Partnership/LLC New Auditing Rules Newsletter

The Bipartisan Budget Act of 2015 resulted in several important changes in the way partnerships and limited liability companies will be treated for federal income tax purposes and the judicial process that will be applied to these entities. For tax years beginning after December 31, 2017, these new rules will have a significant effect on many issues involving federal income tax treatment of these entities. These issues range from the designation of a "partnership representative" to potentially having to pay an entity-level tax after a partnership auditing adjustment. However, the new rules also show entities how to "push out" a partnership auditing adjustment to the partners to avoid having to pay a tax at the entity level.

The new partnership audit rules will apply to all partnerships, but certain partnerships will be able to "elect out" of these rules each year if they meet certain requirements. The partnership must have 100 or fewer partners that must be individuals, C Corporations, S Corporations, or an estate of a deceased partner. A partner also may be a foreign entity if it would be classified as a C Corporation were it domestic. Keep in mind that the "100 or fewer partners" rule specifically applies to the number of Schedules K-1 that are issued by the entity. Therefore, this rule is better thought of as a "100 or fewer K-1s" rule. This means that partnerships who have an S Corp as a partner may not be able to qualify to elect out of the new partnership rules if the S Corp distributes many K-1s that cause the total number of all Schedules K-1 issued by both entities to exceed 100. Lastly, the partnership must file an election with a timely filed return identifying the names and identification numbers of each of the partners, and the partnership must also notify each partner of the election.

Another change is that instead of having a "tax matters partner," the new rules require that the partnership designate a "partnership representative." This person does not have to be a partner, but they do have to have a substantial presence in the United States. The IRS will select a partnership representative in the event the entity does not select one. The partnership representative has sole authority to act on behalf of the partnership and will be able to bind the partnership and all partners in a federal income tax audit or judicial proceeding. Furthermore, the partnership representative will be the only person associated with the partnership that will receive notice of any proposed partnership adjustments, final adjustments, or any administrative proceeding that has been initiated.

The new rules also dictate that the entity itself can potentially bear the burden of paying a tax liability resulting from partnership adjustments determined during a federal income tax audit or judicial proceeding. The tax is known as an "imputed underpayment" and is calculated by netting together all the partnership adjustments and applying the highest applicable tax rate of any partner to each of the partners, meaning that a C Corporation that is a partner could have the 39.6% individual rate applied to its share of the adjustment if individuals are also partners in the partnership.

However, the partnership also has the option of "pushing out" the imputed underpayment to the partners themselves. To push out the adjustments to the partners, the partnership must make this election within 45 days of receiving a final notice of partnership adjustment from the IRS.

Upon making the election, the partners will then also be required to add interest to the tax liability assessed to them through the adjustment at a rate two percentage points higher than the general interest rate on underpayments. This interest is calculated from the due date of the partner's return for the tax year being reviewed. The statute of limitations requires that these adjustments may not be made three years after the later of the date the partnership return for the reviewed year was filed, the return date (including extensions), or the date the partnership files an administrative adjustment request (AAR).

There are also a few items that are treated in a similar manner as they were under the TEFRA rules. For example, the partnership may file an AAR to adjust its taxable income and take account of it in the year the AAR is filed instead of the prior year. Additionally, partners are still required to treat all items of income, deduction, credit, etc., on their returns in a manner consistent with the treatment of such items on the partnership return.

These new auditing rules significantly impact the way partnerships and LLCs will be treated going forward for federal income tax purposes, and these rules will greatly influence how partnerships and similar entities are handled throughout an audit or judicial proceeding. As the effective date for these new rules approaches, many other issues and consequences of these changes may arise in unforeseen ways. The information above is only a sample of the many changes and requirements of the IRS's new partnership auditing rules. It is not intended to be a complete summary and should not be relied upon in constructing a partnership/LLC operating agreement.