

New Partnership Audit Rules: Concepts and Issues, Part 1

By Christian Brause

Christian Brause is a partner at Sidley Austin LLP. The views expressed herein are his own and are not the views of Sidley Austin. An earlier version of this report was presented at the New York Tax Club on November 18, 2015.

In this report, Brause reviews the reasons Congress enacted the new partnership audit rules, and he summarizes the core concepts and elements of the new regime. Brause also discusses various practical issues that arise under the new rules, with a particular emphasis on investment funds, so-called UPREIT and UP-C structures, acquisitions involving partnerships, and securitization transactions.

Table of Contents

I.	Introduction	621
II.	Reasons for the New Partnership Audit Rules	621
	A. Background	621
	B. Problems Encountered With TEFRA	622
	C. Political Developments Before the BBA	623
III.	New Partnership Audit Rules: An Overview	624
	A. Repeal of TEFRA and the ELP Audit Rules	624
	B. Entity-Level Tax Assessment and Collection	624
	C. Partner Audits and Consistent Reporting	625
	D. New Partnership Representative Concept	626
	E. Commencement and Conclusion of an Audit	626
	F. Administrative Adjustment Request	627
	G. Statute of Limitations on IRS Adjustments	627
	H. Judicial Review of Audit Results	628
	I. Certain Special Rules	629
	J. Push-Out Election	629
	K. Small Partnership Opt-Out Election	630
	L. Bankrupt Partnerships	630
	M. Effective Date and Transition Rules	630

IV.	Certain Practical Issues	631
	A. Small Partnership Opt-Out Election	631
	B. Partnership Representative	633

I. Introduction

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015 (BBA), which contains new rules governing partnership tax audits.¹ On December 18, 2015, Congress passed, and Obama signed into law, the Protecting Americans From Tax Hikes (PATH) Act of 2015, which includes some corrections to the new audit rules,² effective as if those corrections had been part of the BBA.³ This report reviews the reasons for the enactment of the new audit rules, summarizes the core concepts and elements of the new regime, and discusses various practical issues that arise under the new audit rules, with a particular emphasis on investment funds, so-called UPREIT and UP-C structures, acquisitions involving partnerships, and securitization transactions.

II. Reasons for the New Partnership Audit Rules

A. Background

Congress codified the partnership tax rules in subchapter K in 1954. However, because partnerships were mostly used in small businesses then, no special rules regarding partnership tax audits were enacted in 1954.⁴ Accordingly, audits of partnerships had to be conducted by the IRS in the form of

¹P.L. 114-74, section 1101.

²H.R. 2029, section 411.

³Section 411(e) of the PATH Act.

⁴See Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82 (Dec. 31, 1982), at 267. The JCT explained:

Since a partnership is a conduit rather than a taxable entity, adjustments in tax liability may not be made at the partnership level. Rather, under prior law adjustments were made to each partner's tax return at the time that return was audited. A settlement agreed to by one partner with the Internal Revenue Service was not binding on any other partner or on the Service in dealing with other partners. Similarly, a judicial determination of an issue relating to a partnership item generally was conclusive only as to those partners who were parties to the proceeding. The Code provides a period of limitations during which the IRS can assess a tax or a taxpayer may file a claim for a refund. Generally, the period is 3 years from

(Footnote continued on next page.)

multiple partner-level audits, an approach consistent with the aggregate theory of partnerships.⁵ As the result of the proliferation of the larger tax shelter partnerships in the 1970s, Congress came around and adopted partnership tax audit rules (with the exception for small partnerships with fewer than 10 partners) as part of the 1982 Tax Equity and Fiscal Responsibility Act.⁶ TEFRA permitted, for the first time, the conduct of partnership audits on the partnership level in some circumstances.

Since the enactment of TEFRA almost 35 years ago, the world has changed fundamentally: The limited liability weaknesses of the limited partnership have been largely eliminated;⁷ the new business entity form of the limited liability company has been introduced with spectacular success;⁸ the check-the-box rules have been enacted;⁹ the tax rates of individuals and corporations have changed significantly; master limited partnerships have been invented;¹⁰ private equity has been invented; real estate and the hedge fund businesses have seen earth-shattering growth; electronic tax return filings have been introduced;¹¹ and last but not least,

complex international business transactions have become the norm rather than the exception.¹²

The TEFRA audit rules have not, unsurprisingly, been able to deal with this changed reality. As a result, large partnerships have not, for all intents and purposes, faced any real audit risk in recent years.¹³ This is because, among other things, virtually no partnership elected into the special, streamlined, elective audit regime applicable to electing large partnerships (ELPs), which was enacted in 1997¹⁴ and was a parallel audit regime to TEFRA.¹⁵ Accordingly, before the enactment of the new audit rules, we had three audit regimes applicable to partnerships: the elective small partnership audit regime outside TEFRA on the partner level;¹⁶ the TEFRA regime; and the elective audit regime applicable to ELPs.

B. Problems Encountered With TEFRA

The following weaknesses have prevented the IRS from conducting meaningful partnership tax audits.

First, the TEFRA rules themselves are complex and have therefore resulted in many interpretative

the date the tax return is filed (if filed before the due date, the due date is treated as the date filed). If more than 25 percent of the gross income is omitted from a return, the statutory period for assessment is 6 years. In the case of a partnership, the income tax return of each of the partners under prior law began that individual partner's period of limitations. Except in the case of Federally registered partnerships, the date of filing of the partnership return did not affect the individual partner's period limitations. In order to extend the period of limitations with respect to partnership items, the IRS was required to obtain a consent for extension of the statute of limitations from each of the partners — not the partnership. Generally, an agreement to extend the period of limitations related to all items on the return of the partner who consented to the extension.

⁵JCT, "General Explanation of Tax Legislation Enacted in 2015," JCS-1-16 (Mar. 2016) (the Bluebook), at 52.

⁶P.L. 97-248, sections 401-407. Regarding the tax shelter problem, see, e.g., American Bar Association Section of Taxation, "Proposal as to the Audit of Partnerships," 32 *Tax Law*. 551 (1979).

⁷Del. Code Ann. tit. 6, section 17-303 (Delaware Revised Uniform Limited Partnership Act) (limited liability of limited partners; eliminating, as a practical matter, the concept that a limited partner loses its limited liability protection if it "participates in the control of the limited partnership's business").

⁸See Thomas A. Humphreys, *Limited Liability Companies and Limited Liability Partnerships*, section 1.03, "History of the LLC"; see also Rev. Rul. 88-76, 1988-2 C.B. 360 (discussing partnership treatment of LLCs before check-the box-election regime).

⁹T.D. 8697; see also Notice 95-14, 1995-1 C.B. 297 (proposing the concept of checking the box).

¹⁰In 1981 Apache Petroleum Co. was the first master limited partnership listed on the New York Stock Exchange.

¹¹Internal Revenue Service Restructuring and Reform Act of 1998, H.R. 2676, 105th Cong., 2d Sess., section 2001 (declaring

(Footnote continued in next column.)

the policy that paperless returns should be the preferred method of filing returns, with the goal that at least 80 percent of returns should be filed electronically by 2007; section 6011(f).

¹²See generally Martin Wolf, *Why Globalization Works* (2004).

¹³Government Accountability Office, "Large Partnerships: With Growing Number of Partnerships: IRS Needs to Improve Audit Efficiency," GAO-14-732 (Sept. 18, 2014), at 19; written testimony of IRS Commissioner John A. Koskinen before the Senate Finance Committee on IRS Budget and Current Operations (Feb. 3, 2015).

¹⁴P.L. 105-34, sections 1221-1222 (codified as sections 771-777 and sections 6240-6242). For historic background on the elective large partnership rules, see Treasury, "Widely Held Partnerships: Compliance and Administration Issues: Report to the Congress" (1990) (report discusses the practical problems encountered regarding large partnership audits); see also H.R. 3419, 103d Cong., 1st Sess. (1994) (1994 proposed large partnership audit rules); and New York State Bar Association Tax Section, "Report on the Large Partnership Provisions of the Tax Simplification Bill" (Dec. 16, 1994); see further S. Rep. No. 105-33, at 238 (1997) (legislative history).

¹⁵GAO-14-732, *supra* note 13, at 31 (in 2011 only 15 ELPs had 100 partners and \$100 million or more in assets).

