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The New BBA Centralized Partnership Audit Rules and Bankruptcy: A Shotgun Wedding Without Any Marital Bliss

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A. Lavar Taylor

I. Introduction

Bankruptcy and taxes. Taxes and bankruptcy. These two topics go together like peas and carrots. Except that tax professionals don't like peas, and bankruptcy professionals don't like carrots.

It appears to be a metaphysical certainty that Congress, when it enacted the new Centralized Partnership Audit Regime ("CPAR") rules contained in §§ 6221 through 6241 of the Internal Revenue Code in 2015, forgot that it had enacted the Bankruptcy Code almost forty years earlier. These new CPAR rules have replaced the so-called TEFRA partnership audit rules,[1] and are generally effective for tax years starting after December 31, 2017. Thus, in 2019 we have entered the very first tax return filing season in which the CPAR rules potentially may apply to all tax partnerships, which can include not only "real" partnerships but also multi-member limited liability companies that have elected to be treated as partnerships for income tax purposes.

The CPAR statutory scheme is in many places completely incompatible with the Bankruptcy Code, despite the fact that a Technical Corrections Act was passed in 2018. Yet, these two statutory schemes must co-exist. Hence the subtitle: A Shotgun Wedding without Any Marital Bliss.

Bankruptcy practitioners and trustees would be unwise to attempt to thoroughly understand the new CPAR rules on their own. Indeed, even most tax practitioners will likely never truly understand these new rules. While the statutory provisions are not lengthy, the regulations implementing those provisions consume hundreds of pages.[2] Rather than attempt to explain comprehensively all of these rules and regulations—an impossible task in a short article—this article provides an examination of several key aspects of the new CPAR rules that should be of interest to bankruptcy practitioners and trustees, along with questions as to how each of these key aspects might interact with the Bankruptcy Code.

II. Bankruptcy Practitioners and Trustees Must First Determine Whether the New CPAR Rules Apply to a Tax Partnership or to a Partner in a Tax Partnership

The first step in figuring out whether there is a need to deal with the new CPAR rules is to determine whether an entity that is in bankruptcy (or is contemplating filing bankruptcy) is a tax partnership that is governed by the new CPAR rules. In addition, where any person or entity is in bankruptcy, or is contemplating filing bankruptcy, it is necessary to determine whether that person or entity has an ownership interest in, or other connection with, an entity that is a tax partnership governed by the new CPAR rules. This creates a whole new area of required due diligence for bankruptcy practitioners and trustees.

By default, all partnerships are governed by the CPAR rules for tax years beginning after December 31, 2017.[3] However, certain partnerships are eligible to elect

out of the CPAR rules. Such an election is done on annual basis.

First, partnerships that furnish/file 100 or fewer Form K-1s in a given tax year may be eligible to elect out of the new CPAR rules.[4] This "100 or fewer Form K-1s" rule is not straightforward, however. For example, when a partnership with one or more Subchapter S corporation partners makes this election, the partnership must count all of the S-corporation shareholders for purposes of the "100 or fewer Form K-1s" threshold.[5] If the partnership does not satisfy this "100 or fewer Form K-1s" requirement in a given year, the partnership is subject to the new CPAR rules for that year.

Second, to be eligible to elect out of the new CPAR rules, each partner of the partnership must be "an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner."[6] Thus, for example, if a grantor trust is a partner in a particular year, the partnership may not elect out of the new CPAR rules for that year. This provision has generated a great deal of heartburn for estate planners, who often rely on grantor trusts as an estate planning tool.

Assuming that the partnership is eligible to elect out of the CPAR rules for a given year, certain procedural requirements must be met for the election to be valid. First, the election must be included with a timely filed partnership return for the election year.[7] Failure to timely file the election with respect to any year means that the partnership will be governed by the CPAR rules for that year.[8] Second, all current partners must be notified of the election.[9]

If a partnership makes a valid, timely election out of the CPAR rules for a given year, any adjustments made to the partnership's tax return as the result of an audit of that return will affect only the partners of the partnership. And, once a valid election out has been made, the IRS cannot assess additional taxes against the partners of the partnership without (1) auditing the tax returns of the partners individually and (2) proposing any additional taxes owed prior to the expiration of the statute of limitations on assessment for each partner individually. These are the same rules that applied prior to the enactment of the TEFRA partnership provisions in 1982.

Because elections out of the CPAR rules are made on an annual basis, the due diligence that needs to be done by bankruptcy practitioners and trustees is significant. Merely determining that there was or was not an election out for only one tax year out of many to which the CPAR rules might apply is not sufficient.

