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The Partnership Audit Rules Under the Bipartisan Budget Act

by

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This portfolio is dedicated to my husband, Per, and my daughter, Stella.

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TAX MANAGEMENT PORTFOLIOS™

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The Partnership Audit Rules Under the Bipartisan Budget Act

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *The Partnership Audit Rules Under the Bipartisan Budget Act*, No. 629-1st, discusses the rules enacted by the Bipartisan Budget Act of 2015 that govern partnership audits and adjustments. The Portfolio addresses procedural issues, including those relating to the partnership representative and the steps involved with an audit and judicial review. The Portfolio also discusses the various ways in which an adjustment might be taken into account, which may affect the amount that must be paid and who bears the benefits or burdens of an adjustment.

This Portfolio may be cited as Kraus, 629-1st T.M., *The Partnership Audit Rules Under the Bipartisan Budget Act*.

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DETAILED ANALYSIS

I. BBA Audit Rules — Overview and General Applicability

A. Background

Before the enactment of the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA), the Internal Revenue Service (IRS) did not have a centralized proceeding in which the IRS could directly audit a partnership's tax return. Instead, a partnership's tax return was audited indirectly; the IRS would examine a partnership's tax items in an audit of a partner by evaluating whether the partner properly reported its share of partnership items. If an adjustment was made to a partnership item, the adjustment would only affect the partner under audit; the other partners would not be affected. To make a corresponding adjustment with respect to another partner, the IRS would have to open an audit of that other partner and resolve the issue in a separate proceeding that might not be coordinated with the audit of the first partner. This approach was inefficient and often produced inconsistent results.

In 1982, Congress enacted TEFRA so that the IRS could generally resolve partnership issues in a single centralized partnership-level proceeding that would bind all partners. This may have been an improvement from the IRS's perspective, but audits of partnership-related items continued to be difficult. One problem was that TEFRA was purely procedural; it did not affect who owed tax or the amount of tax owed. Moreover, the burden was on the IRS to implement the adjustment. As a result, the IRS had to locate the tax returns of those who were partners in the affected partnership tax year, recompute the amount of tax owed by each of these partners and collect any additional tax owed (and perhaps interest and penalties) from them. This was extremely burdensome when the partnership had many partners or when the partners were themselves pass-through entities, and this burden may be one reason why the IRS subjected partnerships to less scrutiny than C corporations.

As TEFRA provided a cumbersome and sometimes ineffective approach for partnership audits, Congress enacted the Bipartisan Budget Act of 2015 (BBA),¹ which repealed TEFRA² and created a new set of rules for adjustments that relate to partnerships. Like TEFRA, the BBA addresses partnership-related items through centralized proceedings at the partnership level. In other respects, however, the BBA is quite different from TEFRA. One key difference is that the BBA is not simply a set of procedural rules. Rather, it is intended to address procedural and administrative issues, and it does so by modifying who owes tax and the amount of tax owed. Another difference is that TEFRA generally provided only one way

in which an adjustment would be taken into account. In contrast, the BBA provides a partnership with multiple options. The BBA also shifts some of the procedural burden of implementing an adjustment from the IRS to the partnership and its partners.

Comment: Are the BBA rules working as intended? For several years, the total number of partnerships filing returns had been increasing, while the audit rate for partnerships had been decreasing. This trend has been especially pronounced in the context of large partnerships. In tax year 2019, there were 20,052 large partnerships, an increase of over 150% since tax year 2007; however, the audit rate for large partnerships decreased from 1.4% for tax year 2007 to just 0.3% (54 out of 20,052 partnerships) for tax year 2019, representing a nearly 80% decline. IRS officials attributed the declining large partnership audit rate to budgetary and resource constraints; however, with increased funding provided through the Inflation Reduction Act, the IRS has committed to increasing enforcement activities to help ensure tax compliance of large partnerships. In addition, the IRS's most recent Data Book suggests that the audit rate for all partnerships is beginning to increase again.³

B. Who Bears Potential Liability

Before the BBA, the only partners who would be liable for any additional amounts that were due were those who were partners in the partnership's tax year that was under audit. Under the BBA, that tax year is called the "reviewed year," and those who were partners in that year are "reviewed-year partners."⁴

The BBA rules provide many alternatives for how an adjustment is taken into account, and different persons may be liable (or bear the economic burden) under the different alternatives. Under the BBA's default rule, it is the partnership that must pay any additional tax, interest or penalties that are owed. In that case, the economic burden falls on those who are partners in the year the payments are made, unless someone else (such as a prior partner) has agreed to indemnify the partnership or the partners for these expenses. There are alternatives, however, in which direct liability may be borne by the reviewed-year partners or by other partners.

Tax liabilities are not the only economic consequences that may result from an adjustment. In evaluating the different options available under the BBA rules, it is also important to consider who will benefit from any favorable adjustments, especially since favorable adjustments may be more common under the BBA than they were before the BBA. This is a result of the grouping rules that are discussed in V.B.1.c., below. For example, if a partnership recognized ordinary income but characterized that income as capital gain on its return, this error would be corrected by recharacterizing the income, and this recharacterization previously would have been viewed as a single, unfav-

¹ Bipartisan Budget Act of 2015, Pub. L. No. 114-74.

² The BBA also repealed the rules for elective large partnerships (ELPs) (former §771–§777 and former §6240–§6255). These rules were elective, and very few partnerships opted to be subject to those rules.

Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations issued thereunder.

³ See, e.g., 2023 IRS Data Book, Publication 55-B (Rev. 4-2024).

⁴ §6225(d)(1); Reg. §301.6241-1(a)(8), §301.6241-1(a)(9).

avorable adjustment. Under the BBA rules, however, this error might be corrected through two separate adjustments that do not offset each other — an unfavorable adjustment (an increase in ordinary income) and a favorable adjustment (a decrease in capital gain).

1. Reviewed-Year Partners Liable

Under the BBA, the reviewed-year partners may be directly liable for any additional amounts due in the following situations:⁵

- The partnership elects for the BBA not to apply;⁶
- The reviewed-year partner files a return that is inconsistent with the partnership's return and the IRS conducts an audit of that partner but not an audit of the partnership;⁷
- The modification rules are applied to reflect that the reviewed-year partners have taken an adjustment into account in amended returns, under the pull-in (or “alternative”) method, or through a closing agreement;⁸
- The partnership makes a valid §6226 “push-out” election;⁹ or
- The IRS determines that the issue should be addressed in a partner-level proceeding, not a BBA proceeding, pursuant to regulations authorized under §6241(11) regarding special enforcement procedures.¹⁰

2. Partners in Later Tax Years Liable

There are two situations in which those who are partners in a year after the reviewed year may be directly liable for any additional amounts that are due:

- The IRS determines that the partnership has “ceased to exist;”¹¹ or
- The partnership fails to pay the amount due within 10 days of receiving notice and demand for the payment.¹²

C. Applicable Tax Years

The BBA rules generally apply to partnership tax years that begin after December 31, 2017.¹³ It doesn't matter when the tax return is filed or when an audit begins. Therefore, returns filed for a tax year ending on December 31, 2017, generally are not subject to the BBA rules even though those returns may be filed by the partnership and audited by the IRS after 2017.

⁵ The amounts that they owe might, however, be different from what they would have owed under TEFRA.

⁶ §6221(b). See I.C.1., below.

⁷ Reg. §301.6222-1(c)(4). See IV.C.1., below.

⁸ §6225(c); Reg. §301.6225-2(d)(2), §301.6225-2(d)(8). See V.C.3.b.(1), V.C.3.b.(2), and V.C.3.b.(3), below.

⁹ See V.C., below.

¹⁰ §6241(11). See II.C., below.

¹¹ §6241(7); see V.B.7., below.

¹² §6232(f)(1)(B); see V.B.8., below.

¹³ Bipartisan Budget Act of 2015 (BBA), Pub. L. No. 114-74, §1101(g)(1)–§1101(g)(3). The BBA has been amended twice since its enactment, but the amendments are effective as if they were included in the BBA as originally enacted. See the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113 (PATH Act), Div. Q §411(e); and the Tax Technical Corrections Act of 2018, Pub. L. No. 115-141, Div. U §207.

Certain partnerships are eligible to “elect out” of the BBA rules for a particular tax year, in which case that tax year would not be subject to the BBA. There is also an early “opt in” election that certain partnerships could make so that the BBA rules would apply to tax years that began before 2018.

1. Opt-Out Election

Under §6221(b), certain partnerships are allowed to elect for the BBA rules not to apply. When this “opt-out” election is made, the partnership items are not evaluated in a centralized proceeding.¹⁴ Instead, partnership items would be adjusted in the course of an audit of a partner, and the audit of one partner might not be coordinated with the audit of another partner.

This opt-out election is made for a particular tax year.¹⁵ For example, an eligible partnership that is on a calendar year could opt out with respect to its 2018 return but have its 2019 return be subject to the BBA rules.

The opt-out election cannot be revoked without IRS consent. The request to revoke the election is made on Form 15288, *Request to Revoke Partnership Election under IRC Section 6221(b) or Request to Revoke Election under 1101(g)(4)*.¹⁶

If the request to revoke the election is made more than 30 days after the Notice of Selection for Examination (NOSE) has been issued, the request will not be granted unless there are unusual circumstances and the revocation is administratively convenient for the IRS and the partnership.¹⁷

a. Eligibility

A partnership cannot elect out of the BBA rules for a particular tax year unless it has 100 or fewer partners in that year and all of its partners are eligible partners.¹⁸

(1) Number of Partners

The number of partners generally is determined by the number of Schedules K-1 that the partnership must issue for the tax year.¹⁹ For example, if a husband and wife each hold a separate interest in the partnership, the partnership is required to issue a separate Schedule K-1 to each of them, and they would be treated as two separate partners. If instead the couple lives in a community property state and the husband holds only a community property interest in the wife's interest in the partnership, the partnership is not required to issue a Schedule K-1 to the husband. In that case, the wife would be counted as a partner but the husband would not.²⁰

When a partner is an S corporation, each of the shareholders of the S corporation is treated as a partner in the partnership for purposes of the 100-partner limit.²¹ For example, if a partner is an S corporation with 50 shareholders, the corporation

¹⁴ The TEFRA rules would not apply because the BBA repealed TEFRA for tax years that begin after 2017.

¹⁵ §6221(b)(1).

¹⁶ See Reg. §301.6221(b)-1(c)(1). When revoking the election, a partnership must also appoint a partnership representative by submitting Form 8979, *Partnership Representative Designation or Resignation*.

¹⁷ IRM 4.31.9.7.5.1. If the IRS rejects the request to revoke the election, the partnership has no right to appeal the rejection.

¹⁸ §6221(b).

¹⁹ §6221(b)(1)(B).

²⁰ Reg. §301.6221(b)-1(b)(2)(iii) Exs. (1) and (2).

²¹ §6221(b)(2)(A)(ii); Reg. §301.6221(b)-1(b)(2)(ii).

and shareholders would be treated as 51 partners; each of the 50 shareholders would be counted as a partner, as would the S corporation itself.²²

(2) Eligible Partners

For a partnership to elect out of the BBA rules for a particular tax year, each partner in that year must be an eligible partner.²³ Eligible partners include individuals, C corporations and estates of deceased partners.²⁴ Foreign entities are also eligible when they are treated as corporations under Reg. §301.7701-2(b) (i.e., entities that are treated as per se corporations under Reg. §301.7701-2(b)(8), entities that are treated as corporations by default under Reg. §301.7701-3(b)(2)(i) (B), and entities that are treated as corporations as a result of a check-the-box election under Reg. §301.7701-3(c)).²⁵ It does not matter whether the partner is tax exempt.²⁶

A partner is not an eligible partner if it is a partnership, a trust, a foreign entity that is not an eligible foreign entity, a wholly owned entity that is disregarded as separate from its owner for federal income tax purposes (whether under Reg. §301.7701-2(c)(2)(i) or otherwise), or any person that holds an interest in the partnership on behalf of another person.²⁷

An S corporation qualifies as an eligible partner even if it has a shareholder that would be an ineligible partner if it held the partnership interest directly.²⁸ For example, an S corporation is an eligible partner even if one of its shareholders is a disregarded entity or a qualified small business trust. However, a qualified subchapter S subsidiary (QSub), as defined by §1361(b)(3), is not an eligible partner.²⁹

(3) Controlled Foreign Corporations and Passive Foreign Investment Companies

Under §6241(12), when a partner is a controlled foreign corporation (CFC), each U.S. shareholder (as defined in §951(b) or §953(c)(1)) with respect to that CFC is treated as a partner in the partnership, except as otherwise provided by the Secretary. When a partner is a passive foreign investment company (PFIC), a similar rule applies with respect to taxpayers that make elections under §1295.

Nevertheless, it is possible that U.S. shareholders of a CFC or the shareholders who have made QEF elections will not be treated as “partners” in the context of the opt-out election. The number and the eligibility of partners is generally determined based on the persons to whom the partnership must provide statements under §6031(b), and a partnership is not required to provide such shareholders with statements under §6031(b).

b. Time and Manner of Making Election

The opt-out election is made on Schedule B-2 (Form 1065), *Election Out of the Centralized Partnership Audit Regime*, which must be attached to a timely filed partnership tax return (with extensions) for the tax year that is subject to the election.³⁰ On this form, the partnership must provide each partner’s name and taxpayer identification number.³¹ When a partner is an S corporation, the partnership must also provide the name and taxpayer identification number of each shareholder of the S corporation.³²

The partnership must also notify each of its partners of the election within 30 days of making the election.³³

2. Early Opt-In Election

Although the BBA generally applies only to tax years that begin after December 31, 2017, a partnership may elect to apply the BBA to a tax year that began after November 2, 2015, and before January 1, 2018.³⁴ This early opt-in election cannot be revoked without IRS consent. The request to revoke the election is made on Form 15288, *Request to Revoke Partnership Election under IRC Section 6221(b) or Request to Revoke Election under 1101(g)(4)*.³⁵

a. Eligibility

The early opt-in election cannot be made if the partnership has already filed an amended return or an administrative adjustment request (AAR) under the TEFRA rules for the tax year at issue, or has filed an AAR before January 1, 2018.³⁶ Also, an early opt-in election is not valid if it frustrates the purposes of the BBA — for example, by impeding the ability of the IRS to collect tax.³⁷

b. Time and Manner of Election

There are only two situations in which a partnership may make the early opt-in election: when the IRS has selected the partnership’s return for examination, and when the partnership files an AAR for the year at issue. Therefore, the early opt-in election is not allowed unless it is clear that it will affect the IRS.

(1) Opt-In Election when Return Selected for Examination

If the IRS audits a partnership return for an eligible tax year, the partnership may elect for the BBA to apply to that tax year. This election must be made within 30 days of the date of the Notice of Selection for Examination (NOSE), which is

²² Reg. §301.6221(b)-1(b)(2)(ii), §301.6221(b)-1(b)(2)(iii) Ex. (4).

²³ §6221(b)(1)(C).

²⁴ §6221(b)(1)(C); Reg. §301.6221(b)-1(b)(3)(i).

²⁵ Reg. §301.6221(b)-1(b)(3)(iii).

²⁶ CCA 202147012.

²⁷ Reg. §301.6221(b)-1(b)(3)(ii).

²⁸ Reg. §301.6221(b)-1(b)(3)(i), §301.6221(b)-1(b)(3)(iv) Ex. (2).

²⁹ Reg. §301.6221(b)-1(b)(3)(ii)(D), §301.6221(b)-1(b)(3)(ii)(G). This represents a change in the government’s position; Notice 2019-6 stated that the government intended to issue regulations that treated QSubs like S corporations for purposes of determining eligibility. The final regulations are effective for taxable years ending on or after November 20, 2020.

³⁰ §6221(b)(1)(D)(i); Reg. §301.6221(b)-1(c)(1); Instructions for Schedule B-2 (Form 1065).

³¹ §6221(b)(1)(D)(ii).

³² §6221(b)(2)(A)(i).

³³ Reg. §301.6221(b)-1(c)(3).

³⁴ BBA, Pub. L. No. 114-74, §1101(g)(4).

³⁵ See Reg. §301.9100-22(a).

³⁶ Reg. §301.9100-22(c)(4), §301.9100-22(d).

³⁷ Reg. §301.9100-22(a); see also T.D. 9780, 81 Fed. Reg. 51,795 (Aug. 5, 2016) (preamble to temporary regulations on opt-in election).

a written notice that the IRS intends to audit the return.³⁸ The deadline for making this election cannot be extended.³⁹

The opt-in election may be made on Form 7036, *Election under Section 1101(g)(4) of the Bipartisan Budget Act of 2015*, or on a separate statement, as described in I.C.2.c., below. The election must be sent to the IRS contact identified in the NOSE.⁴⁰

When a partnership makes an early opt-in election, it will have a short window in which it will be allowed to file an AAR. An AAR must be filed before the IRS issues a notice of administrative proceeding (NAP),⁴¹ and the IRS may issue the NAP 30 days after receiving the early opt-in election.⁴²

(2) Opt-In when Filing an AAR

A partnership also may elect for the BBA rules to apply to an eligible tax year when filing an AAR for that year.⁴³ This election is made by attaching an election statement to the AAR that is filed, and the heading “Election under Section 1101(g)(4)” must be written at the top of the Form 1065 or Form 1065-X that is filed as part of the AAR. This AAR is filed in accordance with the BBA’s rules regarding AARs, not the TEFRA rules.⁴⁴ For example, if the partnership does not “push out” the adjustments to its partners, the partnership might be required to pay an imputed underpayment when it files the AAR.

When an early opt-in election is made in connection with an AAR, the BBA rules will apply to all adjustments made with respect to the applicable tax year, even if those adjustments are not reflected on the AAR.⁴⁵

c. The Election Statement

To make an early opt-in election, a partnership generally must file an election statement that satisfies the requirements described below.⁴⁶

If the partnership has received a NOSE, however, it may make the election by filing Form 7036, *Election under Section 1101(g)(4) of the Bipartisan Budget Act of 2015*.

(1) Heading

The statement must have “Election under Section 1101(g)(4)” as its heading if the election is filed after receipt of a NOSE.⁴⁷

³⁸ Reg. §301.9100-22(b)(1). The NOSE is sometimes referred to as an initial contact letter (ICL). See generally IRM 4.31.9.7.8.

³⁹ Reg. §301.9100-22(a).

⁴⁰ Reg. §301.9100-22(b)(2)(i).

⁴¹ §6227(c). A partnership may, however, file an AAR if the IRS withdraws the NAP. Reg. §301.6231-1(f).

⁴² Reg. §301.9100-22(b)(2)(iii).

⁴³ The instructions for making this election are provided in the Instructions for Form 1065-X (2018) (if not filing electronically) or in the Instructions for Form 8082 (2018) (if filing electronically).

⁴⁴ Reg. §301.9100-22(c)(1). The BBA’s rules regarding AARs are discussed in chapter VI., below.

⁴⁵ Reg. §301.9100-22(c)(1).

⁴⁶ Reg. §301.9100-22(b)(2)(ii), §301.9100-22(c)(3); Instructions for Form 1065-X (2018), Instructions for Form 8082 (2018).

⁴⁷ Reg. §301.9100-22(b)(2)(i).

(2) Information Provided

The election statement must provide the following information and statements:⁴⁸

- The partnership’s name, taxpayer identification number, and the partnership taxable year for which the election is being made;
- The name, taxpayer identification number, address, and daytime telephone number of the individual who signs the statement;
- A statement that the partnership is electing to apply §1101(c) of the BBA for the partnership return for the tax year at issue; and
- The designation of the partnership representative, including its name, taxpayer identification number, address, daytime telephone number, and any additional information required by guidance issued by the IRS.

(3) Representations

The election statement must include the following representations:⁴⁹

- That the partnership is not insolvent and does not reasonably anticipate becoming insolvent before resolution of any adjustment with respect to the partnership taxable year for which the election is being made;
- That the partnership has not voluntarily filed, and does not reasonably anticipate filing, a petition for relief under title 11 of the United States Code;
- That the partnership is not subject to, and does not reasonably anticipate becoming subject to, an involuntary petition for relief under title 11 of the United States Code;
- That the partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential imputed underpayment with respect to the partnership taxable year that may be determined under subchapter C of chapter 63 of the Tax Code as amended by the BBA; and
- That the individual signing the statement is duly authorized to make the election and that, to the best of the knowledge and belief of the individual signing the election, all of the information contained in the statement is true, correct and complete.

The last representation must be signed under penalties of perjury.

Note: In *SN Worthington Holdings LLC v. Commissioner*, the taxpayer complied with all of the requirements outlined above to make the opt-in election, including the requirement to make a representation about having sufficient assets. Based on a review of the partnership’s tax return, the IRS determined that the partnership would be unable to pay an imputed underpayment. When the partnership refused to provide any addition-

⁴⁸ Reg. §301.9100-22(b)(2)(ii), §301.9100-22(c)(3); Instructions for Form 1065-X (2018), Instructions for Form 8082 (2018).

⁴⁹ Reg. §301.9100-22(b)(2)(ii)(E)(1)–§301.9100-22(b)(2)(ii)(E)(4), §301.9100-22(c)(3); Instructions for Form 1065-X (2018), Instructions for Form 8082 (2018).

al information about its net worth, the IRS determined that the opt-in election was invalid and proceeded under the TEFRA procedures. The Tax Court, however, determined that the election was valid because the requisite representation was provided; the regulations do not require the partnership to prove that the representation was correct. As a result, the Notice of Final Partnership Administrative Adjustment (a TEFRA notice, not a BBA notice) was invalid.⁵⁰

⁵⁰ 162 T.C. No. 10 (May 22, 2024).

(4) Signature

The election statement must be signed and dated either by the tax matters partner under the TEFRA regime or by an individual who has authority to sign the partnership return for the tax year at issue.⁵¹ The fact that an individual signs and dates the election will constitute prima facie evidence that the individual is authorized to make the election on behalf of the partnership.⁵²

⁵¹ Reg. §301.9100-22(b)(2)(ii); Instructions for Form 1065-X (2018), Instructions for Form 8082 (2018).

⁵² Reg. §301.9100-22(b)(2)(ii); Instructions for Form 1065-X (2018), Instructions for Form 8082 (2018).

II. Scope of BBA

A. Importance of Scope

There are two reasons why the scope of the BBA rules is important. First, when an issue falls within the scope of the BBA, it will be addressed under the BBA's procedural rules. For example, it will generally be evaluated in a partnership-level proceeding that involves the partnership representative, not the partners. In addition, the statute of limitations will be determined with respect to the partnership under the BBA rules. A partner's separate statute of limitations would generally not apply.

Second, when the BBA applies to an adjustment, it may affect how the adjustment is taken into account. For example, the BBA rules can affect who is liable for any additional amounts that are due; the persons who are potentially liable include the partnership, the reviewed-year partners, and those who are partners in years that follow the reviewed year. The BBA rules can also affect the amount of additional tax, penalties and interest that are owed, whether refunds are available, and the treatment of tax attributes such as the partnership's basis in its assets and a partner's basis in its partnership interest.

The BBA rules generally apply to adjustments made to "partnership-related items" (PRIs), adjustments that are attributable to PRI adjustments, and associated penalties and interest. Its scope is limited, however, to partnerships that are required to file a U.S. partnership income tax return. The IRS has the authority under §6241(11) to specify situations in which it will not apply the BBA rules, as discussed further below.⁵³

B. Which Adjustments Are Governed by the BBA

Section 6221(a) identifies the types of adjustments that are generally governed by the BBA. It provides, "Any adjustment to a partnership-related item shall be determined, and any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item shall be determined, at the partnership level, except to the extent otherwise provided in this subchapter."⁵⁴

Therefore, the BBA generally governs adjustments to "partnership-related items" (PRIs), but its scope also extends to items that are not PRIs; namely, (1) taxes attributable to adjustments to PRIs, and (2) penalties, additions to tax, and additional amounts which relate to an adjustment of an item that is within the scope of the BBA.

1. Partnership-Related Items (PRIs) — In General

Regulations define a PRI as:

- Any item or amount with respect to a partnership which is relevant in determining the tax liability of any person under Chapter 1 of the Code;
- Any partner's distributive share of any such amount; or
- Any imputed underpayment determined under the BBA rules.⁵⁵

⁵³ See II.C., below.

⁵⁴ See also Reg. §301.6221(a)-1(a).

The last two items are relatively straightforward, but the first item warrants additional explanation. The regulations provide that an "item or amount with respect to a partnership" is an item or amount that is: (a) shown or reflected (or required to be shown or reflected) on the partnership's tax return; or (b) required to be maintained in the partnership's books and records.⁵⁶ Therefore the BBA procedures may apply, and a partnership might owe tax, with respect to something that is not an item of partnership income or loss — such as whether a transaction was a disguised sale in which a partner recognized gain, or whether a partnership mischaracterized its nonrecourse liability as recourse, as discussed below.

PRIs, however, do not include certain "person-specific items" that involve information that is specific to someone other than the partnership (such as a partner), as discussed in the next section. In addition, the Treasury Department and the IRS have issued regulations that give the IRS authority to not apply the BBA rules to PRIs in certain situations.⁵⁷

2. Exception for Person-Specific Items

PRIs do not include certain items that depend on facts that are specific to someone other than the partnership, such as a partner. Under this "person-specific exclusion," an item or amount is not "with respect to the partnership," and, therefore, not a PRI, when:

- It is shown (or required to be shown) on a return, or in the books and records, of a person other than the partnership (e.g., a partner); and
- It is the result of applying the Tax Code to facts *specific* to that other person (e.g., a partner) *after* application of the Tax Code to a PRI.⁵⁸ (Emphasis added.)

For example, if a partnership donates property to a charity, the amount of the donation and its status as a contribution of property (rather than cash) would constitute PRIs that fall within the scope of the BBA. Any adjustment to those facts would generally be resolved in a proceeding that involves the partnership representative, and if the partnership misreported these facts, the partnership might have to pay tax.

A partner, however, does not simply report its share of the partnership's charitable deduction. Section 170(b) imposes a limitation based on the partner's adjusted gross income. If the IRS adjusts the partner's adjusted gross income, an associated adjustment to the §170(b) limitation would not be subject to the BBA because it satisfies both criteria for the person-specific exception.⁵⁹ The first criterion is satisfied, for the §170(b) limitation is shown on a return of the partner, and the partner is a person other than the partnership. The second criterion is also satisfied, for the §170(b) limitation depends on facts and circumstances that are specific to someone other than the part-

⁵⁵ §6241(2)(B); Reg. §301.6241-1(a)(6)(1)(ii).

⁵⁶ According to the statute, the scope also includes any item or amount relating to any transaction with, basis in, or liability of the partnership that is relevant in determining the tax liability of any person under Chapter 1, even if such item or amount would not otherwise be a PRI. Final regulations, however, adopt a narrower approach than the statute.

⁵⁷ See II.C., below.

⁵⁸ Reg. §301.6241-1(a)(6)(iii).

⁵⁹ Reg. §301.6241-1(a)(6)(vi)(C) Ex. 3.

nership (i.e., the adjusted gross income of the partner), and the limitation takes these facts and circumstances into account after the PRI has been determined. As a result, if a partner erroneously calculates its adjusted gross income and therefore misapplies the §170(b) limitation, the IRS would adjust the partner's adjusted gross income and §170(b) limitation in a proceeding that is not governed by the BBA, and the partnership would not owe any tax as a result of that adjustment. Instead, the partner would directly owe any tax that must be paid as a result of that adjustment.

The person-specific exception therefore applies to an item that reflects something that is related to the partnership as well as something that is not. The partnership-related aspects would be PRIs within the scope of the BBA and therefore adjusted in a partnership proceeding. The nonpartnership aspects would generally not be PRIs; whether they are adjusted in a BBA proceeding (versus a partner-level proceeding) depends on whether the adjustment is attributable to an adjustment to a PRI, as discussed in the next section.

3. Non-PRIs Within the Scope of the BBA

Under §6221(a), the BBA governs two types of items that are not PRIs. One type is a tax that is attributable to an adjustment to a PRI. The other type consists of penalties, additions to tax, and additional amounts which relate to an adjustment made under the BBA.

When is tax attributable to an adjustment to a PRI? The most obvious example is the tax that a partner directly owes due to an adjustment to a PRI. For example, if the IRS increases the amount of income that is allocated to a partner, any additional tax owed by the partner with respect to such income is attributable to that adjustment and hence within the scope of the BBA. Therefore, if the partnership pays the associated imputed underpayment, the IRS cannot require the partner to pay tax on that income in a partner-level proceeding. The scope might also extend adjustments to non-PRIs when the adjustment is solely attributable to the adjustment to a PRI.⁶⁰ Examples may include a partner's gain in a disguised sale and a partner's capital gain or loss under §751, as discussed in II.B.4.d. and II.B.4.e., below.

Practice Point: Adjustments to non-PRIs under the BBA do not affect the calculation of the imputed underpayment. The imputed underpayment is calculated with respect to "partnership adjustments," which consist of adjustments to PRIs and do not include adjustments to non-PRIs.⁶¹ Therefore, the adjustment to such non-PRIs would occur solely under the BBA rules (not under a partner-level proceeding) but not increase the imputed underpayment. Similarly, adjustments to non-PRIs are not taken into account under the true-up rule. The true-up rule applies only to partnership adjustments.⁶² Therefore, if the adjustment to a non-PRI is taxpayer-favorable, there might not be any way for the partnership or any partner to reap the benefit

of that adjustment under the default rule.⁶³ To capture the benefit of a favorable adjustment to a non-PRI that is within the scope of the BBA, the partnership will need to avail itself of the amended-return or pull-in modification, or make a §6226 push-out election.

4. Examples

a. Partnership Income or Loss and a Partner's Allocable Share

PRIs include the partnership's items of income and loss, the character of that income or loss, and the allocation of that income or loss to the partners.⁶⁴

b. Outside Basis

The regulations state that a partner's basis in its partnership interest is not a PRI because this basis is excluded as a person-specific item.⁶⁵ However, outside basis may be affected by PRIs; e.g., due to the amount of partnership liabilities allocated to a partner under §752,⁶⁶ or to the tax basis of property that a partner contributes to the partnership in a nonrecognition transaction.⁶⁷ Therefore, an adjustment to outside basis might be within the scope of the BBA even though outside basis is not a PRI.

c. Partnership Liabilities

PRIs include the amount and character of partnership liabilities and any changes to those liabilities from the preceding tax year.⁶⁸ The characterization of a liability as recourse or non-recourse and the allocation of the liability to the partners can affect whether a partner recognizes gain under §731 or has losses limited under §704(d) or the at risk rules. Therefore, an adjustment to the character or the allocation of a partnership liability is within the scope of the BBA. If a partnership mischaracterizes or misallocates its liability on its tax return, the error may result in an imputed underpayment that the partnership must pay under the default rule, even if the adjustment would not have affected the amount of tax that a partner should have paid. Moreover, a mischaracterization might result in an imputed underpayment even if the mischaracterization does not affect the amount of liability that is allocated to any partner.⁶⁹ The application of the default rule to a mischaracterization of partnership liabilities is discussed in more detail in V.B.1.b., below.

d. Disguised Sales

If a partner transfers built-in gain property to a partnership and the partnership transfers cash to the partner, the partner and the partnership might take the position that the transfers are nonrecognition events under §721. The IRS, however, might disagree and treat the partner as selling the property to the partnership pursuant to the disguised sale rules of §707(a)(2)(B). In

⁶³ See the §751 example in V.B.6., below.

⁶⁴ Reg. §301.6241-1(a)(6)(v)(A), §301.6241-1(a)(6)(v)(B), and §301.6241-1(a)(6)(v)(I).

⁶⁵ Reg. §301.6241-1(a)(6)(iii). This approach is narrower than §6241(2)(B)(i), which appears to include a partner's basis as a PRI.

⁶⁶ Reg. §301.6225-1(a)(6)(v)(E), §301.6225-1(h) Ex. 7.

⁶⁷ Reg. §301.6241-1(a)(6)(v)(D).

⁶⁸ Reg. §301.6241-1(6)(v)(E).

⁶⁹ See Reg. §301.6225-3(d)(4) Ex. 4. See also Reg. §301.6225-1(h) Ex. 7.

⁶⁰ Non-PRIs that are within the scope of the BBA may be analogous to computational adjustments under TEFRA, which are defined in Reg. §301.6231(a)(6)-1(a)(2).

⁶¹ Reg. §301.6241-1(a)(6) (defining "partnership adjustment"), §301.6225-1 (governs how imputed underpayment is calculated).

⁶² Reg. §301.6225-3 (addresses partnership adjustments that do not result in an imputed underpayment).

that case, the partner would have omitted gain from the sale of the property to the partnership. The mischaracterization would not, however, affect the partnership's income or loss until the property is depreciated or sold. Nevertheless, the recharacterization of the transaction affects PRIs, and an adjustment to those PRIs would be within the scope of the BBA and may result in an imputed underpayment.

As noted above, PRIs include items or amounts that must be shown or reflected on the partnership's tax return or books and records, if such items are relevant in determining the tax liability of "any person under chapter 1 of the Tax Code." There are many lines on the return and partnership books and records that would reflect the character of the transaction, including:

- Schedule M-2 line 2 — amount of capital contributed by the partners;
- Schedule K-1, Section M and associated attachment — partner's contribution of property with built in gain and the amount of built-in gain; and
- Partnership books and records — partnership basis in the property.

These lines on the return and books might also be relevant in determining the tax liability of "any person under chapter 1 of the Tax Code." If so, each of these lines would constitute a separate PRI that could be adjusted in an audit and result in an imputed underpayment.⁷⁰ It does not matter whether the partnership's income is affected in the year the property is transferred to the partnership.

Moreover, the person-specific exception does not appear to apply. That exception applies only with respect to amounts shown on a return or on the books and records of someone other than the partnership. Errors on the partnership's return (which includes the Schedules K-1), including errors to informational non-income items, appear to be squarely within the scope of the BBA. As a result, if the IRS determines that the transactions were a disguised sale, the partnership might effectively owe tax with respect to the gain that the partner should have recognized (or possibly a tax on the value of the contributed property). The partnership would not be paying tax on the income omitted by the contributing partner; instead, the partnership would be paying tax for errors on its return and in its books and records.

The partner's gain in a disguised sale does not appear to be a PRI. PRIs do not include person-specific items, which are items or amounts "of income shown or required to be shown on a return of a person other than the partnership ... that result[] after application of the Code to a PRI based upon the person's specific facts and circumstances."⁷¹ This exclusion appears to describe a partner's gain from a disguised sale, for such gain is required to be shown on the return of someone other than the partnership, and such gain might be ordinary or capital, depending on the partner's specific facts and circumstances.

However, tax owed by the partner as a result of the disguised sale would be a tax that is attributable to an adjustment to a PRI. Hence, any tax owed by the partner on this gain is

determined under the BBA, not under a partner-level proceeding.⁷² If the partnership pays the applicable imputed underpayment, the IRS should not be able to collect tax from the partner as well.

e. Sections 741 and 751(a): Gain or Loss Recognized in the Sale of a Partnership Interest

When a partner sells its partnership interest, the partner generally recognizes capital gain or loss under §741. However, if the partnership has so-called "hot assets" (generally, assets that produce ordinary income), the partner might also recognize ordinary income or loss under §751. The amount of ordinary income or loss generally equals the amount of ordinary income or loss that would have been allocated to the partner from the sale of the partnership's hot assets had the partnership sold all of its assets in a taxable transaction. The amount of capital gain or loss equals the total gain or loss recognized by the partner minus the ordinary income (or plus the ordinary loss) recognized by the partner under §751.

The amount of the partner's ordinary income or loss is a PRI. First, it is an item or amount with respect to the partnership because it must be reported on the partnership's tax return.⁷³ Second, it is relevant in determining a person's tax liability under Chapter 1. Therefore, an adjustment to ordinary income or loss recognized under §751 could result in an imputed underpayment that the partnership might be required to pay.

How is an adjustment to the capital gain or loss treated? The answer might depend on the reason why the adjustment is made. The partner's capital gain or loss does not appear to be a PRI, for it is not required to be shown or reflected on the partnership's tax return or its books and records. However, the capital gain or loss may be changed as a result of an adjustment to a PRI, in which case the associated tax implications may be governed by the BBA.

For example, the adjustment to capital gain or loss might stem from an adjustment to the amount of ordinary income recognized under §751, which is a PRI. Alternatively, the adjustment to capital gain or loss might be attributable to an adjustment to the amount realized in the sale, and the amount realized is a PRI when it is an amount that the partnership must show or reflect on its tax return or books and records (e.g., in connection with §743(b)). In these situations, any change in the tax owed by the partner with respect to its capital gain or loss would be attributable to an adjustment to a PRI. Therefore, any change to the partner's capital gain or loss would be addressed under the BBA, not in a partner-level proceeding. If the partner paid too little tax on its capital gain or loss, the IRS could not collect additional tax from the partner in a partner-level proceeding. The flip side is that if the partner paid *too much* tax on its capital gain or loss (because the partner underreported its ordinary income or overreported its ordinary loss), the partner would not be able to file a refund claim. Any tax owed with re-

⁷⁰ Calculation of the imputed underpayment in the disguised sale context is discussed further in V.B.1.b. and V.B.6.a., below.

⁷¹ Reg. §301.6241-1(a)(6)(iii).

⁷² As the partner's gain is not a PRI, an adjustment to that gain would not be a "partnership adjustment." Therefore, that adjustment would not be taken into account in the calculation of the imputed underpayment.

⁷³ On the 2021 Schedule K-1, for example, such information is reported on Line 20 using code AB. See also Reg. §1.6050K-1(c)(2), which requires partnerships to provide this information to partners who sell their partnership interests.

spect to an adjustment to the capital gain would be handled in a BBA partnership-level proceeding, with BBA remedies. Here, if the partner overreported its capital gain, it appears that there might be no remedy available under the default rule, for the true-up rule would not apply.⁷⁴

In contrast, some adjustments to capital gain or loss do not relate to an adjustment to a PRI. For example, the amount realized in the sale is sometimes not a PRI, in which case an adjustment to the amount realized and the capital gain recognized would not be subject to the BBA. Instead, they would be addressed in a partner-level proceeding.

f. Section 734 and Section 743 Adjustments

The scope of the BBA includes §734(b) and §743(b) adjustments to the basis of partnership property. The regulations explicitly state that PRIs include “any item or amount of the partnership resulting from an election under section 754.”⁷⁵ In addition, the partnership is required to attach to its return a statement that describes how the basis adjustments under §734 or §743 are calculated and the allocation of the adjustments to its assets,⁷⁶ and these basis adjustments must also be reported on the partner’s Schedule K-1 when they are taken into account for tax purposes. These basis adjustments are therefore items or amounts with respect to a partnership. Therefore, they are PRIs and will generally be evaluated in a partnership-level audit. In addition, any adjustments made to the basis adjustments will be taken into account under the BBA (e.g., by the partnership paying an imputed underpayment).

C. Special Enforcement Matters — IRS Authority to Turn Off BBA Rules

Section 6241(11) provides the Treasury with broad authority to issue regulations to address special enforcement matters under which the BBA rules will not apply. The Treasury has exercised this authority by issuing Reg. §301.6241-7.

