SOUTHERN FEDERAL TAX INSTITUTE

PARTNERSHIP AUDIT RULES: TRAPS FOR THE UNWARY

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Kate Kraus is nationally recognized and has more than 20 years of experience in tax planning and structuring. She advises on a wide range of partnership, corporate, and real estate matters, including joint ventures, fund formations, financing transactions, mergers and acquisitions, restructurings, liquidations, debt workouts, bankruptcies, and REIT transactions.

Kate also advises and represents clients in federal and state tax controversies. She is a leading authority on the new partnership audit rules that were enacted by the Bipartisan Budget Act of 2015 (the BBA). Kate's work in this area includes the *Bloomberg BNA Tax Management Portfolio* on the BBA, for which she was named Tax Portfolio Author of the Year by *Bloomberg BNA* in 2023. She is also Conference Co-Chair of Practicing Law Institute's Understanding the BBA Partnership Audit Rules conference.

Kate is often asked to speak at conferences around the country. She has published articles in *Tax Notes* and *Corporate Taxation* and has served as a contributing author of *Colliers on Bankruptcy Taxation*. Her comments have also appeared in numerous publications, including *The New York Times*, the *Forbes Money and Market* blog, *Tax Notes*, the *Bloomberg Daily Tax Report*, and *Law360*.

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- 36 years as a tax lawyer in the tax practice group of the law firm of King & Spalding LLP in their Atlanta office (30 years as an equity partner, six years as an associate). Retired from King & Spalding in 2019 but continue to speak and write on federal income tax matters.

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THE CENTRALIZED PARTNERSHIP AUDIT RULES (BBA)

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I. INTRODUCTION / BACKGROUND INFORMATION

A. Certain Defined Terms

1. "**AAR**" means an "administrative adjustment request" filed by the partnership representative on behalf of a BBA partnership under section 6227 (or, as the context requires, filed by a TEFRA partnership).

2. "**adjustments that do not result in an IU**," **also referred to as** "**do-not-result adjustments**" or "**DNR adjustments,**" refer to the two categories of partnership adjustments identified in Reg. § 301.6225-1(f)(1) that do not "result in" an IU and thus are required to be taken into account by the audited partnership in the partnership's adjustment year in accordance with Reg. § 301.6225-3; or, in the context of an AAR partnership, taken into account by reviewed year partners as provided in Reg. § 301.6227-2(d) and Reg. § 301.6227-3(a) and (b)(1); or taken into account by a pass-through partner paying an IU either with respect to AAR adjustments (see Reg. § 301.6227-3(c)(2) and Reg. § 301.6226-3(e)(3)) or with respect to section 6226 push-out adjustments (see Reg. § 301.6226-3(e)(4)(v)). In IRS forms and instructions these are referred to as "ATDNR" adjustments.

3. "**adjustment year**" means the partnership taxable year in which a court decision relating to the adjustment becomes final or, in any other case, the year in which the Notice of Final Partnership Adjustment ("FPA") is mailed or, if the partnership waives the restrictions on assessment under section 6232(b) as provided in section 6232(d)(2), the date the IRS executes the waiver. IRC § 6225(d)(2); Reg. § 301.6241-1(a)(1). In an agreed case, the waiver of restrictions on assessment occurs by the partnership signing, and the IRS countersigning, Form 14792 (Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts). <u>See</u> IRM 4.31.9.9.2.9(5) (01-24-2024).

a. In the case of an AAR, the adjustment year is the taxable year in which the BBA partnership files the AAR.

4. "**adjustment year partner**" means any person who held an interest in the partnership at any time during the adjustment year of the audited partnership. Reg. § 301.6241-1(a)(2).

5. "**affected partner**" means, in the context of the section 6226 push-out election or a push-out by an AAR partnership, any partner (including a pass-through partner) that held an interest in a pass-through partner at any time during the pass-through partner's taxable year to which the adjustments in the statement furnished to the pass-through partner relate. Reg. § 301.6226-3(e)(3)(i); Reg. § 301.6227-3(c)(1); Instructions for Forms 8985 and 8986 (Dec. 2024) (see the definitions of "affected partner" and "pass-through partner's tax year end to which the adjustments relate").

6. "**Alternative Procedure**" means the alternative IU modification procedure authorized by section 6225(c)(2)(B) in lieu of filing actual partner amended returns, also referred to by some practitioners as the "pull-in procedure" and by the IRS in its forms as "PAP" (Partner Alternative Procedure).

7. "**ART**" means the "**additional reporting year tax**" (which can be positive or negative) as determined and reported by reviewed year partners or affected partners in the context of (1) an AAR filed by a BBA partnership accompanied by a push-out of the partnership adjustments (Reg. § 301.6227-2(c) and (b)(1)), (2) a section 6226 push-out election by an audited partnership (Reg. § 301.6226-3(a)), or (3) a push-out of adjustments by a pass-through partner (Reg. § 301.6226-3(e)(3)(iv) and Reg. § 301.6227-3(c)(4)). The ART is reported on the partner's reporting year return (using Form 8978 and related Schedule A), together with applicable interest and penalties.

8. "**BBA**" means, as the context dictates, the Bipartisan Budget Act of 2015, as amended, or the centralized partnership audit rules enacted thereunder and contained in subchapter C of chapter 63 of subtitle F of the Code.

9. "**chapter 1 taxes**" refers to taxes imposed by chapter 1 (Normal Taxes and Surtaxes) of subtitle A (Income Taxes). Chapter 1 is comprised of sections 1 through 1400Z-2 of the Code. (In certain contexts the BBA regulations and this outline refer to certain chapter 1 taxes that are imposed directly on a partnership.)

10. "**DI**" means the individual appointed as the "designated individual" for an entity partnership representative under Reg. § 301.6223-1(b)(3)(ii).

11. "**DNR Adjustments**" means adjustments that do not result in an IU, as defined above.

12. "**first affected year**" means, in the context of the push-out election under section 6226 or a push-out by an AAR partnership, the taxable year of a reviewed year partner that includes the end of the partnership's reviewed year. Reg. § 301.6226-3(b)(2)(i). In the context of a pass-through partner that does its own push-out, the "first affected year" of an affected partner (other than a pass-through partner) is such partner's taxable year that includes the end of the pass-through partner's taxable year to which the adjustments relate. See Reg. §§ 301.6226-3(e)(3)(iv) and -3(b)(2)(i)). The pass-through partner's taxable year to which the adjustments relate is the pass-through partner's taxable year that includes the end of the audited partnership's or AAR partnership's reviewed year. See Instructions for Forms 8985 and 8986 (Dec. 2024) (definitions of "affected partner" and "pass-through partner's tax year end to which the adjustments relate").

13. "**finally determined**" means, with respect to partnership adjustments, in the context of the deadline for furnishing push-out statements to partners under section 6226, the later of the expiration of time to file a petition for readjustment under section 6234, or, if a petition is filed, the date when the court's decision became final. Reg. § 301.6226-2(b)(1).

14. "**former partners**" means, for purposes of the cease-to-exist regulations under section 6241(7), the persons who were partners during the adjustment year, or, if there are no adjustment year partners of a partnership that ceases to exist, the persons who were partners during the last taxable year for which a partnership return was filed. Reg. § 301.6241-3(d)(1) and (3).

15. "**FPA**" means a Notice of Final Partnership Adjustment (Letter 5933 for the partnership and Letter 5933-A for the PR).

16. "**IU**" means a partnership-level imputed underpayment as defined in Reg. § 301.6241-1(a)(3). If an audited partnership pays an IU on partnership adjustments, the IU is calculated in accordance with section 6225(b) and Reg. §§ 301.6225-1 and -2. If an audited partnership makes a push-out election and a pass-through partner elects to pay an IU on its share of adjustments, the IU is determined in accordance with Reg. § 301.6226-3(e)(4). If a partnership files an AAR and pays an IU, the IU is determined in accordance with Reg. § 301.6227-2 or, in the case of a pass-through partner paying an IU with respect to AAR push-out adjustments, the IU is determined in accordance with Reg. § 301.6227-3(c).

17. "**indirect partner**" means any person who holds an interest in the partnership indirectly through one or more pass-through partners or through a disregarded entity. Reg. § 301.6241-1(a)(4).

18. "**intervening years**" of a reviewed year partner means, in the context of the section 6226 push-out election or a push-out by an AAR partnership, any taxable year of such partner following the first affected year and ending before the reporting year as to which the partner's tax attributes and tax liabilities are affected by reason of the partner taking into account the push-out adjustments in the partner's first affected year. Reg. § 301.6226-3(b)(3)(i); Reg. § 301.6227-3(b)(1). If a pass-through partner does a push-out, the term has the same meaning when applied to the affected partners of the pass-through partner (other than an affected partner that is itself a pass-through partner). Reg. § 301.6226-3(e)(3)(iv); Reg. § 301.6227-3(c)(4).

19. "**modification year**" means, in the context of a PMAR or Alternative Procedure modification of an audited partnership's IU, any taxable year of a relevant partner participating in such modification with respect to which any tax attribute (as defined in Reg. § 301.6241-1(a)(10)) of such partner is affected by reason of the partner taking into account its distributive share of all partnership adjustments in the first affected year (as defined in Reg. § 301.6226-3(b)(2)(i)). See Reg. § 301.6225-2(d)(2)(ii)(B). A modification year can be a year that precedes or follows the first affected year.

20. "**NAP**" means a Notice of Administrative Proceeding (Letter 5893 for the partnership and Letter 5893-A for the PR).

21. "**NOPPA**" means a "Notice of Proposed Partnership Adjustment" (Letter 5892 for the partnership and Letter 5892-A for the PR).

22. "**PMAR**" is the term used by the IRS in BBA form instructions to refer to a modification of an IU by way of a partner amended return. PMAR stands for "Partner Modification Amended Return."

23. "**PAP**" is the term used by the IRS in BBA form instructions to refer to the Alternative Procedure to a partner modification amended return (PAP stands for "Partner Alternative Procedure").

24. "**PR**" means the individual or entity designated by a BBA partnership under section 6223(a) and Reg. § 301.6223-1(c) as the partnership representative with respect any partnership taxable year.

25. "**PRI**" means a "partnership-related item" as defined in section 6241(2)(B) and Reg. § 301.6241-1(a)(6)(ii).

26. "**partnership adjustment**" means any adjustment to a partnership-related item. IRC § 6241(2)(A); Reg. § 301.6241-1(a)(6).

27. "**partnership-partner**" means a partnership that holds an interest in another partnership. Reg. § 301.6241-1(a)(7).

28. "**pass-through partner**" means an upper-tier partnership, S corporation, non-grantor trust, or estate that holds a direct or indirect interest in a BBA partnership. Reg. § 301.6241-1(a)(5).

29. "**PIP**" means the "partners' interests in the partnership" test in Reg. § 1.704-1(b)(3) under which partnership allocations that do not comply with the section 704(b) economic effect safe harbors but which nevertheless satisfy the PIP requirements will be respected for section 704(b) purposes.

30. "**relevant partner**" means, in the context of the procedures for modifying an imputed underpayment, any reviewed year partner (including a pass-through partner, such as a partnership-partner, but not a disregarded entity), and any "indirect partner" (other than a disregarded entity). Reg. § 301.6225-2(a).

31. "**reporting year**" means, in the context of a section 6226 election or an AAR push-out election, the taxable year of a reviewed year partner that includes the date on which a section 6226 statement or comparable AAR statement was furnished to the partner. Reg. § 301.6226-3(a); Reg. § 301.6227-3(a). In the case of an affected partner holding its interest in an audited partnership or AAR partnership indirectly through a pass-through partner, the affected partner's reporting year is the partner's taxable year that includes the date on which the audited partnership or AAR partnership furnished Forms 8986 to its reviewed year partners. Reg. § 301.6226-3(e)(3)(iv); Reg. § 301.6227-3(c)(4).

32. "**reviewed year**" means the partnership taxable year to which a partnership adjustment relates. IRC § 6225(d)(1); Reg. § 301.6241-1(a)(8). The term also applies to the partnership taxable year to which an administrative adjustment request ("AAR") relates. Reg. § 301.6227-1(a).

33. "**reviewed year partner**" means any person who held an interest in an audited partnership or an AAR partnership at any time during the reviewed year of such partnership. Reg. § 301.6241-1(a)(9).

a. In at least one instance, the regulations also refer to a partner in a partnership-partner that holds an interest in a BBA partnership as a "reviewed year partner." See Reg. § 301.6232-1(d)(1)(iii).

34. "**specified tax attributes**" means the tax attributes listed in Prop. Reg. § 301.6225-4(a)(2) that are required to be adjusted by the partnership and its adjustment year partners in accordance with Prop. Reg. § 301.6225-4 as a result of partnership adjustments, namely, tax basis and book value of partnership property; amounts determined under section 704(c); the adjustment year partners' bases in their partnership interests and their capital accounts; and earnings and profits under section 312. (Note: If a section 6226 election is made, the "tax attributes," as defined immediately below, of the partners and the partnership are adjusted as provided in Prop. Reg. § 301.6226-4 rather than Prop. Reg. § 301.6225-4. See Prop. Reg. § 301.6225-4(a)(5)(i).)

35. "**tax attributes**" mean anything that can affect (i) the amount or timing of a partnership-related item, or (ii) the amount of tax due in any taxable year. Reg. § 301.6241-1(a)(10).

Examples include basis and holding period, character of tax items, and carryovers and carryback of tax items. "Tax attributes" can refer to either partner tax attributes or partnership tax attributes, depending on the regulatory context.

36. "**take effect**" means, for purposes of the "cease to exist" rules under section 6241(7), (i) the date on which partnership adjustments are the subject of a settlement agreement with the IRS, (ii) the date of a final court decision, or (iii) the date on which the time to file a petition for readjustment under section 6234 expires. AAR adjustments "take effect" when the AAR is filed. Reg. § 301.6241-3(c) (cross-referencing Reg. § 301.6226-2(b)(1)).

B. BBA Legislation

1. The centralized partnership audit rules – also commonly referred to as the "BBA" – were enacted by the Bipartisan Budget Act of 2015, Pub. L. 114-74, and subsequently amended by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113 (the "PATH Act") and the Tax Technical Corrections Act of 2018, contained in Title II of Division U of the Consolidated Appropriations Act of 2018, Pub. L. 115-141 (the "TTCA").

a. The TTCA was signed into law on March 23, 2018 and its amendments to the BBA provisions were effective retroactively.

2. Section 1101(a) of the BBA removed former sections 6221 through 6234, known as the "TEFRA" audit rules, effective for "returns filed for partnership taxable years beginning after December 31, 2017," and replaced it with new sections 6221 through 6241, which are housed in subchapter C of chapter 63 of subtitle F (Procedure and Administration) of the Code. Section 1101(g)(1) of the BBA.

3. Also repealed were the special audit rules relating to electing large partnerships (formerly housed in subchapter D of chapter 63) and related provisions in part IV of subchapter K of chapter 1.

4. The new BBA regime became fully effective in 2018.

5. There is no "real" Congressional legislative history for the BBA audit rules, even though they represent a sea change in the audit procedures for partnerships and partners. See Preamble to T.D. 9969, 87 Fed. Reg. 75473, 75477 (Dec. 9, 2022) (stating that there is no legislative history of the BBA provisions).

6. The provisions had a 10-year revenue estimate of over $9 billion.

7. For a technical explanation of the centralized partnership audit rules prior to the TTCA corrections, see Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, JCS-1-16 (March 2016), pp. 51-83 (the "BBA Bluebook").

8. For a technical explanation of the TTCA amendments, see Staff of Joint Committee on Taxation, General Explanation of Certain Tax Legislation Enacted in the 115th Congress, JCS-2-19 (Oct. 2019), pp. 149-165 (the "TTCA Bluebook").

C. Final and Proposed Regulations

1. The initial comprehensive set of proposed regulations was issued in June 2017. See REG-136118-15, 82 Fed. Reg. 27334 (June 14, 2017) (the "June 2017 Proposed Regulations").

a. Note: A prior version of these proposed regulations was made publicly available by the IRS in January 2017 but this version was withdrawn after the Trump administration issued a regulatory freeze order on January 20, 2017. The version published in the Federal Register in June 2017 was largely identical to the "preview version" but there were differences. See Preamble to February 2019 Final Regulations (as subsequently defined herein), 84 Fed. Reg. at 6482.

2. Final regulations relating to the BBA opt-out election under section 6221(b) were issued in January 2018. T.D. 9829, 83 Fed. Reg. 24 (Jan. 2, 2018) (the "January 2018 Final Opt-Out Regulations").

3. The first set of proposed tax attribute regulations was issued in February 2018. REG-118067-17, 83 Fed. Reg. 4868 (Feb. 2, 2018) (the "February 2018 Proposed Tax Attribute Regulations").

4. Final regulations relating to the partnership representative were published in August 2018. T.D. 9839, 83 Fed. Reg. 39331 (Aug. 9, 2018) (the "August 2018 Final PR Regulations").

5. At that time, the IRS also re-proposed regulations that consolidated several sets of previously proposed regulations and also made changes and additions to reflect the TTCA amendments. See REG-136118-15, 83 Fed. Reg. 41954 (Aug. 17, 2018) (the "August 2018 Proposed Regulations"; withdrawing, to the extent not previously finalized, (i) the June 2017 Proposed Regulations, (ii) the February 2018 Proposed Tax Attribute Regulations, (iii) proposed regulations relating to certain international aspects of the BBA (REG-119337-17, 82 Fed. Reg. 56765 (Nov. 30, 2017)), and (iv) proposed regulations relating to the application of section 6226 and section 6227 to tiered partnerships as well as certain BBA administrative and procedural aspects (REG-120232-17 and REG-120233-17, 82 Fed. Reg. 60144 (Dec. 19, 2017)).

a. The Preamble to the August 2018 Proposed Regulations states that the preambles to the withdrawn Notices of Proposed Rulemaking continue to be relevant to the extent not inconsistent with the Preamble to the August 2018 Proposed Regulations, and provides Federal Register citations to the Preambles of the former proposed regulations where relevant. 83 Fed. Reg. at 41955.

b. The TTCA amendments are discussed in the Preamble to the August 2018 Proposed Regulations. Further clarification can be found in the Preamble to the February 2019 Final Regulations.

6. Final regulations were published in February 2019 that modified and finalized many of the provisions in the August 2018 Proposed Regulations. T.D. 9844, 84 Fed. Reg. 6468 (Feb. 27, 2019) (the "February 2019 Final Regulations").

a. Because the proposed regulations were filed with the Federal Register on August 12, 2018, the applicability dates in the final regulations generally provide that the regulations apply to partnership taxable years beginning after December 31, 2017, and ending after August 12, 2018.

7. The February 2018 Proposed Tax Attribute Regulations were withdrawn and re-proposed, with certain changes, as part of the August 2018 Proposed Regulations (the re-proposed tax attribute regulations are separately referred to herein as the "August 2018 Proposed Tax Attribute Regulations").

a. Prop. Reg. §§ 301.6225-4 and 301.6226-4 and related proposed amendments to the section 704(b), 705 and 706 regulations were not finalized in the February 2019 Final Regulations and remain in proposed form.

b. They are proposed to be effective retroactively. See, e.g., Prop. Reg. § 301.6225-4(f)(1).

c. The August 2018 Proposed Tax Attribute Regulations are intended to do a number of things.

(1) One is to allocate the IU payment burden for capital account and outside tax basis purposes among those adjustment year partners who were also reviewed year partners or are "successors" to reviewed year partners.

(2) Another is to provide for adjustment of specified partner tax attributes by "notional" partnership items to reflect the manner in which partnership adjustments would have impacted the partners had they not been blocked from passing through by the interposition of the IU regime at the partnership level.

(3) To obtain a complete Preamble explanation of these proposed regulations, one should begin with the Preamble to the February 2018 Proposed Tax Attribute Regulations, and then consult the Preamble discussion of the changes that were made as part of the re-proposing of such regulations in the August 2018 Proposed Regulations. See Preamble, August 2018 Proposed Regulations, 83 Fed. at 41959 and 41962.

(4) The Preamble discussion of the August 2018 Proposed Tax Attribute Regulations does not specifically state that the proposed regulations can be relied upon prior to being finalized; however, if finalized in their present form, they will apply retroactively. See, e.g., Prop. Reg. § 301.6225-4(f)(1); Prop. Reg. § 301.6226-4(d)(1).

(5) The 2024-2025 Priority Guidance Plan (Partnerships, Item 16) dated Oct. 3, 2024 includes finalization of these proposed regulations. However, it is rumored that there is internal dissension over the direction taken in these proposed regulations and that they may be withdrawn.

8. In November 2020, the IRS issued new proposed regulations making further changes and additions to certain aspects of the BBA regulations, including the "cease to exist" final regulations under section 6241(7) that were included in the February 2019 Final Regulations, as well as new proposed regulations dealing with special enforcement matters under section 6241(11). See REG-123652-18, 85 Fed. Reg. 74940 (Nov. 24, 2020) (the "November 2020 Proposed Regulations").

9. The November 2020 Proposed Regulations were finalized, with changes, in T.D. 9969, 87 Fed. Reg. 75473 (Dec. 9, 2022) (the "December 2022 Final Regulations"). The December 2022 Final Regulations are generally effective for taxable years ending on or after November 20, 2020. (See the "applicability date" paragraphs of the various BBA regulations for the specific provisions to which this effective date applies, such as Reg. § 301.6225-1(i)(1).)

10. There are currently no proposed or final regulations under the failure-to-pay rules of section 6232(f), which was enacted by the TTCA.

11. Certain amendments to the BBA regulations were proposed in REG-101607-23, 88 Fed. Reg. 40528 (June 21, 2023) (relating to the section 6417 direct pay energy credit rules) and finalized in T.D. 9988, 89 Fed. Reg. 17546 (March 11, 2024).

a. One amendment modified the PRI definition to classify any chapter 1 tax liability imposed directly on a partnership as an item "with respect to the partnership," even if not required to be reflected or shown on the partnership's return or maintained in its books and records.

b. The other change added the current version of Reg. § 301.6241-7(g), which provides that the IRS can adjust any tax, penalties, etc. that are imposed directly on a partnership under chapter 1, and determine any PRI as part of any such adjustment to the amount and applicability of any such tax or other amounts, without regard to the BBA rules.

D. BBA Forms/Publications

Note: Audited partnerships and pass-through partners of audited partnerships are required to submit most BBA-related forms electronically. Partnerships filing AARs file them either electronically or by paper filing depending on how they filed the original partnership return.

Schedule B-2, Form 1065 (Election out of the Centralized Partnership Audit Regime) (Dec. 2018)

Form 15288 (Request to Revoke Partnership Election under Section 6221(b) or Request to Revoke Election under 1101(g)(4)) (Oct. 2022)

Form 15057 (Agreement to Rescind Notice of Final Partnership Adjustment) (Feb. 2019)

Form 15028 (Certification of Publicly Traded Partnership to Notify Specified Partners and Qualified Relevant Partners for Approved Modifications Under IRC § 6225(c)(5)) (Dec. 2024)

Form 14726 (Waiver of the Notice of Final Partnership Adjustment (FPA)) (Oct. 2020)

Form 8989 (Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment) (Oct. 2020)

Form 8988 (Election for Alternative to Payment of Imputed Underpayment) (Oct. 2020)

Form 8986 (Partner's Share of Adjustment(s) to Partnership-Related Item(s)) (Dec. 2024)

Form 8985 (Pass-Through Statement – Transmittal/Partnership Adjustment Tracking Report) (Dec. 2024)

Form 8985-V (Tax Payment by a Pass-Through Partner) (Dec. 2019)

Form 8984 (Extension of the Taxpayer Modification Submission Period Under Section 6225(c)(7)) (Oct. 2020)

Form 8983 (Certification of Partner Tax-Exempt Status for Modification Under IRC § 6225(c)(3)) (Oct. 2020)

Form 8982 (Affidavit for Partner Modification Amended Return Under IRC § 6225(c)(2)(A) or Partner Alternative Procedure Under IRC § 6225(c)(2)(B)) (Oct. 2020)

Form 8981 (Waiver of the Period Under IRC Section 6231(b)(2)(A) and Expiration of the Period for Modification Submissions Under IRC Section 6225(c)(7)) (Oct. 2020)

Form 8980 (Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)) (Dec. 2024)

Publication 5346, Instructions for Form 8980 (Dec. 2024)

Form 8979 (Partnership Representative Revocation, Designation, and Resignation) (Dec. 2024)

Form 8978 (Partner's Additional Reporting Year Tax) (Jan. 2023)

Schedule A (Form 8978) (Partner's Additional Reporting Year Tax – Schedule of Adjustments) (Jan. 2023)

Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)) (Dec. 2024)

Form 1065-X (Amended Return or Administrative Adjustment Request (AAR)) (Dec. 2024)

<u>Certain IRS-Initiated BBA Letters/Forms</u>

Letter 2205-D, Initial Contact to Schedule Appointment – Partnership Returns **[notice of selection for examination]**

Letter 5893, Notice of Administrative Proceeding – Partnership **[NAP]**

Letter 5893-A, Notice of Administrative Proceeding – Partnership Representative

Letter 5895, Preliminary Partnership Examination Changes and Imputed Underpayment **[Preliminary NOPPA]**

Form 14791, Preliminary Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts

Letter 5891, 30-Day Letter

Letter 5892, Notice of Proposed Partnership Adjustments – Partnership **[NOPPA]**

Letter 5892-A, Notice of Proposed Partnership Adjustments – Partnership Representative

Form 14792, Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts

Form 886-A, Explanation of Adjustments

Letter 5975, Notice of Modification Request Determination

Form 15027, Partnership Summary of Approved Modifications and the Imputed Underpayments

Letter 5933, Notice of Final Partnership Adjustment – Partnership **[FPA]**

Letter 5933-A, Notice of Final Partnership Adjustment – Partnership Representative

Form 872-M, Consent to Extend the Time to Make Partnership Adjustments

E. Keeping Final and Proposed BBA Regulations and TEFRA Regulations Straight

1. Those who do tax controversy work will want to keep a copy of a pre-BBA Code handy with former subchapter C of chapter 63 of the Code (TEFRA sections 6221 through 6234), as well as a set of the pre-BBA regulations.

2. The current Thompson Reuters Checkpoint regulations contain both the new BBA regulations and the old TEFRA regulations, which can lead to confusion. To make matters worse, the new BBA regulations are mixed in with the previously proposed versions – most of which are no longer proposed. One must be careful sorting through this mess.

3. As of the date of this outline, as far as this author is aware, the only BBA regulations still in proposed form are the August 2018 Proposed Tax Attribute Regulations.

4. Generally speaking, you will know you are looking at a pre-BBA regulation if it has a small letter after the Code section reference and before the hyphen – e.g., "§ 301.6224(c)-2" or "§ 301.6231(a)(5)-1." The BBA regulations generally do not contain a letter before the hyphen.

a. However, in the case of the regulations under section 6221 and 6233, the situation is reversed: the pre-BBA versions have no small letter (e.g., Reg. § 301.6221-1) and the BBA versions have the letter "a" or "b" before the hyphen. See Reg. § 301.6221(a)-1, Reg. § 301.6233(a)-1, Reg. § 301.6233(b)-1.

F. Opt-In Election for Certain Pre-2018 Periods

1. Returns filed for partnership taxable years beginning on or before December 31, 2017 continue to be governed by the now-repealed TEFRA provisions (unless the TEFRA small partnership exception or the electing large partnership rules apply).

2. As noted, the BBA rules had a delayed effective date, but under Section 1101(g)(4) of the BBA, partnerships are permitted to elect to apply the BBA to partnership taxable years beginning on or after November 2, 2015, and before January 1, 2018. Reg. § 301.9100-22(a).

3. The opt-in election generally must be made within 30 days after the partnership is notified (by Letter 2205-D) that the return of the partnership has been selected for examination. Reg. § 301.9100-22(b)(1).

a. The electing partnership must provide a written statement that satisfies the requirements of Reg. § 301.9100-22(b)(2).

b. That regulation requires the opt-in partnership to make a series of representations, one of which is that "[t]he partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential [IU] with respect to the partnership taxable year that may be determined under subchapter C of chapter 63…" Reg. § 301.9100-22(b)(2)(ii)(E)(4).

c. See SN Worthington Holdings, LLC v. Commissioner, 162 T.C. 228 (2024) (Tax Court rejected IRS argument that the petitioner's failure to provide additional evidence of ability to pay rendered its BBA opt-in election invalid; regulations only required the partnership to make the representation; thus, the BBA rules applied rather than TEFRA, the Commissioner's FPAA issued under TEFRA was invalid, and the Tax Court dismissed the case for lack of jurisdiction).

d. A partnership can also make an opt-in election for an eligible year for purposes of filing an AAR under the BBA in accordance with IRS forms and instructions. Reg. § 301.9100-22(c).

G. State BBA Variants

1. While this outline focus on the federal BBA provisions, reportedly more than 20 states have adopted some variation on BBA audit procedures (e.g., Georgia, New Jersey, California, Minnesota, Ohio, Hawaii, Arizona, Oregon, Maine, Rhode Island and West Virginia), which generally include the requirement to file a federal adjustments report with the state taxing authority following the conclusion of a BBA examination and may or may not permit entity-level tax payment for state purposes.

2. States must contend with the BBA procedures and entity-level IU payments by partnerships. Simply because the state has adopted legislation to conform to the current IRC does not mean that its assessment and collection systems will work properly to collect state tax resulting from BBA audit adjustments.

3. How a BBA partnership and its partners report the results of a federal examination to those states that haven't adopted BBA-type procedures may be unclear. States historically have been notified through the receipt of the final revenue agent's report (RAR) under IRS information exchange processes, but BBA procedures don't necessarily sync up with those requirements. If a BBA partnership elects to push-out adjustments, there may not be a mechanism to communicate the push-out adjustments to a particular state taxing authority. Also, conventional partner and partnership amended returns that would otherwise trigger state amended returns are not a fixture of the BBA regime (putting aside IU modification through partner amended returns).

4. The state tax impacts of a BBA partnership filing a federal AAR also need to be considered.

H. Pre-BBA Partnership Audit Procedures

1. For years prior to the effective date of the BBA provisions, there remain three sets of rules for tax audits of partners and partnerships:

a. Partnerships with 100 or more partners could elect the "electing large partnership" ("ELP") audit rules in pre-BBA section 775 and sections 6240-6255. A number of the concepts in the BBA rules find their origin in the ELP rules.

b. Partnerships that did not satisfy the TEFRA small partnership exception (e.g., that have more than 10 partners) and that were not electing large partnerships were subject to the TEFRA partnership audit rules enacted in 1982. These are found in TEFRA sections 6221 through 6234.

c. Small partnerships with 10 or fewer partners that did not elect to come under the TEFRA audit rules are subject to partner-level audits for pre-BBA taxable years, with the tax treatment of an adjustment to a partnership's items of income, gain, loss, deduction, or credit being determined in partner-level proceedings.

2. Although under TEFRA the treatment of "partnership items" was determined at the partnership level and binding on all partners, the TEFRA rules did not change the process for collecting underpayments attributable to partnership adjustments. Deficiencies in tax resulting from such adjustments were collected from each partner separately, along with any additional tax from "affected items" (partner items affected by adjustments to partnership items) determined at the partner level.

a. The IRS had at least one year from the final redetermination of partnership adjustments to pursue assessment against a partner for the resulting deficiencies. TEFRA Section 6229(d).

3. The partner-level collection process was initiated by the IRS, not the partners. The IRS viewed this as a major TEFRA headache – identifying partners and going after them to collect tax, interest and penalties resulting from a partnership audit.

II. OVERVIEW OF BBA REGIME

A. <u>Primary Reason for the BBA – Make it Easier for IRS to Get the Money In</u>

1. The BBA attempts to invert the TEFRA tax collection process. Under the BBA, partnership adjustments initially result in an "imputed underpayment" ("IU") which is imposed on, and collected from, the partnership (along with interest and penalties), unless the adjustments are pushed out to the partners under a section 6226 push-out election or the IU is "modified" by partners filing amended returns (or using the Alternative Procedure) to take into account their shares of the partnership adjustments at the partner level. Other IU modifications can be requested based on certain partner tax characteristics or tax impacts.

a. The logistical problems faced by the IRS under TEFRA are discussed in the Preamble to the June 2017 Proposed Regulations, 82 Fed. Reg. at 27336.

2. If a push-out election is made, then the reviewed year partners are responsible for doing, in effect, pro forma amended (but unfiled) returns for the "first affected year" and any intervening years for which tax attributes are affected, and then reporting and paying the resulting tax "correction amounts" (plus interest at a rate 2 percentage points higher than the normal underpayment rate) with their "reporting year" returns, as opposed to filing partner amended returns for the first affected year and intervening years. The reporting year is the partner's taxable year in which the partner was furnished a push-out statement by the partnership.

3. A push-out election thus puts the onus on the partners, rather than the IRS, to determine and pay what they owe as a result of the BBA audit adjustments.

4. In theory, the partners should do what they are supposed to do when they get their push-out statements, which also go to the IRS and provide a means of cross-check. That is, they should determine and pay the additional taxes, interest and penalties with their reporting year returns, so that in theory the IRS gets in all or most of the money to which it is entitled without having to chase down partners and partner returns. The 2% additional underpayment interest incentivizes the partners to accurately determine their correction amounts and pay them with their reporting year returns on a timely basis.

5. The BBA, unfortunately, is horrifically complex, and probably only those who are in the trenches right now with an actual BBA audit, litigated case or an AAR filing can begin to appreciate how bad it really is. It also creates the risk of an entity-level tax for every BBA partnership – a risk that must be considered in every partnership M&A transaction; every partnership interest sale, issuance or redemption; every partnership termination. It is a risk that should be addressed in every partnership agreement. It is quite apparent that Congress has traded TEFRA for an even more complicated and burdensome system, and partnerships eligible to make the annual opt-out election need to seriously evaluate the pros and cons of that option.

6. For a lucid analysis of the BBA provisions, see Kate Krause, The Partnership Audit Rules Under the Bipartisan Budget Act, 629-1st Tax Mgmt. Portfolio. Another excellent resource is Chapter 10A of William McKee, William Nelson & Robert Whitmire, Federal Taxation of Partnerships and Partners (Thomson Reuters/Tax & Accounting, 4th ed. 2007) (the "McKee Nelson treatise"). Also cited herein are some of the deeper-dive articles on specific BBA topics written by Jenni Black, who was heavily involved in the BBA regulations projects.

B. BBA Basics

1. Under section 6221(a):

(i) any adjustment to a partnership-related item ("PRI") is determined,

(ii) any tax attributable to such adjustment is assessed and collected, and

(iii) any penalties or additions to tax which relate to such adjustment are determined,

"at the partnership level" except to the extent otherwise provided under the BBA rules. See Reg. § 301.6221(a)-1(a); section 6211(c) (providing that in determining the amount of any deficiency, adjustments to PRIs are made only as provided in subchapter C).

2. A partnership and its partners are bound by all partnership actions taken under the BBA and by any final decision in a BBA proceeding brought with respect to such partnership. IRC § 6223(b). Yet, unlike TEFRA, partners have no rights whatsoever in connection with a partnership BBA examination – e.g., no notice rights, no right to participate, no right to file a petition, no nothing. They only have whatever rights the partnership agreement gives them.

3. Generally speaking, a PRI is "any item or amount with respect to the partnership" (without regard to whether it appears on the partnership's return) which is relevant in determining the chapter 1 tax liability of any person, and any partner's distributive share of any such item or amount. IRC § 6241(2)(B). The statute states that this includes "any item or amount relating to any transaction with, basis in, or liability of" the partnership.

a. Under Reg. § 301.6241-1(a)(6)(ii), an item or amount is "with respect to the partnership" if it is shown or required to be shown on the partnership return, or is required to be maintained in the partnership's books and records.

4. For BBA purposes, the term "partnership" means any partnership required to file a return under section 6031(b). IRC § 6241(1). This applies even if it is determined that the entity filing the return was not, in fact, a tax-recognized partnership, or if such entity is determined by the IRS not to exist. See Reg. § 301.6241-5(a) and (b).

5. In general, the statutory scheme seeks to impose a partnership-level tax liability, in the form of an IU, resulting from adjustments to PRIs in lieu of forcing the IRS to go after the partners individually. However, there are important circumstances under the BBA where partnership adjustments are taken into account by the partners and they become the taxpayers, such as the section 6226 push-out election and IU reduction through partner amended return or Alternative Procedure modifications.

a. Section 6225(a) provides that if adjustments to PRIs for any reviewed year result in an IU, the partnership must pay an amount "equal to such [IU] in the adjustment year" as provided in section 6232. An IU determined in an FPA must be paid by the partnership in the same manner as a tax imposed on the partnership for the adjustment year. Reg. § 301.6225-1(a)(2).

b. Section 6225 is disengaged, however, if the partnership elects to push out the adjustments to its partners under section 6226.

6. For purposes of the BBA provisions, the "adjustment year" is the partnership taxable year in which a court decision becomes final, if the partnership litigated the partnership adjustments; if not, it is the year in which the FPA was mailed. In the case of AAR adjustments, the adjustment year is the partnership taxable year in which the AAR was filed. IRC § 6225(d)(2); Reg. § 301.6241-1(a)(1).

a. If an FPA is mailed in December 2025, the 90-day period to file a petition for readjustment would not expire until 2026. Nevertheless, if the partnership does not file a petition, the adjustment year is 2025, not 2026.

7. An IU is not a tax imposed under chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes). Rather, it is imposed by subchapter C (Treatment of Partnerships) of chapter 63 (Assessment) of subtitle F (Procedure and Administration). See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75487. Nevertheless, section 6232(a) provides that an IU is assessed and collected in the same manner as if it were a tax imposed under subtitle A for the adjustment year, subject to the restrictions on assessment in section 6232(b). The deficiency procedures of subchapter B of chapter 63 do not apply. Reg. § 301.6232-1(a).

a. An IU payment, and any interest, penalties and additions to tax or additional amounts with respect thereto, are nondeductible by the partnership. They are treated as section 705(a)(2)(B) noncapital, nondeductible expenditures that reduce the partners' outside tax bases. IRC § 6241(4); Reg. § 301.6241-4(a).

b. An IU is not always paid by an audited partnership as a result of an IRS examination that results in positive partnership adjustments. It can also be self-reported and paid by a pass-through partner that elects to pay an IU on its share of push-out adjustments from a source partnership, or by a partnership filing an AAR to correct errors in the reporting of PRIs on a previously filed return and electing to pay an IU attributable to the corrections rather than doing a push-out of the adjustments out to its partners.

c. The IRS cannot assess and collect an IU until the close of the 90th day after the date of mailing of an FPA and, if a petition for readjustment of partnership items is filed with respect to the FPA, until the decision of the court becomes final. IRC § 6232(b).

8. Assuming a push-out election is not made, any partnership adjustments that "do not result in an IU" ("DNR adjustments") are taken into account by the partnership and the partners in the partnership's adjustment year, as regular pass-through items under subchapter K. See IRC § 6225(a)(2); Reg. § 301.6225-3(a); Reg. § 301.6227-2(d) (same rule in the AAR context).

9. Importantly, and notwithstanding some "rough justice" commentary by the drafters of the regulations, the IU calculation is not intended or designed to be a surrogate for the actual increased partner tax liabilities that would result from requiring the partners to take into account the partnership adjustments in the reviewed year. See Preamble, November 2020 Proposed Regulations, 85 Fed. Reg. at 74949 ("the centralized partnership audit regime … is designed to approximate the chapter 1 liability on the adjustments that would have been owed by the partners, not the partnership"). Indeed, in many respects the entity-level IU calculation is designed to ensure the maximum possible adverse tax result, deviating substantially from the actual tax outcomes if the partners had reported the partnership adjustments themselves, unless the IRS approves one or more permitted modifications to bring the IU closer to partner tax reality.

a. First, the IU is computed by applying the highest of the section 1 and section 11 rates in effect for the reviewed year, regardless of the actual effective tax rates to which the reviewed year partners were subject, although certain rate modification procedures are available to redress inequities. IRC § 6225(b)(1).

b. Second, complex grouping and netting rules are designed to leave many taxpayer-favorable adjustments (like an increase in an item of partnership loss or deduction) out of the IU calculation, with such adjustments being pushed forward and taken into account by the partners in the partnership's "adjustment year" rather than the reviewed year to which they are sourced. IRC § 6225(a)(2); Section 6225(b)(4).

(1) Increasing the IU with this type of cherry-picking also increases the partnership's interest cost for the period commencing with the filing of the reviewed year return and ending with the due date of the adjustment year return. IRC § 6233(a)(2).

c. Third, partnership adjustments can give rise to an IU even though they are adjustments to non-income, non-expense items. For example, an adjustment to reallocate Schedule K-1 partnership liabilities among the partners, or to adjust reported tax capital accounts, can give rise to an IU. This sort of adjustment (of which there are many return items that could be candidates for an adjustment) typically has no direct connection to the partners' taxable incomes for the reviewed year. The drafters viewed this as an inevitable consequence of the statutory provisions, and in particular, the fact that an IU is not a chapter 1 tax, but rather an entirely separate liability imposed on the partnership, not its partners. See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75478 ("the [IU] under the [BBA] is not designed to be the exact amount of the tax liability that would have been paid by the partners, nor is it a substitute for partner tax liability."

d. Fourth, the economic burden of an IU payment falls on the adjustment year partners rather than the reviewed year partners, putting the onus on management to determine whether and how to reallocate that burden through other means, such as special partnership allocations, clawbacks and other contractual arrangements.

10. These factors may make the push-out election under section 6226 the more palatable alternative in many circumstances. However a push-out carries a cost in the form of a 2% increase in the underpayment rate (referred to by some as “hot interest”), as well as costs incurred by the partnership in generating the push-out statements furnished to the partners and costs incurred by the partners in determining and paying their correction amounts.

11. Alternatively, modification (reduction) of the IU by partners filing amended returns (or using the Alternative Procedure that avoids filing actual amended returns) and paying the additional taxes and interest at the partner level – but without the push-out 2% interest rate bump – may be preferable.

12. The partnership is also subject to penalties determined as if the partnership were an individual subject to chapter 1 tax. IRC § 6233(a)(3).

13. Under section 6233(a)(2), underpayment interest on an IU is determined as if the IU were an underpayment of tax for the reviewed year. It runs from the unextended due date of the partnership’s reviewed year return and ends on the **earlier of** (i) the date prescribed for payment (see Reg. § 301.6232-1(b)) (i.e., IRS notice and demand for payment), (ii) the unextended due date of the partnership’s adjustment year return, or (iii) the date the IU is fully paid. Reg. § 301.6233(a)-1(b)(1).

a. If the IU is not paid on the date prescribed for payment, the partnership is also liable for interest determined as if the IU were treated as an underpayment of tax imposed for the adjustment year. Further, in that event section 6232(f)(1)(A) increases the underpayment interest rate by 2 percentage points. IRC § 6233(b)(2); Reg. § 301.6233(b)-1(c).

14. Upper-tier “partnership-partners” and certain other pass-through partners have their own choice to make if the audited partnership pushes out the adjustments under section 6226. They can either determine and pay an IU on their shares of the adjustments, as reported to them by the audited partnership on Form 8986 (Partner’s Share of Adjustment(s) to Partnership-Related Item(s)) (Dec. 2024), or they can elect to push-out the adjustments to their own partners, and so on up the chain.

15. DNR adjustments (such as taxpayer-favorable **negative** adjustments from decreases in income or increases in deduction, see Reg. § 301.6225-1(f)) are generally taken into account by the partnership in the adjustment year, and the normal rules of subchapter K apply with respect to the treatment of the adjustment year partners as to such adjustments. <u>See</u> IRC § 6225(a)(2); Reg. § 301.6225-1(f)(2); Reg. § 301.6225-3(a) and (c). There are important exceptions to this adjustment year treatment of DNR adjustments:

a. where an IU is determined and the partnership makes a section 6226 election to push out all of the adjustments associated with the IU to the reviewed year partners,

b. where a reviewed year partner takes into account the partner’s share of adjustments by filing a partner amended return or by using the Alternative Procedure in connection with an IU modification request,

c. an AAR partnership must always push out DNR adjustments to its reviewed year partners, even if it elects to pay an IU on AAR adjustments, and

d. special rules apply to DNR adjustments of pass-through partners electing to pay an IU on their shares of push-out adjustments from an audited or AAR partnership.

16. Reviewed year partners receive no interest to compensate them for not being able to take into account taxpayer-favorable adjustments until the adjustment year, as opposed to the reviewed year to which they are sourced. They ought to receive interest, but they don't.

a. Some commentators refer to the roll-forward of DNR adjustments to the partnership adjustment year as "true-up" adjustments, in the sense that they belatedly, without interest, compensate the reviewed year partners for tax items that they improperly reported (typically to their tax detriment) on their reviewed year returns and which remain unchanged in this process.

b. On the other hand, the partnership's IU liability from the positive partnership adjustments **does** bear interest from the due date of the reviewed year return. IRC § 6233(a)(2). The interest inequity is magnified as the number of years that have elapsed since the reviewed year multiply.

17. The economic burden of partnership adjustments that result in an IU necessarily falls on the adjustment year partners and not the reviewed year partners unless:

a. a modification to the IU is approved by way of amended returns or the Alternative Procedure in which one or more reviewed year partners participate, which is an alternative to filing actual amended returns,

b. a section 6226 or AAR push-out election is made, or

c. the partnership agreement or other contractual arrangements shift the economic burden of the IU to the reviewed year partners.

d. As will be discussed, proposed section 704(b) regulations seek to visit the tax burden of PRI adjustments resulting in an IU on the reviewed year partners or their "successors."

18. It is clear that individual partners are not responsible for any additional partner-level taxes resulting from adjustments that result in an IU, provided the partnership pays the IU liability on time.

a. <u>See</u> Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6474 ("payment of the [IU] by the partnership relieves the partners of any chapter 1 liability attributable to the reviewed year partnership adjustments"); Preamble to February 2018 Proposed Tax Attribute Regulations, 83 Fed. Reg. at 4870 ("…in the case of a positive partnership adjustment that is taken into account in [determining an IU], section 6225 does not itself provide for an item of taxable income under section 703(a) to be allocated to partners.").

b. It is somewhat surprising that there is not a more explicit "no double-counting" statement in the BBA provisions and regulations. <u>See</u> CCA 202452012 (May 1, 2023) (Office of Chief Counsel corrected internal presentation apparently showing that the partners had to report the partnership adjustments even though the partnership paid the IU resulting therefrom).

c. Note the following in support of the obvious:

(1) Section 6225(a)(1) and (2) (partnership adjustments that do not result in an IU are taken into account by the partnership in the adjustment year); Reg. § 301.6225-3(c) ("the rules under subchapter K …. with respect to the treatment of partners apply" in the case of adjustments that do not result in an IU). This indicates that the subchapter K rules do <u>not</u> apply to adjustments that <u>do</u> result in an IU, which is consistent with how section 6221(a) and section 6225(a) are drafted – i.e., once a tax is imposed on PRI adjustment at the partnership level, the adjustment is not taxed a second time at the partner level.

(2) Prop. Reg. § 301.6225-4 (creating "notional items," not real items, corresponding to partnership adjustments of items of income, gain, loss and deduction taken into account in determining an IU, for the limited purpose of adjusting partner capital accounts and outside tax basis).

(3) Reg. § 301.6241-7(i) (providing that the "special enforcement matters" rules, whereby the IRS can treat PRIs as non-PRIs in connection with a partner examination under certain circumstances, do not apply to the extent the partner can demonstrate that the partnership adjustments included in the IRS deficiency or adjustment were previously taken into account by such person under the BBA, such as an amended return modification or push-out election, or were included in an IU paid by the partnership or a pass-through partner in which the partner was a reviewed year partner or indirect partner).

C. <u>Opt-Out Election for Eligible Partnerships</u>

1. "Eligible partnerships" can elect out of the BBA regime as to any particular partnership taxable year. IRC § 6221(b).

2. If the opt-out election is made, neither the BBA nor TEFRA applies. Instead, the IRS must make partnership-related adjustments by conducting individual 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. <u>See</u> Reg. § 301.6221(b)-1(a); Preamble, June 2017 Proposed Regulations, 82 Fed. Reg. at 27337 ("Partnerships that elect out of [the BBA] are subject to the pre-TEFRA audit procedures under which the IRS must separately assess tax with respect to each partner under the deficiency procedures under subchapter B of chapter 63").

a. An opt-out partnership does not have to select a partnership representative. <u>See</u> Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6527. However, it can still be subject to the BBA in its capacity as a partnership-partner of a BBA partnership.

b. The opt-out election cannot be revoked as to a particular partnership taxable year without IRS consent. Consent to revoke is requested on Form 15288 (Request to Revoke Partnership Election under Section 6221(b) or Request to Revoke Election under 1101(g)(4)) (Oct. 2022). If a partnership is notified by the IRS that it intends to audit a partnership taxable year for which an opt-out election was made, and the partnership wants to revoke such election, the instructions accompanying Form 15288 state that the partnership should submit Form 15288, together with Form 8979 appointing a PR, within 30 days after the partnership receives Letter 2205-D.

3. An opt-out partnership cannot file an AAR to correct an error. In the Preamble to the February 2019 Final Regulations, the IRS stated that "[t]he manner in which a partnership that has elected out should report changes to its original return is outside the scope of these regulations." 84 Fed. Reg. at 6522. However, the current instructions for Form 1065-X (Amended Return or Administrative Adjustment Request (AAR)) (Dec. 2024), which are applicable to paper filings, indicate that the opt-out partnership files an amended partnership return and amended K-1s, and the partners file amended returns. <u>See</u> Instructions for Form 1065-X (Dec. 2024), p. 9; Instructions for Form 8082 (Dec. 2024), p. 4.

4. It appears that the requirement in section 6222 that partners file consistently with the partnership return (absent disclosure) does not apply to partners of an opt-out partnership. See Reg. § 301.6221(b)-1(a) (providing that the provisions of subchapter C, of which section 6222 is a part, do not apply for any partnership taxable year for which an eligible partnership makes a valid opt-out election).

5. How to Make the Election. The opt-out election is made on a **year-by-year basis** by checking "yes" on question 33, Schedule B, Form 1065 (2024) on a **timely filed** (including extensions) Form 1065 for the year in question and completing Schedule B-2 (Form 1065), Election out of the Centralized Partnership Audit Regime (Dec. 2018). IRC § 6221(b)(1)(D); Reg. § 301.6221(b)-1(c)(1).

a. The Preamble to the January 2018 Final Opt-Out Regulations states that a timely filed return includes a superseding return filed before the original due date (including any extensions). 83 Fed. Reg. at 29.

b. Schedule B-2 requires all eligible partners, their TINs, and their eligibility tax status to be listed, along with the shareholders of any S corporation partner and their TINs and tax status. See Reg. § 301.6221(b)-1(c)(2).

c. The requirement to disclose the tax status of an S corporation's shareholders (specifically required in Reg. § 301.6221(b)-1(c)(2)) is interesting because section 6221(b)(2)(A)(ii) only requires disclosure of S shareholder names and TINs. Maybe the IRS is just eager to know (and wants the S corporation and partnership to share in the excitement) if there are ineligible S shareholders lurking in the shadows.

6. Because this is a statutory deadline and not a regulatory deadline, 9100 relief is not available for a late election, subject to the exception in Reg. § 301.9100-2(b) (automatic six-month extension allowed from the **unextended due date** of the return to make a statutory or regulatory election where the due date is the return due date or the due date of the return including extensions, either with or without extensions, and the taxpayer takes corrective action within that six-month period).

7. Since the election must be filed with the partnership's return, a partnership does not have the luxury of taking a wait-and-see approach and making the opt-out decision in connection with an impending audit.

8. The partnership must notify each partner within 30 days of making the opt-out election "in the form and manner determined by the partnership." Reg. § 301.6221(b)-1(c)(3); section 6221(b)(1)(E) (partnership must notify partners of the election in the manner prescribed by the Secretary).

a. The Preamble to the June 2017 Proposed Regulations states that the notice "may be in writing, electronic, or other form chosen by the partnership." 82 Fed. Reg. at 27344; see also the discussion in the Preamble to the January 2018 Final Opt-Out Regulations, 83 Fed. Reg. at 30.

b. The notice requirement applies only to direct partners; it does not apply to the shareholders of an S corporation partner. See Preamble, January 2018 Final Opt-Out Regulations, 83 Fed. Reg. at 30.

c. Schedule K-1 does not provide a mechanism to inform the partners of an opt-out election. However, if a schedule is attached to the K-1 that discloses it, that ought to suffice. If this is not done, a separate communication to the partners must be made, which is a ball waiting to be dropped. Moreover, the partner communication must be renewed each year, since the election is year-by-year.

d. The IRS and Treasury unfortunately rejected the suggestion of some commentators that a check-box be added to the K-1 indicating that the opt-out election had been made.

e. While paragraph (c)(3) itself does not condition the validity of the election on providing timely partner notifications, Reg. § 301.6221(b)-1(a) refers to "a valid election in accordance with paragraph (c)," and section 6221(b)(1) lists partner notification as one of five conditions that must be met for a valid election. Thus, it would be foolhardy to assume that a failure to timely notify the partners is harmless error.

9. All Partners Must Be "Eligible Partners." The opt-out election requires that each partner to whom the partnership furnishes a statement under section 6031(b) (a Schedule K-1) qualify as an "eligible partner" for the partnership's entire taxable year. Reg. § 301.6221(b)-1(b)(1)(ii).

a. An eligible partner is defined to be:

(1) an individual (including a nonresident alien),

(2) a C corporation as defined in section 1361(a)(2),

(3) an S corporation,

(4) an "eligible foreign entity," or

(5) an estate of a deceased partner. See IRC § 6221(b)(1)(C); Reg. § 301.6221(b)-1(b)(3)(i)).

b. The reference to qualifying as an eligible partner "for the partnership's entire taxable year" does not mean that a partner is ineligible it was a partner for only part of the year; it simply means that it must be an eligible partner for the duration of its ownership during the year. See Reg. § 301.6221(b)-1(b)(2)(iii), Example (3).

c. An "eligible foreign entity" is a foreign entity that would be treated as a C corporation if it were a domestic entity. Reg. § 301.6221(b)-1(b)(3)(iii).

d. A REIT or RIC is a C corporation and thus is an eligible partner, as is a tax-exempt organization that is classified as a corporation (but not a tax-exempt trust). See Preamble to June 2017 Proposed Regulations, 82 Fed. Reg. at 27343.

e. A partner is **not** an eligible partner if the partner is a:

(1) disregarded entity,

(2) qualified subchapter S subsidiary ("QSUB"),

(3) partnership,

(4) trust (including a grantor trust),

(5) ineligible foreign entity,

(6) an estate of an individual other than a deceased partner, or

(7) a person who holds an interest in the partnership on behalf of another person (i.e., nominee holder). Reg. § 301.6221(b)-1(b)(3)(ii).

f. The disregarded entity, QSUB, and nominee holder exclusions apply to taxable years ending on or after November 20, 2020 (the date the November 2020 Proposed Regulations were filed with the Federal Register). See Reg. § 301.6221(b)-1(f).

g. Thus, for example, if an individual holds his interest in a partnership through a disregarded LLC or grantor trust **at any time** during the partnership's taxable year, the partnership cannot make an opt-out election for such year.

h. The apparent rationale for treating S corporations as eligible partners, but not partnerships and disregarded entities, is that S corporations are generally limited to no more than 100 shareholders, and those shareholders cannot be partnerships (although a disregarded entity qualifies if the owner is a qualifying S shareholder). Congress apparently did not want an opt-out partnership to be able to have tiers of partnerships in its ownership structure that could complicate the process of chasing down direct and indirect partners for tax liabilities arising from adjustments to PRIs.

i. On the other hand, if a partnership has an S corporation as a partner (an SCo is an eligible entity), the fact that the S corporation has a disregarded entity or qualified small business trust as a shareholder does not cause the partnership to have an ineligible entity as a partner. Reg. § 301.6221(b)-1(b)(3)(i).

10. 100 Partner Limitation ("100 K-1 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.

a. The 100-partner limit is satisfied only if the aggregate number of Schedule K-1s the partnership furnishes under section 6031(b), together with the aggregate number of Schedule K-1s furnished by an S corporation partner to its shareholders under section 6037(b), does not exceed 100 for the taxable year. Reg. § 301.6221(b)-1(b)(2)(i) and (ii).

b. If partner A sells her interest to partner B during a partnership taxable year, each receives a K-1 for such year and both K-1s count for purposes of the 100 K-1 limit. Reg. § 301.6221(b)-1(b)(2)(iii), Example (3).

c. If the 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), the partnership is treated as issuing only one K-1 for this purpose. Preamble to June 2017 Proposed Regulations, 82 Fed. Reg. at 27343.

d. The Schedule K-1 furnished to an S corporation partner counts as one Schedule K-1 in this total, even though the K-1s issued to the S corporation's shareholders are also counted. Reg. § 301.6221(b)-1(b)(2)(iii), Example (4).

e. Partners who are married to each other count as separate partners for this purpose because each receives a K-1. Reg. § 301.6221(b)-1(b)(2)(iii), Example (1). On the other hand, if one spouse merely has a community property interest in the other spouse's partnership interest, the first spouse does not receive a K-1 and is not counted as a partner. Reg. § 301.6221(b)-1(b)(2)(iii), Example (2).

11. IRS Reverses Position and Determines that a QSUB is an Ineligible Partner. In IRS Notice 2019-06, 2019-3 I.R.B. 350, the IRS construed the BBA provisions to mean – in the absence of regulations to the contrary – that a "qualified subchapter S subsidiary," or QSUB, is a "C corporation" because under section 1361(a)(2) it is a "corporation" that is not an S corporation. Thus, the Notice unambiguously stated, a QSUB is an eligible partner for purposes of the opt-out election requirements.

a. The Notice also stated, however, that regulations would be issued that would subject QSUB partners to the look-through approach that applies to S corporation partners for purposes of the 100 K-1 limit.

b. Alas, IRS and Treasury changed their minds. As first announced in the November 2020 Proposed Regulations, the December 2022 Final Regulations reversed the Notice (exercising the IRS's "special enforcement matters" regulatory authority in section 6241(11)(B)(vi)) by providing that a QSUB partner is not an eligible partner, period. See Reg. § 301.6221(b)-1(b)(3)(ii)(G) (effective for taxable years ending on or after November 20, 2020).

c. For BBA taxable years ending prior to such date, taxpayers should be able to rely on Notice 2019-06's statement that a QSUB is an eligible "C corporation" partner under existing law. According to the Preamble to the November 2020 Proposed Regulations, the statutory S corporation partner look-through rule by its terms does not apply to a QSUB partner. 85 Fed. Reg. at 74942.

