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REPRINTED FROM:

RISK & COMPLIANCE MAGAZINE

APR-JUN 2017 ISSUE

www.riskandcompliancemagazine.com

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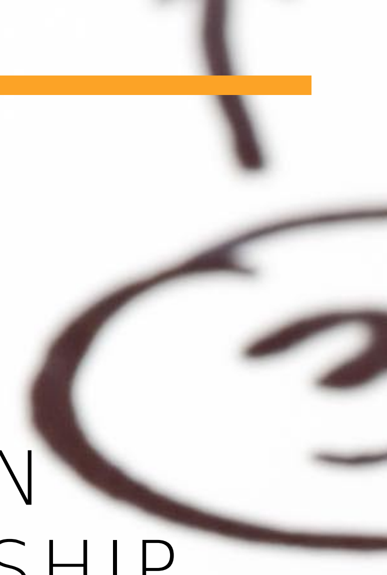
ROPES & GRAY

Published by Financier Worldwide Ltd
riskandcompliance@financierworldwide.com



PERSPECTIVES

ONE STEP CLOSER: AN UPDATE ON PARTNERSHIP AUDIT REFORM IN THE UNITED STATES

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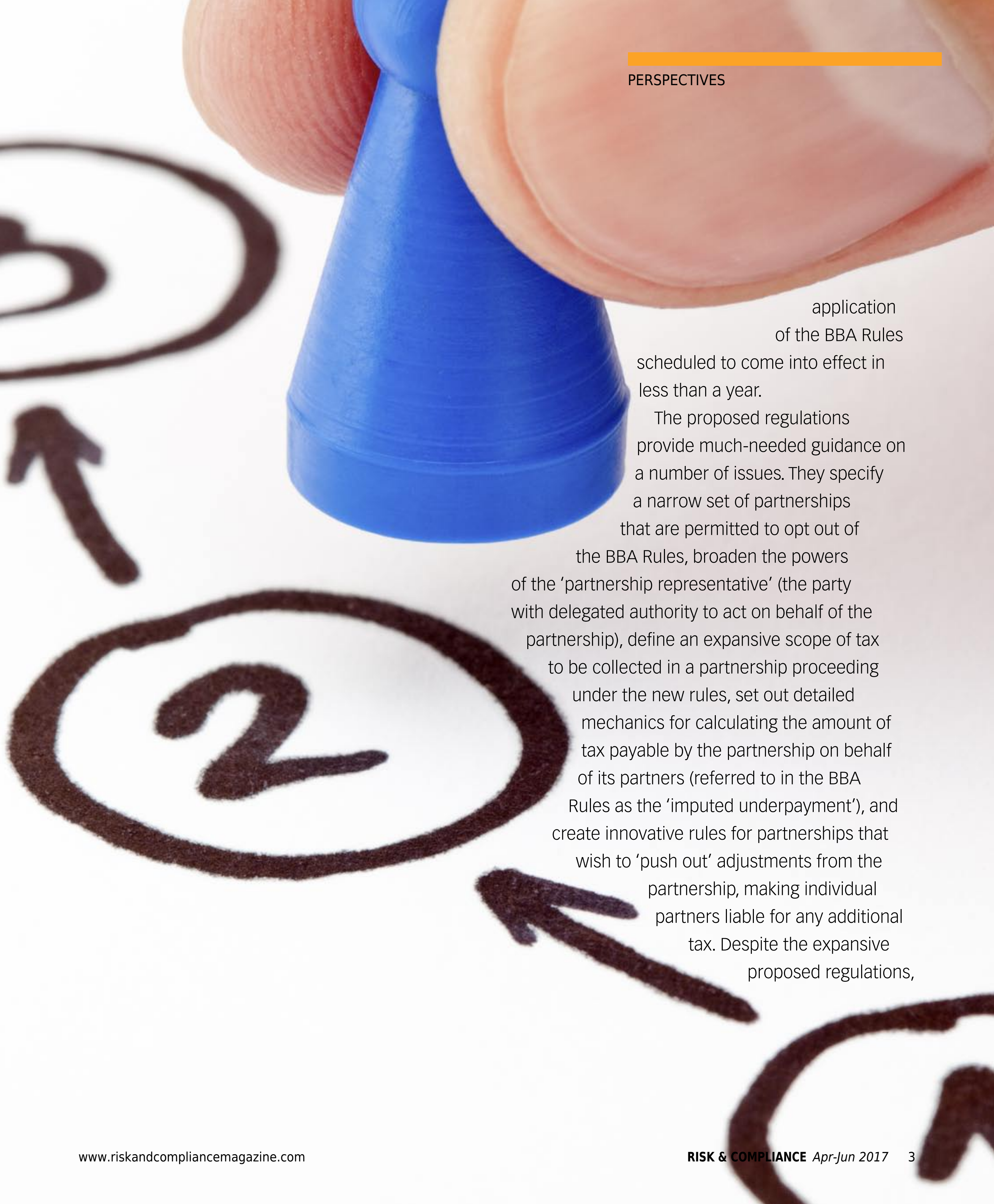
In an effort to boost enforcement of tax rules against large, complex partnerships, the US Congress gave the Internal Revenue Service (IRS) a gift in late 2015: the ability to both audit partnerships and collect any underpaid tax directly from those partnerships. These sweeping changes, part of the Bipartisan Budget Act of 2015 (BBA rules), will come into effect for tax years of a partnership beginning in 2018 (unless the particular partnership opts in early). Because Congress left much of the work to implement these new rules to the Department of Treasury (Treasury) through regulations, the business community has been waiting to find out just how expansive the rules will be and many businesses have been left to guess at how individual economic arrangements will fare under the new regime.

