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Important Changes in the Rules Governing Income Tax Audits of Partnerships and LLCs

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CHANGES TO OPERATING AGREEMENTS AND PARTNERSHIP AGREEMENTS WILL BE REQUIRED BEGINNING IN 2018

In the Bipartisan Budget Act of 2015, Congress made significant changes in the rules governing federal income tax audits of partnerships (and LLCs that are taxed as partnerships), including assessing federal tax deficiencies resulting from such audits against the partnerships and LLCs themselves. Although these rules were enacted in 2015, they generally are first effective for partnership federal income tax returns for taxable years beginning after December 31, 2017.

Under the current (pre-2018) centralized partnership (LLC) audit regime, partnership and LLC audits generally are conducted administratively at the entity level (through the "tax matters partner" or "TMP"), but any deficiency in tax resulting from the audit is assessed against and payable by the partners (members) who were partners (members) in the tax year under audit, not by the partnership or LLC. In addition, the federal income tax law generally requires the Internal Revenue Service (the "Service") to notify the partners at the beginning of an audit and allows each partner to participate individually in challenging the Service's position in litigation.

The new rules change these fundamental principles; audit deficiencies will, in most cases, now be assessed against and paid by the partnership or the LLC, not by the partners or members themselves. The Service is no longer obligated to notify the partners as to the audit, and the individual partners have no legal right to participate in the audit. These changes have several very profound implications, some of the most important of which are discussed briefly below.

Agreements Should Be Revised. As a result of the changes discussed below, existing partnership agreements must be reviewed, and most of them will require revision. Generally, unless changes are made in these agreements to address the new audit rules, substantial risks exist of unintended and adverse tax and financial consequences to partners and members if income tax audits occur and tax deficiencies are assessed. These risks include the imposition of federal income tax liability on partners or members that never realized any benefit from the transactions giving rise to the audit adjustments.

Tax Matters Partners Are Now "Partnership Representatives." The new rules eliminate the position of tax matters partner and create a new position designated the partnership representative. The partnership representative need not be a partner or member—it can be any person or entity, as long as it has a substantial presence in the United States. If the partnership representative is an entity and not an individual, the partnership representative entity must appoint a single individual through whom the partnership representative will act for all purposes of these audit rules. The partnership or LLC can act as its own partnership representative.

Unlike the TMP, which typically was designated in the operating agreement or partnership agreement, the partnership representative must be designated ***annually*** on the partnership's or LLC's tax return, and that designation applies for that year only. If the entity does not designate a partnership representative, the Service may select whomever it chooses to serve as the partnership representative.

Partnership Representatives Have Greater Authority to Determine Tax Liabilities. The statute and regulations give significantly more authority to the partnership representative than was given to the former tax matters partner. Whereas under the pre-2018 rules most partners had a right to notice, rights to participate in the audit process and certain rights to contest individually any assessment that resulted from the audit, the partnership representative now has sole authority to act on behalf of the partnership in connection with negotiating and agreeing to settlements with the Service, agreeing to a notice of final partnership adjustment, determining whether any tax from an adjustment will be paid at the partnership or partner level and other matters. Even if the partnership representative exceeds the authority granted under the partnership or operating agreement, the partnership representative's decision is binding on the partnership (and its partners) vis-à-vis the Service.

Because of the numerous decisions that a partnership representative may make that could adversely affect the partners, the partnership representative now has added risk of personal liability for the decisions he or she makes.

Due to these changes, partnership agreements and operating agreements now should include provisions addressing the authority of the partnership representative and the rights of partners/members to participate in the tax audit process, approve settlements with the Service and other procedural matters. Existing agreements typically will not contain such important provisions. Provisions addressing the indemnification or exculpation of "tax matters partners" should be reviewed in light of their enhanced responsibilities and authority.

Economic Cost of Audit Deficiencies May be Borne by the Wrong Partners. As noted above, the pre-2018 rules provide that any partnership tax adjustments are reflected on the income tax returns of the partners in the partnership for the tax year under audit, and those partners are responsible for payment of any tax due as a result of that adjustment. The new rules require that (unless certain elections to the contrary are made, as discussed below) any tax deficiency resulting from a partnership adjustment be determined, assessed and collected at the partnership (LLC) level in the year the audit is finalized. Therefore the partners or members who suffer the economic loss from a tax audit will be the partners or members in the year the audit is finalized (because the partnership is required to pay the tax in such year), not the partners in the year under audit. In the case of partnerships that are audited after they cease to exist, the liability for any tax deficiency is imposed on the persons who were partners at the time the partnership ceased to exist, not on the persons who were partners for the year under audit.

