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CLIENT ALERT

December 28, 2018

New IRS Audit Rules Mean Tax Deadline Looming for Partnerships and LLCs to Make Big Decisions

By Keith A. Wood

On January 1, 2018, new IRS audit rules went into effect that made big changes on how the IRS will conduct future audits of partnerships (i.e, general and limited partnerships and LLCs). These new changes give the IRS more power in conducting audits of partnership tax returns.

Before 2018, in most cases, if the IRS wanted to audit the tax return of a partnership, the IRS had to open up audits of the individual partners (or LLC members). And, the IRS would then have to assess tax, penalties and interest at the partner level instead of the partnership level. This made it difficult for the IRS to effectively audit partnerships because of the difficulty in tracking down multiple partners and conducting multiple audits.

As a result, the IRS audit rates of partnerships have historically been very low. Of the 4.8 million partnership returns that are filed each year, only about .3% are audited each year. This is all about to change because of the new partnership audit rules.

Under the new partnership audit rules, the IRS (in most cases) will only have to pursue an audit against the partnership and the IRS can then assess any tax, interest or penalties directly against the partnership without having to track down the individual partners. Some in Congress have estimated that the new partnership audit rules will help the U.S. Treasury collect over $9 billion in additional taxes over the next 10 years.

In addition, under the new partnership audit rules, it's entirely possible that current partners could end up having to bear the economic burden of a tax liability arising from an audit of prior years when the partnership was made up of different partners. And, any taxes are assessed at the highest individual income tax rate (currently 37%) even if some of the partners are subject to lower tax rates (although in some limited circumstances it may be possible to convince the IRS to lower its tax assessment to account for partners who are subject to less than a 37% tax rate).

In very limited circumstances, it may be possible for a partnership\LLC to ”opt out" of the new partnership audit regime. If the “opt out” election is made by an eligible partnership, then any audits will be conducted at the partner level and not directly at the partnership level, and tax assessments will be made based upon the tax rates of the partners rather than at the maximum tax rate of all individuals.

However, it would be fairly unusual for a partnership to be eligible to “opt out" of the new partnership audit rules. For example, partnerships are not eligible to make the “opt out” election if any of their partners are partnerships, single member LLCs, or grantor trusts such as revocable living trusts.

So, in most cases, even our small partnerships will be subject to the new partnership level IRS audit regime.

The new partnership audit rules became effective on January 1, 2018, and therefore they apply to all 2018 tax returns filed for partnerships and LLCs. Between now and the due date for filing your partnership tax return for 2018 (i.e. March 15, 2019 or September 15, 2019 for extenders), there are a number of critical decisions that have to be made before then.

1. <u>If you are eligible to make the “opt out” election, should you do so</u>? Most partnerships, who are eligible to make the“opt out” election, probably will want to file an election with their 2018 tax return in which they notify the IRS they are opting out of the new audit regime for the 2018 tax year. The opt out election has to be made each and every year on a timely filed partnership tax return.

In addition, it is likely that many lenders will require borrower partnerships to make the “opt out” election, if eligible.

2. <u>Who will the Partnership designate as its Partnership Representative for IRS audits</u>? Under the new audit rules, every partnership must designate a “Partnership Representative” on its 2018 tax return. The Partnership Representative is given extensive authority to make any and all decisions relating to the handling of IRS audits, including consenting to tax assessments against the partnership. So, every partnership or LLC out there needs to decide now on who it will designate on the 2018 tax return as the designated “Partnership Representative.”

3. <u>Does the partnership agreement need to be amended to address other potential audit matters</u>? If a partnership undergoes an IRS audit, the Partnership Representative can elect to “push out” any tax assessments to the partners who were partners during the actual tax year under audit. However, absent a contrary provision in the partnership agreement, the decision of whether to “push out” or not “push out” is entirely within the discretion of Partnership Representative.

Again, as discussed above, under the new partnership audit rules, it’s entirely possible that current partners could end up having to bear the economic burden of a tax liability arising from prior years when the partnership was made up of different partners. So, unless the Partnership Agreement is revised to require the Partnership Representative to make the “push out” election, or to impose indemnification obligations on those who were partners during an audited year, newly admitted partners could bear the tax burden for old partners who are now long gone.

<u>Conclusion</u>. Between now and March 15 (or September 15 for extenders), every partnership or LLC has critical decisions that must be made as a result of the new partnership audit rules. Hopefully, there will be a lot of discussion between now and then between our partnership clients and their CPAs. The next step may involve a call to the partnership’s legal team to address changes that need to be made to the partnership\LLC agreement.

***Keith A. Wood** is both an attorney and CPA with a special background in taxes. He also is a board-certified specialist in estate planning and probate law. He may be reached at 336-478-1185 or **kaw@crlaw.com**.*