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Coming Soon: Partnership Representatives For Tax Issues

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Law360, New York (May 31, 2017, 11:24 AM EDT) -- Partnerships, especially large partnerships, have become an increasingly common form for business activity. Between 2002 and 2011, the number of partnerships with 100 or more partners and $100 million or more of assets more than tripled, to 10,099.

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Existing Internal Revenue Service tools established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) have been unable to keep up with these developments, leading to a substantially lower audit rate for partnerships as compared to corporations. As a result, Congress in the Bipartisan Budget Act of 2015 (the 2015 Act) enacted a new regime for audits of partnerships that will take effect for most partnerships for tax years beginning in 2018.[1]

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A key element in this new partnership audit regime is the establishment of the "partnership representative" as the sole contact point between a partnership and the IRS during an audit and the sole decision-maker on behalf of the partnership with regard to all tax-related administrative and judicial proceedings. This article discusses the responsibilities of the partnership representative established in the 2015 Act (and contemplated in the proposed regulations) and identifies key considerations for partners and partnerships to keep in mind as they prepare to select and work with a partnership representative in the new regime.

Reasons for Establishing the Role of Partnership Representative

The 2015 Act's creation of the partnership representative role was intended to correct difficulties faced by the IRS in auditing partnerships under prior law. Although TEFRA provided for the identification of a Tax Matters Partner, the IRS was nonetheless unable to effectively conduct many audits. The IRS frequently encountered difficulties with the identification of the Tax Matters Partner resulting in audit delays.

Further, in addition to the Tax Matters Partner, other partners were entitled to notice of the audit and could participate in the audit and any litigation that resulted. Consequently, completing the audit within the period for assessing additions to taxes from the individual partners was extremely challenging. As a result, the 2015 Act created the partnership representative and assigned it substantially greater powers for managing the partnership audit.

The statutory provisions regarding the partnership representative in the 2015 Act were designed to address the perceived limitations with the Tax Matters Partner. The statute has a clear procedure for identifying the partnership representative and allowing the IRS to fill the position if the partnership fails to do so promptly. The partnership representative is to be designated with the filing of the partnership's return each year.

The procedures for the replacement or resignation of the partnership representative require notice to the IRS, so that at any point the IRS knows who is responsible for the audit. In the event the IRS determines that a valid partnership representative designation is not in effect, the partnership has only thirty days to designate one following notice from the IRS, or the IRS will designate one. In cases where there have been multiple resignations or replacements of a partnership representative, the IRS may act to designate a new representation immediately.

Furthermore, the IRS now has wide flexibility in who it chooses as the partnership representative. These procedures should eliminate delays in the audit resulting from the IRS searching for an appropriate point of contact with the partnership.

In addition, the law requires that the partnership representative be accessible to the IRS. The regulations specify that the partnership representative must have a substantial presence in the U.S. A substantial presence requires the representative to have a U.S. street address, a U.S. telephone number, a U.S. taxpayer identification number and the capacity to meet with the IRS in the U.S. at a reasonable place and time.

An entity can be designated as the partnership representative, but if the partnership representative is an entity, an individual associated with the entity who satisfies the substantial presence requirement must also be designated. In either case, the IRS has a clearly defined point of contact in dealing with the partnership.

The centralized partnership audit regime also eliminates the need for the IRS to deal with multiple partners in the audit process. In stark contrast to TEFRA, where individual partners had rights to notice of significant audit events and the right to participate in the process, under the centralized partnership audit regime, the partnership representative is the sole point of contact between the partnership and the IRS.

The 2015 Act does not require either the IRS or the partnership representative to advise partners about developments related to the audit. Although nothing prohibits the partnership representative from keeping the partners advised of audit developments or from soliciting their input on decisions, the proposed regulations are clear that, without the IRS's permission, only the partnership representative may participate in meetings with the IRS.

Authority and Responsibilities of the Partnership Representative

The 2015 Act grants the partnership representative broad powers to bind the partnership and its partners on tax matters. The proposed regulations are clear that the partnership representative's actions bind the partnership even if such actions violate the partnership agreement or any contracts between the partnership representative and the partnership.

Even actions in violation of state law may be enforced by the IRS. While contractual limits on the partnership representative may enable the partnership or partners to seek damages from the partnership representative, the partnership representative's actions are conclusive for tax purposes. Given the authority granted the partnership representative, the judgment of the partnership representative will be a key concern of the partnership and its partners.