12. Compare TEFRA Small Partnership Exception. The TEFRA audit procedures did not apply (unless the partnership elected otherwise) to small partnerships, which were partnerships with 10 or fewer partners, each of which was an individual (other than a nonresident alien), a C corporation, or estate of a deceased partner. IRC § 6231(a)(1)(B). A husband and wife were treated as one partner for this purpose.

a. The small partnership exception did not apply if any partner was a "pass-thru partner," which was defined in TEFRA section 6231(a)(9) as a partnership, estate, trust, S corporation, nominee or similar person through which another person held its interest in the partnership. Reg. § 301.6231(a)(1)-1(a)(2).

b. This included single member LLCs. See Seaview Trading, LLC v. Commissioner, 858 F.3d 1281 (9th Cir. 2017); Rev. Rul. 2004-88, 2004-2 C.B. 165.

c. For pre-BBA taxable years of small partnerships, the IRS must make adjustments to partnership tax items on each partner's return separately and institute deficiency procedures at the partner level to collect the resulting tax. See Preamble, June 2017 Proposed Regulations, 82 Fed. Reg. at 27335.

d. In the Preamble to the June 2017 Proposed Regulations, the IRS made this interesting observation about multiple partnerships being formed among related parties to facilitate opt-out (82 Fed. Reg. at 27344):

> "In addition, the IRS intends to carefully scrutinize whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for federal income tax purposes. The types of arrangements that the IRS will carefully review include those where the profits or losses of partners are determined in whole or in part by the profits or losses of partners in another partnership, and those that purport to be something other than a partnership, such as the co-

ownership of property. If it is determined that two or more partnerships that have elected out of the centralized partnership audit regime have formed a constructive or de facto partnership for a particular partnership taxable year and are recast as such by the IRS, that constructive or de facto partnership will be subject to the [BBA] because that constructive or de facto partnership will not have filed a partnership return and, therefore, will not have made a timely election out as required under section 6221(b)(1)(D)(i) and these proposed regulations. The constructive or de facto partnership may also have more than 100 partners or an ineligible partner, making it ineligible to elect out."

(For more on this, see the discussion in the Preamble to the January 2018 Final Opt-Out Regulations, 83 Fed. Reg. at 26.)

13. Pros and Cons of Opt-Out.

a. Many tax advisors who have waded through the BBA regulations and forms may find it hard not to recommend an annual opt-out election for their partnership clients that qualify.

b. The inequities of the IU calculation, the complexities of the IU modification rules, the issues of a disconnect between reviewed year partnership ownership and adjustment year partnership ownership, the 2% interest bump on a push-out election, and the overall complexity of the BBA and required information reporting, make opt-out seem very attractive. Let the IRS go after the partners one-by-one and best of luck to you.

c. However, opt-out requires, among other things, no disregarded entity partners, no partnership-partners, no trust partners, and no estate partners other than the estate of a deceased partner. These are major impediments.

d. The risk of a qualifying partner transferring an interest to an eligible partner without the partnership's knowledge, or even with the partnership's knowledge but without awareness of the tax consequences, cannot be dismissed as a remote possibility. If an S corporation is a partner, share transfers or issuances could result in additional K-1s counting against the 100 K-1 limit.

e. Opt-out means that the IRS goes after each partner individually. The partnership loses control of the process. The partnership may not be keen on sharing partnership financial and other information with the partners to assist them in defending an audit of their partnership tax items.

f. Partner level audits could easily expand to include other non-partnership issues, whereas a BBA audit is necessarily limited to the partnership's tax issues.

g. Partnerships hoping to preserve opt-out eligibility on an ongoing basis may need to impose transfer restrictions to prevent eligible partners from transferring (or being deemed to transfer) their interests to ineligible partners.

h. 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 the partners out of it, and doing the same thing at the state level in those states that have BBA-type procedures.

i. Consolidated groups that routinely extend their statutes of limitation may perceive a benefit in having the BBA apply to in-house partnerships owned by group members so that the partnership audit moves forward on a separate track and subject to its own section 6235 period of limitations on adjustment.

j. Service partnerships, like law and accounting firms with offices in different states, may see frequent state audit activity compared to virtually no federal audit activity. For states that have BBA-type audit procedures, controlling these audits and paying state taxes at the partnership level may be more efficient and ease the burden on the partners, although apportioning the economic burden among the partners still has to be addressed.

k. Opt-out partnerships and their partners may incur more legal and accounting costs collectively with partner-level audits than if the BBA procedures applied.

l. Partners of an opt-out partnership are not bound by the consistency requirement of section 6222.

m. Opting out may invite the partners to ask, "if this is so great, how come we didn't do it before?"

D. Partners Can Be Treated Like Mushrooms Under the BBA

1. There is no requirement under the BBA that the partnership or the IRS notify the partners of:

a. The commencement, progress and resolution of an audit.

b. The fact that the partnership resolved the audit by paying an IU, or the amount of the IU (and interest and penalties).

c. If the partnership files an AAR reporting taxpayer-adverse adjustments, the fact that it paid an IU on those adjustments.

2. Partners necessarily become involved if the partnership makes a section 6226 push-out election, chooses to push out AAR adjustments, or seeks approval for partner amended return or other IU modifications.

3. There is no BBA requirement to seek partner approval for BBA actions, such as a push-out election. Partners can, of course, negotiate for notice and approval rights of various BBA-related actions or inactions.

4. The IRS has the authority under Reg. § 301.6223-2(d)(1) to permit a partner (other than the PR) to participate in an administrative proceeding. For example, the IRS might exercise that authority to permit a partner who filed inconsistently with the partnership return to participate in a partnership proceeding that is initiated by the IRS to resolve the inconsistency. See Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6476.

E. Penalties Under the BBA

1. The applicability of penalties is determined at the partnership level as if the partnership were an individual and the IU were an actual underpayment of tax by the individual. The partnership can assert partnership defenses, such as reasonable cause. However, it cannot raise partner-level defenses. See IRC § 6221(a); IRC § 6233(a)(3); Reg. § 301.6221(a)-1; Reg. § 301.6233(a)-1(c)(1).

2. If the IRS asserts a penalty in a BBA proceeding and the partnership requests modification based on a partner amended return or the Alternative Procedure, the adjustments taken into account in that modification no longer contribute to an IU, which in turn reduces any penalty asserted at the partnership level. However, the partner must pay the asserted penalty with its amended return (or as part of the Alternative Procedure), provided, in the case of the substantial understatement penalty, that the applicable threshold is exceeded at the partner level. Reg. § 301.6225-2(d)(2)(viii); Reg. § 301.6233(a)-1(c)(2)(v)(F), Example (6).

a. In order for a relevant partner to raise a partner-level defense to a penalty, the partner must first pay the penalty with the amended return modification and then file a claim for refund. Reg. § 301.6225-2(d)(2)(viii). The same is true in the context of penalties paid as the result of a push-out election. Reg. § 301.6226-3(d)(3).

3. See CCA 202044009 (Oct. 23, 2020) (discussing how the BBA rules apply in the context of a civil fraud penalty asserted against a conservation easement partnership).

F. A Deeper Dive Into "Partnership-Related Item"

1. A "partnership adjustment" is any adjustment to a PRI. Reg. § 301.6241-1(a)(6)(i). The regulations define the term PRI as any "item or amount with respect to the partnership" (including any item or amount relating to any transaction with a partnership, basis in a partnership, or liability of a partnership) which is relevant in determining the tax liability of any person under chapter 1 of the Code, including any distributive share of such an item or amount. IRC § 6241(2)(B); Reg. § 301.6241-1(a)(6)(ii). An IU is itself a partnership item. Id.

a. An item or amount is "with respect to the partnership" if it is "shown or reflected, or required to be shown or reflected, on a return of the partnership under section 6031 or the forms and instructions prescribed by the [IRS] for the partnership's taxable year," or it is required to be maintained in the partnership's books and records. Reg. § 301.6241-1(a)(6)(iii).

b. Section 6241(2)(B)(i) provides that a PRI is any "item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return)." The parenthetical language, according to the Preamble to the February 2019 Final Regulations, includes as PRIs "items or amounts that factor into the determination of items or amounts that do appear on the partnership return." 84 Fed. Reg. at 6471. Thus, items that are "reflected" on the return, even though not "shown," can be PRIs.

c. Conversely, an item or amount shown or required to be shown on a return of a person **other than the partnership** that results after application of the Code to a PRI based on the person's specific facts and circumstances (including an incorrect application of the Code or taking into account erroneous facts and circumstances) is not "with respect to the partnership." Reg. § 301.6241-1(a)(6)(iii). The Preamble to the February 2019 Final Regulations states that this is intended to make clear that affected items and computational adjustments under TEFRA are not within the scope of BBA partnership-related items. 84 Fed. Reg. at 6473.

2. As originally enacted by the BBA, section 6221(a) referred to "adjustments to partnership income, gain, loss, deduction or credit" being determined at the partnership level. The TTCA adopted the term "partnership-related item" instead and relocated the definition to section 6241(2)(B). The TTCA Bluebook (p. 149) states that the partnership audit rules are not narrower than TEFRA and are intended to have a scope sufficient to address those items described as partnership items, affected items and computational items under TEFRA.

a. However, the Preamble to the February 2019 Final Regulations leaves no doubt that the drafters consciously rejected a partnership-related item definition that would sweep in affected items and computational adjustments because they believed the system that they constructed, with a set of overkill IU rules and a backup push-out mechanism to "get it right" at the partner level with penalty interest coercion, would sufficiently protect the fisc. 84 Fed. Reg. at 6472-6473. The following excerpt (p. 6473) is particularly revealing:

> "The rules for calculating an imputed underpayment under section 6225 and the computation rules under section 6226 are sufficiently broad to ensure that the tax attributable to items that would have been partnership items, affected items, and computational adjustments under the TEFRA is collected under the centralized partnership audit regime. When the partnership pays an imputed underpayment, the application of limitations and restrictions is assumed and favorable adjustments are disregarded unless a partnership demonstrates that partner tax attributes should override those assumptions. In this way, the imputed underpayment determination, including any modifications, sufficiently accounts for those types of items that would have been affected items or computational adjustments under TEFRA. Similarly, in the case of an election under section 6226, the re-computation process necessarily involves the application of items that would have been affected items or computational adjustments."

b. Thus, for example, under the PRI definition finally adopted, a partner's outside basis – which was an affected item under TEFRA – is not a partnership-related item under the BBA, although it is affected by various PRIs. More specifically, in the vernacular of the regulations, a partner's outside basis is not an item or amount with respect to the partnership because it is shown in the <u>partner's</u> book and records and takes into account facts and circumstances specific to that partner. Reg. § 301.6241-1(a)(6)(iii) (last sentence). It is, however, affected by various PRIs, such as the partner's distributive share of tax items, distributions, contributions, and allocable share of partnership liabilities as shown on the partner's K-1. <u>See</u> CCA 202433009 (April 10, 2023).

c. Similarly, whether a partner recognizes outside gain under section 731 as a result of an actual or constructive partnership distribution of money should not be a PRI. It is not an item or amount with respect to the partnership, though it is affected by PRIs, i.e., the fact of, and the amount and character of, the distribution itself.

d. The application of the section 465 at-risk rules to a partner likewise would not appear to be a PRI, although certain determinations critical to the application of section 465 could be. For example, whether a liability constitutes qualified nonrecourse financing is a PRI because it is an item and amount shown on the partnership's tax return and K-1s and/or is otherwise maintained in its books and records. <u>See</u> Reg. § 301.6241-1(a)(6)(v)(E).

3. The Preamble to the February 2019 Final Regulations states that records voluntarily maintained by a partnership with respect to a partner's outside basis are not "required" and thus are not PRIs:

> "For example, a partnership may choose to maintain the outside basis of each of its partners in its books and records, even though the Code does not require [that] this information be maintained by the partnership. The rule make clears that the voluntary recording of an item in the partnership's books is not determinative of the meaning of the phrase 'item or amount with respect to the partnership.' A partnership cannot convert an item or amount that is not with respect to the partnership into an item or amount that is with respect to the partnership merely by including that item or amount in the partnership's books and records."

84 Fed. Reg. at 6471-6472.

4. An item or amount is "relevant in determining the tax liability of any person under chapter 1" without regard to whether such item or amount, or adjustment thereto, has an effect on the tax liability "of any particular person under chapter 1." Reg. § 301.6241-1(a)(6)(iv). The Preamble to the August 2018 Proposed Tax Attribute Regulations makes clear that if the item or amount could potentially affect a partner's chapter 1 tax liability, it is "relevant" even if there is no evidence of actual tax impact on one or more reviewed year partners:

> "An item or amount is a partnership-related item if the item or amount is relevant in determining any person's liability under chapter 1 if the item might have any effect on any person's liability under chapter 1 regardless of whether it actually does have such an effect. Consequently, the IRS is not required to determine if an adjustment would have an actual effect on any person's chapter 1 liability under the Code."

83 Fed. Reg. at 41956.

5. Section 6031(b) requires the partnership to furnish a statement to the partners (i.e., Schedule K-1s) showing their distributive shares and other information. The partnership is required to file the K-1s with the IRS as part of its Form 1065 and are considered a part of the "return." Thus, amounts reflected on the K-1s filed with the IRS are PRIs, as are any forms required to be filed with the Form 1065, such as Form 8990 (section 163(j)), Form 8308 (section 751(a)), or Form 8996 (QOF certification).

a. See Box I of Form 1065 (2024), p. 1 (requiring K-1s to be attached); Instructions for 2024 Form 1065 (Jan. 2025), p. 12 (same); Reg. § 301.6222-1(a)(5)(iii), Example (3) (the Schedule K-1 for partner C that was filed as part of the partnership's return was different from the Schedule K-1 that was furnished to C; C's return was filed consistent with the K-1 that was issued to C; C nevertheless is treated as having filed inconsistently with the partnership return); Rev. Proc. 2019-32, 2019-33 I.R.B. 659 (K-1s are part of the section 6031(a) partnership "return").

6. The regulations state that a PRI includes the following nonexclusive list of items:

a. The character, timing, source and amount of the partnership's income, gain, loss, deductions and credits, and the character, timing and source of the partnership's activities. Reg. § 301.6241-1(a)(6)(v)(A) and (B).

b. The character, timing, source, value, and amount of any contributions to, and distributions from, a partnership. Reg. § 301.6241-1(a)(6)(v)(C).

c. The partnership's basis in its assets, the character and type of assets, and the value of the assets (or revaluation such as in a partnership book-up under the section 704(b) regulations). Reg. § 301.6241-1(a)(6)(v)(D).

d. The amount and character of partnership liabilities (e.g., recourse or nonrecourse), and any changes to those liabilities from the preceding year. Reg. § 301.6241-1(a)(6)(v)(E). Thus, a partner's allocable share of such liabilities as shown on the partner's K-1 is a PRI. See Reg. § 301.6241-1(a)(6)(v)(E); CCA 202444004 (July 19, 2023) (PRI includes a partner's liability share reported on the Form 1065 and Schedule K-1, but does not include a section 752(b) constructive distribution of money resulting from a reallocation of a liability from one partner to another under because a constructive distribution is not reported on the Form 1065; the latter conclusion is debatable, given that the character and amount of "distributions" are PRIs).

e. The category, timing and amount of the partnership's expenditures. Reg. § 301.6241-1(a)(6)(v)(F).

f. Any item or amount resulting from a partnership termination. Reg. § 301.6241-1(a)(6)(v)(G).

g. Any item or amount of the partnership resulting from a section 754 election. Reg. § 301.6241-1(a)(6)(v)(H). This would include both section 743(b) basis adjustments personal to a partner and section 734(b) common basis adjustments, both of which are required to be shown on attachments to the partnership's return and K-1s and are clearly "with respect to the partnership." The income and expense reported on the partners' K-1s related to the annual amortization of positive and negative section 743(b) adjustments likewise are PRIs.

h. Partnership allocations and any special allocations. Reg. § 301.6241-1(a)(6)(v)(I).

i. The identity of a person as a "partner" in a partnership. Reg. § 301.6241-1(a)(6)(v)(J).

j. Whether an entity filing a partnership return is in fact classified as a partnership for tax purposes, and whether such entity even existed at all during the taxable year for which it filed a partnership return. See IRC § 6241(8); Reg. § 301.6241-5(a) and (b) (providing that the BBA rules apply to any entity filing a partnership return for the year, even if the entity is ultimately determined not to constitute a tax partnership or not to have existed as an entity). See also Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649, 652-654 (D.C. Cir. 2010), aff'g in part, rev'g in part and remanding 131 T.C. 84 (2009) (whether or not a tax partnership existed is a TEFRA partnership item); RJT Investments v. Commissioner, 491 F.3d 732 (8th Cir. 2007) (whether partnership was a sham was a partnership item under TEFRA); United States v. Woods, 571 U.S. 31, 39 (2013) ("[A] determination that a partnership lacks economic substance is an adjustment to a partnership item.")

7. Other examples of PRIs not specifically referred to in the nonexclusive list in the regulations would include:

a. Whether there has been a disguised sale of property to a partnership or a tax-free contribution. This could derive from Reg. § 301.6241-1(a)(6)(v)(C) (a PRI includes the "character … and amount of any contributions to, or distributions from, the partnership") or from the fact that property purchased in a disguised sale takes a section 1012 cost basis, and the basis of partnership property is a PRI under Reg. § 301.6241-1(a)(6)(v)(D); see Instructions for Form 8986 (Dec. 2024), p. 4 (describing the reporting of disguised sale adjustments).

b. The application of the character freezing rules of section 724(b) to property contributed to a partnership.

c. The amount shown as a partner's tax capital account, which is required to be shown on the partner's K-1 and is relevant to a partner's chapter 1 tax liability because it is relevant to the partner's outside basis.

d. Whether and to what extent a partner recognizes ordinary income or loss under section 751(a) or "unrecaptured section 1250 gain" upon the sale of a partnership interest.

e. Certain partnership-level determinations relating to the application of section 469.

(1) These would include the section 469-related items required to be reported by the partnership on Form 1065, such as the characterization of activities as trade or business, rental real estate, or rental activity other than real estate; the tax items attributable to such activities; grouping of activities; and items that could be subject to recharacterization under the anti-passive income generator rules. See Instructions for Form 1065 (2024) (Dec. 2024), pp. 18-19. However, a partner's material or significant participation would be determined at the partner level and is not a PRI. Cf. Estate of Robert W. Quick v. Commissioner, 110 T.C. 172 (1998) (determination of partner's material participation in partnership's trade or business activities was not a partnership item under TEFRA; it did not affect the partnership's tax reporting or information required to be maintained in its books and records).

8. The extent to which the application of section 751(a) to a partner's gain or loss on sale of a partnership interest is a PRI warrants further discussion.

a. To begin, the application of section 751(a) is obviously relevant in determining a selling partner's chapter 1 tax liability, so the first of the two PRI requirements is met.

b. The "with respect to the partnership" test is also satisfied. Under the section 751(a) regulations, the ordinary income or ordinary loss realized by a partner on the sale or exchange of the partner's interest in the partnership's section 751 property is the amount of income or loss on such property that would have been allocated to the partner (to the extent attributable to the partnership interest sold and taking into account section 704(c) allocations) if the partnership had sold all of its property in a fully taxable transaction for cash equal to the property's FMV immediately prior to the partnership interest sale. Reg. § 1.751-1(a)(2).

(1) The partner's capital gain or loss is a residual "plugged" amount that derives not only from the partner's section 751(a) income or loss, but also from the partner's outside tax basis and the amount realized on sale.

c. The amount of ordinary income or loss allocated to the selling partner in the hypothetical sale is not dependent on the partner's facts and circumstances. It is based on the allocation and distribution provisions in the partnership agreement; section 704(c) allocations (if applicable); and the partnership's determination of which of its assets constitute hot assets on the hypothetical sale date and their FMVs. Partnership allocations and special allocations are PRIs under Reg. § 301.6241-1(a)(6)(v)(I), as are the character, type and value of assets under Reg. § 301.6241-1(a)(6)(v)(D).

(1) The FMV of hot assets is determined at the partnership level. It is not dependent on, or grossed up from, the amount realized by the selling partner. In this regard, the Preamble to the final section 751 regulations issued in 1999 states as follows: "One commentator suggested that where a partnership interest is sold or exchanged, the transferor and the transferee of a partnership interest should be permitted jointly to assign values to partnership assets in a written agreement. Because this approach is inconsistent with the hypothetical sale approach of the regulations, this suggestion has not been adopted." Preamble to T.D. 8847, 1999-2 C.B. 701, 64 Fed. Reg. 69903 (Dec. 15, 1999).

(2) The hot asset reporting requirements were significantly expanded starting with 2019 returns. See Instructions for Form 1065 (2019) (Feb. 2020), p. 51 (requiring reporting of hot asset gain or loss on selling partner's K-1 in box 20, code AB with attached statement). Presumably for this reason, a CCA containing internal comments on an IRS internal presentation regarding the BBA rules states, with respect to a particular redacted slide, that "751 gain is only a PRI for tax years 2019 and forward when it was required to be listed on the Form 1065." See CCA 202452012 (May 1, 2023), p. 10. This comment was made even though the regulations specifically include the character, type and value of assets as PRIs, and a selling partner ordinarily cannot determine the partner's share of section 751(a) gain or loss without the partnership's help in identifying hot assets, their FMVs, and the amount of hot asset gain or loss properly allocable to the partner.

(3) Under recently proposed regulations (which taxpayers are entitled to rely upon for 2025 partnership interest sales pending issuance of final regulations), a partnership is required to report to the selling and purchasing partners on Form 8308 "filled out in accordance with the instructions" by January 31 of the following year. See REG-108822-25, 90 Fed. Reg. 40269 (Aug. 19, 2025) (proposing to amend the section 6050K regulations by deleting Reg. § 1.6050K-1(c)(2), which presently requires partnerships to furnish the information required by Part IV of Form 8308, in addition to the other three parts, by the January 31 deadline). According to the Preamble, only the information required in Parts I, II and III of Form 8308 needs to be provided to seller and buyer by January 31. Part IV requires disclosure of the seller's hot asset income or loss. The Preamble states that the Form 8308 instructions will be updated to require the completed Form 8308 to be attached to the partnership's Form 1065 (see Reg. § 1.6050K-1(f)(1), unchanged by the proposed regulations). The Preamble also states that the partnership will continue to report a selling partner's share of section 751(a) ordinary income or loss on the partner's K-1 (as already required before the proposed regulations). The section 751(a) income or loss is reported in box 20 of Schedule K-1 with Code AB. See Instructions for Form 1065 (2024) (Dec. 2024), p. 61.

(4) These are items that the partnership is required to report to the selling partner based on determinations made from its own books and records. Further, other facts relevant to the hot asset determination may be shown in the partnership tax returns and/or books and records; for example, in the case of dealer property, how the property was reported on the Schedule L balance sheet, how many sales did the partnership engage in, etc. Depreciation recapture, an unrealized receivable, would also be derived from the partnership's tax returns and books and records. Thus, it seems clear that PRIs include determinations of the character and value of hot assets and the amount of hot asset income or loss that would be allocated to a selling partner under the hypothetical sale construct of the section 751(a) regulations.

(5) It should be noted that the June 2017 Proposed Regulations (interpreting the pre-TTCA version of the BBA) included the "partnership asset" category (item (D) found in the current regulations verbatim, but also added, by way of example, the following language: "including any effect the character or value of the partnership's assets has on the sale or exchange of an interest in the partnership (for example, for purposes of section 751(a))." See Prop. Reg. § 301.6221(a)-1(b)(1)(i)(D), June 2017 Proposed Regulations, 82 Fed. Reg. at 27372. There is no indication in the accompanying Preamble that the omission of such language in the final regulations (along with certain other PRI examples in the proposed regulations) reflects a change of heart as to whether a partner's section 751(a) gain or loss is a PRI; it clearly is.

d. However, the amount of the selling partner's capital gain or loss depends not only on the amount of ordinary income or loss that the partner would be allocated in the section 751(a) hypothetical sale, but also on the partner's outside basis and amount realized. Thus, it would appear that the selling partner's residual capital gain or loss component is not a PRI, although it is affected by the section 751(a) PRI.

(1) Assume a BBA examination results in a positive adjustment from an increase in section 751(a) gain and the partnership pays an IU. If the partner's correlative adjustment to decrease capital gain or increase capital loss is not a PRI, as appears to be the case, the selling partner may need to file a claim for refund, in which case the partner needs to keep the partner-level statute open or file a protective claim for refund. A push-out election eliminates this problem, as would a partner modification amended return (PMAR).

e. Cf. TEFRA Reg. § 301.6231(a)(3)-1(a)(1)(vi)(E) ("partnership items" under TEFRA include "amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine … the application of sections 751(a) and 751(b)"). The Tax Court muddied the waters as to the meaning of this regulation in Regents Park Partners v. Commissioner, T.C. Memo. 1992-336. In that TEFRA case, the FPAA determined, among other things, that "upon the sale of a partner's interest in the partnership, the partner must treat the portion of any gain from excess depreciation, attributable to the property's overvaluation, as ordinary income." In a confusing opinion with little analysis, the Tax Court took note of the express reference to the "application of section 751(a)" in the TEFRA regulations, and concluded, cryptically, that "partnership items include, inter alia, the elements necessary to determine whether section 751(a) or (b) applies, but not its consequences." The court went on to state: "Further, they [i.e., partnership items] do not include the character of the partnership interests in the hands of the individual partner, so as to determine the type of gain or loss, whether ordinary or capital, which occurs when the individual partner disposes of his interest." Thus, the court concluded that the FPAA's determination did not involve a partnership item, and therefore it did not have jurisdiction to decide that issue.

(1) Notably, Regents Park was decided under the pre-1999 version of the section 751 regulations. It is unclear whether the court would have reached the same TEFRA conclusion under the current hypothetical sale approach. See also Glade Creek Partners, LLC v. Commissioner, T.C. Memo. 2023-82, n. 10 (in a footnote not germane to the ultimate holding of the case, Tax Court stated that "the character of gain or loss under section 751 is an affected item," citing Regents Park as authority; however, it also stated that "in general, the character of partnership property as a capital asset, a section 1231 asset, or inventory is a partnership item").

G. Determination of PRI in a Partner-Level Examination – Special Enforcement Matter Authority

1. Reg. § 301.6241-7(b) was promulgated pursuant to the IRS's authority in section 6241(11)(A) to provide that the BBA does not apply to PRIs involving "special enforcement matters." Paragraph (b) gives the IRS the discretionary authority to determine that the BBA rules do not apply to a PRI adjustment if three conditions are met:

a. an examination is being conducted of a person other than the partnership;

b. a determination regarding a PRI is made as part of, or underlying, an adjustment to an item that is **not** a PRI; and

c. the treatment of the PRI on the partnership's return under section 6031(a) or in the partnership's books and records is based in whole or in part on information provided by the audited person from that person's books and records.

2. The IRS can invoke its paragraph (b) authority in a partner-level examination even though the section 6235 period of limitations on making PRI adjustments is still open. (See the discussion of this point in the Preamble to the December 2022 Final Regulations, 87 Fed. Reg. at 75484.)

3. Paragraph (b) applies to partnership taxable years beginning after December 20, 2018, which is the date the rule was previewed in Notice 2019-6, 2019-3 I.R.B. 350. See Reg. § 301.6241-7(k)(2).

4. The regulations provide an example where partner A contributes an asset to a partnership in 2018 with a claimed basis of $50, which the partnership also reports on its tax return and books and records as its carryover basis, based on the information A provided. See Reg. § 301.6241-7(b)(2), Example.

a. In 2019, A sells his interest for $100 and reports a $50 gain. The IRS examines A's 2019 return and determines that the contributed asset's basis was actually $30, and thus A's outside basis was $30.

b. The example states that even though the contribution is a PRI under Reg. § 301.6241-1(a)(6)(v)(C), the IRS can determine that the BBA rules do not apply to the contribution and thus make a determination about it in connection with its determination of A's outside basis. This is because the partnership's reported basis in the asset was based on information provided to it by A.

c. The paragraph (b) special enforcement rule became effective for "partnership taxable years" beginning after December 20, 2018, and thus applies to the partnership's 2019 taxable year. Note, however, that in the example the IRS asserts its special enforcement authority to determine that the BBA rules do not apply to the contribution, which arose in the partnership's 2018 taxable year – prior to paragraph (b)'s effective date, which is framed in terms of "partnership" taxable years beginning after December 20, 2018. The example does not address this apparent disconnect. One way to reconcile the example with the effective date rule is to infer that the IRS is determining a **2019** PRI in connection with the partner-level examination, because the partnership presumably reported the carryover basis on its 2019 return as well as its 2018 return.

d. The example states that the partnership and the other partners are not bound by the IRS's determination of the "contribution PRI" in connection with the examination of partner A. See Reg. § 301.6241-7(h)(2).

5. Reg. § 301.6241-7(f) provides another special enforcement situation where the section 6235 period of limitations on making adjustments to a partnership's PRIs has expired. In that event, the IRS can adjust any PRI that relates to any item or amount for which **a direct partner's or an indirect partner's** period of limitations on assessment of chapter 1 tax has not expired, provided that either (i) the direct or indirect partner is related to the closed-year partnership under section 267(b) or section 707(b), or (ii) the direct or indirect partner agrees, in writing, to extend the partner's section 6501 period for the taxable year and the extension expressly provides that the partner is extending the time to adjust and assess any tax attributable to PRIs for the taxable year.

a. The paragraph (f) rule is effective for partnership taxable years ending on or after November 30, 2020. Reg. § 301.6241-7(k)(1).

6. If the IRS determines in accordance with Reg. § 301.6241-7(b) or -7(f) (or one of the other identified special enforcement matters) that some or all of the rules under subchapter C of chapter 63 do not apply to any PRI or portion thereof, the IRS must notify the taxpayer as to whom the adjustment is being made, in writing, of such determination. Reg. § 301.6241-7(h)(1).

a. The drafters of the November 2020 Proposed Regulations asked for comments as to when the IRS must notify the taxpayer, but the final regulations do not address timing of the notification or the consequences of failing to notify. 85 Fed. Reg. at 74950.

7. Reg. § 301.6241-1(a)(6)(iii) was amended in March 2024 to provide that any tax, penalty, addition to tax, or additional amount imposed on the partnership under chapter 1 is an item or amount with respect to the partnership. T.D. 9988, 89 Fed. Reg. 17546, 17596 (such change is effective for partnership taxable years ending on or after June 21, 2023); see the Preamble explanation in REG-101607-23, 88 Fed. Reg. 40528, 40541 (June 21, 2023).

a. This is so regardless of whether such amount is required to be reflected or shown on the partnership return or maintained in the partnership's books and records. This would apply, for example, to an electing partnership taxpayer under section 6417 that is subject to the excessive payment rule in section 6417(d)(6).

b. Although regulations promulgated pursuant to the IRS's special enforcement authority permit it to adjust chapter 1 taxes imposed directly on a partnership without conducting a BBA examination (see Reg. § 301.6241-7(g)), the Preamble to the November 2020 Proposed Regulations comments that "there could be situations where an adjustment to a chapter 1 tax or penalty owed by the partnership would be more appropriately adjusted at the partnership level, such as when the adjustment relates to, or results from, other adjustments being made at the partnership level." 85 Fed. Reg. at 74949. Thus, the 2024 amendment making it clear that a partnership's chapter 1 tax liability is an item or amount "with respect to the partnership" is intended to give the IRS a fielder's choice when auditing a partnership's chapter 1 tax liability – either conduct a BBA examination or utilize its special enforcement authority to do so outside of the BBA.

8. Other situations where the IRS has exercised its special enforcement authority:

a. Termination and jeopardy assessments, see Reg. § 301.6241-7(c).

b. Criminal investigations, see Reg. § 301.6241-7(d).

c. Indirect methods of proof of income, see Reg. § 301.6241-7(e).

d. Reg. § 301.6241-7(j) provides that the IRS can adjust any election that results or could result in a payment to the partnership in lieu of a federal tax credit or deduction without regard to the BBA procedures.

H. Effect of BBA Adjustments on Non-Chapter 1 Taxes and Withholding Obligations

1. The BBA only applies to determine PRIs relevant to a partner's chapter 1 tax liability. It does not apply to taxes such as self-employment taxes (chapter 2 SECA tax), net investment income tax (chapter 2A NII tax), and taxes and withholding relating to foreign persons (chapter 3, excluding section 1443(b)) and foreign account reporting (chapter 4). See IRC § 6241(9)(A) (added by the TTCA); Reg. § 301.6241-6(a)(1).

2. However, a partnership adjustment made for purposes of chapter 1 tax liability, to the extent relevant to tax or withholding imposed under a chapter **other than chapter 1**, must be taken into account for purposes of such other tax or withholding – e.g., an increase in partnership taxable income for chapter 1 purposes must also be taken into account for self-employment tax purposes. IRC § 6241(9)(A) ("any partnership adjustment determined [under the BBA] for purposes of chapter 1 shall be taken into account for purposes of [chapters 2, 2A, 3 and 4] to the extent such adjustment is relevant to such determination"); Reg. § 301.6241-6(a)(1) (last sentence).

3. The amount of net investment income required to be shown on a partner's K-1 for purposes of the NII tax (Schedule K-1, Box 20, Codes A, B and 20) does not affect the partner's chapter 1 tax liability and is not a PRI. However, if an adjustment to net investment income results from an increase in the partner's ordinary income, the latter adjustment is a PRI, and a determination regarding that PRI must be taken into account when the IRS conducts an examination of the partner's NII tax liability. Id.

4. Example: Assume a partnership with a non-U.S. partner is audited for a reviewed year and the partnership's reported effectively connected income allocable to such partner is increased. The partnership's section 1446 withholding obligation is also increased for the reviewed year.

a. If the partnership pays an IU attributable to such adjustment, it is deemed to have satisfied its section 1446 withholding obligation by doing so. Reg. § 301.6241-6(b)(3).

b. If the partnership makes a push-out election, it is required to deduct and withhold the tax due under section 1446 in the adjustment year. Reg. § 301.6241-6(b)(4).

5. Section 6501(c)(12) gives the IRS until one year after the date which is 90 days after the mailing of the FPA (or, if litigation ensues, one year after a final court decision) to assess NII tax or SECA tax resulting from PRI adjustments.

6. Availability of Limited Partner SECA Exclusion – BBA Treatment

a. In Soroban Capital Partners, L.P. v. Commissioner, 161 T.C. 310 (2023), the Tax Court held that whether a partner is a "limited partner" under section 1402(a)(13), and thus exempt from self-employment tax on the partnership's business income that is attributable to the limited partner interest, is determined by applying a functional analysis test that focuses on whether the partner was an investor in the business or an active participant.

(1) In a subsequent memorandum opinion, the Tax Court applied the functional analysis test and held that three state law limited partners were active and did not qualify for the section 1402(a)(13) exclusion. Soroban Capital Partners, L.P. v. Commissioner, T.C. Memo. 2025-52, on appeal No. 25-2079, 2d Cir., Aug. 27, 2025.

(2) See also Denham Capital Management LP v. Commissioner, T.C. Memo. 2024-114, on appeal, No. 25-1349, 1st Cir., April 7, 2025 (reaffirming Soroban and holding that five limited partners were more akin to employees than passive investors and were not limited partners under section 1402(a)(13), and also holding that such issue was a TEFRA "partnership item"; on appeal, the taxpayer is contesting both such holdings); Sirius Solutions LLLP v. Commissioner, Tax Ct. Docket No. 11587-20, on appeal No. 24-60240, 5th Cir., May 15, 2024 (taxpayer is appealing the Tax Court's adverse decision that was entered without a formal opinion on February 20, 2024).

b. Soroban involved TEFRA proceedings. The Tax Court held that the partner's status as a "limited partner" for SECA tax purposes was a "partnership item" that had to be determined in a TEFRA partnership-level proceeding because the functional analysis involves factual determinations into the roles and activities of the individual partners with respect to the partnership's activities. 161 T.C. at 324.

(1) TEFRA section 6231(a)(3) defines a partnership item as "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A [Income Taxes] to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level."

(2) TEFRA Reg. § 301.6231(a)(3)-1(b) provides that the term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, gain, loss, deduction, credit, etc.

c. To constitute a partnership-related item under the BBA, an item must not only be "with respect to the partnership" but also must be "relevant in determining the tax liability of any person under chapter 1 of the Code."

(1) A partnership is required to report an individual partner's self-employment income on Schedule K-1 and also indicate if the partner is a "limited partner or other LLC member." See Schedule K-1 (2024), Part II, Line G and Part III, Line 14. Further, the Tax Court has held that a partnership must separately state net earnings from self-employment except to the extent allocated to a limited partner. Olsen-Smith, Ltd. v. Commissioner, T.C. Memo. 2005-174. Thus, the "with respect to the partnership" requirement for a PRI would appear to be satisfied.

(2) The question then becomes whether the applicability of the limited partner exclusion is "relevant" to determining chapter 1 tax liability. The SECA tax is a chapter 2 tax, and being relevant to a chapter 2 tax does not suffice to make an item a PRI. However, the IRS is understood to take the position that the amount of partnership self-employment earnings and availability of the limited partner exclusion are relevant in determining chapter 1 tax liability because section 164(f)(1) permits taxpayers to deduct one-half of SECA taxes for income tax purposes (but not the .9% additional Medicare tax) as an above-the-line deduction.

(3) If the IRS determines partnership self-employment earnings and the applicability of the limited partner exclusion in a BBA proceeding, it would have the extended period of limitations in section 6501(c)(12) at its disposal for pursuing SECA tax against the partner.

d. Suppose the IRS does not conduct a BBA audit, but instead conducts a SECA tax audit of a limited partner and asserts that the section 1402(a)(13) exclusion does not apply.

(1) Reg. § 301.6241-6(a) provides that, for purposes of determining taxes imposed under any chapter **other than** chapter 1, e.g., chapter 2 SECA tax and chapter 2A NII tax, the IRS can make an adjustment to a PRI (which definitionally has to be relevant in determining the **chapter 1** tax liability of any person) in a partner-level proceeding.

(2) Example. Partner A is a partner in a BBA partnership. The IRS initiates an audit of partner A and determines that the amount of partner A's NESE from the partnership is higher than reported on the partner's K-1. The IRS can make the adjustment to partner A's share of partnership NESE, and impose SECA tax on partner A, without first conducting a BBA audit of the partnership, even if such share (and the applicability of the section 1402(a)(13) exclusion) are PRIs based on the IRS's section 164(f)(1) deduction theory.

e. In a letter to IRS and Treasury dated June 28, 2024, p. 18 (the "June 28, 2024 AICPA Letter"), the AICPA addressed the situation where the IRS conducts a BBA audit of a partnership "and determines that the only partnership adjustment is to line 14, net earnings from self-employment, of $1,000,000" – i.e., a reclassification adjustment only – and the partnership paid an IU resulting from that adjustment. The AICPA recommended that, in order to avoid double taxation in this context, the partner should not have to pay additional SECA tax if the partnership pays an IU on the reclassification adjustment.

f. The General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals (March 17, 2024) (the "2025 Greenbook"), p. 173, proposed to amend the definition of a PRI to include items that affect a person's chapter 2 and 2A taxes. In determining an IU resulting from partnership adjustments to such items, the proposal would apply the sum of the highest rates of tax in section 1401(b)(1) (2.9%) and (b)(2) (.9%) in effect for the reviewed year. Thus, these non-chapter 1 taxes would be brought under the BBA regime.

7. Suppose the IRS makes a partnership adjustment to recharacterize a partnership's reported investment capital gain as ordinary income from a dealer trade or business. Assume the partners paid net investment income tax ("NII tax") on the reported capital gain. The IRS also makes a separate adjustment to characterize such ordinary income as net earnings from self-employment on the basis that the partners are actively involved in the dealer business and the limited partner exclusion does not apply.

a. In this situation, as will be discussed, the IRS should exercise its discretionary authority to disregard (solely for IU purposes) the self-employment earnings adjustment since it is already reflected in the primary dealer income adjustment.

b. Assume that the partnership agrees with the adjustments and makes a section 6226 push-out election. As discussed later in this outline, the partners' "correction amounts" from the primary ordinary income adjustment under Reg. § 301.6226-3(b) only take into account changes in the partner's chapter 1 tax liability. The NII and SECA taxes are not chapter 1 taxes and thus are not factored into the correction amounts. (See the discussion of this point in the Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6512.)

c. If the IRS initiates a partner-level proceeding to collect the SECA tax, the partners will want to credit the NII tax previously paid against the SECA tax liability or otherwise obtain a refund of the NII tax. <u>See</u> IRC § 1411(c)(6) (NII tax does not apply to any item taken into account in determining self-employment income); section 6501(c)(12) (giving IRS additional time to assess NII tax or SECA tax resulting from PRI adjustments). The affected partners may wish to file protective claims for refund or otherwise keep their individual statutes open until the dust settles on this.

I. <u>Partners Must File Consistently With Treatment of PRIs on Partnership Return (or with AAR Adjustments) Absent Disclosure</u>

1. Partners of BBA partnerships must report PRIs consistently with the treatment of such items on the partnership's return unless the partner notifies the IRS of the inconsistency by filing Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)) (Dec. 2024) with an original or amended partner return. <u>See</u> IRC § 6222(a); Reg. § 301.6222-1(a) (partner's "return" includes an amended return); Reg. § 301.6222-1(c) (consistency requirement does not apply if partner notifies IRS of inconsistent treatment); Instructions for Form 8082 (Dec. 2024), p. 8.

2. If the partner does not file consistently with the partnership's treatment of a PRI and does not notify the IRS of the inconsistent treatment, the IRS can adjust the partner's inconsistently-reported item to make it consistent with the partnership's return and can assess the resulting partner-level tax deficiency as a mathematical or clerical error without instituting a partnership proceeding. IRC § 6222(b); Reg. § 301.6222-1(b)(2). The abatement procedures are not available. Id.

3. A math or clerical error assessment notice to a BBA partnership that the IRS has adjusted or will adjust PRIs to correct the error and assess any resulting IU is not an FPA, and the partnership cannot file a petition for readjustment with respect to such notice. Reg. § 301.6232-1(d)(1)(i). However, the abatement procedures apply.

4. If a BBA partnership-partner files inconsistently with a lower-tier BBA partnership and does not notify, the IRS can assess an IU on the partnership-partner based on the adjustments required to make the partnership-partner's return consistent with the audited partnership's return, as if it were a math or clerical error. IRC § 6232(d)(1)(B); Reg. § 301.6232-1(d)(1)(i); Reg. § 301.6222-1(b)(3). The abatement procedures are not available. Reg. § 301.6232-1(d)(1)(ii)(B). However, the partnership-partner can correct the inconsistency prior to assessment by filing an AAR. Id.

a. It is not clear what happens at the pass-through partner level if adjustments that do not result in an IU are a byproduct of conforming the partnership-partner's return to the BBA partnership return.

5. As noted earlier, the consistency requirement apparently does not apply to the partners of an opt-out partnership, since section 6222 is part of subchapter C. However, a partnership-partner that has opted out of the BBA is nevertheless subject to the BBA rules in its capacity as a partner of a BBA partnership. Reg. § 301.6221(b)-1(d)(1). Thus, an opt-out partnership is subject to the consistency requirement as to a lower-tier BBA partnership. Reg. § 301.6222-1(a)(2) and -1(a)(5)(vi), Example (6).

a. If an opt-out partnership-partner files inconsistently with a BBA partnership and does not notify, the IRS can assess any tax with respect to the partnership-partner's reviewed-year partners or indirect partners resulting from an adjustment to conform to the BBA partnership's return as if it were a math or clerical error with respect to such partners. IRC § 6232(d); Reg. §§ 301.6232-1(d)(1)(ii)(B) and -1(d)(1)(iii). The abatement procedures are not available, but the partnership can correct the inconsistency by filing an amended return.

(1) This direct assessment authority with respect to the partners of an opt-out partnership-partner is unusual, because section 6222 and the regulations thereunder do not expressly apply a consistency requirement to indirect partners of a BBA partnership holding their interests through an opt-out partnership-partner. See Jenni Black, Inconsistently Inconsistent: Open Questions on Inconsistent Treatment Under BBA, 188 Tax Notes Federal 1483, 1484 (Sept. 1, 2025).

6. The treatment of a PRI on the partnership's "return" means the return (or amended return or AAR) filed with the IRS, and includes the treatment of such item on any statement, schedule or list filed with the IRS. Reg. § 301.6222-1(a)(4). This includes the treatment of such item on any section 6226 push-out statements filed by the partnership with the IRS. Reg. § 301.6222-1(a)(4)(ii).

a. The Preamble to the June 2017 Proposed Regulations states that the Schedule K-1s provided **to the partners** under section 6031(b) – as opposed to the K-1s the partnership files with the IRS – are not part of the "return" for this purpose. 82 Fed. Reg. at 27345. Thus, if a partner files consistently with a Schedule K-1 furnished to the partner which incorrectly fails to conform to the Schedule K-1 that the partnership files with the IRS (unlikely to happen, but it could), the partner is treated as having filed inconsistently.

b. However, if the IRS notifies the partner of the inconsistency, the partner will be treated as having timely notified the IRS of the inconsistent treatment by (i) demonstrating that the partner's return was consistent with the erroneous Schedule K-1 furnished to the partner and (ii) making a timely election. See IRC § 6222(c)(2)(B); Reg. § 301.6222-1(a)(5)(iii), Example (3).

7. A partner cannot notify the IRS of inconsistent treatment with PRIs after the partnership receives a NAP for the taxable year to which the items relate. Reg. § 301.6222-1(c)(5).

8. A partner is subject to the same consistency requirement and disclosure exception as to AAR push-out adjustments. See Reg. § 301.6227-1(a)(4)(i) (for purposes of section 6222, the treatment of items on a partnership return includes the treatment reported on an AAR).

a. A partner wishing to file inconsistently with pushed-out AAR adjustments reported on Form 8986 (Partner's Share of Adjustment(s) to Partnership-Related Item(s)) (Dec. 2024) does so by including Form 8082 with the partner's reporting year return. The reporting year return is the partner's return for the taxable year in which the AAR partnership furnished Form 8986 to the partner (i.e., the year in which the AAR was filed). See Instructions for Form 8082 (Jan. 2024), p. 11.

9. Section 6226 push-out statements are different. A partner cannot file inconsistently with disclosure as to push-out adjustments made under section 6226, which are actions taken by the partnership under the BBA and binding on the partners under section 6223(b)(1). Thus, if a partner omits a particular push-out adjustment in its calculation of additional reporting year tax, the IRS can redetermine the tax liability taking into account the omitted adjustment and assess the resulting underpayment of tax as if it were a math or clerical error. The abatement procedures are not available. See Reg. § 301.6226-1(e); Reg. § 301.6222-1(c)(2); Reg. § 301.6222-1(b)(4)(ii), Example (2); Reg. § 301.6222-1(a)(5)(v), Example (5); section 6222(b); Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6475.

10. If no partnership return is filed, all items reported on a partner's return are deemed to be inconsistent. Reg. § 301.6222-1(a)(3).

11. If a partner files inconsistently and notifies, the IRS can either institute a partner-level proceeding to adjust the item, or it can commence a partnership-level proceeding under the BBA, or, it appears, do both. Reg. § 301.6222-1(c)(4)(i).

a. The IRS can determine that the proper treatment of the item is something other than what the partner reported or the partnership reported. Reg. § 301.6222-1(c)(4)(ii).

b. If the IRS commences a partnership-level proceeding, the inconsistent partner is not allowed to participate unless the IRS consents. Reg. § 301.6223-2(d)(1). Further, if the IRS issues an FPA validating the partnership's original reporting, that determination is binding on the partner under section 6223 and the partner has no right to contest the FPA determination. That is solely the prerogative of the PR.

c. A final decision with respect to a **partner-level** proceeding involving a disclosed inconsistent position is not binding on the partnership or any other partner. IRC § 6222(d); Reg. § 301.6222-1(c)(4)(ii). However, the partnership may need to file an AAR to conform its reporting to the finally determined treatment of the item in the partner-level proceeding.

d. The regular period of limitations on assessment applies to the partner-level proceeding.

12. There are no BBA provisions addressing how the consistency rules apply to pass-through partners other than partnerships – i.e., S corporations, trusts and estates. The section 6232(d) assessment rules by their terms only apply to partnership-partners. For a discussion of the issues involved here, see Jenni Black, Inconsistently Inconsistent: Open Questions on Inconsistent Treatment Under BBA, Part 2, 188 Tax Notes Federal 1487 (Sept. 1, 2025).

J. Treatment of S Corporations Under the BBA

1. S corporations are not subject to the BBA rules except to the extent they own interests in BBA partnerships.

2. If an S corporation owns an interest in a BBA partnership that makes a push-out election, Reg. § 301.6226-3(e)(5) provides the S corporation (as well as estates and trusts) is treated as a partnership, and its shareholders as partners, and thus are subject to the paragraph (e) rules for "pass-through partners." See also IRC § 6226(b)(4); Reg. § 301.6241-1(a)(5) (defining pass-through partner to include an S corporation).

3. The S corporation can either elect to pay an IU as to its allocable share of push-out items, or it can make its own push-out election and furnish statements to its shareholders. See Reg. § 301.6226-3(h)(8), Example (8).

4. The same rules apply if a partnership pushes out AAR adjustments to an S corporation partner. IRC § 6227(b)(2); Reg. § 301.6227-3(c).

5. As under pre-BBA law, if the IRS audits an S corporation, it must go after the S shareholders individually for tax resulting from an adjustment to S corporation items.

a. The Small Business Job Protection Act of 1996 repealed the TEFRA audit rules that previously applied to S corporations.

6. Section 6037(c) provides that an S shareholder must file consistently with the S corporation return unless the shareholder notifies IRS of the inconsistency. If the inconsistent shareholder fails to notify, the IRS can make the appropriate adjustments to conform the shareholder's treatment to the S return and can assess the resulting tax liability as a math or clerical error under section 6213(b)(1) without going through the deficiency procedures. The abatement procedures do not apply. IRC § 6037(c)(3).

III. PARTNERSHIP REPRESENTATIVE

A. Role and Authority

1. The partnership representative ("PR") has more power than the tax matters partner under the old TEFRA rules. IRC § 6223.

2. Unlike TEFRA, where the "tax matters partner" had to be a partner, a PR does not have to be a partner, officer or employee of the partnership. Reg. § 301.6223-1(b)(1).

3. As the word "representative" connotes, the PR manifestly acts as the agent of the partnership in a BBA proceeding. Section 6223(a) refers to the PR as having "the sole authority to act on behalf of the partnership" for purposes of subchapter C.

a. Section 6223(b) states that "all partners shall be bound … by actions taken under this subchapter by the partnership" – it does not refer to actions taken by the PR.

4. The PR designated for a particular partnership taxable year has sole authority to bind the partnership and its partners vis-a-vis the IRS for all purposes under the BBA with respect to such taxable year. Reg. § 301.6223-2(d)(1) and (2).

5. The same is true for a designated individual ("DI") of an entity PR – the DI has the sole authority to bind the entity PR and hence the partnership and its partners. Id.

6. The failure of the PR "to follow any state law, partnership agreement, or other document or agreement has no effect on the authority of the [PR] or the [DI] as described in section 6223 and [Reg. §§ 301.6223-1 and -2]." Reg. § 301.6223-2(d)(1).

7. Partners (other than a PR-partner) cannot participate in a partnership administrative proceeding under the BBA without the permission of the IRS. Reg. § 301.6223-2(d). The BBA does not require the PR to notify the partners of an audit or obtain partner agreement for an IU payment, push-out election or settlement.

8. Key points to remember:

a. The partnership agreement can impose contractual limits on the power of the PR, even though they are ineffectual vis-a-vis the IRS. The PR can be a total puppet of a partnership administrative or management committee and be required to get advance approval for every decision taken. The PR doesn't have to have any real power.

b. The PR's authority derives from federal tax law and is not dependent on the PR having the requisite authority under state law or the partnership agreement. The partnership could theoretically be held hostage by a "rogue" PR because the PR can bind the partnership vis-a-vis the IRS even if the PR's actions are unauthorized, but more likely, a partnership may find that the PR is simply not up to the job or shirking its duties. The partnership's recourse is to replace the PR at the first opportunity (any partner with the requisite authority can sign a Form 8979 PR revocation), and in an extreme case sue for breach of the partnership agreement.

c. The partnership's tax return must be signed by a tax-recognized partner to be a valid return. It does not have to be signed by the PR, but if the PR is assigned that duty, the PR must be a tax-recognized partner.

B. Designating and Removing Partnership Representative

1. Designation of PR and DI (if PR is an Entity)

a. Any "person" can serve as a PR, provided such person has a "substantial presence" in the United States, which means having a U.S. TIN, a U.S. street address, and telephone number with a U.S. area code. An individual PR or the DI of an entity PR must be available to meet with the IRS in the United States at a reasonable time and place as determined by the IRS in accordance with Reg. § 301.7605-1. See Reg. § 301.6223-1(b)(2).

b. An entity (including a disregarded entity) can be designated as the PR, provided the **partnership** (not the PR entity) appoints a "designated individual," or DI, as the sole person through whom the entity PR will act and with whom the IRS will deal. The DI has the sole authority to bind the PR entity, and thus bind the partnership, in a BBA proceeding. The DI need not be an employee, officer or director of the entity PR. Regardless of the individual's lack of connection to the entity PR, the IRS is entitled to rely on the partnership's DI designation as conclusive evidence of the individual's authority to act on behalf of the entity PR and the partnership. Reg. § 301.6223-1(b)(1) and (3); Reg. § 301.6223-2(e), Example (3).

c. Both the PR entity and the DI must have a substantial presence in the United States. Reg. § 301.6223-1(b)(3)(ii); Instructions for Form 8979 (Dec. 2024), p. 3.

d. The partnership can designate itself as PR (if it has a substantial presence in the United States), but it must designate a DI to act on the partnership's behalf in its PR capacity. Reg. § 301.6223-1(b)(1).

(1) For example, the partnership could designate itself as the PR and name an employee of the partnership as DI, with reporting obligations to the partnership's board. (There may be a good reason to do this; someone please tell me.)

e. The PR (and the DI of an entity PR) must be designated separately by the partnership for each partnership tax year on Form 1065. Reg. § 301.6223-1(c). The PR/DI designation for a particular partnership tax year does not automatically roll to the next partnership tax year. The person designated on the return controls, even if the partnership agreement specifies someone else. The PR/DI designation is effective on the date the return is filed. Reg. § 301.6223-1(c)(2).

f. The partnership agreement often designates (often in the "Tax Matters" or "Taxes" section) the person who will serve as the PR, which is typically a general partner or LLC manager. Alternatively, the agreement can specify that the PR for each partnership taxable year will be designated by the partnership's board, management committee, etc.

g. A power of attorney (e.g., Form 2848) cannot be used to designate a PR/DI. Reg. § 301.6223-1(a).

h. Resignations, revocations and successor designations of the PR/DI are effected with IRS Form 8979 (Partnership Representative Revocation, Designation, and Resignation) (Dec. 2024).

2. **<u>Resignations</u>**

a. <u>Resignations</u>. The PR/DI may resign for a partnership taxable year only after the IRS issues a NAP for such year, and the PR/DI must notify the IRS in writing of the resignation. Reg. § 301.6223-1(d)(2). The Instructions for Form 8979 (Dec. 2024), p.2, state that a resignation can also be submitted after Letter 2205-D is issued, which is consistent with the regulatory rule that applies to revocations.

b. The resignation is effective when the IRS receives the notification. Reg. § 301.6223-1(d)(3). The PR/DI cannot name their own successors. Reg. § 301.6223-1(d)(1).

c. In other words, the PR/DI is "stuck" in this role until the IRS comes a-calling.

d. The IRS is supposed to notify the partnership of the resignation within 30 days of receiving such notice, and the partnership has 30 days to name a successor. If it does not, the IRS can name a PR. Reg. §§ 301.6223-1(d)(1) and (f)(1).

e. In the case of an entity PR, the resignation of the DI terminates the PR's status, and vice versa. Reg. § 301.6223-1(d)(3)(iii) and (iv).

f. A resignation must be mailed or faxed by the PR or DI directly to the current IRS employee point of contact, and only after issuance of a Letter 2205-D or a NAP. See Instructions for Form 8979 (Dec. 2024), p. 2.

3. Revocations

a. Subject to significant constraints on timing, the partnership can revoke the designation of the PR or DI and must simultaneously designate a successor. Reg. § 301.6223-1(e)(1).

b. A revocation can be made only after the IRS issues a notice of selection for examination (Letter 2205-D, Initial Contact to Schedule Appointment - Partnership Returns) or a NAP for the partnership taxable year for which the designation or appointment was effective. See Reg. § 301.6223-1(e)(2)(i); Reg. § 301.6223-1(e)(8), Example (1) (purported PR revocation ineffective because it was not made in connection with an AAR and was made prior to the IRS mailing a notice of selection for examination or a NAP).

(1) Letter 2205-D only goes to the partnership, not the PR. The Preamble to the August 2018 Final PR Regulations states that "[b]ecause the notice of selection for examination is only issued to the partnership, and not the [PR], this rule allows the partnership to make a change to the [PR] without the involvement of the [PR] (whom the partnership may be removing for cause)." 83 Fed. Reg. at 39336.

c. A revocation should be mailed or faxed to the current IRS employee point of contact (revenue agent, appeals officer, counsel).

d. The revocation must be signed by a person **who was a partner at any time during the taxable year to which the revocation relates**, or as otherwise provided in IRS guidance. Reg. § 301.6223-1(e)(4).

(1) While Form 8979 does not mention this important requirement, the Instructions do (see p. 1), when defining an "authorized person."

(2) The person signing the Form 8979 must declare, under penalties of perjury, that he or she "is duly authorized by the partnership or LLC" to designate the new PR. If a disregarded entity is a partner in the reviewed year and the parties intend for it to sign the Form 8979, the person authorized to bind the disregarded entity under state law would sign the Form 8979. See CCA 202433010 (July 1, 2024).

4. A revocation and designation of a new PR/DI can also be made in conjunction with the filing of an AAR, provided the AAR was not filed for the sole purpose of doing a revocation and the AAR was filed prior to receiving Letter 2205-D or a NAP. Reg. § 301.6223-1(e)(2)(ii). In this situation, the change in PR/DI is effective immediately prior to the AAR filing, and thus the new PR/DI signs the AAR. Reg. § 301.6227-1(a).

5. The revocation and designation of successor are "immediately effective upon the IRS's receipt of the written notification." Reg. § 301.6223-1(e)(3). It appears that this is effective only for the partnership taxable year for which the NAP was issued. If the person serving as PR or DI was also designated as such for subsequent taxable years, those designations remain in effect as to those later taxable years until the IRS issues an Examination Notice or a NAP as to any such year, at which time the partnership can submit a Form 8979 for such year.

(1) The January 2019 Instructions for Form 8979 stated that if the PR's or DI's address changes, Form 8979 is not required to be filed. Instead, a written notification with the new contact information should be mailed or faxed to the current IRS employee point of contact for the partnership taxable year under audit. This directive does not appear in the current Instructions, but the Instructions do contain the following statement: "Address information provided on Form 8979 will not change your last known address with the IRS. Use Form 8822, Change of Address, to change your home address or Form 8822-B, Change of Address or Responsible Party—Business, to change your business address." <u>See</u> Instructions for Form 8979 (Dec. 2024), p. 2.

