TAX

NEW PARTNERSHIP AUDIT REGULATIONS: PREPARE FOR CHANGE

Regulations governing audits of large partnerships were already burdensome, but a law set to take effect soon should make partners wince even more.

The story starts with a bit of legislative history. Since 1982, the Tax Equity and Fiscal Responsibility Act and its subsequent amendments have provided audit and litigation procedures for large partnerships. TEFRA remains in force today but in 2018 it will be replaced by the Bipartisan Budget Act of 2015. Although the IRS announced proposed regulations in January 2017, they have not been published in the Federal Register, likely as a result of the Trump administration's freeze on regulatory guidance.

"Under TEFRA, the Internal Revenue Service could determine which partner actually paid taxes on income from partnership operations, and people have gotten used to those rules over the past 35 years," says Jennifer Ray, a partner in Crowell & Moring's Tax Group. "But BBA will push more of the work onto the partnership's owners. The IRS supports this change at a time when it is being asked to do more with less."

Among the many differences between the large-partnership audit regimes for TEFRA and BBA, perhaps the most prominent relate to the collection of taxes and the person designated to represent the partnership with regard to tax matters.

Tax collection. TEFRA audits occur at the partnership level, but tax is ultimately collected from individual partners—a process that can be especially difficult for the IRS to navigate due to the complex ownership structures of many large partnerships.

BBA audits will also occur at the partnership level, but, in a crucial difference, the default rule will be that the partnership pays the taxes. A partnership can elect to push the tax liability out to the partners only by agreeing to a higher interest charge. [Note: Partnerships can opt out of BBA partnership audit rules if they meet specific criteria.]

Designated representative. Under TEFRA, the partnership must designate a partner (called the "tax matters partner") to represent it on tax matters. TEFRA contains requirements to notify partners of certain events, and partnership agreements typically require the tax matters partner to keep the other partners informed about proceedings and discussions with tax authorities as well as to obtain the other partners' consent to take material actions.

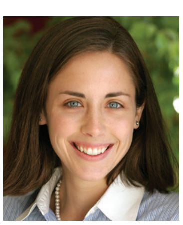
BBA calls the designated person—which BBA doesn't

KEY POINTS

New audit regime
The audit regime for large partnerships is changing.

Partnership pays taxes
The partnership—not its individual partners—will pay taxes owed after audit.

Review partnership agreements
Make sure that agreements address issues raised by the new audit regime.



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require to be a partner—the "partnership representative" and gives him or her the exclusive right to take audit-related actions. Other partners have no rights under the BBA to receive information or to participate. As with tax collection under BBA, this simplifies the audit process for the IRS but makes it more onerous for partners.

Ray has little doubt that many of the proposed BBA regulations will become finalized eventually.

What about the Trump administration's mandate that two regulations be eliminated for every new one adopted? Which existing regulations would have to be cut so that the BBA regulations could become official? "The two-for-one concept makes sense in many areas," notes Ray, "but not in tax law. Numerous tax regulations exist to provide necessary guidance to taxpayers."

ACTION STEPS

There are a number of steps that existing and potential LLCs (and other entities treated as partnerships for tax purposes) should consider in anticipation of the BBA audit regime, if they haven't already done so, Ray says.

- **Restructure current partnership agreements.** It's critical to review LLC and partnership agreements that were originally written to comply with TEFRA. "Agreements will have to spell out some things with particular clarity," says Ray. "The issues that are most important in this regard include how the partnership representative should be selected, what the partnership representative can and cannot do during the audit, and how to decide whether the partnership itself pays taxes or passes taxes on to individual partners."

- **Clarify tax obligations of buyers and sellers of partnership interests.** The parties should agree on whether the seller has to indemnify the buyer for the seller's share of any of the partnership's pre-closing tax liabilities. Failure to specify who pays (and what they pay) is virtually an invitation to disputes.

- **Decide whether eligible partnerships should opt out of BBA rules.** This decision will be made on an annual basis, with the partnership's tax return and before the partnership knows whether it will be audited.

LAYING THE GROUNDWORK FOR CHALLENGES TO REGULATIONS

The comment period for the proposed regulations relating to the Bipartisan Budget Act of 2015's large-partnership audit provisions, which began in January, could well be uneventful. The importance of comments, however, could be significantly affected by an unrelated tax case making its way through the federal courts.

In *Altera Corp. v. Commissioner*, the U.S. Tax Court unanimously held invalid a 2003 Treasury Department regulation mandating that controlled entities entering into qualified cost-sharing arrangements share stock-based compensation costs.

In February 2016, the IRS appealed the decision to the Ninth Circuit Court of Appeals, which hasn't yet issued its decision.

Altera's relevance to BBA lies in a portion of the Tax Court's decision related to the Administrative Procedure Act. The Tax Court held that the Treasury Department (of which the IRS is a bureau) is subject to APA's notice and comment requirements.

One of these requirements is that government agencies must not only give the public an opportunity to comment on proposed regulation, but also must respond to the comments received. Under APA, failure to respond could render the proposed regulations invalid.

"The *Altera* decision means, among other things, that tax lawyers must be experts in the Administrative Procedure Act," says David Fischer, a partner in Crowell & Moring's Tax Group. "This is a good thing for parties in litigation with the IRS because it creates a significant procedural burden that the IRS must meet. If they want their proposed regulations to become law, they'd better respond to comments."

For opponents of the proposed BBA regulations, the message is clear: submitting comments could create an additional right to challenge.