Preparing Partnership Returns Under the BBA

By Guinevere Moore and Elizabeth Yablonicky

Guinevere Moore and Elizabeth Yablonicky examine two key issues that every tax professional must address with their partnership clients before filing the 2018 IRS Form 1065, U.S. Return of Partnership Income.

Tax return preparation is not for the faint of heart. Return preparers are expected to understand and advise their clients on a myriad of ever-changing tax issues, from what type of entity will provide the best tax advantages for a business to which deductions have been created, expanded, or eliminated under the tax code. Clients expect their tax professionals to have all the answers to their tax-related questions and to be able to help them keep taxes as low as legitimately possible. Tax preparation software is an essential aid for return preparers; it serves as both a time-saving tool and helps ensure that federal income tax returns are accurate and complete. Return preparers must be careful, however, to ensure that reliance on return preparation software does not supplant their own careful study of the Internal Revenue Code and thinking about how new tax laws will impact their clients.

The 2019 filing season marks the first time that return preparers will implement the changes to partnership taxation that Congress passed in 2015 under the Bipartisan Budget Act ("BBA").[1] The BBA repealed the old partnership federal income tax regime known as the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and replaced it with a simpler, streamlined process that combines the examination, collection, and assessment function all at the partnership level. The drastic changes between the old TEFRA regime and the new BBA system will almost certainly result in unhappy taxpayers who do not understand how these changes will impact them and have not thought through how best to prepare for the new partnership audit regime. Tax professionals who do not adequately advise partnership clients about their options on how to proceed in light of the BBA will find themselves with unhappy clients and—more importantly—potential malpractice claims. This article discusses two key issues[2] that every tax professional who prepares partnership returns must address with their partnership clients before filing the 2018 IRS Form 1065, *U.S. Return of*

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Partnership Income: (1) whether the partnership is eligible to elect out of the BBA, and if the partnership is eligible to elect out, whether the partnership should make the election, and (2) if the partnership is not eligible to elect out of the BBA or decides not to elect out, who should serve as the partnership's partnership representative.

Why Did Congress Change the Rules for Partnerships?

A 2014 Government Accounting Office ("GAO") study[3] made striking findings regarding the audit rate of large partnerships: under TEFRA, less than one percent of large partnerships were audited for 2012, compared with 27 percent of large corporations the same year. The dramatically lower audit rate for large partnerships was attributed to the significant difficulty the Internal Revenue Service ("IRS") had identifying the person who was authorized to represent the partnership in an audit, known as the Tax Matters Partner ("TMP"), and the complexity of large partnership structures, which made it difficult for the IRS to pass audit adjustments across tiers to taxable partners.[4]

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The IRS had difficulty auditing partnerships under TEFRA in large part because of the rules applicable to the TMP. Partnerships were required to appoint a partner in the partnership to be the TMP. If the partnership wanted to change the TMP, or if the TMP ceased being a partner in the partnership or otherwise became ineligible to serve as the TMP, it was difficult for the IRS to determine who had authority to act on behalf of the partnership. The IRS was required to conduct audits through the TMP, but the TMP did not have absolute authority to bind all partners and the partnership in IRS audits or litigation. The few partnership audits that the IRS managed to conduct yielded negligible results for the agency, especially compared with the outcomes of corporate audits.

Congress eliminated these problems by repealing TEFRA and replacing it with the BBA. The BBA automatically applies to all partnerships that do not elect out of the regime. The BBA also radically shifts the way IRS audit adjustments will impact partnerships in placing both the assessment *and* collection function at the partnership level. Under TEFRA, tax assessed against a partnership was paid at the partner level. In a significant departure from past practice, under the BBA, adjustments to partnership-related items, resulting assessment *and* collection of tax will take place at the partnership level.[5]

What Partnerships Are Subject to the BBA?

Beginning in the 2019 filing season for filing the 2018 IRS Form 1065, every partnership that does not elect out of the BBA will be subject to the BBA. Return preparers must begin advising their partnership clients on whether the partnership is eligible to elect out of the BBA by looking at the make-up of the partnership. Partnerships that issue more than 100 K-1s (to partners and shareholders of S-corporation partners) are not eligible to elect out of the BBA.[6] In addition, partnerships that have 100 or fewer partners, but have even one partner that is not "eligible," may not elect out of the BBA.[7] A partner is not an "eligible" partner if the partner is a partnership, a trust, a foreign entity that would not be treated as a C Corporation were it domestic, a disregarded entity, an estate of an individual other than a deceased partner, or a person who holds an interest in the partnership on behalf of another person.[8] If a partnership has 100 or fewer partners and all partners are "eligible," then it may elect out of the BBA.

