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Get Ready – The Internal Revenue Service May Be Knocking on Partnership Doors Next Year

By Larry Brant on 12.8.20 | Posted in Federal Law, IRS, Tax Planning

Introduction

On November 2, 2015, the Bipartisan Budget Act ("Act") was signed into law by President Barack Obama. One of the many provisions of the Act significantly impacted: (i) the manner in which entities taxed as partnerships are audited by the Internal Revenue Service ("IRS"); and (ii) who is required to pay the tax resulting from any corresponding audit adjustments. The new rules sprung into life for tax years beginning after December 31, 2017.

Under the old law, entities taxed as partnerships, (including most multi-member limited liability companies ("LLCs")[1], generally did not pay income tax. Rather, they computed and reported their taxable income and losses on IRS Form 1065. The partnership provided each of its partners with a Schedule K-1, which allowed the partners to report to the IRS their share of the partnership's income or loss on their own tax returns and pay the corresponding tax. Upon audit, pursuant to uniform audit procedures enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), examinations of partnerships used to be conducted generally under one of the following scenarios:

- For partnerships with ten (10) or fewer eligible partners, examinations were conducted by a separate audit of the partnership and then an audit of each of the partners. The IRS ultimately had to assess and collect any taxes owing from the partners.

- For partnerships with greater than ten (10) partners and/or partnerships with ineligible partners, examinations were conducted under uniform TEFRA audit procedures, whereby the examination, conducted at the partnership level, was binding on the taxpayers who were partners of the partnership during the year under examination. Still, the collection of any taxes owing was at the partner level.

- For partnerships with 100 or more partners, at the election of the partnership, examinations were conducted under uniform "Electing Large Partnership" audit procedures, whereby the examination, conducted at the partnership level, was binding on the partners of the partnership existing at the conclusion of the audit. Again, the collection of any taxes owing was at the partner level.

Lawmakers believed a change in the TEFRA audit framework was necessary for the efficient administration of Subchapter K of the Code. If a C corporation is audited, the IRS can assess an additional tax owing against a single taxpayer—the very taxpayer under examination—the C corporation. In the partnership space, however, despite the possible application of the uniform audit procedures, the IRS was required to examine the partnership and then assess and collect the taxes owing from multiple taxpayers (i.e., the partners of the partnership).

As a result of the burdensome audit rules (from the Service's perspective), few partnership audits occurred. The Government Accountability Office (the "GAO") reported in 2014 that, for tax year 2012, less than one percent of partnerships with more than $100 million in assets were audited. Whereas, for the same tax year, more than 27 percent of similarly-sized corporations were audited. The GAO concluded the vast disparity was directly related to the increased administrative burden placed on the IRS under the then existing partnership examination rules.

As previously reported, effective for tax years beginning on or after January 1, 2018, new centralized examination rules may apply to entities taxed as partnerships, allowing the IRS in many cases to simply examine the partnership and assess it with any tax owing (thereby eliminating the need to audit the partners and collect the tax from the partners). With the new rules in place, which streamline the process from the government's vantage point, most commentators and tax practitioners highly anticipated that the number of partnerships examined by the IRS each year would dramatically increase. Due in large part to the COVID-19 pandemic, we have not yet seen any increased audit activity. That, however, may be about to change!

Representatives of the IRS recently announced that the Service intends to dramatically ramp up the audit of partnerships in 2021. In fact, it is hiring revenue agents to assist in its efforts to place more focus on partnerships.

As the lyrics in the Black Eyed Peas hit song *Get Ready* proclaim:

We ain't playin' no games
Do you hear what I'm sayin'?
This is for real, this is for real
Get ready, get ready
Get ready, get ready
Get ready, get ready

Action Required

Tax practitioners, if they have not already done so, need to get their partnership clients' houses in order and ready for IRS audits, including:

- Undertaking a careful review of the new audit regime, including the applicable Treasury Regulations, and how the regime may impact a partnership.

- Undertaking a careful review of each partnership and its partners to determine if the partnership is eligible to elect out of the new audit regime. If it can elect out, most tax practitioners believe a partnership should do so. The “elect out” option must be exercised annually. Did the partnership elect out in 2018 and/or 2019? Will it elect out on its 2020 partnership return?

- Taking an inventory of the partners to ensure eligibility to elect out exists. Consider amending the partnership agreement to restrict ownership (and the transferability of partnership interests) to persons or entities who will not render the partnership ineligible to elect out of the new regime.

- Alerting the client to carefully consider each person or entity before they are admitted to the partnership to determine whether the new admittee will render it ineligible to elect out of the new regime.

- If a partnership cannot elect out of the new audit regime, consider: (i) amending the partnership agreement so that the partners direct (by the terms of the agreement) the Partnership Representative ("PSR") to elect or in good faith consider the alternative payment system. Each partner should affirmatively approve this amendment and agree to be so bound; and (ii) amending the partnership agreement so that the partners from each reviewed year (in the ownership proportions they hold during each such reviewed year) bear any economic burdens of an IRS examination, rather than the partners for the tax year in which the examination concludes (in the ownership proportions they hold at the conclusion of the audit). Accordingly, consideration should be given to adding: (a) a provision expressly allowing the partnership to withhold distributions from any partner in order to pay the resulting tax; (b) a “clawback” provision requiring that the partners from the review year indemnify the partnership and other partners for their share of the resulting liability; (c) a provision expressly allowing the partnership to set up a reserve in

anticipation of a tax liability; and/or (d) a provision expressly providing a method by which any tax liability that cannot be recovered from departed or reduced-interest reviewed-year partners is allocated and assumed by the remaining partners.

- Determining whether the partnership agreement's "Tax Matters Partner" provision (which applied under the old regime) has been replaced with an updated provision addressing the PSR under the new regime. A totally new PSR provision should be considered when drafting or amending the partnership agreement. Such a provision should include, but not be limited to, the following:
  - The appointment, removal and replacement of the PSR;
  - The duties of the PSR;
  - An obligation of the PSR to notify partners, including both current and any former partners who could be impacted, of any IRS audits;
  - An obligation of the PSR to keep the partners informed as the audit progresses;
  - The granting of authority to the PSR to resolve audits and make decisions about tax matters, including making elections such as a "push out" election under the new regime, and any limitations on such authority;
  - A release of the PSR of all liability relating to audits, provided the PSR acts in good faith and without gross negligence;
  - A requirement that the partners (current and former) cooperate and provide the PSR with any needed information and/or documentation for purposes the audit;
  - An agreement of each of the partners (current and former) to file amended returns and/or comply with any audit results, including paying their share of any resulting tax liability; and
  - Specifically directing or limiting the authority of the PSR with respect to electing out of the new audit regime and/or other elections available to the partnership under the new regime.

Conclusion

Even though a partnership is not yet under examination, there is no time to wait to (i) review the partnership and the possible impact the new audit regime may have on it; (ii) review the partnership's options under the new audit regime; and (iii) update the partnership agreement, adding necessary PSR and related provisions. Waiting for the audit letter from the IRS may be too late.

[1] This blog post will use the term “partnership” to refer to all entities taxed as a partnership, including such multi-member LLCs. Accordingly, references to “partnership agreement” will encompass partnership agreements and LLC operating agreements.

Tags: Barack Obama, Bipartisan Budget Act, Internal Revenue Service, New Partnership Audit Rules, partnerships, President Obama, Tax Audit, tax practitioner, Taxpayer