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A review of changes to IRS audits of tax partnerships in dentistry

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THE US CONGRESS AND THE INTERNAL REVENUE SERVICE (IRS) continue to bring forward new tax developments. If you are a recipient of a Schedule K-1 from a limited liability company (LLC) or another entity that files a partnership tax return (IRS Form 1065), you need to be up to speed on the new IRS partnership audit regime. You would be well advised to prepare proactively for the contingency of a potential IRS partnership audit.

PARTNERSHIP TAX CLASSIFICATION

Keep in mind that receiving Schedule K-1 does not mean that you are a partner in a tax partnership, because S corporations also issue these to their shareholders. Hence, first, you need to be sure that the LLC or other entity issuing your Schedule K-1 is classified as a tax partnership for federal tax purposes.

Many dental LLCs and other entities with multiple owners (particularly those that own real estate) choose the tax partnership classification, given the generous tax benefits it offers. Some multidocor and multioffice dental practices tend to be structured as tax partnerships or may include a tax partnership in the overall ownership structure.

LEGISLATIVE AND COMPLIANCE TAX CHANGES

Historically, tax partnerships have seen less scrutiny on the IRS audit front. Recent developments in tax legislation and more detailed tax reporting to the IRS have facilitated greater transparency in this area. These changes have also enabled and empowered the IRS to streamline its audit procedures and enforcement where tax partnerships are concerned.

Further, the IRS has implemented the Global High-Wealth Program with a sole emphasis on high-income individuals and the business entities connected to these individuals, which frequently include partnerships. This year, President Biden is seeking to allocate a budget of approximately \$80 billion

to the IRS specifically for audits and technology upgrades for use in the next 10 years.

As a result, the IRS has been refocusing its audit efforts on tax partnerships.

NEW CENTRALIZED IRS PARTNERSHIP AUDIT REGIME

The new IRS partnership audit regime applies to tax years beginning on or after January 1, 2018. Unless a partnership takes additional steps, by default, tax deficiencies—additional tax, penalties, and interest—are imposed directly on the partnership rather than its partners. Practically, the new IRS audit regime for partnerships has been centralized. This is a significant distinction from the workings of the prior regime (the Tax Equity and Fiscal Responsibility Act of 1982, or TEFRA). Under the prior regime, tax deficiencies were imposed directly on the partners, and the partners were responsible for the payment of any additional tax, penalties, and interest associated with the partnership's affairs.

Unless a partnership is eligible and

requests to modify the applicable tax rate, the new regime applies the highest individual and corporate rates to any additional tax deemed to be due.

ELECTING OUT

Also by default, this regime applies to *all* entities taxed as partnerships (IRS Form 1065 filers). This general rule has an exception for eligible tax partnerships. A partnership that is eligible to elect out and actually makes a valid election out of the new regime would not be subject to the regime for a specific tax year. Of course, electing out is neither permanent nor applicable to all future years, as a partnership's eligibility may change from one tax year to another. Rather, partnerships must elect out on an annual basis. The election out of the regime is made on a timely filed partnership tax return (IRS Form 1065).

ELIGIBILITY FOR ELECTING OUT

A partnership's ownership structure determines whether the partnership may elect out. Trusts, disregarded entities, and partnerships as partners preclude a partnership from electing out. In that case, dental partners may wish to reevaluate whether the benefits of being classified as a partnership outweigh the benefits of any other structure. If they do, the partners may wish to incorporate transfer restrictions and other protections in the partnership's governing documents. If they do not, the partners may wish to look into restructuring—adopting an eligible small partnership structure.

BENEFITS OF ELECTING OUT

A partnership that elects out successfully would be audited under the prior regime. As a result, tax deficiencies would be imposed directly on the partners. If the IRS finds the election out of the regime to be invalid for any reason, the partnership is stuck with the new audit regime.

LOSS OF ELIGIBILITY TO ELECT OUT

Loss of a partnership's eligibility to elect out may be inadvertent. That can happen when the partnership or its partners are not vigilant when admitting new partners, and an ineligible partner joins the partnership. For

this reason, a partnership may wish to be prepared for an ineligibility to elect out scenario and a potential audit under the new regime. Dental partners would be wise to carefully consider the structure and governance of the partnership to adapt to audit preparedness, particularly in case the partnership has to defend an IRS audit at the partnership level.

PARTNERSHIP REPRESENTATIVE

Note that the *tax matters partner* no longer exists. The *partnership representative* has replaced the tax matters partner. While the tax matters partner had to be a partner, that is not the case anymore. Now, anyone—any individual or business entity—may serve as the partnership representative so long as one has substantial presence in the United States.

That means that any partner or any outside advisor, accounting firm, law firm, or any other third party may be eligible to take on the role of a partnership representative. Even the partnership itself may serve as its own partnership representative so long as it appoints a designated individual to act in that capacity.

SOLE AUTHORITY TO ACT

Note also that the new IRS audit regime grants the partnership representative the sole authority—essentially, the highest level of authority—to act on behalf of the partnership. No one but the partnership representative may communicate with the IRS and take action on anything concerning IRS audits, IRS appeals, or tax litigation. The IRS will meet, discuss, and correspond directly with the partnership representative and only with the partnership representative. Of course, the partnership representative may delegate authority to tax counsel or another tax professional who can communicate with the IRS and advise on prudent actions.

The partnership representative has the sole authority to legally bind the partnership and *all* partners to any settlement and other agreement with the IRS. Inclusivity is quite broad where this binding effect is concerned. All audit-year and current-year partners may suffer consequences under the new tax regime unless, and potentially even when, contractual precautions are taken. While contractual mechanisms can be implemented to

shift risks, the partnership representative's actions are binding on the partnership and the partners from the IRS's perspective.

All that means that, once the partnership representative has been selected and has taken an action, individual partners may not intervene. Thus, careful selection of the partnership representative becomes critical.

CHANGING THE PARTNERSHIP REPRESENTATIVE

Changing a partnership representative is not straightforward and is certainly not an option once a partnership tax return has been filed. The new regime imposes special rules and timing for replacing a partnership representative.

Choose wisely when it comes to your partnership representative.

FORTHCOMING IRS AUDITS

The IRS has been initiating audits of open tax years beginning after January 1, 2018. It has also been hiring auditors with substantive expertise specifically in partnership taxation. The IRS announced that audits of large partnerships (with income or assets of \$10 million or more) under the Large Partnership Compliance Program, a special pilot program, began last year. This time, the IRS is deploying data analytics to perform risk assessments and identify partnerships and tax issues for audit. The results and learning from these data analytics efforts will be leveraged and applied more broadly to partnerships across the board. **DE**



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