Industry insights

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New partnership audit regulations for professional service firms

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The IRS reissued Bipartisan Budget Act of 2015 partnership audit regulations on June 14, 2017 (the new partnership audit regime). Baker Tilly's National Tax Team issued an alert that included information about these new regulations and recommended steps that partnerships should take going into 2018, when these regulations become effective. The original alert applies to a broad range of activities operating in the partnership format. This article is intended for law firms and other similar professional service firms, which function differently from real estate partnerships or other types of investment partnerships. The new regulations create the need for changes to every partnership, LLC or LLP agreement.

Electing out of the new partnership audit regime

The regulations allow firms with 100 or fewer Schedules K-1 to elect out of the new rules. While most law firms prefer to be covered by the new rules, there are occasions where a small/mid- sized firm may choose to elect out of these rules. The election is made annually on the tax return when it is filed for the previous tax year. If the firm elects out, then rules similar to those in effect prior to this new law will apply. Each partner will be deemed to be under audit and the IRS will make adjustments that it determines necessary on each partner's individual return for the year under audit. This will require the partners to amend their state returns for each state in which they file based on partnership activity.

The new regulations create a partnership tax liability

A partnership is a flow-through entity that does not pay federal income taxes—until now. The new regulations dictate taxes resulting from partnership adjustments made pursuant to an IRS exam will be assessed against and collected from the partnership. The assessment from the reviewed year return will be made in the adjustment year and is payable with the filing of the partnership's Form 1065, U.S. Return of Partnership Income, for the adjustment year. The "reviewed year" is the year under audit. The "adjustment year" is the year in which the audit adjustments become final. The tax paid will be treated as a non-deductible expense item on the income tax return in the adjustment year. The adjustments made will be allocated to the partners on Schedule K-1 as an item of income gain, loss or deduction which is non-taxable or non-deductible but impacts partners' basis and capital accounts.

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How adjustments are treated under the new regulations

The regulations do not address how the adjustments and the tax expense will be allocated among the partners. Without regulations addressing the issue, it is prudent to provide for this in the partnership agreement. Since the nondeductible expense reduces each partner's basis and capital account, it is presumed that most firms will want to specially allocate it to the reviewed year partners based on their reviewed year distributive shares. Firms must decide if they want to charge any departed partners for their respective shares, either by withholding it from any payments still due, requesting payment from the former partner or creating a contingent holdback amount when a partner leaves, which will be paid out to them after the expiration of the statute of limitations on that year's return. If amounts are unable to be collected from departed partners, then the firm must decide if those amounts are to be allocated only to reviewed year partners, or to all adjustment year partners.

Pursuant to the regulations, taxpayer-favorable adjustments do not produce a refund to the partnership but are reported as Schedule K-1 adjustments to adjustment year partners who were also reviewed year partners. This may either be a reduction of an income item or an increase of an expense item as the case may be. If any reviewed year partner is not also an adjustment year partner, then their share of any adjustment is allocated to the departed partner's successor in interest. If the partnership cannot identify the successor in interest or if there is not one, then the adjustment is allocated to the remaining adjustment year partners according to their respective adjustment year distributive shares. No positive adjustments are allocated to any adjustment year partner unless they were also a review year partner or a successor in interest.

Push-out election

The default rules require the tax to be collected at the partnership level. Under the push-out election, the partnership representative can elect, at the conclusion of the audit, to "push-out" the imputed adjustment the "reviewed year" partners, who will pay the tax, penalties and interest. The election must be made with 45 days of the final notice of partnership adjustment. Statements must be filed with the "reviewed year" partners and the IRS to report the adjustment.

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The partnership representative

The new partnership audit regulations require partnerships to identify a partnership representative. This is different than the previous tax matters partner (TMP). ***The partnership representative has sole authority to act on the behalf of the partnership***. The partnership representative controls the IRS exam, decides whether and when to extend the statute of limitations, whether to accept a settlement and whether to agree to an adjustment. In short, every major decision related to an IRS exam is made by the partnership representative. Consultation with any of the partners is not required by statute or the new regulations. The partnership representative must raise penalty defenses regardless of whether the defense relates to the partner or the partnership. The partnership representative may be a firm. If the partnership tax return does not identify a partnership representative the:

- IRS can appoint a partnership representative for the partnership; and
- IRS's appointment is not a reviewable decision.

The appointment of the partnership representative must be made on the tax return each year and the representative does not carry over from year to year. The problem arises when a named representative for a particular tax year is no longer with the firm or available to act as the partnership representative when the audit occurs or while the audit is ongoing. The IRS has indicated that they will allow the firm to name a new partnership representative after notification of an audit.

While the IRS is not bound by any decisions discussed in the partnership agreement, partnerships are well-advised to identify a partnership representative in their operating agreements or to provide a process in the partnership agreement for appointing the partnership representative. This may not be binding on the IRS, but hopefully will give the IRS guidance as to whom it should appoint as the partnership representative.

Planning considerations:

Consider putting limitations on the acts of the partnership representative, e.g., the partnership representative cannot accept a settlement offer without first obtaining the approval of executive or management committee. While not enforceable under the regulations, these types of restrictions in the operating agreement may create a legal obligation of the partnership representative before entering into an agreement with the IRS.

Other considerations

As states evaluate the impact of the new federal audit rules, there are several issues to consider. First, each state will determine whether it will conform to the federal rules, so it is likely there will be multiple adaptations of these rules at the state level.

Second, the IRS will increase its information sharing with the states, but only with the state listed in the taxpayer address on the federal return. Consequently, it is unclear how additional states in which the partnership files will obtain audit changes made to its returns.

Third, it may be necessary to have a different partnership representative for each state that may also be different from the federal partnership representative. As a result, the terms and definitions of the partnership representative may become even more complex if the partnership operates in multiple states.

Fourth, the process to make adjustments may vary by state. Certain states may require amendment of prior-year returns while others may allow current-year adjustments, and others may require a push-out of adjustments to the partners.

Other areas of consideration include: type and year of any state apportionment changes, apportionment versus allocation of audit adjustments and the impact to nonresident withholding requirements.

Conclusion

Partnerships are well-advised to consider the changes imposed by the new audit regulations, and review and make changes to operating and other agreements as soon as possible. Do not wait until the firm is audited to get your partnership agreements modified. Let all partners know the rules of the game that apply under these new rules. Current and prospective partners will want to know exactly how partnerships plan to address the new rules. Take note, even the smallest partnerships should at least amend their partnership agreements to identify the partnership representative.

For more information on this topic, or to learn how Baker Tilly specialists can help, contact our team.