These regulations identify four situations in which the IRS may adjust PRIs in the context of an audit of or proceeding against a specific partner, not the partnership itself. Any adjustment to a PRI that is made outside of the BBA rules will bind only those who are parties to the proceeding; those who are not parties are not bound.⁷⁷

Also, the IRS cannot turn off the BBA rules to the extent the partner can demonstrate that adjustments to PRIs included in the deficiency or an adjustment by the IRS were either (1) previously taken into account under the BBA rules by the person being examined; or (2) included in an imputed underpayment paid by a partnership (or pass-through partner) for any tax year in which the partner was a reviewed-year partner or indirect partner but only if the amount included in the deficiency or adjustment exceeds the amount reported by the partnership to the partner that was either reported by the partner or indirect partner or is otherwise included in the deficiency or adjustment determined by the IRS.⁷⁸

The special enforcement regulations also provide two additional rules. First, they provide for an extended statute of limitations in a partner-level examination. Second, they provide a special rule for liabilities of a partnership under chapter 1 of the Code (i.e., liabilities not arising under the BBA).

1. PRIs that Underlie Non-PRIs

Under Reg. §301.6241-7(b)(1), the IRS may determine that the BBA rules do not apply to an adjustment of a PRI if (1) an examination is being conducted of a person other than the partnership; (2) a PRI is adjusted, or a determination regarding a PRI is made, as part of, or underlying, an adjustment to a non-PRI of the person whose return is being examined; and (3) the treatment of the PRI on the return of the partnership or in the partnership’s books and records is based in whole or in part on information provided by the person whose return is being examined.

Example: On June 1, Year 1, A acquires an interest in Partnership by contributing Asset to Partnership in a §721 contribution (Contribution). Partnership claims a basis in Asset of \$50 under §723 equal to A’s purported adjusted basis in Asset as of June 1, Year 1, based on information A provided to Partnership. There is no activity in Partnership that gives rise to any other PRIs between June 1, Year 1 and June 2, Year 2. On June 2, Year 2, A sells its interest in Partnership to B for \$100 and reports a gain of \$50 based on A’s purported adjusted basis in Partnership of \$50 under §722 (reflecting solely A’s purported adjusted basis in Asset immediately before the Contribution). The IRS opens an examination of A and determines that A’s outside basis was \$30, not \$50, because A’s adjusted basis in Asset immediately before the Contribution was \$30 instead of the \$50 claimed by A. The IRS may adjust A’s outside basis (which is not a PRI) even though it involves a determination about the Contribution (which is a PRI) because the Contribution underlies an adjustment to a non-PRI (A’s outside basis) and the Partnership’s adjusted basis in Asset is based on information provided by A to Partnership.⁷⁹

2. Termination and Jeopardy Assessments

For any tax year of a partner or indirect partner for which an assessment of income tax under §6851 or §6861 is made, the IRS may adjust any PRI with respect to such partner or indirect partner as part of making an assessment of income tax under §6851 or §6861 without regard to the BBA rules.⁸⁰

3. Criminal Investigations

For any tax year of a partner or indirect partner for which the partner or indirect partner is under criminal investigation, the IRS may adjust any PRI with respect to such partner or indirect partner without regard to the BBA rules.⁸¹

⁷⁴ Application of the BBA default rule to §751(a) is discussed further in V.B.1.b. and V.B.6.b., below.

⁷⁵ Reg. §301.6241-1(a)(6)(v)(H).

⁷⁶ Reg. §1.734-1(d), §1.743-1(k).

⁷⁷ See Reg. §301.6241-7(h).

⁷⁸ See Reg. §301.6241-7(i).

⁷⁹ See Reg. §301.6241-7(b)(2). In this example, the partnership is subject to the BBA and has no liabilities, and the partnership and partner each have a calendar year tax year.

⁸⁰ See Reg. §301.6241-7(c).

⁸¹ See Reg. §301.6241-7(d).

4. Indirect Methods of Proof

The IRS may adjust any PRI as part of a determination of any deficiency (or portion thereof) of the partner or indirect partner that is based on an indirect method of proof of income without regard to the BBA rules.⁸²

5. Extended Period of Limitations

The BBA period of limitations for making an adjustment to a PRI is generally governed by §6235. Under the special enforcement regulations, if that period has expired but a PRI relates to an item or amount for which a partner's period of limitations on assessment of tax imposed by Chapter 1 has not expired, there are two situations in which the IRS may nevertheless adjust the PRI. The first is where the direct or indirect partner is related to the partnership under §267(b) or §707(b). The second is where the direct or indirect partner agrees in writing pursuant to §6501(c)(4) to extend the partner's §6501 period of limitations on assessment for the tax year, but only if the agreement expressly provides that the partner is extending the time to adjust and assess any tax attributable to PRIs for the tax year.⁸³

6. Penalties and Taxes Imposed on the Partnership Under Chapter 1

Under the special enforcement regulations, the IRS may adjust any tax, penalties, additions to tax, or additional amounts imposed on, and which are the liability of, the partnership under Chapter 1 without regard to the BBA rules. The IRS also may adjust any PRI, without regard to the BBA rules, as part of any determinations made to determine the amount and applicability of the tax, penalty, addition to tax, or additional amount being determined without regard to the BBA rules.⁸⁴

7. Elections Resulting in Payments to a Partnership

The IRS may 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 subchapter C of chapter 63. The IRS may also make determinations, without regard to subchapter C of chapter 63, about the payment itself as well as any partnership-related item relevant to adjusting the election or the payment.⁸⁵

⁸² See Reg. §301.6241-7(e).

⁸³ See Reg. §301.6241-7(f).

⁸⁴ See Reg. §301.6241-7(g). Any determinations under this rule would be treated as a determination under a chapter of the Code other than Chapter 1 for purposes of Reg. §301.6241-6.

⁸⁵ Reg. §301.6241-7(j), T.D. 9988, 89 Fed. Reg. 17,546 (March 11, 2024), generally applicable to taxable years ending on or after June 21, 2023. Reg. §301.6241-7(k)(3). For a detailed discussion of direct pay elections under §6417, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*, at XI.A. For a detailed discussion of the election to sell eligible clean energy credits (transfer election) under §6418, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*, at XI.B.

D. Partnerships Not Required to File a Partnership Return

The BBA does not apply to entities or arrangements unless a U.S. partnership income tax return must be filed.⁸⁶ Therefore, the BBA will not apply to a qualified joint venture between two spouses who make a §761(f) election, or to an oil and gas arrangement that has made a valid election under §761(a) to be treated as something other than a partnership.⁸⁷ In addition, a foreign partnership is generally not required to file a U.S. partnership income tax return unless it has U.S. source income or income that is effectively connected with a U.S. trade or business.⁸⁸ The source of a partnership's income may depend on the status of its partners. For example, when a partnership sells personal property that is not inventory, it may have U.S. source income simply because a partner is a U.S. resident.⁸⁹

If a partnership return is filed, the entity or arrangement generally will be treated as a partnership under the BBA, even if the return was not required.⁹⁰ There is an exception to this rule, however, when the sole purpose for filing a partnership return is to make a §761(a) election.⁹¹

E. Taxes Other than Chapter 1 Income Taxes

The BBA applies to income taxes imposed under Chapter 1 of Subtitle A of the Tax Code. It does not generally apply to the following:

- Chapter 2 — self-employment taxes (SECA);
- Chapter 2A — the net investment income tax;
- Chapter 3 — withholding obligations for fixed or determinable annual or periodical income (FDAP) or income that is effectively connected with the conduct of a U.S. trade or business (ECI);
- Chapter 3 — withholding relating to U.S. real property (FIRPTA); or
- Chapter 4 — withholding relating to foreign accounts (FATCA).⁹²

Although these other types of taxes and obligations are outside the scope of the BBA, there is some coordination between a BBA proceeding and the rules that apply to such taxes and obligations. The relationship between these rules is discussed in V.D.4. and chapter VIII., below. Moreover, items on a partnership's tax return that relate to those other chapters may sometimes affect Chapter 1 tax liabilities, in which case adjustments to these items may be made under the BBA.⁹³

⁸⁶ §6241(1).

⁸⁷ Reg. §1.6031(a)-1(c)(1).

⁸⁸ Reg. §1.6031(a)-1(b).

⁸⁹ §865(a) and §865(i)(5).

⁹⁰ Reg. §301.6241-5(a), §301.6241-5(b).

⁹¹ Reg. §301.6241-5(c)(2).

⁹² §6241(9).

⁹³ See V.B.1.b., below (discussing how an apparent SECA adjustment may in fact be a PRI under the BBA).

III. Partnership Representative

A. Role of the Partnership Representative

Under the BBA, partnership-related items (PRIs) and associated amounts such as interest and penalties are resolved through centralized procedures at the partnership level, and the partnership and partners are represented in this proceeding by a single person. This person is generally the “partnership representative.”⁹⁴

However, when the partnership representative is an entity, the partnership representative plays no role under the statute and regulations, and it is an individual (the “designated individual”) who plays the role that would otherwise have been played by the partnership representative.⁹⁵ As a partnership representative that is an entity has no powers or duties under the BBA, this portfolio generally uses the term “partnership representative” (PR) to refer either to a partnership representative that is an individual or to the designated individual. The term does not refer to a partnership representative that is an entity unless the context makes clear that such entities are being discussed.

The BBA confers great power on the partnership representative. No one else is authorized to act on behalf of the partnership with respect to matters that are within the scope of the BBA;⁹⁶ the actions of the partnership representative will bind the partnership, the partners, and any other person whose tax liability may be affected by adjustments made under the BBA.⁹⁷ For example, the partnership and its partners will be bound by any settlement or closing agreement that the partnership representative enters into. The partnership representative’s authority also extends to litigation, so the partnership and its partners will be bound by any final decision in a judicial proceeding in which the partnership representative acts on behalf of the partnership and its partners.

A partnership must designate a partnership representative for each tax year that is subject to the BBA audit rules.⁹⁸ When a partnership’s tax return is audited, it is the partnership representative designated for the tax year at issue who will be involved in the audit, not the partnership representative designated for the year in which the audit takes place.⁹⁹ For example, if a partnership designates Stella as its partnership representative for Year 1 and designates Bill as its partnership representative for Year 3, and in Year 3 the IRS audits the partnership’s tax return for Year 1, Stella, not Bill, would be the partnership representative involved in the audit.

Status as a partnership representative for a particular tax year remains in effect until the partnership representative resigns, the partnership revokes the designation, or the IRS determines that the designation no longer has effect.¹⁰⁰ Treasury reg-

ulations restrict when the partnership representative may resign or have his or her status revoked; the partnership representative generally may not be changed until the IRS sends a notice of selection for examination for the applicable tax year or the partnership files an administrative adjustment request (AAR) for that tax year.¹⁰¹ A partnership will often want to change who its partnership representative is when its partnership representative becomes disassociated from the partnership — (e.g., when the person leaves the employ of the partnership). Disassociation from the partnership is not, however, a time at which the designation of the partnership representative may be changed unless the IRS has already opened an audit.¹⁰²

B. The Rights of the Partners

The BBA does not give partners any right to participate in an audit or other BBA proceeding, and the BBA does not require the IRS or the partnership representative to inform the partners about partnership proceedings.¹⁰³ This does not mean that the partners will be uninformed and powerless. It does, however, mean that if the partners want to receive information or have control rights, they should provide for such rights in the partnership agreement, in a contract with the partnership representative, or in other documentation.¹⁰⁴ They should also consider what rights will be given to former partners.

If current or former partners will be given a right to receive information about BBA proceedings, the partners must determine who will be obliged to provide the information and how that obligation will be imposed. Many partnership agreements are including provisions that require the partnership representative to provide notice or act under someone else’s direction, but these provisions will not bind the partnership representative if the partnership representative does not sign the partnership agreement. Also, the partnership representative is not the only source from which partners may obtain information; the IRS is required to provide the notice of selection for examination (NOSE), the notice of administrative proceeding (NAP), the notice of proposed partnership adjustment (NOPPA), and the notice of final partnership adjustment (FPA) to the partnership itself, so the partners might be able to obtain these documents from the partnership.¹⁰⁵

Different partnerships give partners different types of notice rights. Some partnerships require their partnership representatives to give partners copies of all correspondence with the IRS and all court filings. Others are required to provide significant notices and documents, such as a NOSE, a NAP, a NOPPA, an FPA, and any court filings.

⁹⁴ §6223.

⁹⁵ Reg. §301.6223-1(b).

⁹⁶ §6223(a). See, e.g., CCA 202505027 (statute of limitations extensions were invalid because they were signed by individuals other than the designated partnership representative or designated individual).

⁹⁷ §6223(b); Reg. §301.6223-2(a).

⁹⁸ Reg. §301.6223-1(a), §301.6223-1(c). A partnership that has made a valid election out of the BBA audit rules under §6221(b) is not required to designate a partnership representative. T.D. 9839, Section 1.B, 83 Fed. Reg. 39,331, 39,335 (Aug. 9, 2018) (preamble to final regulations).

⁹⁹ See, e.g., Reg. §301.6223-1(c)(3).

¹⁰⁰ Reg. §301.6223-1(a).

¹⁰¹ Reg. §301.6223-1(d), §301.6223-1(e).

¹⁰² Reg. §301.6223-1(d), §301.6223-1(e). Resignation and revocation are addressed in III.F., below.

¹⁰³ Reg. §301.6223-2(d). Under the Due Process Clause of the U.S. Constitution, however, it might be that a partner cannot be bound by a proceeding unless it receives notice and has other rights.

¹⁰⁴ In addition to obligations imposed by contract or the partnership agreement, a partnership representative might have fiduciary duties under state law. Also, a partner might have rights under the Due Process Clause of the U.S. Constitution.

¹⁰⁵ Reg. §301.6231-1(a), §301.9100-22(b)(1).

Many partnerships are also providing their partners with various types of control rights. Examples of such provisions include the following:

- The partnership representative must act as directed by a majority of the reviewed-year partners, a majority of the adjustment-year partners,¹⁰⁶ or a certain percentage of the partners from the reviewed year and the adjustment year (or other years);¹⁰⁷
- The partnership representative must act as directed by the general partner or manager of the partnership;
- The partnership representative must obtain the prior written consent of certain partners regarding the manner in which an adjustment will be taken into account unless the adjustment (or the amount that the partnership would be required to pay) would be less than a specified amount;
- The partnership representative must obtain the prior written consent of the adjustment-year partners if an adjustment will be taken into account through the partnership's payment of taxes, interest, penalties, or other associated amounts; and
- The partnership representative cannot make a §6226 election unless it has made a good faith effort to provide the reviewed-year partners with an opportunity to take advantage of the §6225(c) modification procedures by amending their returns, complying with the "alternative" or "pull in" modification, or entering into a closing agreement.¹⁰⁸

The IRS will not be affected by the partnership representative's contractual obligations to the partners. From the IRS's perspective, the partnership representative's actions will be valid and binding, even if such actions are in breach of the partnership agreement or the partnership representative's contractual obligations.¹⁰⁹ For example, the partnership agreement might require the partnership representative to obtain the consent of all partners for a particular tax year before agreeing to extend the statute of limitations for that year. If the partnership representative breaches this provision and agrees to extend the statute of limitations without obtaining the requisite consent of the partners, the statute of limitations will be extended.¹¹⁰ The

¹⁰⁶The adjustment-year partners are those who are partners in the adjustment year. Reg. §301.6241-1(a)(2). The adjustment year is the partnership taxable year in which (i) a decision becomes final in a judicial proceeding brought under §6234; (ii) an administrative adjustment request is filed under §6227; or (iii) an FPA is mailed (or the IRS executes a waiver of restrictions made by the partnership under §6232(b)) and (i) and (ii) do not apply. Reg. §301.6241-1(a)(1).

¹⁰⁷A partnership may consider giving voting rights to all partners who may be affected by an adjustment, in which case voting rights would be given to the reviewed-year partners, the adjustment-year partners, and possibly other partners (such as those who are partners in the partnership's final year). Will all sets of partners have the right to vote? And if they do, how much voting power does each partner (or each group of partners) have?

¹⁰⁸These modifications are discussed below in V.C.3.b.(1), V.C.3.b.(2), and V.C.3.b.(3), below. A reviewed-year partner will often owe less under these modification rules than it would if a §6226 election is made.

¹⁰⁹Reg. §301.6223-2(d). If the Due Process clause of the U.S. Constitution is not satisfied, however, a partnership representative's actions might not be binding.

¹¹⁰Reg. §301.6223-2(e) Ex. 1.

partners could, however sue the partnership representative for breaching the partnership agreement.

C. *Liability of the Partnership Representative*

If a person is designated as the partnership representative, this designation will not affect the amount of tax that this person owes the IRS. There might be other reasons why that person owes tax (e.g., the person might be a reviewed-year partner and the partnership might make a §6226 election), but any tax owed will not be because of the person's status as partnership representative.

A partnership representative might, however, be liable for breaching its contractual or other obligations (such as fiduciary duties) to the partnership and the partners. A partnership representative should therefore consider obtaining limits on his or her potential liability to the partnership and the partners. If the partnership representative is affiliated with the partnership, the partnership representative might already have a right to be indemnified under the partnership agreement or other agreements.

D. *Eligibility*

There are only two criteria that must be satisfied in order for a person to be eligible to serve as the partnership representative.¹¹¹ First, the person must have a "substantial presence in the United States."¹¹² Second, if the person is an entity, the partnership must appoint an eligible individual as the "designated individual" who effectively acts as the partnership representative.¹¹³ There are no other requirements. Therefore, it does not matter whether the partnership representative is a partner or has any other relationship with the partnership.

1. *Substantial Presence in the United States*

Under the BBA, a person has a substantial presence in the United States when:

- The person is available to meet in person with the IRS in the United States at a reasonable time and place, as determined by the IRS;
- The person has a U.S. street address and telephone number with a U.S. area code; and
- The person has a U.S. taxpayer identification number.¹¹⁴

A person may have a substantial presence in the United States even if he or she spends the majority of her time outside the United States.¹¹⁵

2. *Entities as Partnership Representatives: The Designated Individual*

In order for an entity to be eligible to serve as the partnership representative, the partnership (not the partnership representative) must appoint an individual (the "designated individual") to be the sole person through whom the partnership representative will act for all purposes of the BBA, and the design-

¹¹¹Reg. §301.6223-1(b)(1).

¹¹²Reg. §301.6223-1(b)(2).

¹¹³Reg. §301.6223-1(b)(3).

¹¹⁴Reg. §301.6223-1(b)(2).

¹¹⁵Reg. §301.6223-1(b)(4) Ex. 3.

nated individual must be appointed when the partnership representative is designated.¹¹⁶ If the partnership does not properly appoint a designated individual at the time that the entity is designated as the partnership representative, the entity will not be eligible to serve as the partnership representative.¹¹⁷

A designated individual must have a substantial presence in the United States.¹¹⁸ No other criteria must be satisfied. Therefore, the individual does not need to be a partner, affiliate, or employee of the partnership or the partnership representative. In fact, the individual could be entirely unrelated to both the partnership and the partnership representative.

E. Designating the Partnership Representative

The partnership representative is generally designated by the partnership, but there are situations in which the IRS may make the designation.

1. Designation by the Partnership

A partnership must designate a partnership representative (PR) (including a partnership representative that is an entity) for each tax year,¹¹⁹ and this designation must be made on the tax return the partnership files for that year.¹²⁰ The partnership agreement does not need to specify who the partnership representative will be, but the partners may want the partnership agreement to address this issue to avoid future disputes. If the partnership agreement designates one person as the partnership representative, but a different person is designated as the partnership representative on the applicable tax return, then the partnership representative is the person designated on the return. The designation remains in effect until the IRS determines that there is no designation in effect or until the partnership is allowed to make a new designation because the IRS has begun an audit or the partnership has filed an AAR.¹²¹ The IRS is not required to determine that a designation is invalid, even if it knows that the designation is invalid.¹²²

Once a partnership has filed its tax return for the year at issue, there are only four situations in which a partnership may make a designation (if no designation is in effect) or designate a new representative (if it has previously designated a partnership representative).¹²³ The first two situations are when the prior partnership representative resigns or has its status revoked. As discussed below, resignation and revocation are not allowed unless an administrative adjustment request (AAR) is filed or an audit has commenced.¹²⁴ Third, a partnership may designate a partnership representative after the IRS has notified the partnership that there is no designation in effect.¹²⁵ Fourth, a part-

nership may designate a partnership representative when filing a valid AAR.¹²⁶

Therefore, a partnership will not necessarily be allowed to designate a new partnership representative when its original partnership representative ceases to have a substantial presence in the United States (perhaps because the person dies), or when its partnership representative ceases to be affiliated with the partnership. Instead, the designation will remain in effect until the IRS determines that there is no designation in effect, or until the partnership is allowed to make a new designation because the IRS has begun an audit or the partnership has filed an AAR.

If a partnership makes an invalid designation (e.g., by designating an ineligible person), the designation will be deemed valid until the IRS determines that the designation is invalid.¹²⁷ Therefore, the actions taken by the designated person before the IRS determines that the designation is invalid will bind the partnership and the partners, but actions taken after that time will not.¹²⁸ If the invalid designation is made in connection with the revocation of a prior designation, however, the invalid designation will not be deemed valid and the revocation will not have effect.¹²⁹

When a partnership is allowed to designate a partnership representative after it has filed its tax return for the applicable year, it may use Form 8979 to make this designation.

2. Designation by the IRS

The IRS is authorized to designate a partnership representative (PR) in certain situations. Before making such a designation, the IRS must first determine that there is no designation in effect.¹³⁰ There are six situations in which the IRS is allowed, but not required, to make this determination.¹³¹ Once the IRS makes this determination, a partnership will usually have 30 days in which it may designate a partnership representative.¹³² If the partnership does not designate a partnership representative within that period, the partnership representative may be

¹²⁵ Reg. §301.6223-1(f). See III.E.2., below. If the partnership does not designate a partnership representative within 30 days of the date that the IRS mails such a notice, the IRS may designate the partnership representative.

¹²⁶ A partnership may designate a partnership representative as prescribed in forms, instructions, and other guidance. Reg. §301.6223-1(c)(2). According to the Instructions for Form 8979, a partnership may designate a partnership representative when filing a valid AAR. See “When to File” in Instructions for Form 8979. The inclusion of a title, such as “Member,” on the signature line of Form 8979 does not affect the validity of a person’s appointment as a partnership representative, for a person’s current or previous connection to a BBA partnership is not a determinative factor when considering a person’s (or entity’s) eligibility to serve as a partnership representative. See CCA 202208015.

¹²⁷ Reg. §301.6223-1(b)(1).

¹²⁸ Reg. §301.6223-2(b), Reg. §301.6223-2(e) Ex. 5. In addition, the IRS intends to advise its agents to provide partnerships with an opportunity to cure a defective designation unless there are reasons why the opportunity to cure should not be given; e.g., time constraints or multiple revocations. T.D. 9839, Section I.C.i, 83 Fed. Reg. 39,331, 39,334 (Aug. 9, 2018) (preamble to final regulations).

¹²⁹ Reg. §301.6223-1(e)(5).

¹³⁰ Reg. §301.6223-1(f)(1).

¹³¹ Reg. §301.6223-1(f)(2).

¹³² Reg. §301.6223-1(f)(1). The partnership is not allowed to designate a new partnership representative if the IRS’s determination is based on the partnership having revoked the status of its partnership representative more than once in a 90-day period. Reg. §301.6223-1(f)(4).

¹¹⁶ Reg. §301.6223-1(b)(3).

¹¹⁷ The entity would generally be deemed to be eligible until the IRS determines that the entity is ineligible, however, and any actions taken by the entity before that determination would be binding on the partners and the partnership. Reg. §301.6223-1(b)(1), §301.6223-1(b)(3)(ii).

¹¹⁸ Reg. §301.6223-1(b)(3)(i). The individual would therefore be eligible to be designated as the partnership representative.

¹¹⁹ Reg. §301.6223-1(a).

¹²⁰ Reg. §301.6223-1(c)(2).

¹²¹ Reg. §301.6223-1(b)(4) Ex. 2.

¹²² Reg. §301.6223-1(f)(2).

¹²³ Reg. §301.6223-1(c)(2).

¹²⁴ See III.F.1. and III.F.2., below.

designated by the IRS.¹³³ When the IRS makes a designation, it will notify the partnership of the name, address and telephone number of the new partnership representative.¹³⁴

a. Situations in Which the IRS Is Allowed to Determine that There Is No Partnership Representative Designation in Effect

The IRS may determine that there is no partnership representative in the following situations:¹³⁵

- The partnership representative or the designated individual does not have a substantial presence in the United States;
- The partnership designated an entity as the partnership representative but did not appoint a designated individual;
- The partnership failed to make a valid designation on its tax return for the year at issue;
- The partnership representative or designated individual has resigned and no successor has been designated;
- The partnership has revoked the status of its partnership representative more than once within a 90-day period; or
- The designation is no longer in effect for reasons described in published guidance.¹³⁶

b. Who the IRS May Designate

When the IRS is authorized to designate the partnership representative, the IRS has much discretion in who it may designate. Regulations impose only two requirements. First, the person must have a substantial presence in the United States, and if the person is an entity, the IRS must also appoint a designated individual who has a substantial presence in the United States.¹³⁷ Second, the IRS cannot designate an employee or agent of the IRS unless that person was a partner in the reviewed year or is a partner at the time of the designation.¹³⁸

In addition to those restrictions, regulations provide a list of factors that the IRS will ordinarily consider, but the IRS is not required to take these factors into account or give them any particular weight.¹³⁹ These discretionary factors are the following:

- Whether there is a partner from the reviewed year or at the time the designation is being made who is eligible;
- The views of partners having a majority interest in the partnership;
- The person's general knowledge in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership;

- Whether the person is a United States person (as defined by §7701(a)(30)); and
- The profits interest of the partner if the person is a partner.

F. Replacing the Partnership Representative

A partnership representative is designated for a particular tax year.¹⁴⁰

Example: A partnership designates Stella as its partnership representative for Year 1. As a result, Stella will generally be the partnership representative in connection with any audit of the Year 1 tax return, even if the audit occurs many years later.

It is possible to change the partnership representative for a particular tax year, but there are restrictions on when and how this may be done. Most significant is that a partnership generally cannot designate a new partnership representative until it files an administrative adjustment request (AAR) for the tax year at issue or the IRS commences an audit of that year.¹⁴¹

Comment: Note that in the instructions for IRS Form 8979, the IRS has identified other situations in which the partnership representative may be changed, including when filing an IRS Form 8985 tracking report, filing an IRS Form 8988 push-out election, or making a request that requires the partnership to extend its statute of limitations (e.g., a request for a private letter ruling).

If a partnership representative attempts to resign or if the partnership attempts to revoke the designation before that time, those actions will not have effect. The Treasury adopted this rule so that the IRS would not have to process changes in the designation unless and until the change would affect the IRS.¹⁴²

Practice Point: As discussed more below, it is not clear whether the form to change the partnership representative (Form 8979) must be signed by a person who is both (1) a partner in the year at issue, and (2) a person authorized under state law to change the partnership representative. Regarding the second issue (authorization), if “authorized” means authorization under state law, one approach is for the partnership agreement to give a partner for the year at issue the power to change the partnership representative. This may not be necessary, however. A person might have authority under state law to designate a new partnership representative by signing Form 8979 even though the person does not have the power to decide who the successor partnership representative will be. For example, a partnership agreement might provide that the manager has the authority to decide who a successor partnership representative will be, even though the manager is not a partner. In that case, the manager might not be authorized to sign Form 8979, but the manager could determine who the successor will be and authorize someone who was a partner in the relevant tax year to sign the form that designates the appropriate person as the successor.

¹³³ Reg. §301.6223-1(f)(1).

¹³⁴ Reg. §301.6223-1(f)(5)(i).

¹³⁵ Reg. §301.6223-1(f)(2).

¹³⁶ To date, no such guidance has been issued.

¹³⁷ Reg. §301.6223-1(f)(5)(ii).

¹³⁸ Reg. §301.6223-1(f)(5)(iii).

¹³⁹ Reg. §301.6223-1(f)(5)(ii).

¹⁴⁰ Reg. §301.6231-1(a).

¹⁴¹ Reg. §301.6223-1(d)(2), §301.6223-1(e)(2).

¹⁴² T.D. 9839, Section 1.B.i, 83 Fed. Reg. 39,331, 39,335–36 (Aug. 9, 2018) (preamble to final regulations).

1. Resignation of the Partnership Representative

The discussion below addresses partnership representatives that are individuals or entities; it is not limited to partnership representatives that are individuals.

A partnership representative may resign, but only after the IRS has issued a notice of administrative proceeding (NAP) for the applicable tax year.¹⁴³ Any attempt to resign before that time will not have effect.¹⁴⁴

Once the IRS has issued a NAP, a partnership representative may resign by filing Form 8979 with the IRS. The resignation takes effect when the IRS receives the form.¹⁴⁵ When the partnership representative is an entity, its resignation will also terminate the appointment of the designated individual.¹⁴⁶

A resignation may be valid even if the partnership is not informed that the resignation occurred. The regulations do not require a partnership representative to inform the partnership of its resignation. The IRS, on the other hand, is required to notify the partnership of the resignation within 30 days of receiving the Form 8979, but the resignation will be valid even if the IRS fails to provide this notice.¹⁴⁷ A partnership should therefore consider requiring its partnership representative to inform the partnership if it resigns.

Once a partnership representative has resigned, a new partnership representative may be designated using Form 8979. It is not entirely clear who has authority to designate the successor. The only guidance provided by the regulations is that the resigning partnership representative cannot designate its successor.¹⁴⁸ According to the jurat on Form 8979, the person who signs the designation must declare under penalties of perjury that the person is duly authorized by the partnership or LLC to make the designation.¹⁴⁹ This declaration appears to be addressing a person's authority under state law (e.g., under the partnership agreement) to make the designation. The instructions for Form 8979, however, state that the designation must be signed by an "authorized person," which is defined as a person who was a partner at any time during the partnership tax year to which the designation relates.¹⁵⁰

Practice Point: The language in the instructions might be interpreted as an additional restriction on who may sign the designation, in which case there would be two requirements that must be satisfied: the person must be authorized under state law (e.g., under the partnership agreement), and the person must have been a partner during the partnership tax year to which the designation relates. Alternatively, the instructions for Form 8979 might be explaining what it is to be "authorized by the partnership" to sign the designation, in which case it would not matter whether the person who signs is authorized to do so under state law.

2. Revocation by the Partnership

A partnership may revoke its designation of its partnership representative, but there are signification restrictions on when revocation is allowed. Also, the partnership must obtain the consent of the IRS before revoking the designation of a person who had been designated by the IRS to be the partnership representative.¹⁵¹

a. When Revocation Is Allowed

A partnership (or its partners) may revoke the designation of a partnership representative for a particular tax year, but in only two situations. First, revocation is allowed after the IRS has issued a notice of selection for examination (NOSE) or a notice of administrative proceeding (NAP) (i.e., after the IRS has commenced an audit of the partnership). Second, revocation is allowed when a partnership files an administrative adjustment request (AAR), so long as the AAR is not filed for the sole purpose of revoking the designation of a partnership representative.¹⁵² An attempt to revoke the designation prematurely will not have effect.¹⁵³

Due to these restrictions, a partnership might not be allowed to revoke the designation of its partnership representative when it would like to designate someone else. A partnership representative will often be a partner, employee, manager, or some other person who has a relationship with the partnership, and the partnership may wish to revoke that designation when that person becomes disaffiliated from the partnership, especially if the relationship has become adversarial. If the partnership does not file an AAR and if the IRS has not yet issued a NOSE or NAP, however, the partnership will not be able to sever its relationship with that person, and that person will continue to have the power to bind the partnership and the partners until one of those events occurs and the designation is validly revoked.

Moreover, the regulations do not ensure that a partnership will be able to revoke the designation of its partnership representative before that person acts in a manner that binds the partners and the partnership. For example, the partnership representative could file an AAR. The partnership would theoretically be allowed to revoke the designation of its partnership representative at that time, but the partnership would not exercise this right to revoke the designation if it does not know that the AAR was filed.

An IRS audit is the other context in which a partnership representative might act in a manner that binds the partners and the partnership. A partnership should generally be able to revoke the designation of its partnership representative before the partnership representative knows that the IRS has opened an audit of the partnership. The first notice that the IRS issues in an audit is the NOSE, and it sends the NOSE to the partnership, not to the partnership representative.¹⁵⁴ The second notice is the NAP, which is sent to the partnership and to the partner-

¹⁴³ Reg. §301.6223-1(d)(2).

¹⁴⁴ Reg. §301.6223-1(d)(1).

¹⁴⁵ Reg. §301.6223-1(d)(3).

¹⁴⁶ Reg. §301.6223-1(d)(3).

¹⁴⁷ Reg. §301.6223-1(d)(1).

¹⁴⁸ Reg. §301.6223-1(d)(1).

¹⁴⁹ Form 8979, Part IV.

¹⁵⁰ Instructions for Form 8979 — Who May File.

¹⁵¹ Reg. §301.6223-1(e)(6).

¹⁵² Reg. §301.6223-1(e)(2).

¹⁵³ Reg. §301.6223-1(e)(1).

¹⁵⁴ T.D. 9839, Section 1.B.i, 83 Fed. Reg. 39,331, 39,336 (Aug. 9, 2018) (preamble to final regulations).

ship representative.¹⁵⁵ Therefore, there is a window of time between the issuance of the NOSE and the issuance of the NAP in which a partnership may revoke the designation of its partnership representative before that person has an opportunity to act. The statute and regulations do not address how long this window will be, so a partnership that would like to revoke the designation of its partnership representative should act promptly after receiving a NOSE.

If a partnership would like to revoke the designation of its partnership representative before revocation is allowed, the partnership may want to consider asking the partnership representative to agree not to act in that capacity. If the partnership representative agrees not to act in that capacity but breaches this agreement (e.g., by filing an AAR), the partnership and partners would be bound by the partnership representative's actions, but they would be able to sue the partnership representative for damages.

A partnership may also want to consider asking a partnership representative who has become disaffiliated from the partnership to provide copies of any communications it receives from the IRS.

b. How to Revoke the Designation

To revoke the designation of the partnership representative, the partnership must give the IRS written notice of the revocation. Form 8979 may be used, but it appears that any written notice will suffice so long as it satisfies the requirements provided in the regulations. For the revocation to be valid, the form or notice must state that the prior designation is being revoked, designate the new partnership representative for the applicable tax year, and appoint a designated individual if the new partnership representative is an entity.¹⁵⁶

There may be some uncertainty in who is authorized to sign the revocation. Both the regulations and the applicable signature block on Form 8979 require the person who signs the revocation to certify under penalties of perjury that it is authorized by the partnership to revoke the designation.¹⁵⁷ (The signature block on Form 8979 also requires that person to certify under penalties of perjury that it is authorized by the partnership to designate the successor.) This language appears to relate to whether the person signing the revocation is authorized under state law (e.g., pursuant to the partnership agreement) to revoke the designation and designate the successor.

The person who signs might also have to have been a partner in the year to which the revocation relates. The instructions for Form 8979 state that the revocation (and the associated designation of the successor) must be signed by an "authorized person," which is defined as a person who was a partner at any time during the partnership tax year to which the designation relates.¹⁵⁸ In addition, the regulations provide that a revocation must either be signed by a person who was a partner in the year

to which the revocation relates, or be signed in accordance with forms, instructions, or other guidance.¹⁵⁹ Therefore, a revocation might have to be signed by a person who was a partner in the partnership tax year to which the revocation relates, and that person might also have to be authorized to sign the revocation under state law.

Practice Point: In CCA 202527015, the IRS took the position that Form 8979 did not need to be signed by a reviewed-year partner, but the IRS might have taken this position so that it could argue that the statute extension had been validly executed. The Internal Revenue Manual clearly adopts the opposite position and states that Form 8979 must be submitted by a person who was a partner in the reviewed year.¹⁶⁰

If the partnership representative was designated by the IRS, the designation cannot be revoked without the permission of the IRS.¹⁶¹ There is not yet any guidance on how this consent is to be obtained.

G. The Designated Individual: Appointment, Resignation, and Revocation

A specific individual — the designated individual — must be appointed to act on behalf of the partners and the partnership when an entity is designated as the partnership representative.¹⁶² No designated individual need be appointed when the partnership representative is an individual.

Designated individuals are generally subject to the same rules that apply to partnership representatives. Both the designated individual and the partnership representative must have a substantial presence in the United States.¹⁶³ In addition, both are appointed or designated by the partnership; the designated individual is not appointed by the partnership representative.¹⁶⁴

The partnership must appoint the designated individual when it designates the partnership representative.¹⁶⁵ If the partnership designates an entity as its partnership representative without simultaneously appointing a designated individual, the entity will act as the partnership representative and be able to bind the partnership and the partners, but the IRS may subsequently determine that the designation of the entity will not have further effect.¹⁶⁶ In that case, the partnership would have a 30 day period in which it could make a proper designation of a partnership representative. If the partnership does not make a proper designation in that period, the IRS is allowed to designate the partnership representative.¹⁶⁷

¹⁵⁹ See Reg. §301.6223-1(e)(4). See also CCA 202547015 (advising that Reg. §301.6223-1(e)(4) requires that revocation of a PR must be signed by a person who was a partner at any time during the partnership taxable year in which the revocation relates or as provided in forms, instructions, and other guidance from the IRS; but Instructions to Form 8979 state that the person signing Form 8979 declares under perjury that they are authorized to revoke designation of the current PR and designate a new PR, therefore, if the person was authorized by another partner to make the revocation and designation at the time of signing Form 8979, then the revocation and designation were valid, even if the signer did not meet the requirements of Reg. §301.6223-1(e)(4)).

¹⁶⁰ See IRM 4.31.9.7.6(7) and 4.31.9.7.6.2(2).

¹⁶¹ Reg. §301.6223-1(e)(6).

¹⁶² Reg. §301.6223-1(b)(3).

¹⁶³ Reg. §301.6223-1(b)(3).

¹⁶⁴ Reg. §301.6223-1(b)(3).

¹⁶⁵ Reg. §301.6223-1(b)(3)(ii).

¹⁶⁶ Reg. §301.6223-1(b)(4) *Ex. 2*.

¹⁶⁷ Reg. §301.6223-1(f)(1). See III.E.2., above.

¹⁵⁵ §6231(a)(1).

¹⁵⁶ Reg. §301.6223-1(e)(5).

¹⁵⁷ Reg. §301.6223-1(e)(5)(i); Instructions for Form 8979, Part IV, Section A.

¹⁵⁸ Instructions for Form 8979 — Who May File. *But see* CCA 202547015 (advising that when there is a deceased partnership representative (PR), revoking the deceased PR and designating a new PR is necessary and valid under Reg. §301.6223-1(e)(3)).

The rules that apply to the resignation of a partnership representative also apply to the resignation of the designated individual. For example, the designated individual cannot resign until the IRS has begun an audit of the applicable tax year.¹⁶⁸ In addition, when a designated individual resigns, the designation of the partnership representative automatically terminates. Similarly, when a partnership representative resigns, the appointment of the designated individual automatically terminates.¹⁶⁹

Revocation is also governed by the rules that apply with respect to a partnership representative. For example, a partnership cannot revoke its appointment of a designated individual until the partnership files an administrative adjustment request or the IRS has commenced an audit, and the revocation is not valid unless the partnership appoints a new designated individual.¹⁷⁰ A partnership may revoke the appointment of its designated individual without revoking the designation of its partnership representative, but if the partnership revokes the designation of its partnership representative, the appointment of the designated individual will terminate.¹⁷¹

H. Updating Contact Information

Regulations provide that a partnership representative or designated individual must keep the IRS apprised of any changes to its mailing address, if such updates are required by forms, instructions, or other guidance prescribed by the IRS.¹⁷² At present, the only guidance on updating contact information is in the instructions for Form 8979. These instructions explain how a partnership representative or designated individual may update its address, but it is not clear that the instructions require the updates. In addition, the instructions provide that the new address should be provided in writing to the “current IRS point of contact (e.g., revenue agent, appeals officer, counsel),”¹⁷³ so the instructions do not address a change of address that is made before an audit has begun.

