Why (Nearly) Every Partnership Agreement Should be Amended

By Jason B. Freeman, JD, CPA | Column Editor

The new partnership audit rules generally take effect for tax years beginning in 2018 – partnerships and their partners will ignore them at their peril. The new rules, enacted under the Bipartisan Budget Act of 2015 (BBA), dramatically change the regime that currently governs partnership tax audits, assessments and collection. The changes will impact not only *how* tax adjustments are assessed, but *who* is ultimately responsible for them. In many cases, the new rules will substantially alter the allocation of risk among partners (e.g., among past, current and future partners) related to uncertain tax positions or future tax adjustments.

As a result, they will impact the valuation of partnership and LLC interests and the due diligence necessary in a transaction that involves such an interest. In some cases, they will also create potentially costly disputes among partners that could even embroil CPAs who may be viewed as having failed to inform the partnership of the impact of the new rules or the need to have their operating or partnership agreement reviewed.

The good news, however, is that the BBA offers many opportunities for both flexibility and certainty. But to fully take advantage of these opportunities, partnerships will need to review and revise their agreements now – before the new regime goes into effect. Indeed, nearly every partnership (including LLCs treated as a partnership) should have its operating or partnership agreement reviewed (and probably revised) before the end of the year to incorporate provisions that are specifically tailored to the BBA regime.

Background

The BBA, as amended by the Protecting Americans from Tax Hikes Act of 2015, repeals the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Electing Large Partnership audit regimes that currently govern partnership administrative procedures. In their place, it imposes a new, centralized partnership audit regime that generally provides for the assessment and collection of tax at the partnership level.

The new rules were designed to streamline partnership audits and to reduce the administrative burden on the IRS. They were also designed to make it easy to collect partnership-related tax assessments. The result will be a renewed focus on partnership audits. Partnerships and their professionals can expect to see an increase – likely a fairly dramatic one – in the number of partnership audits after 2017.

The default rules under the BBA regime completely change the partnership audit landscape. Assessments will now generally be made against the partnership itself, a change at odds with the traditional concept of the partnership as a non-taxpaying, flow-through entity under Subchapter K. And where the IRS makes an assessment based on a prior year (a "reviewed year" in the BBA terminology), the current partners will be responsible for paying that assessment – unless, that is, the partnership makes an available election to push those assessments out to prior reviewed-year partners.

As one can see, the decision about whether to make such an election may pit various partners' interests against one another. Partners may not only have come and gone, but their respective interests may have shifted over time. Add in the fact that one person – the "partnership representative," who may owe competing state-law fiduciary duties to various partners and may also have their own self-interest in mind – has sole discretion under the new law to make those decisions and one can see that the prospect for costly disputes under the default BBA structure is ripe. Fortunately, many of these otherwise inevitable disputes can be avoided by proactively revising the partnership's operating or partnership agreement to address the new rules.

New and Uncertain Sources of Guidance

While much is clear under the new legislation, there are still many issues up in the air with respect to its implementation. In January of 2017, the IRS issued proposed regulations on the new rules. However, those proposed regulations were quickly withdrawn by an executive order imposing a moratorium on federal rulemaking. As a result, their status remains somewhat unclear, but they do provide a source of relevant guidance and a window into the IRS' thinking on a number of issues.

In addition, both houses of Congress previously introduced a technical corrections bill, The Tax Technical Corrections Act of 2016, that would have enacted several fundamental changes and clarifications to the BBA's rules. However, the Technical Corrections Act was not adopted before last year's session adjourned. With the renewed prospect of tax reform on the horizon, it may very well serve as a blueprint for any partnership tax changes that make their way into future tax legislation.

Regardless, however, of the status of any proposed regulations or technical corrections bills, the BBA's statutory provisions will go into effect in 2018 by force of law. So, again, partnerships should ready themselves for the changes to come.

Issues to Address

There are numerous BBA-related issues that should be addressed in new and existing partnership and operating agreements. This Tax Topics column will briefly address a few of the more common issues.

Electing Out of the BBA

Partnerships with 100 or fewer partners that meet certain requirements may be eligible to elect out of the BBA regime. Such eligible partnerships should address whether an "election out" of the BBA will be mandatory. Each election out must be made on an annual, year-by-year basis. It is important to keep in mind that the election-out decision is not a onesize-fits-all proposition; some partnerships may actually benefit from the new BBA regime depending on their circumstances. Most, however, will probably prefer to elect out of the BBA.

