



New Partnership Tax Audit Rules To Go Into Effect on January 1, 2018

Beginning on January 1, 2018, the tax audits of a partnership or multiple-member LLC are subject to new rules (the “new partnership tax audit rules”). The new partnership tax audit rules streamline the audit and collection process when the tax return of a partnership or multiple-member LLC is reviewed by the IRS (and some states).

The implementation of the new partnership tax audit rules will require changes to most partnership agreements and LLC operating agreements currently in effect – taking no action in response to the new rules is not a valid option.

- **Brief Overview of Existing Rules.** Under the current tax audit rules, the audit of a partnership or multiple-member LLC is conducted at the partner level (if the partnership or multiple-member LLC has 10 or fewer partners or members) or at the partnership level (if the partnership or multiple-member LLC has more than 10 partners or members). The IRS deals with the named Tax Matters Partner when conducting the tax audit. If there are any changes to the partnership or LLC return, the assessment and collection occurs at the partner or member level. Therefore, under the current rules, the audit process can occur at the partnership/LLC level and the collection process occurs at the partner/member level.
- **Brief Overview of New Rules.** Under the new partnership tax audit rules, the general rule is that the audit and collection processes are integrated and occur at the partnership or LLC level. Therefore, if there are any changes to the partnership or LLC return, the IRS collects the extra tax, interest and penalties from the partnership or the multiple-member LLC. This streamlining of the tax audit process is intended to raise revenue collected by the IRS because the IRS no longer has to chase the partners and members for the payment of additional amounts due.

Under the new partnership tax audit rules, the partnership or multiple-member LLC must name a “partnership representative.” The partnership representative deals with the IRS with regard to any tax audit and has broad authority to make decisions on behalf of the entity being audited. The “partnership representative” does not have to be a partner of a partnership or a member or manager of a multiple-member LLC.

Considerations for, and Possible Approaches to, Changing Partnership Agreements and Multi-Member LLC Operating Agreements

- **Remove Reference to Tax Matters Member and replace with “Partnership Representative.”** As noted above, partnership agreement or multi-member LLC Agreement must be amended to designate the “partnership representative” for 2018 and each successive year. Consideration may be given around the scope of authority to grant to such “partnership representative” and whether he, she, or it will be indemnified by the entity for service in that capacity.
- **Affirmative “Opt-Out” of the New Rules.** In certain circumstances, the partnership or the multiple-member LLC can elect to “opt-out” of the new partnership tax audit rules. If this election is made, the partnership or multiple-member LLC remains subject to the current tax audit rules. The “opt out” election is only available to a partnership or multiple-member LLC that has 100 or fewer partners or members and each such partner or member is an individual, C corporation, a foreign entity that would be treated as a C corporation were it a US entity, an S corporation, or the estate of a deceased partner or member. Therefore, if a partnership or multiple-member LLC has a partnership, multiple-member LLC or a trust as a partner or member, then such partnership or multiple-member LLC cannot elect to “opt-out” of the new partnership audit rules.
- **Amendment to provide the ability of the LLC to “Push-Out” Assessed Taxes Following Audit to relevant partners/members.** If a partnership or multiple-member LLC cannot “opt-out” of the new partnership tax audit rules, the partnership or multiple-member LLC must pay the assessed tax, interest and penalties and then (if necessary) collect the amounts paid from the current partners or members. If, however, there has been a change in partners or members from the year under audit to the year of the audit, the partnership or multiple-member LLC may consider making an election to “push-out” the obligation to pay the assessed tax, interest and penalties to the partners or members in the tax year under audit.
- **Amendment to Elect to Adjust Tax Amounts Depending Actual Tax Liability of Individual Partners/Members.** If the partnership or multiple-member LLC cannot “opt-out” of the new partnership tax audit rules, and decides not to shift the burden of the payment of the assessed taxes, interest and penalties to the partners or members in the tax year under audit, then the partnership or multiple-member LLC must pay the assessed tax measured at the highest individual income tax rates. The partnership or multiple-member LLC may elect to reduce the amount of the tax due by taking into account the correct tax

liability of the actual partners or members. This election can be made where (a) at least one partner or member from the year of the audit files an amended return consistent with the IRS audit findings, (b) at least one partner or member is tax-exempt, or (c) a lower rate applies because a partner or member is a C corporation or because the income is subject to a lower rate (such as a dividend or capital gain).

As the brief summary above illustrates, the new partnership tax audit rules involve complex considerations that will dictate the form and content of amendments to (or restatements of) each partnership agreement or LLC operating agreement.

Please contact Nelson Toner, Esq., (207) 774-1200, ntoner@bernsteinshur.com, at your earliest convenience to discuss any required changes to your partnership agreement or LLC operating agreement to bring your documents into compliance with the new partnership audit rules.