LOEB & LOEB LLP

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Important Revisions to Partnership Tax Audit and Payment Rules

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The recently enacted 2015 Budget Act includes a dramatic change in the rules for tax audits of, and the payment of tax deficiencies by, partnerships (including limited liability companies that are taxable as partnerships). Although the new rules generally are not effective until 2018, partnerships may elect to apply the rules sooner. In light of these new rules, agreements for acquiring or disposing of partnership interests require additional provisions dealing with these rule, new partnership agreements need to take them into account and existing partnerships should consider how their agreements should be amended.

Under the new rules, audits with respect to items of income, gain, loss, deduction and credit from a partnership are generally conducted at the partnership level, and the partnership (not any of the partners) is liable for any deficiency based on an assumed tax rate. As a result, the partners in the year in which the adjustment is made (called the “adjustment year”) bear the cost, rather than the persons who were partners in the year that was audited (called the “reviewed year”).

There are two general methods under the statute to put the burden back on the reviewed year partners. First, a partnership that has 100 or fewer partners (taking into account certain look-through rules), each of which is an individual, a C corporation (including a foreign entity that would be a C corporation if it were domestic), an S corporation or an estate of a decedent, may elect out of the new rules. Partnerships and trusts are not qualified partners for this purpose. As a practical matter, this election out will not be available to private equity or hedge funds, which typically have partnership members. For other partnerships, it raises questions for clients as to whether they want to prohibit nonqualified partners and disqualifying transfers so as to come within this exception, and what to do if they already have such partners. Although audits at the partner level may be less likely, transfers to family partnerships and trusts are very common for estate and family planning.

If the partnership does not (or cannot) elect out, it may still elect to require the deficiency based on the partnership level adjustments to be paid by the reviewed year partners. In such a case, however, the interest rate charged by the IRS will generally be increased by 200 basis points.

In the audit, the partnership is represented by a partnership representative who may or may not be a partner. All partners are bound by the partnership level adjustment. Net downward adjustments will not result in refunds, but will reduce the partnership’s income otherwise allocated to the partners in the adjustment year. Special rules apply to misallocations between partners.

The purpose of the new rules is to make it easier to audit partnerships and collect any related deficiencies. As a result, we expect the new rules will increase such audits. Unfortunately, there are many open questions and much of the implementation of the new rules has been left to future guidance. We will keep you apprised of additional developments.

If you have any questions or would like assistance with your agreements, please contact Alan Tarr in NY (212.407.4900, atarr@loeb.com) or Tom Lawson in LA (310.282.2298, tlawson@loeb.com).

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