Tax Controversy Corner

The New "Partnership Representative"

By Megan L. Brackney

Under the new Bipartisan Budget Act of 2015 (the "BBA"),[1] there are significant changes to the partnership audit rules. Like TEFRA,[2] the BBA requires partnership-level resolution of partnership income, gain, loss, deduction and credits. Unlike TEFRA, under the BBA, the IRS will assess tax at the partnership level (as opposed to the partner level) based on an imputed underpayment amount at the highest applicable federal tax rate, subject to some key exceptions.[3] The BBA also contains numerous changes to the procedures for assessment and collection of tax, and for judicial review.[4]

This column focuses on one specific procedural change, the elimination of the Tax Matters Partner (TMP), and the creation of a new Partnership Representative (PR). Before discussing the significant differences between the TMP and the PR, and some strategies for dealing with this legislative change, practitioners should be aware of the entities to which the BBA will apply. Under TEFRA, partnerships with 10 or fewer members were not subject to its provisions unless they elected to be treated as TEFRA entities.[5] For partnership years beginning after December 31, 2017 (unless the entity opts in early),[6] all passthrough entities are subject to the BBA except for those with 100 or fewer members who affirmatively opt out.[7]

Under the BBA, the new PR has sole authority to bind a partnership and the partners of such partnership to all decisions made in partnership audit proceedings.[8] The Treasury may issue regulations that impose some duties on the PR, but at this time, the PR has no duties to the other partners or the partnership. This is a major difference from the TMP, and partners should be aware of it and define the duties and obligations of the new PR in their partnership agreements.

1. The PR Does Not Have to Be a Partner

A chief difference between the PR and the TMP is that the PR does not have to be a partner of the partnership. The PR may be a partner or he or she also may be any "other person" who has a substantial presence in the United States.[9] If the partnership does not designate a PR, the IRS can select "any person" as the PR.[10] This change is significant because the person with authority to bind the partnership no longer has to be a partner. Although conflicts of interest between the partnership and the TMP sometimes existed,[11] because the TMP also was a general partner,[12] the interests of the partnership and the TMP were aligned and the TMP could be trusted to act in the partnership's best interest. However, under the BBA,

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the PR does not have to have any financial interest in the partnership, but could be a manager, a third party hired to act as the PR or any other person, the only constraint being that the person has to have a substantial presence in the United States. Thus, the new PR, unlike the TMP, may have no stake in the outcome in the partnership audit or may even have an interest that conflicts with that of the partnership or individual partners.

2. The PR Has Sole Authority to Bind the Partnership But Does Not Have Any Statutory or Fiduciary Duties to the Partnership

The TMP was "the central figure of partnership proceedings."[13] TEFRA required the TMP to keep each partner informed of all administrative and judicial proceedings related to the adjustment of partnership items.[14] This included providing information to the partners regarding closing conferences with the revenue agent, proposed adjustments, rights of appeal, Appeals conferences, settlements, consent to extension of the statute of limitations on assessment, filing of a request for administrative adjustment, filing for judicial review, appealing judicial determinations and final judicial decisions.[15]

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The TMP also had independent authority to act on behalf of the partnership to execute an extension of the statute of limitations for assessment,[16] to enter into settlement agreements on behalf of the partnership or to file a judicial challenge to those adjustments and to make strategic decisions, including whether to settle with the government.[17] However, the TMP's actions were constrained by its fiduciary duty to the other partners and the partnership.[18] This fiduciary duty has been described as follows:

> By centralizing tax-related proceedings of the partnership in one person or entity, Congress created a statutory analogue of the class representative in class action proceedings. And just as class members, though entitled to due process safeguards, can be bound by the results of a proceeding to which they are non-parties because the class representatives owe them fiduciary duties, so the limited partners secure their due process protection as a result of the fact that the TMP stands in a fiduciary relationship toward them. We conclude that the TMP's duty to the individual limited partners and to the partnerships in general is beyond question.[9]

The BBA, in marked contrast, does not require the PR to provide any notice to the partners, even notice of the existence of the audit in the first place. The PR has no statutory or fiduciary duties to the partnership or the other partners even though the PR has the sole authority to bind the partnership and the partners to any decision he or she makes during an audit or judicial proceedings. The PR's lack of any duty to the partners or partnership combined with the PR's absolute authority to bind the partners and partnership could cause problems if the PR does not provide notice to the partners or partnership and resolves the audit in a manner that is not in their best interests.

