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SPECIAL ALERT ON DEVELOPMENTS IN

Tax Reform

For more information, contact one of the following attorneys at Lipsitz Green Scime Cambria.

Michael Schiavone

Michael Schiavone has provided legal guidance to businesses for over 30 years. He concentrates his practice in the areas of business law, tax planning, commercial real estate, sports law, and estate planning. Mr. Schiavone can be reached at:
Phone: 716 844 3500
E-mail: mschiavone@lglaw.com

Matthew B. Morey

Matthew B. Morey counsels clients through significant events in the life of their businesses including contractual matters, corporate and partnership tax matters, compliance matters, cost-effective solutions when conflicts arise, and strategies to assist in the growth of their businesses. Mr. Morey can be reached at:
Phone: 716 849 1333
E-mail: mmorey@lglaw.com

Micelle M. Ragusa

Micelle M. Ragusa advises clients on all facets of their business' operations. She focuses her practice on virtually every aspect of corporate and commercial law including tax strategies and regulatory compliance, mergers and acquisitions, corporate governance, entity formation, negotiation and drafting of various contracts, commercial real estate acquisitions and sales, and contractual disputes.
Phone: 716 849 1333
E-mail: mragusa@lglaw.com

Changes to Tax Audits for Partnerships

Effective as of January 1, 2018, certain rules governing federal income tax audits of partnerships have changed substantially as a result of the passage of the Bipartisan Budget Act of 2015 (the "Act"). These changes require taxpayers who conduct business as a partnership or other entity treated as a partnership for tax purposes (such as a limited liability company with multiple owners) to amend their partnership agreements (if you conduct business as a partnership) or operating agreements (if you conduct business as a limited liability company) to address issues raised by the new rules.

The new rules imposed by the Act fundamentally change the way in which an underpayment of tax is assessed in connection with a federal income tax audit of a partnership. Prior to the Act, the Internal Revenue Service ("IRS") was required to collect an assessment for an underpayment of income tax directly from the partners of a partnership. However, under the new rules, effective as of January 1, 2018 the partnership (or entity taxed as a partnership) is liable for the payment of unpaid federal income taxes arising from an audit. This means the IRS is no longer required to separately assess and collect each partner's share of an income tax obligation arising from an audit, but rather, may collect directly from the partnership or entity itself.

Tax Matters Partner vs. Partnership Representative

Prior to the Act, partners in a partnership designated a "tax matters partner" to represent the partnership on certain tax related matters. Under the new rules, the partners no longer designate a "tax matters partner" to represent the partnership, but rather are required to designate a "partnership representative" to act on its behalf. If the partners do not designate an individual to act as the "partnership representative," then the new law allows the IRS on its own to select the party that will serve as the representative.

It may seem that the concept of designating a "tax matters partner" or "partnership representative" is essentially the same and just a change in nomenclature – however, that is not the case. Unlike a "tax matters partner", a "partnership representative" has the sole authority to act on behalf of the partnership with the IRS in connection with an audit or other tax re-

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lated proceeding, and can bind the company without the other partners' consent (absent an agreement otherwise). Further, there is no requirement that the partnership representative communicate the status of the tax audit with the other partners. Finally, the "partnership representative" does not need to be a partner at all. Accordingly, it is very important for partners to give some thought as to who will serve as the "partnership representative," and to require that individual to keep the other partners reasonably informed of matters concerning an audit or other tax proceeding. In certain situations, it may also be appropriate for the partners to require the "partnership representative" to obtain the other partners' consent before proceeding with certain actions on its own with the IRS, such as settling a tax dispute or tolling the statute of limitations.

Deficiency

If an audit results in a deficiency, the partnership will be liable for the tax and the partners may be required to contribute their respective pro-rata share of the deficiency as an additional capital contribution. Moreover, any deficiency resulting from the audit will be assessed against the partners in the year the audit is concluded – as opposed to that tax year that is subject to the audit. This could produce unintended consequences if there have been changes in partnership ownership.

Opt-out

In certain situations, some partnerships or other entities taxed as partnerships may be eligible to "opt out" of complying with the new partnership audit rules. However, in order to "opt out," the partnership must satisfy the following requirements: (i) have 100 or fewer partners, and (ii) each partner must be an individual, an estate, a C corporation, an S corporation, and certain other foreign entities.

The opt-out election is not available to partnerships that have an entity taxed as a partnership as a partner (such as a limited liability company that is a member of another limited liability company). Further, the "opt out" election must be made each year by the company on its tax return, otherwise, the new rules will apply. As a general matter, it is usually beneficial for the partnership to "opt out" of complying with the new rules, to the extent possible. Accordingly, taxpayers who wish to "opt out" should consider amending their governing agreements confirming that all of the partners agree that the partnership will "opt out" when possible.

Push-out

The partnership or limited liability company can elect to use an alternate procedure to "push out" the tax liability to audited-year partners or members. The partnership or LLC can elect to issue statements of adjustment to the persons who were partners (or members) during the audited year and any adjustments will be taken into account by the audited-year partners (or members) on their own tax returns (with interest paid at a higher rate) in the adjustment year.

Conclusion

In sum, passage of the Act has significantly changed the rules governing federal income tax audits of partnerships, which raises issues that are likely not adequately addressed in your existing partnership and operating agreements. Accordingly, we recommend that you consider the various issues raised by the passage of the new partnership audit rules and amend your governing agreements to adequately address these issues.

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