I. Whether an Entity Should Be Designated as the Partnership Representative

A partnership representative may be an entity, including the partnership itself or an entity that is disregarded for federal income tax purposes.¹⁷⁴ It may, however, be better to designate an individual. There are no clear advantages that may be obtained by designating an entity rather than an individual as the partnership representative, and the designation of an entity may increase procedural complexity and confusion.

It is true that there are a number of inconvenient restrictions that apply when the partnership representative is an individual. For example, the individual must have a substantial presence in the United States, and there are limitations on when the individual may resign and when the designation may be revoked. These restrictions cannot, however, be circumvented by

designating an entity as a partnership representative. When an entity is designated, the partnership must also appoint a particular individual (the designated individual) who will effectively act as the partnership representative, and that individual will be subject to the same restrictions as the partnership representative (i.e., the individual must have a substantial presence in the United States), and the appointment of the individual cannot be revoked until the IRS begins an audit or the partnership files an AAR.

In addition, the BBA gives no powers to a partnership representative that is an entity. The powers that a partnership representative would ordinarily have are given to the designated individual, and the BBA does not give the partnership representative the right to appoint the designated individual, revoke the appointment, or control the designated individual.

If an entity is designated as the partnership representative, it is important that its relationship with the designated individual, and the amount of autonomy that is granted to the designated individual, be addressed and that any limitations on the designated individual (including an obligation to act solely under the direction of the partnership representative) be imposed pursuant to documentation that binds the designated individual. The BBA does not address any of these issues, so it is the partnership’s obligation to ensure that these matters are addressed.¹⁷⁵

Practice Point: Partnerships that are designating entities as their partnership representatives often address the designated individual by including a provision in the partnership agreement that provides that there will be a designated individual who will be the sole person through whom the partnership representative will act. Such a provision might not be adequate, however. For example, this language does not make clear whether the designated individual must act solely as directed by the partnership representative. Moreover, the designated individual will not be bound by the provision if he or she does not sign the partnership agreement, and the designated individual might not have any rights to be indemnified under the partnership agreement. A partnership might therefore consider having the designated individual and partnership representative enter into a separate contract that spells out the designated individual’s duties and obligations.

If the reason the partnership wants to designate an entity as its partnership representative is that it wants the entity to determine how an audit will be handled, it can accomplish this goal without designating an entity as the partnership representative. The person who is the partnership representative does not need to be the person (or group) that decides how an audit will be handled. A partnership may designate an individual as its partnership representative and then require that individual to act solely as directed by a particular entity.

Example: A partnership would like its general partner to determine how audits are handled. The general partner is

¹⁶⁸ Reg. §301.6223-1(d)(1).

¹⁶⁹ Reg. §301.6223-1(d)(3)(iii), §301.6223-1(d)(3)(iv).

¹⁷⁰ Reg. §301.6223-1(e)(2), §301.6223-1(e)(5)(iii).

¹⁷¹ Reg. §301.6223-1(e)(1), §301.6223-1(e)(3)(iii), §301.6223-1(e)(3)(iv).

¹⁷² Reg. §301.6223-1(a) (requires the partnership representative to update its contact information if required by IRS guidance).

¹⁷³ Instructions for Form 8979.

¹⁷⁴ Reg. §301.6223-1(b)(1).

¹⁷⁵ Similarly, the BBA provides that the partnership representative is the sole person authorized to act on behalf of the partnership and the partners, but the BBA does not address how much autonomy the partnership representative has (e.g., whether the partnership representative must obtain consent before taking certain actions or must act solely as directed by a certain group of partners).

an entity, however. The partnership may designate an individual as its partnership representative and then require that individual to act solely as directed by the entity that is the general partner.

If an entity is designated as the partnership representative, care should be taken in evaluating who has authority to take which actions; the scope of the partnership representative's powers might not be as broad as one would expect it to be. For example, if the designated individual resigns, the partnership representative cannot appoint the next designated individ-

ual. The resignation would automatically terminate the designation of the partnership representative, so there would not be any partnership representative to take any action.¹⁷⁶ Moreover, a partnership representative does not have the authority to appoint a designated individual.¹⁷⁷ Similarly, a partnership representative does not have the authority to revoke the appointment of a designated individual, so an attempt by the partnership representative to revoke the appointment may be invalid.¹⁷⁸

¹⁷⁶ Reg. §301.6223-1(d)(3)(iv).

¹⁷⁷ Reg. §301.6223-1(b)(3).

¹⁷⁸ Reg. §301.6223-1(e)(1).

IV. Consistent Returns

A. General Rule

A partner generally must treat partnership-related items (PRIs) in a manner that is consistent with the treatment of such items on the partnership's return.¹⁷⁹ As discussed in detail below, the consequences of taking an inconsistent position depend on whether the partner notifies the IRS of the inconsistency. A partner is obligated to file consistently with the partnership's return even if the Schedule K-1 it receives from the partnership is inconsistent with the partnership's return, but in that case the partner may be deemed to have given the IRS notice of the inconsistent position.¹⁸⁰

B. No Notice of Inconsistent Treatment

If a partner treats an item inconsistently but does not notify the IRS of the inconsistent treatment, the IRS may adjust the partner's return to conform to the partnership's return as if it were correcting a mathematical or clerical error on the partner's return.¹⁸¹ Outside of the BBA context, when the IRS makes an assessment with respect to a mathematical or clerical error, the taxpayer has an opportunity to contest the assessment under §6213(b)(2). This opportunity is not provided to partners that file inconsistently without providing notice to the IRS.¹⁸² As a result, the partner will not have an opportunity to contest the adjustment.

The partnership and the partnership representative would not be affected by this adjustment; they would not owe any tax or imputed underpayment. It is the partner who filed inconsistently who would be liable for any additional amount that is due.¹⁸³ The regulations do not explicitly address whether the partner might be entitled to a refund.

C. Notice of Inconsistent Treatment

If a partner takes a position that is inconsistent with the partnership's return and provides the IRS with proper notice of the inconsistent position, the IRS cannot adjust the partner's return as if it were correcting a mathematical or clerical error. Instead, the IRS must audit the partner in a partner-level proceeding or audit the partnership in an ordinary BBA proceeding before making an adjustment that would affect the partner (or the partnership).¹⁸⁴ The IRS is allowed to conduct both a partner-level audit and a partnership-level audit.¹⁸⁵

To provide proper notice, the partner must report its inconsistent position on Form 8082 and attach that form to the return on which it takes the inconsistent position.¹⁸⁶

1. Partner-Level Proceeding

When a partner notifies the IRS that it is reporting inconsistently, the IRS may evaluate the disputed item in an audit of the partner that does not involve the partnership or the partnership representative.¹⁸⁷ In this audit, the IRS may determine the proper amounts that should have been reported by the partner; the IRS is not required to choose between the position taken on the partner's return and the position taken on the partnership's return.¹⁸⁸ In addition, the IRS may adjust items that are not related to the partnership.¹⁸⁹

If any additional tax is due, it is the partner who would be liable, not the partnership. In addition, the partnership and the other partners would not be bound by the adjustment unless the partnership is made a party to the proceeding.¹⁹⁰

It is not clear how an adjustment made in a partner-level proceeding would affect tax attributes such as the partner's capital account or the partnership's basis in its assets.

2. Partnership Proceeding Under the BBA

The IRS may conduct a partnership-level audit regardless of whether it conducts a partner-level audit of a partner who reports inconsistently and provides proper notice of the inconsistent treatment.¹⁹¹ This partnership-level audit would be a standard BBA audit in which the partnership representative would represent the partnership and all current and former partners; a partner that reported inconsistently would not have a right to participate, even if the partner provides notice of the inconsistent treatment.¹⁹²

A partnership-level audit under the BBA is designed to correct any errors in the partnership's return and to minimize the IRS's burden in making an adjustment. It is not designed to ensure that the correct amount of tax is paid. As a result, the treatment of an adjustment in the partnership-level proceeding might not properly take into account the amount of tax paid by a partner who took an inconsistent position.

Example: A partnership allocates \$0 of income to Stella in Year 1. Stella, however, disagrees with the partnership's position, so she reports \$1 million of income from the partnership and provides proper notice of the inconsistent treatment. A few years later, the IRS conducts a partnership-level audit in which the IRS and the partnership representative agree that the partnership should have allocated \$1 million of income to Stella in Year 1. Under the BBA, there are multiple ways in which that adjustment may be taken into account. If the default rule applies, the partnership would pay tax on the additional \$1 million of income (this tax is the imputed underpayment).¹⁹³ It would not matter that Stella had properly reported that \$1 million

¹⁷⁹ §6222.

¹⁸⁰ §6222(c)(2).

¹⁸¹ Reg. §301.6222-1(b)(1), §301.6222-1(b)(2).

¹⁸² Reg. §301.6222-1(b)(2).

¹⁸³ Reg. §301.6222-1(b)(2).

¹⁸⁴ Reg. §301.6222-1(c)(1).

¹⁸⁵ Reg. §301.6222-1(c)(4)(i).

¹⁸⁶ Reg. §301.6222-1(c)(1). Partner's Instructions for Schedule K-1 (Form 1065) — Inconsistent Treatment of Items.

¹⁸⁷ Reg. §301.6222-1(c)(4).

¹⁸⁸ Reg. §301.6222-1(c)(4)(ii).

¹⁸⁹ Reg. §301.6222-1(c)(4)(ii).

¹⁹⁰ Reg. §301.6222-1(c)(4)(ii).

¹⁹¹ Reg. §301.6222-1(c)(4)(i).

¹⁹² Reg. §301.6222-1(c)(4)(i).

¹⁹³ The default rule and the imputed underpayment are discussed in V.B., below.

of income on her return for Year 1. That \$1 million of income would therefore be taxed twice.

The modification rules may provide a better result.¹⁹⁴ Under the modification rules, a partnership may take into account an amended return filed by a partner or a closing agreement that a partner enters into with the IRS.¹⁹⁵ It appears that Stella's original return may be treated as an amended return for purposes of this "amended-return" modification.¹⁹⁶ In addition, the partnership might be able to take into account Stella's inclusion of that \$1 million of income under the "alternative" (or "pull-in") method.¹⁹⁷

Another way in which the partnership adjustment might be taken into account is through a §6226 push-out election.¹⁹⁸ Under that approach, the partnership would not owe any additional tax. Stella would be required to recalculate the amount of tax she should have paid had she included that \$1 million as income in 2020. As she actually reported that \$1 million as income in Year 1, the §6226 election would not affect the amount of tax, interest, or penalties that she would be required to pay as a result of the partnership-level adjustment.

Practice Point: A §6226 election, however, does not always result in a partner paying the same amount of tax that the partner would have paid had the partner reported the adjusted amounts on its original return. Therefore, there may be situations in which a §6226 election would affect the amount of tax that must be paid by a partner who took an inconsistent position.

The consequences may be quite different if a partnership allocates too much income to a partner.

Example: A partnership allocates \$1 million of income to Stella in Year 1. Stella disagrees with this allocation, however, so she reports no income from the partnership and provides proper notice of her inconsistent position. Some years later, the IRS conducts a partnership-level audit in which the IRS and the partnership representative agree that no income should have been allocated to Stella in Year 1. The resulting adjustment would not result in an imputed underpayment. Instead, the true-up rule would apply by default, which means that the partnership would omit \$1

million of income (or report an additional \$1 million of losses) in the adjustment year.¹⁹⁹ It would not matter that the \$1 million had never been included in income on Stella's return.

D. Partnership that Provides Incorrect Information

A partner is required to file a return that is consistent with the partnership's return even if the partnership does not provide the partner with the information it would need to file consistently.²⁰⁰

Example: A partnership takes one position on its Form 1065 and the Schedules K-1 that it files with the IRS but takes a different position on the Schedules K-1 that it provides to its partners. If a partner's return is consistent with the Schedule K-1 it receives but not consistent with the Form 1065 and Schedule K-1 that the partnership files with the IRS, the partner's return will be inconsistent with the partnership's return.

A partner who files in a manner that is consistent with the information it receives from the partnership may, however, elect to be treated as if it gave proper notice of its inconsistent treatment.²⁰¹

E. No Return Filed by Partnership

If a partnership does not file a tax return, the partnership-related items on the partner's return are deemed to be inconsistent with the partnership's return.²⁰² When a partner does not provide notice that its return is inconsistent with the partnership's, the IRS is allowed to adjust the partner's return to conform to the partnership's as if there were a mathematical or clerical error.²⁰³ For purposes of this rule, a partnership that does not file a return is deemed to have filed a return that reports no income or loss.²⁰⁴ Therefore, if a partnership does not file a tax return, the IRS may remove all partnership income and loss that the partners report on their tax returns as if it is correcting a mathematical or clerical error.

¹⁹⁹ The true-up rule is discussed in V.B.2., below. The adjustment year is the partnership taxable year in which: (i) a decision becomes final in a judicial proceeding brought under §6234; (ii) an administrative adjustment request is filed under §6227; or (iii) a notice of final partnership adjustment is mailed (or the IRS executes a waiver of restrictions made by the partnership under §6232(b)) and (i) and (ii) do not apply. Reg. §301.6241-1(a)(1).

²⁰⁰ Reg. §301.6222-1(a)(1).

²⁰¹ Reg. §301.6222-1(d).

²⁰² Reg. §301.6222-1(a)(3).

²⁰³ Reg. §301.6222-1(b)(1), §301.6222-1(b)(2).

²⁰⁴ Reg. §301.6222-1(b)(1).

¹⁹⁴ The modification rules are discussed in V.C., below.

¹⁹⁵ §6225(c).

¹⁹⁶ Reg. §301.6225-2(d)(2)(ii).

¹⁹⁷ §6225(c)(2)(B); Reg. §301.6225-2(d)(2)(x). See discussion in V.C.3.b.(2), below.

¹⁹⁸ The §6226 push-out election is discussed in V.D., below.

V. Treatment of Adjustments Made as a Result of an IRS Audit

A. Overview

When the IRS makes an adjustment under the BBA, the partnership and its partners have multiple options for how the adjustment will be taken into account. The different alternatives are subject to different procedural rules. In addition, the different approaches produce different economic results. They determine who will be affected by an adjustment, how any additional amount due will be calculated, and the amount and type of tax benefit that may result from a favorable adjustment.

The alternatives are not designed so that the correct amount of tax is paid by the correct persons; instead the intent is to ensure that enough tax is paid and to ease the IRS's administrative burden in collecting tax. As a result, the amount of tax that is paid may exceed the amount that would have been due had the correct amounts been reported on the original returns, and one person might have to effectively pay tax on another person's income. It may be possible for the "correct" persons to pay the "correct" amount of tax, but the partners and the partnership must bear more of the procedural burden to achieve this result.

Practice Point: None of the alternatives is a silver bullet that will provide the perfect result in every situation. Each approach has advantages and disadvantages, and the best approach for one situation might not be the best approach for another situation.

Fortunately, a partnership might be able to adopt different approaches for different adjustments.²⁰⁵ In addition, the partnership agreement and the partnership's tax returns do not need to specify which approach the partnership will adopt to take an adjustment into account. This decision does not need to be made until the IRS has commenced an audit and proposed specific adjustments.

Practice Point: It may nevertheless be useful to consider the possible alternatives when drafting a partnership agreement or other transactional documentation to ensure that the partners and the partnership will be able to best take advantage of the options available in the event that an adjustment is made. For example, some of the modification rules require the cooperation of the partners, so it may be helpful if the partnership agreement includes a provision that requires the partners to provide such cooperation.

At a high level, the alternatives may be classified as the default rule, the modification rules, and the §6226 election (the so called "push-out election"). The default rule determines how adjustments will be treated in the event that no elections are made and the partnership does not avail itself of any special procedures that might produce a more favorable result.²⁰⁶

Practice Point: The primary benefit of the default rule is simplicity. It might be the best approach to take when adjustments are small or the number of partners is large.

The modification rules enable a partnership to reduce the amount it must pay or have the adjustment be taken into ac-

count by its partners.²⁰⁷ The modification rules will generally produce a better result for the partners than the default rule, but the burden is on the partnership to establish that the modifications are appropriate.

The §6226 election will enable a partnership to avoid paying any tax or related amounts, but it might be difficult to make a valid election, and the election might result in the partners paying more than they would be required to pay under a different approach.²⁰⁸

Two terms are important when discussing the alternatives available. The "reviewed year" is the partnership taxable year for which income or loss was misreported.²⁰⁹ For example, if the IRS makes an adjustment to the partnership's return for Year 1, the reviewed year is Year 1. The "adjustment year" is generally the year in which the adjustment becomes final. If the partnership does not contest the adjustment in court, the adjustment year is the partnership tax year in which the IRS mails the notice of the final partnership adjustment to the partnership. If the partnership waives the 90-day period that must pass before the IRS may assess an imputed underpayment, the adjustment year is the partnership's tax year in which the IRS executes this waiver.²¹⁰ If the adjustment is contested in Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, the adjustment year is the partnership tax year in which the court's decision becomes final.²¹¹ When a partnership files an administrative adjustment request (AAR), however, the adjustment year is not the year in which the adjustment becomes final. Instead, it is the year in which the AAR is filed.²¹²

B. Default Rule

Section 6225(a) provides the default rule that applies when the IRS makes an adjustment and the partnership does not make any elections or take any steps to modify the result. The default rule will often result in too much tax being paid, and it will sometimes result in the wrong persons bearing the economic burden of the tax, but there are situations in which the default rule will be advantageous. Procedurally, it is the simplest approach. It enables a partnership to resolve an audit by making a payment to the IRS. The reviewed-year partners do not need to be notified, and they do not need to amend their tax returns or make any payments. In addition, there is no need to calculate how the adjustment would have affected their tax liabilities, and there is no need to analyze the partners' tax attributes such as net operating losses. Therefore, the default rule may be advantageous when the adjustment is small or the number of partners is large.

Nevertheless, the default rule represents a fundamental departure from how errors have historically been rectified. Outside of the BBA context, the additional tax owed or the refund that is due equals the amount by which the tax was overpaid or underpaid. The tax deficiency or refund therefore reflects the net effect that the adjustments have on the tax that should have

²⁰⁵ Reg. §301.6226-3(h)(4) Ex. 4.

²⁰⁶ The default rule is discussed in V.B., below.

²⁰⁷ The modification rules are discussed in V.C., below.

²⁰⁸ The §6226 election is discussed in V.D., below.

²⁰⁹ §6225(d)(1).

²¹⁰ Reg. §301.6241-1(a)(1)(iii). The imputed underpayment is the tax that the partnership must pay under the default rule or under the modification rules.

²¹¹ §6225(d)(2)(A); Reg. §301.6241-1(a)(1)(i).

²¹² §6225(d)(2)(B); Reg. §301.6241-1(a)(1)(ii).

been paid. In contrast, the BBA default rule generally functions as a tax on errors in reporting; if there is an error on a line of the partnership's tax return (including the Schedules K-1) or certain books and records, tax might be owed on the amount by which that line is adjusted. That is, if a line on the return is adjusted by \$1 million, the partnership may have to pay tax on \$1 million. It does not matter whether the adjustment would have affected the amount of income that a partner should have reported on its tax return or affected the amount of tax a partner should have paid.

Under the default rule, there are two ways in which a partnership adjustment might be taken into account. The first is in the calculation of the "imputed underpayment" that the partnership must pay. The imputed underpayment is effectively a tax on all "positive adjustments," net of certain "negative adjustments." Any excess negative adjustments — that is, negative adjustments that do not affect the amount of the imputed underpayment — are taken into account under a "true-up rule." Under the true-up rule, the partnership adjusts the amount of income or loss it allocates to its partners in the adjustment year to reverse or offset the prior error.²¹³ This rule is as important as the imputed underpayment calculation, for it will generally apply whenever income is misallocated or mischaracterized. It is also critical to understand the true-up rule when negotiating indemnities or when terminating a partnership.²¹⁴

It is the "grouping" rules that determine whether a negative adjustment may offset a positive adjustment in the imputed underpayment calculation (and thereby reduce the imputed underpayment) or whether the adjustment will be taken into account under the true-up rule.²¹⁵

Refunds are not available under the default rule.²¹⁶ If a partner paid too much tax, there are three ways in which the adjustment might be taken into account:

- The partnership might be required to pay tax on the adjusted amount (i.e., pay an imputed underpayment), notwithstanding the fact that the partner already paid too much tax;
- The adjustment might offset some other adjustment and thereby reduce the imputed underpayment that the partnership might otherwise have had to pay; or
- The true-up rule might apply.

The default rule is complex. First, an adjustment must be classified as "positive" or "negative." These terms are not synonyms for "favorable" and "unfavorable." At a high level, unfavorable adjustments are generally positive, but taxpayer-favorable adjustments are not all the same type. Some are negative while others are positive. Positive adjustments generally result in an imputed underpayment, so many taxpayer-favorable adjustments may result in an imputed underpayment, even though a partner might have already paid too much tax.

²¹³ The true-up rule is discussed in V.B.2., below.

²¹⁴ See Kraus, "BBA Indemnities May Result in Double Taxation," 171 Tax Notes 1, 27–33 (Apr. 5, 2021).

²¹⁵ The grouping rules are discussed in V.B.1.c., below.

²¹⁶ Refunds are sometimes available under the modification rules, as discussed in V.C.3.b., below. If a §6226 election is made, a partner may effectively receive a nonrefundable credit but not a refund. See V.D.2., below.

Because the default rule is effectively a reporting tax, not an income tax, it is possible for many duplicative adjustments to be made. For example, if the IRS determines that a \$1 million payment must be capitalized, not deducted, the IRS may adjust the line on the return on which the deduction was reported, as well as the tax basis of an asset on the partnership's balance sheet. As discussed below, these would both be treated as positive adjustments, resulting in \$2 million of positive adjustments. The "subsume rules" mitigate this problem.²¹⁷

The imputed underpayment and the true-up rule address "partnership adjustments," which are adjustments to partnership-related items (PRIs).²¹⁸ As discussed in II.B.3., above, the scope of the BBA extends to certain items that are not PRIs. Adjustments to non-PRIs or tax attributable to non-PRIs do not affect the calculation of the imputed underpayment or the application of the true-up rule. Instead, under the default rule, such adjustments are ignored. Examples of non-PRIs that may be within the scope of the BBA may include the gain a partner should have recognized in a disguised sale and a partner's capital gain or loss from the sale of a partnership interest. These examples are discussed in V.B.6.a. and V.B.6.b., below.

1. The Imputed Underpayment

Under the default rule, a partnership must pay an "imputed underpayment" to resolve many types of adjustments. The imputed underpayment is generally a tax on all "positive adjustments" net of some "negative adjustments." The net amount is called the "total netted partnership adjustment,"²¹⁹ and that is the amount that is taxed unless credits are also adjusted.²²⁰ The grouping rules determine when a negative adjustment may offset a positive adjustment.

Example — Omitted income: The IRS increases a partnership's income by \$1 million. This constitutes a positive adjustment of \$1 million. If this is the only adjustment made, there would be a \$1 million total netted partnership adjustment, and the partnership would pay tax (the imputed underpayment) on this amount. It does not matter how much tax was underpaid by the partners.²²¹ For example, it would not matter if the partners were tax exempt or had suspended losses that would have offset that additional income. However, if the IRS also made a negative adjustment of \$1 million and that negative adjustment is allowed to offset the positive adjustment under the grouping rules, the total netted partnership adjustment and the imputed underpayment would be \$0.

²¹⁷ For further discussion of the subsume rules, see V.B.1.d., below.

²¹⁸ Reg. §301.6225-1 (providing calculation of the imputed underpayment), Reg. §301.6225-3 (addressing the true-up rule and adjustments that do not result in an imputed underpayment), Reg. §301.6241-1(a)(6) (defining "partnership adjustment").

²¹⁹ Reg. §301.6225-1(b)(1)(iii).

²²⁰ Adjustments to credits are discussed in V.B.4., below.

²²¹ Under the modification rules, however, the amount that a partnership must pay may be adjusted to reflect amounts paid by the partners or the amounts that the partners should have paid. For discussion of the modification rules, see V.C., below.

a. Tax Rate

The imputed underpayment generally equals the total netted partnership adjustment multiplied by the applicable tax rate.²²² The tax rate is the highest rate of income tax in effect under §1 (the individual tax rates) or §11 (the corporate tax rates) for the reviewed year. The rate is not affected by taxes imposed by other sections, such as the net investment income tax or self-employment tax.²²³

For example, in 2024, the highest tax rate under §1 (for individuals) was 37% and the highest tax rate under §11 (for corporations) was 21%, so if the IRS makes an adjustment to a partnership's return for 2024, the imputed underpayment would be computed using a tax rate of 37%.

Practice Point: It would not matter whether the partners were C corporations, or whether the income was long-term capital gain that would have been allocated to an individual. These factors may, however, be taken into account to reduce the amount of tax that is owed under the modification rules, as discussed in V.C., below.

b. Negative and Positive Adjustments

To calculate the imputed underpayment, each adjustment to a PRI must be classified as positive or negative. These terms are not synonyms for “favorable” and “unfavorable.” If an adjustment is favorable for the IRS and unfavorable for the partners (e.g., if the IRS increases the amount of income that the partnership should have reported), the adjustment will generally be positive and result in an imputed underpayment. On the other hand, some taxpayer-favorable adjustments are negative adjustments, but others are positive. When a favorable adjustment is positive, it may generate an imputed underpayment, even though a partner might have already paid too much tax.

Regulations define a positive adjustment as any adjustment that is not a “negative adjustment.”²²⁴ A negative adjustment is defined as:

- a decrease in an item of income or gain,
- an increase in an item of loss or deduction,
- an increase in an item of credit,
- a decrease in an item of tax, penalty, addition to tax, or additional amount for which the partnership is liable under chapter 1, or
- a decrease to an imputed underpayment calculated by the partnership.²²⁵

Consequently, an adjustment to an item of income, gain, loss, or deduction (an Income Item) may be a positive adjustment or a negative adjustment, depending on the direction of the adjustment. However, there are many items reported on a return or in the partnership's books and records that are within the scope of the BBA but are not Income Items (Non-Income Items). If a Non-Income Item is adjusted, there is only one situation where the adjustment is a negative adjustment: when the

adjustment is an increase to an item of credit. All other adjustments to Non-Income Items are positive adjustments.²²⁶

Therefore, if an Income Item is adjusted, the adjustment is generally a negative adjustment if it is taxpayer-favorable, but is a positive adjustment if it is IRS-favorable. Adjustments to Non-Income Items, however, are always positive adjustments (except for an increase in an item of credit).

Example — Liabilities on the Schedules K-1: A partnership allocates \$0 of liabilities to a partner on the partner's Schedule K-1, and the IRS increases the recourse liabilities allocated to that partner by \$1 million. That adjustment is an adjustment to a PRI, and it is a positive adjustment because it is an adjustment to a Non-Income Item but not an adjustment to a credit. If that is the only adjustment made, the imputed underpayment would equal \$1 million multiplied by the applicable tax rate. It does not matter that this adjustment would ordinarily be viewed as favorable to the taxpayer, or that the taxpayer might have paid too much tax because it thought its basis in the partnership interest was lower.

If the partnership had mischaracterized its liabilities, reporting that a partner was allocated \$1 million of recourse liabilities instead of \$1 million of nonrecourse liabilities, two lines on the Schedule K-1 would be adjusted (the amount of recourse liabilities and the amount of nonrecourse liabilities). Both items are Non-Income Items that are not credits, so both adjustments would be positive, even though one item was increased and the other was decreased. Therefore, both could be taxed unless a subsume rule applies.²²⁷

Example — §751(a) Ordinary Income: When a partner sells an interest in a partnership that has hot assets, she may recognize ordinary income or loss under §751(a). The partnership is required to report the amount of ordinary income or loss recognized under §751(a) on the Schedule K-1.²²⁸ Therefore, the amount of ordinary income or loss is a PRI.

²²⁶ See also T.D. 9969, 87 Fed. Reg. 75,473, 75,476, Preamble section 2.A (Dec. 9, 2022) (“adjustments to a partnership's non-income items are always positive adjustments, are never negative adjustments, and are not netted against any adjustments to a partnership's items of income, gain, loss, deduction, or credit under section 702(a).”); CCA 202148006.

²²⁷ See CCA 202444004 (discussing reallocation of partnership liability). The subsume rules are discussed in V.B.1.d., below. The application of the subsume rules to the recharacterization of a liability is illustrated in Ex. 4 of Reg. §301.6225-3(d)(4). The regulations also provide two other examples of adjustments to liabilities. In one, a liability is recharacterized but the IRS makes only one adjustment. The IRS decreases one type of liability but apparently does not officially adjust the other type. See Reg. §301.6225-1(h)(7) Ex. 7. The other example appears to take a materially different approach. In Prop. Reg. §301.6225-4(e), Ex. 5, the IRS recharacterizes and reallocates a liability, and the IRS appears to look at what the net effect might be for the partners, instead of making adjustments to specific lines on the tax return. This Ex. 5 does not appear to reflect the government's current position. It is not consistent with how the regulations calculate the imputed underpayment, and it was proposed in 2018, before the other examples were issued in final regulations.

²²⁸ For the 2025 tax year, for example, the information is reported on Box 20 using Code AB.

²²² If credit items are adjusted, there is an additional step in the calculation of the imputed underpayment. See V.B.4.

²²³ §6225(b)(1)(B).

²²⁴ Reg. §301.6225-1(d)(2)(iii).

²²⁵ Reg. §301.6225-1(d)(2)(ii).

It is not clear whether the amount of ordinary income is an Income Item or a Non-Income Item. If it is an Income Item (perhaps because it is the income or loss of a partner), then an adjustment to that ordinary income would be a positive adjustment when it increases the ordinary income or decreases the ordinary loss recognized by the partner, but not otherwise. That is, the adjustment would be positive when the partner underreported ordinary income (and probably paid too little tax) but not when the partner reported too much ordinary income (and probably paid too much tax). If instead the §751(a) amount of ordinary income is a Non-Income Item (perhaps because it is not an item of partnership income or loss), any adjustment to that amount — be it an increase or decrease — would automatically be a positive adjustment that could result in an imputed underpayment.

If a partner's ordinary income under §751(a) is adjusted, a corresponding adjustment should be made to the capital gain or loss that the partner recognized in the sale. This capital gain or loss does not appear to be a PRI, as discussed above.²²⁹ Nevertheless, the scope of the BBA appears to extend to any associated adjustment to the capital gain or loss (or the tax attributable to that capital gain or loss), for that adjustment is attributable to an adjustment to a PRI (namely, the ordinary income or loss recognized).²³⁰ Therefore, the adjustment to capital gain or loss is addressed under the BBA, not in a partner-level proceeding. This means that if the partner overreported its capital gain (or underreported its capital loss), it cannot file a refund claim under the default rule. Instead, the adjustment is rectified under the BBA partnership proceeding. However, under the default rule, nothing is done to address the adjustment to capital gain or loss because it is not a PRI. The net result is that if the IRS increases the amount of ordinary income by \$1M, the imputed underpayment would equal \$1M multiplied by the applicable tax rate. There should be a corresponding \$1M decrease in capital gain (or increase in capital loss), but that adjustment would not produce any tax benefit for the partnership or the partner.

Example — Disguised Sale: A partner transfers property with built-in gain to a partnership, and the partner and the partnership take the position that the transfer is a tax-free contribution under §721. There are at least three lines that could be adjusted if the IRS determines that the transfer was instead a disguised sale: (1) Schedule M-2 line 2 (amount of capital contributed by the partners); (2) Schedule K-1, Section M and associated attachment (partner's contribution of property with built-in gain and the amount of built-in gain); and (3) Partnership books and records (partnership tax basis in the property). Each of these is probably a PRI that is a Non-Income Item but not an item of credit. Therefore, if all three of these items or amounts are adjusted, there would be three positive adjustments. As a result, all three adjustments could be subject to tax under the default rule.²³¹ The gain recognized by the partner is not a PRI, but an adjustment to the tax owed by the partner with respect to that gain would be within the scope of the

BBA because that adjustment is attributable to the adjustment of a PRI.²³² Therefore, under the default rule, the partner would not be liable for tax on that gain. In addition, an adjustment to that gain would not affect the imputed underpayment owed by the partnership, for the imputed underpayment only takes into account adjustments to PRIs, and the partner's gain is not a PRI.

Example — Self-Employment Income: If a partnership allocates income to a partner that constitutes self-employment income, that income may be subject to self-employment taxes under §1401, which is in Chapter 2 of the Tax Code. To ensure that partners have the information that they need to calculate their self-employment taxes, partnerships are required to report each partner's self-employment income or loss from the partnership on the partner's Schedule K-1.²³³ The BBA's scope extends only to Chapter 1 of the Tax Code, so one might think that an adjustment to a partner's self-employment income or loss could not result in an imputed underpayment. However, when a person pays self-employment tax under Chapter 2, that person is entitled to a deduction under §164(f) — i.e., under Chapter 1 — for one half of the self-employment taxes paid.²³⁴ Therefore, this income tax deduction generally equals 7.65% of the partner's net self-employment income. An adjustment to self-employment income on a Schedule K-1 may therefore affect a partner's income tax under Chapter 1, which means that self-employment income may be a PRI.²³⁵

For example, the IRS may increase the amount of self-employment income on a partner's Schedule K-1 by \$1 million. The implication of the adjustment under Chapter 1 is that the partner might have underreported her §164(f) deduction by \$76,500. In other words, no income was omitted under Chapter 1; instead, the partner might have overreported Chapter 1 income by up to \$76,500. If the BBA did not apply, the partner would not owe additional tax under Chapter 1 but might instead be entitled to a Chapter 1 refund. The default rule is different, for it is effectively a reporting tax on positive adjustments, not a tax on income that was omitted under Chapter 1. As a line on the Schedule K-1 was adjusted by \$1 million, the amount of the adjustment under the default rule is \$1 million, not \$76,500. Moreover, this adjustment appears to be a positive adjustment and therefore taxed — even though the partner did not underpay its Chapter 1 tax.²³⁶ If anything, the partner

²³² See §6221(a), discussed in II.B.3., above.

²³³ For the 2024 tax year, for example, this amount is reported on Line 14 of Schedule K-1.

²³⁴ No deduction is allowed with respect to the 0.9% "additional tax" imposed by §1401(b)(2).

²³⁵ See also CCA 202444007 (holding that SECA tax is not a PRI). In contrast, the §1411 net investment income tax is imposed under Chapter 2A, but there is no associated deduction allowed under Chapter 1. Therefore, if an adjustment is made to an amount on a Schedule K-1 that relates solely to the net investment income tax and not any Chapter 1 tax, the adjustment would not be within the scope of the BBA and no imputed underpayment would result.

²³⁶ See, e.g., IRM 4.31.9.6.2.1, IRM 4.31.9.6.7(3).

²²⁹ See II.B.1. and II.B.2., above.

²³⁰ See §6221(a), discussed in II.B.3., above.

²³¹ This extreme result might be avoided if a subsume rule applies. See V.B.1.d., below.

overpaid the Chapter 1 tax by failing to claim the §164(f) deduction.

Practice Point: It is unclear whether self-employment income is treated as an Income Item or as a Non-Income Item under the default rule, but either way the adjustment would be positive. If self-employment income is an Income Item, the adjustment would be positive because the adjustment is an increase to the Income Item. If instead self-employment income is a Non-Income Item, an adjustment would always be positive, no matter whether the amount was increased or decreased.

Practice Point: If the IRS adjusts self-employment income in a BBA proceeding and the partnership pays the associated imputed underpayment, the partner would remain liable for self-employment tax under Chapter 2. The payment of the imputed underpayment would satisfy the partnership's and partner's obligations under Chapter 1, but the payment would not reduce the partner's Chapter 2 liability. The partner remains liable for the associated self-employment tax under Chapter 2. That would be addressed in a separate proceeding, but the statutes of limitation are coordinated.²³⁷

c. The Grouping Rules

When the IRS makes multiple adjustments to a taxpayer's income and losses and the BBA does not apply, there is no need for a special set of rules to determine whether one adjustment might offset another. All adjustments are generally taken into account by recalculating the amount of tax the taxpayer should have paid.²³⁸ For example, if income and itemized deductions are both increased, the taxpayer might not owe any additional tax, for the additional deductions might offset the additional income. It is also possible that the additional deductions would provide no tax benefit, in which case the taxpayer would owe tax on the omitted income. The calculation would be governed by the ordinary tax rules and would not be affected by the fact that the income and deductions were adjusted in connection with an IRS audit.

The default rule is fundamentally a reporting tax, not a tax on omitted income or overreported losses. The grouping rules, however, bring the default rule one step closer to an income tax, for they determine when a negative adjustment may offset a positive adjustment when calculating an imputed underpayment.

The grouping rules operate by separating adjustments into different groups and subgroups. If adjustments are in the same subgroup (or in the same group, if there are no subgroups), they may offset each other.²³⁹ But an adjustment in one group or subgroup cannot offset an adjustment that is in a different group or subgroup. Therefore, if a positive adjustment and a negative adjustment are in the same subgroup, the negative adjustment may offset that positive adjustment, but it cannot offset a positive adjustment that is in a different group or subgroup.

Once the grouping rules are used to determine the extent to which negative adjustments may offset positive adjustments, the resulting net positive adjustments are added together to pro-

duce the total netted partnership adjustment (if any). Therefore, the total netted partnership adjustment generally equals the sum of all positive adjustments, minus any negative adjustments that are allowed to offset positive adjustments under the grouping rules. Any negative adjustments that do not offset positive adjustments are addressed under the true-up rule.²⁴⁰ Special rules apply when adjustments are made to credits or a partnership's tax, interest, penalties or imputed underpayment.²⁴¹

The grouping rules are not mandatory. The IRS is authorized to modify the grouping rules to "appropriately reflect the facts and circumstances."²⁴² Therefore, when all partners are C corporations, the IRS might determine that the limitations that apply to miscellaneous itemized deductions need not be taken into account when grouping adjustments.

Practice Point: It is not clear whether these modifications must be made under the modification procedures that are discussed below, or whether they may be made in some other manner.²⁴³ It is also not clear how much discretion the IRS has. If the partnership establishes that two adjustments would have actually offset each other on the partners' tax returns had the amounts been properly reported, is the IRS required to modify the groupings to allow for such netting?

The grouping rules do not directly relate to the calculation of multiple imputed underpayments, a topic that is discussed in V.E., below.

(1) Separately Stated Items and Items Subject to Preferences, Limitations or Restrictions

If two items are adjusted and these items would have to be reported separately under the separate-statement rules of §702, the two items must be put in separate groups or subgroups.²⁴⁴ Under the §702 regulations, two items must be separately stated if the separate statement could affect a partner's tax liability.²⁴⁵ It does not matter if the items in question are allocated to a partner who would be affected by the separate statement.

