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Major Changes Coming to How the IRS Will Audit Partnerships

Tax Advisory Group

Start Now to Prepare for New IRS Rules Governing Partnership Audits

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The IRS has established new rules governing audits of partnerships that address how the audits will be conducted, how adjustments will be taxed and allocated, and which partnerships will be subject to the rules. The new "partnership-level audit" rules don't go into effect until 2018, but partnerships can invoke the rules now for audits of tax years beginning after November 2, 2015.

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THE BASICS

The IRS has structured the new rules around three basic principles. If your partnership is subject to the rules:

- The audit will be conducted at the partnership level.
- Only one partner will represent the partnership in the audit.
- Any tax increase determined by the audit will be assessed and collected at the partnership level.

RULES GOVERNING TAX RATES

The statute states that the tax rate for any partnership-level audit adjustment will be the highest individual or corporate income tax rate in effect for the reviewed year. However, there are also a couple of provisions that could allow for a rate reduction:

- Any part of the adjustment that could be allocated to a particular partner, including a C corporation or even a tax-exempt partner, could be taxed at that partner's lower rate.
- Any part of the adjustment that would be allocated to capital gains or qualified distributions would be taxed at those rates.

OPT-OUT ELECTIONS

Qualifying partnerships will be able to opt out of the new rules, even after they go into effect in 2018. To be eligible for an opt-out election:

- The partners can only be individuals, C corporations, S corporations or an estate. If a partnership has a non-grantor trust or a partnership as a partner, an opt-out election is not available. It is still uncertain whether or not grantor trusts will be eligible.

- The partnership must have fewer than a hundred K-1s required to be issued for the tax year. The count includes all K-1s issued by an S corporation partner.
- The opt-out election must be made on the partnership return for the elected year, each year the opt-out is elected, and returns must be filed on time. At present, the IRS has not issued guidance on filing late for an opt-out election.

While only one person will represent the partnership in an IRS audit under the new rules, the partners through their partnership agreement will decide how broad or narrow to make that individual's powers.

PUSH-OUT ELECTIONS

Under the new rules, the partnership can simply pay any additional tax resulting from an audit as it is computed, that is, at the reviewed year's highest individual or corporate rate. Or the partnership can elect to "push out" the tax to applicable partners, presumably the entities responsible for the adjustment.

In the absence of a push-out election, the tax is borne by the current partners. So even a person or other entity that was not a partner in the reviewed year will share responsibility for the tax.

A few nuances of push-out elections that are as yet undetermined or for which there is yet no guidance include:

- While there is no deduction for the tax paid relative to the adjustment, there could be some reduction in partners' tax bases, as historically has occurred relative to partnership audits and adjustments.
- There is no current guidance on how individual partners' taxes might be affected. Congress expects Treasury to establish procedures for taking into account various carryovers, such as losses suspended under the at-risk or basis rules, passive loss carryovers and net operating loss carryovers. However, there are privacy as well as audit concerns in how that information might be gathered.
- It appears that a partnership-level audit adjustment will not be subjected to the 3.8 percent net investment income tax or self-employment taxes. If a push-out election is made, both taxes would be assessed.

AMENDED RETURN ELECTION

In lieu of a push-out election, a partnership could chose to have one or more partners file amended returns taking into account their share of the audit adjustments. The amended-return election has not generated much interest, as in most cases the results will mirror a push-out election. Except where an audit is adjusting the allocation of deductions between partners, thus creating a tax increase for one partner and a corresponding decrease for another.

PREPARING FOR 2018

While only one person will represent the partnership in an IRS audit under the new rules, the partners through their partnership agreement will decide how broad or narrow to make that individual's powers. In preparation for implementation of the rules in 2018, partners should address the following questions and issues:

- Can the partnership representative extend the statute of limitations?
- Can the partnership representative settle the audit?
- Can the partnership representative hire outside advisors to assist in the audit?
- What notice responsibilities, if any, should the partnership representative have to the other partners?
- Should there be a procedure for removing a partnership representative?
- Should you permit a transfer to a person who would make an LLC ineligible for an opt-out election?
- If eligible, should an opt-out election be required?
- Should a push-out election be required?
- What other partnership agreement provisions should be considered?
- Given an opt-out election requires disclosure of S corporation shareholders, the partnership agreement might require an S corporation partner to provide that information.
- Consideration should be given as to whether partners should be required to disclose personal attributes, such as basis, at-risk and passive loss carryovers, and net operating loss carryovers.

Finally, the new rules encourage filing partnership returns by their due date without extensions, including that doing so reduces the time the IRS has to initiate an audit.

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Nick is a Principal in the Youngstown, Ohio office of HBK CPAs & Consultants. He is a member of the HBK Tax Advisory Group. Nick has experience with individual, partnerships and corporate tax compliance and research issues. Nick is active in many external and internal educational/training efforts and provides support and expertise to the firm in total as it relates to federal, state and local tax issues. He is a member of the American Institute of Certified Public Accountants (AICPA) and the Ohio Society of Certified Public Accountants (OSCPA).

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