Partnership Audit Rules: Traps for the Unwary

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October 29, 2025

Why Do We Have the BBA?

- Dramatic increase in number of large partnerships
- Partnerships difficult to audit
  - Audit rate in 2015: 0.2%
- Solution: Bipartisan Budget Act of 2015 (BBA)
  - Different procedures
  - Different economic result (tax liability / tax benefit)
  - Different taxpayers may be liable

Taxpayer's Menu of Options

Options	Omitted Income	Overreported Income
1. Default rule – partnership treated as taxpayer	Partnership pays tax (imputed underpayment)	Partnership omits future income (current-year adjustment)
2. Modifications to reduce tax owed by partnership without partners taking adjustment into account (e.g., rate reduction)	Partnership pays tax (imputed underpayment)	Partnership omits future income (current-year adjustment)
3. Modifications where partners take adjustment into account (e.g., amended returns, Alternative Procedure, closing agreement)	Historic partners amend returns (or take comparable measures) and pay tax	Historic partners adjust prior returns; refunds sometimes available
4. Section 6226 push-out election	Historic partners pay tax	Historic partners might get tax reduction but no refund
5. Election out	Historic partners pay tax	Refunds available

Opt-Out Election

Opt-Out Election for Eligible Partnerships

- "Eligible partnerships" can elect out of the BBA regime
- Election made on a **year-by-year basis** by checking "yes" on question 33, Schedule B, Form 065 (2024) on a **timely filed** (including extensions) Form 1065 and completing Schedule B-2, Form 1065.
- All eligible partners, their TINs, and their eligibility tax status must be listed, along with shareholders of any S corporation partner and their TINs/tax status.
- Partnership does not have luxury of taking wait-and-see approach and opting out later in connection with impending audit

Opt-Out Election for Eligible Partnerships (cont.)

- If opt-out election is made, neither BBA nor TEFRA applies
- IRS must pursue adjustments to partnership tax items by conducting partner-level audits subject to the normal deficiency (and refund) procedures as was the case (i) under pre-TEFRA law or (ii) in TEFRA years where the "small partnership" exception applies
- Consistency requirement in section 6222 apparently not applicable

Opt-Out Partnerships Must Timely Notify Partners

- The partnership must notify each partner within 30 days of making the opt-out election, “in the form and manner determined by the partnership.”
- Notice requirement applies only to direct partners
  - Does not apply to shareholders of an S corporation partner
  - Preamble to June 2017 Proposed Regulations states that notice “may be in writing, electronic, or other form chosen by the partnership”
  - Schedule K-1 does not provide a check box to inform partners of opt-out
  - Could attach notice to partner K-1s
  - If not, a separate communication to partners must be made
  - Partner communication must be renewed for each annual opt-out election
  - Non-compliance with notice requirement could invalidate election

Opt-Out Election – Eligible Partner Limitation

- Opt-out requires that each partner to whom partnership furnishes a K-1 for the year to qualify as an "eligible partner"
- An eligible partner is:
  - an individual (including a nonresident alien),
  - a C corporation as defined in section 1361(a)(2),
  - an S corporation,
  - an "eligible foreign entity," and
  - an estate of a deceased partner
- An "eligible foreign entity" is a foreign entity that would be treated as a C corporation if it were domestic
- A REIT or RIC is a C corporation and thus is an eligible partner

Opt-Out Election – Eligible Partner Limitation (cont.)

- A partner is **not** an eligible partner if partner is:
  - a disregarded entity,
  - a qualified subchapter S subsidiary (QSUB),
  - a partnership,
  - a trust (including a grantor trust),
  - an ineligible foreign entity,
  - an estate of an individual other than a deceased partner,
  - or a person who holds an interest in the partnership on behalf of another person (i.e., nominee holder).
    - Disregarded entity, QSUB, and nominee holder exclusions apply to taxable years ending on or after November 20, 2020

Opt-Out Election – Eligible Partner Limitation (cont.)

- Thus, for example, if an individual holds an interest in the partnership through a disregarded LLC or grantor trust **at any time** during the year, partnership cannot opt-out
- Congress did not want an opt-out partnership to be able to have tiers of partnerships in its ownership structure that could make it harder to chase down direct and indirect partners for tax liabilities related to opt-out partnership tax items

Opt-Out Election – "100-Partner" Limitation

- An eligible partnership can have no more than 100 partners for the taxable year, but this does not mean what it appears to mean
  - 100-partner limit satisfied only if aggregate number of K-1s furnished by partnership, <u>plus</u> aggregate number of K-1s furnished by any S corporation partners to their shareholders, does not exceed 100 for the taxable year
  - **Note**: If partner A sells her interest to partner B during the year, each receives a K-1. Both K-1s count for purposes of the 100 K-1 limit
  - If partnership furnishes more than one K-1 to a partner (e.g., one for a limited partner interest and one for a general partner interest), partnership is treated as issuing only one K-1
  - K-1 furnished to an S corporation partner counts as one K-1 in the total, even though the K-1s issued to the S shareholders are also counted

Pros and Cons of Opt-Out

- Tax advisors who have spent time wading through the BBA provisions may find it hard not to recommend an annual opt-out election for eligible partnerships
- It avoids:
  - Inequities of the IU calculation
  - complexities of the IU modification rules
  - issues of a disconnect between reviewed year partnership ownership and adjustment year partnership ownership,
  - 2% interest rate bump in a push-out election
- Let IRS go after partners one-by-one and best of luck

Pros and Cons of Opt-Out (cont.)