One major decision the partnership representative is likely to confront is the question of whether to extend the statute of limitations. In general, absent an extension, the IRS must issue its Notice of Proposed Partnership Adjustment within three years of the latest of the date that the partnership's return was filed or the date that it was due. For large corporations, extensions of the statute of limitations are commonly requested, and one would expect that will also be the case for large partnerships under the new regime.

Refusal to extend the statute may well result in the IRS resolving all open audit issues against the partnership. Granting the extension may enable the parties to resolve the audit without requiring the partnership to escalate the matter to Appeals or the courts. On the other hand, granting the extension will delay the resolution of the audit. Such delay may complicate the development of evidence to support the partnership's position. Delays can be particularly problematic in situations where information relevant to the audit may be in the possession of partners. Such information is likely to become less accessible with the passage of time. Hence, the partnership will want a partnership representative who can reasonably balance these concerns.

The partnership representative will also need to think strategically about when and how to obtain information from the partners. Under the new regime, the partnership representative may need information from the reviewed year partners to effectively resolve the audit. This is particularly true if the IRS asserts penalties. The new regime requires that all penalty defenses, including any defenses applicable to individual partners, be presented in the partnership level proceeding.

Therefore, the partnership representative will need to determine whether partner level defenses are available and obtain the necessary information from the partners. Obtaining the necessary information may be difficult, particularly if a reviewed year partner is no longer a partner. The partnership representative will also need to consider whether the disclosure of information from a partner would result in a waiver of privileges, such as the attorney-client privilege, with respect to the information.

The partnership representative will also need to decide whether to challenge or compromise any IRS proposed adjustment. The partnership representative will have the authority to decide whether on not to contest a proposed adjustment through the Appeals process and whether the matter should be litigated. The partnership representative will also have authority to decide which forum should be used to litigate the case.

Finally, the partnership representative will have the authority to enter into settlements with the IRS regarding the proposed adjustment. Therefore, the partnership will want to designate a partnership representative that has the ability to assess the costs and benefits of challenging any proposed partnerships adjustments.

In the event that the audit results in an adverse adjustment to the partnership, the partnership representative will face numerous decisions that will impact the amount of tax due and who bears the economic cost of that tax liability. Under the new regime, the default option is that the partnership will pay tax on any imputed underpayment resulting from the IRS's proposed adjustment at the highest income tax rate in effect. However, this imputed underpayment may be larger than the tax that would have been due if the IRS's proposed adjustment had originally been reported on the Schedule K-1s for the reviewed year.

For example, some of the partners may be exempt from tax. Accordingly, the new regime provides for a modification process that attempts to adjust the partnership level payment closer to the amount that would have been paid at the individual partner level. However, obtaining the modifications will require the partnership representative to obtain information about the tax characteristics of individual partners.

The partnership representative will need to determine if a modification is likely to reduce the total tax liability due. In addition, because the modification procedure must be conducted before the partnership has exhausted its ability to challenge a proposed adjustment, the partnership representative must weigh the difficulties in seeking a modification against the likelihood no liability may ultimately be due. If the partnership representative concludes that a modification is appropriate, it will then need to obtain information from the reviewed year partners in order to request the modification from the IRS.

Moreover, the partnership representative must consider the fact that, even if a request for modification resulted in the imputed underpayment being equivalent to the tax cost that would be incurred if the liability had originally been paid at the partner level, the modification procedure still results in the tax being paid at the partnership level years after the reviewed year. Because the partners may have changed in the interim, payment by the partnership may result in the economic burden being shouldered by a different group of partners.

The partnership representative therefore has the ability to make a push-out election for the partnership. The push-out election would require that the reviewed year partners report the IRS's adjustments on their returns in the year in which the statements showing their share of the adjusted amounts are furnished to them.

While the push-out election may reduce the total amount of tax paid and result in any liability being borne by the partners for the reviewed year, it may not always be the best option. For one thing, the interest charge to the partners will be two percent higher than the interest charge applied to a payment made by the partnership. Further, pushing out the adjustments will require additional tax computations by all of the reviewed year partners.

For some partnerships, thousands of returns could be required. Hence, after transaction costs are considered, the partnership representative may conclude that given the size of the adjustment, the number of partners and the degree to which ownership of the partnership has stayed constant, payment at the partnership level may be the best course of action. These are all significant decisions demanding a partnership representative who can be relied upon.

