Federal Income Tax Alert

BIG Changes in IRS Partnership Tax Audit Rules Coming in 2018

Partnership and LLC agreements should be reviewed and amended to deal with the new IRS partnership level audit procedure and its effect

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In General

Changes in federal tax law taking effect in 2018 will change procedure and shift liability for federal income tax determined to be due in Internal Revenue Service ("IRS") audits of partnerships.

Partnership agreements, and governing documents of limited liability companies taxed as partnerships, should be reviewed and amended to be in place for 2018 and later years. They should be amended to recognize and meet the new IRS partnership audit requirements and provide for appropriate action to be taken by the partnership in an IRS audit. The new partnership audit rules change the tax year in which IRS partnership audit adjustments are to be made, the liability for and collection of any additional tax assessed by the IRS in a partnership audit, and how a partnership and partners can be represented in an IRS audit.

For federal income tax returns filed for partnership tax years beginning after 2017, new federal income tax law repeals the current tax reporting provisions and significantly changes IRS partnership audit and adjustment rules under the Internal Revenue Code ("Code").[1] Federal tax law providing for this was enacted in 2015, to be effective for tax years after 2017. Income Tax Regulations have now been proposed and published to implement the law beginning in 2018.[2] Present IRS partnership tax return audit and adjustment procedures are removed and repealed for tax years after 2017.[3]

A new IRS *"centralized partnership audit regime"* for its audit, adjustment, assessment, and collection of federal income tax will apply to all partnerships, including limited liability companies classified as partnership for tax purposes, [4] except for certain eligible partnerships that have filed a valid "election out."

The liability for underpayment of income tax for a tax year audited by the IRS ("*reviewed-year*") will now be assessed *at the partnership level*, against the partnership itself (not the partners) in the year the IRS completes a partnership audit ("*adjustment year*"), which may often be in a subsequent tax year. For example, the IRS could audit a partnership tax return for the 2018 tax year, and not complete the audit until 2020. Any additional tax found to be due by the IRS on 2018 partnership income would be assessed to and payable by the partnership, rather than the partners, in 2020.

This new regime assessing a tax deficiency determined in an IRS audit at the partnership level instead of against the partners who realized the income in the prior reviewed-year will generally make partnerships audited by the IRS be treated more like a corporation than a "pass-through" entity as to a tax deficiency. The changes are intended to simplify and accelerate IRS audits of partnerships, and make it easier for the IRS to assess and collect income tax deficiencies determined in a partnership audit. The new rules may enable the IRS to audit more partnerships. For partnerships and partners the changes could have significant, unexpected and costly effects.

Planning and Action: **Review and Amend Partnership and LLC Agreements to specifically recognize and deal with the new IRS partnership tax audit rules**

Planning and action taken to be effective in 2018 is recommended as to:

(1) How to most effectively deal with an IRS partnership audit under the new rules;

(2) Review and amendment of each partnership and limited liability company (taxed as a partnership) agreement so that the new IRS partnership tax audit rules will be expressly covered and dealt with effectively by the agreement in the event of an audit;

(3) Designation of a *partnership representative* of the partnership to act for the partnership in an IRS audit, which is required for every partnership under the new rules;

(4) Whether a partnership "*election out*" under the new IRS partnership audit rules is possible and should be made;

(5) If the alternative so-called "*push out*" of an IRS partnership audit tax assessment provided for under the new rules can and should be made by a partnership; and

(6) The intended effect of IRS partnership audit adjustments as between the *partnership* and the *present and any prior partners*.

For example, as to item (3), the designation of a *partnership representative* required under the new rules will have potentially significant effects in the case of an IRS partnership audit in the future. An existing partnership agreement may provide for and identify a "*Tax Matters Partner*" under the audit rules applicable for tax years prior to 2018. However, that provision probably would not satisfy the requirement of designating a *partnership representative* for 2018 and later tax years under the new rules. Most important, a designated partnership representative under the new rules will have different and substantially greater authority to bind the partnership and all of its partners in dealing with an IRS audit. 5

The ability and right of taxpayers that are partners in a partnership or members of an LLC to make or cause to be made a particular amendment in the partnership agreement or LLC operating agreement may differ. The agreement may contain provisions authorizing a particular partner, member or manager, or a majority of partners or members, to amend the agreement in this context. The potential effect of the new regulations on a partner, as well as amendment of the governing agreement in a particular way with respect to IRS audits, adjustments and assessments under the new audit regime may nevertheless be significant. Each partnership or LLC agreement should therefore be reviewed, and a confirmation sought as to how the entity intends to amend the governing agreement to apply to and act with respect to IRS audits in the future under the regulations.

