Bloomberg Tax

Tax Management Memorandum™

The BBA's 'Cease to Exist' Rule in Partnership M&A Transactions

By Christian Brause, Eric Grosshandler, and Alvin Wang[*]
Sidley Austin LLP

Under the centralized partnership tax audit regime enacted in 2015 as part of the Bipartisan Budget Act[1] (the "BBA"), when the Internal Revenue Service ("IRS") makes an assessment for an underpayment of tax of a partnership, the IRS generally must first seek payment directly from the partnership itself rather than from its partners.[2] This general rule is similar in principle to an IRS audit of a C corporation, where any tax assessment is borne by the C corporation, not its shareholders (although, of course, its shareholders indirectly bear the economic burden of any additional tax collected). Under the BBA, however, the partnership may, through its "partnership representative," elect to "push out" that tax assessment liability to its partners, thereby, shifting the statutory obligation to pay tax from the partnership to certain of its partners by operation of the statutory law.[3] Given that C corporations are not plagued by the "entity versus aggregate theory" tension that exists in partnership taxation, no similar statutory regime to "push out" a corporation's tax liabilities to its shareholders exists in the C corporation context.[4]

The application of the BBA is relatively clear in situations where an IRS audit commences and ends with a tax assessment *while the partnership and its partners are still in existence*, both for state law and federal income tax purposes.

- *Example 1*: In year 1, individuals A and B form an entity, AB LLC, treated as a partnership for tax purposes. A and B own equal portions of AB LLC. In year 3, AB LLC receives a notice of adjustment from the IRS relating to year 1 of AB LLC's tax return. In year 4, AB LLC and the IRS agree that there is an imputed underpayment of $100. Under the BBA, AB LLC may pay the IRS the imputed underpayment amount directly. Alternatively, the partnership representative of AB LLC may choose to "push out" the tax liability of $100 to A and B,

---

[*] Chris Brause is a partner at Sidley Austin LLP. He focuses on advising clients on tax aspects of domestic and international mergers and acquisitions, structuring of alternative investments and the formation of alternative investment vehicles, REITs (including mortgage REITs) and GP-stakes transactions.

Eric Grosshandler is a senior managing associate at Sidley Austin LLP. He focuses on advising clients on tax structuring and other U.S. tax considerations in domestic and cross-border mergers and acquisitions, in particular private equity funds.

Alvin Wang is a managing associate at Sidley Austin LLP. He advises clients on tax aspects of public and private mergers and acquisitions and fund formation.

The views expressed here are the authors' and are not those of Sidley Austin LLP.

This article may be cited as Christian Brause, Eric Grosshandler, and Alvin Wang, *The BBA's 'Cease to Exist' Rule in Partnership M&A Transactions*, 64 Tax Mgmt. Memo. No. 11, 173 (May 22, 2023).

[1] Pub. L. No. 114-74, 129 Stat. 584 (2015). Unless otherwise specified, all references to "Code" and "§" are to the Internal Revenue Code of 1986, as amended, and all "Reg. §" references are to the Treasury regulations promulgated thereunder, all as in effect as of the date hereof.

[2] §6225(a)(1), §6225(b)(1); Reg. §301.6225-1(a)(2) (the default rule takes the imputed underpayment into account at the partnership level. Under the default rule, the partnership is liable for the imputed underpayment and no historic partners are liable for the imputed underpayment paid by the partnership).

[3] §6226(a), §6226(b); Reg. §301.6226-1(a), §301.6226-1(b)(1) (if a push-out election is made, the "reviewed-year partners" (i.e., partners in the year of misreported income or loss) are liable for the imputed underpayment. When a partnership makes a valid push-out election, the default rule does not apply and the partnership is not liable for any imputed underpayment). A "push-out" election must be filed within 45 days of the date the final partnership adjustment is mailed by the IRS. Reg. §301.6226-1(c)(2).

