



Tax Audit Risk Shifted from Partners to Partnership

NEW TAX PARTNERSHIP AUDIT PROCEDURES

A legislative change to partnership tax audit procedures enacted under the Obama administration is set to go into effect as of January 1, 2018. All tax partnerships need to be prepared to make certain amendments to their governance agreements, preferably prior to December 31, 2017.

All partnership agreements and operating agreements of LLCs taxed as partnerships will need amendment.

PRESENT LAW

Under present law, entities taxed as partnerships are required to appoint a tax matters partner to represent the partnership in connection with IRS audits. If the result of an audit is an alleged deficiency, the tax matters partner can agree on behalf of the partnership or dispute the deficiency, but cannot bind the partners. Once the deficiency becomes final, it is assessed to and collected from the partners in the year under audit.

NEW LAW

Under the new law, there is a nomenclature difference and the tax matters partner is now known as the "partnership representative." The partnership representative still represents the partnership in audits and still has the authority to agree to deficiencies or dispute them, but also can bind the partners. The new audit procedures also are significantly different in that once a final determination is made, the default rule is any deficiency is assessed and collected against the partnership. This creates the possibility that the partners in the year that the liability of the partnership for a prior years' taxes arises (the "reviewed year") will be different or own different percentages than the partners of the year of the audit (the "adjustment year").

There are certain exceptions to this default rule:

- The primary exception is certain "small partnerships may elect out of the new audit treatment and remain subject to the old audit rules. Generally, the definition of a small partnership is one in which 100 or fewer K-1s are prepared for the year, and the election has to be made each year on the return for that year and is applicable only to the year for which it was made. Note that not all small partnerships qualify. Notably, under proposed regulations, partnerships with certain types of entities, for example, trusts or disregarded entities as partners, are not eligible for this election.
- Another exception applies if all of the partners in the reviewed year file amended returns and pay their deficiencies within 270 days of the determination of the deficiency.

- Finally, under certain circumstances, the partnership representative can elect to “push out” the tax liability from the partnership to the partners in the reviewed year.

ACTIONS REQUIRED

All tax partnership operational agreements should be amended to either appoint a partnership representative or establish a procedure for the appointment of a representative by the partners/members.

- The amendment should include the authority of the partnership representative to make the elections discussed above or should provide a procedure for the granting of that authority by the partners/members.
- Some agreements simply may require the partnership representative to elect out (assuming the entity is eligible for this election). Others may require the partnership representative to push out the tax liability in all cases.
- In situations where an election out or push out is not made, the agreement should require the reviewed year partners to indemnify the partnership for any payments of deficiencies made on their behalf.
- The agreement should also provide indemnification to the partnership representative for acts permitted under the agreement.

OTHER CONSIDERATIONS

In view of the possibility that a tax partnership may be obligated for the taxes of its partners under the new audit provisions, care should be taken when purchasing an entity taxed as a partnership or joining an entity taxed as a partnership to secure indemnities to provide protections to the purchaser/new member for tax liabilities accruing prior to purchase or admission.

This possibility may also require revisions to private placement memoranda or offering statements relating to securities in entities taxed as partnerships.

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