Are You Ready for the New IRS Partnership Audit Rules?

A new partnership audit regime goes into effect for the 2018 tax year that assesses incremental taxes, penalties and interest at the partnership level. However, many partnerships can elect to follow alternative rules. Here's guidance on what's changing, including the importance of choosing a partnership representative to handle audit matters. We've also got good news for partnerships that missed the new tax filing deadline for the 2016 tax year.

Legislation enacted in 2015 established a new IRS audit regime for partnerships and limited liability companies (LLCs) that are treated as partnerships for tax purposes. Here's a comparison between the old and new partnership audit rules, along with a summary of recently proposed guidance to help partners prepare for the changes that are effective starting with the 2018 tax year.

Important note: To keep things simple, we'll refer to any LLC that's treated as a partnership for tax purposes as a partnership and any LLC member that's treated as a partner for tax purposes as a partner.

Old Rules

Under the old rules, the federal income tax treatment of partnership items of income, gain, deduction and credit is generally determined at the partnership level, even though these tax items are passed through to the partners and reported on their returns. After a partnership audit is completed and the resulting adjustments to partnership tax items are determined, the IRS generally recalculates the tax liability of each partner and sends out bills for additional taxes, interest and penalties to the partners.

This set-up was deemed to be inefficient, so Congress established a new audit regime for partnerships. However, the old rules will continue to apply to most partnerships for tax years beginning in 2017.

The Big Difference

The new partnership audit regime applies to partnerships with more than 100 partners at the partnership level. The big difference under the new rules is that, subject to certain exceptions, any resulting additions to tax and any related interest and penalties are generally determined, assessed and collected at the partnership level.

Specifically, the partnership — not the individual partners — will be required to pay an imputed tax underpayment amount, which is generally the net of all audit adjustments for the year multiplied by the highest individual or corporate federal income tax rate in effect for that year.

However, the partnership can pay a lower amount if it can show that the underpayment would be lower if it were based on certain partner-level information, such as:

- Differing tax rates that may be applicable to specific types of partners (for example, individuals, corporations and tax-exempt organizations), and

- The type of income subject to the adjustments (for example, ordinary income vs. capital gains or cancellation of debt income).

An alternative procedure, known as the "push-out election," allows the partners to take the IRS-imposed adjustments to partnership tax items into account on their own returns. Or, if eligible, a partnership can elect out of the new rules altogether. (See below for more details on both elections.)

Partnership Representatives

The new partnership audit rules eliminate the tax matters partner role that applied under the old rules. Instead, partnerships will be required to designate a partnership representative. The partnership representative has the sole authority to act on behalf of the partnership in IRS audits and other federal income tax proceedings.

If the partnership doesn't choose a representative, the IRS can select an individual or entity to fill that role. If the partnership representative is an entity (as opposed to an individual), the partnership must appoint a designated individual through whom the partnership representative will act.

Under the proposed regulations, the partnership representative has a great deal of authority, and no state law, partnership agreement, or other document or agreement can limit that authority. Specifically, the partnership representative has the sole authority to extend the statute of limitations for a partnership tax year, settle with the IRS or initiate a lawsuit. Any defense against an IRS action that isn't raised by the partnership representative is waived.

With all this authority comes the associated risk, which may mean that some partnerships will have a hard time finding someone willing to act as the representative. Partnerships should consider indemnifying or compensating their partnership representatives accordingly.

According to the proposed regulations, partnerships must designate a partnership representative separately for each tax year. The designation is done on the partnership's timely filed (including any extension) federal income tax return for that year.

Partnerships should amend their agreements to establish procedures for choosing, removing and replacing the partnership representative. In addition, the partnership agreement should carefully outline the duties of the partnership representative.

The Push-Out Election

As noted above, under the new rules, a partnership must pay the imputed underpayment amount (along with penalties and interest) resulting from an IRS audit — unless it makes the push-out election. Under the election, the partnership issues revised tax information returns (Schedules K-1) to affected partners and the partnership isn't financially responsible for additional taxes, interest and penalties resulting from the audit.

As the name suggests, the push-out election allows the partnership to push the effects of audit adjustments out to the partners that were in place during the tax year in question. This effectively shifts the resulting liability away from the current partners to the partners that were in place during the tax year to which the adjustment applies. The push-out election must be filed within 45 days of the date that the IRS mails a final partnership adjustment to the partnership. This deadline can't be extended. The proposed regulations specify the information that must be included in a push-out election. The partnership must also provide affected partners with a statement summarizing their shares of adjusted partnership tax items.

Partnership agreements should be updated to address whether the partnership representative is required to make the push-out election or the circumstances in which a push-out election will be made. When deciding whether to make the election, various factors should be considered, including:

- The effect on partner self-employment tax liabilities,
- The 3.8% net investment income tax,
- State taxes, and
- The incremental cost of issuing new Schedules K-1 to affected partners.

Partnerships may want to require their partnership representatives to analyze specified factors to determine whether a push-out election should be made.

Option to Elect Out of the New Rules

Eligible partnerships with 100 or fewer partners can elect out of the new audit rules for any tax year, in which case the IRS must separately audit each partner. However, the option to elect out of the new partnership audit regime is available only if all of the partners are:

- Individuals,
- C or S corporations,
- Foreign entities that would be treated as C corporations if they were domestic entities,
- Estates of deceased partners, or
- Other persons or entities that may be identified in future IRS guidance.

The election out must be made annually and must include the name and taxpayer ID of each partner. The partnership must notify each partner of the election out within 30 days of making the election out.

Eligible partnerships may want to amend their partnership agreements to address whether electing out will be mandatory. In most situations, electing out will be preferable. However, partnerships looking to maintain flexibility in their partnership agreements should include provisions indicating how the decision to elect out will be made.

Partnerships choosing to elect out may want to amend their agreements to prohibit the transfer of partnership interests to partners that would cause the option to elect out to be unavailable. They also may want to limit the number of partners to 100 or fewer to preserve eligibility for electing out.

Important note: Many small partnerships may assume that they're automatically eligible to elect out of the new partnership audit rules because they have 100 or fewer partners. That's not necessarily true. For example, the option to elect out isn't available if one or more of the partners are themselves a partnership (including an LLC that is treated as a partnership for tax purposes). Also, if there is an S corporation partner, each S corporation shareholder must be counted as a partner for purposes of the 100-partner limitation.

Coming Soon

Although the new partnership audit rules don't take effect until next year, partnerships should start reviewing partnership agreements and amending them as necessary. At a minimum, partnerships that don't expect to elect out of the new audit rules should appoint a partnership representative before filing their 2018 returns. We can help you get up to speed on the new partnership audit rules and recommend specific actions to ease the transition.