Under the audit rules applicable to ELPs, audit adjustments to partnership items of income or loss are treated as additional income or loss for the year in which the adjustment is made and takes effect, which income or loss flows through to the partners in that year (as opposed to the year to which the audit adjustment relates). See section 6242(a)(1). Also, an ELP had the right to elect an imputed underpayment. See section 6242(a)(2)(A) and (b)(4). The imputed underpayment is calculated based on the highest individual or corporate tax rate applicable to the year to which the audit adjustment relates. See section 6242(b)(4) and (d)(3).

¹⁶For a small partnership, the IRS must issue a separate audit report to each partner, and each partner may act individually to challenge its own audit report under the deficiency procedures that otherwise apply to individuals.

issues regarding merely procedural matters. This has complicated partnership audits significantly (particularly when compared with audits of corporations).¹⁷ The source of the complexity was Congress's attempt to reconcile the concept of an entity-level audit approach with the aggregate theory of partnerships, which resulted in an entity-level audit but with the partners as participants in the audit proceedings.¹⁸ The attempt to blend those two conflicting concepts created numerous problems:

- under TEFRA it was necessary to distinguish between items subject to the entity-level audit approach (that is, partnership items) and items reserved for determination on the level of the individual partners;
- the statute of limitations rules applicable to the partnership on one hand and the partners on the other hand were confusing;¹⁹
- identifying partners, particularly in tiered partnership structures, was necessary and often challenging;
- it was necessary to conduct two levels of audits to secure any tax collections; and
- it was necessary to amend a large number of tax returns to run adjustments through the tax return system (that is, amend partnership tax returns and then amend the corresponding tax returns of the partners for the past years under review).

Second, the TEFRA rules combined with the partnership rules created a significant economic

disincentive for IRS agents to begin a partnership audit, because the success of audits is measured by the amount of additional taxes collected. Given that partnership audits are procedurally more difficult than corporate audits, the only reason for the IRS to allocate more resources to partnership audits would be the chance to secure comparatively more additional tax collections. However, because under TEFRA no taxes (and therefore no interest or penalties) could be collected on the partnership level itself, a TEFRA partnership audit alone resulted in no tax collections. Only if the TEFRA audit was combined with audits of partners could the IRS hope to secure additional tax collections. Thus, if a partnership had many partners (including other partnerships) in different court districts, the IRS faced the need to conduct a large number of audits under the supervision of different courts, even though all the substantive tax issues related back to a single partnership. Within a consistently underfunded and understaffed agency, these practical considerations carry great weight with employees.

Third, the sheer complexity of the TEFRA audit rules created a significant economic disincentive for partners and partnerships to settle any partnership audits early, particularly when compared with corporate audits. This also made pursuing partnership audits a relatively unattractive strategic choice within the IRS.

Finally, a significant portion of issues that may arise in partnership audits concern the proper allocation of tax items among the partners. Assuming all the partners were in the same tax position, this was a zero-sum game for the IRS from a tax collection perspective because an upward adjustment for one partner would be offset by a corresponding downward adjustment for another partner. And often the IRS had no good ability to determine before the commencement of an audit whether partners were in different tax positions (loss carryforwards, tax exemptions, foreign tax credits, etc.). Again, this feature was a major disincentive for the IRS to allocate already scarce audit resources to partnership audits under TEFRA due to this additional risk of bad audit selection.

C. Political Developments Before the BBA

In its green book released in early 2014, the Obama administration announced that it would like to make the streamlined, entity-level audit regime for ELPs mandatory for large partnerships (those with more than 1,000 direct or indirect partners).²⁰

¹⁷See Koskinen written testimony, *supra* note 13 (“having to follow the TEFRA procedures is now more of a burden for the [IRS] than a help”); see also Petition for Writ of Certiorari at 16, *Irvine v. United States*, No. 13-1040 (Feb. 24, 2014) (TEFRA rules “continue to divide the circuits 30 years after TEFRA’s enactment”).

¹⁸The typical TEFRA audit process consists of the following steps: (1) the IRS identifies and notifies the tax matters partner and partners with notification rights; (2) the IRS begins its field audit of books and records of the partnership; (3) the IRS completes its field audit work and determines audit adjustments, if any, and notifies the tax matters partner and the partners with notification rights about its adjustments; and (4) the IRS passes through any audit adjustment to taxable partners’ returns (so-called campus audit).

¹⁹Section 6229 (TEFRA) provides that the statute of limitations for partnership audits does not expire before three years after the original due date of the return or date of return filing, whichever is later. According to the IRS’s position, section 6229 may extend, but never shorten, the statute of limitations. Thus, the IRS audits partnerships beyond the three-year statute of limitations of section 6229 if the statute of limitations for the partners under section 6501 has not yet expired for one or more partners. See *Rhone-Poulenc Surfactants & Specialties LP v. Commissioner*, 114 T.C. 533 (2000) (reviewing the issue and siding with the IRS’s position); and *AD Global Fund LLC v. United States*, 67 Fed. Cl. 657 (2005) (discussing the interaction of sections 6229 (TEFRA) and 6501 and the related case law).

²⁰Treasury, “General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals” (Mar. 2014), at 218 (“The
(Footnote continued on next page.)

As his final act before retirement, then-House Ways and Means Committee Chair Dave Camp on February 25, 2014, released his (Republican) draft of a comprehensive tax reform act. That legislation, the Tax Reform Act of 2014 (TRA 2014), would have completely repealed both TEFRA and the ELP audit rules and replaced them with a new, mandatory regime largely modeled on the (repealed) ELP audit rules.²¹

On June 18, 2015, Ways and Means Committee member James B. Renacci, R-Ohio, introduced the Partnership Audit Simplification Act of 2015.²² This bill was based on TRA 2014 and was in large parts similar to the new audit rules. However, neither the House nor the Senate voted on it.

In the context of avoiding another fight over the debt ceiling, Democrats and Republicans behind closed doors negotiated the BBA, which includes the new audit rules as a projected revenue raiser. Those rules reflect that the Obama administration and Camp had reached essentially the same conclusions regarding partnership tax audits. The BBA therefore adopts, with some changes, the partnership tax audit rules of TRA 2014.

Because the new audit rules are intended to be a revenue raiser, it is likely that the goal of Congress is to bring the frequency of partnership audits in line with the frequency of corporate audits. That would be a massive change from current practice.

proposal would mandate the streamlined ELP audit and adjustment procedures, but not the simplified reporting, for any partnership that has 1,000 or more partners at any time during the taxable year, a 'Required Large Partnership.'").

²¹JCT, "Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III — Business Tax Reform," JCX-14-14 (Feb. 26, 2014), at 255. The JCT explained:

The proposal repeals the substantive tax provisions and voluntary centralized audit procedures for ELPs, as well as the audit procedures for TEFRA partnerships. In place of the repealed audit procedure, a single system of centralized audit, adjustment and collection of tax is mandated for all partnerships, except those eligible partnerships that have filed a valid election for a taxable year. . . . Under the proposed system, the audit and adjustments of all items are determined at the partnership level. These items include income, deductions, credits, and any partner's distributive share, as well as the taxes, interest or penalties attributable to such items. Unlike present law, distinctions among partnership items, non-partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined . . . and assessed against and collected from the partnership with respect to that year rather than the reviewed year.

²²Partnership Audit Simplification Act of 2015, H.R. 2821, 114th Cong., section 2(c).

According to a September 2014 report by the Government Accountability Office, only 0.8 percent of large partnerships (that is, those with more than \$100 million of assets and 100 or more direct or indirect partners) were audited in 2012.²³ By comparison, 27.1 percent of large corporations were audited that year. If the goal of the new audit rules is to bring large partnership audits in line with large corporate audits, large partnership audit activity must increase by approximately 2,700 percent. Whether this is indeed the goal and whether it could be achieved without significantly increased funding of the IRS (and better training of agents) remain to be seen.

III. New Partnership Audit Rules: An Overview

A. Repeal of TEFRA and the ELP Audit Rules

The BBA completely repeals TEFRA and the ELP audit rules,²⁴ which creates a clean slate for the new approach to the partnership audit problem. That is a sensible approach in light of the goal to simplify partnership audit procedures: Rather than trying to fix specific aspects of a broken system, Congress opted to draft something new.