[4] Generally speaking, the "entity versus aggregate theory" of partnerships refers to the balance under the partnership rules where a partnership is treated as either (1) a separate entity apart from its partners (i.e., the entity approach), or (2) as an aggregate of all of its partners (i.e., the aggregate approach). The entity-versus-aggregate dichotomy exists throughout the Subchapter K rules and is beyond the scope of this article.

who would then be *solely* responsible for paying the tax.[5] This result makes sense to the IRS, the partners and the partnership. On the one hand, the IRS gets paid. On the other, the tax liability is either indirectly (if the partnership pays the tax) or directly (if the partners pay the tax) borne by the partners in the partnership who are economically the correct parties to bear such tax liability.

If, however, by the time the IRS gets around to auditing an open partnership tax year, the partnership has terminated and its partners are no longer partners, either for tax purposes or in the applicable state law meaning of the term, there is a question as to who the IRS may look to in order to collect the underpayment of tax. Let's start with the simple example of a partnership liquidation.

- *Example 2*: In year 2, AB LLC (1) sells all of its assets and distributes the cash proceeds, after settling all known liabilities, in complete liquidation to A and B and (2) files its final IRS Form 1065 by checking "final return."[6] AB LLC is liquidated as a state law matter. In year 3, the IRS issues a notice of adjustment to recently liquidated AB LLC. In this example, there is no partnership left for the base rule to technically apply. Furthermore, because the partnership has liquidated, a question exists as to whether there is still a "partnership representative" that could cause the former partnership to make a "push-out" election to allocate the underpayment to its now former partners.

It stands to reason that the BBA rules should provide the IRS the ability to seek payment from partners A and B in this context when the partnership has truly wound up and ceased business operations, since the partnership is no longer in existence as a legal matter and is therefore also no longer a creditworthy source of payment. This would generally be consistent with rules in the corporate context where, under transferee-successor common law principles, if a corporation does not set aside sufficient funds in liquidation to pay outstanding tax claims, the IRS may hold the shareholder/distributees liable for any unpaid tax.[7]

Now, let's consider when a corporate buyer acquires all of the interest of a target partnership from its partners. Unlike in the simple liquidation scenario, here the business operations of the former partnership *continue to exist*, even though for tax purposes not conducted in partnership form (i.e., now in disregarded entity form). As a result of the discretion the IRS has in determining whether a partnership "ceases to exist" solely for purposes of the BBA rules,[8] there is ambiguity as to whether the IRS would look to the corporate buyer, the target partnership or the partner sellers for payment of an imputed underpayment from an assessment under the BBA.

- *Example 3*: Same as above, except in year 3, A and B each sell their interests in AB LLC to X, a corporation for tax purposes in a transaction treated as a sale of partnership assets resulting in a termination of the partnership under §708(b)(1). As a result of the sale, AB LLC is now treated as a disregarded entity for tax purposes in year 3.[9] What happens in year 3 if AB LLC, now owned by X, receives a notice of adjustment from the IRS relating to year 2 of AB LLC's tax liabilities?[10]

As described in more detail below, the IRS has the authority to seek payment from former partners of a partnership, in our case, A and B, for any imputed underpayment (i.e., a tax liability). The statutory mechanism to do so is the "cease to exist" rule: if the IRS determines — in its discretion — that the partnership has "ceased to exist," the IRS may collect the imputed underpayment from the partnership's former partners.[11] However, if the IRS does not affirmatively determine that the partnership has "ceased to exist" solely for BBA purposes, then the IRS may seek payment only from the former partnership (i.e., AB LLC) and thereby, indirectly, its current owners (i.e., X). The regulations provide the IRS discretion to determine whether a partnership "ceases to exist" even where the partnership has terminated pursuant to the general partnership rules under Subchapter K of the Code, thereby creating a disconnect between the substantive partnership termination rules under Subchapter K and the procedural partnership "cease to exist" rule under the BBA. This is the case in Example 3. However, except as described below, neither the regulations nor any other further authority specify how the IRS should reasonably exercise its "discretion" under the "cease to exist" rule. While the IRS's broad discretion may ease the administrative burden to the IRS of tax collection upon partnership tax audits, the lack

[5] Reg. §301.6226-1(a).

