The BBA Is Coming

Are You and Your Clients Prepared?

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Why Here? Why Now?

- Partnerships are among the fastest growing types of business entity.
- Current rules for the audit of partnerships and LLCs, particularly larger ones, are among the most complex in the Tax Code.
- TEFRA audit procedures considered ineffective.
  - Partners may participate in proceedings in their own capacities;
  - IRS must collect deficiencies from partners, often collecting little or no tax;
  - Small partnerships (<=10) excluded.
- Tiered partnerships, in particular, have created nightmares for IRS auditors.

Who Will Be Affected By The BBA?

- Any person or entity that is, *or becomes*, a partner in a partnership or a member in an LLC with a taxable year beginning on or after January 1, 2018.
- Audits of prior tax years remain subject to TEFRA audit procedures.
- Since pre-2018 audits remain a possibility, partnership or LLC operating agreements must account for both.

Common Client Examples:

- Companies held by families with agreeable family dynamics:

- Companies held by families with discord and/or competing interests:

Common Examples, cont.:

- Companies held by unrelated parties where ownership interests regularly change hands:

The Point Being…

- Different arrangements implicate different structural considerations.
- There is no "one size fits all" drafting panacea.

How Will Clients be Affected?

TEFRA (old regime)

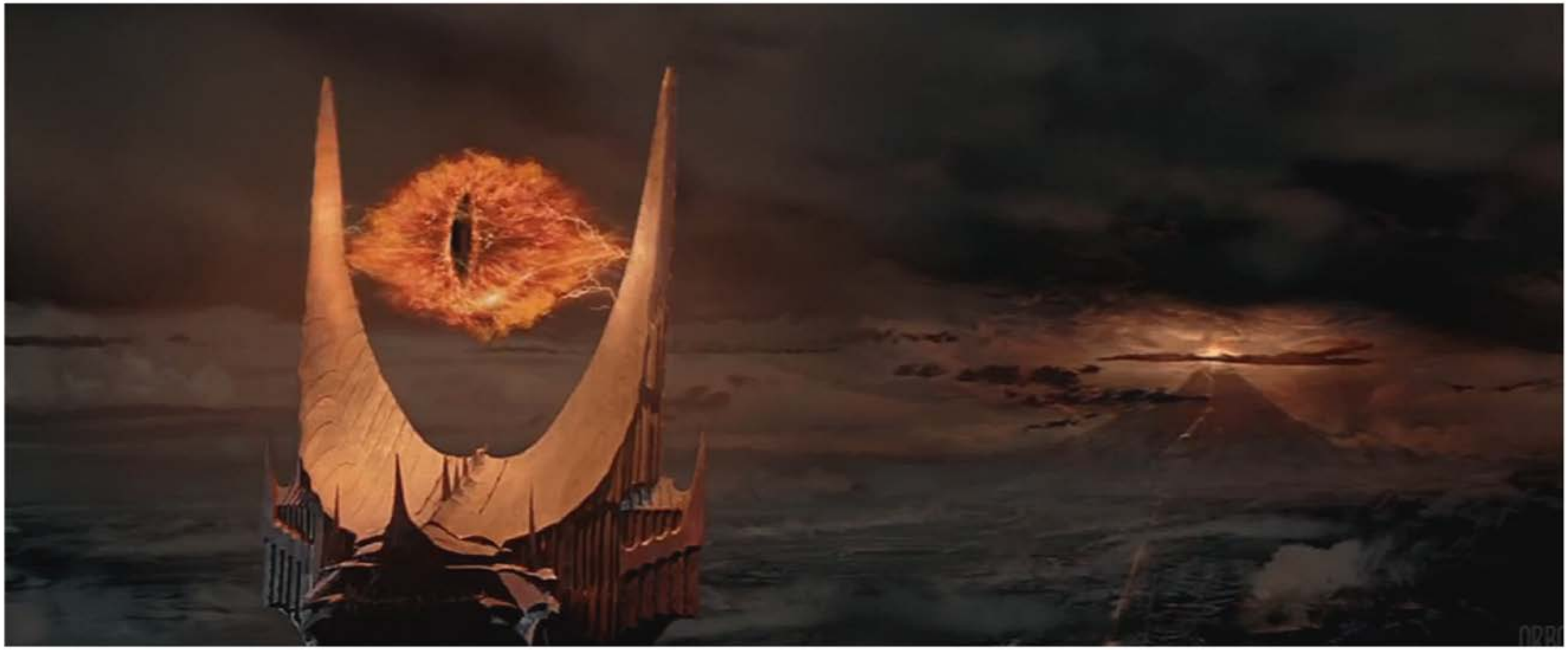
- Partners in tax year under audit responsible for underpayment.
- Tax calculated at partner level.
- Tax Matters Partner ("TMP") and "notice partners" allowed to represent partnership and participate in audits.

