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Are You Ready for the New Partnership Audit Rules?

Partnerships and LLCs have grown in popularity given their governance flexibility, liability protection, special income and deduction allocations, and the single level of taxation they provide to partners. However, due to a lack of resources, the IRS only audits less than 1% of partnerships and collects little tax from these audits.

To make it easier for the IRS to audit partnerships and collect the tax, the *Bipartisan Budget Act of 2015* was signed into law in November 2015, ideally resulting in a significant increase in tax revenue.¹

Although these new rules are effective for partnership tax years beginning after December 31, 2017,² a partnership may elect to apply the new rules to any partnership tax years beginning after November 2, 2015 and before January 1, 2018.³

The Bipartisan Budget Act contains some significant changes to the current audit standards; adjustments will be made at the partnership level and the resulting tax will be assessed and collected from the partnership. It also includes many elections and decisions that partnerships must consider in the event of a federal audit.

All partnerships and LLCs taxed as partnerships should carefully review certain tax provisions in their agreements to address these changes and avoid unintended tax consequences to the partners and partnership.

While proposed regulations governing these new partnership rules were issued on January 18, 2017, the Trump administration published a presidential memorandum two days later that put a freeze on all new regulations, which has delayed formal issuance of these new rules.

The rules are still scheduled to go into effect after December 31, 2017; however, many detailed questions related to the operation of these rules will remain unanswered until these regulations are issued and final. For now, the proposed regulations should be used as guidance.

Current Partnership Audit Rules

To help understand the changes to come under the new act, an understanding of the current partnership rules is required.

1) Partnerships with more than 10 partners, as well as LLCs treated as partnerships for tax purposes with more than 10 members, fall under the *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA) unified audit rules. Under the TEFRA rules, the tax treatment of partnership items of income, gain, loss, deduction, and credit as well as any additions to tax or penalties from adjustment to partnership items as a result of an IRS audit are all generally determined at the partnership level. In other words, the IRS can conduct a single partnership-level audit procedure to resolve all issues for partnership items.

Once the partnership-level audit is completed and the resulting adjustments are determined, the IRS recalculates the tax liability for each partner for the affected year. The adjustment is “passed-out” to the partners on record for the period during which it applies. The partners are responsible for any deficiency on their own tax returns, which is revised to include their share of the audit adjustment and be taxed at the partner’s individual tax rate.⁴

2) Unless the partnership elects it, the TEFRA rules do not apply to a partnership with 10 or fewer partners – each of whom is an individual (other than a non-resident alien), a C corporation, or the estate of a deceased partner. Note this exception does not apply to partnerships that have a pass-through partner, such as an S corporation, partnership, trust, or disregarded entity. For such small partnerships, the IRS generally conducts separate audits of the partnership and each partner.⁵

3) The partnership is required to appoint a representative known as a Tax Matters Partner (TMP) to represent them in dealing with the IRS under a federal audit. The TMP must be a partner in the partnership who receives the audit notification, conducts the audit, and enters into a settlement agreement on behalf of the partners.

How the New Audit Rules Will Work

The new rules call for auditing partnerships and their partners at the partnership level – including adjustments to partnership items of income, gain, loss, deductions, or credit for the applicable partnership tax year (and partners' share of such adjustment).⁶ Subject to certain exceptions (outlined later), any additions to tax and related penalties are generally determined, assessed, and collected at the partnership level.

For a net adjustment that increases the partnership's taxable income for a specifically audited year (the "reviewed year"), the partnership is required to pay any additional tax (the "imputed underpayment") in the year that the adjustment is finalized (the "adjustment year").⁷ This means that all current partners could bear economic responsibility for improper tax reporting in prior years, even if they were not a partner at the time.

Partnerships generally must pay tax equal to this imputed underpayment, which typically is the net of all adjustments for any reviewed year multiplied by the highest individual or corporate tax rate in the review year.⁸ Currently, the individual rate of 39.6% would apply even if all the partners are C corporations (for which their highest marginal rate is 35%).

