Navigating the New IRS Partnership (LLC) Audit Rules

DECEMBER 21, 2017 BY SCOTT DOLSON

Legal Update (updated January 4, 2018)

New laws governing IRS partnership audits (the "New Audit Rules") were enacted during 2015 and are effective for all partnership tax returns filed for partnership tax years beginning January 1, 2018. The New Audit Rules apply to LLCs taxed as partnerships. The current partnership audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) will not apply for tax years subject to the New Audit Rules. Tax and business lawyers at Frost Brown Todd have been preparing for the implementation of these new rules since 2015 and have extensive knowledge of the rules and considerable experience working with owners of LLCs and partnerships to address the impact of the rules, as well as preparing for their impact on transactions involving the purchase or sale of LLC or partnership interests.

The New Audit Rules will apply to all entities taxed as partnerships, including LLCs. A partnership may elect out for a tax year if (i) each of its partners is an individual, a domestic C corporation, a foreign entity taxable as a C corporation, an estate of a deceased partner, or an S corporation; and (ii) it has issued 100 or fewer Schedule K-1s. LLCs or partnerships with complex trusts or other partnerships as partners must operate in accordance with the New Audit Rules, which will complicate estate planning involving gifts to complex trusts and investment partnerships, including private equity funds. Partnerships, trusts and disregarded entities are not "eligible partners" for purposes of qualifying to elect out of the New Audit Rules.

An opt-out election must be made with respect to specific annual return and only applies with respect to that return. The election must be made on an annual return-by-return basis. All partners must be provided notice annually of the election opt-out and the partnership must provide the names and tax identification numbers (SSNs) of the partners to the IRS.

For partnerships that do opt out, the IRS will be forced to audit partnership items and collect deficiencies at the individual partner level. In the future, we expect that many eligible small tax partnerships will elect to opt out in order to avoid some of the harsh aspects of the New Audit Rules. If the experience of operating under TEFRA is any guide, there is a perception that the IRS will be less likely to audit in situations where it is forced to audit the returns of each partner rather than just the partnership.
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The new Audit Rules introduce the role of the "partnership representative"

Under the New Audit Rules, TEFRA's "tax matters partner" has been replaced with a "partnership representative." The IRS will deal solely with the partnership representative, and the partnership representative’s actions will be binding on all former and current partners. The partnership representative does not need to be a partner and can be an individual or an entity, but must have a "substantial U.S. presence." If the partnership doesn't appoint a representative, the IRS has the authority to designate one.

The New Audit Rules shift responsibility for the audit process and tax liability for past years to the LLC and potentially to the current owners

The New Audit Rules provide for a centralized system for audit, adjustment, assessment and collection of tax that applies to all partnerships that do not qualify and elect to opt-out. The New Audit Rules were adopted because under TEFRA too few partnerships were audited, most audits resulted in little or no additional tax, and the IRS had difficulty collecting taxes from partners. In addition to the statutes enacted by Congress during 2015, the IRS has issued extensive regulations addressing the operation of the new rules.

Under the New Audit Rules, the partnership, rather than its partners, is generally liable for additions to tax, penalties, interest and additional amounts (collectively, "Tax Liabilities"). If there is an audit of a prior-year return, adjustments for that prior year are required to be paid by the LLC or partnership in the year that the adjustment is finalized. This can result in current partners indirectly or directly bearing the economic responsibility for prior years, even if they owned different interests or no interests during that timeframe.

Underpayments are calculated using the highest individual or corporate tax rates in effect for the reviewed year. Assuming that Congress passes the 2017 tax reform legislation, the highest rate would be the 37% percent individual rate. The underpayment rate doesn't take into account capital gains or other lower rates, all of which would be taxed at the 37% percent rate. The partnership representative may counter a proposed underpayment amount with information regarding lower tax rates applicable to one or more partners (e.g., the existence of tax-exempt or non-U.S. partners) or evidence that one or more partners has filed amended tax returns taking into account the asserted additional Tax Liabilities.

Any adjustments that reallocate the distributive share of any tax item from one partner to another will take into account only the upwards adjustment, disregarding the corresponding decrease in income or gain. This rule greatly increases the stakes involved when the focus of an audit is on the proper allocation of income or loss.

