YOU MUST UPDATE YOUR OPERATING AGREEMENTS
IN LIGHT OF THE NEW PARTNERSHIP RULES
(THIS INCLUDES PARTNERSHIP AGREEMENTS)
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The Bipartisan Budget Act of 2015 (P.L. 114-74), signed into law on November 2, 2015, (the "2015 Act") instituted significant changes to the partnership audit process, including the following changes which are effective for partnership taxable years beginning after December 31, 2017:

- ***Entity level taxation***. IRS will not assess individual partners, but will assess the partnership for what the 2015 Act terms the partnership's "imputed underpayment."

- ***Assessment against the partnership***. The assessment against the partnership for any imputed underpayment will be the year of adjustment not the year to which the adjustments related. This means that current partners may be liable for erroneous tax benefits garnered by former partners.

- ***Partnership representative***. The 2015 Act introduces a new empowered "partnership representative" to replace of the "tax matters partner" authorized by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

As described below, many smaller partnerships (or LLCs treated as partnerships for tax purposes) may opt out of the entity level taxation imposed by the 2015 Act and, in the opinion of most tax practitioners, should opt-out where possible. When used in this article, the term "partnership" includes not only general and limited partnerships, but also limited liability companies treated as partnerships for tax purposes. For the same reason, "partnership agreement" includes an LLC's operating agreement.

The IRS has yet to issue guidance or proposed rulemaking with respect to the 2015 Act; however, there are a number of concepts practitioners will want to consider when drafting new (or revisiting old) partnership agreements and operating agreements. This information is especially important to those practitioners who are not tax specialists, and may want to obtain some advice from a tax specialist knowledgeable about the new rules under the 2015 Act.

Under the 2015 Act, there are three alternatives for which a partnership may be taxed: the opt-out election under Section 6221(b), the push-out election under Section 6226(a)(2), and the default method under Section 6225(a).

Opt-Out

The 2015 Act allows for partnerships with 100 or fewer partners to opt-out under Section 6221(b) of the new audit rules. This is an annual election. The general consensus in the tax world is that a partnership should make the Section 6221(b) election to opt-out whenever possible. However, many (if not most partnerships) will be unable to take advantage of the opt-out provisions because the 2015 Act makes the 6221(b) election unavailable to a partnership that has another partnership or a trust (except a trust of a deceased partner) as a partner. In addition, although an S-Corporation is a permitted partner, the rules look-through the S-Corporation to its shareholders to determine who is a partner of the partnership for the purposes of determining whether the Section 6221(b) election is available. If the Section 6221(b) election

is available, the partnership must (i) make an affirmative election annually on a timely filed return, (ii) inform each partner of its election, and (iii) submit the name and taxpayer identification of each partner to the IRS. If the opt-out election is available and desired by the partners, a practitioner may want to consider the following drafting items in the partnership agreement:

- The partnership agreement should state whether the opt-out election is mandatory or optional? If optional, the partnership agreement should state whether the election, and the determination to make the election, is subject to approval by the general partner or managers without member or partner input. Alternatively, does the partnership representative have the authority to make the election without member/manager/partner approval?

- To preserve the opt-out option, the partnership agreement should include transfer restrictions to restrict the transfer of a partnership interest to a non-qualifying person under Section 6221(b).

- The partnership agreement should require partners to provide the partnership representative the necessary information to submit to the IRS to support the opt-out election.

Push-Out

Section 6226(a)(2) of the 2015 Act allows the partnership to push-out the items of adjustment to all prior year partners. To make the election, the partnership, within 45 days of the final notice of adjustment, must furnish the IRS and each partner who held an interest in the partnership during the reviewed year, a statement of such partner's distributive share of each item of adjustment. The reviewed year partners (rather than the partnership) will be responsible for paying their share of the adjustment, plus interest calculated at an increased rate. Upon receipt of the statement, each partner must take the adjustments described on the statement into account as provided in Section 6226(b). In drafting the partnership agreement, consider the following:

- Is the push-out election subject to approval of the members/limited partners, or is it discretionary to the manager of the LLC, the general partners of the partnership, or the partnership representative?

- Agreement of the partners, whether current or former, that they will pay the tax set forth in the statement issued by the partnership.

Default Method

If neither the opt-out election nor push-out election is made, the default method in Section 6225 will apply. Under the default method, the assessment will be made against the partnership at the entity level in the year in which the adjustment is finally determined. This means that partners will bear the burden of taxes that would have been owed by partners who are no long part of the partnership.

The highest marginal rate will be applied to determine the imputed underpayment. However, the 2015 Act does provide three instances in which the imputed underpayment may be reduced: (i) a partner may file an amended tax return and pay any tax due for the year being reviewed, (ii) the partnership demonstrates that all or a portion of the imputed underpayment is allocable to a partner who is a tax-exempt entity, or (iii) the partnership demonstrates that all or a portion of the imputed underpayment would be allocable to a C corporation, or in the case of an individual, a reduced capital gain rate or dividend income rate would apply. The partnership has 270 days from the date of notice of the proposed adjustment to file any

documents or evidence that a reduction in the imputed underpayment would apply. The 2015 Act requires the Treasury to establish procedures under which the imputed underpayment may be reduced. As we are still awaiting Treasury regulations, you may still want to consider the following drafting points even if the partnership chooses not to make the opt-out election or the push-out election discussed above:

- Require current and former members to provide the LLC the information it may need to demonstrate to the IRS the availability of a reduction in the imputed underpayment.
- Address allocation of tax payments to the adjustment-year partners.
- Should partners (former, as well as current) be obligated to pay the partnership their share of the imputed underpayment?
- Should the operating agreement require members to submit an amended return and pay the related taxes?

Partnership Representative

The 2015 Act requires partnerships to appoint a partnership representative. The partnership representative replaces the TEFRA tax matters partner and has significantly more authority than the tax matters partner had under TEFRA. The partnership representative need not be a partner, but the partnership representative must have a substantial presence in the United States. If the partnership fails to appoint a partnership representative, the IRS may appoint a partnership representative.

The partnership representative, unlike the tax matters partner, will have the sole authority to act on behalf of the partnership and will have the power to bind the partnership in the audit process. In addition, partners do not have the right to participate in the proceedings or receive notice of the proceedings from the IRS. Understanding the significant authority that the partnership representative has under the 2015 Act, practitioners may want to consider addressing the following key issues in operating agreements:

- Rules on electing the partnership representative.
- Duty to inform and give notice to partners of the initiation and progress of an audit.
- Restrictions on the partnership representative’s authority to take any binding action in connection with an audit (e.g., extending statute of limitations, settling an audit, and other material concessions).
- Indemnification of the partnership representative.

One unresolved issue for practitioners to consider is whether the operating agreement should include provisions for both the tax matters partner, and the new partnership representative during the transition period. An alternative may be to appoint a partnership representative but only grant the partnership representative the authority of a tax matters partner under TEFRA until the effective date of the 2015 Act, and then expand the authority of the partnership representative to address the requirements of the 2015 Act.

Conclusion

There is much in the 2015 Act that is necessary for all lawyers working with limited liability companies and partnerships to understand, whether or not working as tax specialists. Lawyers who are not tax specialists may need to consult tax specialists to fully comprehend and implement the requirements of the 2015 Act for existing limited liability companies and partnerships, as well as when drafting operating agreements or partnership agreements for new entities to be formed as limited liability companies or partnerships.