If the partnership does not elect out of the BBA, either because it is not eligible or it chooses not to, then the partnership must designate a partnership representative, which is discussed in detail below. If the partnership is eligible to elect out, then the partnership will likely want advice regarding the risks and benefits of electing out of the BBA.

Considering Whether to Elect Out of the BBA

Every partnership that is eligible to elect out of the BBA should consider whether it is in the partnership's best interest to do so. Because TEFRA has been repealed, partnerships that elect out of the BBA become subject to pre-TEFRA partnership audit rules, which require that the IRS separately audit the partnership and each partner. The non-BBA partnership will be subject to the general rules on assessment and collection of tax deficiencies:

any adjustment to partnership taxable income will flow through to the partners, and the statute of limitations for the assessment will be determined individually for each partner. Partners will make any statute of limitations extension, settlement offer, Tax Court petition or refund suit separately, on a partner-by-partner basis.[9]

Of the many factors that partners in eligible partnerships should consider, three stand out:

- Under the BBA, IRS audits will be conducted at the partnership level.[10] The examination, assessment, *and payment* required will be imposed at the partnership level. If a Partnership makes a valid election out of the BBA, then examinations will be conducted at the individual partner level. Although partners may wish to control their individual examinations and defend their own examinations as they see fit, one possible benefit to partnerships under the BBA would be to have the partnership defend tax positions at the partnership level, reducing the costs to defend the examination, streamlining the process and eliminating the possibility that different partners will undercut each other in different approaches.
- Under the BBA, if an IRS examination results in an underpayment of tax attributable to partnership items, the tax is generally imputed to the partnership and may be assessed and collected at the partnership level in the year that the partnership adjustments become final (the adjustment year).[11] Adjusted items are netted and the partnership-level tax is a non-deductible expense of the partnership in the adjustment year.[12] If a partnership elects out of the BBA, any additional tax will be assessed at the *partner* level and for the adjusted tax year.
- Under the BBA, the statute of limitations for all partnership items will be determined at the partnership level.[13] If a partnership makes a valid election out of the BBA, the statute of limitations will be determined at the individual partner level.

These are just three of the many factors eligible partnerships should consider when voting on whether to elect out of the BBA. IRS officials have repeatedly assured taxpayers that electing out of the BBA "will have absolutely no effect" on whether the partnership is selected for examination.[14]

Procedures for Opting Out of the BBA

To opt out of the BBA, the partnership must make an election on the partnership's tax return and provide the IRS with the name and taxpayer identification number of every person who was a partner during the taxable year, including each S corporation shareholder treated as a partner, and affirmatively state that each partner is an eligible partner under Code Sec. 6221(b).[15] The partnership must notify each of the partners that the election has been made, within 30 days of making the election, in the form and manner determined by the partnership.[16] The election must be made each year on a timely filed Form 1065, Schedule B, and by completing Form 1065, Schedule B-2, *Electing Out of the Centralized Partnership Audit Regime*.

Procedures for Remaining in the BBA

Every partnership that files IRS Form 1065 is automatically subject to the BBA unless the partnership is eligible to elect out of the BBA *and* makes a valid election in accordance with the rules above. Partnerships that are subject to the BBA must designate a partnership representative.

What Is a Partnership Representative?

When Congress repealed TEFRA and replaced it with the BBA, it eliminated the TMP and created the role of partnership representative. Unlike the TMP, the partnership representative does not need to be a partner in the partnership but must have "substantial presence" in the United States.[17] Also unlike the TMP, the partnership representative has sole, exclusive, and absolute authority to bind the partnership in IRS audits and in litigation—regardless of any state law or partnership agreement to the contrary.[18] Partnerships are required to designate a partnership representative for each tax year, on the partnership's tax return for that year.[19] Once a partnership representative is designated for a tax year, the designation is irrevocable for that tax year, unless and until the IRS begins an audit or the partnership requests an administrative adjustment (similar to an amended tax return).[20]

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partnership representative has absolute, final authority to bind a partnership in all disputes with the IRS. If the partnership does not appoint an eligible partnership representative, then the IRS will choose a partnership representative for the partnership.[21] As incredible as that may seem, it is true: if the partnership does not select a partnership representative at all, or chooses a partnership representative who is not eligible to serve in that capacity, the IRS may unilaterally appoint a representative who can irrevocably bind the partnership in all IRS matters.

