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Exam

Final Regulations Empower Partnership Representatives in BBA Partnership Audit Regime

By George A. Hani*

I. Introduction

The Bipartisan Budget Act of 2015 (the "BBA") fundamentally changed how the Internal Revenue Service ("IRS") will conduct audits of partnerships. The BBA repealed the partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and the electing large partnership regime and replaced them with a new set of rules for centralized partnership audits and judicial review of partnership audit adjustments. The new BBA partnership audit rules are generally effective for audits of tax returns filed for tax years that begin after December 31, 2017. Most aspects of the new audit regime will not impact taxpayers unless and until an audit of such tax year begins, but two important aspects of the new regime require decisions at the time the return for such year is filed. One aspect is whether the partnership elects out of the new audit regime if it so desires and is eligible to do so. The second is the designation of the "partnership representative." Final regulations regarding the election out were released on January 2, 2018.[1] In addition, final regulations regarding the partnership representative were released on August 9, 2018.[2] Each of these finalized portions of the proposed regulations issued on June 14, 2017.[3] Key features of the rules regarding the partnership representative are discussed below.

A. Overview of New Partnership Representative Rules

As part of the BBA, Congress created the partnership representative ("Partnership Representative"), effectively as a replacement for the TEFRA tax matters partner ("TMP"). The role of the Partnership Representative in a BBA partnership audit, however, is vastly different from the role the TMP played in a TEFRA partnership audit. Importantly, in a BBA audit, the IRS can audit, assess, and collect at the partnership level while in a TEFRA audit the IRS could audit at the partnership level but, once the audit is completed, then had to assess and collect at the partner level. In addition, the scope of items that can be reviewed and adjusted in a BBA audit is at least as broad as what could be reviewed and adjusted in a TEFRA audit, and is potentially much broader. As amended by the TTCA, a BBA audit can go beyond just the particular items of income, gain, loss,

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deduction, or credit and can include "any item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return and including an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of, the partnership) which is relevant … in determining the tax liability of any person under chapter 1" of the Code.[4] Further, the Partnership Representative has the sole authority to act on behalf of the partnership for purposes of the BBA audit regime,[5] while under TEFRA, individual partners had various notice rights as well as the ability to opt out of decisions made by the TMP and contest audit adjustments themselves. Under the BBA, the partnership and all of its partners are bound by actions taken by the Partnership Representative on behalf of the partnership and by any final decision in a proceeding brought under the BBA audit regime.[6] The expansion of the audit activity that can now be taken at the partnership level coupled with the sweeping and apparently absolute power of the Partnership Representative makes the choice of the Partnership Representative (and as discussed below, the choice of the "designated individual" if needed) critical for a partnership and its partners.

Each partnership must designate, in the manner prescribed by the Secretary, a partner or other person with substantial presence in the United States as the Partnership Representative.[7] The Final PR Regulations require (as did the June Proposed Regulations) the appointment of a "designated individual" if an entity is selected as the Partnership Representative.[8] The June Proposed Regulations allowed the Partnership Representative to appoint the designated individual while the Final PR Regulations vest that decision solely with the partnership. The identification of the Partnership Representative and, if needed, the designated individual must be made on the partnership return for the tax year. This is an annual decision, so while there are rules restricting the timing for changing a Partnership Representative or designated individual once selected for a particular tax year (discussed below), a partnership is free to use a different Partnership Representative and/or designated individual for different tax years.

II. Discussion

The Final PR Regulations address certain key features of the June Proposed Regulations that drew much attention from taxpayers and tax practitioners. These include (1) the authority of the Partnership Representative, (2) the qualifications to be a Partnership Representative, and (3) the process for changing the Partnership Representative.

