MALONEY & KENNEDY PLLC
Certified Public Accountants

15 Dartmouth Drive, Suite 203
Auburn, NH 03032
Phone: (603) 624-8819
Fax: (603) 625-6371

197 Loudon Road, Suite 210
Concord, NH 03301
Phone: (603) 736-9536
MaloneyandKennedy.com

Richard J. Maloney, CPA, ABV
Kevin C. Kennedy, CPA, CFE

Jessica P. Wiley, CPA
Janeen A. Sorrentino, EA
Patricia A. Mantone, EA

OBSERVATIONS

This is one of periodic blogs we produce on financial issues that impact the practice or business of the legal community
This blog is available at http://www.maloneyandkennedy.com/category/observations/tax/

NEW PARTNERSHIP AUDIT RULES

January 23, 2019

A long, long time ago (well, 2015), a Republican Congress enacted and President Obama signed the Bipartisan Budget Act of 2015. One feature of that legislation was the enactment of new IRS audit rules for partnerships. The effective date was set as January 1, 2018. Now, with preparation of the 2018 tax returns, the time has come to talk again about the impact of these rules.

First, some background. Partnerships are clearly subject to the IRS partnership rules. However, partnerships are fading as the entity of choice for businesses and are being replaced by limited liability companies (LLCs). Under the Internal revenue Code, LLCs do not have an existence. Instead, to paraphrase an old joke, they are what you want them to be. If there are at least two members of an LLC, the <u>default</u> provision is that the LLC will be taxed under the partnership rules. However, an LLC can elect out of the partnership rules and be taxed as a corporation (C or S corporation). For now, we will assume that an LLC is being taxed as a partnership. That being said, if partnership agreements or LLC operating agreements have not been updated to reflect the new tax audit rules, now is the time.

The good news is that these rules can be avoided; the bad news is that this requires affirmative action by the partnership. On the 2018 partnership tax return, there is a question on page 3 (#25). There is also a reference[1] to Schedule B-2. If the tax return preparer is unaware of any changes in the partnership/LLC agreement, he/she will probably make an assumption that no election is to be made and thus, with the return, bind the partnership.

Are the new rules really that bad? They very well could be, especially for a minority partner. Historically, when partnerships with fewer than 10 partners were audited, the tax adjustments were made at the partner level. If there were adjustments to a partnership return because of an IRS audit, the IRS would then adjust the individual returns of the partners.

Under the new rules, the tax audit adjustment of all items of income, gain, loss, deduction, or credit are made at the partnership level, making the partnership liable for any resulting underpayment of tax instead of the individual partners. The net change in income is taxed at the highest individual or corporate rate, regardless of the rate applicable to the individual partner.

[1] Copies of each are attached

There are three problems with this approach:

1. Individual partners may not be taxable at the highest rate;
2. Partnership assets are used to pay the tax liability; and,
3. Partners at the time of audit may not have been partners when the activity took place.

There are relief opportunities: A "small partnership" can affirmatively elect out of these rules annually with the filing of the partnership tax return, in which case the existing rules will apply (audits will be conducted at the individual partner level). A small partnership is generally defined as having no more than 100 partners, none of which is another partnership.
In addition, partnerships subject to an audit can seek to mitigate the imposition of the highest individual or corporate tax rate on any imputed underpayment through the following processes:

1. Push Out/Pass through election
    a. Audit adjustments taken into account by the partners who were partners during the **reviewed** year.
    b. The partnership must notify partners within 45 days after notice of adjustment is received from the IRS
    c. Each partner is required to include the audit adjustments in the year in which the audit concludes (i.e. not an amended return).
    d. The normally applicable underpayment interest rate for such partner is increased by two percent, and penalties may apply.
2. Amended Schedule K-1s for partners
    a. Issued to each partner, who was a partner for the **reviewed** year,
    b. If a partner files an amended tax return and pays the taxes within 270 days of the partnership receiving notice of a proposed partnership adjustment, then such amount would be deducted from the amount the partnership owes at the entity level.

Another significant change resulting from the new rules is the replacement of a "tax matters partner" with a "partnership representative". The IRS will select a partnership representative if the partners fail to make an appointment, which would be binding upon a partnership. The partnership representative:

a. Is the only person that will receive any notice from the IRS.
b. Has exclusive authority to represent the partnership in an IRS audit.
c. Does not have to actually be a partner in the partnership.
d. Is required to have a "substantial presence" in the United States.
e. Has more power than the tax matters partner and can bind partners to a settlement with the IRS without their input or consent.

Other provisions of the new law:

a. No statutory requirement under the new rules for the IRS or the partnership representative to notify other partners that an audit has commenced.
b. No statutory rights for any partner other than the partnership representative to participate in a partnership audit.

The IRS will continue to issue additional guidance relating to the imposition of these changes.

Action Items: In light of these new rules, we strongly recommend that all partnership and limited liability company agreements be reviewed to confirm whether they are in line with the intent of the partners and, if necessary, be amended to elect out of the new rules and provide appropriate guidance and procedures if an election is inadvertently overlooked, including the designation of a partnership representative and the imposition of any requirements for it to provide partners with notice or obtain consent. In addition, it is important to consider these rule changes in the event of any partnership changes, including the addition of any new partners. If the partnership wishes to elect out of the new rules, the agreements should be amended and the tax return preparer notified.

RICHARD J. MALONEY, CPA, ABV | KEVIN C. KENNEDY, CPA, CFE | JESSICA L. PARASCO, CPA | JANEEN A. SORRENTINO, EA