- However, opt-out requires, among other things,
  - no disregarded entity partners
  - no partnership-partners
  - no trust partners,
  - no estate partners other than the estate of a deceased partner
- Risk of eligible partner transferring interest to ineligible partner without partnership's knowledge (or even with knowledge but without awareness of opt-out impact) is not remote
- If there are S corporation partners, transfers or issuances of shares could result in additional K-1s counting against the 100 K-1 limit
- Opt-out means that the IRS goes after each partner individually. Partnership loses control of the process
- Partner level audits could expand to include non-partnership issues; BBA audit is necessarily limited to partnership tax issues
- Opt-out partnership will have to assist partners in their audits if partnership issues are involved (provide documents, books and records, financial information, etc.)

Pros and Cons of Opt-Out (cont.)

- Opt-out partnerships should impose transfer restrictions to preserve eligibility
- Large partnerships with many partners may see an advantage for the partners in being able to pay an IU at the partnership level and leave partners out of it
- May also be true at state level where states have BBA-type procedures
- Must evaluate on a case-by-case basis
- Opt-out partnerships and their partners may incur more legal and accounting costs collectively with partner-level audits than if the centralized audit procedures applied
- Opt-out partnership may be compromised by maverick partners who file inconsistent

The Default Rule

Default Rule

- Goal: simplify IRS procedures
  - Treat partnership like a box
  - Determine tax liability without looking outside the partnership
- Not an income tax
  - Instead: an excise tax on errors on lines of the return

Default Rule - Example

- Partnership omits $100 of income
  - “Positive adjustment”
  - Imputed underpayment (“IU”): Partnership pays tax at 37% rate
- Partnership overreports $100 of income
  - “Negative adjustment”
  - Current-year adjustment: Partnership omits $100 of income (or reports an additional $100 loss) in the “adjustment year”
    - Character should match
    - How does this work for adjustments to dividends?

Default Rule

- Prospective solution
  - Adjustment affects current partners, not historic partners
- Line-by-line approach, to take into account various limitations and rates
- If $100 of capital gain is recharacterized as ordinary income,
  - Ordinary income is increased by $100
    - Imputed underpayment = $100 x 37%
  - Capital gain is decreased by $100
    - Current-year adjustment of $100 of capital loss (or $100 less capital gain)
    - Adjustment does not offset the adjustment made to ordinary income

Default Rule

- Positive adjustments
  - Result in an imputed underpayment
- Negative adjustments
  - Offset a positive adjustment (thereby reducing the imputed underpayment); or
  - Handled through current-year adjustments

Default Rule

- Positive adjustments include
  - Any unfavorable adjustment to an item of income or loss
  - **Any adjustment** to a non-income item, including
    - Partner share of liabilities / classification of liabilities on Schedule K-1
    - Balance sheet (basis in land)
    - Recharacterization of intercompany debt
    - Capital contributions
    - Self-employment income

Default Rule

- Self-employment earnings: Line 14 of Schedule K-1
- If a partner has $100,000 of self-employment earnings
  - Partner must pay self-employment tax on that $100,000
    - SECA is a Chapter 2 tax, so not within the scope of the BBA
  - Partner may generally deduct one half of SECA taxes under Section 164(f)
    - This is a Chapter 1 deduction – relates to regular income tax
    - If SECA income is $100,000, the Chapter 1 deduction is generally 7.65% of that, or $7,650
- If IRS increases self-employment earnings by $100,000
  - Amount of adjustment: $100,000 (not $7,650)
  - Adjustment is positive, even though the adjustment would generate a Chapter 1 deduction (albeit for a different amount)
- Partner must also pay SECA taxes on $100,000
  - Enforced under partner-level audit, not BBA audit
  - Coordinated statute of limitations: Section 6501(c)(12)

Default Rule

- Much duplication possible; for example,
  - Self-employment earnings
  - Section 199A calculations
  - Section 163(j) calculations
- Subsume rule
  - IRS allowed – but not required – to treat an adjustment as $0 when it is duplicative
  - Regulations impose no limits on IRS discretion

Default Rule

- For some partner-level adjustments,
  - BBA might turn off normal rules that would apply to partner-level adjustment;
  - But BBA provides no remedy for the IRS or the taxpayer
- Example: Section 751(a)
  - Partner sells partnership interest and reports $100 of gain:
    - $30 capital gain
    - $70 ordinary income
  - IRS increases ordinary income amount by $10, to $80
    - That $10 adjustment is taxed (the imputed underpayment)
  - Capital gain should be reduced by $10; does this produce any tax benefit?

