RICHEY MAY & CO

Partnership Operating Agreements: Amendments Needed in 2018

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Effective for partnership tax years beginning after December 31, 2017, the IRS procedures applied for auditing an entity tax return treated as a partnership for tax purposes has changed significantly. The changes were designed to make it easier for the IRS to audit partnerships by adjusting, assessing, and collecting additional taxes, interest and penalties at the partnership level as opposed to the audit adjustments being pushed out to the partners in the partnership, with any additional tax and penalty amounts being paid at the partner level.

As a result of the new audit procedures, all partnerships need to amend their operating agreements during 2018 to address "partnership representative" designation requirements as well as how decisions with regard to various elections available to the partnership under an IRS audit examination will be made and how other audit issues will be handled. Only one representative will be authorized to represent the partnership each tax year and this individual should be designated on the tax returns filed each year. This individual may be a different person each tax year, but once named as the "partnership representative" on the tax return, this individual generally cannot be replaced later without IRS consent. The partnership representative is the only one who can act on behalf of the partnership in the examination even if they are no longer a partner in the year the IRS examines the prior year return(s). Their actions will bind the partnership and all partners.

The most significant impact of the new audit rules is that the partners who own the partnership during the year the company is audited will be responsible for any additional taxes, penalties and interest rather than the partners who owned the partnership during the year under examination. These assessments are generally imposed upon the partnership which impacts the current partners. Various elections are available including an election out of these new procedures for some qualifying partnerships. It is also only through the partnership agreement provisions that partners will be able to address indemnifications or other remedies to account for the economic implications of differences in partnership ownership between the audit year and the year that the IRS examines and imposes assessments upon the company.

The audit procedures prior to these changes were implemented and governed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). These rules still apply to partnership tax years beginning prior to 1/1/2018. Without going into great detail, audit assessments of tax, interest and penalties for prior years will continue to be imposed upon the partners who owned the partnership during the tax year under examination.

Under the general rules applied under the new law, certain partnerships with fewer than 100 partners will have the ability to elect out of these new rules and have pre-TEFRA rules apply. These rules required the IRS to audit individual partners. However, partnerships will only be eligible to elect out if each of the partners in the partnership 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 election out is an annual election made on a timely-filed tax return of the partnership and is to be made by the party named as the partnership representative. If any of the partners are a disregarded entity such as a single member LLC or Q-Sub, the partnership is not permitted to elect out of these new audit procedures even though the owner of the disregarded entity would otherwise be an eligible partner.

The partnership representative makes all the decisions including whether to accept the audit results, work out compromises with the agent, or pursue appeals. Since the situation could arise where new partners who enter the partnership end up bearing the burden of IRS audit adjustments to a prior year in which they were not a partner in the partnership, we strongly recommend that partnerships amend their current operating agreements before year-end to incorporate a number of new provisions. **Some of the key provisions to consider adding are:**

1. Including a provision that establishes the process to name a partnership representative including the term of their designation. In addition, the role of a tax matters partner can be removed as to tax years after 2017 since the partnership representative role has greater authority and responsibilities. (Note: A partnership representative can be either a partner or non-partner).
2. Partnership representative oversight and possible indemnification provisions for their actions.
3. Establish obligations/indemnifications upon departing partners.
4. Partnership elections available for IRS audit adjustments – decision-making coordination including potentially requiring the partnership representative to make specific elections based upon Managing Partner or Executive Committee direction.
5. Partner responsibilities to amend returns if requested by the partnership in a push out election by the partnership representative.

The Richey May tax team is available to consult with you and your legal team in addressing the new audit rules in amended operating agreements. Please reach out to us at **info@richeymay.com** with any questions you may have regarding these changes.