

Partnerships Must Respond to New Audit Rules

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The recently-enacted Bipartisan Budget Act of 2015 includes a far-reaching overhaul of the rules applicable to IRS partnership audits and tax adjustments. This will be significant for partnerships and limited liability companies taxed as partnerships (collectively, "Tax Partnerships"), as well as for firms that sponsor, advise, or market Tax Partnerships to investors.

Although the changes generally take effect beginning in 2018, and Treasury regulations will be issued that contain the specifics of the law's operation, it is important to act now to evaluate how the new rules will impact both existing and newly-formed Tax Partnerships and to take responsive actions. Such actions may include amending existing partnership and LLC operating agreements, and planning whether to now make certain elections further discussed below.

Under the Act, a Tax Partnership will be liable for any additional tax, interest, and penalties imposed due to any partnership audit adjustment, under principles substantially different from those that have previously applied.

Among other things, any IRS adjustments generally will be taken into account at the Tax Partnership level, rather than allocated to its partners, in the year the audit or judicial review is completed, and the cost of any adjustment will flow to the partners/LLC members in that year, rather than to those partners who benefitted in the tax years under audit.

Nevertheless, the Act allows certain Tax Partnerships with 100 or fewer qualifying partners/members to opt out of the new audit rules by making an annual election on timely filed returns. The Act also permits Tax Partnerships to "push down" the audit adjustments to prior-year partners and prescribes how to make that election.

The Act further provides for audits to be handled by a "designated partnership representative," who can be a partner/LLC member or any other person with a substantial U.S. presence. This replaces the concept of a "tax matters partner" under current audit rules.