[6] *See* https://www.irs.gov/pub/irs-pdf/f1065.pdf; line G (2).

[7] *See generally* §6901(a)(1)(A)(i), §6901(h) (the term "transferee" includes "distributee"); *Phillips v. Commissioner*, 283 U.S. 589 (1931) (stockholders who have received the assets of a dissolved corporation may be compelled to discharge therefrom the unpaid federal taxes on the income and excess profits of the corporation).

[8] §6241(7) ("cease to exist" rule); Reg. §301.6241-3.

[9] *See generally* Rev. Rul. 99-6, Situation 2, 1991-1 C.B. at 433–34.

[10] *See generally* §6501(a), which specifies a three-year limitation period applicable to a partnership.

[11] §6241(7); Reg. §301.6241-3(a).

ISSN 0148-8295

of clarity concerning the way the IRS will exercise its discretion leads to uncertainty for taxpayers as to who will be responsible for the imputed underpayment tax when buying and selling partnership interests that result in partnership terminations pursuant to §708(b)(1).

THE 'DEEMED PUSH-OUT' ELECTION UNDER THE 'CEASE TO EXIST' RULE

Under the regulations, if the IRS determines that a partnership has ''ceased to exist,'' then (1) the partnership is no longer liable for any unpaid amounts resulting from a partnership adjustment, and (2) the partnership adjustment is taken into account by the ''former partners.''[12] This ''deemed push-out'' election allows for the IRS to collect against ''former partners'' (as defined herein), rather than the partnership itself, where the current partners would ultimately bear the economic burden of any tax liability.[13] ''Former partners'' are generally partners in the partnership at any time in the taxable year that the adjustment becomes final[14] or, in the case where there are no partners in the taxable year in which the adjustment becomes final, those who were partners during the last taxable year for which the partnership filed an income tax return.[15] If a partnership ceases to exist before a partnership adjustment ''takes effect,''[16] the adjustment will be taken into account by the former partners of the partnership.[17] A partnership that ''ceases to exist'' would no longer be liable for any unpaid amounts resulting from a partnership adjustment.[18] The regulations state:

> [A] partnership ceases to exist *if the IRS makes a determination* that the partnership ceases to exist because:
>
> *(i)* the partnership *terminates* within the meaning of section 708(b)(1); *or*
>
> *(ii)* the partnership does not have the ability to pay, in full, any amount that may be due under the provisions of subchapter C of chapter 63 for which the partnership is or may become liable. For purposes of this section, a partnership does not have the ability to pay if the IRS determines that the partnership's account is currently not collectible based on the information the IRS has at the time of such determination.[19]

The regulations, however, restrict the IRS's broad discretion somewhat by clarifying that a ''cease to exist'' determination is *not* effective if (1) the partnership has made a valid ''push-out'' election or (2) has paid all amounts due by the partnership within 10 days of notice and demand for payment.[20] Thus, this regulation clarifies that a terminated partnership — such as a partnership that turned into a disregarded entity — could make a ''push-out'' election.[21]

In Example 3, the sale of AB LLC to X results in a termination of the partnership under §708(b)(1); however, AB LLC (now owned by Corporation X) continues its cash-generating business otherwise unchanged. Thus, AB LLC's ability to pay any imputed underpayment to the IRS has arguably not changed at all solely as the result of the sale/termination transaction. If the IRS nonetheless makes a determination that AB LLC has ''ceased to exist'' for purposes of the BBA and such determination is effective (i.e., AB LLC has not made a valid ''push-out'' election), then AB LLC, now a disregarded entity of Corporation C, would no longer be liable for any imputed underpayment and only the former partners, A and B, would be liable for such amounts.[22]

