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New IRS Tax Audit Rules For Partnerships And Multiple-Member LLCs

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Tax audit rules for partnerships and multiple-member LLCs elected to be taxed as partnerships have changed effective January 1, 2018. In many cases, the new rules will result in tax, interest and penalties from an audit adjustment being initially imposed upon the partnership instead of the partners. The position of “tax matters partner” has been replaced by the position of “partnership representative”, and this new position has substantially greater authority to deal directly with the IRS and to make binding choices for the partnership. As a result, most existing partnership and LLC agreements will need to be amended during this coming year to address the requirements, elections and administration of the new tax audit rules. An explanation of the changes, and suggestions for handling the new rules, are summarized in the attached information sheet.

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Corporate & Business Organizations
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INFORMATION SHEET ON NEW PARTNERSHIP TAX AUDIT RULES (EFFECTIVE 1/1/18)

How Did the Partnership Audit Rules Change?

For tax years which began **prior** to January 1, 2018, the old Tax Equity and Responsibility Act of 1982 (“TEFRA”) audit procedures continue to apply. Under the TEFRA rules, partnerships and LLCs taxed as partnerships appoint a tax matters partner (generally, a partner or a member-manager) to represent the company in federal tax proceedings and to keep other partners/members notified during such administrative proceedings. Importantly, TEFRA generally requires the IRS to conduct audits at the partnership (or LLC) level, **and any audit adjustments are passed through and collected from the partners (or members)**. Tax audits of small partnerships and LLCs are an exception, and are conducted at the partner (or member) level absent an election. Under TEFRA, small partnerships or LLCs are defined as those with ten (10) or fewer members or partners where all the members or partners are either: (a) individuals, (b) C-corporations, or (c) estates of deceased partners.

For tax years beginning January 1, 2018, Title XI of the Bipartisan Budget Act of 2015 (“BBA”) shall apply. Under the BBA rules, **the IRS assesses and collects tax from partnerships (and LLCs taxed as partnerships) directly from the partnership or LLC, rather than the partners or members, unless certain elections are made by the partnership representative.** These new rules are intended to streamline the IRS’s partnership audit and collection process. The IRS can collect tax underpayment and any related payments and interest directly from the partnership. The IRS no longer has to “chase” separate partners to collect their share of taxes. The IRS takes the money directly from the partnership, leaving the partnership to allocate responsibility among partners. This also means that current partners will bear the economic burden of tax liability from prior years even if that partner was not a partner during the audited year. Partnership-level tax liability can be shifted back to the audited-year partners to the extent those partners file amended returns and pay taxes on the increased tax liability. A “partnership representative” (who is not required to be a partner) has the sole authority and responsibility of representing the partnership in audits and judicial tax proceedings. Under these new rules, partners have no right to participate in these proceedings and are not entitled to notice of audit proceeding unless such a requirement is included as a duty of the partnership representative in the partnership or LLC agreement.

The below chart highlights the main differences between the old “TEFRA” rules and the new “BBA” rules:

Old Rules – TEFRA	New Rules – BBA
“**Tax matters partner**” (a member-manager or partner) appointed to represent the company in tax proceedings. Must keep partners notified.	“**Partnership representative**” (not necessarily a partner) appointed to represent the company in tax proceedings. **No requirement** to keep partners informed.
Tax assessment at the **partner (or member) level**. Audits conducted at the partnership level, with adjustments passed through and collected from partners (exception: small partnership or LLC – audits conducted at partner level).	Tax assessment at the **partnership level**(unless alternative procedure election or opt out). IRS collects and assesses tax from partnerships directly from the partnership, rather than the partners. Adjustments are not passed through to partners.
Partners are notified and informed about audits and judicial proceedings, have rights to participate, and rights to contest results.	Partners and members have no right to participate in audits or judicial proceedings, and are not entitled to notice of audit proceedings.

What Are My Choices?

Each year, the partnership or LLC will need to choose one of the following options in an audit: (1) opt out election under IRC Section 6221(b) (if requirements are met); (2) Company-level payment of tax underpayment under IRC Section 6225; or (3) alternative procedure election under IRC Section 6226 to issue statements of adjustment to audited year members. The effect of the new rules is that current-year partners or members will bear the economic burden of tax liability from prior years unless one of the following applies:

1. The partnership or LLC **opts out**. A partnership or LLC can annually opt out of the new audit rules, **provided** they meet the following qualifications: (i) 100 or less partners (or members), (ii) each partner (or member) is an individual, deceased partners’ (or members’) estate, a C-corporation, an S-corporation (with a look-through rule for calculating the number of the partners/members), or any foreign entity that would be treated as a C-corporation if it were a domestic entity. A partnership or LLC is **not** permitted to opt out if any partner/member is a trust or partnership or LLC.
2. The partnership or LLC elects to use an alternative procedure to **push out** the tax liability to audited-year partners or members. The partnership or LLC can elect to issue statements of adjustment to the persons who were partners (or members) during the audited year, and any adjustments are taken into account by the audited-year partners (or members) on their own tax returns (with interest paid at a higher rate) in the adjustment year.
3. The audited-year partners or members file amended returns and pay taxes on the increased tax liability, which then reduces the partnership-level or LLC-level tax liability. **If a partnership or LLC does not elect the alternative procedure or opt out, then the tax underpayment is collected from the partnership**. However, the amount of underpayment may be reduced to the extent that partners file amended returns that include the reviewed year of the partnership, and take into account the audit adjustments allocable to these partners (where one partner is tax exempt, a C-Corporation, or because the adjustment is made to a qualified dividend or a capital gain). The underpayment can also be reduced for the portion of the underpayment allocable to a tax-exempt partner.

Can We and Should We Opt Out?

- Opt out is only available if you meet the requirements noted above. Partnerships or LLCs with trusts or partnerships (including LLCs taxed as partnerships) as partners (or members) **cannot** elect out of the new audit rules.
- A partnership or LLC that is eligible for opting out will avoid completely the new partnership-level BBA tax audit requirements.
- Opting out does require a simplified partnership structure and the partnership must provide the IRS with the partners names and Tax Identification Numbers, thus giving the IRS more clear information (than they had under TERFA) to collect from each partner. Opting out may also create a higher likelihood of an audit for that year.
- If you can opt out, and want to opt out, you will need to amend the partnership or LLC agreement to reflect an intention to opt out where the election requirements are met.
- Our advice: If you can, opt out. If you cannot opt out, push out.

What Do We Do Now?

Be proactive about amending existing partnership and LLC agreements to address the following:

- Add a designated partnership representative as an alternative to the tax matters partner. Note the IRS will designate one of its choice if you do not;
- Identify the specific authority (and limitations on authority) of the partnership representative to take action that reduces the partnership level tax liability or, if applicable, permits the partnership to "push out" or otherwise shift tax liability to the partners;
- Indicate what duty the partnership representative has to provide information and notice of audits to the partners (or members);
- Establish rules for determining whether and when the partnership will seek to avoid collection of the tax at the entity level, including through an election to "push out" any tax liability;
- Create rules which maximize the eligibility and ability of the partnership to elect out of the partnership level audit rules.