(2) <u>See</u> CCA 202501009 (April 11, 2024) (emailed advice indicating that an individual PR could file Form 8822 to notify IRS of a different PR address, and a BBA partnership could use Form 8822-B to notify IRS of a different address for the partnership).

b. <u>Example</u>. Assume a law firm designates one of its tax partners as the PR for partnership taxable year X, and the partner later leaves the firm.

(1) That partner continues as the PR for taxable year X until the individual resigns or the PR designation is revoked by the partnership – which can only occur in connection with the commencement of an examination for such taxable year (or the filing of an AAR).

(2) The partnership agreement (or the partner's exit agreement) should provide that the PR agrees to keep the partnership informed of changes in his or her address and contact information and will not take any actions in a PR capacity without prior notice to, and the consent of, law firm management.

6. Finally, the IRS requires the successor PR/DI to renew the appointment of any person acting under a power of attorney by filing a new IRS Form 2848. <u>See</u> Instructions for Form 8979 (Dec. 2024), p. 1.

IV. BBA AUDIT TIMELINE

A. <u>Initiation of BBA Audit</u>

1. Guidance relating to Exam procedures in BBA cases is set forth in IRM 4.31.9, Pass-Through Entity Handbook, BBA Field Examination Procedures.

2. Guidance relating to Appeals procedures in BBA cases is contained in IRM 8.19.14, Appeals Pass-Through Entity Handbook, Bipartisan Budget Act of 2015 Procedures.

3. Publication 9388 (BBA Roadmap for Taxpayers) (Rev. July 2021) presents a useful diagram of the various stages of a BBA audit.

4. As a first step the IRS, under a self-imposed requirement, sends Letter 2205-D ("Examination Notice") to the partnership notifying the partnership that it will be audited for the specified year. A separate Examination Notice is mailed for each audit year.

a. Upon receipt of such letter, the partnership has the right to revoke the PR designation or DI appointment and designate a replacement by filing Form 8979 (Partnership Representative Revocation, Designation, and Resignation (Dec. 2018). Reg. § 301.6223-1(e)(2)(i).

5. Not less than 30 days after the Examination Notice is issued, the IRS sends a formal Notice of Administrative Proceeding ("NAP") to the partnership and to the PR (Letters 5893 and 5893-A). Reg. § 301.6231-1(a)(1).

a. Once the NAP is mailed, the partnership cannot file an AAR for the examination year, and partners cannot amend their returns to file inconsistently with the partnership return and disclose. IRC § 6227(c) (last sentence); Reg. § 301.6227-1(b); Reg. § 301.6222-1(c)(5).

b. The minimum 30-day period following the issuance of the Examination Notice gives the partnership a window to file corrective AARs (e.g., correct any errors or modify aggressive return positions) and get its act together. AAR corrections also avoid the 2% interest rate bump that comes with a section 6226 push-out.

B. **Examination, 30-Day Letter, Issuance of NOPPA**

1. The IRS examination team conducts the audit, issues IDRs, etc.

2. A preliminary report of examination changes is issued, consisting of Letter 5895 (Notice of Preliminary Partnership Examination Changes and Imputed Underpayment), Form 14791 (Preliminary Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts), and Form 886-A (Explanation of Adjustments).

a. This package only goes to the PR, not the partnership.

3. If the case is unagreed, a 30-day BBA letter (Letter 5891 with Forms 14791 and 886A) is issued with a summary report showing the proposed adjustments and a preliminary computation of the IU, penalties and interest.

a. This package only goes to the PR, not the partnership.

4. The 30-day letter gives the partnership the right to file a protest within 30 days with the Independent Office of Appeals over disputed matters, such as substantive issues, penalties and IU adjustment groupings and subgroupings.

a. If the partnership requests an Appeals Conference, there generally must be at least 18 months remaining on the section 6235(a)(1) statute of limitations at the time the case goes to Technical Services. IRM 4.31.9.10.2(2) (10-29-2021). If not, the IRS will request an extension from the partnership on Form 872-M. See IRC § 6235(b). Note that while section 6501(c)(4)(B) specifically refers to a taxpayer's right to limit an extension to particular issues, section 6235(b) contains no such language.

5. In general, the partnership files its Appeals protest, and the hearing is held, with the Appeals Office servicing the area where the partnership has its principal place of business.

6. IRS Technical Services then reviews the case, the protest, the examiner's rebuttal, determines whether any corrections are warranted, and if not, forwards the case to Appeals.

7. At the end of the Appeals process, Appeals or IRS Technical Services sends a Notice of Proposed Partnership Adjustment, or NOPPA (Letters 5892 and 5892-A) by certified mail to both the partnership and the PR identifying the proposed adjustments (whether agreed or unagreed) for the taxable year. The NOPPA also computes a preliminary IU amount, if any, resulting from the proposed adjustments (on Form 14791), along with estimated interest and penalties.

8. Potential IU modifications are disregarded at this point because the NOPPA starts the 270 day modification period. IRC § 6231(a)(2); Reg. § 301.6225-1(a)(3).

9. As a result of amendments made by the TTCA, a separate period of limitations applies to the mailing of the NOPPA.

a. The NOPPA must be mailed no later than the period of limitations on making adjustments for the taxable year that is set forth in paragraph (1) of section 6235(a). IRC § 6231(b)(1).

b. The paragraph (1) period is three years after the later of the unextended due date of the partnership return or the date it was filed (or the date on which an AAR was filed with respect to such year). See Reg. § 301.6231-1(b)(1); section 6241(3) (defining "return due date" as the unextended due date of the partnership return).

c. This period can be extended using Form 872-M. Reg. § 301.6231-1(b)(1); section 6235(b).

10. The IRS can withdraw a NOPPA (Reg. § 301.6231-1(f)) and presumably issue another one, provided it does so within the applicable time period. See Reg. § 301.6235-1(c) (referring to the date of the "last" NOPPA).

11. At the conclusion of the Appeals process, Appeals sends the case to the Ogden BBA Unit for processing.

C. Request for IU Modification

1. After the NOPPA is issued (but not before), the PR has 270 days, or roughly nine months, to file a request for IU modifications on Form 8980 (Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)) (Dec. 2024) with the Ogden BBA Unit.

a. The partnership can request an extension of the modification submission period using Form 8984 (Extension of the Taxpayer Modification Submission Period Under Section 6225(c)(7) (Oct. 2020)). Reg. § 301.6225-2(c)(3).

2. During the 270-day period, the IRS is precluded from issuing an FPA unless the partnership waives that restriction using Form 8981. IRC § 6231(b)(2)(A); Reg. § 301.6231-1(b)(2).

3. If the partnership requests modification by way of one or more partner amended returns or the Alternative Procedure, the 270-day period gives the partnership time to coordinate the amended return process, make sure participating partners have paid all taxes and other amounts due, and obtain the required partner affidavits to that effect.

4. All modifications must be approved by the IRS.

5. As will be discussed, the section 6235 period of limitations on making adjustments does not expire until the later of several dates, one of which is the date that is 270 days after the date on which required information for the modification(s) is "so submitted" to the IRS. IRC § 6235(a)(2). As interpreted by the regulations, such information is not deemed to be "so submitted" until the expiration of the 270-day modification period, regardless of when it was actually submitted. Thus, under the regulations, the IRS has 270 more days after that (or 540 days from the issuance of the NOPPA) to issue an FPA unless the partnership waives the modification period by submitting Form 8981. However, as will be discussed, in JM Assets, LP v. Commissioner, 165 T.C. No. 1 (July 2, 2025) (court-reviewed), the Tax Court (citing Loper Bright) held that on the facts presented, this regulation was an invalid interpretation of the statutory words "so submitted," and that the IRS had 270 days from "the date JM Assets submitted everything required to be submitted" for its modification request.

6. The Ogden BBA Unit then issues Letter 5975 (Notice of Modification Request Determination) and Form 15027 (Partnership Summary of Approved Modifications and the Imputed Underpayment) to the PR showing any approved modifications and a recomputed IU.

7. If there is a dispute regarding modification, the partnership may first request a conference with the group manager. If the disagreement cannot be resolved, the partnership can take it to Appeals, but Appeals will not reconsider a prior unagreed substantive issue. See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 4; IRM 9.19.14.2.6(1) and 8.19.14.5.3(3) (10-19-2021).

8. The Ogden BBA Unit then sends by certified mail a Notice of Final Partnership Adjustment ("FPA") to both the partnership and the PR (Forms 5933 and 5933-A), together with Form 15027 and Form 886-A (explanation of adjustments).

a. The FPA can make adjustments that were not in the NOPPA. See CCA 202417014 (Jan. 11, 2024).

9. The FPA cannot be mailed before the date which is 270 days after the date the NOPPA is mailed and must be mailed no later than the period of limitations on making adjustments provided in section 6235(a). IRC § 6231(a) and (b)(2); IRC § 6235(a)(3); Reg. § 301.6231-1(b)(2); Reg. § 301.6235-1(a)(2) and (b).

10. The partnership can waive the FPA requirement and any restrictions on assessment under section 6232(b) by using Form 14726 (Waiver of the Notice of Final Partnership Adjustment (FPA) (Oct. 2020). Waiving the FPA means the partnership foregoes the opportunity to make a push-out election and can be assessed immediately as to the IU, as Form 14726 explicitly states.

D. Push-Out Election – Procedural Steps

1. If the partnership wishes to make a section 6226 push-out election, the PR must electronically file the election on Form 8988 (Election for Alternative to Payment of Imputed Underpayment) (Oct. 2020) within 45 days after the date on which the FPA is mailed by the IRS. IRC § 6226(a)(1); Reg. § 301.6226-1(c)(2).

a. After reviewing the election for completeness, the IRS will countersign the election and send a copy of the signed Form 8988 to the PR. Instructions for Form 8988 (Oct. 2020), p. 3. On-line BBA instructions state that the partnership should not provide Forms 8986 to the partners until the countersigned election has been received.

2. However, the partnership (but not the partners) can still petition a court for readjustment even if it makes a push-out election, provided it does so within 90 days after the issuance of the FPA. IRC § 6234(a); Reg. § 301.6226-1(f).

3. If a push-out election is made for the reviewed year, the PR must mail the required push-out statements (Form 8986) to the reviewed year partners and file them with the IRS (together with Form 8985) **no later than 60 days after** the date all of the partnership adjustments are "finally determined." Reg. § 301.6226-2(a), (b)(1) and (c). The partnership must first request a push-out tracking number using the BBA Online Forms Submission Service, and that number is entered on the Forms 8986 and 8985.

a. The adjustments are "finally determined" upon the later of the expiration of time to file a petition for readjustment under section 6234, or, if a petition is filed, the date when the court's decision becomes final. See Reg. § 301.6226-2(b)(1); section 7481 (specifying when a Tax Court decision becomes final).

b. If the partnership files a petition for readjustment, the case may go back to Appeals for further consideration, depending on the facts and circumstances.

E. Mailing of NAP, NOPPA, and FPA Notices

1. The NAP, NOPPA and FPA notices must be mailed to both the partnership and the person or entity designated as PR for the taxable year to which the notices relate. IRC § 6231(a); Reg. § 301.6231-1(a).

a. A notice will be treated as "mailed to the partnership representative" if it is mailed to the PR that is reflected in the IRS records as of the date the notice is mailed. Reg. § 301.6231-1(d)(1).

2. Section 6231(a) states that the FPA is "sufficient" if mailed to the last known address of "the partnership representative or the partnership," even if the partnership or PR has terminated its existence. IRC § 6231(a) (flush language).

3. Reg. § 301.6231-1(c) extends the statutory "last known address" rule for an FPA to the NAP and NOPPA notices as well.

4. In CCA 202501009 (April 11, 2024), the Office of Chief Counsel provided emailed advice that an individual PR could file Form 8822 to provide clear and concise notification of a different PR address, and a BBA partnership could use Form 8822-B to provide clear and concise notification of a different address for the partnership.

a. Cf. Reg. § 301.6212-2(a) (last known address of a "taxpayer" is the address that appears on the taxpayer's most recently filed tax return, unless the IRS is given "clear and concise" notification of a different address).

5. The IRS can issue more than one FPA to a partnership for a taxable year – e.g., each containing different adjustments. However, once the partnership has petitioned a court for a readjustment of the FPA, the IRS cannot issue another FPA for such taxable year except in the case of fraud, malfeasance, or misrepresentation of a material fact. IRC § 6231(c); Reg. § 301.6231-1(e).

6. The IRS can rescind an FPA if the partnership consents. IRC § 6231(d); Reg. § 301.6231-1(g).

7. The IRS can withdraw a NAP or NOPPA at any time; the consent of the partnership is not required. Reg. § 301.6231-1(f). If the IRS withdraws a NAP, for example, the prohibitions on (i) the partnership filing an AAR, and (ii) a partner notifying the IRS that the partner is treating a PRI inconsistently with the partnership's return, no longer apply.

F. Waiver of 270-Day Time Periods

1. A partnership can waive the 270-day restriction on issuance of the FPA and the 270-day modification period by filing Form 8981 (Waiver of the Period Under IRC Section 6231(b)(2)(A) and Expiration of the Period for Modification Submissions Under IRC Section 6225(c)(7)) (Oct. 2020). Once counter-signed by the IRS, the waiver becomes effective, the modification period ends, and the IRS can issue an FPA.

2. The waiver permits the FPA to be issued sooner and speed up the partnership's ability to take the case to court and/or make a push-out election.

G. Period of Limitations on Adjustment Under Section 6235

1. The BBA repealed the TEFRA partnership-level period of limitations on assessment of tax attributable to partnership items (and affected items) in TEFRA section 6229(a), and added a new concept: a limitation period on making "adjustments" to PRIs under subchapter C for any partnership taxable year. The period of limitations for mailing the FPA is provided in section 6235(a) and Reg. § 301.6235-1. The section 6235 rules are complicated; the examples in Reg. § 301.6235-1(e) are helpful.

2. Unless extended by agreement under section 6235(b) (or certain other exceptions apply), the section 6235 period ends upon the **later of** the following three dates:

a. Date 1 – The date which is three years after the later of:

(1) the "return due date" for the partnership return for the taxable year in question, which is the **unextended** due date (see section 6241(3)),

(2) the date the return was actually filed, or

(3) the date on which the partnership filed an AAR for such year. Reg. § 301.6235-1(a)(1). The filing of an AAR refreshes the IRS's period of limitations for making BBA adjustments to PRIs. If a partnership files an AAR on October 1, 2025 that relates to 2023, that will give the IRS until at least October 1, 2028 to make adjustments to 2023 PRIs, including PRIs that were not adjusted in the AAR.

b. Date 2 – **If the partnership requests IU modification**, Date 2 is the date which is 270 days (plus the number of days of any modification period extension) "after the date on which everything required to be submitted to the IRS pursuant to section 6225(c) is so submitted." Reg. § 301.6235-1(b)(1). So what does "so submitted" mean?

(1) The regulations tell you the answer, and the answer is the same no matter when information is submitted: "so submitted" means the date the 270-day modification period (as extended) expires, even if the partnership submits the information sooner than that date. See Reg. §§ 301.6235-1(b)(2) and -1(e)(6), Example (6). Thus, if the partnership requests modification, Date 2 gives the IRS another 270 days (roughly 9 months) to mail the FPA **following** the 270-day modification period.

(2) If the partnership does not request any modifications, Date 2 drops out of the picture, and the section 6235 period is the later of Dates 1 and 3. See Reg. § 301.6235-1(e)(3), Example (3).

(3) If the partnership waives the 270-day modification period, the "so submitted" date is the date on which such period expires. Reg. § 301.6235-1(b)(2)(i)(B).

c. Date 3 – The date which is 330 days (roughly 11 months) after the date the "last NOPPA" is mailed (plus the number of days of any modification period extension agreed to by the IRS, even if the PR does not request a modification). Reg. § 301.6235-1(c).

(1) The 330-days-after-NOPPA rule gives the IRS at least 60 more days to issue an FPA if the 270-day modification period expires with no request for modification having been made (thus rendering Date 2 inapplicable). See Reg. § 301.6235-1(e)(3), Example (3).

3. The Tax Court held the so-submitted regulation to be invalid in JM Assets, LP v. Commissioner, 165 T.C. No. 1 (July 2, 2025) (court-reviewed), at least as applied to the facts of that particular partnership.

a. The court held that the IRS had 270 days to issue the FPA starting from "the date JM Assets submitted everything required to be submitted" for its modification request. It held that the date of the partnership's initial and only submission on Form 8980 controlled where (i) the partnership made no additional submissions, (ii) the IRS made no requests for additional information, and (iii) the IRS ultimately approved the modification request.

b. In a footnote, the court declined to comment on the application of the regulation in situations where the partnership "does not submit everything required to be submitted."

c. JM Assets suggests that the so-submitted date is determined with the benefit of hindsight. If that is true, the IRS will not know, during the modification process, what the applicable so-submitted date will be. For example, if the one-and-only modification request is submitted on day 30 of the 270-day period, and the request is approved with no additional information being requested or submitted, day 30 becomes the so-submitted date, which means Date 2 for section 6235 purposes is 270 days after day 30, or 300 days after the NOPPA was issued.

d. This, in turn, means that the controlling "later of" section 6235 date for timely issuance of the FPA is Date 3, which is 330 days after the NOPPA was issued. On the other hand, if the IRS asks more information, and the taxpayer submits it on day 240 and the request is approved, under JM Assets Date 2 presumably would be 270 days after day 240, in which case Date 3 becomes irrelevant. IRS delays in processing the requested modification could work to its detriment in terms of the applicable period of limitations unless, after focusing on the request, it makes a legitimate request for more information. See Jenni Black, Hindsight is 20/20: JM Assets and the Blow to Tax Certainty, Parts 1 and 2, 188 Tax Notes Federal 263 (July 14, 2025).

4. If the section 6235 statute has run on a particular BBA partnership taxable year, the IRS has a potential end-around via the "special enforcement matter" rule in Reg. § 301.6241-7(f).

a. Paragraph (f) allows the IRS to adjust a PRI outside of the BBA rules in connection with an audit of a **direct or indirect** partner of a BBA partnership as long as (i) the direct or indirect partner's period of limitations on assessment of chapter 1 tax is still open and (ii) the direct or indirect partner is related to the BBA partnership under section 267(b) or section 707(b).

b. The IRS is required to notify the taxpayer that it is proceeding under its special enforcement authority. Reg. § 301.6241-7(h). The regulations do not say when this must occur, or the consequences if it does not occur.

5. A six-year statute applies on making partnership adjustments if the partnership has a substantial omission from gross income. IRC § 6235(c). If there is fraud, the adjustment can be made at any time. IRC § 6235(c)(1).

6. If a partnership is required to file Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) (Dec. 2024) or any other information specified in section 6501(c)(8), section 6235(b)(5) provides that the period of limitations on making partnership adjustments does not begin to run until the date determined under section 6501(c)(8) (e.g., if Form 5471 is not filed and should have been, the section 6235 period does not commence until the Form 5471 is filed).

7. The section 6235(a) period of limitations on adjustment can be extended using Form 872-M. See IRC § 6235(b); IRM 4.31.9.8.4.3 (01-24-2024). The 872-M must be signed by the PR or DI for the reviewed year; a POA cannot sign the form. (Note that Form 872-M does not extend the section 6227(c) period for filing an AAR.)

a. See CCA 202505027 (Oct. 4, 2024) (Office of Chief Counsel determined that Forms 872-M purporting to extend the section 6235 period were invalid because they were signed by someone other than the DI for the entity named as PR for the reviewed years; IRS had delayed mailing of NOPPA based on what it thought were valid extensions).

b. Separate Forms 872-M are used for each reviewed year.

H. Mammoth Cave Property LLC (T.C. Docket No. 5401-24) – Taxpayer Argues That NOPPA Was Sent to Wrong PR at Wrong Address

1. In a pending Tax Court case involving a BBA partnership, the petitioner filed a summary judgment motion dated January 15, 2025 asking the court to declare the FPA for its 2018 taxable year untimely because the NOPPA mailed by the IRS on July 11, 2022 identified a former PR entity rather than the current PR entity. See Mammoth Cave Property LLC v. Commissioner, T.C. Docket No. 5401-24.

2. If a valid NOPPA wasn't issued, the IRS would not have the benefit of the 330-days-from-NOPPA rule under section 6235(a)(3) and the FPA would be untimely.

3. There is no dispute that the IRS acknowledged and accepted the revocation of the prior PR and designation of a new PR and DI prior to issuing the NOPPA.

4. The IRS's response to the motion contends that, while the NOPPA concededly named the wrong PR in the address line, the NOPPA nevertheless was mailed to the correct address in Welsh, Louisiana for the new PR (referred to by the parties as the "Welsh Address") and correctly identified the new individual (Mills) named as DI for the new PR.

5. The petitioner contends that it submitted to the IRS Ogden Service Center (but apparently not to the revenue agent handling the examination) a request for change of the new PR's address on a Form 8822-B dated January 7, 2022, changing it from the Welsh Address to an address in Missouri (the "Missouri Address"). The request for change of address of the new PR was filed with the IRS more than six months prior to the issuance of the NOPPA.

6. The IRS contends that it did not process the change in address request until August 24, 2022, and therefore its electronic records continued to show the Welsh Address for the PR at the time the NOPPA was mailed on July 11. Further, the IRS alleges that the petitioner and its representatives continued to use the Welsh address on certain BBA-related forms filed during the modification process. The IRS also contends that petitioner was not prejudiced by the alleged NOPPA technical defects.

I. Who Signs the Form 2848?

1. The IRS takes the position that the power of attorney on Form 2848 must be signed by the PR or DI. See IRM 4.31.9.7.10(2) (Jan. 1, 2024); Instructions for Form 2848, p. 7 (Sept. 2021).

2. If the PR or DI changes, the IRS's position is that the new PR or DI must execute a new Form 2848 in order to allow the partnership's accountant or lawyer to continue to represent the PR before the IRS. See IRM 4.31.9.7.10(3) (Jan. 1, 2024).

3. This is understood to be based on the IRS' view that the person represented by lawyer or accountant under the Form 2848 is the PR, since it has the sole authority to act on behalf of the partnership in the BBA audit.

4. The process of completing a BBA Form 2848 in a manner that the IRS will deem acceptable is proving to be an "amazing race" challenge for some, requiring multiple failed attempts before finally getting a POA that sticks. Before submitting one, the tax advisor would do well to review the Form 2848 rules set out in IRM 4.31.9.7.10 (Jan. 1, 2024).

J. Section 6603 Deposit by Partner to Stop Running of Interest in BBA Audit

1. Under section 6621(a)(2), the normal underpayment interest rate on tax deficiencies and penalties is the "federal short-term rate" plus 3 percentage points, compounded daily. See IRC § 6622(a) (requiring daily compounding); section 6601(e)(2) (imposing interest on penalties). A special rule applies to "large corporate underpayments."

a. Section 6621(b)(1) requires the IRS to determine the federal short-term rate under section 1274(d) for the first month of each calendar quarter, and section 6621(b)(2) provides that such rate becomes applicable during the first calendar quarter beginning after such month. Notice 88-59, 1988-1 C.B. 546. Thus, the underpayment rate in effect for any given quarter is determined in advance for the first month of the preceding quarter.

2. If a section 6226 push-out election is made, however, the underpayment rate is increased by 2 percentage points. IRC § 6226(c)(2)(C). Thus, the push-out election underpayment rate becomes the federal short-term rate plus 5 percentage points. For the fourth quarter of 2023, for example, a 10% underpayment rate (compounded daily) applied to partners of a BBA partnership that made a push-out election.

3. Section 6603 permits a reviewed year partner to make a deposit (as opposed to a payment of tax) with the IRS to stop the running of interest.

4. In early 2023, the IRS posted to its website instructions for partners wishing to make a section 6603 deposit relating to a BBA partnership audit.

a. To find these, go to www.irs.gov, search for "BBA partnership audit process," then scroll down to "Deposit under IRC 6603 made by (terminal) partner."

b. The website instructions (marked "last reviewed or updated: 02-Jul-2025") state that a "(terminal) partner" of a BBA partnership "under examination" may make a section 6603 deposit by remitting a check or money order to the Internal Revenue Service Center where the taxpayer files its return, or to the appropriate office at which the BBA partnership's return is under examination, together with a written statement designating the remittance as a deposit. ("Terminal partner" is not defined on the website but may mean a partner other than a pass-through partner.)

5. The making of the deposit does not prevent the partnership or partner from continuing to contest the audit adjustments.

6. The website requires the following information to be provided in the written statement:

> "The written statement must also include the name and TIN of the partnership under exam; the reviewed year of the partnership under exam; the Audit Control Number (ACN) of the partnership under exam; a statement identifying the amount of and basis for the BBA audited partnership's disputable tax (for example, if partnership requested appeal, include 30 day letter, or if partnership petitioned court, include case docket number, [or] if partnership plans to petition court, include a copy of NOPPA or FPA); and the partner's estimated allocable share of the adjustments and the tax, interest, and penalty calculation (the amount of payment)."

a. While the website instructions base the deposit on the partner's estimated allocable share of partnership adjustments, the instructions sensibly do not condition the partner's ability to make a deposit on the partnership having already made a push-out election. (The IRS takes the position that a push-out election cannot be made before the FPA is issued, see Reg. § 301.6226-1(c)(2) and Instructions for Form 8988 (Oct. 2020), p. 2.)

b. If a push-out election is made, a partner who previously made a BBA deposit includes a statement with the partner's reporting year return requesting that the deposit be applied against the underpayment resulting from the ART, as reported on the partner's Form 8978. See Instructions for Form 8978 (Partner's Additional Reporting Year Tax) (Dec. 2024), p. 5.

(1) The statement must include the date and amount of the original deposit, the name and TIN of the BBA partnership under exam, the reviewed year, and the Audit Control Number (ACN) of the partnership.

(2) A copy of the statement is required to be faxed to the Ogden BBA Unit.

7. If the deposit is returned, in whole or in part, interest is payable to the extent the deposit is attributable to a "disputable tax" within the meaning of section 6603(d) and Rev. Proc. 2005-18, 2005-1 C.B. 798. Interest is payable at the federal short-term rate (compounded daily) applicable to each quarter during which the deposit was outstanding. IRC §§ 6603(d)(4); 6611(a); 6621(a)(1).

a. Taxpayers can use any reasonable method for determining the amount of disputable tax. Section 7.02, Rev. Proc. 2005-18. The Revenue Procedure provides that the taxpayer must (i) have a reasonable basis for its treatment of the item, and (ii) reasonably believe that the IRS also has a reasonable basis for its position. The taxpayer must submit a written statement with the deposit explaining the basis for the taxpayer's belief as to the reasonableness of each side's position.

(1) This curious requirement is apparently intended to prevent taxpayers from using the IRS as a bank to earn interest on a deposit relating to a bogus tax controversy.

(2) As noted above, the written statement accompanying the BBA deposit establishes the disputable tax amount by including the 30-day letter, a copy of the NOPPA, or the FPA, depending on where the partnership is in the process. In each case, the partner must submit "the partner's estimated allocable share of the adjustments and the tax, interest, and penalty calculation (the amount of payment)."

8. <u>Can a Partnership Make a Deposit in Respect of an IU</u>?

a. Section 6232(a) provides that an IU is assessed and collected "as if it were a tax imposed under subtitle A" for the adjustment year.

b. Section 6233(c) states: "For rules allowing deposits to suspend running of interest on potential underpayments, see section 6603." The TTCA Bluebook (p. 162), which added this cross-reference to section 6603, states that the provision clarifies that, before the due date for payment of an IU, a partnership can make a deposit to suspend the running of interest, and a partner can do so with respect to partner tax payments resulting from a section 6226 election.

c. Section 6603(a) provides that a taxpayer may make a deposit "to pay any tax imposed under subtitle A or B or chapter 41, 42, 43, or 44" which has not been assessed as of the time of deposit. An IU is imposed under chapter 63, which is part of subtitle F. Subtitle F is not referenced in section 6603(a). It is not clear that the "as if it were a tax imposed under subtitle A" language in section 6232(a) is sufficient to make the deposit procedures applicable to an IU, although the TTCA Bluebook evidently did not perceive that to be an issue.

d. The IRS website only provides instructions for making a BBA deposit by partners, not the audited partnership.

V. CALCULATION OF IMPUTED UNDERPAYMENT

A. <u>Definition</u>

1. The term "imputed underpayment" ("IU") is defined in the regulations as the amount determined in accordance with section 6225, Reg. § 301.6225-1, and, if applicable, Reg. § 301.6225-2, which contains the modification rules. <u>See</u> Reg. § 301.6241-1(a)(3).

2. In the context of a section 6226 push-out election, an IU means the amount determined in accordance with Reg. § 301.6226-3(e)(4), which deals with a pass-through partner that elects to pay an IU on its share of pushed out adjustments from the audited partnership. Id.

3. In the case of an AAR where no push-out election is made, the IU is the amount determined in accordance with Reg. § 301.6227-2 or Reg. § 301.6227-3(c) (pass-through partner). Id.

4. The IU is imposed by section 6225(a)(2) but is assessed and collected in the same manner as if it were a tax imposed on the partnership for the adjustment year in accordance with Reg. § 301.6232-1, subject to the restrictions on assessment in section 6232(b). See IRC § 6232(a); Reg. § 301.6225-1(a)(2). However, the regular deficiency procedures do not apply.

5. The rules for calculating the IU are fearsomely complex. It is useful to keep in mind the bare-bones statutory guidance before diving into the regulations.

a. Section 6225(b)(1) states that, except as otherwise provided in section 6225, any IU for a reviewed year is determined by the Secretary by "appropriately netting" all partnership adjustments for the reviewed year, and applying the highest rate of tax in effect for the reviewed year under sections 1 or 11.

b. Partnership adjustments are first separately determined and netted "as appropriate" within each category of items required to be separately stated under section 702(a) or any other provision of the Code. IRC § 6225(b)(3).

c. Adjustments that would decrease the IU and could be subject to any additional limitation under the Code (or not allowed against ordinary income) if the adjustment were taken into account by any person, are not taken into account under section 6225(b)(1) except to the extent otherwise provided by the Secretary. IRC § 6225(b)(4).

d. Finally, in the case of an adjustment that reallocates the distributive share of any item from one partner to another, the adjustment is taken into account by "disregarding so much of such adjustment as results in a decrease in the amount of the [IU]." IRC § 6225(b)(2).

B. Circumstances in Which a Partnership "Self-Reports" an IU

1. An IU can be determined by the IRS in the course of a BBA audit, where the IRS determines adjustments to one or more PRIs and calculates the resulting IU.

2. In addition, a partnership or pass-through partner can determine and pay an IU of its own volition in the following circumstances:

a. When a BBA partnership files an AAR reporting changes to PRIs and determines and pays an IU on such adjustments in lieu of pushing them out to its partners.

b. When a pass-through partner (which term is defined to include an S corporation, estate or trust, see Reg. § 301.6241-1(a)(5)) receives a push-out of adjustments from a BBA partnership under section 6226 and elects to pay an IU resulting from such adjustments in lieu of doing its own push-out to its partners, shareholders or beneficiaries.

c. When a pass-through partner pays an IU as part of an amended return modification. See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75486 (as corrected by T.D. 9969, 88 Fed. Reg. 755, see correction items 5 and 6).

d. To adjust the reported IU and underlying partnership adjustments in these circumstances, the IRS must conduct a BBA examination and issue an FPA. Id.

C. Positive and Negative Adjustments

1. The first step in determining the IU is to classify partnership adjustments as "positive" or "negative" adjustments. Time to pause here while the tax advisor absorbs fully the peculiar terminology of these regulations: "positive" and "negative" refers to the effects of adjustments on the IU amount – positive resulting in a larger IU, negative resulting in a smaller IU. However, they are not the same as "increases" or "decreases" to partnership items.

2. For example, an adjustment that increases tax credits is a negative adjustment to the IU.

3. Negative adjustments are defined in Reg. § 301.6225-1(d)(2)(ii) to mean any adjustment to a PRI that is:

a. a decrease in an item of partnership "income" or "gain,"

b. an increase in an item of partnership "deduction" or "loss" (which are treated as "decreases in income" under Reg. § 301.6225-1(d)(2)(i)(C)),

c. an increase in an item of credit,

d. a decrease in an item of tax, penalty, addition to tax, or additional amount for which the partnership is directly liable under chapter 1 (such items are "with respect to the partnership" under Reg. § 301.6241-1(a)(6)(iii) and thus treated as PRIs), or

e. a decrease in a partnership IU.

4. **A positive adjustment is any adjustment to a PRI other than a negative adjustment**. Reg. § 301.6225-1(d)(2)(iii). This simple one-sentence default rule has far-reaching consequences, as will be evident in the discussion of so-called "non-income" adjustments later in this outline.

5. Negative PRI adjustments are taxpayer-favorable adjustments and for that reason they are discriminated against under the BBA and regulations.

6. **Note**: There is no definition in the BBA statutory provisions or regulations of "income," "gain," "loss" and "deduction." Generally speaking, it means what you would think it means, i.e., items allocated under section 704(b). Prior to the TTCA amendments, section 6241(2) defined the term "partnership adjustment" to mean any adjustment in the amount of "any item of income, gain, loss, deduction, or credit" (and to any partner's distributive share of such items), and section 6221(a) (as then in effect) provided that any adjustment to "items of income, gain, loss, deduction, or credit" is determined and taxed at the partnership level. The June 2017 Proposed Regulations would have broadly defined "income, gain, loss, deduction, or credit" for BBA purposes to include such items as the character, timing and source of the partnership's activities, contributions and distributions, amount and character of partnership liabilities, and so on. See Prop. Reg. § 301.6221(a)-1(b)(1) (June 2017 Proposed Regulations). The TTCA amended section 6241(2) to provide for the PRI definition we now have, namely, any item or amount with respect to the partnership that is relevant in determining the chapter 1 tax liability of any person. A conforming amendment was made to section 6221(a) to provide that "any adjustment to a partnership-related item" is determined at the partnership level.

7. The concept of chapter 1 tax liabilities for which the **partnership** is liable was introduced in the November 2020 Proposed Regulations. This addresses the situations where a partnership can actually be liable for a tax at the partnership level, independent of an IU under the BBA.

D. Grouping of Positive and Negative Adjustments

1. Positive and negative adjustments are put into one of four groupings:

a. reallocation grouping (adjustments that reallocate PRIs to and from partners);

b. credit grouping (adjustments to credits, including adjustments to credit recapture, see Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6486);

c. creditable expenditure grouping (adjustments to creditable expenditures, including reallocations of such expenditures); and

d. residual grouping – a catch-all grouping including any adjustment to a PRI not falling within the first three groupings. Reg. § 301.6225-1(c)(1).

(1) The residual grouping includes adjustments to PRIs that derive from an item that cannot be allocated under section 704(b). Reg. § 301.6225-1(c)(5)(ii).

2. If a grouping includes any negative adjustment, then the subgrouping rules in Reg. § 301.6225-1(d) come into play. If all adjustments within a grouping are positive, no subgrouping is required. Reg. § 301.6225-1(d)(1).

E. Subgrouping Rules.

1. Assuming at least one partnership adjustment in a grouping is negative, then adjustments that relate to items that would be netted at the partnership level and allocated as a single PRI for section 702(a) purposes are placed in the same subgrouping and netted, whether positive or negative. IRC § 6225(b)(3); Reg. § 301.6225-1(d)(3)(i).

2. If an adjustment is made to an item that may be subject to a preference, limitation or restriction (or not allowed as a deduction against ordinary income by any person), it must be placed in its own separate subgrouping. IRC § 6225(b)(4)(B); Reg. § 301.6225-1(d)(3)(i).

a. An example would be a negative adjustment resulting from an increase in loss from a partnership trade or business activity. Such loss is potentially subject to a section 469 limitation at the partner level, depending on the partner's individual circumstances (e.g., a partner who did not materially participate in the activity). Thus, the negative adjustment to the trade or business loss is placed in a separate subgrouping. See Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6482.

3. Items placed in separate subgroupings within a grouping cannot be netted. Reg. § 301.6225-1(e)(2). No netting is permitted across groupings either, and adjustments from one taxable year cannot be netted with adjustments from another taxable year. Id.

4. Paragraphs (1) through (7) of section 702(a) enumerate certain partnership tax items required to be separately taken into account by the partners. Paragraph (8) is bottom line taxable income exclusive of the separately stated items.

a. Section 702(a)(7) authorizes regulations to prescribe other items of income, loss, deduction or credit that must be separately accounted for by partners, and the regulations add a number of additional separately stated items under this authority. Reg. § 1.702-1(a)(8)(ii) requires separate statement of a partner's distributive share of any partnership item which, if separately taken into account by the partner, would result in a tax liability for that partner (or any other partner) different from that which would result if not taken into account separately.

b. Thus, for example, a positive adjustment from an increase in a LTCG item and a negative adjustment from an increase in a LTCL item both involve items in the section 702(a)(2) category. The regulations require the "combined net amount" of section 702(a)(2) LTCG and LTCL items to be reported to partners as a single item. Reg. § 1.702-1(a)(1). Since they are netted at the partnership level and allocated as a single item under section 702(a)(2), they go into a single subgrouping and are netted within that subgrouping.

c. If adjustments are made to two separate items that were properly lumped together on a single line of the K-1 or identified with the same K-1 code description, they ordinarily would be netted in the IU calculation. See Jenni Black, The Imputed Underpayment: Treating Adjustments as Zero Under the BBA, 185 Tax Notes Federal 679, 680 n. 7 (Oct. 28, 2024).

5. Examples (1) and (2) of Reg. § 301.6225-1(h) illustrate the "within the same section 702(a) category" netting rule but do not shed a great deal of light on its meaning and scope.

a. In Example (1), an audit results in a $5 increase in ordinary income (a positive adjustment) and a $10 increase in an "ordinary deduction" (a negative adjustment). Both adjustments go in the residual grouping. The example tells you how they are subgrouped.

(1) The example assumes, without giving any specifics, that the negative adjustment relating to the ordinary deduction "would not have been netted at the partnership level with the … adjustment to ordinary income and would not have been required to be allocated … as a single [PRI] for purposes of section 702(a) [and other IRS guidance]."

(2) The example also states that, because the negative adjustment relating to the deduction item would reduce the IU and yet "might be limited if taken into account by any person," it must be placed in a separate subgrouping from the ordinary income adjustment and cannot be netted. The negative adjustment, though banned from the IU calculation, does not pull a vanishing act; rather, it rolls forward and is reported on the partnership's adjustment year return. This partially compensates the reviewed year partners (to the extent they are allocated the adjustment year deduction) for overpaying their taxes in the reviewed year, but the government has the use of their money in the interim without having to pay interest.

b. In Example (2), the facts are the same except the critical assumptions are reversed without any explanation – that is, the ordinary income and ordinary deduction adjustments are assumed to be netted and allocated as a single PRI at the partnership level under section 702(a).

(1) The example concludes that the adjustments are combined in one subgrouping and netted. The $10 negative adjustment in the example exceeds the $5 positive adjustment, resulting in a net negative adjustment of $5. Thus, there is no IU.

(2) Although not stated in the example, because neither adjustment "results in an IU" (see the discussion later in this outline), this causes both adjustments to be taken into account in the adjustment year. Reg. § 301.6225-1(f)(2). This adjustment-year outcome is made explicit in Example (1) with respect to the separately subgrouped negative adjustment,

6. Recharacterization and reallocation adjustments are discussed later on, but briefly summarized, such adjustments generally result in a positive and negative adjustment that must be separately subgrouped (thus precluding netting) within the applicable grouping.

a. If a particular partner or group of partners has two or more reallocation adjustments or two or more recharacterization adjustments that are allocable to such partner or group of partners, those adjustments may be subgrouped and netted subject to the limitations in Reg. § 301.6225-1(d)(3)(i) and Reg. § 301.6225-1(e). <u>See</u> Reg. § 301.6225-1(d)(3)(ii)(A); Reg. § 301.6225-1(d)(3)(iv).

b. Reg. § 301.6225-1(h)(12), Example (12), illustrates that the "two or more reallocation adjustments to the same partner(s)" exception does not apply – even though each of the two partners has two reallocation adjustments – because one of the reallocation adjustments is to capital gain or loss which cannot be netted at the partnership level under section 702(a) with the ordinary income reallocation adjustments.

7. The IRS has the discretion to subgroup adjustments in a manner different from the above "when such subgrouping would appropriately reflect the facts and circumstances." Reg. § 301.6225-1(d)(1). In addition, the partnership can request departures from the grouping and subgrouping rules in the IU modification process. Reg. § 301.6225-2(d)(6).

8. The drafters rejected a commentator's request to provide for some form of netting where an adjustment accelerates an item of income or defers an item of deduction from one partnership tax year to another, stating that the BBA statutory scheme treats each reviewed year on a stand-alone basis. <u>See</u> Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6477-6479.

F. <u>Rules Intended to Avoid Double-Counting of Positive Adjustments</u>

1. If (i) an AAR partnership chooses to pay an IU on the AAR adjustments, (ii) the IRS determines an IU in a BBA audit, or (iii) a pass-through partner chooses to pay an IU on its share of push-out adjustments from the partnership (whether sourced to a partnership AAR or section 6226 push-out election), Reg. § 301.6225-1(b)(4) provides two rules that are intended to provide relief when one adjustment is reflected in, related to, or results from another adjustment.

a. **Rule No. 1** – "If the effect of one partnership adjustment is reflected in one or more other partnership adjustments, **the IRS may** treat the one adjustment as zero solely for purposes of calculating the [IU]."

b. **Rule No. 2** – If a positive adjustment to an item is "related to, or results from" a positive adjustment to another item, "one of the positive adjustments **will generally be treated as zero** solely for purposes of calculating any [IU]" **unless the IRS determines otherwise**.

2. Rule No. 1 applies only if the IRS is determining an IU. Rule No. 2 can be applied by taxpayers, e.g., an AAR partnership paying an IU or a pass-through partner paying an IU with respect to push-out adjustments.

a. See Reg. § 301.6225-1(b)(4) (last sentence); Preamble to November 2020 Proposed Regulations, 85 Fed. Reg. at 74945 (proposing a different version of Rule No. 2); Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75478; Instructions for Form 1065-X (Dec. 2024), p. 13 ("Note: If a positive adjustment to an item is reflected in positive adjustments to other items, the positive adjustment of equal or lesser magnitude that is reflected may be treated as zero solely for purposes of calculating any IU").

b. Of course, the IRS could disagree with an AAR partnership's or a pass-through partner's self-help application of Rule No. 2 in a subsequent BBA examination.

3. Rule No. 2 only applies to duplicative positive adjustments where one adjustment relates to, or results from, another. By contrast, Rule No. 1 allows the IRS to disregard both positive and negative adjustments if the "effect" of one adjustment is "reflected" in one or more other partnership adjustments.

4. The purpose of "solely" in the phrase "solely for purposes of calculating any [IU]" in these two rules means that the adjustment, even though ignored in the IU calculation, still has tax impact. For example, the adjustment still rolls forward and is taken into account by an audited partnership in the adjustment year (e.g., an adjustment to the basis of a partnership asset), or, if a push-out election is made, the two related or duplicative adjustments would still be pushed out.

5. An example from the IRM illustrates the application of Rule No. 1 ("reflected in another adjustment").

a. The example involves a proposed audit reallocation of $900 of capital gain recognized on the partnership's sale of real estate contributed by partner A that was erroneously allocated equally ($300 each) to all three partners. In fact, due to the operation of section 704(c), the $900 gain should have been entirely allocated to partner A, the contributing partner. This gives rise to a positive $600 adjustment to capital gain (the increase in A's allocable share) for IU purposes and a negative $600 adjustment (the decrease in the other two partners' shares). Neither of these adjustments is ignored; the positive adjustment enters the IU and the negative adjustment rolls forward to the adjustment year, where it is reported as a reduction in capital gain (or presumably as a LTCL if there is no capital gain in the adjustment year) that would be allocated to B and C, assuming they are still partners.

b. Now assume that, in addition to the two positive and negative reallocation adjustments, the IRS also determines that the original tax return reporting of the entire $900 as capital gain was incorrect, and that $450 of the gain should have been reported as unrecaptured section 1250 gain (taxed at 25%). The recharacterization adjustment gives rise to a positive $450 adjustment (the increase in unrecaptured section 1250 gain) and a negative $450 adjustment (the decrease in regular capital gain). The IRM concludes that these two adjustments are treated as zero under Rule No. 1 because they already are reflected (for IU purposes) in the positive $600 reallocation adjustment. In other words, since the reallocation adjustment already puts $600 of capital gain-related adjustment in the IU basket where it is taxed at the maximum rate (ignoring modification), it would be duplicative to add the positive $450 recharacterization adjustment resulting from the increase in unrecaptured section 1250 gain. See IRM 4.31.9.9.2.2.5(2) (10-29-2021) ("Treating both recharacterization adjustments as zero adjustments ensures that the adjustments are not counted twice since the tax effect of such adjustments is already reflected by the reallocation adjustments being made"). The negative $600 adjustment still carries forward to the adjustment year.

c. It seems logical that, if the $450 positive adjustment is disregarded as being reflected in the $600 positive adjustment, the corresponding negative $450 adjustment would be disregarded also and would not carry forward to the adjustment year. However, Rule No. 1 does not seem to clearly compel that outcome since it disregards adjustments reflected in other adjustments "solely" for purposes of calculating the IU.

6. While Rule No. 2 is phrased in terms of one positive adjustment being disregarded if it is related to or results from another positive adjustment, the rule should also apply to disregard multiple positive adjustments, each of which is related to or results from a "keynote" positive adjustment.

a. This is illustrated in Example (1) of IRM Exhibit 4.31.9-1. The example assumes an increase to partnership ordinary income of $1 million reported on Line 1, Ordinary Business Income (Loss), Schedules K and K-1, which is a positive adjustment. This creates ripple effect $1 million increases to Line 14 (Net Earnings from Self-Employment) and Line 20 (Code Z) (199A QBI), both positive adjustments. The Example concludes that the $1 million positive adjustment from the Line 1 increase is included in the IU, but the positive adjustments relating to Lines 14 and 20 (Code Z) are treated as zero (solely for IU purposes) under the IRS' discretionary authority as being duplicative of the Line 1 adjustment.

7. The Preamble to the December 2022 Final Regulations states that the anti-duplication (or what some commentators call the "subsume" rule) does not allow the partnership to treat an adjustment as zero if one is negative and one is positive. It gives as an example the case where an ordinary loss is recharacterized as a capital loss. 87 Fed. Reg. at 75478. In that event, there is both a positive adjustment (decrease in ordinary loss treated as increase in income) and a negative adjustment (increase in capital loss treated as a decrease in income). The Preamble states that the partnership cannot treat the negative adjustment "as zero for purposes of calculating the [IU]." While unclear, this comment may have been intended to make clear that the subsume rule does not operate to **net** offsetting positive and negative adjustments for IU purposes – i.e., producing a net IU adjustment of zero – simply because they are related.

a. <u>See</u> Reg. § 301.6225-3(d)(1), Example (1) (stating that a recharacterization adjustment changing an ordinary loss to a LTCL gives rise to a positive adjustment (decrease in ordinary loss) and a negative adjustment described as a "decrease in long-term capital gain," with the negative adjustment being reported as a separately stated item on the partnership's adjustment year return).

G. <u>Calculation of Imputed Underpayment – Applicable Rate</u>

1. The IU is determined by multiplying the "total netted partnership adjustment" by the highest of the section 1 or section 11 rates in effect for the reviewed year. IRC § 6225(b)(1)(B); Reg. § 301.6225-1(b)(1)(iv).

2. The "total netted partnership adjustment" is the sum of all net positive adjustments in the reallocation grouping and the residual grouping. Reg. § 301.6225-1(b)(2).

3. The resulting IU amount is then increased, dollar-for-dollar, by a net positive adjustment in the credit grouping resulting from a decrease in credits. <u>See</u> Reg. § 301.6225-1(d)(2)(iii) (decrease in credits defaults to a positive adjustment because it is not described in the category of negative adjustments); Reg. § 301.6225-1(b)(1)(v)(A) (increasing the tentative IU liability by the amount of the positive credits adjustments).

4. If there is a net negative adjustment in the credit grouping (from an **increase** in credits), it is treated as an adjustment that does not result in an IU (a DNR adjustment) and rolls forward to the adjustment year, **unless** the IRS determines that such negative adjustment should be taken into account as a dollar-for-dollar offset to the IU liability under Reg. § 301.6225-1(e)(3)(ii). See Reg. § 301.6225-1(b)(1)(v)(B).

a. It is not clear why the regulations permit net negative credit adjustments (from an increase in credits) to reduce the IU only if the IRS determines to allow it. This seems inconsistent with the Joint Committee Explanations. See BBA Bluebook, p. 63; TTCA Bluebook, p. 152.

b. As discussed below, the roll-forward-to-adjustment-year treatment does not apply if the net negative adjustment is attributable to a tax, penalty or additional amount imposed directly on the partnership under chapter 1. Reg. § 301.6225-1(e)(3)(ii) (last sentence).

H. Do-Not-Result Adjustments Taken Into Account in Adjustment Year

1. Any netted negative adjustment that "does not result in an IU" under the rules set forth in Reg. § 301.6225-1(f)(1) is "taken into account" by the audited partnership in the adjustment year as provided in Reg. § 301.6225-3 and allocated among the adjustment year partners. Reg. § 301.6225-1(f)(2). The rules of subchapter K with respect to the treatment of partners apply with respect to such adjustment, as modified by proposed section 704(b) regulations (described below). Reg. § 301.6225-3(c). There are two situations that produce DNR adjustments.

a. First, under Reg. § 301.6225-1(f)(1)(i), an adjustment does not result in an IU if, after grouping, subgrouping and netting, the result of netting within a grouping or subgrouping is a "net negative adjustment" as defined in Reg. § 301.6225-1(e)(4)(ii). A net negative adjustment is excluded from the "total netted partnership adjustment" under Reg. §§ 301.6225-1(e)(3)(i) and 301.6225-1(b)(2) and cannot reduce the IU (except where the IRS allows a net negative adjustment to credits to be taken into account). Thus, it does not result in an IU and rolls forward to the adjustment year, unless the partnership makes a push-out election under section 6226. See Reg. § 301.6225-1(a)(1); Reg. § 301.6225-3(a).

b. Second, adjustments, whether positive or negative, do not result in an IU if, after grouping, subgrouping and netting, the result is an IU of **zero or less than zero**. Reg. § 301.6225-1(f)(1)(ii). In such a case, all adjustments roll forward to the audited partnership's adjustment year. However, to the extent the partners take the DNR adjustments into account by approved specified modifications (e.g., PMARs and Alternative Procedure), they are not taken into account in the adjustment year. Reg. § 301.6225-2(e); Reg. § 301.6225-3(b)(5).

c. The Instructions for Form 1065 (2024) (Jan. 2025), p. 20, state that the partnership should provide a statement with its adjustment year return describing the DNR adjustments incorporated therein, including the line numbers to which the adjustments relate.

2. **Example**. The IRS audits a BBA partnership in 2025 and proposes two adjustments for reviewed year 2020. One is a $100 increase to ordinary business income (positive adjustment) and the other is a $25 decrease to royalty income (negative adjustment). These adjustments are not of like character and would not be netted under section 702(a). Thus, they are placed in separate subgroupings within the residual grouping under Reg. § 301.6225-1(c)(5)(i). Assume no IU modifications and no push-out election.

a. Because the negative adjustment cannot be netted against the positive adjustment, it is a DNR adjustment under Reg. § 301.6225-1(f)(1). See Reg. § 301.6225-1(e)(2) (negative adjustment within a subgrouping can only be netted with a positive adjustment in the same subgrouping).

b. The partnership pays an IU of $37 on the $100 business income adjustment. The negative adjustment is taken into account in the adjustment year in accordance with Reg. § 301.6225-3(b)(1) and -3(b)(2) and allocated among the adjustment year partners as either a component of non-separately stated income or loss for the adjustment year or as a separately stated item (if separate statement is required under section 702(a)).

c. The $25 of royalty income incorrectly reported by the partners in 2020 stays on their 2020 returns, unchanged. No amended returns are filed.

3. If the IRS approves an IU modification by way of PMARs or the Alternative Procedure, then the portions of all adjustments, whether positive or negative and including DNR adjustments, properly allocable to the participating partners are taken into account by them at the partner level and are excluded from the IU altogether and any DNR adjustments taken into account do not roll forward to the adjustment year. Reg. § 301.6225-3(b)(5).

4. **Example**. Example (3) of Reg. § 301.6225-3(d)(3) illustrates the treatment of adjustments resulting in an IU of zero or less than zero.

a. Assume that in year 3 the IRS audits a partnership's year 1 return and determines that its original $100 basis in asset A (placed in service in year 1) should be reduced by $10.

b. A decrease in the basis of an asset is treated as a positive adjustment by default under Reg. § 301.6225-1(d)(2)(iii) because it is not one of the negative adjustments listed in Reg. § 301.6225-1(d)(2)(ii).

c. Assume the adjustment would result in a $4 IU (the Example assumes a 40% maximum rate), except that the IU is fully offset by a negative $4 adjustment to credits in year 1 – that is, a $4 increase in tax credits which the IRS determines, under its discretionary authority in Reg. § 301.6225-1(e)(3)(ii), to allow in determining the IU.

d. Since the netted basis and credit adjustments result in an IU of zero, both adjustments are taken into account in year 3 (assumed to be the adjustment year). If the partnership still holds the asset, the remaining basis of the asset is reduced in year 3 by $10.

e. Although not addressed in Example (3), the negative adjustment resulting from the increase in credits presumably is reported on the adjustment year return as a separately stated item. Reg. § 301.6225-3(b)(3).

5. A net negative adjustment to a tax, penalty or additional amount for which the partnership is directly liable under chapter 1 (collectively, "direct chapter 1 tax items"), or any adjustment to an IU calculated by the partnership, is grouped in the credit grouping. Reg. § 301.6225-1(f)(3) provides special rules for the application of the DNR adjustment rules in paragraph (f) where the IU calculation produces an IU of zero or less than zero due to the inclusion of a net negative adjustment attributable to direct chapter 1 tax items or to an adjustment to an IU itself.

a. See Reg. § 301.6225-1(c)(3) (defining "credit grouping" to include each PRI adjustment that is or could be reported as a credit on the partnership's return); Reg. § 301.6225-1(h)(13), Example (13) (negative adjustment to chapter 1 tax liabilities included in credit grouping); Reg. § 301.6225-1(e)(3)(ii) (last sentence provides that net negative adjustments to direct chapter 1 tax items or to an IU calculated by the partnership are not DNR adjustments); Reg. § 301.6241-1(a)(6)(iii) (treating direct chapter 1 tax items as being "with respect to the partnership" and thus constituting PRIs); Reg. § 301.6241-1(a)(6)(ii)(C) (an IU constitutes a PRI).

6. DNR adjustments that do not involve an adjustment to an item of income, gain, loss, deduction or credit, such as negative adjustments from changes in balance sheet items or tax capital accounts, are taken into account by adjusting the item on its adjustment year return, but only to the extent the item would appear on such return without regard to the adjustment. Reg. § 301.6225-3(b)(8). If the item is already reflected on the adjustment year return or in any year between the reviewed year and the adjustment year, the partnership does not create a new item in the amount of the adjustment on the adjustment year return. Id.

a. Thus, if the IRS determines in the reviewed year that (i) a partnership liability is nonrecourse rather than recourse, and (ii) one of the two resulting positive adjustments (decrease in recourse liability, increase in nonrecourse liability, each positive) is treated as zero solely for IU purposes, the adjustment to reflect the correct nonrecourse character is taken into account in the adjustment year, but only to the extent the liability is still shown on the adjustment year return, and only as to the then-remaining amount of the liability. See Reg. § 301.6225-3(d), Example (4).

7. The Instructions for Form 8985 (Dec. 2024), p. 1 (push-out transmittal report), state that any adjustment to an item "which is not a monetary item (for example, an election made by the partnership)" is a DNR adjustment. This might mean no more than the obvious, i.e., a non-monetary adjustment can't contribute to an IU; however, it could also mean that if the IRS denies or allows a reviewed year tax election in the course of a BBA audit, the "adjustment" doesn't take effect until the adjustment year. Query what the tax consequences to the partners would be of an election adjustment if there are other adjustments that result in an IU and the partnership elects to push out.

I. Adjustment Year Allocation of Do-Not-Result Items

1. Reg. § 301.6225-3(c) provides that "the rules under subchapter K …. with respect to the treatment of partners apply" in the case of DNR adjustments. Similarly, Prop. Reg. § 301.6225-4(d) provides that, with respect to DNR adjustments, the tax attributes of a partnership and its partners are adjusted under the normal subchapter K rules.

2. Prop. Reg. § 301.6225-4(d) states that such adjustments are allocated in the adjustment year in accordance with Prop. Reg. § 1.704-1(b)(4)(xiii). Such proposed regulation provides that such allocations, while lacking substantial economic effect, are nevertheless deemed to be in accordance with PIP if allocated in the same manner as they would have been allocated in the reviewed year, treating successors as reviewed year partners for this purpose.

3. A pass-through partner would report its share of DNR adjustments reported by the audited partnership on its adjustment year return in the same manner as it would any other K-1 items for that year.

J. <u>What if an IU is Determined After the Partnership Terminates or a Reviewed Year Partner Sells its Interest?</u>

1. What happens if the partnership has ceased to be a tax-recognized partnership by the time PRI adjustments are finally determined in an FPA or final judicial proceeding and result in an IU, and negative DNR adjustments are supposed to be taken into account in the adjustment year ?

a. There is no "adjustment year" because there is no partnership. It is not clear what happens in this situation. Possibly the DNR adjustment vaporizes. If there is still time left on the section 6227(c) period of limitations, the partnership might try to claim it via an AAR filed with respect to its final return.

2. What happens if a partner in the reviewed year sells his or her interest after the reviewed year and subsequently the IRS determines a positive partnership adjustment for the reviewed year that results in an IU obligation?

a. If the partnership pays the IU, does the partnership agreement require the seller to indemnify the partnership for the seller's pro rata share of the liability?

b. If not, does the seller have any indemnification obligation to buyer under the P&S agreement? The buyer is economically hurt by the IU payment if seller is not obligated to indemnify the partnership.

c. What if there are both positive and negative adjustments, such as from recharacterizing LTCG to OI? The positive OI adjustment creates an IU, which the partnership pays, but the reported LTCG stays on the reviewed year partners' returns unchanged, while the negative adjustment to LTCG – which theoretically is supposed to make them whole – rolls forward to the partnership's adjustment year, when seller is no longer a partner. Should this buyer-side tax benefit reduce the amount of seller's indemnity obligation or be taken into account in some way in determining the buyer's purchase price?

