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Changes in Partnership Audit Procedures Call for Changes in Partnership Agreements

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As 2017 draws to a close, changes that will go into effect for tax years that begin after Dec. 31 mean that every business that is treated as a partnership for federal income tax purposes needs to revise their partnership or operating agreement. The changes, which include the treatment of small partnerships, control over the audit process, and shifting of the tax bill from partners to the partnership, will render existing agreements obsolete and leave partners' interests unprotected.

In late 2015, Congress passed the Bipartisan Budget Act (BBA), which included provisions altering the process for auditing partnerships, which have been governed by procedures adopted when the current law, the Tax Equity and Fiscal Responsibility Act (TEFRA), passed in 1982.

The changes were designed to make it easier for the IRS to audit partnerships and to collect the additional taxes it assesses. The new audit procedures will apply to general partnerships, limited partnerships, limited liability partnerships, and multi-member limited liability companies that have elected to be taxed as partnerships.


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As an example of the magnitude of the changes, consider the contrast in partners' rights in connection with an audit under current law and under the BBA:

Currently, partners have the right to receive notice of an audit, to participate in the audit, and to seek judicial review if they are dissatisfied with the outcome.

Next year, partners will have no right to notice of the audit, to participate in it, or to seek judicial review of the outcome. A partnership representative will get to make all of the decisions, binding all of the partners without any input from them. And in certain situations, the IRS can appoint the partnership representative.

Existing partnership agreements were drafted with TEFRA's procedures in mind and rely upon them for the protection of partners' rights. With those safeguards removed, existing agreements will now become obsolete.

In addition, partners may essentially pay someone else's tax bill, as the new procedures contemplate that the partnership will pay any additional tax determined in the course of an audit, placing the economic burden of the tax on the current year partners. While the new audit procedures provide options to avoid this situation, partnership agreements should be revised to establish appropriate audit protocols.

In these three key areas—the treatment of small partnerships, control over the audit, and shifting the tax bill away from the partnership—businesses operating as partnerships should understand the changes to existing law created by the BBA and the potential structural issues that they create.

TREATMENT OF SMALL PARTNERSHIPS

• Summary of the law.

TEFRA, which currently governs partnership audits, established a centralized audit regime that applied to most partnerships, but small partnerships were excluded.

Small partnerships were defined as having ten or fewer partners, each of whom was either an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.

A partnership that met those criteria would not be subject to TEFRA, and the IRS had to audit each partner individually. The only exception would be if the partnership decided it wanted to have TEFRA's procedures apply.

Under the BBA, partnerships will have to opt out of the centralized audit regime affirmatively. The default position is that they are covered, no matter how small.

The ability to opt out is valuable because the new BBA regime was designed to make audits easier for the IRS. The BBA permits a partnership to opt out if it meets the following criteria:

The partnership has no more than 100 partners, which is measured by the number of Schedule K-1s it distributes.

The members of the partnership are individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic, S corporations, or the estates of deceased partners.

A partnership that includes disregarded entities or partnerships cannot opt out. While the Treasury Department was given the authority to expand the list of eligible partners, it has promulgated proposed regulations that do not do so and that decision appears to be final.

• Structural considerations.

A common structure for many partnerships is to have a general partner or managing member that is a disregarded entity for liability protection; under the BBA that arrangement precludes the partnership from opting out.

Partnerships should consider how they want to approach the result of an audit and then provide for that approach in their agreement.

If the general partner or managing member were an S corporation, that partnership might qualify to opt out.

Consequently, existing partnerships should consider restructuring if the other relevant criteria are met.

Ideally, this would be done before the end of the current tax year, to assure that the partnership can opt out for the 2018 tax year. If that time-table cannot be met, it is still worth considering because it will preserve the partnership's ability to opt out in future years.

Another major consideration is preserving the partnership's ability to opt out by precluding disqualifying transfers of a partnership interest to a partnership or a disregarded entity.

