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Centralized Audit Regime Issues for Buyers and Sellers of Partnership Interests: Protecting Against Audit Risks

Structuring the Purchase or Sale of Partnership Interests Under New IRS Audit Rules

TUESDAY, OCTOBER 29, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Critical provisions of the centralized audit regime

Centralized Audit Regime Issues for Buyers and Sellers of Partnership
Interests: Protecting Against Audit Risks

Legislative & Regulatory Developments

- Enacted on November 2, 2015 as part of the Bipartisan Budget Act of 2015 (H.R. 1314, 114th Cong. / PL 114-74).
- Broader technical corrections included in Consolidated Appropriations Act, 2018 (Appropriations Act, P.L. 115-141).
- Some regulations under Section 704 still in proposed form: August 17, 2018.
- Final regulations on released on January 2, 2018; August 9, 2018; and February 27, 2019.

Overview of Centralized Audit Regime

- New default regime under which the IRS can make adjustments to partnership items at the partnership level, and then collect tax, penalties and interest from the partnership.
- A partnership that receives an adjustment may elect to “push-out” the adjustment and have the partners pay the additional tax.
- The partners may also file amended returns or use the alternative “pull-in” procedure to reduce the imputed underpayment.
- Qualifying partnerships may elect out of the default regime by filing an annual election and providing information about their partners.

Scope of Audit Regime

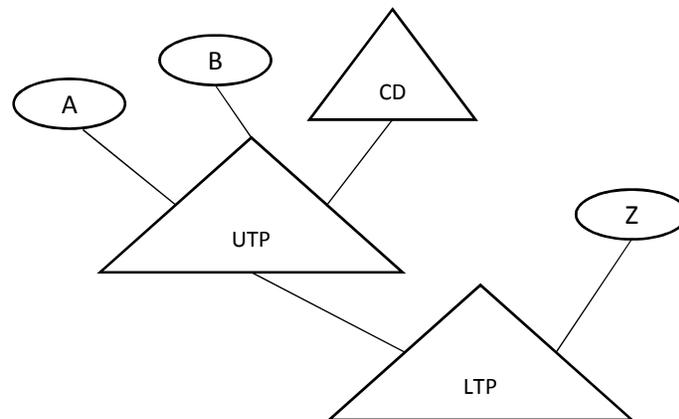
- Applies to “partnership-related items.”
- Partnership-related item defined as any item or amount with respect to the partnership that is relevant in determining the income tax liability of any person.
- The new centralized audit regime does not apply to taxes imposed by other chapters (e.g., self-employment taxes and net investment income taxes) although partnership adjustments are taken into account to determine these taxes.
- Sales of partnership interests – the regime does not apply to gain on sale recognized under Section 741, but not clear on Section 751(a)

Scope of Audit Regime

- “With respect to the partnership “ - The item or amount is shown or reflected, or required to be shown or reflected, on a return of the partnership or is required to be maintained in the partnership’s books or records.
- “Relevant in determining any person’s income tax liability”- An item or amount with respect to the partnership is relevant in determining the tax liability of any person under chapter 1 without regard to the application of subchapter C of chapter 63 and without regard to whether such item or amount, or an adjustment to such item or amount, has an effect on the tax liability of any particular person under chapter 1.

Example 1

- A, B, and CD are equal partners in the UTP partnership for the tax year 2018. A and B are individuals. CD is a partnership. UTP operates its own trade or business, and also owns a 20% interest in a lower tier partnership (“LTP”).



Example 1

- A sells his interest in UTP to E in 2019.
- The partnership's 2018 tax year is audited in 2020.
- B sells her interest in UTP to F in 2021.
- The audit is finalized in 2022.
- The following adjustments are made as a result of the audit:
 - \$40 of ordinary income reallocated from CD to A.
 - \$100 of long term capital gain recharacterized as ordinary income.
 - \$10 of additional interest expense is allowed.
 - \$20 of A's recourse liabilities are determined to be nonrecourse.

Default Regime

- UTP does not make the push out election and no partners file amended returns or use the alternative procedure.
- UTP has the following adjustments:
 - +40 ordinary income from reallocation
 - +100 ordinary income from recharacterization
 - -10 increased interest expense deduction
 - +20 for nonrecourse liability
 - Total: \$160 adjustment, multiplied by highest rate of tax (e.g., 40%) = \$64 imputed underpayment owed by UTP in 2022.

