CHANGING IRS AUDIT REGIME

The new centralized audit regime for partnerships drastically changes the way partnership audits will be conducted by the Internal Revenue Service. Previously, under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit rules, if deficiencies were found in the partnership return that resulted in the incorrect pass through of tax-related items to partners, the IRS had to open an audit proceeding against each of the partners separately if the agency wanted to assess these deficiencies against all the partners.

Moving forward, individual partner audits will no longer be needed in order for the IRS to levy a tax assessment as a result of a deficiency found in a partnership return. Instead, the IRS will take the deficiency calculated and apply the highest individual rate applicable in the year of the deficiency to determine the tax. The tax will then be assessed against the partnership directly and appear as a non-deductible expense.

The new audit regime rules also call for the appointment of a partnership representative, an individual or entity who serves as the sole point of contact with the IRS during an audit. He or she possesses the legal authority to bind the partnership and its partners when agreeing to settlements, receiving and accepting notice of partnership adjustments, and making any appropriate elections related to the audit. *NOTE: If an entity is appointed as the representative, an individual must still be selected as the primary IRS contact. Also, the representative doesn't need to be a partner of the partnership, so almost anyone can serve.*

Can a partnership elect out of the new rules?

Yes, but eligibility requirements limit the opportunities. To elect out, partnerships must have fewer than 100 partners and must not have any partners who are disregarded entities, partnerships, or trusts. If a partner is a S-Corporation, each shareholder of the S-Corporation counts toward the 100-partner limit, and all must meet the eligibility requirement. Since most investment partnerships have partners that are trusts or other partnerships, electing out of the new audit regime is very difficult.

If a partnership is audited, when will that happen?

An audit will generally take place several years after the year in which the tax return was filed. Once an audit does occur, it will take even more time to resolve. Consequently, a partnership will end up with tax, interest, and penalties for one tax year assessed in a later tax year. Because the partnership is now directly responsible for paying the tax out of partnership funds, this could place older tax burdens on new partners or shift them from partners who have exited to the remaining partners, or both.

How can this issue be resolved?

The partnership can address this issue in several ways. For example, the partnership representative can elect to "push out" the tax assessed so that the partners from the tax year under audit pay the tax. Of course, the partners won't be able to challenge the tax assessment, meaning that partners who exited years prior may suddenly discover they have a tax bill—one with higher-than-normal penalties since the underpayment penalty will be 2 percent more in this circumstance. The partnership representative could also ask for modification of the assessment if there are appropriate factors, such as tax-exempt partners. They might also choose to accept the assessment and agree to pay it out of partnership funds.

If the partnership elects to pay the assessment, those partners currently in the partnership bear the responsibility for the tax since the assessment reduces the partnership assets in the year the tax is assessed. The partnership might address this by creating a claw-back provision in its partnership agreement, allowing the partnership to seek payments from former partners for their share of the tax or by creating a holdback on exiting partners' payouts, retaining a percentage until the statute of limitations expires. The partnership representative may also decide that partners currently in the partnership must shoulder the burden. Regardless of the solution chosen, it should be specified in the partnership agreement so that all partners are clearly aware of their obligations.

Are there any special considerations when working with a partnership representative?

The new position of partnership representative has many issues that partnerships need to address. Under the new rules, the partnership representative's authority cannot be limited by the partnership for purposes of dealing with the IRS; however, the partnership agreement can provide limitations for investors to sue under state law for things such as breach of contract or fiduciary duty.

To ensure partnership representatives are handling matters in a way that's acceptable to investors, the partnership agreements need to address several concerns.
These include:

- **Selection of the representative.** Since the partnership representative isn't required to be a partner, virtually anyone can serve. That said, fund managers, general partners, or other partnership leaders may not necessarily be the best choice to serve in this role. In many instances, they might lack the necessary tax skills or be put into positions where they have to make decisions contrary to the interest of one or more of the individual investors, compromising their relationship with these investors. Investment companies need to carefully consider all their options and potential conflicts when designating who will serve.
- **Partner input and decision-making.** Unlike in previous years, where each partner controls the decisions related to his or her personal audit, those decisions will now be made for the partner. The partner will not be able to challenge the agreement made by the partnership representative, so it's imperative to address the input partners will have, if any.
- **Indemnification**. It's important to determine whether or not the representative will be indemnified, and if so, to what degree and under what circumstances. Since decisions made by the representative may benefit one or more partners and be less advantageous for others, it could create a situation where no matter the action of the representative, someone is adversely affected.
- **Communication.** Since the IRS will communicate directly with the representative, it could be entirely possible for an IRS audit to occur and many partners not be aware. What's the obligation of the representative and partnership management to actively communicate with the partners, including former partners who might be affected by a push out or claw-back?

Will the new rules trigger more audits in the future?

Almost certainly—the advantages to the IRS are numerous. In the past, a deficiency had to be spread among the partners, and many were simply too small to warrant conducting dozens of individual audits. Under the new rules, only one audit is required, significantly shifting the benefit-versus-cost ratio in favor of the IRS. Also, since assessments at the partnership level will be applied at the highest individual rate, more revenue will be generated from partnership audits than if the audit assessments are passed through to the partners. Finally, the IRS's collection efforts are facilitated because the agency only needs to collect from one source instead of many. Preparing for the possibility of a future audit is essential now that the rules have changed.

WE CAN HELP

For more information or if you have any questions about how the new audit regime rules will impact your partnership, please contact your Elliott Davis advisor or a member of our Investment Companies practice.

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