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This is About Tax – But You Really Should Read This One –IRS Can Now Collect Partners' Taxes on Audit Directly from Partnerships

Legislation passed on November 2, 2015 will give the IRS the power to collect taxes directly from partnerships that result from an audit of the partnership's tax return.

What this means – to make it super simple – is if a partnership has a tax liability as a result of an audit, the partnership will be responsible for paying off that tax liability to the IRS. This will reduce the cash available to distribute to its partners. Depending on the terms of the partnership agreement, this could cause one partner to bear the burden of another partner's tax.

To be clear – this is <u>not</u> joint and several liability; however, the IRS effectively has a lien on the partnership that comes ahead of any distributions that would be made to the partners. Also, this tax is only imposed in cases where the IRS has decided to audit the partnership's tax return and found out it misreported its taxable income. Under the old rules, the IRS would have to try and collect any additional tax owed from each partner individually. Now they can just asses the tax against the partnership and leave it up to the entity to try and figure out who owes what.

This is important news in the real estate world. Forever, partnerships have been so-called "pass-through" entities, meaning they are not taxable directly. Instead, each partner is subject to tax on its share of the partnership's income. That is now no longer the case when it comes to audit adjustments. Here are highlights…..

First – this applies not only to partnerships, but also to LLCs that are treated as partnerships for tax purposes. All references here to "partnerships" include LLCs (other than LLCs that only have a single member or elect to be taxed as a corporation).

Second – the partnership will be required to designate a single "partnership representative" (similar to a tax matters partner) who will control the audit process on behalf of the partnership and the other partners.

Third – the rules do not take effect until 2018; however, they will apply to partnerships in existence now.

Fourth – so we don't all overreact, it is important to emphasize that this will only apply in a situation in which the audit shows that the tax return filed is incorrect or the IRS disagrees with how the partnership is reporting its taxable income.

Fifth – when these rules take effect, the IRS will be able to send a tax bill directly to the partnership for any tax resulting from an audit of a partner in a prior year. This means that the current partners will effectively bear that tax, even if they did not own an interest in the partnership in the year that was audited.

Sixth – a minor corollary point is that even if the partnership doesn't actually end up owing tax, the partnership will be stuck with the expense, and hassles, of dealing with the IRS to resolve the audit, unless it elects out as described below.

Seventh – an important exception will allow a partnership to shift the tax liability back on to its partners for the audit year by sending a notice to those partners and the IRS that identifies each partner's share of the adjustment. Those partners would then be required to take the adjustments into account on an amended return. This means a partnership can effectively opt out; however, it will have reporting obligations to effectuate this.

Eighth – partnerships with fewer than 100 partners can elect out of these new rules, but only if all of the partners are individuals, estates, or corporations. Unfortunately, if a partnership has another partnership as a partner, it cannot elect out. So this election will not be available to tiered partnership arrangements unless the IRS issues regulations expanding the availability of this election.

Ninth – there are no regulations yet. When regulations are issued they may make things better or worse.

Now – to cut to the chase as to what this means:

1. All new partnership agreements should have provisions added to deal with the issues posed herein. These will include possible indemnification obligations for non-payment of tax to the extent other partners are adversely affected, increased scrutiny on who the accountants are, possibly greater

requirements for audited financial statements, reporting obligations of the partnership, clear withholding provisions and others.

2. Partnership agreements should either designate a partnership representative or provide authority to designate a representative. Partners will need to decide the extent to which a partnership representative will take direction from other partners or involve them in the audit process.
3. All lenders to partnerships should have provisions in their loan documents that deal with these issues. The IRS's tax lien will be inferior to secured debt; however, it will impair the single-purpose nature of borrowers, for example.
4. Any party acquiring a partnership interest in an existing partnership will need to assess the risk of a future partnership-level tax liability, including the need for more extensive representations and expanded indemnities upon the purchase of a partnership interest.
5. Partners in existing partnerships will need to be mindful of these issues. They may – or may not – have the power to amend their partnership agreements; however, they will need to be vigilant to make sure these issues do not adversely affect them.

Our tax group is closely monitoring this legislation and future developments. Notably, Stephen Land, who heads our tax group, will become Chair of the Tax Section of the New York State Bar Association in January. In this capacity, he will be spearheading commentary and working with Tax Section members to draft a report to the Treasury Department pertaining to the development of this legislation. The Treasury Department and IRS value and rely on these reports when drafting or amending regulations. Our tax team will therefore be as close to these issues as any tax lawyers can be.

If you have any questions about these rules or are concerned about how they may affect your partnership arrangements, please reach out to:

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