In addition, the BBA regulations require that all items in a group or subgroup be subject to the same preferences, limitations, restrictions, or limitations in offsetting ordinary income. If two items are not subject to the same limitations, they cannot be in the same group or subgroup, even if that limitation does not apply to any of the partners.²⁴⁶ As a result, a negative adjustment generally cannot offset a positive adjustment unless the two adjustments would always be able to offset each other, no matter what type of actual or hypothetical partner they affect.²⁴⁷

Example — Miscellaneous itemized deductions and corporate partners: The IRS increases a partnership's miscellaneous itemized deductions by \$10 million (a negative adjustment) and increases the partnership's capital gain by \$10 million (a positive adjustment). Sections 67 and 68 impose limitations on miscellaneous itemized deductions

²³⁷ This coordination is discussed further in VII.C., below.

²³⁸ See §6211.

²³⁹ See Reg. §301.6225-1(c)–§301.6225-1(e).

²⁴⁰ See Reg. §301.6225-1(f).

²⁴¹ See V.B.4. and V.B.5., below.

²⁴² See Reg. §301.6225-1(c)(1).

²⁴³ See V.C., below.

²⁴⁴ See Reg. §301.6225-1(c)–§301.6225-1(e).

²⁴⁵ See Reg. §1.702-1(a)(8)(ii).

²⁴⁶ See Reg. §301.6225-1(d)(3).

²⁴⁷ See Reg. §301.6225-1(c)–§301.6225-1(e).

reported by individuals, trusts, and estates, so the negative adjustment would generally not be allowed to offset the positive adjustment — even if all partners were C corporations and therefore not subject to the limitations imposed by §67 and §68.²⁴⁸ The negative adjustment would therefore not offset the positive adjustment when calculating the imputed underpayment. The partnership would owe tax on a total netted partnership adjustment of \$10 million, and the negative adjustment would be resolved under the true-up rule. This means that when a negative adjustment is made to an item that might be subject to special limitations or rules, that adjustment will generally be taken into account under the true-up rule, not by reducing the imputed underpayment.

(2) Misallocated Income

When a partnership allocates income to the wrong partner, the BBA treats the misallocation as two errors because two lines on the Schedules K-1 are adjusted. These two adjustments cannot be grouped together.²⁴⁹ Instead, the partnership may be required to pay tax on the positive adjustment.

Example: A partnership allocates \$10 million of income to Stella, but that income should have been allocated to Jonathan. The IRS corrects this error by making two adjustments: it decreases Stella's share of income by \$10 million, and it increases Jonathan's share by \$10 million.

These two adjustments must be grouped separately. One "group" consists of the additional \$10 million of income allocated to Jonathan.²⁵⁰ There are no other adjustments in that group, so \$10 million is included in the calculation of the total netted partnership adjustment. The other "group" consists of the negative \$10 million adjustment to income allocated to Stella. There are no other adjustments in that group, so there are no positive adjustments that can be offset by the negative adjustment. The net effect is that the partnership pays tax (the imputed underpayment) on the \$10 million total netted partnership adjustment, and it resolves the negative \$10 million adjustment under the true-up rule.²⁵¹

(3) Mischaracterized Items

Similarly, when an item on a return is mischaracterized, there are two lines on the tax return to correct. The amount on

one line would be increased, while the amount on another line would be decreased. A mischaracterization is therefore corrected by making two separate adjustments. If the item at issue is a Non-Income Item and not an item of credit, both adjustments would be positive and the amount of the adjustment would generally be taxed twice in the imputed underpayment calculation. If instead an Income Item is adjusted, one adjustment would be positive and the other would be negative.²⁵² The two adjusted items would be separately stated, so under the grouping rules, the two adjustments would generally be put in different groups and therefore not offset each other. The partnership would take into account the omitted income or excess loss by paying tax (i.e., the imputed underpayment),²⁵³ and it would take into account the favorable adjustment by omitting income (or reporting additional loss) in the adjustment year.²⁵⁴

Example: A partnership reports \$10 million of capital gain, but the IRS determines that the gain is ordinary income. This error is therefore corrected through two adjustments: a \$10 million increase in ordinary income and a \$10 million decrease in capital gain. Capital gain or loss is subject to special limitations and preferences, so the two adjustments cannot be grouped together. Therefore, the negative adjustment (the decrease in capital gain) cannot offset the positive adjustment (the increase in ordinary income). Under the default rule, the partnership would pay tax on \$10 million of omitted ordinary income and omit \$10 million of capital gain that it recognizes (or report an additional \$10 million of capital losses) in the adjustment year.²⁵⁵

(4) Adjustments Made for Different Tax Years

If a partnership omits \$1 million of income in Year 1 and reports \$1 million too much income in Year 2, the partners would report the correct amount of income in total, but the income would be reported in the wrong year. Before the BBA, these partners might not have owed any additional tax, but they might have owed interest for the one-year period in which they had underpaid their taxes.²⁵⁶

Adjustments under the BBA are taken into account on an annual basis, however. Therefore, under the BBA's default rule, each tax year is treated separately, and an adjustment to an item from one year cannot offset an adjustment to an item from another year.²⁵⁷ As a result, the \$1 million negative ad-

²⁴⁸ The increase in miscellaneous itemized deductions might be allowed to offset a decrease in miscellaneous itemized deductions that have the same character and are subject to the same limitations, however.

²⁴⁹ §6225(b)(2); Reg. §301.6225-1(c)(2).

²⁵⁰ §6225(b)(2); Reg. §301.6225-1(c)(2).

²⁵¹ The partnership would therefore omit \$10 million of income it recognizes in the adjustment year that it otherwise would have allocated to Stella (or the partnership would allocate an additional \$10 million of losses to her for the adjustment year). She would therefore include \$10 million too much income in the reviewed year and \$10 million too little income (or \$10 million too much loss) in the adjustment year. Reg. §301.6225-3(b)(4). Under proposed regulations, the partnership would be required to specially allocate the imputed underpayment to Jonathan; the other partners would generally not be affected. Prop. Reg. §1.704-1(b)(2)(iii)(a), Prop. Reg. §1.704-1(b)(2)(iii)(f), Prop. Reg. §1.704-1(b)(4)(xii).

²⁵² Reg. §301.6225-1(c)(6).

²⁵³ Reg. §301.6225-1(b)(1), §301.6225-1(d)(2)(iii).

²⁵⁴ Reg. §301.6225-1(f), §301.6225-1(d)(2)(ii).

²⁵⁵ Reg. §301.6225-1(h) Ex. 4.

²⁵⁶ The partners might not owe any additional tax because the amount of tax they overpaid for Year 2 might offset the amount of tax they underpaid for Year 1. They would, however, owe underpayment interest with respect to the Year 1 underpayment for the first year in which there is an underpayment (the year that begins on the date the Year 1 tax returns were due). §6601. Then, starting on the date the Year 2 tax returns were due, the partners would owe underpayment interest on the Year 1 underpayment, and they would be entitled to overpayment interest on the Year 2 overpayment. §6611. To the extent that the amount of the underpayment equals the amount of the overpayment, the net interest rate would equal 0%. §6621(d). Therefore, if the underpayment equals the overpayment, the partners would generally owe one year of underpayment interest.

²⁵⁷ Reg. §301.6225-1(e)(2).

justment for Year 2 (the reduction in income) cannot offset the \$1 million positive adjustment for Year 1 (the increase in income) when calculating the imputed underpayment. The partnership would therefore have to pay tax on the \$1 million of income omitted from the Year 1 return. The adjustment to the Year 2 income would be taken into account under the true-up rule, so the partnership would omit \$1 million of the income it recognizes in the adjustment year (or report an additional \$1 million of loss for the adjustment year). In addition, the partnership would owe underpayment interest on the \$1 million of income that was omitted from its Year 1 return, but no overpayment interest would be provided with respect to the excess \$1 million of income reported in Year 2.²⁵⁸

d. The Subsume Rules

As the BBA addresses errors on a tax return or in the partnership's books and records on a line-by-line basis, adjustments may be duplicative.

Example: A partnership deducts \$100, but the IRS determines that this is a capitalizable expense. The IRS therefore makes two adjustments: it decreases the deduction by \$100, and it increases the partnership's basis in an asset by \$100. Both adjustments are positive adjustments, so the total netted partnership adjustment would generally be \$200. Therefore, the partnership would generally have to pay tax on \$200, even though the error only affected \$100 of income.

The two "subsume rules" of Reg. §301.6225-1(b)(4) mitigate this result. Under the first subsume rule, if the effect of one partnership adjustment is reflected in one or more other partnership adjustments, the IRS may treat one adjustment as zero when calculating the imputed underpayment. Therefore, in the example above, the IRS could treat either of the adjustments as zero, which would leave a total netted partnership adjustment of \$100 instead of \$200. This first subsume rule does not appear to apply in the context of an administrative adjustment request (AAR), for it does not give the partnership the authority to treat any adjustment as zero.²⁵⁹

Under the second subsume rule, 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 imputed underpayment unless the IRS determines otherwise. Unlike the first subsume rule, this second one applies in the context of an AAR. However, it only applies if both adjustments are positive. If one of the two adjustments is negative (e.g., if one adjustment increases a depreciation deduction and the other decreases basis), this second rule does not apply.

In both subsume rules, the IRS has the power to determine that an adjustment should be treated as zero. It is not clear how much discretion the IRS has.

Example: A partnership reports a \$100 recourse liability on its tax return. The IRS determines that the liability is a

nonrecourse liability and makes two adjustments: recourse liabilities are decreased by \$100, and nonrecourse liabilities are increased by \$100. Both adjustments are made to Non-Income Items, so both are positive. Under a subsume rule, the IRS determines that the adjustment to nonrecourse liabilities should be treated as zero for purposes of calculating the imputed underpayment, so the imputed underpayment is effectively a tax on \$100, not a tax on \$200.²⁶⁰ There is nothing in the regulations that requires the IRS to apply a subsume rule in this situation, however.

e. Treatment of the Imputed Underpayment

For tax purposes, an imputed underpayment constitutes a nondeductible and noncapitalizable expense of the partnership.²⁶¹ This might mean that the imputed underpayment is a tax liability of the partnership, not a tax liability of the partners. If it were the partners' tax liability, it would be treated as a deemed distribution or a loan to the partners, not as a nondeductible and noncapitalizable expense.²⁶² Some practitioners, however, are treating a partnership's payment of an imputed underpayment as a deemed distribution to the applicable partners (i.e., a payment of an expense of the partners) instead of as a partnership expense. While not technically correct, this approach may be simpler to implement and generally provide the correct results.

Treasury has proposed regulations that would require a partnership to specially allocate an imputed underpayment to the partners who should have included the omitted income (or the partners who included too much loss).²⁶³ These regulations would require a special allocation of the economic burden as well as the associated nondeductible and noncapitalizable expense that is allocated under §704.

The proposed regulations are proposed to take effect for partnership taxable years that begin after 2017, as well as any earlier tax years for which the partnership has elected to apply the BBA.²⁶⁴ Therefore, if the regulations are finalized in their current form, special allocations of the imputed underpayment will be mandatory and override any contrary provisions in a partnership agreement.

Note: Currently, the regulations are merely proposed, and proposed regulations cannot override the provisions of a partnership agreement that relate to distributions and tax allocations. Therefore, if a partnership would like to specially allocate an imputed underpayment (both the economic burden and the associated nondeductible and noncapitalizable expense that is allocated under §704), the partnership agreement should include provisions to this effect. A partnership may want to con-

²⁶⁰ See Reg. §301.6225-3(d)(4) Ex. 4.

²⁶¹ §6241(4); Reg. §301.6241-4(a) (treating the imputed underpayment as an expenditure described in §705(a)(2)(B)).

²⁶² The fact that the imputed underpayment is a reporting tax, not an income tax, also supports the characterization of the imputed underpayment as a tax that is imposed on a partnership.

²⁶³ Prop. Reg. §1.704-1(b)(2)(iii)(a), Prop. Reg. §1.704-1(b)(2)(iii)(f), Prop. Reg. §1.704-1(b)(2)(iv)(i)(4), Prop. Reg. §1.704-1(b)(4)(xii), REG-118067-17, 83 Fed. Reg. 4868 (Feb. 2, 2018). It is not clear how this special allocation should be made when it would result in a negative capital account balance.

²⁶⁴ Prop. Reg. §301.6225-4(f).

²⁵⁸ Interest is discussed further in V.B.9., below.

²⁵⁹ AARs are discussed further in chapter VI., below.

sider having such special allocations be made at the discretion of the manager or general partner. Some adjustments may be small and not worth the complexity that results from special allocations.

f. Associated Adjustments to Tax Attributes

Treasury has issued proposed regulations that address the treatment of tax attributes when there is an imputed underpayment under the BBA's default rule.²⁶⁵ Under these proposed regulations, all tax attributes for tax years that precede the adjustment year are determined by the amounts actually reported on the tax return, even though those amounts may not have been correct. Then, in the adjustment year, certain tax attributes (the "specified tax attributes") are modified to reflect the adjustment.²⁶⁶ These attribute adjustments do not have retroactive effect.²⁶⁷ No modification is made to attributes for prior tax years or to tax attributes that are not specified tax attributes.

The specified tax attributes are the tax basis and book value of the partnership's property, amounts determined under §704(c), and the adjustment-year partners' outside basis and capital accounts.²⁶⁸ Section 734(b) adjustments and §743(b) adjustments are not specified tax attributes, so they are determined by the amounts reported on the return and are not modified in the adjustment year.²⁶⁹

Specified tax attributes are adjusted in the manner that they would have been adjusted had the items on the original tax return been properly reported, but these changes are delayed so that they take effect in the adjustment year, not the reviewed year.²⁷⁰

Example: In Year 1, a partnership omits \$10 million of income that should have been allocated to Stella. As the partnership does not report that income, Stella's capital account and basis in her partnership interest are not increased by that \$10 million in Year 1. The IRS then audits the partnership and makes a positive adjustment to rectify this error. The adjustment year is Year 5. As a result of this adjustment, specified tax attributes such as capital accounts and basis are modified in Year 5 in the manner that they would have been modified in Year 1 had the partnership properly reported its Year 1 income. Therefore, Stella's capital account and basis are increased by \$10 million in Year 5. The specified tax attributes are therefore adjusted to reflect the correct amounts, but the adjustments are made in the adjustment year, not in the reviewed year.

Under these rules, no adjustment would be necessary (or allowed) for intervening years, even though the returns for those years may reflect the error from the reviewed-year return.

Example: In Year 1, a partnership pays \$10 million to acquire a machine and reports \$10 million of bonus depreciation.

The machine was not placed in service until Year 2, however, so the partnership should have reported \$10 million of bonus depreciation for Year 2, not Year 1. Therefore, if the BBA did not apply, two tax returns would be incorrect — the return for Year 1 and the return for Year 2.

Under the proposed regulations, if the IRS disallows the bonus depreciation reported for Year 1, the return for Year 2 would not be adjusted. The Year 1 return would be treated as if it were correct, so the \$10 million of bonus depreciation that was erroneously reported for Year 1 would reduce the basis in the machine by \$10 million in Year 1. As the basis in the machine would be \$0 in Year 2, no depreciation would be allowed in Year 2. The partnership's Year 2 return did not report any such depreciation, so that return would be treated as if it were correct.

This does not mean that \$10 million of basis disappears without producing any tax benefit, so long as the partnership continues to hold the machine in the adjustment year. Under the proposed regulations, that \$10 million of basis would be resurrected and added to the basis of the machine in the adjustment year.²⁷¹

The net result would be that the partnership deducts \$10 million in Year 1 and pays tax on \$10 million in the adjustment year (i.e., pays the imputed underpayment). In addition, the basis of the machine would be decreased by \$10 million in Year 1 and increased by \$10 million in the adjustment year. By reporting the bonus depreciation in Year 1, the partnership and partners would not lose the tax benefits that can result from the \$10 million of basis, but the benefits would be shifted from Year 2 to the adjustment year (or possibly a later year).

The result may be worse if the partnership does not own the machine in the adjustment year. The proposed regulations do not allow a partnership to adjust its basis in assets that it no longer holds in the adjustment year.²⁷² In addition, basis adjustments that should have been made to an asset that is no longer held cannot be reallocated to other assets.²⁷³ Therefore, if the partnership disposed of the machine before the adjustment year, the partnership would not be allowed to increase its basis in any asset by \$10 million in the adjustment year. The partners would nevertheless increase their basis in their partnership interests by \$10 million in the adjustment year, which may result in an inside-outside basis disparity.²⁷⁴

If a partner has transferred part or all of her partnership interest to another partner, or if a partner has received a liquidating distribution from the partnership, it is the specified tax attributes of the successor that are adjusted. These successor rules are discussed in V.B.3., below.

²⁶⁵ Prop. Reg. §301.6225-4.

²⁶⁶ Prop. Reg. §301.6225-4(a)(1).

²⁶⁷ Prop. Reg. §301.6225-4(a)(3).

²⁶⁸ Prop. Reg. §301.6225-4(a)(2).

²⁶⁹ For an example of how the BBA applies when a partner has §743(b) basis adjustments, see V.B.6.d., below.

²⁷⁰ Prop. Reg. §301.6225-4(b).

²⁷¹ This increase would not have retroactive effect, so the basis in Year 2 would continue to be \$0.

²⁷² Prop. Reg. §301.6225-4(b)(2).

²⁷³ Prop. Reg. §301.6225-4(b)(2).

²⁷⁴ Prop. Reg. §301.6225-4(b)(6)(iii).

2. *Adjustments that Do Not Result in an Imputed Underpayment*

Much attention is focused on the imputed underpayment, but it is also important to consider the treatment of adjustments that do not result in an imputed underpayment.

a. *Negative Adjustments and the True-Up Rule*

There are two ways in which a negative adjustment may be addressed under the default rule. One is discussed above: a negative adjustment will sometimes reduce an imputed underpayment by offsetting a positive adjustment. Otherwise, a negative adjustment is generally resolved under the true-up rule, which is provided in §6225(a)(2) and Reg. §301.6225-3.²⁷⁵

Under the true-up rule, a partnership takes into account an adjustment by making an offsetting “true-up adjustment” in the adjustment year.²⁷⁶

Example: A partnership reported \$1 million too much income for Year 1. The IRS reduces the partnership’s income for Year 1 by \$1 million and makes no other adjustments. The adjustment year is Year 3. Therefore, the partnership either omits \$1 million of its Year 3 income or it reports an additional \$1 million of losses in Year 3. As a result, the partnership reports \$1 million too much income for the reviewed year (Year 1) and \$1 million too little income for the adjustment year (Year 3).

The true-up rule is generally intended to reverse the error made on the return for the reviewed year, but it will not always put partners in the same position that they would have been in had the items been properly reported on the original tax returns.

(1) *Omitting Income Versus Reporting Additional Loss*

There are two possible approaches for making a true-up adjustment in the adjustment year: omitting income or reporting additional losses. It is not clear whether the partnership may choose which approach to adopt, or, if not, which of the two approaches must be applied when.

The two approaches might produce different results. For example, if the IRS determines that a partnership reported \$10 million too much income in the reviewed year, the partnership would make a true-up adjustment either by omitting \$10 million of its adjustment-year income, or by reporting \$10 million of additional losses in the adjustment year. The first approach (omitting income) is not beneficial unless the partnership recognizes at least \$10 million of income in the adjustment year; otherwise, it would not have \$10 million of income to omit. If instead the partnership could take the adjustment into account by reporting \$10 million of additional losses, it would not matter whether the partnership recognized \$10 million of income in the adjustment year.

(2) *Character of the True-Up Adjustment*

The character of the true-up adjustment (the income that will be omitted or the additional losses that will be reported in

the adjustment year) must match the character of the income (or loss) that was overreported (or underreported) in the reviewed year.²⁷⁷ For example, if the partnership reported too much long-term capital gain, it is long-term capital gain that is omitted (or additional long-term capital loss that is reported) in the adjustment year. If the partnership has no long-term capital gain in the adjustment year, the partners and the partnership might not benefit from the adjustment. Similarly, if the partnership reported too much dividend income and the error is rectified by omitting dividend income in the adjustment year, the adjustment might provide no benefit if the partnership has no dividend income in the adjustment year.

(3) *Allocation of the True-Up Adjustment to the Partners*

A partnership may want to allocate a true-up adjustment so that it benefits the partner who reported too much income (or too little loss) in the reviewed year.

Example: A partnership allocated \$10 million too much income to Stella in the reviewed year. The IRS makes an adjustment to correct this error, and this adjustment is taken into account under the true-up rule. Therefore, the partnership will omit \$10 million of its adjustment-year income or report an additional \$10 million of adjustment-year loss. If this true-up adjustment is not specially allocated to Stella (that is, if the income that is omitted is not income that otherwise would have been allocated to Stella, or the additional losses are not allocated to Stella), Stella will not be able to benefit from the adjustment until she can take advantage of the extra basis she would have in her partnership interest as a result of the erroneous allocation, which might not happen until she disposes of her partnership interest.²⁷⁸

There is one situation in which final regulations require a true-up adjustment to be specially allocated to the partner that had been allocated too much income (or too little loss): when the error in the reviewed year was a misallocation.²⁷⁹ Therefore, if the excess \$10 million of income that the partnership allocated to Stella in the above example should have instead been allocated to a different partner, the associated true-up adjustment must be specially allocated to Stella, not some other partner. It does not matter whether the partnership agreement provides otherwise.

Such special allocations of a true-up adjustment may become mandatory whenever the true-up rule applies, even if an adjustment does not involve a misallocation. Proposed regulations, if made final, would generally require true-up adjustments to be specially allocated to the partner or partners who were allocated too much income (or too little loss) in the reviewed year.²⁸⁰ At present, these regulations are only proposed and therefore cannot override the provisions of a partnership agreement. Therefore, the allocations provided in the partner-

²⁷⁵ Negative adjustments in the credit grouping are sometimes treated differently, however. See V.B.4., below.

²⁷⁶ §6225(a)(2); Reg. §301.6225-3.

²⁷⁷ Reg. §301.6225-3(b)(2).

²⁷⁸ The treatment of tax attributes such as outside basis is discussed in V.B.1.f. and V.B.2.a.(5), below.

²⁷⁹ Reg. §301.6225-3(b)(4).

²⁸⁰ Prop. Reg. §1.704-1(b)(4)(xiii).

ship agreement will determine how a true-up adjustment is allocated, so long as those allocations have substantial economic effect or are in accordance with the partners' interests in the partnership.²⁸¹

Example: A partnership allocated \$10 million too much income to Stella in Year 1. The IRS audits the partnership's return for Year 1 and corrects this error. The resulting true-up adjustment consists of an additional \$10 million of loss that the partnership may report in the adjustment year, which is Year 4. The partnership agreement for Year 4 provides that 7% of losses are to be allocated to Stella. Under the partnership agreement, Stella would be allocated only \$0.7 million of the true-up adjustment, even though she was the partner who had been allocated \$10 million too much income in the reviewed year. Moreover, the allocation of the true-up adjustment might have substantial economic effect because the allocation would affect capital account balances, which might in turn affect the amounts that the partners would receive in a liquidation.²⁸² A partnership may therefore want to consider including provisions in its partnership agreement that authorize special allocations of true-up adjustments.

(4) Amount of Tax that Is Overpaid Does Not Matter

The true-up rule (like the imputed underpayment calculation) rectifies errors made in the amounts of income or loss that are reported on a tax return. It does not take into account the extent to which the excess income or underreported loss affected the amount of tax paid by the partners. Therefore, the true-up rule will apply even when no tax was overpaid. For example, a partnership might allocate \$10 million too much capital gain to a partner that did not pay any tax on that gain as a result of its tax-exempt status. Under the true-up rule, the partnership would nevertheless omit \$10 million of income (or report an additional \$10 million of losses) in the adjustment year, regardless of whether the tax-exempt partner remained a partner in the partnership.

(5) Tax Attributes

Proposed regulations provide that under the true-up rule, all tax attributes are treated as if the partnership's returns are correct, both for the reviewed year and for the adjustment year.²⁸³

Example: A partnership allocates \$10 million too much income to Stella in Year 1. Therefore, Stella's capital account and basis in her partnership interest are increased by that \$10 million in Year 1. Then, in Year 5, the IRS adjusts the Year 1 income and the partnership takes the adjustment into account by omitting \$10 million of Year 5

income that it otherwise would have allocated to Stella. Stella's capital account and basis will reflect the Year 5 income that is actually allocated to her but will not be increased by the \$10 million of Year 5 income that is omitted to rectify the error from Year 1.

b. Adjustments to Non-Income Items that Do Not Result in an Imputed Underpayment

Adjustments to Non-Income Items are generally per se positive adjustments that cannot be offset by negative adjustments to Income Items, so they often result in an imputed underpayment.²⁸⁴ However, there are situations where an adjustment to a Non-Income Item does not result in an imputed underpayment. For example, it is possible that the adjustment will be offset by a negative adjustment to a credit, with no imputed underpayment resulting.²⁸⁵

If a Non-Income Item is adjusted and the adjustment does not result in an imputed underpayment, the partnership takes the adjustment into account by adjusting the item on its adjustment-year return, but only to the extent the item would appear on the adjustment-year return without regard to the adjustment.²⁸⁶ However, if the item is already reflected on the partnership's return for the adjustment year or any year between the reviewed year and the adjustment year, a partnership would not create a new item in the amount of the adjustment on the partnership's adjustment-year return. The relationship between these rules and the proposed regulations regarding attribute adjustments is not clear.²⁸⁷

3. Successor Rules

Although the default rule often treats the partnership as an entity, proposed regulations would require items relating to adjustments to be specially allocated to particular partners so that the adjustment will affect the partner that included the wrong amount of income or loss but will generally not affect the other partners.²⁸⁸

a. In General

When a partner has been allocated too little income (or too much loss), that partner would be specially allocated the imputed underpayment that the partnership pays, and it is that partner's outside basis and capital account balance that would be adjusted to reflect the additional amount of income (or decreased amount of loss) that is taken into account. Similarly, when a partner has been allocated too much income (or too little loss), that partner would be specially allocated the resulting true-up adjustment, so that partner would be the person who omits income (or reports additional loss) in the adjustment year. Partners that are allocated the correct amount of income or loss

²⁸¹ Reg. §1.704-1(b)(2)(i). Treasury and IRS might take the position that allocations of true-up adjustments cannot have substantial economic effect. Prop. Reg. §1.704-1(b)(4)(xiii).

²⁸² Treasury and IRS might, however, take the position that allocations of true-up adjustments cannot have substantial economic effect. Prop. Reg. §1.704-1(b)(4)(xiii).

²⁸³ Prop. Reg. §301.6225-4(d), REG-118067-17, 83 Fed. Reg. 4868 (Feb. 2, 2018).

²⁸⁴ Special rules apply to adjustments to credits, to an imputed underpayment or to a partnership-level tax, penalty, or interest under chapter 1. See V.B.4 and V.B.5., below.

²⁸⁵ Reg. §301.6225-3(d)(3) Ex. 3.

²⁸⁶ Reg. §301.6225-3(b)(8).

²⁸⁷ Cf. Prop. Reg. §301.6225-4, discussed above.

²⁸⁸ Prop. Reg. §1.704-1(b)(1)(viii), Prop. Reg. §1.704-1(b)(2)(iii)(a), Prop. Reg. §1.704-1(b)(2)(iii)(f), Prop. Reg. §1.704-1(b)(2)(iv)(i)(4), Prop. Reg. §1.704-1(b)(4)(xi)–§1.704-1(b)(4)(xv).

will generally not be affected by the adjustments if the proposed regulations are finalized.

These special allocations of the imputed underpayment, tax attribute adjustments, and true-up adjustments are generally not affected by changes in the partners' interests in the partnership.²⁸⁹

Example: A partnership omitted \$100 million of income from its Year 1 return and therefore must pay an imputed underpayment equal to \$100 million multiplied by the applicable tax rate. Stella held a 7% interest in the partnership in Year 1 and therefore should have been allocated 7% of all income or losses recognized by the partnership in that year. As a result, the partnership would allocate 7% of the imputed underpayment to Stella. In addition, Stella's capital account would be increased by \$7 million, and her basis in her partnership interest would also be increased by \$7 million, even if her interest in the adjustment year was more or less than 7%.

There are two situations where the allocations would be affected by a change in the reviewed-year partner's (Stella's) interest in the partnership. First, if the partner transferred part or all of her partnership interest to a transferee partner, the transferee partner would be a successor to the reviewed-year partner and therefore would be allocated a corresponding share of the imputed underpayment, tax attribute adjustments, or true-up adjustments that otherwise would have been allocated to the reviewed-year partner (Stella).²⁹⁰ Second, if the reviewed-year partner (Stella) received a liquidating distribution from the partnership and was therefore no longer a partner, the adjustment-year partners would be her successors and step into her shoes for purposes of these allocations and attribute adjustments.²⁹¹

Therefore, the reviewed-year partner's allocations are not affected if her interest is decreased by distributions (other than a liquidating distribution) or by contributions made by other partners, increased by her own contributions, or modified to reflect the value of the services she provided. But her allocations would be affected if she transfers part of her partnership interest, if she is no longer a partner, or if she becomes a successor to another partner's interest.

b. Anti-Abuse Rules for Adjustments to Outside Basis

As discussed in V.B.1.f., above, proposed regulations provide that when an adjustment is taken into account in the imputed underpayment calculation, a partner's basis in its partnership interest is a specified tax attribute that is modified in the adjustment year to reflect the adjustment. The partner whose

basis is adjusted is the partner that should have been allocated the additional income (or that was allocated too much loss).²⁹² For example, if a partnership omitted \$10 million of income that should have been allocated to Stella in the reviewed year, Stella's basis would be increased by \$10 million when the partnership pays tax on the \$10 million adjustment in the adjustment year.

When a partner has transferred part or all of its partnership interest, or when the partner's interest in the partnership has been liquidated, these adjustments to outside basis are generally made with respect to the successor. However, there are two anti-abuse rules under which basis adjustments are not made with respect to a successor.²⁹³

First, a successor's basis is not adjusted when the successor is a taxable person (not a tax exempt person), the predecessor partner was tax-exempt, and the partnership did not pay an imputed underpayment because it availed itself of the predecessor's tax-exempt status pursuant to the modification procedures.²⁹⁴

Second, a successor's basis is not adjusted when the successor is related to its predecessor, the successor acquired the partnership interest from the predecessor in a transaction (or series of transactions) in which not all gain or loss was recognized, these transactions occurred when the reviewed year was under audit, and a principal purpose of the transaction (or transactions) was to shift the economic burden of the imputed underpayment to a related party.²⁹⁵

4. Tax Credit Items

Special rules apply when an adjustment is made to a credit. An increase to a credit is a negative adjustment, and a decrease is a positive adjustment.²⁹⁶ Under the grouping rules, adjustments to credits are put in a separate credit grouping.²⁹⁷ If the net adjustment to credits is positive, the imputed underpayment is increased by that net amount.²⁹⁸

If instead the net adjustment in the credit grouping is negative, that net adjustment is generally treated as an adjustment that "does not result in an imputed underpayment" for purposes of Reg. §301.6225-1(f).²⁹⁹ In that case, the true-up rule generally applies, so the net negative adjustment would be treated as a credit that is reported in the adjustment year.³⁰⁰ However, the IRS has discretion to instead use the adjustment to reduce an imputed underpayment that might otherwise be owed.³⁰¹

5. Items of Partnership Tax, Penalties, Interest, and Imputed Underpayment

Special rules apply when there is an adjustment to a partnership's item of tax, penalty, addition to tax, other liability under Chapter 1, or an imputed underpayment — i.e., amounts

²⁸⁹ Prop. Reg. §1.704-1(b)(1)(viii), Prop. Reg. §1.704-1(b)(2)(iii)(a), Prop. Reg. §1.704-1(b)(2)(iii)(f), Prop. Reg. §1.704-1(b)(2)(iv)(i)(4), Prop. Reg. §1.704-1(b)(4)(xi)–§1.704-1(b)(4)(xv).

²⁹⁰ Prop. Reg. §1.704-1(b)(1)(viii)(b)(2). If part or all of her interest is transferred but the partnership cannot determine who the transferee partner is after exercising reasonable diligence, the successors will include each partner in the adjustment year other than: (i) those who were partners in the reviewed year and (ii) those who are identifiable as the transferee of a different partnership interest. Prop. Reg. §1.704-1(b)(1)(viii)(b)(3).

²⁹¹ Prop. Reg. §1.704-1(b)(1)(viii)(b)(4).

²⁹² Prop. Reg. §1.704-1(b)(4)(xi), Prop. Reg. §301.6225-4(b).

²⁹³ Prop. Reg. §301.6225-4(b)(6)(iii)(B).

²⁹⁴ Prop. Reg. §301.6225-4(b)(6)(iii)(B)(1).

²⁹⁵ Prop. Reg. §301.6225-4(b)(6)(iii)(B)(2).

²⁹⁶ Reg. §301.6225-1(d)(2).

²⁹⁷ Reg. §301.6225-1(c)(3).

²⁹⁸ Reg. §301.6225-1(b)(1)(v)(A), §301.6225-1(e)(3)(ii).

²⁹⁹ Reg. §301.6225-1(e)(3)(ii).

³⁰⁰ Reg. §301.6225-1(f), §301.6225-3(b)(3).

³⁰¹ Reg. §301.6225-1(b)(1)(v)(B), §301.6225-1(e)(3)(ii).

for which the partnership has primary liability (partnership tax items).³⁰² If the adjustment to a partnership tax item decreases the amount owed by the partnership, the adjustment is a negative adjustment.³⁰³ Otherwise it is a positive adjustment.

Adjustments to partnership tax items are generally treated as adjustments to tax credits. They are included in the credit grouping, and if the net adjustment in that grouping is positive, that positive amount is added to the imputed underpayment.³⁰⁴ However, adjustments to partnership tax items are not treated like adjustments to credits when the net adjustment in the credit group is negative due to a net negative adjustment to partnership tax items. When there is a net negative adjustment to credits but no adjustments to any partnership tax items, that net negative adjustment generally is reported as a credit on the partnership's adjustment-year return, unless the IRS allows the net negative adjustment to reduce the imputed underpayment due.

In contrast, if there is a net negative adjustment to partnership tax items, and that net negative adjustment causes the net adjustment in the credit grouping to be zero or less than zero, the imputed underpayment is recalculated without taking into account the net negative adjustment to partnership tax items.³⁰⁵ That recalculated imputed underpayment may be offset by the net negative adjustment to partnership tax items. Any excess net negative adjustments to partnership tax items may reduce other amounts that the partnership might owe.³⁰⁶ For example, if the partnership had previously paid an imputed underpayment, the partnership might be able to apply the excess net negative adjustments against that payment and file a refund claim. Or if the partnership owes an imputed underpayment that it has not yet paid, it may use the excess net negative adjustments to offset that liability.³⁰⁷ The excess net negative adjustments are not taken into account under the true-up rule, however.³⁰⁸

6. Default Rule Examples

a. Disguised Sales

When a partner transfers property with built-in gain to a partnership, the partner and the partnership might take the position that the transfer is a tax-free contribution under §721. This position would be reflected on many lines on the partnership's tax return and books and records.

Example: In Year 1, Stella transfers property with \$2 million of basis and \$10 million of value to a partnership, and

the partnership transfers \$10 million of cash to Stella. Stella and the partnership take the position that these transfers are nonrecognition events under §721 and §731. Therefore, (1) Section L of Stella's Schedule K-1 reports a contribution of \$10 million; (2) Section M of Stella's Schedule K-1 and the associated statement report a contribution of property with \$8 million of built-in gain; (3) Section N of Stella's Schedule K-1 reports a \$8 million increase in Stella's share of net unrecognized §704(c) gain; and (4) the partnership's books and records provide that the partnership's basis in the property is \$2 million.³⁰⁹

Each of these items might be a PRI that could be adjusted if the IRS recharacterizes the transfer as a disguised sale in which Stella recognized \$8 million of gain under §707(a) (2). In that case, there would be four adjustments — one for \$10 million and three for \$8 million. As all of these items are Non-Income Items that are non-credit items, all four adjustments would be positive adjustments. This would result in a \$34 million total netted partnership adjustment that could be taxed. Under the subsume rules, three of these adjustments might be treated as \$0, in which case the imputed underpayment would be a tax on only \$10 million of adjustment. (Note, however, that Stella underreported only \$8 million of gain.) If the applicable tax rate is 37%, the imputed underpayment would then be \$3.7 million.

If proposed regulations are finalized, the partnership would be required to allocate the \$3.7 million economic burden and the associated \$3.7 million nondeductible and noncapitalizable expense to Stella. The economic allocation would reduce the value of Stella's partnership interest by \$3.7 million. If Stella's partnership interest is worth at least \$3.7 million, the other partners would generally not be affected. In the absence of final regulations, the economic and tax allocation of this imputed underpayment would be made pursuant to the terms of the partnership agreement so long as the tax allocations are respected under the §704 regulations.

However, the economic burden would not necessarily be borne by the person who is allocated the imputed underpayment; the partners may enter into contracts that shift this burden. For example, the transfer of the property in Year 1 might be pursuant to a contribution agreement that requires Stella to indemnify the partnership for any imputed underpayment that results from the transfer.

Under proposed regulations, the specified tax attributes would also be adjusted, but not until the adjustment year. Therefore, if the adjustment year is Year 5, no tax attributes would be adjusted for Years 2–4. For those intervening years, the partnership would be treated as having \$2 million of basis in the property, and Stella's basis would be increased by the \$2 million of basis she had in the property and decreased by the \$10 million of cash distributed (assuming that this does not cause her basis to be less than

³⁰² Examples include the penalty that applies to Opportunity Zone funds under §1400Z-2(f) and liabilities of a real estate mortgage investment conduit under §860F or §860G.

³⁰³ Reg. §301.6225-1(d)(2)(ii).

³⁰⁴ Reg. §301.6225-1(c)(3), §301.6225-1(e)(3)(ii), §301.6225-1(b)(1)(v).

³⁰⁵ Reg. §301.6225-1(f)(2), §301.6225-1(f)(3)(ii)(A).

³⁰⁶ Reg. §301.6225-1(f)(3)(ii)(B), §301.6225-1(f)(3)(ii)(C), Reg. §301.6225-1(h)(13) Ex. 13, Reg. §301.6225-1(h)(14) Ex. 14.

³⁰⁷ REG-123652-18, 85 Fed. Reg. 7940 (Nov. 24, 2020) (Preamble to Prop. Reg. §301.6225-1) ("the partnership may be able to recoup that amount to offset a prior payment. For instance, if the adjustment related to an amount previously paid by the partnership, the partnership may file a claim for refund of the amount in accordance with §6511. Alternatively, if the amount has not been previously paid by the partnership, the remaining net negative adjustment to a chapter 1 liability will reduce the amount of chapter 1 tax, penalty, additional amount, addition to tax, or imputed underpayment owed by the partnership.")

³⁰⁸ Reg. §301.6225-1(f)(3)(i).

³⁰⁹ Disclosure might also be required under Reg. §1.707-8. The characterization of the transaction might also affect the partnership's income or loss if the property is depreciable or is sold by the partnership.

\$0).³¹⁰ This should accord with the positions that Stella and the partnership presumably took on their returns for the intervening years, so those returns would not require adjustment.

Specified tax attributes would be adjusted in Year 5. It appears that this is done in a manner that reflects the amounts that would have resulted had the transaction been properly reported on Stella's and the partnership's original tax returns.³¹¹ Therefore, in Year 5, the partnership would increase its basis in the asset by \$8 million, and the property would no longer be treated as property that was contributed with built-in gain. In addition, Stella would increase her basis in her partnership interest by \$8 million. Stella's capital account balance would also be adjusted but there would not be any adjustment to make, for her capital account balance would not be affected by the recharacterization of the transactions.

