

4 Last-Minute Considerations For Partnership Representatives

By Amy Lee Rosen

Law360 (March 6, 2019, 9:30 PM EST) -- Barring extensions, less than 10 days remain until the deadline for partnerships' 2018 tax returns, but there is still time to amend partnership agreements to make sure adequate controls are in place over partnership representatives.

Here, Law360 explores what partners should consider when picking their partnership representative and protections the representatives should secure when taking on the role.

Discuss Scope of Partnership Representative's Power

The partnership representative's role is crucial because the U.S. government issued final rules on the centralized partnership audit regime in December that said no partner other than the partnership representative can participate in a partnership audit, and individual partners cannot participate in a partnership-level administrative or judicial proceeding.



The IRS issued final rules in December for the new audit regime Congress created in the Bipartisan Budget Act to assess and collect tax at the partnership level instead of from individual partners. (AP)

The partnership representative serves as the formal designee to deal with audits from the new centralized partnership audit regime, created under the Bipartisan Budget Act of 2015, or BBA, as an attempt to ease the administrative burden on the Internal Revenue Service. Partnerships are now on the hook to pay tax and are automatically enrolled in the new regime unless they opt out. The partnership representative replaces the tax matters partner who acted as the representative under the old rules, the Tax Equity and Fiscal Responsibility Act of 1982, or TEFRA.

The change to a partnership representative, along with the partnership filing deadline coming up on March 15, means that even though partnerships may be ignoring the centralized partnership audit regime since audits will not happen for another few years, partnerships will still be deciding who their partnership representative is in the next nine days, according to Don Susswein, a principal at RSM US LLP.

"I continue to believe that the thousands of partnerships that are about to put a name [of the partnership representative on their tax returns] also should be spending a little bit of time dealing with the implications, not of who they select, but what the ground rules are going to be for what that party does," Susswein said.

Jennifer Breen, a partner at Morgan Lewis & Bockius LLP, told Law360 there are many options for structuring a partnership representative's scope of powers. She said one strategy is having a point of contact, such as a general partner or the manager of the partnership, who would have to approve or direct the partnership representative before the representative acts.

Another approach can be for decisions of varying degrees of importance — such as whether to extend the statute of limitations, agree to an adjustment or whether to file a petition or not — to be done through a vote of the partners through a certain percentage for approval, Breen said. Or voting can be done through a majority in interest, where if a partner owns 50 percent of the partnership they have a larger sway in calling the shots since he or she will be the most affected by an audit, she explained.

Terence Floyd Cuff of Loeb & Loeb LLP told Law360 that the decision-making process over the powers of the partnership representative will vary from partnership to partnership because what is appropriate for a syndicated partnership is not necessarily the right approach for a family partnership.

"If you have a small family partnership between different generations of the same family where most of the partnership wealth comes from a grandfather or a grandmother or a father, I think it's very likely the person who contributed most of the wealth to the partnership will be in control," he said. "That can make sense if all of the wealth is coming from one person."

On the other hand, if there is a negotiated joint venture or deal between different parties, it is possible that there is a partnership representative as well as a management committee that controls the PR's decisions.

"My inclination in many partnerships is that absolutely everything that the partnership representative does must be pre-approved by the management committee," Cuff said.

If partnerships do not plan appropriately, then highly abbreviated partnership representative provisions create the potential that people will be disadvantaged in an audit, spinning into future litigation that could turn very nasty in some but certainly not all partnerships, he added.

Inspect Partnership Agreements, Side Letters

Once the scope of the partnership representative's powers has been discussed, Breen said she tells her clients to look at any related LLC agreements and side letters to make sure documents are properly updated.

"A partnership or partners could have a side letter or agreement that is kind of a partnership representative agreement that gives the PR some direction from the partnership of when they'll notify the partners about the examination, when decisions will be made, how those decisions will be made and who gets to make the final decision," she said.

A partnership should review its controls over the partnership representative because, without any limiting agreements, she or he has exclusive power to make decisions on behalf of the partnership —

such as file a petition or pay an imputed underpayment on behalf of the partnership — and these decisions do not need consent of the other partners unless that is required in a partnership agreement or a side letter, Breen said.

Cuff explained that another thing to consider is the partnership representative's capacity because as people get older, there's a point in one's life when a person may not think as clearly as he or she used to.

"It's possible to have someone who was a marvelous PR and he suffers Alzheimer's, so you're not going to want him representing you," he said. "It's important to have a provision that allows you to remove the PR and substitute someone ... the clause will differ from situation to situation, but in many partnerships there will just be an absolute right to remove, either for cause or not. In others, it will be for cause and cause will be defined carefully."

Contemplate Protections for Partnership Representative

Agreements should not just include provisions controlling how the partnership representative acts but should also provide protections for the partnership representative because there may be situations where the partnership representative may make a decision that other partners — either current or former — may disagree with, Cuff said.

