Partnership/LLC Audit Rules – Considerations for Updating Your Operating Agreement

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On November 2, 2015, the U.S. Congress passed the Bipartisan Budget Act ("BBA"), which established new audit procedures for partnerships and limited liability companies taxed as partnerships (collectively referred to as "partnerships"), which fundamentally changed the procedures for how partnerships are audited and how the tax adjustments are implemented (the "BBA audit rules").[1] Prior to 2018, audit examinations by the Internal Revenue Service (the "IRS") were generally governed by the procedures set forth in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which provided for the designation of one of the partners as a tax matters partner ("TMP") who was charged with representing the partnership in dealings with the IRS and in any judicial proceedings. Under TEFRA, the IRS had to provide a notice of audit to all the partners and, once the IRS made audit adjustments to the partnership's return, any resulting tax deficiency was assessed and collected from the individual partners who were partners in the year under audit. Under TEFRA, individual partners had the right to participate in the audit, challenge the IRS's adjustments if not done so by the TMP and negotiate their own settlement with the IRS. This led to inconsistent tax reporting by the partners and created an administrative burden for the IRS. Thus, Congress enacted the BBA audit rules, which were designed to streamline the audit process.

The BBA audit rules, set forth in sections 6221 through 6241 of the Internal Revenue Code, which are generally applicable to partnerships beginning with tax year 2018 and thereafter, repealed TEFRA and substantially overhauled partnership audit procedures by centralizing assessment and collection of tax at the partnership level. As the result of the new audit regime, certain provisions of existing partnership operating agreements may no longer be relevant and there may be substantial risks of adverse consequences to current and former partners and investors acquiring interests in partnerships in the case of an income tax audit by the IRS. Thus, it is important that businesses taxed as partnerships update their operating agreements by taking into consideration the BBA audit rules.[2] Since partnerships vary in size, operations, management, number and types of partners and have other unique characteristics, there is no standard approach to updating an operating agreement. However, in this article we highlight significant changes in the audit procedures and discuss how these changes should be addressed in the operating agreements.

Partnership Representative

Under the BBA audit rules, a TMP was replaced by a partnership representative (the "Partnership Representative") who can be a person or an entity, including the partnership itself, and who is not required to be a partner of the partnership.[3] The Partnership Representative is designated annually on the partnership's tax return and if a partnership fails to designate a Partnership Representative, the IRS can select any person to serve in that role.[4] Unlike a TMP, a Partnership Representative has the exclusive authority to act and bind the partnership and all the partners in an audit proceeding vis-à-vis the IRS,[5] the IRS is not required to provide a notice of an audit to other partners and the partners have no legal right to participate in an audit and negotiate their own settlement with the IRS.

Given the broad binding authority of the Partnership Representative, partners should give serious considerations to the appointment of the Partnership Representative in the operating agreement. In the case of an individual acting as a Partnership Representative, the operating agreement should provide for procedures to revoke such designation or appoint a successor Partnership Representative. In the case of an entity acting as a Partnership Representative, which can be the Partnership itself, the operating agreement should name a designated individual, as required by regulations, through whom the Partnership Representative will act, and provide for the process of replacing such person. The operating agreement should also discuss the extent of control that the partners could exercise over the Partnership Representative and the limitations to be imposed on the Partnership Representative's authority in dealings with the IRS.

In addition, since partners are not entitled to receive notices from the IRS, the operating agreement should include notice provisions, which could require that the Partnership Representative keep other partners reasonably informed of the audit and any material developments, consult with the partners prior to taking certain actions, and/or provide each partner with an opportunity to participate in discussions with the IRS.

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[1]See BBA, P.L. 114-74, Section 1101 (Nov. 2, 2015). Following the passage of BBA, the BBA audit rules have been amended by the Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113 (Dec. 18, 2015) and the Consolidated Appropriations Act, P.L. 115-141, Technical Corrections Related to Partnership Audit Rules (March 23, 2018). In addition, the IRS and the Treasury issued several sets of final regulations clarifying and providing additional guidance on application of the audit rules to partnerships.

[2]The operating agreements for partnerships in existence prior to 2018 should retain TMP provisions until the statute of limitations for such years expires and should also include provisions covering the BBA audit rules.

[3]Any individual will qualify as a Partnership Representative if this person has a U.S. tax I.D., address and phone number and has substantial presence in the United States by making themselves available to meet in person with the IRS. In the case of an entity acting as a Partnership Representative, it must have a designated individual through whom the Partnership Representative will act. See Code § 6223; Regulation § 301-6223-1.

[4]See Regulation § 301.6223-1(f).

[5]Code § 6223(a).

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Partnership Level Assessment

Another fundamental change under the BBA audit rules involves assessment and collection of tax at the partnership level. Under TEFRA, once the IRS made determinations of the tax deficiency at the partnership level, it made corresponding adjustments and assessed the tax against individual partners who were partners in the year under audit. The BBA audit rules, however, provide for assessment and collection of any additional tax liability (the "imputed underpayment") at the partnership level, calculated at the highest income tax rate, in the tax year the audit is finalized as opposed to the tax year under audit.[6]

Given this change, in the case of an assessment of imputed tax liability against the partnership, the partnership may not have sufficient funds to pay the tax and the partners may not be necessarily obligated to reimburse the partnership for the payment of imputed tax liability. In addition, since the assessment is made in the year the audit is finalized, current or incoming partners of a partnership, who may not have been partners in the year under audit or may have held a smaller ownership interest in the given year, may be indirectly liable for the taxes attributable to former partners, absent any protections under the operating agreement.