Can the IRS also require Stella to pay tax on the gain she recognized in the disguised sale, in a separate partner-level proceeding? Any additional tax owed by Stella would be a tax attributable to an adjustment to a PRI, so any additional tax owed by Stella is governed by the BBA and would not be handled in a separate partner-level proceeding.³¹² Yet under the BBA default rule, no tax is paid on that gain. Under the default rule, the partners do not pay any additional tax. No tax is paid by the partnership, either, for the gain does not appear to be a PRI,³¹³ and adjustments to non-PRIs do not affect the imputed underpayment.

b. Section 751(a) and the Sale of a Partnership Interest

Gain or loss from the sale of a partnership interest is generally capital, not ordinary, under §741. However, when the partnership has so-called "hot assets" (generally, assets that produce ordinary income), §751(a) requires the seller to recognize her share of the ordinary income or loss that would result if the partnership had sold all of its assets. Then the seller's capital gain or loss from the sale is computed so that the total amount of income, gain, and loss that is included (capital and ordinary) equals the total gain or loss recognized in the sale. Therefore, if the IRS increases the ordinary income recognized by the seller under §751(a), the capital gain should be decreased (or capital loss increased). Under the default rule, the increase to ordinary income is taxed because it is included in the calculation of the imputed underpayment, but no benefit is provided to the partnership, the selling partner, or any other partner to reflect the reduction to capital gain.

Example: Stella sells her partnership interest to Bill and recognizes \$10 million of gain in the sale. The partnership

determines that Stella recognized \$1 million of ordinary income under §751(a) and reports this amount on Stella's Schedule K-1 (Form 1065).³¹⁴ Stella files her return in a manner that is consistent with the information she receives from the partnership, so she reports \$1 million of ordinary income and \$9 million of capital gain from the sale.

The IRS audits the partnership and increases the ordinary income that Stella should have reported from the sale by \$3 million. This is a positive adjustment to a PRI, so under the default rule the partnership would be required to pay tax (the imputed underpayment) on the \$3 million adjustment. Under the proposed successor rules,³¹⁵ the partnership would allocate this tax payment to the person who bought Stella's partnership interest, so Bill would bear the economic burden of this tax.³¹⁶

When the ordinary income recognized under §751(a) is increased by \$3 million, the amount of capital gain recognized should be decreased by \$3 million. The amount of capital gain is not itself a PRI, but any adjustment to the tax owed on that gain would be attributable to the adjustment to ordinary income (a PRI). Therefore, the amount of capital gain is a non-PRI that is within the scope of the BBA and is not addressed in a separate partner-level proceeding. This means that Stella cannot file a claim for refund for the "excess" tax she paid on \$3 million of capital gain. Under the BBA default rule, no taxpayer benefits from the capital gain adjustment. It does not reduce the imputed underpayment, and it is not taken into account under the true-up rule. The net effect is that \$3 million is taxed at the highest rate applicable to an individual or corporation, when the adjustment is fundamentally a change to the character of \$3 million of income.

c. Partnership Omits Income Before Sale of Partnership Interest

When a partner sells her partnership interest and the IRS subsequently increases the amount of income (or decreases the amount of loss) that should have been allocated to that partner before the sale, the correct amount of income will ultimately be taken into account as taxable income, but the default rule may produce this result by taxing too much income in the adjustment year and then taxing too little income in a later year. In addition, when evaluating whether the seller should be required to indemnify the partnership for an imputed underpayment, adjustments to outside basis should be taken into account. Otherwise the seller may effectively pay tax twice with respect to the omitted income (or excess losses).

Example: At the beginning of Year 1, Stella is granted a profits interest in a partnership. This partnership interest has a value of \$0 and a basis of \$0. Then, in Year 1, the

³¹⁰ The transactions would have no net effect on Stella's capital account, for they would increase her capital account balance by \$10 million and decrease the balance by \$10 million.

³¹¹ Prop. Reg. §301.6225-4(b)(4)(ii), Prop. Reg. §301.6225-4(e) Ex. 5.

³¹² §6221(a); Reg. §301.6221(a)-1(a), discussed in II.B.3., above.

³¹³ Reg. §301.6241-1(a)(6)(ii), §301.6241-1(a)(6)(iii), discussed in II.B.1. and II.B.2., above.

³¹⁴ For the 2025 tax year, for example, the information is reported on Schedule K-1 Box 20 using code AB. See Partner's Instructions for Schedule K-1 (Form 1065); Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, or statement as described in Reg. §1.6050K-1(c)(1)(i) as amended by TD 10048, 91 Fed. Reg. 29,362 (May 20, 2026).

³¹⁵ See V.B.3., below.

³¹⁶ Prop. Reg. §1.704-1(b)(2)(iii)(f)(4), Prop. Reg. §301.6225-4(c).

partnership recognizes \$10 million of income that should be allocated to Stella, but it omits this income from its return. That income increases the value of Stella's partnership interest by \$10 million. In Year 2, Stella sells her partnership interest to Bill for \$10 million. Stella therefore reports \$10 million of gain on her Year 2 return. The IRS subsequently audits the partnership and increases the Year 1 income that should have been allocated to Stella in Year 1 by \$10 million. The adjustment year is Year 5.

Stella paid tax on \$10 million of income. This is the correct amount of income that should have been taxed, for there was \$10 million of economic income. The mistake was that she paid tax on the gain from the sale in Year 2 instead of her \$10 million share of the partnership's income from Year 1. If she had reported her \$10 million share of partnership income, she would not have reported any gain from the sale of her partnership interest.

When the IRS adjusts the Year 1 income, the partnership must pay tax on a \$10 million adjustment, notwithstanding that Stella had already effectively paid tax on that income. Therefore, if Stella is required to indemnify the partnership for the imputed underpayment, she would pay tax on the \$10 million adjustment and pay tax on her gain from the sale of her partnership interest, even though there was only \$10 million of economic gain. Moreover, her gain from the sale would not be reduced by \$10 million as a result of the adjustment. Under proposed regulations, outside basis is increased to reflect the additional \$10 million of income, but it is Bill's outside basis that is increased, not Stella's. Stella would therefore pay tax on too much income if she is required to indemnify the partnership.

For example, if the applicable tax rate for the imputed underpayment is 37%, the partnership would pay \$3.7 million of tax with respect to the \$10 million of income it omitted. Under the proposed attribute adjustment regulations, this payment would result in a \$10 million increase and a \$3.7 million decrease in the partners' outside basis, but these adjustments would be made to Bill's outside basis, not Stella's. These adjustments would therefore not affect the gain Stella recognized in the sale of her partnership interest. Therefore, if Stella indemnifies the partnership for the \$3.7 million imputed underpayment, she would be paying the tax on the partnership's \$10 million of income. She would also pay tax on the gain from the sale of her partnership interest. The amount of this gain would equal \$6.3 million (\$10 million minus \$3.7 million) if she may treat the \$3.7 million indemnity that she pays as a loss from the sale of her partnership interest under *Arrowsmith*.³¹⁷ In total, she would pay tax on \$16.3 million of income, even though there was only \$10 million of economic income.³¹⁸

The adjustment and indemnity, however, would provide Bill with a built-in loss of \$6.3 million (or \$6.3 million less built-in gain). Bill is the successor to Stella, so when the partnership pays the imputed underpayment in Year 5, Bill's outside basis would be increased by the \$10 million of Year 1 income that is being taxed in Year 5, and would be decreased by the \$3.7 million paid by the partnership. Bill's outside basis would therefore be increased by \$6.3 million, but due to Stella's indemnity, the value of the partnership interest would not be affected.

In sum, Stella may pay tax on \$6.3 million too much income but Bill would obtain a \$6.3 million built-in loss or \$6.3 million less built-in gain. Too much income would be subject to tax until Bill recognizes that \$6.3 million built-in loss (or decreased amount of built-in gain); e.g., on the sale of his partnership interest.

If Stella does not indemnify the partnership, she would pay tax on \$10 million of gain from the sale of her partnership interest and the partnership would pay tax on the \$10 million of income that it omitted. A total of \$20 million of income would therefore be taxed. Bill's basis in his partnership interest would be increased by \$10 million to reflect that \$10 million of partnership income was taxed, and it would be decreased by the \$3.7 million imputed underpayment. The imputed underpayment would also decrease the value of Bill's partnership interest by \$3.7 million. The net effect for Bill would therefore be a \$3.7 million economic loss and a \$10 million built-in loss (or less built-in gain) in his partnership interest.³¹⁹

Therefore, no matter whether Stella indemnifies the partnership, the IRS will generally collect too much tax when the audit is resolved, and Bill will obtain a built-in loss (or less built-in gain) in his partnership interest.

Partners other than Stella and Bill would generally be unaffected by the adjustment. They would not be allocated the imputed underpayment, and their tax attributes would not be adjusted.

d. Section 743(b) Adjustments

As illustrated in the prior example, when a partnership omits income (or overreports its losses) and a partner sells its partnership interest before the partnership's income (or loss) is adjusted, too much income will generally be taxed when the adjustment is made and the buyer will obtain a built-in loss (or less built-in gain) in its partnership interest.

The buyer might not be able to obtain an immediate benefit from that built-in loss (or reduced built-in gain), but the buyer will be able to retain the benefit of any §743(b) adjustments that were calculated at the time of sale, even if those §743(b)

³¹⁷ See *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

³¹⁸ If the \$3.7 million indemnity payment cannot be treated as a loss from the sale of the partnership interest under *Arrowsmith*, Stella would recognize \$10 million of gain on the sale of her partnership interest and pay tax on \$20 million of income.

³¹⁹ The partnership's payment of the imputed underpayment would reduce the value of Bill's partnership interest by \$3.7 million and also reduce his basis in his partnership interest. Therefore, that would result in an economic loss but not change the built-in gain or loss in the partnership interest. In addition, his outside basis would be increased by \$10 million to reflect the fact that an additional \$10 million of partnership income had been taxed. There would not be a corresponding increase to the value of the partnership interest, so that would result in \$10 million of built-in loss (or \$10 million less built-in gain) in the partnership interest.

adjustments are inconsistent with the adjustment that the IRS makes to the partnership's income in the reviewed year. Under proposed regulations, only "specified tax attributes" are adjusted to reflect an adjustment that is taken into account under the default rule, and §743(b) adjustments are not specified tax attributes.³²⁰

Example: Stella contributes \$10 million to a partnership in Year 1 in exchange for a partnership interest. The partnership uses the \$10 million contributed by Stella to purchase a machine, and in Year 1 the partnership reports \$10 million of bonus depreciation with respect to the machine, all of which is allocated to Stella. The partnership should not have reported this depreciation in Year 1, however, because it did not place the machine in service until Year 2.

At the beginning of Year 2, Stella sells her partnership interest to Bill for \$10 million because the value of the partnership's assets (the machine) did not change. Stella accordingly reports \$10 million of gain from the sale. The partnership has a §754 election in effect, so Bill obtains a §743(b) adjustment of \$10 million with respect to the machine. The IRS disallows the bonus depreciation for Year 1, and the adjustment year is Year 5. Under the default rule, the partnership must pay an imputed underpayment (i.e., the partnership must pay tax on \$10 million of income).

At that point, Stella would have deducted \$10 million of depreciation and paid tax on \$10 million of gain from the sale of her partnership interest.³²¹ In addition, the partnership would pay tax on \$10 million of income as a result of the adjustment. A total of \$10 million of income would have been taxed even though there was no economic income or loss.

It may seem appropriate for Bill to lose the benefit of his §743(b) adjustment, for he would not have had a §743(b) adjustment had the partnership properly reported its depreciation. However, under the proposed regulations, his \$10 million of basis adjustment under §743(b) would not be affected because it is not a specified tax attribute. Therefore, Bill may retain the tax benefits from that §743(b) adjustment, regardless of whether those tax benefits are realized before the adjustment year. Any depreciation of the §743(b) basis adjustment before Year 5 would be respected, and any remaining amount of the §743(b) basis adjustment would be available to be depreciated or taken into account when the machine is sold.

This result is reasonable. In the adjustment year, too much income has been taxed: there was no economic income (or loss), but a total of \$10 million of income has been taxed. This is generally not rectified until Bill can take advantage of the additional \$10 million of basis he receives in his partnership interest as a result of the adjustment the IRS makes to the partnership's Year 1 depreciation.³²² Or-

dinarily Bill would not be able to benefit from that additional basis until he disposes of his partnership interest in a taxable transaction. By retaining his §743(b) adjustment, however, Bill will effectively be able to benefit from his additional outside basis without having to dispose of his partnership interest. For example, when the §743(b) adjustment is depreciated, it will reduce his outside basis by \$10 million and thereby eliminate the extra \$10 million that was added to his basis in his partnership interest as a result of the adjustment. Bill would therefore have a depreciable §743(b) adjustment of \$10 million instead of a \$10 million built-in loss (or reduced built-in gain) in his partnership interest.

The partnership would also increase its basis in the machine by \$10 million in Year 5. The net result would be as follows:

- The partnership pays tax on \$10 million of income and in Year 5 holds a machine with a basis of \$10 million.
- Stella reports \$0 of net income or loss. This consists of \$10 million of depreciation and \$10 million of ordinary income from the sale of her partnership interest.
- Bill reports \$10 million of deductions or loss (or reduced gain), either from his §743(b) adjustment or from the \$10 million of additional basis he has in his partnership interest. Bill would also be allocated the imputed underpayment paid by the partnership.

e. Partnership Reports Too Much Income

When a partner sells a partnership interest and the IRS then determines that the partner had been allocated too much income (or too little loss) from the partnership, the selling partner will not be entitled to a refund under the default rule, but the partner should nevertheless include the correct amount of income or loss when all of the partner's tax items are taken into account. In addition, the buyer may be entitled to what might be viewed as a windfall, for the true-up adjustment will enable the buyer to defer the recognition of income or gain.

Example: At the beginning of Year 1, Stella is granted a profits interest in a partnership with \$0 basis and \$0 value. In Year 1, the partnership erroneously allocates \$1 million of income to Stella. In Year 2, Stella sells her partnership interest to Bill for \$0 because the partnership interest had no value. She reports a \$1 million loss from the sale because she included \$1 million of Year 1 income in her basis when calculating her gain or loss from the sale. The IRS audits the partnership and reduces the income the partnership allocated to Stella in Year 1 by \$1 million. The adjustment year is Year 5.

Stella would not be affected by the adjustment. For example, she would not be entitled to a refund of the excess amount of tax she paid for Year 1. She would have nevertheless included the correct amount of income when she takes into account the loss from the sale of her partnership interest. If the Year 1 return had allocated the correct

³²⁰ Prop. Reg. §301.6225-4(a)(2), REG-118067-17, 83 Fed. Reg. 4868 (Feb. 2, 2018).

³²¹ The gain would be ordinary under the recapture rules.

³²² Bill's basis in its partnership interest would not be increased, however, if an anti-abuse rule applied. See V.B.3.b., below.

amount of income to her (\$0), she would have reported \$0 income from the partnership in Year 1 and \$0 of gain or loss in the Year 2 sale of her partnership interest, for a total of \$0 gain or loss. Due to the error, she reported \$1 million of partnership income in Year 1 and a \$1 million loss in Year 2 from the sale of her partnership interest, resulting in a total of \$0 gain or loss. The total amount of income reported by Stella would therefore be correct (i.e., \$0), but Stella might nevertheless be affected by the error. The Year 1 income and Year 2 loss would not be taken into account in the same year, and they might not have the same character.

Bill, on the other hand, would be affected by the adjustment. Under the true-up rule, the partnership would omit \$1 million of income (or report an additional \$1 million of loss) in the adjustment year. If Stella were still a partner in Year 5, this adjustment to income or loss would be made to the income or loss that is allocated to her. Stella, however, is no longer a partner in Year 5. Under the successor rules, Bill is her successor, so the true-up adjustment would be made with respect to Bill. The partnership would either omit \$1 million of Year 5 income that it would have otherwise allocated to Bill or allocate an additional \$1 million of loss in Year 5 to Bill.

If the true-up adjustment is an omission of taxable income, Bill would receive the economic benefit of \$1 million of partnership income without having to pay tax on that income, but he would not receive a corresponding \$1 million increase in the basis of his partnership interest.³²³ The adjustment would therefore result in \$1 million of economic gain that is not taxed until Bill sells his partnership interest or otherwise takes his basis in his partnership interest into account. Bill would therefore defer \$1 million of income that he would have ordinarily had to take into account in Year 5.³²⁴

7. Ceasing to Exist

There are three ways in which the IRS may force the partners of a partnership to take BBA adjustments into account and pay any additional tax or other amounts that are due. One is under the special enforcement regulations, discussed in II.C., above. The others are the “cease-to-exist” rules under §6241(7) and the “failure-to-pay” rules under §6232(f). These two sets of rules differ in which partners are liable and in how their liability is calculated. When a partnership terminates, the partners will generally not know which set of rules will apply.

The cease-to-exist rules of §6241(7) apply when a partnership has “ceased to exist” before adjustments “take effect.” Under these rules, the partnership will no longer be liable for an imputed underpayment or associated amounts.³²⁵ Instead, the

³²³ The omitted income does not appear to be treated as tax-exempt income under §705(a)(1)(B). Bill’s capital account would not be increased by the \$1 million of Year 5 income that is omitted, but Bill would have stepped into the shoes of Stella’s capital account balance, and Stella’s capital account would have reflected the \$1 million of excess income she was allocated in Year 1.

³²⁴ A true-up adjustment that is an allocation of excess loss should produce a similar result, although losses may be suspended under provisions such as §465, §469, and §704(d).

“former partners” must take the adjustment into account and pay any additional amounts due.³²⁶ All of these terms have special definitions under the BBA.

a. When an Adjustment Takes Effect

The cease-to-exist rules of §6241(7) apply when a partnership ceases to exist before the adjustments “take effect.” An adjustment takes effect (1) when the adjustment becomes finally determined (as described in Reg. §301.6226-2(b)(1)); (2) when the partnership and the IRS enter into a settlement agreement regarding the adjustment; or (3) for adjustments requested on an AAR, when the AAR is filed.³²⁷ Under Reg. §301.6226-2(b)(1), an adjustment is finally determined 90 days after the date on which a notice of final partnership adjustment (FPA) is mailed or, if judicial review is sought in Tax Court, the Court of Federal Claims, or federal district court, the date on which the court’s decision becomes final.

Therefore, an adjustment “takes effect” very early in the proceeding. If the adjustments take effect after a partnership has ceased to exist, the cease-to-exist rules of Section 6241(7) will not apply, but the “failure-to-pay” rules may apply.³²⁸

b. What Constitutes Ceasing to Exist

“Ceasing to exist” is a term that the BBA introduced into the Tax Code; it is not the same as a termination for tax purposes or a dissolution under state law, and a partnership does not automatically cease to exist when it terminates or dissolves.

A partnership does not cease to exist unless the IRS determines that the partnership has ceased to exist.³²⁹

The IRS may make this determination in two situations: (1) when the partnership is unable to pay the amount it may owe under the BBA, or (2) when the partnership has terminated for tax purposes under §708(b)(1).³³⁰ For example, one person might have acquired all of the interests in the partnership or the partnership might have wound up its affairs. The IRS is not, however, required to make this determination, and if it does not make this determination, the partnership will not cease to exist for purposes of the BBA, even if the partnership has terminated under §708(b)(1).³³¹

The determination that a partnership has ceased to exist may have retroactive effect. If the partnership has terminated under §708(b)(1), it ceases to exist on the last day of its final tax year, even though this may be before the date the IRS determines that the partnership has ceased to exist. If the partnership ceases to exist in connection with its inability to pay the amount due, it ceases to exist on the date the IRS makes its determination that the partnership has ceased to exist.³³²

³²⁵ Reg. §301.6241-3(a)(2).

³²⁶ §6241(7).

³²⁷ Reg. §301.6241-3(c).

³²⁸ §6232(f)(1). The failure-to-pay rules are discussed further in V.B.8., below.

³²⁹ Reg. §301.6241-3(b).

³³⁰ Reg. §301.6241-3(b)(1). A partnership does not have the ability to pay if the IRS determines that the partnership’s account is currently not collectible based on the information that the IRS has at the time of such determination. Reg. §301.6241-3(b)(1)(ii).

³³¹ Reg. §301.6241-3(a)(1).

³³² Reg. §301.6241-3(b)(2).

c. Consequences of Ceasing to Exist Under Section 6241(7)

When a partnership ceases to exist before an adjustment takes effect, the partnership is no longer obligated to make any payments to the IRS under the BBA.³³³ Instead, the “former partners” must take the adjustment and associated amounts (e.g., interest and penalties) into account.³³⁴

If the IRS determines that a partnership has ceased to exist, that determination does not prevent the partnership and the partners from availing themselves of the modification rules.³³⁵

If a partnership makes a valid push-out election under §6226, the partnership will not cease to exist. If the IRS has determined that the partnership has ceased to exist, that determination will not be effective, and the push-out election will be valid.³³⁶

(1) The Former Partners Who May Be Liable

Under the cease-to-exist rules, the former partners are the adjustment-year partners, if there are any.³³⁷ The adjustment-year partners are generally those who were partners at any time during the partnership taxable year in which the notice of final partnership adjustment (FPA) is mailed, or, if the partnership seeks judicial review under §6234, the partnership tax year in which the court’s decision becomes final.³³⁸ If there are no adjustment-year partners (for example, because the FPA is mailed after the partnership has terminated), the former partners are those who were partners during the last tax year for which the partnership filed an income tax return.³³⁹

Note: A former partner who is liable for the taxes and other amounts might not have been a partner in the reviewed year.

(2) Amount of a Former Partner’s Liability

Under §6241(7), when a partnership ceases to exist before an adjustment takes effect, the adjustment is generally taken into account as if a §6226 election were made, but instead of the adjustment being taken into account by the reviewed-year partners, the adjustment is taken into account by the former partners.³⁴⁰ It is not clear how the former partners would take the adjustment into account.

Example: A partnership omits \$10 million of income from its Year 1 tax return. In Year 1, the partnership has two partners — Stella and Jonathan — each of whom holds a 50% interest. In Year 2, Bill purchases Stella’s 50% interest and a 40% interest from Jonathan, so that Bill holds a 90% interest and Jonathan holds a 10% interest at the end

of Year 2. In Year 3, the partnership liquidates and files its final tax return. The IRS increases the partnership’s Year 1 income by \$10 million, and the adjustment year is Year 4. If the applicable tax rate is 37%, the partnership would be liable for a \$3.7 million imputed underpayment.

The IRS, however, determines that the partnership has ceased to exist before the adjustment takes effect. As a result, the partnership is not liable for the imputed underpayment, and the former partners must take the adjustment into account. The former partners are ordinarily the adjustment-year partners, but in this example the partnership does not exist in the adjustment year (Year 4), so there are no adjustment-year partners. The former partners would therefore be those who were partners during the last tax year for which the partnership filed an income tax return (i.e., Year 3). As a result, Jonathan and Bill would be required to take the adjustment into account.

The partnership has an imputed underpayment of \$3.7 million, but the amount owed by Jonathan and Bill might be different. They must recalculate the amount of tax they should have paid had they included an additional \$10 million of income on their returns as if a §6226 election had been made. It is not entirely clear how this should be done. One question is how much of the \$10 million of income should be allocated to each partner. Another question is in which tax year the income should be taken into account.

One approach might be to consider the reason why it is Jonathan and Bill who are taking the adjustment into account: it is the former partners who are liable, and here the former partners are those who were partners in Year 3. As it is the Year 3 partners who must take the income into account, it might be that the \$10 million of additional Year 1 income is treated as if it were recognized in Year 3, in which case it would be allocated based on the Year 3 percentages and taken into account by Jonathan and Bill as if the income were Year 3 income. Under that approach, Jonathan would take into account 10% of the \$10 million of income as Year 3 income, even though that \$10 million of income was recognized in Year 1 when he held a 50% interest. In addition, Bill would take into account 90% of the \$10 million of income as Year 3 income.³⁴¹

These calculations would be made under the rules that govern §6226 elections, so Jonathan and Bill would take into account their own attributes and any special characteristics of the \$10 million of income that was omitted. For example, the income might be long-term capital gain and therefore subject to a 20% tax rate. In that case, Jonathan and Bill would collectively owe no more than \$2 million of tax, in contrast to the \$3.7 million underpayment that the partnership had owed.³⁴²

³³³ Reg. §301.6241-3(a)(2).

³³⁴ §6241(7); Reg. §301.6241-3(a)(1).

³³⁵ Reg. §301.6241-3(a)(1).

³³⁶ Reg. §301.6241-3(b)(3).

³³⁷ Reg. §301.6241-3(d)(1).

³³⁸ However, when a partnership waives the restrictions on assessment under §6232(b), the adjustment year is the partnership taxable year in which the IRS executes the waiver. Also, when a partnership files an administrative adjustment request (AAR), the adjustment-year partners are those who were partners in the partnership taxable year in which the AAR was filed. Reg. §301.6241-1(a)(1).

³³⁹ Reg. §301.6241-3(d)(2).

³⁴⁰ Reg. §301.6241-3(e).

³⁴¹ Similarly, if the partnership had issued a profits interest in Year 3, the partner who received that interest would be allocated its share of income as if the income were recognized in Year 3, even though there is no sense in which that partner is a successor to a reviewed-year partner.

³⁴² The BBA does not apply to taxes imposed by chapters other than Chapter 1 of the Tax Code. It therefore does not apply to the net investment income tax, which is imposed under Chapter 2A of the Tax Code.

It appears that Jonathan and Bill would benefit from an additional \$10 million of basis in their partnership interests. Each additional dollar of partnership income that is allocated to a partner should generally increase the partner's basis in his partnership interest so that the income is taxed only once.³⁴³ Therefore, if Jonathan and Bill take into account an additional \$10 million of partnership income in Year 3, they should be allowed to obtain the benefit of an additional \$10 million of basis. For example, if the Year 3 liquidation was taxable, this additional \$10 million of basis would reduce the gain or increase the loss recognized in the liquidation.

Even though Jonathan and Bill appear to be allowed to reduce the gain (or increase the loss) they recognize in the Year 3 liquidation, the adjustment could nevertheless affect their tax liability for Year 3 because the character of the additional income included might differ from the character of the gain that is reduced (or loss that is increased). The additional Year 3 income, for example, might be ordinary, while the liquidation gain (or loss) might be capital. Stella would not be affected by the adjustment even though she was a reviewed-year partner. She sold her interest before the adjustment year, so she is not a former partner. The \$10 million of Year 1 income that was omitted presumably corresponds to economic income, however, and \$5 million of that economic income would have been attributed to Stella's interest when she sold her partnership interest. The purchase price therefore could have taken that \$5 million of value into account, even though that \$5 million was not reflected in her basis. As a result, Stella might have effectively paid tax on \$5 million of the "omitted" income when she sold her partnership interest.

(3) Obligation to Issue Statements

When the IRS notifies a partnership that it has ceased to exist, the partnership must inform each former partner of the items it must take into account by sending a statement analogous to the "Section 6226 Partner Statement" that a partnership must send to its reviewed-year partners when it makes a §6226 election. The partnership must also send a copy of these statements to the IRS. These statements must be sent to the former partners and the IRS within 60 days from the later of (1) the date that the partnership is notified by the IRS that it has ceased to exist or (2) the date the adjustment takes effect.³⁴⁴

If the partnership does not send these statements within this 60-day period, the IRS may determine how the adjustments should be allocated to the former partners based on information that is "reasonably available" to the IRS.

The information that is reasonably available to the IRS might not be very accurate. For example, the IRS might not have the partnership agreement for the applicable year (the adjustment year or the year for which a final tax return was filed), and the IRS might not be obligated to request the partnership agreement from the partnership when allocating the ad-

justed amounts. If the IRS does not have the relevant partnership agreement, its best information might be the profit and loss percentages reported on the Schedules K-1 for that year, but those percentages might not be appropriate for allocating an adjusted amount. For example, a partner's share of profits might depend on how much income there is to allocate.

Planning Point: If a partnership will not be able to provide the statements within the 60-day period, it may want to consider providing the IRS with the information it would need to allocate the adjusted items properly.

d. Termination Without Ceasing to Exist

If a partnership terminates under §708(b)(1) but the partnership does not cease to exist before the adjustments take effect, the rules of §6241(7) would not apply. However, it is possible that the failure-to-pay rules of §6232(f) would apply.

8. Partnership Failure to Pay

Under §6232(f), if a partnership fails to pay an imputed underpayment or any associated interest or penalties within 10 days of the date on which the IRS provides notice and demand for such payment, the IRS may assess the partners for such amounts.³⁴⁵ In addition, the underpayment interest rate would be increased by 2 percentage points, so it would be 5 percentage points (not 3 percentage points) more than the short-term applicable federal rate.³⁴⁶

Practice Point: Note that the partnership remains liable until the full amount is paid.³⁴⁷

Under these failure-to-pay rules, the total amount of the partners' liability equals the amount that the partnership owed.³⁴⁸ The tax liability is not recomputed to take into account the attributes of the partners.

Example: A partnership omitted \$100 million of long-term capital gain and owes an imputed underpayment of \$37 million as a result. The partners would owe \$37 million (and the associated interest and penalties), even if they were individuals who ordinarily would be eligible for a maximum 20% rate on such long-term capital gain. This is different from the results that arise when a §6226 election is made or when the cease-to-exist rules of §6241(7) apply. Under those rules, the partners recalculate the amount of tax they would have owed if they had reported the additional \$100 million of long-term capital gain on their own returns.

The partners who may be assessed generally are those who are partners at the close of the adjustment year.³⁴⁹ However, when a partnership ceases to exist after an adjustment takes effect, the partners who are liable are those who were "former partners" under the cease-to-exist rules.³⁵⁰

³⁴⁵ §6232(f)(1)(B).

³⁴⁶ §6232(f)(1)(A).

³⁴⁷ §6232(f)(4).

³⁴⁸ §6232(f)(1)(B).

³⁴⁹ §6232(f)(1)(B). It is not clear who bears the liability if there are no partners at the close of the adjustment year.

³⁵⁰ §6232(f)(1)(B). As discussed in V.B.7, above, a partnership does not cease to exist unless the IRS so determines. If the partnership ceases to exist before the adjustments take effect, the cease-to-exist rules of §6241(7) apply.

³⁴³ §705.

³⁴⁴ Reg. §301.6241-3(e)(2)(ii). These statements are discussed in V.D.5.b. below.

The partners do not have joint and several liability. Instead, each partner is liable for its “proportionate share” of the amount due.³⁵¹ There is no guidance on how a partner’s proportionate share is to be determined. Perhaps the amount will be allocated based on how the expense would have been allocated to the partners had the partnership paid the amount due, for the amount due is fundamentally an expense or liability of the partnership.

Any assessment of the partners under the failure-to-pay rules must be made within two years of the date that the IRS provides the partnership with notice and demand for payment.³⁵²

9. Interest

Under the default rule, a partnership may owe interest with respect to the imputed underpayment and associated amounts, but no overpayment interest is available.³⁵³

a. The Imputed Underpayment

A partnership must pay underpayment interest with respect to an imputed underpayment as if the imputed underpayment were tax that the partnership should have paid for the reviewed year. Interest starts to accrue on the day after the date the partnership was required to file its tax return for the reviewed year, without taking extensions into account.³⁵⁴ The interest rate is the general underpayment rate provided by §6621(a)(2), but it is increased by 2 percentage points when the partnership fails to pay the imputed underpayment within 10 days of the date that the IRS provides notice and demand for the payment.³⁵⁵ Deposits may be made under §6603 to suspend the running of interest.³⁵⁶

b. No Overpayment Interest and No Interest Under the True-Up Rule

In contexts other than the BBA, a taxpayer is generally entitled to overpayment interest when it has paid too much tax.³⁵⁷ The BBA is different. A partnership and its partners are not entitled to overpayment interest when an adjustment is made under the BBA’s default rule because technically there is not an overpayment of tax.

Example: A partnership allocated \$10 million too much income to its partners in the reviewed year. Under the true-up rule, the partnership rectifies this error by omitting \$10 million of income (or reporting \$10 million more loss) for the adjustment year. No overpayment interest would be paid to the partnership or to the partners, even though the partners might have paid tax on the excess \$10 million of income that was reported in the reviewed year.

The interest rules are therefore more favorable for the IRS than for taxpayers. The consequences of this disparate treat-

ment of overreported and underreported items are magnified by the grouping rules that apply to the computation of an imputed underpayment.³⁵⁸

Example — Mischaracterized income: In 2018, a partnership mischaracterizes \$10 million of ordinary income as capital gain. The IRS, therefore, recharacterizes that gain as ordinary income. Under the BBA, this is treated as two adjustments: ordinary income is increased by \$10 million, and capital gain is decreased by \$10 million. Under the grouping rules, the decrease in capital gain generally would not be allowed to offset the increase in ordinary income when calculating the tax base for the imputed underpayment. Therefore, the increase in ordinary income would result in an imputed underpayment of \$3.7 million, and the partnership must pay underpayment interest on that amount.

The decrease in capital gain is taken into account under the true-up rule. The partnership would therefore omit \$10 million of capital gain or report an additional \$10 million of capital losses on its return for the adjustment year. No overpayment interest would be available, however.

Note: When a negative adjustment does not reduce the amount of an imputed underpayment, it will not reduce the amount of interest owed by the partnership.

c. Late Payments of the Imputed Underpayment

When a partnership does not pay the imputed underpayment on the date it is due, interest accrues as if the imputed underpayment were an underpayment of tax that was imposed in the adjustment year.³⁵⁹

d. Penalties

Outside the BBA context, §6601 generally requires a taxpayer to pay interest with respect to penalties that are due. This provision also applies under the BBA.³⁶⁰ In applying these rules, the partnership return for the reviewed year is treated as the return with respect to which the penalty is imposed.

10. Penalties

Penalties are addressed in a partnership-level proceeding.³⁶¹

a. Accuracy-Related and Fraud Penalties

The accuracy-related and fraud penalties of §6662–§6664 may be imposed on a partnership when an adjustment is taken into account under the default rule. These penalties are generally applied as if the partnership were an individual and the imputed underpayment were an underpayment or understatement for the reviewed year.³⁶² For example, outside of the BBA context, a substantial underpayment penalty may apply when the tax understatement (which is generally the tax deficiency) is more than 10% of the amount of tax that should have been re-

³⁵¹ §6232(f)(1)(B).

³⁵² §6232(f)(6).

³⁵³ §6233. For a discussion of why overpayment interest is unavailable, see V.B.9.b., below.

³⁵⁴ §6233(a)(2); Reg. §301.6233(a)-1(b)(1).

³⁵⁵ §6233(a)(2), §6232(f)(1).

³⁵⁶ §6233(c).

³⁵⁷ §6611.

³⁵⁸ The grouping rules are discussed in V.B.1.c., above.

³⁵⁹ §6233(b)(1).

³⁶⁰ Reg. §301.6233(a)-1(b)(2).

³⁶¹ Reg. §301.6233(a)-1(c)(1).

³⁶² §6233(a)(3); Reg. §301.6233(a)-1(c).

ported.³⁶³ To apply this penalty under the BBA default rule, the imputed underpayment is treated as the tax understatement. In addition, the amount of tax that should have been reported is the amount of tax the partnership should have reported had it been an individual. As a result, a penalty might apply even if the adjustment would not have affected the amount of tax the partners should have paid because the partners were tax exempt or had losses that were suspended under §469.

In addition, negative adjustments that are taken into account under the true-up rule will not reduce the amount of penalties that are owed.³⁶⁴ This may produce a harsh result when an item is mischaracterized or misallocated, for in those situations there is both a positive adjustment and a negative adjustment, and the negative adjustment will generally be taken into account under the true-up rule and not reduce the imputed underpayment. In those situations, penalties may apply with respect to the positive adjustment, and the negative adjustment would not reduce the amount of penalty owed.

Example — Mischaracterized Income: For Year 1, a partnership reports \$100 million of capital gain. The IRS, however, recharacterizes that gain as ordinary income. Under the BBA, this is treated as two adjustments: ordinary income is increased by \$100 million, and capital gain is decreased by \$100 million. Under the grouping rules, the decrease in capital gain generally would not be allowed to offset the increase in ordinary income when calculating the tax base for the imputed underpayment. In addition, the highest tax rate for an individual in Year 1 is 37%, which is higher than the corporate tax rate. Therefore, the increase in ordinary income would result in an imputed underpayment of \$37 million, and the decrease in capital gain would be taken into account under the true-up rule.

A substantial understatement penalty may apply if the imputed underpayment (which is treated as the understated amount) exceeds a threshold amount.³⁶⁵ This threshold amount is generally 10% of the tax the partnership would have owed if it had been an individual in Year 1.

If the partnership had been an individual, it would have owed approximately \$37 million of tax with respect to its \$100 million of ordinary income. As a result, the threshold amount is \$3.7 million (10% of the \$37 million of tax). The imputed underpayment (\$37 million) therefore exceeds the threshold amount (\$3.7 million), and a substantial understatement penalty could apply. This penalty would equal 20% of the imputed underpayment.

The negative adjustment (the reduction in capital gain) would not affect the amount of the penalty. The substantial understatement penalty is generally determined by the threshold amount and the amount of the imputed underpayment, but neither of those amounts is affected by the negative adjustment. Moreover, there is no special rule that allows a penalty to be reduced to reflect the negative adjustment.

³⁶³ §6662(d)(1)(A). If the taxpayer claims a deduction under §199A, the percentage is reduced from 10% to 5%. §6662(d)(1)(C).

³⁶⁴ Reg. §301.6233(a)-1(c)(2)(i).

³⁶⁵ Reg. §301.6233(a)-1(c)(2).

If instead there is a negative adjustment that is allowed to offset a positive one under the grouping rules, the negative adjustment may reduce a penalty by reducing the amount of the imputed underpayment.³⁶⁶

A reasonable cause and good faith defense is available, but only when it is the partnership that has reasonable cause and good faith for its position. The reasonable cause and good faith of the partners are irrelevant.³⁶⁷

If any portion of an imputed underpayment is attributable to fraud, there is a presumption that the entire imputed underpayment is attributable to fraud for purposes of applying the penalty for fraud under §6663. To rebut this presumption with respect to a portion of the imputed underpayment, a partnership must establish the amount that was not attributable to fraud by a preponderance of the evidence.³⁶⁸

b. Failure to Pay the Imputed Underpayment

Outside the BBA context, §6651(a)(2) generally imposes a penalty when a taxpayer fails to pay when due the amount shown as tax on a return unless the failure is due to reasonable cause and not willful neglect. The penalty ranges from 0.5% to 25% of the unpaid amount, depending on how long the failure has continued. This penalty may be imposed when a partnership fails to pay an imputed underpayment on the date required.³⁶⁹ When applying §6651(a)(2) to a partnership's failure to pay an imputed underpayment, the imputed underpayment is treated as tax shown on a tax return.³⁷⁰

C. Modifications to the Default Rule

Under the default rule, a partnership takes adjustments into account in the imputed underpayment calculation or under the true-up rule. When there is an imputed underpayment, the partnership must pay the imputed underpayment, which generally equals the total netted partnership adjustment (generally the amount of income that was omitted, the amount of losses that were overreported, and amounts that were misallocated or mischaracterized, net of certain negative adjustments) multiplied by the highest rate of tax that was in effect for an individual or a corporation under §1 or §11 for the reviewed year.³⁷¹ Under the true-up rule, a partnership takes an adjustment into account by omitting income or reporting additional losses in the adjustment year.³⁷² Therefore, the default rule does not take into account any attributes of the partners or of the income or loss that is adjusted, and the burdens and benefits of an adjustment fall on those who are partners in the adjustment year.

