taxnotes®

state

Volume 93, Number 5 ■ July 29, 2019

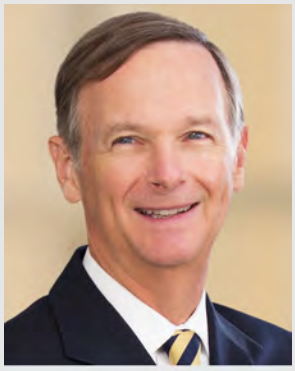
Should Operating Agreements Be Amended To Account for New Audit Rules?

by James R. Browne

Reprinted from *Tax Notes State*, July 29, 2019, p. 387

Should Operating Agreements Be Amended To Account for New Audit Rules?

by James R. Browne



James R. Browne

James R. Browne is a partner with Barnes & Thornburg LLP.

In this article, Browne analyzes whether partnerships should amend their operating agreements in response to new centralized partnership audit rules.

This year partnerships (including limited liability companies classified as partnerships for tax purposes)[1] are filing 2018 tax returns, which are generally the first returns that are subject to the new centralized partnership audit rules that Congress enacted in 2015.[2] A common question is whether partnerships with operating agreements that do not specifically address the new partnership audit rules (affected partnerships) need to amend those agreements.

In many cases, amending an affected partnership's operating agreement to account for the new partnership audit rules is a prudent and relatively easy undertaking, and could produce collateral benefits (such as providing a convenient opportunity to identify and address other problems that might be lurking in the operating agreement). But amending the operating agreement won't always be feasible. For example, a partnership might not be able to obtain the necessary approvals to adopt the amendments, either because the partnership can't locate all the partners needed to approve the amendments or the partnership can't get approval from a sufficient number or percentage in interest of the partners. And even in cases when adopting the applicable amendments may be feasible, the expense and inconvenience (or worse) involved in obtaining the necessary approvals might not be justified given the partnership's risk of being audited or the risk of disputes arising among the partners in connection with any such audit.

This article gives some background on the new rules to provide context in analyzing whether an affected partnership should amend its operating agreement. It then examines some provisions of the new rules commonly cited as reasons necessitating or justifying amendments to operating agreements of affected partnerships, and considers some consequences that realistically might follow from failing to adopt amendments. My conclusion is that while each affected partnership that has the ability to amend its operating agreement should independently evaluate the need to adopt amendments to address the new partnership audit rules in the context of its unique circumstances, there will be many situations in which the partnership will reasonably conclude that it should not pursue amendments solely to address the new rules.

[1] References in this article to partnerships are intended to include LLCs classified as partnerships for tax purposes, references to partners are intended to include members of such LLCs, and references to the general partner are intended to include a manager of such an LLC.

[2] *See* P.L. 114-74, section 1101, 129 Stat. 584, 625 (2015). Even though the rules were enacted over three years ago, I refer to them in this paper as the "new" rules because they are generally effective for audits of tax returns filed this year and to distinguish them from the rules that were in effect from 1982 generally through 2017 (which I refer to as the "old" or "prior" rules). See T.D. 9844 for a history of the applicable statutory provisions and amendments and administrative guidance.

Background

Before 2018, audits of partnership tax items were generally conducted at the partnership level rather than at the partner level. Once the partnership-level audit was concluded and the adjustments to the partnership's tax items were finalized, the Internal Revenue Service had the daunting task of flowing through those adjustments to each partner's tax return, calculating the resulting tax liability of each partner, and then assessing and collecting the tax from those partners if the partners did not amend their returns to reflect the adjustments. For the largest partnerships, there could be hundreds or thousands of partners, and in many cases the affected partners might themselves be flow-through entities, and sometimes multiple tiers of flow-through entities. The process for auditing partnerships, flowing through any adjustments to the direct and indirect partners, and calculating the resulting tax liability was so daunting that the IRS, consciously or unconsciously, audited very few partnerships.[3]

The new rules significantly reduce the burdens on the IRS in auditing large partnerships. The apparent purpose is to increase the audit rates of, and tax collections from, those partnerships. *The most significant change made by the new rules is to permit the IRS to assess and collect tax against the partnership rather than against the individual partners.*[4] Another significant change was to greatly expand the authority of the partnership representative (known under the old rules as the "tax matters partner" and known under the new rules as the "partnership representative") in dealing with the IRS regarding audits and appeals, and to reduce or eliminate the IRS's obligations to communicate with the partners regarding such matters.[5] These changes, and others, could have significant effects on existing partnerships and their partners, and those effects might not be adequately addressed in partnership operating agreements of affected partnerships.

