Did You Say a Taxable Partnership?

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A PLETHORA OF PARTNERSHIPS

According to a recently released IRS analysis of tax return data, the number of partnerships and partners in the U.S. continues to increase, as do the total receipts and the value of total assets for all partnerships. LLCs classified as partnerships account for the majority of this growth.

These figures are a manifestation of the fact that the partnership represents the most flexible form of business entity: there are no restrictions on who may be a partner; the only limitation on the economic arrangement among the partners is that it have substantial economic effect. Furthermore, partnerships do not pay federal income taxes on their income, but "pass through" any profits and losses to their partners, who must include those profits and losses on their own income tax returns.

As partnerships have grown in number, size, and complexity, the IRS has found it increasingly difficult to audit them and to collect any resulting income tax deficiencies, especially in the cases of large partnerships and tiered partnerships. In response to these difficulties, Congress recently enacted the Bipartisan Budget Act of 2015 ("BBA"), adding a number of new tax compliance provisions to the Code. A key feature of the BBA is that it imposes liability for any audit adjustments with respect to an earlier partnership tax year on the partnership, rather than on those persons who were partners during the audited tax year.

PARTNERSHIP AUDITS

Prior to the BBA, three different regimes existed for auditing partnerships. For partnerships with ten or fewer partners, the IRS generally applied the audit procedures for individual taxpayers, auditing the partnership and each partner separately. For most large partnerships with more than ten partners, the IRS conducted a single administrative proceeding (under the so-called "TEFRA" rules, which were adopted in 1982) to resolve audit issues regarding partnership items that were more appropriately determined at the partnership level than at the partner level. Under the TEFRA rules, once the audit was completed and the resulting adjustments were determined, the IRS recalculated the tax liability of each partner in the partnership for the particular audit year. In the case of partnerships with 100 or more partners that elected to be treated as Electing Large Partnerships (ELPs) for reporting and audit purposes, partnership adjustments generally flowed through to the partners for the year in which the adjustment took effect, rather than the year under audit.

THE BBA'S CHANGES

Under the BBA, the TEFRA and ELP rules are repealed, and the partnership audit rules are streamlined into a single set of rules for auditing partnerships and their partners at the partnership level. Under the streamlined audit approach, the IRS will examine the partnership's items of income, gain, loss, deduction, credit, and the partners' distributive shares, for a particular year of the partnership (the "reviewed year"). Any adjustments (including interest and penalties) will be taken into account by, and will be collected from, the partnership – not the reviewed year partners – in the year that the audit or any judicial review is completed (the "adjustment year"), and the tax resulting from such adjustments will be computed at the highest marginal rate for individuals or corporations without regard to the character of the income or gain.

A "TAXABLE PARTNERSHIP"

This marks an important change in the audit of closely-held partnerships. The IRS will collect the tax from the partnership, even if the persons who were partners in the reviewed year are no longer partners in the adjustment year. Stated differently, the current-year partners will bear the economic burden even though the adjustments relate to a prior year in which the composition of the partnership may have been different.

Partnerships will have the option, however, of demonstrating that the adjustment would be lower if it were based on certain partner-level information from the reviewed year rather than imputed amounts determined solely on the partnership's information in such year. This information could include amended returns of partners opting to file, the tax rates applicable to specific types of partners (e.g., individuals, corporations), and the type of income subject to the adjustment (e.g., ordinary income, dividends, capital gains).

IMPORTANT EXCEPTIONS

Under the BBA, a partnership with 100 or fewer partners is permitted to elect out of the new rules, in which case the partnership and partners will be audited under the general rules applicable to individual taxpayers. In order to qualify for this "small partnership" election, each partner of the partnership must be an individual, a C corporation, an S corporation, or the estate of a deceased partner. Another partnership and a trust cannot be partners of an electing small partnership. Among other things, it should be noted that the election is to be made on an annual basis, it must be made on a timely-filed partnership return, and the partnership must notify the partners of the election.

A partnership that does not qualify for the small partnership election, or which does not elect to be treated as such, will be permitted (in accordance with rules to be issued by the IRS), as an alternative to taking the adjustments into account at the partnership level, to pass the adjustments along to its partners by issuing adjusted Form K-1s to the reviewed-year partners, in which case those partners (and not the partnership) will take the adjustments into account on their individual returns in the adjustment year through a simplified amended-return process.

A partnership must elect this alternative not later than 45 days after the date of the notice of partnership adjustment (a "6226 election"). Where the election is made, the reviewed-year partners will be subject to an increased interest charge as to any tax deficiency.

LOOKING AHEAD

Because the BBA marks a significant change in the audit of partnerships, and because it applies to both existing and new partnerships, its effective date is delayed: the new rules will become effective for returns filed for partnership tax years beginning after 2017. Until then, the IRS should have sufficient time to promulgate any regulations to implement the changes. It should also afford partnerships the time to adjust to the new audit regime, and especially to the new default rule that applies to every partnership unless the partnerships elects out.

Most partnerships that qualify will likely make the annual election to be treated as a small partnership. However, many small partnerships will not qualify for this election because they include trusts or other partnerships as partners. In any case, partners and partnerships will have to ensure that their partnership agreements address the new rules. This may include whether to elect out of the new regime or to elect to pass-through the adjustments to the review-year partners.

Partnerships may also want to include indemnity provisions in their agreements, pursuant to which current partners and former partners of a partnership will agree to indemnify the partnership or each other for their pro rata share of any deficiencies resulting from an IRS audit of the partnership. This may be especially important to transferees of partnership interests, including potential new investors, who are also likely to insist upon increased levels of due diligence before acquiring such an interest.

I don't know about you, but the years seem to be going by faster and faster. Before you know it, these rules will go into effect. Don't wait. Start your preparations now.

ABOUT THE AUTHOR

Lou leads his firm's tax practice, and has extensive experience in corporate, partnership, and individual income taxation, estate and gift taxation, and not-for-profits, including tax planning, transactions, ruling requests, and tax controversy. He lectures frequently on these subjects and has written for various legal publications. Lou has been recognized by Super Lawyers, and is admitted to practice in New York and in the U.S. Tax Court.

Editor's note:

Business Docx®, WealthCounsel's document drafting system for business law attorneys, already reflects major editorial changes necessary to make operating agreements for LLCs taxed as partnerships comply with the BBA and its repeal of TEFRA. For more information, please visit www.wealthcounsel.com.