Client Update

Bipartisan Budget Act of 2015 Revamps Partnership Tax Audit and Collection Procedures

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The Bipartisan Budget Act of 2015 signed by President Obama yesterday substantially changes how the IRS makes tax audit adjustments to partnerships and limited liability companies (LLCs) that are treated as partnerships for tax purposes. The changes are intended to enhance the IRS's ability to audit partnership tax returns, and to enable the IRS to collect taxes, interest and penalties that flow from a partnership tax audit adjustment directly from the affected partnership. As a result of the prevalence of LLCs and limited partnerships, the changes will affect a broad range of industries, including private investment funds, master limited partnerships (MLPs) and real estate partnerships.

The new partnership tax audit rules, which will apply to tax returns of partnerships for tax years beginning after 2017, provide that any tax adjustments resulting from IRS audits of partnerships generally will be determined and collected at the partnership level, even though partnerships are not subject to income taxes and the partners are the relevant taxpayers. These rules are a broad departure from the existing partnership tax audit rules, whereby the IRS generally audits the tax return of the partnership but then is required to make tax adjustments, and collect any additional taxes, interest and penalties, at the partner level.

Under the new rules, unless a partnership elects to implement the Form K-1 adjustment procedure described below, it will need to satisfy the cost of a tax adjustment from its own balance sheet or with contributions from its partners. As a result, the cost of the tax adjustment will, in the first instance, be borne by the individuals and entities that are partners of the partnership when the IRS makes the tax adjustment, which may be different persons or have different ownership percentages than the partners for the earlier year that was reviewed in the audit.

Tax adjustments will be imposed on the partnership based on the highest rate of tax for U.S. individuals or corporations that was in effect for the year that is the subject of the audit. The rules contemplate that the IRS will establish procedures to reduce the partnership tax adjustment to take into account allocations to a partner that would not owe tax as a result of its status as a tax-exempt entity or a foreign person, or if a partner files an amended tax return. However, as a practical matter, the inherently imperfect nature of this process and the substantial additional cost that could result from the rules' highest rate approach may drive many partnerships to use the elective Form K-1 procedure.

Under the elective Form K-1 adjustment procedure, instead of the general rules described above, following a partnership tax adjustment, the partnership will be permitted to send amended Form K-1s to the individuals or entities that were partners of the partnership in the earlier year that was reviewed in the tax audit. Each partner for the reviewed year will then be required to pay any additional tax, interest and penalties in the current year, rather than by amending tax returns for the reviewed year. Under this procedure, the partners are required to pay a higher rate of interest on underpayments of tax, at the federal short-term rate plus 5% (rather than the generally applicable 3% spread).

The new rules provide an exception for partnerships with 100 or fewer partners, which are permitted to opt out of the new rules. However, this small partnership exception does not apply to a partnership in which another partnership is a member, which appears to make the exception inaccessible to any tiered partnership structure regardless of the number of ultimate partners.

Prior to the effectiveness of the new rules, partnerships and LLCs that are treated as partnerships for tax purposes should review their operating agreements to determine whether to implement amendments to enable (if desired) or require the partnership to elect the Form K-1 adjustment procedure or to allocate the cost of tax adjustments in a different manner than other costs for the year in which the adjustment is made and to clawback the cost of adjustments from former partners. In addition, buyers of partnership and LLC interests should consider the approach of the target partnership or LLC to the new rules, so that the buyers can assess whether they could be required to bear the cost of an entity-level tax adjustment.

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Please do not hesitate to contact us with any questions.