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## **LLCS TAXED AS PARTNERSHIPS SHOULD CONSIDER AMENDING THEIR OPERATING AGREEMENTS**

Effective January 1, 2018, the IRS enacted significant changes to the partnership audit rules. These rules apply only to LLCs taxed as partnerships. They do not apply to LLCs taxed as disregarded entities or S corporations. Amendments to the operating agreements of LLCs taxed as partnerships may be necessary to avoid negative consequences caused by the recent changes to the partnership audit rules.

As under the pre-2018 partnership audit rules, the IRS audits partnerships at the partnership level; however, under the new partnership audit rules, the IRS is now allowed to both assess and collect any tax owed on an underpayment at the partnership level.

Further, under the new partnership audit procedures, the IRS may (i) adjust any item or amount relating to the LLC that is relevant in determining the income tax liability of any member; (ii) adjust any member's distributive share of any such item or amount; and (iii) tax any underpayment at the highest tax rate. While imputed underpayments, interest, and penalties are usually imposed at the partnership level, the LLC may elect to make the partners pay the amounts due. The new audit rules also require the designation of a Partnership Representative ("PR"), who has the sole authority to act on behalf of the LLC concerning the audit, which may bind and affect the individual tax liability of each member. If the LLC does not designate a PR, the IRS will designate the PR.

### **Opting Out of the New Partnership Audit Rules**

LLCs may opt out of the new audit rules if certain conditions are met. LLCs with 100 or fewer partners may opt out if all partners are individuals, C corporations, S corporations, estates of deceased partners, or foreign entities that would be taxed as C corporations if they were domestic entities. LLCs that issue a Schedule K-1 to trusts, foreign entities that would not be taxed as C corporation if they were domestic entities, disregarded entities, estates of individuals who are not partners, and individuals who hold interest in the partnership on behalf of another are not eligible to opt out of the new audit rules. To opt out, LLCs must timely submit Schedule B-2 with Form 1065 to opt out each year.

LLCs that successfully opt out are audited under pre-TEFRA rules, meaning that the IRS cannot audit the partnership itself, but must audit each partner separately. Any audit adjustment of partnership operations is made to an individual partner's tax return pursuant to an audit of the individual partner. This results in no entity level tax. Also, LLCs that opt out will not need to appoint a PR.

## Making the Most of the New Partnership Audit Rules

Each LLC taxed as a partnership should consider amending its operating agreement to address the recent changes in audit rules. The following is a list of issues you may want to address in an amendment:

- Should the PR's control and authority to make audit decisions on behalf of the LLC be limited?
- Should the LLC select a different PR? If so, should there be limitations on whom the LLC can choose?
- How should the PR be removed or appointed?
- Should the LLC restrict transfers of membership interest to new members who will allow the LLC to continue to opt out of the new rules?
- Does the LLC need to obtain additional information from members regarding the new audit rules or the decision to opt out?
- Does the LLC need to determine how it will allocate audit expenses among its members?
- Should partners in the year of the audit be responsible for paying the audit adjustment or should the partners in the year to which the adjustment relates be responsible for paying the audit adjustment?
- How are disagreements among members relating to an audit to be resolved?
- How is an audit handled during the LLC's dissolution?

This list is not exhaustive; every LLC has its own unique circumstances that require specific tax and business planning. Please contact our office if you would like us to help you amend your LLC's operating agreement or if you have any questions and would like to discuss these issues in more detail.

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