As a result, incoming partners (members) may be liable for tax deficiencies attributable to former partners or members. This risk may be dealt with in various ways through additional provisions in partnership or operating agreements, but existing agreements likely do not contain provisions addressing such issues and, therefore, fail to protect against these risks.

This liability issue may be mitigated in certain ways, including by requiring each partner (and former partner) to contribute his or her share of the tax deficiency. As explained below, the new rules also allow the partnership to elect to "push out" the tax liability to the partners for the year under audit, in which case each partner individually will be liable for the tax deficiency instead of the partnership.

Under the default provisions of the new rules, partnership adjustments are made at the partnership level in the year the audit is finalized and not in the year under audit. Thus, any adjustments made by the Service during the year the audit is finalized with respect to the partnership items for the year under audit may cause significant distortions to the partnership tax attributes and the tax liability of the current partners.

Certain Partnerships and LLCs May Opt Out of the New Rules. The law allows certain partnerships to opt out of the new rules or, after an audit occurs, to require the partners in the year under audit (instead of the entity) to pay the tax (the push-out election mentioned above), but those decisions are made by the partnership representative (absent provisions in the partnership or operating agreement to the contrary). Those elections are not available to all partnerships or LLCs, however. For example, partnerships with more than 100 partners or certain types of partners such as trusts (including living trusts or revocable trusts) are ineligible to elect out of these new rules. Elections to opt out of these new rules must be made each year when the partnership files its tax return.

It will be important for operating agreements and partnership agreements to address the authority and process for making any such elections. The partners may wish to include in the partnership agreement provisions limiting ownership to persons that are permissible owners to allow the opt-out election, as in the case of an S corporation. Existing operating agreements and partnership agreements likely do not contain such provisions.

Partners or Members With Unique Tax Attributes Must Ensure That They Are Taken Into Account. In determining the tax deficiency at the entity level, the new rules generally compute the partnership's tax deficiency upon audit by applying the maximum tax rates applicable to individuals or corporations (whichever is higher), disregarding the tax status and attributes of individual partners or members (e.g., partners that are tax-exempt or have net operating losses). The new rules do allow those partner-level attributes to be taken into account, but it is up to the partnership representative to ask the Service to do so. Operating and partnership agreements in existence today likely will not give the partnership access to the information needed to make such requests or afford such partners the right to demand that their partnership representative give them the benefit of their own personal tax attributes, nor will they contain provisions for properly allocating any tax deficiency paid by the partnership among the various partners in a manner that reflects those attributes. The downside to the push-out election is that the interest rate charged by the Service on the imputed deficiency amount will be two percentage points higher than if the tax assessment was imposed on the partnership.

Investors in or Acquirers of Partnership or LLC Interests Have New Risks. The fact that partnerships and LLCs now bear a risk of income tax deficiencies at the entity level has significant implications for persons acquiring or selling (or issuing) interests in partnerships or LLCs. For acquirers (including investors), the possibility of income tax liability at the entity level resulting from audits of years during which the acquirer was not an owner must be taken into account as an additional diligence issue and a risk to be addressed between the purchaser/investor and seller/issuer (very similar to the risk of contingent income tax liability in a C corporation). This risk might be mitigated if the partnership agreement provides for each partner to indemnify the partnership for its share of the partnership tax obligation.

Issuers of LLC or Partnership Interests Have Additional Disclosure Obligations. Because the risk of tax deficiencies is now borne by the entity, issuers of partnership or LLC interests should address this risk in the disclosure materials provided to potential investors. Since the partnership agreement (or LLC operating agreement) typically will contain important provisions designed to deal with these issues, those offering materials should discuss and explain those provisions as well.

OUR RECOMMENDATIONS

Regulations interpreting these new rules have only recently been proposed, the Service has received numerous comments and technical corrections legislation may correct some of the new law's issues. However, the fundamental changes made by this new regime will take effect for tax year 2018 and beyond, and accordingly it is essential, in almost all cases, that existing partnership agreements or operating agreements be amended to address these changes. Persons offering or selling LLC or partnership interests to investors and persons acquiring or investing in partnerships or LLCs must be cognizant of the implications of these new rules and the risks that they create.

Unfortunately there is no one-size-fits-all approach to dealing with these new rules in partnership or operating agreements. Rather the appropriate provisions to address these issues will depend on a variety of factors and will have to be tailored to the specific circumstances of each particular case.

Our tax attorneys are available to consult with you and explain the new rules and their implications further, and to assist in formulating appropriate strategies to address them. If you would like to discuss these new rules and their implications for your particular situation, we encourage you to contact your Husch Blackwell attorney, and he or she will put you in contact with one of our tax attorneys who will assist you.