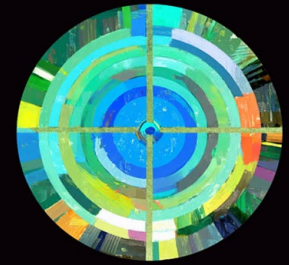


## M&A Tax Talk

### IRS enforcement and priorities in M&A



Congress has allocated billions of dollars to the IRS in 2022 through the Inflation Reduction Act. Per Congressional direction, the IRS is using the funds to update its technology and to increase its focus on pass-through entities and high income taxpayers. To that end, the IRS has been rolling out significant enforcement efforts in the last two years.

As part of those efforts, the IRS is focusing on enforcement with respect to partnerships, specifically. Historically, it was procedurally difficult to audit partnerships and to collect the additional tax owed by the partners. Thus, partnerships had a much lower audit rate compared to corporations.<sup>1</sup> In 2015, Congress enacted the Bipartisan Budget Act (BBA), which created the Centralized Audit Partnership Regime (effective generally in 2018). The BBA was designed to make it easier for the IRS to audit partnerships and collect any liability owed from the partnership or partners. Between the new audit regime and the influx of IRS funding, many taxpayers and practitioners are seeing a significant increase in the number of partnerships under examination.

As an example, the IRS has opened up examinations of 76 of the largest partnerships in the United States. These partnerships have, on average, \$10 billion in assets, and represent a cross section of industries including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms, and other industries. Further, by 2026, the IRS intends to increase its large partnership audit rate ten-fold. To

facilitate this increased enforcement, the IRS is opening a new unit to focus on large or complex pass-through entities, specifically partnerships and S-corporations.

Although passthrough entities are a significant focus for the IRS, corporate taxpayers are still subject to IRS scrutiny. Reflecting that scrutiny, the IRS is expanding the IRS's Large Corporate Compliance program, which focuses on auditing the largest corporate taxpayers. It also has announced a transfer pricing initiative focused on large foreign-owned corporations. In addition, the IRS has promised to address potential abuse of various corporate tax incentives.

To achieve all these goals, the IRS has attempted to hire thousands of new employees.

#### **BBA partnership considerations in M&A**

As discussed above, Congress changed the way the IRS audits partnerships and how partnerships adjust prior year returns. Businesses may want to pay close attention to these rules during mergers and acquisitions, otherwise they could owe significant liabilities relating to pre-acquisition years.

Before the BBA, if the IRS audited a partnership and determined it owed additional tax, the reviewed year partners (i.e., the partners for the year being audited) would pay the additional tax. Similarly, if a partnership filed an amended return and owed additional tax, the reviewed year partners had to pay the additional tax. Thus, when partners sold their interest, many

buyers were not as concerned about due diligence on prior year tax returns because they knew the sellers (the reviewed year partners) would be liable for any additional tax for pre-acquisition years.

Under the default BBA rules, the partnership is liable for additional amounts owed in pre-acquisition years. This means that it is the current owners of the partnership that bear the burden of the payment being made by the partnership. However, a partnership can elect out of the default rules and instead push out the adjustments to the reviewed year partners (i.e., the sellers). The elections must be made timely and in a specific manner; so, buyers of partnership interests may want to negotiate and retain rights regarding the push-out election to analyze whether they might be disadvantaged.

Buyers and sellers often need to consider the BBA regime for other reasons, as well. In a BBA partnership, the only person who has any "rights" before the IRS is the partnership representative. The partnership representative is designated on each year's tax return and cannot be changed until the IRS audits the partnership or the partnership files an administrative adjustment request (an "AAR", a method of changing prior year return). A partnership cannot change its partnership representative just because of a change in ownership; thus, buyers and sellers may want to consider whether the partnership should change its partnership representative if the IRS audits the partnership or if it files an AAR. Similarly, buyers and sellers may want to

1. Internal Revenue Service, May 2, 2024, IRS releases Strategic Operating Plan update outlining future priorities; transformation momentum accelerating following long list of successes for taxpayers, [IRS releases Strategic Operating Plan update outlining future priorities; transformation momentum accelerating following long list of successes for taxpayers](#) | Internal Revenue Service

negotiate control over the timing of when a partnership files an AAR, because the timing determines in which year the partners pay additional tax or receive (essentially) a non-refundable credit.