III. If the CPAR Rules Apply, Bankruptcy Practitioners and Trustees Need to Understand the Procedural Rules and Which Parties May Be Liable for Any Additional Tax Owed as the Result of an Audit of the Partnership's Tax Return(s)

The CPAR rules have turned the tax world upside down. These rules, left unchanged, will turn the bankruptcy world both upside down and inside out.

A. Who Can Be Liable for Taxes Owed as the Result of Adjustments to a Partnership's Tax Returns

Under the new CPAR rules, it is possible that, in the event of an IRS audit of the partnership's tax return, taxes could be owed by any of the following parties:

1. The partnership itself may be liable for taxes based on adjustments made to the partnership's tax return(s) for the year(s) under audit. *The taxes, however, would be owed by the partnership for the tax year in which the adjustments at issue in any administrative or judicial proceeding involving the partnership's tax returns for earlier years become "final."*[10] For example, assume that the IRS audits a partnership's tax returns for 2019 and 2020 and proposes increases in the partnership's net income of $1 million for each of these years. If these proposed adjustments are upheld in court, and the court decision becomes final in the year 2026, the partnership could be liable for tax on this $2 million of additional income in the year 2026. This result could occur even though all of the income, deductions, and credits of the partnership shown on the original 2019 and 2020 partnership tax returns flowed through to the partners of the partnership in those years.

   How is the amount of tax owed by the partnership computed? The answer can be complicated. For now,

just assume that tax may be computed at the highest possible tax rates of the partners.

2. The partners of the partnership in the year in which the dispute regarding the proposed adjustments to the partnership's tax return(s) for earlier tax years becomes final may be liable for taxes owed as the result of adjustments to the partnership's tax return(s) for those earlier years.[11]

   Thus, for example, take the scenario in 1) above, where the IRS proposes adjustments to the partnership's 2019 and 2010 tax returns and the court decision upholding these adjustments becomes final in 2026. If the partnership is liable in the year 2026 for the tax on the adjustments to the partnership's tax returns for 2019 and 2020 and the partnership fails to pay the taxes that are owed, the IRS may assess the taxes owed by the partnership for the year 2026, on a pro rata basis, against the persons/entities who are partners as of the close of the partnership's 2026 tax year. The IRS may assess the taxes against the 2026 partners even though none of the 2026 partners may have been partners in 2019 or 2020!

3. The partners of the partnership in the years for which the partnership's tax return(s) are being audited may liable for the additional taxes owed. This could happen if the partnership makes a so-called "push-out election,"[12] which is discussed below.

The fact that there are three possible parties (or sets of parties, in the case of the partners) who could be held liable for additional taxes owed as the result of an audit of a partnership's federal income tax returns creates challenges for bankruptcy practitioners and trustees. The default rule, however, is that the partnership is liable for any tax owed as the result of adjustments made to the partnership's tax returns that were audited, and this liability is imposed in the year in which the adjustments to the partnership's tax returns for earlier years become "final."[13]

The enactment of the CPAR rules created a bonanza for transactional attorneys who draft partnership agreements. They were required to include indemnification provisions dealing with the potential consequences to the partnership, current partners, and future partners of adjustments made by the IRS to the partnership's federal tax returns. These indemnification provisions, in turn, are of interest to bankruptcy practitioners and trustees because they give rise to contingent claims and, in some cases, will give rise to actual claims.

B. How Are Audits and Any Subsequent Court Proceedings Handled Under the CPAR Rules?

The CPAR rules differ significantly from the old TEFRA partnership audit rules on the question of who may participate in an audit of the partnership's tax return and in judicial proceedings arising out the audit of the partnership's tax return. The partnership must be represented at all times by a single partnership representative (or, if the partnership representative is an entity, that entity must assign a "designated individual" to act on behalf of the entity).[14] The partnership must designate a representative for each individual tax year, and a representative may represent the partnership only for the designated year(s).[15] That representative need not be a member of the partnership, but must have a substantial presence within the United States.[16]

Partners (other than the partnership representative) are precluded from participating in any partnership audit or in any administrative or judicial proceedings arising out of the partnership audit,[17] and there is no statutory requirement that the partnership representative provide notice to any of the partners regarding either the partnership audit or any subsequent administrative or judicial proceedings.[18] Absent a provision in the partnership agreement, partners (and attorneys representing partners) may not be informed of any partnership audit proceedings. Such notification requirements would normally be dealt with in the partnership or LLC agreement, requiring that careful attention be paid to the notification requirements in the partnership agreement.

