Roberts & Holland LLP

To Our Clients and Friends: **November 13, 2015**

New Partnership Audit Rules May Not Apply Until 2018, But They Are Your Headache Right Now

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Major changes are coming to the ways in which partnerships' Federal income tax returns are examined by the IRS and in which disputes regarding partnerships' tax reporting are resolved in court. But those changes will generally be effective only for returns filed for taxable years beginning after December 31, 2017. In the typical case, this will mean that the new rules will first apply to returns that are filed during 2019, with respect to the 2018 taxable year. Why is it important that you pay attention right now?

The existing system for examining most partnership tax returns was put in place in 1982 and last subject to a major "tune up" in 1997. Congress has been concerned for many years that the existing system does not enable the Government to audit partnerships' returns effectively and to collect any unpaid tax in an efficient way. In an effort to ensure that businesses conducted in partnership -- including limited partnership and LLC -- form pay their "fair share," the Bipartisan Budget Act of 2015 has rewritten the rules completely.

In general, the new rules make two huge departures from the existing system. First, control of the audit and litigation process is centralized in a single "partnership representative." The rules do not appear to provide a mechanism for a direct or indirect partner, other than the partnership representative, to participate in any administrative or judicial proceeding in connection with examination of the partnership's tax returns.

Second, if an underpayment of tax is found at the end of an administrative or judicial proceeding, the partnership itself, rather than the partners to whom the partnership's income normally "flows through," will be liable. (The partners, and not the partnership, will continue to be liable for tax on income actually allocated to them on the partnership's return as originally filed.) The economic burden of any adjustment will be borne by the persons who are partners in the year that the proceeding comes to an end (and in their partnership percentages for that year), whether or not they were partners during the year under review, rather than by the persons who were partners during the year under review.[1]

Many of the new provisions are written very poorly, and some of those that seem clear lead to extremely onerous results. Accordingly, it is expected that there will be significant pressure for clarification through Treasury Regulations or legislative "technical corrections." There may even be a lobbying effort to get the new provisions repealed entirely before they come into effect.

Meanwhile, as we await clarification from Treasury or Congress, it is important for anyone who is contemplating either entering into a partnership, limited partnership, or limited liability company agreement or acquiring an interest in an existing entity to focus on what rights and restrictions and what representations, warranties, and covenants to seek. The areas to be covered include:

1. ***Election Out of New Rules***. Under limited circumstances, a "small" partnership (that is, one that has 100 or fewer direct and indirect partners and that meets other statutory requirements) may be eligible to elect not to be subject to the new rules. Should the partners bind themselves to make that election, if it is available? If feasible, should the partners agree to restrict transfers of partnership interests in a manner that will increase the likelihood that the election will continue to be available?

2. ***Designation and Powers of Partnership Representative***. Who will be the partnership representative (or who will have the ability to designate that person)? Should the agreement require the partnership representative to take direction from some designated group of partners? Can the agreement require the partnership representative to facilitate, to the extent permitted by the IRS and the courts, the participation of all partners in the process? Obviously, the position that one takes on some of these issues depends on whether or not one will be (or is representing the person who will be) the partnership representative.

3. ***Indemnity for Payment by Partnership***. If an IRS examination adjusts a partnership's income, and the partnership, as contemplated by the new rules, is obligated to make a payment to the IRS, should the persons who were partners during the year the return for which was examined be obligated to reimburse the partnership? If so, in what amounts, and at what time?

4. ***Alternative Payment Procedures***. The new rules do offer some alternative structures under which the burden of liability for any underpayment can be shifted back to the partners from the partnership. Unfortunately, it is very unclear exactly how these procedures will work and what collateral disadvantages arise if a partnership attempts to take advantage of them. The partners may want a provision in their agreement to govern who decides whether or not to use these alternative procedures, the obligation of partners to cooperate, and so on.

5. ***Representations, Warranties, and Indemnities Upon Purchase of Partnership Interest***. Purchasers of corporate stock typically obtain appropriate representations, warranties, and indemnities with respect to potential income tax liabilities of the corporation. However, purchasers of partnership interests have historically not exhibited the same level of concern, because partnerships have not generally incurred Federal income tax liability of their own.[2] The new rules change that. Any purchaser of a partnership interest during 2018 or a subsequent year now needs to be concerned with the possibility that an IRS audit of a pre-purchase period can result in the imposition of liability for payment of tax (and interest and penalties) on the partnership itself. Accordingly, the same sorts of contract provisions that have been found in corporate stock purchase agreements may now be needed in partnership interest purchase agreements.[3]

6. ***Amendment of Existing Agreements***. Whenever new partnerships are formed, or partnership interests are sold, between now and 2018, the parties will naturally focus on these new rules. However, existing partnerships will become subject to these rules on January 1, 2018, so partners should also think about whether they want to amend existing agreements, written against a very different statutory and procedural background, to deal with these issues.

We are continuing to study and to analyze these new rules (including numerous technical aspects and additional rules not summarized above), and we will be monitoring relevant statutory and regulatory developments closely. For now, anyone contemplating a partnership transaction must place dealing with these rules high on the list of concerns. Do not hesitate to contact Elliot Pisem (212-903-8777; episem@rhtax.com), Richard Levine (212-903-8729; rlevine@rhtax.com), Stuart Gross (212-903-8723; sgross@rhtax.com), or one of our other attorneys if you have any questions about these rules.

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[1] The partnership may not be entitled to the benefit of partner-level losses and other favorable tax attributes that could have been used to reduce any partner's tax liability if the partnership's income had been reported correctly in the first instance.

[2] Of course, even under existing law, partnerships may have entity-level liabilities for all sorts of Federal, state, and local taxes, including withholding obligations with respect to other persons' (employees', foreign partners', etc.) Federal income tax, and purchasers of partnership interests already need to be concerned about such liabilities.

[3] In the case of purchases prior to 2018, a purchaser may also want assurance that the partnership will not elect (and has not elected) to apply the new rules before the January 1, 2018, effective date.