NEW PARTNERSHIP TAX AUDIT RULES DEMAND YOUR ATTENTION

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Effective January 1, 2018, new audit rules under Congress’s 2015 Bipartisan Budget Agreement will go into effect and raise havoc in the investment and business worlds. These new rules will turn the audit process 180 degrees to be much more favorable to the Internal Revenue Service, putting each partner at greater risk of tax assessments well after the filing of the partnership’s tax returns. Limited liability companies (LLCs) that choose to be taxed as a partnership are similarly affected. LLCs and partnerships need to be aware of how these rules will work to IRS’s favor in order to avoid surprises, frustrations and potentially unfair (yet fully legal) tax assessments to partners in the future.


Under current rules, small partnerships (that is, those with 10 or fewer partners, none of whom are themselves LLCs or limited partnerships) are not audited at the partnership level. Rather, the IRS selects individual partners for audit and, in the course of that audit, reviews the partnership tax return, raising the possibility that other partners may be drawn into audit as well.

Each partner participates in his or her own audit, but there is no right to participate in any other partner’s audit. Typically, however, partners will coordinate their efforts when more than one partner is the subject of an audit in order to pose a consistent defense and minimize the total tax liability. IRS may then issue proposed adjustments to a partner’s return (and to other partners’ returns), and each partner independently pursues appeals within the IRS and/or judicial challenge to those adjustments. Most important, the IRS must pursue separate collection efforts against each individual partner, thereby making the entire process inefficient to the IRS’s disadvantage.

Larger partnerships and those with "disqualified" partners (i.e., LLCs, limited partnerships or foreign taxpayers) are bound to rules enacted in 1982. Those rules provide that the tax audit is conducted at the partnership level with a single "tax matters partner" taking responsibility for communication among the partners and the IRS. However, the collection process is still conducted at the individual partner level, making collection of additional assessments still inefficient for the IRS.


(a) General. The new rules provide that unless a partnership is permitted under the rules to elect out of the new rules and in fact does elect out, audit is conducted at the partnership level and the IRS may collect additional taxes, penalties and interest at the partnership level in the year of the adjustment, regardless of
whether the partners are the same in that year as opposed to the year under review. Furthermore, the individual partners cannot participate in the partnership audit. Rather, one "personal representative" acts on behalf of the partnership and binds the partnership to any adjustments finally determined and agreed upon. It is up to the partners to determine among themselves what rights they reserve to themselves when a partnership audit arises, including the right to notice, the right to status reports, and the right to indemnification for liabilities greater than the partners' appropriate share of the additional taxes and penalties. Note that the assessment is made by the IRS at the highest individual tax rate (currently 39.6%), regardless of any individual partner's marginal tax bracket.

(b) Elect-Out Option. Newly defined "small partnerships" (that is, those with 100 members or less, all of whom are "qualified" partners) may elect out of these new rules under an annual election made with a timely-filed partnership tax return. The election must identify all partners by name and social security numbers or EINs (for example, for S corporation partners). This "electing-out" right raises many questions to be asked by the partners and answered within the Partnership Agreement (or Operating Agreement for LLCs):

1. Is the option to be automatic as long as it is available, or it is one that should require annual approval by the partners? Alternatively, do the partners leave it to the personal representative to determine whether the option should be elected?

2. If the partners decide upon an annual election, should it be subject to an evergreen clause that requires affirmative election out of the option in a later year?

3. If left to the personal representative to decide, what factors should the personal representative take into account?

4. What liabilities apply to the personal representative if the election is not made but should have been made?

5. Does the partnership require the partners to file individual amended returns for any reviewed years and pay the taxes associated with any adjustments as finally determined, and if so, what liabilities arise if not done so?

(c) Push-Out Option. All other partnerships not eligible for the "elect-out option" may obtain similar relief by "pushing out" the audit onto the partners in the year under review (not the year in which the review occurs). This election must be made by the personal representative within 45 days after the date of the IRS's Notice of Final Partnership Adjustment. Note that the IRS still collects from the partnership the additional taxes and penalties, thereby requiring the partners beforehand to consider including within the Partnership Agreement covenants...
requiring affected partners to pay the tax to the partnership, to be then remitted to the IRS. Note also that the affected partners have no right to appeal within the IRS any of the proposed audit adjustments, but instead must pay the tax and seek refund separately if they wish to contest the assessment.

Keep in mind that the IRS’s assessment will be at the highest individual tax rate for the year of review. If any one partner complies with filing an amended return and pays the tax liability, the partnership can then seek adjustment to the assessed liability based upon whatever facts and circumstances may impact the marginal tax rate of the affected partners. Absent that, the partnership has no standing to contest the liability.

This "push-out" right raises several questions for the partners to consider within their Partnership Agreement (or Operating Agreement):

1. To what extent should authority be given to the personal representative to make the push-out election? Should it be mandatory in any case? Should it be an election voted on by the partners?

2. What indemnification should be given to the personal representative for his actions in electing the option?

3. What notice requirements should be imposed upon the personal representative to notify all affected partners (including former partners) of the partnership?

The new audit rules place a heavy emphasis on initial discussion and planning among the partners (or members) in dealing with future tax audits. Listed above are just some of the issues that a partnership or LLC should address within the Partnership or Operating Agreement to determine and establish the partners' rights and obligations. We'd be happy to review your current agreements and assist in developing a workable strategy for you.