A New World for Partnership Audits: Nuts and Bolts Until Regulations are Issued

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Since the enactment of the unified audit procedures under TEFRA in 1982, we have all gotten comfortable with how to draft partnership and operating agreements by incorporating customary provisions to address those audit requirements into these agreements. Our world has now been turned upside down, as Congress enacted the Bipartisan Budget Act ("the BBA") on November 2, 2015, which will flip these audit rules on their head. Section 1101 of the BBA completely eliminates the TEFRA audit requirements (former IRC §§6221 through 6234, and the former electing large partnership provisions), and replaces them with a brand new scheme for the conduct of partnership audits (new IRC §§6221 through 6241). With limited exceptions, these new audit rules will be effective for partnership taxable years starting after December 31, 2017.

BBA §1101 grants regulation writing authority to Treasury and the IRS in many areas, but it is anticipated that such regulations will not be issued in proposed form until after this article is published. Therefore, this article addresses the new audit rules based only on how the statute is written, including certain commentary provided to the IRS in response to Notice 2016-23 (March 4, 2016). We have provided some practice points for your consideration, focusing on decisions that should be made as soon as possible by you and your clients to address the BBA rules ("BBAR"), as well as suggested changes to operating and partnership agreements ("O/PA") (references in this article to a "partnership" and "partners" includes LLCs taxed as partnerships and their members unless otherwise noted).

Partnership Representative

One of the obvious differences between TEFRA and the BBAR is the elimination of the Tax Matters Partner ("TMP") and its replacement with the Partnership Representative ("PR"). The BBAR requires a partnership to designate a person with a "substantial presence in the United States" as the PR, having sole authority to act on behalf of the partnership under the BBAR audit procedures. Unlike a TMP, the PR does not have to be a partner. If the partnership does not designate a partnership representative, the IRS has authority to do so.

Under the BBAR, the PR will have substantially more authority than a TMP. Most concerning, the IRS will no longer have any obligation to notify anyone other than the PR as to the start of an audit proceeding, proposed adjustments, and final adjustments. Language can be put into the O/PA that requires the PR to provide such notice to all, or a certain subset, of the partners, but such language will only be enforceable amongst the parties to the O/PA; the IRS is not bound by that language, and the failure of the PR to perform in accordance with the O/PA does not change the audit result.

Therefore, partners should address in their O/PA several threshold issues about the PR:

- Who should be entrusted with making the very important decisions permitted or required by the BBAR that will be binding upon the partnership and partners for tax reporting and audit purposes? This will include the very critical "elect-out" and "push-out" elections discussed below.
- As a practical matter this important decision will depend in large part on who you represent. If you are representing management or a majority owner, then it is likely that you and your client will push for the PR to be a key manager or owner or at least to control the process for how the PR will be selected. If you represent a minority owner, then you and your client will probably want to actively participate in this decision, or at least want the O/PA to contain specific standards about how this appointment is made, as well as standards or other parameters about how the PR will exercise its authority under the BBAR.
- If the PR is not designated solely on the basis of its status in the O/PA (e.g., it does not say something like " . . . the manager shall also act as the company's PR . . ."), then the O/PA should specifically cover the selection, removal and replacement of the PR.
- The O/PA should address the scope of the PR's authority. Should the PR be obligated to take "marching orders" (with respect to exercising its default statutory authority) from management alone, certain designated partners or by some other decision-making process in the O/PA?
- What other obligations should apply to the PR? In many cases the partners will reasonably expect (at a minimum) the same rights they would have with respect to a TMP, including notices of key developments during the audit, prior approval of significant events,

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such as extending the statute of limitations, settling the final audit, filing a petition for readjustment and other material matters.

- What specific rights should other partners have with respect to a PR's exercise of its authority in the course of an audit, e.g., notifications to other partners, blocking rights (concerning audit resolution or other agreements with the IRS), or other decisions that could adversely impact a partner)?
- What standards of performance duties should apply to the PR? If the PR is also a manager or general partner (or member in member-managed LLC), should normal or statutory duties apply while acting in PR capacity, or should the O/PA contain more specialized or "customized" obligations? What kind of exculpatory or indemnity provisions should apply to its decisions and actions affecting the partners?

Election into BBAR Before Effective Date

An interesting twist provided by the BBA is to allow partnerships to currently elect into its new audit regime, rather than wait for the effective date in 2018. Just as this article was going to press the IRS released Temporary Regulations providing additional guidance regarding an election to apply the new rules for tax years beginning before January 1, 2018. It may be advantageous for some partnerships and partners and the election should be considered, particularly if the partnership has already received an audit notice, in which case there is a 30-day deadline for making the election. A detailed explanation of the early election considerations is beyond the scope of this article and readers are encouraged to review the proposed regulations just released for more on the subject.