### IRS priorities relevant to M&A

The IRS's Large Business and International Divisions identifies specific areas of targeted enforcement called "campaigns." Frequently, the IRS will select taxpayers based on these campaigns. Several of these campaigns impact M&A transactions. Even outside campaigns, there are enforcement efforts that impact M&A transactions.

### Allocation of success-based fees without Rev. Proc. 2011-29

Since 2020, the IRS has been focused on success-based fees paid in transactions under Treas. Reg. § 1.263(a)-5(a). These fees are presumed facilitative and must be capitalized. However, the fees may be allocated to non-facilitative activities, and currently deducted, if the taxpayer meets the documentation requirements under Treas. Reg. § 1.263(a)-5(f). Rev. Proc. 2011-29 allows a safe harbor election for allocating success-based fees paid in covered transactions under Treas. Reg. § 1.263(a)-5(e)(3) without meeting the above documentation requirements so long as 70% of these fees are allocated as non-facilitative and 30% are allocated as facilitative. The IRS continues to focus on this issue and, recently, has publicly denied some taxpayers' requests to make a late safe harbor election under Rev. Proc. 2011-29 to deduct 70% and capitalize 30% of a success-based fee paid to an investment banker.

### Costs that facilitate an IRC 355 transaction

In 2018, the IRS announced it would conduct audits of taxpayers that deducted costs with IRC 355 transactions instead of capitalizing them. The IRC requires taxpayers to capitalize the costs to facilitate a tax-free corporate distribution under IRC section 355 (e.g., spin-off, split-off, split-up). These costs are not currently deductible. The IRS initiated the campaign out of concern that some taxpayers may execute a corporate distribution and improperly deduct the costs that facilitated the transaction in the year the distribution was completed.<sup>2</sup>

### Limitations on consolidated net operating loss carryovers

As part of the Tax Cuts and Jobs Act, Congress revised the rules on how taxpayers can carryover losses from one year to another year. The IRC limits how consolidated groups can use carryover losses from recent acquisition or disposition of a member of a consolidated group. The IRS announced it will focus audits on consolidated groups that either acquire a member with a net operating loss carryover or dispose of a member to which a portion of the group's net operating loss was attributable.

### Sales of business assets or partnership interests

As IRS enforcement intensifies, sellers in M&A transactions may want to prioritize record-keeping and strategic planning. For those engaging in asset sales, maintaining comprehensive receipts to establish basis can significantly mitigate tax-related risks

and ensure smoother transactions. When complete records are unavailable, one can potentially use alternatives such as historical records of tangible investments or audited financial statements. However, without a strategic approach during an audit, it may be challenging to convince the IRS or Appeals to accept these alternatives without a substantial haircut.

In the realm of partnership interests, the IRS's focused campaign on the sale of partnership interests underscores the importance of quality support. A fair market value study can be valuable in establishing that individual partners who sell a partnership interest reported the proper split between ordinary income and capital gains, which may be taxed at 37% and 20% respectively. The IRS may select even relatively small sales for examination under this campaign.

### Conclusion

Given the IRS's increased resources and focus on pass-through entities and large taxpayers, businesses should be prepared for more audit activity by the IRS. When engaging in M&A transactions, taxpayers should consider all the implications of the BBA regime and the potential for IRS scrutiny on campaign and other compliance issues.

