Bond Case Briefs

Municipal Finance Law Since 1971

What's in your Partnership Agreement? Why Non-Taxpaying Entities Should Care About Allocations of Taxable Income.

Even before the advent of P3s (public-private-partnerships), it was not uncommon for a governmental entity or a 501(c)(3) to enter into a joint venture with a for-profit, taxpaying entity. Sometimes these joint ventures take the form of either a state law partnership or a state law limited liability company ("LLC"). Most LLCs are taxed as partnerships for federal income tax purposes, which generally means that they are pass-through entities. In other words, the partnership itself does not pay tax on its taxable income (like a corporation would). Rather the taxable income flows through to the partners who are required to pick up their respective distributive shares of the partnership's items of income and loss on their own separate federal income tax returns.

Why would a non-taxpaying entity care about allocations of taxable income? Because the manner in which "taxable income" is determined, and its allocation among the various partners in the partnership could impact the amount of cash flow available to be distributed to the partners in the partnership. Even non-taxpaying entities should care about their cash flow from partnerships and/or LLCs. This is especially important in light of new legislation that changes the manner in which partnership audits by the IRS are resolved.

Over the past several decades, most partnership audits were conducted by the IRS under the rules set forth in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA" yes, that TEFRA, the same act that gave us the notice, hearing, and approval requirements for qualified private activity bonds). Under the audit rules set forth in TEFRA, the IRS would determine what adjustments needed to be made at the partnership level. The IRS would then recalculate each partner's tax liability after flowing the adjustments through the partnership to the separate partners, and collect any additional tax owed from the individual partners rather than the partnership. Especially for large partnerships, this has been a cumbersome process for the IRS. It would be similar to the IRS trying to collect from the bondholders rather than the issuer the additional tax owed on bonds that were issued as tax-exempt bonds but that were ultimately determined to be taxable.

For tax years beginning on or after January 1, 2018, the manner in which a lot of partnership audits are conducted by the IRS will change. Most significantly, for many partnerships, any additional taxes owed to the IRS will be assessed against the partnership rather than the individual partners. This change can have inequitable results under certain circumstances. For example, assume that the IRS finalizes an audit of a partnership's 2018 tax year in 2020. Any additional taxes resulting from partnership adjustments made to the 2018 taxable year will normally be paid by the partnership in 2020. Thus, a partner that joined the partnership in 2019 will, as a result of the partnership's reduced cash flow (used to pay the 2018 tax liability), own a less valuable partnership interest in 2020, and have a decreased chance of receiving distributions from the partnership beginning in 2020.

The new IRS audit rules do allow partnerships to adopt certain procedures intended to alleviate the unfairness outlined above. First, the partnership agreement can require that each person who was a partner from the adjustment year (2018 in the above example) file an amended tax return picking up its distributive share of the audit adjustment. This would benefit tax-exempt partners, because only the taxable partners would be required to file an amended income tax return to report the distributive share of taxable income that arises from the audit adjustment. Second, the partnership can make an election to transfer its obligation to pay the additional tax to the partners that were partners in the audit year who would then pay the tax in the year the audit was finalized (2020 in the above example). This election would shift the economic burden of the additional tax liability from the partnership (and, thus, all of its current partners, including tax-exempt partners) to the taxable persons who were partners in the partnership for the year under audit.

Although the new IRS audit rules for partnerships do not apply until January 1, 2018, partnerships can elect into them now, and once they are effective, certain partnerships may elect out of them. Accordingly, it is important that all partners, including non-taxpaying partners, understand the economic ramifications of these rules and know what the partnership agreement says about them. In other words, each partner should be able to answer the question: What’s in your partnership agreement?

Squire Patton Boggs

The Public Finance Tax Blog

By Cynthia Mog

October 26, 2016