



new partnership audit regime and partnership m&a transactions

MSK Client Alert

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Background:

Congress has changed the way partnership¹ audits will be conducted in the future. Beginning with tax years starting on or after January 1, 2018, audits will still be done at the partnership level; however unlike current practice where adjustments and additional tax payments are made at the partner level, under the new rules the adjustments and additional tax payments will in many cases now be done at the partnership level with the payments made in the year the tax audit is finalized. The changes were made to make it easier for the IRS to audit partnerships.

The new rules raise a number of unanswered questions in the M&A arena all of which require a significant rethinking of the way partnership M&A transactions are structured and documented. There are likely to be significant differences in the responses to the Open Issues set out below between a transaction involving a LLC, which would survive as a separate legal entity after the acquisition, and a limited partnership which would terminate and not exist as a separate legal entity after the acquisition as it would only have one member.

As an example, assume that A, B and C are the members of ABC LLC, with B being the manager and partnership representative. In January 2019, D purchases all of the outstanding membership interests from A, B and C for cash, ABC LLC becomes a single member LLC for corporate law purposes, and D become the manager and implicitly the "partnership representative."

For tax purposes, Revenue Ruling 99-6 provides that D is treated as purchasing assets, while A, B and C are treated as selling membership interests.

practice areas

corporate & business
transactions

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transactional tax



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Open Issues:

1. If the IRS decides in 2021 to audit the ABC LLC for the 2018 tax year, who do they contact – B or D? If B, is B obligated to inform D of the audit? What if they contact D?
2. Did D do tax due diligence on ABC LLC prior to the purchase, and establish a purchase price holdback for any federal or state tax exposures at the ABC LLC level in the membership interest purchase agreement? Was that set up as a separate item under the escrow agreement to be held until the last of the tax statutes of limitations has expired?
3. If the IRS seeks to impose additional taxes for the 2018 tax year, are those taxes imposed on ABC LLC, now surviving as a single member LLC owned by D, or on the terminated tax partnership? Presumably on ABC LLC although very unclear. What happens if the proposed tax and penalty assessments exceed the amounts in escrow – did the membership interest purchase agreement provide for indemnification by A, B and C in such event?
4. Who controls the audit for the 2018 tax year – B or D? Was the issue of audits of pre-acquisition tax years addressed in the membership interest purchase agreement?
5. If ABC LLC retained tax advisors, can D as the manager of the surviving LLC gain access to the tax advisors' work papers, memorandums, etc.? If the tax advice was incorrect, can A, B and C, the former members, assert claims against the advisor? Probably not, since the LLC (and not its members) was most likely the client of the tax advisors. What about B in its capacity as the former partnership representative? Was the issue of advisor – client privilege addressed in the membership interest purchase agreement?
6. If the tax authorities assess penalties against ABC LLC, at what level is "reasonable cause" determined? At the LLC level or at the member level?

¹For these purposes, partnerships are treated as including both limited partnerships and limited liability companies classified as partnerships.