Client Alert

New Rules Require Changes to Partnership and LLC Operating Agreements

The Bipartisan Budget Act of 2015 (P. L. 114-74) includes a complete overhaul of the procedures that apply to Internal Revenue Service (IRS) audits of partnerships, including limited liability companies (LLCs) taxed as partnerships and their partners. The Act also repeals the Tax Equity and Fiscal Responsibility Act (TEFRA) audit rules that have been in place since 1982 and the reporting and audit procedures for electing large partnerships in effect since 1998. Unfortunately, while there is substantial uncertainty about how the new procedures will be implemented, the Act will have a significant impact on entities operating in partnership or LLC form. These entities are therefore advised to anticipate issues and address them proactively for transactions currently being negotiated. In addition, amendments to existing transaction documents and governing instruments may be necessary.

The Act, signed into law on Nov. 2, 2015, changes the partnership audit process:

- The "tax matters partner" (TMP) is replaced with the "partnership representative."
- Liability is imposed at the partnership level rather than at the partner level for partnership audit adjustments.
- Liability is imposed in the year of an adjustment rather than the tax year to which an adjustment relates.

The Act gives the IRS broad authority to issue regulations to implement the new law. Many questions raised by the Act will have no clear answers until these regulations are issued. This alert addresses some of the initial questions raised by the Act and makes recommendations for amending existing partnership agreements and LLC operating agreements.

Issues that Partnerships and LLCs taxed as Partnerships Need to Address

There are several key issues to monitor, consider and discuss with your partners/members. Besides those noted above, consider these key issues:

Existing partnership and LLC operating agreements should be reviewed, and amendments must be drafted to address aspects of the new rules, including:

- designating the partnership representative in place of the TMP
- determining the partner(s) that will control the decision to opt out of the new regime
- preventing assignments of partner interests to persons that would preclude the ability to opt-out
- addressing the payment of entity-level tax
- committing to making certain elections if an audit adjustment occurs
- addressing circumstances where partners agree to "adjusted information returns" in lieu of entity-level tax

Negotiations will be necessary to determine the partnership representative and the contractual limitations on the authority of such representative.

In secondary market transactions, parties acquiring partnership interests must consider their potential share of the partnership's liability regarding prior tax years if the partnership has not elected out of the new regime. Parties may want to include certain protection provisions to address this issue in the entity's governing documents or in agreements governing the transfer.

Many technical tax issues arise from subjecting partnerships to tax that must be considered. For example, provisions governing the allocation of the tax paid by the partnership will be necessary where the tax profiles of the partners differ. Many partnership agreements and LLC operating agreements allocate items based on the partners' percentage interest in the partnership; however, some partners, such as tax-exempt entities, may not find this allocation scheme appropriate. In such a situation, the partners would likely prefer to allocate the tax expense based on the relative amounts for which the partners would be liable if assessment was made at the partner level rather than at the partnership level. However, this will significantly increase administrative and bookkeeping costs, and the partners must balance the added burden of this allocation scheme against the benefits from the more economically accurate allocation.

ADDITIONAL INFORMATION

For more information, please contact:

Howard Stross | (813) 852-6500| hstross@strosslaw.com and vadams@strosslaw.com

This Client Alert has been prepared by Stross Law Firm, P.A. for our clients. Although prepared by professionals, it should not be a substitute for legal counseling in specific situations. Readers should not act upon the information above without professional guidance.