New IRS Audit Rules: Is Your Health Care LLC Ready?

By PETER DOMAS and RALPH LEVY, JR.

Bipartisan Budget Act of 2015 (BBA), which was signed into law in November 2015, contains significant changes to the way the IRS will audit limited liability companies and partnerships beginning in 2018. These changes will also have far ranging effects to the way members of many limited liability companies must prepare for a potential tax liability resulting from an IRS audit. Under the BBA, the TEFRA audit rules that have been in place for nearly thirty years were repealed and replaced with new "streamlined" entity-level audit rules. Since many health care limited liability companies and professional limited lability companies are relatively small entities (less than 10 members) and taxed as partnerships, the health care industry in particular must prepare for the new audit rules under the BBA.

Summary of Prior Provisions

The old TEFRA rules provided that a "small partnership" was automatically exempt from an entity-level audit by the IRS. To be a "small partnership," an LLC must generally have fewer than 10 partners and have no members who were an LLC or a corporation. Furthermore, the qualification of being a small partnership was determined on an annual basis, and it was possible for a partnership to be covered by the TEFRA entity-level audit rules in one year and not in a subsequent year.

Tax liability resulting from an IRS audit under TEFRA also passed through to the ultimate individual members' tax returns. This requirement often caused significant difficulty for the IRS in both determining each partner's share of the tax liability adjustment, as well as collecting the tax owed from each member. The difficulty in collecting outstanding amounts owed was further complicated by the IRS being unable to apply any tax liability to the entity, even though members of an LLC could change multiple times during the period being audited.

Summary of New Rules

Although the new audit rules under the BBA were designed to make the IRS's collection of tax liabilities simpler, this simplification will require a significant redesign of the way members must look at their relationship with their company, and with the company's current and former members. The key features of the new audit rules are as follows:

- Rather than assessing a tax to individual partners, the IRS will assess the partnership with an "imputed underpayment" at the individual or corporate tax rate based on the type of members that own the entity regardless of the actual tax rate that would otherwise apply to each of the partnership's individual members.
- Any tax liability from an audit will be assessed at the company level in the year of the adjustment (when the audit occurs) rather than the tax year under audit. As a result, subject to one exception, current members may be liable for tax errors that benefited the company's prior members.
- The new law requires an LLC to appoint a "Partnership Representative." It is not yet known whether the IRS will treat this person the same as the Tax Matters Member. The Partnership Representative, however, will have the sole authority to act on behalf of the partnership for audit related matters.

- Small Partnership Exception
- LLCs with fewer than 100 members, and which have no member that is an LLC or a C- Corp (S-Corps are allowed) may opt out of the new audit rule. To opt out, an LLC must:
- Elect the opt-out each year on its 1065;
- Inform each partner of the election;
- Submit to the IRS the names and TINs of each of the meambers, including the names of each of the shareholders of an S-Corp member.

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Ralph Levy, Jr. is Of Counsel at Dickinson Wright. He has Assisted owners of dialysis clinics in dispositions to national dialysis providers (straight sales and joint venture dispositions), negotiated medical director service agreements on behalf of nephrology groups with national dialysis providers and on behalf of owners of dialysis clinics with nephrologists and/or nephrology groups, assisted regional provider of therapeutic foster care and family based and other services for developmentally disabled persons in several transactions involving the acquisition of and/or provision of management and administrative services to other providers of similar services, among related assignments. Prior to his involvement with Dickinson Wright, Ralph was a private practitioner in Nashville for more than 35 years, except for a 10-year period as General Counsel, Executive Vice President and Secretary of Gambro Healthcare, Inc., a national provider of dialysis services. He is the author of more than two dozen published articles.

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Peter Domas is Of Counsel at Dickinson Wright. Peter's practice is devoted to representing clients in the health care industry, and assisting them in navigating the complex statutory and regulatory environment unique to healthcare corporate, transactional, and litigation matters. Peter also counsels clients on the development and maintenance of effective internal compliance programs with a special focus on federal and state fraud and abuse laws, reimbursement regulations, and HIPAA. Prior to entering the practice of law, Peter directed the Midwest's contract compliance audit operations for a national service company whose clients include numerous national, local and government insurance providers. Peter is also a Certified Public Accountant in both Michigan and Illinois. Counsel to mid-market health care companies including ambulatory surgery centers, skilled nursing facilities, and physician group practices by providing lead counsel and coordinating legal counsel on a wide array of matters including corporate matters, operations, acquisition and divestiture transactions, joint venture projects, corporate governance, business planning and financial transactions, and legal compliance.

