"TAX TIPS: Changes are coming to IRS partnership audits"

Carl J. Grassi | Saturday, December 12, 2015

The budget bill signed by President Barack Obama on Nov. 2 included a significant change in the way IRS partnership audits will be handled.

Partnership audits have become a more pressing issue for the IRS as more businesses are taxed as partnerships, including limited liability companies.

Because the IRS must generally assess and collect any deficiencies from the individual partners after a partnership audit, enforcement can be difficult.

The new rules will allow the IRS in most cases to assess any additional tax against the partnership itself instead of having to proceed against the individual partners.

These changes are significant enough that partnerships and LLCs should review and consider revising their governing documents in anticipation of the effective date.

Under the current audit rules (which are generally still effective until 2018), there are basically three different types of partnership audits. Electing Large Partnerships, or ELPs, have audits done at the partnership level, and any adjustments are reflected on the partners' current year returns (as opposed to having to amended prior year returns).

Other partnerships with more than 10 partners are audited under the unified partnership audit rules. After an audit of the partnership under these rules, any assessment must be made (and collected) from the individual partners. A partnership with fewer than 10 partners is generally audited by auditing the individual partners. A report from the U.S. Government Accountability Office issued last year determined — and the IRS has long complained — that these rules make it difficult to audit partnership and LLCs, especially those with large numbers of partners.

The budget bill eliminates these distinctions and provides for a single set of rules governing partnership audits.

After the effective date of these rules, the IRS will examine the partnership's return, and the partnership will (with a number of exceptions) be responsible for any adjustments in the year that the audit was completed, or in the year that any judicial proceeding relating to the audit becomes final.

The partnership will generally pay tax on any assessment at the highest individual or corporate tax rate, although procedures will be available for a partnership to show that this rate is not appropriate.

This is a significant change because partnerships have never before been required to pay tax at the entity level as opposed to the partner or member level.

There are a number of ways that a partnership can essentially opt out of these rules.

An election will be available whereby the partnership can choose to issue adjusted information returns to its partners instead of having the partnership pay the tax liability. Partnerships with 100 or fewer partners that have only certain types of partners (essentially individuals and corporations) would also be allowed to opt out of these rules and have audits performed at the individual partner level by making an annual election and meeting certain reporting requirements.

There are a number of changes that partnerships and LLCs should consider making to their partnership agreement or operating agreement as a result of these new rules.

First, should the partnership opt out of the new audit provisions? The decision to opt out of these rules can be made either annually or within a set period of time after the IRS assessment. Who makes this decision, and if the annual opt out is chosen, should the agreement contain transfer restrictions to keep a partner from transferring an interest to a non-qualifying partner (such as an LLC) that will prevent the partnership from making this election?

Other possible agreement revisions could address what happens when partners buy and sell partnership interests. If the partnership does not opt out of these rules, a new partner buying in during the current year could be responsible for taxes that relate to a year prior to the purchase.

Should the agreement provide that the partnership has recourse against partners who have left the partnership if a tax is assessed for a year during which they were a partner? The answer to each of these issues depends on the nature of the partnership and the relationship between the partners, but some thought should be given to the possibly of amending the agreement to address these issues.

While these rules are applicable to tax years beginning after 2017, some partnerships can elect to have these rules effective as of Jan. 1, 2016. These provisions were designed to raise $9 billion over the next 10 years — a clear sign that more partnership and LLC audits are on the way. Partnerships and LLCs should therefore review their agreements now to consider whether any changes need to be made.

Click here to see the original article published in Crain's Cleveland Business.

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