Practical implications of TEFRA partnership audit rules repeal: Issues to consider now

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In brief

Recently released temporary regulations (T.D. 9780) provide guidance for electing to apply the new partnership audit rules for partnership tax years beginning after November 2, 2015. (*See* Tax Insights from Mergers and Acquisitions, Temporary regulations address election into new partnership audit regime (Aug. 8, 2016); *see also* Tax Insights from Washington National Tax Services, New law makes significant changes to partnership audit and adjustment procedures (Nov. 5, 2015).

Absent an election of earlier application, the new partnership audit rules take effect for tax years beginning in 2018. Under the new rules, the IRS generally will collect tax at the partnership level on adjusted partnership items at the highest corporate or individual rate in effect for the audited year.

This tax, however, is likely to be the 'wrong' amount and is likely to be borne by the 'wrong' partners. As discussed below, the statute offers partners some limited ways to right these wrongs — or possibly opt out entirely — but partners need to understand these exceptions well before an audit — even before acquiring an interest in a partnership — to take advantage of them.

The new partnership audit rules, enacted in 2015, raise many practical and technical questions that have yet to be answered. Significant administrative guidance and possibly Congressional action to supplement the new rules are expected. Given the delayed effective date and need for clarifying guidance, many partnerships have not yet analyzed the significant practical implications of the new rules. Prior to the effective date, however, partnerships and partners need to respond to the rules in their current form. We believe that it is advisable to start focusing on the impact of the new rules and plan accordingly.

This PwC Insight takes an in-depth look into what partnerships and their partners should be doing before the new rules take effect.

In detail

Background

The partnership audit and adjustment rules enacted as part of the Bipartisan Budget Act of 2015 and amended by the Protecting Americans from Tax Hikes Act of 2015 (the BBA audit rules) revolutionize the manner in which partnerships will be audited and related taxes will be assessed and collected for tax years generally beginning after December 31, 2017.

Beginning in 2018 (except with respect to partnerships electing earlier application), the so-called TEFRA partnership audit rules are repealed. Partnership audits and the assessment and collection of related taxes will be centralized at the

partnership level, and partners will have no statutory right to receive notice of, or to participate in, any partnership audit, appeal, or judicial review.

Any tax assessed will be collected at the partnership level and borne indirectly by the persons who are partners during the year of the partnership adjustment (not the year under examination), unless the partnership elects to 'push out' the adjusted partnership items to the persons that were partners in the year under examination (the push-out election). A decision to pay tax at the partnership level or to push out adjusted partnership items can affect materially the total amount of the tax and which partners bear the tax liability.

Under the TEFRA rules that have been in place since 1982, partnership items have been examined at the partnership level. But in stark contrast to the BBA audit rules, any resulting assessment and collection of tax under the TEFRA rules has been pursued at the partner level. Moreover, the TEFRA rules have provided partners with significant rights to notice and participation in IRS partnership audits, appeals, and judicial review. Partners generally do not bear tax liability for partnership-level adjustments without notice required by law and certain rights to participate in the proceeding.

Just as important, there currently is little or no risk that a taxpayer will bear more tax as a result of a TEFRA adjustment of a partnership item than the taxpayer would bear if audited directly. A taxpayer today bears the burden of taxes with respect to partnership items only for the years in which the taxpayer was a partner in the audited partnership, and the amount of tax takes full account of the taxpayer's attributes, such as marginal tax rate, limitations, and available losses and credits.

BBA changes

The BBA's radical changes to partnership audit and adjustment procedures will affect the manner in which partnerships and partners assess and allocate the risk of uncertain partnership tax positions. Such actions will take on additional importance with an expected increase in IRS audits of partnerships. The BBA audit rules were enacted to streamline IRS audits of large and tiered partnerships and to reduce the administrative burden with respect to the assessment and collection of underpayments determined as a result of partnership audits. A more centralized audit and collection process is likely to result in an increase in partnership audit activity as the rules are phased in.

