

# All Partnerships Should be Thinking about the New Partnership Audit Regime Now

## Insight — 10/24/2017

A new centralized audit regime for federal income tax audits of tax partnerships (including limited partnerships and LLCs) will take effect for all partnership taxable years beginning after December 31, 2017. The new audit rules make fundamental changes to the way federal income tax owing as a result of audit adjustments and amendments to partnership returns is paid by partners and partnerships. All partnerships need to consider and plan for these rules.

Under the new audit rules, tax owing as a result of a partnership audit or amendment to a partnership return will be payable by the partnership itself, not the partners with respect to whom the adjustment relates, unless the partnership takes certain steps. Thus, if the composition of a partnership's partners or the partners' percentage interests change over time, the new rules may result in the current partners bearing the cost of an adjustment to tax attributable to a prior taxable year when they were not yet partners or bearing more (or less) of the cost than they would have borne based on percentage interests during the year to which the adjustment relates.

Partnerships may elect out of the new audit rules, but only if they qualify as "small partnerships." A partnership will generally qualify as a small partnership for any taxable year if (i) it has no more than 100 partners (directly or indirectly through S corporations that are themselves partners) and (ii) it has no partners that are themselves partnerships, trusts (including grantor trusts), nominees, estates, or disregarded entities (e.g., single-member LLCs). If a partnership successfully elects out of the new rules, the IRS will need to audit each partner separately in order to make an adjustment to tax.

Any partnership that expects to elect out of the new rules for 2018 should confirm before January 1, 2018, that it has no ineligible partners. Depending on its size, moreover, the partnership may wish to set limits on transfers of partnership interests (including indirect transfers through S corporation partners) to avoid running afoul of the 100-or-fewer-partners rule.

Partnerships that do not, or cannot, elect out of the new rules may still be able to shift liability for adjustments to tax back to those who were partners during the year for which the adjustment was made. But this may require various amendments to their existing partnership agreements. For example, the new rules permit partnerships to make a "push-out" election, shifting liability for payment of the tax resulting from an audit adjustment to

those who were partners during the year with respect to which the adjustment relates. Making this election, however, will require all partners to provide certain information to the partnership. Partnerships interested in preserving their ability to make the push-out election may wish to revise their partnership agreements to require their partners to furnish this information in a timely manner, whether or not they are still partners when the information is requested.

Partners and partnerships may also choose to handle liability for taxes resulting from adjustments contractually through indemnification provisions in the partnership agreement. Such provisions might require those who were partners during the taxable year with respect to which the audit relates—whether or not they are partners during the taxable year in which the audit is finalized—to pay over to the partnership their pro rata shares of the tax owing.

In addition, the new rules eliminate the familiar concept of "tax matters partner" in favor of a "partnership representative." The partnership representative, who (unlike the TMP) need not be a partner, will have sole authority under the rules to act on behalf of the partnership. If a partnership fails to designate a partnership representative, the IRS may select any person to act as such. Thus, in addition to addressing liability for tax adjustments, partners and partnerships may wish to revise their agreements to specify who will serve as the partnership representative and consider whether and how to limit contractually the partnership representative's authority to act with respect to tax matters.

The new audit rules are lengthy and complex. *The above discussion is intended only as a summary of certain key provisions. It does not purport to address all the issues that may arise under the new rules, and it is not intended as legal or tax advice.* The new rules, moreover, are still in a state of flux. The IRS and Treasury Department have proposed regulations interpreting and applying the new rules, but as of this writing those regulations have not been finalized. Thus many questions remain about how the rules will work in practice.

Nevertheless, in anticipation of the January 1, 2018, effective date, partners and partnerships would be well advised to consider amending their partnership agreements to account for the rules in their current state, recognizing that additional amendments may be necessary once the regulations are finalized.

If you have questions about these issues or would like to discuss amending your partnership agreement, please contact the Tax and Benefits team.

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