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Legal Alert

NEW AUDIT RULES: PART 3 - WHO PAYS THE TAX?

This is the third of our articles dealing with the new audit rules established for partnerships for tax years beginning after December 31, 2017. This article deals with whether, after an audit resulting in the need for additional payment to the IRS, to (a) apply the default rule of taxing the partnership during the year of the audit (the "audit year") so that the then-current members bear the tax burden, or (b) elect to "push out" the tax to those who were partners during the year being audited (the "review year").

<u>Default Rule – Partnership Level Taxation</u>

The new audit rules were expressly designed to assess tax at the partnership – rather than the partner – level. If an audit determines that there are adjustments in income, the IRS can assess the tax liability at the partnership or LLC level using the highest marginal tax rate for individuals (currently 37% but subject to change by Congress) regardless of the actual tax rate applicable to the actual members of the LLC or partnership. The law imposes taxability on the entity and thus indirectly on all current members, even if those current members were not members in the partnership during the review year for which the underpayment has been declared.

The partnership or LLC may be able to mitigate the entity-level liability by preparing and delivering K-1s for the audit year to those partners to whom the adjustments relate. The impact of going down that route would have to be determined on a case-by-case basis at the time the results of any audit were known.

<u>The "Push Out" Election</u>

An alternative is for the LLC or partnership to elect (through its Partnership Representative – the "PR") to have its review year partners (not its current members) take into account the adjustments made by the IRS, and pay any tax due as a result of those adjustments. In that case, the partnership will not be required to pay the imputed underpayment. Clearly, those who were not partners or members in the review year (but are in the audit year) would encourage the PR to make such an election.

The LLC or partnership would pass the adjustments along to its review year partners or members by issuing amended Schedule K-1s for the review year to them. All those partners (and not the partnership) would then take the adjustments into account on their individual returns and be responsible for not only the deficiency amount but also any penalties and interest. The entity (through its PR) must elect this alternative within 45 days after the date of the notice of a partnership adjustment.

It is clear that great care needs to be taken in amending the partnership agreement to be precise as to what items are to be deemed partnership level items and how items are to be taxed.

We've assembled a team of our business attorneys to help our clients evaluate the new audit rules and decide how to address them in their partnership agreement or LLC operating agreement. If you'd like to have us evaluate your situation, let us know at New_IRS_Audit_Rules@gblaw.com. We look forward to hearing from you.

You can read the first alert of the series about who can opt out in Part 1 of the New Audit Rules, plus find more on our website about designating a partnership representative in Part 2 of the New Audit Rules.