In considering the potential effects of the rule changes on partnerships, a relevant fact is that most partnerships have a near zero probability of an audit. Of all partnership returns filed in 2017, only 0.2 percent were audited through October 2018.[6] While the apparent objective of the new rules is to increase the audit rate for large partnerships, judging by the audit rate for all taxpayers and considering the IRS's resource constraints (even taking into account recent appropriations), it is unlikely that the overall partnership audit rate will rise above 1 percent even under the new rules. The rate for the largest partnerships and those disclosing hot-button issues may be higher (possibly much higher). But for most partnerships, the risk of an IRS audit with a material change to reported tax items is very low.

Analysis of Reasons for Amending

This article does not attempt to explain or analyze all the potential effects of the new audit rules on all partnerships. Rather, it focuses on specific provisions of the new rules that are commonly cited as reasons why affected partnerships need to amend their operating agreements, and considers what consequences might realistically follow from failing to adopt applicable amendments.

Designation of a Partnership Representative

A common recommendation is that an affected partnership should amend its operating agreement to designate a partnership representative under the new audit rules, and to address the circumstances in which the representative may be removed and replaced. While having such provisions in the operating agreement is undeniably desirable, what might be the consequences if they are not added?

[3] *See* Government Accountability Office, "Large Partnerships," Rep. No. GAO-14-732 (Sept. 2014).

[4] *See* IRC section 6221. This change applies only to income taxes imposed under IRC chapter 1. Self-employment taxes (chapter 2) and net investment income tax (chapter 2A) are assessed and collected through normal deficiency proceedings at the partner level. IRC section 6241(9)(A); Treas. reg. section 301.6241-6(a). For withholding taxes on payments (chapter 3) and withholding taxes on payments to foreign entities (chapter 4) attributable to any adjustments to partnership tax items under the new rules, the incremental withholding taxes are assessed and collected from the partnership for the year the audit is finalized (adjustment year) and not for the year to which the adjustment relates (reviewed year). IRC section 6241(9)(B); Treas. reg. section 301.6241-6(b).

[5] Compare IRC section 6223 (before amendment) with section 6223 (as amended).

[6] IRS, *2018 Data Book*, p. 23 (Table 9a) (May 2019).

The initial designation of a partnership representative for a tax year is actually made on the partnership tax return for that year,[7] not in the operating agreement. Therefore, the real question is whether the existing operating agreement adequately grants authority to some person or persons to designate a partnership representative on the applicable tax returns. If the operating agreement gives the general partner broad authority to manage all aspects of the partnership's operations, to appoint officers and agents and delegate authority to them, and to make all elections related to the filing of tax returns and administration of tax matters, that general grant of authority may be sufficient to facilitate the general partner's designation of a partnership representative.

If in such a case the general partner designates as the partnership representative for the 2018 and future years' tax returns the person serving as the tax matters partner for prior years (or otherwise designates a person in accordance with the procedures for designating a tax matters partner), that may be an acceptable result for all partners without the need for a formal amendment to the partnership's operating agreement. Similarly, if the operating agreement has a procedure for obtaining approval for major decisions, those approval procedures might be sufficient to facilitate the partnership's designation of a partnership representative without the need for an amendment. When the scope of the general partner's authority is more ambiguous and there are no clear procedures for obtaining approval for the designation of a partnership representative, and when disputes might arise regarding the selection of a partnership representative, the partnership might chose to amend the partnership agreement to designate a partnership representative, or to provide a procedure for doing so, and to address the other issues listed below.

The new audit rules provide comprehensive provisions addressing a partnership representative's resignation, a partnership's revocation of a representative's designation, a partnership's designation of a replacement representative, and the designation of a partnership representative by the IRS when no valid designation is in effect.[8] Like the rules regarding the initial designation of a partnership representative, the rules regarding the resignation, removal, and replacement of a partnership representative are designed to operate independently of any provisions in the partnership's operating agreement, at least as between the IRS and the partnership. If the existing operating agreement is sufficient to facilitate the initial designation of the partnership representative, it may also be sufficient to facilitate the removal and replacement of a partnership representative.