Observation: Complicating matters further are numerous unanswered questions that will have to be resolved by administrative guidance or statutory changes. Well before 2018, partnerships, partners, future partnership representatives, and prudent advisors will want to monitor those developments and begin to consider the impact of the BBA audit rules on the terms of partnership agreements and the due diligence and negotiation strategies of all parties involved.

Elevated role of a single person: the partnership representative

Every partnership subject to the BBA audit rules will have a person who will act as the 'partnership representative.' Any person with a 'substantial presence in the United States' may be the partnership representative. That person can be, but does not need to be, a partner in the partnership. A partnership generally will designate its own representatives under procedures to be prescribed by the IRS. If a partnership fails to designate a representative, the IRS is empowered to designate the partnership representative for the partnership.

The partnership representative has the sole and exclusive authority to act on behalf of the partnership and to bind all partners in respect of partnership matters subject to the BBA audit rules. This authority includes representing the partnership during an audit, negotiating and agreeing (or disagreeing) to settle with the IRS, and seeking judicial review of an IRS adjustment. The partnership representative apparently is the only person who has the authority to make (or not make) the push-out election or to identify partner tax attributes that can reduce a partnership's effective tax rate, as discussed below.

Observation: The BBA audit rules, unlike the TEFRA rules, do not provide partners with any rights to be notified at key stages during a partnership audit or to participate in the audit, appeal, or later judicial review. Without notice, the partnership representative can bind partners to whatever outcome results from partnership proceedings. At a minimum, partners may want to negotiate some form of notification rights and oversight rights — such as participation, approval, consultation, or veto rights with respect to the partnership representative's authority. Partnership representatives may want the same to reduce the risk of internal disagreements. They may also seek to be indemnified for any losses while performing duties as agreed.

If the partnership representative is not a partner, the terms of the agreement between the partnership and its partnership representative may have to be negotiated and documented separately from the

partnership agreement. Rights and responsibilities provided by default under state partnership law, such as fiduciary duties, may not extend to the separate agreement.

Choices under the BBA audit rules

How the BBA audit rules will affect a partnership and its partners will depend, in significant part, on choices the partnership, the partnership representative, and the partners make, or fail to make. Choosing not to address the BBA audit rules is in fact a choice to apply the default rule to adjusted items: partnership-level taxation at the highest effective tax rate without reduction. The choices presented by the rules include:

- the choice, if a partnership is eligible, to elect out of the BBA audit rules, in which case partners would be separately audited, assessed, and taxed on their allocable share of partnership items;
- the choice to pay tax on the adjusted items at the partnership level which would be calculated at the highest effective tax rate (i.e., the default rule);
- the choice to provide additional information about the partners' tax attributes to the IRS in order to reduce the tax under the default rule;
- the choice to reduce tax under the default rule if affected partners amend their own tax returns; and
- the choice to avoid the default rule by electing to 'push out' the adjusted items to the persons who were partners in the reviewed year (i.e., the push-out election).

Election out of the BBA audit rules

A partnership that issues no more than 100 Schedule K-1s in a given tax year can elect out of the BBA audit rules for the tax year, provided that its partners are only individuals, C corporations, S corporations (looking through and counting each shareholder as a separate partner), estates of a deceased partner, or foreign entities that would be C corporations if they were domestic (collectively, permitted partners). This election generally would subject each partner to separate examination, assessment, and collection under procedures as they existed before the TEFRA rules were enacted. It multiplies the number of administrative proceedings and subjects each partner's tax year to a potentially expansive audit.

Observation: In auditing a partner directly, the IRS is not limited to focusing on partnership items. As a result, electing out of the BBA audit rules is not necessarily the most desirable course of action. Partners might try to mitigate some of the costs of this alternative by agreeing to coordinate defense efforts of any tax proceedings relating to partnership items. However, any determination or settlement with respect to one partner would not, as a matter of right, be available to the other partners.