"The PR has the right to settle an audit, and the other partners may say 'it's a horrible settlement, you never should have entered it, we're going to sue you,'" Cuff said. "That's not a satisfactory situation for the PR to be sued for his efforts."

Cuff told Law360 he believes the partnership representative has a legitimate right to a strong indemnification provision as long as she or he acted within a proscribed standard of conduct. The partnership representative should also be given a covenant not to be sued by current or former partners, which is contingent on acting within that same proscribed standard of conduct, he added.

The indemnification agreement says if there is a liability and the partnership representative pays out money, he or she will be reimbursed, while the covenant not to sue is much stronger because it says that everybody agrees not to sue the partnership representative as long as that person acted in accordance with the agreed-upon standard of conduct, Cuff explained.

"Partnerships are up against a deadline and are thinking 'what is the minimum amount we need to do,' which is that they need to get a PR in place," he said. "If someone is going to accept that, he should ask for indemnification and covenant not to sue."

Breen agreed it is important to discuss the exposure of the partnership representative to liability to disgruntled partners who may not like the results of an audit.

"If I was the PR seeking to be hired, I'd want to make sure there were limits to what a disgruntled partner could come after me for," she said.

Meanwhile, Susswein said part of the indemnification conversation should include self-interest because, while that topic may already be covered by existing rules and fiduciary responsibilities, it should still be re-examined to make sure the partnership representative is not given a blank check to act only in her or his self-interest and against the interests of the partnership.

For example, self-interest could come into play if the IRS raises two questions in an audit, where one issue may be that certain gains to the general partner were short-term capital gains, and not long-term capital gains as claimed, while the second issue would be the partnership's partners took too many deductions for business payments, which will affect the limited partners, Susswein said.

"So let's say the general partner is the partnership rep, and goes to the IRS and says 'Let's cut a deal. Give me a break on what affects me and I'll concede the part that affects the limited partners.' Obviously that's a conflict of interest," he said. "I'm sure no general partner would act that way, but it should be dealt with in a side agreement that says, 'Yes, you have authority, but you can't enrich yourself at our cost.'"

Susswein explained that under the TEFRA rules, former partners could maintain their positions. But now the partnership representative controls both what happens to the partnership during the adjustment year, which is when the audit happens, as well as what happens to the partners in the reviewed year.

A situation could arise in which the partnership representative sees an issue that affects only the former partners for a small amount but would cost the partnership a lot of money just to answer the IRS' phone call, so it's just easier to push out the liability to the former partners, he said.

"The former partners may say, 'How dare you do that? Because you gave up the issue for nothing. You weren't diligent in your representing of us.' And the [partnership representative] would say: 'Why should I represent you? You aren't even a partner anymore. And why should I spend the money that would go to current partners to protect your interest?'" Susswein said.

Thus, it is important to spend time walking such an example to figure out the rules of the road, such as whether the partnership representative has full discretion or if he or she can only exercise prudent business judgment or something else, Susswein explained.

Assess Pay, Outside 'PRs for Hire'

Other topics worth addressing are whether and how much to pay a partnership representative and if a partnership should look to an "organization for hire" to be its partnership representative, Breen said.

"I've started to see some PRs for hire — people who have hung out a shingle that are to be engaged as a registered agent who would serve as the PR," Breen said. "But I think that this is the first thing, as far as the BBA goes, the first big decision, aside from electing out, which will also be made on that tax return."

Breen told Law360 she has seen some relationships in which the partnership representatives are paid for their services, especially when the roles and responsibilities are specifically laid out.

"If you're going to engage in that sort of relationship with another representative to serve the partnership in that capacity, I think it is important you clearly articulate in the agreement what they can and can't do on behalf of the partnership," she said.

Breen said she generally sees a flat fee being offered to be a partnership representative, which ranges from \$1,000 to \$2,500 and is followed by an hourly fee once an audit begins, which is around \$400 to \$600 per hour, she said.

"The company that I know of that has been held as a PR for hire, they're a 109-year-old company that's

a registered agent. So their business is being a registered agent or a trustee," she said. "It seems like a good fit because it's not a legal practitioner."

Hiring a partnership representative with one of these companies may especially be helpful for groups of taxpayers that are not necessarily based in the U.S., she said.

"The PR has to have a substantial presence in the United States [and] there are some partnerships that just don't have a person that can serve in that role. They just don't have a U.S. presence," Breen said. "So they need to appoint somebody who has a U.S. phone number and can readily meet with" the IRS.

Cuff said that whether partnership representatives should get paid depends on the situation. Those responsibilities could just go with the job of being a general partner if that person is chosen for the role, he said. On the other hand, the job of a partnership representative can be a difficult one, and there is certainly no standard set in the industry, he explained.

"The best I can say is that you have hit on a very significant and a very delicate issue," he told Law360. "There are many partnerships that will say 'those are the duties of the PR or the general partner' while there will be others that say 'this will be a lot of work and we should pay for it.'"

--Editing by Tim Ruel and John Oudens.

Correction: An earlier version of this article misspelled Breen's name in one instance. The error has been corrected.