Modification

Modification

- Reduce amount of imputed underpayment owed by partnership
- Shift tax liability to the partners
- Possible to treat different adjustments / different partners differently
- 270-day period after NOPPA is issued in which to request IRS approval of modifications

Reduce IU: Tax Rate Modification

- C corporations: 21%
- Individuals allocated long-term capital gain: 20%
- Tax exempt partners: 0%
  - Only if income would not be UBTI
- Foreign partners: 0%
  - Only if income would not be subject to US income tax
- Treaty benefits

Shift Liability to Partners

- Amended Return Modification
  - The only approach that will always produce “correct” result
  - Regular underpayment interest applies
  - Partnership has no statutory power to force partners to amend
  - Partners must pay additional tax before judicial review
  - Tiered structures are complicated
- Alternative Procedure Modification – generally worse
  - As complicated as the amended return modification
  - No refunds available
  - Less privacy – Form 8982 discloses TP’s revised TI and AGI

Slice-and-Dice Modifications

- May separate one adjustment from another adjustment
- May separate one partner’s share of an adjustment from another partner’s share

Practice Tip

- Rules for a partner's "share" of an adjustment for purposes of modification might be surprising
- Example: for rate modification
  - Reg. 301.6225-2(b)(3)(iii)(A): generally look at how adjustment would be allocated under subchapter K
    - What does this mean for balance sheet adjustments?
  - Reg. 301.6225-2(b)(3)(iv): if special allocations and multiple adjustments, generally use hypothetical liquidation approach based on fair market value, not Section 704(b) values
- Solution: have NOPPA specify the allocation

IRS Discretion?

- Must IRS be reasonable?
  - Duplicative adjustments
  - Modifications so that IU matches the partner’s tax underpayment
- Will IRS grant reasonable modifications that are not explicitly listed in the statute?

Section 6226 Push-Out Election

Section 6226 Push-Out Election

- Roughly similar to pre-BBA audits
- Partnership does not pay tax
- Historic partners pay tax
  - Amount is often what they should have paid (the “correct” amount)
- Partnership is completely hands-off on partner push-out compliance

Push-Out Deadlines

- Election (Form 8988) must be filed by PR within 45 days after FPA mailing, but actual push-out to reviewed year partners does not occur until adjustments are finally determined (final court decision or expiration of time to file petition)
- If no petition filed within 90 days of FPA, regulatory examples indicate that “finally determined” date is 91st day, not 90th day – partnership has 60 days <u>after</u> 91st day to furnish and file push-out statements on Form 8986
- Preparing push-out statements is complicated – start early

Push-Out Election Might Be Good

- Partnership does not have to pay tax – avoids hit to current year partners
  - Historic partners take adjustments into account and pay tax
- Often results in less tax
  - Partners may have NOLs or other useful tax attributes
- Election is generally under control of the partnership
  - Does not matter whether partners cooperate
- Tiered push-out possible

Push-Out Election Might Be Unavailable

- Partners that are foreign corporations
- Tiered structures: deadlines might be hard to satisfy – upper-tier partnership might have **0 days** available to push out its share of adjustments, when a lower-tier partnership makes a push-out election
- IRS takes the position that push-out election can only be made after FPA is issued (within 45 days). If partnership signs NOPPA or waives issuance of FPA, push-out option is gone
- IRS might disagree with manner in which the partnership allocates the adjustments
- If AAR partnership pays IU, IRS could examine AAR and determine IU was incorrectly calculated – if partnership owes more than it thought, too late to reverse course and do push-out

