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IMPENDING PARTNERSHIP TAX AUDIT CHANGES NECESSITATE AMENDMENTS TO PARTNERSHIP AND LLC AGREEMENTS

Important new IRS tax audit rules will become effective January 1, 2018. If they have not done so already, entities taxed as partnerships, including limited liability companies, should consider amending their partnership or LLC agreements to address the new rules.

Audit Assessments

Subject to the exceptions described below, under the new audit rules the partnership itself will be responsible for any audit adjustments the year in which the audit is completed or any judicial proceeding relating to the audit becomes final. Partnerships have never before been required to pay tax at the partnership level, and this means that partners who benefitted from an aggressive tax position taken the year under audit but who are no longer partners when the audit takes place will not have to pay their share of any audit assessment. The remaining partners, including any new partners, will be responsible for the assessment since it will be paid out of partnership assets when the audit concludes. Presumably, most partnerships will want to amend their partnership agreements to provide for claw back rights or indemnification from former partners in these circumstances.

According to the new rules, any tax resulting from an audit adjustment is calculated by multiplying the net increase in income resulting from the audit by the highest federal income tax rate, which currently is 39.6%, the highest marginal individual tax rate. This rate and the resulting tax liability can be modified if the partnership can demonstrate that **[the liability]** should be lower based upon the partners' applicable tax rates, although the means of demonstrating this have not yet been specified by the IRS.

There are three ways a partnership can opt out of some or all of the provisions of the new audit rules:

"Opt Out"

A partnership can "opt out" completely from the new rules, but only if the partnership has 100 or fewer partners that meet certain criteria - generally, individuals, corporations and estates of deceased partners (a partnership with a trust as a partner is ineligible to opt out). To opt out, a partnership must make a so-called section 6221 election on its information return for the year for which it wishes to opt out and provide the IRS with the names and taxpayer identification numbers of its partners and of the shareholders of any S corporation partner. Partnerships that opt out will be allowed to have audits performed at the partner level, but will remain subject to the new partnership representative rules discussed below.

"Push-out"

Partnerships, including those that cannot opt out of the new rules, will be able to elect not to be subject to the audit rules imposing the assessment liability on the partnership and to instead issue adjusted information returns to its partners reflecting their share of the audit adjustment. The partners are permitted to calculate any additional tax as though the adjustment had been made in the year under audit taking into account the partners' actual tax rates, instead of the highest federal tax rate. Also, if this "push-out" election is timely made, the adjusted income information is issued to those who were partners in the year under audit rather than in the year that the audit is performed. New partners, therefore, will not be responsible for taxes of partners who have left the partnership after the year under audit. With a push-out election, however, interest on any underpayment will be assessed at a rate that is 2% higher than if the partnership had paid the tax.

Section 6225 Reporting

The third way to avoid having the partnership pay any audit assessment is for all the partners to agree to file amended returns under I.R.C. Section 6225. Since the entire amount of any assessment would be reflected on

the partners' amended returns, the partnership would not bear the assessment. This is useful for partnerships with partners who have different tax rates since each partner would be liable to pay its share of the assessment at its own rate. The partners' agreement to file amended returns should be contained in the partnership or LLC agreement.

Partnership Representative

Under the current rules, individual partners generally have the right to participate in partnership audits even though the partnership has designated a traditional tax matters partner, and the tax matters partner has only limited authority in connection with certain audits. Under the new audit rules, the tax matter partner is replaced by a "partnership representative" who has complete authority to act on behalf of the partnership, effectively it is when dealing with the IRS. This includes the ability to bind the partnership, and effectively the partners, with respect to audits and other proceedings, including settlements and decisions on such matters whether to extend the statute of limitations or to litigate any audit assessment. The new rules do not require the partnership representative to inform partners of audits or their status, and unlike a tax matters partner, the partnership representative does not need to be a partner of partnership. If a partnership does not designate a partnership representative the IRS may select any person as the partnership representative.

Be aware that the new audit rules are intended to increase federal tax revenues by $10 billion over 10 years, so more partnership and LLC tax audits can be expected.

If they have not done so yet, partnerships and LLCs should immediately consider making changes to their partnership or LLC agreements to address the new rules.

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If you would like more information or assistance in amending your partnership or LLC agreement, please contact the TroyGould PC attorney with whom you regularly work or any of our tax or corporate attorneys.