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New IRS audit rules for partnerships will have a big impact

New tax rules passed by Congress late last year dramatically overhaul the regime for IRS partnership audits.

Limited liability companies and other tax partnerships will need to directly engage with these rules and modify their governing documents to address them. Failure to do so may result in partners being stuck with the bill for taxes that arose before they even joined the partnership and other significant issues.

Generally, a partnership does not pay income tax. Rather, each partner reports his or her share of the partnership's income or loss on their own tax return and pays the corresponding tax.

Under current law, for most partnerships, the IRS first both conducts an audit and makes any adjustments at the partnership level. Once that audit is complete, the IRS must assess tax against each partner from the audit year individually.

The new rules, adopted as part of the Bipartisan Budget Act of 2015 and effective beginning in 2018, change both how the IRS audits partnerships and who pays audit adjustment taxes.

Under the new rules, the IRS generally will assess tax against the partnership itself for any underpayments discovered on audit. This represents a change to the fundamental proposition that partnerships themselves are not taxpayers.

Tax is assessed in the year that the audit is complete. This change shifts the economic burden of an adjustment to partners in the audit year, rather than the reviewed year.

While this makes collection easier for the IRS, it often will not make economic sense. Partnership agreements and/or documents related to the transfer of partnership interests will need to specifically engage with this issue to ensure that the persons that were actually partners in the year that the underpayment occurred bear the burden of the tax. Purchasers of partnership interests and other new partners need to make sure that they are contractually protected against liabilities prior to their becoming a partner unless they agree to assume these liabilities as part of the deal.

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Tax is due at the highest tax rate applicable in the reviewed year. The tax can be reduced if the partnership can show that application of the highest applicable tax rate is not appropriate for its partners. Partnership agreements should require that partners provide the partnership with the necessary information to generate this reduction.

The underpayment by the partnership is reduced if partners voluntarily amend their returns to pay tax for the audited year. Partnership agreements may wish to engage with this option as well.

As an alternative to the above, the new law allows the partnership to elect for the persons that were partners in the year under audit to pay the tax. If the "push out" election is made, the partnership issues adjusted Schedule K-1s to the reviewed year partners. The partners then report the tax, with interest (at an increased rate), on their returns for the year in which the adjustment is made.

Partnership agreements and/or documents related to transfers of partnership interests should specifically address this election. Consideration will need to be given to whether to require the election or to give the partnership the flexibility to decide whether to make the election in the future based on the circumstances (with appropriate indemnities if desired).

Under the new regime, partnerships may appoint any person or entity with substantial presence in the U.S. to serve as the "partnership representative" before the IRS. This replaces the old concept of the "tax matters partner" who was required to be a partner of the partnership. The partnership representative has the sole authority to act on behalf of the partnership.

The authority of the partnership representative needs to be addressed in detail in the partnership agreement as well. The new rules are focused on making it easier for the IRS to audit partnerships. Accordingly, the rules make all decisions of the partnership representative binding on the partnership, and provide that the partners are not entitled to notice of audits or adjustment. To ensure that all partners are treated fairly, the partnership agreement should include contractual provisions defining the authority of the partnership representative and requiring the representative to keep the other partners apprised of audit activity.

The new rules are applicable to all partnerships, unless the partnership elects out. Partnerships are eligible to elect out of the new rules if they issue 100 or fewer Schedule K-1s for the tax year and have no partners that are entities taxed as partnerships or are otherwise disqualified.

For eligible partnerships, whether to elect out is a critical decision. If a partnership elects out, the IRS may still audit the partnership, but must make adjustments at the individual partner level. This makes the audit process much more difficult for the IRS, and also avoids all of the technical issues presented by the new rules. The decision must be made in advance on the timely filed return for each tax year.

The new rules are intended to make it easier for the IRS to audit partnerships and they certainly do so. However, they are a blunt instrument that can result in the "wrong" parties bearing economic responsibility for partnership adjustments. Taxpayers will need to address the new rules in partnership agreements and partnership purchase and sale documents. While the new rules will not apply until 2018 returns are audited, their impact is so significant that taxpayers should begin to address them immediately.

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