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# Tax

## Significant Changes to Partnership Tax Audits Coming

**Action item: To allow the IRS to more easily audit and collect taxes from entities taxed as partnerships, including LLCs, new centralized partnership audit rules enacted as part of the Bipartisan Budget Act of 2015 are going into effect in 2018. The IRS has issued proposed regulations for implementing the new rules, which require careful consideration by these entities. Before year end, partnerships and LLCs will need to review their governing documents, and consider amending their agreements due to the new rules.**

In less than six months, on January 1, 2018, the new centralized partnership audit rules enacted by Congress as part of the Bipartisan Budget Act of 2015 ("BBA") will go into effect. The new rules were drafted in response to the proliferation of business entities that are taxed as partnerships (such as LLCs), and the perceived difficulty in being able to both effectively audit these entities and to assess and collect tax from the individual parties as appropriate.

The BBA creates a new partnership audit regime that significantly changes the procedures for partnership audits under the Tax Equity and Fiscal Responsibility Act ("TEFRA") and the special rules for Electing Large Partnerships ("ELP"). Under the new rules, tax adjustments resulting from partnership examinations will generally be assessed at the partnership level rather than the individual partner level. This enables the IRS to collect tax due on partnership adjustments at the entity level, effectively imposing an entity level tax on partnerships. Previously, under TEFRA, adjustments to partnership items were determined in a single proceeding at the partnership level, but then flowed through to partners pursuant to a complex set of rules requiring significant IRS time and effort. The new rules are intended to simplify the complexity of the current partnership audit rules, and increase the ability of the IRS to examine partnerships, particularly large and tiered partnerships.

In addition, as a result of the new rules, careful consideration will have to be given in drafting the operative provisions of the governing documents, including but not limited to the expansion of the role and powers of the partnership representative, and the manner in which the various elections available to the entity will be dealt with.

### Features of New Audit Rules

In general, the new audit rules completely replace the rules under TEFRA and ELP, and provide new rules for determining, assessing, and collecting tax in connection with adjustments resulting from an examination of a partnership. The new audit

regime is intended to provide a single set of rules that apply to all partnerships, regardless of size, and is intended to improve the ability of the IRS to audit partnerships, particularly large and highly tiered partnerships.

A summary of key provisions of the new centralized audit regime is provided below:

- ***Tax adjustments made at partnership level:*** As previously provided, under the new rules, tax adjustments resulting from an examination of a partnership will be assessed and collected at the partnership level rather than the individual partner level, effectively imposing an entity level tax on partnerships. Under modification provisions, the partnership bears the burden of modifying any proposed adjustments, and partners are bound by any result agreed to by the partnership.

- ***Election out of BBA:*** The new audit rules are intended to provide a single set of rules that apply to all partnerships regardless of size or number of partners, unlike TEFRA, which had generally applied only to partnerships with more than 10 partners. The BBA provides that eligible partnerships may elect out of the centralized audit regime, although the IRS warns that electing out of the new regime will not prevent a partnership from being audited. The IRS intends to closely review a partnership's decision to elect out of the centralized partnership audit regime, to ensure that the election out rules are not being used to frustrate IRS compliance efforts. Eligible partnerships that make a valid opt-out election, if selected for audit, will be audited pursuant to pre-TEFRA audit procedures under which the IRS must separately assess tax with respect to each partner under regular deficiency procedures.

- ***Consistent treatment:*** Similar to TEFRA, the BBA requires that a partner treat items from the partnership consistent with the partnership's treatment of the items on the partnership's return. Unlike TEFRA, however, any underpayment of tax by a partner resulting from a failure to treat an item consistently will be treated as a mathematical or clerical error, allowing the IRS to immediately assess and collect such tax, except in certain circumstances where the partner has properly notified the IRS of the inconsistency.

- ***Partnership representative:*** The new audit rules require each partnership to designate a "partnership representative" who will be granted broad authority to bind the partnership and all partners in an examination, replacing the "tax matters partner" ("TMP") concept that applied under TEFRA. The partnership representative will also have sole authority to act on behalf of the partnership in any examination or other IRS proceeding. Generally, partners may not participate in or contest the results of an examination or other proceeding without permission of the IRS, nor do partners have any right to notice of an IRS proceeding. The proposed regulations further provide that the broad authority of the partnership representative may not be limited by state law or partnership agreement. Any action taken by the partnership representative with respect to the centralized partnership audit regime is valid and binding on the partnership for tax purposes regardless of state law, partnership agreement, or any other document or agreement.

  Unlike the TMP, the partnership representative may be any person, including an entity or a non-partner, as long as the person meets certain eligibility requirements. Partnerships must designate the partnership representative each year on their annually filed partnership return, and a designation for one taxable year is not valid as to another taxable year. A partnership representative designation remains valid and in effect until the partnership, the partnership representative, or the IRS takes an affirmative action to terminate that designation, as set forth in the proposed regulations. If a partnership fails to designate a representative, the IRS may designate any person to serve as partnership representative, and the designation may not be revoked without the consent of the IRS.

- ***Imputed underpayment and modification procedures:*** Generally, a partnership will be required to pay any imputed underpayment in the adjustment year, and the IRS may calculate more than one imputed underpayment for a single taxable year. The imputed underpayment is calculated by multiplying the total netted partnership adjustments by the highest applicable federal income tax rate in effect for the reviewed year. The proposed regulations provide a detailed framework for grouping and subgrouping adjustments, which is intended to enable the IRS to net adjustments according to applicable restrictions and limitations. Any imputed underpayments resulting from such adjustments are set forth in a notice of proposed partnership adjustment ("NOPPA") mailed to the partnership and partnership representative.

  A partnership may request modification with respect to an imputed underpayment under modification procedures set forth in the proposed regulations. The modification provisions are intended to allow individual partners to demonstrate that based on their specific factual circumstances, the tax calculated on their individual amended returns will reduce the imputed underpayment of the partnership.

- ***Push-out procedure:*** As an alternative to paying any or all of the imputed underpayment(s), a partnership may elect to "push out" adjustments to its reviewed year partners rather than paying any or all of the imputed underpayment(s). If a partnership makes a valid election in accordance with the regulations, the partnership is no longer liable for the imputed underpayment(s). In addition to making an affirmative election, the partnership is required to furnish statements (separate from the K-1s) to the reviewed year partners with respect to each partner's share of the adjustments, and file those statements with the IRS. If any or all imputed underpayments are pushed out, the reviewed year partners will be responsible for the tax attributable to the adjustments. The regulations require partnerships that make a push-out election to calculate a "safe harbor" amount, which a partner may elect to pay rather than the additional reporting-year tax that would otherwise be calculated by the partner.

## Conclusion

Generally, the new audit rules will be effective for partnership taxable years beginning after December 31, 2017. Although the new rules are intended to reduce complexities under TEFRA, and improve the ability of the IRS to audit large partnerships more efficiently, the new rules present new challenges for partnerships. Partnerships should review their partnership agreements before the end of the year, and consider amending their agreements in anticipation of the new rules taking effect in 2018.

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