Electing Out of BBAR

The BBA permits partnerships with 100 or fewer partners to elect out of the BBAR. To make this elect-out option ("EOO"), a partnership must consist solely of partners who are individuals, the estates of deceased partners, "C" corporations, a foreign corporation that would be treated as a "C" corporation under U.S. tax classification rules, and "S" corporations. The BBA authorizes Treasury to promulgate regulations to expand the list of eligible partners in accordance to rules similar to those applicable to "S" corporations. So, excluded from eligible partnerships are those which have as partners the following entities: another partnership, limited liability companies; grantor trusts, complex trusts, tax exempt entities and disregarded entities.

If an "S" corporation is a partner, then the BBA authorizes a look thru to the "S" corporation's shareholders to determine whether the 100 or fewer partners test is met. It is not clear whether the "S" corporation itself is counted as a partner in determining the 100 or fewer test. It is also unclear whether spouses owning "S" corporation stock as tenants by the entireties or as community property will be counted as one or two partners. Another issue is whether an interest transferred during the year will be considered as having one, two or multiple owners. These issues need to be clarified in the regulations to be issued by Treasury.

The EOO is an annual election, to be exercised on the tax return for the partnership each year. Assuming that the election is made, then any IRS audit will follow the normal deficiency procedures and not the BBAR. The BBA does not provide a specific audit and assessment procedure to replace the TEFRA rules when a partnership makes the EOO, but the IRS will likely follow the current procedures for the audit of "S" corporations; that is, the IRS will audit the partnership, get control of the partners' returns for the year(s) under audit, and then flow the results to each partner under the deficiency procedures.

The EOO raises several issues that should be addressed in the O/PA:

- Determining whether to exercise the EOO, and whether the partnership has eligible partners for that purpose.
- Requiring current and former partners to provide the partnership and PR the information needed under the BBAR to make the election (as well as the push-out election discussed below), and requiring partners to file, or prohibit them from filing, amended returns (e.g., under IRC §6225)?
- What O/PA provisions may be appropriate for preserving a partnership's eligibility to make the EOO, including binding "eligible owner" transferees and restricting transfers to "ineligible" persons?
- If the EOO will be exercised, what language might the O/PA contain to mandate (or facilitate by specified approval of partners) annual exercise of the EOO?
- Who should be entrusted to make the EOO – a general partner, manager, a majority in interest, unanimous approval of owners?
- What are the actual mechanics of making a timely EOO election – will it be a default or "evergreen" provision in the O/PA, subject to review by the partners from time to time, or will the authorized person(s) have to affirmatively make the decision annually?
- How will the partnership or partners enforce the partnership's obligation to exercise the EOO if the responsible person fails to do so on the timely filed Form 1065?
- If the EOO becomes unavailable for any reason (e.g., an interest is acquired by an ineligible partner), what "back-up" or other planning considerations (discussed below) should be addressed in the O/PA?

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Responsibility for Partnership Level Adjustments

As a preliminary matter, the BBA uses two terms to differentiate the tax year return being audited ("reviewed year") from the year in which those adjustments become final, either through agreement with the partnership, or at the conclusion of all appeal or judicial process ("adjustment year"). The centerpiece of the BBAR is that the partnership is primarily liable for the "imputed underpayment" resulting from the adjustment of "partnership items" made in the adjustment year, irrespective of the reviewed year to which the adjustment relates. Partnership items are defined more restrictively in the BBA than they are in TEFRA, and are limited to items of "income, gain, loss, deduction and credit." The concept of "affected items" under TEFRA is also eliminated by the BBA. The imputed underpayment is to be taxed at the highest rate of income tax then applicable to individuals or "C" corporations.

Although the partnership has the primary liability for the imputed underpayment, there are two methods by which this liability can be reduced or eliminated at the partnership level. The first method is to attempt to modify the imputed underpayment under IRC §6225(c). There are three alternatives means by which to modify the imputed underpayment: (a) have the reviewed year partners file amended returns <u>and</u> pay the resulting tax, interest and applicable penalties; (b) demonstrate to the IRS's satisfaction that some of the adjustments are allocable to tax exempt partners; and (c) demonstrate to the IRS's satisfaction that some of the partners are subject to a lower rate of tax, or that some of the adjustments (i.e., capital gains and dividends allocable to partners who are individuals) are subject to a lower rate of tax.

The procedures for seeking a modification are as follows. Once the IRS issues the notice of proposed partnership adjustment, the partnership will have a 270-day period in which to submit evidence to the IRS regarding any or all of the means of modification. This 270-day period can be extended with the consent of the IRS. If the partnership does not submit a request for modification, then the IRS has 60 days in which to issue the notice of final partnership adjustment.