Under the BBA and the proposed (but withdrawn) regulations, a partnership with a partner that is itself a partnership, trust, disregarded entity or nominee is not eligible to elect out of the BBA regime. Partnerships that want to avoid the new BBA rules may want to impose restrictions on the transfer of partnership interests to such partners and limit ownership to certain eligible entities to maintain their ability to elect out.

The Partnership Representative

The BBA does away with the TEFRA tax matters partner and, in its place, creates an entirely new role: the partnership representative. The partnership representative has sole authority to unilaterally bind all other partners in an administrative or judicial proceeding, including the ability to settle, extend a statute of limitations or bring court action. The IRS will communicate exclusively with the partnership representative throughout any such proceedings and the partnership representative is not obligated to provide notice to partners.

Existing partnership and operating agreements are drafted around the soon-to-be-outdated TEFRA tax matters partner concept. TEFRA, for instance, provides rules that require notice to be provided to partners and that give certain partners a right to be involved in proceedings. TEFRA also provides for background rules to select a tax matter partner where one is not in place. Those rules will not govern in a BBA world. In contrast to TEFRA, under the BBA, if a partnership representative designation is not in effect, the IRS has authority to select any person to serve in that role.

At a minimum, partnership and operating agreements should provide a process for selecting, removing and replacing the partnership representative. Under the BBA, and unlike under TEFRA, a partnership representative need not be a partner. A partnership representative could, for instance, leave the partnership but still remain as the partnership representative. This scenario and others can be addressed.

Operating and partnership agreements can also be used to impose state-law obligations on the partnership representative to provide notice to partners of certain events. For instance, they can be used to impose an obligation to notify partners of the commencement of an audit, any proposed assessment and the procedural options available at any given stage.

Finally, many partnerships may wish to limit the partnership representative's authority over certain tax matters. For instance, a partnership may provide that certain decisions – such as extending a statute of limitations or settling a dispute – require a majority, supermajority or even a unanimous vote of the partners. While such restrictions may not limit the partnership representative's authority from the standpoint of the IRS, they will provide state-law recourse for actions that do not comply with the operating or partnership agreement. In a similar fashion, partnerships may want to address the fiduciary duties, if any, of the partnership representative, either limiting or expanding such obligations in light of the unique needs of the partnership.

The 'Push Out' Election

The BBA provides for a "push-out" election that allows a partnership to push, as the name implies, a partnership adjustment out to prior-year partners ("reviewed-year" partners). In other words, the "push-out" election provides a mechanism to push the liability related to the adjustment back to those reviewed-year partners who received the economic benefit from the adjusted tax item, rather than imposing liability on the partnership itself, which would cause current-year partners – who may be different from the reviewed-year partners – to bear the ultimate economic burden of the assessment.

However, the push-out election is not automatic or self-executing. The partnership must make the election within 45 days of the notice of final partnership adjustment and must provide the reviewed-year partners with a statement reflecting their share of the adjustments. The reviewed-year partners must then take those adjustments into account and pay any resulting tax, penalties and interest.

Of course, there are considerations that may impact the desirability of a push-out election. For instance, a push-out election may subject the adjustments at the partner level to greater interest rates and may also have self-employment tax, net investment income tax and state tax implications.

Partnerships can address the push-out election in their operating or partnership agreements. Doing so may avoid costly disputes among reviewed-year partners and current partners about the proper treatment and whether to make the election that will determine who is ultimately liable. A partnership representative – who has the authority to choose whether to make the push-out election – may even have a self interest in the decision, underscoring the need to address these issues ahead of time and before the question arises.

Moving Forward

Practitioners can expect to see significant increases in the number of partnership audits in future years as a result of the BBA. Practitioners will find that the new audit rules under the BBA are far different from those under the existing TEFRA and Electing Large Partnership regimes.

The BBA will have a dramatic impact both in terms of how partnership assessments are made and who is ultimately responsible for them. In many cases, its default rules will lead to inequitable results and opportunities for elections or procedural steps that present serious conflicts of interest and questions about fiduciary duties. That, of course, will inevitably lead to costly disputes and unnecessary tension among partners. In fact, in some cases, CPAs may even find themselves embroiled in future disputes, accused of failing to inform the partnership of the impact of the new rules or notifying it of the need to have its agreement reviewed.

Many of these issues and risks, however, can be addressed and mitigated by proactively having legal counsel review and, where appropriate, amend partnership and operating agreements to anticipate and address the changes to come. ■

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