Partners are bound by the results of a partnership proceeding, even though they may not participate in that proceeding.[19] This statutory requirement could conceivably create a due process issue, for example, where a single partnership representative is required to represent all partners, but two or more partners have adverse interests in the resolution of the issues raised in the partnership proceeding. The possibility of two partners having adverse interests in the resolution of the issues raised in the partnership proceeding is particularly

acute where issues raised in the audit include issues relating to the potential cancellation of debt income at the partnership level.

This problem can become even more acute when the partnership fails to designate a representative, or if the partnership representative resigns or has their designation revoked. The IRS may appoint a representative itself, if it determines that there is no valid representative.[20] If the IRS makes that determination, it will notify the partnership that there is no valid designation of a partnership representative, and the partnership will have thirty days to designate a partnership representative.[21] Moreover, if no designation is made by the partnership within the thirty-day period and the IRS then designates a representative itself, the IRS's appointment of the partnership representative may be revoked by the partnership only with permission from the IRS.[22] Potential due process issues will have to be addressed by the courts as they arise.

The shifting of a potential tax deficiency from the partnership to its partners following an audit of the partnership return is referred to a "push out" election, and is done pursuant to IRC § 6226. A push out election means the partnership will shift the imputed underpayment(s) from the partnership to the partners in the year(s) for which the partnership's tax return(s) were audited, or "review year" partners.[23] This election must be made within forty-five days of the partnership receiving the Final Partnership Adjustments ("FPA") from the IRS.[24] Furthermore, while the election may be made at the discretion of the partnership representative,[25] the partnership must furnish notices to the review year partners and to the IRS, stating the partners' respective shares of the FPA, within sixty days after making the election.[26]

IV. Bankruptcy Practitioners and Trustees Will Need to Perform Due Diligence Regarding the Applicability and Application of the CPAR Rules

By now, the bankruptcy practitioners and trustees who are reading this article should realize that they will need to perform due diligence regarding both the applicability and the application of the CPAR rules. Below is a very simplified description of some of that due diligence.

A. Where the Tax Partnership is the (Prospective) Debtor

In connection with any anticipated or existing bankruptcy proceeding involving a tax partnership (which includes both a "real" partnership and a multi-member limited liability company that has elected to be treated as a partnership),[27] a bankruptcy professional representing the tax partnership, or a trustee administering the partnership bankruptcy estate, must undertake the due diligence necessary to determine whether the CPAR rules apply to that entity for any tax year.[28] That due diligence will include a review of all of the partnership's tax returns for years 2018 forward, and, if there are questions as to whether there was a valid election out of the CPAR rules for any such year, that due diligence could be considerable.

If the CPAR rules do not apply, the tax partnership cannot be held liable for any additional taxes owed as the result of any audit of the partnership's tax return. Any audit of the partnership's tax return will result in additional taxes owed by the tax partners to which the income and expenses flowed. Thus, any tax underpayments owed as the result of an audit of the partnership's tax returns will not have a direct effect on either a reorganization or a liquidation of the partnership. (There may be some indirect effects, but that is a different article.)

If the CPAR rules do apply, then a significant amount of additional due diligence will be necessary. First, the bankruptcy professional or trustee will need to determine whether there are any ongoing partnership level administrative proceedings or partnership level judicial proceedings involving the IRS. If there are no such proceedings, they must still monitor all correspondence from the IRS in case the IRS starts an audit of the partnership's tax return(s) during the bankruptcy proceedings. If there are ongoing CPAR-related proceedings of any kind, the bankruptcy practitioner representing the debtor or trustee should consult a tax professional with appropriate experience and knowledge. Because the outcomes of an audit, or of subsequent administrative or judicial proceedings, could result in the imposition of liability on the partnership or on existing or former partners of the partnership, prompt development of the facts and prompt consultation with a qualified tax professional will be essential.

Second, the bankruptcy professional will need to review the partnership agreement, along with any additional agreements that may exist involving the partnership and existing and/or former partners, to determine the extent to which those agreements address obligations relating to tax issues. The contents of those agreements will affect what steps are to be taken going forward.

B. Where the Tax Partner is the (Prospective) Debtor

In connection with any anticipated or existing bankruptcy proceeding involving a person or party who is a partner in a tax partnership that may be subject to the CPAR rules, a bankruptcy professional representing the tax partner and a trustee managing the tax partner's bankruptcy estate must determine whether the new CPAR rules apply to the tax partnership in which the tax partner is a partner.

Doing that due diligence may prove difficult in certain cases. It will include obtaining a copy of the partnership's tax returns for all years 2018 forward. It may also require obtaining information from (or regarding) other partners in the tax partnership. In addition, bankruptcy professionals and trustees must recognize that every person, and every entity, that files (or is considering filing) bankruptcy could, potentially, be a partner in a partnership covered by the CPAR rules.

