Significance of the Partnership Representative Under the New Centralized Partnership Audit Regime

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The procedures relating to audits of entities taxed as partnerships (including many limited liability companies) have been almost completely revised, generally effective for tax years beginning after 2017. The old Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, ("TEFRA") audit procedures have been replaced by a new regime enacted into law on November 2, 2015. The new approach will, in many cases, result in the tax, interest and penalties from an audit adjustment being imposed upon the partnership instead of its partners. The position of "tax matters partner" ("TMP") under the TEFRA rules has been replaced by the position of "partnership representative" ("PR"). This is not merely a name change. A PR has duties, responsibilities, and authority that are vastly more significant than those of a TMP. The new procedures are discussed in some detail in a previous Tax Alert and article.

On January 18, 2017, the IRS issued proposed regulations to implement the new centralized audit regime (the "Proposed Regulations"). Almost immediately after issuance of the Proposed Regulations, President Trump issued an executive order requiring federal agencies to eliminate two existing regulatory rules for every new one. This restriction on issuance of regulations might delay implementation of the Proposed Regulations. This article does not address all aspects of the new audit regime, but instead focuses on the new role of PR as amplified in the Proposed Regulations.

Comparisons of a PR to a TMP

The basic concept of both a TMP and a PR is a person designated to act as a liaison between the partnership and the IRS in the event of an audit. Generally, the TMP must be a general partner (or member-manager in the case of an LLC). The TMP cannot be a non-partner, such as a non-partner manager, even if that person is in the best position to understand and have available the partnership's books and records. In practice, the IRS says in some cases it experienced difficulty contacting the TMP because they are outside of the U.S. or simply unreachable. In the case of a TMP that is an entity, the IRS complained that it sometimes must identify and track down an individual who can act for the entity. The new rules attempt to remedy these IRS concerns.

More important is the fact that under TEFRA, while a TMP has authority to bind the partnership, it cannot bind other partners. A partner other than the TMP has rights during an audit, including certain notification rights and the right to participate in the proceeding and to contradict the actions taken by the TMP.

In contrast, under the new audit system the PR can be any person, including a non-partner, provided they have a substantial presence in the U.S. (as defined below). Significantly, the PR has sole authority to bind the partnership, and all partners and the partnership are bound by the actions of the PR and any final decision in an audit proceeding. Other partners no longer have a statutory right to notice of, or to participate in, the partnership-level audit proceeding. Decisions that can be made by a PR may include the important economic choice of whether to have the liability for an audit adjustment borne by the partnership or by the partners in the reviewed year. The enhanced role of a PR means careful attention should be given to the proper designation of a PR and any directions or limitations the partners want to impose on the PR.

Requirement to Have a PR

Effective for tax years beginning after 2017 (or earlier if elected), each partnership must designate a PR for each partnership taxable year. There may be only one designated PR for a taxable year. A proper designation remains in effect until terminated by: (i) a valid resignation; (ii) a valid revocation; or (iii) a determination by the IRS that the designation is not in effect. A PR must update its contact information whenever it changes (such notification to be given as provided by IRS forms or other guidance).

Eligibility to be a PR

Any person is eligible to serve as a PR provided they have a "substantial presence in the U.S.," defined as:

1. Being available to meet in person with the IRS in the U.S. at a reasonable time and place;
2. Having a street address in the U.S. and a telephone number where they can be reached during normal business hours; and
3. Having a U.S. taxpayer identification number.

A person who is not an individual (i.e., an entity) may be a PR only if an individual who meets the above requirements is appointed by the partnership as the sole individual through whom the PR will act for all purposes. A PR satisfying these requirements is referred to as an "entity partnership representative" ("EPR") (and the individual through whom the EPR acts is referred to as the "designated individual" ("DI")). DI status automatically terminates on the date that designation of the EPR, for which the DI, was appointed is no longer in effect.

Manner of Appointment of a DI

A DI is appointed at the time of designation of an EPR in the manner provided by IRS prescribed forms or other guidance. If a partnership fails to appoint a DI, the IRS may determine that the EPR designation is not in effect.

Capacity to Act

A person does not have the capacity to act and is therefore ineligible to serve as a PR or a DI in the event of: (i) death, (ii) a court order adjudicating the person as not having the capacity to manage his or her person or estate, (iii) a court order enjoining the person from acting on behalf of the partnership or the EPR, (iv) incarceration, (v) liquidation or dissolution under state law in the case of an EPR, or (vi) any similar situation where the IRS reasonably determines the person may no longer have the capacity to act.

Annual Designation of PR by the Partnership

The partnership must designate a PR separately for each taxable year. The designation is effective only for the taxable year for which it is made. Except for a designation made after a resignation, revocation or designation made by the IRS, the PR designation must be made on the a partnership tax return for the partnership taxable year to which the designation applies and must include all information required by any applicable IRS form or other guidance. The designation of the PR and, if applicable, the appointment of a DI is effective on the date the partnership return is filed. Therefore, if a subsequent IRS audit covers multiple reviewed taxable years, there could be different PRs for each year. The PR in effect for the year in which the audit is actually conducted may not be in control of decisions relevant to the reviewed year or years.

Resignation of the PR

A PR may resign by notifying the partnership and the IRS in writing of the resignation. The notification to the IRS, submitted in accordance with any applicable IRS form or other guidance, may include a designation of a successor PR for the taxable year for which the designation of the resigning PR was in effect. If the resigning PR does not designate a successor, the IRS will determine there is no designation in effect and the partnership will have the opportunity to designate a successor PR.

A PR may resign simultaneously with the filing of a valid administrative adjustment request ("AAR") after receipt of a notice of administrative proceeding for the partnership taxable year, or at such other time as prescribed by the IRS. If a PR resigns in connection with the filing of an AAR, the PR must designate a successor PR. A partnership may not use the form prescribed by the IRS for filing an AAR solely for the purpose of allowing the PR to resign.

