

Partners Need to Consider Amending Partnership Agreements to Address New Partnership Audit Rules

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New rules found in Internal Revenue Code sections 6221 through 6241, as amended by the Bipartisan Budget Act of 2015, govern IRS tax audits of partnerships, limited liability companies, and other entities and arrangements classified as partnerships for U.S. federal income tax purposes. The changes made by these rules will significantly impact partners in partnerships and careful attention should be paid to these rules by all partners in partnerships. These rules will become effective for all partnership taxable years that begin on or after January 1, 2018.

The new rules replace the existing Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) partnership tax audit and tax litigation rules and remove certain rules applicable to the audit and taxation of electing large partnerships. The new rules also replace the current “tax matters partner” with a “partnership representative.” Accordingly, partners in partnerships (and members of limited liability companies and other entities and arrangements classified as partnerships) need to consider amending their agreements to address the new rules. The following discussion is intended to address all entities and arrangements classified as partnerships for federal income tax purposes.

When Are the New Rules Effective?

Generally, the new rules are effective for partnership taxable years that begin on or after January 1, 2018. Small partnerships (generally those with 100 or fewer partners that are not partnerships, trusts, certain foreign entities, disregarded entities, or nominees) may be eligible to elect out of the new rules each taxable year, as described below in the section titled “Election Out.”

Do the New Rules Require an Amendment to the Partnership Agreement?

No, the new rules will take effect regardless of whether the partners amend their partnership agreement. Proposed Treasury regulations provide that a partnership must designate a “partnership representative” (defined below) on the partnership’s tax return for partnership taxable years that begin on or after January 1, 2018, which for a calendar-year partnership will be due on March 15, 2019 or, with an extension, on September 16, 2019.

However, there are good reasons that partners may desire to amend their partnership agreement to designate a partnership representative or provide a procedure for such designation well before the time a partnership representative must be designated. For example, if the selection of the partnership representative is expected to be controversial, partners may wish to make the selection sooner rather than later and memorialize the selection in the partnership agreement. In addition, partners may desire to add provisions to their partnership agreement such as (1) language detailing the rights and obligations of the partnership representative similar to existing language detailing the rights and obligations of the tax matters partner, and (2) an indemnity provision requiring current partners to indemnify the partnership in certain situations, see “Payment of Imputed Underpayment” below.

There also are additional considerations regarding how and when to amend, several of which are discussed below.

What Do the New Rules Provide?

Partnership Representative

The partnership representative is similar to, but different in several critical ways from, the tax matters partner under TEFRA. Under TEFRA, a partnership was required to designate a tax matters partner to act as a liaison between the partnership and the IRS. That tax matters partner was required to be a general partner and could be an individual or an entity. The tax matters partner had the authority to bind the partnership, but not to bind other partners in the partnership. Also, a partner that was not the tax matters partner had rights during an examination, including certain notification rights and the right to participate in the proceeding.

In contrast, under the new rules, the partnership representative is not required to be a partner, and can be any person (including an individual or an entity) with a substantial presence in the U.S. The partnership representative has the sole authority to bind the partnership, and all partners and the partnership are bound by the actions of the partnership representative and any final decision in a proceeding brought under the new rules. In addition, the new rules do not include a statutory right to notice of, or to participate in, the partnership-level proceeding for any person other than the partnership and the partnership representative. If a partnership does not designate a partnership representative, the IRS may select any person as the partnership representative, with certain limitations.

The partnership representative language can be an important factor in determining when and how to amend the partnership agreement because the powers of the partnership representative with respect to the partners can be adjusted through the agreement. For example, partners generally will want the right to approve or participate in certain actions of the partnership representative. In addition, partners generally will want the right to be notified by the partnership representative regarding certain events. Finally, the partnership representative generally will want to be indemnified by the partnership for actions performed and costs incurred in good faith in its capacity as partnership representative.

