

New Partnership Audit Rules

Should you amend your Operating or Partnership Agreement?

New rules governing federal tax audits and collections for partnerships and limited liability companies taxed as partnerships (referred to as “**Tax Partnerships**” below) will go into effect for tax years beginning in 2018 and after. In a significant departure from the rules that applied to tax years before 2018, any additional tax liability resulting from an audit under the new rules will be computed, imposed and collected at the entity level. A Tax Partnership formed prior to 2018 may wish to amend its partnership agreement or operating agreement (the applicable agreement referred to as the “**Governing Agreement**” below) to address at least certain aspects of these new audit rules. The following provides a basic overview of certain of the new audit rules and how they differ from the current audit regime, and summarizes several aspects of the new audit rules that a Tax Partnership may wish to address through an amendment to its Governing Agreement.

Under the system applicable to most Tax Partnerships for their tax years prior to 2018 (the “TEFRA Rules”), audits and determinations of partnership tax items take place at the partnership level, and then the IRS makes the corresponding adjustments and collects any additional tax at the level of the partners. The Bipartisan Budget Act of 2015, with subsequent amendments by the Protecting Americans from Tax Hikes Act of 2015, overhauled the TEFRA Rules for tax audits and collections for Tax Partnerships for their tax years beginning after December 31, 2017 (the new rules, the “**BBA Audit Rules**”). Under the BBA Audit Rules, the IRS will continue to conduct the audit and determine adjustments to Tax Partnership tax items at the entity level, but it will now also assess and collect an imputed tax amount on upward income adjustments (calculated using the highest rate) at the entity level. The imputed tax will be a current Tax Partnership liability (indirectly born by current partners in proportion to their current interests) even though it was determined in respect of a previous year (when the identity

and interests of partners may have differed). A limited category of Tax Partnerships will be eligible to elect out of the BBA Audit Rules (the election is made annually on the entity's tax return) – those with 100 or fewer partners all of which are C or S corporations, individuals or estates (among other requirements). Entities with owners that are trusts (whether grantor trusts or nongrantor trusts), LLCs, partnerships and single member disregarded entities are not eligible to elect out of the BBA Audit Rules. In addition, the BBA Audit Rules provide various alternatives a Tax Partnership can pursue to reduce the entity level tax amount and/or shift the liability to the adjustment year partners, including:

- A “push-out election” under which the Tax Partnership pushes out the adjustment items (and any resulting tax liabilities) to the audit year partners. The push-out election carries an additional 2% interest charge to the partners and timing requirements that may present a compliance challenge.
- The filing of amended tax returns and the payment of additional taxes by one or more of the audit year partners will reduce the entity level tax.
- The imputed entity level tax may be reduced by providing information establishing that one or more partners are tax-exempt or subject to a lower rate of tax (*e.g.*, capital gains rates).

Other significant changes made by the BBA Audit Rules relate to partners' rights in respect of the audit and the broad authority vested in a “**Partnership Representative.**” Under the TEFRA Rules, most partners are entitled to notice from the IRS of an audit and have certain participation rights. Under the BBA Audit rules, these rights are eliminated and the IRS will communicate and deal only with the Tax Partnership's Partnership Representative as identified on its tax return for the year under audit. The Partnership Representative will have authority to bind the Tax Partnership, and in some cases its partners, in the context of an IRS audit.

The BBA Audit Rules will apply to all Tax Partnerships for tax years beginning after 2017 regardless of whether any Tax Partnership's Governing Agreement addresses

them. However, an amendment to the Governing Agreement to address at least certain aspects of the BBA Audit Rules may be in the best interests of one or more of the Tax Partnership, its management, the Partnership Representative and/or its partners (which interests may be in conflict). Among the matters and potential issues under the BBA Audit Rules that an amendment to the Governing Agreement might address are:

- **Election out of the BBA Audit Rules** – If the election is available, who makes the decision whether to make the election or should it be required? Additional transfer restrictions may be needed to preserve the availability of the election.
- **Contribution obligations in respect of entity level tax** – Absent a push-out election, upward income adjustments will result in an imputed tax liability to the Tax Partnership which (a) it may not be able to pay from available cash reserves and (b) will be indirectly borne by the current partners in proportion to their current interests. A current partner will bear a disproportionate share of the audit year imputed tax if such partner either was not a partner or held a smaller percentage interest in the audit year. Without an amendment to the Governing Agreement, partners and former partners are likely under no obligation to contribute funds (including by withholding from distributions) to reimburse the partnership for their proportionate share of the audit year imputed tax amount.
- **Discretion and authority of the Partnership Representative** –
 - Although management may, in most instances, want to retain the broad authority and discretion granted to the Partnership Representative under the BBA Audit Rules, the Governing Agreement might specifically authorize the Partnership Representative to take such actions and serve as a disclosure to and acknowledgment by the partners of the breadth of such authority.
 - In some situations (*e.g.*, partners with significant leverage, multi-manager entities), the Governing Agreement might impose limits on the authority of the Partnership Representative (although the IRS is not bound to these limitations). These limits might include requiring the Partnership Representative to make the push-out election, or to obtain requisite

consent or follow the instructions of the consent group with respect to audit related elections, modification procedures and administrative or judicial proceedings.

- **Identity and standard of care of the Partnership Representative** –
 - The Governing Agreement can disclose and identify the Partnership Representative (who need not be a partner) and address the replacement of the Partnership Representative.
 - If the Partnership Representative is to be released from claims and/or indemnified by the Tax Partnership in respect of losses arising from its actions as Partnership Representative, or at the other end of the spectrum, if the Partnership Representative is to act as a fiduciary of the partners, the Governing Agreement will need to be amended to so provide.
- **Partner cooperation** – Absent amendment to the Governing Agreement, the partners may have no obligation to cooperate with the Partnership Representative and/or provide information and documentation needed to reduce the entity level tax under the modification provisions of the BBA Audit Rules.
- **Partners' rights** – If the partners are to be given any notification, information (*e.g.*, copies of IRS correspondence) or participation rights in respect of tax audit matters under the BBA Audit Rules, the Governing Agreement will need to provide those rights.

If you have any questions about the BBA Audit Rules or wish to discuss potential amendments to your Governing Agreement to address the BBA Audit Rules, please feel free to contact [Stacey Brady](#), [Kristin King](#) or any Schell Bray attorney with whom you may have previously worked on your partnership or LLC matter.