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Tax Audits and Litigation | Alert

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Quick Guide: Overview of New Partnership Tax Audit Rules

The new partnership tax audit rules apply to multi-member LLCs and other entities treated as partnerships for federal income tax purposes.

The rules are effective for tax years beginning after December 31, 2017.

- The precise mechanics remain in flux with many clarifications still to come.

Potential for tax to be imposed at the partnership level.

Partnership representative replaces the tax matters partner.

- Partnership examinations are managed at the partnership level by a partnership representative who has the power to bind the partnership and its partners during an audit.

Partnerships with 100 or fewer partners can elect out of the new audit rules if all partners of the partnership are one of the following:

- An individual, a C-Corp, a foreign entity that would be treated as a C-Corp if it were domestic, an S-Corp or an estate of deceased partner, but not a partnership.

DIRECT PARTNERSHIP INCOME TAX LIABILITY

CAUTION – DEFAULT RULE:

Absent an election, the partnership may be liable for underpayment of taxes in a given year.
TO AVOID THIS RESULT CONSIDER:

Alternative 1: Partners amend returns	Alternative 2: Election to push out underpayment liability (the "push out method")
If partners of an audited partnership file amended returns reflecting the final partnership adjustment and pay their allocable share of the adjustment, the partnership gets an offsetting reduction in its direct liability.	The push out method allows a partnership to pass on the liability for additional taxes to partners and thus avoids entity level liability. Partnership must make this election within 45 days of a final partnership adjustment. Partnership must furnish to each reviewed year partner and to the IRS a statement of the partner's share of any adjustment to income, gain, loss, deduction, or credit as determined by the final partnership adjustment.

New Partnership Tax Audit Rules Checklist

Formation Considerations	
☐ **Is the partnership eligible to opt out of the new regime?**	It must have less than 100 partners, each of which is either an individual, a C-Corp, or an S-Corp, but not a partnership.
☐ **Can a new partnership be structured so as to remain eligible for electing out?**	For example, by maintaining less than 100 partners and not using a tiered structure.
Partnership Representative Considerations	

☐ **How is a partnership going to choose the partnership representative?**	Existing operating agreements can be amended to deem the tax matters partner as the partnership representative or change rules on how a partnership representative is selected. Partnership representative does not have to be a partner, but must have a substantial presence in the U.S. If partnership does not designate a partnership representative, the IRS has the authority to designate one on behalf of the partnership.
☐ **What authority will the partnership representative have to act on behalf of the partnership?**	Does the partnership representative have the authority to make any elections on behalf of the partnership? Can the partnership representative require partners to amend their returns?
Audit Considerations	
☐ **Should the partnership elect to apply the push out method?**	Election must be made within 45 days following a final partnership adjustment. Partnership must furnish to each reviewed year partner and to the IRS a statement reflecting each partner's share of the final partnership adjustment.
☐ **Should the partnership require the partners to file amended returns?**	In some cases it may be easier for the partnership to pay the underpayment directly and seek indemnification from the partners.
Indemnification Considerations	
☐ **Who is liable for the imputed underpayment when the partnership pays the tax or incurs expenses during a partnership audit?**	Should the partnership indemnify its partners or should the partners indemnify the partnership? The Board may have authority to allocate the tax burden among the partners as offsets to future distributions.
☐ **How is indemnification handled when partners sell their interest in the partnership?**	Operating agreement should address specifics of any indemnification obligations.

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