Push-Out Election Might Be Bad

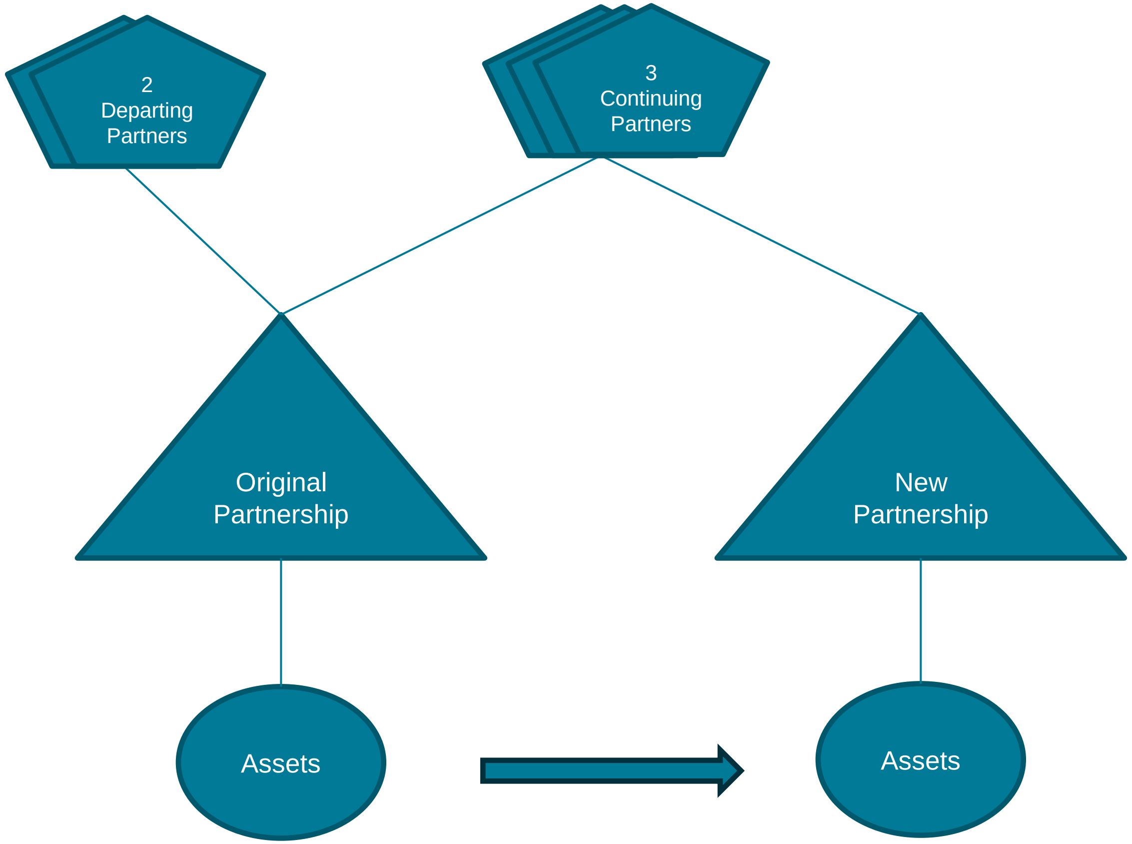
- Adjustment might be small
- Complicated forms
- Burdensome for the partners
- Interest
  - Higher deficiency interest (2 percentage points higher)
  - No interest paid by IRS on prior “overpayment”
- For a favorable adjustment
  - Partner receives non-refundable credit, not a refund
  - Partner might be put into the AMT
  - Loss of tax basis without anyone receiving an associated tax benefit

Partnership Terminations and Continuations

Did the Partnership Terminate?

- The IU liability might stick to the tax partnership
- Did the tax partnership terminate?
  - See Section 708 on partnership continuations, mergers, and divisions
  - When one partnership sells its assets to another partnership, and the two partnerships have some partners in common, are they the same partnership under Section 708?

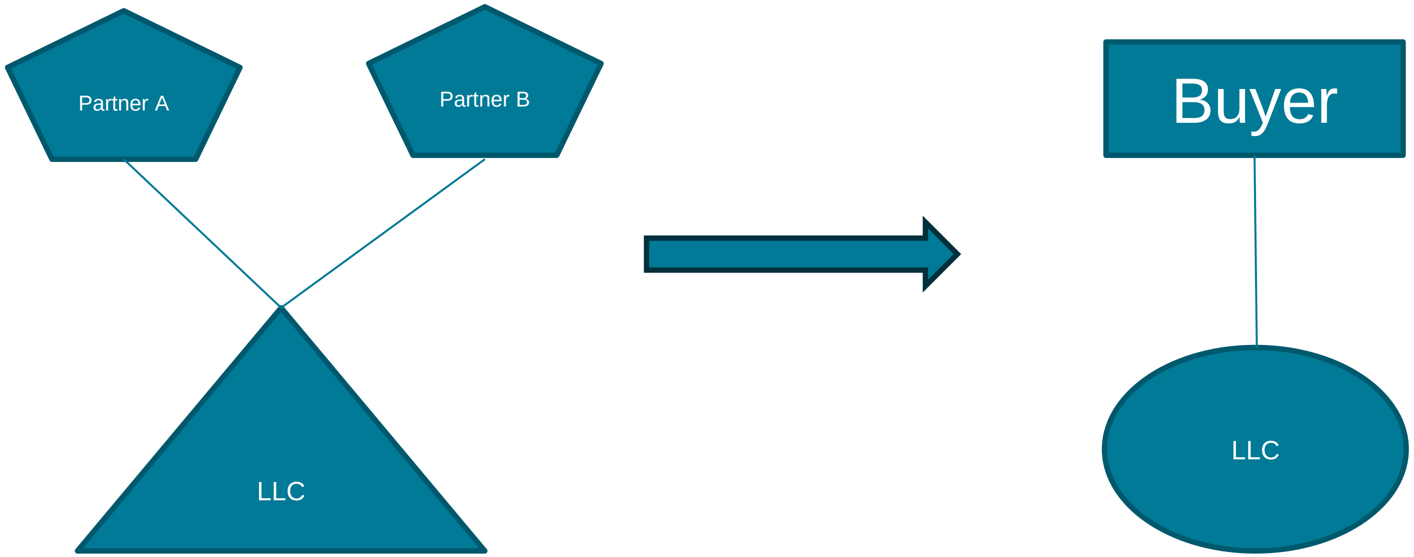
Rev. Rul. 66-264



- Transaction under state law
  - Asset sale from Original Partnership to New Partnership
  - Some partners in common
- Tax treatment
  - New Partnership is Original Partnership
  - Redemption or sale of partnership interests
- BBA result: New Partnership may be liable for any IU of the Original Partnership

Did the Legal Entity Dissolve?