If the IRS determines that there is no valid designation of a partnership representative for an applicable tax year, the IRS will designate one (after having afforded the partnership notice of the deficiency and 30 days to designate an eligible partnership representative).[9] There are only two limitations: First, the person must have a substantial presence in the United States; and second, the person cannot be an IRS employee, agent, or contractor unless the person was a reviewed-year partner.[10]

In selecting a partnership representative, the IRS may, but is not required to, take into account various factors. A principal consideration is whether there is an eligible reviewed-year partner, or an eligible partner at the time the designation is made, who will serve as partnership representative. Other factors are the views of the partners having a majority interest in the partnership regarding the designation; the general knowledge of the person in tax matters and the administrative operation of the partnership; the person's access to the books and records of the partnership; whether the person is a U.S. person; and the profits interest if the person is a partner. Having the IRS designate a partnership representative is not a desirable

[7] Treas. reg. section 301.6223-1(a), (c); IRS Form 1065.

[8] Treas. reg. section 301.6223-1.

[9] Treas. reg. section 301.6223-1(f).

[10] Under the new regulations, the "reviewed year" is the partnership's tax year to which any adjustment to a partnership-related item relates, and the term "reviewed-year partner" means any person who held an interest in a partnership at any time during the reviewed year.

result, but it might be the only option in some situations.

Another situation that might arise is a partnership that designates a representative in direct violation of the partnership agreement. In such a case, provided the designated partnership representative is an eligible person,[11] the designation is apparently binding between the partnership and the IRS until the partnership representative resigns, or the partnership revokes the designation, in accordance with the IRS rules. A partnership in this situation probably has problems that are beyond what can be cured with a simple amendment to the operating agreement.

Partnership Representative Rights and Obligations

Under the prior partnership audit rules, the IRS and the tax matters partner were required to provide notice to some partners of specified material events regarding a partnership audit. Also, every partner had the right to participate in any phase of the partnership audit proceedings, and the tax matters partner generally did not have the right to bind the partners to any settlement of the IRS's proposed adjustments. Under the new rules — other than the requirement that the IRS send to the partnership any notice of commencement of an administrative proceeding, notice of proposed partnership adjustments, and notice of final partnership adjustments — the IRS has no obligation to communicate with anyone other than the partnership representative regarding the audit and any appeals, and the partnership representative has the exclusive authority to deal with the IRS regarding the audit and any appeals, including the exclusive authority to enter into a settlement agreement.[12]

From the perspective of a general partner who serves as the partnership's tax matters partner under the old rules and will serve as the partnership representative under the new rules, the new rules generally impose fewer limitations on the general partner's authority and may be seen as a favorable development from that perspective. A possible negative effect is that the general partner may feel more exposed to claims by other partners that the partnership representative acted improperly regarding the handling of an audit. Accordingly, at a minimum, a partnership representative (and, if an entity, its designated individual) will want to ensure that any such exposure is covered by appropriate provisions in the partnership's operating agreement dealing with limitation of fiduciary duties, exculpation from liability, and indemnification. The partnership representative might also want to ensure that the operating agreement requires the partnership to obtain and keep in force applicable directors and officers insurance, and that the required coverage extends to the partnership representative in its capacity as such.

If the existing agreement contains adequate protective provisions that unambiguously extend to the person serving as the partnership representative, it might not be necessary to amend the operating agreement. If the protective provisions do not clearly extend to the partnership representative, the partnership may not be able to find a person willing to serve in that capacity without an amendment to the operating agreement extending such protections.

From the perspective of the partners who are not the partnership representative and who do not have effective control over the actions of the partnership representative, the new rules reduce those partners' statutory information, participation, and consent rights for audit proceedings. However, those other partners may have contractual information, participation, and consent rights under the affected partnership's existing operating agreement, and those contractual rights may extend to proceedings under the new partnership audit rules. In such a case, an amendment to the partnership operating agreement may not be necessary. When the other potentially affected partners do not have such contractual rights, or when the partners consider any contractual rights insufficient to protect their interests regarding such proceedings, they might have no effective ability to force a remedial amendment to the operating agreement, and the partnership might not be inclined to propose or support such an amendment.

