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PLANNING UPDATE
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BUDGET ACT OF 2015 REQUIRES AMENDMENTS TO LLC OPERATING AGREEMENTS

The Bipartisan Budget Act of 2015 was signed into law on November 2, 2015. The Act repealed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit rules and changed the procedures for partnership audits. Significant changes for small businesses include:

- The partnership itself, and not just the partners, is now responsible for audit adjustments. This creates new challenges for partnerships and their current and former partners.
- The Act replaces the role of "tax matters partner" with the new role of "partnership representative" who is not required to be a partner. This makes prior provisions of partnership and operating agreements that applied to tax matters partners obsolete.
- The Act imposes liability to the partnership or Limited Liability Company in the year of adjustment instead of in the tax year to which the adjustment relates. This can reallocate risk among current and former partners.

As a result of these legislative amendments we suggest that you meet with your advisors to review the changes that need to be made to your operating agreements to comply with the new tax law requirements.

Summary of TEFRA Audit Rules as they pertain to LLCs taxed as Partnerships

Partnerships with ten or fewer partners are audited at the partner level. The IRS may not make partnership level adjustments if only individuals, estates or C corporations are partners. Partnership tax returns are only audited in connection with audits of partners' tax returns.

Partnerships with more than ten partners are audited under unified TEFRA procedures that are binding on the partners. The IRS may adjust partnership-level items and re-assess partners for the tax resulting from the adjustment.

Overview of the New Audit Rules

The new Act repealed the TEFRA audit rules and replaced them with new rules designed to streamline partnership audits. These new rules allow the IRS to assess and collect taxes resulting from partnership audits at the partnership level instead of passing the adjustments through to the partners.

If an audit requires adjustment to partnership items or allocations, the new rules require the partnership to pay the resulting taxes. These taxes are referred to as the "imputed underpayment amount" (IUA) and are calculated using the highest tax rate applicable to individuals or corporations in the audited year. When computing the IUA, the partnership may not deduct tax, interest or penalties paid by the partnership during that year.

This new system shifts the financial responsibility for tax adjustments from the partners to the partnership itself. This shift of tax liability from the partners to the partnership can increase the IUA. Because the IUA is computed at the partnership level, the partners' individual tax attributes are ignored. For example, a partner's net operating losses do not offset the partnership's IUA, even though the net operating loss would have offset the partner's share of the income had it been distributed. Similarly, income that would be allocated to a tax-exempt partner (and thus escape taxation) is now computed at the partnership level, where the partner's exempt status is ignored.

Because of these changes, the tax liability of the partnership may be greater than the aggregate tax liability of the partners would be if the assessment occurred at the partner level. In recognition of this disparity, the Act directs the IRS to issue regulations setting forth procedures for adjusting the IUA to consider the partners' tax pro les. These adjustments should take partner-level exclusions and tax rates into account to reduce the IUA.

Overview of the New Audit Rules (Con't.)

The new Act is silent about whether partners are secondarily liable if the partnership cannot pay the tax resulting from the adjustment. This could occur, for example, if the partnership is bankrupt or insolvent. The legislative summary of the Act seems to indicate that the partners would not be secondarily liable in this context. The IRS will likely issue regulations to clarify this issue.

Under the new Act, the partnership must make audit adjustments in the year that the audit or judicial review is completed (the "adjustment year"), not in the year to which the adjustment relates. For example, assume a partnership is audited in 2018 for a mistake on its 2016 tax return and the audit is completed in 2019. Under the new audit rules the adjustment would be made in 2019 (and affect the partnership's 2019 taxes) even though the mistake occurred in 2016.

Assessment in the adjustment year shifts risk from former partners to current partners. Partners that leave the partnership are unlikely to be affected by future adjustments, but this relief comes at the expense of the new partners, who are now responsible for tax adjustments that relate to prior years. These adjustments could increase the new partners' tax liability even though it relates to a year in which the new partner owned no partnership interest.

There are elections available to limited liability companies taxed as partnerships, provided the operating agreement contains language to permit the elections and all partner members agree with the terms.

Partnership Representative

TEFRA required partnerships to designate a "tax matters partner" to represent the partnership before the IRS. As the name suggests, only a partner could be a tax matters partner. The tax matters partner could extend the statute of limitations and act as the representative of the partnership before the IRS in any audit proceedings. Even with these responsibilities, the authority of the tax matters partner is not exclusive.

The new Act repeals all provisions relating to tax matters partners. It replaces the prior role of "tax matters partner" with the new role of "partnership representative." The partnership representative need not be a partner, as long as the partnership representative has a substantial presence in the United States. The partnership representative has exclusive authority to represent the partnership in IRS audits. The partnership and each partner are bound by the decisions of the partnership representative. **The IRS may choose a partnership representative if the partnership fails to do so.**

Limited liability company operating agreements should be revised to appoint a "partnership representative" to replace references to the "tax matters partner" and define the roles and responsibilities of the partnership representative.

Although the Act does not become effective until January 1, 2018, partnerships may elect to apply the new audit rules to tax returns led by the partnership for tax years beginning after November 2, 2015, and before January 1, 2018. This transition period creates challenges for planners, who cannot predict whether the election to apply the new rules will be advantageous for a given partnership.

Existing partnership and limited liability company operating agreements may not allow the tax matters partner to make this election. As a general rule, the agreements should specify whether the partnership representative can make this election and whether any further approval is required.

We advise members of limited liability companies taxed as partnerships and partners in partnerships to meet with their advisors to discuss these changes and amend their agreements to comply with the new audit procedures and the elections that are available to them.