

YORKHOWELL
& GUYMON
ATTORNEYS AT LAW

6405 SOUTH 3000 EAST, SUITE 150
SALT LAKE CITY, UTAH 84121
801-527-1040
WWW.YORKHOWELL.COM

NEW IRS RULES FOR LLCs AND LPS: PARTNERSHIP REPRESENTATIVE

Background:

Starting January 2018, the Internal Revenue Service (IRS) regulations have changed regarding how the IRS interacts with an LLC or LP (the “Partnership”), taxed as a partnership, during an audit. Under the current regulations, the Partnership was required to appoint a “tax matters partner” or “tax matters member.” When the IRS would audit the Partnership, this tax matters partner would be the liaison between the partnership and the IRS. The new regulations introduce a new liaison between the IRS and the Partnership, the “Partnership Representative.” Under the new rules, the Partnership Representative can bind all the partners in the Partnership, the Partnership itself, and the Partnership Representative is the only person that has the authority to participate in a partnership-level audit procedure.

Why the Change:

When the IRS audited the Partnership in the past, the IRS eventually would need to interact with all the members of an LLC or partners in a LP. In complex, multi-tiered partnership structures, this became difficult for the IRS to identify and monitor all the partners in these entities. The partners or members could intervene in the audit, cause complications, and even litigate over the issues. In the event of litigation, the IRS would need the agreement of every partner or member to settle. For complex and sophisticated entities with many partners or members, this became complicated. Thus, by only interacting with the Partnership via the Partnership Representative, makes communication easier for the IRS in the event of an audit.

Implications:

If a Partnership Representative is not appointed in an operating agreement, the IRS may select anyone they want to serve in this important position. The Partnership may designate anyone to serve as the Partnership Representative, unlike a tax matters member, the Partnership Representative does not need to be a member or partner in the Partnership. The Partnership must designate who will serve as its Partnership Representative on the Partnership’s tax return, and it is effective for only one year. Designations must be made for each tax year. The only requirement is that the Partnership Representative have a “substantial presence” in the United States. To have a substantial presence: first, the person must be able to meet in person with the IRS in the United States at a reasonable time and place; second, the Partnership Representative must have an address in the United States and telephone number where the Partnership Representative can be contacted during normal business hours; and third, the Partnership Representative must have a TIN. An entity may serve as a Partnership Representative, however, the Partnership must appoint an individual that meets the substantial presence requirements, to act on behalf of such entity.

If the Partnership does not designate a Partnership Representative, the IRS may select anyone to serve as the Partnership Representative. In selecting the person, the IRS will consider: whether the person is a partner or member in the Partnership; the person’s access to the books and records of the Partnership; the views of the partners or members having a majority interest in the Partnership; and whether the person is a citizen of the United States.

We advise amending your operating agreement to appoint the person you would intend to be your Partnership Representative.

Election Out:

Some small Partnership entities may elect or opt out of these new rules. These include partnerships with less than 100 eligible partners, which include, C Corporations and S Corporations, but each S Corporation shareholder counts toward the limit. Disregarded entities, or single member LLCs, and living trusts are not allowed to elect out. In order to elect out, the Partnership must provide to the IRS names and tax ID numbers of all the Partnership's members and partners, and must notify its partners within 30 days after making the election.

The IRS is taking electing out very seriously, and stated:

“In addition, to ensure that the election out rules are not used solely to frustrate IRS compliance efforts, the IRS intends to carefully review a partnership's decision to elect out of the centralized partnership audit regime. This review will include analyzing whether the partnership has correctly identified all of its partners for federal income tax purposes notwithstanding who the partnership reports as its partners. For instance, the IRS will be reviewing the partnership's partners to confirm that the partners are not nominees or agents for the beneficial owner.”

<https://www.irs.gov/pub/irs-irbs/irb17-28.pdf>

Conclusion:

As discussed, the new regulations and rules are aimed at larger partnerships, with many partners and members with complex structures. While there are few more technical rules in regarding the partnership representative, however, those are only necessary in the case of an audit. We recommend amending your LLC's Operating Agreement or partnership agreement to designate this Partnership Representative.

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