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Revisiting Your Partnership Agreement: Practical Considerations In Light Of The New Partnership Audit and Adjustment Provisions

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For nearly twenty-five years, the audit and adjustments to the federal income tax liabilities of partnerships (and limited liability companies taxed as partnerships[1]) have been governed by the rules and procedures referred to by tax practitioners as "TEFRA."[2] That all changed with the enactment of Title XI of the Bipartisan Budget Act of 2015 ("Act").[3] The Act significantly alters the audit and adjustment provisions of the Internal Revenue Code of 1986, as amended, applicable to partnerships and partners. In general, the new audit and adjustment provisions will apply to returns for partnership tax years beginning January 1, 2018.[4]

For partnerships subject to the audit and adjustment provisions of the Act, an increase in a partnership's taxable income from an audit will generally result in a tax, computed at the highest rate applicable to an individual or corporation[5], levied on the partnership, not the partners (the "partnership level tax").[6] Because the identity of the partners and their respective partnership interests are not always identical, or even substantially identical, year to year, the partnership level tax can carry dramatic economic consequences. For example, assume adjustments are incurred in one year (the "audit year"), but determined and applied in a subsequent year (the "adjustment year"). In this situation, the economic burden of adjustments incurred in the audit year will be stomached by the partners *in the adjustment year* in proportion to their partnership interests *in the adjustment year* (as opposed to the partners in the audit year in proportion to their partnership interests in the audit year).

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[1] The word "partnership" when used in this article also refers to a limited liability company taxed as a partnership, and the phrase "partnership agreement" also refers to an operating agreement.
[2] Tax Equity and Fiscal Responsibility Act of 1982, I.R.C. §§ 6221 – 6234.
[3] H.R. 1314, 114th Cong. (2015) (enacted).
[4] *See* § 6241(g) of the Act.
[5] The highest individual or corporate rate is used regardless of whether any such person is a partner.
[6] *See* § 6225 of the Act.

The new regimen does, however, provide two mechanisms for assigning responsibility for the partnership level tax to the audit year partners; specifically, the amended return mechanism and the passthrough election mechanism. The amended return mechanism generally provides that if one or more audit year partners file an amended return for the audit year reporting all partnership adjustments allocable to the partner (and for any other taxable year with respect to which any tax attribute is affected by reason of that adjustment) and pays the tax due as a result of such adjustments, then the partnership may disregard that partners allocable share of the adjustments in computing the partnership level tax. Stated differently, if proper amended returns are filed by all audit year partners and each of those partners pays the resulting increase in tax, there would be no partnership level tax.[7]

The passthrough election mechanism generally provides that the partnership may elect to pass through the adjustments to the audit year partners, and accordingly, avoid payment of the partnership level tax. If the partnership utilizes this passthrough election mechanism, the audit year partners would owe interest on any increase in tax resulting from the pass through of the adjustments at a rate 200 basis points higher than the rate normally applicable to tax underpayments.

It is safe to assume that few, if any, partnership agreements address, or even contemplate, imposition of a partnership level tax and the economic burden of said tax on adjustment year partners (who may be newly admitted partners) or the varying of partnership interests from the audit year to the adjustment year. Although the new regimen is not effective until January 1, 2018, it is not too early to begin considering amendments to the partnership agreement to address the potential economic impacts. For example, assuming the primary objective of the partnership is to impose the burdens of partnership adjustments on the audit year partners (who may be former partners) in proportion to their audit year partnership interests, the partnership agreement may be amended to address the following concepts:

1. Specific, adjustment related indemnification in favor of the partnership from each partner and former partner;

2. Circumstances when it is acceptable for the adjustments to result in a partnership level tax (for example, when the partners, and their respective partnership interest, are the same for the audit year and the adjustment year);

3. If it is not acceptable for the adjustments to result in a partnership level tax, consider mechanisms to induce the audit year partners to file and pay tax under the amended return mechanism (one such inducement, for example, may be that in default of the amended return mechanism, the partnership will make a passthrough election, which would, by its terms, result in the application of an interest rate that is 200 basis points higher than the normal underpayment rate to the partners' increased tax liabilities); and

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[7] Note: the new section 6225(c)(2) amended return mechanism is riddled with anomalies, a discussion of which is beyond the scope of this article.

4. If a passthrough election is not necessary to achieve the partnership's objectives, procedures to protect audit year partners from that election and the increased interest rate.

Another significant change in the Act is the elimination of the "tax matters partner." Under TEFRA, the tax matters partner was the "face" of the partnership audit. The tax matters partner would provide information to the partners, serve as part notice partner, and, to a limited extent, function as the decision maker for purposes of the audit. The Act replaces the tax matters partner with the "partnership representative," whose role throughout the audit is more substantial than that of the tax matters partner. The partnership representative has the ability to make decisions and take actions that have a binding effect on some, most or all of the partners.[8] This ability is the result of the Act providing a breadth of authority to the partnership representative (who need not even be a partner).[9] Therefore, the introduction of the partnership representative in the Act creates duties, responsibilities, and potential liabilities that were absent in the role of the tax matters partner. Accordingly, partnerships (and their partners) should consider amending the partnership agreement to address the procedural changes under the new regimen, such as requiring the partnership representative to provide correspondence to each affected partner which is, or may be, material to the audit. The partnership agreement could also be amended to require the partnership representative to exercise his authority only after notice has been provided to all affected partners pursuant to written directions from an oversight group.

It is important to note that certain partnerships may "elect out" of the Act's audit and adjustment to federal tax liability provisions.[10] Specifically, partners with no more than one hundred partners, all of whom are individuals, estates, or corporations, may elect out.[11] A partnership with an upper-tier partnership as a partner, however, may not elect out under the terms of the Act[12] If a partnership elects out, the audit and adjustment to liability of the partnership and its partners will be governed by pre-TEFRA law.[13]

The Act has, in many ways, changed the landscape of partnership tax audits. Although certain aspects of the new regimen are riddled with anomalies, we do know this much: the new regimen will be effective, at the latest, for partnership tax years beginning January 1, 2018. Partnerships (and their partners) would be wise to address the issues presented by the Act sooner rather than later. At a minimum, partnerships should consider partnership agreement amendments which address the election out, the partnership level tax, the economic burden of the partnership level tax on the partners, and the position of partnership representative.

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[8] *See* § 6223 of the Act.
[9] *Id*.
[10] *See* § 6221 of the Act.
[11] *Id*.
[12] The Act does, however, authorize the Internal Revenue Service to provide, by administrative guidance or regulation, election out treatment for partnerships with an upper-tier partnership as a partner. *See* § 6221 of the Act.
[13] Tax adjustments are applied at the partner level under pre-TEFRA law, with each partner treated independently.