New partnership and LLC audit rules will affect IRA and Plan investments

Dale R. Vlasek | Wednesday, February 24, 2016

Over the past few years, as qualified retirement plan (Plan) participants and Individual Retirement Account (IRA) holders have looked to diversify their retirement portfolios and increase return, a number have invested in non-traditional assets often using a Limited Liability Company (LLC) as the investment vehicle.

Although there is nothing in the law that prohibits Plans or IRAs from investing in LLCs, such investments create challenges. First, because these LLCs are not publicly-traded, determining their value for Plan or IRA administrative purposes can be problematic. Second, because the LLCs are typically designed as pass-through entities for tax purposes, these investments have the potential to create unrelated business taxable income (UBTI) for the Plans and IRAs and may cause what is normally a tax-deferred vehicle to pay income tax.

On top of these existing challenges, a new one has recently been added. As part of the Bipartisan Budget Act of 2015, Congress gave the Internal Revenue Service (IRS) the ability to audit the tax returns of pass-through entities such as partnerships and LLCs, and to assess any tax deficiencies on the entity at the highest individual tax rate. There are ways that the entity can reduce that level of tax or alternatively opt out of tax at the entity level and have the partners or members taxed individually at their own respective rates. This opt-out can take place at the time of the audit or may be addressed in the documents establishing the partnership or LLC.

Prior to these rules, the IRS tended not to spend much time auditing pass-through entities because of the difficulty of then going after the partners or members individually. Rather, the IRS tended to simply audit the individual owners based on their personal tax returns. With these new rules the IRS will have more reason to directly audit the partnerships or LLCs. These new rules will be effective in 2018. See our alert "New audit rules require careful review of partnership and operating agreements" for more information about these new audit rules.

As suggested above, under the new rules, partnerships or LLCs can elect to have the current partners or members bear the tax adjustment individually. This can happen at the time of the audit or be written into the partnership or LLC agreement. If the partnership or LLC were to elect to have the partners or members bear the tax adjustment, or if that was in the agreement and the adjustment created UBTI, the Plan or IRA may need to pay income tax for an event that happened before the IRA or Plan owned the interest.

While this is not a reason to avoid having an IRA or Plan invest in LLCs, it is one more factor to consider. If one decides to invest, one is best advised to examine the tax provisions of the agreement and decide whether the return is worth the UBTI tax risks.

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