Electing out of the BBA audit rules may be a desirable option with respect to strategic and other corporate joint ventures consisting of a few corporate partners. The election generally is not expected to be available in tiered partnership structures, commonly used by private equity, real estate, and other alternative investment funds, and will not be available for partnerships with more than 100 partners. The election is made with a timely filed partnership return for each qualifying tax year. Partnerships wanting to preserve this option should consider restricting transfers of partnership interests to, or admissions to the partnership of, partnerships, trusts, and other persons that would prevent a partnership from electing out of the BBA audit rules.

The default rule: IRS examines, assesses, and collects tax at the partnership level

Under the default rule, the IRS examines a partnership's items of income, gain, loss, deduction, or credit for a partnership year (the reviewed year). Adjusted items are netted, and the partnership must pay tax in the 'adjustment year,' which generally is the year in which the IRS sends the notice of final partnership adjustment (or in the case of an adjustment under judicial review, the year in which the court's decision becomes final).

The tax is imposed on the net adjustment at the highest rate then in effect for individuals or corporations. Partners in the adjustment year effectively will bear the tax costs resulting from adjustments to the reviewed year, even though those partners may not have been partners in the reviewed year. The statute refers to the partnership-level tax amount determined under the default rule as the 'imputed underpayment.'

The manner in which the imputed underpayment is calculated and taken into account (and the approach taken with respect to overpayments) can result in a materially different overall tax liability than would have resulted had the partnership properly included the adjusted items on its partnership tax return for the reviewed year (the 'correct return position'). (The 'correct return position' concept was developed by the New York State Bar Association Tax Section in its 'Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015' to

illustrate the BBA audit rules and their implications.)

For example, if partners' distributive shares of partnership income or other items are adjusted, the imputed underpayment includes only the adjustment that increases the imputed underpayment (e.g., the increase to one partner's distributive share of income) and ignores the corresponding decreases (e.g., decreases to other partners' distributive shares of income). The imputed underpayment also does not automatically take into account partner-level tax attributes and status, such the tax-exempt status of a partner, which could reduce the overall tax liability. As discussed below, the imputed underpayment can be reduced by some, but not all, partner-level tax attributes and tax status.

Observation: In short, the default rule can change the amount of tax and shift the economic burden of the tax to different partners. These problems may outweigh the convenience of the default rule, but there may be circumstances that favor choosing the default rule. It may be preferable when the imputed underpayment is relatively small or the partner group is relatively stable and the imputed underpayment is not materially different from the tax calculated under the correct return position.

The default rule also may be preferable even if those conditions do not exist. The IRS is limited to examining partnership items in the reviewed year. The imputed underpayment takes into account only those adjusted partnership items for the reviewed year, and interest is charged on the imputed underpayment at the normal underpayment rate. Some of the alternatives discussed below leave open the possibility that the IRS can review other aspects of the separate tax returns of partners in the reviewed year. In addition, tax underpayments determined under the push-out election (discussed below) take into account the effect of pushed-out adjustments on the years between the reviewed year and the adjustment year. Also, the rate of underpayment interest is increased by two percentage points if the partnership makes the push-out election.

The BBA audit rules do not require partnerships to choose an approach to addressing adjusted partnership items in a reviewed year until the adjustment year. That timing permits the partnership representative, in its discretion or as guided by terms negotiated with partners, to weigh the relative pros and cons of the default rule and alternatives (discussed below) in light of the facts and circumstances in the year under review. There is no requirement for consistent application of the alternatives from year to year.

The default rule with adjustments to account for partner tax attributes

Under procedures to be established by the IRS, a partnership will be able to reduce the imputed underpayment under the default rule to the extent the partnership can demonstrate that an adjusted item is allocable to a partner that is tax exempt or a C corporation, or is capital gain or qualified dividend income allocated to an individual.

The IRS has the authority to consider other factors that would reduce the imputed underpayment. Therefore, partnerships may want to require direct and indirect partners to provide sufficient information necessary to take full advantage of any future guidance and to apportion the cost of failing to do so only to partners who refuse to supply such information.

