Partnership Agreement Advisory

July 12, 2018

Are You Ready for the New Partnership Audit Regime?

Katten previously alerted our readers to the changes in partnership audit rules [See Katten Advisory, "New Partnership Audit Regime Set to Take Effect in 2018, Proactive Planning Recommended," August 7, 2017]. The Internal Revenue Service (IRS) has since issued guidance on certain aspects of these rules.

To the extent a partnership, LLC, or other entity taxable as a partnership has not considered the impact of these rules, existing partnership agreements should be reviewed to assess whether they need to be amended to address the new rules. Moreover, each partnership may need to appoint a "partnership representative," or else the IRS may choose one who may not have the partnership's or its partners' interests in mind. Appointment of a partnership representative may require careful thought as to the contractual rights, limitations and protections imposed on and provided to the partnership representative by amendment of the partnership agreement.

Background

For taxable years beginning on or after January 1, 2018, the new centralized partnership audit regime passed as part of the Bipartisan Budget Act of 2015 is now in effect. The new regime allows the IRS to more effectively and efficiently audit partnerships by (1) allowing the IRS to collect from the partnership any partnership tax adjustment; and (2) requiring the appointment of a partnership representative to act as the point-person and binding decision maker with respect to any IRS audit procedures and related matters.

Implications

The new rules generally apply to all entities taxable as partnerships unless the partnership is eligible to elect to "opt-out" of the new regime. It is anticipated that the opt-out election will be available only in some circumstances because only partnerships with 100 or fewer partners, and whose partners consist only of eligible partners, may elect to opt-out of these rules. The term "eligible partners" includes individuals, C corporations, certain foreign entities, S corporations, and estates of deceased partners but, according to the proposed regulations, does not include single-member LLCs (even though the sole member of the LLC is the K-1 partner) or trusts (whether complex or grantor trusts).

Under the prior rules, the IRS collected partnership tax assessments at the partner level. The new regime changes this. The partnership itself will be required to pay any tax assessment, unless the partnership makes a valid election to "push-out" the assessed liability (including penalties) to the partners. Without a push-out election, the rules effectively require the tax liability of the audited tax year to be borne by those that are partners during the year of audit (regardless of whether they were partners during the

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audited year). This is a departure from the prior law pursuant to which any partnership adjustment was imposed on the partners of the audited year. The push-out election allows the partnership to cause those that were partners in the audited year to bear the tax adjustment. The consequences of making the push-out election should be evaluated on a case-by-case basis.

The new regime also eliminates the current position of the "tax matters partner," instead opting for a "partnership representative" to act with a broader role on behalf of the partnership. In addition, the concept of other partners having the right to receive "notice" of and to participate in the audit has been eliminated. The partnership representative will now be the only person representing the partnership without any notice or participatory rights required to be given to any non-representative partner. Vis-à-vis the IRS, the partnership representative has the sole authority to act on behalf of the partnership during an IRS audit or other tax proceedings involving any partnership item and can bind the partnership and its partners.

Importantly, if a partnership fails to appoint a partnership representative, the IRS may choose one for it. Proposed IRS regulations provide that the partnership representative can bind the partnership and its partners, even if it exceeds the power granted to him, her or it in the partnership agreement. Partnerships need to consider whom to appoint as their representative (which does not have to be a partner in the partnership but must be a person or entity with a US presence) and the contractual rights, limitations and obligations they would want to grant and impose on their representative.

Next Steps

The new regime will affect most partnerships and multi-member LLCs. In order to prepare for the new regime, we again recommend that partnership agreements should be reviewed and amended as necessary to deal with some or all of the following provisions, among others, to accommodate the new rules:

- whom to appoint as the partnership representative and procedures for his, her or its replacement;
- indemnification provisions for the partnership representative;
- contractual limitations of power on the partnership representative and/or notice requirements to partners with respect to all IRS (and, where applicable, state income tax) communications;
- if it is eligible, whether the partnership should make elections to opt-out of the new regime or to push-out the assessed tax liability to the partners;
- how to allocate any tax liability that is imposed on the partnership; and
- the ability of the partnership to obtain, upon request, certain information from its partners necessary for the partnership to modify its tax liability.

Given the complexity and broad scope of the rules, each partnership agreement should be reviewed and amended based on the facts and circumstances of the partnership and its partners.