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LEGAL UPDATES

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Changes to Operating and Partnership Agreements Required in 2018

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Congress has made significant changes related to the audit of partnership income tax returns (including returns of LLCs taxed as partnerships), including who bears the obligation to pay the tax due as a result of any such audit. The new rules apply to partnership (LLC) returns for tax years beginning after December 31, 2017.

These new rules have profound implications for virtually every partnership or LLC. Following are some of the most important changes:

Tax matters partners are now partnership representatives. The partnership representative must be designated each year. If the entity does not select the representative, the IRS will do so.

Partnership representatives have greater authority to determine tax liabilities. For a partnership to which these new rules apply, the tax law no longer grants any partner a right to notice, to participate in the audit, to individually contest any assessment, or to participate in any court proceedings. Therefore, the partnership or operating agreement must address these rights. Since the tax law previously provided those protections, existing agreements typically do not do so.

Economic cost of audit deficiencies may be borne by the wrong partners. A tax deficiency from an audit generally will be assessed and collected from the partnership or LLC itself, not from the individual partners or members. Thus, the current partners or members may suffer the economic loss from a tax audit for a tax year in which they were not a partner or member. As a result, incoming partners (members) may be liable for tax deficiencies attributable to former partners or members. While there are means to deal with this risk through additional provisions in partnership or operating agreements, existing agreements do not contain such provisions and therefore do not protect against this risk.

Certain partnerships and LLCs may opt out of the new rules. The law allows certain partnerships to opt out of the new rules or, after an audit occurs, to require the partners in the year under audit (instead of the entity) to pay the tax. Operating and partnership agreements must address the process for making or not making these elections, but existing operating and partnership agreements do not contain such provisions.

Partners or members with unique tax attributes must ensure that they are taken into account. Some partners or members may have unique tax attributes that would reduce or eliminate their share of an audit deficiency (e.g., a partner may have loss carryforwards or be a tax-exempt entity), but the new rules require that the partnership representative specifically request that they be taken into account. Operating and partnership agreements should give partners the right to demand that they receive the benefit of their personal tax attributes, and require that they cooperate and provide the information necessary to do so, but existing agreements do not contain such provisions.

Investors in or aquirers of partnership or LLC interests have new risks. The potential partnership audit tax liability must be considered by both the buyer and seller of a partnership or LLC interest. A buyer will be concerned with the potential liability and will need to make this part of its due diligence and its consideration of the transaction structure, and the additional potential liability may negatively impact pricing of the transaction. A seller may be concerned regarding the loss of control over an audit for which it may have an indemnity obligation.

Issuers of LLC or partnership interests have additional disclosure obligations. These added risks and the agreement provisions that address them must be discussed in the disclosure materials provided by issuers to potential investors.

What This Means to You

As a result of these and other changes in the rules, existing LLC partnership and operating agreements should be reviewed and updated. Otherwise, partners and members could face unintended and adverse tax and financial consequences following an income tax audit and tax deficiency assessment.

For a more thorough explanation of these new rules and some of their most important implications, please visit our white paper.

Contact Us

If you would like to discuss these new rules and their implications for your particular situation, please contact John Emanuel, Dan Geraghty, Ray Kreienkamp, Jason Reschly or another member of Husch Blackwell's Taxation team.