3. A push-out election would solve these issues, as would a PMAR by a selling reviewed year partner. However, a buyer may not be in a position to compel a such actions, particularly if it is purchasing less than all of the partnership interests.

K. <u>The IRS Can Determine More Than One IU for a Reviewed Year</u>

1. The IRS may, in its discretion based on the facts and circumstances, determine more than one IU for a partnership taxable year. This can be a single "general" IU and one or more "specific" IUs. Reg. § 301.6225-1(g). The general IU consists of all adjustments that are not taken into account in determining a specific IU (other than DNR adjustments, which are separately taken into account in the adjustment year as provided in Reg. § 301.6225-1(f)(2)).

2. For example, a specific IU could be determined if certain PRI adjustments are allocated to one partner or a group of partners "that had the same or similar characteristics or that participated in the same or similar transaction." Reg. § 301.6225-1(g)(2)(iii)(A).

3. A specific IU might also be determined with respect to a reallocation adjustment that shifts an item from one partner to another. <u>Id.</u>

4. The partnership can request a modification to the number and composition of IUs. Reg. § 301.6225-2(d)(6).

5. A partnership can make a push-out election as to the adjustments associated with one IU but not as to those associated with another IU. Reg. § 301.6226-1(a).

L. Reallocation Adjustments

1. If an adjustment reallocates a PRI among the partners, the reallocation generally results in two separate adjustments, one that reverses the improper allocation and one that effectuates the proper allocation. Reg. § 301.6225-1(c)(2)(i) (defining reallocation adjustment). These generally result in one positive and one negative adjustment which are separately subgrouped within the reallocation grouping. Reg. § 301.6225-1(c)(2)(ii); Reg. § 301.6225-1(d)(3)(ii)(A).

a. Adjustments that reallocate credits are placed in the credit grouping and then subgrouped; adjustments that reallocate creditable expenditures are placed in the creditable expenditure grouping and then subgrouped. Reg. § 301.6225-1(c)(2)(i); Reg. § 301.6225-1(c)(3) and (4).

2. **Example**. Assume the IRS makes a reallocation adjustment of $50 of deduction in the reviewed year (year 1) from partner B to partner A. This results in an increase in A's loss share, which is treated as a negative adjustment to income for IU purposes (see Reg. § 301.6225-1(d)(2)(i)(C) and (d)(2)(ii)) and a decrease in B's reported loss share, which is treated as a positive adjustment to income for IU purposes (see Reg. § 301.6225-1(d)(2)(i)(D) and (d)(2)(iii)).

a. Although both positive and negative adjustments are placed in the reallocation grouping, they are separately subgrouped within the reallocation grouping. Reg. § 301.6225-1(d)(3)(ii)(A).

b. The positive and negative reallocation adjustments **cannot be netted for IU purposes**. This results in an IU of $18.5 (37% x $50) due to the isolation of the $50 positive adjustment relating to partner B. This asynchronous treatment is expressly mandated for a reallocation adjustment by section 6225(b)(2). See Reg. §§ 301.6225-1(e)(2) and -1(h)(12), Example (12).

c. The negative adjustment to partner A's income resulting from the deduction increase does not "result in" an IU and is taken into account by the partnership in the adjustment year under Reg. § 301.6225-3 (assumed to be year 5).

(1) See Reg. § 301.6225-3(b)(4) (the do-not-result portion of the reallocation adjustment is allocated to the adjustment year partner(s) who were also reviewed year partner(s) with respect to whom the amount was reallocated).

d. The partnership thus allocates the entire $50 negative adjustment in year 5 to partner A. See Reg. § 301.6225-3(d)(2), Example (2). This is intended to compensate A (without interest) for A's overreporting of taxable income in year 1. If A is no longer a partner in year 5, it would be allocated, under the proposed section 704(b) regulations, to A's "successor."

(1) See Prop. Reg. § 1.704-1(b)(4)(xiii) (providing that the allocation of items attributable to DNR adjustments is deemed to be in accordance with PIP if allocated among the adjustment year partners in the manner they would have been allocated in the reviewed year, treating successors as reviewed year partners); Prop. Reg. § 1.704-1(b)(1)(viii)(b) (defining "successor");

see also Preamble to the February 2018 Proposed Tax Attribute Regulations, 83 Fed. Reg. at 4872 (discussion of negative reallocation adjustments).

3. The adjustment year roll-forward does not apply, however, if either the DNR adjustment is taken into account by a "relevant partner" (reviewed year partner or affected partner of a pass-through partner) as part of an approved specified modification (see Reg. § 301.6225-3(b)(5)), or the adjustment is "associated with" the IU under Reg. § 301.6225-1(g) and the partnership makes a push-out election under section 6226, in which case it is taken into account by the partners in the reviewed year under Reg. § 301.6226-3 (see Reg. § 301.6225-3(b)(6)).

4. The IU that would otherwise result from the positive adjustment on a stand-alone basis may be modified (reduced) if **all reviewed year partners affected by the reallocation adjustment** file amended returns reflecting the adjustment (or use the Alternative Procedure), including amended returns for any modification year in which the partner's tax liability is affected by changes in partner tax attributes resulting from the adjustment. See IRC § 6225(c)(2)(C); Reg. § 301.6225-1(d)(2)(ii)(C); Reg. § 301.6225-2(d)(2)(x)(B).

a. The filing of amended returns could result, for example, in one partner owing tax and another receiving a refund.

b. This obviously requires all partners who are affected by the reallocation adjustments to act in concert.

5. A section 6226 push-out election can only be made if there is an IU (whether general or specific). Since a reallocation adjustment increases one partner's allocation of an item while decreasing another partner's allocation of the item, a positive and a negative adjustment should result. Thus, an IU can be determined on the positive adjustment, and the partnership can push out both adjustments with a timely section 6226 election and timely furnishing of push-out statements to the reviewed year partners. See Reg. § 3301.6226-3(h)(4), Example (4).

6. Unhappy results can arise from a reallocation adjustment if the partnership does not make a push-out election under section 6226, or the affected partners do not utilize the amended return modification or Alternative Procedure to modify the IU.

a. **Example**. A BBA audit results in $100 of ordinary income (OI) being reallocated from Partner A to Partner B in year 1 (the reviewed year).

b. The reallocation of OI to B results in a positive adjustment that contributes to an IU; the corresponding negative adjustment for A's reduction in OI does not. Applying a 37% rate, the partnership pays a $37 IU in the adjustment year (plus interest accruing from the year 1 return due date under section 6233(a)(2)).

c. Meanwhile, the OI that A incorrectly reported in year 1 stays on A's year 1 return, unchanged.

d. In year 5, the partnership reports the $100 negative adjustment as a non-separately stated item and allocates it solely to A, the reviewed year partner to whom the reallocated OI was originally and incorrectly allocated. See Reg. § 301.6225-1(f)(2); Reg. § 301.6225-3(b)(4).

e. Depending on A's year 5 tax situation, however, A may not be able to fully utilize the negative adjustment.

f. The government thus has the benefit of the IU payment (at the maximum tax rate) plus interest, and enjoys, at the very least, a time value of money benefit from having the use of A's taxes paid on the erroneously allocated year 1 income without paying refund interest. Indeed, it may even enjoy a double tax benefit to the extent A cannot take full advantage of the year 5 negative adjustment.

7. If instead the partnership had erroneously allocated $100 of ordinary loss to partner A, the reallocation of the loss from partner A to partner B would give rise to a $100 positive adjustment (the decrease in A's loss share from $100 to zero) and a $37 IU. See Reg. § 301.6225-1(h)(12), Example (12) (illustrating a reallocation of OI and LTCL).

a. However, instead of enjoying the tax benefit of the reallocated ordinary loss in year 1, Partner B can only receive a reduction in non-separately stated partnership income or loss in year 5.

b. Here again, the IRS enjoys a time money of value benefit in that it collects interest on the IU while also enjoying the use of B's tax overpayment in year 1 without paying B refund interest – that is, an overpayment relative to what B would have paid if B had been allowed the $100 reallocated loss in year 1 instead of year 5. The IRS also potentially enjoys a double tax benefit to the extent B cannot fully utilize the year 5 negative adjustment.

M. Recharacterization Adjustments

1. A recharacterization adjustment is an adjustment that changes the character of a partnership item, such as capital gain to OI, ordinary loss to capital loss, or active loss to passive loss. Reg. § 301.6225-1(c)(6)(i).

2. A recharacterization adjustment produces two separate adjustments for BBA purposes: one reverses the improper characterization and the other effectuates the proper characterization. Reg. § 301.6225-1(c)(6)(iii). This generally produces a positive adjustment and a negative adjustment – e.g., a change in character of a $100 item of LTCG to OI produces a positive $100 adjustment (increase in OI) and a negative $100 adjustment (decrease in LTCG). This applies even though the amount of the item is unchanged. Reg. § 301.6225-1(h)(4), Example (4).

3. Similarly, the recharacterization of a claimed ordinary loss to LTCL results in a deemed increase in partnership income (from a decrease in ordinary loss), which is a positive adjustment, and a deemed decrease in partnership income (from an increase in LTCL), which is a negative adjustment. Only the positive adjustment factors into the IU. The negative adjustment for the increase in LTCL is taken into account as a separately stated item in the adjustment year. (For an example of ordinary-to-capital loss recharacterization, see Reg. § 301.6225-3(d)(1), Example (1).)

4. In the cited examples, both adjustments fall into the residual grouping but are placed in separate subgroupings because the adjustment to LTCG or LTCL is a separately stated item under section 702(a). Reg. §§ 301.6225-1(c)(5)(i) and 301.6225-1(d)(3)(i) and (iv).

a. Recall that positive and negative adjustments can be netted only if they are in the same subgrouping, and a net negative adjustment in a subgrouping is excluded from the calculation of the total netted partnership adjustment to which the maximum rate is applied. See Reg. § 301.6225-1(e)(4)(ii) (defining "net negative adjustment"); Reg. § 301.6225-1(d)(3)(i) and (iv) (each positive and negative adjustment resulting from a recharacterization of an item is placed in its own separate subgrouping within the residual grouping); Reg. §§ 301.6225-1(b)(1)(iv) and -1(b)(2) (defining "total netted partnership adjustment" to include only positive adjustments in the reallocation grouping and the residual grouping).

5. In the LTCG-to-OI example, the original $100 LTCG reported on the partnership's return for the reviewed year and the reviewed year partners' K-1s stays on their returns as is, undisturbed.

a. To ameliorate the potential double taxation that that would create (i.e., leaving the partners' shares of reported LTCG intact while imposing an IU liability for the positive adjustment to OI), the $100 negative LTCG adjustment is taken into account on the partnership return for the adjustment year under Reg. § 301.6225-3, as a negative separately stated reduction of a LTCG item under section 702(a). See Reg. § 301.6225-3(b)(2); Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6485 (describing the negative roll-forward adjustment in this particular recharacterization context as "effectively, a $125 increase in long-term capital loss").

b. The adjustment year is the partnership taxable year in which either a decision of a court becomes final, if the issue goes to litigation, and if not, the year in which the notice of final partnership adjustment is mailed. IRC § 6225(d)(2). Adjustment-year treatment does not apply, however, if the adjustment is taken into account by a relevant partner as part of an approved specified modification or the partnership makes a push-out election under section 6226. See Reg. § 301.6225-3(b)(5) and (6).

c. The negative adjustment to LTCG is allocated among the partners in the adjustment year in accordance with Prop. Reg. § 1.704-1(b)(4)(xiii) (allocation deemed to in accordance with PIP if allocated in the manner in which the item would have been allocated in the reviewed year, treating "successors" as reviewed year partners).

d. What if an individual partner does not have sufficient capital gains in the adjustment year (both individually and through the partnership) to utilize the separately stated negative adjustment? Presumably it is treated like an item of LTCL that can be carried forward, but the regulations are not clear on this.

e. In the ordinary loss-to-LTCL example, a similar inequity arises. The partners are forced to recapture the tax benefit of their improper year 1 ordinary loss by indirectly bearing an IU tax on such amount (computed at the maximum possible rate unless modified), plus interest. Yet, there was a real loss incurred in year 1; only its character was disputed. Unfortunately, they don't get to enjoy the LTCL until year 5 at the earliest, possibly much later or not at all.

N. Consequences of a Section 751(a) Income Adjustment Under the BBA

1. If the IRS audits a partnership and increases a partner's share of section 751(a) ordinary income – which, as previously discussed, is a PRI – resulting from a partnership interest sale, the positive adjustment contributes to an IU. What happens to the decrease in the partner's capital gain (or increase in capital loss) that necessarily results from that adjustment?

2. Under the "hypothetical sale" approach adopted by the section 751(a) regulations, the ordinary income or loss realized by a partner on the sale or exchange of the partner's interest in section 751 property is the amount of income or loss on such property that would have been allocated to the partner (to the extent attributable to the partnership interest sold and taking into account remedial allocations to such partner under Reg. § 1.704-3(d)) if the partnership had sold all of its property in a fully taxable transaction for cash equal to the property's FMV immediately prior to the partnership interest sale. See Reg. § 1.751-1(a)(2). The difference between the gain or loss the partner would have recognized absent section 751(a) and the amount of the partner's section 751(a) ordinary income becomes the partner's capital gain or loss on the sale.

a. Example. A partner sells his 50% interest in a cash method service partnership that holds $14,000 of cash method receivables (UR). The partner realizes consideration of $16,000 on the sale (including relief of partnership liabilities). His tax basis in his partnership interest (including liability share) is $10,000. Absent section 751(a), the partner would have a capital gain of $6,000 under section 741.

(1) If the partnership sold the UR immediately prior to the partnership interest sale, the selling partner would recognize $7,000 of OI (50% x $14,000).

(2) The partner therefore recognizes $7,000 of ordinary income on the sale and a $1,000 capital loss. The capital loss equals the difference between the $6,000 capital gain the partner would recognize in the absence of section 751(a) and the $7,000 ordinary income recognized under section 751(a). See Reg. § 1.751-1(g), Example (1); see also Prop. Reg. § 1.751-1(g), Example (1) (illustrating the same concept but taking section 704(c) principles into account in determining the amount of the selling partner's section 751(a) income). See REG-151416-06, 2014-47 I.R.B. 870, 79 Fed. Reg. 65151 (Nov. 3, 2014).

b. This outcome under the section 751(a) regulations is, to say the least, counterintuitive: a partner can recognize ordinary income in excess of the partner's outside partnership interest gain. Indeed, the ordinary income can exceed even the amount realized, and a partner who recognizes an overall loss on the partnership interest sale can still recognize ordinary income attributable to the partner's interest in section 751 property if the FMV of the partner's interest in such property exceeds its tax basis in the hands of the partnership. This is a clear application of the aggregate approach to partnership taxation.

3. Unlike the amount of the partner's section 751(a) income, which derives solely from the amount of ordinary income that would be allocated to the partner in a hypothetical sale of the partnership's hot assets at FMV, the partner's capital gain or loss component of the partnership interest sale is a plugged or residual number that depends on the partner's outside basis, amount realized, and amount of hot asset income or loss. Thus, the capital gain or loss component of the partner's tax consequences resulting from the sale should not be a PRI, although it is affected by a PRI.

4. How does the partner realize the tax benefit of the reduced capital gain or increased capital loss resulting from a BBA adjustment to the partner's section 751(a) income that is not pushed out? The partner could file an amended return if the section 6511 period of limitations is still open. A push-out election allows the partner to take both tax effects into account in determining the partner's additional reporting year tax. Alternatively, the partner could participate in a PMAR or use the Alternative Procedure.

O. Adjustment of Specified Tax Attributes; Creation of Notional Items; Allocation of IU Expenditures

1. To the extent partnership adjustments are taken into account in determining an IU, the August 2018 Proposed Tax Attribute Regulations require the reviewed year partners or their successors to adjust "specified tax attributes" by creating and allocating "notional" items with respect to the partnership adjustments that do not otherwise have partner-level tax impacts under subchapter K. Prop. Reg. §§ 301.6225-4(a)(1) and -4(b)(6)(i).

a. Note: If a push-out election is made under section 6226, the partners and the partnership adjust "tax attributes" (not just "specified" tax attributes) under the rules in Prop. Reg. § 301.6226-4 rather than Prop. Reg. § 301.6225-4. See Prop. Reg. § 301.6225-4(a)(5)(i). However, if a partnership-partner pays an IU as to its share of push-out adjustments, the rules under Prop. Reg. § 301.6225-4 kick back in. See Prop. Reg. § 301.6225-4(a)(5)(ii).

2. Specified tax attributes are:

a. tax basis and book value of partnership property;

b. amounts determined under section 704(c);

c. the adjustment year partners' bases in their partnership interests and capital accounts; and

d. earnings and profits under section 312. Prop. Reg. § 301.6225-4(a)(2).

3. Section 743(b) adjustments are not specified tax attributes. See the discussion in Kate Krause, The Partnership Audit Rules Under the Bipartisan Budget Act, 629-1st Tax Mgmt. Portfolio, p. A-35.

4. The rationale for adjusting the partners' bases in the partnership by the notional items is to avoid potential double taxation of the same amount of income: once by bearing the burden of an IU at the partnership level, and potentially again at the partner level when the partnership makes distributions to the partner or the partner sells its interest. See Preamble to February 2018 Proposed Tax Attribute Regulations, 83 Fed. Reg. at 4870.

5. The adjustments to specified tax attributes are made **in the adjustment year**. Thus, to the extent an adjustment to a specified tax attribute is reflected on a federal tax return, it is "generally first reflected on any return filed with respect to the adjustment year." Prop. Reg. § 301.6225-4(a)(3).

a. This timing rule is also reflected in the proposed section 704(b) regulations discussed below, which require notional tax items attributable to a partnership adjustment resulting in an IU to be allocated to the reviewed year partners "or their successors."

b. As will be discussed, this adjustment year timing rule likely does not apply in the context of adjustments to partner and partnership "tax attributes" where a section 6226 push-out election is made (except where a partnership-partner pays an IU as to its share of partnership adjustments).

6. The attributes are not adjusted if they were already adjusted as part of the partnership adjustment. Prop. Reg. § 301.6225-4(b)(1).

7. Assume the IRS makes a partnership adjustment to recharacterize an ordinary loss as LTCL, and the partnership pays an IU on the positive adjustment. If the improper ordinary loss allocation gave rise to a reviewed year NOL at the partner level, the partner does not reduce the NOL carryforward to subsequent years. The partner "paid" for that tax benefit (and, to the extent the NOL was carried forward, actually prepaid) with the partner's share of the IU tax and interest for the reviewed year. This is not even a wash from a time value standpoint. Further, the partner cannot hope to enjoy any tax benefit from the economic loss associated with the recharacterized item until the DNR negative adjustment attributable to the increase in LTCL is reported on the partnership's adjustment year return.

a. The Preamble to the February 2018 Proposed Tax Attribute Regulations requested comments as to whether other tax attributes, such as NOL carryovers, should be treated as "specified tax attributes" and adjusted when a partnership pays an IU:

> "Specifically, commenters are requested to address whether guidance should provide a general rule that partnership adjustments and notional items are taken into account as items for all purposes of Subtitle A, except to the extent of the partner's actual tax due. For example, guidance could provide that the partner level tax calculation includes notional items for purposes of calculating the tentative tax due, but that for purposes of determining the ultimate tax due, the partner's share of the imputed underpayment would be subtracted. Alternatively, guidance could provide a list of tax attributes that are generally adjusted, and a list of those that are not."
>
> 83 Fed. Reg. at 4871.

8. For a partnership adjustment that increases income and gain, the proposed regulations create a corresponding notional item of income and gain; for a decrease in income or gain, a notional item of expense or loss; for an increase in expense or loss, a notional item of expense or loss is created; and for a decrease in expense or loss, a notional item of income or gain is created. Prop. Reg. § 301.6225-4(b)(3).

9. The allocation of notional items associated with a partnership adjustment, while lacking substantial economic effect, is deemed to be in accordance with the PIP if allocated in the same manner that the "corresponding actual item" would have been allocated to the reviewed year partners, treating "successors" as reviewed year partners for this purpose. Prop. Reg. § 1.704-1(b)(4)(xi). Such allocations adjust the partners' capital accounts (Prop. Reg. § 301.6225-4(b)(6)(ii)) and subject to certain exceptions, the partners' outside bases in the partnership (Prop. Reg. § 301.6225-4(b)(6)(iii)). However, true to their notional nature, they are not included in the partners' taxable income.

a. To the extent a partnership adjustment (i) decreases income or gain (resulting in a notional item of expense or loss), or (ii) decreases an expense or loss (resulting in a notional item of income or gain), it follows that the partnership incorrectly reported "excess items." In this excess-item situation, the allocation of the notional item is also deemed to satisfy PIP if allocated to the reviewed year partners or their successors in the manner in which the corresponding excess item was allocated in the reviewed year. Prop. Reg. § 1.704-1(b)(4)(xi) (last sentence).

b. A "successor" includes the transferee of all or part of an interest held by a reviewed year partner where the capital account of the reviewed year partner carries over to the transferee. Prop. Reg. § 1.704-1(b)(1)(viii)(b)(2).

10. The rules of subchapter K apply with respect to the adjustment of partner and partnership "tax attributes" as a result of a DNR adjustment taken into account in the adjustment year. See Prop. Reg. § 301.6225-4(d) and Reg. § 301.6225-3(c). The allocation of a DNR adjustment does not have substantial economic effect, but is deemed to be in accordance with PIP if allocated in the manner in which the item would have been allocated in the reviewed year, treating "successors" as reviewed year partners for this purpose. Prop. Reg. § 1.704-1(b)(4)(xiii).

11. The PIP-compliant section 704(b) allocations described above are deemed to have substantial economic effect for purposes of the fractions rule in section 514(c)(9)(E)(i)(II). Prop. Reg. § 1.704-1(b)(4)(xv).

12. Notional items also adjust the partnership's specified tax attributes as the circumstances require. For example, if the IRS makes a partnership adjustment to disallow the expensing of a $100 partnership asset and the partnership pays an IU on the $100 positive adjustment, the partnership would allocate in the adjustment year a $100 notional item of income to the reviewed year partners or their successors, thus increasing their capital accounts and outside tax basis. Prop. Reg. § 301.6225-4(a)(6); Prop. Reg. § 1.704-1(b)(4)(xi). The partnership would correspondingly increase its tax basis in the asset to $100 (assuming it is still held by the partnership in the adjustment year).

a. See Prop. Reg. § 301.6225-4(a)(1) (requiring appropriate adjustments to tax basis and book value of partnership property for a partnership adjustment resulting in an IU); Prop. Reg. § 301.6225-4(a)(3) (adjustments to specified attributes made in the partnership's adjustment year); Prop. Reg. § 301.6225-4(b)(2) (tax basis and book value are specified tax attributes of the partnership).

13. Notional items are not created for a partnership adjustment taken into account in determining an IU but which does not derive from an item that would have been allocated in the reviewed year under section 704(b). Prop. Reg. § 301.6225-4(b)(4)(ii); see also Reg. § 301.6225-1(c)(5)(ii) (providing that such adjustments fall into the residual grouping).

a. Thus, for example, a notional item is not created for a partnership adjustment that reclassifies a recourse liability as a nonrecourse liability.

b. Also, under Prop. Reg. § 301.6225-4(b)(4), notional items are not created for the following categories of partnership adjustments taken into account in determining an IU:

(1) if the creation of a notional item would duplicate a specified tax item or an actual item already taken into account;

(2) for a partnership adjustment that changes an item of deduction to a noncapital, nondeductible section 705(a)(2)(B) expenditure (the rationale being that such item has the same effect on specified tax attributes irrespective of the adjustment); and

(3) for a partnership adjustment to an item of income exempt from tax under subtitle A of the Code (similar rationale).

c. Notwithstanding that notional items are not created for these items, the proposed regulations require specified tax attributes for the partnership and the reviewed year partners or their successors to be adjusted in a manner consistent with how the partnership adjustment would have been taken into account under the partnership agreement in effect for the reviewed year, taking into account all facts and circumstances. Prop. Reg. § 301.6225-4(b)(4)(i).

14. Allocation of IU Expenditure Under Proposed Section 704(b) Regulations

a. It is not necessary to create a notional item for an IU expenditure, because it is a real economic outlay. Although nondeductible, it still constitutes a section 705(a)(2)(B) expenditure and must be allocated among the partners somehow.

b. Under the August 2018 Proposed Tax Attribute Regulations, if a BBA partnership pays an IU, the allocation of the nondeductible IU expenditure is "substantial" (for purposes of the section 704(b) substantial economic effect test) only if it is allocated to the reviewed year partners or their successors in proportion to the manner in which the notional item to which the IU expenditure relates is allocated, taking into account IU modifications attributable to the partner(s).

(1) See Prop. Reg. § 301.6225-4(c); Prop. Reg. § 1.704-1(b)(2)(iii)(f)(1) (economic effect of allocation of IU expenditure is "substantial" only if allocated in accordance with Prop. Reg. § 1.704-1(b)(2)(iii)(f)); Prop. Reg. § 1.704-1(b)(2)(iii)(f)(2) (prescribing the operative allocation rule); Prop. Reg. § 1.704-1(b)(2)(iv)(i)(4) (same).

(2) As noted above, in order to be respected under PIP, the notional item to which the IU expenditure relates is required to be allocated in the manner in which the corresponding actual item "would have been allocated in the reviewed year under [the section 704(b) rules]," treating "successors" as if they were reviewed year partners, i.e., treated as if they held their interests during the reviewed year. Prop. Reg. § 1.704-1(b)(4)(xi); Prop. Reg. § 1.704-1(b)(1)(viii)(b) (defining "successor").

(3) Assume that a partnership's allocation provisions comply with the primary section 704(b) economic effect safe harbor. Also assume that the partnership specially allocates the entire deduction for the IU payment to only one of the reviewed year partners. Even though the allocation has economic effect, under the proposed regulations it would not have "substantial" economic effect and would have to be reallocated among the reviewed year partners or their successors in the manner described above. See Prop. Reg. § 301.6225-4(e), Example (4).

c. If the partnership agreement's allocations do not satisfy one of the economic effect safe harbors (most agreements today do not), the proposed regulations provide that the allocation of the IU expenditure satisfies PIP only if it is allocated in accordance with the paragraph (b)(2)(iii)(f) rules **and** the partners' distribution rights are reduced by their shares of the IU. See Prop. Reg. § 1.704-1(b)(4)(xii); Prop. Reg. § 1.704-1(b)(2)(iv)(i)(4) (cross referencing the paragraph (b)(4)(xii) allocation rule for PIP purposes); Prop. Reg. § 1.704-1(b)(2)(iii)(f)(1) (apparently containing a bad cross-reference to paragraph (b)(4)(xi) instead of (b)(4)(xii)).

d. The allocation of an IU expenditure resulting from an adjustment for which notional items are **not** created is substantial only if it is allocated to the reviewed year partner or its successor who would have borne the economic benefit or burden of the adjustment if the partnership and partners had originally reported in a manner consistent with the non-income partnership adjustment that resulted in the IU with respect to the reviewed year. Prop. Reg. § 1.704-1(b)(2)(iii)(f)(4).

e. An example in the proposed regulations illustrates how modifications are taken into account. See Prop. Reg. § 301.6225-4(e), Example (2). In that example, a $120 decrease in the ABC partnership's deduction gives rise to a notional income item that is allocated equally among 1/3 partners A, B and C for purposes of adjusting their capital accounts and outside basis (each a specified tax attribute). Absent modification, the partnership would owe an IU of $48, using an assumed 40% rate. However, the partnership's modification requests are approved for (i) tax-exempt partner A and (ii) a rate modification for corporate partner C, which is assumed to be subject to a maximum rate of 20%. These modifications reduce the IU from $48 to $24 [the example incorrectly states that the IU is reduced to $30]. Thus, although normally the IU expenditure would be allocated consistent with the allocation of the notional item to which it relates, Prop. Reg. § 1.704-1(b)(2)(iii)(f)(2) requires modifications to be "taken into account." This aggregate or look-through approach results in the $24 IU expenditure being allocated for capital account and tax basis purposes $0 to A, $16 to B, and $8 to C.

15. The August 2018 Proposed Tax Attribute Regulations would add to the list of "extraordinary items" under the section 706 regulations "any item arising from a final determination [under the BBA] with respect to a partnership adjustment resulting in an [IU]" for which no push-out election is made or for which a pass-through partner pays an IU. Prop. Reg. § 1.706-4(e)(2)(viii).

a. Extraordinary items are items that must be specially allocated based on the partners' interests in the item at the time of day when the extraordinary item occurs (as opposed to under the interim closing of the books method or pro ration method). <u>See</u> Reg. § 1.706-4(e)(1)

b. While there appears to be no Preamble explanation of this proposed regulation, its purpose presumably is to apply the extraordinary item allocation procedures to the allocation of notional items relating to the partnership adjustments included in an IU.

VI. MODIFICATIONS TO IMPUTED UNDERPAYMENT

A. <u>In General</u>

1. Upon issuance of the NOPPA, the partnership can request IRS approval of modifications to the IU to take into account (i) certain specified tax attributes or characteristics unique to one or more of the audited partnership's reviewed year partners and indirect partners and/or (ii) the extent to which one or more partners choose to take into account their shares of partnership adjustments at the partner level and pay any additional taxes resulting therefrom. IRC § 6225(c) and Reg. § 301.6225-2(c). The objective is to reduce the IU in the event the partnership, after receiving an FPA, does not intend to push out the adjustments to the partners under section 6226.

2. The modification can be specific to one or more partnership adjustments that enter into the IU, except in the case of a PMAR or modification by the Alternative Procedure. More than one type of modification can be requested. The PR can also request that certain negative PRI adjustments be netted against positive PRI adjustments even though the rules would not otherwise allow netting, and to modify the number or composition of IUs. Reg. § 301.6225-2(d)(6).

3. Modifications do not reduce the amount of any partnership adjustment per se, but may reduce the portion of the adjustment that factors into the IU calculation. Reg. § 301.6225-2(b)(1). For example, the portion allocable to a tax-exempt partner not subject to UBTI tax on such amount can be excluded from the IU calculation altogether. Reg. §§ 301.6225-2(b)(2)(ii) and -2(f), Example (4).

a. If the IRS were to propose disguised sale-related adjustments in a BBA audit and the "selling" partner agreed to file a partner amended return taking into account such adjustments as part of a modification request, the partnership adjustments would still be taken into account in adjusting the partnership's tax attributes, such as the tax basis of the "purchased" portion of the transferred property and depreciation thereon, even though no IU would result with respect to the portion of the adjustments taken into account on the partner amended return.

4. Any modifications of the proposed IU must be requested within 270 days of the issuance of the NOPPA. Reg. § 301.6225-2(c)(3).

a. The PR can request an extension of the modification period (at the IRS's discretion) if hitches develop, e.g., the PR becomes aware that a partner amended return was accompanied by full payment of all required taxes and penalties but the partner made an error in calculating the interest due. Reg. § 301.6225-2(c)(3)(ii).

5. One look at the relevant forms and instructions should be enough to send chills down the spine of the tax accountants who almost certainly will take it for the team in all of this: the modification process is likely to be distressingly complex and mistake-prone. The process is not for the faint of heart and not for the cheap.

6. The modification process is not an opportunity to have the adjustments reviewed or contested at Appeals. That Appeals opportunity comes earlier in the process, before the NOPPA is issued.

B. Modification Process

1. Section 6225(c)(8) provides that any modification of the imputed underpayment amount "shall be made **only** upon approval of such modification by the Secretary." (Emphasis added.) See Reg. § 301.6225-2(c)(1) and (4).

2. Modifications are requested by the PR using Form 8980 (Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)) (Dec. 2024). Modification forms are generally required to be submitted to the IRS electronically. The instructions for doing so can be found at irs.gov (search for "filing BBA forms electronically" and click on the link for "Electronic submission of forms by audited BBA partnerships and their pass-through partners").

a. The PR needs to register for on-line access to the BBA Online Form Submission Service.

3. The partnership must provide the information required by the forms and instructions, including any additional information requested by the IRS. This may include a copy of the partnership agreement in effect for each taxable year in issue (as expansively defined in Reg. § 1.704-1(b)(2)(ii)(h)), the partnership's structure and ownership, information concerning partnership allocations, and the identity of the relevant partners. See Reg. § 301.6225-2(c)(2)(ii); Publication 5346, Instructions for Form 8980 (Dec. 2024).

4. All adjustments, whether positive or negative, that are reflected in the Form 14792 provided by the IRS as part of the NOPPA package must be shown on the Form 8980 modification request, along with the allocations of such adjustments to the relevant partners. This also includes what the Instructions to Form 8980 refer to as "zero adjustments," which means adjustments treated as zero by the IRS solely for IU purposes under Reg. § 301.6225-1(b)(4) (the anti-duplication rules). See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 8.

5. The modification process relies heavily on partner cooperation. The partnership cannot force a partner to cooperate beyond whatever cooperation undertakings are provided in the partnership agreement (this should be addressed when drafting the agreement).

6. Modification requests are reviewed by the Ogden BBA Unit, which will issue Letter 5975 and Form 15027 to the partnership and PR detailing the approved modifications and a revised IU. IRM 8.19.14.5 (10-19-2021).

a. If the partnership disagrees with one or more modification determinations, it can request a conference with the group manager, and if that is unproductive, the partnership can go to Appeals. See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 4.

7. There is no governing standard for IRS "approval" in the regulations. The regulations only state that the IRS will **not** approve if the partnership fails to provide the information that the IRS determines is necessary to substantiate a modification request or determines that there is a failure by any person to make a required payment. Reg. § 301.6225-2(c)(2).

8. This will eventually get fleshed out in litigation. The determination of an IU is itself a PRI, and an IU takes into account approved modifications. <u>See</u> Reg. § 301.6241-1(a)(6)(ii)(C); Reg. § 301.6241-1(a)(3). If the PR files a petition for readjustment with a court, the court has jurisdiction "to determine all partnership-related items for the partnership taxable year to which the [FPA] relates." IRC § 6234(c). Thus, an IRS denial of a modification request, which if approved would have reduced the IU, should be reviewable on some basis (abuse of discretion?) as part of the process of "determining" the IU PRI. <u>See</u> Jenni Black, <u>Litigating BBA Modification Denials: Open Questions, Potential Chaos</u>, 185 Tax Notes Federal 1449 (Nov. 18, 2024).

a. The Tax Court Rules require a petition filed by a BBA partnership to state "[t]he amount of the imputed underpayment, determined by the Commissioner… and, if different from the Commissioner's determination, the approximate amount of the imputed underpayment in controversy, **including any proposed modification of the imputed underpayment that was not approved by the Commissioner**." Tax Court Rule 255.2(b)(5) (emphasis added).

b. The Preamble to the February 2019 Final Regulations took a hands-off approach regarding a court's review of IU modification disputes (84 Fed. Reg. at 6499):

> "The same comment requested that the IRS include the denial of any modification request in the FPA to ensure that any Tax Court proceeding will also address the dispute regarding the requested modification. This comment was not adopted. Whether and how disputes regarding modification requests are subject to judicial review by a court is not within the purview of the Treasury Department's or the IRS's regulatory authority. **However, to assist with any potential judicial review of modification, the IRS plans to use the FPA as the method for approving or denying modification**. The final regulations do not specify, however, what is required to be included in the FPA for purposes of approving or denying modification. The absence of a regulatory rule in this regard provides the IRS flexibility to allow for the differing circumstances of each administrative proceeding and varying types of modification requests." (Emphasis added.)

9. One can easily imagine the IRS raising any number of issues with a proposed modification, especially if it involves PMAR or the Alternative Procedure, depending on how hard it wants to look at the taxpayer's proof. In reality, a partnership is likely to find itself at the IRS' modification mercy if things go awry unless Appeals can broker a resolution.

C. <u>Types of Modifications</u>

1. Most modifications reduce the partnership's IU obligation based on maximum tax rates applicable to a particular type of partner (individual, corporation, tax-exempt entity, etc.) and/or particular type of income, but do not change the taxpayer (the audited partnership).

2. However, the PMAR and the Alternative Procedure modifications shift the taxpayer from partnership to partner. (Both of these "actual tax liability" modifications are discussed later in this outline.)

3. In addition to PMAR and Alternative Procedure, the following modifications may be requested:

a. In the case of a C corporation partner, the fact that the maximum section 11 rate for the reviewed year (currently 21%) on the corporation's allocable share of partnership adjustments is lower than the maximum section 1 rate (37%, see section 1(j)(1) as amended by Section 70101(a) of Pub. L. 119-21, which made the 37% top rate permanent). See IRC § 6225(c)(4)(A)(i); Reg. § 301.6225-2(d)(4).

b. The fact that a relevant partner is a tax-exempt entity (as defined in section 168(h)(2)) and exempt from tax on its allocable share of the partnership adjustment.

(1) If the adjustment is partially subject to UBTI tax, the tax-exempt entity modification rule applies only to the portion of the adjustment that is not UBTI. Reg. § 301.6225-2(d)(3)(iii) and -2(f), Example (4) (a portion of a tax-exempt partner's share of a partnership adjustment to ordinary income would be treated as unrelated debt-financed income under section 514; assuming the modification request is approved, the nontaxable taxable portion is excluded from the IU while the taxable portion is not).

(2) See IRC § 6225(c)(3); Reg. § 301.6225-2(d)(4); Instructions for Form 8983 (Certification of Partner Tax-Exempt Status for Modification Under IRC § 6225(c)(3) (Oct. 2020), p. 2; Publication 5346, Instructions for Form 8980, (Dec. 2024), p. 20.

c. The fact that the maximum tax rate on an individual partner's allocable share of capital gains or qualified dividends for the reviewed year (20%, see section 1(h)(1) and 1(h)(11)) is lower than the maximum section 1 rate. See IRC § 6225(c)(4)(A)(ii); Reg. § 301.6225-2(d)(4).

(1) An S corporation partner is treated as an individual for this purpose. Id.

d. Modification may be requested based on disregarding a partnership adjustment of a publicly traded partnership to the extent such adjustment would be reduced by a "specified passive activity loss" allocable to a "specified partner" or "qualified relevant partner." Reg. § 301.6225-2(d)(5).

e. Modification may be requested based on a tax treaty reduction or exemption from U.S. tax applicable to a foreign person's allocable share of a PRI, where the foreign person is a relevant partner, or applicable to the partnership itself.

(1) See Reg. § 301.6225-2(d)(9); Preamble to August 2018 Proposed Regulations, 83 Fed. Reg. at 41959 (explaining that the tax treaty modification was added pursuant to the Secretary's authority under section 6225(c)(6)).

f. As noted earlier, a request for modification can be made to alter the number and/or composition of partnership IUs, including requesting that one or more partnership adjustments otherwise precluded from being netted under the grouping and subgrouping rules be grouped as if the limitations and restrictions did not apply. Reg. § 301.6225-2(d)(6).

(1) See Reg. § 301.6225-2(d)(6)(i) and (ii); Reg. § 301.6225-2(f)(8), Example (8) (illustrating this type of modification in the context of an increase to rental real estate income from property A and an increase in rental real estate loss from property B; although these ordinarily would be subgrouped separately because section 469 or other potential Code limitations might apply to limit the loss, the IRS approves a subgrouping modification with respect to the two partners, both of which are publicly traded C corporations not subject to the passive loss rules, which results in the two adjustments being included in the same subgrouping and netted).

g. A partnership can request modification based on a closing agreement or "other modification" not described in Reg. § 301.6225-2(d), which the IRS may approve if it determines it is "accurate and appropriate" based on the information submitted. IRC § 6225(c)(6); Reg. § 301.6225-2(d)(8) and (10).

D. Rate Modifications

1. As one might expect, a rate modification does not reduce the amount of adjustments included in the IU calculation. It only reduces the applicable rate that applies to the partnership adjustment. Reg. § 301.6225-2(b)(3)(i).

2. The first step is to determine how each relevant partner's distributive share of the partnership adjustment that is subject to an approved rate modification was allocated in the NOPPA. If the allocation was not addressed in the NOPPA, then the distributive shares are determined based on how the adjustment would be allocated in the reviewed year under subchapter K and the partnership agreement. Reg. § 301.6225-2(b)(3)(iii)(A).

a. Compare Reg. § 301.6226-2(f)(1)(ii) (reviewed year partner's share of a push-out adjustment that was not originally reported on the partnership's reviewed year return is determined in accordance with how the adjusted PRI would have been allocated under the section 704(b) regulations and the partnership agreement).

3. The portion of an adjustment approved for rate modification is then multiplied by the applicable reduced rate. The resulting amount(s) are then added to arrive at what the regulations refer to as the "rate-modified netted partnership adjustment." Reg. § 301.6225-2(b)(3)(iii). This can be viewed as a component or subset of the ultimate IU amount.

4. The sum of the remaining portion of such adjustment (the portion not approved for rate modification), plus all other partnership adjustments not approved for rate modification (after taking into account other approved modifications) is then multiplied by the highest rate (37%) to arrive at what the regulations call the "total netted partnership adjustment not subject to rate reduction." Reg. § 301.6225-2(b)(3)(ii). This can be viewed as the residual IU component.

5. The two IU components are then added to arrive at the IU.

6. Special Rule for Determining Rate-Modification Distributive Shares in the Case of Special Allocations

a. A special rule applies if (i) partnership adjustments are made to more than one PRI, and (ii) any relevant partner for whom a rate modification is requested has a distributive share of such items that is not the same with respect to all such items. See IRC § 6225(c)(4)(B)(ii); Reg. § 301.6225-2(b)(3)(iv).

b. In that event, the relevant partner's distributive share for rate modification purposes is based on the partner's share of the net gain or loss that would have been allocated to the partner if the partnership had sold all of its assets at FMV at the end of the reviewed year, "appropriately adjusted to reflect [other approved non-rate modifications] with respect to any relevant partner." Reg. § 301.6225-2(b)(3)(iv).

c. The BBA Bluebook (p. 67) contains an example where the positive partnership adjustments relate to rent income from property A and a depreciation deduction from property B. A corporate partner has a 20% distributive share of the property A rent income and a 15% distributive share of the property B depreciation deductions. The differing percentages invoke the special rule. The example states that if the partnership sold all of its assets for FMV at the end of the reviewed year, the corporate partner's percentage share of the resulting gain would have been 20%. Thus, the lower corporate tax rate applies to 20% of the IU.

d. Although section 6225(c)(4)(B)(ii) admits of no exception to the hypothetical sale rule where the relevant partner has different distributive share percentages of two or more partnership adjustments, the regulations permit the partnership to request the IRS to use, for rate modification purposes, (i) the actual distributive share percentages for each partnership adjustment for each relevant partner as specified in the NOPPA, or (ii) if the appropriate allocation of an adjustment is not specified in the NOPPA, the manner in which each adjustment would be properly allocated to the relevant partners under subchapter K at the close of the reviewed year. See Reg. § 301.6225-2(b)(3)(iv); Reg. § 301.6225-2(b)(3)(iii)(A); Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 21.

E. Modification – Tax-Exempt Entities

1. The partnership can request modification by establishing, to the IRS's satisfaction, that a relevant partner is a "tax-exempt entity" that would not owe tax on its share of the adjustments (including DNR adjustments) by reason of its tax-exempt entity status in the reviewed year. Reg. § 301.6225-2(d)(3)(i). A tax-exempt entity is defined by reference to section 168(h)(2)(A), (C) and (D). Reg. § 301.6225-2(d)(3)(ii).

2. Such term includes tax-exempt organizations, U.S. federal and state governmental entities, and a "foreign person or entity." IRC § 168(h)(2)(A)(iii) and (h)(2)(C)(ii). However, it does not include a "foreign partnership" or other "foreign pass-thru entity." IRC § 168(h)(2)(C) (flush language).

3. To request modification, the audited partnership must establish that the relevant partner is a tax-exempt entity and the portion of its distributive share of partnership adjustments that constitute "tax-exempt amounts." See Form 8983 (Certificate of Partner Tax-Exempt Status for Modification Under Section 6225(c)(3)) (Oct. 2020), pp. 1-2 (requiring the tax-exempt entity to certify its status as such and certify that, for the reviewed year, "all or a portion of the relevant partner's distributive share of the partnership's adjustment is not subject to tax under any section of the Internal Revenue Code"); Reg. § 301.6225-2(f), Example (4) (the portion of a tax-exempt partner's share of a partnership adjustment that constitutes unrelated debt-financed income is not excluded from the IU, but modification can be requested as to the remaining nontaxable portion).

4. The Instructions for Form 8983, pp. 2-3, state that, for purposes of Form 8983, "tax-exempt entity" only includes domestic tax-exempt entities described in section 168(h)(2)(A) and foreign partners exempt from tax under section 501(a). The Instructions require the relevant partner to state whether it is domestic or foreign, and if foreign, to indicate whether it is exempt under section 501(a) and whether that is pursuant to an IRS determination letter or an opinion of counsel. A foreign relevant partner should only submit Form 8983 if it is claiming to be exempt from U.S. tax under section 501(a). Id.

5. The partnership must provide all relevant information regarding the partnership adjustments (including DNR adjustments) to the tax-exempt relevant partner in order to allow the latter to accurately complete Form 8983. Instructions for Form 8983 (Oct. 2020), p. 2. The partnership submits Form 8983 along with the partnership's Form 8980 modification request. Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 20.

6. If a foreign relevant partner is claiming tax-exempt status under a tax treaty as an exempt pension trust or under a Code provision other than section 501(a) (such as the portfolio interest exemption or section 892 for foreign governments), the partner does not provide Form 8983 to the partnership. Instead, the partnership files Form 8980 and completes Part VIII (Foreign Partners: Modification Pursuant to Tax Treaty Claims & Statutory Exemptions Other Than Section 501(a)). See Publication 5346, Instructions for Form 8980 (Dec. 2024), pp. 20, 26. The partnership also should request and keep in its records supporting documentation of the partner's right to such treaty or Code tax benefits, e.g., a W-8BEN, W-8EXP or W-8ECI. The supporting documentation is not provided to the IRS. The Form 8980 Instructions indicate that the partner should sign an "Affidavit of Unchanged Status" (a template of which is included in the Instructions) to declare the validity of the form, its applicability to the partner's reviewed year, and the partner's entitlement to a rate reduction or exemption. The affidavit retained by the partnership. See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 28.

F. Modification – Deficiency Dividends Paid by REITs and RICs

1. Modification can be requested where a REIT partner or RIC partner has paid a deficiency dividend under section 860(f) that takes into account such partner's share of partnership adjustments. Reg. § 301.6225-2(d)(7).

2. This is intended to apply, for example, where a partnership receives a NOPPA and a REIT partner decides to pay a deficiency dividend as to its share of partnership adjustments for the reviewed year before the partnership proceeding is concluded, in order to zero out the increase in its REIT taxable income for the REIT taxable year that corresponds to the reviewed year. (Since the NOPPA is not issued until the partnership has had its IRS Appeals hearing, the adjustments are final at that point absent litigation or a change of heart by the IRS prior to issuing the FPA.)

3. The basis for approving such modification is similar to the basis for an amended return modification – that is, the REIT has effectively taken into account its share of partnership adjustments by doing a self-determination under section 860(e)(4) and declaring a remedial deficiency dividend. Because it has pushed the tax impact of the adjustments up to its shareholders, the REIT's share of partnership adjustments is excluded from the partnership's IU calculation.

a. See Preamble to June 2017 Proposed Regulations, 82 Fed. Reg. at 27355; Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6501 (explaining that the issuance of a NOPPA is not a "determination" for purposes of section 860(e)).

4. The Instructions for Form 8980 (Publication 5346 (Dec. 2024), Part VI, p. 24) require that the deficiency dividend be paid before the request for modification is submitted and that documentation (e.g., a closing agreement or Form 8927, as well as Form 976) be provided with the partnership's modification submission.

G. Modification – Indirect Relevant Partners

a. As noted, modifications can be sought not only for direct reviewed year partners, but for indirect partners who hold their interests in the audited partnership through a pass-through partner. Reg. § 301.6225-2(c)(2)(ii).

b. Assume an audited partnership has two equal partners, individual A and partnership-partner B. Partnership-partner B has two equal partners, individual C and tax-exempt entity D. The audited partnership can request an IU modification as to the 25% portion of the audited partnership adjustments that ultimately flows up to D. This means that 25% of the partnership adjustments is excluded from the IU base. See Reg. § 301.6225-2(b)(2)(ii); Reg. § 301.6225-2(f)(3), Example (3).

c. The audited partnership must provide sufficient information to the IRS regarding the tiered ownership structure. Additionally, the tax-exempt indirect partner must complete Form 8983 and provide it to the PR, who files it with the IRS along with the partnership's Form 8980.

d. The tax-exempt partner must certify the portion of its distributive share of partnership adjustments (see Form 8983 (Part III, column (6)) that constitute tax-exempt amounts, i.e., the portion that is not subject to tax as UBTI (including under the section 514 debt-financed UBTI rules).

H. Modifications of Do-Not-Result Adjustments

1. The audited partnership can also request modification for DNR adjustments described in Reg. § 301.6225-1(f)(1)(ii) (adjustments resulting in an IU of zero or less than zero) using one of the following:

a. the partner amended return or Alternative Procedure modifications,

b. the closing agreement or "other" modifications,

c. and/or an additional modification permitted under Reg. § 301.6225-2(d)(6) (relating to the number or composition of IUs). IRC § 6225(c)(9); Reg. § 301.6225-2(a); Reg. § 301.6225-2(e).

2. Section 6225(c)(9) was enacted by the TTCA and gives the Secretary the authority to modify to establish procedures permitting modification of adjustments not resulting in an IU. The TTCA Bluebook provides no explanation of its purpose. The paragraph (e) rule first appeared in the August 2018 Proposed Regulations, but the Preamble is similarly unrevealing. In any event, the rule is apparently intended to give partners the same opportunity to use PMARs or the Alternative Procedure to take into account all partnership adjustments at the partner level in the "zero or less than zero" DNR situation as they would have if the positive adjustments had resulted in an IU and the negative adjustments rolled forward to the adjustment year.

3. Assume that the IRS conducts an audit and the only adjustments are taxpayer-favorable negative adjustments.

a. Unless modification is available, such adjustments are taken into account by the audited partnership in the adjustment year and are allocated to the adjustment year partners. See Reg. § 301.6225-1(f)(2); Prop. Reg. § 301.6225-4(d) (such adjustments are allocated in the adjustment year in accordance with Prop. Reg. § 1.704-1(b)(4)(xiii), which provides that the allocations are deemed to be in accordance with PIP if allocated in the same manner as they would have been allocated in the reviewed year, treating successors as reviewed year partners).

b. A push-out election is not available because there is no IU.

c. It would appear that all of the negative adjustments constitute DNR adjustments under the "zero or less than zero" rule, and therefore the PMAR and Alternative Procedure modifications should be available under paragraph (e) so that partners can take them into account in the reviewed year rather than the adjustment year.

d. The IRS could also withdraw the NAP and give the partnership the opportunity to file an AAR and push the DNR adjustments out to the reviewed year partners. Reg. § 301.6231-1(f).

I. How Do Modification Requests Apply to Pass-Through Partners Holding Interests in the Audited Partnership?

1. For purposes of the modification rules, the term "relevant partner" includes (i) a reviewed year partner, including any pass-through partner but not including any disregarded entity, and (ii) an "indirect partner." See Reg. § 301.6225-2(a) (defining "relevant partner").

a. An "indirect partner" means a person who owns an interest in the audited partnership through one or more pass-through partners or through a disregarded entity. A pass-through partner means an upper-tier partnership or S corporation, or an upper-tier trust or estate where the "indirect partner" is a beneficiary. See Reg. § 301.6241-1(a)(5) (defining "pass-through partner"); Reg. § 301.6241-1(a)(4) (defining "indirect partner"); section 6225(c)(2)(F) (providing for amended return modifications with respect to any partner or shareholder of an upper-tier partnership or S corporation).

b. A "relevant partner" also includes an upper-tier partnership that has opted out of the BBA.

2. Modifications can be requested by the audited partnership with respect to an indirect partner in such partnership. If the partner is "indirect" simply because the partner owns its interest in the audited partnership through a disregarded entity, the audited partnership merely has to establish that the partner is the tax owner of such interest to support a modification as to such partner. Reg. § 301.6225-2(c)(2)(ii).

3. If a relevant partner is an indirect partner because it holds its interest in the audited partnership indirectly through an upper-tier pass-through partner, a modification request by the audited partnership for the indirect partner will require the PR of the audited partnership to provide the IRS with any information that the IRS may require relevant to the pass-through partner. Id.

a. As an example, the regulations mention an amended return modification request as to an indirect partner holding its interest in the audited partnership through a pass-through partner, where the IRS may require the same information that would have been required to be filed if the pass-through partner had filed its own PMAR. See IRC § 6225(c)(2)(F) (as added by section 203(a) of the TTCA [note: it appears that two different provisions of the TTCA enacted different versions of subparagraph (c)(2)(F); this has not yet been fixed]; Reg. § 301.6225-2(c)(2)(ii).

VII. MODIFICATION BY PARTNER AMENDED RETURN OR ALTERNATIVE PROCEDURE

A. Partner Amended Return Modification

1. An audited partnership can request modification based on **one or more** relevant partners (including indirect partners) **either**:

a. filing partner amended returns reflecting their allocable shares of **all** partnership adjustments and the tax effects of any resulting attribute reduction; paying the additional taxes, penalties and interest due with the amended returns; and providing a partner certification on Form 8982 to the PR that the appropriate taxes, interest and penalties have been paid, or

b. participating in the Alternative Procedure whereby the relevant partner prepares, **but does not file**, the equivalent of a pro forma amended return reflecting the additional tax that would result from reporting the partner's allocable share of all partnership adjustments; remitting the tax, interest and penalties directly to the IRS; and providing a partner certification to the PR that the appropriate taxes, interest and penalties have been paid.

c. In either case, the PR forwards the partner certifications to the IRS as part of the PR's modification request. See IRC § 6225(c)(2)(A) and (B); Reg. §§ 301.6225-2(d)(2) and -2(d)(2)(x).

2. The PMAR procedure and the Alternative Procedure ensure that actual tax liabilities resulting from the adjustments are paid by participating partners instead of the typically inflated and distorted IU liability. It also puts the economic burden of the taxes on the participating reviewed year partners instead of the adjustment year partners bearing an IU. However, it does require the participating partners to pay tax before the partnership has had a chance to have its day in court. Also, a partner's participation in a PMAR or Alternative Procedure is purely voluntary. By contrast, a section 6226 push-out is a cram-down – partners have no consent rights other than what the partnership agreement gives them. Fortunately, if one or more partners fail to comply fully with a valid push-out election, it doesn't affect the election's validity and does not reinstate a partnership's IU liability.

3. Section 6225(c)(2)(D) provides that, for BBA partnership adjustments taken into account in a PMAR or the Alternative Procedure and any related adjustments to tax attributes, the section 6501 and 6511 periods of limitations do not apply with respect to taxes paid as a result of such adjustments. See IRC § 6225(c)(2)(D); Reg. § 301.6225-2(d)(2)(iv) ("Generally, the period of limitations under sections 6501 and 6511 do not apply to [a PMAR]."

a. Thus, for example, if a NOPPA is mailed to the partnership more than three years after the partner filed his or her return for the year that includes the end of the reviewed year, the section 6501 and 6511 periods of limitation do not preclude (i) the partner from filing a PMAR, (ii) the payment and assessment of taxes due, or (iii) the partner from receiving any credit or refund resulting from the partnership adjustments. See TTCA Bluebook, p. 155. A refund might be claimed, for example, by a partner whose taxable income is reduced by a reallocation adjustment.

b. No other corrections or changes can be made on the partner amended return – only those related to the BBA adjustments and resulting adjustments to tax attributes. Reg. § 301.6225-2(d)(2)(i). Conversely, if the partner's individual statute is closed, the IRS is precluded from poking around in the amended return and raising other, non-BBA issues; the lifting of the section 6501 period of limitations under section 6225(c)(2)(D) only applies "[i]n the case of adjustments" taken into account on the amended return and to "any amounts paid" with such return. See TTCA Bluebook, p. 155 (section 6501 does not preclude the filing of partner amended returns and the assessment of tax related thereto "but these results apply only with respect to adjustments to [PRIs] for the reviewed year (and the effect of such adjustments on any tax attributes)").

4. Amended returns cost money to prepare. So do the pro forma amended returns that need to be prepared if the Alternative Procedure is used – this is likely to be a push in terms of fees and headaches. Amending state income tax returns is another expense.

5. The PMAR process is completed before the partnership adjustments are finally determined. A final determination through IRS settlement or litigation may require further amendments.

6. The payments required under the PMAR or Alternative Procedure bear interest at the normal underpayment rate. The 2% bump that applies in a section 6226 push-out does not apply.

7. Once a partner files a partner amended return, it cannot subsequently file another amended return without IRS permission. Reg. § 301.6225-2(d)(2)(vii)(B).

8. If the partnership subsequently makes a push-out election, the push-out statements disregard any approved modifications for purposes of determining the reviewed year partners' shares of the adjustments. Reg. § 301.6226-2(f)(2). However, the push-out statements must reflect any approved IU modifications with respect to reviewed year partners or indirect partners (this is for the benefit of any pass-through partner that chooses to pay an IU on its share of push-out adjustments). Reg. § 301.6226-2(e)(5). In the case of PMAR or Alternative Procedure modifications, the participating partners' correction amounts are determined by taking into account any taxes previously paid with the PMAR or Alternative Procedure. Reg. § 301.6226-3(b)(2)(ii)(A).

B. Drilling Down on Partner Amended Return Process

1. A PMAR requires a participating relevant partner to do the following:

a. First, the partner must file an amended return for the "first affected year" (the partner's taxable year that includes the end of the partnership's reviewed year) that takes into account **all** partnership adjustments, whether positive or negative (including DNR adjustments), that are properly allocable to such partner for the reviewed year. See IRC § 6225(c)(2)(A)(ii); Reg. § 301.6225-2(d)(2)(i). If there are multiple IUs, the amended return must reflect all adjustments relating to each of them, even if the partnership is requesting a PMAR only as to a particular IU. See Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6489-6490.

b. Second, the partner must file amended returns for any "modification years" for which any "tax attribute" of the relevant partner is affected by reason of taking into account the partnership adjustments in the first affected year. See Reg. §§ 301.6225-2(d)(2)(i) and -2(d)(2)(ii)(B); Reg. § 301.6241-1(a)(10) (defining "tax attribute").

(1) A modification year can come before or after the first affected year. Reg. § 301.6225-2(d)(2)(ii)(B).

(2) Note that the definition of "tax attributes" is broader than "specified tax attributes."

