

Operating Agreements: The Power of the Partnership Representative

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Recently, a colleague asked me to review an operating agreement (not one that my colleague had drafted) from a tax standpoint. The LLC was classified as a partnership for federal income tax purposes. Setting aside the tortured regulatory allocations (it was a service partnership, distributions were pro rata, and there was no 704(c) property (property with a built-in gain or loss at the time the property was contributed to the LLC)), it was fairly straightforward. But therein lies the problem. The often-overlooked section designating a partnership representative needed substantial work. Wait, what!?

The Bipartisan Budget Act ("BBA") of 2015 made the centralized partnership audit regime applicable to all partnerships for tax years beginning after December 31, 2017. I frequently encounter many older operating agreements that refer to a "Tax Matters Manager," which came about under the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. If your operating agreement is one of these, for the reasons discussed below, it needs to be updated.

Under TEFRA, before the effective date of the centralized regime, partnerships could elect the centralized audit regime or have each individual partner audited. Obviously, large partnerships preferred the centralized regime, while smaller ones frequently elected to have an audit at the partner, not the partnership level. The BBA changed all that by taking away the election and making the centralized regime mandatory for partnerships with more than one hundred (100) partners, while partnerships with one hundred (100) or fewer partners can opt out of the centralized audit regime. *IRC § 6221(b)*; *Treas. Reg. § 301.6221(b)-1(b)*.

Sadly, I have seen many small partnerships, or, more appropriately, the lawyer drafting the operating agreement, simply copy these provisions from an operating agreement they thought looked good without ever giving a moment's thought to the impact and consequences of these provisions. In fact, the LLC whose operating agreement prompted this particular column had less than ten (10) members. And as Professor Ted Seto, my partnership tax professor, drilled into us, partnership tax is the one area of tax law where the Code and Regs dictate the business deal.

The power of the partnership representative is august, cannot be overstated, and definitely should not be overlooked. Under the BBA, the partnership representative is **the sole person** with authority to act on behalf of the partnership **and its partners!** *Treas. Reg. § 301.6223-2(a)*. Further, "no partner, or any other person, may participate in an administrative proceeding without the permission of the IRS." *Treas. Reg. § 301.6223-2(d)*. So, even if you wanted to participate, absent the Service's permission, you can't. The partnership representative's decisions **are binding on each partner** of the partnership. *Treas. Reg. § 301.6223-2(a)*. Disagree with a decision made by the partnership representative in an audit? Tough. You're bound.

Can't we limit the power of the partnership representative by including provisions in our operating agreement? As far as the Service goes, no. In fact, any such limits are prohibited by *Treas. Reg. § 301.6223-2(c)(1)*, which states, "[n]o state law, partnership agreement, or other document or agreement may limit the authority of the partnership representative or the

designated individual as described in section 6223 and this section." Yikes!

The partnership must designate a partnership representative separately for each tax year, and the designation is effective only for the tax year for which it is made. *Treas. Reg. § 301.6223-1(c)(1)*). The designation is made on the partnership's tax return (IRS Form 1065) and is effective when the return is filed. *Treas. Reg. § Regs. Sec. 301.6223-1(c)(2)*. The partnership representative need not be a partner. Also, the partnership representative does not have to be a person, though if the partnership representative is an entity, it is required to have a "designated individual" so the Service has an actual human being as its point of contact.

Clearly, the regs say plenty of things a partnership can't do, which begs the question, what **can** a partnership do? ***What you can do*** is include provisions in your operating agreement that: (1) require the partnership representative to acknowledge it acts in a fiduciary capacity with respect to the partners; (2) requires the partnership representative to provide notice to each partner immediately upon the receipt of any notice (and provide a copy of any such notice) the partnership representative receives from the Service that seeks to make any adjustment or impose any penalty with respect to the partnership or its partners; (3) requires the partnership representative to employ experienced tax counsel to represent the partnership in connection with any audit or investigation of the partnership by the Service and in connection with all subsequent administrative and judicial proceedings arising out of such audit; (4) requires the partnership representative to get approval from the partners before taking any position or action with the Service, including but not limited to any decision: (i) to enter into a settlement agreement which purports to bind the partners other than the partnership representative (which, as noted above any decision will); (ii) to file a petition or request contemplated in Section 6227(a) of the Code; (iii) to enter into an agreement extending the period of limitations as contemplated in Section 6235(b) of the Code. Finally, under the BBA, the partnership can either pay an assessment or penalty at the entity level or pass it down to the partners to be paid pro rata by each partner. This election can be made with respect to each separate assessment or penalty, so to provide the most flexibility, the operating agreement should permit this decision to be made by the partners on a case-by-case basis, then communicated to the Service through the partnership representative.

What's in your operating agreement?

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