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New Partnership Audit Rules – Plan Ahead Before the Tax Bill Arrives

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A new set of rules for partnership audits (New Audit Rules), which generally take effect January 2018, fundamentally alter the manner in which the Internal Revenue Service (IRS) will conduct audits of partnerships, multi-member LLCs, and certain unincorporated organizations, including joint ventures, treated as partnerships for federal income tax purposes (collectively, Partnership).

The New Audit Rules, created under the Bipartisan Budget Act of 2015 (P.L. 114-74, Act § 1101), will not only govern IRS procedures for conducting a Partnership audit but their application will also have the potential to shift the tax burden resulting from an audit among the Partnership and the partners.

Under the default rule of the New Audit Rules, if an IRS audit of the Partnership results in an increase in its taxable income — the Partnership itself will be responsible for paying the additional taxes. If there has been any change in the Partnership's ownership from the year under audit to the year the IRS assesses

the additional Partnership tax, this default rule could effectively shift the tax burden from the former partners to the current partners. Thus, in some cases, current partners could be left paying the former partners' tax bill under the New Audit Rules.

The New Audit Rules permit a Partnership to opt out of the default rule by making an affirmative election with the IRS to shift the tax liability from the Partnership to those taxpayers that were partners during the year(s) under audit. However, the discretion as to whether such an election should be made is granted to a "partnership representative," who will have the sole authority to act on behalf of the Partnership and the partners during the course of the audit.

This represents a significant change in partnership tax law that may not be contemplated in many existing LLC operating agreements or partnership, joint venture or collaborative agreements (collectively, the Partnership Agreement). As a result, any entity or individual invested in a Partnership should take steps to review the terms of the governing Partnership Agreement to determine whether the New Audit Rules are addressed, and if not, to supplement the Partnership Agreement with a plan for how the Partnership will respond to a potential IRS audit.

The failure to properly cover the New Audit Rules in a Partnership Agreement could leave an unsuspecting partner in the unfortunate position of paying a Partnership tax bill for a former partner without knowledge that the Partnership was even under audit review. Thus, it is critical for any partner invested in a Partnership to understand the function of the New Audit Rules by consulting a tax advisor; and, together with the other partners, formulating a plan for handling a possible audit.