Alert: New IRS Tax Audit Rules for Partnerships
March 16, 2018

The Bipartisan Budget Act of 2015 (“Act”) made significant changes to the Internal Revenue Service’s (“IRS”) partnership audit rules effective for partnership tax years beginning in 2018. How the new audit rules will affect a partnership and its partners will depend, in large part, on choices the partnership, the partnership representative, and/or the partners make or fail to make.

This article provides highlights of some of the key aspects of the new partnership audit rules and offers some risk management guidance and tools to help firms minimize potential liability issues.

Overview

The new rules, which assess and collect tax at the partnership level, replace the old “TEFRA[1]” audit rules that allowed the IRS to audit the partnership, but required any ultimate tax adjustments to be collected from individual partners. However, while TEFRA generally applied to large partnerships, the new partnership audit rules apply to large as well as small partnerships. Under the new rules, the IRS will audit at the partnership level, but will be relieved of the burden of having to collect tax from individual partners. If the IRS determines that additional tax is due at the conclusion of an audit, the Act allows the IRS to impose tax, interest, and penalties on the partnership at the entity level in the year of the adjustment, at the highest rate then in effect for individuals or corporations (the “default rule”). Consequently, the partnership would pay the tax directly, causing the then-current partners to indirectly pay their respective share of the tax.

However, two provisions under the “default rule” permit partnerships to reduce the tax owed at the time of the assessment. The first provision allows the partnership to provide the IRS with sufficient information regarding the individual tax attributes of the affected partners (e.g., tax exempt status, etc.) to help reduce the tax. The second provision would permit one or more partners to amend their tax returns for the year under examination taking into account all adjustments properly allocable to such partners, and pay tax due with their amended returns.

Alternatively, the Act does have provisions to allow certain partnerships the ability to elect out of the new rules. (Refer to section “Available Options for Partnerships” below for more details.)

The Act also eliminated the position of “tax matters partner” and replaced the position with a “partnership representative.” The partnership representative under the new rules has a much more expansive role. As explained in more detail below under the sections “New Partnership Representative Role” and “Risk Management Guidance,” the authority granted to this new role poses some significant concerns as to who should serve as partnership representative, as well as the scope and limits of the authority granted to this position under a partnership agreement.

[1] Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”)

Available Options for Partnerships to Elect Out of the New Audit Rules
The Act does allow for the following options to elect out of the new audit rules:

- Small partnerships (100 or fewer eligible partners*) may choose to "***opt out"*** of the new partnership audit rules by making an annual election on a timely filed Form 1065 for the applicable tax year. This option will not be available to any partnership that itself has partners that are also partnerships (including LLCs taxed as partnerships).
  *Note: Each S-Corporation shareholder counts as a partner for purposes of the "100 or fewer eligible partners" rule. Eligible partners are individuals, C-Corporations, S-Corporations, and estates of deceased partners.

- Another option, the ***"push out"*** election, is available to partnerships once a notice of final partnership adjustment is issued. The partnership would need to make a timely election within 45 days of receiving a notice of final partnership adjustment to "push out" the assessment to the individuals that were partners during the audited tax year. However, the election comes at a cost: The rate of interest assessed on underpaid taxes rises two percentage points (i.e., from 3% to 5%) if this election is utilized.

Under the above options, the partnership would pass through the tax adjustment to the persons who were partners during the audited tax year by issuing amended Schedules K-1. Each partner receiving an amended Schedule K-1 would be required to amend their returns for the audited tax year.

New *Partnership Representative* Role
Under the new rules, the partnership representative has the sole and exclusive authority to act on behalf of the partnership and to bind all partners with respect to partnership matters subject to the partnership audit rules. This authority includes, but is not limited to, making relevant elections, representing the partnership during an audit, negotiating and agreeing (or disagreeing) to settle with the IRS, and seeking judicial review of an IRS adjustment.

The Act allows the appointment of any person—partner or not — "with a substantial presence in the United States" as the partnership representative. The IRS has not yet provided guidance as to what "a substantial presence in the United States" means, but it is expected that the Act will allow for a broader array of potential people who will be eligible to represent the partnership. **Partnership and LLC agreements should be revised to provide for who will act as the partnership representative because in the absence of an appointed person, the IRS has the discretion to pick a partnership representative.** The filing of the 2018 Form 1065, *U.S. Return of Partnership Income*, will be the first return requiring a person to be designated as the partnership representative.

Risk Management Guidance

- **DO NOT TAKE ON THE ROLE OF PARTNERSHIP REPRESENTATIVE.** Some partnerships may perceive you, their trusted advisor, as a good candidate for this position. However, taking on the partnership representative role would mean stepping into the shoes of the client, which poses significant liability risks, as well as potential insurance coverage implications to the firm. In addition, a conflict of interest would exist if you previously had, have, or subsequently have client relationships with the partnership and any current or former partners. The conflict issue could well expand were there to be a change in partnership ownership in a future year. As such, CAMICO strongly encourages CPAs to **NOT take on the role of partnership**

representative for any clients of the firm. However, in the event that you, *or another member of your firm,* contemplate taking on such a position for a client, we strongly encourage you to contact CAMICO first so that we can help you to evaluate the risks associated with the respective partnership representative position, as well as assess any potential coverage issues.

- Send a client notification letter to your partnership clients (including LLCs taxed as a partnership) informing them of some of the significant highlights of the new rules. From a risk management perspective, it is important for CPA firms to ***warn*** and ***advise*** partnership clients of the implications that these changes may mean to them. For example, you may want to inform the client that under the Act, current partners could find themselves liable for tax adjustments relating to events preceding their entry into the partnership. A strong call to action message should be included in the communication encouraging clients to seek guidance from legal counsel to revisit and update as appropriate their partnership agreements to address items such as:
    - Identifying a partnership representative, establishing qualifications for the partnership representative, and terms for removal of or resignation by the partnership representative.
    - How the new audit rules are to be applied, the scope of discretion afforded the partnership representative, and partners' participation and consent rights.
    - Establishing procedure for choosing whether to elect out of the new partnership rules.
    - Restrictions regarding transfers of partnership interests to ineligible partners.

  CAMICO provides sample client notification letters to CAMICO policyholders on the CAMICO Members-Only Site under Knowledge Tree –> Reference Library –> Alert Documents –> 2018 –> New IRS Tax Audit Rules for Partnerships. CAMICO strongly encourages firms to retain a list of the clients to whom the letter is sent.

- Update your 2018 partnership and LLC tax engagement letters to include the following: A request that the client identify the designated partnership representative, and a section for the client to indicate if they want to make the annual election to opt out of the new audit rules. CAMICO provides updated engagement letter templates for CAMICO policyholders.