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New IRS Partnership Audit Rules Take Effect in 2018 – Are You Prepared?

By Alan S. Kufeld, CPA

A major shift has occurred in how the Internal Revenue Service (IRS) will handle partnership tax examinations in the future. On June 13, 2017, the IRS re-released proposed regulations providing guidance on new partnership audit rules. Under these rules, regulators have created new centralized procedures for the audit, assessment, and collection of tax. This move significantly changes how partnership adjustments are determined and passed through to partners.

The new centralized partnership audit regime stipulates that partnerships may now be assessed tax at the partnership level for IRS tax examinations as opposed to the tax assessment taking place at the individual partner's level. These new rules apply to virtually all partnerships and take effect beginning in 2018. However, there are proactive steps partners can take now to prepare for these changes.

This legislation was enacted under the Bipartisan Budget Act of 2015 (BBA) and will repeal the longstanding partnership audit rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The IRS originally issued these proposed regulations on January 18, 2017, and withdrew them on January 20, 2017, only to ultimately reissue them again on June 13 with minor adjustments.

What exactly does this new legislation mean for future partnerships and partnership investment opportunities?

Key Changes in the New Rules

Under the new partnership audit rules, any imputed underpayment of taxes will be assessed at the top corporate or individual tax rate at the partnership level. It's particularly important to note the IRS will assess the partnership in the year of the adjustment — when the examination ends — as opposed to the year of examination. This could create a rift among current and former partners if not properly addressed in partnership agreements.

Take, for instance, a partner who was in the partnership as of the review year, but exited prior to the year of adjustment. Assuming the examination resulted in the partnership being assessed an imputed underpayment — under the new rules — it is possible that the exiting partner would not have a tax liability because he or she exited the partnership before the year of adjustment. If not properly addressed, existing and new partners could assume the tax liability of the former partner.

Establishing a Partnership Representative

The new law also stipulates that partnerships appoint a person to serve as the "partnership representative" to assist with closing examinations more swiftly and efficiently. This role is very different from the role of the tax matters partner under the repealed TEFRA rules.

Under the new rules, the partnership representative now has sole authority to act on behalf of the partnership, and his or her actions are binding on the partners. Under the previous TEFRA rules, each partner was granted more authority and had notice rights for IRS-related matters.

Accordingly, the shift toward a partnership representative for IRS matters should cause partnerships to rethink operating partnership agreements. This partnership representative will have a significant role in the examination process, so his or her selection should be approached with care and caution.

Who Can Opt Out of the New Rules?

The new rules generally apply to all partnerships. However, partnerships that satisfy certain requirements and have 100 or fewer partners may elect out of the new regime annually.

Interestingly, a partnership may not opt out of the new audit rules if any of its partners are partnerships or trusts. If a partnership opts out, any adjustments resulting from an examination could flow to each partner individually, as the rules stipulate under TEFRA. Partnerships electing to opt out of the new rules will be required to follow cumbersome procedural requirements each year.

Preparing for the Rule Change

Family offices should take a close look at the partnership agreements and understand these provisions when considering investment opportunities prospectively.

Looking ahead to when these new regulations take effect in 2018, partnerships should focus on fully understanding the impact of the rules and preventive actions that can be taken now to ensure compliance and limit exposure.

Key Steps to Take Now

Here are some key steps to take in light of these new rules:

- Review BBA regulations and applications with your legal and tax team.
- Carefully select and begin defining the roles and responsibilities of the partnership representative and consider dedicating a section of the partnership agreement to defining the scope of power and responsibilities.
- Address how to allow the partnership to have its partners (past, present and future) fairly share in any partnership level tax liability resulting from examination.
- Consider the number of partners allowed to enter the entity, along with the types – individual, trust, etc.
- Maintain a flexible partnership agreement in case the BBA rules change.
- Consider specifying notice and participation rights for partners.
- Consider options available to fund and allocate the partnership tax liability.
- Address if partners are required to file amended returns and how compliance can be substantiated to reduce an imputed underpayment.
- Keep the option to elect out of the BBA audit rules viable by restricting transfers of partnership interests to ineligible partners.
- Continue to monitor state conformity.

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