IRS's DISCRETION IN THE 'CEASE TO EXIST' DETERMINATION

The regulations reveal a meaningful distinction between the ''cease to exist'' rule under the BBA regulations and the Subchapter K partnership termination rule by providing the IRS discretion to determine whether a partnership ceases to exist even if a partnership terminates under §708(b)(1).[23]

Under §708(b)(1), a partnership is ''considered as terminated'' only if ''[1] *no part of any business, financial operation, or venture of the partnership continues to be carried on* [2] *by any of its partners in a*

[12] Reg. §301.6241-3(a)(1), §301.6241-3(a)(2), §301.6241-3(e).

[13] Because the rules under Reg. §301.6241-3 are substantially similar to the ''push-out'' election described in §6226 and the Treasury Regulations thereunder, these rules are commonly referred to, and referred to herein, as a ''deemed push-out election.''

[14] Reg. §301.6241-3(d)(1).

[15] Reg. §301.6241-3(d)(2).

[16] An adjustment for this purpose generally takes effect when it is paid in full. Under Reg. §301.6241-3(c)(1), partnership adjustment under Subchapter C of Chapter 63 takes effect when the adjustment becomes finally determined as described in Reg. §301.6226-2(b)(1); when the partnership and the IRS enter into a settlement agreement regarding the adjustment; or, for adjustments appearing on an administrative adjustment request, when the request is filed.

[17] §6241(7); Reg. §301.6241-3(a)(1).

[18] Reg. §301.6241-3(a)(1), §301.6241-3(a)(2), §301.6241-3(e).

[19] Reg. §301.6241-3(b)(1) (*emphasis added*).

[20] Reg. §301.6241-3(b)(3).

[21] Reg. §301.6241-3(f)(1) *Ex.* 1.

[22] §6241(7); Reg. §301.6241-3(a)(2).

[23] Reg. §301.6241-3(b)(1).

ISSN 0148-8295

partnership.''[24] There is no statutory discretion or affirmative procedure required to determine whether a partnership has terminated under §708(b)(1). In our example, partners A and B sold all their interests in AB LLC, resulting in AB LLC becoming a disregarded entity for tax purposes that is wholly owned by X. Even though X continues the AB LLC business, after the sale no historic ''partners'' are carrying on activities in a ''partnership'' and therefore AB LLC is treated as terminated for purposes of §708(b)(1).

Under the procedural BBA rules, however, a partnership ''ceases to exist'' only if the IRS *makes a determination,* in its sole discretion, that a partnership ceases to exist.[25] Therefore, even when a partnership terminates for purposes of §708(b)(1), an affirmative determination by the IRS is still required for that partnership to ''cease to exist'' for BBA purposes. In Example 3, if the IRS makes such a determination, then only A and B would be responsible for the imputed underpayment.[26] However, if the IRS does not make such a determination, then X, now indirectly operating the business of AB LLC (although in disregarded entity form), would be liable for the tax even if the imputed underpayment was attributable to a tax year of the former partnership in which A and B were partners of AB LLC.

Consistent with the overall goal of the BBA stated above, the ''cease to exist'' rule is designed to ensure that the IRS has broad latitude to determine from whom to collect an assessed amount of tax to ease the administrative burden of collection. The preamble to the regulations state:

> The cease-to-exist rules are inherently related to collection issues with respect to amounts not paid as a result of an administrative proceeding under the [BBA]. Where a taxpayer or partnership properly owes amounts to the U.S. government, the IRS should be provided broad latitude, within the statutory limits, to ensure that such amounts are ultimately collected. To that end, it is administratively necessary for the IRS to retain its discretion to make a determination about whether a partnership ceases to exist.[27]

