New Partnership Tax Audit and Collection Rules Impact Divorce Property Settlements

BY
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Introduction. Family lawyers deal with property settlements often involving interests in partnerships or limited liability companies ("**LLC**"). Sometimes all of the partnership/LLC interest is awarded to one spouse; sometimes the partnership/LLC interest is awarded in some portion to each spouse. Up until this year (2018), the tax consequences of the division of the partnership/LLC interest were pretty much straight forward: tax liabilities arising out of the partnership/LLC for post-divorce years were the responsibility of the spouse owning the partnership/LLC interest; tax liabilities arising out of the partnership/LLC for pre-divorce years were the responsibility of whichever spouse the property settlement agreement stated was liable. Beginning for tax year 2018 and forward, those straight forward rules just got discarded as applied to IRS tax audits of a partnership or LLC.

Since family lawyers tend to shy away from anything having to do with taxes, the purpose of this article is to present a comprehensible overview of the very complex and developing new Internal Revenue Service ("**IRS**") rules relating to tax liabilities arising out of an IRS audit of a partnership or LLC for tax years beginning in 2018 and thereafter. For purposes of this article, references to "partnership" means a partnership, a LLC, or any arrangement taxed as a partnership for federal income tax purposes. An example of how these new tax audit rules might affect property settlements is set out toward the end of this article.

Prior Tax Audit Rules. For decades, partnerships have not been subject to federal income tax. Rather, the income, gains, losses, deductions and credits ("**Tax Items**") have been allocated to the partners in accordance with their respective percentage interests, and the partners have paid federal income tax based on their share of the partnership's Tax Items. If the IRS audited the partnership and determined that there was an income tax deficiency allocable to the partnership, the income tax deficiency was taken into account by the persons who were partners of the partnership in the year audited, who paid the tax based on their share of the tax deficiency. In 1982, Congress adopted what is known as TEFRA, which allowed the IRS to conduct the audit at the partnership level and impose the tax resulting from the audit at the partner level on those persons who were partners during the year audited by the IRS.

New Tax Audit Rules. In 2015, Congress adopted Section 1101 of the Bipartisan Budget Act of 2015 ("**BBA**") that adopted a new centralized partnership audit regime ("**Audit Regime**") that generally assesses and collects tax at the partnership level, not the partner level, resulting from an audit of the partnership. This new Audit Regime, set out in Sections 6221 to 6241 of the Internal Revenue Code, commences with partnership tax years beginning in 2018. Partnership tax years prior to 2018 are governed by the old audit rules. Partnership tax years beginning in 2018 are governed by the new audit rules. The new Audit Regime applies to any entity taxed as a partnership for federal income tax purposes. Thus, entities formed and taxed as partnerships are subject to the Audit Regime, as well as joint ventures and limited liability companies taxed as partnerships. In addition, arrangements that were not intended by the owners to be

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partnerships for federal income tax purposes will be subject to the new Audit Regime if the IRS decides the arrangement is a partnership for federal income tax purposes. However, entities formed under state law as a partnership or limited liability company but that are disregarded for federal income tax purposes will not be subject to the new Audit Regime since the disregarded entity does not file a partnership tax return. As of the date of this article, the IRS has issued Proposed Regulations on June 14, 2017, November 30, 2017, and December 19, 2017, and final Regulations on January 2, 2018, dealing with the "opt-out" election discussed below.

The Audit Regime imposes, with certain exceptions discussed below, on the partnership the resulting tax from an IRS audit of the partnership and it is the partnership, and not the partners, that is required to pay the tax (including interest and penalties). Generally, the partnership pays the tax in the year in which the IRS adjustments are finally determined by the IRS or through judicial proceedings (the "**Adjustment Year**"). Thus, the persons that were partners during the prior year that is the subject of the IRS audit (the "**Reviewed Year**") do not bear, directly or indirectly, the resulting tax. Rather, the persons who are partners in the later Adjustment Year bear the economic consequences of the tax paid by the partnership even though the tax relates to an adjustment of Tax Items for a prior tax year.

Two Elections.

Opt-Out Election.

