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Comprehensive Partnership Audit Reform Requires Amendments To Partnership (and LLC Operating) Agreements

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Professionals

Heather L. Preston; Lynn E. Fowler; Charles E. Hodges II; James E. Brown

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Congress has recently scrapped the existing procedures for IRS audits of partnerships. The new rules (the “BBA Audit Rules”¹) are effective for partnership taxable years beginning on or after January 1, 2018. A partnership that fails to address key concepts of the BBA Audit Rules could make a partner indirectly liable for federal income tax of the partners assessed for a year prior to becoming a partner. ***Almost all partnership (and LLC operating) agreements will need to be amended at a minimum to clarify which partners will be liable with respect to audit adjustments asserted by the IRS.***

Broad Scope: The BBA Audit Rules apply to all partnerships except for a limited category of small and mid-sized partnerships that are eligible to elect-out of the application of these rules.

Default Procedure—Partnership Liable in Adjustment Year: The BBA Audit Rules authorize the IRS to assess the maximum possible tax that could have been due at the partner level, plus applicable penalties and interest, against the partnership itself in the year the audit concludes, subject to certain adjustments.

Alternative Procedures—Reviewed Year Partners Liable: Partnerships desiring to completely avoid the default procedure of adjustment year partnership liability generally have two options:

- **Option 1—Amended Returns:** If every partner who was a partner in the year under review files an amended return taking all of the IRS’s adjustments into account and pays their resulting tax, then the partnership is not liable for any underpayment or interest.
- **Option 2—Partnership Election to Shift Liability:** The partnership itself can elect at the conclusion of an audit for its reviewed year partners to take adjustments into account in the adjustment year by issuing revised K-1s to partners for the reviewed year. The election causes each such partner’s tax for its year in which the revised K-1s are issued to be increased to reflect the adjustments from the revised K-1s, plus penalties and interest. The interest rate is 2% higher than normal.

Implications

Partnership (and LLC Operating) Agreements Require Amendment: Almost all partnerships and LLCs will need to amend their partnership agreements to address the following issues:

- Agreements should determine which of the above-described procedures will apply in the event of audit adjustments by the IRS.
- Agreements should require cooperation with requests from the partnership representative for information that could reduce any imputed underpayment asserted by the IRS.

¹ New sections 6221 to 6235, and 6241, of the Internal Revenue Code.

Small and Mid-Sized Partnerships Should Decide Whether to Elect-Out: Small and mid-sized partnerships should assess in advance whether they qualify to elect-out, and if so whether to do so.

For more information regarding the BBA Audit Rules, please contact a member of our Tax Team.

Name	Telephone	Email
Heather L. Preston	+1 404 815 6045	HPreston@kilpatricktownsend.com
Lynn E. Fowler	+1 404 815 6653	LFowler@kilpatricktownsend.com
Charles E. Hodges II	+1 404 532 6950	CHodges@kilpatricktownsend.com
James E. Brown	+1 202 824 1433	JaBrown@kilpatricktownsend.com

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