Treasury releases final guidance on new IRS audit regime as states consider model legislation

David M. Kall | Friday, May 3, 2019

Late last year the IRS and Treasury finalized regulations to implement a new centralized IRS audit regime for partnerships and LLCs taxed as partnerships. Meanwhile, the Multistate Tax Commission recently approved model uniform legislation for states to adopt to address the new federal regime for auditing partnerships. These new rules have significant implications for tax filings for tax years beginning in 2018 and require amending partnership and operating agreements. Let's take a more in-depth look at the new system and what you can do to prepare.

Amend All Partnership Agreements

Congress enacted sweeping changes to how the IRS audits partnerships and LLCs through the Bipartisan Budget Act of 2015 (BBA). The new audit regime takes effect for the 2018 tax year and is designed to raise tax revenue and make it easier for the IRS to audit partnerships and LLCs. To that end, the BBA and new Treasury Regulations centralize the assessment and collection of tax directly at the entity level for the partnership or LLC.

Traditionally, the IRS has audited and assessed tax on the partners or members rather than the entity itself. Now, income generated through partnerships still generally flows through to partners for tax reporting purposes, but the IRS will perform its audits at the entity level.

In light of the new centralized audit regime, all partnerships and multi-member LLCs should amend their

governing documents (i.e. partnership agreement or operating agreement) to:

- designate a “Partnership Representative” who will have the sole authority to make binding decisions in IRS audit proceedings; and
- authorize selections regarding complex set of elections under the new rules.

Additional content on the new federal partnership audit rules, including information and analysis, is available here.

Model State Legislation

In addition to issues raised with respect to managing the IRS audit itself, the new federal laws to audit flow-through vehicles at the entity level raise a host of issues with state income taxes. Taxpayers reporting state income tax adjustments corresponding to IRS audits currently face a wide array of state laws that can create a sizable tax compliance burden. Three major issues that arise including identifying the triggering event that requires state reporting for federal adjustments (e.g. when all tax issues and appeals are final), how long the taxpayer has to report (e.g. at least 180 days) the adjustments, and how the changes are reported to the states.

In collaboration with the Council on State Taxation, the American Bar Association, and the Tax Executives Institute, the Multistate Tax Commission approved model legislation in January 2019 that states may adopt to uniformly address these issues. The model legislation proposes a default rule that direct partners (as opposed to tiered partners) pay the state level adjustment within 180 days after the all federal issues are finally and conclusively decided, i.e. the “final determination date.” If states adopt the legislation, it would provide uniformity as to the timeframe for reporting to the states for federal audit adjustments.

Under the model legislation, audited partnerships to do the following for the “reviewed” tax year under IRS audit:

- Within 90 days of the final determination date:
  - File a federal adjustments report.
  - Notify direct partners of their distributive share adjustments.
  - File amended composite/withholding returns and pay the related tax liability that would have been due had the final federal adjustments been reported properly as required.
- Within 180 days of the final determination date, each direct partner (excluding tiered partners), must:
  - File an federal adjustment report to the state.
  - Pay the additional tax, including penalty and interest, to the state that would have been due had the final federal adjustments been reported properly as required (less any applicable credits).
- Tiered partners have 90 days after the date of the federal deadline to complete all of the above reporting requirements and make all payments.

As an alternative to the default rule in which the direct partners pay additional tax owed to the states, the audited partnership can make an election to pay, as follows:

- Within 90 days of final determination date, the audited partnership shall:
  - File a federal adjustments report.
  - Nnotify the state of the election.
- Within 180 days of final determination date, the audited partnership shall:
  - Pay tax on behalf of partners based on calculation prescribed, as calculated at the highest tax rate for each partner type.

Looking Ahead

The 2019 calendar year is shaping up to be an eventful one with respect to the new centralized federal audit process for partnerships and LLCs taxed as partnerships. We should expect taxpayers to review their partnership and operating agreements as they prepare and file their tax returns for the 2018 tax year. In addition, states may adopt model legislation to provide uniformity in reporting state adjustments for federal audit changes and hopefully ease the compliance burden that taxpayers face.

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