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# New Partnership Audit Guidelines and Related Elections

There are big changes under the new centralized partnership audit regime rules that will apply to all partnership returns filed beginning in 2018. While we refer to partnerships throughout, this includes LLC's filing a partnership return (1065). Because the examination process has been streamlined, new guidelines are expected to dramatically increase the audit rates for partnerships.

Under the prior rules, the IRS had to collect from the individual partners for any changes determined on the partnership return. This was extremely cumbersome for the IRS in dealing with large partnerships. The new regime changes this in some cases. The partnership itself may be required to pay any tax assessment, unless the partnership makes a valid election to "push-out" the assessed liability (including penalties) to the partners.

Some of the big changes as a result of the new guidelines that you should be aware of include:

## Provisions that May Impact You

The IRS may collect any additional tax, interest, and penalty directly from the partnership rather than from the partners (the tax could be assessed at the highest individual tax rate).

Current partners could be responsible for tax liabilities of prior partners.

New elections and opt-outs will be available and your operating agreement may need revision to specify who makes these decisions.

There are many new tax terms and concepts that will likely require you to adjust your partnership's operating agreement.

In particular, the new term "partnership representative" replaces the prior "tax matters partner." The partnership representative is critical; they will act as the primary point of contact between the IRS and the partnership during an audit.

## New Audit Process

Under the centralized system, the audit of a partnership will occur at the partnership level. Any adjustment to items of income, gain, loss, deduction or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, will be determined at the partnership level. Also, any tax attributable to these items will be assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an ad-

justment of any item of income, gain, loss, deduction or credit of a partnership for a partnership taxable year, or to any partner's distributive share thereof, will be determined at the partnership level as well.

The IRS can now assess an entity-level tax on an imputed underpayment (generally calculated at the highest individual income tax rate) against a partnership in the adjustment year (e.g., the year a notice of the final partnership audit adjustment ("FPAA") is mailed). Therefore, under the new rules, if the audit of a partnership's 2018 return is concluded in 2020 and results in a tax assessment, the economic cost of the tax assessment will be indirectly borne by the partners in 2020, who may differ from the partners in 2018. The payment of any tax, interest, and penalties by the partnership is treated as a non-deductible payment.

## Partnership "Push Out" Election

Partnerships will have the option to elect, within 45 days of the notice of an FPAA, to pass the underpayment adjustment to the partners of the reviewed year, which will effectively shift the tax burden to those partners. The partners of the reviewed year then must re-determine their tax for the reviewed year, the year the adjustment was furnished (the "statement year"), and all intervening years (making appropriate adjustments to tax attributes) and increase these partners' tax in the statement year.

## Operating Agreement Revisions May Be Necessary

In order to address the new regime requirements, we recommend that partnership

33 Blair Park Rd.  
Williston, VT 05495

49 North Main St.  
Rutland, VT 05702

[info@dh-cpa.com](mailto:info@dh-cpa.com)  
[www.dh-cpa.com](http://www.dh-cpa.com)

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# New Partnership Audit Guidelines

agreements should be reviewed and amended as necessary to deal with some or all of the following provisions, among others, to accommodate the new rules:

- Whom to appoint as the partnership representative and procedures for his, her or its replacement;
- Appropriate indemnification provisions for the partnership representative;
- Contractual limitations of power on the partnership representative and/or notice requirements to partners with respect to all IRS (and, where applicable, state income tax) communications;
- Provisions for whether and when the partnership will pay versus the push out or elect out provisions (such as up to a specified dollar amount);
- Provisions for when the partnership should make an election to opt-out of the new regime or to push out the assessed tax liability to the partners;
- If the partnership does elected push out, the ability to contact former partners;
- How to allocate any tax liability that is imposed on the partnership;
- The ability of the partnership to obtain, upon request, certain information from its partners necessary for the partnership to modify its tax liability;
- Extending partnership indemnification obligations for period of time after the sale of a partnership interest;
- Partnerships interested in electing out may want to consider restricting the number, type of partners, and the ability of its partners to change tax status;
- The extent to which partners should be entitled to notification of partnership audit developments and the extent to which partners are permitted to influence those audits; and
- Terms and conditions for amending partnership or LLC operating agreements to address possible changes or updates to the new rules.

Given the complexity and broad scope of the rules, each partnership agreement should be reviewed and amended based on the facts and circumstances of the partnership and its partners.

## Electing Out of the New Provisions

Certain partnerships with 100 or fewer partners may elect out of the provisions. To do this, the partnership may make an annual "opt-out" election with their timely filed tax return (Form 1065). In addition, the partnership must provide the following information: name, correct taxpayer identification

number, and federal tax classification of each partner. A partnership electing out of the regime must notify each of its partners of the election within 30 days – in a manner elected by the partnership.

The IRS will need to make assessments against all of the partners in separate partner level proceedings if a partnership elects out of the centralized partnership audit regime. Thus if a partnership proceeds to make the election out, its partners should confirm that they will have sufficient access to the partnership books and records if they need to substantiate the amounts allocated by the partnership and IRS audit. Finally, if the partnership makes an election out, the applicable statute of limitations for assessment of tax will be determined at the partner level and is further determined separately for each partner.

For several reasons (including not all guidance has yet been made available) we are recommending that most partnerships elect out of the new partnership audit rules.

- Because of the transfer of individual partner discretion regarding the management of an audit to the new partnership representative,
- Because audit adjustments would be reflected in the year an audit is concluded rather than in the year being audited
- Because it is uncertain how will the states respond to the new rules
- Because any tax assessed will be done at the highest individual marginal tax rate, currently 37%.
- And finally, because operating agreements need to be revised to reflect the new provisions.

Unfortunately, not all partnerships will be eligible to elect out of the new provisions. Partnerships with individuals, C corporations and S corporations as partners are eligible to elect out, but partnerships with other partnerships or disregarded entities as partners **will not be eligible**. As a result, any partnership with even a single partner that is a disregarded entity or partnership will not be eligible to elect out.

If you would like to discuss these new partnership changes and how they may impact your entity please contact our office to schedule a strategy session.

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