The modification rules of §6225(c) provide a myriad of options for modifying the application of the default rule so that the tax consequences may be more closely aligned with the results that would have arisen had the original returns reported the correct amounts.³⁷³ For example, some modifications allow a partnership to reduce the tax rate to reflect attributes of the

³⁶⁶ Reg. §301.6233(a)-1(c)(2)(v)(C) Ex. 3.

³⁶⁷ Reg. §301.6233(a)-1(c)(1), Reg. §301.6233(a)-1(c)(2)(iv)(D).

³⁶⁸ Reg. §301.6233(a)-1(c)(2)(iv).

³⁶⁹ §6233(b)(3)(A).

³⁷⁰ Reg. §301.6233(b)-1(d).

³⁷¹ §6225(b)(1); Reg. §301.6225-1(b)(1).

³⁷² §6225(a)(2); Reg. §301.6225-3.

³⁷³ See V.C.3., below.

partners or of the income or loss that was adjusted.³⁷⁴ Other modifications allow an adjustment to be taken into account by the partners instead of the partnership.³⁷⁵

The modification rules provide other benefits as well. Some modifications give a partnership flexibility in how the BBA is applied. For example, modifications are available to revise the number and composition of imputed underpayments.³⁷⁶ That way, some adjustments may be taken into account under one approach, and other adjustments may be taken into account under a different approach. In addition, the IRS has authority to make any modification that it deems to be appropriate, even if the modification is not explicitly listed in the regulations.³⁷⁷

To obtain the benefits of a modification, a partnership must make a proper request for the modification and provide documentation that adequately substantiates the request.³⁷⁸ Otherwise, the IRS is not required to evaluate whether a modification might be available.

Example: A partnership omits \$10 million of long-term capital gain that should have been allocated (directly or indirectly) to an individual in Year 1, when the highest tax rate that applies to an individual or corporation is 37%. As a result, the partnership would generally be required to pay tax on that \$10 million of gain at a 37% rate under the default rule. However, in Year 1, the long term capital gains rate for individuals is 20%. Therefore, under the modification rules, the partnership could ask the IRS to reduce the tax rate to 20% to reflect that the income was long-term capital gain that would have been allocated to an individual in Year 1. To obtain this modification, the partnership would need to establish that this \$10 million of omitted gain would have been allocated to an individual. This might be straightforward for the partnership if the individual holds her partnership interest directly, but it might be more difficult if the individual holds her partnership interest indirectly.

1. Partner Cooperation

The modification rules will often require the cooperation of the partners. Such cooperation may sometimes be as simple as providing certification of the partner's tax status.³⁷⁹ In other situations, cooperation may be more burdensome.

Example: Top Partnership owns an interest in Bottom Partnership, and the IRS audits Bottom Partnership. To avail itself of the modification rules, Bottom Partnership may need to determine and document how Top Partner-

ship allocates items to its partners and the tax status of those partners. Moreover, modifications in which the partners of Top Partnership take adjustments into account will not be available unless the partners are willing to recalculate the amount of tax they should have paid and pay any additional amounts that are due. If they refuse to recalculate their tax liabilities and pay the associated amounts, the modification will be unavailable.

Partner cooperation may therefore be beneficial, but the BBA does not give a partnership the power to compel such cooperation. For example, a partnership cannot file an election with the IRS that would require its partners to amend their returns and pay any additional tax that is due pursuant to the modification rules.

Planning Point: Partners may want to consider including provisions in their partnership agreement that address the extent to which a partner must cooperate so that the partnership may avail itself of the modification rules.

2. IRS Approval

A modification request must be approved by the IRS to have effect.³⁸⁰ It appears that the IRS must approve certain requests so long as they are properly requested and substantiated.³⁸¹ These modifications generally include reductions to the tax rate a partnership must pay,³⁸² the exclusion of adjustments from the calculation of an imputed underpayment (including exclusions on the basis of amended returns filed by the partners or the adoption of the "pull-in" method), or the special modification available for publicly traded partnerships.³⁸³ It is not clear if the IRS must approve requests for other modifications that are properly requested and substantiated.

3. Types of Modifications

Many different modifications are possible. Some modifications allow a partnership to reduce the amount it pays by taking into account attributes of the partners. Other modifications allow a partnership to reduce the amount of the adjustment it takes into account because its partners take the adjustment into account instead. Still other types of modifications are allowed at the discretion of the IRS when the modification is appropriate.

a. Reducing Imputed Underpayments by Taking Partner Attributes into Account

Many of the available modifications enable a partnership to reduce the amount of its imputed underpayment by taking into account certain attributes of the partners who should have taken into account the adjusted income (or who erroneously took into account the adjusted loss). Some of these modifications involve reducing the applicable tax rate;³⁸⁴ others exclude the adjusted amount from the tax base and therefore effectively apply a 0% rate.³⁸⁵

³⁷⁴ See V.C.3.a., below.

³⁷⁵ See V.C.3.b., below. The §6226 election, discussed below, also enables attributes of the partners and the adjusted income or loss to be taken into account, and allows the adjustment to be taken into account by the partners. The §6226 election may produce different results than those available under the modification rules, however.

³⁷⁶ Reg. §301.6225-2(d)(6). See V.C.3.d., below.

³⁷⁷ Reg. §301.6225-2(d)(10). See V.C.3.e., below.

³⁷⁸ Reg. §301.6225-2(c).

³⁷⁹ For example, to take into account a partner's status as tax-exempt, the tax-exempt partner must certify that it is tax-exempt and that the adjustment would not have resulted in unrelated business taxable income. See Form 8980 and Form 8983.

³⁸⁰ Reg. §301.6225-2(b).

³⁸¹ §6225(c).

³⁸² §6225(c)(3) and §6225(c)(4).

³⁸³ §6225(c)(2)(A), §6225(c)(2)(B), and §6225(c)(5)(A).

³⁸⁴ Reg. §301.6225-2(b)(3)(i).

³⁸⁵ Reg. §301.6225-2(b)(2).

The modifications that reduce the applicable tax rate do not ensure that the amount of tax paid by the partnership (the imputed underpayment) is no more than what the applicable partner should have paid if the partner had taken the adjusted amounts into account.

Example: A partnership omits \$10 million of income from Year 1 that should have been allocated to a C corporation. In Year 1, the highest corporate tax rate is 21%, and the highest individual tax rate is 37%. The partnership may therefore request a modification so that the \$10 million of income is subject to a 21% tax. Had the partnership allocated that income to the corporation in Year 1, however, the corporation would not have owed any additional tax in Year 1 or any other year for which a return has been filed because the income would have been offset by the corporation's substantial losses.

Practice Point: Also, when applying a modification to the tax rate that applies in the imputed underpayment calculation, a partner's share of an adjustment might be different from the amount the partner would have been allocated on the original returns, had the original returns been prepared properly.³⁸⁶ In other words, a partner's share of an adjustment might not be determined under Subchapter K. The partnership may, however, ask the IRS to apply Subchapter K to determine how an adjustment is allocated. It is not clear whether the IRS may refuse to accede to this request. Also unclear is how to allocate adjustments that relate to items that are not normally allocated to a partner (e.g., adjustments to the balance sheet).

(1) Foreign Persons

Under the Tax Code, foreign persons are not required to pay U.S. income tax on certain types of income.³⁸⁷ In addition, a foreign person may qualify for treaty benefits that reduce or eliminate the U.S. tax that otherwise would be owed.³⁸⁸ When an adjustment is made under the BBA and the adjustment relates to income (or loss) that should have been (or was) allocated to a foreign partner, a partnership may take the partner's foreign status and applicable treaty benefits into account in computing its imputed underpayment.³⁸⁹

Example: A partnership can establish that \$10 million of income that it omitted should have been allocated to a foreign partner who would not have owed tax on that income due to its status as a foreign person. The partnership may request a modification of its imputed underpayment so that the tax base (the amount that is taxed) does not include that \$10 million of income. If instead that \$10 million of income would have been subject to a 10% tax rate pursuant to a treaty, the partnership may request a modification so that the imputed underpayment is calculated by applying a 10% rate to that \$10 million of income.

³⁸⁶ Reg. §301.6225-2(b)(3)(iii)(A).

³⁸⁷ See, e.g., §871.

³⁸⁸ §894.

³⁸⁹ §6225(c)(3); Reg. §301.6225-2(d)(3), §301.6225-2(d)(9).

(2) Tax-Exempt Entities

Tax-exempt entities generally are not required to pay tax on their income unless the income is unrelated business taxable income.³⁹⁰ Under the BBA, a partnership's imputed underpayment may be modified to take into account a partner's status as a tax-exempt entity.³⁹¹ Therefore, if a partnership omits \$10 million of income that should have been allocated to a tax-exempt partner, and that income would not have been unrelated business taxable income for the partner, the partnership may request that its imputed underpayment be modified so that it does not take that \$10 million of income into account.

For purposes of this modification rule, tax-exempt partners include organizations that are tax exempt under §501,³⁹² the United States, any state or political subdivision thereof, any possession of the United States, and any agency or instrumentality of the foregoing.³⁹³

(3) C Corporations

When computing the amount of an imputed underpayment, the tax rate that generally applies is equal to the maximum rate that could apply to an individual or a corporation for the reviewed year. At present, this tax rate equals the highest rate that can apply to the ordinary income of an individual; C corporations are taxed at a lower rate.

Under the modification rules, a partnership may obtain the benefit of this lower corporate tax rate with respect to omitted income that should have been allocated (or overreported losses that were allocated) to a partner that was a C corporation.³⁹⁴

Example: A partnership omitted \$10 million of income from Year 1 that should have been allocated to a C corporation. In Year 1, the highest corporate tax rate is 21%, and the highest individual tax rate is 37%. The partnership would be required to pay tax at a 37% rate on that income under the default rule. The partnership, however, would be able to request a modification to reduce the applicable tax rate to 21%; i.e., the highest rate applicable to a C corporation in Year 1.

This modification does not enable partnerships to take advantage of provisions like the dividends received deduction³⁹⁵ that effectively reduce the tax rate but take the form of a deduction.

³⁹⁰ §501(a) and §501(b).

³⁹¹ Reg. §301.6225-2(d)(3).

³⁹² Cooperatives described in §521 are not treated as tax-exempt for this purpose, however. §168(h)(2)(A); Reg. §301.6225-2(d)(3)(ii).

³⁹³ A corporation is not treated as an instrumentality of the United States, a state, or a subdivision thereof (a domestic government) if all its activities are subject to tax under Chapter 1 and a majority of its board of directors is not selected by the domestic government. §168(h)(2)(D); Reg. §301.6225-2(d)(3)(ii). Section 168(h)(2)(A)(iii) includes any foreign person or entity (other than a foreign partnership or foreign pass-through entity) as a tax-exempt entity.

³⁹⁴ §6225(c)(4)(A)(i); Reg. §301.6225-2(d)(4).

³⁹⁵ §243.

(4) *Qualified Dividend Income and Capital Gain that Should Have Been Allocated to an Individual*

Individuals are generally eligible for reduced tax rates on long-term capital gain and qualified dividend income.³⁹⁶ These reduced rates are available under the modification procedures when there is an increase in a partnership's qualified dividend income or long-term capital gain that should have been allocated to an individual.³⁹⁷

Example: A partnership omitted \$10 million of long-term capital gain from Year 1 that should have been allocated to Stella. The highest individual or corporate tax rate in Year 1 is 37% but the highest long-term capital gains rate for individuals is 20%. The imputed underpayment may be modified so that the \$10 million is taxed at the 20% capital gains rate, not the 37% rate that would generally apply.

(5) *Publicly Traded Partnerships*

An imputed underpayment is generally computed without regard to any suspended losses of the partners, such as passive activity losses. A publicly traded partnership (PTP), however, may request a modification that enables it to reduce its imputed underpayment by taking into account certain suspended passive activity losses of its partners.³⁹⁸

There are many restrictions on a PTP's use of its partners' suspended passive activity losses. For a partner's passive activity losses to be available to the PTP, the partner must have been a partner from the "first affected year" (which will often be the reviewed year³⁹⁹) through the partner's taxable year in which the PTP's adjustment year ends.⁴⁰⁰ The person with the suspended passive activity losses does not need to hold the interest in the PTP directly; the PTP may use passive activity losses of a person who holds its interest in the PTP indirectly through another partnership or an S corporation.⁴⁰¹

The portion of a partner's passive activity losses that is available to reduce the total netted partnership adjustment (which is generally the tax base in the imputed underpayment calculation) is called a "specified passive activity loss."⁴⁰² The statute, the regulations, and Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*, appear to provide different descriptions of how the specified passive activity loss is computed.

According to the statute, a partner's specified passive activity loss is the lesser of two amounts. The first amount is the partner's passive activity losses that are attributable to the PTP with respect to the partner's taxable year in which the reviewed year ends. The second amount is the partner's passive activity losses that are attributable to the PTP as determined for the partner's taxable year in which the adjustment year ends.⁴⁰³

Regulations also provide that a partner's specified passive activity loss is the lesser of two amounts, but these amounts might be different from the amounts described by the statute. According to the regulations, the first amount is the "affected-year loss," which is the partner's passive activity losses that are attributable to the PTP as determined at the end of the first affected year.⁴⁰⁴ This appears to accord with the statute. The second amount is effectively (a) the partner's passive activity losses under §469(k) with respect to that PTP when the modification is being calculated,⁴⁰⁵ reduced by (b) the amount by which the partner has already used its affected-year losses to offset income or gain relating to that interest in the PTP.⁴⁰⁶

Example: A PTP and a partner have the same tax year and the partner has a \$5 million passive activity loss with respect to the PTP at the end of the reviewed year. In calculating the partner's specified passive activity loss, the first amount (i.e., the "affected-year loss") would equal \$5 million. If none of those losses offset income in an intervening year or in the adjustment year, and if no additional passive activity losses are generated after the first affected year, the second amount (under the statute and under the regulations) would also equal \$5 million. Therefore, the specified passive activity loss available to the PTP would equal \$5 million under the statute and under the regulations.

If, however, the partner used \$1 million of the reviewed-year loss to offset income in an intervening year, it appears that the specified activity loss available for the PTP would be only \$3 million under the regulations. Under the regulations, the specified activity loss is the lesser of two amounts, one of which is: (a) the amount of passive activity losses with respect to the PTP when an adjustment has been proposed and the modification is being calculated, minus (b) the amount of affected year (reviewed-year) losses that have offset income relating to the PTP. The amount for (a) would equal \$4 million if the PTP did not incur net losses after the reviewed year, for the partner started with \$5 million of suspended losses from the first affected year and used \$1 million of those losses to offset income in an intervening year. The amount for (b) would equal \$1 million, for the partner used \$1 million of its losses to offset income in an intervening year. Therefore (a) minus (b) would equal \$3 million (i.e., \$4 million – \$1 million). This means that the use of \$1 million of passive activity losses in an intervening year could reduce the amount of losses available to the PTP by \$2 million. In contrast, the statute does not appear to take into account whether any of the losses from the first affected year have offset any income.

³⁹⁶ §1(h).

³⁹⁷ §6225(c)(4)(A)(ii); Reg. §301.6225-2(d)(4).

³⁹⁸ §6225(c)(5).

³⁹⁹ It appears that the first affected year is the partner's tax year that includes the end of the reviewed year. Reg. §301.6225-2(d)(5)(ii)(A), §301.6226-3(b)(2).

⁴⁰⁰ Reg. §301.6225-2(d)(5)(iii).

⁴⁰¹ Reg. §301.6225-2(d)(5)(iv), §301.6241-1(a)(4).

⁴⁰² Reg. §301.6225-2(d)(5)(i).

⁴⁰³ §6225(c)(5)(B).

⁴⁰⁴ Reg. §301.6225-2(d)(5)(ii)(A).

⁴⁰⁵ More precisely, this amount is the partner's passive activity losses under §469(k) with respect to that partnership as computed at the end of the partner's tax year that includes the adjustment year, or, if the adjustment year has not yet been determined, for the most recent year for which the partnership has filed a tax return. Reg. §301.6225-2(d)(5)(ii)(B).

⁴⁰⁶ Reg. §301.6225-2(d)(5)(ii)(B).

Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*, appears to provide for a different calculation of the specified passive activity loss that may reduce an imputed underpayment. According to the form, if the partner has used any of the passive activity losses relating to the PTP that it had at the end of the first affected year to offset any income, the specified passive activity loss is the lesser of; (a) the affected-year loss or (b) the affected-year loss minus the amount of the affected-year loss that has offset income. If instead the partner has not used any of its affected-year losses, the specified passive activity loss is the partner's passive activity loss under §469(k) with respect to that PTP as computed at the end of the most recent year for which the PTP has filed a tax return.

A partner's suspended passive activity loss carryovers may be used only once. If a PTP uses a partner's carryovers to offset its income for purposes of computing an imputed underpayment, the partner must reduce the amount of its passive activity loss carryovers so that they are not used a second time to offset income or gain that is recognized later.⁴⁰⁷

Under proposed regulations, the tax benefit obtained from a partner's passive activity losses must be specially allocated to that partner.⁴⁰⁸ Such special allocations would result in PTP interests that are not fungible.

b. Adjustments Taken into Account by Partners, Not by the Partnership

There are four types of modifications that result in an adjustment being taken into account by the partners rather than the partnership. When these modifications are approved, the partnership is not required to pay an imputed underpayment and the partnership would not apply the true-up rule.

In the first type, the reviewed-year partners amend their returns to take the adjustment into account.⁴⁰⁹ They must also pay any additional tax, interest, and penalties that are due, and they may be entitled to a refund. The second type (the "pull in" or the "alternative procedure") generally produces similar results without the partners having to file amended returns.⁴¹⁰ Refunds are not available under the pull-in method, however.⁴¹¹ Third, modification may be allowed when the IRS enters into a closing agreement with a partner.⁴¹²

The fourth type involves partnerships that have a real estate investment trust (REIT) or a regulated investment company (RIC) as a partner.⁴¹³ When a REIT or RIC takes its share of an adjustment into account by distributing a deficiency dividend, the partnership may exclude that portion of the adjustment when applying the default rule. In this situation, it is not the reviewed-year partners who are taking the adjustment into account; the adjustment would instead be taken into account by those who are investors in the REIT or RIC at the time the deficiency dividend is distributed.

(1) Amended Returns

Under the default rule, a partnership generally takes an adjustment into account by paying an imputed underpayment or making a true-up adjustment. The BBA statute and regulations, however, provide a set of rules under which an adjustment may instead be taken into account by the reviewed-year partners if they amend their tax returns to reflect their shares of the adjustment. In order for such an amended return modification to be approved by the IRS, various criteria must be satisfied. For example, the partners must pay any associated tax, interest, and penalties that may be due.⁴¹⁴ Additional criteria are discussed below.

The amended return modification procedures discussed in this V.C.3.b.(1) are not the only way in which a partner's amended return might be taken into account under the modification rules. The amended return modification rules are one of the modification rules that are explicitly listed in the regulations, but the IRS also has general authority to approve modifications that are appropriate. Therefore, the IRS might approve a modification that reflects a partner's amended return under this general authority, even if the amended return modification rules are not all satisfied.⁴¹⁵

(a) A Partner's Amended Return

Under the amended return modification rules, a partnership cannot modify the application of the default rule to reflect the amended return of a partner unless the partner's amended return reflects its share of all items that are adjusted in the BBA proceeding.⁴¹⁶ There is no de minimis exception.

Example: The IRS makes two adjustments to a partnership's income: it increases the income that should have been allocated to Stella by \$1 million, and it disallows \$7.43 of deductible expenses that were allocated to Stella. In order for the partnership to modify the application of the default rule, Stella would need to file an amended return that takes into account both adjustments. If her amended return takes into account the additional \$1 million of income but not the disallowed expenses, the default rule will apply and the partnership will be required to pay tax on the \$1 million of income that was omitted.

A partner's amended return must also take into account any associated changes to the partner's tax attributes.⁴¹⁷

Example: In Year 1, a partnership omitted \$1 million of income that it should have allocated to Stella. In Year 1, Stella sold her partnership interest. In calculating her gain from the sale, she did not increase her basis in her partnership interest by the \$1 million of income that the partnership omitted. Therefore, she reported \$1 million too much gain from the sale. To apply the amended return modification rules to the \$1 million of omitted income, Stella's

⁴⁰⁷ Reg. §301.6225-2(d)(5)(v).

⁴⁰⁸ Prop. Reg. §1.704-1(b)(2)(iii)(f)(2).

⁴⁰⁹ See V.C.3.b.(1), below.

⁴¹⁰ See V.C.3.b.(2), below.

⁴¹¹ Reg. §301.6225-2(d)(2)(x)(A).

⁴¹² See V.C.3.b.(3), below.

⁴¹³ See V.C.3.b.(4), below.

⁴¹⁴ §6225(c)(2)(A).

⁴¹⁵ The IRS's general authority to approve modifications that are appropriate is discussed in V.C.3.e., below.

⁴¹⁶ Reg. §301.6225-2(d)(2)(i).

⁴¹⁷ Reg. §301.6225-2(d)(2)(ii); Form 8982.

amended return for Year 1 would need to report the \$1 million of partnership income that had been omitted, and also report \$1 million less gain from the sale of her partnership interest.

The changes to the partner's tax attributes must also be reflected in the partner's other tax returns.⁴¹⁸ If those returns have already been filed, they must be amended in connection with the request for the modification.⁴¹⁹

It is not clear how the partnership's tax attributes are treated under the amended return modification rules. For example, it is not clear whether or when a partnership would adjust its basis in its assets to reflect an adjustment.

For a partner's amended return to be taken into account under the amended return modification rules, the return cannot make any changes that are unrelated to the BBA proceeding.⁴²⁰ This rule may be beneficial for taxpayers. Taxpayers often do not want to amend their tax returns because an amended return, like the original return, is signed under penalties of perjury, so all known errors must be corrected. Under the amended return modification rules of the BBA, however, the partner's amended return cannot correct known errors that are unrelated to the BBA adjustments. If a partner would like to revise its reporting of items that are unrelated to the BBA adjustments, the partner may wish to consider alternative approaches such as entering into a closing agreement that takes into account both the BBA-related adjustments and the other adjustments.

(b) Which Partners Must Amend Their Returns

It is generally possible for a partnership to obtain a modification that reflects one partner's amended returns even if the other partners do not amend their returns.⁴²¹

Example: The IRS increases the amount of income a partnership should have reported by \$10 million, \$2 million of which should have been allocated to Stella. Stella amends her return and pays the associated taxes and other amounts; the other partners do not. The partnership may obtain a modification so that its imputed underpayment is based on the \$8 million of income that should have been allocated to the other partners. If the modification is allowed, the partnership would not owe tax with respect to the \$2 million of income that should have been allocated to Stella. Under proposed regulations, the imputed underpayment would be specially allocated to partners other than Stella, so she generally would not bear the economic cost resulting from that tax.⁴²²

Different rules apply when income or loss is misallocated. When an adjustment relates to a misallocated item, a modification will generally not be approved unless all affected partners file amended returns.⁴²³ The IRS may, however, treat a partner as having filed an amended return under the amended return

modification rules if some other modification rule would enable the partnership to avoid taking that partner's share of an adjustment into account.⁴²⁴ For example, a partner might take its share of an adjustment into account under the "pull in" or alternative method or through a closing agreement. Alternatively, a partner's share of an adjustment might be modified to reflect that the partner is tax exempt and therefore would not have owed any additional tax had it reported the adjusted amounts. In these situations, the IRS may deem the partner to have filed an amended return under the amended return modification rules. In that case, such partners would not need to file an amended return in order for a modification relating to a misallocated item to be approved.

(c) Refunds

If an adjustment is negative and would reduce the amount of tax a partner should have paid, the partner may obtain a refund under the amended return modification rules.⁴²⁵ The general period in which a taxpayer must file a refund claim under §6511 does not apply with respect to amended returns that are filed in accordance with the amended return modification rules.⁴²⁶

Practice Point: In contrast, refunds are not available under the pull-in modification rules.⁴²⁷ In addition, when a §6226 election is made, the partners may effectively receive a nonrefundable credit but not a refund.⁴²⁸

(d) Privacy

Under the modification rules, it is the partnership's obligation to prove that a modification should be allowed. Therefore, a partnership must establish that its partners filed amended returns and paid any associated amounts to avail itself of the amended return modification rules. The partnership, however, is not required to provide the IRS with copies of its partner's amended returns. Instead, the partnership may provide a partner's certification on Form 8982, *Affidavit for Partner Modification Amended Return Under IRC Section 6225(c)(2)(A) or Partner Alternative Procedure Under Section 6225(c)(2)(B)*, that it properly amended its returns and paid the requisite amounts.⁴²⁹

(e) Deadlines and the Statute of Limitations

An amended return may be taken into account under the modification rules even if the IRS's statute of limitations for assessing the partner under §6501 or the partner's period for filing a refund claim under §6511 has expired.⁴³⁰

To take advantage of the amended return modification rules, a partner must amend its returns and pay the associated tax, interest and penalties at or before the time that the partnership requests the modification.⁴³¹ Modifications must be re-

⁴¹⁸ Reg. §301.6225-2(d)(2)(ix).

⁴¹⁹ Reg. §301.6225-2(d)(2)(ii)(B).

⁴²⁰ Reg. §301.6225-2(d)(2)(i).

⁴²¹ Reg. §301.6225-2(f) Ex. 2.

⁴²² Prop. Reg. §1.704-1(b)(2)(iii)(f)(2), Reg. §1.704-1(b)(4)(xii).

⁴²³ §6225(c)(2)(C).

⁴²⁴ §6225(c)(2)(C); Reg. §301.6225-2(d)(2)(ii)(C).

⁴²⁵ §6225(c)(2)(D).

⁴²⁶ §6225(c)(2)(D); Reg. §301.6225-2(d)(2)(iv).

⁴²⁷ Reg. §301.6225-2(d)(2)(x)(A); IRS Pub. 5346, Instructions for Form 8980 (Refunds Not Allowed Under the Alternate Procedure).

⁴²⁸ See V.D.2., below.

⁴²⁹ Reg. §301.6225-2(d)(2)(ii); Form 8980 and Form 8982.

⁴³⁰ Reg. §301.6225-2(d)(2)(iv).

⁴³¹ Reg. §301.6225-2(d)(2)(ii) and §301.6225-2(d)(2)(iii).

quested within 270 days after the date the notice of proposed partnership adjustment (NOPPA) is mailed, unless the IRS agrees to extend this deadline.⁴³² Therefore, a partner might be required to amend its return and pay associated amounts before the dispute is resolved. The partnership, however, will have an opportunity to obtain review from the IRS Independent Office of Appeals (IRS Appeals) before the IRS issues the NOPPA. Therefore, the appeals process will be available before payment is required.⁴³³

However, amended returns must generally be filed and associated payments made before the partnership obtains judicial review in Tax Court or any other court unless the IRS agrees to extend the deadline beyond the 270-day period following the date the NOPPA is mailed.⁴³⁴ For example, if the IRS proposes to increase a partnership's income by \$1 million, the affected partners must generally file amended returns and pay the associated taxes, interest, and penalties before the issue is adjudicated. If the partnership prevails in court, a partner who paid tax, interest, and penalties in connection with an amended return would be entitled to file a second amended return and seek a refund.⁴³⁵ That refund claim is subject to the general period of limitations under §6511; the period is not extended to take into account the judicial proceedings under the BBA.⁴³⁶ Therefore, such a partner should consider filing a protective claim for a refund before its statute of limitations expires.

(f) *Pass-Through Partners and Indirect Partners*

When an audited partnership has a partner that is a pass-through partner, the audited partnership may request a modification to reflect an amended return filed (and taxes paid) by an indirect partner.⁴³⁷ Such a modification requires pre-approval from the IRS.⁴³⁸

Instead of an indirect partner taking the adjustment into account, another alternative is for a pass-through partner to take the adjustment into account itself and pay any associated taxes or other amounts.⁴³⁹ The amount it owes equals the amount it would have owed had the audited partnership made a §6226 election and the pass-through partner had elected to pay the amount due with respect to its share of the adjustments instead of pushing out those adjustments to its own partners.⁴⁴⁰ In calculating the amount due, the pass-through partner may take into account any modifications approved with respect to its direct and indirect partners.⁴⁴¹

If a pass-through partner takes an adjustment (the "IU adjustment") into account by paying an imputed underpayment,

and if the pass-through partner has other adjustments that do not result in an imputed underpayment (the "non-IU adjustments"), the pass-through partner will take those non-IU adjustments into account under Reg. §301.6225-3, which governs adjustments that do not result in an imputed underpayment.⁴⁴² If a pass-through partner is not required to pay an imputed underpayment, however, then it is not clear how the non-IU adjustments are taken into account; perhaps they are not taken into account.

(g) *Penalties*

Under the default rule, penalties are applied as if the partnership were the taxpayer at issue. For example, the application of a substantial understatement penalty depends on whether the partnership had a substantial understatement, not whether any partner had a substantial understatement. In addition, defenses that depend on a taxpayer's specific facts (such as a taxpayer's reasonable cause and good faith under §6664) are applied based on the partnership's facts, not the partners' facts. Therefore, it does not matter if a partner acted with reasonable cause and good faith when taking positions on its tax return; only the partnership's reasonable cause and good faith be taken into account.⁴⁴³

When a partner files an amended return under the modification rules, the application of a penalty or additional amount is determined in the partnership-level proceeding, but the amount is determined by the facts relating to the partner.⁴⁴⁴ For example, the application of a substantial understatement penalty would depend on whether the partner had a substantial understatement, not whether the partnership had a substantial understatement.

Planning Point: It is possible for an adjustment to result in a substantial understatement when evaluated at the partnership level but not when evaluated at the partner level, in which case the penalty could be avoided by applying the amended return modification rules. Alternatively, an adjustment might result in a substantial understatement when evaluated at the partner level but not at the partnership level, in which case the default rule might provide a better result.

Defenses that relate to the partner's specific facts (such as the §6664(c) defense based on reasonable cause and good faith) may be taken into account under the amended return modification rules, but only through refund proceedings.⁴⁴⁵ A partner cannot take such partner-specific defenses into account when submitting its amended tax return and paying the additional amounts required under the modification rules. A partner must first pay the full amount of the penalty and then file a refund claim in which it asserts its partner-specific defense.

(2) *Alternative Procedure (Pull-In Modification)*

Section 6225(c)(2)(B) provides for an "alternative procedure" that is often referred to as the "pull-in modification."⁴⁴⁶ In many respects the pull-in modification is similar to the amend-

⁴³² §6225(c)(7).

⁴³³ See IRM 8.19.14.

⁴³⁴ A modification must generally be requested within 270 days after the date a NOPPA is mailed, but judicial review generally cannot be requested until 270 days after the date a NOPPA is mailed. Before filing a petition in court, the partnership must receive a notice of final partnership adjustment (FPA), and the FPA generally cannot be sent earlier than 270 days after the date the NOPPA is mailed. §6231(b)(2)(A), §6234(a).

⁴³⁵ Reg. §301.6225-2(d)(2)(vii)(C).

⁴³⁶ Reg. §301.6225-2(d)(2)(vii)(C).

⁴³⁷ §6225(c)(2)(F); Reg. §301.6225-2(d)(2)(v).

⁴³⁸ See IRS Pub. 5346, *Instructions for Form 8980*, Item D.

⁴³⁹ Reg. §301.6225-2(d)(2)(vi).

⁴⁴⁰ Reg. §301.6225-2(d)(2)(vi).

⁴⁴¹ Reg. §301.6225-2(d)(2)(vi)(B), §301.6226-3(e)(4)(iii).

⁴⁴² Reg. §301.6225-2(d)(2)(vi)(B).

⁴⁴³ Reg. §301.6233(a)-1(c)(1), §301.6233(a)-1(c)(2)(iv)(D). The application of penalties under the default rule is discussed further in V.B.10., above.

⁴⁴⁴ Reg. §301.6225-2(d)(2)(viii).

⁴⁴⁵ Reg. §301.6225-2(d)(2)(viii).

⁴⁴⁶ See also Reg. §301.6225-2(d)(2)(x).

ed return modification; either way, the partner must calculate the additional taxes, interest, and penalties it would owe if it took the adjustment into account (e.g., by including the additional income or excluding the excess losses) on its returns for the affected years. The partner, however, does not actually file an amended return. Instead, the partner certifies on Form 8982, *Affidavit for Partner Modification Amended Return Under IRC Section 6225(c)(2)(A) or Partner Alternative Procedure Under Section 6225(c)(2)(B)*, that it has properly computed and paid the additional taxes, interest, and penalties it would have owed if it took its share of the proposed adjustment into account. The partner must also agree to make appropriate adjustments to its tax attributes.⁴⁴⁷

There is an important difference between the amended return modification and the pull-in modification: if the adjustment would reduce the amount of tax owed by a partner, the partner may obtain a refund under the amended return modification rules but not under the pull-in method.⁴⁴⁸

Example: A partnership allocated \$10 million too much income to Stella, and Stella accordingly paid tax on that \$10 million of income. Stella would be able to obtain a refund under the amended return procedure but not under the pull-in method.

Moreover, if the partnership requests a pull-in modification with respect to that adjustment, it appears that the true-up rule would not apply because the adjustment would not be taken into account under the default rule.⁴⁴⁹ This means that if the pull-in method is requested with respect to an adjustment that would decrease the amount of tax owed by a partner, the partner will not get a refund, and the partnership will not reduce the income (or increase the loss) it allocates in the adjustment year. It might be that a partner that paid too much tax has no remedy.

This prohibition on refunds applies when a partnership is requesting a pull-in modification, but other types of refunds may be available.⁴⁵⁰ For example, refund procedures are the only way in which a partner may avail itself of partner-specific defenses to penalties.⁴⁵¹ In addition, a partner that adopts the pull-in method may request a refund if a court revises the adjustments that the partner took into account.⁴⁵² For example, if a partner takes into account a \$1 million reduction in its share of income under the pull-in method and the Tax Court subsequently determines that the partner's share of income should have been reduced by \$2 million, the partner might be allowed to request a refund. The applicable statute of limitations would be the partner's period under §6511, which might not be open when the court renders its decision. Therefore, a partner may want to consider filing a protective claim for a refund before its statute of limitations expires.

(3) Partner Closing Agreement

When a partner enters into a closing agreement that takes its share of an adjustment into account, the partnership may request a modification so that this portion of the adjustment is not resolved under the default rule.⁴⁵³

Example: A partnership omitted \$10 million of income that it should have allocated to Stella. Stella enters into a closing agreement with the IRS under which she agrees to pay tax and associated interest and penalties on that \$10 million of income. In a BBA proceeding, the IRS proposes to increase the partnership's income by that same \$10 million. The partnership would then be able to request a modification of the proposed adjustment so that the partnership would not be liable for any tax, interest, or penalties with respect to that \$10 million of omitted income.

The BBA generally addresses taxes imposed under Chapter 1 but not other taxes such as self-employment taxes or the net investment income tax.⁴⁵⁴ A closing agreement, on the other hand, may have a broader scope, and the IRS might not agree to enter into a closing agreement unless the agreement addresses all types of tax that might be implicated.⁴⁵⁵

Practice Point: One risk with a closing agreement is that its terms are generally final, and under the BBA modification rules, the closing agreement must be entered into and associated amounts must be paid before there is an opportunity for judicial review.⁴⁵⁶ Therefore, a settlement agreement that is conditional on the results of a court proceeding might be a better approach. Such a settlement agreement is not explicitly listed in the regulations as grounds for obtaining a modification under the BBA, but the IRS might nevertheless authorize such a modification under its general authority to make modifications that are appropriate.⁴⁵⁷

(4) REITs and RICs

A modification is available to take into account deficiency dividends that are distributed under §860(f) when a partner is a real estate investment trust or a regulated investment company and the deficiency dividends take into account adjustments that both (1) are made pursuant to the BBA and (2) qualify as adjustments within the meaning of §860(d)(1) or §860(d)(2).⁴⁵⁸

c. Partnership Closing Agreements

If a partnership enters into a closing agreement with the IRS, that agreement will not automatically affect the application of the default rule. To modify the default rule so that it does not take into account the adjustments that are addressed in a closing agreement, a partnership must request a modification of the default rule under the modification procedures.⁴⁵⁹

⁴⁴⁷ Reg. §301.6225-2(d)(2)(x); Instructions for Form 8982.

⁴⁴⁸ Reg. §301.6225-2(d)(2)(x)(A).

⁴⁴⁹ Reg. §301.6225-2(e).

⁴⁵⁰ Reg. §301.6225-2(d)(2)(vii)(C).

⁴⁵¹ Reg. §301.6225-2(d)(2)(viii).

⁴⁵² Reg. §301.6225-2(d)(2)(vii)(C).

⁴⁵³ Reg. §301.6225-2(d)(8).

⁴⁵⁴ §6241(9).

⁴⁵⁵ Reg. §301.6225-2(d)(8).

⁴⁵⁶ §7121.

⁴⁵⁷ Reg. §301.6225-2(d)(10).

⁴⁵⁸ Reg. §301.6225-2(d)(7).

⁴⁵⁹ Reg. §301.6225-2(d)(8).

d. Number and Composition of Imputed Underpayments

A partnership may request a modification of the number of imputed underpayments, in which case some adjustments may be taken into account in the computation of one imputed underpayment and other adjustments would be taken into account in the computation of a different imputed underpayment.⁴⁶⁰ Such modifications may be useful when the partnership would like to have some adjustments taken into account under one BBA approach (e.g., the default rule) but other adjustments taken into account in a different manner (e.g., under §6226).

A partnership may also request a modification to the grouping rules that determine whether a negative adjustment can offset a positive one or whether the negative adjustment must instead be taken into account under the true-up rule.⁴⁶¹ This type of modification might allow attributes of the partners to be taken into account.

Example: The IRS increases a partnership's income from one activity by \$1 million and increases the partnership's losses from a different activity by \$1 million. If the partners were subject to the at-risk rules and the partnership had properly reported its income and losses on its original return, the additional loss could have been suspended under §465 and the partners could have owed tax on the additional income. Therefore, under the default rule, the two adjustments would be put in separate groups and the negative adjustment would not offset the positive adjustment when computing the partnership's imputed underpayment. The partnership would accordingly pay tax on the omitted income and apply the true-up rule to take into account the underreported loss.

The reviewed-year partners, however, were C corporations that were not subject to the at-risk rules, and the at-risk rules are the only reason why the negative adjustment might not offset the positive adjustment when computing the imputed underpayment under the default rule. Therefore, the partnership may request a modification in which the two adjustments are grouped together so that they offset each other. If the IRS allows such a modification, the negative adjustment would be taken into account in the imputed underpayment calculation by offsetting the positive adjustment. The true-up rule would not apply.

e. Other Modifications

The regulations give the IRS authority to approve other modifications that are not explicitly listed.⁴⁶² One type of modification that the IRS might consider relates to a settlement agreement that is not a formal closing agreement under §7121. The IRS often enters into such settlement agreements, and they may offer a partner an opportunity to obtain a refund in the event the adjustment is challenged in court and the partnership prevails.

⁴⁶⁰ Reg. §301.6225-2(d)(6).

⁴⁶¹ The grouping rules are discussed in V.B.1.c., above.

⁴⁶² Reg. §301.6225-2(d)(10).

