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Do You Have an Entity (LLC, LP, LLP) That is Taxed as a Partnership?

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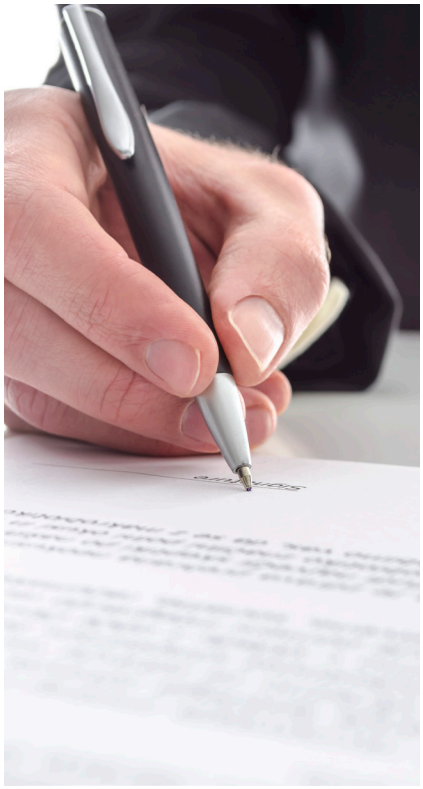
A FREEBORN & PETERS CORPORATE PRACTICE GROUP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

Congress and the President recently passed a new law that will have the effect of increasing partnership audits and recordkeeping burdens. Under the new law, any resulting tax burden from an audit will default onto the partnership.



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It's time to take a look at that partnership or operating agreement.

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act. As part of the Act, Congress repealed the previous regimes for auditing partnerships, and replaced the old regimes with a new streamlined procedure. The new audit rules are a reaction to the increasing number of widely held partnerships (partnerships with thousands of partners) and the IRS' difficulty in auditing such partnerships and issuing adjustments to each partner. The Act provides a simpler mechanism for the IRS to audit partnerships and collect tax from the audits. The IRS expects an increase in the number of partnership audits beginning in January 2018, the date the Act goes into effect.

Under the Act, Partnership Assessments Are Made at the Partnership Level

The most significant change to the current partnership audit rules is that any audit adjustment resulting in a federal tax deficiency, including penalties and interest, must be paid at the partnership level rather than the partner level. At the end of an audit, if the IRS concludes that a tax adjustment is necessary, it will issue a notice to the partnership. The IRS will then apply the highest marginal rate of tax to determine the tax due. The tax is calculated without regard to the character of the income or gain (i.e., capital or ordinary), and without regard to any partner-level tax attributes.

This is a marked change from the current rules, under which the IRS audited the partnership and assessed each partner for his or her share of partnership adjustments. Under the old rules, any tax liability from the audit would be imposed on only those partners who were partners in the audited year. By contrast, under the new Act, because the partnership is the taxpayer, partners in the year the adjustment is finalized will bear the financial burden of the tax assessment, even if one or more partners were not partners in a prior year the audit was conducted.

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Partnership Can Provide Partner-Specific Information to IRS to Decrease Tax Due

The partnership and partnership representative (discussed below) have nine months from the date of the IRS notice of proposed tax to provide the IRS with partner-specific information to modify the proposed adjustment and tax due. Such information can include: (i) tax-exempt partners; (ii) C corporation or foreign partners that have allocated ordinary income; or (iii) individuals who are allocated capital gains or qualified dividend income. The IRS has yet to establish procedures to implement this modification process.

The proposed tax can also be reduced by having individual partners file amended returns, taking into account their allocable share of adjustments and paying any tax due.

Alternative for Taxes to be Paid at Partner Level

The Act provides an election to shift the tax assessment at the partnership level onto the partners. Within 45 days after the date of the final audit adjustment, the partnership can elect to provide each partner with his or her share of any adjustment, likely via an adjusted Schedule K-1, shifting the tax burden from the partnership to the partners for the audited year. The partner would make the adjustments on his or her own tax return. However, there is a cost associated with this election, in the form of an extra 2% interest charge applicable to any tax underpayments.

