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Client Alert: Proposed Regulations Confirm Broad Scope of New Partnership Audit Rules, Affecting Partnerships and LLCs Treated as Partnerships – Is Your Operating Agreement Ready?

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The IRS has issued proposed regulations that implement the “centralized partnership audit regime” recently enacted by Congress. The new regime is a complete overhaul of existing partnership audit rules and will impact every partnership, including each LLC treated as a partnership for federal income tax purposes, for taxable years beginning after December 31, 2017. Taxpayers are encouraged to discuss with their tax advisors appropriate modifications to their existing and future partnership agreements and LLC operating agreements to address the new regime.

Centralized Partnership Audit Regime

The new regime allows the IRS to assess and collect taxes associated with audit adjustments (including any penalties) directly upon the partnership or LLC (hereinafter, entity), rather than passing adjustments through to individual owners. In the alternative, an entity may elect to pass through the final adjustment amount to those persons who were owners in the year under audit by providing a statement to those owners and the IRS. If this election is made, interest imposed upon owners’ adjustment amounts will be applied at a rate that is 2% higher than the otherwise prescribed statutory rate. Each entity must designate a “partnership representative” (who need not be an owner of the entity), or the IRS will select one for the entity. In the proceeding to determine the entity’s final adjustment amount, the partnership representative has the sole authority to act on behalf of the entity and sole authority to bind the entity and all of its owners.

Opting Out of the Regime

Entities with fewer than 100 owners may affirmatively opt out of the new regime, so long as all of the owners are individuals, estates, C corporations or S corporations. Opting out is not available if even one owner is, for example, a partnership, trust or disregarded entity.

June 2017 Proposed Regulations

The proposed regulations take an expansive view of the scope of the centralized partnership audit regime. The IRS takes the position that the regime covers all items and information related to or derived from the partnership or LLC taxed as a partnership. Although the proposed regulations provide detailed rules for implementing many aspects of the regime, there is still uncertainty about the application of the new regime in certain circumstances, such as in the context of tiered partnership structures.

Impact on Partnership Agreements and LLC Operating Agreements

The centralized partnership audit regime is a dramatic change in the law. Under the default rules, only the entity will be liable for taxes and penalties associated with audit adjustments. The partnership representative exercises unilateral control in the audit process, and there is no specific requirement as to whether and how a partnership representative communicates with the owners about the audit. Taxpayers should consider incorporating provisions in partnership agreements and LLC operating agreements addressing the new regime, including:

- Opt-out provisions for qualifying entities
- Rules for designating a partnership representative
- Contractual obligations of the partnership representative, including restrictions on actions that may be taken by a partnership representative without owner consent
- Provisions governing communication between the partnership representative and the owners, including rules requiring the entity or partnership representative to notify the owners in the event of an audit
- Provisions requiring the owners to share information with the partnership representative necessary to present defenses and reduce the final adjustment amount
- Indemnification of the entity in the event of an adjustment, including survival provisions applicable to former owners who were owners in the year under 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.