- The IU liability may stick to the legal entity
  - Rev. Rul. 99-6 transactions



- Consider contributing assets to a new single member LLC and selling the new LLC

True Termination: Failure to Pay Rules

- Partnership liable for IU, notwithstanding termination
- If it fails to pay the IU within 10 days of notice and demand,
  - The partners in the last tax year for which a return was filed will generally become liable for the IU
  - Each partner liable for its "proportionate share"
    - What does this mean?
  - Does not address negative adjustments
    - IU may be large because not offset by negative adjustments
    - Negative adjustments might produce no tax benefit
- Sale-within-a-merger rules result in momentary interest as a partner

Partnership Representative

Partnership Representative

- Partnership representative ("PR"): sole person who may communicate with IRS and bind the partnership and partners
  - May be an entity, if an individual is appointed as the designated individual ("DI")
    - This introduces complexity and confusion without providing any benefits
  - PR may be a scrivener; no need to give it any decision-making powers
- If a PR violates the partnership agreement,
  - Its action is still valid and binding on the partnership, but
  - The PR may be sued for damages.

Partnership Representative

- PR/DI usually does not sign the partnership agreement
  - How will the PR be bound by its terms?
  - How will the DI be bound by its terms?
- PR is designated on the tax return, not in the partnership agreement
  - Designation is for a specific tax year
- Designation is sticky – cannot be changed until an audit begins or an AAR is filed
  - PR/DI cannot resign before that time
  - Does not matter if PR/DI leaves the partnership
  - Use of DI does not solve this problem

Partnership Representative

- IRS sends correspondence to PR's home address
  - Is the post office holding the PR's mail while he or she is on vacation?
  - Does the PR date-stamp mail received at home?
  - Some notices sent only to PR, not to partnership:
    - Summary report
    - 30-day letter
    - Notices regarding modification request
- Solution: have copies of notices sent to someone with a power of attorney

General Controversy Issues

General Controversy Issues

- BBA audits may be slower than other audits
- Short taxpayer deadlines
  - 30 days from Notice of Selection for Examination to file an Administrative Adjustment Request
  - 10 days to respond to IRS BBA Unit for modification procedures
- Do not sign the Notice of Proposed Partnership Adjustment if you intend to make a push-out election

General Controversy Issues

- IRS is adjusting items that have no effect on a partner’s tax liability
- IRS is making duplicative adjustments (e.g., Section 199A calculation) but generally treating them as $0
- Modification procedures
  - Cumbersome
  - IRS generally granting modifications that are explicitly described in the statute and regulations
  - IRS is less willing to exercise its authority to grant a modification that is “reasonable” (e.g., so that the imputed underpayment corresponds to the amount of tax the partners should have paid)

Indemnities

Indemnities: Negative Adjustments

- Many adjustments will have an associated negative adjustment. Who should receive the benefit of that adjustment?
- Example: The IRS recharacterizes $100 of capital gain as ordinary income.
  - Two adjustments:
    - Ordinary income increased by $100
    - Capital gain decreased by $100
  - If a former partner must indemnify the partnership for the imputed underpayment, will the former partner benefit from the adjustment to capital gain?

Indemnities: Outside Basis

- Outside basis must be adjusted to avoid two levels of tax
  - If partnership has $100 of income, outside basis increases by $100
- If the IRS increases partnership income by $100 and partnership pays IU, outside basis increases by $100 of "notional income" under proposed regulations
- If partner has already sold its partnership interest, who receives the additional $100 of outside basis?
  - Buyer! Buyer may have a loss available to harvest.
- Seller may end up paying tax on $200 of income
  - If Seller indemnifies the partnership for the IU, Seller is paying tax on $100 of partnership income;
  - But Seller paid tax on $100 too much gain on the sale of her partnership interest
- Note: Treasury might withdraw this guidance

Interest

Interest

- Generally must pay underpayment interest, sometimes at a higher rate (e.g., with push-out election)
- No overpayment interest available under the default rule or with a push-out election
- This asymmetry is exacerbated by how adjustments are treated
  - If income is recharacterized and default rule applies, underpayment interest is owed on the bad adjustment, but no overpayment interest is available for the good adjustment