The Audit Regime contains two (2) elections that can be made by the partnership to alter the general rules of this new Audit Regime. The first election is an "opt-out" election that allows the partnership, under certain limited conditions, to elect out of the new Audit Regime. If the partnership elects out of this new Audit Regime, then any audit of the partnership is conducted at the partner level and any resulting adjustment of Tax Items and tax is assessed against the persons who were the partners during the year that was audited (ie, the Reviewed Year). While this opt-out election seemingly is a convenient way to put the economic consequences of an audit back on the persons who were the partners during the year audited, the conditions under which a partnership can make the opt-out election are severely limited and may not apply in reality to many partnerships.

- First, the opt-out election has to be made by the partnership on a timely filed partnership federal return for the year in which an election is to be made.
- Second, the partnership can have no more than one hundred (100) partners, which is measured by the number of Schedule K-1 forms issued by the partnership for the year in which the opt-out election is to be made. However, if one (1) of the partners is an S corporation, the number of Schedule K-1 forms issued by the S corporation to its shareholders is included for purposes of determining the one hundred (100) partner rule.
- Third, a partnership can opt-out of the new Audit Regime only if its partners during the year for which the election is to be made consisted solely of the following: individuals, C corporations, S corporations, foreign entities that would be treated as domestic corporations for federal income tax purposes and estates of deceased individuals. Thus, partnerships that have at any time during a taxable year for which the election is to be made a partner who is not one of the permitted partners cannot make the opt-out election. Ineligible partners include a partnership, a trust, a disregarded entity, the estate of an individual other than a deceased individual or any person that holds an interest in a partnership on behalf of another person.

Push-Out Election.

The second election that a partnership can make to alter the general rules of the Audit Regime is to "push-out" IRS audit adjustments of a Reviewed Year to the persons who were the partners during the Reviewed Year. If this election is timely made, the economic burden of the IRS audit of the Reviewed Year is borne directly by the persons who were the partners during

the Reviewed Year and the partnership is not liable for the tax due under the audit. While there is no restriction on the identity or number of partners, the partnership must make this election within forty five (45) days after the IRS sends the partnership what is called the Notice of Final Partnership Adjustment ("**FPA**"). While the tax burden is shifted back to the persons who were partners during the Reviewed Year, those same persons did not have, and do not have, the right to participate in the IRS audit and have no voice with the IRS in that process. Thus, all decisions made by the partnership relating to the audit are binding on all the partners, including the Reviewed Year partners. In addition, the additional tax owed by the Reviewed Year Partners is computed by taking the IRS audit adjustments into account for the Reviewed Year but is reported by the Reviewed Year Partners on their tax returns for the year the push-out election is made and is paid with the tax return for such year (which is a year after the Reviewed Year).

Modification. The Audit Regime also contains a provision allowing a partnership to reduce all or a portion of the partnership's liability for the tax resulting from the audit through a procedure referred to as the Modification Procedure. Under this Procedure elected by a partnership, the Reviewed Year partner files an amended return with the IRS that takes into account that partner's respective share of the IRS proposed tax adjustments and that partner pays the resulting tax, thus reducing the tax liability of the partnership. Unlike the push-out election, this Modification Procedure is voluntary and the Reviewed Year partners are not required to file an amended return under the statute, but the partnership agreement could require the Reviewed Year partners to do so. In addition, if this Modification Procedure is utilized and the Reviewed Year partner files an amended return, that partner must make any corresponding adjustments in years subsequent to the Reviewed Year taking into account the effects of the adjustments in a subsequent year arising out of the IRS audit of the partnership for the Reviewed Year.

Ceased to Exist. The new Audit Regime also has a unique provision that applies if the partnership "ceased to exist," which is defined as including not only dissolution but also the inability of the partnership to pay (as determined by the IRS) the tax liability arising from the tax audit. In this case, the Audit Regime allows the IRS to assess and collect the tax from the persons who were partners in the Adjustment Year or during the last year the partnership filed a tax return. This provision, which can be applied through tiered partnerships, is an example of the new powers of the IRS to collect the tax resulting from an audit from partners despite the dissolution of the partnership or an insolvent partnership.