[11] Treas. reg. section 301.6223-1(b).

[12] Treas. reg. section 301.6231-1. The partnership must consent to the withdrawal of a notice of final partnership adjustment.

Election Out

Partnerships with 100 or fewer direct partners for a tax year may elect out of the new partnership audit rules for that tax year if each partner is an eligible partner. An eligible partner is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were a domestic entity, an S corporation, or an estate of a deceased partner. The election is made on a timely filed tax return for the year and must include the name, U.S. taxpayer identification number, and type of eligibility for each partner, and the partnership must provide notice of the election to all partners. The effect of the election out is that any adjustment to partnership tax items must be proposed and assessed by the IRS in traditional audit proceedings for each partner, and not in proceedings conducted at the partnership level.

The election out is not available if any partner is a partnership (even one that has validly elected out of the new partnership audit rules), a trust, an ineligible foreign entity, a disregarded entity, estate of an individual other than a deceased partner, or any person holding an interest in the partnership for another person. Also, future proposed regulations are expected to deny the election out to a partnership having a qualified subchapter S subsidiary as a partner except when specific requirements are met.[13]

Commentators often recommend that partnership operating agreements be amended to expressly permit or require the election, and to prohibit transfers of partnership interests to persons who are not eligible partners (that is, transfers that would preclude the partnership from making an election out of the new partnership audit rules). This recommendation probably only makes sense, if at all, for a partnership that currently qualifies for the election out. If it doesn't, there would not seem to be any immediate need to amend the operating agreement to permit or require the election or to restrict transfers.

For affected partnerships that are eligible to make the election out of the new rules, their existing operating agreements might already include provisions that are sufficiently broad to facilitate making the election if the circumstances justify it. Those partnerships might conclude that it is preferable to simply make the election (if it chooses to do so) rather than seek amendments specifically authorizing or requiring the election. Or the partnership might conclude (perhaps with input from some or all of the partners) that it does not want to elect out and therefore does not want to seek an amendment authorizing or requiring the election.[14]

For affected partnerships that want to preserve their eligibility to elect out through restrictions on transfers of partnership interests, their operating agreements might already include provisions prohibiting all transfers or giving the general partner broad authority to prevent transfers of partnership interests for any reason. Those partnerships generally should not need to amend their operating agreements to restrict transfers of partnership interests to ineligible partners. Some partnership agreements contain a list of permitted transfers that the general partner cannot block, and the permitted transfers might include transfers to persons who are not eligible partners under the new partnership audit rules (for example, transfers to family trusts). In those cases, the partnership might conclude that the partners' interests in making permitted transfers outweigh the potential benefits of making the election out, and that the partnership's operating agreement should not be amended to override the right to make permitted transfers to ineligible persons.

When an affected partnership is eligible to make an election out, intends to make an election out for 2018, and places a high value on being able to make the election in future years, the partnership might choose to pursue the recommended amendments to its operating agreement (that is, requiring an election out for all applicable years and prohibiting transfers of partnership interests to ineligible persons).

[13] *See* Notice 2019-06, 2019-03 IRB 353 (Jan. 14, 2019).

[14] A partnership might choose not to elect out due to a concern that the IRS might be more likely to audit a partnership that makes the election, or a concern that any such an audit would be more administratively costly and difficult for the partnership and the partners than a partnership-level audit.

Allocation of Imputed Underpayments

If a partnership is audited under the new rules and a tax deficiency (referred to as an "imputed underpayment" under the new rules[15]) is assessed against and collected from the partnership, there are several reasons why the economic effects of the partnership's tax payment might not be allocated among the partners according to their respective shares of the underlying adjustments. In addition to the situation in which there are changes in partners or their relative ownership interests after the reviewed year, the following two situations can create such distortions:

1. If the partnership has a multi-tier distribution waterfall (that is, cash is not distributed to partners strictly according to their relative capital contributions), the tax payment reduces the cash available for distribution, which may cause the economic effect of the tax payment to fall on the partners in proportion to their sharing ratios under the last tier or tiers of the distribution waterfall. The partners' relative shares of distributions under those tiers will not necessarily reflect the partners' allocable shares of the underlying partnership tax items that gave rise to the imputed underpayment.
2. The partnership can seek modifications to the imputed underpayment to account for partners that are tax-exempt partners, for partners that are C corporations (that is, are taxed at a lower rate than the highest tax rate applicable to other taxpayers), for partners who are individuals eligible for a lower tax rate on long-term capital gain items, and for some other factors.[16] Many partnership operating agreements do not contain provisions that would allow the general partner to adjust the cash distributions to partners to account for a partner's individual contribution to any modification (reduction) in the imputed underpayment.

