New IRS Tax Audit Rules and Divorce Agreements

BY CHARLES D. PULMAN AND MATTHEW L. ROBERTS

Divorce property settlement agreements often involve interests (partnership interests) in partnerships or limited liability companies (LLC). Sometimes all of the partnership interest is awarded to one spouse; sometimes the partnership interest is awarded in some portion to each spouse. Prior to 2018, the tax consequences of the division of a partnership interest for post- and pre-divorce years were straight forward: tax liabilities arising out of such partnership interest for post-divorce years were the responsibility of the spouse owning the partnership interest during the post-divorce year; tax liabilities arising out of such partnership interest for pre-divorce years were the responsibility of whichever spouse the property settlement agreement stated was liable for pre-divorce year taxes. Beginning in 2018, these straight-forward rules no longer apply.

New Audit Regime

The new IRS rules (Audit Regime) apply to a tax audit of an entity taxed as a partnership for federal income tax purposes, including joint ventures and LLCs taxed as partnerships. The Audit Regime does not apply to entities that are disregarded for federal income tax purposes. These new IRS rules are complex and subject to IRS Regulations that are not final and are still being issued by the IRS.

Prior to 2018, the IRS conducted a partnership audit at the partnership level and imposed the resulting tax on the persons who were partners in the year that was audited (Audit Year). Under the new Audit Regime, the IRS conducts a partnership-level audit and assesses and collects the resulting tax from the audited partnership in the year the audit is final. Thus, under the new Audit Regime, the economic burden of the tax is borne by the persons who are partners in the year the partnership pays the tax and is not borne by the persons who were the partners in the earlier year that was audited.

There are certain elections (not discussed here) that the partnership can make to shift the tax resulting from the IRS audit back to the Audit Year partners.

The new Audit Regime requires careful drafting of property settlement agreements and divorce decrees (Divorce Instruments) to address the shifting of tax liabilities resulting from the partnership audit of a pre-divorce year, and the economic consequences of the tax, from a pre-divorce year to a post-divorce year. Generally, Divorce Instruments contain provisions that make one or both spouses responsible for federal income tax liabilities incurred prior to the year of divorce. Divorce Instruments also typically contain indemnity provisions where one spouse indemnifies the other spouse for the payment of pre-divorce tax liabilities. Because the new Audit Regime generally imposes the tax on the partnership, with the economic consequences of the tax falling on the partners during year the tax is paid, the intent of the parties, and the Divorce Instruments, must be clear as to which party bears the consequences of an IRS audit of the partnership for a pre-divorce year.

Example

Assume SF and SM are divorced in the year 2021 and one of the assets is a 40 percent community property interest in P partnership. The Divorce Instruments award the 40 percent 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. The IRS concludes in 2022 a tax audit of P for 2019 and proposes adjustments to the partnership return, resulting in a tax deficiency of $200,000, of which SF's share is $80,000.

P pays the tax in 2022. It is not clear whether the tax is a pre- or post- divorce year tax. At first blush, it would seem that the $80,000 is a "tax liability of the parties" which SM is required to pay and indemnify SF since the tax relates to the tax return of the parties for pre-divorce year 2019. However, the $80,000 may be a post-divorce year tax because the tax is assessed against the partnership, and not SF, in a post-divorce year. In the latter case, SF will bear the economic consequence of the tax paid by P, which is exactly opposite of what the result would have been if the audit year had been in 2017 (a pre-Audit Regime year).

Conclusion

The New Audit Regime significantly changes the obligations and liabilities of the parties with respect to the economic consequences of an IRS audit of the partnership. If the parties want the economic consequences of the audit and related obligations and liabilities to be what they would have been prior to 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 customary tax language in Divorce Instruments do not address these new issues. **HN**

Charles D. Pulman and Matthew L. Roberts are attorneys with Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP. They can be reached at cpulman@meadowscollier.com and mroberts@meadowscollier.com, respectively.

Tuesday, September 11, Noon at Belo

Joseph Crespiono,
Professor of History at Emory University,
discusses his book:
"Atticus Finch: The Biography"

MCLE 1.00

Sponsored by the Business Litigation, Corporate Counsel, TIPS, and Trial Skills Sections