2. Internal Revenue Service, May 3, 2024, *Large Business and International active campaigns*, [LB&I active campaigns](#) | [Internal Revenue Service \(irs.gov\)](#)

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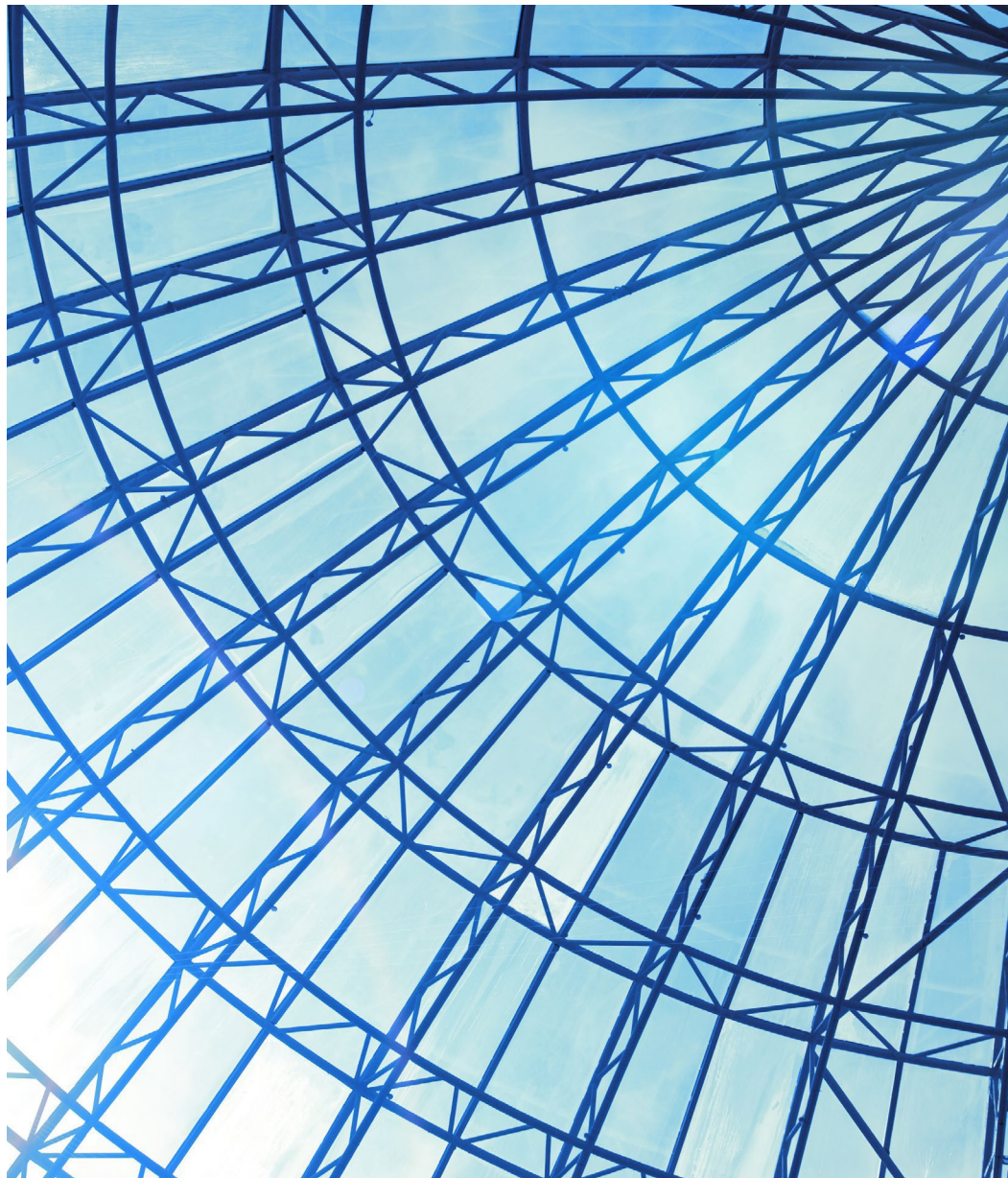
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