NEW PARTNERSHIP AUDIT RULES APPLY BEGINNING JANUARY 1, 2018: IS YOUR BUSINESS READY?

Date: 20 July 2017

Corporate/M&A Alert

New partnership audit rules will be effective for audits of tax years beginning in 2018. Proposed Treasury Regulations have been released and are expected to be finalized in the next few months. (The comment period is open until August 14, 2017; please contact Elizabeth Crouse or Mary Burke Baker, below, if you are interested in the process or are considering providing comments to the Internal Revenue Service (the "IRS").) These rules significantly change partners' information and payment expectations upon audit of a partnership and should be considered sooner rather than later.

1. Why should you be concerned about the new rules?

In 2015, Congress passed a comprehensive new partnership audit regime. Under the rules that apply through 2017, partnership audits are usually done at the partnership level, but partners have broad information and participation rights, and all adjustments are paid and enforced at the partner level. Due in part to the work required to involve all partners in an audit, very few partnerships have been audited under the current rules. Under the new partnership audit rules, any audit will occur at the partnership level; in general, all adjustments will be calculated by reference to the partnership (and not the partners); all payments resulting from an audit will be made by the partnership; and partners will have no information or participation rights in respect of the audit. Given the simplified process from the IRS perspective, audit rates for partnerships are expected to increase.

In addition, many states are considering changes to their own partnership audit rules and processes in response to the new federal partnership audit rules. It is not yet clear exactly how or whether states will change their partnership audit rules, but taxpayers should expect changes at the state level as well.

2. To which entities do the new rules apply?

All partnerships and entities or other arrangements that are treated as partnerships for U.S. federal tax purposes are subject to the new audit rules if they are subject to U.S. tax jurisdiction. This includes domestic general and limited partnerships, any multi-member limited liability company that has not elected to be treated as a corporation, unincorporated joint ventures where the co-venturers share in any profits and losses, and non-U.S. entities that are treated as partnerships and subject to U.S. federal income tax jurisdiction, for example, by reason of engaging in a U.S. trade or business directly or through a domestic entity that is treated as a partnership for U.S. federal tax purposes.

These types of partnerships may include operating business partnerships as well as private funds, special purpose vehicles set up to hold particular assets, co-investment funds, and entities serving as general partners, managing members or vehicles to allocate performance allocations or carried interest among a group of employees, in each case if they satisfy the criteria in the preceding paragraph.

©2005-2026 K&L Gates LLP. All Rights Reserved.

An entity that is treated as disregarded (that is, a single-member LLC that has not elected to be treated as a corporation for U.S. federal tax purposes) will not be subject to the new audit rules. In addition, partnerships that have dissolved prior to 2018 are not subject to the new audit rules.

3. Who pays the audit adjustment?

In general, under the new rules, partnerships will be responsible for paying any tax, penalties, or interest that arise from any adjustment resulting from an audit of the partnership. Under the Proposed Treasury Regulations, certain partnerships that issue no more than 100 K-1s may elect "out" of the audit rules (note, however, that under current guidance, this election is not available to partnerships that have partnerships or disregarded entities as partners).

It is important to note that the new rules require that the audit adjustment be calculated at the partnership level and, in general, without regard to the tax classification, tax assets, or other attributes of the partners. Some mechanisms are available under the Proposed Treasury Regulations to reduce the impact of an audit adjustment or require that partners (including former partners) in the audited year are liable for the adjustment amounts (these rules are particularly important for tax-exempt investors, which should carefully consider appropriate side letter provisions in order to ensure that their tax-exempt status is taken into account in calculating the impact of any audit adjustment). *Nonetheless, under the Proposed Treasury Regulations, there remains a material risk that an adjustment at the partnership level will result in more tax than would have been due if the partnership's income had been properly accounted for on its return*.

4. Who controls the audit? What influence do partners have over the audit?

Under the new rules, the partnership must designate a "partnership representative" on each of the partnership's U.S. federal income tax returns. The designated partnership representative controls the audit and, by law, is the only person empowered to work with the IRS. If the partnership representative is an entity, an individual must also be appointed to serve as the "designated individual," that is, the only person authorized to deal with the IRS in regard to an audit of that tax year. (The IRS has not yet indicated how a designated individual will be appointed, i.e., on the partnership's annual tax return or otherwise.) The partnership representative (or designated individual, as applicable) does not have to be a partner in the partnership.

By law, the partnership representative (and any designated individual) controls all partnership audit proceedings with the IRS (partners may not participate), and there is no requirement that the IRS inform the partners of audit proceedings in any circumstance. However, the partnership agreement may require the partnership representative to provide notice of audit proceedings, require that the partnership representative obtain a partner vote, or otherwise restrict the activities of the partnership representative. A breach of any duty in the partnership agreement may be pursued under contract law, but the partnership representative's act or failure to act will be binding on the partnership vis-à-vis the IRS. In addition, the Proposed Treasury Regulations provide for the partnership to remove a partnership representative in certain circumstances (please note that language regarding a partnership's or a partnership representative's removal of a designated individual has not yet been released). However, the IRS has been abundantly clear that it will deal only with the partnership representative (or designated individual, as applicable). In addition, it is extremely important to appoint a qualified partnership representative (and designated individual, if necessary) because a failure to do so will result in an appointment by the IRS.

©2005-2026 K&L Gates LLP. All Rights Reserved.

The partnership representative and any designated individual must have a "substantial presence" in the United States, determined by having a U.S. postal address, telephone number, and taxpayer identification number. The partnership representative (or designated individual, if applicable) must also be able to physically meet with an IRS representative at the IRS's discretion. Given today's technology, it is technically possible for an individual physically located outside the United States to act as a partnership representative or designated individual, but we note that the IRS may release additional guidance regarding qualification of the partnership representative or designated individual. If power of attorney is given by the partnership to an attorney or accountant in the context of an audit, it may be possible for a partnership representative or designated individual to function similarly to a registered agent (i.e., subject to direction by the partnership acting with its counsel). However, particular attention must be paid to liability and indemnification for bad acts or failure to act as instructed.

5. Partnerships should amend their partnership agreements now!
Although the Proposed Treasury Regulations have not yet been finalized and more guidance is forthcoming in IRS instructions, the guidance that is currently available includes clear direction about a number of matters that are unlikely to be changed in the final regulations. Partnership agreements should be reviewed and revised now to account for, at minimum, the new partnership representative requirements (appointment of any required designated individual would generally be better handled through internal processes of the partnership representative). We also generally recommend that provisions concerning indemnification of the partnership and the partners be considered to account for the characteristics of different partners and adjustments that otherwise disproportionately affect certain partners. The latter provisions are particularly important for tax-exempt investors.

KEY CONTACTS



CHARLES H. PURCELL
PARTNER

SEATTLE
+1.206.370.8369
CHARLES.PURCELL@KLGATES.COM



WON-HAN CHENG
PARTNER

SEATTLE
+1.206.370.8331
WON-HAN.CHENG@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.