EPSTEIN BECKER GREEN

corporate services

CLIENT ALERT

Reminder: The New Partnership Audit Rules Are Effective for Tax Years Beginning January 1, 2018

by David E. Weiner and David E. Weiss

December 2017

Executive Summary

The Bipartisan Budget Act of 2015 ("**BBA**"), enacted on November 2, 2015, provided for sweeping changes to the way partnerships are audited, including the ability of the Internal Revenue Service ("**IRS**") to levy U.S. federal income tax on a partnership directly. These rules affect all partnerships, limited liability companies, and other entities treated as a partnership for U.S. federal tax purposes (sometimes collectively referred to as "**partnerships**," and the underlying partners and members are sometimes collectively referred to as "**partners**"). The BBA's new partnership audit rules ("**New Partnership Audit Rules**") are intended to make the audit of partnerships easier and less expensive for the IRS.

For tax years beginning January 1, 2018, partnerships will be directly liable for any U.S. federal tax resulting from an IRS adjustment that increases the partnerships' income. The New Partnership Audit Rules impose the partnership-level tax at the highest statutory rate (currently, the individual tax rate of 39.96 percent), although the partnership may request a reduction/modification of the tax due to various factors related to the underlying partners.

The New Partnership Audit Rules also state that a so-called "**partnership representative**" is to be named by the partnership. The partnership representative replaces the designated "tax matters partner" under existing partnership audit rules. The partnership representative has sole authority to bind the partnership, which includes entering into IRS settlements and contesting IRS adjustments in court, and the underlying partners would be bound by the partnership representative's actions. If a partnership has not designated an appropriate person to act as the partnership representative, the IRS can appoint a person as such. Under the New Partnership Audit Rules, partners do not have notice or participation rights in IRS audits and legal proceedings, which is a significant departure from the existing partnership audit rules that provide partners with certain notice and participation rights. The New Partnership Audit Rules do not, however, prohibit placing contractual limitations on the partnership representative's powers. Therefore, partners should consider contractually requiring the partnership representative to act pursuant to a standard of conduct and/or to consult with partners.

Partnerships and limited liability companies and their partners and members should review their partnership agreements and limited liability company operating agreements (collectively referred to as "**governing agreements**") as changes are likely required due to the BBA's New Partnership Audit Rules.

Specific Provisions and Practice Tips

- *Partner Representative*. The New Partnership Audit Rules empower the partnership representative with significant authority. The partnership representative has the sole power to represent the partnership in IRS adjustment proceedings and related court contests. Only the partnership representative may raise defenses to tax (and interest and penalties related thereto) on behalf of the partnership, which may include defenses applicable to a specific partner. The failure by the partnership to assert a defense may cause such defense to be waived by not only the partnership but also the underlying partners. Partners will be bound by the actions of the partnership as directed by the partnership representative, and partners do not have a statutory right to participate in the IRS adjustment proceedings and court contestations.

  The partnership representative does not need to be a partner in the partnership; however, such person must have a substantial presence in the United States. Moreover, if a partnership representative is not designated, the IRS may select any person to be the partnership representative. Proposed regulations have been issued that provide factors for the IRS to consider when it designates the partnership representative; however, the factors are not binding and, again, the IRS may designate any person as the partnership representative.

  > ***Practice Tip:*** Amend governing agreements to designate a partnership representative. Consider including a provision that requires the partnership representative to act pursuant to a standard of conduct (e.g., commercially reasonable, good faith, etc.). Such provision may state that acting in a commercially reasonable manner or in good faith encompasses consulting with tax counsel, responding timely to all IRS inquiries, and attending all proceedings and hearings. In addition, decide whether to include a provision to contractually limit the partnership representative's ability to act unilaterally. Such provision may require the partnership representative to consult with partners and take certain actions only with partner consent.

- *Partnership-Level Tax.* The New Partnership Audit Rules provide that any adjustments to a partnership's income, gain, loss, deduction, or credit (and any partner's distributive share thereof) are determined at the partnership level at the highest tax rate in effect for the tax year. Partnerships may request a reduction in the calculated tax due to various factors, including underlying partners being subject to a lower tax rate or being tax-exempt entities. The New Partnership Audit Rules provide that any federal tax attributable to adjustments, including penalties and interest, is assessed and collected at the partnership level.

> ***Practice Tip:*** Consider including a provision in governing agreements that requires partners to provide certain information to the partnership representative that may help reduce any tax exposure. Also consider including a provision that allows the partnership representatives to provide information regarding underlying partners to the IRS.

- *Opting Out of Partnership-Level Tax.* The New Partnership Audit Rules contain two "opt out" elections that enable the partnership to avoid additional tax from adjustments being imposed on the partnership directly:

  - The first opt-out election allows a partnership to elect for an underpayment adjustment to be taken into account at the partner level, and not the partnership level. A partnership is required to make such election within 45 days of the notice of final partnership adjustment. Moreover, the partnership needs to provide the IRS and its partners with a statement of each partner's share of the adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment).

  - A second opt-out election allows certain partnerships to elect for the New Partnership Audit Rules not to apply to them at all. However, the New Partnership Audit Rules provide that only partnerships that meet certain eligibility criteria may make this election (e.g., a partnership needs to have 100 partners or less, the partners may only be "flow through" in certain circumstances, etc.). An annual election must be filed with the partnership's timely filed tax return.

> ***Practice Tip:*** Consider including a provision in governing agreements that requires partners to provide certain information to the partnership representative to enable the partnership to evaluate and/or to make an opt-out election. Also, decide whether to include a provision that allows the partnership representative to make an opt-out election from the partnership-level tax. Speak with your tax counsel about partnership eligibility to opt out of the New Partnership Audit Rules.

- *Potential Consent for Changes to Governing Agreements.* As with all amendments to governing agreements of partnerships and limited liability companies, a determination should be made as to whether and to what extent those amendments will require consent of partners/members or can be undertaken by the general partner/managing member acting independently.

> ***Practice Tip:*** Determine with your legal counsel whether amendments to governing agreements require consent of the partners/members.

Conclusion

All Epstein Becker Green clients operating or investing in partnerships or limited liability companies should consider the effects of the New Partnership Audit Rules and amend their governing agreements to account for these rules. Specifically, partnerships and limited liability companies and the respective general partners and managing members should consider amending their governing agreements to designate a "partner representative," require partners to provide certain information that may reduce a proposed IRS adjustment, and allow for the partnership to make an opt-out election of the partnership-level tax. Investors should speak with partnerships and limited liability companies and the respective general partners and managing members about rights to participate in IRS audits and court contestations thereof and constraints on the partnership representatives' independent actions to bind the entities and the investors.

*   *   *

For more information about this Client Alert, please contact:

David E. Weiner
New York
212-351-5586
deweiner@ebglaw.com

David E. Weiss
New York
212-351-3740
dweiss@ebglaw.com