(3) **Example**. Assume that in year 5 the IRS makes a partnership adjustment with respect to the partnership's year 1 taxable year that increases partnership taxable income. The partner's allocable share of that adjustment, if taken into account in year 1 (the partner's "first affected year"), would increase the partner's taxable income. However, assume that such adjustment is fully offset by a year 1 NOL of the partner (a "tax attribute"). The additional NOL consumption in year 1 reduces the amount of NOL that previously was carried forward to the partner's taxable years 2, 3 and 4 (the "modification years"). The reduction in NOL carryforward obligates the partner participating in a PMAR to amend not only the partner's return for the first affected year (reflecting the adjustment and the increased NOL consumption), but also the returns for the modification years (reflecting the reduction in NOL carryforward), and to pay any additional taxes due in those years.

(4) Any adjustment to a relevant partner's tax attributes in the first affected year or any modification year that result from filing PMARs or using the Alternative Procedure are binding on the relevant partner, and a failure to make appropriate adjustments to tax attributes is treated as a failure to treat a PRI in a manner consistent with the partnership's return under section 6222. The partner cannot use the disclosure exception under section 6222(c). Reg. § 301.6225-2(d)(2)(ix).

2. The relevant partner's amended return tax liability is determined based on the partner's actual tax rate and facts and circumstances for such year, not the maximum tax rate required in computing an IU. The PMAR procedure and the Alternative Procedure allow a partner to use NOLs to offset adjustments that increase taxable income. By contrast, partner NOLs or other tax attributes cannot not reduce a partnership IU.

3. The Instructions for Form 8982 (Oct. 2020), p. 9, state that the PMARs must include the unique audit control number associated with the NOPPA, and the partner's payment must identify the payment as "Partner Payment for BBA Modification."

4. If a relevant partner takes into account its share of partnership adjustments on a partner amended return and the IRS approves the modification, the partnership's IU is determined without regard to such share of adjustments. <u>See</u> Reg. § 301.6225-2(f)(2), Example (2) (share of partnership adjustments taken into account on a partner amended return not included in the audited partnership's calculation of the total netted partnership adjustment).

5. Except in the case of a reallocation adjustment, it is not necessary that all partners file PMARs or use the Alternative Procedure in order to have the modification approved by the IRS as to any particular partner. Reg. § 301.6225-2(d)(2)(ii)(C). All partners affected by a reallocation adjustment must participate in the modification, either by way of a PMAR or the Alternative Procedure, in order for the modification to be approved, unless unusual circumstances are present. An example might be where a partner's share of a reallocation adjustment is separately modified based on the partner's tax-exempt status and excluded from the IU. <u>Id.</u>

6. The payment of taxes, interest and other amounts must made at the time the amended return is filed with the IRS. IRC § 6225(c)(2)(A)(iii); Reg. § 301.6225-2(d)(2)(ii)(A). The partnership must demonstrate to the IRS that the partner took into account its allocable share of all partnership adjustments for all IUs (if more than one IU is determined by the IRS for such partnership) on an amended return, made the required adjustments to tax attributes and filed partner amended returns for other "modification years" (whether before or after the reviewed year) as necessary to reflect adjusted tax attributes, and paid all taxes, interest and penalties due. Reg. § 301.6225-2(d)(2)(ii). **Full payment by the relevant partner of the additional amounts due is a precondition to getting IRS approval for the modification**. <u>See</u> Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 17.

7. In order for the partnership to meet its evidentiary burden, each relevant partner filing a PMAR must provide the PR with a certification on Form 8982 (Oct. 2020). The partner must certify (Part III of Form 8982) under penalties of perjury that all required amended returns have been filed and the date of filing; that all taxes, interest and penalties have been paid and the dates of payment; that the partner's allocable share of partnership adjustments as set forth in the NOPPA and all related tax attributes affected by the adjustments have been taken into account in determining the tax liability (or refund); and that no other unrelated items were adjusted in the amended return(s).

a. If the partner is an individual filing a joint return, both spouses must sign Form 8982.

b. The partner filing the amended return is only required to provide the Form 8982 affidavit to the partnership's PR, not to the IRS. The partnership files the Form 8982 with the IRS along with its Form 8980 modification submission.

c. Separate Forms 8982 must be provided by the participating partner for each reviewed year and, if the partner is receiving adjustments from more than one source partnership, separate Forms 8982 must be provided to each such partnership for each reviewed year.

d. The partner does not provide a copy of the amended returns to the PR.

e. Form 8982 does not require the partner to disclose the amounts paid with the amended return, or any other potentially sensitive information such as revised taxable income. This is an importance distinction relative to the Alternative Procedure, where Form 8982 (Section B, Part III) requires disclosure of revised adjusted gross income and revised taxable income for the first affected year. The PR and the partnership will see that information.

8. After the partner amended returns are filed with the Service Center where the partner normally files returns and all required payments are made, the PR files the Forms 8982 and the partnership's Form 8980 with the IRS.

9. The IRS will deny a modification request if it determines that the partnership failed to provide information that the IRS deemed necessary to substantiate the request (including supplemental requests for information), or that there was a failure "by any person to make any required payment" relating to a PMAR or Alternative Procedure modification. Reg. § 301.6225-2(c)(2)(i) (last sentence).

10. A partner must pay all penalties due with a modification amended return or the Alternative Procedure. To the extent the partner believes it has a reasonable cause defense or the penalty should otherwise be refunded, the partner must pay the penalties first and then file a claim for refund on Form 843, Claim for Refund and Request for Abatement. See Reg. § 301.6225-2(d)(2)(viii) (last sentence); Instructions for Form 8982 (Oct. 2020), pp. 8, 13.

11. The partner amended returns must be filed, all additional amounts due must be paid, and Forms 8982 and 8980 must be filed by the partnership, prior to the expiration of the 270-day modification period commencing on the date the NOPPA is mailed under section 6231 (unless that period is extended by the IRS). IRC § 6225(c)(7); Reg. § 301.6225-2(d)(2)(iii).

12. A partner amended return can also result in a claim for refund, such as from a reallocation adjustment that reduces a partner's share of income or gain or increases the partner's share of loss or deduction. However, as will be discussed later in this outline, no refund can be claimed if the partner uses the Alternative Procedure. <u>See</u> Reg. § 301.6225-2(d)(2)(x)(A) (modification request under Alternative Procedure is not a claim for refund with respect to any person); Instructions for Form 8982 (Oct. 2020), p. 13.

13. Unlike the additional reporting year tax (ART), which is an add-on or reduction to the partner's reporting year tax return liability in the context of an AAR push-out or a section 6226 push-out, payments made with a PMAR or Alternative Procedure are not reported on the partner's reporting year return. ART reporting is unique to push-outs.

C. <u>What Happens if the Partner Amended Return Adjustments are Later Changed Through Settlement or Litigation, or the IRS Subsequently Denies the Modification Request?</u>

1. Assume that, after a partner files a PMAR or uses the Alternative Procedure and pays the additional taxes due as a result of the partnership adjustments allocated to that partner, (i) the partnership settles with the IRS on some basis or litigates the adjustments, and the outcome would have resulted in a lower tax liability for the partner filing the amended return, or (ii) the IRS subsequently denies the partnership's modification request relating to the PMAR.

2. In that event, Reg. § 301.6225-2(d)(2)(vii)(C) provides that the restriction on the partner filing a subsequent amended return or claim for refund does not apply, and the partner may file a subsequent return or claim for refund. <u>See</u> Preamble discussion in the February 2019 Final Regulations, 84 Fed. Reg. at 6491-6492.

3. **However, the regulation is explicit that any such return or claim for refund is subject to the regular section 6511 period of limitations.** IRS and Treasury evidently concluded that the lifting of the section 6501 and 6511 periods of limitation in section 6225(c)(2)(D) should only apply to the initial assessment or refund relating to a PMAR or the assessment of tax paid under the Alternative Procedure. This means the participating partners should file protective claims for refund or otherwise keep their individual statutes open until these contingencies fully resolve.

D. <u>Partnership's Role in Partner Amended Return or Alternative Procedure Modification</u>

1. The audited partnership must provide the partner with all information necessary to prepare the PMAR or use the Alternative Procedure, including a description of all positive and negative adjustments and the partner's allocable share of such adjustments and any DNR adjustments.

2. The partnership also provides information about groupings, subgroupings, whether the adjustment was included in a general or specific imputed underpayment, and information about penalties attributable to each adjustment. <u>See</u> Instructions for Form 8982 (Oct. 2025), p. 5. As discussed below, such information would be needed for any pass-through partner that chooses to file a PMAR and pay an IU on its allocable share of the adjustments. <u>See</u> Reg. § 301.6225-2(d)(2)(vi)(A); Reg. § 301.6226-3(e)(4)(ii).

3. The Instructions for Form 8982 (Oct. 2020), pp. 1-2, 6, state that the partnership must file the Forms 8982 furnished by the participating partners with the IRS electronically together with its Form 8980 request for modification.

a. Note that Form 8982 must be manually signed by the participating partner (although the Form is a "fillable form"). The Instructions for Form 8982 state that the partnership must upload two separate files when it submits Form 8982 with Form 8980: (i) the completed fillable form, and (ii) a separate signature file which is a scanned pdf of the Form 8982 signature page.

E. Partner Amended Return Modification – Pass-Through Partners

1. The regulations permit (in accordance with IRS forms, etc.) a pass-through partner to implement an amended return modification as to its share of the audited (source) partnership adjustments. The pass-through partner files an amended return and pays an amount calculated in the same manner as the amount it would pay if it were to pay an IU on its share of push-out adjustments under Reg. § 301.6226-3(e)(4)(iii). See Reg. § 301.6225-2(d)(2)(vi)(A).

a. This option is also available to an opt-out partnership-partner, as well as the other types of pass-through partners identified in Reg. § 301.6241-1(a)(5). Id.

2. The amended return for the pass-through partner is made on Form 1065-X which, according to the Preamble to the June 2017 Proposed Regulations, is not an AAR, "but rather is a stand-alone document that is filed solely for modification purposes." 82 Fed. Reg. at 27354; see also Instructions for Form 1065-X (Dec. 2024), pp. 7-8, 13.

3. A pass-through partner can also use the Alternative Procedure. See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 17.

4. If a pass-through partner participates in a PMAR, it takes into account any adjustments that do not result in an IU on its partnership return for the taxable year that includes the date on which it makes the IU payment, in accordance with Reg. § 301.6225-3. See Reg. § 301.6225-2(d)(2)(vi)(B); Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 17.

5. Partnership adjustments taken into account on a pass-through partner's PMAR are not taken into account in the audited partnership's IU base, while at the same time making it unnecessary for its direct and indirect partners to file their own PMARs or use the Alternative Procedure. Indeed, the pass-through partner does not even send amended Schedule K-1s to its partners (or its shareholders or beneficiaries, in the case of S corporations, estates and trusts). Instructions for Form 8982 (Oct. 2020), p. 9. The buck stops at the pass-through partner level.

6. On the other hand, using the pass-through partner as a shield in this way may be more expensive because IU-type calculations often yield a higher-than-actual liability.

F. Pre-Approval Process – Modifications Relating to Partners of Pass-Through Partners

1. In determining the amount of the pass-through partner's amended return IU payment obligation, the pass-through partner may take into account modifications (rate, tax-exempt status, amended return, etc.) with respect to one or more of its own direct and indirect partners. Reg. § 301.6225-2(d)(2)(vi)(B). However, such modifications must be requested from the IRS **by the audited partnership and must be pre-approved by the IRS**.

a. See IRC § 6225(c)(2)(F) (as added by section 203(a) of the TTCA); Reg. § 301.6225-2(d)(2)(vi)(A), which cross-references Reg. § 301.6226-3(e)(4)(iii), which in turn expressly takes into account modifications approved with respect to a relevant partner holding its interest in the audited partnership through a pass-through partner); Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 16; Instructions for Form 8982 (Oct. 2020), p. 10 (see the discussion of Part I, line 6); see also the Preamble discussion of this point in the November 2020 Proposed Regulations, 85 Fed. Reg. at 74946.

2. The pre-approval process is described in the Form 8980 instructions (p. 16) and illustrated with an example.

a. In a nutshell, pre-approval means the PR first submits electronically, early in the process, a Form 8980 (including the indirect partner's Form 8982) requesting IRS approval of a modification (such as a PMAR) for the indirect relevant partner. The pre-approval request must not only describe the requested modification but also provide information about the audited partnership's and the pass-through partner's ownership structure and allocations relevant to the requested modification.

b. **Once the pre-approval is received**, the pass-through partner then files its own PMAR, calculating its IU payment obligation by taking into account the pre-approved modification with respect to its partner(s) (each an indirect relevant partner as to the audited partnership), and making the required PMAR payment.

c. The audited partnership then submits a second, supplemental Form 8980 to the IRS requesting a modification of the **audited partnership's IU** to reflect the PMAR filed by the pass-through partner, which took into account the pre-approved indirect partner PMARs or other modifications.

3. Pre-approval is not required if **all** partners of the pass-through partner participate in the audited partnership's modification request as relevant partners filing their own PMARs or using the Alternative Procedure. Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 16.

G. Other Aspects of Partner Amended Return Modification

1. The regulations and the required partner affidavit on Form 8982 (Part IV) (Oct. 2020) provide that the partner amended return takes into account only the partnership-related adjustments (and adjustments to partner tax attributes affected by the adjustments) and no other adjustments or corrections that the partner might wish to make. See Reg. § 301.6225-2(d)(1)(i); Reg. § 301.6225-3(d)(5), Example (5) (added by the December 2022 Final Regulations).

2. With the benefit of hindsight, a partner may be reluctant to re-up a penalties-of-perjury signing declaration – e.g., the partner may have discovered an error or possible error in its previously filed return at the time the partnership modification is sought, or bad law might have come out that undermines a position taken on the original return. The taxpayer would seem to be in a box here, because the regulations do not permit any other adjustments to the return and yet the amended return must be signed.

3. Taxpayers may not like having to file state and local amended returns simply to address a partnership adjustment.

H. "Alternative Procedure" to Filing Actual Partner Amended Returns

1. Under the Alternative Procedure, the participating relevant partner doesn't file an actual amended return, but comes close. The partner computes and pays all taxes, interest and penalties that would be required to be paid if the relevant partner had filed actual amended returns reflecting the partner's allocable share of all partnership adjustments in the NOPPA (both positive and negative, including DNR adjustments) for the first affected year and for all subsequent modification years, and provides a Form 8982 certification (with Schedule B completed) to the partnership. IRC § 6225(c)(2)(B); Reg. § 301.6225-2(d)(2)(x); Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 18. However, no refund can be claimed under the Alternative Procedure.

2. The relevant partner must agree to take into account any adjustments to any partner tax attributes resulting from the partnership adjustments. Reg. § 301.6225-2(d)(2)(x)(A). As is the case with an actual PMAR, no other partner-level adjustments can be taken into account.

3. While the Alternative Procedure makes it unnecessary for partners to file actual amended returns in the IU modification process, the numbers still have to be crunched. IRS instructions state that the partner should prepare pro forma returns in order to compute the required tax payments and maintain them as part of the partner's books and records. <u>See</u> Instructions for Form 8982 (Oct. 2020), p. 12.

4. The Preamble to the February 2019 Final Regulations (84 Fed. Reg. at 6495) and the TTCA Bluebook (p. 153) refer to the Alternative Procedure as a "pull-in" or "push-in" procedure, intending a contrast to the section 6226 "push-out" election.

a. The "pull-in" metaphor seems intended to evoke the partnership acting as the relevant partners' surrogate in submitting to the IRS information regarding the taxes they would owe if they had actually filed amended returns, accompanied by partner-funded payment of the resulting partner-level tax liabilities – i.e., the partnership "pulls in" the tax and tax calculation information from participating relevant partners and reports to the IRS on their behalf instead of either (i) the partners taking into account their shares of the adjustments by filing amended returns, or (ii) the partnership "pushing out" all the IU-related adjustments under section 6226 and letting the partners take it from there.

b. Yet, as this alternative approach has evolved in the regulations and forms, the partnership's role seems much the same as its role in a PMAR – it still has to provide the necessary information to the participating partners, receive back their affidavits on Form 8982, and transmit the Forms 8982 and the partnership's Form 8980 to the IRS.

c. In the end, the pull-in metaphor is not a good one, and no doubt this is why the regulations and forms abandoned it. (In an effort to imbue it with content when all hope seems lost, the McKee Nelson partnership treatise refers to **both** PMAR and the Alternative Procedure as "pull-in" procedures, viewing the partners as volitionally pulling in the partnership adjustments to their own returns as opposed to the partnership making the section 6226 election and pushing them out.)

5. The Instructions for Form 8980, Publication 5346 (Dec. 2024), p. 18, and for Form 8982 (Oct. 2020), p. 12-13, state that, in order for the IRS to approve the Alternative Procedure modification, a relevant partner must electronically pay all taxes due (and interest and penalties) as a result of taking into account the partner's distributive share of the adjustments for the first affected year and all modification years.

a. The partner must identify the remittance as "Partner Payment for BBA Modification."

b. With a regular partner amended return, by contrast, the relevant partner can pay the additional taxes due by any means. Instructions for Form 8982 (Oct. 2020), p. 9.

c. The relevant partner signs Section B of Form 8982 certifying that all partnership-related adjustments in the NOPPA have been taken into account (along with related adjustments to partner tax attributes) in determining the indicated tax liability, and that all taxes, interest and penalties due as a result of the Alternative Procedure have been paid. As with a PMAR, the partner provides Form 8982 to the PR, who submits it to the IRS along with the partnership's Form 8980.

6. The IRS has assessment authority with respect to Alternative Procedure payments even though an actual amended return is not filed. IRC § 6201(a)(1).

7. As noted, there is a significant drawback under the Alternative Procedure relative to filing PMARs: any refund that might result from taking into account negative partnership adjustments cannot be obtained under the Alternative Procedure. <u>See</u> Reg. § 301.6225-2(d)(2)(x)(A) (a modification request under the Alternative Procedure "is not a claim for refund with respect to any person"); Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6496; Instructions for Form 8982 (Oct. 2020), p. 13; Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 18.

a. A refund can only happen in the modification context by way of an **actual** partner amended return under section 6225(c)(2)(A).

b. The Preamble to the February 2019 Final Regulations states that permitting refunds only in connection with the filing of actual partner amended returns "allows the IRS to track the refund appropriately and ensure it is processed efficiently." 84 Fed. Reg. at 6496.

8. The Alternative Procedure resembles in some respects a section 6226 push-out election, which also does not require filing amended returns, but it avoids (as does a PMAR) the 200 basis point increase in underpayment interest that goes with a push-out. Still, the Alternative Procedure is an IU modification that must be approved by the IRS. If IRS determines that one or more participating partners did not compute their taxes, interest and penalties correctly, the partnership's modification request could be rejected and the partnership has an IU problem. With a push-out election, the partnership simply sends out the statements showing each reviewed year partner's share of the adjustments; what happens from then on is the partner's sole responsibility, and the partnership no longer has any IU risk as long as the election was valid and the push-out statements were timely and accurate.

9. Note: If the Alternative Procedure is used, the participating partner must disclose to the partnership the partner's **revised adjusted gross income and revised taxable income**. <u>See</u> Form 8982 (Oct. 2020), Section B, Part III. Some partners may be reluctant to disclose this information to the PR and partnership. Such disclosures are **not** required if partners file actual PMARs. <u>See</u> Form 8982 (Oct. 2020), Section A, Part III.

10. Pass-through partners choosing the Alternative Procedure do not file amended returns and do not issue amended K-1s to their partners, shareholders or beneficiaries. (Recall that if a pass-through partner chooses to do a PMAR and pay an IU at the pass-through partner level, the pass-through partner must file Form 1065-X.) Instead, the pass-through partner pays (electronically) an amount computed like an IU on its allocable share of the partnership adjustments, together with interest and penalties, and provides a Form 8982 to the audited partnership. <u>See</u> Instructions for Form 8982 (Oct. 2020), p. 12.

11. All relevant partners affected by a reallocation adjustment must file PMARs in order for the audited partnership to take advantage of a PMAR modification with respect to such adjustment. Reg. § 301.6225-2(d)(2)(ii)(C). A relevant partner using the Alternative Procedure is treated as having filed an amended return for this purpose, as long as the partner does so for the first affected year and all modification years. Reg. § 301.6225-2(d)(2)(x)(B).

12. As is true with a PMAR, the Alternative Procedure does not prevent the partnership from continuing to contest the partnership adjustments that enter into the modified IU and potentially modifying the adjustments in an IRS settlement or in a post-FPA judicial proceeding.

a. If this results in a taxpayer-favorable change to a partnership adjustment, the relevant partners who previously used the Alternative Procedure can savor their victory only by filing a claim for refund. (The prohibition on claiming a refund under the Alternative Procedure of taxes previously paid does not apply in this limited "had I known then what I know now" context.) As noted earlier, however, this time around the partner is fully subject to the section 6511 period of limitations (later of three years from the filing of the return or two years from the date of payment). To protect against these contingencies, it may be advisable to keep the partner's individual statute open or file a protective amended return or claim for refund. See Reg. § 301.6225-2(d)(2)(vii)(C); Instructions for Form 8982 (Oct. 2020), p. 13 (stating that an Alternative Procedure partner can file "an amended return based on a final court determination that reduces or eliminates an [IU], or protective claim filed in anticipation of a final court decision," in which case the partner "must use the pro forma revised taxable income from the first alternative procedure as the starting point for [the partner's] subsequent alternative procedure or amended return").

b. Section 6234(c) gives the court jurisdiction to redetermine PRIs, the proper allocation of such items among partners, and applicability of any penalties or additions to tax or additional amounts for which the partnership may be liable under subchapter C. However, section 6234(c) does not authorize the court to order a refund of tax paid by partners who participated in a PMAR or the Alternative Procedure.

VIII. NON-INCOME ADJUSTMENTS CAN RESULT IN AN IU

A. Overview

1. One of the more shocking aspects of the BBA, as interpreted by the regulations, is that an adjustment to a non-income, non-expense item on a partnership return or K-1, including attached schedules – e.g., Schedule L balance sheet items, liability allocations, liability character determinations, section 743(b) adjustments, section 751 amounts, tax capital accounts – can result in a positive adjustment, or even **two** positive adjustments, and thus can result in an IU. See Preamble to November 2020 Proposed Regulations, 85 Fed. Reg. at 74945 (non-income adjustments include adjustments to items that are not items of income, gain, loss, deduction, or credit, such as partnership assets, liabilities, and capital accounts and other items that are shown on the partnership return or maintained in its books and records).

2. Indeed, the Preamble to the December 2022 Final Regulations unabashedly admits that "the adjustments could result in an imputed underpayment in situations where no income would have been recognized if the item had been correctly reported originally." 87 Fed. Reg. at 75478.

3. This derives from a literal interpretation of a very broad PRI definition: "any **item or amount** with respect to a partnership" required to be shown or reflected on the partnership return or K-1s (or required to be maintained in its books and records) that is "relevant in determining the tax liability of any person under chapter 1," and any partner's "distributive share of such item or amount." IRC § 6241(2)(B); Reg. § 301.6241-1(a)(6)(ii); see, e.g., Reg. § 301.6241-1(a)(6)(v)(E) (a PRI includes the amount and character of partnership liabilities and any change in such liabilities from preceding year) and Reg. § 301.6241-1(a)(6)(v)(D) (a PRI includes basis, character, type and value of partnership assets).

a. Neither section 6241(2)(B) nor the regulations purport to define "item."

4. Thus, there may not be any direct correlation between the adjusted non-income item and the partners' taxable incomes – adjustments to partner liability allocations being a prominent example. This is yet another way that an IU can become wildly inflated relative to the actual partner tax consequences of partnership adjustments. Commenters on the November 2020 Proposed Regulations criticized this result, but IRS and Treasury determined that it was called for given the structure of section 6225 and the broad definition of PRI, which includes many non-income items. See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75475-75479.

5. There are many other possibilities in this "money adjustment" house of horrors. The notion can be carried to an insane extreme – e.g., a single PRI adjustment to income or expense has ripple effects that can result in many line item numerical changes on Form 1065 and the K-1s. Clearly, such secondary line item changes stemming from an adjustment to partnership income or expense should not themselves be adjustments to "PRIs" that ladle more positive adjustments into the IU stew. See Reg. § 301.6241-1(a)(6)(v) (illustrative examples of PRIs give no suggestion that ripple-effect line item changes from an adjustment to partnership income, expense and credit items constitute PRIs in and of themselves); See Jenni Black, The Imputed Underpayment: Treating Adjustments as Zero Under the BBA, 185 Tax Notes Federal 679 (Oct. 28, 2024).

6. IRS representatives reportedly have said that any "money adjustment" on a return can result in a positive IU adjustment, which could include, for example, a reclassification of an asset on the Schedule L balance sheet. See Instructions for Forms 8985 and 8985-V (Dec. 2024), p. 8 (stating that "[a]ny adjustment to a balance sheet item is treated as a positive adjustment").

a. What about an adjustment to a PRI that appears on the Form 1065 but that cannot be expressed in dollars, such as whether a partner is a general or limited partner? Such "fact adjustments," even though they involve a PRI, cannot themselves provide the basis for a partnership adjustment that "results in" an IU. However, they may lead to a dollar-denominated PRI adjustments, e.g., a partner's limited partner status can affect SECA and section 752 and section 704(b) allocations. See CCA 202148006 (Nov. 24, 2021) (expressing the view that an adjustment to gallons eligible for fuel credit is a nonmonetary adjustment – as the CCA puts it, it is not a "money number" – and therefore cannot give rise to an IU).

7. Remember that adjustments that **decrease** non-income, non-expense items that could have an affect on a partner's chapter 1 tax liability, but are not themselves elements of taxable income, do not constitute a negative adjustment as technically defined in Reg. § 301.6225-1(d)(1)(ii) and thus default to positive adjustments. See Reg. § 301.6225-1(d)(2)(ii) and (iii) (defining positive adjustment as any adjustment that is not a negative adjustment; defining negative adjustment to mean, among other things, any adjustment that decreases an item of income or increases an item of expense, but omitting an adjustment that decreases a non-income, non-expense item).

8. Adjustments to such items fall into the "residual grouping" because they derive from an item that could not be allocated to a partner under section 704(b). See Reg. § 301.6225-1(c)(5)(ii).

9. The IRS wants taxpayers to draw comfort from the IU anti-duplication rules, which give the IRS the discretion to disregard an adjustment the effect of which is reflected in one or more other partnership adjustments, and allow the partnership (in the context of an AAR or a pass-through entity paying an IU on push-out adjustments) to disregard a positive adjustment that relates to, or results from, another positive adjustment. In the latter case, however, the IRS can override the partnership's determination. Reg. § 301.6225-1(b)(4).

B. Some Examples of Non-Income, Non-Expense Items

1. The scope of potential non-income adjustments, as the IRS and Treasury have come to see it, is fully revealed in Example (3) of Reg. § 301.6225-3(d)(3). Example (3) was promulgated as part of the December 2022 Final Regulations, almost four years after the February 2019 Final Regulations adopted the current PRI definition, including its requirement that the determination of whether an item or amount is "relevant" in determining the chapter 1 tax liability of "any person" is made "without regard to whether [the] item or amount, or an adjustment to such item or amount, has an effect on the chapter 1 tax liability of any particular person under chapter 1." See Reg. § 301.6241-1(a)(6)(ii)(A) and (iv). Example (3) holds that a decrease in the basis of a partnership's nondepreciable asset from $100 to $90 is treated as a $10 positive adjustment, even though the asset was not sold during the reviewed year and the overstatement of nondepreciable basis ordinarily would not have had an immediate tax impact on any reviewed year partner.

2. Example (4) of Reg. § 301.6225-3(d)(4), also promulgated in the December 2022 Final Regulations, involves an IU resulting from a recharacterization of a recourse liability to a nonrecourse liability. The IRS determined two positive adjustments (one for the increase in nonrecourse liabilities and the other for the decrease in recourse liabilities) and determined to ignore one of them for IU purposes. The example is devoid of facts indicating that the recharacterization would have resulted in immediate income or gain recognition for any reviewed year partner under sections 731, 752(b) or 465(e), or loss disallowance under section 704(d) or section 465.

a. See also CCA 202436012 (April 10, 2024) (adjustment to the amount of a partner's contributions to a partnership is a non-income positive adjustment resulting in an IU); CCA 202417014 (Jan. 11, 2024) (adjustment to a partnership's "QBI"– referring to "qualified business income" under section 199A – is treated as a positive adjustment under Reg. § 301.6225-1(d)(1)(iii) unless the IRS determines under Reg. § 301.6225-1(b)(4) that the adjustment is already reflected in other positive adjustments; CCA does not provide any facts relating to the circumstances of the adjustment); CCA 202148006 (Nov. 24, 2021) (emailed advice stating that inclusion in IU does not depend on "whether/how/if" the adjusted item would be taxed at the partner level; the pivotal issue is whether a change is made to a "money number" on the return).

b. The IRS expects taxpayers to take solace in the anti-duplication rules, which is all well and good if they are liberally invoked by the IRS and, when partnerships affirmatively assert Rule No. 2, the IRS uses great restraint in exercising its override authority. This will be essential when – not if – potential line item adjustments multiply like rabbits.

3. There are, of course, many other items shown on a return that are numerically expressed and thus a possible candidate for treatment as a "partnership adjustment" if incorrectly stated. Consider the following example borrowed from Example 2 in Corey Dalton's rubber-meets-the-road article, A Partnership-Partner Received a Push-Out Statement: Now What?, 187 Tax Notes Federal 471, 474 (April 21, 2025). Assume the IRS makes a $100 downward adjustment to ordinary business income reported on line 1 of the K-1s. The IRS also makes an equal downward adjustment to the amount reported in line 20, Code Z (section 199A ordinary income and loss). The primary adjustment unquestionably involves a PRI; the secondary QBI adjustment presumably also fits the bill as a technical matter. Both are shown on the partnership return and both are relevant to determining the partners' chapter 1 tax liabilities.

a. The line 20, Code Z amount is for informational purposes to assist the partners in recomputing their section 199A deduction; it tells the partners that the decrease in ordinary business income reduced QBI by the same amount. So how is the QBI adjustment treated under the BBA? If viewed as a "decrease in an item of income," it is a negative adjustment. This would result in two negative adjustments, neither of which "results in" an IU, and both would both roll forward to the partnership's adjustment year return. Reg. § 301.6225-1(f)(2). They could not be the subject of a push-out election because the adjustments do not result in an IU and are not associated with an IU. IRC § 6226(a)(1); Reg. § 301.6226-1(b)(1) (reviewed year partners take into account their shares of adjustments "associated with the IU").

b. However, since the line 20, Code Z adjustment decreases the amount of reported "trade or business income" (QBI) for section 199A purposes, it might be viewed as an informational non-income adjustment that defaults to a positive adjustment under Reg. § 301.6225-1(d)(2)(iii). If so, then that adjustment, even though directly related in the but-for sense to the negative adjustment to line 1 income, cannot be disregarded for IU purposes unless the IRS chooses to disregard it (solely for IU purposes) under Reg. § 301.6225-1(b)(4) on the basis that the "effect" of the QBI adjustment is "reflected" in the primary income adjustment, which is negative. However, the IRS ought to disregard it, and the partnership would take into account both DNR adjustments in the adjustment year.

c. Alternatively, the partners could request PMAR or Alternative Procedure modification of the DNR adjustments, in which they would get the tax benefits of the adjustments in the reviewed year. Reg. § 301.6225-2(e).

d. CCA 202417014, discussed above, states that the field's proposed QBI adjustment would give rise to a positive adjustment for IU purposes. That outcome makes sense – at least within the apparent intent and structure of the regulations – if the QBI adjustment merely recharacterizes partnership income (e.g., from QBI to non-QBI). The decrease in QBI could be treated as a positive "character" adjustment that enters the IU calculation. However, if the QBI adjustment simply tracks another adjustment that increases or decreases reported taxable income, arguably both adjustments are adjustments to an "item of income." In that case, if they are increases, both are positive adjustments, and the IRS presumably would use its discretionary authority to disregard the QBI adjustment for IU purposes. If they are decreases, both are negative adjustments and taken into account in the adjustment year.

C. Liability Character Adjustment – Example (4), Reg. § 301.6225-3(d)(4)

1. Example (4) of Reg. § 301.6225-3(d)(4) was added by the December 2022 Final Regulations and is effective for taxable years ending on or after November 20, 2020. See Reg. § 301.6225-3(e)(1).

2. Facts of Example (4). An IRS audit of a partnership's 2020 return results in a $1,000 liability's tax classification being changed from recourse to nonrecourse. In the BBA world this involves two separate adjustments: one adjustment is a $1,000 increase in nonrecourse liabilities of $1,000 (zero before, $1,000 after) and the other is a $1,000 decrease in recourse liabilities ($1,000 before, zero after). [A parenthetical in the example incorrectly refers to a "decrease" to nonrecourse liabilities and an "increase" to recourse liabilities.] The Example is silent as to the partners' outside bases and the manner in which the liability was originally allocated under section 752.

3. Under Reg. § 301.6225-1(d)(2)(iii), **both of the liability adjustments are positive adjustments by default,** since they do not involve, and are not deemed to be, a "decrease in an item of income" and drop out of the narrowly defined category of "negative adjustments." However, the Example states that the IRS exercises its discretion under Reg. § 301.6225-1(b)(4) to treat the positive increase-in-nonrecourse-liabilities adjustment as zero for solely for IU purposes because the effect of such adjustment is already reflected in the recourse liability positive adjustment.

4. Under the assumed facts, the IRS permits a **negative credits** adjustment of $400 to offset the IU resulting from the $1,000 positive adjustment, which, due to the assumed 40% rate, exactly zeroes out the IU. Without the fortuity of the credits adjustment, however, the entire amount of the liability recharacterization would have resulted in an IU, without regard to whether it caused any reviewed year partner to recognize taxable gain or have losses disallowed under section 704(d).

a. To understand how a "negative" adjustment to credits can offset the liability-adjustment IU, one must appreciate the fact that an **increase** in tax credits (like other taxpayer-favorable adjustments) is treated as a negative IU adjustment. Reg. § 301.6225-1(d)(2)(ii). This makes sense once you get accustomed to the regulatory rulebook. Unfortunately for the reader, the increase in credits which leads to the "negative" IU adjustment must be inferred from the facts of Example (4).

b. Example (4) states that the negative increase-in-credits adjustment and the positive liability adjustment do not "result in" an IU because they net out to a zero IU. See Reg. § 301.6225-1(f)(1)(ii). Consequently, there is no IU on these assumed facts, and both adjustments are taken into account in **2022**, the adjustment year. See Reg. § 301.6225-1(f)(2). In that year, they are subject to the normal pass-through rules of subchapter K, subject to the caveat that, under Prop. Reg. § 1.704-1(b)(4)(xiii), the allocation of such items is deemed to be in accordance with PIP if allocated in the manner in which the items would have been allocated in the reviewed year, treating successors as reviewed year partners. See Reg. § 301.6225-3(c).

(1) Example (4) does not specifically refer to the credits adjustment being taken into account in the adjustment year, but the reference to "both adjustments" not resulting in an IU appears to refer to the liability adjustment and the credits adjustment, as opposed to the two up-and-down liability positive adjustments. The net negative adjustment to credits should be reported on the 2022 return as a separately stated item. See Reg. § 301.6225-3(b)(3).

(2) The conclusion that the credits adjustment rolls forward where a net negative credits adjustment fully offsets an IU is made explicit in the Preamble to the June 2017 Proposed Regulations, 82 Fed. Reg. at 27351 (as you read this, bear in mind that the paragraph -1(f)(1) and (2) rules were originally proposed as paragraph -1(c)(2)).

5. There may be a disconnect between Reg. § 301.6225-1(e)(3)(ii) and Example (4) which is worth discussing, not because the facts of Example (4) are likely to occur in the real world, but because it helps to flesh out an important concept in the regulations: adjustments that result in an IU and those that do not.

a. Net negative adjustments generally do not result in an IU and are taken into account by the partnership in the adjustment year. See Reg. § 301.6225-1(e)(4)(ii); Reg. § 301.6225-1(f)(1)(i). However, Reg. § 301.6225-1(e)(3)(ii) permits the IRS to override this general rule in the case of negative credit adjustments and allow them to be taken into account in the IU calculation. This may be one reason why the definition of DNR adjustments in Reg. § 301.6225-1(f)(1) contains the introductory caveat "except as otherwise provided in paragraph (e)."

b. Even though the $400 negative adjustment to credits in Example (4) is taken into account by the IRS and fully offsets the $400 liability adjustment IU, the Example concludes that the negative credits adjustment does not "result in an IU" under the "zero or less than zero" rule. Thus, such adjustment, along with the liability adjustment, must be taken into account in the adjustment year. The same analysis is employed in Examples (3) and (5) of Reg. § 301.6225-3(d), which involve an adjustment to the basis of a partnership asset, with the IU attributable to that adjustment being fully offset by a negative increase-in-credits adjustment. Because the credits adjustment zeroes out the IU, both the credits adjustment and the basis adjustment are pushed forward to the adjustment year, which means the IU calculation ends up being pro forma only. See Reg. §§ 301.6225-1(f)(2) and 301.6225-3(a) and (b)(3).

c. Paragraphs (e)(3)(ii) and (f)(1)(ii) can be harmonized in the context of negative credit adjustments by construing paragraph (e)(3)(ii) as subject to override by paragraph (f)(1)(ii) if the effect of allowing the negative credits adjustment in the IU calculation is to reduce the IU to zero or less than zero. In other words, if the IRS allows a net negative credit adjustment which merely **reduces the IU** but does not eliminate it altogether, it is treated as an adjustment that "results in" an IU and therefore does not roll forward to the adjustment year.

6. Since the liability-related adjustments in Example (4) are not adjustments to income, gain, loss, deduction or credit, Reg. § 301.6225-3(b)(8) requires them to be taken into account on the partnership's 2022 adjustment year return, "but only to the extent the item would appear on the adjustment year return without regard to the adjustment."

a. What does this mean exactly? It means that if the liability was paid off after the reviewed year and prior to the adjustment year, no adjustment is made in the adjustment year. But if the liability is still around in the adjustment year, the character adjustment is made on the 2022 return. The example illustrates the point by stating that if $500 of the liability is paid off in 2021, the partnership only makes a $500 character adjustment in 2022, changing the remaining $500 liability from recourse to nonrecourse.

7. Because both adjustments get pushed into the adjustment year, partners who were allocated a share of the liability in the reviewed year based on the incorrect recourse characterization presumably suffer whatever adverse section 752(b)/465 tax consequences come with that recast only in 2022 and subsequent years (e.g., loss of outside basis and/or at-risk amount, potential gain recognition under sections 752(b) and 731, at-risk recapture under section 465(e)).

a. If this is a fair reading of Example (4), the result is that any partners who benefited from erroneously treating the liability as recourse were let off the hook for 2020 and 2021. However, this is solely due to the fact that Example (4) conveniently assumes that the IRS exercises its discretion to allow a negative credits adjustment to zero out the tentative IU, which then causes both the liability adjustment and the negative increase-in-credits adjustment to roll forward to 2022.

8. Assume that the facts of Example (4) are modified so that there was no negative credits adjustment, or, if there was, the IRS decided not to allow the adjustment to offset the IU resulting from the positive liability adjustment, thereby pushing the credits adjustment into the adjustment year. In that event, the partnership would have a reviewed year IU from the liability adjustment unless it pursued PMAR modification or did a push-out.

(1) If the partnership paid the IU, the IRS would have been indifferent to letting the partners off the hook for 2020 and 2021; it would have collected more than its pound of flesh at the partnership level as opposed to the partner level.

b. Assume, instead, that the negative credits adjustment were $399 instead of $400, so that the 2020 calculation produced an IU of one dollar. Assume that the IRS allowed the credits adjustment to offset the IU. In that event, the credits adjustment and the positive liability adjustment would have "resulted in an IU" of $1, and the only adjustment that would be taken into account in the adjustment year is the remaining positive liability adjustment (which was disregarded by the IRS solely for IU purposes). Any partners who would otherwise have suffered adverse tax impacts in

2020 and 2021 from the liability recast do not get away with murder; the IU consumed their valuable tax credits.

c. If the IRS were to commence a BBA audit for 2021 and make the same liability character adjustment, the partnership and all partners would be bound by the final resolution of the 2020 proceeding pursuant to section 6223(b)(2), and presumably would be similarly bound in 2021, absent a change in facts or law.

9. Example (4) was added by the December 2022 Final Regulations, and thus presumably reflects the government's latest thinking on liability-type adjustments. The odd fact pattern was apparently contrived to illustrate two main points: (i) the new rule in Reg. § 301.6225-1(f)(1)(ii) (first proposed in the November 2020 Proposed Regulations) that all partnership adjustments that net to produce a zero or negative IU must be carried forward to the adjustment year, and (ii) how a liability recharacterization adjustment is given effect in the adjustment year.

a. The more important takeaway, though, is that liability recharacterization adjustment can result in an IU without regard to whether the resulting section 752 liability shift caused any reviewed year partner to recognize outside gain or suffer loss disallowance. <u>See</u> Preamble to the December 2022 Final Regulations, 87 Fed. Reg. at 75476. This is an extraordinary outcome – in the absence of a push-out, partners bear the economic burden of what is effectively a tax on non-income, determined in a vacuum without regard to real partner-level tax consequences. They bear that burden either because the partnership pays an IU liability with no credit offset, or, if credit offset is allowed, the partnership pays the IU by consuming valuable credits. But, because liability character **potentially** could impact the partners' chapter 1 tax liability, the government believes that it satisfies the PRI "relevancy" test, and, since the liability is expressed in dollars, the IRS has a positive IU adjustment to play with.

D. <u>Liability Character Adjustment – Example (7), Reg. § 301.6225-1(h)</u>

1. Example (7) of Reg. § 301.6225-1(h) also involves a liability recharacterization adjustment, but offers a somewhat different rationale.

a. (It should be noted that when Reg. § 301.6225-1 was revised in 2022, Example (7) was not revised to conform to the amendments – specifically, it refers to Reg. § 301.6225-1(d)(2)(iii)(B), which was deleted by the 2022 amendments. <u>See</u> Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75479 (explaining the reason for the deletion).)

2. In Example (7), a partnership reported a liability of $100 on its 2020 return and classified it as recourse. The IRS reclassified it as nonrecourse, which results in a $100 positive adjustment that cannot be allocated under section 704(b) and falls in the residual grouping. Reg. § 301.6225-1(c)(5)(ii). The adjustment is then multiplied by an assumed 40% maximum tax rate to arrive an IU of $40. Like Example (4), no information or assumptions are provided regarding the partners' bases in the partnership or how the partnership allocated the liability among the partners on the K-1s.

3. Example (7) states that this adjustment is treated as a "$100 increase in income" (a positive adjustment) because such recharacterization "could result in up to $100 in taxable income if taken into account by any person." The rationale for this assumed worst-case scenario appears to be rooted in now-deleted Reg. § 301.6225-1(d)(2)(iii)(B), which provided that a non-section 704(b) adjustment that "<u>could result</u> in an increase in income or decrease in a loss, deduction or credit of any person <u>without regard to any particular person's specific circumstances</u>" is treated, as appropriate, either as a positive adjustment to income or to a credit. (Emphasis added.)

a. A similar notion appears in the current PRI definition, which requires that the item be "relevant in determining the tax liability of any person under chapter 1" (Reg. § 301.6241-1(a)(6)(ii)(A)), but the determination of relevancy is made "without regard to whether [the item or amount or an adjustment thereto] has an effect on the tax liability of any particular person under chapter 1" (Reg. § 301.6241-1(a)(6)(iv)).

4. Compare this to the rationale cited in Example (5) of Prop. Reg. § 301.6225-4(e), where a partnership liability was originally reported as a nonrecourse liability and the IRS determines it to be a recourse liability. Unlike Examples (4) and (7), Example (5) provides information about partner tax consequences: the recast causes partner A, who is stated to have a zero outside basis, to go from a $100 liability share to a zero share. The Example states that this results in a "$100 income inclusion in the residual grouping to account for the cumulative effects of these adjustments … under §§ 1.752-1(c) and 1.731-1(a)(1)(i)."

a. Example (5) tells you there is an immediate dollar-for-dollar tax impact on partner A from the liability shift from A to B, and that is the amount of the adjustment. Example (7), on the other hand, doesn't speak in terms of a taxable liability shift; instead, it takes the draconian approach of treating the entire amount of the liability as a positive adjustment solely because it could cause up to $100 of income recognition by any partner.

b. Example (5) also concludes that the IU expenditure (40% assumed rate multiplied by the $100 positive adjustment in the residual grouping) is allocated to partner A under Prop. Reg. § 1.704-1(b)(2)(iii)(f)(4) "because A would have borne the economic burden of the partnership adjustment if the partnership and its partners had originally reported in a manner consistent with the partnership adjustment." (Example (5) assumes that the partnership does not request modification under Reg. § 301.6225-2.)

5. Note that Example (7), unlike Example (4), does not analyze the liability character adjustment (from recourse to nonrecourse) as involving two positive adjustments (one implementing the correct character and the other reversing the incorrect character, and each being equal to the full amount of the liability). Reg. § 301.6225-1(c)(6)(iii). (Recall that in Example (4), the IRS exercised its discretion to disregard for IU purposes the positive adjustment to implement the nonrecourse character.) Example (7) simply states that the character reclassification results in a "$100 increase in income" and a single corresponding positive adjustment.

6. Example (7) could also have been analyzed as a liability "reallocation" adjustment based on the resulting change in the section 752 liability allocation. Under this approach, the positive adjustment would equal the net decrease in liability share for the partners who were allocated the liability based on the incorrect recourse character ("net" meaning net of their post-adjustment shares of the nonrecourse liability), with a second positive adjustment attributable to the net increase in any partner's liability share, but which presumably would be disregarded on the ground that it is "related to, or results from" the first positive adjustment under Reg. § 301.6225-1(b)(4).

a. CCA 202444004 (July 19, 2023), discussed earlier, adopts this approach. It determined the amount of the liability reallocation adjustments (the reason for which is not explained in the CCA) as being equal to the liability shift among the partners. Specifically, the decrease in liability share for the partner who was over-allocated gives rise to one positive adjustment, and the increase in liability share for the partner who was under-allocated gives rise to another positive adjustment, with the field having the discretion to disregard one of them.

7. Another liability character adjustment (not mentioned in any of the examples) would be one that recharacterizes qualified nonrecourse financing under the section 465 at-risk rules as nonqualified.

E. Effect of Liability-Related Adjustments on Partners

1. What happens to the partner who was allocated the debt under the improper recourse or nonrecourse liability characterization if the partnership pays an IU on the positive adjustment resulting therefrom? Suppose the partner had an outside basis of zero, and the recharacterization would cause a taxable liability shift. An IU payment by the partnership ordinarily means that the underlying partnership adjustments do not flow through to the partners.

a. A partner's outside basis is not a PRI, although it is affected by PRIs. Could the IRS audit a partner and assert a zero outside basis with attendant section 731 gain recognition, relying on the liability determination in the partnership proceeding, which is binding on the partners under section 6223(b)(2)? This seems contrary to the notion that adjustments contributing to a partnership-paid IU do not pass through to the partners and cause havoc there too. What about the partners' subsequent taxable years?

2. Under the August 2018 Proposed Tax Attribute Regulations, "notional items" are not created for items that result in an IU but are not allocated under section 704(b). Thus, there is no outside basis increase for the partners under Prop. Reg. § 301.6225-4(b)(6)(iii)(A). See Prop. Reg. § 301.6225-4(b)(4)(ii).

a. This is confirmed by Prop. Reg. § 301.6225-4(e), Example (5)(ii) in the context of the nonrecourse-to-recourse adjustment. The Example states that no notional items are created since the adjustment is not allocated under section 704(b). Instead, "specified tax attributes" are adjusted in a manner that is consistent with how the partnership adjustment would have been taken into account under the partnership agreement … taking into account all facts and circumstances." Example (5) concludes that "[i]n this case, no specified tax attributes are adjusted."

3. If, instead, the partnership pushes out the positive and negative liability adjustments under section 6226, the reviewed year partners would report and pay correction amounts with their reporting year returns for the first affected year (and any intervening years for which tax attributes are affected) due to any section 731/752(b) gain, section 465(e) recapture, or loss disallowance under sections 704(d) or 465 that results from taking the liability adjustments into account at the partner level.

a. The partnership and the partners are bound by a final determination, e.g., an IRS settlement, in any proceeding brought under the BBA. IRC § 6223(b)(2); Reg. § 301.6223-2(a). Thus, regardless of whether the partnership pays an IU or pushes out, the liability recharacterization adjustment would presumably be viewed as binding on the partnership and the partners with respect to future taxable years, absent a change in facts or law.

b. The reviewed year partners and the partnership would also adjust their partner and partnership tax attributes that are affected by the push-out adjustments to the extent not already adjusted as part of the partnership adjustment. Prop. Reg. § 301.6226-4(b).

4. Amended Return Modification Alternative?

a. If the partnership becomes aware of the liability mischaracterization before the IRS issues a NAP (e.g., during the minimum 30-day period following the issuance of Letter

2205-D), it could correct the error voluntarily by filing an AAR and pushing out the liability adjustment to the partners.

b. After a NAP is issued, the partnership could deal with a liability-character adjustment by requesting a modification based on the reviewed year partners filing amended returns (or use of the Alternative Procedure) for the first affected year and any modification years where tax attributes are affected, and reporting all tax due (plus interest and penalties) based on the recharacterized liability and attendant liability reallocation among the partners with their reporting year returns. IRC § 6225(c)(2)(A); Reg. § 301.6225-2(d)(2).

c. The amended returns might reflect no tax due (e.g., the partner's liability share increased or remained at zero), or it might reflect outside section 731(gain) if the partner had a negative tax capital account and lost liability share as a result of the adjustment.

(1) Cf. Reg. § 301.6225-3(d)(5), Example (5) (illustrating the effect of a PMAR in the case of a partnership adjustment that reduces the basis of a nondepreciable partnership asset).

(2) The IRS has to approve the PMARs. The PR must provide the IRS with documentation that the affected partner(s) filed the amended return(s) and paid all tax, penalties and interest due. The same is true with the Alternative Procedure. See IRC § 6225(c)(2)(B); Reg. § 301.6225-2(d)(2)(x).

(3) Could a liability reallocation be viewed as a "reallocation adjustment" to the extent it changes the manner in which the partnership liability was allocated for section 752 purposes among the partners? If so, all affected partners would have to file PMARs (or use the Alternative Procedure). See Reg. § 301.6225-1(c)(2)(i) (defining a "reallocation adjustment" as any adjustment that allocates or reallocates a PRI to and from a particular partner or partners and assigning such adjustments to the "reallocation grouping"); but see Reg. § 301.6225-1(c)(5)(ii) (assigning adjustments to PRIs not allocated under section 704(b) to the residual grouping); section 6225(c)(2)(C) and Reg. § 301.6225-2(d)(2)(ii)(C) (each referring to the partners' "distributive shares" of the reallocation adjustment, a term not ordinarily used to refer to partner liability allocations under section 752); CCA 202444004 (July 19, 2023).

(4) Partner tax payments made in connection with PMAR and Alternative Procedure modifications are subject to the normal underpayment interest rate, thus avoiding push-out hot interest.

(5) The PMAR and Alternative Procedure modifications require the participating reviewed year partner to pay the tax attributable to the partner's share of the adjustments before they have been finally determined. If the proposed liability recharacterization reflected in the amended return is ultimately not adopted in a final court decision or IRS settlement, the partner would need to file a refund claim within the normal section 6511 period of limitations. See Reg. § 301.6225-2(d)(2)(vii)(C).

F. Shift of Basis from Depreciable Property to Land

1. Assume that in year 3, the IRS audits a partnership's year 1 return and proposes a partnership adjustments that reallocate $100 of a partnership's claimed $500 basis in a building to the underlying land and adjusts year 1 depreciation expense accordingly. Assume a 10-year depreciation schedule. The partnership claimed depreciation in year 1 of $50, but it should have been $40. The parties agree to the adjustments. No push-out election is made. The IRS does not examine year 2.

2. The basis reallocation could be viewed as two $100 positive adjustments to the Schedule L balance sheet (assume the balance sheet is maintained on a tax basis) that fall into the residual grouping. The amounts are relevant to the partners' chapter 1 tax liability, and they are shown or reflected on the partnership's return; thus, they constitute PRIs. The decrease in building basis produces one positive adjustment, the increase in land basis produces another positive adjustment. (All non-income adjustments are treated as positive IU adjustments.) See Reg. § 301.6225-3(d), Example (3) (decrease in basis of nondepreciable asset from $100 to $90 treated as a $10 positive non-income adjustment; the example does not involve a basis reallocation, just a straight basis reduction).

a. The tax basis of assets is required to be maintained in the partnership's books and records and thus constitutes a PRI under Reg. § 301.6241-1(a)(6)(iii) independent of how it is reported on Schedule L.

3. Because the two positive adjustments are related, one of them will generally be treated as zero solely for IU purposes unless the IRS determines that an adjustment should not be treated as zero. Reg. § 301.6225-1(b)(4). The IRS should not override this default in this circumstance.

4. Separately, the IRS adjusts the claimed year 1 building depreciation downward by $10 (1/10 of $100), consistent with the basis shift. A reduction of depreciation expense is treated as an increase in an item of income and thus is a positive adjustment. Reg. § 301.6225-1(d)(2)(i)(D). Under Reg. § 301.6225-1(b)(4), the IRS should either disregard $10 of the basis adjustment on the ground that it is reflected in the $10 increase in income from the depreciation adjustment, or it should disregard the depreciation adjustment. Either way, the resulting IU should be $100 (not $100 + $10).

5. Assume the partnership pays an IU of $37 (37% x $100).

6. The partners' year 1 tax returns would still reflect the $10 of erroneously claimed depreciation; no change is made to those returns because the partnership chose to pay an IU rather than push-out or request modification by PMARs. Their year 2 returns similarly reflect $10 of erroneously claimed depreciation in that year, but the IRS does not examine the partnership's year 2 return. The year 1 IU payment effectively recaptured the $20 of excess year 1 and year 2 depreciation deductions, and prepaid (at the highest possible tax cost) for the future excess depreciation deductions. So when do the partners get the benefit of the bought-and-paid-for $100 basis, which is now relocated to the land?

7. Under proposed regulations, the basis reallocation and the year 1 depreciation adjustment would be reflected by restating prospectively the respective building and land bases on the partnership's adjustment year return, but taking into account the adjusted year 1 depreciation and the actual year 2 depreciation reported on the year 2 return (which the IRS did not examine). Thus, the building's basis would be adjusted from the reported $400 basis ($500 minus $50 of reported depreciation in each of years 1 and 2) to $310 ($500 - $100 basis adjustment = $400; $400 - $40 of adjusted year 1 tax depreciation and $50 of unadjusted tax depreciation claimed in year 2 = $310). The partners will not enjoy the tax benefit of the $100 additional land basis until sale.

a. See Prop. Reg. § 301.6225-4(b)(2) (partnership must make appropriate adjustments to the book value and tax basis of its assets "to take into account any partnership adjustment"); Prop. Reg. § 301.6225-4(a)(3) (specified tax attributes, including tax basis of partnership property, are first adjusted in the partnership's adjustment year); Prop. Reg. § 301.6225-4(e), Example (1)(v) (IRS disallowance of partnership's expensing of a nondepreciable asset purchased for $100 in the reviewed year results in a positive $100 IU adjustment; partnership adjusts its specified tax attributes by restating the book and tax basis of the asset to $100 in the adjustment year); Prop. Reg. § 301.6226-4(c), Example (iii) (at beginning of year 1 partnership acquires a $1,500 asset and incorrectly depreciates it over 10 years rather than 20 years; in year 3, IRS initiates a year 1 audit and adjusts depreciation downward from $150 to $75; IRS does not audit year 2; partnership elects to push out the year 1 adjustment; under Prop. Reg. § 301.6226-4(b), partnership increases the asset's tax basis on its year 3 return from $1,200 to $1275 to reflect the year 1 downward adjustment of $75 while leaving unchanged the claimed year 2 depreciation of $150 because the IRS did not make an adjustment for that year).

8. One must resist the temptation to superimpose one's own vision of tax rationality on the BBA system: while there is a $100 land basis increase in the adjustment year to replace the loss of building basis, there is no offsetting adjustment to account for the fact that the partners only claimed $20 of excess depreciation in year 1, but paid an IU computed as if they had depreciated the full $100. The partnership does have options to remedy the injustice:

a. It can make a section 6226 election to push out the basis adjustment and depreciation adjustment. The reviewed year partners would report the correction amounts attributable to the reduced year 1 depreciation and the effect of any change in tax attributes in intervening years, plus hot interest, with their reporting year returns. No adjustment would be made to the partners' share of year 2 depreciation because the IRS did not audit year 2.

b. The partnership could request approval of an "other" IU modification under Reg. § 301.6225-2(d)(10) pursuant to which the positive adjustment related to basis would be reduced to $20 **solely for IU purposes**. The full $100 basis adjustment would still be taken into account in the adjustment year when the partnership restates its basis in the land and building.

c. The partnership could request PMAR or Alternative Procedure modification. Under this option, the only adjustment that would be taken into account by the participating reviewed year partners in determining their correction amounts for the first affected year (year 1) would be the $10 reduction to depreciation. Adjustments to the partnership's basis in land and building (a specified tax attribute) would be made in the adjustment year. Prop. Reg. § 301.6225-4(a)(1) and (3). Normal underpayment interest would apply.

G. <u>Treatment of Disguised Sales Under BBA</u>

1. The treatment of a disguised sale under the BBA is interesting. To be a PRI, an item or amount must be with respect to the partnership. The regulations provide that items or amounts relating to "any **transaction with**, liability of, or basis in the partnership" are with "respect to the partnership" only if they are shown or reflected, or required to be shown or reflected, on the partnership return or are required to be maintained in the partnership's books and records. Reg. § 301.6241-1(a)(6)(iii).

2. Gain recognized by a partner under section 707(a)(2)(B) in a disguised sale of property purportedly contributed to a partnership is not an amount required to be shown or reflected on the partnership's return. It should be viewed as an item that is not a PRI itself but is affected by PRIs (much in the same way that a partner's outside basis is viewed under the BBA). However, whether the partnership made a taxable purchase of the property and takes a section 1012 cost basis in all or part of the property is a PRI. So, too, is the character of the partnership-to-partner transfer as a subchapter K distribution or sales consideration. The "character" and "amount" of contributions to, and distributions from, a partnership are PRIs, as is the partnership's basis in its property. Reg. § 301.6241-1(a)(6)(v)(C) and (D).

3. Suppose the contributing partner and the partnership take the position that a property transfer is wholly tax free under section 721, with a carryover basis to the partnership. The IRS audits the contribution year and asserts that the contribution was a disguised sale in part, giving the partnership a section 1012 cost basis in the purchased portion of the property. The IRS also makes collateral adjustments for depreciation deductions resulting from the step-up and section 704(c)-related allocations resulting from the fact that the partner is now contributing less property with a value/basis disparity than originally reported on the Form 1065.