Given the purpose of the ''cease to exist'' rule, the IRS may choose to exercise its discretion in a way that would collect the most taxes, rather than attempting to collect such taxes from the source that appears to be the fairest as an economic matter. The IRS may not be inclined to collect against A and B, where both A's and B's whereabouts are difficult to ascertain or where they lack the wherewithal to pay, and X, through AB LLC, continues to operate a profitable business. Alternatively, it could be that A and B are companies like Google or Microsoft and AB LLC and X are in financial distress. It is unclear based on the regulatory language and legislative history who might bear tax liability for an imputed underpayment where a partnership is terminated for purposes of §708(b)(1), as in our example. Whether it is a likely result that the IRS uses its discretion to seek tax payments from X through AB LLC remains to be seen, however, such a result is clearly permitted by the current language of the regulation.

If A and B as sellers and X as buyer do *not* specifically address the allocation of any tax liabilities stemming from post-closing BBA assessments relating to pre-closing tax periods when the target AB LLC was still a partnership in their purchase and sale agreement, the parties could be left at the mercy of the IRS's discretion, although the buyer seems to be often in a position to make a ''push-out'' election to the detriment of the sellers (most notably in deals in which there is by agreement no pre-closing tax indemnity).[28] While this result seems somewhat harsh from a taxpayer's perspective, we do not provide recommendations on changes to the current law. Rather, we focus more narrowly on how one might provide the most certainty to buyers and sellers when dealing with the allocation of risk from a BBA audit in an acquisitive transaction similar to the sale by A and B of AB LLC X as described above.[29]

STRUCTURING AND CONTRACTUAL APPROACHES

Possible Approaches for Buyer ('X')

Buyer will want to protect against any imputed underpayment tax liability imposed on it as a result of the IRS not treating the target as having ''ceased to exist'' by doing one or more of the following:

[24] §708(b)(1).

[25] Reg. §301.6241-3(b)(1).

[26] Reg. §301.6241-3(a)(2).

[27] T.D. 9844, 84 Fed. Reg. 6468 at 6528 (Feb. 27, 2019).

[28] Reg. §301.6241-3(b)(3).

[29] This article (a) is not a legal opinion and does not provide any legal advice, (b) does not purport to cover in any meaningful detail the centralized partnership audit regime under the BBA or the IRS's discretion in the determination of whether a partnership ceases to exist based on the partnerships ability to pay pursuant to Reg. §301.6241-3(b)(1)(ii), and (c) does not purport to address the application of the ''cease to exist'' rule as applied to partnership mergers or divisions pursuant to §708(b)(2). The sole focus of this article is to describe the partnership ''cease to exist'' rule in Reg. §301.6241-3(b)(1)(i) in the context of partnership terminations pursuant to §708(b)(1) and its potential impact to parties in typical private M&A transactions.

ISSN 0148-8295

- **State Law Asset Purchase or Pre-Closing Asset Drop-Down:** Rather than Buyer purchasing all of the partnership interests in the target partnership, Buyer may either:
  - o Purchase the assets directly from the target partnership under applicable state law; or
  - o Have Seller contribute the partnership assets to a newly formed single-member limited liability company and purchase the SMLLC from the partnership.

  Because Buyer would never own the target partnership, Buyer is expected to be able to avoid any BBA audit risk attributable to the target partnership.[30]
- **Include a 'Push-Out' Election:** Buyer can include in the purchase agreement a covenant requiring that the parties agree that the partnership representative shall cause the target (former partnership) to make a "push-out" election.[31] Buyer should also consider requiring in the purchase agreement that Buyer selects a new partnership representative when permitted under the BBA rules, since it is the partnership representative that makes the "push-out" election. Additionally, a specific reference could be made in the information and cooperation provision of the purchase agreement to ensure that Buyer has sufficient information to ensure that the "push-out" election may be validly made.
- **Agree to the Tax Treatment:** Buyer should consider ensuring that the parties agree to the intended tax treatment of the transaction and agree not to take any action or position contrary or inconsistent to such treatment. Specifically, the tax treatment of the transaction could include a statement to the effect that the parties agree to treat the target, AB LLC, as:
  - o Terminated for purposes of §708(b)(1), and;
  - o Ceasing to exist for purposes of Reg. §301.6241-3(b)(1).