B. Entity-Level Tax Assessment and Collection

The most relevant new concept introduced by the new audit rules is the adoption of an entity approach by creating a tax collection mechanism on the partnership level for *all* partnerships.²⁵ However, this major deviation from TEFRA is not an entirely new concept; it was already in use in the now-repealed audit rules for ELPs (although on an elective basis only).²⁶

Under general rules, a partnership must file a partnership tax return including Schedules K-1 showing all items of income or loss, credit, and distributive shares of each partner.²⁷ Large partnerships must file their partnership tax returns on magnetic media.²⁸ Under the new audit rules, any adjustment to items of income or loss, credit, or any distributive share of a partner reflected on the partnership tax return will be determined solely at the partnership level.²⁹ If the IRS adjusts any item of income or loss, credit, or distributive share thereof, (1) the partnership will pay any imputed underpayment for that adjustment in the adjustment year

²³GAO-14-732, *supra* note 13, at 20.

²⁴BBA, section 1101(a) and (b).

²⁵Section 6221(a) (adjustments) (BBA); section 6232(a) (assessments) (BBA).

²⁶See section 6242(a)(2)(A) and (b)(4).

²⁷Section 6031.

²⁸Section 6011(e)(2); reg. section 301.6011-3(a) (partnership with more than 100 partners).

²⁹Section 6221(a) (BBA).

(the year in which the audit is concluded, not the tax year that is under audit),³⁰ and (2) any adjustment that does not result in an imputed underpayment will be taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8), or, in the case of a tax credit, as a separately stated item.³¹ For this purpose, any imputed underpayment for any partnership adjustment for any reviewed year (that is, the year under audit)³² will be determined by (1) netting all adjustments of items of income, loss, or deduction on a dollar-for-dollar basis and multiplying that net amount by the highest tax rate in effect for the reviewed year under section 1 (39.6 percent in 2015)³³ or section 11 (35 percent in 2015);³⁴ (2) treating any net increase or decrease in loss under clause (1) as a decrease or increase, respectively, in income; and (3) taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount determined under clause (1).³⁵ It is important to note that for any adjustment that reallocates the distributive share of any item from one partner to another, that adjustment will be taken into account under clause (1) of the preceding sentence by *disregarding* any corresponding decrease in any item of income or gain, and any corresponding increase in any item of deduction, loss, or credit (the one-way upward adjustment rule).³⁶

Any imputed underpayment will be assessed and collected in the same manner as if it were a tax imposed for the adjustment year by subtitle A of the code (concerning income taxes).³⁷ This means the partnership is deemed to be an income taxpayer solely for assessment and collection purposes, even though it is not a taxpayer under section 701.

If there is an adjustment for a reviewed year, interest for late tax payment will be computed and paid by the partnership, and the partnership itself will be liable for any penalty, addition to tax, or additional amounts.³⁸ For this purpose, interest will be computed for any partnership adjustment under general rules for the period beginning on the day after the partnership tax return due date for the reviewed year and ending on the partnership tax

return due date for the adjustment year (or, if earlier, the date payment of the imputed underpayment is actually made).³⁹ Proper adjustments to the interest amount so calculated will be required for partnership tax years after the reviewed year and before the adjustment year by reason of the partnership adjustment.⁴⁰ Any penalty, addition to tax, or additional amount will be determined at the partnership level as if that partnership had been a natural person subject to income tax for the reviewed year and the imputed underpayment was an actual underpayment (or understatement) for that reviewed year.⁴¹

For any failure by the partnership to pay an imputed underpayment on the date prescribed therefor, the partnership is liable for interest and any penalty, addition to tax, or additional amount.⁴² For this purpose, interest is the interest that would be determined by treating the imputed underpayment as an actual underpayment of tax in the adjustment year.⁴³ Penalties, additions to tax, or additional amounts are the penalties, additions to tax, or additional amounts that would be determined by (1) applying section 6651(a)(2) (concerning additions to tax for failure to pay tax) to that failure to pay, and (2) treating the imputed underpayment as an actual underpayment of tax for purposes of sections 6662 through 6664 (concerning accuracy- and fraud-related penalties).⁴⁴

Finally, no deduction will be allowed under the income tax rules of the code for *any* payment required to be made by a partnership under the new audit rules.⁴⁵ Accordingly, neither income tax payments nor interest or penalty payments are deductible by the partnership. Although this is consistent with generally applicable rules regarding tax and penalty payments,⁴⁶ the nondeductibility of interest for late tax payments puts partnerships under the new audit rules in a worse position than corporations. Nondeductibility is, however, consistent with the rule for noncorporate taxpayers.⁴⁷

C. Partner Audits and Consistent Reporting

A partnership audit under the new rules is strictly separate and independent from any audit

³⁰Section 6225(d)(2) (BBA).

³¹Section 6225(a) (BBA).

³²Section 6225(d)(1) (BBA).

³³Section 1(a).

³⁴Section 11(b)(1)(d).

³⁵Section 6225(b)(1) (BBA).

³⁶Section 6225(b)(2) (BBA).

³⁷Section 6232(a) (BBA).

³⁸Section 6233(a)(1) (BBA).

³⁹Section 6233(a)(2) (BBA).

⁴⁰*Id.*

⁴¹Section 6233(a)(3) (BBA).

⁴²Section 6233(b)(1) (BBA).

⁴³Section 6233(b)(2) (BBA).

⁴⁴Section 6233(b)(3) (BBA).

⁴⁵Section 6241(4) (BBA). The same rule applied under the ELP audit rules; *see* section 6242(e).

⁴⁶Section 275(a)(1)(A) (federal taxes); section 162(f) (penalties).

⁴⁷Section 163(h)(1) (interest on underpayment of tax is treated as personal interest).

that the IRS may conduct on the partner level for non-partnership items (for example, mortgage or charitable deductions for individuals). Accordingly, the IRS will presumably treat all partnership items reported to a partner on a Schedule K-1 as correct and conduct the audit of the partner's tax return on that basis.⁴⁸ Similarly, any judicial review of adjustments to a partner's tax return may not include a review of partnership items because partnership items are solely within the scope of judicial review by the court that has jurisdiction over the partnership adjustment. If it later turns out that partnership items on the Schedule K-1 were incorrectly reported, the partner's tax return will generally not be reopened to reflect the necessary corrections. Instead, as described above, under the general mechanism of the new audit rules, the corrections flow through to the partner on his Schedule K-1 for the adjustment year.

A partner must, on the partner's return, treat each item of income, loss, or credit attributable to a partnership in a manner consistent with the treatment of those items on the partnership return.⁴⁹ Any underpayment of tax by a partner as a result of failing to comply with this obligation to report tax items in a manner consistent with the tax treatment of those items on the partnership tax return will be assessed and collected in the same manner as if the underpayment were on account of a mathematical or clerical error appearing on the partner's return, and section 6213(b)(2) will not apply to any assessment of that underpayment.⁵⁰

A partner may, however, file a tax return that is inconsistent with the partnership tax return if (1) either the partnership has filed a partnership tax return but the partner's treatment of an item on the partner's return is (or may be) inconsistent with the treatment of that item in the partnership tax return, or the partnership has *not* filed a partnership tax return; and (2) the partner properly files with the Treasury secretary a statement identifying the inconsistency.⁵¹ For this purpose, under a special rule, a partner will be deemed to have properly informed the secretary regarding a particular tax item if the partner demonstrates to the satisfaction of the secretary that the treatment of the item on the partner's tax return is consistent with the (incorrect) tax treatment of the item on the Schedule K-1 furnished to the partner by the partnership and the partner elects to have this special rule apply for that item.⁵²

⁴⁸See reg. section 301.6231(a)(6)-1(a)(2).

⁴⁹Section 6222(a) (BBA).

⁵⁰Section 6222(b) (BBA).

⁵¹Section 6222(c)(1) (BBA).

⁵²Section 6222(c)(2) (BBA).

Any final decision regarding an inconsistent position identified by the partner in a proceeding to which the partnership is not a party will not be binding on the partnership.⁵³

D. New Partnership Representative Concept

From a procedural aspect, the new audit rules replace TEFRA's concept of a tax matters partner with the new concept of a partnership representative. The IRS has to deal solely with the partnership representative because that is the only person who may act on behalf of the partnership during a partnership audit governed by the new audit rules,⁵⁴ and the actions of the partnership representative are binding on all former and current partners.⁵⁵

Each partnership will designate (in the manner described by Treasury) a partner or other person with a substantial presence in the United States as the partnership representative; that person will have the sole authority to act on behalf of the partnership under the new audit rules.⁵⁶ In any case in which a designation is not in effect, the Treasury secretary may select *any person* as the partnership representative.⁵⁷ This represents a change because under the TEFRA rules, only a partner could act as the tax matters partner.⁵⁸

E. Commencement and Conclusion of an Audit

Under the new audit rules, the IRS commences a partnership audit by notifying the partnership representative that it will conduct a partnership audit.⁵⁹ The IRS is not required to issue notices to any partners of a partnership; the new audit rules contain no provision requiring it to do so. Accordingly, consistent with the entity approach of the new audit rules, the audit is solely a two-party administrative proceeding between the IRS and the partnership. This is an important change because the IRS will now be able to commence an audit without the need to know all the partners of the partnership.