By shifting the liability to the partner, only the partners present during the audited year will be liable for tax. Thus, it solves the problem of having partners who may not have been partners during the audited year being subject to tax. Again, the IRS has not yet provided the methodology to make the election and provide a statement of adjustments for each partner.

Partnership Representative

The Act replaces the "Tax Matters Partner" with a "Partnership Representative." The Partnership Representative does not have to be a partner, and he or she will have the "sole authority to act on behalf of the partnership." Importantly, the Act removes the right of partners to participate in audits; the Partnership Representative will have sole authority to act on behalf of the partnership in connection with audits or judicial proceedings. The partnership and partners will be bound by the actions of the Partnership Representative.

Small Partnerships Can Opt-Out of New Audit Rules

Most partnerships will be subject to the Act. However, certain small partnerships can opt out of the new partnership audit rules if they meet statutory requirements: (i) the partnership has 100 or less partners; (ii) the partners are individuals, C corporations, S corporations or estates of deceased partners; and (iii) an annual election is timely filed. Each S corporation shareholder is also considered a "partner" for the 100 person limit. All other partnerships are subject to the Act and cannot opt out. In addition, partnerships can elect to utilize the new partnership audit rules currently,

though the IRS needs to write procedures as to how to make such an election.

Food for Thought

The new partnership audit rules will have an enormous impact on partnerships, partnership agreements, as well as partnership interest purchase agreements and fund documents. Some questions to consider:

Q: Do I need to revise my partnership (or operating) agreement?

A: Yes. Minimally, the partnership agreement will need to provide for the designation of a partnership representative with authority to act as needed under the new rules. In addition, the agreement will need to be revised for the new audit procedures as prescribed under the Act, which differ from the previous rules.

Q: Do I need to do anything now, since the new law is not effective until 2018?

A: Partnership agreements should be reviewed to determine what revisions will need to be in place by 2018. Such revisions may include: (i) procedures to opt out of the new partnership rules; (ii) designation of a partnership representative; and (iii) indemnification of partners in the year of assessment who were not partners in the audited years.

Q: It sounds like we are still waiting for implementing rules from the IRS. What can I do now?

A: Consider giving the General Partner, Manager, or another partner authority to amend the partnership agreement as new IRS guidelines are released. In addition, the new Act will require greater recordkeeping of partners' tax classifications, which may be an onerous task. A partnership will need to consider mechanisms for collecting, maintaining, and updating such information.

Q: Partners in my partnership sometimes change; do I have any special concerns?

A: Partnerships will need to keep detailed records of partners, so as to provide the IRS with partner-specific information to modify any proposed tax assessment, or make an election to assess tax at the partner level.

Q: What happens if I do nothing?

A: If you do nothing, your partnership will be subject to the new Act as of January 2018, even if you meet the guidelines to opt out as a small partnership. If the partnership does meet the requirements to opt out, the partnership can timely elect to opt out in the following year. Under the Act, if your partnership is audited, the partnership will be subject to tax at the highest marginal federal tax rate, which is currently 39.6%.

Q: Are there any special deadlines I should be aware of?

A: There are three important deadlines outlined in the Act. First, if your partnership qualifies as a small partnership eligible to opt out of the new Act, the partnership needs to timely elect to opt out on an annual basis. Second, a partnership has 45 days from the date it receives a final assessment to elect for the tax to be paid by the partners rather than by the partnership. Third, a partnership has nine months from the date of the IRS proposed tax notice to provide the IRS with information on its partners to reduce the tax due.

While the Act provides an overview of the new audit regime, it lacks many crucial details as to how the new audit rules will be implemented. Almost certainly, the new audit rules will impact partnership agreements, as well as purchase agreements and fund offering documents. Although the Act does not become effective until 2018, affected partnerships should start considering the rules now and how they intend to comply.

If you have any questions about the Act, changes to your partnership agreement, or how the Act impacts your partnership, please contact us.

We will continue to monitor updates to the law and forthcoming IRS guidance, and we will provide updated information once it is available.

ABOUT FREEBORN & PETERS LLP

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