A. Authority of the Partnership Representative

As noted above, the statute gives the Partnership Representative the sole authority to act on behalf of the partnership and to bind all partners to any decisions made by the Partnership Representative in the context of a BBA audit. This includes all of the many critical decisions made in the course of an audit, such as extending the statute of limitations, agreeing to or contesting (administratively or in court) any proposed audit adjustments, and implementing one of the avenues embedded in the BBA regime to ameliorate the potential draconian impact of the imputed underpayment (for example through modification of the imputed underpayment or electing to "push out" the audit adjustments under Code Sec. 6226). The IRS's desire to have a single point of contact for conducting the audit is reasonable, legitimate, and avoids some of the needless frustration and complexity of TEFRA audits. The IRS also recognizes that partners and partnerships may separately contract with the Partnership Representative to "define the scope and limits of their relationship."[9] Such limits could include, for example, requiring notice and/or input for certain decisions a Partnership Representative might make in the course of the audit, and may even restrict or limit the Partnership Representative's ability to take certain actions without some form of approval. However, the preamble also states that "because the IRS is not a party to these agreements, it is not bound by any of them."[10] The preamble further provides that "[a]ny remedy the partnership would have against the partnership representative if the partnership representative failed to act in accordance with those agreements would be under state law with respect to the partnership representative."[11] Thus, the IRS is not concerned about any such contractual or state-law rights that a partner may have. The IRS will look only to the Partnership Representative and accept all decisions of the Partnership Representative as binding on the partnership and its partners. The legal basis for the IRS view, as noted in the preamble to the Final PR Regulations, is that "the authority of the partnership representative under federal law preempts any state law requirements."[12] The IRS and Treasury modified the operative language in the regulation, but with essentially the same effect. While the June Proposed Regulations provided that "no state law, partnership agreement, or other document could limit the authority of the partnership representative,"[13] the Final PR Regulations articulate it this way: "The failure of the partnership representative to follow any state law, partnership agreement, or other document or agreement has no effect on the authority of the partnership representative or the designated individual."[14]

Time (and perhaps litigation) will tell if the IRS can accept the decision of a Partnership Representative if the IRS knows that in making such decision, the Partnership Representative has exceeded its authority under state law, the partnership agreement, or otherwise. In the meantime, it may be possible that IRS agents may ask (or IRS forms may require) a Partnership Representative to affirm that such decision is within its authority. We have seen a glimmer of this approach in the recently released draft Form 8979 *Partnership Representative Revocation, Designation and Resignation*, for which the person who signs on behalf of the partnership to revoke a partnership representative designation or designated individual appointment must declare under penalties of perjury that "I am duly authorized by the partnership or LLC to (1) revoke the designation of the partnership representative or the appointment of the designated individual and (2) make a designation of a successor partnership representative (and appointment of a designated individual, if applicable) or make an appointment of a successor designated individual."

B. Qualifications to Be a Partnership Representative

Under the statute, the only qualifications to be a Partnership Representative was to be a "person" that has "a substantial presence in the United States."[15] The June Proposed Regulations had added a third requirement to be a Partnership Representative, which is that the selected person have "capacity to act." While the Final PR Regulations largely followed the June Proposed Regulations on the first two (statutory) requirements, the Final PR Regulations dropped the third requirement that had been added in the June Proposed Regulations.

The "capacity to act" requirement drew a significant amount of commentary. The June Proposed Regulations had included a laundry list of circumstances in which a Partnership Representative would lack capacity to act, including a catch-all category for "any similar situation where the IRS reasonably determines the person may no longer have the capacity to act."[16] Commentators suggested other circumstances in which someone might have lost the capacity to act and also asked the IRS and Treasury to adopt standards for the catch-all category.

Upon reflection, the IRS and Treasury dropped the "capacity to act" requirement. The preamble correctly notes that "partnerships are in the best position to make the decision as to who can best represent them before the IRS" and "that regulations regarding capacity to act would provide an unnecessary limitation on the partnership's choice of who it believes is the best person to act on the partnership's behalf."[17]

The elimination of this requirement has important implications for the prospect of the IRS designating a Partnership Representative. Under the statute, if the partnership fails to designate a Partnership Representative, the IRS can designate any person to serve in that role. If that were to happen, the partnership cannot revoke or terminate that designation (although the designated Partnership Representative could resign). If a partnership designates a Partnership Representative (or appoints a designated individual) that does not meet all the requirements to be a Partnership Representative, then the IRS will give the partnership time to rectify, but if the partnership fails to do so, the IRS could end up designating a Partnership Representative, which again cannot be revoked or terminated by the partnership. Partnerships and practitioners worried that IRS agents could use the capacity to act requirement as a basis to remove a Partnership Representative and create the prospect of an IRS-designated Partnership Representative. The elimination of the capacity to act requirement also eliminates this prospect.

