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Client Alert: New Partnership Audit Rules Impose Federal Income Tax Liability Directly on Partnerships/LLCs

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In November, 2015, as part of the Bipartisan Budget Act of 2015, new rules were enacted governing partnership audits and assessments by the IRS. For taxable years beginning after December 31, 2017, the new partnership audit rules repeal the current partnership audit rules and replace them with a new regime applicable to all partnerships (including limited liability companies treated as partnerships for federal income tax purposes).

Under the new rules, if the IRS adjusts a partnership item of income, gain, loss, deduction or credit for a taxable year, the IRS will impose the resulting tax liability **directly on the partnership** (even though the partners, rather than the partnership, were originally responsible for tax liability resulting from partnership income in the taxable year under review). The IRS will determine the amount of the partnership liability by applying an assumed maximum tax rate to the adjustment. Future Treasury Regulations will establish procedures for modifying the applied tax rate, for example, to take into account specific tax rates that would apply to particular partners (such as applying a lower tax rate to the portion of an adjustment attributable to capital gain of an individual partner).

If the IRS makes an adjustment, a partnership can avoid direct tax liability by electing to provide those who were partners in the taxable year under review with a statement reflecting their respective shares of the adjustment. If this election is made, the partners' tax liability will take into account liability attributable to subsequent taxable years resulting from adjustments to tax attributes in the earlier year. In addition, imputed interest imposed upon partners' underpayments will be applied at a rate that is 2% higher than the otherwise prescribed statutory rate.

A partnership may request an IRS adjustment of partnership items for a previous year. Any such adjustment will be taken into account under rules similar to those above.

All partnerships must designate a person with a substantial presence in the U.S. to be the “partnership representative” (or the IRS will select one for the partnership). The partnership representative is not required to be a partner of the partnership. The partnership representative will have the sole authority to act on behalf of the partnership in the case of an audit under the new rules, which actions will bind the partnership and all of its partners.

Generally, a partnership will be eligible to elect out of the new partnership audit rules for a particular taxable year if (i) the partnership is required to furnish not more than 100 K-1s for such taxable year, and (ii) each partner is either an individual, a C corporation, a foreign entity that would be treated as a C corporation were it domestic, an S corporation or an estate of a deceased partner. Such an election must be made on the tax return filed by the partnership for such taxable year.

There is much uncertainty about the application of the new partnership audit rules, and many details have been left for future Treasury Regulations. Taxpayers should consider incorporating provisions into their existing and future partnership agreements and LLC operating agreements to address these new rules, such as indemnification of the partnership in the event of a partnership assessment, and limitations on the ability of the partnership representative to act unilaterally in the event of an IRS audit.

Contact your Vorys attorney if you have any questions or if we may assist you in modifying your existing partnership and LLC operating agreements.