SPECIAL ISSUE

brief

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Understanding the New IRS Partnership Audit Rules

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AMERICAN SENIORS HOUSING ASSOCIATION
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Understanding the New IRS Partnership Audit Rules

Although tax reform has been a topic of every business and personal conversation and fodder for endless stories in the media since the beginning of the year, there is something important that ASHA members need to know and it has nothing to do with tax reform. New rules were issued which completely change how partnerships will be audited by the IRS. These rules, known as the Consolidated Partnership Audit Regime (CPAR) are effective for partnership tax years beginning January 1, 2018.

WHY CPAR?

The purpose of CPAR is to streamline the audit of partnership returns. Under CPAR, these audits will be completed at the partnership level with adjustments calculated and paid at the partnership level. This is a dramatic shift from the past where the IRS would determine an audit adjustment and how the adjustment should be allocated to all the partners. The IRS would then go to each partner to assess any increase in tax, considering each partner's tax situation (rates, NOLs, passive loss carryforwards, etc.). In tiered partnerships, or partnerships with many partners, the old rules were cumbersome and resulted in a low percentage of partnerships being audited. Now, the IRS can make an adjustment, calculate the tax and make the assessment - all at the partnership level. Not surprisingly, it is expected that the percentage of partnerships being audited will increase substantially under CPAR.

HIGHLIGHTS OF CPAR

Partnership Representative

Under CPAR the partnership must designate a "partner representative," which is like the old "tax matters partner" but with much more authority. The partnership representative has the authority to bind the partnership, regardless of state law.

In addition, the partnership representative is not required to inform the partners of audit proceedings. If the partnership representative is an entity rather than an individual, the partnership must also designate a “designated individual”. The partnership representative and designated individual do not have to be partners in the partnership.

It is important to designate a qualified partnership representative and designated individual. If you do not, the IRS will select one for you!

Audit Adjustments

Let’s assume that the IRS audits your partnership and determines an understatement of income for the year being audited. The IRS will then assess a partnership level tax assuming the highest rate in effect for the reviewed year. Under these general rules, each partner’s separate tax attributes are not considered. For example, partners may have passive loss carryforwards that could offset the additional income. They may have NOLs, or carryforward losses from basis limitations. It is likely that some partners have tax rates lower than the highest individual rate. Under the general rules of CPAR, none of this is accounted for. A partnership with non-profit partners can demonstrate that a lower rate would apply and the tax will be reduced.

Mitigating the Impact

There are a few options which may mitigate the impact of CPAR.

1. **Elect out of CPAR**

   Some partnerships may elect out of the CPAR. However, based on my experience, very few entities will qualify. If you can elect out, you fall under the old rules where the assessments are made at the partner level rather than at the partnership level.

   Only eligible entities may elect out of CPAR. An eligible entity is a partnership with 100 or fewer K-1s (includes underlying S corporation owners), and the owners can only be individuals, deceased partner’s estates, C corporations, S corporations, and foreign “per se” corporations.

   If the partner group for the year includes any of the following, the partnership cannot elect out of CPAR: trusts (including grantor trusts), partnerships, disregarded entities (single member LLCs), nominees or other types of estates. It should also be noted that married couples are counted as two members. Tax exempt partners look not to their tax status, but their organizational status.

2. Partners amend tax returns for the imputed underpayment

Partners may amend their separate tax returns, taking into account the adjustments and paying the tax due for all affected years. Amended returns can only be filed if the period of limitations has not expired for the year at issue.

3. "Push out"

The partnership may elect to force the partners who were partners in the year under review to report the audit adjustment at the partner level by furnishing to each partner a statement showing their share of the adjustment. This election must be filed within 45 days of the date the "Notice of Final Partnership Adjustment" is mailed. There are no extensions available. With a "push out" election the partnership is no longer liable for the payment of tax.

I believe that most partnerships will want to elect out of CPAR if possible. However, if your partnership is like ones I work with, very few are eligible. I found that only 2% of partnership clients I work with were eligible to elect out of CPAR.

PARTNERSHIP AMENDMENTS

Over the course of 2018, partnership agreements should be reviewed and updated to account for all the aspects of CPAR. You will want to consider the following questions/issues with your attorney:

- Should the partnership agreement name a partnership representative?
- Do you want to bind the partnership representative to the other partners through an indemnification clause?
- What permissions do the partners want to confer on the partnership representative?
- What elections should be made and when?
- What portion of the partners must approve the IRS settlement (technically none in the eyes of the IRS)?
- When does the partnership require the partners to amend their tax returns?
- When can the partnership elect to "push out" imputed underpayments?
- If an IRS audit occurs and there is an imputed adjustment, the partnership should know how the partnership representative handles the distributions (for current & past partners). Are distributions reduced by payments of tax? Do former partners need to reimburse the partnership for their share of the tax?
- If possible, you may also want to consider restructuring to meet the elect-out provisions for an eligible entity.

THE BOTTOM LINE

The implications of these new rules can have a significant impact on partners. Now is the time to make sure the partnership agreement is in alignment with what the partners want and need, considering future changes to the partnership itself and its respective partners.

If you have not already done so, talk with your CPA and attorney to make sure you understand the CPAR and its impact to your partnerships.

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ABOUT THE AUTHOR

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