New Partnership Audit Rules for 2018

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The new partnership audit rules under the Bipartisan Budget Act of 2015 (the "**BBA Rules**") are scheduled to go into effect on January 1, 2018 for partnerships with a calendar year. The BBA rules signal a marked change in the way entities that are classified as partnerships for federal income tax purposes are audited in that for the first time, the entities, not their partners or members, are liable to pay the tax resulting from an IRS adjustment ("**Imputed Underpayment**"). The tax rate on that Imputed Underpayments is the highest rate under § 1 or § 10 of the Internal Revenue Code (39.6% at the time of the publication of this article). These BBA Rules are effective for partnership taxable years beginning in 2018 so **PLANNING SHOULD START TODAY** by all general and limited partnerships and multi-member limited liability companies. The balance of this article provides answers to key questions related to the BBA Rules, as well as planning ideas to consider in light of these BBA Rules.

For purposes of this article, the term "partnership" refers to every type of multi-owner unincorporated business entity that is classified as a partnership for federal income tax purposes, including, but not limited to, multi-member limited liability companies ("LLCs"), general and limited partnerships and statutory business trusts; and the term "partner" also refers to members of LLCs.

Q1. How are audits, assessments and collection of federal income tax deficiencies different under the BBA Rules versus the "Old Rules" under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")?

Under the BBA Rules, audits of partnerships that are not BBA small partnerships will be determined at the partnership level (and not at the partner level as is the case under TEFRA). In that regard, partnership audits will bind the partnership and its partners in connection with partnership audits at the audit level, as well as at the administrative level and with respect to tax court appeals.

Q2. What is a BBA small partnership under the BBA Rules?

BBA small partnerships are partnerships with no more than 100 partners. With respect to those 100 partners, partners can only be (i) individuals, (ii) estates, (iii) C corporations, (iv) S corporations, and (v) foreign entities that would be C corporations if they were domestic entity. Thus, if ownership includes a partner that is a revocable trust, single member LLC, or partnership (i.e. tiered partnerships), the entity does not qualify as a BBA small partnership.

PLANNING POINT: Instead of holding partnership interests in a revocable trust or a single member LLC, partners could hold those interests individually and avoid probate under the Transfer on Death Security Registration Act. In the event that a partnership is a partner of a partnership, the partnership could distribute their interests in that partnership to its partners.

Q3. What must a BBA small partnership do to avoid the BBA rules?

BBA small partnerships must file an election to be treated as a BBA small partnership on their federal tax return each year starting with the 2018 calendar year. If a partnership fails to file an election, it will be subject to the BBA Rules even though it otherwise qualifies as a BBA small partnership.

PLANNING POINT: Partnership/Operating Agreements of BBA small partnerships should include provisions restricting transfer or issuance of interests to partners who are not qualified to be a partner in a BBA small partnership; partners may also want to include BBA audit provisions in the event that the partnership inadvertently fails to make a required election or admits an ineligible partner to the partnership. Finally, the partnership must put in place a measure to ensure that its tax professional files the election for each tax year starting with the 2018 calendar year.

Q4. What does the term "Partnership Representative" mean under the BBA Rules?

Under the BBA Rules, the "Tax Matters Partner" is eliminated and replaced with Partnership Representative. Only the Partnership Representative of a partnership, not the partners, may participate in a partnership audit under the BBA Rules; in fact, the Partnership Representative does not even have to notify the partners that the partnership is under audit under the BBA Rules. And if no Partnership Representative is designated by the partnership, the IRS may select any person to serve as Personal Representative, including persons who are not partners of the partnership. Thus, it goes without saying that all partnerships, even those that are BBA small partnerships, appoint a Partnership Representative to handle audits under the BBA Rules.

PLANNING POINT: Partnership/Operating Agreements should be amended to designate a Partnership Representative (and successor Partnership Representatives), as well as the Partnership's authority with respect to the BBA Audit (i.e. authority to settle an adjustment) and his duty to involve other partners in the BBA Audit.

Q5. Which partners bear the economic burden of adjustments for the year under audit (the "Reviewed Year")?

Unless the partnership makes a "Push Out" election, the partners of a partnership in the year the audit is performed (the "**Adjustment Year**"), bear the burden of the Imputed Underpayment for the Reviewed Year ***even if they were***

not partners in the Reviewed Year. For example, a person added as a partner to a partnership in 2019 would bear the harsh economic burden of an Imputed Adjustment for a prior Reviewed Year (i.e. 2018) even though he or she was not a partner of the partnership in the Reviewed Year. Accordingly, partnerships must plan for changes in ownership or ownership percentage. Specifically, a partnership may elect to pay the tax with its tax return in the Adjustment Year, or make a "Push Out" election to cause applicable partners to pay the tax with their individual tax returns for the Adjustment Year. In the example above, the partners in the Reviewed Year (2018), and not Adjustment Year (2019), would pay his or her share of the Imputed Underpayment if a "Push Out" election is made by the partnership.

PLANNING POINT: Partnerships should consider whether to include mandatory "Push Out" provisions in their partnership/operating agreement or require the partnership to file an amended return with an "Administrative Adjustment Request."

Q6. Should Partnerships consider making an election to be taxed as an S corporation to avoid the BBA Audit Rules?

An easy way for a partnership to avoid the BBA Rules is to elect to be a S corporation under the check the box regulations. However, partnerships should consider the benefits of avoiding the BBA Rules and the costs of losing the benefits under sections 701, 702, 721, 731, 734, 743, 751, and 752 of the Internal Revenue Code (and the social security tax avoidance available to partners) before making an S corporation election.

The BBA Rules are numerous and complex, and therefore, it is not possible to address all of the BBA Rules in detail. This summary is intended to provide a useful overview of the big picture issues that every partnership needs to consider and address in light of the BBA Rules, as well as flag the importance of beginning the planning process now.