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TAX AND WEALTH ADVISOR ALERT: PARTNERSHIP AND LLC AUDITS ARE COMING—IS YOUR PARTNERSHIP OR LLC PREPARED FOR THE NEW RULES?

With all the tax changes taking effect in recent years, entities taxed as partnerships may have overlooked an important change from a few years ago—the new partnership audit rules. The changes to the partnership audit rules were unrelated to the highly publicized Tax Cuts and Jobs Act of 2017, and instead were introduced in the Bipartisan Budget Act of 2015 (BBA), effective as of January 1, 2018. The BBA dramatically overhauled the former rules for partnership audits, repealing and replacing the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership rules.

Although the new rules are very complex, the biggest changes are that (1) partnerships rather than partners will now be liable for any tax deficiencies resulting from an IRS audit unless the partnership elects out of the new rules, and (2) the new position of "Partnership Representative" gives that person much greater power to make binding decisions than the traditional "Tax Matters Partner." Accordingly, it is important for members and partners to familiarize themselves with some of these changes and ensure that protections and plans are built into the partnership or operating agreements.

New Rule Changes

Prior to 2018 under TEFRA, if the IRS wanted to conduct an audit on the activity of a partnership, it was required to audit and collect tax from its partners. Thus, the IRS could audit the partnership as long as the IRS assessed and collected any understatement of partnership tax, interest, and penalties at the *partner level*. The amount of tax due from the partner depended on the partner's other tax attributes (i.e., the partner's other items of income, gain, loss, deduction, and credit), and the IRS collected the resulting tax from each partner. Over time, the application of TEFRA caused huge headaches for the IRS due to the administrative burden of matching and tracking each partner, collecting from or refunding each partner, and navigating tiered partnership complexities.

To combat these issues, the IRS created a streamlined audit approach under the BBA, called the Centralized Partnership Audit Regime (CPAR). CPAR provides that the IRS can still audit

the activity of the partnership, however, the IRS can now access and collect any resulting understatement of tax, interest, and penalties (which under the new rules is referred to as the "imputed underpayment") directly from the partnership, rather than from the partners.

While the IRS can audit (within the statute of limitations) the partnership's items of income, gain, loss, deduction, credit, and partners' distributive shares for any particular year of the partnership (the "reviewed year"), any imputed underpayment due from the partnership will be assessed in the year that the audit or any judicial review is completed (the "adjustment year"). By collecting the tax payable in the adjustment year rather than the reviewed year, ownership changes may produce what some partners consider unfair results. For instance, a new partner in an existing partnership may find it unfair to bear the tax burden for adjustments to the prior year's tax returns.

Additionally, under the new audit regime, instead of a tax assessment calculation based on the other tax attributes of each partner, the imputed underpayment assessed against the partnership is calculated by multiplying the total netted partnership audit adjustment for the reviewed year against a single tax rate. The tax rate will be the higher of (1) the highest income tax rate in effect for individuals (currently 37%) and (2) the tax rate applicable to corporations (currently 21%). Depending on a partner's individual tax situation this is an undesirable outcome if the partner falls into a lower tax bracket. However, following the rules published in the regulations, the partnership may modify the underpayment amount if the partnership can show the IRS that a partner's share of an adjusted item is subject to a lower tax rate, or if the partnership can establish that a partner has agreed to an adjustment and paid the resulting tax through an amended return. These potential modifications must be timely submitted and approved by the IRS.

Electing Out of New Partnership Audit Rules

The IRS does allow a partnership to elect out of the new audit regime under certain circumstances. In order to elect out of the new audit rules, the partnership must meet two requirements: (1) the partnership must have 100 or fewer partners during the tax year, and (2) all partners must be "eligible partners" at all times during the tax year. Eligible partners include individuals, C corporations, S corporations, or estates of deceased partners. The list of eligible partners does not include partnerships, trusts, disregarded entities, nominees or other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner. If there is even one ineligible partner, the partnership cannot elect out of the new audit regime. Further, if the partnership has an S corporation as a partner, the shareholders of the S corporation will count toward the 100-partner rule.

An election to opt out must be made annually on a timely filed tax return and the partnership must notify partners of the election within 30 days of making the election. The partnership must also disclose the names and taxpayer identification numbers of all partners on its tax

return. The result of this election moves the adjustment and assessment of tax to the partner level.

"Push-Out" Election

The new rules also provide that a partnership can make a "push-out" election, which allows a partnership to shift or "push-out" any tax liability due upon audit to the partners that were actually partners during the reviewed year (which eliminates the partnership's responsibility to pay the tax). Unlike the election to opt out of the new audit rules, this election is available to all partnerships; however, this election can be made only by the Partnership Representative (as detailed below).

This election must be made within 45 days after the IRS issues the final adjustment and the partnership must then furnish statements to the reviewed year partners within 60 days of the final adjustment showing the partner's share of the adjustment. Based on statements, each reviewed year partner will calculate the partner's tax for the reviewed year and any interim years after the reviewed year and preceding the adjustment year. The partners then pay the aggregate tax plus interest (an additional 2% interest is charged using this election) and penalties with their income tax return for the adjustment year (i.e., the current year's tax return).

Goodbye Tax Matters Partner, Hello Partnership Representative

Under the new regime, a Partnership Representative replaces the familiar Tax Matters Partner. With TEFRA, a Tax Matters Partner would simply act as a go-between with the partnership and the IRS. In contrast, with the CPAR changes, the Partnership Representative has full authority to act on behalf of the partnership and take any necessary actions that are binding on the partnership and all its partners. Additionally, the Partnership Representative is not bound by a fiduciary duty to act in the best interest of the partnership.

Another departure from the old rules is that the Partnership Representative is not required to be a partner, unlike the Tax Matters Partner. It can be anyone that the partnership feels is capable and knowledgeable enough to make decisions on IRS assessments. The partnership must designate a Partnership Representative on its tax return filing each year. It is important to note that the old Tax Matters Partner does not automatically become the new Partnership Representative and if no Partnership Representative is appointed, the IRS will appoint one. A partnership can remove its Partnership Representative, but only after a Notice of Administration Proceeding is issued by the IRS.

Considerations for Partnership and Operating Agreement Amendments

As a result of the new audit rules, entities taxed as partnerships should begin preparing for the effect of the new regime and consider addressing potential issues with their existing

partnership or operating agreements. For example, if the partnership is eligible and plans to opt out of the rules altogether, the operating agreement should require the Partnership Representative to make the election annually. Partners may even want to prohibit any transfer of a partnership interest to an ineligible partner that could prevent an opt-out election.

If the partnership is unable to opt-out or chooses not to, the operating agreement should specify how the partnership will pay an imputed underpayment and how the imputed underpayment will be allocated amongst the partners, old and new. The operating agreement should also stipulate whether or not the partnership will make a push-out election.

Moreover, at the very least, given the broad discretion a Partnership Representative is allowed under the new regime, a partnership should appoint or designate a process for appointing a Partnership Representative in its operating agreement. The operating agreement should also address when/if the Partnership Representative will be liable to the partners for failure to make an election or making an election that was not in the best interests of the partnership. A partnership may also consider amending or adding indemnification provisions for the Partnership Representative.

A partnership may also want to consider including language that requires the Partnership Representative to notify partners upon certain stages in an audit or require the Partnership Representative to consult with or obtain consent of the partners before taking a position, agreeing to a settlement, or making an election. All of the foregoing issues can and should be addressed in amendments to operating agreements, and there is still time to do so before the IRS begins audits in earnest under the new regime.

If you are interested in learning more about the new partnership audit rules, please contact attorney Britany E. Morrison at O’Neil Cannon