

NEWSLETTER

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WATCH OUT! NEW PARTNERSHIP AUDIT RULES IMPACT MORE AREAS THAN YOU MAY THINK

Audits of partnerships aren't a flashy topic, but new audit rules will have everyone scrambling to figure out their implications. To make things worse, these rules need to be addressed now in partnership and operating agreements, among other places. Since LLCs are treated as partnerships for federal income tax purposes, the new rules apply equally to LLCs.

What happened? Partnership income passes through to, and is reported and paid by, its partners. So even if the IRS successfully audits a partnership, it must chase down all of the partners to collect on an audit adjustment. In today's world of multiple tiered partnerships, this isn't a feasible IRS job, and they essentially gave up. For example, the audit rate in 2012 for large corporations was 27.1%, and for large partnerships was 0.8%.

In November of 2015, Congress pushed through a whole new set of audit rules as part of the Bipartisan Budget Act. The intent is to make it easier for the IRS to audit partnerships. The rules are effective for tax years beginning after 12/31/17.

What are the New Rules? The thrust of regime change is that following an audit, the IRS can collect tax, penalties and interest directly from the partnership (or LLC). Obviously, this makes collections much easier. A partnership doesn't pay tax, so the audit rules apply the highest applicable rate to calculate the liability for an underpayment (subject to some minor adjustments).

Keep in mind that audit adjustments take place a few years after the audited tax year. This means the partners in the adjustment year bear the economic loss, even if they weren't the partners at the time of the audited year. The fact that the partnership is liable for the adjustment raises many planning issues, including:

- Assuming some of the partners have changed between audit year and adjustment year, will new partners have recourse against the former partners from the audited year?
- Must current partners contribute to pay for the audit adjustment, penalties, audit costs and litigation? Will former partners who were partners during the audited year be required to pay these expenses?
- How will the audit adjustment costs be allocated among the partners? (By the way, audit adjustments are nondeductible.)

These types of issues do not have an obvious or one-size-fits-all resolution, and they are left open for applicable agreements to identify and address.

The old audit rules – known as TEFRA – are repealed effective 12/31/17. TEFRA provided for one partner to coordinate a partnership audit and any judicial proceedings – this partner is known as the “Tax Matters Partner.” After an audit, TEFRA gave the IRS one year to collect tax from the individual partners. Under the new audit rules, there is no more Tax Matters Partner. Instead, there is a Partnership Representative who has the sole authority to act on behalf of the partnership. This

can be any person (whether or not a partner) with a substantial presence in the U.S. The specifics of the representative's role and how the costs of an audit are funded are other matters left to the agreements.

Can a Partnership Elect Out? A partnership can elect out of the new regime if it has 100 or fewer eligible partners. But only individuals, C corporations, S corporations and estates of deceased partners are eligible. If a partnership (including an LLC) or a trust is a partner, an election out isn't possible, no matter how few partners there are. An election out is made annually on a timely filed partnership return.

Can a Partnership Elect Not to Pay the Tax Directly? Yes, assuming it makes an election within 45 days after the date of the final adjustment. In that case, the partnership must furnish to each partner for the audited year a statement showing the partner's share of adjustments – most likely a revised K-1. Each partner will then owe tax for the year of the adjustment, not the audited year, along with interest and penalties.

Final Thoughts: There are a wide range of implications arising from the new rules, and more will likely develop as partners, partnerships and their advisors sort through the alternatives. Although the IRS is expected to issue regulations clarifying some of these issues prior to the effective date, the new audit rules are final. Their implications need to be addressed starting now, and existing partnership and operating agreements will need to be amended before the effective date.

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