Assuming the partnership does submit a request for modification, the IRS will then have 270 days in which to consider the request. It is wholly within the IRS's sole and absolute discretion whether to accept all, some, or none of the requested modifications. If the IRS does not accept all of the requested modifications, then the IRS must issue the notice of final partnership adjustment by the end of the 270-day period.

The partnership's payment of taxes ostensibly "on behalf of" the partners raises several important drafting issues for the O/PA, including:

- Making clear in the O/PA that partnership level assessments must be allocated among the reviewed year partners in same manner that adjusted partnership items were allocated among them. Adjustment year ownership or allocation percentages will often be very different from the apportionments that occurred in the reviewed year (e.g., consider target allocation approach or special allocations that do not always follow the partners' stated profit or capital interest percentages). Should special "make-up" or "charge-back" allocations be considered to set-off unanticipated tax consequences resulting from the fact that the partnership's tax payment in the adjustment year will not take into account certain tax factors (e.g., the effect of capital gain treatment not being available to certain partners in the adjustment year or the manner in which the passive activity loss rules might apply differently than in the reviewed year)?
- Considering an indemnity by each partner (in favor of the partnership and any "over-paying" partners) whenever the partnership becomes obligated for any audit adjustment, coupled with withholding and claw-back rights that may be enforced by either or both the partnership and other partners. In many cases, this indemnity can be an extension of the typical withholding and indemnity provisions governing foreign partners. The partnership would have the right to withhold each partner's share of the tax payment from any distributions otherwise payable to the partner, which should be coupled with a separately enforceable indemnity against the partner if distributions are not likely to be timely made to that partner or its successor in interest.
- Assuring that indemnities may be enforced by the partnership and other partners against a dissociated partner who was a partner during the reviewed year (including personal representatives and other successors in interest).
- Apportioning the indemnity obligation when a partnership interest is sold or otherwise transferred (assuring that the seller or assignor remains liable or permitting the transferee to assume that liability – or requiring both to be jointly and severally liable). Similarly, new partners acquiring interests directly from the partnership should consider asking for representations and indemnities regarding tax liabilities arising before their admission to the partnership.

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- This "overhang" of prior years' tax liabilities will be relevant in many other transactions involving partnerships and their owners, including sales of some or all of the interests under purchase and sale agreements, merger and other reorganization transactions, redemptions and other dissociations, offerings of partnership securities (subscriptions and disclosure documents). It will also be a new kind of creditor claim to be dealt with upon the dissolution of a partnership.
- Having each partner appoint the general partner or manager or other designee under a POA to carry-out its indemnity obligations, or even carrying-out the partner's payment obligation if the partnership makes the push-out option (see below) by applying that partner's distributions to the liability.
- Establishing partnership reserves pending audits to fund the partnership's claw-back right should a partner default in paying its share of an adjustment.
- How should indemnity payments be treated for purposes of capital account maintenance? Hopefully this will be clarified when the IRS releases additional guidance. The BBAR make clear that the partnership's assessment payments are not deductible and that basis reductions have to be made by the partner to its (outside) basis in the partnership interest and by the partnership to its (inside) basis in its assets in order to reconcile that outside basis adjustment. However, the other accounting relative to the payment of the partners' imputed tax liabilities is uncertain at this time, including whether (and the extent to which), these payments should be allocated to the partners as a charge against their capital accounts. Such allocations would not be appropriate if the partners' indemnity payments to the partnership are not credited as capital contributions, but if such allocations are mandated, then adjustments will need to be made (e.g., by treating the cash paid by partners to fund the partnership's payment as capital contributions) to cause that accounting to work and to reconcile the partners' capital accounts with their economic deal.

Push Out Election

The second method by which the partnership can eliminate the imputed underpayment is the so-called "push out election" ("POE") under IRC §6226. Under the POE, the partnership shifts or "pushes" the obligation to pay the imputed underpayment to the reviewed year partners, who must include their allocable share of the adjustments in their income tax returns to be filed for the adjustment year. It is critical to note that the reviewed year partners have NO right to challenge the adjustments, which has to occur at the partnership level.

The timing for making the POE is curious. Once the IRS issues the notice of final partnership adjustment, the partnership has 45 days from the date of that notice to make the election, by submitting a statement to the IRS (as to be described in regulations to be issued) and to the reviewed year partners. This 45-day period cannot be extended. However, since this 45-day period starts with issuance of the notice of final partnership adjustment, the partnership still has 90 days to file a court challenge, whether in the U.S. Tax Court, U.S. Court of Federal Claims, or local U.S. district court. Accordingly, a partnership will have to make the POE before it necessarily decides whether to challenge the proposed adjustments. The BBA does contemplate that the IRS can consent to revocation of the POE at the conclusion of any court proceeding.