Default Regime Dilemma

- Who bears the economic cost of the \$64 tax liability?
- What about A and B?
- Under what agreements could A and B be liable?
- Who can collect from them?
- What about the -\$10 of additional interest expense deduction?

Pushout Out Election

- UTP makes a timely push out election. No partners file amended returns or use the alternative procedure.
- The push out statements are mailed in 2022 (the “reporting year”)
- Each partner takes its into account its pro rata share of the adjustments as follows:
 - Calculate correction amount for first adjustment year (e.g., net increase in A’s 2018 tax liability due to \$40 reallocation allocated 100% to A, net decrease for CD)
 - Adjust tax attributes for intervening years (2019-2022) based on first adjustment year (correction amounts can be less than zero)
 - Sum of these correction amounts is paid by the partners in 2022
- Note – No refunds! If CD’s \$40 reduction would have resulted in a refund, CD must file an amended return.
- CD can elect to push out any adjustment, or pay under the default regime

Default vs. Push Out

- Reallocation allocated to A, not CD
- Reviewed year partners liable, not partnership (or adjustment year partners)
- Higher underpayment interest rate
- Cost of preparing statements

Alternative “pull-in” procedure

- What result if each of A, B, and CD file and pay under the alternative procedure?
- Can A and B be compelled to file? What result if they do not?
- Can CD get a refund?

Summary of the three regimes

- Adjustment year partners bear the economic burden under the default regime
- Reallocations difficult under the default regime
- Default regime will often overstate true tax liability
- Reviewed year partners liable under push out election, with increased underpayment interest and strict timing requirements for statements
- Alternative procedure requires full cooperation of reviewed year partners
- No refunds with out amended returns

Ceasing to exist – Example

- Z buys all of the interests of LTP from UTP in 2019.
- As a result, LTP ceases to exist under 708(b)(1).
- LTP is audited for the 2018 year and the adjustment becomes final in 2022.
- Since LTP has ceased to exist, the “former partners” are liable.
- The former partners are the adjustment year partners, or if there are no adjustment year partners, the partners for the last year a partnership income tax return was filed.
- Are E and F required to bear a share of UTP’s share of the imputed underpayment?



Partnership Representative: Authority and Risks

Teresa Abney
October 29, 2019



Partnership Representative

Agenda

- Overview
 - Eligibility
 - Designations
 - Revocation
- Authority & Related Risks

Partnership Representative

Overview

- Eligibility § 301.6223-1(b)
 - Substantial presence in the U.S.
 - Designated individual
- Designation § 301.6223-1(c)
 - Form 1065 or Form 8979 No more SSNs!
 - IRS designation of Partnership Representative § 301.6223-1(f)

<p>Form 8979 (December 2018) Department of the Treasury Internal Revenue Service</p>	<p>Partnership Representative Revocation, Designation, and Resignation Form</p>	<p>OMB No. 1545-0123</p>
<p>▶ Go to www.irs.gov/Form8979 for instructions and the latest information.</p>		

Partnership Representative

Overview (cont'd)

- Revocation § 301.6223-1(e)
 - Timing
 - Who
 - Effect of multiple revocations

Partnership Representative's Authority

- Sole voice of partnership and partners at audit
 - § 6223; § 301.6223-2
 - Actions bind the partnership and all partners
 - IRS's only point of contact
 - No notice partners

Risks:

- No notice
- Bound to PR's decisions with respect to exam, appeals, SOL extensions, filing in court
- Partners disagree on who should be PR

Partnership Representative: Risk Management

Written Agreement

- Partnership agreement
- Separate agreement with Partnership Representative

Terms to include:

- Notice requirements
- How PR is chosen or revoked
- How PR makes decisions and partner approval
- How resulting tax will get paid (e.g., push-out election)
- What role a reviewed-year partner has if sold interest

Warning:
No impact on IRS

Example 1

On its 2018 return, XYZ designates PR1 as its partnership representative. On its 2021 return, XYZ designates PR2 as its partnership representative. In 2022, IRS mails XYZ a Notice of Administrative Proceeding with respect to XYZ's 2018 tax return.

