

November 28, 2017

## Tax Alert – New IRS Partnership Audit Rules Coming Into Effect

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### Immediate Action Required

**All partnerships, including LLCs treated as partnerships for income tax purposes, should amend their partnership and operating agreements to designate a “partnership representative” and potentially provide for certain elections under new partnership audit rules coming into effect in 2018.**

Pursuant to the Bipartisan Budget Act of 2015, significant changes in the US federal income tax partnership audit rules will go into effect for tax years beginning on or after January 1, 2018. The new rules govern the manner in which the IRS may audit and assess income tax against tax partnerships (such as limited partnerships, general partnership and multi-member limited liability companies) and their partners. In light of the new rules, all tax partnerships should prepare for the new audit rules by reviewing and amending their partnership agreements to address the changes wrought by the new audit regime.

### *The Central Concept of the New Partnership Audit Rules*

Partnerships are pass-through entities, meaning that generally the partners, and not the partnership, pay tax on the partnership's income. When a partnership is audited, **the existing rules** require the IRS to make adjustments **at the partner-level and collect tax from the partners.**

**The new rules allow the IRS to collect tax directly from the partnership in certain situations**, even though the partners from the audited year may no longer hold interests in the partnership.

### *Key Aspects of the New Partnership Audit Rules*

The new rules create a default ability for the IRS to collect tax deficiencies (including interest and penalties) from the partnership instead of the partners. As a result, partners who acquire their partnership interests after the year under audit may incur the economic burden of taxes that should have been borne by other partners. The tax is generally calculated using the highest individual tax rate and does not take into account the individual tax situations of the partners (such as other losses available on the partner's return). Thus, the partnership may end up paying more overall tax than would have been paid in the aggregate by the partners as a result of partner-level adjustments.

Under the new rules, the partnership will be represented in all income tax proceedings by a “partnership representative,” who can be selected by the IRS in the absence of a selection by the partnership. Further, partners will have no right to participate in partnership tax proceedings and will be bound by the final result of the proceedings. By contrast, the “tax matters partner” under existing law has a more constrained role and other partners have more ability to participate in the audit proceedings. Thus, the selection of a partnership representative is an important part of preparing for the new rules. The partnership representative must be named on the partnership's tax return every year, but should also be designated in the partnership's partnership or operating agreement.

The new rules include an election to “push out” the tax liability to the partners in the audit tax year so that the IRS collects from those partners and not the partnership or the current partners. There continues to be uncertainty surrounding the scope of this election, however. The push out election is made after the IRS has provided the partnership with a Final Partnership Adjustment as part of an audit, but partnership and operating agreements can provide whether the partnership will make such an election where possible.

Generally, partnerships with no more than 100 partners and with no pass-through entity partners (e.g. upper-tier partnerships) may **elect out** of the new rules and continue to be subject to the existing rules. The election out is made annually on the partnership's tax return.

### *Proposed Treasury Regulations*

On June 13, 2017, the IRS issued proposed regulations expanding upon the new statutory rules. Unfortunately, the proposed regulations do not address all of the uncertainties raised by the new audit regime. Significantly, the proposed regulations leave it unclear whether partnerships will be allowed to make the election to “push out” partnership audit level audit adjustments through upper-tier partnerships.

## **Conclusion**

While the new audit rules and the Treasury Department's failure to promulgate comprehensive final regulations have engendered much uncertainty, there are certain basic steps that all tax partnerships should now consider. These include amending the partnership agreement to cover: the designation of a partnership representative, potential indemnity arrangements between current and former partners, and provisions dealing with the elections to "push out" partnership liabilities to the partners and to elect out of the new rules (including provisions designed to make such elections more feasible).

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