4. Tiered Structures

Under the default rule, a partnership is generally treated as an entity, and adjustments are taken into account without regard to the attributes of the partners.⁴⁶³ The modification rules allow the partners and their attributes to be incorporated into the analysis. Some modifications enable a partnership to reduce the applicable tax rate to reflect the status of its partners; others allow an adjustment to be taken into account by the partners instead of the partnership. These modifications are available with respect to indirect partners who hold their interests through flow-through entities such as partnerships and S corporations.⁴⁶⁴

Example: A tax-exempt entity holds an interest in an upper-tier partnership (UTP) that in turn holds an interest in a lower-tier partnership (LTP). The IRS audits the LTP and increases its income by \$100 million. The tax-exempt entity should have been allocated 15% of that income. The LTP may request a modification so that the tax base for the imputed underpayment equals the \$85 million of income that would not have been allocated to the tax-exempt entity.⁴⁶⁵ If the IRS approves the modification, the LTP would not owe tax on the \$15 million of income that should have been allocated to the tax-exempt entity. To obtain this modification, the LTP would need to establish the tax-exempt status of the entity and the amount of omitted income that would have been allocated to that entity. The partnership would also need to establish that the omitted income would not have been unrelated business taxable income for that entity. An alternative way for the LTP to avoid paying tax on the tax-exempt entity's \$15 million share of income would be through an amended return modification in which the tax-exempt entity amends its return to reflect its share of adjustments.⁴⁶⁶

A partnership must obtain the requisite information and documentation from its direct and indirect partners before requesting a modification, and the request must generally be made within 270 days of the date the notice of proposed partnership adjustment (NOPPA) is mailed.⁴⁶⁷ There is no automatic extension available when a partner is a pass-through entity, but the IRS does have discretion to grant an extension.⁴⁶⁸

Practice Point: If it may be difficult for a partnership to collect the requisite documentation relating to its indirect partners within that 270-day period, the partnership may want to consider collecting this documentation before it receives a NOPPA.

5. Procedural Rules

The IRS is not required to evaluate the extent to which a modification might be appropriate unless the modification is

⁴⁶³ §6225(a).

⁴⁶⁴ Reg. §301.6225-2(a).

⁴⁶⁵ Reg. §301.6225-2(d)(3).

⁴⁶⁶ Reg. §301.6225-2(d)(2)(v).

⁴⁶⁷ §6225(c)(7). In addition, pre-approval is required to obtain a modification based on the amended return filed by an indirect partner. See IRS Pub. 5346, *Instructions for Form 8980*, Item D.

⁴⁶⁸ Reg. §301.6225-2(c)(3)(ii).

requested by the partnership representative in accordance with the procedures specified in regulations and other guidance.

The request is generally made using Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*.⁴⁶⁹ Tax-exempt partners may use Form 8983 *Certification of Partner Tax-Exempt Status for Modification Under IRC Section 6225(c)(3)*, to certify their status as tax exempt, and Form 8982, *Affidavit for Partner Modification Amended Return Under IRC Section 6225(c)(2)(A) or Partner Alternative Procedure Under Section 6225(c)(2)(B)*, provides an affidavit for a partner who has filed an amended return or is adopting the pull-in method. The partnership representative may also be required to provide documentation such as tax returns and the partnership agreement.

The request and all supporting information and documentation must be submitted to the IRS, and partners must pay any associated amounts that are required, within 270 days after the IRS has mailed the notice of proposed partnership adjustment (NOPPA), unless the IRS agrees to extend this period.⁴⁷⁰ The partnership will have an opportunity to seek review of the substantive tax issues from IRS Appeals before it requests a modification.⁴⁷¹ The partnership will also have a second opportunity to seek review from IRS Appeals, but the second opportunity may only address application of the modification rules; substantive tax issues cannot be raised at that time.⁴⁷² Modification requests and the associated documentation and payments must be submitted before the partnership obtains judicial review, however.⁴⁷³

For modifications that involve an amended return or the pull-in approach with respect to an indirect partner, a partnership must obtain approval from the IRS before the indirect partner pays any additional amount or files its amended return.⁴⁷⁴

6. Allocation of the Imputed Underpayment — Who Benefits from a Modification

Under proposed regulations, if a partnership's imputed underpayment is reduced to reflect a modification that relates to a partner's attributes or a partner's taking into account its share of the adjustment (e.g., by filing an amended return), the imputed underpayment would be specially allocated so that the partner involved in the modification will benefit from the modification.⁴⁷⁵

Example: The IRS increases the amount of income a partnership should have reported for Year 1 by \$100 million, \$10 million of which should have been allocated to a tax-exempt entity and \$10 million of which should have been allocated to a C corporation. Assume that, for Year 1, the

highest individual tax rate is 37% and the highest corporate tax rate is 21%. The partnership obtains a modification so that it pays no tax with respect to the \$10 million of income that should have been allocated to the tax-exempt entity. The partnership also obtains a modification so that a 21% rate applies to the \$10 million of income that should have been allocated to the C corporation. The remaining \$80 million of income is taxed at a 37% rate.

As none of the tax (the imputed underpayment) paid relates to income that should have been allocated to the tax-exempt partner, none of the tax would be allocated to that partner. Similarly, the C corporation would be specially allocated the \$2.1 million of tax paid with respect to the \$10 million of income that it should have been allocated. The remainder (\$80 million of income taxed at a 37% rate) would be allocated to the other partners.

These special allocations of the tax paid by the partnership would not simply be tax allocations. The proposed regulations would require partnerships that do not liquidate in accordance with capital account balances to make corresponding economic allocations so that the C corporation bears only \$2.1 million of the economic burden and the tax-exempt partner bears none.⁴⁷⁶

At present, these regulations are merely proposed, so they will not override contrary provisions in a partnership agreement. If the partners would like such special allocations to be made before the regulations are finalized, they should include provisions in their partnership agreement that allow or require these allocations to be made.

D. Section 6226 "Push-Out" Election

Under §6226, a partnership may elect to have an adjustment taken into account by the reviewed-year partners instead of by the partnership and the adjustment-year partners. When this so-called push-out election is made, the default rule will not apply. The electing partnership will not be required to pay an imputed underpayment or associated interest and penalties, and the partnership will not apply the true-up rule.⁴⁷⁷

Although it is the reviewed-year partners who take an adjustment into account when a §6226 election is made, §6226 provides special rules for calculating the additional amount that they owe or any tax benefit they may receive, so the amount of tax they ultimately pay may be different from the amount they would have paid had they reported the adjusted amounts on their original returns (i.e., a §6226 election may affect how much tax is paid). In some situations, a partner may pay "too much" tax, and in other situations a partner may pay "too little." For example, if a partner has paid too much tax with respect to the reviewed year, a §6226 election does not ensure that the partner will receive a refund. In addition, special rules determine what a partner's share of an adjusted item is, and the rules regarding interest may produce a harsh result, for no overpayment interest is available.⁴⁷⁸

⁴⁶⁹ See also IRS Pub. 5346, *Instructions for Form 8980*.

⁴⁷⁰ Reg. §301.6225-2(c)(3).

⁴⁷¹ See IRM 8.19.14.2.5., IRM 8.19.14.2.6(1).

⁴⁷² See IRM 8.19.14.2.6(1), IRM 8.19.14.5.

⁴⁷³ A modification must generally be requested within 270 days after the date a NOPPA is mailed, but judicial review generally cannot be requested until 270 days after the date a NOPPA is mailed. Before filing a petition in court, the partnership must receive a notice of final partnership adjustment (FPA), and the FPA generally cannot be sent earlier than 270 days after the date the NOPPA is mailed. §6231(b)(2)(A), §6234(a).

⁴⁷⁴ See IRS Pub. 5346, *Instructions for Form 8980*, Item D.

⁴⁷⁵ Prop. Reg. §1.704-1(b)(2)(iii)(f), Prop. Reg. §301.6225-4(e) Ex. 2.

⁴⁷⁶ Prop. Reg. §1.704-1(b)(4)(xii).

⁴⁷⁷ §6226(a); Reg. §301.6226-1(a).

⁴⁷⁸ Interest is discussed in V.D.2.c., below.

A §6226 election is not the only way in which adjustments may be taken into account by the reviewed-year partners. The modification rules provide various alternatives, such as the amended return modification and the pull-in modification, that also result in an adjustment being taken into account by the reviewed-year partners instead of the partnership. The amounts that must be paid under these modification rules may be different from the amount that must be paid when a §6226 election is made, and different procedural rules apply. For example, refunds are available under the amended return modification rules but are not necessarily available when a §6226 election is made. On the other hand, one advantage of the §6226 election is that a partnership does not need the cooperation of the reviewed-year partners to make the election. For an amended return modification, the partnership must ask the reviewed-year partners to amend their returns and pay any additional amount that is due. If the reviewed-year partners refuse, the modification is unavailable.⁴⁷⁹

Sometimes a §6226 election is not allowed. There must be an imputed underpayment in order for a partnership to make a §6226 election.⁴⁸⁰ The election cannot be made if all adjustments are negative. In addition, certain adjustments cannot be pushed out.⁴⁸¹

When multiple adjustments are made, a §6226 election may be made with respect to all of the adjustments, or it may be made with respect to a subset of them.⁴⁸²

A §6226 election may not be revoked without the consent of the IRS.⁴⁸³ Consent may be requested using Form 8989, *Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment*. The IRS will not consent to the revocation of the election once the Section 6226 Partner Statements have been furnished to the partners.⁴⁸⁴

1. Consequences for the Partnership Under Audit

When a partnership makes a valid §6226 election, the default rule will not apply, so the partnership will not be liable for an imputed underpayment or associated interest or penalties.⁴⁸⁵ Instead, its partners (or its indirect partners) will take the adjustment into account and pay any additional amount due. The default rule will, however, apply, if the §6226 election is invalid. The IRS is not required to provide a partnership with advance notice or an opportunity to cure a defective election before determining that an election is invalid.⁴⁸⁶

A partnership that makes a §6226 election may have withholding obligations under Chapter 3 or Chapter 4,⁴⁸⁷ as discussed below.

Under Reg. §301.6226-2(g)(4), a partnership that makes a push-out election must pay any chapter 1 taxes, penalties, additions to tax, and additional amounts or the amount of any

adjustment to an imputed underpayment at the time the statements are provided to its partners. Because these amounts are the partnership's responsibility, the partnership cannot push out any adjustments to these items to the partners when making the push-out election.

2. Consequences for the Reviewed-Year Partners

When a partnership makes a §6226 election, the partnership must send each reviewed-year partner a statement (the Section 6226 Partner Statement) that informs the partner that the election has been made and what adjusted amounts the partner must take into account under §6226.⁴⁸⁸

The rules regarding how to determine a partner's share of an adjustment may be surprising. A partner's share might not be the amount that should have been reported on its Schedule K-1. Instead, Reg. §301.6226-2(f) provides special rules for how to determine a partner's share. For example, if the IRS adjusts an item that was reported on the original return and allocated 100% to one partner, then the entire adjustment will generally be allocated to that partner — even if that is not how the amount would have been allocated had the partnership's original tax return reported the adjusted amounts.

Example: Consider a partnership in which distributions are made as follows:

- First, distributions are made to the limited partner to return its capital contributions;
- Next, distributions are made to the limited partner until it receives an X% return on its contributed capital;
- Next, distributions are made to the general partner until a specified hurdle is satisfied;
- Finally, residual distributions are shared 80/20 (limited partner/general partner).

The partnership reports \$1 million of gain from the sale of an asset, and allocates all of that gain to one partner under the terms of the agreement (either the limited partner or the general partner). Assume that this allocation would have been correct, if there were only \$1 million of gain. If the IRS later determines that basis was overstated and that gain should be increased by \$2 million, it appears that this \$2 million of additional gain will generally be allocated to the partner who was allocated the \$1 million on the original return — even if that \$2 million of income would have been at least partially allocated to the other partner under the terms of the agreement had it been reported on the original return.

Anomalous results might also arise if the adjustment would have affected the allocation of other items.

Example: Assume the facts in the Example above. For example, given the waterfall described above, the percentage of income/loss that is allocated to each partner may depend on the amount of net income or loss for the year at issue. That is, in a particular tax year, the partners might share each item of income and loss 30/70 if there is \$10 million

⁴⁷⁹ The modification rules are discussed in V.C., above.

⁴⁸⁰ §6226(a)(1).

⁴⁸¹ These exceptions are discussed in V.D.3., below.

⁴⁸² Reg. §301.6226-1(a).

⁴⁸³ Reg. §301.6226-1(c)(2), §301.6226-1(c)(1).

⁴⁸⁴ Form 8989, *Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment*.

⁴⁸⁵ Reg. §301.6226-1(a).

⁴⁸⁶ Reg. §301.6226-1(d).

⁴⁸⁷ Reg. §301.6226-2(g)(3), §301.6241-6(b)(4).

⁴⁸⁸ Reg. §301.6226-2. This statement is filed using Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s)*.

of net income, but might share each item of income and loss 50/50 if there is \$30 million of net income. An adjustment to one item of income should therefore affect the allocation of other items that might not be adjusted. As a result, if the IRS increases one income item, but does not adjust the allocation of the other items, the taxes owed by the partners under §6226 could differ from the amount of tax they would have owed had the original returns properly reported the adjusted amounts.

Practice Point: These anomalous results may be avoided if the FPA specifies how the adjusted amount is to be allocated and how the allocations of other items might be affected. A partnership might therefore want to consider asking the IRS to address these allocations in the FPA.

Once the partnership determines what each reviewed-year partner's share of an adjustment is, then each reviewed-year partner must determine how "its share" of the adjustment would have changed the amount of tax it should have paid. Section 6226 provides special rules regarding how these "correction amounts" are calculated, as discussed more below. In calculating these amounts, the reviewed-year partners are bound by the adjustments reported on their Section 6226 Partner Statements; they cannot take a position that is inconsistent with those statements.⁴⁸⁹

a. How the Correction Amount Affects the Partner

A partner's total correction amount is an adjustment to the amount of tax that the partner must pay for the tax year in which the Section 6226 Partner Statement is furnished (the reporting year).

(1) Positive Correction Amount

If a partner's total correction amount is positive, it is an additional amount of tax that is due with respect to the reporting year.⁴⁹⁰ The partner must also pay any associated interest and penalties.⁴⁹¹

(2) Negative Correction Amount

When a partner's total correction amount is negative, it is treated like a nonrefundable tax credit in the reporting year.⁴⁹²

⁴⁸⁹ Reg. §301.6226-1(e).

⁴⁹⁰ §6226(b)(2); Reg. §301.6226-3(a).

⁴⁹¹ §6226(c).

⁴⁹² Reg. §301.6226-3(a) provides that a negative correction amount will decrease the amount of tax owed for the reporting year, but it does not authorize a refund to the extent the negative correction amount exceeds the amount of tax otherwise owed for that year. In addition, Reg. §301.6226-3(b)(1) provides that nothing in that regulation "entitles any partner to a refund of chapter 1 tax to which such partner is not entitled."

These provisions mean that a refund is allowed if there is an overpayment of tax with respect to the reporting year but not otherwise. This interpretation of the regulations is made clear in the analogous language in Reg. §301.6227-3(b) and in the preamble to the final version of those regulations. In the version of Reg. §301.6227-3(b) that was proposed on June 14, 2017, Example 2 addressed a partner that owed \$75 of tax for the reporting year before taking into account the correction amount of negative \$100, and the example concluded that the partner would be entitled to a refund of \$25. See REG-136118-15, 82 Fed. Reg. 27,334, 27,399 (Jun. 14, 2017). The final version of this regulation that was published on February 27, 2019, does not state that the partner would be entitled to a refund of \$25. Instead, the final version provides that the part-

It will reduce the amount of tax that the partner owes for the reporting year, but a partner will obtain no benefit from a negative correction amount to the extent that amount exceeds the tax that otherwise would have been due for the reporting year. That excess amount cannot be carried forward (or back) to another tax year, and it cannot be refunded.

Example: A calendar-year partnership recognized \$100 million of long-term capital gain in Year 1 but mistakenly allocated the gain to Jonathan instead of Stella. As a result of this error, Jonathan reported \$100 million of long-term capital gain on his return for Year 1 and paid \$20 million of tax under Chapter 1 on that gain. In Year 8, the IRS allocates that gain to Stella, the partnership makes a valid §6226 election, and the partnership sends Section 6226 Partner Statements to Stella and Jonathan.

If Stella had reported that \$100 million of long-term capital gain on her return for Year 1, she would have owed an additional \$20 million of tax under Chapter 1 for Year 1. If the adjustment would not have had any other effect on the amount of tax she owed for Year 1, or any other tax year, her correction amount would equal \$20 million. This \$20 million correction amount would be treated as additional tax that Stella owes for Year 8 (the year in which the Section 6226 Partner Statement was furnished), not as additional tax that is due for Stella's Year 1 tax year. Therefore, she must pay that \$20 million even if her statute of limitations for Year 1 has expired.

Jonathan would also calculate his correction amount. The adjustment would reduce the tax he should have paid for Year 1 by \$20 million but would not have affected the amount of tax he owed for any other year, so his correction amount would equal negative \$20 million. He, like Stella, would take this correction amount into account as an adjustment to the tax he owes for Year 8. Therefore, he effectively has a \$20 million tax credit that may reduce the tax he owes for Year 8. As this is treated as an adjustment to the amount of tax he owes for Year 8, he may benefit from the adjustment even if his statute of limitations for requesting a refund for Year 1 has expired.

There is only one way in which a correction amount may provide a tax benefit, however: — by reducing Jonathan's taxes for Year 8. It cannot be refunded to Jonathan and it cannot be carried to a different year. Therefore, if he has net losses in Year 8 and would owe no tax for that year even if the negative \$20 million correction amount

ner may obtain a refund with respect to "any overpayment." The preamble to the final regulations explains that the example was revised because the amount of an "overpayment" (i.e., the amount that may be refunded) cannot exceed the amount that has already been paid. See T.D. 9844, 84 Fed. Reg. 6,468, 6,511, 6,521 (Feb. 27, 2019). This revision shows that what matters is whether there is an overpayment for the reporting year, not whether there is an overpayment for the reviewed year (or an intervening year).

Therefore, in Example 2, if the partner had not yet paid any tax for the reporting year, it would not have an overpayment for that year, and it would not be entitled to a refund of \$25. If instead the partner had already paid \$10 of estimated taxes for the reporting year, the partner would have paid \$10 too much tax for the reporting year and would be entitled to a refund of \$10. Either way, the net result would be that the partner pays no tax for the reporting year but gets no benefit from \$25 of the correction amount.

were not taken into account, he would obtain no benefit from the correction amount. If he overpaid the amount of tax he owes for Year 8, he could obtain a refund of the amount that was overpaid, but he cannot obtain a refund simply because he paid too much tax for the Year 1 tax year. Moreover, under proposed regulations, it appears that Jonathan's basis in his partnership interest would not include the extra \$100 million of income that he reported on his Year 1 return. The proposed regulations provide for adjustments to the partner's tax attributes (such as outside basis), but these adjustments do not depend on whether the partner receives any tax benefit from a correction amount.⁴⁹³

(3) AMT

The alternative minimum tax (AMT) for noncorporate taxpayers equals the amount by which the tentative minimum tax exceeds the taxpayer's "regular tax."⁴⁹⁴ The correction amount under §6226 is included in the calculation of "regular tax."⁴⁹⁵ Therefore, a positive correction amount will increase regular tax and reduce the amount of AMT that otherwise would be owed. In contrast, a negative correction amount can increase the AMT that is owed, which would reduce the benefit of the adjustment.

b. Calculation of the Correction Amount

Generally speaking, a correction amount is the amount by which a partner paid too much or too little tax (assuming that the partner's share of an adjustment reflects what should have been reported on the partner's original tax return). A partner must first calculate a separate correction amount for each affected year so that interest and penalties may be computed with respect to each tax year. Then all correction amounts are added together. If the total amount is positive, the total is an additional amount of tax that the partner must pay for the reporting year. If the total amount is negative, it is the amount by which the partner may reduce the tax it pays for the reporting year.⁴⁹⁶ Therefore, if a partner has a positive correction amount for one year and a negative correction amount for another year, those two amounts may offset each other. Only the net amount is reported as additional tax or a tax reduction for the reporting year.

A partner's correction amount takes into account taxes due under chapter 1; it does not take into account other taxes such as the self-employment tax or the net investment income tax.⁴⁹⁷ The IRS, however, is given one year from the date the adjustment becomes final to assess any associated self-employment tax or net investment income tax.⁴⁹⁸

Correction amounts are calculated for the "first affected year" (the partner's taxable year that includes the end of the reviewed year) and "intervening years" (years that follow the first affected year but precede the reporting year).⁴⁹⁹ No correction amount is calculated for years that precede the first affected year, even though the adjusted item might have had an effect in those prior years.⁵⁰⁰

(1) First Affected Year

The first affected year is the partner's tax year in which it included its share of partnership items from the reviewed year.⁵⁰¹ The correction amount for the first affected year equals the amount by which the partner's tax liability for that year would have changed had the partner reported the adjusted amounts on its return.⁵⁰²

Example: The IRS increases the amount of income a partnership should have allocated to Stella in Year 1 by \$10 million. The partnership is on a calendar year, and it makes a §6226 election. Stella's first affected year is Year 1, and her correction amount for that year equals the additional tax she would have owed for Year 1 had she included that additional \$10 million of income on her Year 1 return.

In calculating the correction amount for the first affected year, the partner takes into account any associated adjustments to tax attributes.⁵⁰³

Example: As in the prior example, the IRS increases the amount of income the partnership should have allocated to Stella in Year 1 by \$10 million. Stella, however, sold her partnership interest in Year 1, and when she calculated her gain from the sale, she did not include in her basis the \$10 million of income that the partnership omitted. She therefore reported \$10 million too much gain from the sale on her return for Year 1. As a result, Stella's correction amount should be calculated by including the additional \$10 million of partnership income and by reducing her gain from the sale by \$10 million.

(2) Intervening Years

A correction amount is also calculated for each "intervening year," (i.e., the years that follow the first affected year and precede the reporting year).⁵⁰⁴ The correction amount for an intervening year equals the amount by which the partner's tax liability for that year would have changed had associated adjustments been made to the partner's tax attributes (not the partnership's tax attributes).⁵⁰⁵ These attributes presumably include the partner's basis in its partnership interest.

⁴⁹³ Reg. §301.6226-4(b) and §301.6226-4(c).

⁴⁹⁴ §55(a).

⁴⁹⁵ See Instructions for Form 6251. Reg. §301.6226-3(a) provides that the correction amount increases or decreases the amount of tax imposed by chapter 1, but it does not say that it changes the net or total amount of tax imposed by chapter 1. Instead, the correction amount may be one factor, among many, that affects chapter 1 tax.

⁴⁹⁶ Reg. §301.6226-3(a).

⁴⁹⁷ §6226(b)(2).

⁴⁹⁸ §6501(c)(12).

⁴⁹⁹ Reg. §301.6226-3(b)(2) and §301.6226-3(b)(3).

⁵⁰⁰ §6226(b)(2); Reg. §301.6226-3(b).

⁵⁰¹ Reg. §301.6226-3(b)(2)(i).

⁵⁰² Reg. §301.6226-3(b)(2)(ii).

⁵⁰³ The statute provides that the correction amount for the first affected year is "the amount by which the tax imposed under chapter 1 would increase or decrease if the partner's share of the adjustments ... were taken into account for such taxable year." §6226(b)(3). IRS representatives have told the author that this calculation includes attribute adjustments that affect the first affected year.

⁵⁰⁴ Reg. §301.6226-3(b)(3).

⁵⁰⁵ Reg. §301.6226-3(b)(3).

Example — Associated Adjustment to Partner Attributes: As in the prior example, the IRS increases the amount of income the partnership should have allocated to Stella in Year 1 by \$10 million. Stella sells her partnership interest in Year 2, not Year 1, however. The first affected year is Year 1, and in calculating the correction amount for that year, Stella determines the additional amount of tax she would have owed for that year had she included the additional \$10 million of income from the partnership.

The correction amount for Year 2 would take into account the \$10 million of additional basis Stella should have had in her partnership interest if she had included the \$10 million of partnership income in Year 1. Therefore, the correction amount for Year 2 would equal the amount by which her tax for Year 2 would have decreased if she had recognized \$10 million less gain from the sale.

Although correction amounts for intervening years take into account the manner in which an adjustment would affect the tax attributes of a partner, the correction amounts do not take into account any associated changes to the tax attributes of the partnership.⁵⁰⁶

Example — No associated adjustment for partnership attributes: A partnership reports \$1 million too much depreciation in Year 1 and therefore reduces its basis in its depreciable property by \$1 million too much in Year 1. In Year 2, the partnership sells the property and reports \$1 million too much gain as a result of the excess depreciation reported in Year 1. The IRS audits the partnership's return for Year 1 and disallows the \$1 million of excess depreciation, but the IRS does not examine the return for Year 2.

The partnership makes a §6226 election with respect to the disallowed depreciation. To calculate their correction amounts for Year 1, the partners must recalculate their tax liabilities for Year 1 without taking that excess depreciation into account. If the adjustment would increase the amount of tax they should have paid, the additional amount would equal their correction amounts for Year 1.

Due to the excess reduction in the basis of the depreciable property, the partners included \$1 million too much gain in Year 2. That excess gain, however, is not adjusted when calculating the correction amounts for 2019. Correction amounts for intervening years take into account adjustments to attributes of the partners (e.g., outside basis), but do not take into account adjustments to the attributes of the partnership (e.g., its basis in its assets). The partners therefore do not reduce their gain in Year 2 by \$1 million when calculating their correction amounts for Year 2.

Therefore, the correction amounts would be calculated by eliminating \$1 million of depreciation from the Year 1 tax year, but no change would be made to the amount of gain recognized in the Year 2 tax year. Under proposed regulations, the partners' basis in their partnership interests would be increased by \$1 million in the adjustment year

unless that additional basis was taken into account in calculating a correction amount.⁵⁰⁷ The partnership no longer holds the depreciable property in the adjustment year, so the partnership might not be able to increase its basis in that property (or in any other property).⁵⁰⁸

(3) Prior Years

No correction amount is calculated for any year that precedes the first affected year, even though an adjustment might affect a loss that the partner carried back to an earlier year.⁵⁰⁹

Example: A partnership reports a \$10 million capital loss for its Year 1 tax year and it allocates that loss to a corporation. Both the partnership and the corporation are on a calendar year. The corporation had \$10 million of net capital gain in Year 0, so the corporation carries the loss back to Year 0 and obtains a refund of the tax it paid on that gain.

Some years later, the IRS disallows that \$10 million capital loss. The partnership makes a §6226 election, so the adjustment is taken into account by the corporation, not by the partnership. The corporation's first affected year is Year 1, for that is its tax year that includes the end of the reviewed year. A correction amount would be calculated for Year 1, but that amount would be \$0 because the adjustment would not affect the amount of the tax the corporation should have paid for Year 1. Moreover, no correction amount is calculated for any earlier year, such as Year 0, even though the loss reduced the corporation's tax liability for Year 0.

c. Interest

As discussed above, a reviewed-year partner must calculate a correction amount for its first affected year and for each of its intervening years. A separate correction amount is calculated for each tax year so that interest and penalties may be computed on an annual basis.⁵¹⁰

(1) Underpayment Interest

When the correction amount for a tax year is positive (i.e., when the adjustment would increase the amount of tax the partner should have paid), the partner must pay underpayment interest on that correction amount.⁵¹¹ The interest rate is 5 percentage points more than the federal short-term rate.⁵¹² This is 2 percentage points higher than the rate that ordinarily applies.⁵¹³

⁵⁰⁷ Prop. Reg. §301.6226-4(b).

⁵⁰⁸ Prop. Reg. §301.6226-4 does not provide for adjustments to be made to the basis of the partnership's other assets.

⁵⁰⁹ §6226(b)(2); Reg. §301.6226-3(b).

⁵¹⁰ Reg. §301.6226-3(c) and §301.6226-3(d).

⁵¹¹ Reg. §301.6226-3(c)(1).

⁵¹² §6226(c)(2)(C).

⁵¹³ §6621. The large corporate underpayment rate (known as "hot interest") also equals 5 percentage points more than the federal short-term rate. The large corporate underpayment rate applies to a C corporation's underpayments of more than \$100,000, but it does not apply until after a deficiency has been proposed. §6621(c).

⁵⁰⁶ Reg. §301.6226-3(b)(3).

Underpayment interest begins to accrue on the date that the additional tax would have been due (without an extension) if the adjustment had been reflected on the taxpayer's original returns, even though the additional tax is not required to be paid until after the adjustment is made.⁵¹⁴ Underpayment interest will therefore start to accrue before the additional tax is due.

Example: On its Year 1 tax return, a partnership omitted income that should have been allocated to Stella. In Year 6, the partnership's income is adjusted to include the omitted income, the partnership makes a §6226 election, and the partnership furnishes Stella with a Section 6226 Partner Statement. The adjustment would have increased the amount of tax she should have paid for Year 1 by \$1 million, so she has a positive correction amount of \$1 million for Year 1. That correction amount will increase the amount of tax she must pay for her Year 6 tax year by \$1 million (it would affect the amount she must pay by April 15, Year 7). The underpayment interest, however, would start to accrue on April 15, Year 2 (i.e., Stella's unextended due date for filing her return for Year 1).

(2) Overpayment Interest

No overpayment interest is available when a correction amount for a tax year is negative (i.e., when the adjustment would decrease the amount of tax the partner should have paid).⁵¹⁵ This may produce a harsh result when there is a positive correction amount for one tax year and a negative correction amount for another tax year.

Example: A partnership omits \$10 million of long-term capital gain from its return for Year 1. This gain should have been allocated to Stella, and if she had been allocated that gain, she would have paid an additional \$2 million of tax for Year 1. Then, in Year 2, Stella sells her partnership interest. She does not increase her basis in her partnership interest by the \$10 million of omitted gain from Year 1, so she reports \$10 million too much gain from the Year 2 sale and pays \$2 million too much tax for Year 2. Stella therefore pays the correct amount of tax, but she pays \$2 million too little for Year 1 and \$2 million too much for Year 2.

Some years later, the IRS adjusts the partnership's Year 1 income to include that \$10 million of gain that had been omitted, and the partnership makes a §6226 election. Stella's correction amount for Year 1 equals \$2 million (the additional tax she would have owed had she included the \$10 million of partnership gain on her return for Year 1), and she must pay underpayment interest on this amount at the increased rate that applies when a §6226 election is made.

Stella's correction amount for Year 2 would be negative \$2 million, for that is the amount of excess tax she paid for that year. No overpayment interest is available with respect to this overpaid tax, however.

Therefore, her total correction amount is \$0 (\$2 million minus \$2 million), and she would owe underpayment interest on \$2 million of tax. This will not be reduced or offset by any overpayment interest for the Year 2 correction amount because no overpayment interest is available.

Note: Unlike the push-out election of §6226, it appears that overpayment interest is available under the amended return modification rules of §6225(c).⁵¹⁶ Therefore, when an adjustment will result in an overpayment for one tax year and an underpayment for a different tax year, it might be more advantageous for a partner to amend its tax returns than it is for the partnership to make a §6226 election.

d. Penalties

A partnership that makes a valid §6226 election is not liable for any penalties that relate to an adjustment (or the portion of the adjustment to which the §6226 election relates).⁵¹⁷ Instead, it is the reviewed-year partners who would be liable.

There are three steps in determining whether a penalty applies and the amount that a partner must pay. First, the application of a penalty is evaluated at the partnership level, based on the partnership's facts.⁵¹⁸ It is not entirely clear how this analysis is to be done.

If it is determined in step one that a penalty may apply with respect to an adjustment, each partner must compute the amount of penalty that it must pay in step two. This amount is calculated on an annual basis. In this calculation, the correction amount for the year at issue is treated as an underpayment or understatement of the partner.⁵¹⁹ Also, this analysis is generally based on the characteristics of, and facts and circumstances applicable to, the partner, but the analysis does not take into account partner-specific defenses such as the reasonable cause and good faith defense of §6664(c).⁵²⁰

Example — Application of a §6662 Substantial Understatement Penalty to a Taxable Partner: A partnership omits \$100 million of long-term capital gain from Year 1 that should have been allocated to Stella. The IRS adjusts the partnership's income and the partnership makes a §6226 election. As a result, Stella has a \$20 million correction amount for year 1, and she has no other correction amounts for any other tax year. In step 1, it is determined that a §6662(b) penalty may apply. Therefore, in step 2, Stella must determine the amount of penalty that she owes under §6662(b).

One type of penalty that may be imposed under §6662(b) is a substantial understatement penalty. The application of a substantial understatement penalty under §6662(b) generally depends on whether the taxpayer has omitted more

⁵¹⁴ Reg. §301.6226-3(c)(1).

⁵¹⁵ Reg. §301.6226-3(c)(1).

⁵¹⁶ Under the amended return modification rules of Reg. §301.6225-2(d)(2), it appears that a partner's amended return is respected as an amended return. Refunds are available, and there is no special rule in the BBA that would prohibit overpayment interest. In addition, §6621(d) should be available to eliminate interest on offsetting adjustments for overlapping periods.

⁵¹⁷ §6226(c)(1).

⁵¹⁸ Reg. §301.6226-3(d)(1).

⁵¹⁹ Reg. §301.6226-3(d)(1) and §301.6226-3(d)(2).

⁵²⁰ Reg. §301.6226-3(d)(3).

than 10% of the tax it should have reported.⁵²¹ In evaluating the applicability of this penalty to Stella, her \$20 million correction amount for Year 1 would be treated as an understatement for Year 1. Therefore, she would owe a substantial understatement penalty for Year 1 if that \$20 million correction amount is more than 10% of the tax that Stella should have reported for Year 1. It would not matter how much income Stella reported for her reporting year.

Example — Application of §6662 to a Tax-Exempt Partner: A partnership omits \$100 million of income from Year 1 that should have been allocated to a tax-exempt partner. The IRS adjusts the partnership's income and the partnership makes a §6226 election. As a result, the tax-exempt partner has a \$0 correction amount for Year 1 and every other tax year. In step 1, it is determined that a §6662(b) penalty may apply. Therefore, in step 2, the tax-exempt partner must determine the amount of penalty that it owes under §6662(b). In applying §6662(b), the correction amount for a year is treated as the amount of the underpayment. As the tax-exempt partner has a \$0 correction amount for each year, it would not be treated as having an underpayment for any year, and it would not owe any penalty under §6662(b).

In step 3, partner-specific defenses (defenses that relate to facts that are specific to a particular partner and not the partnership) are available. Therefore, a partner will not be subject to a substantial understatement penalty if it has reasonable cause and good faith for the position it took on its return.⁵²² To avail itself of such a defense, however, the partner must first pay the penalty and then file for a refund for the reporting year.⁵²³

e. REITs and RICs

When a partnership makes a §6226 election and a reviewed-year partner is a REIT or RIC, that partner may avail itself of deficiency dividend procedures with respect to an affected year if it makes a correct "determination" within the meaning of §860(e)(4) that one or more of the adjustments reflected on its Section 6226 Partner Statement constitutes an adjustment within the meaning of §860(d).⁵²⁴

f. Reporting

A partner reports its correction amount, penalties, and interest on Form 9978 *Partner's Additional Reporting Year Tax*, which is filed with the partner's tax return for its reporting year (the tax year in which the Section 6226 Partner Statement is furnished).

3. Adjustments that Cannot Be Pushed Out

Sometimes a partnership has primary and direct liability for paying an amount to the IRS. For example, a partnership

may be liable under chapter 1 of the Code for a tax, penalty, or additional to tax. Examples include the penalty that applies to Opportunity Zone funds under §1400Z-2(f) and liabilities of a real estate mortgage investment conduit under §860F or §860G. Similarly, a partnership may be liable for an imputed underpayment (e.g., because it filed an AAR but did not push out those adjustments). If any of these amounts are adjusted, those adjustments cannot be pushed out.⁵²⁵

4. Withholding and Reporting Obligations Under Chapters 3 and 4

The scope of the BBA generally does not include the withholding and reporting rules of chapter 3 and chapter 4 (i.e., the rules relating to fixed, determinable, annual, or periodical income (FDAP); effectively connected income (ECI); the Foreign Investment in Real Property Tax Act (FIRPTA); and the Foreign Account Tax Compliance Act (FATCA)). Therefore, a partnership's compliance with those rules is not audited in a partnership-level proceeding under the BBA. When a partnership makes a §6226 election, however, chapter 3 and chapter 4 withholding is required with respect to the adjusted amounts.⁵²⁶

a. Partnership Obligations

When a partnership makes a §6226 election, the withholding rules of chapter 3 and chapter 4 generally apply as if the adjusted amounts were reported in the reviewed year, so a reduced rate will generally be available if it would have been available for the reviewed year.⁵²⁷

Example: When a partnership filed its return for Year 1, it omitted \$100 of dividend income that should have been allocated to Stella, a nonresident alien. Dividend income is ordinarily subject to a 30% withholding rate under §1441, but if the partnership had properly reported that dividend income on its return for Year 1, a 10% rate would have applied because Stella provided the partnership with valid documentation certifying that she is eligible for that reduced rate.

In Year 8, the IRS adjusts the partnership's return to correct this error, and the partnership makes a §6226 election. Therefore, the partnership is not required to pay an imputed underpayment, but the partnership must pay the IRS the withholding due under §1441 and file and issue the returns that are required under chapter 3 and chapter 4. The 10% rate applies because the partnership has documentation certifying that dividend income allocated to Stella is eligible for that reduced rate, and that documentation was valid for dividend income recognized in Year 1. It would not matter whether the documentation had since expired and cannot be relied upon for dividend income that is recognized in Year 8. In addition, if the partnership does not have documentation that establishes Stella's eligibility for the reduced rate for dividend income recognized in Year 1, it may rely upon new documentation it receives from Stella in Year 8 so long as the documentation includes a signed

⁵²¹ §6662(d). The threshold is 5% when the taxpayer has reported a deduction under §199A. §6662(d)(1)(C).

⁵²² §6664(c).

⁵²³ Reg. §301.6226-3(d)(3).

⁵²⁴ Reg. §301.6226-3(b)(4).

⁵²⁵ Reg. §301.6226-2(g)(4); see also Reg. §301.6225-1(h)(13) Ex. 13.

⁵²⁶ Reg. §301.6241-6(b)(4).

⁵²⁷ Reg. §301.6241-6(b)(4).

affidavit stating that the information and representations are accurate with respect to the reviewed year (Year 1, in this example).⁵²⁸

There is one way in which withholding in connection with a §6226 election differs from the withholding that would have been required had the adjusted amounts been correctly reported on the partnership's original return. Reg. §1.1446-6 generally allows withholding with respect to effectively connected income to be reduced to reflect partner-specific attributes such as net operating loss carryovers or losses suspended under §704(d). This rule does not apply when a §6226 election is made.⁵²⁹

A partnership must pay the amount withheld on or before the due date for the partnership's return for the adjustment year, without taking extensions into account.⁵³⁰ The associated tax and information returns must be filed and issued for the year that includes the date on which the partnership pays the withholding.⁵³¹

b. Consequences for the Reviewed-Year Partner

A partner may claim a credit under §33 for the amount of withholding that a partnership pays with respect to that partner. This credit is allowed for the partner's reporting year (i.e., its tax year in which it is furnished with a Section 6226 Partner Statement).⁵³²

A U.S. income tax return must be filed by a reviewed-year partner that is allocated additional income that is subject to withholding under chapter 3 or chapter 4 in connection with a §6226 election, even if the partner ordinarily would be exempt from this requirement because it is not engaged in a U.S. trade or business and its tax liability is fully satisfied by withholding at the source.⁵³³

5. Requirements for a Valid Election

A partnership makes a §6226 election by filing or providing three types of forms:

- The §6226 election form (Form 8988);
- The "Section 6226 Partner Statement" (Form 8986); and
- A Section 6226 transmittal report (Form 8985).

