THE MARSTON GROUP PLC

The New Partnership Audit Rules

What You Need to Know for the 2018 Tax Year and Beyond

The passage of the Bipartisan Budget Act of 2015 brought with it significant new federal partnership income tax audit rules that will apply for tax years 2018 and beyond to partnerships and their partners, as well as multi-member limited liability companies (LLCs) and their members. The new audit rules apply to all partnerships and LLCs that elect to be treated for tax purposes as partnerships. As explained below, certain small partnerships (100 or fewer partners) that have only "eligible" partners can elect to opt out of the new rules.

Why Did the IRS Change the Rules?

Prior to 2018, audits of partnerships and LLCs were conducted by the IRS under the Tax Equity and Fiscal Responsibility Act (TEFRA), which assessed adjustments of partnership items at the individual partner level. The rules under TEFRA created a burdensome audit process for the IRS, requiring them to deal individually with the partners of an audited entity, including assessments and collections of tax resulting from the audit. As a result, few partnerships were audited, as the IRS could not directly assess partnerships but had to pursue each partner for its share of the assessment, often through multiple tiers. The new rules, known as the Centralized Partnership Audit Regime (CPAR), are designed to assess and collect tax and penalties at the partnership level. From the IRS' standpoint, these new rules should simplify adjustments and collection of tax, limit the number of individuals the Service must deal with in an audit, and make the overall audit process much more efficient, thus increasing the number of partnerships the IRS can examine.

What Is Included in the New Audit Rules?

For partnerships that do not opt out of the new rules, the IRS will audit a partnership and any resulting adjustments will be made at the partnership level in the tax year in which the audit is completed. If the audit results in a tax deficiency, any tax, interest, and penalties will be assessed against and collected from the partnership rather than the individual partners. Unless the partnership timely elects out of the new rules, or unless certain elections are made as described below, the adjustment year partners will bear the audit assessment, including interest and possibly penalties, even if some or all partners are different than the partners in the reviewed year. Therefore, under the new rules, partners could potentially be responsible for someone else's income tax liability.

Partners Will Be Bound by Actions of Partnership Representative (PR)

The new audit rules replace the concept of the "tax matters partner" with a "partnership representative (PR)" who has the sole authority to act on behalf of the partnership with respect to the IRS. The PR will control the audit and any appeal. Unlike the tax matters partner, the partnership representative need not be a partner, but still must have a "substantial presence" in the United States. The partnership and all partners are bound by any actions or decisions of the PR. The PR also has the authority to make a "push-out" election (see below) on behalf of the partnership. Only the PR may raise defenses to penalties, including defenses that may be available to some but not all partners. Any defense not raised by the PR will be waived. Further, no partner other than the PR has a right to notice of any audit or partnership adjustment, and no one other than the PR may participate in the audit without IRS consent. Finally, there is no legal obligation for the PR to keep partners updated about the status of the audit or to even notify the partners that an audit will occur.

Partnerships must designate a PR each tax year. Such designation is done on the partnership's timely filed federal income tax return for that year. If the partnership fails to designate a PR, the IRS may select any person with a substantial presence in the United States as the PR, and such selection cannot be revoked without the IRS' consent.

Election to "Push Out" Adjustments to Reviewed Year Partners

A partnership can make an election within 45 days of the date of the notice of final partnership adjustment to apply the adjustment rules at the partner level instead of the partnership level, an election known as a "push-out" election. The partnership representative (PR) makes the push-out election. If such election is made, the reviewed-year partners must pay (and the partnership is not required to pay) the imputed underpayment, including any penalties and interest, in the year of the final partnership administrative adjustment. The partnership must also issue a revised Form K-1 to the partners and the IRS with this election, which shows each partner's share of the adjustment. Absent a push-out election, the partnership must make any imputed underpayment, and absent an indemnity obligation from the partners in the reviewed year in favor of the partners in the adjustment year, the burden of such taxes will fall on persons who are partners in the adjustment year (even if they were not partners in the reviewed year).

Consistency Requirements

The new audit rules require each partner to report each item of income, gain, loss, deduction, or credit attributable to the partnership in a manner that is consistent with the treatment of such item on the partnership's tax return. The partner's duty of consistency extends to the partner's treatment of the item with respect to the amount, timing, and characterization of each partnership-related item. If a partner does not comply with this requirement, any underpayment of tax from such noncompliance may be assessed and collected by the IRS immediately against the partner without issuing a notice of deficiency, and the partner has no right to petition the Tax Court for a redetermination of the deficiency. To avoid this treatment, the partner must notify the IRS of the inconsistent treatment.

Dissolved Partnerships

Under the new audit rules, if a partnership has dissolved before a partnership audit adjustment takes effect, the former partners must take into account any partnership adjustment as if the partnership had made a push-out election. "Former partners" are the partnership's adjustment-year partners, and if no adjustment-year partners exist, the partners of the partnership during the last taxable year for which a partnership return was filed are considered to be the former partners.

Opting Out of the New Rules

An eligible partnership may elect to opt out of the partnership-level audit rules. To be eligible to elect out, the partnership must have 100 or fewer partners during the year, and all partners must be "eligible" partners (i.e., an individual, a C corporation, an S corporation, or the estate of a deceased partner). Partners not considered eligible partners include a partnership, a trust, a disregarded entity (single member LLC), or the estate of an individual other than a deceased partner. Partnerships that opt out of the new audit rules will be subject to pre-TEFRA audit procedures under which the IRS must separately assess tax to partners under deficiency procedures. The election to opt out must be made annually on a partnership's timely filed return (including extensions) for the year to which the election relates. An election to opt out may only be revoked by the partnership with the IRS' consent. Even partnerships that opt out of the new audit rules must appoint a partnership representative (PR).

Actions Partnerships May Need to Take Promptly Regarding the New Rules

If they have not already done so, partnerships should consult with their legal counsel to consider reviewing and amending their partnership agreements as needed to take into account the new audit rules. Partners should consider who would be the best PR, as the PR must be officially appointed and in place before the 2018 tax return must be filed. Because each partnership's ownership structure and activities are unique, no "one size fits all" solution exists, but provisions to consider adding or revising may include:

- The designation and removal of the partnership representative (PR)
- The designation and removal of the individual who must be appointed under the proposed regulations, if the PR is an entity
- Whether partner consent will be required for making elections or settlements by the PR, including push-out and opt-out elections
- Appropriate indemnifications for the PR
- Reimbursement of the PR for the cost of obtaining professional assistance
- Requirements that the PR provide notice of and updates on audit proceedings, to obtain partner votes on various issues, and/or to otherwise restrict the activities of the PR
- The ability for management to make capital calls to cover the partnership's tax liabilities
- If the partnership intends to make the opt-out election, restrictions on transfers of partnership interests to entities that are ineligible partners
- Obligations of partners to provide information and cooperate with the requests of the PR
- If the partnership makes a "push-out" election, the ability to contact former partners
- Terms and conditions for amending the partnership agreement to deal with changes or updates to the new rules

The new centralized partnership audit regime is an extensive set of rules that are effective for tax returns filed for partnership tax years 2018 and beyond. If they have not already done so, partnerships and multi-member limited liability companies should consult with their legal counsel and CPA to ensure that they understand the sweeping implications of the rules and the changes that may need to be made to their partnership operating agreements.

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