4. The IRS seems to have a couple of options in terms of creating positive IU adjustments. The increase in the partnership's basis in the property (relative to its originally reported carryover basis), even though partnership-favorable, is a non-section 704(b) adjustment that produces a positive IU adjustment in the residual grouping. Alternatively, the IRS could assert a positive adjustment equal to the portion of cash or other consideration (including deemed cash consideration from nonqualified liability shifts) transferred to the partner that is treated as sales consideration as opposed to a subchapter K "distribution."

5. At this point, we have a partnership in danger of becoming a surrogate taxpayer on the partner's disguised sale gain due to the potential IU. To avoid this the partnership should either (i) solicit the partner's cooperation in participating in a PMAR or Alternative Procedure that makes the selling partner take the partner's share of all adjustments (positive or negative, including DNR adjustments) into account at the partner level via amended returns or pro forma amended returns, or (ii) push out the adjustments to the partner under section 6226.

a. The Instructions for Form 8986 (Dec. 2024) state as follows (at Part V, p. 4) with respect to disguised sale adjustments that are pushed out:

> "**Disguised sale adjustments**. Distributions to a partner that were changed as part of an audit proceeding to disguised sale proceeds under section 707 should be reported with the column (a) line number that corresponds to the Schedule K-1 "Other" category and with column (c), code DS. The partnership should also include a statement in Part VI describing the asset that was sold, the proceeds, and the tax basis of the asset at the time of the contribution."

b. Under Prop. Reg. § 301.6226-4(b), the partners and partnership must adjust tax attributes affected by the pushed out adjustments, unless such attributes were already adjusted as part of the adjustment.

c. If a partnership believes that there are risks associated with a contributing partner's disguised sale position, it should secure the partner's commitment (in the contribution agreement or partnership agreement) that, in the event the IRS makes disguised sale adjustments, the partner will participate in PMARs or consent to a push-out election (assuming the partner's consent would otherwise be required).

6. Note that under the June 2017 Proposed Regulations, which interpreted a different PRI definition, a PRI included "items related to transactions between a partnership and any person including disguised sales, guaranteed payments, section 704(c) allocations, and transactions to which section 707 applies." See Prop. Reg. § 301.6221 (a)-1, 82 Fed. Reg. at 27372.

IX. SECTION 6226 PUSH-OUT ELECTION

A. Overview

1. In lieu of paying an IU, a partnership can make a section 6226 election on Form 8988 to push out all of the adjustments resulting in an IU, and any DNR adjustments that are "associated with" the IU, to the persons who were partners at any time during the reviewed year. <u>See</u> Reg. § 301.6226-1(b)(1) and (2); Reg. § 301.6241-1(a)(9) (defining "reviewed year partner").

a. If the IRS determines one or more specific IUs, it will also designate which DNR adjustments are associated with a specific IU. Reg. § 301.6225-1(g)(2)(iii)(A).

b. The "general" IU consists of all adjustments not taken into account in determining a specific IU, other than DNR adjustments associated with a specific IU. Reg. § 301.6225-1(g)(2)(ii).

c. Any DNR adjustments that are not associated with a specific IU are deemed to be associated with the general IU. Reg. § 301.6225-1(g)(2)(iii)(B). Thus, if the IRS determines only one IU (i.e., no specific IUs), all DNR adjustments are associated with the IU and become subject to the push-out.

d. If the IRS does not determine an IU, the push-out option is off the table.

2. The reviewed year partners then determine the amounts by which their tax liabilities would increase for the partner's taxable year that includes the end of the reviewed year and any intervening taxable year – referred to as "correction amounts" – and report the additional tax, plus interest at 2% over the normal underpayment rate (hot interest), on their returns that include the date on which the push-out statements were furnished to the partners, i.e., the "reporting year returns."

3. <u>Example</u>. For reviewed year 2020, the IRS recharacterizes an ordinary loss as a LTCL. The decrease in ordinary loss results in a positive adjustment for IU purposes. The FPA is mailed in 2023, the partnership does not file a petition for readjustment, and the adjustments are finally determined in 2023.

a. The increase in LTCL is a negative adjustment that does not result in an IU. It is, nevertheless, "associated with" the IU. If the partnership makes a push-out election, both the positive and negative adjustments are pushed out to the reviewed year partners, who determine correction amounts for 2020 and any intervening years for which partner tax attributes are affected. The partners report the sum of the correction amounts (whether positive or negative) as "additional reporting year tax" on their reporting year returns. Reg. § 301.6226-3(h)(2), Example (2).

b. If a push-out election is **not** made, the partnership pays an IU based on the positive adjustment only. The negative adjustment (increase in LTCL) is reported on the partnership's 2023 adjustment year return.

c. The IRS need not worry about keeping the partner's statute of limitations open for the first affected year and any intervening years because the ART tax liability is reported on the partner's reporting year return. IRC § 6226(b)(1) ("each partner's tax imposed by chapter 1 for the [reporting year] shall be adjusted by the aggregate of the correction amounts" for the partner's taxable year that includes the end of the reviewed year and any intervening years).

d. The push-out election ensures that the reviewed year partners bear the tax burden attributable to the pushed out adjustments, leaving the current year partners as innocent bystanders.

4. There are drawbacks. In addition to paying hot interest on underpayments, a push-out is complex, requiring complex forms and schedules to complete, furnish to partners, and file with the IRS. The opportunities for mistakes abound.

5. If there are tiers of partnerships, each pass-through partner in the chain must also push-out (or pay an IU). If each entity in the chain elects to push-out, the deadline for furnishing the statements and filing with the IRS **is the same for each entity, which is the extended due date for the audited partnership's adjustment year return**. If each entity screws around and waits until the last minute to deliver push-out statements, the entity at the top of the chain gets progressively squeezed as to its own push-out. Thus, paying an IU at the audited partnership level or pass-through partner level may be preferable in some circumstances, even though it may overstate "real" partner tax liabilities.

6. Like IU modification forms, push-out related forms are generally required to be submitted to the IRS electronically. The instructions for doing so can be found at irs.gov; search for "filing BBA forms electronically" and click on the link for "Electronic submission of forms by audited BBA partnerships and their pass-through partners."

7. If the FPA includes more than one IU, the partnership can make a push-out election as to one or more of the IUs. However, for any specific IU for which push-out is elected, all of the partnership adjustments associated with that specific IU must be pushed out. See Reg. § 301.6225-1(g) (rules for determining general and specific IUs); Reg. § 301.6226-1(a).

8. The Instructions for Form 8985 (Dec. 2024), p. 1 (push-out transmittal report), state that any adjustment to an item "which is not a monetary item (for example, an election made by the partnership)" is a DNR adjustment. How this sort of adjustment gets pushed out and what its tax effects are is unclear.

B. Making the Push-Out Election

1. Section 6226(a)(1) provides that the Form 8988 push-out election must be filed by the partnership with the IRS "not later than 45 days after the date of the [FPA]." Reg. § 301.6226-1(c)(2) states that the Form 8988 must be filed "within 45 days of the date the FPA is mailed by the IRS."

a. "Within 45 days of" and "within 45 days after" mean the same thing, obviously – the date of FPA mailing is not counted. See Reg. § 301.6223-2(e), Example (2) ("within 45 days after").

b. **The 45-day deadline cannot be extended**. Reg. § 301.6226-1(c)(2).

c. Some have wondered whether the election could be made before the FPA is issued, or if no FPA was issued. The statutory language is not totally clear; it identifies an endpoint for the election period but does not clearly specify the FPA mailing date as the starting point, although that is certainly a fair reading of the statute.

(1) In any event, the IRS forms and website instructions are clear that the election can only be made after an FPA is issued – not before. See Instructions for Form 8988 (Oct. 2020), p. 2 (under "Purpose of Form 8988"); Publication 5346, Instructions for Form 8980 (Dec.

2024), p. 4. **Thus, if a partnership agrees with the proposed adjustments and signs the NOPPA, or waives the issuance of an FPA by executing Form 14726 to speed up the resolution of the case, it has forfeited the push-out option.**

(2) The 2025 Greenbook, p. 174, proposed to amend section 6226 to permit the push-out election at any time after the issuance of the NOPPA but not later than 45 days after the FPA is issued.

2. The partnership files the election electronically with the IRS. It must be e-signed by the designated PR or DI (using a five-digit PIN) for the reviewed year. See Instructions for Form 8988 (Oct. 2020), at pp. 2-3. The instructions at irs.gov/bbapartnerships (click on the dropdown menu captioned "Signature Requirements") indicate that Form 8988 can also be e-signed by the PR's power of attorney using a PIN signature. The IRS will review the election for completeness, countersign it, and provide a copy of the countersigned election to the PR.

3. Form 8988 requires a list of the reviewed year partners and their addresses and TINs to be attached, as well as the FPA. Reg. § 301.6226-1(c)(3)(ii).

4. Insofar as the regulations and forms are concerned, partner consents and partner cooperation are not required to make and implement a push-out election. The election is exclusively the partnership's call, subject to any restrictions contained in the partnership agreement.

5. The partnership is not required to notify the partners of the election (unlike the opt-out election, where the regulations require partner notification). However, it is probably foolhardy for a partnership to keep an irrevocable push-out election under wraps until the push-out statements are mailed.

6. Separate Forms 8988 must be filed for each reviewed year as to which a push-out election is being made. Each general and specific IU for which push-out is elected must be identified on the form. Reg. § 301.6226-1(c)(3)(ii).

7. The push-out election can only be revoked with IRS consent. The PR can request consent by electronically filing Form 8989 (Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment) (Oct. 2020). See Reg. § 301.6226-1(c)(1).

a. The revocation must be submitted and approved by the IRS before push-out statements are furnished to the reviewed year partners. See Instructions for Form 8989 (Oct. 2020), p. 2.

8. If a valid push-out election is made, the partnership is completely off the hook for the IU liability; no assessment or proceeding can be made to collect the IU from the partnership, even if one or more partners fail to pay their push-out taxes. IRC § 6226(a); Reg. § 301.6226-1(b)(2). Further, the partnership does not have to police the partners' push-out compliance, putting it in the same "hear no evil see no evil" mode as when it issues K-1s.

a. If the partnership has any foreign partners, it remains liable for any withholding tax liabilities under chapter 3 (sections 1441-1464, other than section 1463(b)) and chapter 4 (sections 1471-1474). Reg. § 301.6241-6(b)(4)(i).

b. In the unlikely event the audited partnership is subject to a chapter 1 tax on all or a portion of the adjustments at the partnership level, the audited partnership must pay any such chapter 1 tax, interest and penalties at the time it furnishes the push-out statements to its partners. Any adjustments to such items are not included in the push-out statements. Reg. § 301.6226-2(g)(4).

C. Partners Bound by Treatment of PRIs on Push-Out Statement

1. Reg. § 301.6226-1(e) provides that the push-out election and push-out statements are binding on the partners under section 6223 unless the IRS says differently. Further, a partner cannot treat any PRIs reflected on the partner's push-out statement inconsistently with how they are treated on the statement filed with the IRS.

a. See Reg. § 301.6222-1(a)(4)(ii) (for purposes of section 6222(a) consistency requirement, treatment of a PRI on the partnership's return includes any treatment of such item on statements filed under section 6226); Reg. § 301.6222-1(c)(2) (disclosure exception to consistency requirement not applicable to section 6226 push-out adjustments).

2. If a partner fails to pay the taxes resulting from the push-out election, the IRS can assess the partner for the unpaid additional reporting year tax in the partner's reporting year as a math error without going through the deficiency procedures. IRM 4.31.9.8.2.2(1)(c) (10-29-2021). This is true even if the partner discloses the inconsistent reporting on the reporting year return.

D. Push-Out Election Requires That the FPA Determine an IU

1. A push-out election can only be made if the FPA determines one or more IUs for a reviewed year. IRC § 6226(a)(1); Reg. § 301.6226-1(a) (election is an alternative to payment of an IU); Reg. § 301.6226-1(b)(1) (reviewed year partners take into account their shares of adjustments "associated with the IU").

2. If the partnership adjustments result in an IU of zero or less than zero, a push-out election cannot be made, and all of the adjustments are taken into account in the adjustment year. Reg. § 301.6225-1(f)(2).

a. For example, if the only FPA adjustment in the reviewed year is a reduction of partnership income or an increase in deductions (each a negative adjustment), there is no potential IU and the push-out election is not available.

3. As noted, a push-out of adjustments related to an IU includes any DNR adjustments that are associated with the IU under Reg. § 301.6225-1(g). See Reg. § 301.6226-1(b)(2); Reg. § 301.6225-3(b)(6). Such adjustments are not taken into account in the adjustment year, as they would be if the partnership were paying the IU instead of pushing out.

E. Furnishing Push-Out Statements to Reviewed Year Partners

1. The partnership must furnish to each reviewed year partner a statement on Form 8986 (Partner's Share of Adjustment(s) to Partnership-Related Item(s)) (Dec. 2024) showing the partner's share of the adjustments. IRC § 6226(a)(2); Reg. § 301.6226-2(a). This is something like an amended K-1.

a. In contrast to the approach taken in the June 2017 Proposed Regulations, the partnership does not report on the statements changes in partnership tax attributes – like a change in asset basis or depreciation resulting from a change in the partnership's depreciation method in a prior year. See Preamble to August 2018 Proposed Tax Attribute Regulations, 83 Fed. Reg. at 41961, 41967 (explaining that this change was made to conform to the TTCA's reference to partner tax attributes in section 6225(c)(2)(B)(ii), relating to the Alternative Procedure).

2. Push-out statements must be furnished to the partners and electronically filed with the IRS no later than **60 days after the date** the partnership adjustments are "finally determined." See Reg. § 301.6226-2(b)(1) and (c); Reg. § 301.6226-2(e)(4) and (5); Reg. § 301.6226-2(b)(3)(iii), Example (3) (illustrating the timeline).

3. The adjustments are finally determined upon the later of (i) the expiration of the time to file a petition for readjustment with a court under section 6234(a), or (ii) if a petition is filed, the date the court's decision becomes final. Reg. § 301.6226-2(b)(1).

4. Separate push-out statements are required to be furnished for each reviewed year for which push-out is elected. They must be filed separately from the current year K-1s. Reg. § 301.6226-2(a). A failure to provide a timely, complete and correct statement is subject to the payee statement penalty under section 6722(a). Id.; see section 6724(d)(2)(JJ).

5. According to examples in the regulations, if a partnership does not file a petition for readjustment, the adjustments are finally determined on the **91st day** after mailing of the FPA – not the 90th day. See Reg. § 301.6226-3(h), Examples (2), (3), (4), (6), (7), (8) and (9). This means that the 60-day statement period begins to run on the **92d day**. See Reg. § 301.6226-2(c) (deadline is 60 days "after the date" the partnership adjustments are finally determined). Last-minute partnerships and their advisors might be jubilant to learn they have one more day than they might have guessed.

a. The Preamble to the June 2017 Proposed Regulations gives an example which indicates that the adjustments are finally determined on the last day of the 90-day petition period (82 Fed. Reg. at 27359), but the final regulations are clear that it is on the day after.

6. A Tax Court decision becomes final when the time for filing a notice of appeal expires (section 7481(a)(1)) or, if appealed, as provided in section 7481(a)(2), (3) and (4). It appears that the Tax Court's decision becomes final on the 90th day after the decision was entered, if no appeal was filed. See, e.g., United States v. Hans, 921 F.2d 81 (6th Cir. 1990). In any event, once the date of the Tax Court decision becoming final is established, the partnership has 60 days after that date to furnish and file. See Reg. § 301.6226-2(b)(3)(iii), Example (3) (Tax Court decision becomes final on April 10; 60-day period starts on April 11 and ends on June 9).

7. The regulations state that "furnishing" must be done in accordance with IRS forms and instructions. Reg. § 301.6226-2(b)(2). However, Form 8986 and the accompanying instructions provide no guidance on how to furnish the statements.

a. Compare Reg. § 301.6221(b)-1(c)(3) (partnership must provide notice of opt-out election to the partners within 30 days, such notice to be made "in the form and manner determined by the partnership"); Preamble to June 2017 Proposed Regulations, 82 Fed. Reg. at 27344 (notice to partners of opt-out election "may be in writing, electronic, or other form chosen by the partnership").

b. The section 6226 regulations state that if furnishing of the statement is done by mail, the partnership must mail to the current or last known address of the reviewed year partner. Reg. § 301.6226-2(b)(2). If returned undeliverable, the partnership must use reasonable diligence to identify a correct address and re-mail. Id.

c. An example in the regulations indicates that timely mailing equals timely furnishing. See Reg. § 301.6226-2(b)(3)(i), Example (1).

d. While the IRS has approved electronic delivery of K-1s to partners who consent to such delivery (thus satisfying the "furnishing" requirement of section 6031(b)), there does not appear to be any similar guidance that would apply to Form 8986. See Rev. Proc. 2012-17, 2012-10 I.R.B. 453.

e. The safest and most expedient furnishing procedure: send the Forms 8986 both by certified mail and email, and the partners can flip the email to their accountants.

8. Push-out statements must also be provided to reviewed year partners who are no longer partners. The partnership agreement and a withdrawing partner's exit agreement should require prompt notification of partner address changes, although this will probably be a breach waiting to happen.

9. There is no foot-fault exception. However, the Preamble to the February 2019 Final Regulations states that "if a partnership makes an election under § 301.6226-1 and furnishes statements to 99 out of 100 reviewed year partners, the partnership's push-out election is valid unless and until the IRS determines the election is invalid." 84 Fed. Reg. at 6509.

F. 60-Day Deadline Will Engender Many Last-Minute Crises

1. If the partnership fails to timely comply with all of the push-out statement rules in Reg. § 301.6226-2, including the 60-day statement deadline, the IRS could determine that the election is invalid and proceed to assess an IU without regard to the limitations on assessment in section 6232(b). Reg. § 301.6226-1(d).

a. See Reg. § 301.6226-1(c)(1) (push-out election valid only if "all requirements" of Reg. § 301.6226-2 are satisfied); Form 8988 (Oct. 2020) (warning that a failure to furnish and file push-out statements could result in an invalidity determination); Instructions for Form 8986 (Jan. 2024), p. 2; Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6508 ("the IRS may invalidate an election under section 6226(a) for any failure to meet the requirements of § 301.6226-1, regarding how an election must be made, or § 301.6226-2, regarding the manner in which statements must be furnished").

2. It is not hard to imagine a partnership failing to meet the 60-day statement deadline or at the very least enduring a gut-wrenching last-minute crisis.

3. Fortunately, the regulations provide that errors in push-out statements may be corrected, and the corrected statements re-furnished and re-filed, without IRS consent for a period of 60 days after the statement due date. If an error is discovered after the 60-day period, IRS consent is required. Reg. § 301.6226-2(d)(1) and (2).

a. If the IRS discovers an error or cannot determine if the statements are correct due to the partnership's failure to comply with any requirement of Reg. § 301.6226-2, the IRS may, but is not compelled to, inform the partnership and request that it furnish and file corrected statements or provide such additional information as is necessary. Reg. § 301.6226-2(d)(3).

b. The IRS cannot base an invalidity determination on statement errors that are timely corrected in accordance with the above. Reg. § 301.6226-1(d).

G. <u>Determining Reviewed Year Partners' Shares of Adjustments</u>

1. A reviewed year partner's "share" of a partnership adjustment (see section 6226(a)(2)) is determined under the rules provided in Reg. § 301.6226-2(f)(1)(i). The primary rule is that adjustments are allocated to the reviewed year partners "in the same manner" as the adjusted PRI was originally allocated among the partners on the reviewed year partnership return.

a. If the adjustment involves a PRI that was allocated to a specific partner or in a specific manner (including a reallocation adjustment), the reviewed year partners' shares of such adjustment are determined "in accordance with the adjustment" (which presumably means plugging the adjusted item or amount into the allocation scheme and see where it goes). Reg. § 301.6226-2(f)(1)(iii).

b. If the adjusted item was not reported on the return originally, then the allocation is made on the basis of an "if I knew then what I know now" allocation, taking into account the section 704(b) regulations and the partnership agreement. Reg. § 301.6226-2(f)(1)(ii).

c. What happens if running the PRI adjustment through the partnership agreement's tax allocation provisions results in a different sharing ratio than the originally allocated item? Logically the partnership agreement should govern, assuming the allocations are otherwise valid under the section 704(b) regulations. The words "in the same manner" ought not preclude that deference.

d. What happens if the push-out partnership adjustment relates to an item that is not allocated under section 704(b)? There appears to be no guidance on this point. The answer might be obvious for certain non-income adjustments; for example, if the partnership adjustment relates to the partners' section 752 liability shares, each partner's "allocation" of that push-out adjustment should be the change in that partner's liability share.

2. These rules also apply in the context of an AAR push-out. <u>See</u> IRC § 6227(b)(2) (AAR push-out adjustments taken into account by the "partnership and partners under rules similar to the rules of section 6226"); Reg. § 301.6227-3(b)(1).

3. Under the August 2018 Proposed Tax Attribute Regulations, the partners must adjust their partnership tax attributes (i.e., outside basis and capital accounts) to reflect their shares of push-out adjustments. Prop. Reg. § 301.6226-4(b).

a. The allocation of a push-out item among the partners does not have substantial economic effect for section 704(b) purposes, but is deemed to be in accordance with PIP if allocated by the partnership **in the adjustment year** in the manner in which the item would have been allocated in the reviewed year, followed by any intervening years, and concluding with the reporting year. Prop. Reg. § 1.704-1(b)(4)(xiv); Prop. Reg. § 301.6226-4(a)(3) (providing that push-out partnership adjustments are allocated to the reviewed year partners or affected partners under Prop. Reg. § 1.704-1(b)(4)(xiv)).

4. IU amended return modifications approved with respect to a reviewed year partner or indirect partner are disregarded in determining the partner's share of the reviewed year adjustments. Reg. § 301.6226-2(f)(2). However, the push-out statement must disclose any such modifications approved by the IRS with respect to the reviewed year partner or indirect partner. Reg. § 301.6226-2(e)(5); Reg. § 301.6226-3(e)(3)(iii)(L).

5. How does the IRS challenge the allocation of adjustments on the push-out statements (assuming the FPA did not make an allocation)? It could require the partnership to correct the allocations (see Reg. § 301.6226-2(d)(3)), and if not satisfied with the outcome of that process, it could conceivably determine that the push-out election is invalid for failure to furnish proper statements.

6. If the FPA provides for an allocation of adjustments among the partners (e.g., a reallocation of tax items among the partners), the partnership can petition a court for readjustment of the allocation as well as the adjustments themselves. IRC § 6234(c).

H. Reviewed Year Partners' Correction Amounts and Interest

1. Each reviewed year partner first determines the "correction amount" for the partner's taxable year that includes the end of the reviewed year (the "first affected year").

2. This is the amount by which the reviewed year partner's chapter 1 tax would **increase or decrease** for the first affected year if the partner's taxable income for such year was recomputed by taking into account the reviewed year partner's share of the partnership adjustments reflected in the push-out statement. See IRC § 6226(b)(1) and (c); Reg. §§ 301.6226-3(a) and (b)(2)(ii).

3. The partner does the same pro forma tax recalculation for intervening taxable years to reflect any adjustment to partner tax attributes that results from taking into account the partnership adjustments in the first affected year. Reg. § 301.6226-3(b)(3)(ii).

a. The term "intervening taxable years" means years subsequent to the first affected year and ending prior to the reporting year. IRC § 6226(b)(2)(B); Reg. § 301.6226-3(b)(3)(i).

b. If there were carrybacks from the reviewed year to prior years which are affected by the adjustments, the reviewed year partner does not determine correction amounts for those prior years because they are not "intervening taxable years."

c. Likewise, if taking into account a partnership adjustment (e.g., a reallocation adjustment) would increase a reviewed year partner's NOL that can be carried back from the first affected year instead of forward (e.g., the CARES Act added section 172(b)(1)(D) to provide for a five-year carryback of NOLs arising in taxable years beginning in 2018, 2019, or 2020 unless waived by the taxpayer), the tax benefit of the carryback is not captured in the section 6226 correction amount mechanics.

d. Example. Assume the IRS issues an FPA determining an IU for reviewed year 1 but also determining a negative adjustment to the partnership's reported year 1 capital gain income. The partnership elects push-out. Assume that partner A's originally reported year 1 capital gains were fully offset by capital losses. A's share of the negative capital gains adjustment is $6,000. The negative adjustment frees up $6,000 of A's capital losses, and A can deduct $3,000 of such losses in each of years 1 and 2 for correction amount purposes. See Instructions for Form 8978 (Dec. 2024), p. 3.

e. Example. Assume a $40 positive adjustment to partnership income is pushed out to a partner with respect to the partnership's reviewed year 1. Assume the partner had an unused NOL of $100 for the partner's first affected year which was carried forward and used in the partner's intervening years.

(1) The partner's year tax liability for the first affected year is recomputed by taking into account the $40 of additional income, thereby consuming $40 of the $100 NOL carryforward and leaving only $60 to be carried forward.

(2) The correction amount for the first affected year is zero, but the amounts for the intervening years are positive because of the reduction in NOL carryforward that was originally claimed in such years.

4. The partner then adds the positive and negative correction amounts for the affected and intervening years to arrive at the "additional reporting year tax" which – despite the regulation's use of the word "additional" – can be a positive or negative amount. Reg. § 301.6226-3(b)(1). (This outline refers to the additional reporting year tax as "ART," which is not a proper acronym but easier to say than "ARYT.")

a. This amount is then added or subtracted from the partner's chapter 1 tax liability for the reporting year.

b. The reporting year is the partner's taxable year that includes the date on which the audited partnership furnished the push-out statements to its partners. Reg. § 301.6226-3(a).

c. The partner reports the positive or negative ART on Form 8978 (Partner's Additional Reporting Year Tax) (Jan. 2023) and Schedule A to Form 8978 (Jan. 2023), and includes such forms with the partner's reporting year return. A positive ART is treated as an increase in the partner's chapter 1 tax liability for the reporting year which, along with penalties and interest, must be paid in addition to the tax liability the partner would have owed for the reporting year without regard to the ART. Reg. § 301.6226-3(a).

5. If the reviewed year partner previously participated in a PMAR or Alternative Procedure during the 270-day post-NOPPA modification period, the taxes and interest already paid by the partner are taken into account in determining the partner's ART. The partner is required to make the ART computation with the reporting year return, even if it results in a zero ART. <u>See</u> Reg. § 301.6226-3(b)(3)(ii)(A); Reg. § 301.6226-3(h)(5), Example (5); Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6519.

6. In addition to paying hot interest, the reviewed year partners have to pay their accountants to interpret the Forms 8986, determine the correction amounts, interest and penalties, and prepare Form 8978. In the early years of BBA get-acquainted parties, with everybody struggling to deal with the choices, forms and procedures, you can bet there will be a lot of false steps and mistakes and none of this will come cheap.

7. <u>Positive Correction Amounts Bear Hot Underpayment Interest; Negative Correction Amounts Do Not Receive Overpayment Interest</u>

a. The push-out election has one obvious cost: the reviewed year partners pay underpayment interest on each positive correction amount for the first affected year and for any intervening years from the unextended due date of the return for the taxable year to which such amounts are attributable (Reg. § 301.6226-3(c)(1)), but at an underpayment rate that is 2 percentage points higher than the normal section 6621(a)(2) underpayment rate (normal rate being the short-term AFR plus 3 percentage points). <u>See</u> IRC § 6226(c)(2)(C); Reg. § 301.6226-3(c)(3).

(1) By way of illustration, for the fourth quarter of 2023 the underpayment rate on section 6226 push-out positive correction amounts was 10%.

b. Perversely, however, the partner does not receive overpayment interest on **negative** correction amounts. While the TTCA amended section 6226 to include both positive and negative correction amounts in the ART, it did not make a corresponding amendment to section 6226(c)(2)(B) to provide for interest on negative correction amounts. See IRC § 6226(c)(2)(B) (referring to interest only with respect to tax increases, not decreases); Reg. § 301.6226-3(c)(1); Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6515.

c. The regulations also do not permit netting of positive and negative correction amounts for purposes of computing underpayment interest. See Reg. §§ 301.6226-3(c)(1) (last sentence) and 301.6226-3(b)(1) (last sentence). Each positive correction amount stands on its own for interest purposes.

(1) This contrasts with the normal rule under section 6621(d) that if a taxpayer has an overpayment and an equivalent underpayment for the same period, the net rate of interest on both amounts is zero.

(2) The partners may be better off reducing the IU through a PMAR and paying normal underpayment interest.

8. Example – Timing Adjustments

a. As noted, one's first reaction may be to conclude that a push-out election solves a lot of problems, if one can live with the hot interest and unfair interest computation rules, but things are not always as they seem in the BBA realm.

b. Assume in year 1 the partnership improperly claimed a deduction that should have been deferred to year 2. In year 6, the IRS audits the partnership for years 1 and 2, disallows the deduction in year 1 and issues (i) an FPA for year 1 showing an IU from the positive adjustment and (ii) an FPA for year 2 showing the negative adjustment. See Reg. § 301.6225-1(e)(2) (adjustments from one taxable year cannot be netted against adjustments from another taxable year).

c. The partnership makes a section 6226 election and pushes out the year 1 adjustment to the reviewed year partners, who pay the correction amounts and interest with their reporting year returns.

d. The year 2 FPA makes a negative adjustment to reflect the allowance of the deduction. However, since the taxpayer-favorable adjustment is not associated with an IU for year 2, the partnership cannot push out the adjustment to the year 2 partners. See IRC § 6226(a)(1); Reg. § 301.6226-1(a); Reg. § 301.6225-1(h)(5), Example (5) (illustrating IU determinations in the context of timing adjustments spanning two taxable years).

e. The partnership must take the year 2 negative adjustment into account in the adjustment year (year 6). See Reg. § 301.6225-1(f)(2) (first sentence); Reg. § 301.6225-3(a). Under the August 2018 Proposed Tax Attribute Regulations, such adjustment is allocated to the adjustment year partners who are also reviewed year partners or successors to reviewed year partners.

f. The reviewed year partners receive no interest to compensate them for the tax benefit of a deduction that should have been allowed in year 2 but is now deferred to year 6. Filing an AAR for year 2 may not be an option because an AAR must be filed within three years after the year 2 return was filed, and in any event an AAR cannot be filed after a NAP has been issued for year 2. See IRC § 6227(c); Reg. § 301.6227-1(b). Section 6227(c) does not contemplate agreed-upon extensions, unlike section 6235(b).

g. The partnership could try to address the problem by having the partners file PMARs for year 2 and request modification of the year 2 negative adjustment. This type of modification is permitted if the adjustment results in an IU of zero or less than zero, and a lone negative adjustment technically results in a zero IU. See IRC § 6225(c)(9); Reg. § 301.6225-2(a) and (e).

h. This multi-year timing problem is discussed in the Preamble to the February 2019 Final Regulations, 84 Fed. Reg. at 6505. The drafters rejected a suggestion that a push-out of the year 2 negative adjustment be permitted, on the grounds that section 6226 allows a push-out only if there is an IU. However, the Preamble suggests the possible AAR remedy in this context if the AAR statute of limitations has not expired. It also mentions using the PMAR procedures for year 2 and the possibility of obtaining a year 2 closing agreement with the IRS.

9. SECA and NII Taxes. Any additional SECA or NII tax owed by the partner as a result of the push-out adjustments is not included in the correction amounts because they are not chapter 1 taxes. See Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6512 ("…because the regulations do not require payment of chapter 2 or 2A taxes when a partner takes into account adjustments under section 6226(b), the consequences of failing to pay those taxes is beyond the scope of the regulations").

a. The Instructions for Form 8978 (Dec. 2024), p. 1, state that "[a]ny non-income tax changes that are related to the income tax adjustments on Form 8986 … such as self-employment tax changes, should be reflected on an amended return for the partner's first affected year."

10. Non-section 704(b) adjustments, like a liability reallocation or an adjustment to the amount of a partner's section 743(b) adjustment, are also pushed out, but the correction-amount tax impact depends on how the adjustment impacts partner-level tax attributes in the reviewed year.

a. The Instructions for Form 8978 (Additional Reporting Year Tax) (Dec. 2024), p. 2, give as an example a liability adjustment that reduces a partner's share of recourse liabilities and potentially changes the partner's at-risk amount, which in turn could reduce the partner's allowable loss from the partnership. The adjustment to reduce the partner's allowable loss from the partnership – a partner-level tax attribute adjustment – would be shown on Schedule A to Form 8978 as an increase in income. Id.

I. Effect of Section 6226 Election on Pass-Through Partners

1. A pass-through partner has two choices upon receiving a push-out statement from an audited partnership.

2. Successive Push-Out. The pass-through partner can choose to push out its share of the adjustments shown on the statement to its own "affected partners," or, as applicable, to the pass-through partner's S shareholders or estate or trust beneficiaries, who are treated as affected partners for this purpose. IRC § 6226(b)(4)(A) (including S corporations); Reg. § 301.6226-3(e)(5)(ii) (treating estates, trusts, and their respective beneficiaries similarly to partnerships).

a. Unlike the audited (source) partnership, a pass-through partner does not make a push-out election by filing its own Form 8988. Rather, its push-out is effected by timely furnishing push-out statements on Form 8986 to its affected partners and filing them, together with a Form 8985 partnership tracking report, with the IRS. The push-out statements show the affected partners' shares of the audited partnership adjustments. IRC § 6226(b)(4)(A); Reg. § 301.6226-3(e)(3)(i).

b. An "affected partner" is any partner (or S shareholder or estate or trust beneficiary) that held an interest in the pass-through partner at any time during the pass-through partner's taxable year to which the adjustments in the push-out statement furnished to the pass-through partner relate. Reg. § 301.6226-3(e)(3)(i).

c. A disregarded entity or wholly owned grantor trust is ignored for push-out purposes. The tax owner is treated as the reviewed year partner and must take into account the adjustments reflected on the statement provided to the disregarded entity or grantor trust. Reg. § 301.6226-3(g).

d. The affected partners of the pass-through partner (or the affected S shareholders or trust and estate beneficiaries) determine the appropriate correction amounts for their first affected year, taking into account taxes previously paid by the partner in connection with an IU modification request. Although the regulations are not entirely clear on the point, the first affected year for an affected partner should be such partner's taxable year that includes the end of the pass-through partnership's taxable year to which the adjustments relate.

e. The correction amounts for such year and any intervening years become an ART that is reported with the affected partner's reporting year return.

(1) The affected partner's reporting year is the year in which the **audited partnership** furnished the push-out statements to **its reviewed year partners**. Reg. § 301.6225-3(e)(3)(iv).

f. The affected partner is not subject to a section 6651 penalty provided it pays the ART within 30 days of the extended due date of the audited partnership's adjustment year return. Id.

g. If the pass-through partner is itself subject to chapter 1 tax on all or a portion of the adjustments (e.g., a trust or estate that has undistributed "DNI" and becomes a taxpayer on such income or an S corporation subject to section 1374 built-in gains tax), then the pass-through partner must report the chapter 1 tax attributable to the adjustments as an ART with its reporting year return and include Form 8978. In other words, the adjustments are taken into account by paying the entity-level chapter 1 tax and do not enter into an IU calculation. Reg. § 301.6226-3(e)(6). In addition, an S corporation, trust or estate pass-through partner must only include on the push-out statements it furnishes to its shareholders or beneficiaries the share of adjustments that would have been reported to them under section 6037 (S corporation shareholders) and 6034A (estate and trust beneficiaries) if the pass-through partner had correctly reported the items for the year to which they relate in the first place. Id. (Similar rules apply to the audited partnership in the unlikely event it is subject to a chapter 1 tax on the partnership adjustments and makes a push-out election, see Reg. § 301.6226-2(g)(4).)

(1) See Instructions for Form 8978 (Dec. 2024), pp. 1, 2 (providing that an entity partner can be both a non-pass-through partner and a pass-through partner; "to the extent the adjustments an entity partner receives on a Form 8986 relate to items that are taxable at the entity level, it is considered a non-pass-through partner and with regard to adjustments that pass through to its owners/beneficiaries it is considered a pass-through partner"; "[f]or adjustments to items that are taxable to the entity partner, it should use Form 8978; and for adjustments to items that pass through to the partner's owners or beneficiaries, it should follow the Forms 8985 and 8986 instructions for pass-through partners."

3. Pay an IU. Alternatively, the pass-through partner can determine and pay an IU attributable to its share of such adjustments (unless the entity is already subject to chapter 1 tax on such amounts). See IRC § 6226(b)(4); Reg. § 301.6226-3(e)(4); see Form 8985-V (Tax Payment by a Pass-Through Partner) (Dec. 2019).

a. If the pass-through partner chooses to pay an IU, it must pay such liability and hot interest accruing from the first affected year (and any penalties) by the extended due date of the adjustment year return for the audited partnership. See Reg. § 301.6226-3(e)(4)(ii) (prescribing the due date for IU payment and filing of the tracking report); Reg. § 301.6226-3(e)(4)(iv)(B) (interest on the IU required to be computed in accordance with Reg. § 301.6226-3(c), which includes hot interest).

b. The pass-through partner's IU is determined in the same manner as an IU under Reg. § 301.6225-1, with its share of partnership adjustments being treated as adjustments for the first affected year. Reg. § 301.6226-3(e)(4)(iii).

c. In calculating its IU, the pass-through partner can apply the second anti-duplication rule to disregard a positive adjustment where one positive adjustment is related to, or results from, another positive adjustment. See Reg. § 301.6225-1(b)(4) (last sentence refers to pass-through partners paying an IU).

4. IU Liability Bears Hot Interest. A pass-through partner's IU liability bears hot interest as if the IU were a correction amount for the first affected year. Reg. § 301.6226-3(e)(4)(iv)(B). Thus, going the IU route does not avoid the 2% penalty that would apply to the partners of the pass-through partner if it chose to push out.

5. Beware the Miscalculated IU. Assume an upper-tier partnership (UTP) does not want to hassle its partners and chooses to pay an IU of 100x on its share of push-out adjustments from the audited partnership. Later, after the deadline for furnishing Forms 8986 to UTP's partners has passed, the IRS determines that the correct IU amount was actually 900x. UTP and its accountants conclude there were screw-ups in computing the IU. They now believe a push-out would have been less costly to the partners and the hassle factor doesn't seem so bad now.

a. Unfortunately, the window for pushing out the adjustments to UTP's partners has closed. UTP may have made a reasonable choice that a relatively small IU payment was worth avoiding the headaches for the partners. However, once UTP decides to go down that road, it better be sure that the IU it computed is the IU it owed.

6. Do-Not-Result Adjustments

a. A pass-through partner electing to pay an IU on its share of push-out adjustments must report its share of DNR adjustments on the pass-through partner's return for the taxable year that includes the date the IU payment was made. Reg. § 301.6226-3(e)(4)(v).

b. If the pass-through partner's share of adjustments do not result in an IU, all of the push-out adjustments are reported on the pass-through partner's return for the taxable year that includes the date on which it received the push-out statement from the audited partnership. Id.

7. IU Modifications

a. Any modifications approved by the IRS with respect to the pass-through partner (or a relevant partner owning an interest in the pass-through partner) that are reflected on the push-out statement are taken into account in determining the pass-through partner's IU. See Reg. § 301.6226-3(e)(4)(iii); Reg. § 301.6226-3(e)(3)(iii)(L).

b. However, the pass-through partner cannot separately request modification in its own right. IRC § 6226(b)(4)(A)(ii)(II).

c. This treatment of approved modifications differs from an AAR partnership that pushes out to a pass-through partner. In that context, if the pass-through partner chooses to pay an IU on its share of AAR adjustments, it cannot take into account any modifications. Reg. § 301.6227-2(c); Reg. § 301.6227-3(c)(1).

8. The above rules and choices also apply to an opt-out partnership in its capacity as a partner of a lower-tier BBA partnership. IRC § 6226(b)(4)(C); Reg. § 301.6221(d)(1) and (2) (Examples (1) and (2)).

J. Furnishing of Push-Out Statements by Pass-Through Partner to its Affected Partners

1. If a pass-through partner chooses to push the adjustments upstream to its affected partners, it must do so by furnishing them Forms 8986 (and filing them with the IRS electronically along with Form 8985) by the extended due date for the **audited partnership's adjustment year return** (whether or not an extension is actually requested). IRC § 6226(b)(4)(A); Reg. §§ 301.6226-2(e)(1) and -2(e)(3)(ii).

a. The Preamble to the February 2019 Final Regulations states that this due date "aligns the push out statements furnished by pass-through partners with the extended Schedule K-1 due date for the audited partnership." 84 Fed. Reg. at 6508.

2. The pass-through partner must push out all of the adjustments associated with an IU. It cannot do so selectively.

3. A pass-through partner's failure to furnish and file push-out statements by the extended due date of the audited partnership's adjustment year return takes the push-out option off the table. It becomes liable for the IU at that time, and the IRS can assess without regard to the section 6232(b) limitations.

a. See IRC § 6232(b) (last sentence) and IRC § 6232(f)(2)(A) (defining a pass-through partner's IU obligation as a "specified similar amount"); section 6651(i) (failure of pass-through partner to comply with section 6226(b)(4)(A)(ii) is treated as a failure to pay the IU and as an amount shown as tax on a return); Reg. § 301.6226-3(e)(2)(i); Reg. § 301.6232-1(c)(2).

4. As is the case with an audited partnership doing a push-out, a pass-through partner can correct statement errors without IRS consent for a period of up to 60 days after the due date for furnishing such statements. Thereafter, IRS consent is required.

a. See Reg. § 301.6226-3(e)(3)(i) (last sentence); Instructions for Form 8985 (Dec. 2024), p. 3 ("A pass-through partner who receives a Form 8986 related to an audited partnership can submit a corrected Form 8985 and the related Forms 8986, if applicable, within 60 days of the due date for the initially submitted forms without IRS permission"); Instructions for Form 8986 (Dec. 2024), p. 2 (same).

5. A pass-through partner may receive multiple Forms 8986 from lower-tier partnerships in which it holds interests relating to the same taxable year but involving different partnerships.

a. An upper-tier partnership receiving multiple K-1s from lower-tier partnership investments will typically aggregate the items from those K-1s into a single K-1 that it issues to its own partners. Can it do the same thing for the Forms 8986 it receives, or does it have to match its own push-out statements to those received on a one-for-one basis (i.e., issuing separate Forms 8986 to its partners to correspond to each one received from a lower-tier partnership? The regulations give no hint that aggregation in this manner is acceptable. The June 28, 2024 AICPA Letter recommended that this be permitted to ease the reporting burden on the pass-through partner.

6. Pass-Through Partner Tracking Report. Along with the push-out statements that it files with the IRS, a pass-through partner must obtain a unique outgoing tracking number for its push-out and file a partnership adjustment tracking report on Form 8985. Instructions for Form 8985 (Dec. 2024), p. 4.

a. The tracking report is required whether or not the pass-through partner pushes out the adjustments to its own partners, shareholders or beneficiaries. See IRC § 6226(b)(4)(A)(i); Reg. §§ 301.6226-3(e)(1), -3(e)(2)(ii) and -3(e)(5).

b. The tracking report must be filed no later than the extended due date for the adjustment year return of the audited partnership (even if no extension was requested). Reg. § 301.6226-3(e)(3)(ii). If the pass-through partner fails to timely file the tracking report or files it without showing all the required information, it is subject to the section 6698 penalty. Reg. § 301.6226-3(e)(3)(ii). However, it would appear that a Form 8985 failure does not necessarily invalidate a push-out by the pass-through partner if it otherwise files and furnishes correct push-out statements on a timely basis. Reg. § 301.6226-3(e)(2)(i).

7. All upper-tier pass-through partners are subject to the same rules **and have the same deadline**. Reg. § 301.6226-3(e)(3)(ii).

a. As illustrated in the example below, a partnership two or three tiers removed from the audited partnership may face a severe time crunch because of cumulative delays in furnishing push-out statements progressively up the chain.

b. The audited partnership is required to enter on Form 8986 the date on which it furnished Forms 8986 to its direct partners (see Part II, Box G). Part III (which must be completed if a pass-through partner does its own push-out) does not contain a similar requirement to disclose the date on which the pass-through partner furnished Forms 8986 to its own partners. The June 28, 2024 AICPA Letter (p. 2) recommends that the IRS modify Form 8986 to include a field showing the date on which the pass-through partner furnished Forms 8986 to its partners in order to improve accountability up the chain and make it easier for upstream partners to pin the tail on the right delay donkey.

8. Taking all these headaches and timing constraints into account, it may well be that determining and paying an IU at the pass-through partner level is the administratively simpler and more politically expedient option, even if it is more expensive than pushing out.

K. <u>Example -- Push-Out Deadlines</u>

1. Assume the IRS audits year 1 of a BBA partnership and proposes adjustments. On November 1 of year 5, the IRS mails an FPA. The partnership has 90 days after November 1 to petition for judicial review of the FPA adjustments. IRC § 6234(a). Assume the audited partnership makes a push-out election within 45 days of the FPA mailing date.

2. Push-out statements must be furnished to the reviewed year partners no later than 60 days after the date the FPA adjustments are "finally determined," which occurs upon the later of the expiration of the time to file a court petition or, if a petition is filed, the date the court's decision becomes final. Reg. § 301.6226-2(b)(1).

3. Assume the partnership does not file a timely petition. The 90th day after November 1 of year 5 is **January 30** of year 6. Therefore, according to the regulatory examples, the FPA adjustments are "finally determined" on the **next** day, **January 31**. See Reg. § 301.6226-3(h), Examples (2), (3), (4), (6), (7), (8), and (9). Nevertheless, cautious day-counters may want to proceed on the assumption that the petition period expires on the 90th day, not the 91st day.

4. The audited partnership must furnish and file push-out statements no later than 60 days after the finally-determined date. Assuming the finally determined date is January 31 (the 91st day, as indicated by the examples), and year 6 is not a leap year, the deadline for furnishing and filing Forms 8986 is **April 1 of year 6**.

5. Any pass-through partner that chooses to push-out must furnish and file on or before the extended due date of the **audited partnership's adjustment year return.** The FPA was mailed in year 5 and no petition was filed, so the adjustment year is **year 5**. <u>See</u> Reg. § 301.6241-1(a)(1).

6. The extended due date of the year 5 return is **September 15 of year 6**. <u>See</u> IRC § 6072(b) (calendar year partnerships file by March 15); section 6081 and Reg. § 301.6226-3(e)(3)(ii) (automatic six-month extension counted for this purpose whether or not actually requested by the audited partnership).

a. Assume the audited partnership waited until the last minute to furnish its push-out statements and did so on March 31 of year 6. That gives a first-tier pass-through partner only 5 and a half months to furnish its own statements.

b. However, if there are multiple tiers of pass-through partners, each of them must abide by the same push-out deadline (extended due date of adjustment year return). Thus, if a first-tier pass-through partner drags its feet, the deadline for upper-tier partnerships necessarily will be compressed. A pass-through partner sitting near the audited partnership in the structure chart can't wait till the last minute if there are other pass-through partners on up the chain, but there is no penalty for doing so other than raising the ire of those above them.

7. Reviewed year partners, and affected partners of pass-through partners that also push-out, must report and pay the ART, plus applicable penalties and interest, with their **reporting year returns**. The reporting year for each (including the indirect partners of the audited partnership) is the partner's taxable year that includes the date on which the **audited partnership** furnished the push-out statements to its direct partners – in this example, the reporting year is **year 6**. Reg. § 301.6226-3(a).

a. Thus, the correction amounts will be paid in **year 7** when the partners file their year 6 returns.

8. Assume, instead, that the FPA was mailed on **April 1 of year 5** rather than November 1. No petition is filed and the adjustments are finally determined in year 5 (as opposed to year 6 in the above example).

a. Thus, the audited partnership must furnish push-out statements within 60 days after the finally determined date, which also occurs in **year 5**.

b. The affected partners' reporting year is also **year 5** (the year in which the audited partnership furnishes Forms 8986 to its direct partners).

c. An upper-tier pass-through partner has until the extended due date of the adjustment year return – **September 15 of year 6** – to furnish and file. But, if it procrastinates and sends out push-out statements on July 1 of year 6, one or more of its partners (who are indirect partners of the audited partnership) may have already filed their year 5 returns in blissful ignorance of potential ART tax obligations due with their year 5 returns.

L. Example – FPA Mailed Late in the Year Compared to Early in the Year

1. FPA Mailed October 15

a. IRS mails FPA to audited partnership on October 15, 2025. Partnership files push-out election within 45 days. Petition period expires in 2026 with no petition being filed.

b. Audited partnership's "adjustment year" is 2025, the year in which the FPA was mailed.

c. The adjustments are "finally determined" in January 2026 (when petition period expired). The 60-day clock on furnishing push-out statements commences to run on the finally determined date.

d. Audited partnership furnishes Forms 8986 in February 2026.

e. The reporting year for both reviewed year partners and affected partners of pass-through partners is 2026, the year in which the audited partnership furnished the push-out statements.

f. The reviewed year individual partners determine their ART amounts and remit in 2027 when they file their 2026 reporting year returns.

g. Pass-through partner elects to push out and furnishes Forms 8986 to its affected partners by September 15, 2026 (extended due date of audited partnership's 2025 adjustment year return).

h. Affected partners of pass-through partner determine their ART amounts and remit in 2027 when they file their 2026 reporting year returns.

2. FPA Mailed January 30

a. IRS mails FPA to audited partnership on January 30, 2025. Partnership files push-out election within 45 days. Petition period expires in 2025 with no petition being filed.

b. Audited partnership's "adjustment year" is 2025 (year in which FPA was mailed).

c. Adjustments "finally determined" in 2025 (when petition period expired). The 60-day period for furnishing push-out statements commences on the finally determined date.

d. Audited partnership furnishes Forms 8986 in 2025.

e. The reporting year for both reviewed year partners and affected partners of pass-through partners is 2025, the year in which the push-out statements were furnished by the audited partnership.

f. The reviewed year individual partners determine their ART amounts and remit in 2026 when they file their 2025 reporting year returns.

g. Pass-through partner elects to push out and furnishes Forms 8986 to its affected partners by September 15, 2026 (extended due date of audited partnership's 2025 adjustment year return).

h. Because in this example the reporting year and the adjustment year are the same (as opposed to the reporting year coming after the adjustment year in the preceding example), affected partners of the pass-through partner may have already filed their 2025 returns before receiving the push-out statements. However, no section 6651 penalty is imposed if they pay ART by October 15, 2026.

M. Example -- Push-Out With Pass-Through Partners

1. The following example is distilled from Example (8) of Reg. § 301.6226-3(h)(8), which involves both a recharacterization adjustment and a disallowance adjustment. It also involves pass-through partners that are S corporations.

2. Partnership has two equal partners, both S corporations (P-SCo and Q-SCo). The shareholders are individuals. (Recall that S corporations are not subject to the BBA procedures **except** in their capacity as a partner of a BBA partnership.)

3. Partnership reports an ordinary loss of $1,000 for 2020. IRS audits the partnership, disallows $500 of the ordinary loss and recharacterizes the other $500 as a capital loss. IRS mails an FPA on June 1, 2023 which determines a positive adjustment from the $1,000 decrease in ordinary loss and an IU of $400 (assumed 40% maximum rate).

a. A decrease in loss is treated as an increase in income under Reg. § 301.6225-1(d)(2)(i)(D), which in turn is treated as a positive adjustment under Reg. § 301.6225-1(d)(2)(iii).

4. The FPA also reflects a $500 **negative** adjustment attributable to the increase in capital loss. Since that adjustment does not result in an IU, it must be taken into account in the partnership's adjustment year absent a push-out election.

5. Partnership makes a push-out election within 45 days after receiving the FPA and decides not to contest the FPA.

6. The time for filing a petition for readjustment under section 6234 expires 90 days after the FPA was issued, or August 30, 2023. Thus, the partnership adjustments are deemed to be "finally determined" on August 31, 2023.

7. Partnership furnishes the push-out statements to its two S corporation partners, and mails them to the IRS, on October 12, 2023, which is within 60 days after the date the adjustments were finally determined.

8. The statement furnished to each S corporation partner shows a $500 positive adjustment attributable to an increase in ordinary income. Each statement also shows a $250 negative adjustment attributable to an increase in capital loss.

9. The two SCo partners are "pass-through partners" and are treated like partnerships for purposes of the BBA push-out rules. IRC § 6226(b)(4)(A); Reg. § 301.6226-3(e)(5)(i).

10. P-SCo timely files a partnership adjustment tracking report with the IRS and furnishes a push-out statement to its sole shareholder, an individual.

11. The sole shareholder in this context is called an "affected partner" rather than a "reviewed year partner" because the individual is an indirect partner of the audited partnership. The shareholder determines the appropriate correction amount for 2020 as if the shareholder were a reviewed year partner, taking into account the shareholder's share of both adjustments. The ART (plus interest and penalties) is added to the regular tax liability reported on the shareholder's reporting year return.

a. The P-SCo shareholder's reporting year is 2023, the year in which the **audited partnership** furnished the push-out statements to its two direct S corporation partners. Reg. § 301.6226-3(e)(3)(iv). The date on which **P-SCo** furnished a push-out statement to its shareholder is irrelevant.

b. The P-SCo shareholder will not be subject to a section 6651 addition to tax as long as the shareholder pays the ART no later than 30 days after the extended due date of the audited partnership's 2023 return. Reg. § 301.6226-3(e)(3)(iv).

12. Q-SCo decides not to push out its share of the adjustments and instead computes and pays an IU of $200 ($500 positive adjustment times assumed 40% maximum rate). The IU bears hot interest as if the IU were a correction amount, which is consistent with the fact that Q-SCo is participating in a push-out, even though it chooses to pay an IU in lieu of doing its own push-out.

13. Q-SCo remits the IU and interest, together with a partnership adjustment tracking report, to the IRS in 2024, before the extended due date of the audited partnership's 2023 return (the adjustment year return). Reg. § 301.6226-3(e)(4)(ii).

14. Q-SCo reports the $250 increase in capital loss on its 2024 S corporation return (the taxable year in which it paid the IU, see Reg. § 301.6226-3(e)(4)(v)). Thus, the capital loss shows up on the Q-SCo shareholders' 2024 K-1s.

N. <u>Partner Noncompliance Does Not Invalidate the Push-Out Election</u>

1. The audited partnership and any reviewed year pass-through partners that also choose to push out do not act as policemen in "getting the money in" from the partners – in contrast to the

PMAR and Alternative Procedure modifications, where the partnership has to function as a quarterback to ensure modification approval.

a. For example, the reviewed year partners and affected partners of pass-through partners do not provide affidavits to the audited partnership certifying that they have paid all taxes due as a result of push-out adjustments and tax attribute impacts. By contrast, they must provide a Form 8982 affidavit to the audited partnership in connection with a PMAR or Alternative Procedure.

b. The failure of a reviewed year partner (or an affected partner of a pass-through partner) to timely pay the correction amounts, interest and penalties **does not invalidate** the push-out election. The partnership and the current partners cannot be held hostage by a rogue partner's or former partner's noncompliance or nonpayment by deceased, bankrupt or insolvent partners.

c. A reviewed year partner is responsible for paying the correction amounts, penalties and interest even though such person is no longer a partner in the adjustment year.

d. It is not clear what happens if a reviewed year partner becomes deceased or an entity partner terminates or liquidates after the reviewed year and prior to the time ART reporting would otherwise be required.

2. Any disputes between the partner and the IRS over the correction amounts are resolved with partner-level deficiency procedures for the partner's reporting year. The partnership is not involved.

3. While these push-out realities may not be ideal from the IRS' perspective, the fact remains that the onus is on the partners to determine and pay the ART with their reporting year returns.

O. <u>Section 6226 Push-Out Election – Penalties</u>

1. Even though a partnership makes a push-out election, the applicability of any penalties is first determined at the partnership level in accordance with section 6221(a), with the partnership treated as an individual for this purpose and the IU treated as an underpayment of tax for the adjustment year. IRC § 6233(a)(3). However, in a push-out it is the partners, not the partnership, who owe the penalties. IRC § 6226(c)(1); Reg. § 301.6226-1(b)(1); Reg. § 301.6226-3(b)(1).

2. The penalty amount is determined at the partner level by reference to the partner's correction amounts for the first affected year and any intervening year. Reg. §§ 301.6226-3(d)(1) and (2).

3. The applicability of penalties as shown on the push-out statements are actions of the partnership under section 6223 (as are the partners' shares of the underlying partnership adjustments) and are binding on the partners. Reg. § 301.6226-1(e).

4. If an FPA asserts a substantial understatement penalty, the statements furnished to the reviewed year partners would disclose that determination, and the partners would individually determine the amount of the penalty – e.g., was the applicable threshold exceeded for that partner. Reg. § 301.6226-2(e)(6).

5. If an FPA asserts a section 6663(a) fraud penalty against the partnership, the determination of whether there is fraud is made at the partnership level, taking into account partnership-level conduct and intent as well as partnership-level defenses. If the fraud penalty is applicable and a push-out election is made, the partners are liable for the fraud penalty on any positive ART resulting from their respective shares of push-out adjustments attributable to fraud. See CCA 202044009 (Oct. 23, 2020).

6. To assert a partner-level defense to the penalty (such as a reasonable cause defense under section 6664(c) based on the partner's personal circumstances), the reviewed year partner must pay the penalty and file a claim for refund for the reporting year. This means there is no prepayment forum for contesting the penalty based on a partner-level defense. Reg. § 301.6226-3(d)(3).

P. IRS Invalidity Determination

1. Reg. § 301.6226-1(c)(1) states that a push-out election "is valid until the IRS determines that the election is not valid." The IRS is not required to notify the partnership and give it the opportunity to correct any failure before making an invalidity determination. Reg. § 301.6226-1(d). However, it must notify the PR within 30 days of making such determination. Id.

a. The Preamble to the February 2019 Final Regulations states that "while nothing in the regulations requires the IRS to first contact a partnership prior to making a determination that an election under section 6226 is invalid, the IRS intends to develop procedures under which the IRS will first contact partnerships prior to determining a push out election is invalid in certain cases." 84 Fed. Reg. at 6505.