IRS Partnership Audits and Tax Adjustments Now at the *Partnership Level*

Generally, under the new IRS centralized partnership audit regime, an IRS audit of a partnership for federal income tax will take place at the *partnership level*. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally will be *determined at the partnership level*. Any tax attributable to these items generally is *assessed and collected at the partnership level*. The application of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof will be *determined at the partnership level.*

IRS Partnership Audit Adjustments *Imputed* to Partnership in *Adjustment Year*

A tax deficiency or underpayment resulting from an IRS partnership audit for a prior taxable year, referred to under the new rules as the "*reviewed-year*," is to be *imputed* to the partnership in the year during which the adjustment is finally determined by the IRS, referred to as the "*adjustment year.*" That deficiency is to be assessed against and collected from the partnership in the adjustment year rather than against partners for a prior reviewed-year.

The federal tax code generally treats a partnership and an LLC taxed as a partnership as a "*pass-through*" entity, meaning that a partnership is generally not taxable and passes through its income or loss to its partners for tax purposes. The partners must account for their shares of partnership taxable income in computing their own federal income tax. A partnership must file an information return with the IRS and must send a form (Schedule K-1) to each partner of the partnership and the IRS stating the partner's share of the partnership income. This pass-through treatment does not appear to be changed for initial reporting and payment of tax on partnership income. However, the new IRS centralized partnership audit regime effectively removes the pass-through treatment as to assessment of any additional tax determined to be due by the IRS in an audit of a partnership. The amount of deficiency or underpayment of tax determined from an audit of a partnership tax return will be payable by the partnership itself rather than the partners, subject to certain allowed exceptions.

The imputed underpayment assessed to the partnership is to be calculated by multiplying the partnership adjustment in income by the highest rate of tax applicable to corporate or non-corporate taxpayers in effect for the prior reviewed-year audited. In this regard, the extent to which a partnership agreement may be amended to determine and/or require a particular kind of sharing by partners (and prior partners) of imputed income tax assessed at the partnership level by the IRS in an audit is an important issue.

The new rules provide that a partnership may be able to "*modify*" an imputed underpayment under procedures established by the IRS. However, any such modification of the imputed income amount shall be made only upon approval of the requested modification by the IRS. The modifications may be based upon partners filing amended returns for the prior reviewed-year and paying tax on income which gave rise to an underpayment imputed to the partnership. In such a modification if the tax is paid by the partners with such amended returns the imputed underpayment assessed to and payable by the partnership will exclude the portion of the audit adjustments taken into account in the partners' amended returns for the prior reviewed-year. Also, a modification could be possible in a case of a part of the imputed income being allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity. A modification may also be possible to take into account different rates of tax for the imputed income if allocable to a particular partner or partners and the type of income.

Partnership *Election Out* of the new IRS Centralized Partnership Audit Regime

The new IRS centralized partnership audit regime rules will generally be applicable to any partnership for 2018 and later tax years unless the partnership meets specific eligibility requirements and has made a valid "*election out*" for a taxable year. One of the election out eligibility requirements is that for the taxable year the partnership is required to furnish 100 or fewer statements under Internal Revenue Code section 6031(b) (Schedules K–1) with respect to its partners. A further eligibility requirement for a partnership to make the election out is that each of its partners is an individual, a deceased partner's estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation (provided special rules are met). If this election out is made by a partnership the partners will be audited and assessed for any tax deficiency for the partnership tax year audited under IRS audit rules and procedures generally applicable to taxpayers other than partnerships.

Alternative *"Push Out"* of IRS Adjustments and Payment of Tax Due by Partners

Under the new IRS centralized partnership audit regime rules a partnership may also elect to have the prior reviewed-year partners take into account the IRS audit adjustments made by the IRS in the subsequent adjustment year, and for those prior reviewed-year partners to pay any tax due as a result of those adjustments. In this case, the partnership is not required to pay the imputed underpayment.

