November 3, 2015

Changes to Partnership Audit Procedures May Increase Audit Activity

In General. On Monday, November 2, 2015, President Obama signed the Bipartisan Budget Act of 2015 ("BBA"). The BBA significantly alters the rules governing partnership audits, most notably by imposing liability for audit adjustments on the partnership rather than the partners that were partners in the audited year, absent an election for different treatment as described below. Accordingly, the partnership itself would be subject to any tax arising from the audit adjustment, at the entity level, even though there are generally no U.S. federal "entity-level" income taxes for partnerships. As a practical matter, we expect that the exception may swallow the rule – many partnerships will likely elect out of the basic entity-level regime and use the elective approach described below where the adjustments flow through to the partners, in a manner similar to existing rules.

Effective Date. The new rules will apply only to partnership returns filed for tax years beginning after December 31, 2017. Senator Orrin Hatch (R-UT), Chairman of the Senate Finance Committee, said that he expects the Committee will treat the BBA tax provisions as a "work in process," will consider taxpayer comments in advance of the effective date, and will address taxpayer concerns with the law. Given the political complexity of the legislative process, it is difficult to predict how this will play out, but it is quite possible that the final operative rules may look quite different from the current legislation.

The Current Law

Current law generally permits the Internal Revenue Service (the "Service") to conduct unified audits of partnership items at the partnership level for most partnerships. Once the partnership-level adjustments are finalized, the Service may assess against each partner of the partnership for the year under audit that partner's share of any adjusted partnership items. Current rules also provide that only a designated partner may act on behalf of the partnership, that certain partners are entitled to notice relating to tax audits, and that certain partners may challenge audit determinations in court outside the unified partnership audit.

Changes Under the BBA

The tax provisions of the BBA establish a new partnership audit regime, with a default rule that the partnership is responsible for the taxes arising from audit adjustments at the highest rate in effect (as well as for interest and penalties). Some of the key changes to partnership audit procedures under the BBA include:

- ***Partnership "Entity-Level" Tax As a Result of Audit Adjustments***. After an audit adjustment is final, the partnership, and not the individual partners, is responsible for paying any "imputed underpayment" of taxes, interest, and penalties that arose from an adjustment. In the absence of the election described below, the Service will collect the tax from the partnership.

  - *Tax Arising from the Adjustment Generally Computed at Highest Statutory Rate*. In general, the imputed underpayment is computed by multiplying the additional income arising from the audit adjustment by the highest tax rate for the year under audit (without regard to the character of the income or gain). For these purposes, the rules generally ignore partner-level tax characteristics and attributes (e.g., net operating loss carryforwards) in calculating the amount of the imputed underpayment of a partnership.

  - *Procedures for Reducing the Partnership "Entity-Level" Tax*. The legislation directs the Service to create procedures to identify certain partners not subject to tax (including, as applicable, U.S. tax-exempt partners, foreign partners, and state governments). The legislation also directs the Service to create procedures for taxable partners to provide to the Service partner-specific information showing: (1) the amount of ordinary income that would be attributable to a C-corporation partner (which currently would be taxed at a lower rate than the highest individual ordinary income rate); or (2) the amount of capital gain or qualified dividend income that would be attributable to a partner that is an individual or an S-corporation (which is treated as an individual for these purposes). Because certain types of income attributable to those partners may be tax-free or taxed at a reduced rate, the partnership's provision of the partner-specific information will serve to reduce the imputed underpayment amount assessed at the partnership level. These mitigation procedures are not self-executing; if the Service does not issue implementing regulations or guidance, apparently they will not apply.

  - *Adjustments to Distributive Shares Are Not Netted*. If an audit adjustment reallocates items among partners, decreases in income and gain and increases in losses and deductions are ignored for purposes of computing the aggregate imputed underpayment.

- ***Alternative to "Entity-Level" Approach: Partnership Election To Issue Partner Adjustments***. In lieu of the approach described above, a partnership may elect to issue adjusted Schedules K-1 to individuals or entities that were partners of the partnership during the audited tax year (the "Elective Regime"). This election absolves the partnership of liability for the imputed underpayments resulting from the adjustment. Instead, the individuals and entities who were partners of the partnership during the tax year that was audited are liable for the underpayments attributed to such audited year in the year the audit concludes. Where the partnership makes this election, partners for the audited year

(including individuals) will be liable for interest at the large corporate underpayment rate and any penalties.