2. This "valid till the IRS says it's not" is a strange notion, to say the least. The Preamble to the August 2018 Proposed Regulations even goes so far as to say that "… if a partnership makes an election in accordance with proposed § 301.6226-1 but fails to furnish statements to its partners, that election is valid until the IRS determines otherwise." 83 Fed. Reg. at 41961. This raises a host of questions which Jenni Black explores in Challenging the Validity of a Push-Out Election Under BBA: Is the Push-Out Election a PRI?, 186 Tax Notes Federal 751 (Jan. 27, 2025), and Challenging the Validity of a Push-Out Election under BBA: Forums for Review, Part 2, 186 Tax Notes Federal 755 (Jan. 27, 2025).

a. If a partnership makes a valid push-out election, it is not liable for an IU and the IRS cannot make an assessment. Reg. § 301.6226-1(c)(1). Suppose the IRS makes an invalidity determination due to an alleged failure or defect in furnishing the push-out statements to the reviewed year partners or failure to timely and properly make the push-out election. This might occur after a judicial proceeding for readjustment of the FPA partnership adjustments has been concluded. (Such proceeding is conducted without regard to the making of the push-out election, see Reg. § 301.6234-1(a).) How does the IRS make the invalidity determination?

b. An IU is itself a PRI, but is a push-out election that prevents the IRS from assessing an IU also a PRI for that reason alone?

c. Is it a PRI under the general PRI definition in Reg. § 301.6241-1(a)(6)(ii)(A)? It clearly is relevant to the partners' chapter 1 tax liabilities, but a PRI must also be "with respect to the partnership." Thus, it must be "an item or amount shown or reflected, or required to be shown or reflected, on a return of the partnership under section 6031 or the forms and instructions prescribed by the IRS." The BBA push-out election and push-out statements are not filed with the partnership's return.

d. If the validity of the push-out is a PRI, and the partnership has already petitioned a court for readjustment of the FPA, the IRS is precluded from issuing another FPA. IRC § 6231(c).

e. The Preamble to the February 2019 Final Regulations, in response to a commenter's suggestion that a partnership should be able to seek Tax Court review of an invalidity determination, states that the Tax Court "is a court of limited jurisdiction … and [Treasury] and the IRS do not have authority to confer jurisdiction on [the court]." 84 Fed. Reg. at 6505.

f. An invalidity determination may inevitably get pushed into a refund suit, where the IRS seeks to assess the IU based on its determination, and the partnership is forced to pay the IU and sue for a refund in District Court or the Court of Federal Claims.

Q. Contesting FPA Adjustments if Push-Out Election is Made

1. Making the push-out election does not require the partnership to throw in the towel on the FPA adjustments. It can still litigate them in Tax Court, Federal District Court, or the Court of Federal Claims. See IRC §§ 6226(d) and 6234(a); Reg. § 301.6226-1(f); see Preamble, February 2019 Final Regulations, 84 Fed. Reg. at 6506.

a. There is no right to a jury trial in Tax Court or in the Court of Federal Claims. While there is a right to a jury trial in tax refund suits in Federal District Court (28 U.S.C. § 1346(a)(1)), there is no such right in a TEFRA or BBA partnership action. See 28 U.S.C. § 2402; Silver Moss Properties, LLC v. Commissioner, 165 T.C. No. 3 (Aug. 21, 2025) (court-reviewed), slip op. at 4-5 and n. 8; Eastwood Mall, Inc. v. United States, 47 F.3d 1168 (6th Cir. 1994) (per curiam).

2. As noted, the push-out election must be filed within 45 days of the FPA mailing. If the election is made, the partnership has 45 more days after the election deadline (90 days after the FPA mailing) to commence a judicial proceeding under section 6234(a) to contest (i) the FPA adjustments, (ii) the allocation of such adjustments among the partners, (iii) the IU determination, and (iv) the applicability of any penalties.

3. The partnership must either file a petition for readjustment with the Tax Court (prepayment forum) or make a jurisdictional deposit with the IRS in the amount of the IU and any penalties and additions to tax, and file a petition for readjustment in Federal District Court where the partnership's principal place of business is located or in the Court of Federal Claims. IRC § 6234(a), (b) and (c); Reg. § 301.6234-1(b).

4. If the partnership files a petition, the implementation of the push-out is held in abeyance until the contest is resolved. See IRC § 6226(d); Reg. § 301.6226-1(f); Reg. § 301.6226-2(b)(3)(iii), Example (3); Reg. § 301.6234-1(a).

5. Partners have no contest rights with respect to BBA partnership audit adjustments, even if a push-out election is made. It is strictly up to the partnership/PR to decide whether and for how long to litigate the push-out adjustments, even though deciding not to (or to embark on litigation and then settle) basically means the partnership is folding the reviewed year partners' cards for them.

6. The costs of litigating are economically borne by the current partners unless the partnership agreement or other agreements reallocate this burden, even though it is the reviewed year partners who stand to gain from a favorable litigation outcome. This creates conflict of interest issues if the owners in the reviewed year and the owners in the adjustment year are not substantially congruent.

7. If an unfavorable outcome lies ahead, it could be years before push-out statements are provided to partners, with the meter spinning on 2%+ underpayment interest in the meantime.

a. The partnership could ask for IRS permission to revoke the push-out election and pay an IU instead.

8. Even though the partnership will have no IU liability if it makes an effective push-out election and complies with the push-out requirements, it still must make a jurisdictional deposit with the Secretary if it wants to litigate in District Court or the Court of Federal Claims. IRC § 6234(b)(1). The rationale for this is that push-out validity is indeterminate until litigation is concluded and proper push-out statements are timely furnished to the partners and filed with the IRS. See Preamble to the February 2019 Final Regulations, 84 Fed. Reg. at 6526-6527 (explaining that the deposit is required because the push-out statements are not furnished, and partner tax payments are not made, until after the litigation is concluded).

a. Although the deposit is not a payment of tax, if it is refunded it does bear interest under section 6611. Reg. § 301.6234-1(c).

b. The deposit equals the amount of the IU "shown on the FPA" as of the date of the petition, plus any penalties, additions to tax and additional amounts with respect to such IU. IRC § 6234(b)(1); Reg. § 301.6234-1(b).

9. The FPA package includes Form 15027, which provides the computation of any final IU amount, including approved and disapproved modifications, if any, and interest and penalties. Approved IU modifications should likewise reduce the deposit, as indicated by the following portions of the regulations:

a. Reg. § 301.6241-1(a)(3) defines "imputed underpayment" to mean "the amount determined in accordance with section 6225…, § 301.6225-1, and, if applicable, § 301.6225-2 [which contains the modification rules]."

b. Reg. § 301.6225-1(a)(3) and Reg. § 301.6225-2(b)(1) provide that modifications approved by the IRS may change the amount of the IU as set forth in the NOPPA.

c. Reg. § 301.6225-2(b)(2) states that if the IRS approves a modification request with respect to a partnership adjustment, including (among other listed modifications) PMARs or Alternative Procedure modifications, that adjustment "is excluded from the determination of the imputed underpayment as determined under § 301.6225-1(b)."

d. Reg. § 301.6225-1(a)(2) states that "the FPA will include the amount of any imputed underpayment, as modified under § 301.6225-2 if applicable," unless the partnership waives the FPA.

10. Assume a partnership receives an FPA, makes a timely push-out election and then files a petition for readjustment in District Court, putting up the required deposit. The IRS prevails in a final court decision, and the partnership furnishes the push-out statements to its partners within 60 days of the decision becoming final.

a. At that point, the partnership should be able to request the IRS to refund the deposit (plus interest) because it has no IU liability that can be assessed. See Reg. § 301.6234-1(b); Reg. § 301.6234-1(e); see Preamble discussion, February 2019 Final Regulations, 84 Fed. Reg. at 6527.

b. The refund request is to be made in accordance with IRS forms and instructions. The author is not aware of any such guidance at the present time.

R. Accounting Firms May Need to Reconsider Tax Return Record Retention Policies

1. Reviewed year partners and their accountants will need the partner's tax returns for the first affected year and any intervening years to do the correction amount calculations. Having access to the data in electronic form will be critically important; otherwise, data from a hard copy or pdf copy will have to be re-inputted. Whether that data will be available depends on the firm's record retention policies. Many firms discard many tax-related documents and information after 7 years.

2. Similarly, partnerships and their accountants will need to hang on to the relevant partnership returns and tax data in order to be able to provide push-out statements to reviewed year partners in connection with an audit or an AAR push-out.

3. Push-out statements may not be provided and correction amounts determined until well after the accounting firm's return retention period has passed, particularly if the partnership adjustments are litigated.

S. Adjustments to Partner and Partnership Tax Attributes

1. Section 6226(b)(3) requires partner tax attributes to be appropriately adjusted as a result of taking into account push-out adjustments in the first affected year. The spillover effects of such tax attribute adjustments into intervening taxable years are the reason why correction amounts must also be computed for such years.

a. In addition, section 6226(b)(3) requires partners to adjust their tax attributes (e.g., NOL carryovers) for the partner's reporting year and subsequent taxable years as a result of taking into account the adjustments in the reviewed year. See Reg. § 301.6226-4(b) (last sentence).

b. In contrast to the proposed rules under section 6225 and section 704(b), all tax attributes are adjusted to reflect push-out adjustments, not just specified tax attributes.

2. In a push-out, with the exception of pass-through partners choosing to pay an IU, there generally is no need to create "notional items" to allocate among the partners because the actual partnership adjustments are being pushed out instead of being walled off within a partnership IU.

3. This outline has previously covered how push-out **adjustments** are allocated among the reviewed year partners for purposes of determining their correction amounts and ART. What has not been discussed are the tax impacts of push-out adjustments on partner and partnership **tax attributes**.

a. Prop. Reg. § 301.6225-4(a)(5)(i) provides that, in a section 6226 push-out, tax attributes of the partners and the partnership are adjusted for partnership adjustments as provided in Prop. Reg. § 301.6226-4.

b. Tax attributes are broadly defined in Reg. § 301.6241-1(a)(10) to include anything that can affect the amount or timing of a PRI or the amount of tax due in any taxable year, and include basis, holding period, character of items of income, gain, loss, deduction and credit, and carryovers and carrybacks of such items. A partner's outside basis clearly is a tax attribute.

c. Reviewed year partners and affected partners (holding their interest in the reviewed partnership indirectly through a pass-through partner), and the partnership as well, must adjust their "partnership tax attributes" affected by reason of the push-out adjustments "with respect to the reviewed year," unless an attribute was already adjusted as part of the partnership adjustment. Prop. Reg. § 301.6226-4(a)(1) and (b) (third sentence).

d. Prop. Reg. § 301.6226-4(b) (last sentence) provides that the reviewed year partners and affected partners adjust their "partner tax attributes" (e.g., an NOL carryforward or a partner's outside basis in the partnership) that are affected by the adjustments on the push-out statements, "but these adjustments are calculated with respect to each year beginning with the first affected year, followed by any intervening years…, concluding with the reporting year."

4. Prop. Reg. § 301.6226-4 is frustratingly vague; the lone example sheds some light, but not enough. <u>See</u> Prop. Reg. § 301.6226-4(c), Example (iii). The facts are as follows:

a. The IRS audits a partnership with three equal partners and determines in 2023 (the adjustment year) that depreciation in respect of a partnership asset was overstated by $75 in 2021 due to use of an improper recovery period.

b. The IRS does not audit the partnership for 2022, and the partnership does not file an AAR for such year to correct the erroneous recovery period in 2022.

c. The partnership pushes out the 2021 positive adjustment to the three reviewed year partners, with each partner getting a $25 increase in income from the partner's one-third share of the $75 reduction of depreciation. The Example states that the partners' outside bases and capital accounts "must be increased $25 each with respect to the 2021 tax year." No further change is made to outside bases and capital accounts for 2022 because the IRS did not adjust the partnership's excess depreciation for 2022. Before the adjustment, the partners each had an outside tax basis and capital account of $400; at the end of 2023, they each had an outside basis of $425 due to the reduction in depreciation expense.

d. Example (iii) also indicates that the partnership adjusts its partnership tax attributes, i.e., partnership asset basis and book value, prospectively in the adjustment year, but only to reflect the 2021 adjustment. Such amounts are not restated retroactively on the assumption that the correct recovery method had been used in all years prior to the adjustment year.

(1) Query what happens if the partnership had sold the asset in 2022 and the partnership reported too much gain on the sale, and the partners consequently overstated their 2022 tax liabilities. The partnership may need to file an AAR for 2022 if the period of limitations is still open when the 2021 depreciation adjustment is finally determined.

5. So, when do the partners' outside basis adjustments for tax items resulting from the partnership adjustments take effect? What happens if a reviewed year partner sells the partner's interest after the reviewed year and before the adjustment year?

a. The Preamble to the June 2017 Proposed Regulations reserved on this issue and asked for comments, but stated that IRS and Treasury had concluded that the outside basis and capital account adjustments should be made in the adjustment year and thus affect the adjustment year partners, even if an adjustment year partner acquired its interest from a reviewed year partner during an intervening year. 82 Fed. Reg. at 27366 ("The Treasury Department and the IRS believe that if a reviewed year partner transfers its partnership interest in an intervening year, it is appropriate for the transferee adjustment year partner's capital account and outside basis to be adjusted in the adjustment year"). The Preamble also stated, however, that the amount of such attribute adjustment should be determined as if it had actually been made in the reviewed year by the reviewed year partners "and then modified to take into account all intervening events considered in computing the amount by which the tax imposed under chapter 1 would increase for any intervening year – for example, amortization or depreciation of property." Id.

b. The Preambles to the February 2018 and August 2018 versions of the tax attribute proposed regulations, while containing some mixed signals, on the whole signal a departure from the June 2017 viewpoint. A good place to start is the proposed section 704(b) regulations included in the tax attribute regulation package that deal with tax items attributable to push-out adjustments.

(1) The Preamble to the February 2018 Proposed Tax Attribute Regulations observes that allocations of tax items arising from push-out adjustments do not have substantial economic effect because, although they relate to the reviewed year, the correction amounts are not required to be paid by reviewed year partners until the adjustment year. 83 Fed. Reg. at 4874. Similarly, Prop. Reg. § 1.704-1(b)(1)(viii) states that special rules apply to items of income, gain, loss, deduction and credit that result from final BBA adjustments for section 704(b) purposes "that take into account that the item relates to the reviewed year… but occurs in the adjustment year."

(2) Under Prop. Reg. § 1.704-1(b)(4)(xiv), the allocation of a tax item resulting from a push-out adjustment is deemed to be in accordance with PIP if the item is allocated "**in the adjustment year**… in the manner in which the item would have been allocated [under section 704(b)] **in the reviewed year** … followed by any intervening years…, concluding with the reporting year." (Emphasis added). See Prop. Reg. § 301.6226-4(a)(3); Prop. Reg. § 1.705-1(a)(10). Notably, this section 6226-specific allocation rule, in contrast to certain other proposed section 704(b) allocation rules, does not say "to the reviewed year partners **or their successors**." While Prop. Reg. § 1.704-1(b)(4)(xiv) states that such allocation is made "in the adjustment year," that may simply reflect the reality that no allocation can occur until the partnership adjustments are finally determined and pushed out; it does not necessarily mean that such allocations only have tax effect for outside basis and capital account purposes commencing in the adjustment year.

c. As originally proposed in the February 2018 Proposed Tax Attribute Regulations, Prop. Reg. § 301.6226-4(b) stated that "the reviewed year partners or affected partners must take into account items of income, gain, loss, deduction or credit with respect to their share of the partnership adjustments as reflected on the statements described in § 301.6226-2 or § 301.6226-3(e)(3) (pushed-out items) **in the reporting year** (as defined in § 301.6226-3(a))." (Emphasis added.) This arguably means that a reviewed year partner's tax attributes, like outside basis, aren't adjusted for such tax items until the reporting year and don't have retroactive tax impact. The following sentence in the Preamble to the February 2018 Proposed Tax Attribute Regulations seems consistent with this notion:

> "A commenter recommended that adjustments to capital accounts and basis should be made to the reviewed year partners in the reviewed year to prevent distortions. This comment is not adopted because, in this context, section 6226 clearly applies to the adjustment year."

83 Fed. Reg. at 4875.

The following sentence, however, seems to go the other way:

> "In the case of a reviewed year partner that disposed of its partnership interest prior to the reporting year, that partner may take into account any outside basis adjustment under these [push-out attribute adjustment] rules in an amended return to the extent otherwise allowable under the Code."

83 Fed. Reg. at 4874.

d. Paragraph (b) of Prop. Reg. § 301.6226-4 was revised in the August 2018 Proposed Tax Attribute Regulations, but the accompanying Preamble explanation doesn't offer much insight as to why. Revised paragraph (b) begins by stating that the push-out adjustments must be taken into account by the reviewed year partners in accordance with Reg. § 301.6226-3. This doesn't tell us anything we don't already know; it doesn't inform as how to go about adjusting tax attributes. The next sentence states that that the "reviewed year partners or affected partners and the partnership adjust partnership tax attributes affected by reason of an adjustment reflected [on the push-out statements] "with respect to the reviewed year," except to the extent partner or partnership tax attributes were already adjusted as part of the partnership adjustment." This sentence is ambiguous about timing, in part because it is not clear what "with respect to the reviewed year" is modifying in that sentence. The last sentence (quoted above) states that partner tax attributes affected by the partnership adjustments are "calculated" with respect to each year, starting with the first affected year and ending with the reporting year. Example (iii) indicates that the partner's outside basis adjustment is made "with respect to the [reviewed] year."

e. It would seem that a partner's outside basis should be increased in the reviewed year as a result of taking push-out adjustments into account for correction amount purposes. Assume that a partner takes into account in year 1 (the first affected year) a positive adjustment to partnership ordinary income of $100 that is pushed out. Assume the partner then sold his partnership interest in year 3, before the push-out was implemented, for $150 and had a zero outside basis at the time of sale. Upon receiving the push-out statement in year 5, the partner computes a year 1 correction amount of $37 ($100 x 37%). A fair reading of Prop. Reg. § 301.6226-4(b), though hardly free from doubt, is that the partner's outside basis (a tax attribute) is adjusted in the reviewed year for the tax item to which the push-out adjustment relates, as suggested by Example (iii) above. Consequently, the partner should be able to take that tax attribute adjustment into account in determining a correction amount for year 3 (an intervening year). Such amount would equal the $100 reduction in the originally reported LTCG from the sale multiplied by 20%, or -$20. The sum of the two correction amounts ($17) would be reported on the partner's year 5 return (the reporting year).

f. Thus, the better view under the current proposed regulations (and contrary to the view expressed by the drafters in June 2017) is that any outside basis increase is not enjoyed by the buyer of the reviewed year partner's interest. Rather, it is taken into account by the seller in determining the seller's correction amounts. Ignoring the low probability of a partnership audit, this fact pattern can hardly be considered a remote possibility; it will occur and it will force the tax advisor to take a position one way or the other. A regulatory example is needed.

g. Suppose in reviewed year 1 an FPA makes a downward adjustment to the basis of partnership property, resulting in a positive adjustment and an IU. If the partnership pushes out the adjustment and the property is nondepreciable, it typically would have no immediate tax impact on partner tax attributes, and the reviewed year partners would not report an ART.

(1) On the other hand, if a reviewed year partner contributed the property to the partnership and the adjustment reduces the partnership's carryover basis under section 723, the push-out would affect a partner tax attribute – the contributing partner's outside basis – because the downward adjustment to the property's basis reduces the contributor's outside basis. That tax attribute adjustment, in turn, ought to be taken into account in determining the partner's correction amounts (e.g., it could reduce the partner's allowable partnership loss for the reviewed year or an intervening year after applying section 704(d)).

(2) Because the basis of property is a tax attribute of the partnership, the partnership is required to adjust the property's basis on its books and records in the adjustment year. Prop. Reg. § 301.6226-4(c), Example (iii).

(3) If partnership sold the property in year 2, and that year is also under examination, one would expect the IRS to propose a year 2 positive adjustment equal to the additional gain resulting from the basis reduction. A push-out of that adjustment directly impacts the partners and their correction amounts, as would an adjustment to tax depreciation if the basis reduction involves depreciable or amortizable property.

6. An exception to the general rule that notional items are not created in a push-out applies where a pass-through partner elects to pay an IU on its share of push-out adjustments. In that case, the pass-through partner and its affected partners (or their successors) must adjust their tax attributes – apparently limited in this context to "specified" tax attributes only – in accordance with Prop. Reg. § 301.6225-4. <u>See</u> Reg. § 301.6226-4(a)(2).

a. To accomplish this, notional items are created as provided in Reg. § 301.6225-4(b)(3) in order to give appropriate effect for partner-level specified tax attributes of the reviewed year partners and their successors with respect to the pass-through partner. <u>See</u> Prop. Reg. §§ 301.6225-4(a)(1), -4(a)(5)(ii), and -4(b)(3).

b. Outside basis and capital accounts are specified tax attributes that are adjusted by such notional items. <u>See</u> Prop. Reg. § 301.6225-4(b)(6)(ii) and (iii)(A); <u>see also</u> Prop. Reg. § 1.705-1(a)(10).

T. <u>Push-Out Election v. IU – Conflict Issues</u>

1. Only the person designated as the PR or DI for a partnership taxable year can make the push-out election. The reviewed year partners and the current partners have no say-so except to the extent otherwise provided in the partnership agreement or some other agreement.

2. The interests of the reviewed year partners and the current year partners may conflict.

a. Assume partner A is the PR and the majority owner of a partnership for the year 2020. In 2021 partner A sells most of its partnership interest to a buyer. IRS commences a BBA partnership audit for 2020 and proposes adjustments that result in an IU.

b. Unless the partnership agreement restricts partner A from doing so or partner A is replaced with another PR, partner A could cause the partnership pay an IU for 2020, thus shifting the economic burden to the buyer and the other current partners, in lieu of making a push-out election that would force A, as a reviewed year partner, to bear A's proportionate share of the tax liability resulting from the adjustments.

c. This assumes the partnership agreement does not require A to reimburse the partnership or buyer for a portion of the IU obligation.

d. As will be discussed, if 100% of the partnership interests are purchased, the P&S agreement typically will require a push-out election to be made for reviewed years ending on or before the purchase date and provide for a back-up seller indemnity to the extent the purchaser ends up economically bearing any of the tax cost of pre-sale BBA audit adjustments. It will also restrict the ability of the PR to file an AAR for pre-acquisition years, and mandate a push-out if an AAR is filed.

U. Push-Out Election – CFC and PFIC Partners

1. If a partnership has a controlled foreign corporation (CFC) or passive foreign investment company (PFIC) as a partner, matters can get much more complicated because each of the CFC's "United States shareholders" and each person that has made a "qualified electing fund" ("QEF") election as to the PFIC are treated as partners of the partnership for BBA purposes, unless the Secretary otherwise provides. See IRC § 6241(12) (as added by section 206(m) of the TTCA).

2. The BBA regulations promulgated to date do not address the impact and scope of this special rule. Cf. Reg. § 301.6241-1(a)(4) (defining "indirect partner" without referring to this rule). The Preamble to the August 2018 Proposed Regulations states that in both of these circumstances, "the U.S. shareholder of a CFC and the taxpayer of a PFIC will be treated as the adjustment year partner or reviewed year partner under proposed §§ 301.6241-1(a)(2) and 301.6241-1(a)(9) where applicable." 83 Fed. Reg. at 41969.

3. The Instructions for Form 8986 (Dec. 2024) do not address CFCs and PFICs, although Form 8986 does ask whether the partner is a foreign partner.

4. It appears that a partnership would have to furnish push-out statements to such "deemed partners," which obviously requires the cooperation of the CFC or PFIC. Partnerships should consider requiring each entity foreign partner to certify annually that it is not a CFC or PFIC, and if it cannot, to cooperate in providing information regarding the shareholders of such entities for purposes of the push-out. A failure to send the push-out statements to all persons required to receive them can invalidate the push-out election. Reg. § 301.6226-1(c)(1).

V. Push-Out Election May Not Be a Panacea

1. While it is often said that a push-out election will be the option of choice in many BBA audits, the foregoing discussion should leave no doubt that it has its own administrative costs and complexity, in addition to the 2% interest surcharge, and it drags the partners into a nasty mess they almost certainly did not see coming. Having the partners determine and report their correction amounts is burdensome and expensive, and the people running the partnership may view the push-out process as politically unacceptable and practically infeasible. This is especially true if there are chains of partnerships stacked above the audited partnership.

2. Preparing and filing push-out statements is also burdensome and expensive for the partnership. Paying an IU and reporting any DNR adjustments in the adjustment year is simpler and likely cheaper from an administrative cost standpoint, although the partnership must still deal with issues such as allocating the IU burden among the partners. If modifications are sought, the IU cost may go down but administrative costs and headaches in dealing with the partners and the IRS go up.

a. These considerations are comprehensively addressed in Kate Kraus, The Push-Out Election and AARs Might Not Get You Back to Kansas, Tax Notes Federal, Dec. 2, 2019, p. 1429.

3. In a push-out, partners with a net negative correction amount may not have enough reporting year tax liability to offset with the negative amount. It is treated like a nonrefundable credit; if you can't use it you lose it.

4. Pass-through partners may determine they don't have enough time to do anything but pay an IU on push-out adjustments.

5. Since a pass-through partner is not required to send push-out statements to its partners until the extended due date of the audited partnership's adjustment year return (even if not extended), partners of pass-through partners, unless warned in time, may have already filed their own returns for such year not knowing a push-out was coming.

6. Foreign partners may create additional issues in implementing a push-out (e.g., the CFC/PFIC issues noted earlier).

7. Regardless, one or more partners or even a partnership lender may negotiate for a mandatory push-out.

X. ADMINISTRATIVE ADJUSTMENT REQUESTS (AARS)

A. AARs Under TEFRA

1. A TEFRA partnership corrected treatment of partnership items in a previously filed Form 1065 by having the tax matters partner ("TMP") file an administrative adjustment request (AAR) on Form 1065-X (Amended Return or Administrative Adjustment Request (AAR)), checking the box "TEFRA AAR" and disclosing the effect of the requested adjustments on the partners.

2. The partnership provided amended K-1s to the partners and notified them that the partnership had filed an AAR. TEFRA section 6227(a); Instructions for Form 1065-X (Dec. 2024), p. 8.

a. If filing electronically, the TMP filed a TEFRA AAR using an amended Form 1065 to which was attached Form 8082.

b. A TEFRA AAR generally had to be filed within three years of the date the return was filed and before the IRS mailed an FPAA with respect to the year to which the AAR related. TEFRA section 6227(a).

c. An AAR under TEFRA was effectively an amended partnership return, but there was more to it than that. If a TEFRA AAR requested that its treatment of a partnership item be substituted for the treatment of the item on the originally filed Form 1065 and the IRS allowed such treatment, the IRS could assess any resulting increase in partner tax liabilities as a math or clerical error after giving the affected partners notice of the error correction and the opportunity to object within 60 days. TEFRA sections 6227(c)(1) and 6230(b)(2). If the partnership did not request substituted return treatment, the IRS could (i) make refunds to the partners whose tax liabilities were decreased by the AAR adjustments without conducting a TEFRA proceeding, (ii) commence a TEFRA proceeding, or (iii) do nothing. TEFRA sections 6227(c)(2)(A) and 6230(d)(2).

3. If the IRS did not allow all or any part of the AAR (or sat back and did nothing), the TMP could file a petition for adjustment with a court under TEFRA section 6228(a) within two years after filing the AAR as long as a notice of commencement of an administrative proceeding had not been mailed to the partnership. TEFRA sections 6228(a)(2)(A)(ii) and (a)(2)(B); Reg. § 301.6227(c)-1(b).

4. Any partner tax deficiencies resulting from AAR adjustments that were not treated as a substituted return could not be assessed without the IRS first commencing a TEFRA proceeding and issuing an FPAA.

5. A partner could also initiate an AAR as to the partner's share of partnership items by filing an amended 1040X and attaching Form 8082. TEFRA sections 6227(a) and (d) and 6228(b)(2).

6. TEFRA section 6230(d)(5) provided that in the case of any overpayment by a partner which was attributable to a partnership item (or affected item affected by a partnership item), the IRS should, "to the extent practicable," make any credit or refund of the overpayment without requiring the partner to file a claim.

B. <u>AARs Under the BBA – Overview</u>

1. Under section 6031(b), a partnership subject to the BBA (no opt-out) generally cannot file an amended return or amended K-1s to correct errors after the due date of such return. Instead, BBA partnerships correct errors in the reporting of any PRI for a particular reviewed year by filing an AAR for such year as provided in section 6227. The "reviewed year" terminology is borrowed from the rules that apply to audited partnerships, but similarly means the partnership taxable year to which the partnership adjustments relate. Reg. § 301.6241-1(a)(8).

2. A BBA partnership that files an AAR has two choices if the AAR adjustments result in an IU after applying the IU calculation rules in Reg. § 301.6225-1: the partnership must either pay the IU or push out the adjustments to the reviewed year partners under rules similar to a section 6226 push-out election.

a. Push-out adjustments are taken into account by the reviewed year partners, who determine the resulting correction amounts, applying the section 6226 regulations, and report the positive or negative ART, plus interest, with their reporting year returns.

b. An AAR partnership is automatically liable for the IU if it does not furnish push-out statements to its partners on Form 8986 **at the time it files the AAR**. Reg. § 301.6227-2(c);

3. If the AAR adjustments do not result in an IU, all of the adjustments are required to be pushed out to the partners. This differs from the treatment of an audited partnership, where adjustments not resulting in an IU are reported on the partnership's adjustment year return instead of being pushed out to the reviewed year partners. This difference is dictated by statute. (Compare section 6225(a)(2) with section 6227(b), the last sentence of which provides that rules similar to section 6225 apply to do-not-result AAR adjustments.)

4. Note that a BBA partnership can still file a superseding corrected return on or before the due date of the return, as extended. In that event, the later-filed partnership return is simply substituted for the original return and is not treated as an amended return. <u>See</u> Instructions for Form 1065-X (Dec. 2024), p. 9; Rev. Proc. 2019-32, 2019-33 I.R.B. 659; Rev. Proc. 2025-28, __ I.R.B. __, Section 2.08(2)(b).

a. A partnership could request an extension as a matter of course, even if it intends to file by the unextended due date, so that a window would exist in which a superseding return could be filed after the partnership spots an error without being forced into the cumbersome and potentially disadvantageous AAR process.

5. If the original partnership return was filed by paper, the PR files the AAR by paper using Form 1065-X at the same service center where the original return was filed. See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 1.

a. The August 2023 revision of Form 1065-X is used for taxable years beginning on or after January 1, 2023; the December 2021 revision is used for taxable years beginning in 2021 and 2022; for earlier years, the September 2018 revision is used.

6. If the original return was filed electronically, the PR files the AAR electronically using Form 1065 (checking the amended return box) and attaching a Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)) (Oct. 2023). See the instructions at irs.gov/bbaaar; Instructions for Form 1065-X (Dec. 2024), p. 1.

a. Electronically filed AARs cannot be submitted in the BBA Online Form Submission Service (OFSS), but instead are e-filed through the Modernized e-File system (MeF). See Publication 5346, Instructions for Form 8980 (Dec. 2024), p. 1.

b. The AAR filing procedures are also addressed in IRM 4.31.9.7.7.1 (01-24-2024).

7. The AAR must be signed by the person who is the designated PR or DI **for the partnership taxable year to which the AAR relates**. Reg. § 301.6227-1(c)(1).

a. If, in addition to making partnership adjustments, the AAR includes a Form 8979 removing the current PR and designating a new PR, the two actions are both effective on the date of the AAR filing. Reg. § 301.6223-1(e)(3). Further, Reg. § 301.6227-1(a)(1) (penultimate sentence) states that this is treated as occurring immediately prior to the filing of the AAR. Thus, the AAR should be signed by the newly appointed PR.

(1) The Form 8979 can be signed by any person who was a partner during the reviewed year, which is a workaround in the case of a P/DI who is disgruntled, recalcitrant or missing in action. Reg. § 301.6223-1(e)(4).

b. It appears that an AAR can also be used to file a late partnership election where 9100 relief is granted or to correct other "ministerial" errors. Cf. Instructions for Form 8986 (Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Dec. 2024), p. 1 (stating that any adjustment "to an item which is not a monetary item (for example, **an election made by the partnership**)" is an adjustment that does not result in an IU).

c. See, e.g., PLR 202507011 (Nov. 18, 2024) (taxpayer partnership failed to file an opt-out election for its real property trade or business under section 163(j) and also claimed bonus depreciation for the year; IRS granted 9100 relief to make a late election-out of bonus depreciation and a late section 163(j) opt-out election, both to be made pursuant to an AAR filed under the BBA).

d. The June 28, 2024 AICPA Letter noted that the IRS's e-file software does not accept "no" responses to all three of the following Form 8082 questions: do the AAR adjustments result in an IU; is the partnership electing to have the adjustments taken into account by the reviewed year partners; and are there also adjustments that do not result in an IU. The AICPA letter seems to assume that, for ministerial corrections like a missed tax election, "no" responses would be required for all three questions, putting the taxpayer in a box. However, as noted above, the Instructions for Form 8986 refer to an adjustment relating to a tax election as a DNR adjustment, which suggests that the third question could be answered "yes." The AICPA recommended that the IRS permit such types of corrective action to be effected by a conventional amended partnership return.

8. An AAR could also be used to address a failure to file a required form with the partnership return, provided the three-year statute of limitations on filing an AAR is still open when failure is identified. Assume, for example, that a partnership has "hot assets" within the meaning of section 751 and is required to file Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests) (Oct. 2024) with its Form 1065 for the year in which a "section 751(a) exchange" of an interest in the partnership took place.

a. The partnership is required to provide Form 8308 to the transferor and transferee partners in the section 751(a) exchange within 30 days after year-end (or, if later, within 30 days after the partnership is notified of the exchange or becomes aware of it). Recently proposed regulations (discussed earlier in this outline) would change the filing requirements so that only Parts I, II, and III of the form need to be completed and provided to the seller and buyer within the 30-days-after-year-end deadline. The completed form, including Part IV (which reports the selling partner's share of hot asset income or loss), would be filed with the partnership's Form 1065.

b. If a BBA partnership does not become aware of a section 751(a) exchange until after it files its Form 1065, the Form 8308 instructions indicate that it should either file a superseding return that includes Form 8308 (if the extended return due date is not yet passed) or an AAR that includes Form 8308 as an attachment (if past the filing deadline). <u>See</u> Instructions for Form 8308 (Oct. 2024), p. 1.

c. Similar procedures apply with respect to correction of errors made in the K-1 reporting of section 751(a) income or loss allocable to the transferring partner – either a superseding return if filed prior to the extended due date or an AAR if beyond, subject to section 6227(c) period of limitations.

d. If a BBA partnership is required to file Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) (Dec. 2024) or certain other information described in section 6501(c)(8) and fails to do so, section 6235(b)(5) provides that the period of limitations on making partnership adjustments does not begin to run until the date determined under section 6501(c)(8). That means the section 6235 period does not commence to run **until Form 5471 is filed.** The mechanism for the partnership to belatedly file Form 5471 would be an AAR, but what happens if the section 6227(c) period on filing an AAR has expired when the failure is discovered? (There is no provision in section 6227(c) that contemplates extension of the AAR statute, unlike section 6235(b).)

9. <u>AAR partnership pays IU</u>. If the AAR partnership decides to pay an IU rather than push-out, it must determine the resulting IU liability (taking into account only the modifications specified in Reg. § 301.6227-2(a)(2)) and submit payment **with the filing of the AAR**. <u>See</u> IRC §§ 6227(b)(1) and 6232(a)(2) (providing that the IU shall be paid and may be assessed when the AAR is filed); Reg. § 301.6227-2(a) and (c).

a. For the specific instructions as to how to make the IU payment, see Instructions for Form 1065-X (Dec. 2024), p. 10.

b. Permitted modifications include those relating to tax rate, tax-exempt partners, specified passive activity losses, qualified investment entities, groupings, tax treaties, and any others permitted by the forms and instructions. Reg. § 301.6227-2(a)(2). The notable omissions are PMAR and Alternative Procedure modification, which are expressly excluded by section 6227(b)(1), as well as closing agreement modifications and "other" modifications (see Reg. § 301.6225-2(d)(10)).

c. Prior IRS approval is not required for such modifications. Reg. § 301.6227-2(a)(2)(i). However, the AAR submission must include the basis for any claimed modifications and documentation of the partnership's eligibility for them using Form 8980. See IRC § 6227(b)(1) (providing that the 270-day modification submission period in section 6225(c)(7) does not apply to the modifications permitted under section 6227(b)(1)); Reg. § 301.6227-2(a)(2); Instructions for Form 1065-X (Dec. 2024), pp. 7, 10.

d. The IRS always has the right to examine the modifications, and any other issue relating to the IU calculation (an IU is a PRI), in connection with an audit of the AAR partnership and issue an FPA. If the IRS denies a modification or otherwise disagrees with the IU calculation, the partnership has its standard BBA contest rights (e.g., go to Appeals, file a petition for readjustment in court).

e. The partnership can also include a prepayment of penalties and interest based on estimates, accompanied by supporting calculations. The prepaid estimated penalties and estimated interest are reported on Part IV, Line 2 of Form 1065-X. See Instructions for Form 1065-X (Dec. 2024), p. 10.

f. Any DNR adjustments must be pushed out to the reviewed year partners. See IRC § 6227(b) (last sentence); Reg. § 301.6227-2(d).

10. AAR partnership elects push-out. Alternatively, if the partnership makes a valid election under Reg. § 301.6227-2(c) to push out the adjustments **associated with the IU** to the reviewed year partners, the reviewed year partners must report and pay any resulting ART as to their shares of the adjustments with their reporting year returns. The partnership is off the hook for the IU. As noted, the partnership must furnish Forms 8986 to the reviewed year partners, and file Forms 8986 and Form 8985 with the IRS, at the same time it files the AAR in order to make a valid push-out election avoid IU liability.

a. The push-out is done under the auspices of the section 6226 regulations. However, unlike a section 6226 push-out, hot interest does not apply in an AAR push-out. IRC § 6227(b)(2); Reg. § 301.6227-3(b)(1).

11. IU Computation Required for All AARs. An AAR must always include a computation of the IU resulting from the adjustments, even if (i) the IU is zero or less than zero, or the adjustments are all negative adjustments, or (ii) the partnership elects to push out the adjustments. See Instructions for Form 1065-X (Dec. 2024), p. 10; Instructions for Form 8082 (Dec. 2024), at pp. 11-12.

a. The Instructions for Form 1065-X (Dec. 2024), p. 7, state that if the IRS determines that an AAR partnership's push-out election is invalid, "if the partnership filed its IU calculation and Form 8980 to request permitted modifications to be applied to the IU, those modifications will be considered in making any such determination and potential subsequent assessment."

b. This suggests that the pro forma IU should include the partnership's determination of permitted modifications, and the AAR should include Form 8980 disclosing the basis for such modifications.

c. Given the burden this imposes on an AAR partnership electing push-out, the June 28, 2024 AICPA Letter and a letter submitted by the ABA Tax Section (Comments Concerning the Proposed Regulations Regarding Special Enforcement Matters, Oct. 8, 2021, p. 30) each recommend that the IRS revise the instructions to require an IU computation only if the partnership actually pays an IU.

12. No Turning Back if IU is Understated. If an AAR partnership chooses to pay an IU, it needs to be confident of its IU calculation. If the IRS initiates an examination of the AAR adjustments, it can examine the IU calculation as well (an IU is a PRI). If it comes up with a significantly worse number, it would appear that it is too late for the AAR partnership to reverse course and do a push-out – the Form 8986 push-out statements are required to be furnished and filed when the AAR is filed.

a. See Jenni Black, Practical Tips for Preparing an Administrative Adjustment Request, 185 Tax Notes Federal 1437 (Nov. 18, 2024).

13. Filing of AAR Refreshes the Section 6235 Period. The filing of an AAR for a taxable year refreshes the IRS's period of limitations for making PRI adjustments for such year. For example, if a partnership files an AAR on October 1, 2025 relating to 2023, the IRS has until at least October 1, 2028 to make adjustments to 2023 PRIs. Reg. § 301.6235-1(a)(1)(iii). This applies to any PRI that the IRS might want to examine, not just the specific PRIs that were adjusted in the AAR. This is a potential downside to filing an AAR.

14. Section 905(c). Section 6227(d) directs the Secretary to issue regulations or other guidance providing for the proper coordination of section 6227 with section 905(c), which requires U.S. tax liability to be redetermined when there is a foreign tax redetermination that reduces foreign taxes previously claimed as foreign tax credits by a U.S. taxpayer. Reg. § 1.904-4(b)(2)(ii) requires a BBA partnership to file an AAR if a redetermination of creditable foreign taxes incurred by the partnership would require a partnership adjustment. See Reg. § 301.6227-1(g). The AAR for the affected year must be filed by the due date (with extensions) of the original return for the partnership's taxable year in which the foreign tax redetermination occurs. The period of limitations on filing an AAR under section 6227(c) does not apply in this situation.

C. More on AAR Push-Out

1. An AAR push-out does not involve the filing of amended K-1s and partner amended returns, nor is there an elective procedure for the partners to do so. See Instructions for Form 1065 (2024), p. 9. (Contrast this with a pre-BBA amended K-1, which required the partner to file an amended tax return for the year in question.)

2. Instead, an AAR partnership pushes out the adjustments to the reviewed year partners by furnishing each a statement on Form 8986 (Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Dec. 2024)) showing the partner's allocable shares of the AAR adjustments. Reg. § 301.6227-1(c)(2)(ii) and (e)(1). Forms 8082 and 1065-X require the partnership to state whether it is making an AAR push-out election.

3. As part of its AAR filing, the partnership must provide to the IRS the Forms 8986 together with Form 8985 (Pass-Through Statement-Transmittal/Partnership Adjustment Tracking Report) (Dec. 2024). See Instructions for Form 8986 (Dec. 2024), p. 2.

4. The PR must attest under penalties of perjury that the push-out statements have been provided to the reviewed year partners. See Part I, Section 2, Item D of Form 1065-X; Form 8082, Part I, Item D. The Instructions for Form 8082 (p. 11) state that the PR must manually sign Item D of Form 8082 and, assuming the AAR is being filed electronically, the signed Form 8082 should be attached as a pdf to Form 1065.

5. As discussed earlier, the Form 8986 instructions do not indicate how the partnership should "furnish" the statement to the reviewed year partners. The regulations applicable to a section 6226 push-out election would also apply here. They provide that if the Form 8986 is mailed, it must be mailed to the partner's current or last known address, and if returned undeliverable, the partnership must undertake reasonable due diligence to identify a correct address and re-mail. Reg. § 301.6226-2(b)(2). As noted previously, the safest approach would be to send Forms 8986 by both certified mail and email.

6. Reg. § 301.6227-1(a) states that an AAR can be filed "with respect to any partnership-related item." Thus, adjustments to non-income items that are not allocated under section 704(b) can also be the subject of an AAR push-out. For example, changes to a reviewed year partner's K-1 liability allocation, which will always involve a positive IU adjustment, can, depending on the facts, have an immediate tax impact on the partner if pushed out.

a. Cf. Instructions for Form 8978 (Partner's Additional Reporting Year Tax) (Dec. 2024), p. 2 (indicating that in a section 6226 push-out, a liability adjustment on Form 8986 that reduces a partner's share of recourse liabilities is a non-income adjustment that is pushed out, which potentially changes the partner's at-risk amount and reduces the partner's allowable loss from the partnership; such reduction must be reported on Schedule A of the partner's Form 8978); Instructions for Form 8986 (Dec. 2024), p. 1 (stating that non-monetary adjustments, such as a partnership tax election, are DNR adjustments).

D. AAR Adjustments That Do Not Result in an IU

1. Adjustments that do not result in an IU, or that result in an IU of zero or less than zero (collectively, DNR adjustments) must be taken into account by the reviewed year partners under rules similar to the rules of section 6226, and all potential modifications are disregarded.

2. DNR adjustments must be pushed out even if the AAR partnership chooses to pay an IU. See IRC § 6227(b) (last sentence); Reg. § 301.6227-1(a) (providing that DNR adjustments must be taken into account in accordance with Reg. § 301.6227-3); Reg. § 301.6227-2(d) (DNR adjustments taken into account by reviewed year partners under Reg. § 301.6227-3); Reg. § 301.6227-3(a) (second sentence).

a. In contrast, if an audited partnership pays an IU, it must report any DNR adjustments on its adjustment year return.

3. It is easy to get confused with the DNR rules across the different BBA regimes. Keep in mind the following similarities and differences:

a. In an AAR push-out, all adjustments must be pushed out to the reviewed year partners. Likewise, a pass-through partner electing to push out must do so with respect to its share of all AAR adjustments.

(1) If an audited partnership makes a section 6226 push-out election, all partnership adjustments are pushed out to the reviewed year partners. See Reg. § 301.6226-1(b)(2); Reg. § 301.6225-1(f)(2) (second sentence); Reg. § 301.6225-3(b)(6). The same is true for a pass-through partner if it chooses to do its own push-out rather than pay an IU.

b. If the only AAR adjustments are one or more negative adjustments, they must be pushed out to the reviewed year partners, who take them into account in determining correction amounts for their first affected year.

(1) By contrast, if the IRS audits a BBA partnership and makes only negative adjustments, the partnership takes them into account on its adjustment year return. Reg. § 301.6225-1(f)(2) (first sentence); Reg. § 301.6225-3(a) and (b). (The audited partnership cannot make a section 6226 push-out election because there is no IU.)

(2) The distinction here is rooted in the last sentence of section 6227(b), which provides that DNR adjustments requested in an AAR must be taken into account by the reviewed year partners under rules similar to section 6226 (with appropriate adjustments).

(3) Congress may have been concerned that allowing an AAR partnership to report DNR adjustments in the adjustment year could lead to abusive timing of error corrections.

c. As will be discussed, if a pass-through partner chooses to pay an IU on its share of AAR adjustments, it takes into account any DNR adjustments in its taxable year in which it pays the IU.

(1) The same is true for a pass-through partner that chooses to pay an IU on its share of section 6226 push-out adjustments – any DNR adjustments are reported on its return for the taxable year in which it pays the IU.

4. The partnership must furnish Forms 8986 to the partners showing their shares of such adjustments and include the statements with the AAR filing along with Form 8985. See Reg. § 301.6227-2(d); Instructions for Form 8986 (Dec. 2024), p. 2.

5. The reviewed year partners (other than a pass-through entity partner) determine their correction amounts for the first affected year and intervening years and report any positive or negative ART with their reporting year return, using Form 8978.

a. The regulations contain a minor drafting ambiguity on this point. Reg. § 301.6227-2(d) states that DNR adjustments must be pushed out to the reviewed year partners, who must take them into account "in accordance with Reg. § 301.6227-3." However, the second sentence of Reg. § 301.6227-3(a) states that partners receiving a push-out statement pursuant to Reg. § 301.6227-1(d) "must take into account **adjustments** reflected in the statement **in the reviewed year partner's taxable year**" in which the statement is furnished to the partner – that is, in the partner's reporting year – in accordance with Reg. § 301.6227-3(b). (Emphasis added.) Reg. § 301.6227-3(b) provides that the reviewed year partners must treat the AAR push-out statement as if it were issued under section 6226(a)(2) and report and pay the ART, if any, determined after taking into account the adjustments in accordance with Reg. § 301.6226-3. Thus, the reference in Reg. § 301.6227-3(a) to reviewed year partners "taking into account adjustments" in the reporting year is clearly intended to mean "taking the adjustments into account in the reviewed year and reporting the positive or negative ART on the partner's reporting year return."

E. <u>Partner AAR Correction Amounts</u>

1. Under Reg. § 301.6227-3(b)(1), a partner receiving a statement "described in [Reg. § 301.6227-3(a)]" must treat the statement as if it were a section 6226 push-out statement. Thus, the reviewed year partners determine their respective positive and negative correction amounts for the first affected year and any intervening years, applying the principles of the section 6226 regulations.

2. The sum of a reviewed year partner's positive and negative correction amounts for the first affected year and any intervening years becomes the partner's ART, which is added to or subtracted from the partner's regular tax liability for the reporting year.

a. A negative ART represents the cumulative amounts that the partner has overpaid in the reviewed year and any other years that precede the reporting year as a result of the adjustments.

b. The "reporting year" is the partner's taxable year in which the partner is furnished Form 8986. Reg. § 301.6227-3(a) and (b)(1).

c. Any IU modifications that were included in the pro forma IU calculation required to be submitted with the AAR are disregarded and not included on the Forms 8986. The reviewed year partners must take into account all of the adjustments requested in the AAR. <u>See</u> Reg. § 301.6227-2(c); Instructions for Form 8082 (Dec. 2024), p. 11; Instructions for Form 1065-X (Dec. 2024), p. 7.

3. As is true for a section 6226 push-out election, if a partner's correction amount is negative and exceeds the taxes already paid by the partner with respect to the reporting year, the partner cannot claim a refund of the excess. Reg. § 301.6227-3(b)(1) (penultimate sentence). (More on this in a moment.)

4. **<u>Note</u>**: There is no specific provision in the regulations or the instructions to the relevant forms that gives an AAR partnership a 60-day window after the due date to correct errors in AAR push-out statements, in contrast to the rule that applies to an audited partnership making a section 6226 push-out (see Reg. § 301.6226-2(d)). However, the instructions to the relevant forms provide that pass-through partners doing a push-out **<u>do</u>** have a 60-day window following the statement due date to make corrections without IRS consent. <u>See</u> Instructions for Form 8986 (Dec. 2024), p. 2; Instructions for Form 8985 (Dec. 2024), p. 3.

5. A pass-through partner's due date for furnishing push-out statements to its partners is required to be disclosed by the AAR partnership in Part II, item F of the Form 8986 furnished to the pass-through partner.

6. An AAR partnership must adjust its tax attributes (not just specified tax attributes) "as appropriate." Prop. Reg. § 301.6225-4(a)(4).

F. Refund AARs – Stranded Overpayment Problem

1. As noted, the ART can be a negative number, such as in the case of a refund AAR where the AAR adjustment increases an ordinary loss for the reviewed year. Section 6227 does not expressly address how to account for partner tax payments previously made for the first affected year and any intervening years in the context of the reporting year liability. Unfortunately, the February 2019 Final Regulations reject any such historical or cumulative reckoning in the reporting year.

2. The bottom line is that a "negative ART" credit can only reduce the partner's chapter 1 tax liability for the reporting year down to zero, but does not otherwise create a right to refund of prior year's taxes. Reg. § 301.6227-3(b)(1). The partner can only claim on the reporting year return a refund of any **reporting year** overpayment that results after taking the negative ART into account (e.g., due to prior estimated tax payments).

a. In Reg. § 301.6227-3(b)(2)(ii), Example (2), an AAR partnership's sole adjustment for reviewed year 2020 is a negative adjustment due to an increase in ordinary loss. Partner A determines a correction amount of -\$100 to report as his ART for 2022, the reporting year. Partner A has a 2022 tax liability **without regard to the ART** of \$75. The negative ART amount reduces that tax liability to zero, leaving -\$25 unused and wasted.

b. The Example concludes that "A owes no chapter 1 tax for 2022, and A may make a claim for refund with respect to any overpayment." However, unless partner A has overpaid his reporting year tax liability after taking the negative ART into account, **partner A cannot file a claim for refund for the excess negative amount (-\$25)**. It is treated like a nonrefundable credit rather than a refundable credit.

3. This is the intent of the statement in Reg. § 301.6227-3(b)(1) that "[n]othing in this section entitles any partner to a refund [of chapter 1 tax] to which such partner is not entitled" and "a partnership-partner … may not claim a refund with respect to its share of any adjustment." <u>See</u> IRC § 6402(a).

4. This is referred to as the "stranded overpayment problem." <u>See</u> ABA Tax Section letter to IRS Commissioner Rettig, <u>Comments on the Stranded Overpayment Problem</u> (March 24, 2021). (As previously discussed, this is also a potential problem in a section 6226 push-out election.)

5. When Example (2) was first proposed in 2017 and later re-proposed in 2018, it stated that partner A's chapter 1 tax for the reporting year was zero after taking into account the negative \$100 ART, and that A "may make a claim for refund with respect to the overpayment of \$25." 84 Fed. Reg. at 6521 (Feb. 27, 2019). The Preamble to the June 2017 Proposed Regulations described the proposed rules and the original version of Example (2) as treating the ART similar to a **refundable** credit under section 6401(b). 83 Fed. Reg. at 27369. However, the February 2019 Final Regulations modified the example to state only that "A may make a claim for refund with respect to any overpayment." The Preamble explains the change as follows (84 Fed. Reg. at 6521):

> "Example 2 under proposed §301.6227-3(b)(2), regarding how partners other than pass-through partners take into account AAR adjustments, was revised to remove the language indicating that the partner may make a claim for refund with respect to the overpayment of \$25. Instead, the final regulations provide that the partner may make a claim for refund with respect to "any overpayment." Section 301.6227-3(b)(1) provides that nothing in the rules under § 301.6227-3 entitles any partner to a refund of chapter 1 tax to which such partner is not entitled. Whether an overpayment exists is determined under provisions of the Code and relevant case law outside the

scope of these regulations. Generally, an overpayment and the amount of a refund of an overpayment cannot exceed the amount of tax paid. See section 6511(b)(2), Jones v. Liberty Glass, 332 U.S. 524, 531 (1947). No refund or credit can be made unless it has first been determined that the taxpayer has made an overpayment of tax for the period at issue. Lewis v. Reynolds, 284 U.S. 281, 283 (1932)."

6. Thus, the statement in revised Example (2) that "A may make a claim for refund with respect to any overpayment" refers to an overpayment with respect to the reporting year. However, the unused negative ART is not treated as additional tax deemed paid with respect to the reporting year – even though a negative ART conceptually represents tax overpayments by the partner in prior years. It appears, therefore, that if a negative ART exceeds the taxes otherwise paid or payable paid by the partner with respect to the reporting year, the excess is lost forever.

7. Is There a Solution for the Stranded Overpayment?

a. The February 2019 Final Regulations make it clear that a partner can notify the IRS it is treating an AAR-adjusted item inconsistently in accordance with the provisions of Reg. § 301.6222-1(c). See Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6475 ("the final regulations under § 301.6222-1(c)(2) remove the language stating that the provisions of § 301.6222-1(c)(1) do not apply with respect to a partner's treatment of a [PRI] reflected on an AAR").

b. A partner might try to head off a stranded overpayment problem by filing an amended return reflecting the adjustments and claiming a refund for the affected year(s) within the period of limitations, while disclosing the partner's inconsistent treatment (on the amended returns) with the originally filed partnership return.

c. The idea would be to recover the taxes paid on a year-by-year basis, outside of the AAR correction process. If an AAR is filed that proposes the same adjustments and pushes them out, the partner would not have a negative ART because the partner amended returns already took the adjustments into account.

d. It is not clear that this end-around of the stranded overpayment problem would succeed, even though it may lead to an equitable result. The fact that the February 2019 Final Regulations permit a partner to file inconsistently with an AAR may only mean that a partner is not precluded from taking a contrary position as to the amount or nature of the AAR adjustments (with disclosure), but remains subject to the AAR correction procedures and their linkage to reporting year tax liability.

(1) The Preamble states that, as a result of the changes from the proposed regulations, "a partner may notify the IRS it is treating an AAR-adjusted item inconsistently in accordance with … § 301.6222-1(c)." However, it also states that "in the case of an AAR, section 6223(b) binds each partner to the making of the [AAR] request itself and the mechanism by which the adjustments requested are taken into account, including any election by the partnership to have the partners take into account the adjustments." 84 Fed. Reg. at 6475 (emphasis added).

e. In fact, the partner in this situation would be taking a position that is not inconsistent with the AAR adjustments – the amended return would reflect those adjustments – but rather would be filing inconsistently with the AAR correction mechanics for those adjustments.

f. Consequently, a partner taking this position should file the amended return before the AAR is filed (if feasible), because at that point the amended return would only be inconsistent with the originally filed partnership return – not with respect to adjustments reflected on the yet-be-filed AAR. This timing sequence would seem to put the partners outside of the AAR correction mechanics.

G. AAR Filing Deadline

1. An AAR cannot be filed more than three years after the later of:

a. the date of filing of the partnership return, or

b. the due date for the partnership return determined without regard to extensions. IRC § 6227(c); Reg. § 301.6227-1(b).

2. An AAR cannot be filed after the partnership receives a Notice of Administrative Proceeding ("NAP"), unless such notice is withdrawn (see Reg. § 301.6231-1(f)). IRC § 6227(c); Reg. § 301.6227-1(b).

a. The IRS's internal procedures (not compelled by regulation or statute) require it to provide an examination notice to the partnership (Letter 2205-D) at least 30 days prior to the issuance of the NAP. This gives the partnership a window to rethink aggressive return positions and correct errors through the AAR process.

b. Doing so would avoid the 2% interest surcharge that would apply if the errors or aggressive positions were later corrected through partnership adjustments pushed out to the partners under section 6226. IRC § 6227(b)(2) (parenthetical).

c. **Note**: If a partnership's AAR makes adjustments to reviewed year PRIs but also revokes a PR or DI designation for the reviewed year, it must file the AAR not only before the issuance of a NAP, but also before the partnership receives a **notice of selection for examination** (Letter 2205-D). Reg. § 301.6223-1(e)(2)(ii); Instructions for Form 8979 (Dec. 2024), p. 2.

3. The Preamble to the February 2019 Final Regulations observes that if the IRS initiates a BBA audit and the partnership ultimately agrees with the proposed adjustments, the partnership and the IRS may find it is more efficient for the IRS to withdraw the NAP and allow the partnership to file an AAR with respect to the agreed adjustments. However, in that event the original three-year statute of limitations on filing an AAR still applies and is not tolled by the issuance of the NAP. 84 Fed. Reg. at 6523.

4. There is no provision in section 6227(c) that contemplates an extension of the period of limitations on filing an AAR. An agreement with the IRS under section 6235(b) to extend the limitations period on making partnership adjustments does not extend the period of limitations on filing an AAR.

H. No IRS Approval of AAR Required, but IRS Can Initiate an Audit

1. One might ask, why is it called an administrative adjustment "request"? It is a holdover from the TEFRA language, where the IRS had specified obligations in terms of its response to an AAR. Under the BBA, "request" only has meaning in the sense that the IRS has a renewed period of limitations within which to audit the "requested" PRI adjustments, or any other PRIs, at its discretion.

2. Despite the word "request," the AAR procedure does not require IRS approval, and no approval should be expected. Once filed, the partnership has launched the AAR ship and must know its destination. It does, however, constitute a de facto invitation to the IRS to come on board.

3. The IRS can, within the period specified in section 6235 – as extended by the filing of the AAR – initiate an audit of:

a. the AAR partnership's IU calculation and determination of any modifications thereto;

b. any PRI reported on the AAR partnership's reviewed year return, whether or not adjusted in the AAR;

c. the push-out adjustments and allocation thereof, if the AAR partnership chooses push-out; and

d. potentially other taxable years as well, not subject to the AAR. See Reg. § 301.6227-1(f).

4. An AAR can open up a can of worms, just like a regular refund claim can.

5. If the IRS audits the partnership and disagrees with the AAR adjustments or proposes other adjustments, the AAR partnership can elect to pay an IU or do a push-out in the same manner as any other audited partnership.

I. AARs – Treatment of Pass-Through Partners

1. A reviewed year pass-through partner must take into account the push-out of AAR adjustments in accordance with Reg. § 301.6226-3(e), treating the AAR partnership as if it had made a section 6226 push-out election. Reg. § 301.6227-3(c)(1). The statement it receives from the AAR partnership is treated as if it were a statement issued under Reg. § 301.6226-2. Id.