The default rule with adjustments to account for amended partner returns

The payment due from a partnership under the default rule also can be reduced if one or more partners file amended returns for the year under examination, the returns take into account all adjustments properly allocable to such partners, and payment of any tax due is included with the amended return. In general, the filing of amended returns by some but not all of the partners affected by adjustments should reduce the payment due under the default rule. However, if the adjustment reallocates the distributive share of any item from one partner to another, all partners affected by the adjustment must file amended returns in order to reduce the tax.

Observation: Partnerships seeking to benefit from this alternative should consider the practical implications. For example, convincing or contractually obligating direct and indirect partners to file amended returns and to satisfy any resulting tax liability may be a challenge. The IRS may not be limited to reviewing only the partnership adjustments on the amended returns. Partnerships also will have to prove that their partners filed the requisite amended returns. Absent any guidance on what the IRS will require as proof and the timing of that proof, partners may want to agree simply to respond timely to information requests from the partnership representative until procedures can be developed. They also may want to address whether and when partners can be required to file amended returns and the consequences for failing to do so.

The push-out election

As an alternative to having the partnership pay the imputed underpayment under the default rule,

a partnership may elect within 45 days of the date of the notice of final partnership adjustment to flow through or 'push-out' items adjusted at the partnership level to the persons that were partners in the reviewed year (the push-out election). The push-out election generally prevents adjustment-year partners from bearing tax liability for reviewed years unless they also were reviewed-year partners.

If a partnership makes the push-out election, the partnership will report the adjusted partnership items to the persons who were partners in the reviewed year, regardless of whether they remain partners in the adjustment year. The reviewed-year partners will calculate the additional tax due, if any, for the year under examination and the years from the year under examination to the year of the adjustment by reference to their individual tax attributes. Any additional tax must be reported and paid in the year the persons are notified by the partnership of the adjusted items; no amended returns are filed. It is not entirely clear what the IRS can do, or would do, if some of the reviewed-year partners fail to satisfy fully their tax liability resulting from the pushed out adjustments. Partnerships and partners may want to address in their negotiations potential risks that could arise from a partner's failure to satisfy obligations under a push-out election.

It is not clear whether adjustments pushed out by a lower-tier partnership can be pushed out by an upper-tier partnership. The BBA audit rules address only the statement to be provided to the direct partners if the partnership makes a push-out election and do not address how an upper-tier partnership should treat any such statement.

Observation: It would be helpful if the push-out election could be applied through the partnership tiers to the ultimate taxpayers; however, the staff of the Joint Committee on Taxation arguably concludes otherwise, stating that the upper-tier partnership will pay 'the tax attributable to adjustments with respect to the reviewed year and the intervening years, calculated as if it were an individual.' (Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015* (JCS–1–16), March 2016, p. 70.) IRS officials have expressed support for this interpretation. Partnerships that own interests in other partnerships should consider the consequences that would result from an entity-level tax on adjusted items pushed up by a lower-tier partnership but that cannot be pushed out to ultimate taxpayer partners.

The push-out election mitigates potential distortions caused by the default rule by requiring the reviewed-year partners to bear the tax liability for the reviewed year and to determine that tax liability by taking into account their actual tax attributes. The election, however, comes with a cost. The underpayment interest rate for the tax deficiency is increased by two percentage points. In addition, the reviewed-year partners will have to account for additional tax liability for the years between the reviewed year and the adjustment year that result from adjustments to tax attributes in such years that stem from the pushed-out items.

Consider potential amendments to the terms of partnership agreements

The threat of entity-level taxation and the possibility of increased IRS audit activity should encourage partnerships and their partners to reconsider tax matters provisions in partnership agreements. Tax matters provisions negotiated under the TEFRA rules commonly afford discretion to the tax matters partner to take tax positions and to manage partnership tax audits, appeals, and litigation — sometimes with notice, participation, and consent rights granted to partners and sometimes not. Partners' rights to notice and participation are supplemented as a matter of TEFRA law. In stark contrast, partners have no rights in a partnership proceeding under the BBA audit rules.

