Chambliss

New Partnership Audit Rules

Section 1.01 *Effective January 1, 2018*

Section 1.02 New rules that change the way that partnership entities are audited took effect on January 1, 2018.

Partnership entities include all entities that are taxed as partnerships under federal tax law, including traditional partnerships (limited and general partnerships) and modern entities that are taxed as partnerships (LLCs, PLLCs, LLPs, and PLLPs). They depart fundamentally from prior rules, by focusing audit adjustments at the partnership level so that the assessment and collection of underpaid tax, penalties, and other additions to tax will now be imposed as a matter of default at the partnership level, rather than at the partner level. This was done in part because of the difficulty the IRS was having auditing large partnerships, which were growing in number, and applying adjustments to myriad partners. Thus the new rules potentially impose partnership-level tax, and they give rise to considerable complexity when considering how to ensure the correct partners ultimately bear the economic burden of adjustments. The new rules are expected to increase substantially the amount of revenue generated by partnership audits.

While the new rules were enacted mainly with large partnerships in mind (where the IRS had the most difficulty imposing audit adjustments at the partner level), they do in fact apply as a matter of default to all partnerships. They tighten up and can have a significant effect on how partnerships with even ten or fewer partners will be treated. They will render certain provisions of many partnership agreements obsolete and will require such agreements to include new language to deal with the new rules. Consequently, all partnerships should examine their partnership documentation to make sure that the new rules are incorporated and dealt with effectively; **the cost of doing nothing could be substantial.**

Some highlights of the new rules:

1. **Adjustments at the Partnership Level**. As discussed above, audit adjustments will now be made as a default matter at the partnership level, involving possible tax at the partnership level if nothing is done.
2. **Partnership Representative.** Broadly, the concept of "Tax Matters Partner" is replaced with a new "Partnership Representative," which generally can be a partner or any person with a substantial presence in the United States. The Partnership Representative is granted broad authority to bind the partnership and all partners in an audit or other IRS proceeding. Unlike under old rules, where partners had a right to receive notifications of and to participate in IRS proceedings, the Partnership Representative now has sole authority to do so. The partnership agreement can contain restrictions on the partnership representative's power to act in certain cases.
3. **Election Out.** Partnerships with 100 partners or less can elect out of the entity-level partnership determination. An election out of entity-level partnership determination may be made only on a timely filed

partnership return. To be eligible, all partners must be individuals, C corporations (including any foreign entity that would be treated as a C corporation if domestic), S Corporations, or estates of deceased partners (no upper-tier partnerships are allowed). If the election out is something of importance to an eligible partnership, then care must be taken to amend the partnership agreement to preserve eligibility. For example, the partnership agreement may restrict partners' ability to effect transfers of their interests where to do so may cause the 100 partner threshold to be exceeded or where a transfer would be to an otherwise disqualified transferee. The partnership agreement may also seek to place restrictions on the Partnership Representative's authority to make elections.

4. **Push Out.** Where an underpayment is assessed but the partnership has not (or cannot) elected out of the new rules, the partnership may make an election to "push out" adjustments for a reviewed year to the partners who were partners in that year. To do this, election and reporting requirements must be followed. Where effective, this procedure moves liability from the partnership to the partners.

The new rules were enacted in the Bipartisan Budget Act of 2015, and their implementation was delayed for two years. They are supported by a voluminous set of regulations. This note is intended merely to touch on some important highlights so you can evaluate the need to prepare for them and, if necessary, update your partnership agreement. It is not equipped to deal with the full complexity of the new rules. However, it is important to understand that the new rules will have to be incorporated and dealt with in the governing document (e.g., partnership agreement or operating agreement) of most entities. For example, partnership agreements that do not already take account of the new rules should be amended to deal with such things as:

- Provisions for selecting the partnership representative ("PR") and any restrictions on the PR's authority to act; provisions for indemnifying the PR
- Provisions allowing or requiring an election out or a push-out
- Provisions requiring partners to share information with the partnership where appropriate
- Provisions binding partners to be liable for their shares of tax assessed to the partnership
- Rules governing possible indemnification where a partner sells its interest

The cost of doing nothing could prove to be substantial. For further information, please contact us.