consider whether the push out election is mandatory or discretionary at the election of the partners. Further, consider the partners' need for tax distributions in the event that a push out election is made remembering that the money will need to go to the reviewed year partners. When making plans for tax distributions, bear in mind that the adjustment year partners who were not reviewed year partners (or whose partnership interests increased during between the reviewed year and adjustment year) may expect to receive shares of all cash distributed—even when such adjustment year partners bear little, if any, tax liability for the reviewed year.
4. Determine what modifications may be available and what partner information will need to be collected in order to comply with the modification rules.
5. Consider adding special allocation language to the partnership language to consider the possibility that an imputed underpayment will have to paid at the partnership level. Consider how the partnership could finance the payment of an imputed underpayment.

Conclusion

Simple fairness would seem to dictate that the reviewed year partners should bear the cost of an audit related to the reviewed year at their respective tax rates. Generally, this can only be accomplished when a first tier partnership elects out of the centralized partnership audit regime or elects to push out partnership adjustments to the reviewed year partners. Technical corrections are expected from Congress in 2017. We also anticipate that the IRS will re-issue Proposed Regulations in 2017. Hopefully, both events will help make the planning environment clearer before the centralized partnership audit regime begins in 2018.