This so-called "*push out*" option is made by the partnership. It provides an administrative procedure by which liability for the imputed tax deficiency from the prior reviewed-year audited by the IRS may be avoided at the partnership level, and shifted or pushed out to be required to be paid by the persons who were partners of the partnership in the prior reviewed-year audited.

The prior reviewed-year partners must take their shares of the IRS audit adjustments into account, and have tax imposed on them for the adjustments, as provided for in the regulations. A partnership using this alternative push out approach will be subject to specific requirements under the IRS regulations in order to be approved and allowed by the IRS. An alternative push out election will need to be filed with the IRS within 45 days of the IRS' notice of adjustment to the partnership, and by the partnership furnishing to each prior reviewed-year partner and the IRS a statement of each partner's share of any adjustment of income, loss, deduction or credit determined by the IRS in its audit adjustment.

Every Partnership Must Designate a "*Partnership Representative*" to Act for the Partnership in an IRS Partnership Tax Audit - *Extremely Important*

The Code and regulations governing the new IRS partnership audit regime require that every partnership designate a "*partnership representative*." The importance of the designation of a partnership representative cannot be overstated.

Existing partnership agreements need to be reviewed and amended if necessary in order to meet this requirement and provide for designation of a partnership representative of the partnership for federal income tax audit purposes for 2018 and later years.

Under the new law and IRS regulations a designated partnership representative shall have *sole and binding authority to deal with the IRS* and make decisions for the partnership and all partners concerning a partnership tax return audited by the IRS. This will include the partnership representative (not partners) agreeing to settlements, agreeing to a notice of final partnership adjustment, and making an election to push out partnership income to partners. The partnership representative, simply by virtue of being designated as such, will have the authority to bind the partnership for purposes of the centralized partnership audit regime, without any other action or authorization needed. No other person, regardless of whether that person's tax liability is affected by the actions of the partnership, will be able to participate in the partnership proceeding. Except for a partner that is also the partnership representative, the partners of a partnership will not be able to participate in or contest the results of an IRS audit and examination or other proceeding involving the partnership without permission of the IRS.

A partnership may designate any person, including an entity (*e.g.* a law or accounting firm) to be the partnership representative. A person who is not a partner may be designated as the partnership representative of a partnership. The partnership representative must have a substantial presence in the United States and must have the capacity to act. If an entity is designated as the partnership representative, the partnership must identify and appoint an individual to act on the entity's behalf.

The designation of a partnership representative by a partnership shall be made on the partnership's federal income tax return filed for the partnership's taxable year. A partnership must designate a partnership representative separately for each taxable year. A designation for one taxable year is not effective for any other taxable year. The designation of a partnership representative of a partnership for a particular partnership taxable year (*e.g.* 2018) remains in effect thereafter unless and until that designation is terminated. A partnership may change its designated partnership representative only by following procedures specified by the IRS and notifying the IRS.

The Code and regulations provide that if there is no designation of a partnership representative in effect, the IRS may select any person to serve as partnership representative. There is no distinction between the authority of a partnership representative designated by the partnership and one selected by the IRS. So, if a partnership does not designate a partnership representative the IRS can do so, and the partnership representative the IRS designates will have the same powers and binding authority as one designated by the partnership itself.

State Tax Effects

The IRS partnership audit rules may also affect partnerships and partners with respect to state income tax. Many states in general impose a state income tax upon the taxable income of a taxpayer as determined for federal income tax purposes. Thus, a partnership's income allocated to its partners for federal income tax purposes is usually also reported for purposes of and subject to applicable state income tax. As described above, adjustments of federal income tax due by a partnership and/or its partners under the new IRS partnership audit rules can have differing effects depending upon the size of the partnership and actions and elections made by and for a partnership. Corresponding effects may not necessarily be provided for or occur under current state income tax laws. Also, a partnership and its partners may not all be subject to the same state income tax law or laws. State income tax treatment of adjustments to partnership income made by the IRS pursuant to the new IRS partnership audit rules is therefore another factor that will need to be taken into consideration by partnerships and partners.

Conclusion

The new IRS partnership audit rules involve potentially significant financial impact on partnerships and partners that may differ a great deal from the effect of an IRS partnership tax audit under the prior IRS rules. An IRS audit of a partnership for 2018 and later tax years will be subject to more variables and potential adverse tax consequences beyond direct control by the partners than was the case before.

