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NEWS ALERT

TAX GROUP

Compliance with New Partnership Audit Rules May Require Amendments to Partnership/LLC Agreements

By Marc T. Finer | April 25, 2018

New partnership audit rules (the "New Rules") became effective for tax years beginning on or after January 1, 2018. These rules, which are designed to make it easier for the IRS to audit partnerships and collect additional tax liabilities relating to partnership operations, apply to all partnerships and limited liability companies taxed as partnerships (hereinafter, "partnerships"). The New Rules do not require an amendment to the partnership agreement to be applicable. However, these rules will significantly impact partners/members (hereinafter, "partners"), and not updating the partnership agreement could eliminate the partners' ability to make certain elections and dictate the manner in which important decisions under the New Rules should be addressed. Moreover, unless certain options under the New Rules are addressed in the partnership agreement, potential investors may be reluctant to become partners.

This client alert provides a high-level summary of the new partnership audit rules and the amendments to partnership agreements that should be considered to address these rules:

- **Partnership Representative.** Under the New Rules, the "partnership representative" is given the sole authority to act on behalf of, and bind, the partnership with respect to a partnership audit and other proceedings. The partnership representative is *not* legally required to notify the partners of an audit or keep them updated on the status of the audit. Importantly, the partnership representative is not required to be a partner of the partnership and the IRS is permitted to designate a partnership representative if the partnership fails to do so.

  Given the broad authority granted to the partnership representative and the significant economic effect audit decisions may have on the partnership and the current partners, consideration should be given to including provisions in the partnership agreement that describe the procedure for electing and removing the partnership representative, require the partnership representative to provide the partners with all communications and updates regarding audits and assessments, and limit the authority of the partnership representative to settle or litigate an audit determination without a threshold percentage of partner consent. The partnership agreement should also address whether the partnership representative will be indemnified by the partnership and what fiduciary obligations, if any, the partnership representative will have to the partners.

  If the partnership representative is not a partner, consideration should be given to having the partnership and partnership representative enter into a written agreement which sets forth the terms, compensation, duties, rights, etc. of the partnership representative.

- **Partnership is Liable for Tax Underpayment.** Under the New Rules, the IRS may collect the additional tax liabilities, interest and penalties directly from the partnership in the year the audit concludes. As a consequence, a current partner could be responsible for a share of these liabilities even though the audit related to a prior year in which the partner was not a partner.

- **Options For Reducing Partnership Liability for Tax Underpayment.**

  Partner Amended Return. The underpayment amount paid at the partnership level is reduced to the extent a partner files an amended return for the audit year and pays its allocable share of the additional tax assessment.

  Push-out Election. The partnership is permitted to make an election to transfer the tax underpayment liability to its partners. The election must be made within 45 days after the final notice of the audit adjustment.

  Opt-out Election. A partnership that qualifies as a "small" partnership may annually elect to opt out of the New Rules completely. A "small" partnership is a partnership that has 100 or fewer partners composed entirely of individuals, S and C corporations, certain foreign entities and/or estates of deceased partners. Therefore, a partnership that has other partnerships, disregarded entities (e.g., single member LLCs) and/or trusts as partners is not eligible to elect out of the New Rules. The election is made on the partnership's timely filed tax return for each taxable year and must identify the name and taxpayer identification number of each partner.

  Consideration should be given to including provisions in the partnership agreement that identify the circumstances under which the push-out or opt-out elections may be made, address transfer restrictions with respect to partnership interests if the partnership wishes to maintain its ability to make the opt-out election in future years and describe the recourse (if any) current partners have against former partners if the current partners are required to pay the additional tax, interest and penalties attributable to a year prior to their admission to the partnership (e.g., indemnity provision).

- **New Rules Elective for Prior Tax Years.** While the New Rules are effective for tax years beginning on or after January 1, 2018, partnerships are permitted to apply the New Rules for tax years beginning after November 2, 2015. Consideration should be given as to whether the partnership agreement should include a provision giving the partnership representative the authority to elect to apply the New Rules for tax years after November 2, 2015 and before January 1, 2018.

The New Rules have significantly changed the audit process for partnerships. Therefore, it is important that all existing partnership agreements be reviewed to address these rules. At a minimum, to restrict the otherwise extremely broad authority granted to the partnership representative under the New Rules, partnership agreements should be amended to address the selection of the partnership representative, the authority granted to the partnership representative and the duties and obligations of the partnership representative to the partnership.

On a related note, investment entities, such as private equity funds and hedge funds, will need to consider whether fund offering materials should be updated to include a description of the New Rules and their effects, including that current investors may be liable for additional taxes that relate to a prior year.

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