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Of Partnership Representatives And Push-Out Elections

By **Elizabeth McGinley and Steven Lorch** (June 25, 2018, 6:05 PM EDT)

This is the second of two articles by Bracewell LLP attorneys Elizabeth McGinley and Steven Lorch, discussing the practical implications for partners and partnerships of the new partnership audit rules under the Internal Revenue Code and the related proposed and final Treasury regulations. The first article can be found here.

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On Nov. 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for federal income tax purposes. The new rules, effective for audits of partnership tax years beginning on or after Jan. 1, 2018, generally allow the Internal Revenue Service to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level.

The Partnership Representative

Under the new rules, a partnership must designate a partner, or other person with substantial presence in the United States, to serve as the partnership representative. If the partnership representative is an entity, the partnership representative must appoint an individual, known as the designated individual, through whom it will act for all purposes under the new rules. The partnership representative has the sole authority to act on behalf of the partnership and legally bind the partnership with respect to federal income tax examinations and audits. No contractual arrangement, including any partnership agreement, can limit or alter this authority. Further, only the partnership representative, and no other partner or other person, may participate in any federal income tax examination with the IRS.

For most partnerships, designation of the partnership representative is made without significant negotiation. Very often, a controlling or majority partner is the natural choice, particularly if that partner has effective control over the operation of the partnership. In other partnerships, a minority partner responsible for day-to-day administration of the partnership or with the greatest knowledge of the partnership's business and operation may be best suited for the role. In certain situations, however, it can be difficult to identify any partner willing to accept the responsibilities of the partnership

representative. When the new rules were first signed into law, it was expected that many partnerships would outsource the partnership representative role to an outside adviser for a fee. Some commentators even believed a new industry for partnership representative services would emerge, although that has not yet occurred.

Under the new rules, a critical issue among partners often is how much authority to vest in the partnership representative, and whether to give the other partners a role in the partnership representative's decision-making process. Particularly if the partnership representative is a partner with effective control of the partnership or management responsibility for day-to-day operations, such partner may seek an unfettered right to make decisions with respect to partnership examinations and audits at its sole discretion. In response, other partners may request notice of the initiation of a partnership tax audit, and the right to be reasonably informed with respect to these matters by the partnership representative, as such rights and obligations are not mandated under the new rules. In addition, such partners may seek to impose an obligation on the partnership representative to consult with them on key decisions, determinations and elections related to a partnership tax audit, and may even ask for a prohibition on certain actions by the partnership representative without such partners' consent. However, the partnership representative should be cautious with respect to broad consent rights. Such consent requirements could result in a deadlock among partners, which could delay the orderly administration of a partnership audit or even cause the partnership representative to fail to act prior to a deadline imposed by the new rules or the IRS. An alternative approach is to put such key decisions, determinations and elections in the hands of the partnership's board or other governing body, although this may not necessarily eliminate the risk of deadlock or delay.

When drafting partnership agreements, partners often focus on procedures relating to the push-out election. If made, the push-out election causes audit adjustments to be allocated to the partners in the year under review, instead of the partners in the year the audit concludes and the assessment is made, so those that were partners in the year under review bear the economic burden of the adjustments. Timing is of the essence for making the push-out election. It must be made no later than 45 days after the IRS mails the notice of final audit adjustments to the partnership. Accordingly, the partnership representative will likely prefer to have full control over the decision to make such election, if not the authority in the partnership agreement to make the election in all instances — rather than seek the consent of, and potentially negotiate with, the other partners. The decision to make a push-out election, however, could materially impact the cash tax liability of the other partners and, therefore, such partners may negotiate for a consent right that will survive the partners' exit from the partnership.