Example 1

Suppose in 2020 (the adjustment year), the IRS issues a notice of final partnership adjustment, which increases the partnership's taxable income for 2018 (the review year) by \$1 million. Under the new act, the partnership (not its partners) is subject to \$396,000 in income tax (the imputed underpayment using the 39.6% rate), plus interest and possible penalties.⁹

Exemptions

The imputed underpayment rate does not account for the character of the income; i.e., capital gains or qualified dividends can be taxed at the same 39.6% rate. However, a partnership can reduce this liability by demonstrating that some of its partners are subject to a lower rate (e.g., C corporations, tax-exempt, or individuals subject to a lower rate for capital gains or qualified dividend income).¹⁰

Smaller partnerships where most of the partners are related (i.e., family members) may have an easier time gathering the necessary information to demonstrate a lower tax rate than larger ones.

To ease the burden of this process, the partnership or LLC operating agreement should address at least the following:

- Authority to request and obligation to provide partner-specific information (e.g., partners' tax returns);
- Ability to pay tax from the partnership account or call capital to pay the tax, especially if the partnership does not have the cash to pay the taxes;
- Allocation of the tax burden among the partners; and
- Indemnification and claw back from prior partners.

As previously mentioned, new purchasers of a partnership interest or new partners could be directly or indirectly liable for tax paid by the partnership for previous years. These new partners should perform additional due diligence to understand the potential tax liabilities from prior years.

For mergers and acquisitions involving partnerships, the purchase agreement should address who will bear the economic cost of partnership-level tax liabilities for pre-closing years assessed post-closing, who controls the audit examination of pre-closing years, and elections the partnership can make.

Alternatives to the Entity-Level Tax

The Bipartisan Budget Act provides two alternatives to paying the audit adjustment at the entity level. For each of these alternatives, the procedures must be defined and incorporated in the operating agreements.

Alternative 1: "Push Out" Election

In lieu of the partnership paying the tax on the imputed underpayment, any partnership may elect to issue adjusted statements (essentially revised Schedule K-1s) to those who were partners during the review year. This "push out" election must be made within 45 days of receiving the notice of final partnership adjustment from the IRS.¹¹ Partners then self-assess any added tax computed as if the adjustment had been properly reported for the reviewed year, but the assessment is reported and paid on the return for the year the revised Schedule K-1 is received (rather than amending their returns for the reviewed year).¹²

Example 2

Let's assume the same facts as Example 1 apply, except the partnership elects within 45 days after receiving the final partnership adjustment to issue statements to each partner for the reviewed year (2018) indicating each partner's share of the \$1 million of additional income. Each partner will adjust its 2018 taxable income to determine the additional tax, which is then paid on the partners' 2020 individual returns.¹³



Partners who revise their tax liability for the review year must also adjust subsequent-year tax attributes (e.g., net operating losses, suspended passive activity losses, etc.) to reflect these changes.¹⁴ The partners are liable for the penalty and interest from this reporting, which could be 2% higher compared to if the partnership would have paid the tax.¹⁵

The partnership or LLC operating agreement should address if the “push out” election is mandatory or optional. If it’s optional, consider the fairness between the current vs. prior partners, additional 2% interest, accuracy of the adjustment, and additional partner-level expense.

Alternative 2: Self-Reporting

Instead of the IRS changing the partnership’s income and issuing a notice of final partnership adjustment, the partners may self-report the amounts due by filing amended returns for the review year that take into account their share of the adjustment.¹⁶ If one or more partners self-reports their share of a proposed adjustment, then the imputed underpayment at the partnership level is reduced.

Election Out

To avoid these complex new rules, certain eligible partnerships can elect out¹⁷ of the new rules for any tax year if the following exists:

- The partnership is required to issue no more than 100 Schedule K-1s to its partners;
- Each partner is an individual, an estate of a deceased partner, an S corporation, or a foreign entity that would be treated as a C corporation if it were domestic;
- An election is filed with a timely filed partnership return identifying the names and identification numbers of the partners; and
- The partnership notifies each partner of the election.

