

CORPORATE MATTERS:

PARTNER REPRESENTATIVES AND THE NEW PARTNERSHIP AUDIT REGIME

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Commencing in January 2018, the I.R.S. began a new centralized audit regime with respect to partnerships. It replaces the concept of a “Tax Matters Partner” with a “Partnership Representative.” Although in our practice we mostly see the impact in connection with limited liability companies (“L.L.C.’s”) – which are taxed as partnerships – the new rules are mandatory (subject to certain opt-out rights) for all partnerships, L.L.P.’s, and L.L.C.’s.

TAX MATTERS PARTNER

Prior to January 1, 2018, when a group formed a multi-member L.L.C. in the U.S., it was required to designate one of the members of the new company as the Tax Matters Partner. For many people outside the U.S., the designation caused concern. Frequently, the members did not want to be on record with the I.R.S. in manner distinct from the entity itself, and often, they did not understand what the title entailed.

The role of the Tax Matters Partner was to essentially represent the partnership in tax matters and to be responsible for ensuring that the entity’s tax returns were prepared and filed correctly. Usually this involved providing documentation to the entity’s accountants. While the Tax Matters Partner could also be involved in managing an audit process, each partner maintained the right to receive separate notice from the I.R.S. with respect to any proposed adjustment and had a separate right of appeal. Given the relatively limited powers of the Tax Matters Partner, partners usually gave little thought to who should be appointed and frequently chose the managing member or the dominant partner.

PARTNERSHIP REPRESENTATIVE

The new rules in part reflect the I.R.S.’s frustration with the obligation to provide each partner with notice of an audit and with the partners’ separate rights to appeal. Whereas under the previous law most operating agreements provided for a Tax Matters Partner to handle audit matters with the I.R.S. if required, under the new rules, any audits will be managed at the partnership level by a Partnership Representative. The Partnership Representative has many more powers than the Tax Matters Partner under the old law.

Commencing on January 1, 2018, unless the partnership is able to elect out of the new rules and actually does so, the I.R.S. will only deal with the Partnership Representative and the individual partners have no right to separately appeal any tax assessment. The Partnership Representative also has the power to take other, non-appealable actions with the I.R.S., including agreeing to settle the total tax liability of all partners.

Additionally, in a significant change, the I.R.S. may now collect tax at the partnership level as a result of a tax audit.

The I.R.S. collects the tax from the partnership in the year of the audit (the “adjustment year”). The assessment of the tax, however, is from an I.R.S. audit performed on a prior year (the “reviewed year”). Note, that if there are ownership changes during these years, the new partners in the adjustment year will essentially pay a tax on additional income derived from the reviewed year when they were not a partner. A partnership may, however, make a “push-out” election whereby any tax liability resulting from an audit is pushed out to the partners.

The new rules also eliminate the concept of notice to individual partners. This means that an audit could commence and be finally determined and, unless the Partnership Representative keeps the other informed, the partners could only learn about the audit when they receive a final notice from the I.R.S. – at which stage the action would be unappealable.

Any person is eligible to serve as a Partnership Representative provided they have a “substantial presence” in the U.S. Substantial presence is defined as

- being available to meet in person with the I.R.S. in the U.S. at a reasonable time and place,
- having a street address in the U.S. and a telephone number where they can be reached during normal business hours, and
- having a U.S. taxpayer identification number.

Whereas a Tax Matters Partner was required to be a partner of the entity he or she represented, a Partnership Representative can be any person, including a non-partner, provided they meet the above substantial presence test. The Partnership Representative may be an entity, but if the partnership chooses an entity, the partnership is required to identify and appoint an individual to act on the entity’s behalf.

ELECTING OUT

Subject to certain eligibility requirements, a partnership will be allowed to elect out of the new system, with the effect that its partners will be governed by the audit rules existing prior to January 1, 2018. The eligibility requirements include that the partnership has less than 100 members (as measured by the number of Schedules K-1 the partnership is required to issue) and that each member is an individual, a deceased partner’s estate, a C corporation, a foreign entity that would be required to be treated as a C-corporation if it were a domestic entity, or an S-corporation. The annual election must include the name and taxpayer identification number of each partner, and each partner must receive notice of the election.

IMPACT ON PARTNERS

Depending on the circumstances, partners should consider whether to revise existing operating agreements to provide for the appointment of a Partnership Representative. Where none of the partners reside in the U.S. a third party may need to be appointed. Any revision to an operating agreement may also need to include

restrictions on the Partnership Representative's powers to take certain actions without consent of the partnership or, at least, notice to the partners.

Given the transfer of discretion regarding the management and settlement of an audit from individual partners to the new Partnership Representative, and because audit adjustments would be reflected in the year an audit is concluded rather than in the year being audited, electing out of the new partnership audit rules is worth consideration. Note that, even if a partnership elects out of the new audit rules, a Partnership Representative must still be appointed. As mentioned earlier, this does, however, require each partner to have, and give to the I.R.S., a tax identification number.



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