RIW RUBERTO, ISRAEL & WEINER

LLCs Must Modify Operating Agreements Now To Deal With Tax Law Changes

By Gary Bubb on April 5, 2018

Business entities that are taxed as partnerships (most limited liability companies that have more than one member are taxed as partnerships), will need to modify their operating agreements this year to address recent changes in the Internal Revenue Code that give extraordinary authority and autonomy to the "Partnership Representative."

For tax years that begin on or after January 1, 2018, the IRS has a new weapon to use when auditing partnerships. The Bipartisan Budget Act of 2015 (the "***BBA***"), established a "centralized" IRS audit regime under which the IRS can now assess and collect taxes directly from the partnership, rather than having to assess partners individually. The partnership must designate a Partnership Representative for each tax year (the designation is made in the partnership's federal tax return) and the Partnership Representative will be the sole advocate for the Partnership in all audit dealings with the IRS. The centralized audit process is extremely complex, and it will take taxpayers quite a while to adapt to the new regime, but taxpayers need to take action in 2018 to address the issues surrounding the Partnership Representative. It won't work to simply replace "tax matters partner" with "Partnership Representative" in the "tax matters" section of current operating agreements. The Partnership Representative is a different animal.

The centralized audit regime is solely for the benefit of the IRS. It's too difficult and time consuming for the IRS to audit, assess and collect taxes from individual partners, so the BBA permits the IRS to audit and collect taxes directly from the partnership itself and leave the partners (including partners who were partners in the year that is under audit, even if they are not partners currently) to fight each other over who bears the economic loss on the tax hit. Key elections in deciding who bears this ultimate economic loss, such as the election to "push out" the IRS assessment to the people who were partners in the year that was audited, are made by the Partnership Representative, who has exclusive authority to deal with the IRS, and whose decisions cannot be overturned by the partners.

It is possible for a partnership to "elect out" of the new regime and, in light of the regime's complexity and unpredictability, electing out is the advisable move. An effective election out will force the IRS to assess and collect from the partners separately. However, the partnership can elect out of the regime only if all of its partners/members are "eligible partners". The only eligible partners are individuals, a deceased partner's estate, a domestic corporation (either a C-corporation or an S-corporation), and a foreign entity that would be required to be a C-corporation if it was a US entity. Partnerships are not eligible partners, and there are two other noteworthy absences: trusts and "disregarded entities" are not eligible partners. For estate planning and asset protection reasons, it is very common for trusts and single-member limited liability companies (disregarded entities) to be partners of small businesses that are LLCs or are otherwise taxed as partnerships. Partnerships that

PROFESSIONALS

Gary Bubb

PRACTICES

Corporate & Business

Tax

have ineligible partners cannot elect out of the regime, and therefore must either revise the status of the offending partners so that the election out can be made (for example, a partner that is a single member LLC could elect to be taxed as an S-corporation, thus becoming an eligible partner), or modify their operating agreements to deal with the powers of the Partnership Representative.

Under the new regime, the designation of the Partnership Representative, and the election out of the regime (if available) are made each year on the tax return for the partnership. There are complicated rules about resignation by a Partnership Representative, revocation of the designation of the Partnership Representative, and the ability of the IRS to designate the Partnership Representative in the event of a faulty designation. Without going into detail on these complexities, we advise partnerships to designate a Partnership Representative even if they elect out of the regime. That way, if the election out proves to be invalid, the door won't be open for the IRS to designate the Partnership Representative.

Although the new regime was designed to simplify IRS audits of large and complex partnerships, the restrictive nature of the eligible partner definition sucks all partnerships that have ineligible members, no matter how small the business, into the regime. As a result, all partnerships, including small businesses that have one or more ineligible partners, must begin discussing modifications of their operating agreements to get as much control over their Partnership Representative as possible.

Note that the IRS is not bound by any provisions in an operating agreement that deal with the Partnership Representative. The designation of the Partnership Representative is made on the partnership's tax return, and from that point on the IRS deals strictly with the designated Partnership Representative on tax matters relating to that tax year without regard to the operating agreement or the sensitivities of any partners. However, between the Partnership Representative and the partners, the provisions of the operating agreement will govern. Partners should be thinking about modifications to their operating agreements to cover the following issues in connection with the Partnership Representative and related matters:

- **If the partnership can elect out, consider a provision in the operating agreement that mandates an election out each year and perhaps some language prohibiting admission of ineligible partners;**
- **The Partnership Representative does not need to be a partner, or even affiliated with the partnership. Should the partnership designate an independent Partnership Representative or even a professional Partnership Representative?**
- **Require consent of a majority or higher percentage of the partners before the Partnership Representative can waive the statute of limitations, settle with the IRS or "push out" the payment obligation from the partnership to the partners;**
- **Require the Partnership Representative to give timely notice of all IRS communications;**
- **Require partners to give the Partnership Representative whatever information he or she needs to impose the lowest possible tax bracket on an assessment.**
- **Impose a mechanism to collect from the partners if the Partnership Representative settles with the IRS and the partnership pays an IRS assessment.**

There's a lot going on here; the purpose of the new regime is to permit the IRS to audit more partnerships with fewer procedural safeguards for the partners. Partners should discuss these issues with their tax and/or legal advisors and reach agreement on operating agreement revisions that will help them get comfortable with the new regime.

Gary Bubb *is an attorney in RIW's* ***Corporate & Business****,* ***Mergers & Acquisitions****, and* ***Tax*** *Practice Groups. Gary can be reached at* ***gcb@riw.com*** *or (617) 570-3538.*

POSTED IN: **ARTICLES & QUOTES**, **TAX LAW**