Who is the partnership representative for the 2018 return?

PR1

Example 2

In 2018, XYZ has three partners: A, B, and C.

On its 2018 return, XYZ designates A as its partnership representative. In 2020, A, B, and C sell their interest in XYZ to D.

D doesn't want A to be its partnership representative.

What can D do?

Wait. XYZ cannot revoke the PR1's designation until the IRS issues notice of selection for examination or Notice of Administrative Proceeding.

Example 3

On its 2018 return, XYZ designates PR1 as its partnership representative. XYZ's 2018 return is selected for audit in 2020. In 2021, XYZ has three partners: A, B, and C. A is the majority partner. B is a general partner. A and C are limited partners.

On January 1, 2021, A signs and mails a form revoking PR1 as the partnership representative and designating PR2.

On January 15, 2021, B signs and mails files a form revoking PR2 as the partnership representative and designating PR3.

On February 27, 2021, C signs and mails a form revoking PR3 as the partnership representative and designating PR1.

Who is the partnership representative?

Whomever the IRS picks.

Example 4

On its 2018 return, XYZ designates PR1 as its partnership representative. XYZ's partnership agreement says PR1 cannot extend the period of limitations without the consent of partners A and B.

The period of limitations for making adjustments is March 15, 2022. The IRS asks to extend the period of limitations to March 15, 2023. A and B tell PR1 not to agree to the extension, but he does. PR1 signs the extension.

Is the extension valid?

Yes

Example 5

On its 2018 return, XYZ designates PR1 as its partnership representative. XYZ's partnership agreement says PR1 cannot extend the period of limitations without the consent of partners A and B.

The period of limitations for making adjustments is March 15, 2022. The IRS asks to extend the period of limitations to March 15, 2023. A and B tell PR1 not to agree to the extension, but he does. PR1 signs the extension **and then immediately resigns as a partnership representative.**

Is the extension valid?

Yes



Key Considerations for Buyers and Sellers

Centralized Audit Regime Issues for Buyers and Sellers of Partnership
Interests: Protecting Against Audit Risks

Does the LLC Agreement Protect the Buyer?

If the Company shall make any payments of tax assessments as a result of any dispute, controversy or proceeding:

- (i) to the extent consistent with Subchapter C of Chapter 63 and the Regulations thereunder, the Company shall allocate any such assessment among the current and/or former Members of the Company for the “reviewed year” to which the assessment relates in a manner that reflects the current and/or former Members’ respective interests in the Company for that reviewed year based on each such Member’s share of such assessment as it would be if the Company amended the tax returns for such reviewed year and such Member incurred the assessment directly (using the tax rates reasonably determined by the Managing Member to be applicable), and
- (ii) each current and former Member to which such assessment relates shall pay to the Company such Member’s share of the assessed amounts, including such Member’s share of any additional accrued interest assessed against the Company relating to such Member’s share of the assessed amounts, upon thirty (30) days written notice from the Tax Representative requesting the payment.

The provisions contained in this Section shall survive the dissolution of the Company, the withdrawal of any Member from the Company or the transfer of any Member’s Membership Interest in the Company.

Is a Separate Pre-Closing Tax Indemnity Needed?

- “Pre-Closing Tax Period” means any taxable period (or portion thereof) ending on or before the Closing Date, including the portion of any Straddle Period ending on or before the Closing Date.
- “Pre-Closing Taxes” means Taxes of, or payable by, any Company or any Company Subsidiary for a Pre-Closing Tax Period, including (i) any Taxes of an Affiliated Group pursuant to Treasury Regulation §1.1502-6 or any analogous or similar state, local, or foreign law or regulation, (ii) any Taxes of any Person imposed on any Company or any Company Subsidiary as a transferee or successor, by contract or pursuant to any law, rule or regulation, and (iii) any Transfer Taxes.
- “Straddle Period” means any taxable period that includes but does not end on the Closing Date.