While the partnership will undoubtedly want to focus on the partnership representative's ability to wisely render decisions on these many issues, one should not overlook the fact that a key function of the partnership representative will be managing the audit. The IRS is going to look to the partnership representative as the source for information necessary to conduct the audit. This is clear from the emphasis that the substantial presence requirement places on being able to identify a person whom the IRS can readily contact during the audit.

The ability of the partnership representative to delegate the day-to-day management of the audit is unclear. Under the proposed regulations, the IRS would have the ability to insist on dealing with the designated partnership representative and no one else. However, one would expect the IRS to be more flexible. In corporate tax audits, the IRS is accustomed to dealing with less senior members of the tax department. Furthermore, the exclusivity of the partnership representative as the point of contact seems largely directed at the TEFRA structure where individual partners could participate in the proceedings.

Therefore, one would expect that as long as the IRS has a clear path for having their information requests answered during the audit, it would be willing to allow the partnership representative to delegate that task. However, the partnership representative should anticipate that if the IRS perceives that its inquiries are not being properly answered, the IRS will demand his or her personal attention regarding the audit.

Even if the partnership representative can delegate the day-to-day management of the audit, he or she should be familiar with the tax issues that are likely to arise during the audit and the availability of responsive information. Well-structured audit responses can speed the resolution of the audit and assist in bringing it to a successful conclusion.

If the matter proceeds to Appeals, the partnership will need to have developed a record with the IRS exam team that will support the partnership's legal arguments at Appeals. Hence, even if the routine aspects of the audit can be delegated, the partnership representative will want to be able to oversee the management of the audit.

Choosing and Constraining the Right Partnership Representative

Given the partnership representative's significant authority regarding the partnership's tax matters, partners are likely to be most satisfied by a representative who blends good judgment with a solid technical and factual understanding of the partnership's activities and experience with IRS audits and Appeals proceedings.

For large partnerships with an existing manager, it may make sense simply to include the partnership representative role with the other functions of the manager. If the partners have already accepted the manager as appropriate for dealing with their financial interests, it would seem reasonable that they would also accept that manager dealing with their tax interests.

Furthermore, the manager is likely to have access to the information that will be sought in the event of audit. Finally, partner input on the selection of the partnership representative could be burdensome for larger partnerships, in light of the need to designate a representative for each tax year and, if necessary, replace that representative quickly in order to avoid the IRS designating a representative of its own choosing.

Yet even the perfect blend of judgment, knowledge, experience and — in the case of an existing manager — familiarity may not provide perfect comfort to partners forced to relinquish control over their own tax destinies under the new regime. Although contractual provisions cannot restrict the partnership representative's power to bind the partnership or partners on tax matters, such provisions may provide additional comfort to partners, as well as guidance to the partnership representative, and are thus advisable on a number of key subjects. For example, the partnership agreement and any offering agreements should establish standards for:

- Designating the partnership representative and, if it becomes necessary, replacing him or her;

- How the partnership representative will communicate audit, Appeals and litigation developments to the partnership and/or the partners;
- Whom the partnership representative will consult in deciding how the audit should be conducted, whether a settlement should be made and when litigation will be pursued; and
- How and when the partnership representative will obtain necessary information from the partners during audit, Appeals and/or litigation, including with respect to potential penalty defenses and modification requests.

In addition, partners and advisors should consider contractual provisions related to the major decisions the partnership representative must make under the new regime. For example, provisions regarding whether the partnership representative will request modifications to imputed underpayments or elect to push out those underpayments to the reviewed year partners could provide some measure of predictability for partners. As discussed above, however, whether such actions make sense may vary widely depending on the circumstances facing the partnership.

Conclusion

The 2015 Act imposes a paradigm shift on partnership audits. Among the most consequential changes are the replacement of TEFRA's Tax Matters Partner with the new regime's partnership representative and the endowment of that representative with extensive authority to bind the partners in tax-related administrative and judicial proceedings.

In the months before the new law takes full effect, partners and their advisors should ensure that they understand the breadth of the partnership representative's mandated responsibilities, identify a partnership representative who possesses the qualities they believe are most important for successfully navigating the changed partnership audit landscape, and consider and implement appropriate contractual provisions to guide the representative as he or she prepares to begin work on behalf of the partnership.

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[1] In January 2017, Treasury and the IRS announced proposed regulations implementing the new regime. Although these proposed regulations were subsequently withdrawn pending review and approval by the Trump administration, they remain a useful indicator of the IRS's interpretation and expectations of the new regime.