Given the short time frame in which to make the POE, determining whether the POE is available and whether it is a better alternative will be difficult. Some drafting considerations include the following:

- The threshold authority issues mentioned above, such as whether and how an EOO will be exercised, equally apply to the POE. Who should be entrusted to make the POE – a general partner, manager, a majority in interest, unanimous approval of owners?
- Should the partnership be mandated to make the POE, or should it be left to good faith determination of management or the PR after audit adjustments are made? It many cases the partners' collective tax liability (reviewed year versus adjustment year) may be significantly different (e.g., based upon the nature of the income/ loss adjustments, whip-saw effects among partners, and relative differences in their personal tax attributes in those two years). Therefore, in some situations it would make sense to allow the partnership to "fine tune" the situation by not mandating a POE but instead using a "wait and see" approach.
- If the POE will be optional with the PR, what standards should be specified in the O/PA for this election (e.g., adhering to original economic and tax objectives as closely as possible, taking into account whip-saw effects, overall fairness, ripple effects on other tax factors, such as SECA/NII tax, consistency issues in successive years, etc.)?
- Having reciprocal partner covenants (with indemnities) concerning their filing obligations when a POE is made.
- Making appropriate disclosures to new partners (and transferees) of their POE filing and indemnity obligations.
- Practical issues regarding the enforcement of former partner obligations after their dissociation.
- Complying with third party and certain investors' requirements. For example, a senior lender or mezzanine debt or other venture capital participant will likely have a problem with the partnership discharging

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the partners' otherwise personal liabilities with project cash flow that would have been set aside or distributed for them.

Conclusion

Like the peeling of an onion, each time we look at the BBA, more and more questions are raised. Numerous groups have responded to Notice 2016-23 with comments on the format and coverage of the proposed regulations, including at least one that suggests treating the BBAR as akin to FIRPTA withholding. What is clear is that Treasury and the IRS have their job cut out for them in addressing the many open issues raised by commentators. As practitioners, we have our jobs cut out for us in advising our partnership clients as to the options available, and what may work for one partnership may very well not work for the next one.

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The History of the Annual "Sam Ullman Year in Review"

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First, a bit of Florida Bar Tax Section history. Did you know how the "Sam Ullman Year in Review" came into being? As the story goes according to Richard Josepher, Marvin Gutter, while serving as chair of the Tax Section, was determined to guarantee that Sam Ullman would come and speak at the Section's annual year in review. Marvin, knowing how conscientious and professional Sam Ullman is, and never being afraid to take advantage of someone for the good of the section (as Rick Josepher tells it), figured if he named the event after Sam, Sam would have no choice but to attend for years to come. It worked like a charm! And that, folks, was the beginning of an event that never fails to bring in Florida tax attorneys in droves for a few hours of educational and interesting presentations by their colleagues. While the man of the hour, Mr. Ullman, was greatly missed by everyone in attendance this year, it is quite certain that Sam Ullman (or Professor Ullman to me) would have been very pleased with the well-attended event on this past July 4th weekend at the beautiful Amelia Island.

After opening remarks by Bill Lane, the president of the Tax Section, and chair-elect, Joe Schimmel, the meeting kicked off with "Recent Developments in International Inbound and Outbound Taxation" by Cecilia B. Hassan of Baker & McKenzie LLP and Christopher R. Callahan of Packman, Neuwahl & Rosenberg, P.A. Christopher discussed the FIRPTA withholding rate increase from 10% to 15% applicable to USRPI dispositions/distributions after February 16, 2016. Cece discussed Topsnik v. Commissioner, 146 T.C. No. 1 (2016), where the taxpayer took the position that he was not a U.S. person, and the Tax Court held that the taxpayer was not a German resident, but rather was a "covered expatriate" subject to the exit tax because he was not able to meet his tax filing burden.

Charlotte A. Erdmann of Erdmann Law, PLLC provided everyone with a "Civil Tax Procedure Update," including an update on the amendments to the Tax Court Rules of Practice and Procedure in response to the legislation Congress passed at the end of 2015, including the PATH Act. Charlotte reviewed a number of amendments under this new legislation, including Tax Court Rule 13(e), under which a taxpayer cannot bring a Tax Court proceeding to determine innocent spouse status to challenge a CDP determination if the taxpayer is in a bankruptcy proceeding.

Steven M. Hogan of Ausley McMullen brought it close to home with the "2016 State Tax Update." Steven began his presentation with a discussion of three recent cases decided this year, including American Heritage Window Fashions, LLC v. D.O.R., __ So. 3d __, 2016 WL 2609522 (Fla. 2d DCA 2016), where the Second District Court of

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