At a minimum, provisions in existing partnership agreements that address TEFRA audit procedures should be revised to account for the repeal of the TEFRA audit rules for years beginning no later than January 1, 2018, and revised to address the BBA audit rules. The TEFRA audit provisions should be preserved for pre-2018 years that are still subject to audit through 2021 or longer (depending on any extensions to the statute of limitations).

Partners and partnerships should, however, consider amendments that would designate a partnership representative and address whether, and to what extent, partners will receive notice of and rights to participate in (at least indirectly) BBA audit proceedings. If the partnership representative is not a partner, additional steps need to be undertaken to define and enforce the scope of the partnership representative's relationship with the partnership and its partners.

Observation: Partnerships and their partners will have to balance preserving discretion that is frequently afforded tax matters partners in current partnership agreements and more detailed rules to address the new regime. On one hand, some degree of centralized

control may be desired to streamline a partnership's response to a partnership audit and to navigate timely uncertainties embedded in the BBA audit rules, new IRS guidance that will be forthcoming, and possible changes in the law. On the other hand, partnerships, partners, and partnership representatives may want to agree on key decisions or operating principles in advance, keeping in mind that, absent such agreement, the partnership representative will have the exclusive authority to act on behalf of, and bind, the partnership and its partners.

Topics that would be desirable to address in partnership agreements include:

Choose the manner in which the BBA audit rules are applied

- Partners and partnership representatives may want to specify, in advance, the manner in which the BBA audit rules will be applied, the scope of discretion afforded the partnership representative, and participation and consent rights of the partners. For example, provisions might:
  - Address whether and when an eligible partnership elects out of the BBA audit rules and, in that event, establish ground rules for cooperation and information sharing between partnerships and partners;
  - Require the default rule to be applied for imputed underpayments under a specified amount and the push-out election to be made for imputed underpayments at or over that amount;
  - Address the level of diligence the partnership representative must exercise to identify partner tax attributes that can reduce an imputed underpayment and whether and when partners are required to file amended returns;
  - Establish timing and diligence requirements for partners to respond the partnership representative's reasonable requests for information; and
  - Assign responsibility for those partners failing to cooperate within agreed parameters.

Fund and allocate partnership tax liability

- Address the manner in which partnership tax liability under the default rule will be funded, and allocate that liability among the partners in various circumstances, including:
  - some adjustment-year partners were not partners during the reviewed year;
  - the partnership has insufficient assets to pay the tax (or, if additional contributions from the partners are anticipated, some partners have insufficient assets);
  - the partnership ceases to exist before partnership-level tax is due; and
  - partnership tax liability is caused by one or more partners failing to file amended returns to account for adjusted partnership items or failing to satisfy fully tax liability resulting from amended partner returns or a push-out election.
- Consider requiring partners to indemnify the partnership for any partnership losses resulting from the partners' failure to fully take into account adjusted items at the partner level; consider extending any such indemnification obligation to survive for a period of time (perhaps taking into account relevant statutes of limitation) after a partner retires from the partnership or sells its partnership interest.
- Consider apportioning the partnership tax liability in a manner that takes into account any partner tax attributes that reduce a partnership tax liability.

Tiered partnerships

- Address whether and how information relevant to a lower-tier partnership is provided by partners of an upper-tier partnership.
- Address the effect of a push-out election that may stop at the upper-tier partnership, imposing liability at that level.

Transfers of partnership interests

- If a partnership intends to elect out of the BBA audit rules, consider restricting transfers of partnership interests and admissions of new partners to only partners that will preserve the partnership's ability to elect out.

Procedural matters

- Consider establishing qualifications for the partnership representative and terms for removal of, and resignation by, the partnership representative.
- Address the obligations of the partnership representative and the partners (including indirect

partners) to seek or provide partner tax attributes or other information that can reduce the partnership's imputed underpayment under the default rule.