Upon completion of the audit, the IRS will issue the partnership a notice of proposed partnership adjustment.⁶⁰ This notice will describe the adjustments to the partnership tax return of the reviewed

⁵³Section 6222(d) (BBA).

⁵⁴Section 6223(a) (BBA).

⁵⁵Section 6223(b) (BBA).

⁵⁶Section 6223(a) (BBA).

⁵⁷*Id.*

⁵⁸The ELP audit rules permitted non-partners to act as the representative of the partnership. If, however, no partner was designated to act in that capacity, the IRS had the authority to select "any partner" to act in that capacity. See section 6255(b)(1).

⁵⁹Section 6231(a)(1) (BBA).

⁶⁰Section 6231(a)(2) (BBA).

year, which will be taken into account by the partnership in the adjustment year in calculating its imputed underpayment.

After having received the IRS's calculation of the partnership's imputed underpayment set forth in the notice of proposed partnership adjustment, the partnership representative, on behalf of the partnership, has 330 days (plus the number of days of any extension consented to by the secretary under section 6225(c)(7)) to provide the IRS with additional information, including partner-level information, that would reduce the imputed underpayment.⁶¹

There are two core concepts for the reduction of the proposed imputed underpayment amount. First, the partnership may provide information regarding applicable tax rates on the partner level (for example, long-term capital gains for individuals or tax-exempt status of a partner).⁶² The second important concept is the reduction of the imputed underpayment to the extent that partners file amended tax returns for the reviewed year by taking into account their distributive share of the additional tax liability proposed by the notice of proposed partnership adjustment.⁶³ Under rules to be promulgated by Treasury, if (1) one or more partners file partner tax returns (notwithstanding section 6511) for the tax year of the partners that includes the end of the reviewed year of the partnership; (2) those partner tax returns take into account all adjustments proposed by the IRS in the notice of proposed partnership adjustment; and (3) payment of any tax due is included with that partner tax return, the imputed underpayment amount will be reduced by the portion of the adjustments so taken into account (the amended partner tax return relief).⁶⁴ For any adjustment that reallocates the distributive share of any item from one partner to another, the amended partner tax return relief will be available only if partner tax returns are filed by *all* partners affected by that reallocation.⁶⁵ Finally, except as provided in the procedures under section 6225(c), the information required to be furnished by the partnership under section 6031(b) may not be amended after the due date of the partnership tax return to which that information relates.⁶⁶

Again, the procedural design of the reduction of the imputed underpayment is significant because

now the burden of producing the relevant partner-related information in a timely and proper fashion falls entirely on the partnership and therefore on the partnership representative.

Finally, the audit is completed when the IRS issues to the partnership, 330 days after the issuance of the notice of proposed partnership adjustment, its notice of final partnership administrative adjustment.⁶⁷

F. Administrative Adjustment Request

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any tax year.⁶⁸ Any adjustment will be determined and taken into account for the partnership tax year in which the administrative adjustment request is made (1) by the partnership under rules similar to the rules of section 6225 (other than section 6225(c)(2), (c)(6), and (c)(7)) for the partnership tax year in which the administrative adjustment request is made, or (2) by the partnership and the partners under rules similar to the rules of section 6226 (determined without regard to the substitution described in section 6626(c)(2)(C)).⁶⁹ For an adjustment that would not result in an imputed underpayment, clause (1) above will not apply, and clause (2) will apply with appropriate adjustments.

A partnership may not file an administrative adjustment request more than three years after the later of the date on which the partnership tax return for that year is filed or the last day for filing the partnership tax return for that year (determined without regard to extensions).⁷⁰

G. Statute of Limitations on IRS Adjustments

Under the new audit rules, the statute of limitations for assessing any deficiencies against the partnership is solely based on the partnership return.⁷¹ Accordingly, the statute of limitations will not run until the partnership has filed its partnership tax return.⁷² No adjustment under the new audit rules for any partnership tax year may be made after the later of:

- the date that is three years after the latest of (x) the date on which the partnership tax return for that tax year was filed, (y) the return due date for that tax year, and (z) the date on which the partnership filed an administrative adjustment request for that tax year;

⁶¹Section 6231(a) (second sentence) (BBA) ("270 days"), as amended by section 411(d) of the PATH Act ("330 days").

⁶²Section 6225(c)(4) (BBA), as amended by section 441(a) of the PATH Act (clarifying that a lower rate of tax may be taken into account for either capital gain or ordinary income).

⁶³Section 6225(c)(2) (BBA).

⁶⁴*Id.*

⁶⁵Section 6225(c)(2)(B) (BBA).

⁶⁶Section 6241(e) (BBA).

⁶⁷Section 6231(a)(3) (BBA), as amended by section 411(c) of the PATH Act.

⁶⁸Section 6227(a) (BBA).

⁶⁹Section 6227(b) (BBA).

⁷⁰Section 6227(c) (BBA).

⁷¹Section 6235 (BBA).

⁷²Section 6235(c)(3) (BBA).

- for any modification of an imputed underpayment under section 6225(c), the date that is 330 days (plus the number of days of any extension consented to by the Treasury secretary under section 6225(c)(7)) after the date on which everything required to be submitted to the secretary under that section is so submitted; or
- for any notice of proposed partnership adjustment under section 6231(a)(2), the date that is 330 days after the date of that notice.⁷³

The statute of limitations may be extended by agreement between the IRS and the partnership (represented by the partnership representative) if the agreement is entered into before expiration of the otherwise applicable statute of limitations.⁷⁴

For a false or fraudulent partnership tax return with the intent to evade tax, the IRS may assess a deficiency at any time.⁷⁵ The same rule applies if the partnership files no partnership tax return.⁷⁶ If the partnership omits from gross income an amount properly includable therein and that amount is described in section 6501(e)(1)(A), the applicable statute of limitations is six years.⁷⁷ For purposes of the new audit rules, a return executed by the secretary under section 6020(b) on behalf of the partnership will not be treated as a partnership tax return.⁷⁸

If an FPAA for a partnership tax year is mailed under section 6231, the running of the statute of limitations will be suspended for the period during which an action may be brought under section 6234 (and, if a petition is filed regarding that FPAA, until the decision of the court becomes final) and for one year thereafter.⁷⁹

Because the new audit rules provide for the collection of tax, interest, and penalties on the partnership level, the statutes of limitations applicable to the partners are no longer relevant because no assessments against the partners are needed to collect any underpayment of tax. This is a significant simplification of the audit procedure.⁸⁰

H. Judicial Review of Audit Results

Under the new audit rules, after the IRS has determined that an adjustment to the partnership tax return should be made by issuing an FPAA, the partnership may challenge the IRS's conclusions by

filing, within 90 days of the receipt of the FPAA, a petition for readjustment in the Tax Court, the U.S. district court in which the partnership's principal place of business is located, or the Court of Federal Claims.⁸¹ However, the partnership may file a readjustment petition in a district court or the claims court only if it deposits with the Treasury secretary, on or before the date the petition is filed, the amount of its imputed underpayment (as of the date of the filing of the petition) assuming, for purposes of calculating the deposit amount, the partnership adjustment was made as provided for in the FPAA.⁸² Any deposited amount does not count as a payment of tax in calculating interest for delayed tax payments.⁸³ The deposit requirement is consistent with (and required by) the general concept that the federal district courts and the claims court are courts in which a taxpayer may seek only refunds.⁸⁴ For purposes of determining which district court has jurisdiction, if a domestic or foreign partnership has its principal place of business outside the United States, that partnership will be deemed to have its principal place of business in the District of Columbia.⁸⁵

Only the partnership representative may validly file a petition on behalf of the partnership because the new audit rules contain no provisions that would permit a partner to file a challenge to an FPAA. Consistent with the streamlined entity approach of the new audit rules, the judicial proceeding is strictly a two-party proceeding between the IRS and the partnership; the partners are not parties to it.

If a petition is validly and timely filed in accordance with the new audit rules, a court will have jurisdiction to determine *all* items of income, gain, loss, deduction, or credit of the partnership for the partnership tax year to which the FPAA relates; the proper allocation of those items among the partners; and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under the new audit rules.⁸⁶ Any determination by a court under the new audit rules will have the force and effect of a decision of the Tax

⁷³Section 6235(a) (BBA), as amended by section 411(c) of the PATH Act.