Interest

- Timing errors are more significant
- Outside the BBA, when income or loss is reported in the wrong year, often the net result is merely one year of underpayment interest
  - If taxpayer reports $1M of income in 2020 but the income should have been reported in 2019, net effect on tax may be $0
  - Underpayment interest starts to accrue in 2019
  - Overpayment interest starts to accrue in 2020
  - Net effect: Underpayment interest for a $1M deficiency for one year (2019)

Interest

- Under the BBA, timing errors can result in large net interest liabilities
- In the prior example, underpayment interest would be owed for multiple years, starting in 2019
  - No overpayment interest would offset the underpayment interest
- This is made worse by a Section 6226 push-out election, where the underpayment interest rate is increased by two percentage points

Administrative Adjustment Requests

Administrative Adjustment Request

- BBA partnerships cannot amend their tax returns
- Instead, file an administrative adjustment request (“AAR”)
  - Not the same as an amended return
  - Complicated forms
  - No refunds available; may only receive a nonrefundable credit
    - Self-help? See Reg. 301.6222-1(c)(5)

AARs Under the BBA

- Partnership subject to BBA (has not opted out) cannot file amended return or amended K-1s to correct errors after due date – Section 6031(b)
- BBA partnerships correct errors in the reporting of any PRI by filing an AAR – not the same as an amended return
- AAR must be signed by the PR for the partnership taxable year to which the AAR relates
- If AAR partnership elects to push-out the AAR adjustments, this does not involve amended K-1s or amended partner returns
- Instead, AAR partnership provides Forms 8986 to reviewed year partners
- Partners determine “additional reporting year tax” and include such amount (positive or negative) on their reporting year returns along with Form 8978 (Addition Reporting Year Tax) and Schedule A thereto

Can File Superseding Return Prior to Due Date

- Exception to AAR requirement
- If BBA partnership files corrected return after the original return is filed, but on or before the due date (as extended), later-filed partnership return is simply substituted for the original return and not treated as an "amended return" – does not violate section 6031(b)
- Superseding return avoid AAR process. See Instructions for Form 1065-X (Dec. 2024), p. 9
- Best practice: extend filing deadline so that a superseding return can be filed in that extension window to correct errors without going through AAR process

Paper v. Electronic Filing of AARs

- If the original partnership return was filed by paper, AAR also filed by paper (Form 1065-X)
- Filed at same service center where original return was filed
- If original return was filed electronically, partnership electronically files Form 1065 (checking amended return box G(5)) together with Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)) (Oct. 2023)
- Electronically filed AARs cannot be submitted in BBA Online Form Submission Service (OFSS), but instead are e-filed through Modernized e-file system (MeF)
  - If Form 8082 is filed electronically, it must be manually signed on Part 1 Line b D, and signature page must be filed with Form 1065 as a PDF attachment

AAR Filing Deadline

- AAR must be filed no later than 3 years after the later of:
  - the date of filing of the partnership return, or
  - the due date for the partnership return determined without regard to extensions
- Form 872-M agreement with IRS to extend section 6235(b) period of limitations on making partnership adjustments does not extend AAR period
- AAR cannot be filed after the partnership receives a Notice of Administrative Proceeding ("NAP"), but can be filed during minimum 30-day window after receiving a notice of examination (Letter 2205-D)
  - Note: If partnership intends to revoke PR or DI designation for the taxable year to which AAR relates, AAR must be filed before partnership receives Letter 2205-D

AAR Filing Deadline (cont.)

- IRS's internal procedures require it to provide an examination notice to the partnership (Letter 2205-D) at least 30 days prior to the issuance of the NAP
- Gives partnership a window to rethink aggressive return positions and correct errors through AAR process
- Avoids 2% interest surcharge that would apply in a section 6226 push-out of partnership audit adjustments
- Note: Filing AAR for a partnership taxable year gives IRS a refreshed three-year period of limitations for making partnership adjustments
  - Applies to any and all PRIs IRS may want to examine, not just the PRIs that are adjusted in the AAR

AARs Also Used to Correct Ministerial Errors

- Partnership with section 751 “hot assets” is required to file Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests) (Dec. 2024) with tax return for year in which a “section 751(a) exchange” of a partnership interest took place
- If BBA partnership fails to comply (e.g., it does not become aware of a section 751(a) exchange until after its return, then it should either file a superseding return that includes Form 8308 (if the extended due date is not yet passed) or an AAR that includes Form 8308 as an attachment (if it is past the filing deadline). See Instructions to Form 8308 (Dec. 2024), p. 1.
- AAR also used to file late partnership election where 9100 relief is granted

Form 5471 Trap

- If Form 5471 was required to be filed by partnership but was not included with original return, partnership must file an AAR to submit the form
- But, section 6227(c) period for filing AAR may have expired
- Section 6235 period of limitations on adjustment does not begin to run until Form 5471 is filed – Sections 6501(c)(8) and 6235(b)(5)
- Partnership could be in a box here – it needs to supplement original return to start the statute running but can't

