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Recent Changes in U.S. Tax Law May Affect Government Pension Plans that Invest in Partnerships and Limited Liability Companies

Under current federal income tax law, an entity taxed as a partnership (which includes most domestic limited partnerships and domestic limited liability companies) does not pay federal income tax. Instead, partnership income is allocated to partners who must report and pay federal income tax on their shares of partnership income. The same is true if a partnership is audited and the IRS proposes adjustments to income of the partnership. The partners report adjustments on their own tax returns and pay any resulting tax. Tax-exempt investors, including government pension plans, generally pay no federal income tax on their income, which includes their shares of partnership income. Recent changes to the tax law will require partnerships to pay tax at the partnership level on certain audit adjustments to partnership income, and these changes may affect government pension plans that invest in partnerships.

Under the Bipartisan Budget Act of 2015, Congress replaced the rules governing the audit and adjustment of partnership income tax returns. Generally, beginning in 2018 (or earlier if a partnership elects), partnership audit adjustments will be assessed against, and any resulting tax will be paid by, the partnership. As one might imagine, the new law is complex and includes various elections, adjustments and other special rules. This client alert only discusses certain aspects of the new rules particularly relevant to government pension plans.

1) If a partnership does nothing in response to the new rules, a government pension plan may (through its partnership interest) pay part of any federal income tax assessed on the partnership.

Most partnership agreements currently do not address the possibility of an entity level federal income tax. If not otherwise addressed in the partnership agreement, any tax payable by the partnership would be a nondeductible partnership expense and allocated to all partners, including tax-exempt partners, in accordance with the rules in the partnership agreement for allocation of expenses. Thus, depending on the terms of the partnership agreement, a government pension plan investor may bear a part of this federal tax.

2) Certain partnerships may elect out of these new rules on an annual basis.

Only partnerships with fewer than 100 partners, each of whom is an individual, a C corporation or another category of taxpayers listed in the statute (and none of whom may itself be a partnership or a trust) may elect out of these new rules. A separate election must be made for each taxable year. Government pension plans that invest in a partnership eligible to elect out should discuss this election with the partnership and consider what changes to the partnership agreement are appropriate (e.g., requiring the annual election) to make sure their tax liabilities are limited to the extent possible.[1]

3) If a partnership does not or may not "elect out," the partnership may limit the tax paid with respect to tax-exempt investors and agree to allocate the resulting tax to partners other than government pension plans and other tax-exempt investors.

The new law allows a partnership to calculate the amount of tax payable by the partnership by excluding the portion of the adjustment the partnership demonstrates is allocable to tax-exempt partners that would not owe tax based on their tax status. A partnership agreement may need to be amended to permit this approach, and the partnership agreement would also have to permit (and should require) a special allocation of any federal income tax expense to partners other than tax-exempt partners.

Unfortunately, calculation of the tax payable by the partnership is not a simple matter. For example, the tax is calculated at the highest possible marginal rate for individuals or corporations, generally without adjustment for the actual partners in the partnership. Also, reallocations of income are not netted, so effectively taxes may be paid twice.

1 An open issue is whether a government pension plan is the type of person that may cause a partnership to be prohibited from making this election.

The tax payable by the partnership may be reduced to the extent partners report and pay the tax due on partnership adjustments. First, if (i) one or more partners file returns for the reviewed year, (ii) these returns take into account adjustments for the year and (iii) tax due is paid with these returns, then the partnership's assessed tax is reduced to the extent it is reported and paid by the partners. Second, any remaining tax paid by the partnership would then be allocated to the partners in accordance with the partnership agreement.

4) The new law includes another election that may ultimately be the most popular alternative for addressing partnership audit adjustments.

As an alternative to the default provision discussed in point #3, a partnership may elect to reflect partnership level audit adjustments on Schedules K-1 that are provided to the IRS and to the persons who were partners during the reviewed year. This election must be made no later than 45 days after the date the IRS issues the partnership audit adjustments. Once made, the election may only be revoked with the consent of the IRS. These partners must then report the adjustments on their Schedules K-1 on their own tax returns for the tax year that includes the date the Schedules K-1 are issued. The additional tax, however, is based on the additional amounts that would have been payable for the reviewed year, and the partners may be liable for interest, additions to tax and penalties on these amounts.

There are several ambiguities in the statute and issues that need to be addressed under this alternative. For example, it is not clear that the rule discussed in point #3, which allows the partnership to exclude the adjustment attributable to tax-exempt partners, will apply in these circumstances, though it should.

5) The new rules change who has authority to act on behalf of a partnership in federal income tax matters.

Under current law, a partner, typically the general partner of a limited partnership, is appointed as the "tax matters partner," and this partner has authority to act on behalf of the partnership in resolving federal income tax matters. Under the new law, the partnership must designate a "partnership representative" who has this authority, and this person need not be a partner. Now that certain partnership elections may have a greater impact on tax-exempt investors, government pension plans have a greater interest in who is designated as the partner representative, what elections this person may make and what duties this person may owe the partnership and its partners.

6) Government pension plan investors should consider what impact the new partnership audit adjustment rules may have on their partnership investments.

Because doing nothing may result in an allocation of federal tax expense to government pension plans, government pension plans should consider and discuss with these partnerships what tax elections are appropriate and what changes to partnership agreements are necessary to limit their exposure for tax liabilities if partnership audit adjustments are made. Government pension plans should also consider who will be appointed as partner representative and what authority and duties these persons will have to the partnership and its partners.

7) While the rules are not generally effective until 2018, government pension plans should consider these changes now.

Unless a partnership elects to apply the rules earlier, the new rules will apply beginning in 2018 to all partnerships, including those formed before and those formed after that date. Amending partnership agreements typically requires discussion and consent, so addressing these rules now in new partnership agreements for partnerships to be formed in the future is preferable. Also, partnership agreements for existing partnerships will need to be amended to address these issues.

For More Information

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