⁷⁴Section 6235(b) (BBA).

⁷⁵Section 6235(c)(1) (BBA).

⁷⁶Section 6235(c)(3) (BBA).

⁷⁷Section 6235(c)(2) (BBA).

⁷⁸Section 6235(c)(4) (BBA).

⁷⁹Section 6235(d) (BBA).

⁸⁰See 2015 Bluebook at 75-78 (discussing the new statute of limitations rules and proving examples).

⁸¹Section 6234(a) (BBA).

⁸²Section 6234(b)(1) (BBA).

⁸³Section 6234(b)(2) (BBA).

⁸⁴28 U.S.C. section 1346(a)(1) ("The districts shall have original jurisdiction, concurrent with the United States Court of Federal Claims, of: (1) Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed and collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal revenue laws.")

⁸⁵Section 6241(5) (BBA).

⁸⁶Section 6234(c) (BBA).

Court or a final judgment or decree of the district court or the claims court, as the case may be, and will be subject to further court review as such.⁸⁷ The date of any court determination will be treated as being the date of the court's order entering the decision.⁸⁸ If an action brought by a partnership under the new audit rules is dismissed by a court (other than by reason of a rescission under section 6231(c)), the decision of the court dismissing that action will be considered as its decision that the FPAA is correct, and an appropriate order will be entered in the records of the court.⁸⁹

I. Certain Special Rules

No assessment of a deficiency may be made (and no levy or proceeding in any court for the collection of any amount resulting from that adjustment may be made, begun, or prosecuted) before (1) the close of the 90th day after the day on which the FPAA was mailed; and (2) if a petition is filed in court regarding that FPAA, the decision of the court has become final.⁹⁰ Any action that violates this rule may be enjoined in the proper court, including the Tax Court.⁹¹ The Tax Court has no jurisdiction to enjoin the action unless a timely petition has been filed with it under section 6234, and then only for the adjustments that are the subject of the petition.⁹² The partnership may at any time (regardless of whether any notice of partnership adjustment has been issued), by signed notice in writing filed with the secretary, waive the restrictions provided on the assessment of tax described above.⁹³

If no court proceeding is begun regarding any FPAA during the 90-day period described in section 6234(b), the amount for which the partnership is liable under section 6225 will not exceed the amount determined in accordance with the FPAA.⁹⁴

If a partnership is notified that an adjustment to an item is required because of a mathematical or clerical error appearing on the partnership tax return, rules similar to the those of section 6213(b)(1) and (b)(2) apply to that adjustment.⁹⁵ If a partnership is a partner in another partnership, any adjustment resulting from the upper-tier partnership's failure to comply with the requirements of section 6222(a) regarding its interest in the other (lower-tier) partnership will be treated as an adjustment on

account of a mathematical or clerical error, except that section 6213(b)(2) will not apply to that adjustment.⁹⁶

J. Push-Out Election

Under the new audit rules, a partnership may avoid being liable for the imputed underpayment by electing to push this tax liability out to its partners if the partnership (1) not later than 45 days after the date of the FPAA elects the application of section 6226 for the imputed underpayment (the section 6226 push-out election), and (2) at such time and in such manner as the secretary may provide, furnishes to each partner of the partnership for the year reviewed and to the secretary a statement of the partner's distributive share of any adjustment to income, gain, loss, deduction, or credit as determined in the FPAA (the section 6226 statement).⁹⁷

Each partner's tax liability for the tax year that includes the date the section 6226 statement was furnished will be increased by the aggregate of the adjustment amounts determined for the tax years referred to in that statement.⁹⁸ Those adjustment amounts are (1) for the tax year of the partner that includes the end of the reviewed year, the amount by which the income tax imposed would increase if the partner's share of the adjustments described in the FPAA were taken into account for that tax year;⁹⁹ plus (2) for any tax year after the tax year referred to in clause (1) and before the tax year that includes the date of the section 6226 statement, the amount by which the income tax imposed would increase because of the adjustment to tax attributes described in the next sentence.¹⁰⁰ Any tax attribute that would have been affected if the adjustments described in the FPAA were taken into account by the partner will be appropriately adjusted.¹⁰¹

If a section 6226 push-out election is validly and timely made, any penalties, additions to tax, or additional amounts will nonetheless be determined solely on the partnership level, and the partners of the partnership for the reviewed year will be liable for any such penalties, addition to tax, or additional amounts.¹⁰² By contrast, the amount of interest owed for late tax payment will be determined (1) at the partner level, (2) from the due date of the return for the tax year to which the increase is attributable (determined by taking into account any increases resulting from a change in tax attributes for a tax

⁸⁷Section 6234(d) (BBA).

⁸⁸*Id.*

⁸⁹Section 6234(e) (BBA).

⁹⁰Section 6232(b) (BBA).

⁹¹Section 6232(c) (BBA).

⁹²*Id.*

⁹³Section 6232(d)(2) (BBA).

⁹⁴Section 6232(e) (BBA).

⁹⁵Section 6232(d)(1)(A) (BBA).

⁹⁶Section 6232(d)(1)(B) (BBA).

⁹⁷Section 6226(a) (BBA).

⁹⁸Section 6226(b)(1) (BBA).

⁹⁹Section 6226(b)(2)(A) (BBA).

¹⁰⁰Section 6226(b)(2)(B) (BBA).

¹⁰¹Section 6226(b)(3) (BBA).

¹⁰²Section 6226(c)(1) (BBA).

year), and (3) at the underpayment rate under section 6621(a)(2), determined with 5 percent rather than the usual 3 percent.¹⁰³

K. Small Partnership Opt-Out Election

Even though the new audit rules apply to all partnerships, a partnership may elect out of them for an entire tax year only if (1) each of its partners is an individual, a domestic C corporation, a foreign entity taxable as a C corporation, an estate of a deceased partner, or an S corporation; (2) the partnership has furnished 100 or fewer Schedules K-1 (counting, for this purpose, each shareholder of an S corporation as a partner);¹⁰⁴ (3) the election is made with a timely filed partnership tax return for that tax year and the election includes (in the manner prescribed by the secretary) a disclosure of the name and the taxpayer identification number of each partner of the partnership; and (4) the partnership notifies each such partner of the election in the manner prescribed by the secretary (the small partnership opt-out election).¹⁰⁵

If a partnership makes the small partnership opt-out election and the IRS later makes an adjustment upon auditing that partnership, the IRS must issue a separate audit report to each partner, who can then act individually to challenge his own partnership audit report under the deficiency rules that otherwise apply to natural persons.¹⁰⁶

L. Bankrupt Partnerships

Because the new audit rules transform the partnership into a deemed taxpayer for tax assessment and collection purposes, the question arises of what happens to the partnership's tax liability if the partnership goes bankrupt.

Generally speaking, the filing of a bankruptcy petition under the Bankruptcy Code will trigger, for the protection of the debtor, the automatic stay, which stops the commencement or continuation of any judicial or administrative proceeding against the debtor and the enforcement of any judgment obtained before the commencement of the bankruptcy proceeding.¹⁰⁷ The automatic stay therefore prevents the IRS from bringing or continuing any audit against a partnership that has filed a bankruptcy petition until the automatic stay ends, which generally occurs when the bankruptcy proceeding is concluded.¹⁰⁸

To address these special circumstances in bankruptcy, the new audit rules provide that if a partnership is subject to the Bankruptcy Code, the running of any statute of limitations provided by the new audit rules on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any imputed underpayment) will be suspended during the period in which the Treasury secretary is prohibited by reason of that bankruptcy case from making the adjustment (or assessment or collection) and, for adjustment or assessment, 60 days thereafter, and, for collection, six months thereafter.¹⁰⁹ Further, if a partnership is subject to the Bankruptcy Code, the running of the period specified in section 6234 for purposes of filing a petition with a court will be suspended during the period in which the partnership is prohibited because of the bankruptcy case from filing a petition under section 6234 and for 60 days thereafter.¹¹⁰

To sum up, a bankruptcy of the partnership generally does not affect its liability, unless the partnership's tax liability is dealt with in any restructuring plan. The partnership's tax liability remains in existence and, because of the suspension of the statute of limitations, the IRS will be able to collect on it after the bankruptcy proceeding is concluded. Accordingly, the new audit rules deal with bankrupt partnerships in the same way TEFRA did.