The BBA significantly restructured the partnership audit process in many ways, with the aim of making it easier for the IRS to audit partnerships.

Who Is Eligible to Be a Partnership Representative?

A partnership representative can be any person[22] with "substantial presence" in the United States. The "substantial presence" test under the BBA is not the same test as the "substantial presence" test under Code Sec. 7701(b)(3) to determine whether a non-U.S. person is subject to taxation in the United States. Under the BBA, "substantial presence" requires the partnership representative to have (1) a U.S. taxpayer identification number, (2) a telephone number with a U.S. area code, (3) a U.S. street address, and (4) the ability to make themselves available to meet with the IRS in person in the United States at a reasonable time and place as determined by the IRS. If a partnership has no partners with "substantial presence" in the United States, the partnership must designate a professional partnership representative or some other non-partner who has substantial presence in the United States to be the partnership representative.

What Does a Partnership Representative Do?

A partnership representative has sole and absolute authority to act on behalf of the partnership *for all purposes* with the IRS.[23] This means the partnership representative must decide whether and when to engage an attorney to represent the partnership before the IRS, determine whether and when to extend the statute of limitations to assess tax, communicate with the IRS during IRS examination including responding to Information Document Requests, be available to meet with the IRS in the United States, and either agree to proposed changes in an IRS examination or dispute any tax deficiency the IRS determines in the proper litigation forum. Equally important, the partnership representative needs to be able to advise the partnership regarding the implications of the IRS audit and effectively explain potential options for resolution. In short, the partnership representative is the final word in all IRS matters, and ideally should be experienced in handling U.S. tax audits in order to effectively represent the partnership. Having a partnership representative who knows how to handle an IRS audit on board from the start may provide a significant benefit to the partnership.

At the same time, Treasury explained in the preamble to the final regulations[24] that "the responsibilities and authority of a partnership representative are generally applicable only if a partnership is selected for examination as part of an administrative proceeding or the partnership files an AAR." Put another way, the partnership representative essentially has *no role* unless and until the IRS initiates an examination.

Can the Partnership Change Its Partnership Representative?

Once a partnership representative is designated on a partnership's IRS Form 1065, *U.S. Return of Partnership Income*, the designation *cannot be changed* at any time, for any reason, unless and until:

1. The IRS initiates an examination of the partnership, or
2. The partnership files an Administrative Adjustment Request ("AAR"), the partnership version of an amended return.

An AAR cannot be filed simply to change the partnership representative designation. The practical implication of this rule is that if the partnership appoints a partner as its partnership representative and that partner leaves the partnership, the partnership cannot change that designation unless and until the IRS initiates an examination of the partnership, or the partnership requests an administrative adjustment to the tax return for the taxable year at issue.

When the IRS first released the proposed regulations regarding the partnership representative, tax practitioners raised concerns about partnerships' inability to change the partnership representative absent an IRS audit. What if, for example, the partnership selected a partner to be the partnership representative and that partner was subsequently removed from the partnership for cause? Or just a routine parting of ways? How could the partnership ensure that the departed partner did not bind the partnership in an IRS audit if the partnership lacked the ability to change the partnership representative designation before the audit?

In response to these concerns, the IRS did not allow partnerships to change their partnership representative designation prior to an audit, but instead announced that the notice of selection for examination would be issued to the partnership, and not to the partnership representative.[25] By sending the notice of selection for examination only to the partnership, the IRS intended to "allow the partnership to make a change to the partnership representative without the involvement" of the existing partnership representative whom the partnership may not want to continue in that role.

As a result, all communications regarding IRS examinations are sent to the partnership representative, except the most important one: the notice of selection for examination. This notice instead is sent to the partnership, and the partnership representative does not receive a copy. This may have serious consequences for partnerships, especially foreign partnerships, if the notice of selection for examination sent only to the partnership is received late or not at all.

What Should Partnerships Do Now?