We now have the first major insight into Treasury's plans for the new rules. On 18 January 2017, the Treasury released proposed regulations, although the timing of the release has created uncertainty in the future of these regulations. In the US, federal regulations do not take effect until published in the Federal Register. The proposed regulations were submitted for publication, but never officially published as president Trump froze all unpublished regulations immediately after his inauguration to enable further review by his administration. Nonetheless, the proposed regulations provide partnerships with critical insight into the potential



application of the BBA Rules scheduled to come into effect in less than a year.

The proposed regulations provide much-needed guidance on a number of issues. They specify a narrow set of partnerships that are permitted to opt out of the BBA Rules, broaden the powers of the 'partnership representative' (the party with delegated authority to act on behalf of the partnership), define an expansive scope of tax to be collected in a partnership proceeding under the new rules, set out detailed mechanics for calculating the amount of tax payable by the partnership on behalf of its partners (referred to in the BBA Rules as the 'imputed underpayment'), and create innovative rules for partnerships that wish to 'push out' adjustments from the partnership, making individual partners liable for any additional tax. Despite the expansive proposed regulations, the Treasury and the IRS notably reserved on and requested comments in several critical areas, giving the business community and practitioners an opportunity to influence further rulemaking.

This article focuses on the governance concerns raised by the proposed regulations' approach to the selection and powers of the partnership representative and on the ability of partnerships to opt out of the rules altogether.

The decision to opt out of the BBA rules

The BBA Rules allow certain partnerships to opt out of the new regime, causing partners to become subject to separate audit procedures. However, eligibility for the election is extremely limited. The proposed regulations would limit the range of partnerships that are eligible to elect out to partnerships with: (i) 100 or fewer partners during the year, based on the number of Schedule K-1s issued; and (ii) only 'eligible partners' as partners. The list of eligible partners is narrow: individuals, C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs), 'eligible foreign entities' that are classified or elect to be treated as corporations for US tax purposes, S corporations, estates of deceased partners and tax-exempt organisations classified as corporations. Expressly excluded from the definition of 'eligible partners' are partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees or other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner.

The most concerning implication for partnerships evaluating whether to opt out is that an election out of the BBA Rules could be invalidated by unrelated actions of a single partner. For example, if a partnership has five partners, all of whom are non-US corporations, the partnership may appropriately make an election. However, if one of those partners decides to elect pass-through status for US tax purposes, filing a Form 8832 to be treated as a disregarded entity, the partnership would no longer qualify and its election would be invalid. Since an election out of the BBA Rules is valid until a partnership is notified otherwise by the IRS, the partnership may have no idea this change has occurred, in the absence of contractual protections, until the onset of an IRS audit. As a result, partnerships should consider engaging in significant diligence into the status of partners prior to opting-out and adding contractual provisions requiring notice of changes in entity classification to ensure successful and durable opt-outs.