Each partnership and its partners should therefore consider the new law and IRS regulations and their potential tax effect thoroughly and decide how to best deal with them, including by amendment of the terms and provisions of the partnership agreement.

If you have any questions or would like to discuss how the new IRS partnership tax audit rules may affect you or your partnership or LLC, or want advice or assistance on reviewing and amending a partnership or LLC agreement, please contact any attorney of Gable Gotwals you know or our Tax Law Practice Group.

Footnotes:

1. Effective for federal income tax returns filed for tax years beginning after December 31, 2017, pertinent provisions of the Internal Revenue Code, as described in IRS Notice 2016-23, include:

.Section 6221(a) provides that, in general, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined, and any tax attributable thereto shall be assessed and collected, at the partnership level. The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall also be determined at the partnership level.

.Section 6221(b) provides for certain partnerships required to furnish 100 or fewer Schedules K-1, Partner's Share of Income, Deductions, Credits, etc. to elect out of the new centralized partnership audit regime, if the partnership meets specified requirements.

.Section 6223 provides that each partnership shall designate a partner or other person as a partnership representative. The partnership representative shall have sole authority to act on behalf of the partnership. In any case where such a designation by a partnership is not in effect the IRS may select any person as the partnership representative.

.Section 6225 generally addresses partnership adjustments made by the IRS and the calculation of any resulting imputed underpayment. It provides that the amount of any imputed underpayment resulting from an adjustment must be paid by the partnership. It describes how an imputed underpayment is determined, and describes modifications that, if approved by the IRS, may reduce the amount of an imputed underpayment.

.Section 6226 provides an exception to the general rule under section 6225 that the partnership must pay the imputed underpayment. A partnership may elect to have the reviewed-year partners recognize the adjustments made by the IRS and pay any tax due from those adjustments. In this case, the partnership is not required to pay the imputed underpayment.

.Section 6227 provides that a partnership may request an administrative adjustment, which is to be made in the year the administrative adjustment request is made. The partnership generally has three years from the date of filing the return to make an administrative adjustment request for that year, but may not make an administrative adjustment request for a partnership taxable year after the IRS has mailed the partnership a notice of an administrative proceeding with respect to the taxable year.

.Section 6231 describes notices of proceedings and adjustments, including certain time frames for mailing the notices and the authority to rescind any notice of adjustment with the partnership's consent.

.Section 6232(a) provides that any imputed underpayment is assessed and collected in the same manner as if it were a tax imposed for the adjustment year, except that in the case of an administrative adjustment request that reports an underpayment that the partnership elects to pay, the underpayment shall be paid when the request is filed.

.Section 6234 provides that a partnership may seek judicial review of the adjustments within 90 days of the date the notice of final partnership adjustment is mailed.

.Section 6235 provides the period of limitations on making adjustments.

2. Proposed Regulations, Internal Revenue Service (IRS), Treasury, Centralized Partnership Audit Regime, 82 Fed. Reg. 27334, June 14, 2017.

3. For tax years after 2017 the new law removes and repeals the prior law providing for unified partnership audit and litigation rules that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248 (TEFRA). Those partnership audit and litigation rules are commonly referred to as the TEFRA partnership procedures.

4. In general a limited liability company (LLC) with at least two members is classified as a partnership for federal income tax purposes unless it affirmatively elects to be treated as a corporation. An LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it affirmatively elects to be treated as a corporation.

5. For example, a partnership agreement that was made under prior law might contain a provision reading as follows, or have similar terms:

> "Section 11. *Tax Matters Partner*. The General Partner shall be the Tax Matters Partner for the Partnership for purposes of dealing with the Internal Revenue Service on procedural matters relating to the Partnership as contemplated by Sections 6221-6233 of the Code and the Regulations promulgated thereunder, including the giving and receiving of notices with respect to administrative proceedings or adjustments by the Internal Revenue Service with respect to the Partnership or the reporting of any Partnership item."

This provision would not provide for the designation of a "*partnership representative*" as contemplated and provided for under Code Section 6223 for tax years after 2017. In the absence of an amendment of the partnership agreement to specifically provide for designation of a partnership representative for tax years after 2017, and the partnership acting pursuant to such added provision, the new IRS centralized partnership audit regime could allow and result in the IRS designating a partnership representative of the partnership to have the sole authority to act for the partnership with respect to an IRS audit of the partnership and agreement to and treatment of any tax adjustments made by the IRS in the audit.