3. PR Provisions in Partnership Agreements

Partnerships and partners who are concerned about these BBA provisions can address their concerns through drafting by amending, or creating, partnership agreements that control the identity of the PR, the PR's ability to bind the partners and the partnership and the PR's duties. Below is a list of some considerations and questions for drafting the PR provisions of a partnership agreement.

First, the partnership should define who is eligible to serve as the PR in the first place after considering these questions:

- Must the PR be a partner?
- What other qualifications must the PR possess?
- How does the partnership appoint a PR?
- Should the PR be required to certify that he or she does have a substantial presence in the United States?
- How is the PR selected?
- How is the PR removed?
- What is the PR's term of service?

Second, the partnership should define the duties of the PR, particularly, whether the PR has a fiduciary duty to the partnership and/or partners. In addition, the partnership may define the duties of the PR. This could be done by imposing upon the PR the duties formerly contained in

Code Sec. 6231 and prior Treasury Regulations for TMPs. Alternatively, the partnership could expressly state the PR's duties, which may include the duty to:

- notify the partnership of any audit;
- provide notice of developments in the audit and any subsequent litigation;
- seek consent before extending statutes of limitation on behalf of the partnership;
- conduct the partnership audit in accordance with directives by the partnership;
- seek consent of the partners before entering into a settlement with the IRS;
- seek prior approval of all court filings and pleadings;
- seek approval before incurring audit or litigation expenses on behalf of the partnership; and
- seek approval for hiring counsel, accountants or experts for the audit or other tax litigation on behalf of the partnership.

Third, in order to limit the PR's broad statutory authority, the partnership may want to think about the following questions:

- From whom does the PR take direction, if anyone?
- Should there be an indemnification provision for the PR?
- Do the partners have the ability to sue the PR?
- What are the grounds for removal of the PR?

Partnerships who will be governed by the BBA should begin to consider these issues and others so that there are not unpleasant surprises later on if the partnership is audited under the BBA rules.

ENDNOTES

[1] Act Sec. 1101 of the new Bipartisan Budget Act of 2015 (BBA) (P.L. 114-74), 129 Stat 584 (Nov. 2, 2015).

[2] TEFRA refers to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), formerly set forth in Code Secs. 6221–6233. TEFRA established uniform procedures for determining the tax treatment of partnership items on audit and for obtaining judicial review of those determinations.

[3] Act Sec. 1101 of P.L. 114-74, 129 Stat 584 (Nov. 2, 2015) (amending Code Secs. 6221, 6225 and 6226).

[4] *Id.* (amending Code Secs. 6231–6235).

[5] Code Sec. 6231(a)(1)(B).

[6] Act Sec. 1101(g)(4) of P.L. 114-74 provides that a partnership may elect to have the BBA provisions apply for any return filed for partnership tax years after the November 2, 2015, enactment date.

[7] Code Sec. 6221(b)(1). In order to qualify as a partnership with 100 or fewer partners, each partnership's partners must be an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation or an estate of a deceased partner. Code Sec. 6221(b)(1)(C).

[8] Code Sec. 6223(b).

[9] Code Sec. 6223(a). The statute does not define "substantial presence," but presumably, it will have the same meaning as in Code Sec. 7701(b)(3).

[10] *Id.*

[11] *See, e.g., Transpac Drilling Venture 1982–12,* CA-2, 98-2 ustc ¶50,517, 147 F3d 221, 225.

[12] Former Code Sec. 6231 provided the general rule that the TMP must be a general partner, and if there were no general partner designated, the TMP would be the general partner having the largest profits interest in the partnership at the close of the tax year involved. Code Sec. 6231(a)(7); Reg. §301.6231(a)(7)-1(b).

[13] *Computer Programs Lambda, Ltd.*, 89 TC 198, 205, Dec. 44,072 (1987).

[14] Code Sec. 6223(g) ("[t]o the extent and in the manner provided by regulations, the tax matters partner of a partnership shall keep each partner informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items."); Reg. §§301-6223(g)-1(a)-(b).

[15] *Id.*

[16] Former Code Sec. 6229(b).

[17] *A. Kaplan*, CA-7, 98-1 ustc ¶50,129, 133 F3d 469, 473; *Hirshfield*, DC-NY, 2001-2 ustc ¶50,480 (May 30, 2001), *on reconsideration*, DC-NY, 2002-1 ustc ¶50,109, 177 FSupp2d 220 (2001), *aff'd*, CA-2, 70 FApp'x 609 (2003); Tax Court Rule 248.

[18] *R.K. Phillips*, 114 TC 115, 132, Dec. 53,769 (2000); *Transpac Drilling Venture 1982-12*, CA-2, 98-2 ustc ¶50,517, 147 F3d 221, 225.