AGH CPAs & ADVISORS

ALERT: IRS increases tax risks to partnerships

July 24, 2018

Congress recently enacted significant changes to IRS procedures for audit and adjustment rules for partnerships. The changes are expected to dramatically increase the audit rates for partnerships and will require partners to carefully review, and possibly revise, their partnership's agreements.

New rules generally apply to partnership tax returns with tax years ending after 2017, but action may need to be taken now to amend your partnership agreements to allow for these changes and who makes these decisions. Initial steps include the following:

- Determine if the partnership qualifies to elect or opt out of the new rules and discuss with tax preparer
- Determine the partnership representative who will be replacing the tax matters partner
- Determine any other changes to partnership agreements

The new rules allow the IRS to audit the partnership at the entity level, as well as assess and collect tax against the partnership at the highest individual tax rate. As an additional negative consequence, there is no increase in the partners' basis in the partnership interest as a result of the increase in income and taxes paid.

The new rules only affect tax liability if the IRS audits the partnership and finds more income, less deductions, losses or credits, or an adjustment of allocations between the partners. If there is a decrease in income found during an audit, there is no tax refund to the partnership.

Another implication is that current partners could be responsible for tax liabilities of prior partners. If a partner leaves the partnership and a new partner enters between the time the tax return is filed and several years later when it is audited, the new partner pays the tax due instead of the partner that owned the interest at the time the delinquency occurred. Therefore, the new partner may want to negotiate indemnification or another remedy when acquiring the interest.

The good news is there are several ways for the partnership to elect or opt out of the rules to avoid these consequences.

"Elect Out" option:

Criteria:

- The partnership must have less than 100 partners.
- All partners must be eligible partners: individuals, C corporations, foreign corporations, estates of a deceased partner.
- S corporations are also eligible partners; however, each shareholder of the S corporation counts as a partner.
- Partners must be eligible for the entire tax year.

Partners not eligible under "Elect Out" option: Partnerships, Single Member LLCs and Trusts, including Revocable Trusts

Impact:

- Any audit assessment is made at the partner level.
- The election is made annually on a timely filed partnership tax return.
- Partners can contest the IRS findings.

"Amend Out" or "Pull In" option:

- These can be done even if there are more than 100 partners and the partnership is owned by ineligible partners.
- **"Amend Out"** – Partners file amended tax returns for the reviewed tax year to report the adjustments made by the IRS at the partnership level and pay related tax, penalty and interest (at usual IRS interest rates). The partnership must notify the IRS at the time of the assessment that "Amend Out" will be utilized.
- **"Pull In"** – Partners pay the tax that would have been due with amended tax returns, though no amended tax returns are filed. Not having to file the amended return is the benefit in this option; however, the partnership will have additional administrative costs and effort associated with collecting payments from partners and preparing supporting documentation required by the IRS.
- Tax rate on payments made by partners may be lower than the highest tax rate and partners receive a step up in the partnership basis.

"Push Out" option:

Criteria:

- Any partnership may elect even if there are more than 100 partners and ineligible partners.
- Election must be made within 45 days after IRS mails the notice of final partnership adjustment.
- The partnership provides a "push out statement" to each partner.

Impact:

- The partners are then liable for the tax.
- Partner's basis is increased for the adjustment.
- Drawback of this option is the interest assessed is two percent higher than usual interest rate assessed on underpayments.
- Partners are bound by the partnership level determination.

There are many new tax terms and concepts that will likely require adjustments to your agreements, including your partnership agreements, LLC operating agreements, buy sell agreements, contribution agreements, redemption and dissolution agreements, merger agreements, disclosure documents, and loan agreements.

New "partnership representative" serves critical role

Another item with a large impact is the new term "partnership representative" replacing the prior "tax matters partner." The partnership representative is critical; they will act as the single point of contact between the IRS and the partnership, and the partnership representative will have full authority to bind the partnership and the partners during an audit. The partnership representative can be a partner, but is not required to be. It must be an individual, trust, estate, partnership, association or corporation with a substantial U.S. presence. Provided it is an entity,

a human must be identified as the contact person. The IRS will designate a partnership representative if the partnership does not designate one.

Action may need to be taken now

Action may need to be taken now to amend your partnership operating agreement to allow for these changes and who makes these decisions. We can help you determine the best option for your situation and explore other planning opportunities.

For more information on these changes, please contact your AGH tax advisor or AGH tax senior vice president Shawn Sullivan at 316.291.4110 or Shawn.Sullivan@aghlc.com.

NOTE: Any advice contained in this material is not intended or written to be tax advice, and cannot be relied upon as such, nor can it be used for the purpose of avoiding tax penalties that may be imposed by the IRS or states, or promoting, marketing or recommending to another party any transaction or matter addressed herein.