CONTROL OVER THE AUDIT

• Summary of the law.

TEFRA called for partnerships to designate a "tax matters partner," who would serve as the point person for coordinating communications with the IRS in an audit. The tax matters partner's authority was actually quite limited: The tax matters partner could extend the statute of limitations for all partners; it also might be able to bind smaller partners in a large partnership to a settlement. Instead, individual partners were the key decision makers, and they each had the right to be notified of the proceedings, to participate, and to challenge any administrative disposition in court. These rights were built into TEFRA.

The BBA takes a dramatically different approach: Each partnership is to designate a "partnership representative" who is given statutory authority to bind the partnership and the partners. The partnership representative has real power under the BBA:

Individual partners have no right to receive notice of the audit, and they have no right to participate or to challenge the outcome.

In theory, a partner could learn about an IRS audit for the first time when the audit was completed and he was told to pay additional tax.

The partnership representative does not have to be a partner, and if the partnership does not appoint an appropriate representative, the IRS will do so.

Under this regime, if partners are going to have any rights, they will have to come from the partnership agreement.

• Structural considerations.

Careful thought should go into selecting the partnership representative, and those criteria should be spelled out in the agreement.

The agreement should also impose constraints upon the partnership representative's authority by requiring that certain key decisions only be made after consultation with a management group or a committee of partners. This should be required in a variety of circumstances, such as the following:

Before extending the deadline for the IRS to assess additional tax.

Before raising a defense, such as reasonable cause, that could waive the partnership's attorney-client privilege.

Before waiving the partnership's attorney-client privilege.

Before adopting measures that would shift the tax obligation from the partnership to individual partners.

Before agreeing to a settlement.

Before requesting judicial review.

Note that the proposed regulations take the position that a partnership representative who acts without complying with these types of requirements can still bind the partnership and the partners. It still makes sense to include reasonable constraints on the partnership representative for the following reasons:

It is possible that the Treasury Department will moderate its position when it finalizes the regulations; A responsible representative is unlikely to disregard explicit limits on his authority; and a representative who does violate one of these constraints could presumably be held accountable for any consequences.

Some have suggested that the indemnification rights of the partnership representative should be conditioned upon compliance with these types of constraints.

The agreement should also provide for notice and reporting to the partners concerning any audit, its outcome, and any judicial proceedings.

SHIFTING THE TAX BILL AWAY FROM THE PARTNERSHIP

• Summary of the law.

A fundamental tenet of partnership taxation is that partnerships don't pay taxes, partners do. While TEFRA created a central audit mechanism, the end result was the assessment of individual partners for tax, interest and penalties associated with any adjustment to the partnership's return.

The IRS is tired of chasing individual partners. Consequently, under the BBA, the default position is that the partnership foots the bill for the partners. That can be very unfair; assume that in 2020, the IRS audits a partnership for the 2018 and 2019 tax year and determines that additional tax is due:

The economic burden of that tax will fall on the current partners;

Former partners who were members of the partnership in the relevant years will pay nothing; and

Current partners who have increased their interest in the partnership after 2019 will overpay.

Fortunately, the statute gives partnerships options, which include a "push-out" election that makes the partners in the relevant tax year responsible for the underpayment.

• Structural considerations.

Partnerships should consider how they want to approach the result of an audit and then provide for that approach in their agreement. They may also want to consider contractual provisions that put the tax liability where it belongs, on those who were partners in the relevant tax year.

This issue should be addressed prior to an audit to avoid disputes. Once an audit commences, there will be winners and losers, and it will be hard to reach an appropriate agreement.

Provisions that may be appropriate include the following:

A requirement that the partnership representative elect the statutory option to push out any tax liability to those who were partners in the relevant tax years, at least where the amount at issue is meaningful.

To protect the partnership in the event of an ineffective push-out election, it may be appropriate to add indemnification provisions that require former partners to pay their share of additional taxes assessed for years in which they were partners. •