NEW RULES GOVERNING IRS AUDITS OF TAX PARTNERSHIPS

Inequities May Result if Agreements are not Amended

Effective January 1, 2018, the IRS has made significant changes in the rules applicable to audits of entities treated as partnerships for tax purposes. This includes both general and limited partnerships as well as many limited liability companies. The longstanding rule that partnerships do not pay federal income taxes at the company level remains largely unchanged. Rather, the partnership files an informational return and partners report their share of income or loss on their personal income tax return.

OLD RULES

Under the old rules, the IRS would examine the partnership's income tax return (Form 1065) and make any adjustments to items of income, expense or credit at the partnership level. However, once an adjustment was made, the IRS would proceed against individual partners who held an interest in the partnership during the year under audit, in order to collect any underpayment of taxes, plus interest and penalties.

NEW RULES

Under the new rules, the IRS will still examine the partnership's income tax return and make any adjustments to items of income, expense or credit at the partnership level. *However, once an adjustment is made, the IRS no longer seeks to collect underpayments from individual partners. Instead the IRS will assess and collect any underpayment, as well as interest and penalties, directly from the partnership and not from the individual partners. Perhaps more importantly, this assessment and collection takes place in the year the audit is concluded. If the partners of the partnership have not changed and their respective interests in profits and losses have not changed, application of the new rules should not cause a problem. However, if there are new or different partners or their respective interests have changed in the year the audit is concluded, inequities are likely to result, since the partners who bear the economic burden of the audit adjustments will not be the same as those who reported income or loss in the year the original return was filed.*

EXCEPTION TO NEW RULES

A partnership with 100 or fewer partners may opt-out of the new rules by filing an annual election, but only if (i) the partnership elects a partnership representative* and (ii) all of the partners are individuals, S corps, C corps and estates of deceased partners. If the partnership has a partner that is a flow-through entity (e.g., another partnership or LLC treated as a partnership) the opt-out election is unavailable.

There is also a second type of election that can permit the partnership to shift responsibility for an audit adjustment to the persons who were partners during the year of the audit. However, this requires notice to both the IRS and to each partner during the year of the audit.

SOME PRACTICAL ADVICE

Since the benefits of both elections can be lost if the elections are not filed in a timely manner, we recommend that partnerships and entities treated as partnerships for federal income tax purposes consider amending their partnership and LLC operating agreements to simply reallocate the economic burden of any future audit adjustments to the persons who were partners during the year of the audit, whether or not they are still partners or their partnership interests have changed in the year of the audit adjustment. If we can provide any further information, please contact your regular PLDO attorney or William F. Miller of our Corporate & Business Team at 401-824-5100 or email wmiller@pldolaw.com.

**A Partnership Representative replaces the former position of Tax Matters Partner, though the Partnership Representative has considerable more authority and need not be a partner of the partnership.*

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William F. Miller is a Partner with Pannone Lopes Devereaux & O'Gara LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.

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