Amended Partnership Return. The new Audit Regime also has unique rules for the voluntary filing of an amended partnership return, which is referred to as an Administrative Adjustment Request ("**AAR**"). Under these rules, a partnership may file an AAR for one or more Tax Items applicable to a prior year, i.e., the Reviewed Year. However, the new Audit Regime requires the partnership to take into account the tax adjustment in the later taxable year in which the AAR is filed, which for this purpose is referred to as the Adjustment Year. If the tax adjustments results in less tax owed (i.e., refund of tax), the partners during the prior year to which the AAR relates, i.e., the Reviewed Year, are required to take into account the tax adjustments in the Reviewed Year. Conversely, if the tax adjustments results in additional tax due, the Adjustment Year partners are required to take into account the tax adjustments in the Adjustment Year unless the partnership elects to "push out" the tax adjustments to the partners of the prior Reviewed Year.

Partnership Representative. Under the new Audit Regime, the partnership must designate one (1) person, who is referred to as the Partnership Representative, to deal with the IRS in the audit. The partnership makes this designation on the partnership return and the designation must be made for each tax year. After an IRS audit begins, the Partnership Representative has the sole and exclusive authority to deal with the IRS. Thus, the Partnership Representative

makes all decisions and takes all actions and makes all elections arising out of and related to the audit of the partnership and any resulting judicial proceedings available under the new Audit Regime. Unlike the TEFRA rules, the new Audit Regime rules do not provide or even require that the Partnership Representative give notice of the audit to any person who was or is a partner of the partnership being audited.

Analysis of Partnership Agreements. As a result of the new Audit Regime, partnership agreements will need to be analyzed to determine how these new rules are addressed in the partnership agreement and how that agreement sets out the duties, obligations and liabilities of the persons who are partners during the Reviewed Year and the Adjustment Year. In many partnerships, the identity of the persons in the Reviewed Year and the Adjustment Year will change. Moreover, because persons who were partners during the earlier Reviewed Year may not be partners in the later Adjustment Year, or may own a different percentage interest in the partnership during those periods, the economic consequences of the IRS audit and resulting tax are shifted and are not borne in the same proportion as the partnership interest percentage in the Reviewed Year. For this reason, partnership agreements will need to be reviewed to determine how the economic consequences of the partnership audit and resulting tax will be borne by the persons who were partners during each period of time, whether one group of partners will be required to indemnify another group of partners or the partnership, whether the partnership can require partners during the Reviewed Year to file amended returns and whether partners will be required to contribute to the partnership additional funds to cover any additional tax, penalty, and interest required to be paid by the partnership resulting from the audit.

Partnership agreements also will need to be reviewed to determine the authority of the Partnership Representative and whether the Partnership Representative has to receive the approval of partners (and then which set of partners – Reviewed Year or Adjustment Year or both) for any action or election that the Partnership Representative intends to take, including any obligation of the Partnership Representative to notify the partners of the commencement of an audit and to keep the partners informed of the status of the audit and any judicial action.

Divorce Instruments. The new Audit Regime rules will require careful drafting and scrutiny of property settlement agreements and divorce decrees ("**Divorce Instruments**"). Generally, Divorce Instruments contain provisions that make one or both spouses responsible for federal income tax liabilities incurred prior to the divorce. Moreover, Divorce Instruments typically contain indemnity provisions in which one spouse is required to indemnify the other spouse for the payment of tax liabilities that are the agreed responsibility of the indemnifying spouse. Because the new Audit Regime rules can be manipulated to impose the tax or economic consequences of the tax on the partners during either the pre-divorce Reviewed Year or the post-divorce Adjustment Year, the intent of the parties must be clear as to which party bears the consequences of an IRS audit of the partnership and the Divorce Instruments must clearly set out the obligations and indemnities of the parties resulting from an IRS tax audit of a partnership in which an interest is owned on the date of divorce. If the tax liability is "pushed out" by the partnership to the partners in the Reviewed Year, one or both spouses may be liable for the resulting tax under the terms of the Divorce Instruments. However, if the tax liability is to be paid by the partnership in the Adjustment Year, neither spouse is personally liable for, or required to pay, the tax but the spouse holding the partnership interest in the Adjustment Year will bear the economic consequence of the partnership paying the tax and may even have to contribute cash to the partnership to pay the tax. In addition, the Divorce Instruments may need to include terms addressing the provisions of the partnership agreement dealing with the new Audit Regime rules, including how an IRS audit of the partnership is to be handled by the partnership and the Partnership Representative. The Divorce Instruments should also address whether the spouse

awarded the partnership interest can consent to actions affecting the other spouse without the other spouse's consent.