Shareholders of subchapter S corporations in partnerships are considered partners and must disclose their names, addresses, and taxpayer identification numbers in the election.¹⁸ However, those with partnerships or trusts as partners may not opt out of these rules.

The IRS will also need to issue regulations to address whether or not disregarded entities that are partners will be

considered in determining who owns the interest. However, this may be challenging for some, as it is common to have trusts and partnerships as partners for estate planning and liability protection purposes.

If the election out is made, then the partnership and its partners will be audited separately under the rules applicable to individual taxpayers. Any adjustment to the partnership taxable income will “pass out” to the partners with the assessment of tax determined at the partner level.

More importantly, the IRS must issue a separate audit report to each partner who can independently challenge its own audit report under the deficiency procedures that otherwise apply to individuals.

It is also important to emphasize that this election out must be filed on a yearly tax return, otherwise the default rules under the Bipartisan Budget Act will apply for that tax year. Partnerships that currently qualify to make this election should be careful of future ownership changes that could negate their ability to elect out.

In order to properly address some of these concerns, the partnership and operating agreements should discuss the election out process, address possible ownership transfer restrictions, and consider including covenants in the partnership agreements to remain under 100 partners.

Partnership Representative

A partnership that does not elect out must designate a partner (or another person with substantial presence in the U.S.) as the partnership representative (to replace the role of the TMP under the current rules).¹⁹ This person could be a majority partner or an independent third-party that would represent the partnership’s best interest.

The partnership representative has sole authority to act on behalf of the partnership and may bind the partnership and all partners in IRS audits as well as in any court proceedings.²⁰ If no partnership representative is designated, then the IRS may appoint one.

This representative has exclusive rights to resolve partnership audits and should be carefully vetted. The actions of the partnership representative will bind the tax results of the partnerships and its partners. Disputes may create conflict with the partners if the representative rights are not specified in the partnership agreement.

It's critical for the partnership and operating agreements to specify standards to outline selecting, terminating, and replacing the partnership representative. The agreement should also state the representative's level of authority for key decisions, such as settling the audit or making the push out election.

What the Future Holds

While the new partnership audit rules address many long-standing challenges to the IRS' ability to effectively audit partnerships, they also generate new challenges. These provisions shift the economic burden for past years' tax liability to the adjustment year, leaving partners potentially responsible for tax attributable to years in which they did not have an ownership interest.

Partnerships will need to take these provisions into account and make appropriate revisions to their partnership agreements. Partnerships, including LLCs and other business entities treated as partnerships for federal tax purposes, should carefully consider today how they will navigate these new rules in the future. ■

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Endnotes

1. The new rules governing partnership audits, adjustments, and collections are estimated to raise approximately \$9.325 billion over the fiscal year 2011-2015 budget cycle. See Joint Committee on Taxation, Estimated Revenue Effects of the Tax Provisions Contained in H.R. 1314, the *Bipartisan Budget Act of 2015* (JCX-135-15).
2. *Bipartisan Budget Act of 2015* § 1101(g)(1).
3. *Bipartisan Budget Act of 2015* § 1101(g)(4).
4. IRC § 6221-6234.
5. IRC § 6231(a)(1)(B).
6. IRC § 6221(a).
7. IRC § 6225(a).
8. IRC § 6225(b)(1).
9. Williamson, Donald T. "Partnership Audit Rules for the Next Decade." *CPA-Tax Advisor Magazine*, July 2016.
10. IRC § 6225(c)(4).
11. IRC § 6226(a).
12. IRC § 6226(b).
13. Williamson, Donald T. "Partnership Audit Rules for the Next Decade." *CPA-Tax Advisor Magazine*, July 2016.
14. IRC § 6226(b)(3).
15. IRC § 6226(c)(2)(C).
16. IRC § 6225(c)(1), (c)(2).
17. IRC § 6221(b).
18. IRC § 6221(b)(2).
19. IRC § 6223(a).
20. IRC § 6223(b).