  Although the IRS is not bound by the parties' intent set forth in the contract in determining whether a partnership has "ceased to exist," the language helps to clarify the intention of the parties among each other in respect of a BBA audit and leaves no room for interpretation that the parties intended for any imputed underpayment pursuant to the BBA be pushed out to Sellers.
- **Pre-Closing Indemnity for BBA Items:** Buyer should consider explicitly including an indemnification for any pre-closing taxes of the target resulting from an audit or examination under the BBA. The addition of the indemnification language serves as a backstop to Buyer if the IRS were to determine that the "push-out" election was invalid and therefore failed to shift the imputed underpayment liability to the former partnership (now a disregarded entity) and fails to determine that the partnership has "ceased to exist" for purposes of the BBA.

Possible Approaches for A and B Sellers

If Sellers have negotiated a "no pre-closing tax indemnity" deal with Buyer, sellers will want to prevent the push-out or attribution of any imputed underpayment to them by doing one or more of the following:

- **Structure Into a Partnership Continuation Coupled With Prohibition to Make a 'Push-Out' Election:** Sellers may consider requiring Buyer's acquisition structure to result in a continuation of the partnership for purposes of §708(a) and agree that Buyer may not cause the partnership make a "push-out" election.[32] Furthermore, the purchase agreement could provide for a post-closing restrictive covenant stating that Buyer may not cause the target partnership to terminate for purposes of §708(b)(1) for one full taxable year of the target partnership after the taxable year that includes the closing of the transaction. This is arguably the most effective, and admittedly perhaps the most challenging option from an overall deal perspective. These negotiations should take place as early as possible in the deal process. As a result, because the partnership continues in existence as a partnership after the transaction, the IRS cannot determine that the deemed push-out election has occurred. Because partnership adjustments can only be taken into account by "former partners" in a partnership that has "ceased to exist," the current partners in the partnership (i.e., Buyers) would be liable for any imputed underpayment.
- **Note on Flow-Through Acquisition Structures:** In the case of the acquisition by a part-

[30] For sake of completeness, this does not take into account possible theories of common law transferee-successor liability.

[31] Reg. §301.6241-3(b)(3).

[32] Reg. §301.6241-3(b)(3). If Buyer nonetheless makes a "push-out" election (which Buyer could do because the contractual obligation not to do so does not affect the validity of such election vis-à-vis the IRS), then Sellers could collect damages from Buyer under general material breach of contract rules (i.e., the taxes pushed out to Sellers).

ISSN 0148-8295

nership in a flow-through structure (i.e., no entities in the acquiring chain treated as a C corporation for tax purposes) where a selling partner is contributing equity (i.e., rolling over) into the parent of the acquiror, the acquiring partnership should generally be treated as a continuation of the target partnership, thereby potentially avoiding the ''cease to exist'' rule under the BBA. Using our example, if X were instead a partnership for tax purposes and X acquired AB LLC units from A for cash and from B for X partnership units, then X could be treated as a continuation of AB LLC.[33]

CONCLUSION

Whether the IRS will exercise its discretion to keep a partnership in existence for purposes of the ''cease to exist'' rule under the BBA, even though it has terminated under the general principles of Subchapter K, remains to be seen. Absent additional guidance from the IRS or regulations removing or further clarifying such discretion from the IRS, it seems the prudent course of action for the parties is to use all of the tools at their disposal to ensure that the business deal struck among the parties is fully preserved and is not adversely affected by the IRS's broad discretion in choosing who must pay a tax determined by a partnership tax audit.

[33] A detailed discussion of the partnership continuation rules is beyond the scope of this article.

ISSN 0148-8295

ISSN 0148-8295