Choose a Partnership Representative

Every partnership that is subject to the BBA must appoint a partnership representative. The partnership representative *must* have a U.S. address, phone number and tax identification number, and *should* have experience dealing with IRS examinations and controversies, or at a minimum, stand ready to bring in competent help if an IRS examination is initiated. If there is a possibility that the make-up of the partnership may change over the years, such that the partners in 2020 may be different than the partners in 2018, it may be prudent to appoint a professional partnership representative that is not a partner in the partnership.

Amend the Partnership Agreement

TEFRA has been repealed and the role of TMP no longer exists. This means that no partnership, even those that can elect out of the BBA, will continue to have a TMP. Every partnership needs to amend its partnership agreement to reflect the partnership's way of complying with the new rules, including, for example, the manner of making BBA opt-out notifications to partners. The only duties that the IRS has defined for the partnership representative are duties to the IRS, and *not* to the partnership. Any duties the partnership wants the partnership representative to have to the partnership should be reflected in the partnership agreement or a separate contract between the partnership representative and the partnership. Anything contained in the contract between the partnership and its partnership representative binds the parties to that agreement but does not affect the relationship between partnership representative and the IRS.

Prepare for an IRS Audit

The major policy goal of the BBA was to increase the audit rate of partnerships. The BBA significantly restructured the partnership audit process in many ways, with the aim of making it easier for the IRS to audit partnerships. In addition, the BBA streamlines the audit and collection function to keep both at the partnership level. Partnerships subject to tax in the United States can expect a much higher audit rate as the IRS implements the changes under the BBA.

ENDNOTES

1 Bipartisan Budget Act of 2015, P.L. 114-74 (Nov. 2, 2015), available online at *www.congress.gov/114/plaws/publ74/PLAW-114publ74.pdf* (accessed Feb. 12, 2019).

2 There are countless decisions that partnerships should make in light of the BBA and the significant changes it made to how IRS examinations of partnerships will be conducted. However, for purposes of preparing an IRS Form 1065 for 2018, partnerships must determine whether they are eligible to elect out of the BBA, if so, whether to make the election, and if not, who will serve as the partnership representative.

3 GAO-14-746T (July 22, 2014), available online at *www.gao.gov/assets/670/664917.pdf* (accessed Feb. 12, 2019).

4 *Id.*

5 Code Sec. 6221(a).

6 Code Sec. 6221(b)(1)(B).

7 Code Sec. 6221(b)(1)(C).

8 Code Sec. 6221(b)(1)(C); Reg. §301.6221(b)-1(b)(3).

9 Donald T. Williamson, *Partnership Audit Rules for the Next Decade*, The Tax Adviser (July 1, 2016), available online at *www.thetaxadviser.com/issues/2016/jul/partnership-audit-rules-for-next-decade.html*.

10 Code Sec. 6221.

11 Code Sec. 6225(d).

12 Code Secs. 6225(b), 6241(4).

13 Code Secs. 6231(b)(2), 6235.

[14] Erich Yauch, *IRS Says More Partnership Audit Guidance on the Way*, TAX NOTES TODAY (Mar. 11, 2019), available online at *www.taxnotes.com/tax-notes-today/audits/irs-says-more-partnership-audit-guidance-way/2019/03/11/2970x*.

[15] Reg. §301.6221(b)-1(c)(2).

[16] Reg. §301.6221(b)-1(c)(3).

[17] Reg. §301.6223-1(b)(2).

[18] Code Sec. 6223(b); Reg. §301.6223-2(d).

[19] Reg. §301.6223-1(c)(1), (2).

[20] Reg. §301.6223-1(d), (e).

[21] Code Sec. 6223(a); Reg. §301.6223-1(a); Reg. §301.6223-1(f).

[22] Code Sec. 7701(a)(1). "Person" includes entities, and even the partnership itself. Reg. §301.6223-1(b)(1). If an entity is selected as the partnership representative, the partnership must appoint a "Designated Individual" of the entity to act on behalf of the partnership. Reg. §301.6223-1(b)(3).

[23] Reg. §301.6223-2(a), (d).

[24] T.D. 9839, providing final regulations under Code Sec. 6223, available online at *www.govinfo.gov/content/pkg/FR-2018-08-09/pdf/2018-17002.pdf*.

[25] T.D. 9839, Federal Register/Vol. 83, No. 154/Aug. 9, 2018/Rules and Regulations at 39336, available online at *www.govinfo.gov/content/pkg/FR-2018-08-09/pdf/2018-17002.pdf* (accessed Feb. 13, 2019).