WHY EVEN NON-TAX LAWYERS SHOULD WARN THEIR LLC CLIENTS ABOUT THE RADICAL NEW BBA PARTNERSHIP AUDIT RULES

By John M. Cunningham[1]

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015 (the "BBA"). The BBA contains extensive new statutory rules governing IRS audits of business entities taxable as partnerships. The BBA rules will become effective beginning on January 1, 2018. Affected entities include, among others, general partnerships, limited liability partnerships, limited partnerships, limited liability limited partnerships, and the many millions of multi-member LLCs that accept the default federal income tax regimen of partnership taxation. (For brevity, I will refer here to all of these various types of state-law business entities taxable as partnerships simply as "partnerships").

The BBA rules are radical and draconian. In this article, I will briefly summarize the most important of them. I will also explain why, even if they are not tax lawyers and would never normally provide tax advice to their clients, lawyers who have clients that are partnerships or partners must provide these clients with at least basic advice about the BBA partnership audit rules.

There are 13 key BBA rules of which the above lawyers should be aware and of which they should advise the above clients. If their tax colleagues agree, one safe and simple way by which they can do so is to provide these clients with copies of this article.

The 13 key BBA rules are as follows:

1) With only one major exception, when the IRS decides to audit a partnership under the BBA, (i) it will do so by auditing the partnership itself and not the partners; (ii) it will assess any tax resulting from the audit against the partnership, not against the partners; and (iii) it will collect this tax from the partnership, not from the partners.

2) The partners of a partnership that is audited under the BBA rules will have no statutory right to participate in any partnership audit or even to receive notice of the audit or of audit developments or outcomes.

3) The major exception to the above rule is for BBA "small partnerships"—the BBA technical term for partnerships that have 100 or fewer partners and all of whose partners are either individuals, the estates of deceased individual partners, or legal entities taxable as C or S corporations. Unless the U.S. Treasury Department eventually determines otherwise, BBA small partnerships may *not* include partnerships whose members are, among other types of entities, (i) revocable or irrevocable trusts; (ii) single-member LLCs; or (iii) partnerships that are themselves partners of partnerships. Many existing multi-member LLCs have as partners one or more of these various types of ineligible partners.

4) To avoid the serious tax risks of BBA audits, partnerships that cannot presently qualify as BBA small partnerships should consider restructuring themselves to so qualify. For example, if they have partners that, for estate planning purposes, are revocable trusts, they should request the trustees of these trusts to consider distributing their partnership interests pro rata to their beneficiaries.

5) To avoid the above audit risks, partnerships in formation should, whenever possible, be formed as BBA small partnerships.

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[1] John Cunningham is the principal of the Law Offices of John M. Cunningham, PLLC, Concord, NH, and he is of counsel to the New Hampshire-based law firm of McLane Middleton, P.A. He is the principal author of *Drafting Limited Liability Company Operating Agreements*, the leading U.S. LLC formbook and practice manual, published by Wolters Kluwer Law & Business. He is a former trial lawyer with the Tax Division of the U.S. Department of Justice and a former member of the Foreign Trade and Tax Department of the international law firm of Baker McKenzie. His telephone number is (603) 856-7172. His e-mail address is lawjmc@comcast.net. His website address is http://www.cunninghamonoperatingagreements.com/

6) Even if a partnership qualifies as a BBA small partnership under the above rules, it will not be a BBA small partnership unless it also expressly elects that status in its federal tax returns for 2018 and thereafter.

7) Any tax underpayment determined by the IRS in a BBA partnership audit will, in general, be subject to tax at the highest applicable rate for individuals. This rate is currently 39.6%--as noted, a truly draconian rate.

8) In order to address BBA issues, the partners of both partnerships that *are* BBA small partnerships and of those that are *not* need numerous specialized partnership audit provisions in their partnership agreements; and, if at all possible, they should negotiate and agree on these provisions and should include them in these agreements before January 1, 2018. Furthermore, since so-called "TEFRA" partnership audit provisions will become obsolete in 2018, they must delete these provisions from their agreements if they contain them.

9) In particular, partnerships that are BBA small partnerships need provisions in their partnership agreements that bar their partners from transferring all or any part of their partnership interests to persons ineligible to be partners of BBA small partnerships.

10) Similarly, the partnership agreements of partnerships that are *not* BBA small partnerships need provisions that, among other things, (i) require partners to provide various BBA-mandated information to their partnerships; and (ii) provide for the appointment, resignation, dismissal and replacement of "partnership representatives"—*i.e.*, the persons the BBA requires partnerships to appoint to handle BBA partnership audits.

11) In addition, the partnership agreements of partnerships that are *not* BBA small partnerships must contain provisions protecting partnership representatives from personal liability to partnerships and their partners for actions taken by these representatives in handling BBA partnership audits.

12) Under the relevant BBA rules, a partnership that is subject to tax as a result of a BBA audit may "push out" to its partners or "pull in" to them any tax liability the partnership incurs in the audit, and doing so may be highly beneficial to the partnership itself or to its partners. Thus, after any such audit, a partnership must explore these two procedures. However, determining whether to use them will often require a complex tax and economic analysis.

13) Lawyers representing clients selling or purchasing partnership interests should advise them about the significance for them of the BBA rules in these transactions.

Why must even non-tax lawyers advise their partnership and partner clients about the above BBA rules? The main reason is, quite frankly, that because these rules are unusually complex and difficult to understand, the tax advisers of many partnerships are unlikely to master them.

Furthermore, many of these tax preparers, unless they are also lawyers, are unlikely to be aware of the need for BBA partnership audit provisions in the partnership agreements of their partnership clients. Finally, even if these tax preparers have a solid basic understanding of the BBA, they may not be monitoring Treasury and IRS developments relating to them. In the next few years, these developments are likely to appear at a rapid rate.

Finally, an easy way for business entities to avoid BBA audits is to make S elections. However, many tax preparers are unaware that LLCs and other non-corporate entities may make these elections.

Finally, non-tax lawyers must advise their partnership and partner clients that, even if the tax positions in the federal tax returns of their clients are conservative, they should not assume that the risk of their incurring BBA audits will be small, since:

Because the BBA rules have greatly increased the IRS's partnership audit capability, the IRS is likely to substantially increase the number of its partnership audits, including even audits of relatively small partnerships.

Moreover, because of the increase in IRS partnership audit capability, if the IRS audits individuals and entities who are partners of partnerships, these audits will often prompt the IRS to audit their partnerships.

To summarize: The new BBA partnership audit rules pose grave risks for all partnerships except BBA "small partnerships." Thus, even lawyers who are not tax lawyers have a duty to warn their partner and partnership clients about these rules. For non-tax lawyers, this duty may not be mandated by rules of professional conduct. However, it is unquestionably mandated in the interest of client service.

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