TEFRA REPEAL

ESSENTIAL CHANGES TO PARTNERSHIP AGREEMENTS AND OPERATING AGREEMENTS

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Essential Changes to Partnership Agreements and Operating Agreements

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The Bipartisan Budget Act of 2015 (P.L. 114-74) was signed into law on November 2, 2015. The Act repealed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit rules and changed the procedures for partnership audits. Significant changes include:

- The partnership itself—and not just the partners—is now responsible for audit adjustments. This creates new challenges for partnerships and their current and former partners.
- The Act replaces the role of "tax matters partner" with the new role of "partnership representative." This makes prior provisions that applied to tax matters partners obsolete.
- The Act imposes liability in the year of adjustment instead of in the tax year to which the adjustment relates. This can reallocate risk among current and former partners. The new audit rules have far-reaching effects on partnerships and limited liability companies.

Because of the popularity of the LLC form—and because most multi-member LLCs are taxed as partnerships—these new rules could affect the majority of small businesses. New partnership and operating agreements should be drafted with these rules in mind. Many existing businesses should revise their partnership or operating agreements to reflect these changes. This alert discusses the new audit rules and how they affect partnerships and LLCs taxed as partnerships.

> ***Note:*** *For brevity's sake, the remainder of this alert will discuss these changes using partnership terminology. For LLCs that are taxed as partnerships, the discussion of "partners" and "partnership agreements" in this document apply equally to "members" and "operating agreements," respectively.*

Prior Law: Tax Equity and Fiscal Responsibility Act of 1982

TEFRA was enacted in 1982 to standardize audit procedures and close tax loopholes. The TEFRA audit rules have been in place since 1982, and the related reporting and audit procedures for electing large partnerships have been in effect since 1998. These rules create three categories of partnerships for audit purposes:

- Partnerships with ten or fewer partners are audited at the partner level. The IRS may not make partnership level adjustments if only individuals, estates, or C corporations are partners. Partnership tax returns are only audited in connection with audits of partners' tax returns.
- Partnerships with more than ten partners are audited under unified TEFRA procedures that are binding on the partners. The IRS may adjust partnership-level items and re-assess partners for the tax resulting from the adjustment.
- Partnerships with 100 or more partners can elect to be treated as electing large partnerships (ELPs). The IRS uses unified audit procedures for ELPs. Any adjustments or assessments occur at the partnership level.

Overview of the New Audit Rules

The Bipartisan Budget Act of 2015 was part of a budget agreement by lawmakers to avoid government default. The new Act repealed both the TEFRA audit rules and the unified audit procedures for ELPs. It replaced them with new rules designed to streamline partnership audits. These new rules allow the IRS to assess and collect taxes resulting from partnership audits at the partnership level instead of passing the adjustments through to the partners.

Tax Liability Imposed at Partnership Level

If an audit requires adjustment to partnership items or allocations, the new rules require the partnership to pay the resulting taxes. These taxes are referred to as the "imputed underpayment amount" (IUA) and are calculated using the highest tax rate applicable to individuals or corporations in the audited year. When computing the IUA, the partnership may not deduct tax, interest, or penalties paid by the partnership during that year.

This new system shifts financial responsibility for tax adjustments. Where TEFRA assigned liability for audit adjustments to the partners, the Act assigns liability for IUA to the partnership. Under the new rules, it is the partnership itself—and not the partners—that is responsible for the IUA.

This shift of tax liability from the partners to the partnership can increase the IUA. Because the IUA is computed at the partnership level, the partners' individual tax attributes are ignored. For example, a partner's net operating losses do not offset the partnership's IUA, even though the net operating loss would have offset the partner's share of the income had it been distributed. Similarly, income that would be allocated to a tax-exempt partner (and thus escape taxation) is now computed at the partnership level, where the partner's exempt status is ignored.

Because of these changes, the tax liability of the partnership may be greater than the aggregate tax liability of the partners would be if the assessment occurred at the partner level. In recognition of this disparity, the Act directs the IRS to issue regulations setting forth procedures for adjusting the IUA to consider the partners' tax profiles. These adjustments should take partner-level exclusions and tax rates into account to reduce the IUA.

The new Act is silent about whether partners are secondarily liable if the partnership cannot pay the tax resulting from the adjustment. This could occur, for example, if the partnership is bankrupt or insolvent. The legislative summary of the Act seems to indicate that the partners would not be secondarily liable in this context. The IRS will likely issue regulations to clarify this issue.