M. Effective Date and Transition Rules

The new audit rules will apply to partnership tax returns filed for partnership tax years beginning after December 31, 2017.¹¹¹ Thus, if a partnership files an administrative adjustment request, the new audit rules will apply to that a request for partnership tax returns filed for partnership tax years beginning after December 31, 2017.¹¹² Also, if a partnership makes the section 6226 push-out election, the new audit rules will apply to elections regarding partnership tax returns filed for partnership tax years beginning after December 31, 2017.¹¹³

A partnership may elect (when and in the form and manner as Treasury may prescribe) for the new audit rules to apply to any partnership tax return filed for partnership tax years beginning after November 2, 2015, and before January 1, 2018.¹¹⁴

¹⁰³Section 6226(c)(2) (BBA).

¹⁰⁴Section 6221(b)(1)(B) (BBA); section 6221(c)(2)(A)(i) (BBA). See Bluebook at 59 (S corporation example).

¹⁰⁵Section 6221(b)(1) (BBA).

¹⁰⁶See Bluebook at 57.

¹⁰⁷11 U.S.C. section 362(a).

¹⁰⁸11 U.S.C. section 362(c).

¹⁰⁹Section 6241(6)(A) (BBA).

¹¹⁰Section 6241(6)(B) (BBA).

¹¹¹Section 6241(g)(1) (BBA).

¹¹²Section 6241(g)(2) (BBA).

¹¹³Section 6241(g)(3) (BBA).

¹¹⁴Section 6241(g)(4) (BBA).

IV. Certain Practical Issues

A. Small Partnership Opt-Out Election

1. Rationale for election. Given the congressional intent to simplify the partnership audit rules, the existence of the small partnership opt-out election is a mystery. Why is it needed? There seems to be no good answer, at least in my view. If its justification is based on equity considerations, this would imply that the basic regime of the new audit rules violates basic equity requirements — hardly a convincing argument in light of the section 6226 push-out election, which should be most feasible in small partnership settings. If, however, its justification is more of a practical nature (that is, ease of administration), it is difficult to discern how an audit under the small partnership opt-out election applicable to small partnerships is simpler to handle by IRS agents, more cost efficient, and faster than the basic regime under the new audit rules.

Example 1: A is a Delaware LLC with 99 members, who are all individuals. A will furnish only 99 Schedules K-1 for any tax year. The members reside in all 50 states, do not know each other well, and have only very limited contact with each other. All members are high-net-worth individuals. A is an investment partnership that engages in real estate investments, complex option trading, foreign currency trading strategies, and distressed debt investments. No partnership interest transfers or redemptions occur. There is nothing particularly simple in this case. Accordingly, one would think that this is a prime example in which the new audit rules should apply. If there are disputes about the proper tax treatment of A's complex trading strategies, the IRS would dispute (and possibly litigate) those issues only with A and no one else. However, given the facts, A could make the small partnership opt-out election. Under the opt-out regime, the IRS could face separate settlement negotiations with 99 members and litigation in 50 different district courts.

Example 2: Same as Example 1, except that A is a Cayman Islands limited partnership and the members are residing in 50 different countries. A makes the small partnership opt-out election.

On its face, the small partnership opt-out election is not limited to purely domestic cases. Accordingly, the election should be available in Example 2. These examples show that the small partnership opt-out election is deeply flawed in its design. There would be a possibility for an easier and faster approach for small partnership audits outside the new audit rules only if (1) the tax returns of *all* partners would be subject to the review by the same entry-level court and the same appeals court; (2) the number of partners is so small that it is likely that partners can easily coordinate their efforts; and (3) the partner-

ship and all its partners are U.S. persons.¹¹⁵ In that case, the most rational behavior of the partners in connection with settlements and litigation would be that one partner negotiates and litigates on behalf of all. In this respect, TEFRA's small partnership election was arguably far more sensible because it was limited to 10 partners.¹¹⁶

2. Investment partnerships. Applying the small partnership opt-out election to investment partnerships yields some strange results.

Example 3: Greenwich-based Hedge LP is a Delaware limited partnership that is also taxed as a partnership for U.S. tax purposes. The general partner is GP LLC, a Delaware LLC that is taxed as a partnership. GP LLC has 10 members, all of whom are the key investment professionals. GP LLC earns a carried interest and the management fees from Hedge LP. Hedge LP, which has investor capital in an amount equal to \$2 billion, uses a long-short strategy for U.S. equities without leverage. Hedge LP's investors are U.S. and foreign individuals, state pension plans, private pension plans, university endowments, and section 892 investors. Hedge LP has fewer than 80 investors. Hedge LP asks whether it is entitled to make the small partnership opt-out election.

Hedge LP may not make that election even though it does not use a master feeder structure and does not have more than 100 partners.¹¹⁷ The reason is that its general partner is itself a partnership, thereby triggering the rule that tiered partnerships may not use the small partnership opt-out election. It seems reasonably clear to me that this fact pattern was likely not the one that caused the fear of tiered partnerships, because this tiered partnership structure does not involve the investment or the investor side of the structure. However, there is no "GP out" from the "no tiered partnerships" rule in the small partnership-opt out election. Accordingly, the next question is whether there is a structural fix for this, and it seems there might be: Convert GP LLC into an S corporation. Given the "one class of stock" rule applicable to S corporations,¹¹⁸ this would limit the ability to structure sharing arrangements among the investment professionals. But let's assume, for the

¹¹⁵Examples of these small partnerships might be a local law firm, a local accounting firm, a local web marketing firm, or a family-owned local construction company.

¹¹⁶Section 6231(a)(1)(B) (TEFRA).

¹¹⁷A typical master feeder structure consists of a domestic feeder partnership and a master partnership and an offshore feeder taxable as a corporation. All investment activities occur on the master feeder level. Because the domestic feeder and the master partnership will be tiered partnerships, hedge funds using the master feeder structure cannot use the small partnership opt-out election for the master partnership.

¹¹⁸Section 1361(b)(1)(D).

sake of argument, that these limitations would be acceptable as a business matter.¹¹⁹ Then we would have a strange result: The new audit rules would, in effect, promote the use of S corporations. Why that is good tax policy or sensible from an administrative point of view is unclear to me.

Assume we have now replaced GP LLC with GP S Corp.¹²⁰ May Hedge LP make the small partnership opt-out election? The answer is still no, because state pension plans and section 892 investors are not listed as good partners for purposes of the small partnership opt-out election. I do not see a good reason why they should be treated as bad partners given that they would not make an audit administratively more complex when compared with an audit of 100 foreign and U.S. individuals. Accordingly, it would seem sensible that new regulations would make them permissible partners, although it is not, in my view, entirely clear whether the IRS would have the authority to do so.¹²¹

Finally, the most relevant practical aspect why most investment partnerships will be unable to use the small partnership opt-out election is that funds of funds (which are usually structured as partnerships) represent a significant portion of the investor universe and most asset managers will not be willing to exclude funds of funds from their funds.

3. UPREIT and UP-C structures. Another situation in which the small partnership opt-out election might be relevant involves so-called UPREIT and UP-C structures.

Example 4: A is a U.S. corporation operating a real estate development business in addition to its core business of widget making. A decides to take its real estate business public. The investment bankers propose an UP-C structure such that A contributes its real estate business into a newly formed partnership and NewCo, the initial public offering (IPO) issuer, will buy into that newly formed part-

nership using the net proceeds from the IPO.¹²² NewCo will be the general partner of the partnership. The general counsel of NewCo wants to know whether the small partnership opt-out election is available for the partnership in the UP-C structure.

The answer is yes because (1) the partnership has only two partners (A and NewCo); (2) both partners are eligible partners (C corporations); and (3) the partnership is not part of a tiered partnership structure. What is interesting is that a slight change of the facts will not cause the partnership to be ineligible for the small partnership opt-out election. The facts assume that the real estate business is a development business (for example, condo developments). Accordingly, the use of a real estate investment trust is, practically speaking, precluded by the prohibited transaction rules applicable to REITs.¹²³ If, by contrast, the real estate business is “REITable” (for example, data center operations), the UP-C structure would be replaced by an UPREIT structure to make it more tax efficient. Since a REIT is technically a C corporation under section 1361(a)(2),¹²⁴ a REIT is also an eligible partner for purposes of the small partnership opt-out election.¹²⁵ Thus, the partnership in the case of an UPREIT structure would also be eligible for the small partnership opt-out election.¹²⁶ This result makes sense, in my view, because this change will not make any audit of the UPREIT structure under the small partnership opt-out election more burdensome than the UP-C structure.

