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IRS Announces Proposed Partnership Audit Regulations Which Impact Limited Liability Companies and Partnerships

By John B. Waters, Counsel

The Internal Revenue Service (IRS) has released Proposed Regulations under Section 1101 of the Bipartisan Budget Act of 2015 (BBA), which provide that for tax years beginning after December 31, 2017, all entities taxable as partnerships (including limited liability companies) will be subject to a centralized audit regime. This will make the partnership liable for taxes relating to adjustments to its income, gain, deduction, loss or credits, unless the partnership is eligible to elect out of that regime (and does so) in the manner described in the Proposed Regulations or elects in the manner described in the Proposed Regulations to pass the adjustments to the persons who were partners (or members) during the tax year which resulted in the tax adjustment.

Key Changes

The centralized audit regime outlined in the Proposed Regulations modifies prior law in several key respects:

- All partnerships are subject to the new audit regime, except for "eligible partnerships" (as described below) that elect out of the new audit regime in the manner described in the Proposed Regulations. Under prior law, small partnerships having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner were automatically excluded from the partnership-level audit regime. That automatic exclusion has been eliminated.

- Adjustments to all items of income, gain, deduction, loss, and credit are subject to the centralized audit regime. This eliminates the distinction under prior law between so-called "partnership items," which were subject to partnership level audits, and "non-partnership items," which were not.

- The partnership will be liable for an imputed tax (based on the highest individual rate or corporate rate, as applicable) resulting from an adjustment to the partnership's income, gain, deduction, loss, and credit, unless the partnership elects to pass the adjustment to the persons who were partners in the tax year which was the subject of the audit and provide notice to them of such election in the manner described in the Proposed Regulations. If such election to pass the adjustment to the partners is made, those partners are charged applicable penalties and an additional two percentage points of interest over the normal underpayment rate on their shares of the adjustment.

- A partnership may request a reduction of an imputed tax underpayment to the extent the partnership can show to the IRS under procedures described in the Proposed Regulations that a portion of the adjustment is allocable to a tax exempt partner or C corporation or that a portion of any capital gain or qualified dividend included in the adjustment is allocable to an individual partner.

- A partnership that discovers an error on a prior return may file an administrative adjustment request (AAR) with the IRS to correct the error and either pay the resulting tax deficiency directly or pass the tax adjustment through to the partners, who would pay tax on their shares of the adjustment, except that the additional two percentage points of underpayment interest would not be charged to those partners if that occurs. A partnership may not file an AAR with respect to a tax year if the IRS has mailed a notice of an administrative proceeding concerning that year.

- A partner who treats any tax item from the partnership inconsistently with the partnership's tax treatment of that item will generally be treated as if the partner made a math or clerical error on the partner's return and the IRS will be permitted to immediately assess and collect the tax deficiency relating to that item.

- A partnership must designate a "partnership representative" annually on its tax return who will have the sole authority to represent the partnership in any audit or proceeding and to bind the partnership and partners to all settlements, adjustments, elections, and extensions of the period of assessment. Under prior law, while a partnership would have a "tax matters partner" to represent it before the IRS in a partnership level proceeding, partners were required to be given notice of a partnership proceeding and allowed to participate.

- The partnership representative does not have to be a partner and can be any person or entity so long as such representative has a substantial presence in the United States. A person generally has a "substantial presence" in the United States if the person: (i) is reasonably available to meet in person with the IRS in the United States; (ii) has a U.S. street address and telephone number with a U.S. area code where the person can be reached during normal business hours; and (iii) has a U.S. taxpayer identification number. This changes prior law which required a partnership's "tax matters partner" to be a general partner of the partnership and which specified which general partner would be the tax matters partner when there was more than one general partner.

- If a partnership fails to designate a partnership representative or a partnership representative resigns or is no longer eligible to serve, the IRS may designate a person to serve as partnership representative. In selecting a partnership representative, the IRS may consider whether there is a suitable partner of the partnership either from the tax year under audit or current year. The IRS can also consider: (i) the views of the partners holding a majority interest; (ii) the general knowledge of the proposed representative as to tax matters and administrative operation of the partnership; (iii) the person's access to the books and records of the partnership; and (iv) whether the person is a United States person.

Eligibility to Elect Out of Centralized Audit Regime

Only an "eligible partnership" may elect out of the new centralized audit regime. An "eligible partnership" is a partnership that during a relevant tax year has solely "eligible partners" and is required to furnish no more than 100 "statements" (Schedule K-1 forms) to those partners for that year. If a partnership has an S corporation as a partner, Schedule K-1 forms required to be furnished by that S corporation to its shareholders are counted as statements provided by the partnership. Eligible partners are individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, and estates of deceased partners. The Proposed Regulations clarify that REITs and tax-exempt organizations classified as corporations are considered corporation eligible partners. The Proposed Regulations also clarify that the following entities are not "eligible partners" (i.e., the partnership could not elect out if it has any of the following partners): a partnership, a trust, a foreign entity that would not be considered a C corporation, a disregarded entity or estate of an individual other than a deceased partner. The Proposed Regulations clarify in an example that a disregarded entity is not an eligible partner, even if wholly owned by an individual. The Proposed Regulations also clarify that an S corporation is an eligible partner even if it has shareholders that would not be eligible partners if they held their interests in the partnership directly (such as a qualified small business trust or disregarded entity).

Effect of Electing Out

The Proposed Regulations mention that an eligible partnership that elects out of the centralized audit regime is subject to the pre-TEFRA audit procedures whereby the IRS must separately assess tax with respect to each partner under the deficiency procedures under subchapter B of chapter 63 of the Internal Revenue Code of 1986, as amended.

Issues to be Addressed

In view of the potential liability of a partnership (and indirectly its current partners) for imputed taxes from adjustments that may relate to a prior tax year and the power conferred upon partnership representatives under federal law to solely represent the partnership in any audit or proceeding and to bind the partnership and partners to all settlements, adjustments, elections, and extensions of the period of assessment, partnerships, and entities taxed as partnerships should consider addressing in their partnership agreement or operating agreement before December 31, 2017: (i) the manner of selection of their partnership representative; (ii) responsibility (as among current and former partners or members) for costs and taxes relating to partnership audits and deficiencies; (iii) internal approval requirements for actions by the partnership representative, including, but not limited to, tax settlements, administrative adjustment requests and election to pass adjustments to partners; and (iv) whether the partnership (if an eligible partnership) will elect out of the centralized audit regime.

If you have questions about this topic, please contact one of the listed Roetzel attorneys.

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