Requiring a Push Out Election

- The parties agree in good faith to timely make the Code Section 6226 election (or similar state/local election) in a form and manner reasonably approved by the parties with respect to any Tax assessed against the Company under Subchapter C of Chapter 63 with respect to a Pre-Closing Tax Period.
- Each party shall fully cooperate with and provide to Buyer as of the Closing Date (and shall keep current subsequent to the Closing Date), all information reasonably necessary for Buyer and the Company to comply with and timely make the "push out" election under Section 6226 of the Code with respect to any Tax assessed against the Company under Subchapter C of Chapter 63 with respect to a Pre-Closing Tax Period.

Backstop to the Push Out Election

- In the event that the Code Section 6226 push-out election is not effective for any reason, Seller agrees to indemnify Buyer and the Company for any Tax liabilities in respect of a “reviewed year” or portion thereof that is part of a Pre-Closing Tax Period.
- Any indemnification payment made under this paragraph shall be treated as a purchase price adjustment for Tax purposes.

Cooperation on Audits

After the Closing, each of Buyer, Seller, and the Company shall promptly notify each of the other parties in writing upon receipt of any written notice of any audit or examination by any Taxing Authority or any other judicial or administrative proceeding that relates to Taxes for which Seller could be liable pursuant to this Agreement (each, a “Tax Claim”).

Seller shall coordinate and cooperate with Buyer in all Tax Proceedings and Seller shall have the sole right to employ counsel of its choice and to control the defense of all such Tax Claims for which Seller could have any liability under this Agreement for the full amount of Tax payable with respect to such claim or proceeding (a “Seller Tax Contest Claim”), and shall bear the full cost of pursuing any such claim;

provided, however, that if Buyer or the Company could also have liability with respect to such Tax Claim, Buyer shall be entitled to participate in the defense of such Tax Claim, at its sole expense, with counsel of its choosing, and Seller shall not agree to the settlement of any such Tax Claim or proceeding that would have an adverse effect on Buyer, the Company or any of their respective Affiliates without Buyer’s consent, which shall not be unreasonably withheld or delayed.

Special Drafting for Partnerships that Cease to Exist

- “Pre-Closing Taxes” means Taxes of, or payable by, any Company or any Company Subsidiary for a Pre-Closing Tax Period, including (i) any Taxes of an Affiliated Group pursuant to Treasury Regulation §1.1502-6 or any analogous or similar state, local, or foreign law or regulation, (ii) any Taxes of any Person imposed on any Company or any Company Subsidiary as a transferee or successor, by contract or pursuant to any law, rule or regulation **(including, for the avoidance of doubt, Taxes imposed on the Company as a “former partner” pursuant to Regulations § 301.6241-3)** and (iii) any Transfer Taxes.

Questions & Thank You



Jonathan Stein

Talk to me about: **Tax Aspects
of Joint Ventures, Real Estate
and M&A Transactions**

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BBA Audit Risks: Issues for Buyers and Sellers

Teresa Abney
October 29, 2019



Due Diligence

Agenda

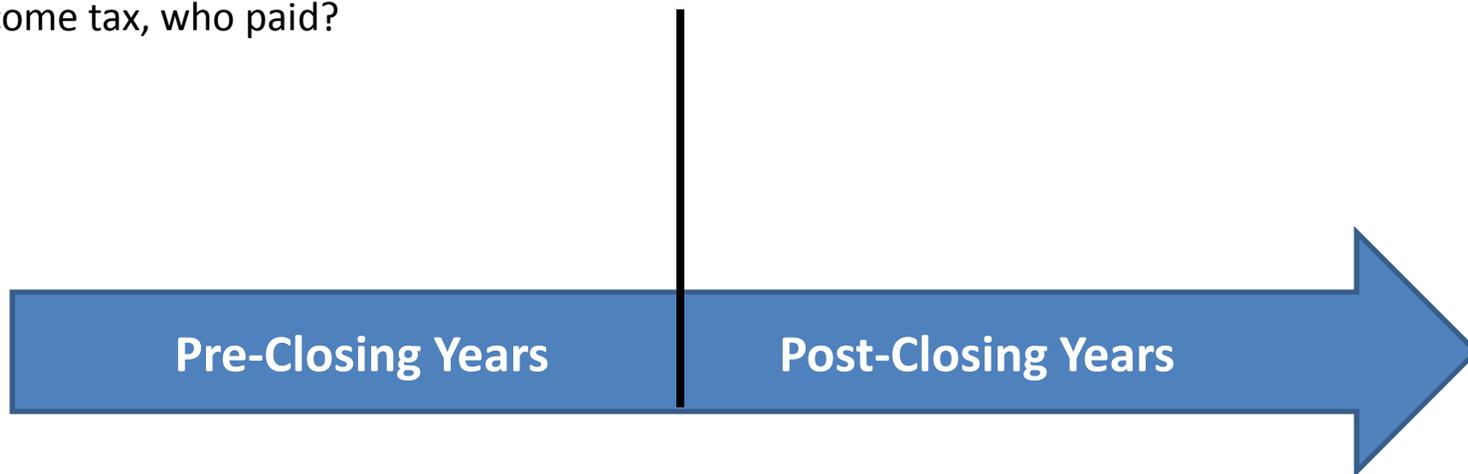
- Due diligence pre-BBA
- Due diligence generally under BBA
- Tips for buyers
- Tips for sellers