While these are both good reasons why an affected partnership might amend its operating agreement, the concerns can often be reduced if the partnership representative makes a timely and valid election to "push out" the audit adjustments to all the partners for the year or years reviewed by the IRS.[17] The election has some timing and information hurdles, and there can be some costs to making the election (most notably, the potential loss of modifications for partners who are passthrough entities that cannot make a corresponding push-out election,[18] and the increased interest rate on the partner-level deficiencies[19]). Therefore, a push-out election isn't a perfect solution. But a partnership might reasonably conclude that the potential to push out audit adjustments offers reasonable and sufficient protection relative to possible barriers and hazards associated with obtaining applicable amendments to the partnership operating agreement.

An important qualification is whether the operating agreement grants sufficient authority to the partnership representative to make the push-out election. For an operating agreement that grants broad authority to the general partner to manage the partnership, delegate authority, and manage all matters concerning taxes, a general partner might conclude that the partnership representative has authority to make the push-out election without the need to amend the operating agreement. In some respects, the election achieves results generally consistent with the results under the prior partnership audit rules,[20] and that might provide some additional justification for the conclusion. In other cases, the general partner might conclude that the push-out election is potentially beyond the grant of authority contemplated in the existing agreement and the more prudent course is to seek an amendment specifically addressing the allocation of imputed underpayments and the partnership representative's ability to make a push-out election (as well as other matters arising under the new partnership audit rules).

[15] Treas. reg. section 1.6241-1(a)(3).

[16] IRC section 6225(c).

[17] IRC section 6226.

[18] IRC section 6226(b)(4).

[19] IRC section 6226(c)(2).

[20] One significant difference is the imposition of increased interest on partner-level deficiencies.

A partnership can also eliminate its imputed underpayment if all reviewed-year partners (including passthrough and indirect partners) file amended returns according to procedures specified under the new audit rules, or if all such partners comply with "pull-in" procedures that generally have the same effect.[21] This is generally not a reliable solution to the two concerns noted above because there is no ability under the new rules to compel the partners' participation in filing amended returns or the alternative pull-in procedures, and few (if any) operating agreements drafted under the prior rules would have imposed such responsibilities on affected partners.

Changes in Ownership

A partnership's payment of an imputed underpayment will generally reduce the cash available for distribution to the persons who are partners at the time the payment is made, even though the adjustments giving rise to the tax payment relate to a prior period (that is, the reviewed year). As a result, a person who is a partner at the time the partnership makes the payment will bear a disproportionate share of the tax payment if the partner either was not a partner, or held a smaller percentage interest, in the reviewed year.

> *Example:* Assume a partnership deduction claimed in 2019 is permanently disallowed in an audit completed in 2022, that the entire imputed underpayment is paid by the partnership in 2022, and that one of the partners during 2019 was fully redeemed before 2022. The persons who are partners in 2022 at the time the partnership pays the imputed underpayment would bear the economic cost of the payment, including the portion attributable to the redeemed partner's share of the disallowed deduction.

This is a change from the prior rules (under which the reviewed-year partners were responsible for any tax deficiencies for the reviewed year according to their allocable shares of the adjustments for the reviewed year) and is likely to be objectionable to the continuing partners. For this reason, many commentators suggest amending partnership operating agreements to impose upon all partners, including former partners, an obligation to (a) file amended returns (or provide the alternative information required under the pull-in procedure) and pay the associated tax if requested by the partnership in connection with any partnership audit under the new partnership audit rules, and (b) indemnify the partnership for their reviewed-year shares of any tax paid by the partnership on any imputed underpayment (to the extent the partner's share of such tax is not mitigated through the modification procedures, the amended return or pull-in procedures, or otherwise).