If the CPAR rules do not apply, then the tax due diligence can shift to the more traditional monitoring of correspondence from the IRS relating to the debtor's tax returns to see if the returns are audited by the IRS. If the CPAR rules do apply, however, a significant amount of additional due diligence will then be necessary, for the same reasons discussed above. The partner debtor/trustee may be incentivized to take steps to cause any liability that accrues as the result of an IRS audit of the partnership's tax returns to be assessed against the partnership.

V. The CPAR Rules Creates Unusual Issues in Bankruptcy Proceedings

There are many issues relating to the CPAR rules discussed above that are going to arise during the course of bankruptcy proceedings. Many of those issues will be identified only as time goes by and the opportunities for these two statutory schemes to collide develop. Nevertheless, there are some very obvious issues that stand out.

For example, suppose that (1) the IRS audits the 2019 tax return of a partnership; (2) in 2025 the partnership files for chapter 11 bankruptcy, and (3) in 2026 a dispute regarding the accuracy of the 2019 partnership return is resolved, resulting in an assessment of taxes owed by the partnership for the year 2026, but that, as of the end of 2026, the partnership's chapter 11 case is still pending:

- Can the 2026 claim for taxes based on adjustments to the 2019 partnership tax return be characterized as a pre-petition claim for bankruptcy purposes because the liability is based on adjustments to a pre-petition tax return, even though the claim is technically a claim for taxes owed for the year 2026 under the Internal Revenue Code?
- If the claim is treated as a post-petition claim, is it entitled to administrative expense status if the liability is for a tax year in which the bankruptcy estate is in existence? If the claim is treated as a pre-petition claim, is the claim entitled to priority status under § 507(a)(8)?
- How will courts construe the scope of a bankruptcy court's jurisdiction to determine the tax liability of a debtor under § 505(a) in the context of the CPAR rules?
- Will the bankruptcy court presiding over a partnership case lose jurisdiction under § 505(a) merely because a partnership has made a push-out election? Must a partnership representative of a partnership in chapter 11 obtain court approval to make a push-out election? Under what circumstances may a pre-petition push-out election be challenged after the fact in bankruptcy court? Can the bankruptcy court extend the forty-five day push-out period?
- How does the pendency of a partnership's bankruptcy proceeding at the time an assessment is made against the partnership affect the ability of the IRS to pursue the partners under § 6232(f)(1)(B) for the taxes owed by the partnership? What happens when both the partnership and the partner(s) are in bankruptcy?

There are also numerous questions relating to the partnership representative.

For example:

- Is the partnership representative a professional which/who must be employed by the court to be paid in a partnership bankruptcy proceeding?
- What happens if the court denies an application to employ the partnership representative? Can a bankruptcy court compel the appointment of a new partnership representative in violation of the "normal" rules for changing the partnership representative?
- Will a trustee in a partnership bankruptcy proceeding be able to assume the powers of a previously named partnership representative under circumstances that would not be recognized by the IRS in the absence of a bankruptcy filing?
- What happens if a partnership representative files for bankruptcy?

These uncertainties, among many other uncertainties, including several that cannot even be identified at the present time, are going to make the confirmation of chapter 11 plans and chapter 7 liquidations more time-consuming, difficult, and expensive.

VI. Statute of Limitations Provisions Applicable in Bankruptcy

The new CPAR rules contain the following special provision regarding the statute of limitations on the assessment and collection of taxes by the IRS[29]:

(6) Partnerships in cases under title 11 of United States Code

(A) **Suspension of period of limitations on making adjustment, assessment, or collection**

The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any imputed underpayment determined under this subchapter) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and—

(i) for adjustment or assessment, 60 days thereafter, and

(ii) for collection, 6 months thereafter.

(B) A rule similar to the rule of section 6213(f)(2) shall apply for purposes of section 6232(b).

In partnership bankruptcy cases, this provision may have no practical effect on the statute of limitations on assessments. Normally, the automatic stay does not prevent an ongoing IRS audit.[30] It also appears that the automatic stay does not bar the filing by a partnership of a tax court petition.[31] This last point may prove to be a trap for unwary practitioners, who may believe that the automatic stay provisions that prevent individuals and corporations from filing tax court petitions under many circumstances also prevent partnerships from filing tax court petitions.

In a collection context, where taxes have been assessed against the partnership prior to the partnership's filing under chapter 11, the provision set forth above will suspend the running of the ten-year statute of limitations applicable to collection proceedings while the IRS is barred from collecting from the partnership by reason of the bankruptcy proceeding.