Due Diligence Pre-BBA

The way it was

If the IRS assessed additional income tax, who paid?

Closing



If the IRS assessed additional income tax in a Pre-Closing Year, the Pre-Closing Year Partners paid

If the IRS assessed additional income tax in a Post-Closing Year, the Post-Closing Year Partners paid

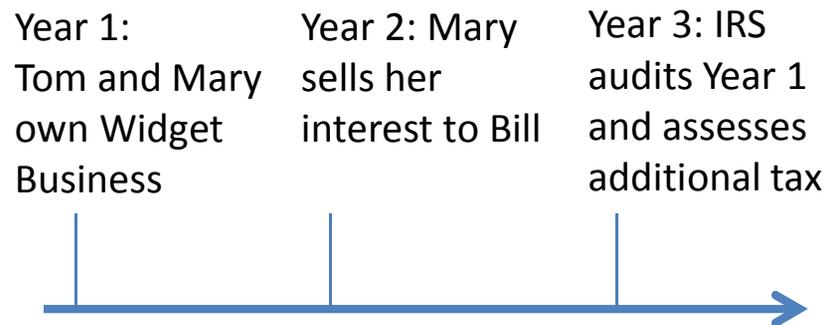
Due Diligence Post-BBA

Change: entity level tax liability

Under BBA, the partnership is liable for any resulting tax liability. Because the tax liability is now an entity-level liability, buyers can no longer ignore Pre-Closing income tax issues.

Due Diligence

Example: Who pays the tax?*



If Widget Business is a Corporation?

Tom and Bill

If Widget Business is a partnership subject to TEFRA?

Tom and Mary

If Widget Business is a partnership subject to BBA?

Tom and Bill

*As under the default rules (e.g., no indemnification, no push-out election, pull-in procedure)

Buyer's Due Diligence

Steps

Step 1: Identify the Pre-Closing years subject to BBA



Step 2: Review tax returns subject to BBA



Step 3: Review existing agreements



Step 4: Risk allocation

Buyer's Due Diligence

Step 1: Identify the Pre-Closing years subject to the BBA

- BBA applies to all tax years beginning after December 31, 2017
- Partnerships could elect in for tax years starting after November 2, 2015
§ 301.9100-11
- Certain partnerships can elect out of the BBA § 6221(b); § 301.6221(b)-1
 - Confirm that partnership was eligible to elect out
 - Confirm that partnership properly made the election for each Pre-Closing Year subject to the BBA

Buyer's Due Diligence

Step 2: Review tax returns and positions

- Similar review as if buying corporation
- Look for uncertain or aggressive tax positions

Documents to collect

- Tax returns
- Legal opinions on tax positions
- Prior audit closing letters

Buyer's Due Diligence

Step 3: Review existing agreements

- Partnership's and partner's relationships with partnership representative
- Is there any agreement to elect out of the BBA?
- Is there an agreement as to how any resulting tax will be paid?

