Barley Snyder

A Business Owners Guide to the New Partnership Audit Rules

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The Bipartisan Budget Act of 2015 - which became effective at the start of this year - instituted new requirements for auditing large partnerships or entities that are taxed as partnerships, such as limited liability companies.

Most practitioners believe that these new IRS rules, which apply to partnership returns filed after Dec. 31, 2017, will streamline the partnership audit process, but not always for the benefit of taxpayers. Fundamentally, for tax purposes, partnerships are "pass-through" entities. A return is prepared at the partnership level where tax items such as income, losses, deductions and credits are netted, and the taxable income or loss is allocated among the partners on their K-1's. Under both the old and new rules, if a partnership is selected for audit, any adjustments coming out of the audit are made at the partnership level. Here's where things get interesting.

Under the old law, adjustments on the partnership return would follow through to the individual partners. Under the new law, any assessments for tax underpayments, penalties, or other additional amount which relates to an assessment are made and collected at the partnership level. If an adjustment does not result in a tax underpayment, the partnership must take the adjustment into account in the adjustment year as a reduction in non-separately stated income, an increase in non-separately stated loss or tax credits as a separately stated items. The new rules also require the appointment of a "partnership representative" to act on behalf of the partnership in the audit. Note that this person has a lot of decision-making authority in the audit context as that person will be the sole person with authority to act on behalf of the partnership for the audit. If the partnership does not designate a representative, the IRS is allowed to select any person with a substantial presence in the United States as a representative.

Smaller partnerships (100 or fewer partners, and no partnerships as partners) are permitted to opt out of the rules on a yearly basis. If a partnership elects out of the new rules, the audit rules under prior law will continue to apply.

At 40,000 feet, the changes are clearly designed to make the audit process easier for the IRS. In some cases, there will be no significant downside to the partners. But consider the impact of the law on a partnership that has changed ownership since the tax year of the audit. Under the old law, the adjustments stemming from an audit would flow through to the partners. Assume an audit of 2016 partnership return occurs in 2018. If an adjustment is made for 2016, the partners during that year would ultimately bear the burden of any underpayment. Under the new law, if an adjustment is made for 2016 resulting in the need to pay more tax, the partnership - and ultimately its owners in 2018 - must bear the burden. So if ownership has changed between 2016 and 2018, there will be inequity.

If you are a partner in a partnership or a member of an LLC, what should you do?

• Consider amending your partnership or operating agreement to opt out of the new law, if your partnership is eligible. Note that you can opt in or out of the audit rules on a yearly basis, but it probably makes the most sense to opt out permanently. This is a very simple change to the partnership documents that we have been making routinely to account for the law.

- If you can't elect out, talk to your accountant or attorney about the impact, and understand how the law will affect you.

- Be diligent in selecting a partnership representative to represent the partnership in an audit. This individual can be an owner, but does not have to be one. Consider carefully the selection of this individual and the amount of authority the partnership wishes to delegate. The partnership has authority to adjust the terms of this relationship and to require partner consent in certain circumstances. This has particular implications if you own less than 50 percent of the partnership.

- Most inequities in the new law stem from the sale of partnership or LLC interests. This can be addressed by accounting for potential tax obligations of departing partners/members in the sale documents.

If you have questions about the new IRS rules and how it can affect your partnership in an audit, please contact me or any member of the Barley Snyder Tax Practice Group.

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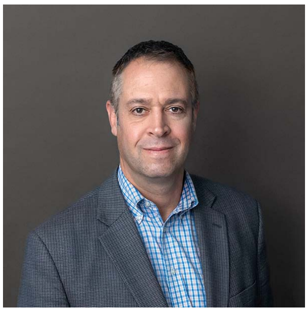

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