- Address the obligations of former partners, the partnership representative, and partnerships to cooperate (e.g., by providing notice to partners and former partners at key stages of partnership proceedings, sharing information, filing amended returns, taking into account pushed-out adjusted partnership items) with respect to reviewed years in which the former partners were partners.
- Consider limiting the ability of the partnership representative to make relevant elections, to settle issues, or to have unfettered discretion in pursuing judicial review without partner participation.
- Consider providing authority to amend the BBA audit rules provisions, and require the partnership representative and partners to cooperate in good faith when additional guidance is issued by the IRS or when the BBA audit rules are amended by Congress.
- Prevent or require a partnership representative to elect early application of the BBA audit rules.

Other considerations

- In addition to, or in lieu of, more detailed provisions, consider generally requiring the partnership representative and partners to take action (including accepting responsibility for their shares of tax liability) that would reach the correct return position to the extent possible.
- In anticipation of heightened IRS audit activity and the risk of partnership-level tax, partners may want to agree on some degree of diligence regarding material, uncertain partnership tax positions, including, for example, a minimum level of documentation or a minimal level of comfort (e.g., substantial authority, more likely than not).

Due diligence to consider when entering or exiting partnerships

The BBA audit rules radically depart from the TEFRA rules on substantive and procedural grounds. Under the default rule, the assessment and collection of tax at the partnership level in the adjustment year practically guarantees that the collected tax will both vary from the tax that would have been imposed under the correct return position and be borne by a different mix of partners (unless there has been no change in partners during and between the reviewed year and the adjustment year). The centralization of partnership audit and collection procedures is expected to increase IRS audits of partnerships. Persons considering entering or exiting partnerships should consider the impact of these developments.

TEFRA or BBA audit rules?

For partners entering new or existing partnerships in the short-to-mid-term, the first question for now (and until the rules become mandatory for all tax years) is whether the partnership has elected, or can elect, into the BBA audit rules. If not, current-law TEFRA and electing large partnership rules will continue to apply. Given the dramatic difference between the two sets of rules, partners may want to negotiate representations and warranties to reduce the risk for surprises.

Taxes for periods prior to entering or exiting a partnership

Participants in merger and acquisition (M&A) transactions, such as buyers of partnership interests (and resulting partnerships from partnership mergers and divisions) should add to their due-diligence list the potential liability for prior-period income taxes and execute that diligence in a manner similar to the manner in which prior-period taxes are 'diligenced' in corporate M&A transactions. Corporations are, and partnerships may be, exposed to uncertain, entity-level tax positions.

The diligence of partnership M&A transactions may warrant further detail. As indicated above, the partnership representative has the exclusive authority (unless contractually restricted) to accept, to mitigate, or to avoid entity-level taxation in the adjustment year. A new partner has potential tax risk for all open partnership tax years subject to the BBA audit rules preceding and including the year in which the partner purchases an interest in the partnership.

The mere fact that a partnership representative is contractually obligated to make a push-out election (to avoid entity-level taxation), but fails to do so, does not absolve the partnership from entity-level taxation under the default rule or the buyer from bearing indirectly a portion of the resulting tax. Even if a partnership representative makes the push-out election, tax distribution or similar provisions in a partnership agreement may cause buyers to indirectly bear a share of taxes for prior periods. In short, risks for prior-period, partnership-level taxes presumably will become a standard topic of negotiation between buyers and sellers of partnership interests.

A buyer of a partnership interest also may want to go beyond negotiating a seller representation and indemnity. For example, a buyer may want to diligence the identity, reputation, and qualifications of the partnership representative and to review provisions in the partnership agreement addressing the BBA audit rules, including provisions that may require or prevent the partnership representative from making a push-out election. A buyer also may want to understand whether and when it will be obligated to file amended separate returns for reviewed years.

Observation: A buyer of an interest in a tiered partnership structure may have additional concerns. It is not clear that adjusted partnership items for which a lower-tier partnership makes a push-out election can be pushed out by an upper-tier partnership to its partners; the IRS informally has signaled that a limit on an upper-tier partnership's ability to further push out a lower-tier partnership's adjusted items may be desirable from the IRS's perspective. Until that issue is clarified, buyers may want to review upper-tier partnership agreements (or request partnership agreement amendments) for terms that apportion the effect of any pushed-out tax liability that is borne by the upper-tier partnership.