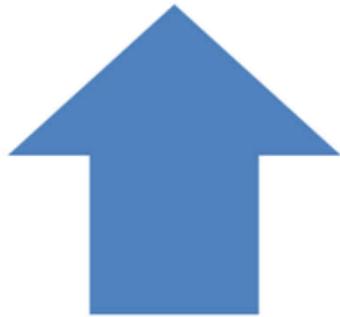
Buyer's Due Diligence

Step 4: Risk allocation

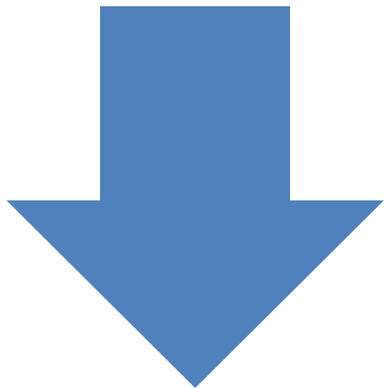
- Decide who pays incomes taxes arising from Pre-Closing years
- Decide how to shift liability to the seller

Seller's Due Diligence

Questions to consider



What is Seller's exposure for taxes arising from a Pre-Closing year?



If Seller has exposure, does it have any control of the audit?

Seller's Due Diligence

What is the seller's exposure for taxes arising from Pre-Closing year?

- Consider whether the seller is contractually obligated to pay tax resulting from an audit of Pre-Closing year
- Consider whether any agreements require or prevent the partnership from electing the push-out election
- Consider whether partnership likely to cease to exist after the sale

Seller's Due Diligence

Example

2018: Sue and Jack own equally own IT LP

2019: Jack sold his interest to Liz

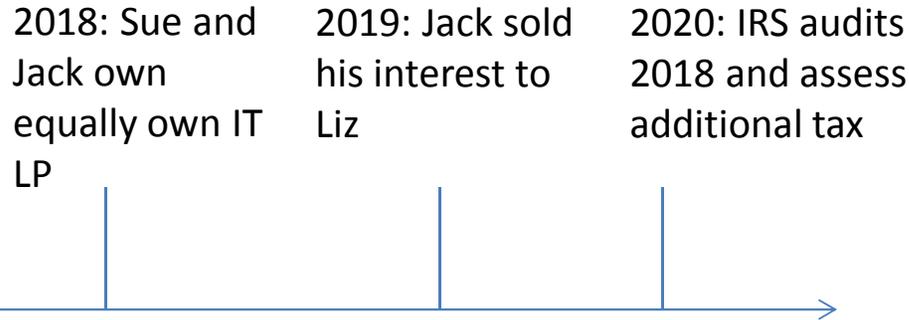
2020: IRS audits 2018 and assess additional tax



**Who
pays the
tax?**

Seller's Due Diligence

Example



Who pays the tax?

Imputed underpayment (default)	Push-out election	Amended return	Pull-in procedure
Mary and Bill	Tom and Mary	Tom and Mary	Tom and Mary

Seller's Due Diligence

Exposure if partnership ceases to exist

- If a partnership ceases to exist and there are no adjustment year partners, then the reviewed-year partners pay the tax **§ 6241(7); Treas. Reg. § 301.6241-3**
- A partnership ceases to exist when:
 - It terminates within the meaning of section 708(b)(1), or
 - The partnership does not have the ability to fully pay the tax due

Exposure only if:

- (1) Partnership ceases to exist
- (2) Seller was a partner during partnership's last tax year
- (3) No adjustment years partners

Seller's Due Diligence

Example

2018: Molly and Sam own equally own ABC LP

2018: Molly and Sam sell to XYZ Inc.

2019: XYZ Inc. dissolves

2020: IRS audits 2018 and assess additional tax

**Who
pays the
tax?**

Seller's Due Diligence

Example

2018: Molly and Sam own equally own ABC LP

2018: Molly and Sam sell to XYZ Inc.

2019: XYZ Inc. dissolves

2020: IRS audits 2018 and assess additional tax

Who pays the tax?

Molly and Sam

Seller's Due Diligence

Seller's right in future audits

- If seller has exposure, what rights does it have with respect to an audit of a Pre-Closing year?
- Seller should negotiate rights to:
 - Notice
 - Access to partnership information
 - PR submits modification information
- If possible, negotiate consent rights (e.g., whether settlement offer accepted or whether a push-out election is made)

Questions?

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