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The New Partnership Audit Rules, Part 6: The Impact on Purchases and Sales of Partnership Interests

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This is the sixth installment of Bracewell Tax Report articles describing the new rules applicable to partnership audits under the Internal Revenue Code and the related proposed and final Treasury regulations. Each installment focuses on certain aspects of these rules and the practical implications to partners and partnerships, particularly as they relate to negotiating and drafting partnership agreements.

On November 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). The New Rules, effective for audits of partnership tax years beginning on or after January 1, 2018, generally allow the IRS to adjust items of income, gain, loss, deduction or credit of a partnership, and collect any resulting underpayment of tax, at the partnership level. Click ***here*** for a general description of the New Rules.

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 taxable periods ending on or prior to the closing date of the acquisition (Pre-Closing Periods). 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, would expose 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 January 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. If the partnership does not make a Push-Out Election, the purchaser would bear the economic burden of the underpayment, either because the partnership satisfies the obligation with its own funds or the partnership calls capital from the then-current partners, including the purchaser, to satisfy the obligation. Accordingly, for partnership interest acquisitions after January 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 sure that tax representations and covenant indemnification for Pre-Closing Periods include coverage for federal income taxes on partnership income.

Purchasers also can request that the partnership make a "***Push-Out Election***" with respect to any federal income tax audit adjustments with respect to Pre-Closing Periods. The Push-Out Election effectively requires the partners in the year subject to audit (the Reviewed Year) to bear the cost of the underpayment. The seller, however, may object to a Push-Out Election for a number of reasons. First, the seller may seek to avoid any post-closing tax claims with respect to the partnership interest, particularly 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 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 seller were subject to the Push-Out Election, it would be obligated to amend its prior year tax returns 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 partner 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.

Finally, the purchaser and seller should consider the impact on future partnership audits if the partnership ceases to exist, including through the conversion to a disregarded entity. Recent Treasury regulations addressing audits of partnerships that have ceased to exist allow the IRS to assess an imputed underpayment on the partners for the year the audit concludes and the assessment is made (the Adjustment Year) (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 of its interests were acquired by a single purchaser, resulting in a conversion from a partnership to a disregarded entity for 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 January 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.

Our next and final installment relating to the New Rules will discuss open issues and questions that remain unanswered under the New Rules.

[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. Purchasers should obtain representations and indemnification with respect to such state and local taxes in a manner similar to non-income taxes imposed on the partnership.