Early Opt-In to New Audit Rules

On August 4, 2016, the IRS issued temporary and proposed regulations addressing how a company may elect to opt-in to the new partnership audit rules for tax years beginning prior to December 31, 2017 . Under the new regulations partnerships may elect to apply the new audit rules to any tax year beginning after November 2, 2015 and ending before December 31, 2017. The partnership may also make such an election within 30 days of receiving the written notice from the IRS that a return for an eligible tax year is selected for an examination. It is likely that most partnerships will not benefit from the new audit rules and thus relatively few will chose to opt-in.

Furthermore, in the event a partnership makes the election to opt in to the new audit rules, it must provide a statement to the IRS that the partnership is not insolvent and does not reasonably anticipate becoming insolvent, the partnership is not currently and does not reasonably anticipate becoming subject to a bankruptcy petition under title 11 of the United States Code and that the partnership has sufficient assets and reasonably anticipates having sufficient assets with which to pay the potential imputed underpayment that may be determined during the partnership examination.

These representations highlight at least one scenario, which may ultimately benefit some partnerships, and weigh in favor of opting into the new audit rules. By adopting the new audit rules, the company, rather than the individual members will be assessed a tax deficiency for the applicable year. As a result, in the event of a significant tax error as to a company that may be insolvent, members may benefit by the shift of tax liability from the partner to the partnership level.

<u>Implications for Healthcare LLCs</u>

As a result of the BBA, each healthcare LLC will need to update its operating agreement to remain in compliance with the law, protect members, and ensure that any tax liability is allocated equitably. These changes should include:

- Requiring managers or officers of companies that meet the small partnership exception to elect out of the audit rules on an annual basis and comply with the member notification requirements;
- Creating rules that limit who can be a member for any company that wishes to opt-out as a small partnership;
- Establishing rules for selection of a Partnership Representative as well as defining actions the Partnership Representative may take;
- Allocating any assessed tax liabilities in accordance with agreed upon measures;
- Providing procedures that members must follow to allow the company to qualify for either of the two exceptions to the imposition of tax at the entity level in the result of an audit (i.e., the small partnership exception or the election under IRC Section 6226 within 45 days after receipt of the final audit notice for the members to pay the tax imposed by the audit);
- Drafting provisions that extend liability for any tax deficiency to departing members in the event the LLC is assessed additional taxes in a year any such member was a member.

Even though the new rules will not take effect until January 1, 2018, the BBA will have a substantive impact on tax planning for healthcare limited liability companies that are taxed as partnerships. As a result, companies need to take proactive steps to prepare for the new IRS audit requirements by reviewing their operating agreements to determine which changes are needed.

Please contact Peter Domas at 248-433-7595, Ralph Levy, at 615-972-0608 or any member of Dickinson Wright's Healthcare Practice Group, for assistance with preparing your LLC for the new audit rules.

On Medicine

Once Lost, Forever Lost

By ALLAN DOBZYNIAK, MD

Physicians are not soldiers who can merely say they are taking orders. They have chosen the profession of medicine. It should be within each physician as a person to do the things necessary to guarantee that the profession remains free to guard its integrity and ethical foundation. Physicians should not react to arbitrary or politically motivated societal boundaries but should act to guarantee that nothing should intervene to ever compromise that which each physician has internalized as his or her just mission regarding each individual patient. By extension then the good of society would be served.

Allan Dobzyniak, MD

The caveat is that physicians be grounded in those subjects that result in thoughtful personal understanding of ethical and moral issues. History, philosophy, literature and even the arts help instill such moral and ethical deliberative abilities to physicians. Medicine should retain its traditional fundamentals as an art and have a thoughtful philosophical view of life and the lives of each individual patient. It must be more than a science imbued with technology servicing a group of anonymous customers.

Many physicians feel demoralized. They see the dilemma but feel hopelessness in its resolution. Sadly, many younger physicians believe in technology as the God of medical science and altruism as its singular moral virtue. This is the path to an unfortunate ending for the profession. Such thinking is simplistic regarding the intrinsically complex nature of a profession whose deliberation of morality, ethics, virtue and understanding of persons and people should be ongoing. Accepting the label of a health care provider shows how far the profession has strayed from its mission and the critical thinking that should be foundational.

To sadly observe the erosion of medicine as a profession certainly explains the general decline in physician morale. In the end, it is those cared for by doctors, their patients, who will suffer the unintentional compromises of a less than enthusiastic group of doctors. Medicine should be the most personally rewarding and joyous profession there is. Wouldn't it be wonderful if each physician could take it upon herself or himself to make certain others, their patients, had the opportunity to enjoy their lives as much as the profession should inherently allow them to enjoy their own?