Resignation of a DI

A DI may resign by notifying the partnership, the PR and the IRS in writing as if the DI was a resigning PR. The notification to the IRS, to be submitted in accordance with any applicable IRS form or other guidance, may include an appointment of a successor DI for the partnership taxable year for which the DI was appointed. If the resigning DI does not appoint a successor, the IRS will determine there is no designation in effect and the partnership will have the opportunity to designate a PR, including the appointment of a DI, or the IRS will designate a PR.

Revocation of Designation

The partnership may revoke the designation of the PR for the taxable year by notifying the PR and the IRS in writing. The notification of the IRS must be submitted in accordance with any IRS prescribed form or other guidance and must include designation of a successor PR for the partnership taxable year for which the designation of the PR was in effect. Failure to satisfy these procedures will be treated as if no revocation has occurred and the PR designation will remain in effect until terminated either by valid resignation, valid revocation or a determination by the IRS that the designation is not in effect.

Time for Revocation

Generally, a partnership may not revoke the designation of the PR before the IRS makes a notice of administrative proceeding. Upon receipt of a notice of administrative proceeding, the partnership may revoke the PR designation. The partnership may revoke a designation of PR for the taxable year when the partnership files a valid AAR for a partnership taxable year. A partnership may not use the form prescribed by the IRS for filing an AAR solely for the purpose of revoking the designation of a PR.

Persons Who May Sign A Revocation

For A General Partnership or Limited Partnership

A revocation of PR status must be signed by a person who was a general partner at the close of the taxable year for which the PR designation is in effect as shown on the partnership tax return for that taxable year. A partner in the partnership who was not a general partner eligible to sign the revocation may sign the revocation only if, at the time the revocation is signed, each general partner eligible to sign is no longer a partner or no longer has the capacity to act.

For A Limited Liability Company

With regard to a revocation of a PR for a limited liability company (“LLC”), a “member-manager” of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner. A member-manager is defined as a member of an LLC who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no elected or designated member-managers of the LLC, each member will be treated as a member-manager. Note that most LLC statutes permit management by a manager who is not also a member. Such person would not fit the definition of member-manager.

Form of the Revocation

To be valid, the notice of revocation must include a certification under penalties of perjury that the person signing the form: (i) is a proper partner or LLC member as described above, authorized by the partnership (or LLC) to revoke the designation of PR; (ii) has provided a copy of the revocation to the partnership and to the PR whose designation is being revoked; (iii) states that the person signing is revoking the designation of the PR; and (iv) subsequently designates a PR in accordance with an applicable IRS form or other guidance.

Revocation of a PR Designated By The IRS

If a PR is designated by the IRS, the partnership may revoke that designation only with the permission of the IRS.

Multiple Revocations

If, within a 90-day period, the IRS receives more than one revocation of a designation of a PR for the same taxable year signed by different persons, the IRS may determine that a designation is not in effect.

Designation of the PR by the IRS

If the IRS determines that a designation of a PR is not in effect for a partnership taxable year, the IRS will notify the partnership and the most recent PR (if any) for that partnership taxable year that a PR designation is not in effect and will provide the partnership with an opportunity to designate a PR. The IRS may determine that the PR designation is not in effect in the case of multiple revocations (as discussed above) or if the IRS determines that: (i) the partnership failed to make a valid designation; (ii) the PR or the DI does not have substantial presence in the U.S. or does not have the capacity to act; (iii) the partnership failed to appoint a DI; or (iv) no successor designation or appointment was made in the case of a resignation of a PR or a DI.

The IRS designates a PR by notifying the partnership of the name, address and telephone number of the new PR. The IRS may designate any person to be the PR. The IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year or at the time the PR designation is made. The IRS may also consider: (i) the views of the partners having a majority interest in the partnership regarding the designation (unclear whether this is a majority in the reviewed year or in the year the audit is being conducted); (ii) the general knowledge of the person in the tax matters and the administrative operation of the partnership; (iii) the person's access to the books and records of the partnership; and (iv) whether the person is a U.S. person.

Binding Effect of Actions of the Partnership and PR

The actions of the partnership and the PR and any final decision in an audit proceeding with respect to the partnership bind the partnership, all its partners and any other person whose tax liability is affected by taking into account, directly or indirectly, adjustments determined under the partnership tax rules (such as indirect partners). For example, a settlement agreement entered into by the PR on behalf of the partnership, a notice of final partnership adjustment with respect to the partnership that is not contested by the PR or the final decision of a court with respect to the partnership if the notice of final partnership adjustments is contested, binds all persons described in the preceding sentence. The termination of the designation of the PR does not affect the validity of any action taken by that PR during the period prior to termination when the designation was in effect.

The PR has sole authority to act on behalf of the partnership. In the case of an ERP, the DI has sole authority to act on behalf of the PR and the partnership. Except for a partner that is the PR or the DI, no partner or any other person may participate in an audit examination or other proceeding involving the partnership without permission of the IRS. No state law, partnership agreement or other document or agreement may limit the authority of the PR or the DI as provided in the Proposed Regulations.

Conclusion

Although the Proposed Regulations are currently frozen because of the recent executive order, they could be reissued in similar form. Experts appear divided on whether some aspects of the regulations exceed the regulatory authority of the IRS.

Given the increased importance of the role of a PR (versus a TMP) and the detailed provisions of the Proposed Regulations regarding the designation and replacement of a PR, close attention should be paid to these regulations. In all situations, specific provisions regarding the PR should be included in any new partnership agreement or operating agreement, or in an amendment to any existing agreement.

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