US Congress Enacts Entirely New Tax Examination and Collection Regime for Partnerships and LLCs

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In recent years, the U.S. Internal Revenue Service ("IRS") and U.S. Congress recognized two important divergent trends. While the use of pass-through entities, such as partnerships and limited liability companies ("LLC"), as business and profit-seeking structures, was growing, the number of IRS examinations of these entities was staying stagnant. According to the IRS's own statistics, the percentage of partnership and LLCs that were examined each year for the past decade was less than one-half of one percent. In 2015, the IRS examined only .51% of the partnership and LLC tax returns that were filed. In comparison, in 2015, the IRS examined over 11% of all large corporate tax returns that were filed.

The IRS and the Congress appear to have laid the blame for the low examination rate, and related lost tax revenue, to the complex procedures set forth in the 1982 partnership examination laws, known as "TEFRA," the statute that originally enacted the unified partnership examination provisions ("TEFRA stands for the "Tax Equity and Fiscal Responsibility Act of 1982"). The inconsistent judicial interpretations of the TEFRA partnership rules, as well as the agency's slow-moving enforcement and actual implementation, demonstrated that these rules were not appropriate for the changing partnership and LLC landscape. Accordingly, Congress made an important change in the law that all persons with partnership or LLC interests should be aware of.

Certain provisions of the Bipartisan Budget Act of 2015 (the "Act") made fundamental changes to the rules by which partnerships, and entities that elect to be treated as partnerships for tax purposes (e.g. limited liability companies), interact with the

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IRS with respect to the tax examination, litigation, and collection process. The Act repealed the "TEFRA" partnership regime and replaced it with an entirely new set of rules. While the new regime has similarities to TEFRA, there are significant changes that will now require careful review and revisions to certain tax provisions of partnership agreements. In light of the new legislation, partnerships and partners should now evaluate the current provisions of their partnership agreements and make fundamental changes to the tax procedure provisions.

Generally, the Act substantially changed (1) the ability of the IRS to collect an underpayment of tax, penalty, and interest from the partnership itself, (2) current partners' exposure to tax liabilities of prior partners, and (3) the powers entrusted in the partnership's

designated liaison with the IRS (formerly known as the "tax matters partner"). Also, Congress provided the Treasury Department with broad regulatory authority to implement the goals of the statutory revisions. Therefore, partnerships should pay attention to the issuance of new Treasury regulations in the coming months.

Some of the statutory revisions that affect typical partnership agreements are as follows:

I. New Tax Terms and Concepts: The new regime repeals well-known TEFRA terms (e.g., "tax matters partner") and creates completely new legal terms and concepts including "partnership representative," "imputed underpayment," "reviewed year," and "adjustment year." To synchronize with the new Code requirements, these terms and concepts should be incorporated into partnership agreements. Reviewing and revising the partnership agreements now will allow for an orderly process if and when the IRS examines a partnership tax return, makes tax adjustments, and/or requires payments of additional tax, penalties, and/or interest. Furthermore, revisions to the partnership agreements will provide clarification of the rights and obligations of the partnership and the partners.

II. Tax Underpayments To Be Collected from Partnership: As under TEFRA, tax adjustments will continue to be made at the partnership level. However, unlike under TEFRA, unless a partnership is eligible to make an annual election and does, in fact, make the election, the tax attributable to an adjustment, and related interest and penalties, will be collected, subject to certain possible adjustments, at the partnership level.

When the IRS makes a tax adjustment, the partnership's current partners (the "adjustment year" partners) will effectively pay the tax for the partners who were in place in the tax year for which the adjustment was made (the "reviewed year" partners). The tax to be paid is based on another new concept, a calculation called the "imputed underpayment." Generally, the imputed underpayment is calculated at the highest tax rate for the reviewed year. This change in the law may require parties to consider or review indemnification provisions in the partnership agreement.

III. Ways to Modify or Avoid Tax Collection at Partnership Level: The "imputed underpayment" collection process can be avoided or modified in one of three ways.

1. Elect Out on Timely Filed Return: First, if a partnership has no more than 100 partners and no partner is itself a partnership (or an entity that has elected to be treated as a partnership, like a limited liability company), then the partnership can make an annual "opt-out" election on a timely filed tax return. To preserve this option, a partnership agreement could be amended to limit the number of partners to 100 and to restrict the ability of other partnerships to join the partnership as a partner. If a partnership elects out of the new regime, the partnership and partners will be examined under the rules applicable to individual taxpayers.

2. "Reviewed Year" Partner Pays Tax With Current Year Individual Return: Second, within 45 days of receiving a notice of final partnership adjustment, any partnership, regardless of size, may elect out of the "imputed underpayment" process so long as it provides the IRS with "a statement of each partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment)." Under this procedure, "reviewed year" partners calculate their share of additional tax due based on the statement described above (i.e., like an amended Schedule K-1) and the "reviewed year" partners will pay the additional amount with their respective current year individual tax returns. An election under this provision, however, increases the applicable underpayment interest rate by two percentage points. The new statute requires fast action by the partnership (i.e., 45 days) to perform computations and send the proper notices. Therefore, a procedure should be put in place to accomplish this procedural route.

3. Modify "Imputed Underpayment" Where Reviewed Year Partner Files Amended Reviewed Year Tax Return: Third, a partnership can reduce the amount of the "imputed underpayment" if one or more of the "reviewed year" partners files an amended return and pays the tax attributable to the adjustment allocable to that partner. To implement this, the partnership must submit information to the IRS sufficient to modify the "imputed underpayment" amount within 270 days of the notice of proposed adjustment. Verifying that an amended tax return has been filed by a reviewed year partner may raise certain privacy concerns. A partnership thus may wish to establish a method that allows for the implementation of this alternative, rather than undergo the "imputed underpayment" procedure.

IV. Powerful New Partnership Representative: The Code now mandates that the partnership designates a "partnership representative" instead of a "tax matters partner." The "partnership representative" will "have sole authority to act on behalf of the partnership" and the "partnership and all partners shall be bound by actions taken ... by the partnership." Interestingly, this controlling entity need not be a partner in the partnership. Furthermore, the new rule significantly curtails the ability of other partners to participate in an IRS examination or litigation with the IRS. Therefore, partnership agreements may need to be adjusted to provide contract rights to other partners that once existed as a statutory matter under TEFRA. For example, a partnership might consider whether the Partnership Representative has unbridled power to settle a case or extend the statute of limitations without approval from the other partners. This new statutory regime obviates the need of the IRS to "chase down" each and every partner to sign a Form 870-PT (Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts) or sign a Form 906 (Closing Agreement On Final Determination Covering Specific Matters) in order to implement an examination's adjustments or a settlement. For present purposes, partnership agreements should be revised to reflect this new, critical designation. If there is no partnership designated representative, the Code gives the IRS the authority to designate one. Certainly, partnerships and partners do not want to relinquish that selection right to the IRS.

These new rules apply to partnership tax years beginning after December 31, 2017. However, a partnership may elect to have the new rules apply to partnership tax years beginning after the date of enactment and before January 1, 2018. Given the many new legal terms and concepts, and the potentially significant shift of the benefits and burdens of post-adjustment tax items, existing partnerships and partners should review and modify their partnership agreements. New partnership agreements should accommodate the new partnership tax audit and collection regime.

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