New Partnership Audit Rules Go Live

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The Bipartisan Budget Act of 2015 ("BBA") fundamentally changed the rules by which partnerships, and entities taxed as partnerships (such as limited liability companies), interact with the Internal Revenue Service ("IRS") in an audit or litigation. The new rules apply to partnership tax years beginning on or after January 1, 2018. We outlined these significant changes to the partnership audit rules in a prior Alert. The BBA repealed the 30 year-old TEFRA partnership audit regime, upending or creating uncertainty with respect to previously-settled partnership tax rules and procedures*.* Many of the implemented regulations remain in proposed form and offer no guidance on certain critical issues. ***Given the myriad uncertainties and burdens of the new regime, U.S. and foreign partnerships (and their advisors) should take steps now to mitigate their risk.***

I. Why Are The New Partnership Audit Rules So Challenging?

Breadth. Whereas TEFRA prescribed partnership-level audit procedures only for "partnership items" and "affected items" of a partner, the BBA's centralized audit regime is extremely broad:

- Partnership-level adjustments are authorized in respect of *all* items and information required to be shown or reflected on a partnership tax return. Thus, audit adjustments of items of a partnership related to transactions between a partnership and a partner not acting in the capacity of a partner, such as disguised fees or disguised sales, would be governed by these rules. For example, the gain recognized by partners who receive cash when a private equity firm takes a stake in a partnership will, in many cases, be subject to these rules even though the partners' gain is recognized "outside" of the partnership.

- The BBA also affects anyone ultimately determined to be a partner, even if such person purports to be, for example, a debtholder. Although the possibility of such an after-the-fact determination by the IRS existed under TEFRA as well, the consequences would be more severe under the BBA because the new regime strips away the rights to notice and participation accorded to partners under TEFRA.

All Powerful Partnership Representative. The BBA replaces the historic role of the "tax matters partner" with a "partnership representative" having far greater autonomy and authority:

- The partnership representative has sole authority to act on the partnership's behalf, and such actions are binding on all partners.

- The partnership representative is also the sole person to whom notices—of an audit's initiation, or of proposed or final adjustments—must be provided by the IRS. Unlike under TEFRA, partners are not entitled to notice of any kind, or to participate in a partnership audit. The partnership agreement or a separate document may provide rights or remedies to the partners amongst themselves, but the IRS will still treat the partnership representative as having unfettered authority.

The concentration of so much power in the hands of a single person raises important governance questions. For some partnerships, such as operating companies run by boards of managers, consideration should be given to amending the partnership agreement to require the partnership representative to secure the board's consent before taking certain actions or making certain elections. For other partnerships, such as investment funds, in which the general partner typically exercises broad management discretion, the general partner will want to retain the authority to make all elections. In such cases, the risk of unanticipated consequences to investors and the potential for conflicts of interest suggest that care must be taken in making adequate disclosure. Moreover, investors may wish to negotiate for notice and/or consultation provisions in the partnership agreement.

Payment of Someone Else's Tax. Under TEFRA, audits occurred and tax adjustments were made at the partnership level. The BBA continues this approach, but adds a twist: as a default rule, tax deficiencies identified in partnership audits are collected from the partnership. The partnership pays—as, by extension, so do the persons who are partners in the year of the adjustment—regardless of whether they were partners or held the same percentage interests in the year under audit. The BBA's "push-out" election, whereby the partnership can choose for the tax to be collected from the persons who were partners in the audited year (the "reviewed year partners"), is riddled with uncertainties and drawbacks:

- If a partnership makes the "push-out" election, it need not notify the reviewed year partners. Rather, the partnership simply sends amended K-1s to the reviewed year partners who must make appropriate adjustments to their own income and tax liability for the audited year and any intervening years. If, for any year, the adjustments produce an overpayment, it cannot be netted against deficiencies in other years.

- For foreign partners, a push-out election can produce an unwelcome surprise. Proposed regulations provide for withholding at the partnership level, if such withholding would have been required with respect to the adjusted items had they been taken into account in the first instance. This could apply, for example, in the case of an increase in the partnership's U.S.-source dividend income. But the foreign partner must still file a U.S. tax return reporting its distributive share of the adjusted items—even if the partner's U.S. tax liability is fully satisfied by withholding at the partnership level, and the partner is otherwise exempt from filing.

