
Getting Ready for the New Partnership Audit Rules

The New Partnership Audit Rules under The Bipartisan Budget Act (BBA) of 2015The Bipartisan Budget Act (BBA) of 2015 was signed into law in November 2015. This new law marks a major change in how the IRS will approach a partnership audit moving forward. This law applies to tax returns filed for partnership tax years beginning in 2018. And repeals the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) that up until December 31, 2017 governed partnership administrative procedures. The BBA sets up a new, centralized system for the audit, adjustment, assessment, and collection of partnership-related taxes.

Main Changes

Partnership Level Assessment - Pursuant to the BBA, partnership adjustments will generally be assessed and collected at the partnership level. This represents a major change from current practice that conflicts with the general flow through treatment that has historically been accorded to partnerships. Generally, the IRS will be able to assess any additional tax resulting from an audit against the partnership itself. This will eliminate the need to proceed against individual partners. The assessment will be made against the partnership the year the audit concludes, and payment will be made from the partnership assets that year. That means those who are partners the year the audit concludes will bear the economic impact of the assessment – not those who were partners the year under audit. This potentially problematic situation in fact can be addressed in either the partnership/LLC agreement or in a purchase agreement for an acquired interest.

Partnership Representative - Every partnership will have to appoint a partnership representative who will have exclusive authority to represent the partnership before the IRS and to make every decision relating to certain elections, audits, and settlements with the IRS.

Under the new audit rules, a "partnership representative" replaces the role of the Tax Matters Partner (TMP) under the previous rules ; who has complete authority to act on behalf of the partnership (and therefore effectively the partners) when dealing with the IRS. This authority includes the ability to bind the partnership and the partners with respect to audits and other proceedings including settlement authority and decisions on procedural issues such as extending the statute of limitations and whether to proceed to litigation.

Importantly, there is no legal obligation under the IRS rules for the partnership representative to keep partners updated on the status of the audit. Or even to notify the partners of the audit. Lastly, unlike a TMP, the partnership representative does not even need to be a partner of the

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partnership. If a partnership does not designate a partnership representative the IRS “may select any person as the partnership representative.”

Applicability and Opting Out

The BBA rules will generally apply to all partnerships. But partnerships that satisfy certain requirements and have 100 or fewer qualifying partners will have the option to elect out of the new rules. If they make an election out, the partnership and its partners will be allowed to have audits performed at the individual partner level.

Smaller partnerships (generally less than 100 partners) are eligible to elect out of the new rules. Only if it meets certain other requirements only if each of its partners is either an:

- individual
- C corporation
- foreign entity that would receive treatment as a C corporation if it were domestic
- S corporation
- an estate of a deceased partner

It is important to realize that if the partnership has a partner that is a partnership or an LLC treated as a partnership, this election out is not available. Also, this requirement precludes any partnership with a partner that is a trust from making the election. Eliminating the availability of this election for many partnerships, since it is common to have partners that are grantor trusts. Disregarded entities and any persons that hold an interest in the partnership on behalf of another person are also ineligible partners.

Other elections are available. Whereby the partnership can choose to issue adjusted information returns to its partners; showing their share of the audit adjustment, instead of having the partnership pay the tax liability or an election to have all of the partners agree to make amended return filings.

Each of these elections are subject to complex rules and require analysis by a competent tax advisor.

Checklist of Issues to Consider in Partnership or LLC Agreements

The new partnership audit rules under the BBA intended to raise significant revenue. Estimates project them to raise almost \$10 billion in tax revenues over the next 10 years. This is a definite sign that more partnership and LLC audits are on the way. This makes it even more imperative that operating agreements and partnership agreements have language addressing the relevant

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issues. And that each partner understands the impact of this new partnership audit arrangement.

Partnership or LLC agreements sets the terms for many important aspects of this type of business arrangement. Partners will likely need to make changes to partnership or LLC agreements, partnership and LLC owners should review agreements now. And begin discussing crucial issues such as:

- Choosing the Partnership Representative
- Limits on the partnership representative's authority
- Planning for important taxpayer elections, among other items
- Authority to make available elections
- Adjustments to distributive shares
- Issues related to purchases and sales of partnership or LLC interests
- Techniques to safeguard that those who were partners in the year under audit, bear the economic impact of the assessment; not those who are partners the year the audit concludes
- Reconciliation of any revised tax calculations

These are just some of the issues the partnership will need to address in response to the BBA's new partnership audit rules with respect to governance and changes to partnership or LLC agreements. Accordingly, we recommend a consultation with a trusted tax advisor.

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