Adjustments Made in Adjustment Year

Under the new Act, the partnership must make audit adjustments in the year that the audit or judicial review is completed (the "adjustment year"), not in the year to which the adjustment relates. For example, assume a partnership is audited in 2018 for a mistake on its 2016 tax return and the audit is completed in 2019. Under the new audit regime, the adjustment would be made in 2019 (and affect the partnership's 2019 taxes) even though the mistake occurred in 2016.

Assessment in the adjustment year shifts risk from former partners to current partners. Partners that

leave the partnership are unlikely to be affected by future adjustments. But this relief comes at the expense of the new partners, who are now responsible for tax adjustments that relate to prior years. These adjustments could increase the new partners' tax liability even though it relates to a year in which the new partner owned no partnership interest.

To fix this potential inequity, there are two ways that partnerships can shift partnership-level tax back to partners from prior years. First, the partnership may compute the IUA by disregarding all income taken into account at the partner level. This method only applies if the following actions occur within 270 days of receipt of the notice of proposed adjustment:

1. The partnership must issue amended Form K-1s to the partners.
2. The partners must file amended tax returns to take into account the revised K-1s. If the adjustment results from a reallocation of income, all partners affected by the adjustment must file amended returns.
3. The partners must pay the tax liability reflected on the new K-1s.

Taken together, these requirements ensure that the partners report and pay all taxes. If so, the IUA is reduced to take these payments into account.

This exception may be difficult to meet. It requires the partnership to accurately calculate the tax effect of the proposed adjustments and issue K-1s to the affected partners. The partners must also convince the former partners to file amended returns and pay all taxes. These former partners may have little incentive to cooperate and, even in the best of circumstances, may need time to verify the partnership's calculation of the assessment.

> ***Drafting Point:*** *Partnerships that wish to take advantage of this option should include binding provisions in their governing documents that require former partners to file amended returns and pay taxes within the prescribed 270-day time period. These provisions should survive the termination of a partner's interest in the partnership.*

The second way that a partnership may shift tax back to the partners is by issuing a statement to the former partners and the IRS. The statement must include the partner's share of any adjustment to income, gain, loss, deduction, or credit. The partnership must issue the statement within 45 days from its receipt of final notice of adjustment. Once the statement is issued, the partnership is no longer responsible for the adjusted amounts. Instead, each prior-year partner becomes responsible for the adjusted amounts reported on the statement.

> ***Drafting Point:*** *The partnership agreement can compel or forbid this adjustment. This could be a negotiation point among the partners. The partnership agreement should be clear about whether the partnership may assess former partners for future adjustments.*

Partnership Representative

TEFRA required partnerships to designate a "tax matters partner" to represent the partnership before the IRS. As the name suggests, only a partner could be a tax matters partner. The tax matters partner could extend the statute of limitations and act as the representative of the partnership before the IRS in any audit proceedings. But even with these responsibilities, the authority of the tax matters partner was not exclusive.

Other partners could participate in the audit process.

The new Act repeals all provisions relating to tax matters partners. It replaces the prior role of "tax matters partner" with the new role of "partnership representative." The partnership representative need not be a partner, as long as the partnership representative has a substantial presence in the United States. The partnership representative has exclusive authority to represent the partnership in IRS audits. The partnership and each partner are bound by the decisions of the partnership representative. The IRS may choose a partnership representative if the partnership fails to do so.

> ***Drafting Point:*** *The partnership representative has more authority than tax matters partners had under prior law. Given this expansion of authority, partners should choose the partnership representative carefully. Provisions relating to tax matters partners should be revised to take into account the differences in the two roles.*

Changes to Statute of Limitations and Administrative Adjustment Request Deadline

Under prior law, the statute of limitations for assessment was based on the last to expire of the partnership's and each partner's statute of limitations. Because the statute of limitations could be tolled for various reasons, the actual period during which the IRS could assess the tax was often much longer.
The Act replaces these rules with a single statute of limitations. Under the Act, the statute of limitations for assessment is three years from the later of:

- The due date of the partnership tax return (without regard to extensions);
- The date that the partnership filed the tax return; or
- The date that an administrative adjustment request is filed.

The Act also changed the deadline for submitting an administrative adjustment request (AAR) to change the reporting of partnership tax items. Under the new rules, an AAR may not be filed after the IRS notifies the partnership of an administrative proceeding. This is a departure from prior law, which allowed AARs to be filed any time before the partnership was notified of the final administrative adjustment.
Although the partnership and the IRS may agree to extend the statute of limitations, the extension of the statute of limitations does not extend the time that the partnership has to request an administrative adjustment.