Lastly, the Treasury has made clear that partnerships should not assume that opting out means less likelihood of audit. To the contrary, the IRS intends to carefully scrutinise opt-out decisions, to identify taxpayer abuse.

The identity and powers of the partnership representative

The BBA Rules require each partner to identify a partnership representative, who must have a 'substantial presence' in the US. The proposed regulations have expanded on these requirements, fashioning a system where the IRS is confident that it need only negotiate or consult with a single person over the course of an audit. Concerns of authority, agency and governance have been left to the business community to sort out.

First, the proposed regulations would make it difficult to change the partnership representative in the absence of an IRS audit. A partnership must designate a partnership representative on its return for each taxable year, and a designation for a partnership taxable year remains in effect until the partnership representative resigns, the partnership revokes the designation or the IRS determines that the designation is not in effect. The proposed regulations provide that a partnership representative may not be changed, either by resignation or revocation, until the IRS issues a notice of administrative proceeding to the partnership or the partnership files an administrative adjustment request for a valid purpose other than changing the partnership representative.

This means that notice may go to an appointed partnership representative who has long-since departed the partnership or its employ, and the IRS is able to negotiate fully with that person. While partnerships are permitted to change the partnership representative at the outset of an IRS audit, the IRS is only required to notify the partnership representative, and not the partnership itself, of the commencement of an audit. In the worst of circumstances, a disgruntled partnership representative could have the means to exact tax revenge on a former partnership employer. From the IRS's perspective, this problem is for the business to resolve through private contracts. Thus, partnerships should consider contractual provisions requiring a partnership representative or designated individual to notify a partnership of an audit, and, upon request, tender its resignation when an audit commences.

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The difficulty in changing a partnership representative may also present problems for partnerships that are sold or have material changes in partners. One solution to the problems created by turnover may be to appoint a legal entity as the partnership representative. The proposed regulations permit entities, including a partnership's management company, to act as partnership representatives so long as that entity identifies and appoints an individual with a substantial presence in the US to act on its behalf.

Second, if a partnership representative has not been designated, the IRS may select any person to serve as a partnership representative, but it will take into consideration whether the person is a partner in the partnership, either in the reviewed year or at the time the designation is made. The IRS may also consider the views of the partners having a majority interest in the partnership, the general knowledge of the person in tax matters and the administrative operation of the partnership, the person's access to the books and records of the partnership, and the status of the person as a US person.

Third, in a significant departure from existing rules, the BBA Rules and proposed regulations also broaden the powers of the partnership representative. All partners, including indirect partners, are bound by the actions of the partnership representative and by any final decision in proceedings brought under the new audit regime. Unless the IRS consents, only the partnership representative may participate in an examination or other proceeding involving the partnership. The partnership representative has the power to agree to a settlement with the IRS, accept a notice of final partnership adjustment (FPA), make a push-out election under section 6226 and request an extension of the period for adjustments under section 6235. The proposed regulations provide that any action taken by the partnership representative is valid and binding on the partnership for purposes of tax law regardless of any other provision of state law, partnership agreement, or any other document or agreement.

Finally, the BBA Rules remove the right of partners to receive notice of partnership proceedings and adjustments and partners no longer have the ability to participate by right in partnership proceedings. The broad powers of the partnership representative, and limited rights of partners, mean that partners may want to take proactive steps now to contractually protect themselves, including requiring notice of an IRS audit from the partnership representative and the opportunity to participate in the audit process, securing the right to force a partnership representative to resign and appoint a new representative in the face of an audit; demanding indemnification rights vis-à-vis a partnership representative who acts outside the scope of his or her powers and strategically using an entity, rather than an individual, to serve as partnership representative, allowing partners to maintain control over the partnership representative itself, even if there is employee turnover.

Overall, partners should be evaluating these and other contractual provisions to minimise the impact of the new audit rules on their new and existing partnerships, with an eye towards 2018 and the disruption it will bring in the way the IRS approaches partnerships. R&C

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