BBA (new regime)

- Partnership in "adjustment year" responsible for underpayment.
- Tax calculated at highest rates in effect for adjustment year.
- Partnership representative is sole representative and point of contact for communications between the partnership and the IRS.

One Partnership Representative to Rule Them All

- … And in the Darkness Bind Them



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Partnership Representative - Selection and Actions

- PR must be appointed *on each annual return*.
- PR selection requires thoughtful consideration because the PR is almost unremovable once appointed.
- What happens if no PR selected by partnership (or named on return), IRS gets to choose.
- PR may (prudently) require indemnification for its actions or be unwilling to serve.
- Consider requiring require notice and participation obligations and a fiduciary standard.
- If possible, use an entity PR and designate an individual to act on behalf of the entity PR .

Power to the Partnership?

- According to Treasury officials, power vested in Partnership Representative to make significant decisions and bind partnership is being delegated to the partnership through the terms of the partnership agreement.
  - *"It's handing over the power back to the private sector and saying that the private sector is best equipped to understand their business needs and concerns. "They should contract around things and they should protect themselves without the government interfering."*
- Takeaway:
  - Default is significantly enhanced authority vested in the PR.
  - Provides another compelling reason why partnership/LLC agreements need to be amended if partners desire to scale back authority or build in safety mechanisms for decision making or for removal and replacement.
  - **BUT:** Proposed Regulations provide that the IRS is not bound by the PR provisions of the partnership agreement.

How Do Clients Avoid This Quagmire?

- "*Eligible*" partnerships can **"opt out"** of the new regime altogether, with election on annual return.
  - Requires proactive steps by the partnership representative.
- Partnership is eligible to opt out if 100 or fewer "eligible" partners
  - Includes individuals, C or S corporations, eligible foreign entities, estates of deceased partners
  - Excludes: lower-tier partnerships, trusts, non-eligible foreign entities, disregarded entities, nominees, etc.
- If valid opt-out election made, audit is conducted at partner level. But who should bear audit and compliance defense costs?

… And If You Can't Avoid Altogether

- If not eligible to opt out, partnerships can seek "**modification**" from the IRS that allows a closer matching of income and deductions
- Partnerships can also "**push out**" tax to persons/entities who were partners during the reviewed year:
- Both procedures require proactive steps by the partnership representative.
- Modification and push out require action within **270** and **45** days respectively after receipt of certain IRS notices.

Importance of Modification Procedures

- BBA applies *highest federal rate* (currently 39.6%) for the "reviewed year" by default.
- Effect can be to turn capital gain (and other normally lower rate) adjustments into deficiencies taxed at top ordinary income rate.
- Modification allows partnership and partners to take advantage of regular rates applicable to adjustments.
- Partners may want to contractually ensure they are not stuck with highest rate (even if taxed at partnership level) by requiring PR to request modification.

