

LLC, partnership audit primer

How to navigate the new IRS audit rules of LLCs, joint ventures and partnerships

On January 1, 2018, IRS audits under the Bipartisan Budget Act (BBA) of 2015 became effective. The new BBA rules, which replace the Tax Equity and Fiscal Responsibility Act (TEFRA) rules, significantly streamline the IRS audit and adjustment process, allowing the IRS to assess and collect underpaid taxes, penalties and interest at the partnership level as opposed to the partner level, making it much easier for the IRS to audit LLCs and Partnerships and assess and collect taxes.

Smart Business spoke with Jeffrey G. DiAmico, a member at Semanoff Ormsby Greenberg & Torchia, LLC, about the implications of the new rules, who it applies to and relief provisions.

Who do the BBA rules apply to?

The BBA applies to all partnerships — including limited liability companies that have elected to be treated as a partnership, and almost any other unincorporated joint business operation, which includes joint ventures — except for certain qualifying partnerships that affirmatively elect out of the BBA rules.

Generally, a qualifying partnership must:

- Have 100 or fewer qualifying partners.
- Have only eligible partners, which include individuals, the estate of a deceased partner, S-corporations, C-corporations or foreign entities treated as a C-corp.
- Attach an annual election statement to a timely filed tax return.

Ineligible partners include: partnerships (tiered structures), trusts (including grantor trusts) and disregarded entities (including single member LLC entities).

How could the new rules impact organizations that file as partnerships?

Under the old TEFRA rules, IRS audits

performed at the partnership level resulted in any adjustments being assessed against each partner, each of whom were entitled to participate during the audit process. These rules were an administrative nightmare for the IRS, which is presumably why it audits less than one percent of partnerships.

Under the BBA, IRS audits for the reviewed year are still at the partnership level. However, the BBA authorizes the IRS to assess any ‘imputed underpayment’ at the partnership level (generally at the highest individual rate of tax), and then to collect any underpaid taxes, penalties and interest from the partnership in the year the audit is completed (the adjustment year). If there are different partners in the adjustment year than in the review year, partners can be responsible to pay for someone else’s income tax liability. This radical outcome should be discussed and addressed through updated indemnification provisions in your partnership or operating agreement.

How will partners be notified of an audit?

Alarming, the IRS is not required to provide notice to individual partners of a partnership audit — the individual partners have no statutory right to participate in the IRS audit or any resulting appeal, or raise partner-level defenses. There will no longer be a tax matters partner. Instead, the partnership must designate a partnership



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representative (PR) for each tax year who is the only person permitted to deal with the IRS. The PR will have the sole authority to act on behalf of and bind the partnership and its partners. Accordingly, your partnership or operating agreement must be amended if you want to impose obligations upon the PR to apprise the partners of an IRS audit and provide them with additional protections.

Are there any relief provisions?

For partnerships that are subject to the BBA and cannot elect out, there are two options to mitigate the damage at the partnership level. The partnership can make a ‘push-out’ of the additional tax liability from the partnership to the partners who were owners during the reviewed year; or the partnership can seek a modification of the imputed amount by following specific rules published in the regulations. Partnership or operating agreements should be amended to include a mechanism for making such an election and obtaining partner consent.

What actions should be taken?

Thoroughly examine your ownership structure and amend your partnership or operating agreement. If you are a multimember LLC, partnership, or joint venture, contact your attorney to discuss what changes are required to your partnership or operating agreement. ●