NOW IS THE TIME TO PREPARE FOR A SEA CHANGE IN PARTNERSHIP TAX AUDITS

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For owners of limited liability companies ("LLCs") and partners in partnerships, life in a tax audit will soon change as a result of legislation that was passed at the end of 2015, specifically, Section 1101 of P.L. 114-74.

H.R.1314 - Bipartisan Budget Act of 2015

This new legislation repealed the existing partnership audit procedures under "TEFRA," which stands for the 1982 Tax Equity and Fiscal Responsibility Act. While the new audit procedures generally begin to apply to partnership tax years beginning after 2017, now is nevertheless the time for businesses taxed as partnerships, including most LLCs, and their owners to understand how they will be affected as a result of the new partnership tax audit procedures coming into effect.

Economic Impact of New Partnership Tax Audit Procedures

Under both TEFRA and the new partnership tax audit procedures, the IRS audits the partnership and requires partnership level resolution of all items of partnership income, deduction, gain, loss, or credit.

However, a **critical difference** between TEFRA and the new partnership tax audit procedures is the economics of who is responsible for the assessed tax liability.

Under TEFRA, the tax audit adjustments would flow through and be the responsibility of the individual owners during the year under audit review.

Unlike TEFRA, the new partnership tax audit procedures require the partnership itself, rather than the individual partners, to foot the bill in the year of adjustment (regardless of the year under audit review).

While at first blush that difference may not appear to be significant, it may make a huge difference economically to an individual who is an owner of the business in the year of the assessment but who was not also an owner of the business in the reviewed year.

Opt-Out May be Possible

Owners of businesses taxed as partnerships should know that there may be opportunities for the business to opt out of the new partnership tax audit procedures. If the business can and does opt out, tax audits will be conducted under pre-TEFRA rules, such that the IRS will audit partnership return items at the partner level. This means that owners of businesses that opt out should be in a position to substantiate to the IRS items of income, loss, etc. that flow through to the owners' tax returns.

Now is the Time to Plan

The bottom line is that big changes in partnership tax audits are on the horizon, making now the time for owners of businesses taxed as partnerships to understand:

- the new partnership tax audit procedures;
- circumstances under which opt-out is possible;
- if opt-out is possible, how should it be accomplished; and
- if opt-out is not possible, how owners may best protect their interests.

In the coming months, owners of businesses that are taxed as partnerships also likely need to re-negotiate existing agreements so that if and when their businesses are audited by the IRS, the path for navigating that tax audit will be clear and handled pursuant to the terms of the parties' agreement and understanding.