CLIENT MEMORANDUM

Bipartisan Budget Act Adopts Sweeping Tax Changes Affecting Partnerships and Most LLCs

October 30, 2015

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The Bipartisan Budget Act of 2015, expected to be signed into law by the President imminently, enacts a dramatic change in the U.S. tax treatment of partnerships. Title XI of the act, "Revenue Provisions Related to Tax Compliance," adopts a new partnership-level audit and assessment procedure for all entities treated as partnerships – which therefore would include most limited liability companies. Under the new rules, tax deficiencies that arise from adjustment of partnership items would, as a general rule, be collected from the partnership, and would be calculated using the maximum tax rates (and would include interest and applicable penalties). The general rule of partnership liability for tax deficiencies is subject to two principal exceptions:

1. The tax due at the partnership level may be reduced for 1) tax items of partners who file an amended tax return reflecting the audit or other adjustment, and pay the tax due, and 2) income items attributable to tax-exempt or foreign partners who would not be subject to tax on that income.

2. Alternatively, the partnership can avoid entity-level liability for the tax deficiency by issuing to each partner a statement showing the partner's share of the audit or other adjustment. In this case, taxable partners will bear liability for the resulting tax deficiency on their allocable share of the partnership adjustment. Note, however, that if this procedure is used, the deficiency interest will be levied at the rate of 5% above the short-term applicable federal rate, rather than the 3% above the AFR applicable to most tax deficiencies.

A very narrow category of partnerships are permitted to elect out of the new partnership-level audit rules. These are partnerships of 100 or fewer partners, whose partners consist exclusively of individuals, estates, S corporations and so-called "C" corporations. Thus, any partnership having as a partner a partnership (including most LLCs), a trust, a regulated investment company, or a real estate investment trust, is ineligible for the election out.

A liberalizing change effected by the measure is that the partnership representative who deals with the Internal Revenue Service need no longer be a member of the relevant partnership or LLC.

The new rules will generally take effect for tax years beginning after December 31, 2017.

The transformative change effected by this measure – imposing liability for tax deficiencies on partnerships (and most LLCs) rather than on the partners and LLC members – means that all or virtually all partnership and LLC agreements, including those presently in effect, will need to be evaluated to determine whether the new audit and tax deficiency rules are appropriately addressed. There will be a host of business issues to consider, such as how the economic cost of a tax liability paid in a current year should be shared among partners, when it relates to income earned and cash possibly distributed in a prior year, possibly to a different set of partners. Also, the parties might want to insure that the partners who pay the tax, or whose status as foreign or tax-exempt reduces tax payable by the partnership, obtain the economic benefit thereof.

Please feel free to call Richard L. Reinhold (212-728-8292, rreinhold@willkie.com) or the other Willkie tax lawyer with whom you work to discuss these new rules, and how they might apply to your particular situation.

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