Also, the imputed underpayment is assessed at the highest individual or corporate income tax rate without taking into account any tax attributes of the individual partners, such as a tax-exempt status of a partner, unless the partnership seeks to modify the imputed underpayment amount. As the result, the tax assessed at the partnership level may be substantially higher than if such tax liability was properly included and reported by the partners in the audit year.

Election Out

While the BBA audit rules are applicable to all the partnerships, certain partnerships with eligible partners may elect out of the new audit regime, in which case the IRS will audit, assess and collect the tax at the individual partner levels. In order to qualify for election out, (i) the partnership must have 100 or fewer partners, which is determined by the number of Schedules K-1 the partnership is required to furnish for the year, and (ii) the partnership's partners may only consist of individuals, C corporations, S corporations, estate of deceased partners or foreign entities treated as C corporations if they were a domestic entity.[7] Non-eligible partners include partnerships, disregarded entities, trusts (grantor and nongrantor, revocable and irrevocable), estates other than of deceased partner, certain foreign entities and nominees.

Such election must be made on a timely filed tax return for the taxable year to which the election applies and it must include all information about each partner requested by the IRS, including such partner's name, U.S. taxpayer identification number ("TIN"), federal tax classification and an affirmative statement that such partner is an eligible partner. A partnership electing out of the BBA audit rules must notify each partner of the election within 30 days in a manner elected by the partnership.[8]

Push-Out Election

After an audit is finalized, a partnership may elect to push out the imputed underpayment to the reviewed year partners thus shifting the burden for any tax, penalties and interest to the partners.[9] The push out election must be signed by the Partnership Representative, filed within 45 days of the final audit adjustment mailed by the IRS and it must include, among other things, the name and TIN of each reviewed year partner. It is important to note that the push-out election requires that the partners pay any tax deficiencies for all the years between the reviewed year and the year in which the adjustment is made. In addition, the interest imposed on any imputed tax liability of a partner is two percentage points higher than the interest rate imposed on the imputed liability of a partnership.[10]

Based on the foregoing, the operating agreement should be updated to address the following:

(i) whether the Partnership Representative should cause the partnership to elect out of the BBA audit rules, push out the adjustments to the audit year partners, pay the imputed underpayment at the partnership level, or whether the managers, the board of directors, the partners or the Partnership Representative should have the authority to decide as to the elections and the payment of imputed underpayment on an annual basis;

(ii) whether the partnership could seek payment and collection of imputed tax liability from the partners, including former partners, who were partners in the year under audit or the year in which final adjustments are made;

(iii) whether the partnership may offset any portion of the tax liability against any distributions made to the partners;

(iv) whether the partnership can require that partners file amended returns in order to seek modification of the imputed underpayment;

(v) whether the partnership should establish a default threshold amount for imputed underpayment, which would determine whether the Partnership Representative should pay the tax at the partnership level or make a push out election;

(vi) provide for a requirement that partners, including former partners, cooperate with the Partnership Representative in connection with any proceeding with the IRS, including providing any information reasonably requested by the Partnership Representative to comply with the BBA audit rules or to assist the partnership in reducing any imputed tax liability;

(vii) provide for the timeframe for the partners to pay their share of imputed underpayment or respond to any other requests in connection with an audit procedure;

(viii) establish the penalty, if any, for partners and former partners who fail to cooperate with the Partnership Representative in connection with BBA audit procedures.

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[6] Code § 6225.

[7] Regulation § 301.6221(b)-1(b)(3).

[8] Regulation § 301.6221(b)-1(c)(3).

[9] Code § 6226.

[10] Code § 6226(c).

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Other Provisions

Transfer Restrictions

Existing operating agreements may lack the required provisions to ensure that the partnership has eligible partners to be able to elect out of the BBA audit rules if such election is desired. In some cases, operating agreements may contain transfer restrictions that may potentially disqualify the partnership from electing out. For example, a permissible transfer of partnership interest from an individual to his or her trust, if implemented, would make the partner an ineligible partner under the BBA audit rules. Thus, partners and partnerships should carefully examine and, if necessary, update transfer provisions and put restrictions on the number and type of partners the partnership may have if they desire to elect out of the application of the BBA audit rules.

Indemnification Provisions

In light of the Partnership Representative's broad authority, there may be more resistance from individuals or entities to serve in that role due to concerns about legal liability for the decisions and actions taken vis-à-vis the IRS. Thus, a partnership agreement should include indemnification provisions with respect to the partnership, the Partnership Representative, or the designated individual, if any, to indemnify such persons against liabilities arising out of their service in their respective roles aside from actions committed in bad faith or gross negligence.

Conclusion

According to a statement by an IRS official, partnership audits under the new audit regime may begin this summer. Thus, it is important that partnership operating agreements are timely revised to provide for the BBA audit rules in order to protect former, existing or incoming partners from unwanted surprises and adverse results of an audit. Likewise, when selling or investing in a business taxed as a partnership, former partners and incoming partners should review the respective audit provisions of the operating agreements of such partnerships to ensure that their interests are properly protected.

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