Acquisitions and Sales of Partnership Interests

Prior to the application of the new rules, purchasers of partnership interests focused primarily on performing due diligence and obtaining representations and indemnification covenants with respect to non-income taxes assessed at the partnership level for pre-closing periods — taxable periods ending on or prior to the closing date of the acquisition. Purchasers generally were unconcerned about federal income tax assessed with respect to the partnership's income for pre-closing periods, as such taxes were payable by the direct or indirect partners of the target partnership, rather than by the partnership itself.[1] Further, prior to the new rules, if there were a federal income tax audit of a partnership with respect to a pre-closing period, any resulting assessment generally would be made on the former partners, and the purchaser of the partnership interest would be unaffected. The implementation of the new rules, however, exposes a purchaser of a partnership interest to liability for underpayment of federal income taxes with respect to partnership income in a pre-closing period beginning on or after Jan. 1, 2018. That is, following a purchaser's acquisition of a partnership interest, the IRS could assess an

imputed underpayment on the partnership for a pre-closing period to which the new rules apply. If the partnership does not make a push-out election, the purchaser would bear the economic burden of the underpayment, either because the partnership would satisfy the obligation with its own funds or the partnership would call capital from the then-current partners, including the purchaser, to satisfy the obligation. Accordingly, for partnership interest acquisitions after Jan. 1, 2018, purchasers should conduct due diligence for uncertain or aggressive positions taken by the partnership in determining its taxable income. In addition, purchasers should be certain that tax representations and covenant indemnification for pre-closing periods include coverage for federal income taxes on partnership income.

Although a purchaser of a partnership interest may prefer that the partnership make a push-out election, the seller may object for a number of reasons. First, the seller may seek to avoid any post-closing tax claims with respect to the partnership interest. This is particularly true if the seller intends to liquidate or otherwise terminate its activity after the closing and wants to avoid long-term exposure to additional costs with respect to the partnership interest sold. Second, the seller may prefer that the purchaser rely solely on the tax representations and covenant indemnification in the purchase agreement to cover the purchaser's share of an imputed underpayment. Such approach typically would allow the seller to negotiate the resolution of the indemnification claim directly with the purchaser. In contrast, if the seller were subject to the push-out election, it would be obligated to amend its tax return for a reviewed year in accordance with audit adjustments reported to it by the partnership after the closing. Moreover, as a practical matter, the seller may not be able to control the partnership's audit procedures and mandate the use of the push-out election in future years. At best, the seller may be willing to commit to use reasonable efforts to cause the partnership representative to make such election.

Alternatively, the seller may propose that the partnership employ the pull-in procedure following the sale of its partnership interest. Like the push-out election, the pull-in procedure would assess any underpayment determined in a federal income tax audit on the reviewed year partners. However, unlike the push-out election, the seller would not be required to amend its prior year tax returns or bear a higher rate of interest on the underpayment, but merely pay its share of the tax related to the audit adjustment and reflect the impact of such adjustments on future tax returns. Accordingly, while the seller would bear the cost of the audit adjustments made after the closing, it would not have the administrative burden of amending its tax return for the reviewed year.

Finally, the purchaser and the seller should consider the impact on future partnership audits if the partnership ceases to exist, including through the conversion to a disregarded entity. Recent U.S. Department of Treasury regulations addressing audits of partnerships that have ceased to exist allow the IRS to assess an imputed underpayment on the adjustment year partners — or, if there are no adjustment year partners, the partners for the last year for which a partnership tax return was filed — as if a push-out election were made. The IRS has discretion to determine when a partnership has ceased to exist, including when the business and operations of the partnership are terminated. The Treasury regulations, however, do not directly address whether an LLC classified as a partnership would cease to exist for this purpose if all its interests were acquired by a single purchaser, resulting in a conversion from a partnership to a disregarded entity for U.S. federal income tax purposes. Until these issues are addressed by future guidance, purchasers should consider mandating the push-out election for audits of pre-closing periods beginning on or after Jan. 1, 2018, to ensure that reviewed year partners bear the imputed underpayment. The seller, on the other hand, should recognize that it could be required to bear its share of the cost of an audit assessment on the partnership after the closing of the sale of the partnership interest, even without a push-out election, if the partnership terminates after the closing.

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[1] Purchasers, however, should note that some state and city taxing authorities impose an entity-level income or franchise tax on partnerships, such as the Texas gross margin tax or the New York unincorporated business tax. Accordingly, purchasers often obtained representations and indemnification covenants with respect to such state and local income taxes in a manner similar to non-income taxes imposed on the partnership.