Importance of Push Out Election

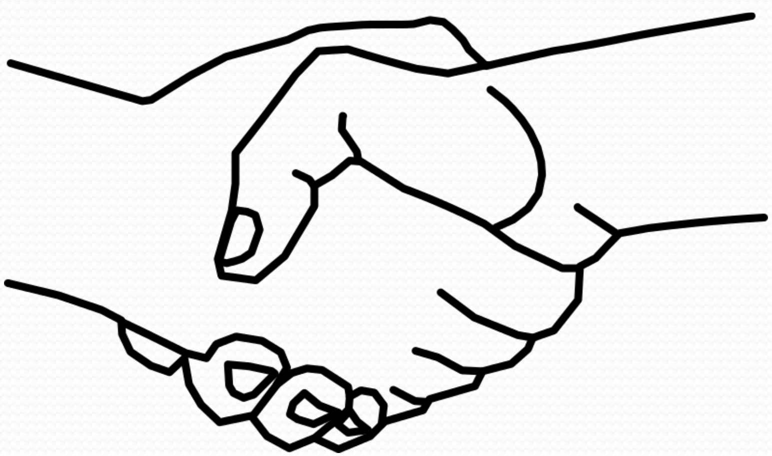
- Push out ensures liabilities are passed through to taxpayers who were partners in the "**reviewed year**" rather than partners who bought in thereafter and remain partners in the "**adjustment year**".
- But push out comes at a cost – interest on deficiencies is 2% higher.
- This may require reexamination of whether better to contractually bind former partners rather than push out to maintain lower overall interest rate on deficiencies.

What’s This Mean In Practical Terms?

- Since, by default, the BBA applies to all partnerships beginning in 2018:
  - New partners in a partnership may find themselves liable for the tax debts of former partners.
  - Absent affirmative action taken, those tax debts will be calculated at the highest individual or corporate rate in effect.
  - Partners – even those with significant interests – will lack any control over the partnership representative’s handling of audit procedures (unless they are contractually provided for).
  - Absent contractual provisions to the contrary, refunds will accrue to adjustment year partners.

. . . In Practical Terms (cont.)

- New rules raise many issues for partners to resolve when negotiating new partnership and operating agreements and amending existing agreements.



Indemnification Provisions Should Not Be Overlooked

- For entities where partners/members regularly change interests, partnerships *must* create indemnification rights in the partnership agreements to avoid new partners' having to pay former partners' tax liability.
  - Must be done in the partnership agreement – no longer available statutorily.
  - Escrows to cover potential liabilities from former partners may be desirable.
  - Flip side: refunds should go to former partners, not new partners.
- Sellers have incentive to *avoid* indemnification or push-out.

Key Questions To Consider

- Should partnership agreements restrict new partners to those who won't disqualify eligibility to opt out?
  - Should ineligible partnerships restructure?
- Should agreements require the partnership's tax liability from an audit adjustment be offset against a distribution to partners, and/or provide for a holdback of distributions to cover potential future liabilities?
- Should such agreements provide further for the allocation of tax among partners who are not indemnified by former partners?
- What enforcement provisions will be necessary to ensure that these provisions are effective?

Key Questions To Consider (cont.)

- Who will be named the Partnership Representative? Who should be able to appoint/replace the PR?
- What notification obligations and fiduciary standard should apply to the PR?
- Should the PR have complete discretion to resolve the audit and bind the partnership or should some form of partner consent be required?
- Who should bear the compliance and audit defense costs if a partnership opts out to put the tax liability risk directly onto the partners?

Careful Planning Is Essential

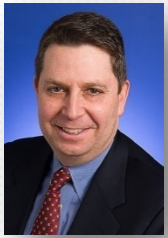
- Current partnership agreements need to be amended to account for the new rules. *Sooner is better*.
  - Ideally, existing partnerships and entities taxed as partnerships should amend their partnership/ operating agreements prior to January 1, 2018.
- The structure of partnerships being formed should be analyzed to ensure maximum flexibility.
- More due diligence will be required in acquisitions of partnership interests due to the new entity level tax.
- "Opting out" will require an annual election on the partnership's tax return.

Must This be Done By Year-End?

- **Yes**, to bind partners who leave partnership before new or amended agreement is signed (to bind them to BBA provisions).
  - *Example*: Right to "push out" tax or seek indemnification from former partners.
- **Yes**, to ensure admission of new partners (via sale of partnership interests or otherwise) does not make partnership ineligible to opt-out.
- **Probably No,** for relatively static partnerships.

BUT: agreement must be amended no later than when 2018 return is due to account for partnership representative requirements.

Questions? Please Contact:



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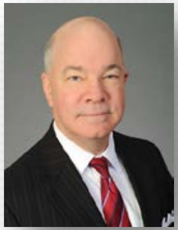

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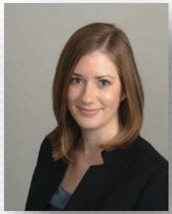

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