VII. Is There Any Hope of Solving These Problems By Means Other Than Endless Litigation in the Bankruptcy Courts and the Tax Court?

There is some hope that the IRS will take administrative steps to resolve some of the issues discussed above, along with other issues that can be expected to arise as the result of the intersection of the Bankruptcy Code and the new CPAR rules. The 2018 Technical Corrections Act added IRC § 6241(11) to the Internal Revenue Code, which permits the IRS to designate certain areas as "special enforcement matters" that are exempt from the application of the new CPAR rules. There is currently no statutory prohibition on the ability of the IRS to designate bankruptcy as an area in which the new CPAR rules have no application.

The IRS, in Notice 2019-6,[32] indicated that it will be addressing certain other topics under the authority it now has under § 6241(11) to exempt certain areas from the application of the new CPAR rules. This gives hope that the IRS will use this section to exempt the application of these provisions in bankruptcy-related situations.

Don't forget that, in Greek mythology, Hope remained in Pandora's Box after that box was opened and had inflicted all of the world's troubles on Earth's population. Certainly one can argue that the enactment of the new CPAR rules without properly coordinating them with the Bankruptcy Code opened up a new Pandora's Box. Congress then gave us all hope by enacting § 6241(11) in the Technical Corrections Act. We can only hope that the IRS frees Hope from the box by exercising its authority under that section to exempt bankruptcy-related situations from the application of those rules.

Endnotes

1 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248. The TEFRA partnership audit rules came to be understood by the IRS and tax professionals as too complex, and they resulted in much litigation throughout the nearly four decades they were in place.

2 There are three sets of Final Regulations. The most recent set was issued on February 27, 2019, and can be found at https://www.federalregister.gov/documents/2019/02/27/2018-28140/centralized-partnership-audit-regime. The other two sets of final regulations were issued on December 29, 2017 (relating to election out of the new partnership rules), and on August 6, 2018 (relating to the Partnership Representative under the new rules and making an election to apply the new rules), and are available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-28398.pdf and https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-17002.pdf, respectively.

3 *See* I.R.C. § 6221 (defining which partnerships are automatically subject to the new BBA Rules).

4 § 6221(b); Treas. Reg. § 301.6221(b)-1(b).

5 I.R.C. § 6221(b)(2).

6 § 6221(b)(1)(C).

7 § 6221(b)(1)(D).

8 *Id.*; Treas. Reg. § 301.6221(b)-1(c)(2).

9 I.R.C. § 6221(b)(1)(E).

10 § 6225(a).

11 § 6232(f)(1)(B).

12 § 6226(a).

13 § 6225(a).

14 § 6223(a).

15 Treas. Reg. § 301.6223-1(c).

16 I.R.C. § 6225(a); *see also* Treas. Reg. § 301.6223-1(b)(2) (stating that a representative has a "substantial presence" in the United States if: (1) they "make themselves available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS" under Treasury Regulation section 301.7605-1 and (2) they have "a United States taxpayer identification number, a street address that is in the United States and a telephone number with a United States area code.").

17 I.R.C. § 6223(a); Treas. Reg. §§ 301.6223-1(a), 301.6223-2(d).

18 *But see* I.R.C. § 6231(a). This section states that the partnership will receive a notice that an audit has been initiated, a notice of proposed adjustments, and a notice of final adjustments to the partnership's returns. However, there is no statutory requirement that the partnership representative or designated individual notify the partnership or the partners of how they plan to handle the audit or of any other sort of audit or litigation strategy.

19 § 6223(a).

20 Treas. Reg. § 301.6223-1(f)(1); *see also* § 301.6223-1(f)(2) (stating the factors the IRS will weigh in determining a designation is in effect).

21 Treas. Reg. § 301.6223-1(f)(1).

22 § 301.6223-1(e)(6).

23 I.R.C. § 6226(a).

24 *Id.*

25 § 6223(b)(1).

26 § 6226(a)(2); Treas. Reg. § 301.6226-2(a).

27 *See* I.R.C. § 6241(1).

28 *See* § 6221 (establishing which partnerships are subject to the new CPAR rules).

29 § 6241(6).

30 11 U.S.C. § 362(b)(9).

31 *See* § 362(a)(8) (stating that the stay prohibits the commencement or continuation of a tax court proceeding only *concerning a corporate tax debtor* for a tax debt that may be determined by the bankruptcy court or *concerning an individual debtor* for a tax debt for a period ending before the date of the order for relief under the Bankruptcy Code).

32 I.R.S. Notice 2019-6 (2018), https://www.irs.gov/pub/irs-drop/n-19-06.pdf.