What is left, then, in terms of eligibility to serve as a Partnership Representative are the two statutory requirements. For those two requirements, the Final PR Regulations largely followed the June Proposed Regulations.

With respect to "person," the Final PR Regulations adopt (as did the June Proposed Regulations) the Code Sec. 7701(a)(1) definition of person.[18] Code Sec. 7701(a)(1) provides that the term person "shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." This definition clearly encompasses entities as eligible to be a Partnership Representative, so the regulations require the partnership to appoint a "Designated Individual" to act "as the sole individual through whom the partnership representative will act for all purposes" related to the BBA audit regime.[19] The Designated Individual must also meet the substantial presence requirement.[20] The Final PR Regulations also clarify that a wholly-owned entity disregarded as separate from its owner for federal income tax purposes can serve as the Partnership Representative.[21] In addition, the Final PR Regulations specifically provide that a "partnership can designate itself as its own" Partnership Representative so long as it meets the other requirements to be a Partnership Representative.[22]

It is worth noting that nothing in the Final PR Regulations requires the designated individual to have any actual authority to act on behalf of the entity Partnership Representative in any other context. The designated individual need not be an officer, director, or other person that state law would authorize to act on behalf of the entity (to, for example, sign tax returns or designate other representatives on a Form 2848) or even be an employee of the Partnership Representative. The designated individual need not even be designated by

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the Partnership Representative as a representative on a Form 2848. While some of the scenarios may seem odd, the lack of rules preventing them reflects the philosophy of the regulations, which is essentially that the IRS does not want to micromanage the relationship between the partnership and its partners and further is not going to write rules to protect the partnership or partners because all the IRS wants is an individual with whom the IRS can efficiently interact in conducting the audit.

The Final PR Regulations modify slightly the term "substantial presence." The Final PR Regulations adopt a two-prong test to have a substantial presence in the United States for this purpose:

(i) The person makes themselves available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS in accordance with Reg. §301.7605-1; and
(ii) The person has a U.S. taxpayer identification number, a street address that is in the United States and a telephone number with a U.S. area code.[23]

The preamble points out that the revised standard for "substantial presence" is "designed to allow the partnership and the IRS maximum flexibility to determine mutually convenient times to meet, to schedule phone calls, and to share information, while at the same time ensuring that the partnership and its books and records are available to the IRS during the administrative proceeding."[24] The Final PR Regulations also add the cross-reference to the existing regulations under Code Sec. 7605 regarding reasonable time and place for examinations that are equally applicable to audits in the BBA partnership audit regime. For similar reasons, the Final PR Regulations dropped the phrase "normal business hours" that had been used in the June Proposed Regulations. The preamble also notes that the use of the phrase "makes themselves available" is "to distinguish between a partnership representative who is generally available to meet and works with the IRS to facilitate communications and a partnership representative who is generally available but refuses to meet with the IRS."[25]

C. Process for Changing the Partnership Representative

As noted above, the initial designation of the Partnership Representative must be made on the partnership's tax return (Form 1065). The Final PR Regulations maintain the rule reflected in the June Proposed Regulations that the Partnership Representative designation may only be changed in the context of an administrative proceeding or in conjunction with the filing of a valid Administrative Adjustment Request ("AAR") (the partnership equivalent to an amended return or refund claim). While many commentators requested rules that would allow changes in the Partnership Representative prior to the commencement of an audit, the IRS and Treasury declined to adopt such rules primarily because there may be no audit and thus no need to add the complexity of tracking such designation changes. There is certain paperwork to complete to effectuate a change in the Partnership Representative designations, and taxpayers who want to make a change can (and should) complete all necessary paperwork and hold such paperwork for submission to the IRS upon the commencement of an audit (or filing of an AAR). Completing the paperwork contemporaneously with the decision avoids the problems of tracking down persons later to complete the forms. The Final PR Regulations also changed the rules so that the notice of administrative proceeding ("NAP") is mailed only to the partnership (rather than to both the partnership and the Partnership Representative as in the June Proposed Regulations), which allows the partnership to effectuate a change in the Partnership Representative before the audit commences in earnest.[26]

Changing the Partnership Representative designation requires that either the current Partnership Representative resigns or the partnership revokes the prior Partnership Representative designation. The logistics, and particularly, the timing of the effective date for such resignations or revocation was the topic of much discussion after the June Proposed Regulations were issued. The June Proposed Regulations included a 30-day effective date for resignations and revocation, and also allowed a resigning Partnership Representative to designate a successor. Commentators envisioned potential breakdowns in the relationship between a partnership and its Partnership Representative and the potential for mischief of a disgruntled Partnership Representative, especially given the sweeping and seemingly absolute authority of the Partnership Representative.