There are several reasons why a partnership might choose to make or not make the recommended amendments to the operating agreement.

First, the concern of partners increasing their ownership interest is largely eliminated if the partnership makes a timely and valid push-out election for the partnership's imputed underpayment. In such a case, the reviewed-year partners (including any former partner) suffer the effects of any partnership adjustments relating to the reviewed year,[22] and changes in ownership after the reviewed year don't affect the allocation of the tax payment burden.[23] As noted in the preceding section, a push-out election has some disadvantages, and a general partner or partnership representative might conclude that it doesn't have authority to make the election absent an amendment to the partnership operating agreement. Therefore, a push-out election will not

[21] IRC section 6225(c)(2).

[22] Treas. reg. sections 301.6226-1(b) and 301.6226-3. Any net negative adjustments for the reviewed year that are not taken into account in computing the imputed underpayment are also taken into account by the reviewed-year partners in the same manner as the adjustments giving rise to the imputed underpayment. Treas. reg. sections 301.6225-1(f) and 301.6225-3.

[23] If anything, partners reducing their ownership interest after the reviewed year might want an amendment providing some assurance that if a push-out election is made for timing adjustments for a reviewed year, the tax benefit of any correlative adjustment in subsequent tax years will be similarly pushed out, or otherwise paid, to those reviewed-year partners according to their interests for the year or years in which the correlative adjustments would otherwise be reported.

always be a viable means of addressing distortions caused by changes in ownership.

Second, the proposed amendment might be resisted on the ground that it would create inconsistencies with how other contingent partnership liabilities are handled in the operating agreement. Absent special provisions to the contrary, continuing partners bear the economic burden of partnership liabilities paid in the current year in accordance with their ownership interests for the current year, even when the liability is attributable to events occurring in prior years. A partnership or some or all of its partners might reasonably conclude that any partnership liability for an imputed underpayment under the new audit rules should be handled in the same manner as other contingent partnership liabilities. Others might argue that the imposition of partnership-level liabilities for income taxes is a major and generally unforeseen change in the potential liabilities of the continuing partners, and that contingent tax liabilities are commonly and properly viewed as fundamentally different from contingent operational liabilities.

Third, the parties to a transaction in which a partner reduces an ownership interest in the partnership may be able to include in their transfer agreement a provision imposing liability on the transferor partner or partners for tax liabilities attributable to periods before the transfer. For example, if the partnership or a continuing partner purchased the interest of a retiring partner, the purchase agreement could provide that the retiring partner is liable for income taxes on partnership-related items accruing on or before the purchase date.[24] This would not require an amendment to the partnership agreement.

Fourth, there will often be practical problems associated with enforcing the proposed supplemental obligations against partners who dispose of their entire interest in the partnership. In many cases the partnership audit will conclude, and any imputed underpayment will be paid, many years after one or more of the reviewed-year partners have exited the partnership. By that time, the partnership might not have contact information for the former partners, or the former partners might be deceased or terminated. Even when the former partners can all be located, the cost of enforcing the required amended return filing obligations against, or collecting the required indemnity payments from, those former partners or their successors in interest might be prohibitive relative to the amounts due. As a result, the amendment may not have much practical use in common situations to which it is intended to apply.

Based on these considerations, some affected partnerships will want to consider amending their operating agreements to address the effect of the new partnership audit rules in the context of changes in ownership, but many affected partnerships will reasonably conclude that such amendments are not necessary or warranted.

Conflicts of Interest

A partnership representative who also holds an equity interest in the partnership might face conflicts of interest in the handling of partnership audits. For example, if the representative is both a partner in the reviewed year and the adjustment year,[25] and if the representative's interest for the adjustment year is less than it was in the reviewed year, the representative would personally benefit by choosing not to make a push-out election for the reviewed year.[26] Similarly, if the representative's share of an imputed underpayment is zero, it might have no economic incentive to vigorously challenge proposed IRS adjustments. Therefore, some commentators recommend that the partnership operating

[24] The transfer agreement might also require that the retiring partner cooperate with the purchaser in imposing liability for pre-transfer income taxes directly on the retiring partner (to the extent possible) through the filing of amended returns, providing information required under the pull-in procedure, and otherwise. The retiring partner might object to such a requirement for a variety of reasons, including the potential difficulty or complexity of amending returns or providing comparable information (*e.g.*, when the partner is a member of a large consolidated group or is a flow-through entity with numerous partners or multiple tiers of partners, or both), or concern that the amended return or comparable information might trigger a requirement to correct other errors in the return or increase the possibility of an audit of the return.

