NEW PARTNERSHIP AUDIT RULES AFFECT MANY FAMILY PARTNERSHIPS

By **Helen Rogers**

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The use of partnerships in estate and wealth transfer planning can provide a number of benefits, such as the consolidation of investment assets, centralized control over those assets, increased creditor protection, a mechanism for management succession and valuation discounts.

Entities taxed as partnerships are "pass-through" entities, meaning that they do not pay federal income taxes themselves. Instead, partnerships pass their items of income and loss through to their partners, who report those items on their individual tax returns and pay income tax at their individual rates. Until Jan. 1, 2018, the tax law provided that if a partnership were audited and the IRS determined that the partnership underreported its income — which would result in the partners underpaying their income taxes — then the IRS would collect the unpaid income tax from the partners of the partnership. The IRS would not look to the partnership itself to pay any unpaid tax liability on their 2020 tax returns.

As of Jan. 1, 2018, the rules regarding audits of partnerships, and the payment of resulting tax liabilities, have changed. The new partnership audit rules provide that if a partnership is audited and the IRS determines that the partnership underreported its income, then the IRS will collect the unpaid income tax from the partnership itself, instead of the individual partners. Alternatively, the partnership can elect to "push out" the income tax liability to the partners who were partners during the year for which the partnership was audited. For example, under the new partnership audit rules, if a partnership's 2018 tax filings are audited in 2020 and the IRS determines that the partnership had an income tax liability for year 2018, then the partnership would pay that liability in 2020, and the partners as of 2020 would bear the economic cost of that liability. If, instead, the partnership elected to push out that liability, then the individuals or entities that were partners in 2018 would pay the tax liability.

An election to push an income tax liability out to the partners of a partnership must be made by a "partnership representative" chosen in the partnership's partnership agreement or in accordance with the partnership's partnership agreement. The partnership representative has significant power in the event of an audit. Not only is the partnership representative the person entitled to elect whether to push out income tax liabilities, but the partnership representative is also responsible for communicating with the IRS and making decisions for the partnership about the audit process, including decisions regarding whether and when to extend the statute of limitations, whether to accept a settlement, and whether to agree to an adjustment. If a partnership agreement does not identify a partnership representative or a method for appointing a partnership representative, then the IRS can appoint a partnership representative, and the IRS's appointment is final.

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Certain partnerships can elect out of the new partnership audit rules. In order to be eligible to elect out, a partnership must have 100 or fewer partners, all of which are (1) individuals, (2) corporations or (3) estates of deceased partners. Note that single-member disregarded entities are not considered partnerships and are not subject to the new partnership audit rules.

Many family partnerships will not be eligible to elect out of the new partnership audit rules. If a partnership has any partner that is a disregarded entity — such as a single-member LLC, a revocable trust or an irrevocable grantor trust — or a partnership, then the partnership cannot elect out.

Families who own partnerships should consider amending their partnership agreements to address the new partnership audit rules as follows:

- Appointing a partnership representative or determining a method for appointing a partnership representative.
- Limiting the partnership representative's authority, such as requiring a partnership representative to obtain the approval of a certain percentage of the partners before taking any action in an audit and before making a push out election. Note that making a push out election can have significant economic impacts on partners, and not all partners may agree on whether a push out election is beneficial.
- Requiring a push out election to protect newer partners — often of a younger generation.

Families who own partnerships should also consult with their tax advisers to determine whether and how they can elect out of the new partnership audit rules entirely.

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