Signing of AAR; Use of AAR to Revoke PR Designation

- Only PR or DI can sign an AAR
- PR or DI must be the one designated on the original reviewed year return to which the AAR relates
- An AAR can also revoke the designation and appoint a new PR or DI (e.g., where an individual PR is deceased or refuses to sign the AAR)
  - <u>AAR cannot be filed for sole purpose of revocation</u>
  - If AAR revokes a PR designation and appoints new PR, AAR must be filed not only before NAP, but also before receiving a notice of selection for examination (Letter 2205-D)
- Change in PR /DI deemed to occur immediately prior to filing of AAR – thus, new PR / DI signs AAR

AAR Partnership Options – Pay IU or Push Out to Partners

- If AAR adjustments result in IU, the partnership must pay IU or do a push-out
  - If it pays the IU, partnership self-determines IU amount
  - Can use subsume rule to disregard duplicative positive adjustments
  - Partnership pays IU plus interest and penalties (amounts can be estimated) with AAR filing
  - Can only take into account certain IU modifications – cannot use partner amended returns and Alternative Procedure
  - Partnership does not need IRS approval of modifications – but must submit supporting documentation with AAR, including Form 8980
  - Any AAR adjustments that "do not result" in an IU must be pushed out to reviewed year partners (differs from section 6226 push-out) – AAR must furnish Forms 8986 to the partners and file them, together with Form 8985, with IRS

Push-Out Option May Be Gone if IRS Determines that AAR Partnership Understated IU

- If an AAR partnership chooses to pay IU, it needs to be confident of IU calculation
- If the IRS initiates BBA audit of AAR's PRI adjustments, it can examine the IU calculation as well (an IU is a PRI) and any asserted modifications
- If IRS comes up with significantly worse number, may be too late for AAR partnership to reverse course and do push-out – Forms 8986 required to be furnished at time of AAR filing

AAR Push-Out

- AAR partnership pushes out AAR adjustments to reviewed year partners by furnishing Forms 8986 showing their allocable shares of the adjustments
- No separate push-out election is made (Form 8988 is not filed)
- No amended K-1s are provided to the partners
- Partnership includes Forms 8986 and Form 8985 (transmittal and tracking report) as part of its AAR filing – these are filed in the same manner as the AAR was filed (paper v. electronic)
- PR attests under penalties of perjury that push-out statements have been provided to the reviewed year partners.
- The partners determine their respective “correction amounts” for the reviewed year and any intervening years, applying the section 6226 push-out rules (no IU modifications allowed)

Forms 8986 Need to be Accurate

- Push-out statements are complicated
- Mistakes could lead to a defective push-out and an IU that AAR partnership had not planned on paying
- For example, AAR partnership might incorrectly omit adjustments it did not think were relevant

How Are Forms 8986 “Furnished” to Reviewed Year Partners?

- If AAR partnership elects push-out, it must furnish Forms 8986 to reviewed year partners <u>at the time AAR is filed</u>
- Regulations do not say how to “furnish” in either an AAR push-out or a section 6226 push-out
- Certified mail to last known address; use reasonable due diligence if returned undelivered
- Should also email a copy to each partner as a backup
- Partner can flip email to partner’s accountant and ruin that person’s day

AAR Push-Out – Non-Income Adjustments

- Adjustments to non-income items (e.g, items not allocable to the partners under section 704(b)) should also be included in AAR push-out statements if they could potentially impact reviewed year partners – e.g., liability recharacterization or reallocation for section 752 purposes
  - <u>Cf.</u> Instructions for Form 8978 (Partner's Additional Reporting Year Tax) (Dec. 2024), p. 2 (in a section 6226 push-out, a liability adjustment on Form 8986 that reduces partner's share of recourse liabilities is a non-income adjustment that is pushed out, potentially changing partner's at-risk amount and reducing partner's allowable partnership loss, which reduction must be reported on Schedule A of Form 8978)

AARs – Additional Reporting Year Tax

- A reviewed year partner's correction amount for the reviewed year, and any correction amounts for intervening years, becomes "additional reporting year tax" ("ARYT") for the reporting year
- Can be positive or negative
- Negative ARYT represents cumulative amounts that the partner has overpaid in the reviewed year and any subsequent years prior to the reporting year as a result of adjustments
- "Reporting year" is the reviewed year partner's taxable year in which partner receives AAR push-out statement

AARs – Additional Reporting Year Tax (cont.)

- Reviewed year partner does **not** recompute **reporting year taxable income** taking into account reviewed year AAR adjustments
- Rather, sum of correction amounts for first affected year and intervening years is add-on (or subtraction) from tax liability otherwise owed by partner for reporting year
- Reviewed year partners (other than a pass-through partner) include Form 8978 with partner's reporting year return
- If there are non-income tax changes that relate to the partnership adjustments on the partner's Form 8986, such as additional self-employment tax from an increase in the partner's share of partnership NESE, the Instructions for Form 8978 indicate that partner should file amended return for first affected year to reflect non-income tax changes

AARs – Additional Reporting Year Tax (cont.)