2. Unless it elects to pay an IU on its allocable share of adjustments, the pass-through partner must furnish Forms 8986 to each partner that held an interest in the pass-through partner at any time during the taxable year of the pass-through partner to which the adjustments relate (referred to as "affected partners") and file these forms, together with Form 8985, with the IRS **by the extended due date (whether or not actually extended) of the AAR partnership's adjustment year return** (i.e., by September 15 for calendar year partnerships). If it does not furnish statements by this deadline, the pass-through partner automatically becomes liable for any IU resulting from the AAR push-out.

a. See Reg. § 301.6227-3(c)(1) (cross-referencing the Reg. § 301.6226-3(e) procedures); Reg. § 301.6226-3(e)(3)(i) (definition of "affected partners" of the pass-through partner); Reg. § 301.6226-3(e)(3)(ii) (filing deadline).

b. The "adjustment year" of an AAR partnership is the year in which it files the AAR.

3. Each partnership in a chain of partnerships above the AAR partnership is confronted with the same deadline. The amount of time they have collectively to decide to implement push-outs up the chain depends, in part, on how early or how late in the year the AAR partnership filed the AAR.

4. As in a section 6226 push-out, a procrastinating pass-through partner can make life miserable for partnerships higher up in the chain.

5. The affected partners of the pass-through partner take into account their shares of the adjustments in the same manner as direct reviewed year partners of the AAR partnership. Reg. § 301.6227-3(c)(4). An affected partner determines and reports the net correction amounts, plus interest and penalties, on the partner's reporting year return. The affected partner's reporting year is the year in which the **AAR partnership** furnished push-out statements to **its reviewed year partners**. Reg. § 301.6226-3(e)(3)(iv).

a. <u>**Note**</u>: Because a pass-through partner does not have to furnish push-out statements to its affected partners until the extended due date of the AAR partnership's adjustment year return, it is possible that an affected partner will have already filed a tax return for the partner's reporting year before it receives a push-out statement from the pass-through partner. In that event, the affected partner would need to file an amended return for the reporting year that includes the correction amount and interest.

6. In lieu of doing a successive push-out, the pass-through partner can choose to pay an IU on the reported adjustments. In that event, it cannot apply any modifications to the amount of the IU. <u>See</u> Reg. § 301.6227-3(c)(1); Instructions for Form 8985 and Form 8985-V (Dec. 2024), p. 3.

a. While an AAR partnership that chooses to pay an IU must do so at the time it files the AAR, a pass-through partner that chooses to do the same thing has until the extended due date of the AAR partnership's adjustment year return to file Form 8985 and remit the tax with Form 8985-V (if paying by check or money order). <u>See</u> Reg. § 301.6227-3(c)(1) (cross-referencing the Reg. § 301.6226-3(e) procedures); Reg. § 301.6226-3(e)(4)(ii) (providing the adjustment year deadline for a pass-through partner); Instructions for Form 8985 and Form 8985-V (Dec. 2024), pp. 3-4.

b. The pass-through partner must take into account any DNR adjustments in accordance with Reg. § 301.6225-3 in the taxable year of the pass-through partner that includes the date the IU is paid.

(1) <u>See</u> IRC § 6227(b) (last sentence); Reg. § 301.6227-2(c); Reg. § 301.6227-3(c)(1) and (2) (cross-referencing the pass-through entity push-out procedures in Reg. § 301.6226-3(e)(3)); Reg. § 301.6226-3(e)(4)(v) (DNR adjustments taken into account by pass-through partner in year of IU payment); Instructions for Form 8985 and Form 8985-V (Dec. 2024), p. 3; Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6522.

7. As noted, the relevant form instructions give pass-through partners up to 60 days after the due date for furnishing Forms 8986 to their affected partners (i.e., the extended due date of AAR partnership's adjustment year return) to correct errors in the statements without obtaining IRS permission. Thereafter, IRS permission is required. <u>See</u> Instructions for Form 8986 (Dec. 2024), p. 2; Instructions for Form 8985 (Dec. 2024), p. 3.

J. <u>Positive AAR Adjustments Related to, or Resulting from, Other Positive AAR Adjustments</u>

1. If the AAR partnership chooses to pay an IU, or a pass-through partner chooses to pay an IU on its share of push-out AAR adjustments, Reg. § 301.6225-1(b)(4) provides two rules to deal with duplicative positive adjustments. <u>See</u> Reg. § 301.6227-2(a)(1) (providing that the determination of the IU amount in the AAR context is made in accordance with the rules in Reg. § 301.6225-1).

a. As previously discussed, the first rule is a one-way street that gives the IRS the discretion to treat a partnership adjustment as zero for IU purposes if its effect is reflected in one or more other partnership adjustments. The second rule can be used affirmatively by an AAR partnership or pass-through partner: if a positive adjustment to one item is "related to, or results from" a positive adjustment to another item, one of the positive adjustments is "generally" treated as zero unless the IRS determines otherwise. (Emphasis added.)

b. See Preamble to November 2020 Proposed Regulations, 85 Fed. Reg. at 74945 (proposing a different version of Rule No. 2); Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75478.

K. Filing Inconsistently With an AAR

1. In contrast to a section 6226 push-out election, which is binding on the partners, a reviewed year partner can choose to file inconsistently with the Form 8986 provided by an AAR partnership. However, it must disclose the inconsistency by including Form 8082 with the partner's reporting year return in order to avoid a math or clerical error assessment. In this situation, the inconsistent reviewed year partner would compute its reporting year ART liability by taking into account the inconsistent amounts/adjustments reflected on the Form 8082 as opposed to what was shown on Form 8986.

2. The notification of inconsistency cannot be made after a NAP has been issued to the partnership for the year in question. Reg. § 301.6222-1(c)(5).

3. A partner's ability to file inconsistently with AAR push-out adjustments with disclosure is supported by the following authorities:

a. Instructions for Form 8082 (Dec. 2024), p. 8; IRM 4.31.9.8.2.2(1)(c) (10-29-2021).

b. The Preamble to February 2019 Final Regulations, 84 Fed. Reg. at 6475 states as follows:

> "When taking into account AAR adjustments under § 301.6227-3, partners must adhere to the consistency requirements under section 6222(a). See § 301.6222-1(a)(4) (providing consistency requirement applies to the treatment of a partnership-related item on an AAR). Nothing in sections 6222, 6223(b), or 6227, however, precludes a partner from notifying the IRS the partner is taking an adjustment into account inconsistently with how the adjusted item was treated in an AAR. While section 6227 imposes certain requirements with respect to AARs, none of those requirements contradict section 6222(c)'s exception to the consistency requirement."

c. See also Reg. § 301.6222-1(a)(4)(i) (for purposes of the consistency requirement, the treatment of a PRI on a partnership return includes the treatment reported in an AAR); Reg. § 301.6222-1(a)(5)(iv), Example (4) (partnership files AAR reporting lower loss than originally claimed and pushes out the adjustment; partner D fails to take into account his share of the adjustment in accordance with section 6227 and presumably does not disclose; partner D thus violates consistency requirement).

4. A pass-through partner files inconsistently with an AAR push-out statement by attaching Form 8082 to the Form 8985 it files with the IRS. Instructions for Form 8082 (Dec. 2024), p. 9.

5. As noted, a partner is bound by the treatment of items shown on Form 8986 in a section 6226 push-out. See Reg. § 301.6222-1(c)(2); Reg. § 301.6226-1(e) (partner's share of adjustments and applicability of penalties as shown on section 6226 push-out statement are actions of the partnership under section 6223 and binding on the partners).

L. Partner Becomes Aware of Error in Recently Filed Partnership Return

1. Assume a BBA partnership files a Form 1065 and discovers an error shortly after the period for filing a superseding Form 1065 has expired. It can only correct the error by filing an AAR. What happens if some or all of the partners have not filed their original returns for such year at the time they receive the AAR push-out statements?

a. This could happen if the BBA partnership did not request an automatic six-month extension but one or more partners are on extension.

b. Another situation might be where a BBA partnership ("UTP") sells interests in a lower-tier partnership ("LTP") in year 1 in connection with a Rev. Rul. 99-6 acquisition of all of the LTP interests by an acquiror, resulting in a final short period year 1 return for terminated LTP. Assume that, after the due date of terminated LTP's final return, it is determined that the return contained an error in reporting a PRI. Terminated LTP can only correct the error by filing an AAR with respect to its final return. What happens if UTP or its partners have not yet filed their returns for year 1 when the AAR push-out is received, or have filed but still have time to file superseding returns?

c. The regulations and the various related form instructions (e.g., Forms 8082, 1065-X, 8986 and 8978 (Additional Reporting Year Tax) do not appear to address these situations.

2. In the Rev. Rul. 99-6 case, assume UTP has already filed its return but still has time to file a superseding return. Assume most of UTP's partners have not filed. One approach might be to bypass the LTP AAR procedure altogether. UTP could file a superseding return with revised K-1s and attach a Form 8032 indicating that it is filing inconsistently with LTP's incorrect final return. The partners of UTP would then file original or superseding returns consistent with the revised UTP K-1s (no Form 8032 would be attached to their returns since they would be filing consistently with Parent's superseding return). LTP would dispense with the hassle of filing an AAR and doing a push-out.

3. If the IRS wants to get into the act when it sees the Form 8082, it could, in theory, examine LTP and make an adjustment to correct the error. LTP would then do a push-out, which it has likely committed to do under the P&S agreement. However, UTP and its partners would have already taken the adjustment into account, so no IU or ART would be due. In this circumstance one would hope that the IRS would leave things well enough alone.

M. IRS Examination of AAR Adjustments

1. Within the period specified in section 6235(a) (generally the later of three years from the date the reviewed year partnership return was filed or three years from the date an AAR was filed with respect to such year), the IRS can initiate an audit of:

a. the AAR partnership's IU calculation and any self-determined modifications thereto, the PRI adjustments, and any other PRIs even though not adjusted in the AAR, or

b. the push-out adjustments, if the partnership elected to push-out. Reg. § 301.6227-1(f).

2. The IRS provides notice of commencement of an AAR examination in the same way it would in a regular BBA audit. IRC § 6231(a) (last sentence).

3. The PR can file a petition for readjustment of any FPA-adjusted items resulting from an AAR audit with the Tax Court, District Court, or Court of Federal Claims, but must do so within 90 days after mailing of the FPA. IRC § 6234(a)(1).

a. The court has jurisdiction to determine all PRIs for the partnership taxable year to which the FPA relates (even if not adjusted in the FPA), including the allocation of such items among the partners and the applicability of penalties. IRC § 6234(c).

N. Can IRS Challenge the Validity of an AAR Push-Out Election?

1. What happens if the AAR partnership fails to attach all of the Forms 8986 to the AAR request? Fails to send them to all of the reviewed year partners? Makes errors in the statements?

2. Reg. § 301.6227-1(c)(2) provides that if an AAR partnership fails to provide the requested AAR adjustments, the push-out statements (if push-out is elected) and related transmittal, 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.

3. Who knows how this will play out in any given situation, but there is always a risk that the IRS could assert that the push-out is invalid and the partnership is liable for an IU on the requested adjustments. See Jenni Black, Challenging the Validity of a Push-Out Election Under BBA: Is the Push-Out Election a PRI?, 186 Tax Notes Federal 751 (Jan. 27, 2025).

4. As noted, the IRS regulations and forms do not explicitly state that the 60-day "no IRS consent required" correction period applies to an AAR partnership's push-out statements, although they do state that it applies to a pass-through partner that pushes out.

5. It would appear that the AAR push-out election is itself a PRI; it is made on the face of the AAR return and affects the chapter 1 liability of the partners. Thus, the IRS should be able to open an exam within the section 6235(a)(1)(C) period and "adjust" (declare invalid) the push-out election itself.

O. Correction of Errors by Opt-Out Partnerships

1. An opt-out partnership doing a paper filing corrects errors by filing an amended return on Form 1065-X, checking the "NonBBA" box in Part I, completing Parts II and V, and providing amended Schedule K-1s or K-3s to the partners. See IRC § 6031(b)(1) (prohibition against filing amended K-1s after partnership return due date does not apply to an opt-out partnership).

a. The partners, in turn, must file amended individual returns. See Instructions for Form 1065-X (Dec. 2024), p. 9.

2. If the opt-out partnership is filing electronically, it uses Form 1065 and checks Box G(5) on page 1. It also includes amended Schedule K-1s or K-3s, as applicable, with the filing and furnishes copies to the partners. See Instructions for 2024 Form 1065 (Jan. 16, 2025), p. 9 (under the caption "Amended Return").

XI. REVIEW – BBA TREATMENT OF PASS-THROUGH PARTNERS

A. <u>Case I – BBA Partnership Files AAR</u>

1. Assume the source BBA partnership files an AAR reporting positive and negative adjustments with respect to a reviewed year.

2. If the AAR partnership pays an IU, any DNR adjustments must be pushed out to the reviewed year partners. Reg. § 301.6227-2(d).

3. If the AAR partnership elects to push out the AAR adjustments to its reviewed year partners, a pass-through partner treats it as if it were a section 6226 push-out. It can choose to pay an IU or do its own push-out. Reg. § 301.6227-3(c).

4. <u>Pass-Through Partner Pays IU</u>. Assume the pass-through partner pays an IU on its share of positive adjustments reflected on the Form 8986.

a. Any DNR adjustments must be pushed out to its affected partners. "Affected partners" are those partners who held an interest in the pass-through partner at any time during the taxable year of the pass-through partner that includes the end of the AAR partnership's reviewed year to which the adjustments on the Form 8986 furnished to the pass-through partner relate. <u>See</u> IRC § 6227(b) (last sentence); Reg. § 301.6227-3(c)(2); Reg. § 301.6227-2(d); Reg. § 301.6227-3(b); Reg. § 301.6226-3(e)(3); Instructions for Form 8985 and Form 8985-V (Dec. 2024), p. 3.

b. No IU modifications can be taken into account at the pass-through partner level. Reg. § 301.6227-3(c)(1).

c. Payment of the IU must be made by the pass-through partner no later than the extended due date of the AAR partnership's adjustment year return using Forms 8985 and Form 8985-V. Normal underpayment interest applies.

d. The pass-through partner submits Form 8985 to the IRS together with the Forms 8986 it provides to its affected partners. (Form 8986 is only relevant in this context if an IU is being paid but there are also DNR adjustments that must be pushed out.)

5. <u>Pass-Through Partner Elects Push-Out</u>. Assume the pass-through partner pushes out its share of all AAR adjustments to its affected partners. It makes the push-out election simply by furnishing Forms 8986 to the affected partners and filing them with the IRS (along with Form 8985) by the extended due date of the AAR partnership's adjustment year return. Reg. § 301.6226-3(e)(3)(ii).

a. The pass-through partner must still go through the exercise of computing an IU even though it is doing a push-out. <u>See</u> Instructions for Form 1065-X (Dec. 2024), p. 10 (AAR partnership must always compute an IU even if pushing out); Instructions for Form 8082 (Dec. 2024), pp. 11-12.

b. The affected partners determine their correction amounts for the first affected year and any intervening years and pay the resulting ART (if positive), together with normal underpayment interest and penalties, with their reporting year returns.

c. The reporting year is the affected partner's taxable year that includes the date on which the **AAR partnership** furnished Forms 8986 to its reviewed year partners. Reg. § 301.6226-3(e)(3)(iv).

B. Case II – Audited BBA Partnership Pays IU But Has DNR Adjustments

1. Assume a BBA partnership is audited and the IRS determines positive and negative partnership adjustments. The positive adjustments result in an IU.

2. If the audited partnership chooses to determine and pay the IU (as modified), any DNR adjustments are taken into account on the partnership's adjustment year return and K-1s. Reg. § 301.6225-1(f)(2); Reg. § 301.6225-3(a).

3. A pass-through partner's K-1 with respect to the audited partnership's adjustment year return will reflect the pass-through partner's allocable share of the DNR adjustments. Such adjustments, after appropriate netting with the pass-through partnership's other tax items, are reported on the K-1s issued by the pass-through partner to its partners.

C. Case III – BBA Partnership is Audited and Elects to Push-Out

1. Assume the IRS determines partnership adjustments resulting in an IU and the audited partnership files a section 6226 election on Form 8988 within 45 days of the FPA mailing. It furnishes push-out statements to its reviewed year partners showing each partner's share of all adjustments associated with the IU on Forms 8986, and does so within 60 days after the "finally determined" date. It files them with the IRS along with Form 8985.

2. A reviewed year pass-through partner can choose to pay an IU on its share of the adjustments or push out the adjustments to its affected partners.

3. Pass-Through Partner Pays IU. Assume the pass-through partner does not furnish push-out statements to its affected partners by the extended due date of the audited partnership's adjustment year return. By failing to do so, it is compelled to determine and pay an IU at the pass-through partner level, plus penalties and hot interest (determined as if the IU were a correction amount for the first affected year), on its share of the partnership adjustments. Reg. § 301.6226-3(e)(4)(iii).

a. The pass-through partner must pay such amounts with Form 8975-V and file Form 8985 by the extended due date of the adjustment year for the audited partnership. Reg. § 301.6226-3(e)(4)(ii).

b. The pass-through partner takes into account any modifications approved by the IRS with respect to the pass-through partner (or a relevant partner owning an interest in the pass-through partner) that are reflected on the Form 8986 furnished to the pass-through partner. Reg. § 301.6226-3(e)(4)(iii).

c. Any DNR adjustments are reported on the pass-through partner's Form 1065 for the taxable year in which it pays the IU. Reg. § 301.6226-3(e)(4)(v). If there is a zero IU after running the IU calculations, all of the adjustments are DNR adjustments and are reported on the pass-through partner's return that includes the date on which the push-out statement was furnished to the pass-through partner. Id.

4. <u>Pass-Through Partner Pushes Out</u>. Assume the pass-through partner pushes out all of the adjustments associated with the IU to its affected partners by timely furnishing push-out statements. The "affected partners" are those partners who held an interest in the pass-through partner at any time during the pass-through partner's taxable year to which the adjustments in the statements furnished to the pass-through partner relate. Reg. § 301.6226-3(e)(3)(i).

a. The pass-through partner must furnish Forms 8986 to the affected partners and file them with the IRS along with Form 8985 by the extended due date of the audited partnership's adjustment year return. Reg. § 301.6226(e)(3)(ii).

b. The partners of the pass-through partner must report and pay the ART, plus penalties and hot interest, with their returns for their reporting year. The reporting year is the partner's taxable year that includes the date on which the **audited partnership** furnished Forms 8986 to **its** reviewed year partners. Reg. § 301.6226-3(e)(3)(iv). The partners include Form 8978 with their reporting year returns.

c. For an affected partner that is not a pass-through partner, no section 6651 penalty applies if the ART is paid within 30 days of the extended due date of the audited partnership's adjustment year return. Reg. § 301.6226-3(e)(3)(iv). This rule becomes relevant when the audited partnership's adjustment year and the partner's reporting year are the same.

d. If there is a chain of partnerships above the audited partnership, the same choices and the same deadlines apply on up the chain. Assume there are two tiers of partnerships above the audited partnership (Tier 1 and Tier 2). Tier 1 receives a push-out statement from the audited partnership and pushes out to Tier 2. Tier 2 pushes out to its partners.

(1) **Both Tier 1 and Tier 2** must furnish and file their respective Forms 8986 by the extended due date of the **audited partnership's adjustment year return**.

(2) All non-pass-through partners of Tier 1 and Tier 2 pay the ART and hot interest with their reporting year returns. <u>See</u> Reg. § 301.6226-3(e)(1) (referring to push-out statements received by a pass-through partner from another pass-through partner); Reg. § 301.6226-3(e)(3)(ii) (establishing the common pass-through partner push-out deadline as the extended due date of the audited partnership's adjustment year return).

5. The same rules generally apply to a partnership pass-through partner that has opted out of the BBA and to an S corporation, trust, or estate pass-through partner. Reg. § 301.6221(b)-1(d)(1) and (d)(2), Example (2); Reg. § 301.6226-3(e)(5).

6. If a pass-through partner is subject to chapter 1 tax on all or a portion of the adjustments (meaning at the entity level, such as a complex trust or estate that does not distribute all income currently), it is not required to pay an IU if it pays the additional reporting year tax (chapter 1 tax) on its share of the adjustments. Further, if it does a push-out, it is only required to include on the push-out statements those adjustments that would have been reported to the owners and beneficiaries under sections 6037 and 6034A if the pass-through partner had correctly reported the items for the year to which the adjustments relate. Reg. § 301.6226-3(e)(6).

D. Case IV – Pass-Through Partner Does Amended Return Modification

1. If a pass-through partner (including an opt-out pass-through partner) participates in a PMAR request with respect to an audited partnership, the pass-through partner files a modification amended return for its taxable year that includes the end of the audited partnership's reviewed year, but does not file amended K-1s with its partners, shareholders or beneficiaries.

2. With that return, the pass-through partner computes and pays an IU on its share of the audited partnership's adjustments in accordance with Reg. § 301.6225-2(d)(2)(vi)(A) and Reg. § 301.6226-3(e)(4)(iii).

3. The pass-through partner's amended return is made on Form 1065-X which, according to the Preamble to the June 2017 Proposed Regulations, is not an AAR, "but rather is a stand-alone document that is filed solely for modification purposes." 82 Fed. Reg. at 27354. See Instructions for Form 1965-X (Dec. 2024), pp. 7-8.

4. Hot interest does not apply.

5. The pass-through partner provides Form 8982 to the audited partnership certifying that it has filed the required PMAR(s) and paid the resulting IU, plus interest and penalties. The PR for the audited partnership then provides Form 8982, along with Form 8980, to the IRS as part of its modification request.

6. The PR of the **audited partnership** must request IRS **pre-approval** for any modifications to the **pass-through partner's IU** with respect to the pass-through partner's direct and indirect partners. See Instructions for Form 8982 (Oct. 2020), p. 15; Reg. § 301.6225-2(d)(2)(vi)(A).

7. Any adjustments that do not result in an IU must be taken into account by the pass-through partner in its taxable year that includes the date it made its IU payment with its PMAR. See Instructions for Form 8980, Publication 5346 (Dec. 2024), p. 17; Reg. § 301.6225-2(d)(2)(vi)(B).

8. The same rules apply to a partnership-partner that has opted out or an S corporation, trust, or estate pass-through partner.

XII. FAILURE TO PAY AND CEASE TO EXIST RULES – SECTIONS 6232(F) AND 6241(7)

A. Section 6232(f) – IRS Can Go After Partners if Partnership Doesn't Pay

1. Section 6232(f) was added by the TTCA and provides the IRS with a failure-to-pay remedy if a partnership does not pay any amount of the IU or "specified similar amount" (as defined in section 6232(f)(2)) within 10 days after the date on which the IRS provides notice and demand for such payment. The statute gives the IRS the right to go after the partners for the IU and penalties and interest.

a. The term "specified similar amount" includes an IU payable by a pass-through partner under section 6226(b)(4)(A)(ii)(II) as a result of being on the receiving end of a push-out. IRC § 6232(f)(2)(A).

b. A "specified similar amount" also includes an amount assessed under section 6232(f) against a partnership-partner as a result of a lower-tier partnership failing to pay an IU. IRC § 6232(f)(2)(B). Thus, the IRS can pursue a section 6232(f) partner-level assessment resulting from an audited or AAR partnership's failure to pay an IU up through a chain of partnership-partners to get to the ultimate owners.

c. The restrictions on assessment in section 6232(b) do not apply to a specified similar amount. IRC § 6232(b) (last sentence). Thus, if a partnership-partner or S corporation partner receives a push-out statement and fails to pay an IU or timely furnish its own push-out statements, the IRS can assess the pass-through partner's IU without regard to section 6232(b).

2. Upon a partnership's failure to timely pay the IU assessment, the IRS can assess against each partner of the partnership "determined as of the close of the adjustment year," which appears to mean a snapshot of the partnership's owners on the last day of the adjustment year, or, if the partnership has ceased to exist, the "former partners" of the partnership (as determined for purposes of section 6241(7), see the discussion below), a tax equal to such partner's "proportionate share" of such amount (including any penalties and interest). IRC § 6232(f)(1)(B).

3. In addition, hot interest kicks in on the delinquent amount. IRC § 6232(f)(1)(A) (note that section 6233(b)(2) and Reg. § 301.6233(b)-1(c) do not advert to this bump-up in the underpayment rate).

4. The adjustment year is the partnership taxable year in which a court decision relating to the adjustment becomes final or, in any other case, the year in which the FPA is mailed (or, if the partnership waives the restrictions on assessment under section 6232(b) as provided in section 6232(d)(2), the date the IRS executes the waiver). <u>See</u> IRC § 6225(d)(2); Reg. § 301.6241-1(a)(1) (providing that the "adjustment year" definition applies for purposes of subchapter C).

a. Note: This is not necessarily the same as the year in which the adjustments "take effect" for purposes of the cease-to-exist rules. Under those rules, if no petition for readjustment is filed, a partnership adjustment does not take effect until the period for filing the petition has expired or when the IRS and the partnership enter into a settlement agreement regarding the adjustment.

5. A partner's "proportionate share" is "such percentage as the Secretary may determine on the basis of such partner's distributive share." IRC § 6232(f)(3). The aggregate proportionate shares must add up to 100%. <u>Id.</u> A partner does not have joint and several liability for the entire IU.

a. Distributive share of what? Is it based on how the IU would have been economically apportioned if the partnership had paid the IU? Based on residual partnership percentage interests? Based on how partnership income was actually allocated in the adjustment year or, if applicable, the final taxable year?

b. The TTCA Bluebook (p. 159) suggests that this could be based either on the allocations specified in the partnership agreement or the actual K-1 allocations for the adjustment year: "For example, the distributive shares set forth in the partnership agreement, or as determined for purposes of Schedule K-1, may serve as a measure of a partner's proportionate share."

6. For this purpose, an S corporation and its shareholders are treated in the same manner as a partnership and its partners. IRC § 6232(f)(5). Since S corporations are not subject to the BBA audit procedures, this provision relates to an S corporation in its capacity as a pass-through partner of an audited BBA partnership.

7. The deficiency provisions in subchapter B do not apply to this partner-level assessment. IRC § 6232(f)(6)(A).

8. There are no proposed or final regulations under section 6232(f). The provision does not require implementing regulations, and the IRS views it as self-executing. See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75479.

9. If a partnership actually ceased to exist before the adjustments are finally determined (e.g., because the partnership terminated under section 708(b)(1)), there would be no "adjustment year" and no "adjustment year partners" because the partnership is gone. However, in that situation section 6232(f)(1)(B) permits the IRS to go after the "former partners" as determined for purposes of section 6241(7) – which in this actual termination situation (as further discussed below) would mean the persons who were partners during the last taxable year for which a partnership return was filed under section 6031. See Reg. § 301.6241-3(d)(2).

B. Section 6241(7) – Treatment of Partnership that IRS Determines has Ceased to Exist

1. Section 6241(7) provides that if a partnership "ceases to exist" before a partnership adjustment "takes effect," the adjustments are taken into account by the "former partners" under regulations prescribed by the Secretary.

2. A key focus here is a wind-down partnership that essentially becomes become judgment-proof before partnership adjustments for prior years are finally determined through settlement, a final court decision, or the expiration of the period to file a petition, making collection of an IU problematic if the partnership did not make a push-out election after the FPA was issued. The statutory solution (conceived before section 6232(f) was enacted, which allows the IRS to collect an unpaid IU directly from the partners) is a forced push-out to shift the tax impacts of the adjustments to the "former partners." "Former partners" does not mean the same thing as "reviewed year partners."

3. The cease-to-exist regulations have had quite an evolution, in part because section 6232(f) was subsequently enacted and created coordination issues with the cease-to-exist rules.

a. Proposed cease-to-exist regulations were published in June 2017. REG-136118-5, 82 Fed. Reg. 27334 (June 14, 2017). For the Preamble discussion, see 82 Fed. Reg. at 27370-27371.

b. The proposed regulations were withdrawn by the August 2018 Proposed Regulations and re-proposed with changes relative to the 2017 version. REG-136118-15, 83 Fed. Reg. 41954 (Aug. 17, 2018). For the Preamble discussion, see 83 Fed. Reg. at 41967.

c. Final regulations were issued as part of the February 2019 Final Regulations. For the Preamble discussion, see 84 Fed. Reg. at 6528-6529.

d. Additional changes to the cease-to-exist regulations were proposed in the November 2020 Proposed Regulations. For the Preamble discussion, see 85 Fed. Reg. at 74945-74946.

e. The regulations were finalized in the December 2022 Final Regulations, For the Preamble discussion, see 88 Fed. Reg. at 75479-75481.

4. Operative Cease-to-Exist Rule. As interpreted by the regulations, if the IRS makes a determination that a partnership (or a partnership-partner of the partnership, including a partnership-partner that made an opt-out election) has "ceased to exist," and the partnership ceased to exist **before** any partnership adjustment "takes effect," then the adjustments are taken into account by the "former partners" as if the partnership had made a push-out election. Reg. § 301.6241-3(a)(1), (a)(3), and (e).

a. After being notified of the cease-to-exist determination, the partnership must furnish to each "former partner" a push-out statement reflecting such former partner's share of the partnership adjustments.

b. The partnership must furnish the statements and file a copy with the IRS no later than 60 days after the **later of** (i) the date the IRS notified the partnership of its cease-to-exist determination or (ii) the date the adjustment "takes effect." Reg. § 301.6241-3(e)(2)(ii).

c. Note that in a section 6226 push-out, the statements must be furnished within 60 days after the adjustments are "finally determined" as opposed to when they "take effect." Adjustments are "finally determined" when there is a final court decision or when the 90-day petition period expires without a petition. Reg. § 301.6226-2(b)(1). "Take effect" means the same thing except that adjustments also "take effect" when they are resolved in an IRS settlement agreement, or, in the case of AAR adjustments, when the AAR is filed.

d. If the IRS makes a cease-to-exist determination, the partnership is no longer liable for any unpaid amounts resulting from the partnership adjustment. Reg. § 301.6241-3(a)(2). The tax impacts of the adjustments fall on the "former partners."

e. The regulations do not indicate whether the section 6226(c)(2)(C) 2% interest bump applies in a "forced" push-out under the cease-to-exist rules. The better view is that it does not, because section 6226(c)(2)(C) refers to elective push-out treatment by an audited or AAR partnership or a pass-through partner. (Note that section 6232(f) specifically provides for hot interest in that context, see section 6232(f)(1)(A).)

5. Take Effect. Adjustments "take effect" for purposes of the cease-to-exist rules:

a. when they are finally determined as a result of the partnership's failure to file a timely petition for readjustment with a court or, if a petition is filed, when the court's decision becomes final,

b. when the partnership and the IRS enter into a settlement regarding the adjustment, or

c. for AAR adjustments, when the AAR is filed. See Reg. § 301.6241-3(c).

6. The IRS cannot make a cease-to-exist determination if the statute of limitations on collection applicable to the assessment of a partnership IU has run or if the partnership has already made a valid section 6226 push-out election. Reg. § 301.6241-3(b)(3). In other words, if the partnership voluntarily enters push-out mode or pays an IU in full, the IRS cannot impose different tax consequences by making a cease-to-exist determination. See Preamble to December 2022 Final Regulations, 87 Fed. Reg. at 75480-75481.

7. Cease to Exist. A partnership "ceases to exist" for purposes of section 6241(7) if the IRS determines that the partnership either:

a. terminated under section 708(b)(1), or

b. does not have the ability to pay in full any amount that "may be due" under subchapter C of chapter 63 for which the partnership is or "may become" liable. See Reg. § 301.6241-3(b)(1) (providing that the inability-to-pay standard is met if the IRS determines that the partnership's account is not currently collectible based on information available to the IRS).

(1) The quoted language was inserted to make it clear that the IRS can make an inability-to-pay determination with respect to a potential future IU liability – not just a liability that is actually due and payable at the time of the determination. See Preamble to November 2020 Proposed Regulations, 85 Fed. Reg. 74940, 74946.

c. Section 708(b)(1) provides that a partnership is considered as terminating only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

(1) The 2024-2025 Priority Guidance Plan (Oct. 3, 2024) includes "Guidance on partnership terminations under § 708" (Partnerships, Item 10).

(2) Under Reg. §§ 1.708-1(b)(3)(i) and 1.706-1(c)(1), the taxable year of a partnership that terminates under section 708(b)(1) closes with respect to all of the partners on its "termination date," which is the date on which the winding up of partnership affairs is completed.

(3) A partnership can also terminate if it does a complete liquidation, including a deemed liquidation that accompanies a check-the-box election to be an association or other partnership incorporation transaction, or if it ceases to have at least two members.

d. If the IRS determines that the partnership terminated under section 708(b)(1), the partnership ceases to exist on the last day of the partnership's final taxable year. Reg. § 301.6241-3(c).

8. No Cessation Until the IRS Says So. A key point: even if a partnership has actually terminated, a partnership does not cease to exist under section 6241(7) **unless the IRS formally determines that it ceased to exist**. There must be an IRS determination that one of the two cessation events has occurred, and the determination must be made before the adjustments "take effect."

a. The drafters rejected a rule that would require the IRS to make a cease-to-exist determination upon a partnership's request. The Preamble to the February 2019 Final Regulations explains:

> "If the IRS receives a letter requesting that the IRS determine that a specific partnership has ceased to exist and providing detailed facts to support such a determination, the IRS will consider the circumstances in the letter and whether it is in the interest of sound tax administration to determine that the partnership has ceased to exist. The IRS, however, will retain its discretion as to whether to determine that a partnership has ceased to exist, even if the facts would indicate that the partnership meets the criteria in § 301.6241-3(b)(1)(i) and (ii)." 84 Fed. Reg. at 6528.

9. Special rules are provided in Reg. § 301.6241-3(d)(1)(ii) to address situations where the IRS makes a cease-to-exist determinations with respect to the audited partnership and with respect to a partnership-partner.

10. Former Partners. The term "former partners" means the partners of the partnership "during the adjustment year that corresponds to the reviewed year" for which the adjustments were made. Reg. § 301.6241-3(d)(1)(i).

a. If the partnership terminates before the adjustment year, the former partners are the persons who were partners during the last taxable year for which a partnership return was filed under section 6031. Reg. § 301.6241-3(d)(2).

b. In contrast to a section 6226 push-out, the section 6241(7) "cease-to-exist" push-out goes to the adjustment year partners rather than the reviewed year partners, unless there are no adjustment year partners, in which case the former partners are those persons who were partners during the partnership's final taxable year. Reg. § 301.6241-3(e)(2)(i); Reg. § 301.6241-3(d)(1) and (2).

c. A "former partner" potentially could include a resulting partnership in a partnership merger that (notwithstanding the generally applicable assets-over fiction in the merger) is treated as purchasing the interest of a partner in a target partnership immediately prior to the merger under the sale-within-a-merger rule in Reg. § 1.708-1(c)(4). See Kate Krause, Partnership Terminations and the Bipartisan Budget Act, 185 Tax Notes Federal 475 (Oct. 21, 2024) (noting this concern among many other issues and uncertainties presented by the cessation regulations) .

11. Adjustment Year. The adjustment year is the partnership taxable year in which the adjustments were determined in a court decision that has become final (if a petition for readjustment was filed), or, in any other case, the year in which the FPA was mailed (or, if the partnership waives restrictions on assessment, the year in which the IRS signs the waiver). See Reg. § 301.6241-3(d)(1)(i); Reg. § 301.6241-1(a)(1) (defining "adjustment year" for purposes of the BBA generally).

a. In the case of AAR adjustments, the adjustment year is the year in which the AAR was filed.

12. The regulations leave much to be desired when it comes to exactly how the former partners take into account the adjustments once they "take effect." If a former partner was also a partner in the reviewed year, then, following the directive in Reg. § 301.6241-3(e)(1) that rules similar to the section 6226 push-out regime apply, the partner arguably would determine correction amounts for the first affected year and intervening years and remit an ART with the partner's reporting year return. If the former partner was not a partner during the reviewed year, then arguably the partner takes them into account in the partner's reporting year that corresponds to the adjustment year. There is no guidance as to how the adjustments are supposed to be allocated among the "former partners."

13. A cease-to-exist determination does not preclude the partnership from seeking modification of the IU. Reg. § 301.6241-3(a)(1). While not relevant to the audited partnership (which ceases to be liable for an IU following such determination under Reg. § 301.6241-3(a)(2)), such modifications could be relevant to a partnership-partner seeking to pay an IU on its share of pushed out adjustments.

C. <u>Relationship Between Section 6232(f) and Section 6241(7)</u>

1. Section 6241(7) potentially applies <u>before</u> the partnership adjustments take effect, and section 6232(f) potentially applies <u>after</u> they take effect. <u>See</u> Preamble to the November 2020 Proposed Regulations, 85 Fed. Reg. at 74946. Section 6232(f) assumes an IU has been finally determined and a notice and demand for payment has been made.

2. Even though a partnership may have actually terminated, it generally will be up to the IRS as to whether to go after the partners for an unpaid IU assessment under the failure-to-pay rules in section 6232(f) with hot interest or make a timely (before the adjustments take effect) cease-to-exist determination under section 6241(7) and force a push-out of adjustments to the "former partners."

3. There is an important difference in the tax effects of the two provisions. Section 6241(7) requires the <u>adjustments</u> to be taken into account by the former partners through a forced push-out. Section 6232(f) allows the IRS to assess tax against (i) the persons who are partners at the end of the adjustment year, or (ii) if the partnership has ceased to exist, against the former partners, for each partner's <u>proportionate share of the unpaid IU</u>. IRC § 6232(f)(3). Consider the effect of non-income adjustments that can generate an IU, but may have more benign tax impacts on the partners if pushed out.

D. <u>Cease to Exist – Example</u>

1. Assume a BBA partnership is audited for reviewed year 2021.

2. The partnership terminates all operations and files a final partnership return for the period ended December 31, 2023.

3. In 2024, the IRS commences an audit of 2021 and issues an FPA on September 30, 2024 that determines adjustments and an IU. The partnership does not make a push-out election.

4. The partnership fails to file a petition within the 90-day period in section 6234. The adjustments thus "take effect" on December 30, 2024. <u>See</u> Reg. § 301.6226-3(h), Examples (2), (3), (4), (6), (7), (8) and (9) (adjustments are "finally determined" on the 91st day where no petition was filed).

5. On October 1, 2024, before the take-effect date, the IRS determines that the partnership terminated under section 708(b)(1) in 2023. On October 30, 2024, it sends a notice of its cease-to-exist determination to the partnership, its PR and the former partners.

6. Absent the termination, the "adjustment year" for the partnership would be 2024, the year in which the FPA was mailed. <u>See</u> Reg. § 301.6241-1(a)(1). However, because the partnership terminated in 2023, there is no adjustment year. Thus, under Reg. § 301.6241-3(d)(2), the partnership is required to send push-out statements to the persons who were partners during 2023, the last taxable year for which a partnership return was filed. The IRS has effectively used the cease-to-exist rules to force a push-out.

7. The partnership must furnish push-out statements to each former partner within 60 days **after** December 30, 2024. Reg. § 301.6241-3(e)(2)(ii) and (3).

8. Alternatively, the IRS could make a notice and demand for payment of the IU, and if the partnership fails to pay within 10 days, proceed under section 6232(f) to collect the IU from the "former partners," i.e., the persons who were partners as of the end of the partnership's 2023 final taxable year.

a. Unlike the section 6241(7) push-out mechanism, section 6232(f) doesn't push out adjustments, with the partners having to figure out their personal tax impacts from the adjustments and the IRS potentially having to track down and audit the partners' correction amounts and payment. Rather, it imposes the partnership's IU liability directly on the termination year partners, with each partner liable for its "proportionate share."

9. As previously discussed, if a BBA partnership has a net negative adjustment relating to a pre-termination reporting year for which an IU was determined, that adjustment ordinarily can only be taken into account in the "adjustment year." IRC § 6225(b)(2); Reg. § 301.6225-3(b)(2). However, if the partnership has terminated, there is no adjustment year. There is no guidance on what happens in this situation. (A section 6226 push-out of all the adjustments to the reviewed year partners avoids this issue.)

E. <u>Section 6241(7) is Silent re Mergers and Divisions</u>

1. Neither section 6241(7) nor the regulations mention partnership mergers and divisions, which are governed by section 708(b)(2) and not section 708(b)(1).

2. A merger or division can result in "continuing" and "terminated" partnerships.

3. Assume a partnership divides into three new state law partnerships in an assets-over division and the transferring partnership is dissolved. Assume that none of the resulting partnerships is viewed as a "continuation" of the prior partnership under Reg. § 1.708-1(d)(1) because in each case the members of the resulting partnership did not own an interest of more than 50% of the capital and profits interests in the prior partnership. The division regulations would treat the prior partnership as having "terminated" and it would file a final return.

a. Assume the IRS audits the prior partnership for a pre-division year, proposes partnership adjustments and determines an IU.

b. The IRS could determine that the prior partnership has ceased to exist under section 6241(7) based on a no-ability-to-pay determination (it is gone). In that case, the adjustments would be pushed out to the former partners.

c. If the IRS does not do so, it could seek to impose IU liability for one or more resulting partnerships under a successor or transferee liability theory. Once again, a push-out election avoids carryover liability to the successor partnerships.

4. If one of the resulting partnerships is the same state law entity that existed prior to the division but is not viewed as a "continuing partnership" under the division regulations, the fact that it is the same legal entity as the reviewed year partnership entity may provide a sufficient basis for subjecting it to the IU liability.

a. Compare the case where an LLC previously classified as a partnership or disregarded entity checks the box to be an association, and more than five years later, checks back to being a partnership or disregarded entity. If the IRS audits a corporate taxable year, it can proceed against the LLC entity even when it resumes noncorporate status because under state law the legal liability for the taxes stays with the entity. <u>Cf.</u> Reg. § 301.7701-2(c)(2)(iii)(A)(1) (disregarded entity treated as separate for purposes of federal tax liabilities for any taxable period when it was not disregarded, meaning that the sole owner ordinarily is not liable for such tax liabilities); Reg. § 301.7701-2(c)(2)(iii)(B), Example (1) (applying state law principles to determine if successor disregarded entity in a merger is liable for tax debts of the predecessor).

5. If a resulting partnership is viewed as a "continuation" of the prior partnership, then the continuation of the prior "tax entity" (as opposed to the prior legal entity) may be a sufficient basis to impose IU liability on the successor tax partnership.

F. BBA Issues in a Rev. Rul. 99-6 Acquisition

1. Assume a real estate joint venture is formed to acquire a property owned by an LLC that is a tax-recognized partnership. The business deal calls for the owners of the target LLC to sell 100% of the interests to an unrelated buyer partnership, which thereafter will hold the LLC as a disregarded entity.

2. Under Revenue Ruling 99-6 (Situation 2), 1999-1 C.B. 432, this is treated as a sale of partnership interests by the sellers. From the buyer's perspective, it is treated as a liquidating distribution of assets to the sellers, followed by a purchase of the assets by the buyer partnership. See, e.g., PLR 200807005 (Feb. 15, 2008) (disregarded entity of buyer partnership acquired 100% of interests in target partnership).

a. Target LLC no longer exists as a tax-recognized partnership following the purchase. Target LLC files a final partnership return for the taxable year ending on the closing date.

3. What happens if the IRS decides to make adjustments to PRIs for pre-acquisition BBA years of target LLC?? (Assume target LLC was not eligible to elect out of the BBA.)

4. As previously noted, an IU is required to be paid by the partnership "in the adjustment year as provided in section 6232" (section 6225(a)(1)) and is assessed and collected "as if it were a tax imposed for the adjustment year by subtitle A" (section 6232(a)).

a. The "adjustment year" is the "partnership taxable year" (i) in which a court decision relating to the adjustment becomes final or, in any other case, in which the FPA is mailed or the partnership executes a waiver of restrictions on assessment, and (ii) in the case of an AAR, the partnership taxable year in which the AAR is made. IRC § 6225(d)(2); Reg. § 301.6241-1(a)(1).

5. These provisions literally cannot be applied in a year when the partnership has ceased to exist for tax purposes. Without a tax partnership, there is no partnership taxable year that can be an adjustment year.

a. The adjustment year is defined in section 6225(d)(2) by reference to the "partnership taxable year" in which there is a final court decision, an AAR is filed, or, in any other case, the year the FPA is mailed (or the date a waiver of restrictions on assessment is executed by the partnership). Reg. § 301.6241-1(a)(1).

b. The term "partnership" means a partnership required to file a return under section 6031. IRC § 6241(1).

6. In the Rev. Rul. 99-6 example, the sale of all the interests in Target LLC results in a section 708(b)(1) termination, since there is only one LLC owner following the sale. Thus, the IRS ought to determine, in this clear-cut case, that Target LLC terminated under section 708(b)(1), and therefore any tax liabilities resulting from an audit of Target LLC's pre-acquisition taxable years should remain with the former partners of Target LLC.

7. If the IRS fails or refuses to determine that Target LLC ceased to exist (e.g., because it perceives Target LLC as a more lucrative debtor than the former members), can an IU be imposed on Target LLC even though its partnership tax existence is over and it is now a disregarded entity of buyer? The disregarded Target LLC is still the same legal entity as in its prior "tax partnership" life, and there is a substantial risk that it would be held liable for any IU imposed with respect to the final and prior BBA partnership taxable years.

a. If the IRS truly (validly? Loper Bright?) has the discretion to ignore tax reality and treat Target LLC as a continuing tax partnership, then presumably it would also reserve the right to impose and collect an IU from Target LLC, notwithstanding its disregarded entity status.

b. If buyer is a tax partnership now operating Target LLC as a disregarded entity, could buyer partnership be viewed as a continuation of Target LLC, even though there is no overlapping ownership of Target LLC's former owners with the owners of the buyer partnership? This seems highly unlikely given the words of section 708(b)(1) ("carried on by any of its partners") and the fact that the merger and division regulations, as well as former section 708(b)(1)(B) (technical termination), employ a 50% ownership threshold for continuation.

8. Alternatively, once the adjustments are finally determined, if the IRS makes notice and demand for payment of the IU from Target LLC and it refuses to pay, the IRS could assert its authority under section 6232(f) to go after the selling partners for their proportionate shares of the IU. Section 6232(f) applies if the partnership ceases to exist after the adjustments take effect and the resulting IU is not paid upon notice and demand for payment. In that event, the Secretary may assess the "former partners" (as determined for purposes of section 6241(7)) for their shares of the IU liability.

9. An asset purchase avoids these issues for the buyer, but it is still possible that a transferee of a partnership's assets could be subject to pre-transfer tax liabilities associated with an IU based on a successor or transferee liability theory.

a. Also, if the buyer partnership or its partners are related to the sellers, the partnership merger and division rules in section 708(b)(2) – not addressed in the BBA rules – might treat the buyer partnership itself as a "continuation" of Target LLC.

10. In the hypothetical Rev. Rul. 99-6 transaction, section 6241(7) could apply if the IRS determines the partnership ceased to exist before the adjustments take effect. See Preamble to November 2020 Proposed Regulations, 85 Fed. Reg. at 74946.

a. If the IRS makes such a determination, it would effectively impose a deemed push-out election as to the "former partners," but not as to the reviewed year partners.

11. If buyer partnership intends on keeping target partnership alive as a tax-recognized subsidiary (e.g., by having a .1% interest purchased by a tax-recognized person other than buyer partnership), the target partnership does not cease to exist under section 708(b)(1) (and Revenue Ruling 99-6 does not apply), which means the "cease to exist" rule that permits the IRS to go after the former partners would not apply unless it is based on an inability to pay determination.

12. If the IRS determines that Target LLC has ceased to exist before a push-out election is made, a regular push-out election under section 6226 may not be an option. In that event, the persons who were partners in the final partnership taxable year (the sellers in the acquisition transaction) may be stuck with the tax under the section 6241(7) rule, as opposed to the reviewed year partners who would bear the tax under the push-out election.

13. Note that buyer partnership cannot revoke the PR or DI designation for the prior reviewed year because it was not a partner during such year and therefore is not an authorized person to sign Form 8979. Reg. § 301.6223-1(e)(4). Thus, sellers' PR or DI will remain in place unless they resign or an authorized person who was a partner during the reviewed year revokes the designation and names a successor.

a. Can a partnership revoke a PR designation for a reviewed year after the partnership has terminated for tax purposes (as here, when it ceases to have at least two members)?

b. The fact that the regulations require the revocation to be signed by a person who was a partner during the reviewed year suggests a "yes" answer. This view draws some support from a Preamble discussion in T.D. 9839, 83 Fed. Reg. 39331, 39337 (Aug. 9, 2018), regarding the deletion of a proposed revocation rule for LLCs and its requirement that the LLC be "currently" classified as a partnership.

14. Sellers will want to control (through their PR or DI) any BBA partnership proceeding involving a pre-sale partnership year, but buyer partnership has an interest in this too, since it now owns Target LLC, an entity that could potentially be exposed to IU liability if things go wrong (like a failed push-out).

15. Buyer partnership should consider doing the following:

a. Determine for what taxable years the target partnership is or was subject to the BBA. For taxable years in which it filed an opt-out election, diligence may be needed to verify that it was an eligible partnership for such years.

b. Determine whether the target partnership has filed any AARs or been the subject of any BBA audits.

c. Determine whether the target partnership received any push-outs from lower-tier BBA partnerships, and whether it determined to pay an IU or do a successive push-out (and, if so, was it a valid push-out).

d. Review all BBA audit correspondence, AARs, IU calculations, etc.

e. Perform due diligence as to any potential issues in pre-acquisition BBA tax years that could lead to potential PRI adjustments.

f. Negotiate for review and approval rights of any settlement or other significant action in the proceeding.

g. Obtain covenants and representations from the sellers that the PR(s) for all relevant BBA years has the authority under the existing partnership agreement to make a push-out election and that sellers will take all necessary and appropriate action to cause the PR for the reviewed year to make such election. If a push-out election is made, all adjustments "associated with" the IU are also pushed out. Thus, negative adjustments that would, absent a push-out, be reported on the BBA partnership's adjustment year return should not be an issue.

(1) For example, the amount of section 751(a) gain recognized by the sellers in the Rev. Rul. 99-6 transaction is a PRI – it depends on the partnership's books and records and is required to be reported by the partnership both on Form 8308 (included with the partnership's Form 1065) and the partner's K-1 (Box 20, Code AB). This would be required to be reported on the final partnership return in a Rev. Rul. 99-6 transaction, and thus could give rise to an IU liability if the amount is incorrect or the sellers whiffed on it completely.

h. Obtain a covenant from sellers that they will not revoke the PR designation and appoint a new PR without the buyer's consent.

i. Consider negotiating with seller to replace the existing PR with a "neutral" PR when the replacement opportunity first arises. It is understood that there are third party intermediaries who will provide this service for a fee. Recall that the PR can be a nonmember.

j. Obtain representations that no BBA proceedings have been instituted against the target partnership and that target partnership did not opt in to the BBA for any pre-2018 taxable years.

XIII. ISSUES TO CONSIDER IN DRAFTING PARTNERSHIP AGREEMENTS

A. <u>Appointing PR; Restricting PR's Authority</u>

1. The PR does not have to be a partner, but that is usually the case. Reg. § 301.6223-1(b)(1).

2. Typically the PR also serves in any corresponding or similar state tax capacity under state laws adopting federal BBA rules or a similar centralized audit system. Many partnership agreements also put responsibility for non-BBA partnership tax matters (preparation and signing of returns, etc.) under the PR's control.

3. Many partnership agreements provide that all material actions, inactions, and elections under the BBA (e.g., opt-out and push-out elections) require approval of firm management (general partner, managing member, board, etc.), but not of the partners.

a. This may work in a controlled setting where the sponsor or manager generally calls all the shots, but in a JV with substantial investor partners, the "outside" partners can be expected to negotiate for consent rights over certain actions, particularly where the tax interests of the partners and the investors may diverge (e.g., if there are tax-exempt investors). Whatever is done in this regard, the partnership should be mindful of the importance of avoiding impasse or process delays when quick BBA-related action is needed.

b. Who decides who will be designated as PR or DI for each partnership taxable year? Often this is left to firm management – the partnership's GP, managing member, board, or administrative committee.

c. Since the PR has absolute power vis-a-vis the IRS, many partnership agreements require prior approval by firm management committee, GP, managing member, etc. of any material action proposed to be taken by the PR (e.g., "any material action, inaction, or election under the BBA shall be approved by in advance by firm management").

(1) If the PR or DI is not a partner and does not normally sign the partnership agreement, one needs to consider how to make the PR/DI subject to whatever constraints are intended to be imposed on such person's authority under the partnership agreement.

d. If the PR ceases to be a partner in the partnership, the partnership cannot revoke the PR's designation and appoint a successor until the IRS has contacted the partnership for an audit of the reviewed year. It is therefore critical that, upon the PR's departure from the partnership or the PR otherwise becoming unable to serve, the PR is obligated to notify the partnership immediately of any IRS BBA or similar state communications or notices and to take action only as specifically directed and approved by partnership management.

e. The PR typically is charged with supervising outside professionals in connection with BBA proceedings. However, the agreement should make it clear that the advisors represent the partnership, not the PR.

4. The partnership agreement could require the PR to act in good faith and in best interests of the partners collectively; could also require that the PR consult with the partners in good faith on a nonbinding basis.

5. It could provide that certain fundamental BBA decisions and elections must be submitted to the approval of the partners, such as a majority-in-interest of the partners or specific heavy-hitter partners.

a. Consents to extend the statute of limitations.

b. Decision to accept adjustment(s), settle or litigate.

c. Choice of venue for litigation; choice of counsel.

d. Filing an AAR.

e. Making a section 6226 push-out election in lieu of paying an imputed underpayment.

f. Approval of the method of apportionment of IU economic burden among reviewed year partners and current partners.

(1) As noted, under proposed regulations, the allocation of the IU expenditure satisfies PIP only if it is allocated in accordance with Prop. Reg. § 1.704-1(b)(2)(iii)(f) to reviewed year partners and their "successors" **and** the partners' distribution rights are reduced by their shares of the IU. Prop. Reg. § 1.704-1(b)(4)(xii).

(2) A partner purchasing an interest from another partner and who constitutes a "successor" to the transferor should consider negotiating for reimbursement rights if an IU is paid and the transferor was a reviewed year partner.

g. Using PMARs and/or the Alternative Procedure to modify the IU.

h. Any action that would have a material disproportionate adverse affect on one or more partners.

B. Indemnifying PR; Reimbursing PR

1. Any direct or indirect costs or expenses incurred by the PR in its capacity as such are treated as partnership expenses. The partnership typically will reimburse the PR for such amounts (e.g., attorney's fees, accounting fees, filing fees, and reasonable out-of-pocket travel and other costs).

2. The partnership will typically indemnify the PR for any liability relating to the conduct of PR duties or with respect to partnership's obligation to pay IU and related liabilities (subject to bad actor carveouts).

3. Partners and former partners typically agree to hold the PR and partnership harmless from any damages, costs and expenses sustained by them as a result of any action, inaction or election (including a push-out election) by the PR or the partnership under the BBA or any similar state proceeding, provided such action, inaction or election was taken or not taken in good faith and not due to gross negligence or fraud.

C. Opt-Out Partnerships

1. If the partnership intends to make an opt-out election whenever eligible, the partnership agreement can (i) require that the election be made for each taxable year that the partnership is an eligible partnership, (ii) provide for restrictions on transfers of interests to ineligible partners (e.g., to disregarded entities), check-the-box elections that would create an ineligible partner (e.g., an S corporation LLC checks to become a partnership or disregarded entity), and transfers that would cause the partnership to exceed the 100 K-1 limit, and (iii) require S corporation partners to disclose the number of K-1s being provided to their shareholders.

2. Consideration should be given to designating a back-up PR in the event the partnership is determined not to qualify for the opt-out election for a particular year and including basic provisions on the back-up PR's authority and duties.

3. The partnership agreement should include an obligation to timely provide information to partners to the extent reasonably necessary to assist them in defending a partner-level audit of partnership tax items.

D. Who Does the Tax Advisor Represent?

1. Tax advisors typically represent the partnership, not the partners or the PR.

2. The engagement letter should be with the partnership and not the PR.

3. As noted earlier, the IRS takes the position that in an examination, the tax accountant or tax lawyer represents the PR and therefore the IRS requires a new Form 2848 if the PR changes. Nevertheless, the partnership is the petitioner in litigation. IRC § 6234(a).

E. Communicating With Partners; Partner Cooperation Commitments

1. An agreement often will require the PR to use commercially reasonable efforts to keep partners reasonably informed of the progress of an IRS audit or any other material tax proceeding and, upon a partner's request, to provide copies of material written communications from the IRS or other taxing authority.

2. Partners may negotiate for more, such as required distribution to partners of all material IRS notices and correspondence and/or review and comment rights relating to all material correspondence with the IRS (e.g., protest letters, responses to exam team, briefs, pleadings).

3. Agreements may require partners to reasonably cooperate in IU modification requests, including providing all necessary information and IRS forms to the partnership in conjunction with its preparation of Form 8980.

a. Requiring partners to file PMARs or participate in the Alternative Procedure goes a significant step further and may not be palatable.

4. Partners should agree to be bound by decisions and elections of the PR under BBA, including settlement, litigation, appeals, etc.

5. Partners should commit to timely provide change of address information to the partnership. Former partners could commit to do so for a specified number of years after departing.

6. Partners should agree to file consistently with the partnership return and K-1s and any partnership amended return, and with any push-out statements furnished in connection with a section 6226 election, except to the extent the partner notifies the partnership in advance of filing of the partner's intent to take an inconsistent position and the basis for doing so.

F. <u>Sharing Economic Burden of IU Payments and Expenses of Administrative Proceeding/Litigation</u>

1. Relatively small IU amounts could be economically borne by the current year partners to keep things simple.

2. Could apportion the economic burden only to current year partners who were also reviewed year partners in proportion to their percentage interests in the reviewed year.

3. Management could have the discretion to require reviewed year partners to reimburse the partnership for their proportionate shares of the IU (e.g., through offset against distributions).

4. Consider whether reviewed year partners should bear all or any portion of the costs of the administrative proceeding and any ensuing tax litigation, as opposed to letting them be absorbed by current year partners.

5. Will retired and former partners with respect to a reviewed year have a contribution obligation? How should one be enforced (deductions against retirement payouts, paid-in capital distributions, guaranteed payments, etc.)? What if the partners' percentage interests have changed since the reviewed year?

6. IU payments apportioned to a former reviewed year partner, to the extent not withheld from ongoing distributions or other payments, could be treated as an interest-bearing loan.

7. The August 2018 Proposed Tax Attribute Regulations contain amendments to the section 704(b) regulations that would require IU expenditures be allocated to those adjustment year partners who are reviewed year partners or successors to reviewed year partners in order to meet the substantiality rules and to be PIP-compliant. Further, if the agreement's allocations do not qualify under an economic effect safe harbor, the partners' distributions rights need to be reduced by the allocation. Partnerships may want to include compliant allocation provisions now.

8. Consider giving the partnership the right to set aside reasonable reserves for payment of IU and interest, penalties and additions to tax.