MEMORANDUM

DATE: March 26, 2018

FROM: Barber Emerson, L.C.

RE: 2018 Partnership and LLC Tax Audit Rules Effective January 1, 2018

New tax rules pertaining to partnership tax audits became effective on January 1, 2018. These rules (the "BBA Rules") are part of the Bi-partisan Budget Act of 2015 and will govern IRS audits of entities classified as "partnerships" for federal income tax purposes. This includes both general and limited partnerships, as well as most limited liability companies. Single-member limited liability companies and corporations, including S corporations, are not affected by these rules. IRS regulations implementing the BBA Rules will significantly change how partnerships and LLC's ("entities") are audited and how these entities may negotiate tax matters with the IRS. For purposes of this Memorandum, all references to "partners" include LLC members.

This Memorandum does not offer any specific legal advice, but instead is for the purpose of providing a summary of the BBA Rules. This summary is not intended to be a complete analysis of the rules or a substitute for seeking further advice as to how the rules affect any particular entity, or whether necessary changes should be made to an entity's partnership or operating agreement.

Most partnerships and limited liability companies will need to revise their partnership or operating agreements to address the BBA Rules. We recommend that any entity taxed as a partnership consult with knowledgeable tax counsel or a certified public accounting firm within the next few months for advice regarding the effect of the new rules on the entity and its partners.

Under the current rules, partnership tax audits are conducted and assessed at the partner level, with the entity represented by a partner who is designated as the "tax matters partner." If any additional taxes result from adjustments to partnership income, deductions, or credits, they are imposed at the individual partner level, not the partnership level, and are assessed directly to those partners who were partners during the audit year in question. Most partners generally have the right to receive information from the IRS in the course of the audit, to elect out of settlements reached by the tax matters partner, and to contest any adjustments separately.

Under the new BBA Rules, additional taxes resulting from an IRS tax audit are assessed and collected at the partnership level. This means that the entity will bear the cost of a prior year's tax liability. As a result, current partners of the entity may indirectly bear the economic burden of an adjustment made for an audit year in which they were not a partner and for which they received no economic benefit. Certain entities may be entitled to elect out of these new rules and apply the prior rules, but the entities that are eligible to elect out are limited. Electing out of the BBA Rules may not be available to most closely held and family-structured entities unless the proposed regulations are changed.

We hope the following will be a helpful summary of the new BBA Rules:

- Prior Year Adjustments and Liability. If an entity-level tax audit occurs, and adjustments are made to the entity's tax return for a prior year (the "reviewed year"), the partnership must pay the deficiency and related interest and penalties during the current year in which the adjustment is made (the "adjustment year"). This means the current, adjustment year partners must effectively pay or bear the economic cost of the tax deficiency for the prior, reviewed year. An entity's partnership or operating agreement should, therefore, be reviewed and probably revised to ensure that profit and loss sharing ratios and reimbursement provisions are added. Former partners should remain liable for their tax burden arising in the reviewed year, even if the entity pays entity-level tax in the adjustment year, so that the economic burden of the additional tax borne by the current, adjustment year partners is based on their reviewed year profit and loss sharing ratios or in some other agreed upon manner.

- Tax Adjustments at the Entity Level. Any entity-level tax deficiency assessed as the result of an IRS tax audit will require the entity itself to pay the additional tax, interest, and perhaps penalties. An entity's partnership or operating agreement, therefore, should require the entity to maintain a reserve fund, or require capital contributions from its partners to cover any such deficiency.

- Partnership Representative. One of the most significant changes made by the new rules requires each entity to designate a Partnership Representative, who may or may not be the same as the tax matters partner. This designation must be made annually and should be coordinated with the entity's tax advisor. If the entity does not designate a Partnership Representative, the IRS may select any person to serve as the entity's Partnership Representative, with certain limitations. The proposed regulations restrict an entity's ability to change the designation of its Partnership Representative, and provide detailed guidelines as to how a Partnership Representative may resign. Consequently, all partnership or operating agreements should give the entity the power to require the Partnership Representative to resign, and should require the Partnership Representative to provide notice to each partner of all audit issues and to seek approval by the entity before binding the entity to any settlement with the IRS. While these provisions may not be binding on the IRS, they should be binding on the partners of the entity. Addressing the relationship of the Partnership Representative to the entity and its partners will be an important element of all partnership or operating agreements, because the IRS is no longer required to notify individual entity partners of audit matters, and because the entity and its partners are bound by agreements made by the Partnership Representative.

- The Election-Out Procedures.

  - To be eligible to elect out of the BBA Rules, the entity can only have individuals, corporations (including S-corporations), and estates of deceased individuals as partners. An entity seeking to elect out of the new rules may not, therefore, have as a partner any partnership, disregarded entity, or trust of any kind, including a revocable trust treated as a grantor trust for federal income tax purposes. If an entity is eligible to elect out of the new rules, or has successfully made the election, the partners should consider including a provision in the partnership or operating agreement restricting future transfers of partnership or LLC interests that would affect the entity's eligibility.

    - The election-out process is tedious and requires the entity to provide substantial information to the IRS. Whether an entity is eligible to make the election and whether the entity should make this election are matters that should be discussed with the entity's tax advisor before filing its 2018 federal income tax return.

    - The BBA Rules create a tension for individuals who are considering the benefits of electing out of the new rules and the benefits of owning interests in an entity through trusts and other partnerships or limited liability companies (i.e., "tiered" structures). Each entity and its partners should conduct a thorough analysis with their advisors to consider whether ownership arrangements for the entity, including trust ownership and ownership by other entities, are preferable for estate planning or other business purposes to re-structuring the entity to be eligible to elect out of the new rules.

- "Pull-In" and "Push-Out" Elections. There are two separate procedures available if a tax audit occurs and results in an adjustment to the entity's tax return. One procedure is the "pull-in" election by which the entity requires one or more of its partners to file amended returns, taking into account all adjustments properly allocable to such partner. This procedure effectively reduces the amount of additional tax payable at the entity level. This procedure is complex and requires knowledgeable advice by the entity's tax advisors, particularly certified public accountants. The second procedure is the so-called "push-out" election by which an entity may elect to include certain adjustments on the returns of the reviewed year partners in the adjustment year rather than amending returns previously filed in the reviewed year. The "push-out" election effectively shifts the economic burden of the entity's audit tax assessment from the entity level to the entity's partners. As with the "pull-in" election, the "push-out" election requirements are tedious and specific and must carefully be implemented with the advice of a knowledgeable tax advisor.

The issues described in this Memorandum should be discussed with each entity's tax advisors, and appropriate amendments or modifications should be made to partnership or operating agreements. At a minimum, each entity should strongly consider designating a Partnership Representative in the event the entity is not eligible to elect of out the new rules. In addition, the partnership or operating agreements of any entity to be formed following the implementation of these rules should consider these issues and the partners must determine how the new audit rules, particularly those pertaining to the Partnership Representative, are to be reflected in their agreements.

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