- If the ART is positive, additional 2% interest that applies in a regular section 6226 push-out does not apply
- ART can be a negative number, such as in the case of a refund AAR where the AAR adjustment increases an ordinary loss
- Under regulations, a negative ART is treated like a <u>nonrefundable</u> credit that can reduce reviewed year partner's chapter 1 tax liability for reporting year down to zero, but does not create refund right (except to the extent partner has overpaid reporting year tax liability, e.g., due to estimated tax payments), and may put partner into the AMT

Even a Push-Out AAR Must Include IU Computation

- AAR must always include a computation of IU resulting from the adjustments, even if AAR partnership elects to push out adjustments
- June 18, 2024 AICPA Letter recommended that IRS revise instructions to delete this requirement if AAR partnership pushes out

AARs –Pass-Through Partner Push-Out

- Reviewed year pass-through partner (an entity filing Form 1065, 1041, or 1120-S) can either
  - pay an IU and push-out do-not-result adjustments or
  - do a further push-out to its own affected partners of its share of adjustments, in same manner as section 6226 push-out
- If pushing out, pass-through partner furnishes Forms 8986 to each partner that held an interest in pass-through partner at any time during pass-through partner's taxable year that includes the end of the pass-through partner's taxable year to which adjustments relate ("affected partners")
- All direct and indirect pass-through partners choosing to push-out must furnish Forms 8986 and file with IRS by extended due date (whether or not actually extended) of <u>AAR partnership's adjustment year return</u>

AARs –Pass-Through Partner Pays IU

- Alternatively, pass-through partner can choose to pay an IU on its share of AAR adjustments
  - No modifications allowed
  - Must pay IU by extended due date of AAR partnership's adjustment year return (i.e., the year in which AAR partnership filed AAR)
    - Compare: AAR partnership that pays IU must do so when it files AAR
  - Pass-through partner completes Form 8985 to report IU calculation and amount paid (if paying by check or money order, also file Form 8985-V)

AARs – Pass-Through Partner Pays IU (cont.)

- Even though pass-through partner elects to pay IU, it must push out any AAR adjustments that do not result in an IU to affected partners
  - Compare: if pass-through partner pays IU in a section 6226 push-out, it reports do-not-result adjustments on its return for the year in which it pays IU
  - Paying IU avoids hassling partners
  - If there is a chain of partnerships above AAR partnership, delays in pushing out across the chain may effectively compel an upper-tier pass-through partner to choose IU option

AARs –Modification of IU

- When computing IU, AAR partnership can only take into account certain modifications to IU
  - e.g., modifications for tax-exempt partners and applicable tax rates are allowed; PMARs and Alternative Procedure are not
- Not required to seek advance IRS approval for modifications; no approval should be expected
- AAR partnership must disclose and provide support for any IU modifications with AAR filing
- IRS can always examine modifications, and any other issue relating to the IU calculation (or any other PRI) by auditing AAR partnership

AAR Push-Out Errors

- What happens if AAR partnership fails to attach all the Forms 8986 to AAR request? Fails to send them to all reviewed year partners? Makes errors in the statements?
- Who knows how this will play out – but the IRS could assert that push-out is invalid and partnership is liable for IU
- Reg. § 301.6227-1(c)(2) – if AAR partnership fails to provide the push-out statements, the AAR adjustments requested, or any other information required by IRS forms and instructions, the IRS may, but is not required to, “invalidate an AAR” or readjust any items that were adjusted in the AAR

Filing Inconsistently With AAR

- Reviewed year partner can file inconsistently with Form 8986 provided by AAR partnership
  - Compare: Partner bound by adjustments shown on section 6226 push-out statement
- Partner discloses inconsistency with AAR push-out on Form 8082; includes Form 8082 with partner's reporting year return
- Notification of inconsistency cannot be made after NAP has been issued for AAR reviewed year

IRS Examination of AAR Adjustments

- The IRS can, but is not required to, initiate an examination of:
  - IU calculation and claimed modifications
  - any PRI reported on the return, whether or not adjusted in the AAR
  - push-out adjustments and allocation thereof, if AAR partnership elected push-out
  - fishing examination of other taxable years not subject to the AAR.
- In this respect, an AAR can open up a can of worms just like a regular refund claim (“no amended return goes unpunished”).
- PR petition for readjustment of any FPA-adjusted items resulting from AAR examination
- Filing of AAR refreshes the section 6235 period of limitations

Protective AARs?

- IRS position is that it is impossible to file a protective AAR
- BBA audits are slower than other audits

Correction of Errors by Opt-Out Partnerships

- Opt-out partnership doing paper filing corrects errors by filing amended return on Form 1065-X, checking the "NonBBA" box in Part I, completing Part II and Part V, and providing amended Schedule K-1s or K-3s to the partners.
  - The partners file amended returns.
- If the opt-out partnership is filing electronically, it uses Form 1065 and checks Box G(5) on page 1.
  - It must also include amended Schedule K-1s or K-3s, as applicable, with the filing and furnish copies to the partners