Small Partnerships May Opt Out

Some partnerships may opt out of the new regime and be subject to partner-level audits under the same rules that apply to individual taxpayers. To qualify, a partnership must meet these eligibility requirements:

- For the taxable year in question, the partnership cannot be required to furnish more than 100 Schedule K-1s to its partners (100-partner limitation).
- Each of the partners must be an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner.

Although a partner that is an S corporation does not preclude the election, each of the S corporation's shareholders are considered partners of the partnership and count toward the 100-partner limitation. But partnerships with trusts or other partnerships as partners cannot currently opt out of the new rules.

The partnership must make the election annually on a timely return. The partnership must notify each partner of the election. The partnership must also give the IRS the information it needs to identify the partners. This information includes the name and tax identification number for each partner or shareholder of an S corporation that is a partner.

The Act gives the IRS the authority to promulgate look-through rules that treat other types of entities similar to S corporations. These rules would presumably look through to the economic interest holders and count them as partners for purposes of the 100-partner limitation. But until this guidance is issued, partnerships with other partnerships or trusts as partners do not qualify and may not elect out of the new audit regime.

> ***Drafting Point:*** *Partnership agreements should include provisions that require or allow the election to be made if it is available.*

Effective Date

Although the Act does not become effective until January 1, 2018, partnerships may elect to apply the new audit rules to tax returns filed by the partnership for tax years beginning after November 2, 2015, and before January 1, 2018. This transition period creates challenges for planners, who cannot predict whether the election to apply the new rules will be advantageous for a given partnership.

> ***Drafting Point:*** *Existing partnership agreements may not allow the tax matters partner to make this election. As a general rule, the partnership agreement should specify whether the tax matters partner/ partnership representative can make this election and whether any further approval is required.*

Drafting under the New Rules

The new audit rules can have far-reaching effects on both new and existing businesses. Any partnership or LLC taxed as a partnership is potentially at risk. Attorneys should carefully review all partnership agreements to ensure that they comply with the new Act. Here are a few guidelines to assist with drafting under the new rules.

Deal with the Transition from Tax Matters Partner to Partnership Representative

Most partnership agreements designate a tax matters partner to represent the partnership before the IRS. The Act makes these provisions obsolete for partnerships that elect to apply the new Act before January 1, 2018, and for all partnerships after January 1, 2018. All provisions relating to the tax matters partner should be replaced with provisions relating to the partnership representative.

Because the partnership representative has more authority than the tax matters partner, new provisions may be needed to clarify the scope of the partnership representative's authority. Sometimes it will be desirable to limit the otherwise broad discretion given to partnership representatives under the Act. This raises several drafting considerations:

- Include provisions appointing the partnership representative. The partnership representative may be designated by name, designated by role (e.g., the general partner or managing partner), or appointed by the partners at a later time.

- Specify whether the partnership representative must also be a partner.
- Consider requiring that the partnership representative obtain the approval of the partners before making any decisions that would bind the partnership.
- Consider imposing fiduciary duties on the partnership representative (requiring the partnership representative to act in the best interest of all partners).

Deal with Opting Out of Partnership-Level Taxation

The partnership agreement should provide specific guidance on the partnership's authority to elect out of partnership-level tax treatment. If the partnership wants to preserve the ability to make the election, the partnership agreement should restrict any transfers to ineligible owners that would cause the partnership to fail to meet the eligibility requirements for opting out of partnership-level taxation.

Deal with Adjustments for Prior Tax Years

The partnership agreement should address the tax liability when an adjustment is made in a year when a partner no longer holds an interest in the partnership. The partnership agreement should also specify whether the partnership may assess former partners for future adjustments. The partnership agreement should:

- allow the partnership to issue statements to partners within 45 days of its receipt of final notice of adjustment; and
- require former partners to file amended tax returns and pay any taxes owed within 270 days of receipt of notice of a proposed judgment.

Taken together, these provisions give the partnership the ability to use either of the two methods for allocating liability to the prior partners. These provisions should survive the termination of the partner's interest in the partnership. The partnership agreement should also require the partners to treat tax items consistently with the partnership's tax return.

Plan for a Flexible Effective Date

Because attorneys do not know whether it may be advantageous for a given client to elect into the new rules before January 1, 2018, partnership agreements drafted between now and January 1, 2018, should include provisions to address the new rules. Consider flexible provisions that allow for the possibility that both regimes will operate concurrently until January 1, 2018.

Planning for Acquisitions of Partnership or LLC Interests

Clients buying new partnership interests should consider these new rules. If the existing partnership agreement does not contain the provisions described above and if the partnership has not elected out of partnership-level taxation, new partners could be liable for adjustments made in connection with prior taxable years. To protect against this risk, new partners should consider indemnification or other protective provisions in either the governing document or the transfer documents.

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