

JANUARY 27, 2016 BULLETIN

Budget Act of 2015 Alert

New Partnership Audit Rules Will Impact New and Existing Partnership Agreements

The Bipartisan Budget Act of 2015 will change significantly the audit, assessment, and collection procedures applicable to entities treated as partnerships for federal income tax purposes (for example, many of the limited liability companies and limited partnerships encountered in business and investment transactions). Although these changes are scheduled to take effect for partnership tax years beginning after December 31, 2017, taxpayers and their advisors should act now to ensure that these changes are taken into account in newly-drafted partnership agreements and to determine the impact of these changes under existing partnership agreements.

Significant changes under the new rules include:

- **Audit, assessment and collection activity will occur at the partnership level.** Except as described below with respect to small partnerships and the partner liability election, partnership audits and assessment of additional tax liability will take place at the partnership level. Any additional taxes, interest and penalties resulting from the audit will be payable by the partnership. Certain "small partnerships" can elect out of this new regime, thereby causing any partnership adjustments to continue to be applied at the partner level. For this purpose, a small partnership will be an electing partnership that issues 100 or fewer Schedule K-1s for the relevant taxable year, and does not have a partner other than an individual, C corporation, foreign entity that would qualify as a C corporation, S Corporation, or estate of a deceased partner.
- **An election is provided to a partnership to impose the assessed tax liability on its partners.** Rather than pay the assessed tax directly, a partnership can elect to impose any adjustment for the taxable year under audit on its partners who were partners during the taxable year under audit (including former partners). This "partner liability election" must be made by the partnership no later than 45 days after the date of the IRS's notice of final partnership adjustment, and the partnership must furnish to each of its partners for the relevant taxable year under audit a statement reflecting the partner's share of any audit adjustment. A partner who receives such a notice would be required to include the adjustment in its income tax return for the taxable year in which the notice is received. The partner also would be liable for its allocable share of penalties and interest imposed with respect to the adjustment.
- **Audit procedure is applied solely at the partnership level.** The new rules replace the "tax matters partner" with a "partnership representative." The partnership representative is appointed by the partnership and does not have to be a partner. If a partnership does not appoint a representative, the IRS can appoint one on its behalf. The partnership representative has the sole authority to act on behalf of the partnership with respect to audit matters. Thus, the representative's actions will bind the partnership and its partners. The new rules do not appear to provide partners with rights to be notified of an audit, to participate in partnership proceedings, or to challenge a partnership assessment in court.

There are a number of questions raised by the Act that are left to be answered by regulations or other guidance issued by the IRS. Taxpayers and their advisors should not wait for this guidance to be issued before addressing the coming rule changes in new and existing partnership agreements. Unlike the prior regime, a number of choices can be made by a partnership under the new rules. Thus, there is no single approach that will apply to all partnerships.

Contractual considerations that should be taken into account under the new rules include:

- **Qualification for the "small partnership" election.**
 - Should the qualifying partnership elect out of the new rules?
 - Should restrictions on new partners and transfer restrictions be imposed to ensure that the partnership continues to qualify as a small partnership?
- **Considerations if "small partnership" election is not available (or not made) and partnership liability election is not made.**
 - Address the allocation of the partnership's tax cost and any other related obligations among the partners (including former partners).
- **Issues Relating to the Partner Liability Election.**
 - Ensure that the partnership has the right to make the election under its governing documents.
 - Consider obtaining partner consent to the election, along with an agreement of the partners to cooperate with any partnership audit (to the extent requested by the partnership) and properly report and pay their allocable share of tax resulting from the election.
- **Partnership Representative.**
 - Adopt a procedure for appointing, terminating and replacing a partnership representative.
 - Address the authority of the representative. Although the representative is given authority to bind the partnership under the Act, the partnership should be able to require that actions of the representative be subject to partner, manager, or board approval.
 - Consider imposing additional obligations on the representative such as a requirement to notify the partners of the existence of an audit and audit developments.

Please feel free to contact Ron Aulbach (412.297.4751) or Mike Silverman (412.297.4937) if you have any questions regarding this information. To receive future bulletins by e-mail, please send an e-mail to bulletins@cohenlaw.com.

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