[25] The new rules generally define the term "adjustment year" to mean the year the notice of final partnership adjustment is mailed, unless the notice is appealed in court, in which case the adjustment year is the year the court decision becomes final. *See* Treas. reg. section 301.6241-1(a)(1).

[26] See the discussion in the preceding section regarding changes in ownership.

agreement be amended to address potential conflicts of interest. One recommendation is to require a push-out election when necessary to prevent an advantage to the partnership representative or its affiliates at the expense of the other partners.[27] A more generic recommendation is to give the partners greater control over elections and other actions taken by the partnership representative.[28]

As noted, the partnership representative or an affiliate often controls the partnership and has no incentive to propose an amendment restricting its authority. Accordingly, only in circumstances in which the other partners have influence over the partnership will an amendment be a practical solution to this concern. In those cases, the operating agreement may already contain sufficient limitations on the general partner's authority, including limitations addressing actual or potential conflicts of interest and handling of partnership legal proceedings, so that there is no compelling need for a further amendment specifically addressing partnership audits. In other cases, the risk of a tax audit being conducted and a conflict of interest arising in connection with such an audit may be of sufficient concern that pursuing an amendment is justified.

Funding Audit Defense Costs and Imputed Underpayments

Under the new audit rules, the partnership representative remains responsible for dealing with the IRS regardless of whether the partnership can compensate the partnership representative for doing so. If an operating agreement does not include provisions for funding audit defense costs in circumstances in which the partnership might lack sufficient funds (for example, following dissolution of the partnership), the partnership may be unable to engage a partnership representative, significantly compromising the partnership's ability to defend itself against proposed tax adjustments.[29]

This same concern existed under the prior audit rules, and existed and continues to exist for other types of proceedings. Therefore, an affected partnership's operating agreement should already have provisions addressing the funding of audit defense costs. If it does not address this issue (other than through a generic or statutory default provision allowing the general partner to establish reserves for contingent liabilities in connection with a dissolution and winding up of the partnership),[30] the new audit rules might justify amendments, and might also open the door to addressing the issue more broadly regarding other types of proceedings.

A related issue is the funding of any imputed underpayments assessed against the partnership at a time when it lacks sufficient funds to make the required payments. This issue did not arise under the prior partnership audit rules because all taxes were collected at the partner level. However, the funding of other types of contingent liabilities always was and still is an issue for affected partnerships. Therefore, as for audit defense costs, the funding of an imputed underpayment should be covered by provisions in the operating agreement (or by default provisions under state law). If the operating agreement does not adequately address this issue, an amendment might be warranted.

One reason a partnership might conclude that it is better to not amend the operating agreement to address the funding of audit defense costs and imputed underpayments is the difficulty of crafting an effective remedy. For example, the most obvious remedy is to require partners to make additional capital contributions to the partnership to cover such costs and liabilities. The partners will often reject this as being inconsistent with their expectations of being insulated from personal liability for partnership obligations. It might be difficult to come up with a remedy that is better than the default of simply having the partnership hold back reserves for contingent liabilities upon liquidation. Many partnerships will prefer to ignore the issue of funding audit defense costs and imputed underpayments

[27] *See* T.D. 9844.

[28] As previously noted, these controls would not be binding on the IRS, and would be effective only as between the partnership representative and the other partners.

[29] See Treas. reg. section 301.6223-1(d) (partnership representative resignation); and -1(f) (appointment of partnership representative by IRS).

[30] Even in the absence of an express provision allowing for reserves, most state laws permit or require such reserves. *See, e.g.*, Del. Code Ann. tit. 6, section 18-804.

because it is not an entirely new issue, is generally an immediate issue only for a partnership in the process of liquidation, and is mitigated for most partnerships by the low risk of an audit.

