Simpson Thacher

Memorandum

New Partnership Tax Audit Procedures

November 10, 2015

Introduction

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015 (the "Budget Act"), which includes significant changes to the rules governing partnership tax audits for taxable years beginning in 2018.[1] The changes generally impose liability for audit adjustments on the partnership itself, rather than the persons who were partners in the audited year, unless the partnership makes an election as described below. Absent an election, the partnership will be subject to additional tax from audit adjustments, even though partnerships are not generally subject to tax at the entity level, and thus the current partners will indirectly bear the tax instead of the partners from the relevant audited year. We expect many partnerships will elect out of this new treatment.

Liability at the Partnership Level

The Budget Act generally provides that all adjustments to a partnership's income, gain, loss, deduction or credit are determined at the partnership level, regardless of the size of the partnership. If an adjustment results in an "imputed underpayment" (generally, an underpayment which would have occurred if the partnership rather than its partners was the taxpayer), subject to the exceptions discussed below, the partnership is required to take that underpayment into account in the year the determination is made, and is required to pay the appropriate tax directly, including any interest and penalties thereof, related to the adjustment. The imputed underpayment is determined by applying the highest tax rate in effect for the reviewed year (currently, 39.6%) regardless of the tax status of the partners.[2]

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[1] References herein to "partnerships" refer to entities treated as partnerships for US federal income tax purposes, and thus generally include partnerships and limited liability companies.

[2] The Budget Act also instructs the IRS to provide procedures under which the imputed underpayment amount may be adjusted to better reflect the amount of taxes that would be due from the partners after taking into account certain tax

Elective Alternative

As an alternative to the partnership paying any imputed underpayment, the partnership may elect (within 45 days of the date of notice of the final partnership adjustment) to shift this liability to those persons who were partners in the partnership in the applicable tax year by issuing a statement (similar to a K-1) to each such person reflecting their allocable share of the adjustment. If a partnership elects to apply such method, each person who was a partner in the relevant year would then take the adjustment into account in computing their current tax liability. Thus, in contrast to prior law, the partner would not have to amend the prior year's tax return, but would instead reflect the additional items of income or deduction in their current year tax return (even though attributable to the prior period). The cost of choosing this method is that interest is calculated at the rate of 5 percentage points above the federal short-term rate, rather than the usual interest rate of 3 percentage points above the federal short-term rate, from the due date of the tax return for the taxable year at issue. This election may be made on an adjustment-by-adjustment basis.

Changes to "Tax Matters Partner"

Under prior law, each large partnership had to designate a "tax matters partner" to handle certain procedural and notice matters relating to tax audits and controversies. The Budget Act replaces those rules with new rules requiring each partnership to designate a "partnership representative" who may act on behalf of the partnership for purposes of the new partnership adjustment rules. Unlike the prior tax matters partner rules, the Budget Act does not require the partnership representative to be a partner in the partnership (but this person must have a substantial presence in the United States).

Some Small Partnerships Can Elect Out of New Regime

Certain smaller partnerships may elect out of the new audit and adjustment rules, in which case the partnership and partners would be audited under the general rules applicable to individual taxpayers, and persons who were partners in the audited year would be liable for the underpayment, rather than the current partners. Generally, to be eligible to make this election, the following conditions must be met:

1. the partnership is required to furnish 100 or fewer Schedule K-1s with respect to its partners, for the given tax year;

2. each of the partners of the partnership is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner; and

3. certain procedural requirements are satisfied.

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characteristics of the partners (for example, tax exempt or foreign status), although to be effective this provision requires the IRS to issue regulations.

By electing out of this new regime, the IRS (rather than the partnership) would separately assess the tax liability of the persons who were partners in the audited tax year, and such persons would file amended tax returns for the prior tax year (rather than reporting the adjustment in their current year tax return). This election may be made separately with respect to any taxable year.

Effective Date

The new audit and adjustment provisions of the Budget Act generally apply to all tax returns filed for a partnership's taxable years that begin after 2017. However, a partnership may elect (once procedures for such election are established by the IRS) for the provisions to apply to any tax return filed for any taxable year that begins after November 2, 2015.

Practical Implications

The consequences of the new legislation should be considered in existing and new partnership agreements and future acquisitions of existing partnership interests. Partnership agreements should generally authorize the general partner or manager to make the above elective alternative election and designate a partnership representative. In acquisitions of partnership interests after 2017, it will be important to keep in mind that, unless the above election is made, the acquiror of the partnership interest (rather than the seller) will economically bear the burden of any adjustment for a pre-acquisition period (after 2017).

The IRS has been granted broad discretion to provide additional guidance and regulations, and we will continue to monitor developments regarding the new legislation.

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