Texas Family Law Practice Manual. The Texas Family Law Practice Manual has suggested provisions for addressing taxes in both the form "Final Decree of Divorce" and the form "Agreement Incident to Divorce." One provision dealing with pre-divorce years provides that either one or both of the parties will be solely or equally "responsible for all federal income tax liabilities of the parties from the date of marriage through December 31, ____," with obligations to pay and to indemnify.

Example.

It is not clear how the above Practice Manual provision would apply under the new Audit Regime. For example, assume SF and SM are divorced in the year 2021 after 20 years of marriage and one of the assets is a 40% community property interest in P partnership, which was owned in the name of SF since 2016. The Divorce Instruments award all of the 40% interest to SF but states that SM is responsible for all federal income tax liabilities of the parties from the date of marriage through December 31, 2020. In the year 2022, the IRS commences and concludes a tax audit of the partnership for the year 2019 and proposes Tax Item adjustments resulting in a tax deficiency of $200,000, of which SF's share is 40% or $80,000.

Suppose the partnership elects in the year 2023 to "push out" the tax liability of $200,000 to the persons who were partners during the tax audit year 2019 and the portion of the tax liability allocable to SF is $80,000. Here, it would seem that the $80,000 is a "tax liability of the parties" for which SM is required to pay and indemnify SF since the tax is computed by reference to the tax return of the parties for the pre-divorce year 2019. However, because the additional tax of $80,000 is reported on the 2023 tax return and paid in 2024, it is not clear if the additional tax is to be reported by SF only since the interest in P was in the name of SF or one-half by each of SF and SM since the interest in P was community property in 2019. Thus, since the additional tax is reported on the 2023 tax return of either SF (or possibly one-half by each of SF and SM), further uncertainty arises as to whether SF or SM, or both, are liable for this additional tax and whether this additional tax is subject to the indemnification under the Divorce Instruments.

If, however, under the above example the partnership did not "push out" the tax liability to the persons who were partners during 2019 but instead the partnership remained liable for the tax, it seems clear that the tax language of the Practice Manual would not cover this situation since the tax liability is the obligation of the partnership and not the partners. However, if the partnership is liable for the tax but insolvent, the "ceased to exist" provision could be used by the IRS to collect the tax from SF in 2022, in which event it is not clear if the tax provision in the Practice Manual would apply since the tax liability asserted against SF in 2022 may not be a "tax liability of the parties" during a year prior to the year of divorce in 2021. Likewise, if the partnership makes a capital call on the partners in 2022 to pay the tax required to be paid by the partnership, the tax language of the Practice Manual would not apply. In either event, SF would bear the economic consequences, which may not be consistent with the intent of the parties.

Suppose further under this example the partnership elects the Modification Procedure, which requires SF to file an amended return for the Reviewed Year reporting that partner's share of the adjustment and paying the resulting share of the tax. The complication in this scenario is the amended return for the Reviewed Year must be signed by the parties who signed the original tax return for the Reviewed Year. If a joint tax return was filed for the Reviewed Year and SM refuses to sign the amended return, the Modification Procedure cannot be utilized by SF. Furthermore, if the partnership agreement obligates SF to file an amended return, SF would be in breach of the partnership agreement. The resulting issue then is who among SF and SM is liable for the damages arising out of the breach of the partnership agreement.

Conclusion. The new Audit Regime significantly changes the obligations and liabilities of the parties to the Divorce Instruments with respect to the partnership interest and the economic consequences of an IRS audit of a partnership with the result that what should have been a pre-divorce year tax liability of the parties turns out to be a post-divorce year tax liability of the partnership arising out of an IRS audit of a pre-divorce year of the partnership. If the parties want the economic consequences of the audit and the related obligations and liabilities to be what they would have been before the application of the new Audit Regime, the tax section of Divorce Instruments will need to be drafted carefully to achieve that result as the tax language in the present Family Law Practice Manual does not address fully these issues. If the parties are willing to "let the chips fall as they may," the present tax language in the Practice Manual can remain. In either event, the divorcing parties need to be made aware of this potential shifting of the property division economics and of the tax liabilities arising out of an interest in a partnership/LLC that is audited by the IRS.