Holding the Bag: Update Your Operating Agreement or Face the Tax Consequences

Description

New Law – Direct Assessment of LLC Tax Liability

The Tax Equity and Fiscal Responsibility Act ("TEFRA") has governed the procedures for auditing partnerships since 1982. Under TEFRA, if the IRS audited an LLC taxed as a partnership, it could not hold the LLC responsible for federal income tax deficiencies. Rather, liability remained with the applicable partners. This is about to change.

For tax years starting in 2018, the Bipartisan Budget Act of 2015 and proposed regulations issued by the Department of Treasury on June 14, 2017 (collectively, the "New Rules") repeal TEFRA and give the IRS the authority under certain circumstances to collect underpaid taxes directly from the LLC at the highest possible income tax rates. As a result, current members of an LLC may end up holding the bag on the tax liabilities of former members.

Although the New Rules create challenges for LLCs, taxpayers can avoid the harshest outcomes through some basic planning. This article discusses the key developments under the New Rules and the steps every LLC should take to protect itself.

Choosing the Right Partnership Representative Is Paramount

The TEFRA audit rules required LLCs to designate one member as the "tax matters partner." Under the New Rules, the concept of the tax matters partner is replaced with the concept of a "partnership representative"; an individual to be designated by the LLC on its tax return each year. The New Rules are flexible as to who may serve as a partnership representative. The partnership representative need not be a member of the LLC as long as he or she is an individual with substantial presence in the United States. The partnership representative could therefore be an individual employed by the LLC's management company or other advisor.

Under TEFRA, the tax matters partner was functionally limited to acting as a liaison between the IRS and the LLC's members and had limited power to bind members to the final resolution of an audit. Minority partners generally enjoyed rights in TEFRA audits to both participate in the process and receive updates directly from the IRS. In contrast, the New Rules vest the partnership representative with the unilateral power to enter into conclusive settlements with the IRS that are binding on members, extend administrative deadlines, accept notices of final partnership adjustments, elect to push adjustments out to individual members (more on this below), and challenge assessments in court.

Vesting these powers in the partnership representative substantially reduces control that the LLC's members previously had over the tax controversy process under TEFRA. The implications of this change are significant. The cost of appointing a partnership representative who proves to be non-responsive, or worse, who makes decisions adverse to the LLC's or its members' best interests, could be disastrous.

Once the LLC appoints a partnership representative for any given tax year, the appointed person must continue in that role until he or she resigns, the LLC revokes the designation, or the IRS revokes the designation. This may not seem problematic, but the New Rules generally do not permit a partnership representative to resign absent other tax-related administrative action, and the LLC's ability to remove or replace the partnership representative during any tax year is restricted.

These limitations on removing and replacing the partnership representative are not intuitive. Under TEFRA, most operating agreements would require a tax matters partner to step down automatically upon withdrawing from the LLC. Under the New Rules, the restrictions on an LLC's ability to change its partnership representative could cause the LLC to be bound by the decisions of an individual whose interests are no longer aligned with those of the entity or its members.

LLCs Can Avoid Entity-Level Adjustments in Certain Circumstances

The New Rules provide relief from the entity-level tax for LLCs that both (i) issue less than 100 K-1 forms annually, and (ii) are owned by some combination of natural persons, estates of natural persons, C corporations, or S corporations. If an LLC meets these criteria, the partnership representative may make an annual election to opt out of the framework of the New Rules altogether for that year, leaving the responsibility for audits and actual tax assessments with the individual members. This opt-out election is limited; if at least one member of the LLC is itself another LLC or trust, then such an election is unavailable. Consequently, any complex or tiered LLC structure will not be permitted to opt out.

For LLCs that cannot opt out of the New Rules, the partnership representative offers some alternatives to reduce or eliminate the possibility of an entity-level assessment. The partnership representative at the end of an audit may elect to "push out" the entity-level adjustments to the individual members who held interests in the LLC during the tax years under audit, including those members that have since withdrawn. This election to push out the entity-level adjustments to the members relieves the LLC of any entity-level adjustments. In many cases, this election should be considered to avoid entity-level taxation. It should be noted, however, that the push-out election does not permit taxpayers to claim refunds in the event their individual statute of limitations are closed.

The New Rules also permit the LLC to request a "modification" of the entity-level assessment to take into account the tax attributes of individual members. For example, this would permit the LLC to reduce the entity-level tax computation to the extent some of the income is allocable to a tax-exempt member. Although this option appears at first glance to be inferior to the push-out election, the proposed Treasury Regulations indicate the modification process can be used to keep an individual members' statute of limitations on refunds open longer.

What Should Members Do to Protect Themselves?

The New Rules in their current form present numerous challenges for LLCs and members wishing to retain some degree of control over their respective tax fates. Specifically, the New Rules expressly provide that no state law, no partnership agreement, nor any other document may restrict the partnership representative's authority to bind the LLC when dealing with the IRS. The full extent of this restriction on the partnership representative's authority is not understood, but it is clear that care needs to be taken in this area considering the potential risk to the LLC upon audit. It is therefore essential to draft operating agreement language that can be used to ensure the partnership representative acts in the best interests of the LLC and its members.

For instance, an LLC could consider putting into its operating agreement provisions for the imposition of personal liability against a partnership representative that mismanages an audit or imposing a duty of indemnification. An LLC may also wish to impose on a partnership representative a duty to keep the members informed on the audit's progress and consider the impact a decision to perform a modification or push-out election will have on members. It should be noted, however, there is a tradeoff with such duties; the more onerous the burdens placed on the partnership representative, the more difficult it will be for the LLC to convince a trustworthy and competent individual to serve in that capacity.

A final point to consider is the allocation of tax liability between current and former members of the LLC in the event that the partnership representative elects to push out the entity's tax liabilities to the members. In particular, the members should consider requiring the partnership representative to elect to push out adjustments to former members when the entity has significant special allocations or complicated histories, as it is unlikely that existing members would want to be subject to entity-level adjustments related to income they did not receive. Conversely, for some entities, the members may want to include language limiting the obligations of former members so as to provide all members with confidence that they will not be on the hook for unexpected payments years after they have ceased being a member. For instance, this may be the most appropriate with certain types of investment partnerships. Regardless of the members' goals, an LLC's operating agreement needs to address the fact that the standard assumptions for dividing liability amongst owners has changed.

Treasury May Not Be Done Yet

The current proposed Treasury Regulations were posted to the Federal Register on Wednesday, June 14, 2017 and the period for submitting public comments is open until August 14, 2017. This is actually the second time the proposed regulations have been posted in 2017, as the initial version posted on January 18th was withdrawn by the Trump administration shortly thereafter.

Despite the hiatus from the Federal Register, the June 14th version is virtually identical to the version posed in January. The proposed regulations are still likely to evolve over the course of the notice and comment period though. LLCs that are concerned with the prospect of entity-level adjustments should therefore remain vigilant to developments in this area.

Conclusion

The New Rules significantly change the traditional dynamic between LLCs and their members when it comes to distributing federal income tax liability and impose significant risk that the wrong party may be liable for back taxes in the event of an audit.

LLCs and their members can protect themselves from the worst outcomes under the New Rules by taking preventative action now. At the very least, adequate planning in this case should include revisions to existing operating agreements and exercising caution in selecting potential partnership representatives. It will also entail adding language to ensure that the partnership representative has clear marching orders in the event of an audit.

If your LLC already has an operating agreement, or if it has yet to implement one, you should consult an experienced business attorney to advise you in advance of the New Rules becoming effective in 2018.

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