Implications for State Tax Audits

The enactment of the new federal partnership rules creates significant questions regarding their interaction with state rules for partnership audits and for reporting state effects of federal audits.[31] Ideally, affected partnerships should review and monitor all potentially applicable state rules to determine if those rules necessitate related amendments to the operating agreement. If a partnership determines that its ability to effect state-specific elections are of critical importance and are not clearly permitted under the existing operating agreement, the state rules could independently justify amending the operating agreement. However, it seems likely that the issues arising under state rules will typically be subsumed within the issues arising under the new federal rules, and a partnership that does not amend its operating agreement to account for the federal rules is unlikely to conclude that potentially applicable state rules change that result.

Is Procrastination an Option?

Assuming an affected partnership can get past the immediate issue of appointing a partnership representative on the 2018 tax return (and future years' returns) without an amendment to the operating agreement, a reasonable question to ask is whether the partnership can simply wait until it receives a notice of audit to address the other issues. Many partnerships will never be audited, and those partnerships, by deferring action, would avoid the cost and anguish of ever having to consider the issues and related amendments. The small minority of partnerships that are audited would, by deferring action until an audit is actually scheduled, be presented with a more exigent reason for amending the operating agreement and perhaps more context to guide the drafting of any such amendments.

Many partnerships will choose procrastination, whether consciously or unconsciously, and that generally shouldn't lead to problems. But it could lead to problems in some fairly common situations. For example, if there are changes in ownership after a tax year and before the commencement of an audit of that year, the partners who have increased their ownership interests will have different incentives on some audit issues (such as a push-out election) relative to the partners who have reduced their ownership interests. If those issues are addressed before there are changes in ownership, all partners might have a more conciliatory approach to the proposed amendments (assuming no partner knows who will increase or decrease ownership interests during the relevant time period). If the issues are deferred, and if the partnership's operating agreement prohibits amendments that adversely affect a partner without the partner's consent (a relatively common provision), a partner with a reduced ownership interest might effectively have a veto right over any proposed amendment that permits or requires a push-out election, or mandates the filing of amended returns.

There could be other changes in circumstances before the commencement of an audit that make it more difficult to obtain the partners' agreement on amendments after the change in circumstances, and that magnify the consequences of failing to adopt the amendments. For example, if the relations among the partners are amicable now but later become strained, it may be more difficult to obtain agreement on partners' rights regarding the partnership representative's conduct of the audit, and the broad statutory authority granted to the partnership representative may be a greater concern to minority partners.

Conclusion

Given that the audit rate for partnerships is very low and unlikely to increase significantly soon, the risk associated with not amending an operating agreement to address the new

[31] The American Institute of CPAs has drafted a position paper and a model statute on reporting adjustments to federal taxable income and federal partnership audit adjustments, and has encouraged the affected states to adopt the model statute (to avoid an inconsistent patchwork of state rules). *See* AICPA, "Partnership Audit and Adjustment Rules" (Mar. 15, 2019). The group reported that as of October 2018, only two states (Georgia and California) had enacted legislation effectively addressing the federal changes.

partnership audit rules is, for most partnerships, very low.[32] Even if an affected partnership is audited and a material imputed underpayment is proposed, it's possible that the partnership will be able, under the terms of its existing operating agreement, to implement elections and procedures under the new partnership audit rules to mitigate or eliminate any unintended consequences under the new rules and to avoid costly disputes among the partners. But many affected partnerships that are audited under the new rules have operating agreements that could produce unintended results or create ambiguities and potential disputes in connection with the audit.

While amending an operating agreement to address the new partnership audit rules is generally the safest alternative (and could produce collateral benefits), it is an overstatement to say that all affected partnerships must or should amend their existing operating agreements in response to the new partnership audit rules. It is a case-by-case decision. Ideally, each affected partnership that has the practical ability to amend its operating agreement will review the agreement in light of the new rules and the issues listed above to determine if amendments are warranted, and will then take appropriate action. Many partnerships will reasonably conclude that amendments are either precluded or unwarranted for various reasons. ■

[32] Some partnerships have a heightened risk of audit because of having a high-dollar amount of income, assets, or transactions, or having specific attributes, transactions, or reporting positions disclosed on the return. The calculus for those partnerships is different from the calculus for most other partnerships.