4. Contractual considerations. It seems advisable to address the small partnership opt-out election in the partnership agreements, particularly whether

¹²²The main benefit of this UP-C structure in this context is the use of the tax receivable agreement between A and NewCo, under which NewCo would pay A for specific tax benefits if and when actually realized.

¹²³Section 857(b)(6) (100 percent tax on prohibited transactions such as developing and selling condos).

¹²⁴Section 1361(a)(2) reads: “For purposes of this title, a C corporation means, with respect to any taxable year, a corporation which is not an S corporation for such taxable year” (emphasis added); see also reg. section 1.856-1(e) (C corporation rules apply to REITs unless the REIT rules provide otherwise).

¹²⁵See Bluebook at 58 (REIT is eligible partner).

¹²⁶The legislative history on this point is interesting. In TRA 2014, the eligible partners were described as “an individual, a C corporation (other than a real estate investment trust or a regulated investment company), any foreign entity that would be treated as a C corporation were it a domestic, or an estate of a deceased partner” (emphasis added). The Partnership Audit Simplification Act of 2015 defined eligible partners in the same manner. The new audit rules, by contrast, changed this in the last minute by adding S corporations and eliminating the carveout for REITs and RICs. Accordingly, it appears that REITs, RICs, and S corporations — all special types of corporations — are eligible partners for purposes of the small partnership opt-out election.

¹¹⁹Note that this is arguably more a theoretical comment than practical one. The reason is that in most circumstances, S corporations are, aside from the “one class of stock” issue, unsuitable vehicles for various entities, including foreign investment professionals and a wide variety of family and estate planning type of vehicles.

¹²⁰Because the 10 investment professionals count in the S corporation structure as partners of Hedge LP, Hedge LP may not have more than 90 other partners. Here, Hedge LP has only 80 other partners.

¹²¹See section 6221(c)(2)(C) (BBA) (Treasury may by regulation or other guidance prescribe rules similar to those applicable to the look-through involving S corporations for any partners not described in those rules or not described as good partners).

the partners expect to rely on that election and whether this restricts the admission of new partners.

B. Partnership Representative

1. Eligible persons, appointment, and replacements. As described above, *any person* may be appointed by the partners to act as partnership representative, if that person has a *substantial presence in the United States*. Accordingly, any U.S. or non-U.S. person, whether an individual or an entity, whether a partner or not, may act as partnership representative. Thus, the U.S.-based asset manager of onshore and offshore funds could be designated as the partnership representative.

Example 5: AB Hedge is a Cayman limited partnership that is also taxed as a partnership for U.S. tax purposes. The general partner is a Cayman corporation owned by a U.K. individual. AB Hedge has only non-U.S. investors, with the exception of one U.S.-based family office. AB Hedge has entered into an investment advisory agreement with Greenwich-based Smart LP, a well-known U.S. asset manager, under which Smart LP earns a management fee and a performance fee. Smart LP is not a partner of AB Hedge. Although AB Hedge usually invests in U.S. stocks and bonds, it has also entered into some privately negotiated credit transactions in year 2. In year 5 the IRS decides to audit AB Hedge. In those circumstances, Smart LP could be designated in AB Hedge's organizational documents as the partnership representative because a U.S. partnership is a person for purposes of the code.¹²⁷ If, however, no person is so designated by contract, the IRS could appoint either the U.S. asset manager or the U.S.-based family office as the partnership representative, and there appears to be no limitation on the agency's discretion about which one to choose.

This example shows that U.S. asset managers should ensure they are designated as the partnership representative. That is no different than under current law regarding TEFRA's tax matters partners. However, because the partnership representative plays a much more significant role under the new audit rules, this designation also becomes more important.

It is unclear what happens if a foreign partnership with foreign partners has no person with a substantial presence in the United States.

Example 6: Same as Example 5, except that Smart LP is U.K. based, there is no U.S. family office investor, and a U.S. law firm regularly advises AB Hedge. Here, the partners could simply not validly select a partnership representative because no one

has a substantial U.S. presence. Because AB Hedge has a U.S. law firm, it is theoretically possible to appoint that firm as the partnership representative. However, it is likely that the U.S. law firm will not accept that designation. Because the substantial U.S. presence requirement applies only to designations by the partners, not to designations by the IRS,¹²⁸ the most sensible choice for the IRS would be to designate Smart LP as the partnership representative, but it would also not be unreasonable (although less practical) to designate the Cayman general partner. Finally, the IRS could theoretically designate the U.S. law firm as the partnership representative.

As the example shows, guidance by the IRS would be helpful, particularly on whether partners may replace a partnership representative that has been designated by the IRS, especially in circumstances such as those described in Example 6. It would also be laudable if the IRS would clarify that it will not designate U.S. law firms, U.S. accounting firms, or other similar U.S. service providers as partnership representatives.¹²⁹

The new audit rules provide no rules on who may act on behalf of an entity that acts as the partnership representative. It would therefore be helpful if the IRS clarified these rules, in particular whether multiple individuals may act simultaneously on behalf of the entity acting as partnership representative.

Given that the partnership representative plays a critical role under the new audit rules, the question of how to replace the partnership representative takes on new significance. The new audit rules do not address the replacement of the partnership representative, and fund documents rarely contain any special rules on how to replace the tax matters partner (often the asset manager), which means that an amendment of the partnership agreement would be required (usually with simple majority) to replace the contractually designated partnership representative. The new audit rules contain no rules on whether the partners of a partnership may replace a partnership representative after a partnership audit has been started by the IRS. Such a replacement, particularly if it occurs late in the audit, could result in significant delays in the audit — a legitimate concern for the IRS. Accordingly, it would be reasonable for the IRS to clarify in regulations whether

¹²⁸Section 6223(a) (BBA) ("In any case in which such a designation is not in effect, the Secretary may select *any person* as the partnership representative" (emphasis added)).

¹²⁹See reg. section 301.6231(a)(7)-1(q) (TEFRA) (stating criteria for the selection of a tax matters partner by the IRS). Given the TEFRA rules, this TEFRA regulation does not address service providers.

¹²⁷Section 7701(a)(1).

the partners may at any time, including after the commencement of an audit, replace the partnership representative.¹³⁰

2. Settlement negotiations and handling litigation.

As noted, the partnership is now liable for any tax deficiencies, including interest and penalties, and the audit and any subsequent litigation are strictly two-party proceedings between the IRS and the partnership. Accordingly, any settlement negotiations would also be solely between the IRS and the partnership, represented by the partnership representative, and any such settlement would be binding on all partners.¹³¹ To cut the partners out of any settlement negotiations and bind them to any settlement negotiated by the partnership representative is one of the critical goals of the new audit rules. The idea is that this would create a larger incentive for partnerships to settle audit issues early, similar to how audit issues are often settled in the corporate audit context.

Given the new legal framework for settlement negotiations, an interesting new issue arises — namely, conflicts of interests for the asset manager.

Example 7: Greenwich-based asset manager A manages multiple hedge funds with similar strategies for different investors. All these funds invest in loans and distressed debt. The IRS decides to audit all funds managed by A, which is the partnership representative for each fund. The IRS conducts all the audits on a parallel track. Finally, the IRS and A sit down to “horse trade” identified audit issues for all audits even though everybody acknowledges that each audit is separate and independent from any of the other audits. After hours of negotiations, the IRS proposes a settlement in Fund X for 40 cents on the dollar for Fund X’s outstanding audit issue (as opposed to the 60 cents on the dollar the IRS had previously sought) if A agrees to a 50 cents on the dollar settlement of the last outstanding issue for Fund Y (as opposed to the 35 cents on the dollar that A had proposed).

Example 8: Asset manager A manages Hedge Fund, a hedge fund using a traditional master feeder structure with quarterly liquidity.¹³² A is the partnership representative for the master partnership. Hedge Fund invests in debt instruments using leverage. U.S. high-net-worth individuals are the investors in the domestic feeder, while U.S. tax-exempt and foreign investors invest through the

offshore feeder. Hedge Fund’s capital is split evenly between the onshore and the offshore feeder. The IRS decides to audit Hedge Fund’s master feeder partnership. The IRS identifies two issues: (1) amount of capital gains on distressed debt instruments in light of the market discount rules; and (2) effectively connected income as the result of loan acquisitions. The proposed audit adjustments for these two issues are split evenly. The audit is conducted for seven months. After weeks of negotiations between the IRS and A, the IRS proposes a settlement of the market discount issue for 30 cents on the dollar (as opposed to the 10 cents on the dollar the IRS had previously sought) and proposes to drop the ECI issue entirely (as opposed to the 35 cents on the dollar that the IRS had previously proposed). A intends to accept this settlement but puts a call in to the partnership’s lawyer for advice.

