

### **3 Reasons to update your LLC operating agreement to address the new tax audit rules**

By Riley Gombart

Effective January 1, 2018, the Bipartisan Budget Act of 2015 made significant changes to the auditing rules for all business entities taxed as partnerships (“Partnership Audit Rules”). This article summarizes some key changes made by the new Partnership Audit Rules and a few important updates members of a limited liability company (“LLC”) taxed as a partnership should consider addressing in their operating agreement. As the Partnership Audit Rules apply to partnerships as well, the suggestions made in this article are also applicable to partners in updating their partnership agreement.

#### **1. Control of Partnership Representative actions**

One significant rule change is the replacement of the “Tax Matters Partner” with a “Partnership Representative” and the scope of authority of the new Partnership Representative.

As with the Tax Matters Partner, the new Partnership Representative is the main contact person to interface with the Internal Revenue Service (“IRS”) for any inquiries and audits of the partnership. However, the Partnership Representative has broader powers and authority with regard to tax audits.

Under the new rules, the Partnership Representative has the sole authority to act on behalf of the partnership and any such actions are also binding on the partners. For example, the Partnership Representative has the authority to meet with representatives of the IRS, settle any tax audit, bind the partnership and all partners to any tax audit settlement, extend the statute of limitations for tax liability for any tax year, and decide whether to contest or acquiesce on partnership adjustments made pursuant to a tax audit.

Given the powers granted to the Partnership Representative, LLC members should consider modifying their operating agreement to include provisions regarding the Partnership Representative to maintain control of decisions made on behalf of the LLC:

- Provisions to designate, remove, and appoint a Partnership Representative;
- Provisions requiring the Partnership Representative to keep the members of the LLC informed of any tax audit; and
- Provisions requiring the Partnership Representative to obtain approval from the members of the LLC prior to making binding decisions regarding a tax audit.

#### **2. Maintaining status to opt out**

On the tax return for each year, an entity may opt-out of the new audit rules if the entity issues 100 or fewer statements under 6031(b) (i.e. Schedule K-1s), the entity’s owners are qualified entities, and the entity notifies each of its owners of the election after making it. Qualified

entities are individuals, C corporations, foreign entities treated as a C corporations, S corporations, or an estate of a deceased owner.

If the members of an LLC wish to continue to meet the requirements to opt-out of the new Partnership Audit Rules, members should consider transfer restrictions in their operating agreement to disallow and void transfers that would make the LLC ineligible to opt-out:

- Restrictions on the types of entities to which a member may transfer its interest; and
- Restrictions on transfers of interests which push the number of owners for the LLC over the 100-entity limit.

### **3. Push out elections and ex-member duties**

Another change made by the Partnership Audit Rules is the shifting of the assessment and collection of taxes and underpayments from partners to the partnership itself. This change transfers the burden of collecting underpayments by partners to the partnership.

This adjustment in underpayment liability includes underpayments by partners no longer associated with the partnership. This could result in an LLC (and thus all *current* members of such LLC) being liable for the underpayment of a member in a prior tax year when such member is no longer part of the LLC.

To push this burden back to the underpaying partners, the Partnership Representative may elect to “push-out” adjustments made by an audit to the members of the year under audit. Of particular importance, this push-out election would include members of the LLC during the year under audit who may no longer be members of the LLC.

As a result members of an LLC may want to consider the following provisions in their operating agreement to address this change in underpayment liability:

- A provision requiring the Partnership Representative to make a “push-out” election for any tax audits resulting in a tax liability due for underpayment made by a member no longer holding an interest in the LLC; and
- A provision, which would survive member withdrawal from the LLC, requiring members to cooperate in good faith with the LLC and the Partnership Representative during an audit of a tax year in which the Member was with the LLC.

Members of an LLC (and partners of a partnership) should take the time to think about how to address the above issues through an amendment or restatement of their operating agreement (or partnership agreement).