The Final PR Regulations address these concerns by making the resignation or revocation generally effective immediately upon receipt by the IRS.[27] This is welcomed news. Particularly with revocations, the partnership can control the timing of the delivery to the IRS, and, as the preamble points out, the partnership can provide the revocation "directly to the IRS employee handling the administrative proceeding to ensure that the IRS has received prompt notification of the change."[28] In addition, the Final PR Regulations added provisions that require the IRS to notify the partnership and outgoing Partnership Representative within 30 days after receipt of a valid resignation or revocation.[29]

Another important change relates to the appointment of the successor or next Partnership Representative. The June Proposed Regulations had permitted a resigning Partnership Representative to identify the new Partnership

Representative. The Final PR Regulations vest that decision solely with the partnership.

III. Conclusion

The new regime for centralized partnership audits is now in effect and here to stay. The Partnership Representative is a critical part of the new regime given the authority vested in the Partnership Representative by the statute. Having finalized regulations allows partners and their partnerships to have a better sense of the lay of the land as they select their Partnership Representatives and amend (or draft) partnership agreements and other agreements or documents establishing the working relationship between the Partnership Representative, the partnership, and the partners.

ENDNOTES

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1 82 FR 28398 (T.D. 9829).

2 83 FR 39331 (T.D. 9839) (the "Final PR Regulations").

3 82 FR 27334, REG-136118-15 (the "June Proposed Regulations"). Aspects of the June Proposed Regulations that have not yet been finalized include rules regarding consistent treatment by partners, partnership adjustments made by the IRS and the determination of the amount of the partnership's liability (referred to as the imputed underpayment), the election for partners to take partnership adjustments into account, and administrative adjustment requests ("AARs"). In addition, the IRS and Treasury issued proposed (and not yet finalized) regulations (1) on November 30, 2017, regarding international provisions under the centralized partnership audit regime, including rules relating to the withholding of tax on foreign persons, the withholding of tax to enforce reporting on certain foreign accounts, and the treatment of creditable foreign tax expenditures of a partnership (82 FR 56765, REG-119337-17); (2) on December 19, 2017, regarding administrative and procedural rules, including rules addressing assessment and collection, penalties and interest, periods of limitations on making partnership adjustments, and judicial review of partnership adjustments (82 FR 27071, REG-120232-17, and REG-120233-17); and (3) on February 2, 2018, regarding adjusting tax attributes (83 FR 4868, REG-118067-17). Finally, the IRS and Treasury issued proposed regulations on August 13, 2018 (REG-136118-15; 83 FR 41954-42015) withdrawing and re-proposing parts of earlier proposed regulations to reflect changes made by the Tax Technical Corrections Act of 2018 ("TTCA").

4 Code Sec. 6241(2)(B)(i).

5 Code Sec. 6223(a).

6 Code Sec. 6223(b).

7 Code Sec. 6223(a).

8 Except where otherwise noted, references to the Partnership Representative include the designated individual for an entity Partnership Representative.

9 83 FR 39342.

10 *Id.*

11 83 FR 39342-3.

12 83 FR 39342.

13 Proposed Reg. §301.6223-2(c).

14 Reg. §301.6223-2(d)(1).

15 Code Sec. 6223(a).

16 Proposed Reg. §301.6223-1(b)(4)(vi).

17 83 FR 39344.

18 Reg. §301.6223-1(b).

19 Reg. §301.6223-1(b)(3)(i).

20 *Id.*

21 Reg. §301.6223-1(b)(1).

22 *Id.*

23 Reg. §301.6223-1(b)(2).

24 83 FR 39334.

25 83 FR 39334.

26 *See* Reg. §301.6223-1(e)(2).

27 Reg. §§301.6223-1(d) and (e).

28 83 FR 39388.

29 Reg. §§301.6223-1(d) and (e).

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