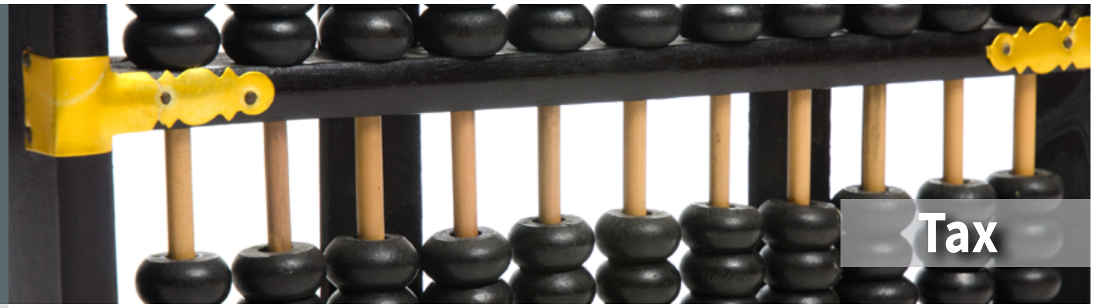

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Amend Partnership and LLC Agreements Now to Address New IRS Audit Rule

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In this Issue:

In late 2015, existing partnership audit provisions (applicable also to limited liability companies taxed as partnerships) were prospectively repealed and replaced with new audit procedures that significantly change how the Internal Revenue Service ("Service") will approach partnership audits. The revised audit provisions become effective for years beginning on or after January 1, 2018. **The impact of these new rules could be dramatic to existing partners and LLC members ("partners") unless there are provisions in entity governing documents that provide protection.**

Without such protection, partners can be bound by agreements made with the IRS without the authority of the partnership or LLC ("partnership") and in certain cases, existing partners can be forced to pay the taxes of former partners for the years they were still partners of the partnership.

Tax Matters Partner Replaced by Partnership Representative

The revised partnership audit provisions replace current partnership appointments of a "tax matters partner" with a "partnership representative" ("PR"). The PR will have significantly more authority than the tax matters partner because the PR will have sole authority to act on behalf of the partnership and may bind the partnership and all partners (unilaterally) in audits as well as in any related court proceedings. Unlike existing audit provisions, no partner will be entitled to notice or other communication from the Service, and the new provisions also do not require the PR provide any notice or updates to the partners. The PR does need not be a partner and, if the partnership fails to appoint a PR, the Service will select a person of their choice as the PR. Thus, existing agreements that do not have PR provisions should be amended to appoint a PR and consideration should be given to provide notice and participation rights of the non-PR partners or specifically limit the authority of the PR to act only with consent of non-PR partners.

Partnership Liable for Tax Deficiency

Another major departure from existing audit provisions is that under the new provisions the partnership, rather than the partners, can be liable for any resulting imputed underpayment of reported adjustments to items of income, gain, loss, deduction, or credit of the partnership. The Service will no longer be required to collect a tax deficiency from the partners of the partnership and instead the deficiency can be assessed against the partnership at the highest marginal rate for individuals or corporations in existence at such time. The PR will have the sole authority to direct the partnership pay the deficiency or to elect to have the partners who were partners during the audited tax year pay the deficiency. If the PR elects to have the partners (and possibly former partners) pay the deficiency, the PR will be required to issue revised K-1s with respect to the audited year and allocate the tax liability among the partners and former partners. Under existing audit provisions, the expense and burden of contacting individual partners or former partners, and allocating tax liability thereto, is the responsibility of the Service. Under the new audit provisions, this burden, responsibility and expense is the obligation of the PR. Since the new procedures place primarily responsibility for any tax deficiency on the partnership, the ability of the PR to successfully shift the liability to the partners, and particularly any former partners who were partners for the audited years but are no longer partners in the year the assessment against the partnership, will be dependent upon the provisions of the partnership agreement. Once again, partnership agreements should be amended to contain provisions that allow the PR to require current and former partners to account for an pay for their own tax obligations. Providing this in the agreement will alleviate the burden otherwise imposed on the partnership and will likely reduce the total taxes paid to the Service given not all partners will be subject to tax at the highest marginal rate in existence at such time.

Partnerships Subject to the New Audit Provisions

All partnerships will be subject to the revised audit provisions although a partnership may elect out (under procedures to be issued) under certain circumstances. Partnerships may elect out if their only partners are "eligible partners" (individuals, estates of a deceased individual, or an S or C corporation), the partnership has less than 100 eligible partners, and the partnership follows timelines and requirements of electing out. It is noteworthy that an "eligible partner" excludes any partner that is a trust or a partnership. Accordingly, any partnership with a partnership, limited liability company or a trust as a partner is not permitted to elect out regardless of the total number of partners in the partnership.

Furthermore, the election out is an annual election that must be made every year to remain effective. If a partnership elects out in some years and not in others, any year for which an election is permissible but not made, the partnership will be subject to the revised audit procedures. There will be competing reasons to either elect out or not and as such, this annual determination must be a thoughtful one made by the PR.

Trump Administration's Regulation Freeze

Many of the regulations necessary to fully implement the revised audit procedures are expected to be issued by the Service. While proposed regulations have been drafted, they are currently unavailable because of the regulation freeze imposed by the Trump Administration. Notwithstanding the absence of regulations, the old audit rules have been repealed and the revised audit provisions have been enacted into law and will become effective as of January 1, 2018, with or without such regulations.

Summary

Because of the broad new powers that will be available to the PR, any partnership or LLC agreement that predates the genesis of this recent law should be amended to appoint and possibly regulate the actions and/or authority of such PR to bind the partnership. In addition, amendments should provide for the appropriate mechanism to reduce the administrative and economic burdens on the partnership itself.

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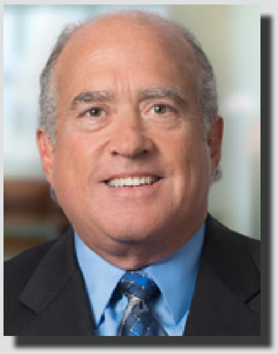

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