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LAW FIRM LLC
hinklaw.com 316.267.2000

December 12, 2017

IRS Makes Significant Changes to Audit Rules for Partnerships and LLC's

This ALERT is relevant to you if:

- Your company is a partnership or limited liability company (LLC) taxed as a partnership; or
- You own an interest in a partnership or limited liability company taxed as a partnership.

ACTION is required on or before December 31, 2017 if (i) the partners/members in your partnership/LLC include a trust (even a grantor trust), another partnership/LLC, or a disregarded entity, and (ii) you want the ability to elect out of the new IRS partnership audit rules for the tax year beginning January 1, 2018. This issue is discussed in more detail below.

Please note that this Alert is not a comprehensive analysis of the new partnership audit rules. Despite the January 1, 2018 effective date, many of the details are still unclear. The IRS has promised that additional guidance will be forthcoming. We will provide one or more additional ALERTS as those details emerge to help you focus on decisions you may need to make. In the meantime, this Alert will serve as an introduction to the new rules and focus on what you may want to address before the end of the year.

Overview

Beginning January 1, 2018, new rules will apply to IRS audits of partnerships and LLCs that are taxed as partnerships (the "New Rules"). To make this Alert easier to read, when we refer to a "partnership," the same principle will also apply to an LLC that is taxed as a partnership. Under these New Rules, in the year that the IRS audits a partnership (the "Reviewed Year"), any resulting adjustments to the income and expense of the partnership will be made at the partnership level and will be taken into account by the partnership in the year the audit is completed (the "Adjustment Year"). If an audit results in an adjustment to income, the default procedure under the New Rules will be to assess the tax at the highest marginal rate in effect under the Internal Revenue Code and collect the deficiency from the partnership itself in the Adjustment Year. (Prior to the enactment of the New Rules, the deficiency was assessed against the individual partners for the Reviewed Year and taxed to them at their own marginal tax rate.)

WICHITA
1617 N. Waterfront Pkwy, Ste. 400 ~ Wichita, KS 67206-6639

OVERLAND PARK
6800 College Blvd., Ste. 600 ~ Overland Park, KS 66211-1533

In other words, under the New Rules, unless a partnership timely elects out of the application of the New Rules, or makes an election to push out the resulting tax liability to the Reviewed Year partners, the Adjustment Year partners will bear the full economic loss of an audit assessment, including interest and possibly penalties, even if some or all of the Adjustment Year partners are different than the partners in the Reviewed Year. It is thus entirely possible that a partner will bear the economic loss for someone else's income tax liability.

Example:

AB Partnership has 2 equal partners – A and B. In 2018 AB Partnership reports income of $1,000. In 2020 the IRS examines the 2018 Form 1065 of AB Partnership and determines that income for 2018 should have been reported as $2,000.

For the 2018 Reviewed Year, there is a presumptive amount due under the New Rules of $396 ($1,000 x 39.6%) that is required to be paid, with interest, by the Partnership in 2020 (the Adjustment Year).

What if B had transferred B's 50% interest in the AB Partnership to C in 2019? C will have incurred an economic loss in 2020 in the form of C's 50% share of $396 payment, plus interest, by the AB Partnership to the IRS for the 2018 Reviewed Year. On the other hand, B will not owe anything to the IRS as a result of the IRS audit even though B was a partner in the year that was audited.

For 2018, if a partnership wants to have the option of electing out of the application of the New Rules and thereby eliminate the possibility that a partner can bear the economic loss for someone else's income tax liability, that partnership (and its partners) must take action on or before December 31, 2017, as described below.

Electing Out of the New Rules

The New Rules allow certain partnerships (referred to as "Eligible Partnerships") to make an election to be excluded from the application of the New Rules. Eligible Partnerships are those (i) that are required to issue less than 100 Schedule K-1s, and (ii) whose partners are, during the entire year, either individuals, estates of deceased partners, C corporations, foreign entities that would be C corporations (if domestic), or S corporations (each of which is considered to be an "Eligible Partner"). *The IRS has issued proposed regulations that provide that partnerships with even one trust (including a grantor trust), partnership, LLC taxed as a partnership, or disregarded entity such as a single-member LLC, as a partner* ***at any time during the year*** *are not eligible to elect-out of the New Rules*. In the case of a partner that is an S corporation, the proposed regulations confirm that each S corporation shareholder is counted as a partner for purposes of the 100 Schedule K-1s limitation.

The election to be excluded from the application of the New Rules must be made when the partnership's 2018 Form 1065 is filed. However, the election may only be made if all of the partners during the year to which the election relates are Eligible Partners. Accordingly, if a partnership wants to have the ability to make the election for the tax year beginning January 1, 2018 and the partnership currently includes any entity that is not an "Eligible Partner" (as set forth above), then the non-eligible partner must transfer its interests in the partnership to an Eligible Partner no later than December 31, 2017.

Pushing out the Liability

In the case where a partnership does not elect out of the New Rules, whether because it is not an Eligible Partnership or otherwise, the default procedure under the New Rules is, as indicated earlier, to assess and collect that deficiency from the partnership rather than the individual partners. As illustrated in the example above, this creates the possibility that a partner can bear the economic loss for someone else's income tax liability. To avoid this result, the New Rules include a mechanism, in the form of a partnership election, which if timely made, allows the partnership to cause the Reviewed Year partners to be responsible for their own tax liability. If the partnership makes this election and sends required information to the Reviewed Year partners and the IRS, the Reviewed Year partners are individually responsible for their respective shares of any tax, interest, and penalties. The cost or downside to the "push out" election is that the interest rate on the underpayment of tax is two points higher than if the partnership itself had paid the liability.

Example:

If the AB Partnership in the example above made the election to push out the 2018 liability to the Reviewed Year partners (i.e., A and B) and sent the required information to the Reviewed Year partners, A and B would each be responsible for their respective shares of the tax (at their own tax rate), penalty (if any), and interest (at a rate 2 percentage points higher than if the partnership had paid the tax), and C would have no liability.

To avoid disputes among partners, the process for determining whether or not to make this election may be something you will want to address in your partnership agreement or LLC operating agreement.

This Alert provides a brief overview of a very narrow component of the new partnership audit rules. We encourage all entities taxed as partnerships to consult with their advisors regarding the new rules and the amendments to partnership / operating agreements that may be required or advisable. In addition, for some partnerships that want the ability and option to elect out of the application of the New Rules for the 2018 calendar tax year, those partnerships and their partners may need to take action before the end of the current year.

If an attorney at our firm drafted your partnership or LLC agreement, we recommend that you contact him or her to discuss these issues. If you have any questions regarding the new IRS audit rules, you are also welcome to call Scott MacBeth or Brian Burris at (316) 267-2000.