Issues for sellers

For tax years beginning in 2018, a seller needs to understand who controls the push-out election for any years in which it was a partner. If a seller cannot prevent the partnership from making the push-out election for a reviewed year during which the seller was a partner, the seller may want to negotiate for notice and participation rights for those reviewed years.

Observation: Sellers of partnership interests for tax years prior to 2018 may consider trying to use the statute to their advantage, by requiring the partnership to elect into the BBA audit rules for taxable years beginning after November 2, 2015, and obligating itself to apply the default rule. Well-advised buyers, however, may have a different view.

Notice and participation rights

As highlighted above, partners do not have any statutory rights to notice or participation in partnership proceedings under the BBA audit rules. Buyers may want to investigate whether there are any contractually enforceable notice and partnership rights between the partnership representative and the partners. Relevant provisions may not be located in the partnership agreement, particularly if the partnership representative is not a partner. If no such rights exist, buyers may want to raise the issue with the partnership representative and other partners. Sellers may want to ensure that their notice and participation rights for reviewed years survive after they sell their partnership interest.

Transfer restrictions to preserve the ability to elect out of the BBA audit rules

A partnership seeking to preserve its ability to elect out of the BBA audit rules may restrict transfers to partners that would prevent the partnership to elect out. Partners entering and exiting partnerships need to analyze how such transfer restrictions could affect their liquidity on exit.

Special considerations

Tax-exempt partners

Special considerations apply to tax-exempt partners, which under the BBA audit rules could bear a portion of the cost of partnership-level taxes that they would not bear if adjusted partnership items were pushed out to the partners.

Tax-exempt partners understandably would want to be no worse off under the BBA audit rules than under the existing regime. They may want, for example, to require the partnership representative to make the push-out election for all material adjusted partnership items. For adjusted partnership items that are not pushed out, they may want to negotiate for partnership agreement provisions that apportion to them the benefit of any reduction in the imputed underpayment attributable to their tax-exempt status. It is not entirely clear how that apportionment would be implemented under the existing BBA audit rules, but future IRS guidance may address that question.

Contractual partnerships

The advent of partnership-level taxation adds to the potentially adverse consequences of unanticipated tax partnerships. Contractual arrangements may be classified as partnerships (even when no entity exists for state, local, or foreign-law purposes) if the terms indicate that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of [an] enterprise." *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

An unexpected contractual partnership likely will be subject to entity-level taxation by default, meaning, as a practical matter, that the unsuspecting partners likely will bear liability for the tax unless they anticipate that risk in advance. Parties to cost-sharing agreements or other complex contractual arrangements that could potentially be classified as partnerships should consider in their agreements disavowing any intent to form a tax partnership and either protectively

electing out of the BBA audit rules (if eligible) or protectively naming a partnership representative and addressing the issues discussed above.

Potential increase in partnership audit activity and the economic and accounting impact of uncertain tax positions

Partnerships may want to reconsider previous 'substantial authority' positions taken in the past in light of the cash flow and potential accounting implications of entity-level taxation. Although the issue is not clear and will depend on the outcome of future legislative and administrative actions, partnerships subject to the BBA audit rules may need to consider tax accounting, including the accounting treatment of uncertainties. Some partnerships therefore may wish to revisit their level of comfort with respect to material tax positions and document material tax positions in anticipation of possibly increased IRS audit activity.

State and local taxes

State and local income tax (SALT) rules often, but not always, mirror federal income tax rules. It remains to be seen how -- or when -- state and local governments will adapt to the BBA audit rules. The nonconformity of state and federal rules in this area may present pitfalls or offer opportunities. If state and local taxes are material, partnerships may wish to consult SALT specialists.

The takeaway

As noted above, the government's interpretation of the BBA audit rules and possibly even the statute itself could change significantly before the rules become mandatory. Nevertheless, informed partnerships, partners, future partnership representatives, and prudent advisors will not wait on the government and will begin to consider the risks and benefits associated with the BBA audit rules.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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