New IRS Audit Rules for Partnerships

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Introduction

Hedge funds, private equity firms, real estate companies, and other businesses structured as partnerships or limited liability companies are paying close attention to recent changes in IRS audit procedures.

The old “TEFRA” audit rules, in place since the 1980s, allowed the Internal Revenue Service (“IRS”) to audit the partnership itself, but required any ultimate tax adjustments to be collected from individual partners. The IRS has long struggled with audits of partnerships, since it can be difficult to collect tax from layers of indirect partners. For example, under TEFRA, a partnership with 10,000 partners, each owing $1,000, is much more administratively onerous for the IRS to pursue than a corporation owing the same $10 million, because the IRS must pursue each partner individually. As a result, audits of partnerships have been relatively rare compared to other types of business entities (less than one percent of partnerships with more than $100 million in assets were audited in 2012, compared to 27 percent of C corporations of equal size). This is expected to change under the new audit rules, which are projected to raise significant amounts of additional revenue over the coming years.

Default Rules

The changes come as part of the Bipartisan Budget Act of 2015, signed into law on November 2, 2015 (the "Act"). Under the Act, the IRS will be able to audit at the partnership level just as under TEFRA, but it will be relieved of the burden of having to collect tax from individual partners. If the IRS determines that additional tax is due at the conclusion of an audit, the IRS will, under the Act, be able to impose tax, interest, and penalties on the partnership itself, i.e., at the entity level. In such a case, the partnership would then pay the tax directly, causing the then-current partners to indirectly pay their respective shares of the tax.

This means that under the rules described above, if a partnership filed a tax return and paid its taxes in year 1 (the year 1 tax return), partner X sold its interest in the partnership to new partner Y in year 2, and the partnership was audited in year 3 in respect of its year 1 tax return, then partner Y would bear its share of any additional tax liability assessed on the partnership in year 3 in respect of the year 1 tax return, despite that partner X, and not partner Y, was a partner in the partnership in year 1.

The above-described situation departs from the TEFRA rules, under which an audit of the partnership in respect of a prior tax year only imposes an economic liability on the partners who were partners in that prior tax year. Under the Act, current partners could find themselves liable for tax adjustments
relating to events preceding their entry into the business. In future acquisitions of partnerships, purchase agreements will need to be carefully drafted in conjunction with partnership agreements to allocate responsibility for adjustments between departing and incoming partners.

Under the Act, a tax assessment on the partnership is initially to be assessed at the highest rate of tax in effect for the reviewed year for individuals or corporations. However, the Act tasks the IRS with providing regulations whereby this maximum rate may be adjusted to the extent that the partnership can show that some of its partners bear a lower rate (e.g., because the tax is in respect of qualified dividend income and the partners are individuals or because the partners are exempt from tax. As such, partnership agreements may need revising to the extent they do not already contain robust cooperation provisions in which limited partners agree to provide the partnership with information about such limited partner relating to taxes that the General Partner may require.

**Election Out of the Rules**

The Act provides a way for the partnership to elect out of the above regime by filing an appropriate election within 45 days of receiving a notice of final partnership adjustment. However, the election comes at a cost: the rate of interest assessed on underpaid taxes rises from 3% to 5% if the election is utilized. Under the election, the partnership would pass through the tax adjustment to the persons who were partners during the audited tax year by issuing amended Schedules K-1. Each partner receiving an amended Schedule K-1 would then be required to file an amended tax return for the audited tax year.

At this time, we anticipate that many partnerships will want to maintain the maximum possible flexibility to make this election as it is merited. Other partnerships may opt to require the election to be made in all cases in which it can do so. Although we expect that many partnerships will typically want to elect out of the rules under the Act as described above, there may be situations in which the partnership may want to utilize the “default” provisions of the Act and have the partnership (and thus the current partners) bear any tax adjustment. In order to provide this flexibility, partnerships may wish to provide that not only should its partners be required to reimburse the partnership and other partners for any taxes allocable to such partner, but partnerships may also wish to ensure that such reimbursement obligations survive the transfer of any partnership obligation. Partnerships may also wish to expressly provide that the “partnership representative” (discussed below) has the power to make (or not make) the election described above.

**Small Partnership Rules**

There will be an option for small partnerships (100 or fewer partners) to opt out of the Act and force the IRS to assess tax against each individual partner, but this option will not be available to any partnership that itself has partners which are also partnerships (including LLCs treated as partnerships). Since tiered structures are so common, this opt-out may be unavailable in many cases.

**Changes to the “Tax Matters Partner”/“Partnership Representative” Role**

The Act eliminates the position of “tax matters partner” in audit proceedings and replaces the position with a “partnership representative.” This definitional shift is expected to be helpful, because as LLCs have multiplied, questions have arisen about who is eligible to serve as “tax matters partner” under various forms of LLC management structures. By contrast, the Act allows the appointment of any person—partner or not—“with a substantial presence in the United States” as the “partnership representative.” The IRS has not yet provided guidance as to what “a substantial presence in the
United States” means, but it is expected that the Act will allow for a broader array of potential people who will be eligible to represent the partnership. Partnership and LLC agreements should generally be revised to provide for who will act as the “partnership representative” because in the absence of an appointed person, the IRS has the discretion to pick a “partnership representative.”

The “partnership representative” will have the authority to bind the entity and its partners in any final decision in a proceeding and in any action taken under the Act (e.g., whether to make an election under the Act, whether to proceed in tax litigation, whether to file a claim for a refund, etc.). As was the case under the TEFRA rules, a partner must treat items for tax purposes in a manner consistent with the partnership, unless such partner files a notice of inconsistent treatment with the IRS. Partnerships may wish to tailor this authority, giving partners more or fewer participation rights as appropriate.

**Start Date for the New Rules**

The new rules will take effect for tax years beginning on or after January 1, 2018, although partnerships may elect to have the Act apply sooner. The IRS has not yet issued regulations relating to the Act and so many questions remain about how the new approach will be implemented. For example, despite that many partnerships operate in a tiered structure, it is not yet clear whether upper-tier partnerships will be able to elect out of the “default” rules under the Act. Existing partnership and LLC agreements should be reviewed before 2018 to determine whether amendments need to be made in light of the new rules. New operating agreements should explicitly incorporate the concepts contained in the Act, even as taxpayers and practitioners await more detailed guidance from the IRS.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 See Internal Revenue Code Sections 6221-6234.
3 Pub. L. No. 114-74, Sec. 1101(a), (c), 129 Stat. 584, 625.

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