This second example is probably the more pertinent one. The conflict of interest here exists because the market discount/capital gains issue¹³³ is relevant only for the onshore feeder, while the ECI/loan origination¹³⁴ issue is important only for the offshore feeder. A has managed to get a better overall result in the settlement than originally proposed by the IRS. However, the benefits of the settlement accrue mostly to the offshore feeder investors. Whether this is a problem will depend on what Hedge Fund’s organizational documents say and on what law governs those documents. If, for instance, the documents say that the partnership representative may settle any partnership tax audits “in its sole discretion,” it seems that A would be able to accept this settlement. If, however, the documents are silent on this point, there would be a concern about whether there would be any grounds for U.S. investors in the onshore feeder to question the proposed settlement (for example, based on breach of fiduciary duties).

¹³³For the discussion, see, e.g., John Kaufmann, “The Treatment of Payments on Distressed Debt Instruments,” 26 *J. Tax’n Invest.* 13 (2008); Andrew W. Needham, “Do the Market Discount Rules Apply to Distressed Debt? Probably Not,” 8 *J. Tax’n Fin. Prod.* 1 (2009); David C. Garlock, “How to Account for Distressed Debt,” *Tax Notes*, May 31, 2010, p. 999; Deborah L. Paul, “The Taxation of Distressed Debt Investments: Taking Stock,” 64 *Tax Law.* 37 (2010); David H. Schnabel, “Great Expectations: The Basic Tax Problem With Distressed Debt,” 89 *Taxes* 173 (2011); Ethan Yale, “Taxing Market Discount on Distressed Debt,” *Tax Notes*, Jan. 7, 2013, p. 85; and NYSBA tax section, “Report on the Taxation of Distressed Debt” (Nov. 22, 2011).

¹³⁴See, e.g., ILM 201501013 (the IRS asserts that an offshore hedge fund is engaged in a U.S. trade or business involving loan origination); see also AM 2009-10 (concluding that lending conducted on behalf of a foreign corporation by a U.S.-based agent will be attributable to the foreign corporation regardless of whether the agent is a dependent or independent agent).

¹³⁰See reg. section 301.6231(a)(7)-1(j) (revocation of designation of tax matters partner).

¹³¹See Bluebook at 61-62.

¹³²“Quarterly liquidity” means that investors may request each calendar quarter partial or complete redemption from the fund on a net asset value (NAV) basis. Notice periods differ, but 30, 45, or 60 days are not uncommon.

Another issue that arises in Example 8 is of a practical rather than technical nature: Why would investors stay in a hedge fund that faces an audit by the IRS? Would the prudent course of action for hedge fund investors, upon commencement of the audit, be to demand redemption to protect them against any adverse outcome from the audit?¹³⁵ Given the quarterly liquidity feature, investors could exit Hedge Fund during the audit. If that were indeed the rational course of action for investors, the mere commencement of an audit could result in a massive outflow of capital, thereby threatening the survival of the fund, which obviously is a significant commercial issue for asset managers. Let's break this down into a series of questions.

First, how would investors know about the commencement of the audit of Hedge Fund? Since the IRS is no longer required to inform any partners about the commencement of an audit, partners would know about the audit only if (1) the IRS makes the commencement of audits in the industry widely known; (2) the partnership representative informs the investors about the audit either voluntarily or under an agreed upon contractual notification right; or (3) the audit becomes industry knowledge (for example, exchange of information among investment professionals, or disclosure of the audit by the asset manager during the due diligence by a potential new investor). So lack of awareness on the part of investors might protect the asset manager in some circumstances, although I suspect that in some cases, an asset manager would need to inform the investors about the commencement of a tax audit.

Second, is there anything that A can do to limit the risk of redemptions? The obvious route is to limit the redemption rights of investors. That's a no-go because investors treasure liquidity very highly, particularly in the post-financial-crisis world. Alternatively, a clawback is theoretically possible, but it is seldom practical to sue for the return of cash from investors that have been completely redeemed.¹³⁶ An alternative approach would be to modify the net asset value (NAV)

¹³⁵This issue does not come up in private equity or real estate opportunity funds because these funds are typically structured as self-liquidating funds without redemption rights. Theoretically, private equity and real estate opportunity fund investors could sell their fund interests to a secondary market buyer of those interests, but any such transaction would require consent by the general partner. Moreover, any secondary market buyer would require an indemnification or a haircut to address the audit risk.

¹³⁶Many fund documents grant the asset manager "prior period adjustment" authority that would allow it to burden the NAV of the partners that should bear the burden of the tax
(Footnote continued in next column.)

definition off which redemptions are keyed, such that the general partner may in its sole discretion book a reserve for the tax audit immediately upon the commencement of the audit, thereby reducing the NAV and reducing the redemption proceeds of any "quitters." It may not always be clear under the definition of NAV whether the general partner may book such a reserve in the absence of any quantification by the IRS, particularly if the general partner has received prior assurances from lawyers or accountants that it is more likely than not that the positions taken by the fund are correct.¹³⁷ Further, if the NAV definition gives broad leeway to the general partner, investors might insist on tightening the NAV definition to ensure that their redemption rights are in fact worth something. However, asset managers usually do not like to take those reserves because that reduces their carried interest (or performance fee) immediately.

Third, how is the partnership audit situation different from an SEC investigation? Conceptually, it isn't. The issue is really entity-level contingent liabilities, whether tax or nontax in nature, and that issue has been around for funds for a long time regarding nontax risks (for example, lawsuits and indemnity claims in negotiated mergers and acquisitions deals).

And finally, is the section 6226 push-out election the critical mechanism to protect asset managers against the horror scenario of mass redemptions? The answer is likely no for traditional (larger) hedge funds using the master feeder structure. That is because typically, most of the cash of those hedge funds is attributable to the offshore feeder, which is treated as a corporation, and one cannot under the new audit rules push audit adjustments through a corporation.

3. Contractual considerations. The new expanded role of a partnership representative exposes any person acting in that capacity to costs and expenses and the risk of indemnification obligations. Accordingly, I believe that the typical partnership provisions should be reviewed and possibly amended. The cost and expense provisions should expressly cover all costs of external accountants and lawyers incurred by the partnership representative. Arguably, the standard exculpation provisions already provide sufficient protection for asset managers.¹³⁸

assessment. However, that authority is of no help for partners that have been redeemed out completely.

¹³⁷For example, sometimes the right to book reserves against NAV is limited to reserves required under generally accepted accounting principles.

¹³⁸The typical exculpation provision in a partnership agreement provides that the partnership shall indemnify and hold harmless all general-partner-related persons from and against
(Footnote continued on next page.)

A more difficult question is how to approach out-of-court and in-court settlements in partnership agreements. One approach would be to prohibit the partnership representative from entering into any settlement with the IRS without the prior consent of all (or a supermajority or a simple majority of) partners (counting, for this purpose, partners who do not cast a vote as partners who vote no). That contractual arrangement would, of course, have no effect vis-à-vis the IRS: The partnership representative would still be able to validly bind the partnership in a settlement agreement with the IRS because the partnership representative is an agent of the partnership with statutorily described powers, which cannot be amended by contract. However, this contractual arrangement would result in a deliberate material breach of contract by the part-

all damages, except for any damages that are finally found by a court to have resulted primarily from the bad faith or intentional misconduct of any such person, or from an intentional and material breach of the partnership agreement.

nership representative, thereby exposing the partnership representative to liability under general contract law principles. Such an arrangement could make it much harder to achieve an early settlement and could increase the costs associated with any audit, and possibly litigation. Particularly in large partnerships with frequently shifting partners (for example, hedge funds), there would be the risk that no settlement proposal would be approved simply because of a lack of a sufficient number of votes. An alternative approach would be to limit (internally) the partnership representative's authority only if a settlement would result in a material tax liability, however "material" would be defined for this purpose. Finally, the partnership agreement could grant the partnership representative broad authority to handle settlements but also expressly provide for a streamlined mechanism under which the partnership representative could seek, on an expedited basis, approval of the settlement proposal by a simple majority of the current partners (which would shield the partnership representative against any liability).

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at tax.notes@taxanalysts.org. Submission guidelines and FAQs are available at taxanalysts.com/submissions.