- Although the push-out election can be applied up through multiple tiers of partnerships, each partnership must supply the IRS with detailed information about its partners in conjunction with pushing out to the next higher tier, or else pay tax on the adjustments pushed out to it by the next lower tier. Sensitivity to disclosures concerning the ultimate partners may thus in practice preclude a partnership from making a push-out election.

- Absent a push-out election, the tax due from the partnership is computed at the highest tax rate then set forth in the Code. Only if a partnership affirmatively demonstrates that one or more of its partners would be subject to a lower rate of tax, is tax-exempt, or has filed an amended return taking that partner's share of the adjustment into account, will the tax due from the partnership be reduced proportionately.

- Neither the BBA nor the proposed and final regulations provide any guidance on capital account and outside basis adjustments in connection with partnership audit determinations that produce additional tax paid by the partnership. It is not clear whether such adjustments are made in the reviewed year or only in the audit year. Either result could distort partnership economics depending upon the situation.

- Even worse, when audit adjustments do *not* produce additional tax, the proposed regulations require that the adjustments be taken into account in the audit year, thus permanently distorting the partners' capital accounts and outside basis.

The myriad possible means of handling an audit adjustment under the BBA may present difficult choices for partnerships. With regard to the push-out election, for example, management may prefer the flexibility to evaluate audit adjustments individually—perhaps pushing out large adjustments but simply paying *de minimis* ones. Investors, on the other hand, may prefer certainty with respect to their ongoing obligations, especially if the composition of the partnership is expected to change frequently over time. Foreign investors, in particular, will be sensitive to the potential U.S. tax filing obligations of a push-out election. How such decisions are made will depend on the terms of the partnership agreement. The agreement will similarly determine whether and how audit adjustments affect the partners' economic deal.

Thematically, the BBA was intended to, and does, shift much of the administrative burden associated with TEFRA audits from the IRS to the partnership. More worrisome, numerous aspects of the regime are ambiguous or remain to be fleshed out.

II. What Should Partnerships Do To Prepare?

Partnerships can mitigate the risks associated with the implementation of the BBA in at least three ways:

- <u>Elect Out</u>: A partnership with no more than 100 partners, none of which is a partnership, disregarded entity, trust, nominee, or estate of an individual other than a deceased partner, can elect out of the BBA regime with respect to any tax year on a timely filed return for that year (including extensions). In recently released final regulations, the IRS refused to relax these strict requirements. Electing out also requires providing a U.S. tax identification number for each partner—including foreign partners who might not otherwise need one. If a partnership elects out, any audit must be conducted at the partner level, partner by partner, under the audit procedures applicable to each partner. Clients should assess their eligibility to elect out and weigh the potential benefits of doing so.

- Amend the Partnership Agreement: Clients should also review their partnership agreements to ensure that those agreements take into consideration the new concepts reflected in the BBA and incorporate protections against the uncertainties of the new regime. A partnership agreement can—and in many cases, should—address three sets of issues raised by the BBA:

  – Governance: Any desired restrictions on the partnership representative's authority must be set forth in the partnership agreement. The agreement can provide notice rights to the partners, require the partnership representative to secure the partners' consent before taking certain actions, or provide contractual remedies for the partners against the partnership representative. The agreement can also establish a default or decision-making mechanism for the BBA's various elections, which must be made annually.

  – Economics: In the event of an audit adjustment at the partnership level, basis and capital account adjustments will be essential to preserving the partners' economic deal. The partnership agreement should address such adjustments. The agreement can also, for example, require reviewed year partners to file amended returns or provide for a claw-back from reviewed year partners, so that audit year partners will not bear the economic consequences of the reviewed year partners' tax.

  – Cooperation: Compliance with the BBA in the event of an audit will require enhanced cooperation from partners. The new regime's various elections and modification procedures are generally coupled with somewhat intrusive disclosure requirements. The partnership agreement can establish partners' disclosure obligations, as well as confidentiality guardrails, to permit compliance with the BBA but minimize the infringement on indirect partners' privacy interests.

- Update Disclosure Materials: Investment partnerships that routinely provide disclosure materials, such as private placement memoranda, to potential investors should update those materials to reflect the new partnership audit rules (in place of TEFRA). Such documents should also describe the partnership's substantive decisions regarding the governance, economic, and cooperation issues discussed above, as embodied in the partnership agreement.

For the latest developments on the new partnership audit rules or to discuss the substance of this Alert, please contact a member of Caplin & Drysdale's partnership tax team:

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