Assessment and Collection of Tax at Partnership Level

The new rules provide that, in general, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) will be determined at the partnership level. This part of the new rules is similar to TEFRA, which allowed the IRS to make adjustments to "partnership items" at the partnership level in one proceeding. However, the new rules are not limited to the TEFRA definition of "partnership items." Furthermore, any tax attributable to an adjustment will be assessed and collected, at the partnership level. This is a departure from TEFRA, which required the IRS to adjust each partner's return to reflect the proper treatment of partnership items and follow deficiency procedures at the partner level if partner-level factual determinations were necessary. Finally, the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment of any such item or share also will be determined at the partnership level.

Payment of Imputed Underpayment

The new rules provide detailed rules relating to the calculation of an imputed underpayment that is beyond the scope of this discussion. Generally, the amount of any imputed underpayment with respect to an adjustment must be paid by the partnership in the adjustment year, unless an election is made to “push out” the imputed underpayment to the “reviewed year” partners. Generally, the “reviewed year” is the partnership taxable year under audit. This election will be described below in the section titled “Push Out.”

For this reason, the partnership and its partners likely will want to be indemnified by each current and former partner of the partnership for the portion of any imputed underpayment attributable to that partner and for any costs and expenses relating to any audit, administrative or judicial proceeding.

Election Out of New Rules

Generally, a partnership may elect out of the new rules for a particular taxable year only if (1) it is required to furnish 100 or fewer Schedules K-1 with respect to its partners, and (2) each of its partners is an individual, corporation, any foreign corporation that would be treated as a C corporation if domestic, or an estate. Special rules apply for purposes of determining the number of partners in the case of a partner that is an S corporation.

A partnership that elects out of the new rules will be subject to the rules that applied before the enactment of TEFRA. Very generally, the IRS will be required to open deficiency proceedings at the partner level to adjust items associated with the partnership, resolve issues, and assess and collect any tax that may result from the adjustments. Each partner-level deficiency proceeding will be subject to its own statute of limitations and venue, which can result in separate partner-by-partner determinations with respect to the same item.

A partnership that desires to elect out of the new rules still may want to designate a partnership representative in the event it fails to qualify for the election out or to act as a “point person” with regard to interactions generally with the IRS.

Push Out

Instead of paying the imputed underpayment, the partnership may elect to have each partner of the reviewed year take into account the adjustments made by the IRS and pay any tax due as a result of those adjustments. Therefore, this election causes the reviewed year partners to bear the burden of any tax that results from taking into account the adjustments.

To make this election, the partnership must (1) make the election no later than 45 days after the date the final partnership adjustment (which is basically the result of the tax audit) is mailed by the IRS, and (2) furnish a statement of each partner’s share of any adjustment as determined in the final partnership adjustment to all of its reviewed year partners. Once made, this election is revocable only with the consent of the IRS.

Very generally, each reviewed year partner must pay with respect to the adjustment year any increase in the tax imposed in the reviewed year and any subsequent years as a result of taking its share of the adjustments into account with respect to the reviewed year. Any penalties, additions to tax, or additional amounts are determined at the partnership level, and the reviewed year partners of the partnership are liable for their proportionate share of any such penalty, addition to tax, or additional amount. In contrast, interest is determined at the partner level and calculated from the due date of the partner’s tax return for the taxable year to which the increase in tax is attributable

taking into account any increases attributable to a change in tax attributes for an intervening year. The interest is computed at a rate that is two percentage points higher than the usual underpayment rate.

Conclusion

Partners in partnerships (and members of limited liability companies and other entities and arrangements classified as partnerships) need to consider the above-described issues in determining when and how to amend their partnership agreements and operating agreements to address the new rules.

Although the IRS does not require a partnership to amend its partnership agreement in order to designate a partnership representative, there are reasons to do so. As discussed above, the timing and substance of an amendment to address the new rules is affected by many factors. Regardless, at the very least, partners should consider amending the partnership agreement to designate a partnership representative, or provide a procedure for such designation, prior to filing the 2018 partnership tax return in 2019.