The partnership may elect to "push out" Tax Liabilities to current or former partners, individually. If a "push out" election is made, the sharing of Tax Liabilities will be determined by the partnership representative or management. Income, loss and other tax items determined at the partnership level will basically be allocated using the equivalent of a Schedule K-1, with the impact of the tax items and the interest for late tax payments determined at the partner level. In which case, the underpayment rate under IRC § 6621(a)(2) will be five percent rather than the usual three percent. But penalties will be determined at the partnership level, which
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could result in partners who don't have any increase in tax liability as a result of the push-out being responsible for a share of the penalties.

Owners of existing LLCs and partnerships should take immediate action

Owners of new and existing LLCs should move immediately towards adding a provision to their agreements addressing the New Audit Rules. In the transaction arena, agreements affecting the transfer or redemption of LLC or partnership interests should address responsibility for tax liabilities governed by the New Audit Rules.

The New Audit Rules will affect transfers of LLC and partnership interests

Beginning in 2018, responsibility for Tax Liabilities under the New Audit Rules will also be an issue whenever there is an assignment of an LLC or partnership interest. An assignee of a partnership interest could become indirectly responsible for an assignor’s Tax Liabilities if they are paid at the partnership level, or if the partnership requires the then-current partners to shoulder the burden of the Tax Liabilities through making additional capital contributions. Buyers should enhance their tax due diligence process if the transaction involves the purchase of an LLC or partnership interest. Interest purchase and redemption agreements should be carefully crafted to allocate contractual responsibility for Tax Liabilities, taking into account both the New Audit Rules and the partnership agreement.

Dealing with the New Audit Rules when drafting state-of-the-art provisions for LLC and partnership agreements

Existing LLC and partnership agreements should be amended to deal with the New Audit Rules. New LLC and partnership agreements should include a provision addressing the New Audit Rules. Because the operation of the New Audit Rules may have a material economic impact, they create an additional set of governance decisions that must be worked through by management, owners and investors. We can guide you through the process of amending LLC and partnership agreements and drafting new agreements to deal with the significant pitfalls and traps associated with the New Audit Rules.

The New Audit Rules create a number of issues that should be considered when drafting or amending agreements:

- Should the initial partnership representative be identified in the agreement? Can the partnership representative be removed, and if so, by whom? How is a replacement partnership representative selected and by whom?
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- What decisions can the partnership representative make without the approval of management or owners, and what decisions require notice and approval of the owners? For example, can the partnership representative extend the entity's statute of limitations or settle audits? What obligation does the partnership representative have to provide owners with notice of audits and additional matters impacting the owners? Should the agreement expressly provide that the partnership representative will be indemnified for claims arising out of his services? Should the agreement include a provision reimbursing the manager or partnership representative for the cost of obtaining professional assistance and other expenses?

- Should the LLC or partnership agreement require opting-out if the entity is eligible to do so? Should this decision be left to management or the partnership representative?

- Should the LLC or partnership agreement prohibit transfers of interests to partnerships or complex trusts or any other assignee who would prevent the entity from opting out?

- Who decides whether there is a "push-out" of tax liabilities to owners? Should the agreement require a push-out of tax liabilities? Or, alternatively, should it require that the LLC or partnership pay the tax liabilities? Who determines the allocation of the tax liabilities that will be pushed out? What if anything should the agreement say about how tax liabilities are allocated among owners?

- Should the LLC or partnership agreement include an express right for management to make capital calls to cover the entity's tax liabilities?

- Should management have the right to amend the New Audit Rules provision without approval of its owners to address evolving IRS rules and regulations and other tax authorities?

- Should the LLC or partnership agreement include an obligation on the part of owners to provide information and otherwise cooperate with the requests of the partnership representative?

- Should the LLC or partnership agreement include an understanding that the New Audit Rules will apply generally where state and local taxing authorities adopt similar rules?

- Should the LLC or partnership agreement address whether an assignee of an interest or a former owner is responsible for tax liabilities? Should it address who is responsible for making additional capital contributions to cover tax liabilities?

- Should the LLC or partnership agreement address in detail the allocation of responsibility for tax liabilities among the current and past partners?

- Should the LLC or partnership agreement include indemnification obligations and/or "claw-back" rights with respect to prior partners?

The drafting of purchase agreements for LLC or partnership interests will be affected by the New Audit Rules

If there is a sale of an LLC or partnership interest, the parties should address in the definitive purchase agreement the allocation of responsibility for partnership-level tax liabilities for pre-sale years assessed post-sale, along with the control of the audit process and decisions regarding applicable elections.
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For additional information, please contact Scott Dolson or any attorney in Frost Brown Todd’s Tax Law Practice Group.