- ***Tax Representative in Lieu of Tax Matters Partner***. The BBA eliminates the concept of a "tax matters partner." A partnership must instead appoint a representative, who need not be a partner, given the sole authority to act on behalf of the partnership with respect to administrative and judicial tax proceedings. This is a practical change that would permit an investment manager, for example, to act as the representative for an investment fund in which it is not a partner.

- ***Audit Participation and Judicial Review***. Only the partnership and the representative are permitted to participate in a partnership audit or to challenge a final adjustment in court. Partners will no longer have standing to seek judicial review.

- ***Binding Effect***. All partners of the partnership will be bound by the actions of the representative and by any final administrative or judicial decisions relating to any Service audits. Partners may not revoke the representative's authority to bind them.

- ***Opt Out for Small Partnerships***. The BBA allows certain partnerships with 100 or fewer partners to opt of the BBA audit regime. Because of the technical and limiting aspects of this exception (e.g., at least on the face of the statute, it will not apply where an upper-tier partnership is a partner of a lower tier partnership), we expect that the election will be of limited utility in the investment fund context and in the context of widely-held private partnerships. Although not entirely clear, the statute may permit the Service to issue regulations to apply this exception to certain tiered partnerships if there are 100 or fewer ultimate partners.

Observations

The BBA partnership audit and adjustment regime will have significant implications for partnerships beyond the realm of procedure and administration. We note the following areas of concern:

- ***Audit Frequency***. The BBA audit rules are intended to simplify the audit process for the Service and seem to eliminate much of the cost and administrative burden associated with auditing large partnerships under the current rules. Moreover, as discussed above, the BBA collection procedures allow the Service to collect an underpayment arising from a partnership adjustment directly from the partnership or, in the alternative, to force the partnership to allocate adjustments among the relevant partners (and former partners) who are liable for the tax. As a result, we expect that the frequency of audits for partnerships will increase significantly under the BBA regime.

- ***Elective Regime Likely To Apply in Most Cases***. Even assuming the Service issues robust procedures permitting partnerships to reduce the applicable "entity-level" tax as described above, we expect that many partnerships will instead opt to use the Elective Regime. In the context of merger and acquisition transactions and investment funds, we expect that many parties will require this approach contractually.

- ***Transactions Involving the Purchase of Partnership Interests***. Absent the choice to use the Elective Regime, the BBA effectively allocates the tax liability associated with partnership items benefiting prior-year partners to current-year partners, even though prior-year partners may have benefited from prior-year partnership earnings and income. We expect that parties acquiring partnership interests or involved in merger and acquisition transactions with partnerships will in the first instance seek to use the Elective Regime for pre-closing periods. If the Elective Regime is not available, we expect that buyers will conduct enhanced due diligence and will likely seek to negotiate more robust tax representations and warranties and tax indemnification provisions.

- ***Tax-Exempt and Foreign Investors***. Under the BBA rules, the degree to which the Service will consider the foreign or tax-exempt status of a partnership's partners in adjusting the liability of the partnership is unclear. At present, and assuming the Service and Treasury do not issue guidance implementing the procedures described above, the BBA does not provide adjustment carve-outs for income attributable to partners that may not otherwise be subject to tax. As a result, in the absence of the Elective Regime, the BBA imposes indirectly an "entity-level" tax on all partnership income attributable to an adjustment. For this reason, tax-exempt and foreign partners are likely to require the partnership to use the Elective Regime.

- ***Partnership Governance***. Under the BBA, partners are denied notice, the ability to participate in an audit, and judicial standing to challenge the results of an audit. Furthermore, partners may not revoke a partnership representative's authority to bind them. Partners with significant interests may seek to negotiate contractual partnership representative approval rights, audit notice rights, and audit settlement approval rights as a result of these changes.

The BBA includes numerous other provisions and many details this summary does not address. We will keep our clients informed with respect to material future developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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