BRACEWELL

INSIGHTS

The New Partnership Audit Rules, Part 4: The Partnership Representative

April 26, 2018

*By: **Elizabeth L. McGinley***

This is the fourth installment of Bracewell Tax Report articles describing the new rules applicable to partnership audits under the Internal Revenue Code and the related proposed and final Treasury regulations. Each installment focuses on certain aspects of these rules and the practical implications to partners and partnerships, particularly as they relate to negotiating and drafting partnership agreements.

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for federal income tax purposes (the New Rules). The New Rules, effective for audits of partnership tax years beginning on or after January 1, 2018, generally allow the IRS to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level. Click ***here*** for a general description of the New Rules.

Under the New Rules, a partnership must designate a partner, or other person, with substantial presence in the United States to serve as the partnership representative. If the partnership representative is an entity, the partnership representative must appoint an individual, known as the designated individual, through whom it will act for all purposes under the New Rules. The partnership representative has the sole authority to act on behalf of the partnership, and legally bind the partnership, with respect to federal examinations and audits. No contractual arrangement, including any partnership agreement or state law document, can limit or alter this authority. In addition, other than the partnership representative, no partner or other person may participate in any examination or other proceeding with the IRS.

The role of the partnership representative represents a broad departure from that of the tax matters partner under the prior partnership audit regime, commonly known as the TEFRA rules. The TEFRA rules required that the tax matters partner be a partner in the partnership that satisfied certain criteria, which, particularly in the case of complex partnerships, often were difficult to apply. In the event a partnership did not properly designate a tax matters partner, the TEFRA rules required a partner to be assigned to the role, either pursuant to statutory rules or by the IRS, before a federal partnership audit could begin. Finally, the TEFRA rules required the tax matters partner to give notice to the other partners of examinations and audits, and permitted other partners to be present and participate directly in relevant proceedings.

For most partnerships, the choice of partnership representative is a straightforward decision that is made without significant negotiation. Very often, a controlling or majority partner is the natural choice, particularly if that partner has effective control over the operation of the partnership. In other partnerships, a minority partner responsible for day-to-day administration of the partnership or with the greatest knowledge of the partnership's business and operation may be best suited for the role. In certain situations, however, it can be difficult to find any partner willing to take on the role and responsibilities of the partnership representative. When the New Rules were first signed into law, it was expected that many partnerships would outsource the partnership representative role to outside advisors for a fee. Some commentators even believed a new industry for partnership representative services would emerge, although this has not yet been the case.

Under the New Rules, a critical issue among partners often is how much authority to vest in the partnership representative, and whether to give the other partners a role in the partnership representative's decision-making process. Particularly if the partnership representative is a partner with effective control of the partnership or management responsibility for day-to-day operations, this partner may seek an unfettered right to make decisions with respect to partnership examinations and audits at its sole discretion. In response, other partners may request notice of the initiation of a partnership examination or audit, and the right to be kept reasonably informed with respect to these matters by the partnership representative, because these rights are not guaranteed under the New Rules. In addition, these partners may seek the right to consult with the partnership representative on key decisions, determinations and elections related to an examination or audit, and may even ask for a prohibition on certain actions by the partnership representative without such partners' consent. However, a partner serving as a partnership representative should be cautious with respect to broad consent rights. Such consent rights could cause a deadlock among partners, which could delay the orderly administration of a partnership audit or even cause the partnership representative to miss a deadline imposed by the New Rules or the IRS. An alternative approach is to put these key decisions, determinations and elections in the hands of the partnership's board or other governing body, although this may not necessarily eliminate the risk of deadlock or delay.

When drafting partnership agreements, partners often focus on procedures relating to the push-out election. If made, the push-out election permits audit adjustments to be allocated to the partners in the year under review as an alternative to the current year partners bearing the resulting assessment. (Click ***here*** for more on the push-out election.) Timing is of the essence for making the push-out election, which must be made no later than 45 days after the IRS mails the notice of final audit adjustments to the partnership. Accordingly, the partnership representative likely will prefer to have full control over the decision to make the election, if not a binding mandate in the partnership agreement to make the election in all instances, rather than seek the consent of, and potentially negotiate with, the other partners. From the other partners' perspective, the decision to make a push-out election for an imputed underpayment can materially impact their cash tax liability and, therefore, these partners may negotiate for a consent right that will survive the partners' exit from the partnership.

Our next installment will focus on the “pull-in” election under the New Rules, which was rolled out as part of the recent Consolidated Appropriations Act, 2018.