The election form (Form 8988, *Election for Alternative to Payment of the Imputed Underpayment-IRC Section 6226*) must be filed with the IRS within 45 days of the Notice of Final Partnership Adjustment (FPA).⁵³⁴ This deadline cannot be extended.⁵³⁵ The election must therefore be made before there is an opportunity for judicial review.

Practice Point: If the partnership agrees to the adjustments made on a notice of proposed partnership adjustment (NOP-

PA), the IRS will not provide an FPA, in which case it might not be possible to make a §6226 election.

Second, the partnership must provide each reviewed-year partner with Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s)* (the "Section 6226 Partner Statement"), which describes the partner's share of the adjustments and related information.⁵³⁶ These Section 6226 Partner Statements must be furnished, and a copy of these statements must be filed with the IRS, within 60 days of the date by which the partnership must file a petition in court to obtain judicial review (i.e., the statements must be furnished and filed within 150 days from the date the FPA is mailed), or, if judicial review is sought in Tax Court, U.S. district court, or the Court of Federal Claims, within 60 days of the date the court's decision becomes final.⁵³⁷ The partners are not required to make any payments until they receive their Section 6226 Partner Statements, so judicial review will be available before the partners must pay any additional amounts that are due. In order for the Court of Federal Claims or a U.S. district court to have jurisdiction, however, the partnership must deposit with the IRS the amount of the imputed underpayment and associated penalties and interest.⁵³⁸ No such deposit is required for Tax Court review.⁵³⁹

Third, the partnership must provide the IRS with a Section 6226 transmittal report (Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*). This form is used to summarize and transmit the Section 6226 Partner Statements. It must be submitted electronically.⁵⁴⁰

If a partnership does not make a proper §6226 election or does not provide Section 6226 Partner Statements or the transmittal report in the manner required, the IRS may determine that the election is invalid, in which case §6226 will not apply and the partnership may be required to pay tax, interest, and penalties.⁵⁴¹

a. The §6226 Election: Form 8988

To make a §6226 election, a partnership must file an election statement with the IRS. Form 8988, *Election for Alternative to Payment of the Imputed Underpayment-IRC Section 6226* may be used; it does not appear to be required. The election must be signed by the partnership representative and must include the following information:

- The partnership's name, address, and taxpayer identification number;
- The taxable year to which the election relates;
- A copy of the FPA to which the election relates;
- The imputed underpayment to which the election relates, if the FPA includes more than one imputed underpayment;

⁵²⁸ Reg. §301.6241-6(b)(4)(ii).

⁵²⁹ Reg. §301.6241-6(b)(4)(ii).

⁵³⁰ Reg. §301.6241-6(b)(4)(i).

⁵³¹ Reg. §301.6241-6(b)(4)(iii).

⁵³² Reg. §301.6226-3(f).

⁵³³ Reg. §301.6226-3(f). Outside of the context of a §6226 election, such persons are generally exempt from filing a U.S. income tax return under Reg. §1.6012-1(b)(2)(i) or §1.6012-2(g)(2)(i).

⁵³⁴ §6226(a)(1).

⁵³⁵ Reg. §301.6226-1(c)(2).

⁵³⁶ Reg. §301.6226-2(a).

⁵³⁷ Reg. §301.6226-2(b)(1), §301.6226-2(c). The statements must be filed electronically with the IRS. Reg. §301.6226-2(c).

⁵³⁸ Reg. §301.6234-1(b).

⁵³⁹ Judicial review is discussed further in V.D.8., below.

⁵⁴⁰ See §6241(10) (granting authority to IRS to require electronic submission of anything required to be submitted under §6226); Instructions for Form 8985 and Form 8985-V (Dec. 2021).

⁵⁴¹ Reg. §301.6226-1(c)(1), §301.6226-1(d).

- The name, taxpayer identification number, and the current or last known address of each reviewed-year partner; and
- Any other information prescribed by the IRS in forms, instructions, and other guidance.⁵⁴²

b. The Section 6226 Partner Statement: Form 8986

A partnership that makes a §6226 election must send a Section 6226 Partner Statement to each reviewed-year partner.⁵⁴³ A statement that is sent through the mail must be sent to the partner's current address or the last address known to the partnership. If a statement is returned to the partnership as undeliverable, the partnership must exercise "reasonable diligence" to determine the correct address and then must re-send the statement using the correct address.⁵⁴⁴

The partnership must also electronically file a copy of the Section 6226 Partner Statements with the IRS.⁵⁴⁵

(1) Persons Who Must Be Sent a Section 6226 Partner Statement

A partnership must send a Section 6226 Partner Statement to each person who was a partner in the reviewed year.⁵⁴⁶ There is no exception for partners that are not affected by the adjustment. A statement must therefore be sent to a partner even when the adjustment does not change the amount of income or loss that is allocated to that partner.

Section 6241(12) provides that for purposes of the BBA, when a partner is a controlled foreign corporation (CFC), each U.S. shareholder (as defined in §951(b) or §953(c)(1)) is treated as a partner in the partnership, except as otherwise provided by the Secretary. When a partner is a passive foreign investment company (PFIC), a similar rule applies with respect to taxpayers that make QEF elections under §1295.

The Secretary has not provided any exceptions to these rules, so it appears that when a partnership has a CFC or a PFIC as a partner, the partnership must provide a Section 6226 Partner Statement to the associated U.S. shareholders and taxpayers that made QEF elections in order for a §6226 election to be valid.

(2) Contents of the Section 6226 Partner Statement

A Section 6226 Partner Statement must include the following information:

- The reviewed-year partner's name, taxpayer identification number, and current or last known address;
- The partner's share of items as originally reported for the reviewed year;
- The partner's share of the partnership adjustments;
- Modifications approved by the IRS with respect to the partner (or, when the partner is a pass-through, any mod-

ifications approved by the IRS with respect to an indirect partner that holds its interest in the partnership through its interest in the reviewed-year partner);

- The applicability of any penalty, addition to tax, or additional amount determined at the partnership level that relates to adjustments that are allocable to the partner; the adjustments to which the penalty or other amount relates; the code section under which the penalty or other amount is imposed, and the applicable rate for the penalty or other amount;

- The date the Section 6226 Partner Statement is furnished to the reviewed-year partner;

- The partnership tax year to which the adjustments relate; and

- Any other information required by forms, instructions, and other guidance prescribed by the IRS.⁵⁴⁷

c. The Section 6226 Transmittal Report: Form 8985

The Section 6226 transmittal report (Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*) is used by the partnership when filing its Section 6226 Partner Statements with the IRS.

6. Tiers

When a partnership (the audited partnership) is audited in a BBA proceeding and makes a §6226 election, it is the partners of the audited partnership, not the audited partnership itself, that take the adjustment into account. When a partner is itself a "pass-through partner" (e.g., a partnership or an S corporation), that pass-through partner may either take its share of the adjustment into account under rules that are analogous to the default rule, or it may effectively make a §6226 election that pushes the adjustment out to its owners.⁵⁴⁸ If those owners are also pass-through partners, they, too, have the same options available.

Example: Stella (an individual) and Inc (a C corporation) are the partners of Top Partnership in Year 1. Top Partnership owns an interest in Middle Partnership, which in turn owns an interest in Audited Partnership. The IRS makes an adjustment to Audited Partnership's return for Year 1 (the reviewed year). Audited Partnership makes a §6226 election and sends to each of its direct partners in Year 1, including Middle Partnership, a Section 6226 Partner Statement. Middle Partnership may either take its share of the adjustment into account by paying an imputed underpayment or applying the true-up rule, or it may "push out" the adjustment to those who were its partners in the reviewed year, including Top Partnership. If Middle Partnership pushes the adjustments out to Top Partnership, Top Partnership will have the same options available. As a result, the three partnerships (Audited Partnership, Middle Partnership, and Top Partnership) may avoid any tax lia-

⁵⁴² Reg. §301.6226-1(c)(3).

⁵⁴³ Reg. §301.6226-2(a). The Section 6226 Partner Statement is made using Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s)*.

⁵⁴⁴ Reg. §301.6226-2(b)(2).

⁵⁴⁵ Reg. §301.6226-2(a), §301.6226-2(c).

⁵⁴⁶ Reg. §301.6226-2(a).

⁵⁴⁷ Reg. §301.6226-2(e).

⁵⁴⁸ Reg. §301.6226-3(e), §301.6241-1(a)(5) (definition of "pass-through partner").

bility and instead have their ultimate partners (including Stella and Inc) pay any additional amounts that are due.

A pass-through partner must either push an adjustment out to its owners or pay any additional amount due by the date by which the audited partnership must file its tax return for the adjustment year, with extensions (the “adjustment-year due date”).⁵⁴⁹ This is the date by which the audited partnership must file its tax return for the adjustment year, with extensions. It does not matter whether the audited partnership is required to file a tax return for that year or whether the audited partnership extends its filing deadline.⁵⁵⁰

The adjustment year is generally the tax year of the audited partnership in which the FPA is mailed, unless the audited partnership seeks judicial review or waives restrictions on assessment under §6232(b).⁵⁵¹ Therefore, in the example above, if the FPA is mailed to the Audited Partnership in 2024 and the Audited Partnership has a calendar year, the adjustment-year due date would generally be September 15, 2025, regardless of whether the Audited Partnership is required to file a tax return for 2024 or whether the Audited Partnership extends its deadline for filing that tax return.

a. *Pass-Through Partners — Pushing Out an Adjustment*

If an adjustment is “pushed out” to a pass-through partner, that pass-through partner may in turn “push out” the adjustment to those who were its owners (e.g., its partners or shareholders) in the year that the adjusted items would have been taken into account had they been properly reported on the original tax returns that were filed.⁵⁵² That way, it is those owners, not the pass-through partner, that will take the adjustment into account and be required to pay any additional tax or other amounts that may be due.

Technically, however, a pass-through partner does not push an adjustment out by making a §6226 election. Instead, it pushes an adjustment out by sending a statement that is analogous to the Section 6226 Partner Statement (a “tiered-partner statement”) to each person that was an owner (e.g., a partner or a shareholder) at any time during the year affected by the adjustment.⁵⁵³ No exception is made for owners who would not be affected by the adjustment. A pass-through partner must also send the IRS a copy of the tiered-partner statements as well as a “tracking report.”⁵⁵⁴

(1) *Timing*

To push out an adjustment, a pass-through partner must file and furnish a tracking report and the tiered-partner statements by the adjustment-year due date.⁵⁵⁵ As discussed above,

this is the extended due date by which the audited partnership must file its tax return for the adjustment year, which is generally the year in which the FPA is mailed or in which the adjustment becomes final pursuant to a court decision. It does not matter how many tiers of pass-through partners there are in the structure. It therefore may be difficult for an upper-tier partnership to meet this deadline.

Example: As in the prior example, Stella (an individual) and Inc (a C corporation) are the partners of Top Partnership in Year 1. Top Partnership owns an interest in Middle Partnership, which in turn owns an interest in Audited Partnership. Audited Partnership has a calendar year, and the IRS adjusts the Audited Partnership’s return for Year 1. The FPA is mailed on December 17, Year 3, and Audited Partnership does not seek judicial review or waive restrictions on assessment, so the adjustment year is Year 3 and the adjustment-year due date is September 15, Year 4. Audited Partnership makes a valid §6226 election and sends timely Section 6226 Partner Statements to its partners, including Middle Partnership. For Middle Partnership to push out its share of the adjustments to its own partners, it must furnish its partners with tiered-partner statements by the adjustment-year due date (September 15, Year 4). As a result, Top Partnership might not receive a tiered-partner statement until September 15, Year 4, but that is the date by which it must furnish its own partners (Stella and Inc) with tiered-partner statements to push out the adjustments to them.

Planning Point: The BBA does not ensure that a pass-through partner will receive information about its share of an adjustment in time to push out the adjustment to its owners. Therefore, when a pass-through partner holds an indirect interest in a lower-tier partnership, the pass-through partner should consider asking the lower-tier partnership to provide timely information about potential and actual adjustments.

(2) *Tracking Report*

A pass-through partner that pushes adjustments out to its own owners must file a tracking report with the IRS by the adjustment-year due date.⁵⁵⁶ The tracking report is filed using Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*. A pass-through partner that does not file this tracking report in the manner required may be subject to penalties under §6698.⁵⁵⁷

(3) *Tiered-Partner Statements*

To push out an adjustment, a pass-through partner must provide tiered-partner statements to those who were its owners (e.g., its partners or shareholders) at any time during the pass-through partner’s taxable year that relates to the audited partnership’s tax year that was adjusted (i.e., the reviewed year).⁵⁵⁸ The tiered-partner statements are analogous to the Section 6226 Partner Statements that the audited partnership provides to its

⁵⁴⁹ Reg. §301.6226-3(e)(1), §301.6226-3(e)(3)(ii), §301.6226-3(e)(4)(ii).

⁵⁵⁰ Reg. §301.6226-3(e)(1), §301.6226-3(e)(3)(ii), §301.6226-3(e)(4)(ii).

⁵⁵¹ Reg. §301.6241-1(a)(1). When an administrative adjustment request (AAR) is filed, the adjustment year is the year in which the AAR is filed. Reg. §301.6241-1(a)(1).

⁵⁵² Reg. §301.6226-3(e)(3).

⁵⁵³ Reg. §301.6226-3(e)(3)(i). The tiered-partner statement is made using Form 8986 *Partner’s Share of Adjustment(s) to Partnership-Related Item(s)*.

⁵⁵⁴ Reg. §301.6226-3(e)(1), §301.6226-3(e)(3)(ii). The tracking report is filed using Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*.

⁵⁵⁵ Reg. §301.6226-3(e)(1), §301.6226-3(e)(3)(ii).

⁵⁵⁶ Reg. §301.6226-3(e)(1).

⁵⁵⁷ Reg. §301.6226-3(e)(2)(ii).

⁵⁵⁸ Reg. §301.6226-3(e)(3).

direct partners, and they are generally subject to the same rules. Like the Section 6226 Partner Statements, the tiered-partner statements are made using Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s)*.

Under the regulations, a tiered-partner statement must include the following information.⁵⁵⁹

- Information about the audited partnership:
 - Its name and taxpayer identification number;
 - The adjustment year;
 - The adjustment-year due date; and
 - The date on which the audited partnership provided the Section 6226 Partner Statements to its direct partners.
- If the pass-through partner that is providing the tiered-partner statement (the “issuer”) is not a direct partner in the audited partnership and therefore received a tiered-partner statement (not a Section 6226 Partner Statement), information about the pass-through partner that provided that tiered-partner statement to the issuer:
 - Its name and taxpayer identification number.
- Information about the issuer:
 - Its name and taxpayer identification number; and
 - Its tax year to which the adjustments relate.
- Information about the recipient of the tiered-partner statement:
 - Its name and taxpayer identification number; and
 - Its current or last known address.
- Information about the recipient's share of the adjustment and related items:
 - The recipient's share of items as originally reported and as adjusted;
 - Modifications approved by the IRS that relate to the recipient;
 - The applicability of any penalties, additions to tax, or other additional amounts determined at the audited-partnership level that relate to any adjustments allocable to the recipient; the recipient's share of the adjustments to which such penalties, additions or other amounts relate; the sections of the Tax Code under which the penalties, additions or other amounts are imposed; and the applicable rate of each penalty, addition or other amount; and
 - Any other information required by forms, instructions, or other guidance prescribed by the IRS (e.g., Form 8986).

b. Pass-Through Partner that Takes Adjustments into Account

If a pass-through partner receives a Section 6226 Partner Statement or a tiered-partner statement from a partnership in which it is a partner, the pass-through partner is not required to push out the adjustment to those who were its owners in the year that the adjusted items would have been taken into account had the adjusted amounts been properly reported on the original tax returns. It may instead take its share of the adjustments into account under the default rule. Under the default rule, positive adjustments result in an imputed underpayment and possibly penalties and interest that the pass-through partner must pay, and negative adjustments either offset positive adjustments (and thereby reduce the imputed underpayment) or are addressed under the true-up rule.⁵⁶⁰

(1) Taking into Account by Making Payment

Any amounts that a pass-through partner must pay (e.g., an imputed underpayment and associated interest and penalties) must be paid by the adjustment-year due date.⁵⁶¹ If the pass-through partner is an indirect partner in the audited partnership, this date might also be the date on which the pass-through partner learns of the adjustment, for it is the date by which the pass-through partner must be furnished with a tiered-partner statement.

Form 8985-V, *Tax Payment by a Pass-Through Partner* should be filed if making payment by check or money order.

(2) Taking into Account Under the True-Up Rule

Under the default rule, the true-up rule applies to adjustments that do not result in or reduce an imputed underpayment. For example, if the audited partnership allocated too much income to one of its partners that is itself a partnership (e.g., Middle Partnership), Middle Partnership could take the adjustment into account by reducing the income or increasing the losses it allocates to its partners in a later year.

The time at which the true-up rule is applied depends on whether there is also an adjustment that results in an imputed underpayment that the pass-through partner must pay. When there is such an imputed underpayment, the pass-through partner applies the true-up rule in the return it files for the tax year in which it pays the imputed underpayment.⁵⁶² For example, if the adjustment year is Year 1 and the pass-through partner pays its imputed underpayment on September 16, Year 2 (the adjustment-year due date), the pass-through partner would take the negative adjustment into account by applying the true-up rule in its return for Year 2 that it files in Year 3.

When the pass-through partner does not have an imputed underpayment, the pass-through partner applies the true-up rule in the return it files for the tax year in which it receives the Section 6226 Partner Statement or tiered-partner statement.⁵⁶³

⁵⁶⁰ Reg. §301.6226-3(e)(4).

⁵⁶¹ Reg. §301.6226-3(e)(4)(ii). Interest would accrue on the imputed underpayment as if it were tax that should have been paid with respect to the reviewed year, so interest would be owed even if the imputed underpayment is paid on time.

⁵⁶² Reg. §301.6226-3(e)(4)(v).

⁵⁶³ Reg. §301.6226-3(e)(4)(v).

⁵⁵⁹ Reg. §301.6226-3(e)(3)(iii).

Therefore, if the pass-through partner receives its Section 6226 Partner Statement or tiered-partner statement in Year 2, the pass-through partner would apply the true-up rule in its return for Year 2 that it files in Year 3.

(3) Tracking Report

A pass-through partner that takes into account its share of adjustments must file a tracking report by the adjustment-year due date.⁵⁶⁴ The tracking report is filed using Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*. A pass-through partner that does not file this tracking report in the manner required may be subject to penalties under §6698.⁵⁶⁵

c. Individuals and C Corporations that Are Indirect Owners

When an individual or C corporation holds its interest in an audited partnership through one or more pass-through partners and the audited partnership makes a §6226 election, there are two ways in which the adjustment might affect the amount of tax that must be paid by the individual or the corporation.

First, all of the pass-through partners may push out the adjustment so that the individual or C corporation takes its share of the adjustment into account by recalculating the amount of tax it should have paid under the rules provided under §6226. In this situation, it is the historic owners who take the adjustment into account (i.e., the individuals and corporations that take the adjustment into account are those who would have been allocated the adjusted amounts had they been properly reported on the original tax returns that were filed).⁵⁶⁶

Second, a pass-through partner might not push the adjustment out to its owners but instead take the adjustment into account itself under the default rule, in which case the true-up rule might be applied. Under the true-up rule, the pass-through partner decreases the income or increases the loss it reports in a later tax year, which could ultimately affect the amount of income and loss reported by those who are partners in that later tax year.⁵⁶⁷

(1) Adjustments that Are Pushed Out to Historic Owners

When an adjustment is ultimately pushed out by a pass-through partner to a C corporation or an individual, the corporation or individual is generally treated as if it received a Section 6226 Partner Statement.⁵⁶⁸ The individual or corporation must recalculate the amount of tax it should have paid in prior tax years (i.e., its correction amounts), and any increase or decrease in the amount that should have been paid will be an adjustment to the amount of tax the individual or corporation pays for the year in which the *direct partners* are furnished with Section 6226 Partner Statements (the “reporting year”).⁵⁶⁹ The individual or corporation must also pay any associated interest and penalties.

Payment might be due before the individual or corporation receives notice of the adjustment. A net correction amount that is positive is treated as additional tax that is owed for the year in which the direct partners are furnished with Section 6226 Partner Statements. The individual or C corporation might not be informed about the adjustment until it receives its tiered-partner statement, however, and those statements do not need to be furnished until the adjustment-year due date. As illustrated in the example below, the adjustment-year due date may be after the date payment is due.

A failure to pay on time will not affect the amount of interest owed with respect to any additional taxes that are due, for such interest starts to accrue on the date that the additional taxes should have been paid if the adjustment had been properly reflected on the partner’s original tax returns.

Late payment could, however, result in penalties under §6651. Regulations therefore provide a grace period; penalties under §6651 will not be imposed so long as the indirect partner reports and pays the additional amount due within 30 days of the adjustment-year due date.⁵⁷⁰ Therefore, if an indirect partner receives its tiered-partner statement on the date the statement must be provided to it (the adjustment-year due date), the indirect partner will not be liable for penalties under §6651 if it pays the additional amounts that are due within 30 days of receiving the tiered-partner statement.

Example: Stella is a partner in Top Partnership, which owns an interest in Middle Partnership, which in turn owns an interest in Audited Partnership. Audited Partnership has a calendar year, and the IRS adjusts the Audited Partnership’s return for Year 1. The FPA is mailed on December 17, Year 3, and Audited Partnership does not seek judicial review or waive restrictions on assessment, so the adjustment year is Year 3 and the adjustment-year due date is September 15 of Year 4.

Audited Partnership makes a valid §6226 election and sends timely Section 6226 Partner Statements to its partners, including Middle Partnership. Middle Partnership pushes out its share of the adjustments and provides a tiered-partner statement to Top Partnership on September 15 of Year 4. Top Partnership, in turn, pushes out its share of the adjustments and provides a tiered-partner statement to Stella on that same day. The tiered-partner statements are therefore timely.

Stella calculates her correction amounts for Year 1 and other affected tax years by determining how much additional tax she owes or excess tax she paid for each year, as determined under the rules that apply when a §6226 election is made. The date on which the additional tax and other amounts must be paid depends on when Audited Partnership provided the Section 6226 Partner Statements to its direct partners (e.g., Middle Partnership). If Audited Partnership provided the Section 6226 Partner Statements in January of Year 4, the additional amount owed by Stella would be added to the tax she must pay for Year 4. She would therefore be required to pay that additional amount by April 15 of Year 5.

⁵⁶⁴ Reg. §301.6226-3(e)(1), §301.6226-3(e)(4)(ii).

⁵⁶⁵ Reg. §301.6226-3(e)(2)(ii).

⁵⁶⁶ Reg. §301.6226-3(e)(3)(iv).

⁵⁶⁷ Reg. §301.6226-3(e)(4)(v).

⁵⁶⁸ Reg. §301.6226-3(e)(3)(iv).

⁵⁶⁹ Reg. §301.6226-3(e)(3)(iv).

⁵⁷⁰ Reg. §301.6226-3(e)(3)(iv).

If instead Audited Partnership provided the Section 6226 Partner Statements on December 29 of Year 3, Stella would be required to pay the additional amount by April 15 of Year 4, even though she did not receive her tiered-partner statement until September 15 of Year 4. She would not be subject to late-payment penalties under §6651 so long as she reports and pays the additional amount due within 30 days of the adjustment-year due date (the date she received her tiered-partner statement).

(2) *Adjustments that a Pass-Through Partner Takes into Account Under the True-Up Rule*

The true-up rule applies when a pass-through partner takes into account an adjustment that does not result in or reduce the amount of an imputed underpayment.⁵⁷¹ As a result, the taxpayers who ultimately take the adjustment into account are those who own the pass-through partner in the tax year in which the true-up rule is applied. For example, if the reviewed year is Year 1 and the pass-through partner takes the adjustment into account by applying the true-up rule to its return for Year 3, the pass-through partner would reduce the income (or increase the loss) it allocates to its owners for its Year 3 tax year.

A detailed example of the operation of a §6226 election in a tiered-partnership structure is provided in Worksheet 2.

7. *Attribute Adjustments*

Proposed regulations address the manner in which tax attributes are adjusted when a §6226 election is made.⁵⁷² Under these proposed regulations, the reviewed-year partners and the partnership adjust their tax attributes to reflect an adjustment, but partners that acquired their partnership interests after the reviewed year do not adjust their tax attributes. Those partners might nevertheless be affected by an adjustment, due to the partnership's adjustment of its tax attributes such as inside basis (the partnership's basis in its assets).

8. *Judicial Review*

A partnership may make a §6226 election and seek judicial review, but the election generally must be made before the court would have adjudicated the proposed adjustment. A §6226 election must be made within 45 days of the date the notice of final partnership adjustment (FPA) is mailed, which would be before any judicial decision is rendered (and would probably be before the date a petition is filed seeking judicial review).⁵⁷³ Moreover, this deadline for filing the §6226 election cannot be extended even when judicial review is sought, and the election is irrevocable unless IRS consent is obtained.⁵⁷⁴

Note: The IRS will not consent to the revocation of the election after the Section 6226 Partner Statements have been furnished.⁵⁷⁵

For a §6226 election to be valid, a partnership must ordinarily provide its partners with Section 6226 Partner Statements.⁵⁷⁶ When judicial review is sought, the Section 6226 Partner Statements do not need to be provided until after the court's decision becomes final.⁵⁷⁷ A partnership cannot, however, effectively revoke or invalidate its §6226 election by failing to provide Section 6226 Partner Statements. A §6226 election is valid until the IRS determines otherwise.⁵⁷⁸

To obtain judicial review, the partnership must file a petition in court within 90 days of the date the FPA is mailed.⁵⁷⁹ If the petition is filed in Tax Court, no taxes or other amounts need to be paid or deposited. If instead the petition is filed in the Court of Federal Claims or a District Court, the partnership must deposit with the IRS the amount of the imputed underpayment and any associated penalties, additions to tax, or additional amounts.⁵⁸⁰ The partnership's imputed underpayment could be significantly larger than the amount of tax the reviewed-year partners would be required to pay if the adjustment is sustained. It is not clear whether the amount of penalties or interest that must be deposited are computed under §6226 or under the default rule of §6225(a), §6225(b), and §6233.

A partnership must provide Section 6226 Partner Statements to its reviewed-year partners within 60 days of the date the court's decision has become final.⁵⁸¹ The tax year in which a partner is furnished with a Section 6226 Partner Statement is its "reporting year," which is the year in which the partner takes into account its share of the adjustments. For example, if the court's decision becomes final in December of Year 1 and the partnership provides the Section 6226 Partner Statements in January of Year 2, a partner that is on a calendar year would take the adjustments into account by adjusting the amount of tax it pays for its Year 2 tax year.

E. *Mix and Match — Multiple Imputed Underpayments*

When more than one adjustment is made with respect to a single tax year, there is generally no more than one imputed underpayment for that tax year, and all of the adjustments would be taken into account under the default rule, under the default rule as modified by the modification procedures, or under §6226. It may sometimes be possible, however, for some adjustments to be taken into account under the default rule (or the default rule as modified by the modification rules), and other adjustments to be taken into account under §6226.⁵⁸² This is done by separating the adjustments so that there are multiple imputed underpayments, with one imputed underpayment taking into account some of the adjustments, and another imputed underpayment taking into account other adjustments. Then one imputed underpayment may be taken into account under the default rule (or the default rule as modified by the modification rules), and another imputed underpayment may be taken into account under a §6226 election.

⁵⁷¹ Reg. §301.6226-3(e)(4)(v).

⁵⁷² Prop. Reg. §301.6226-4.

⁵⁷³ §6226(a)(1), 6234.

⁵⁷⁴ Reg. §301.6226-1(c)(2), §301.6226-1(c)(1).

⁵⁷⁵ See Form 8989, *Request to Revoke the Election for Alternative Payment of the Imputed Underpayment*.

⁵⁷⁶ Reg. §301.6226-1(c)(1).

⁵⁷⁷ Reg. §301.6226-2(b)(1)(ii).

⁵⁷⁸ Reg. §301.6226-1(c)(1).

⁵⁷⁹ §6234(a).

⁵⁸⁰ §6234(b); Reg. §301.6234-1(b).

⁵⁸¹ Reg. §301.6226-2(b).

⁵⁸² Reg. §301.6226-1(a), §301.6226-3(h) *Ex. 4*.

Adjustments may be separated into multiple imputed underpayments under the IRS's discretion.⁵⁸³ In addition, under the modification procedures, a partnership may ask the IRS to

modify the number or composition of the imputed underpayments.⁵⁸⁴

⁵⁸³ Reg. §301.6225-1(g).

⁵⁸⁴ Reg. §301.6225-2(d)(6).

VI. Partnership-Requested Modifications and Administrative Adjustment Requests (AARs)

A. Overview

Under the BBA, a partnership generally cannot file an amended return. Instead, it generally revises its tax return by filing an administrative adjustment request (AAR). An AAR is not a “do-over,” however. With an AAR, the amount of tax owed by a partner might be different from the amount that the partner would have owed had the adjusted amounts been reported on the original returns that were filed. For example, refunds are not allowed under the AAR rules. If a partnership reports too much income on its original return and the partners accordingly pay too much tax, they cannot obtain a refund by having the partnership file an AAR. Instead, the AAR effectively gives the partners a nonrefundable tax credit that may only be used in what is called the “reporting year.”

The AAR rules may be avoided, however, if the partnership files a revised return before the deadline for filing has expired, taking into account any extensions that have been granted. Such a return is a “superseding return.”⁵⁸⁵

Practice Point: A partnership should consider extending its deadline for filing its return even if it will file its return before the unextended deadline. That way, the partnership will have a longer period in which it is possible to file a superseding return.

In addition, Rev. Proc. 2022-39 addresses how a partnership can satisfy the “qualified amended return” requirement under Reg. §1.6664-2(c)(3) for purposes of penalty protection when an audit is conducted under the Large Corporate Compliance Program or the Large Partnership Compliance Program. There have also been limited situations in which the IRS has allowed partnerships to file amended returns instead of AARs, as discussed below.

B. When AARs May Be Filed

An AAR for a tax year must be filed within three years of the date the partnership return was filed or, if later, the due date for filing that return (determined without regard to extensions).⁵⁸⁶

Practice Point: Note that the IRS does not have the power to extend this deadline.⁵⁸⁷

In addition, an AAR cannot be filed once the IRS has mailed the partnership a notice of administrative proceeding (NAP) with respect to the applicable tax year.⁵⁸⁸ The IRS is, however, allowed to withdraw a NAP, in which case the partnership would again be allowed to file an AAR.⁵⁸⁹

C. How Adjustments Are Taken into Account

When an AAR is filed, the manner in which the adjusted amounts are taken into account may depend on whether the adjustments would be taken into account in the imputed underpayment calculation if the default rule were applied.⁵⁹⁰ Under the default rule, positive adjustments are always taken into account in the imputed underpayment calculation. Negative adjustments are taken into account either in the imputed underpayment calculation or under the true-up rule. Which approach applies depends on the grouping rules that are discussed in V.B.1.c., above.

1. Adjustments that Would Be Taken into Account in the Imputed Underpayment Calculation if the Default Rule Applied

For adjustments that would be taken into account in the imputed underpayment calculation if the default rule applied, the partnership may either pay the imputed underpayment and associated amounts, or the partnership may elect for those adjustments to be taken into account by the reviewed-year partners as if a §6226 election were made.⁵⁹¹

a. Payment of the Imputed Underpayment

The imputed underpayment that a partnership pays under the AAR rules is generally calculated under the §6225 default rule.⁵⁹² Certain modifications under §6225(c) are available as well.⁵⁹³ For example, a partnership may take into account a partner’s status as tax exempt or foreign, the status of a partner as a C corporation, the status of a partner as an individual when that partner should have been allocated additional capital gain or qualified dividend income, the modification for passive activity losses that is available for publicly traded partnerships, the modifications relating to the grouping rules, and the modifications available when a partner is a REIT or a RIC. Also, the IRS has authority to issue guidance that allows additional modifications to be taken into account in connection with an AAR.

Some modifications are not available, however. These include the amended-return modification, the pull-in or alternative procedure, and modifications relating to closing agreements.⁵⁹⁴

A partnership must pay the imputed underpayment when it files the AAR.⁵⁹⁵

b. Adjustments that Are Pushed out to the Partners

A partnership may elect to “push out” adjustments that would have been taken into account in the imputed underpayment calculation if the default rule applied. When this election is made, the reviewed-year partners take the adjustments into account as if a §6226 election were made.⁵⁹⁶ To make this election, a partnership must provide statements analogous to

⁵⁸⁵ See Rev. Proc. 2019-32 for a discussion of superseding returns. In addition, the IRS sometimes authorizes alternative approaches to revising a prior return. For example, in the context of employee retention credits, the IRS has allowed taxpayers to use the tax-benefit rule to report additional income for a prior year. See CCA 202538022.

⁵⁸⁶ §6227(c); Reg. §301.6227-1(b). See also CCA 202538022.

⁵⁸⁷ CCA 202538022.

⁵⁸⁸ §6227(c); Reg. §301.6227-1(b).

⁵⁸⁹ Reg. §301.6231-1(f).

⁵⁹⁰ Reg. §301.6227-2(a)(1).

⁵⁹¹ Reg. §301.6227-2(b), §301.6227-2(c).

⁵⁹² Reg. §301.6227-2(b).

⁵⁹³ Reg. §301.6227-2(a)(2).

⁵⁹⁴ Reg. §301.6227-2(a)(2).

⁵⁹⁵ Reg. §301.6227-2(b)(1).

⁵⁹⁶ Reg. §301.6227-2(c).

Section 6226 Partner Statements to its partners on the date the AAR is filed with the IRS, and copies of those statements must be filed with the AAR.⁵⁹⁷

Under this approach, the §6226 rules determine the amount of additional tax that a partner must pay, and this additional amount is treated as additional tax that is due for the partner's year in which it is furnished with the statement (the "reporting year").⁵⁹⁸

Although the underpayment interest rate is generally 2 percentage points higher when a §6226 election is made, this increased interest rate does not apply when a partnership files an AAR.⁵⁹⁹

2. Adjustments that Would Not Be Taken into Account in the Imputed Underpayment Calculation if the Default Rule Applied

Adjustments that would not be taken into account in the imputed underpayment calculation must be "pushed out" to the partners under rules that generally piggyback off of the §6226 push-out rules.⁶⁰⁰ The AAR rules do not allow for a "true-up" approach in which the partnership takes these adjustments into account by omitting income or increasing the losses it reports for the adjustment year.⁶⁰¹

When adjustments are "pushed out" in connection with an AAR, a partnership must provide statements analogous to Section 6226 Partner Statements to its partners on the date the AAR is filed with the IRS, and copies of those statements must be filed with the AAR.⁶⁰²

The §6226 rules determine the amount by which a partner's tax liability may be reduced to reflect the adjustments. This change in tax liability (the "correction amount") is treated as a tax credit for the partner's year in which it was furnished with the statement (the "reporting year").⁶⁰³ Under the §6226 rules, if the "tax credit" exceeds the amount of tax the partner otherwise would have had to pay for the reporting year, the excess amount cannot be refunded or carried forward.⁶⁰⁴

Example: A partnership allocated \$100 too much long term capital gain to Stella in Year 1. The partnership then files an AAR to correct this error. This revision would not result in an imputed underpayment under the default rule, so it must be taken into account under the §6226 rules. That excess income increased Stella's taxes for Year 1 by \$20, so her correction amount is negative \$20. Therefore, Stella may take the adjustment into account as if it were a \$20 credit that may be reported for the reporting year (the year in which receives the statement from the partnership informing her of the adjustment). If her tax for the reporting year is \$27 (not taking the AAR into account), Stella will owe \$7 of tax for the reporting year. If instead her tax for the reporting year is \$8 (not taking the AAR into ac-

count), Stella will owe \$0 of tax for the reporting year, and \$12 of the "tax credit" will not produce any tax benefit.

Practice Point: Before filing an AAR that would result in adjustments that would produce such a nonrefundable "credit," a partnership may want to consider whether its partners would be able to benefit from the "credit." If not, it may be more advantageous to not file the AAR, due to the attribute adjustment rules.

Practice Point: If a partnership has some flexibility as to when it files the AAR, it may want to consider what date would be most advantageous for the partners. The date that the AAR is filed will determine the year in which a partner may take into account a nonrefundable "credit" under §6227 (i.e., the reporting year), and a partner may be able to obtain more benefit from the adjustments in one year than in another year. For example, if a partner has net income in Year 1 and net losses in Year 2, the partner may benefit from the adjustments if the reporting year is Year 1, but not if the reporting year is Year 2. In that case, the partnership may want to consider filing the AAR in Year 1 instead of Year 2.

Practice Point: If the partner's period for filing a refund claim has not expired, it may be better for the partner to amend its tax return to reflect its share of the adjustments and then file a refund claim. The amended return should be filed before the AAR is filed, and the return should include a notice of inconsistent treatment. If filed after the AAR, the amended return might be invalid or otherwise not respected.

D. When Amended Returns May Be Filed

Although a partnership that is subject to the BBA cannot ordinarily revise its return by filing an amended return, the IRS has sometimes allowed partnerships to file amended returns when there is new legislation or guidance that has retroactive effect. The amended return procedures may be more beneficial than an AAR because with amended returns, the partners may be able to obtain a refund, but with an AAR the partners effectively receive a nonrefundable credit. In addition, the amended return procedures accelerate the remedy for the partnership and its partners. With an AAR, partners cannot obtain any benefit from the adjustments until they file their returns for the "reporting year" (i.e., the year in which they receive a statement analogous to a Section 6226 Partner Statement). In contrast, with an amended return, a partner may be able to file a refund claim as soon as the amended return has been filed. An additional advantage is that an amended return does not extend the statute of limitations, but an AAR extends the statute of limitations until three years from the date that the AAR is filed.⁶⁰⁵

When the IRS has allowed an amended return to be filed, the amended returns are optional.

A partnership may file an AAR instead.⁶⁰⁶

1. Rev. Proc. 2020-23

Rev. Proc. 2020-23 was issued to address amendments made by the Coronavirus Aid, Relief, and Economic Security

⁵⁹⁷ Reg. §301.6227-1(c)(2)(ii), §301.6227-1(d).

⁵⁹⁸ Reg. §301.6227-3(a).

⁵⁹⁹ Reg. §301.6227-3(b)(1).

⁶⁰⁰ Reg. §301.6227-3.

⁶⁰¹ Reg. §301.6227-2(d), §301.6227-3.

⁶⁰² Reg. §301.6227-1(c)(2)(ii), §301.6227-1(d).

⁶⁰³ Reg. §301.6227-3(a).

⁶⁰⁴ Reg. §301.6226-3(a), §301.6226-3(b)(1).

⁶⁰⁵ §6235(a)(1)(C).

⁶⁰⁶ Rev. Proc. 2021-50, §2.03(2); Rev. Proc. 2021-29, §2.05; Rev. Proc. 2020-23, §2.05.

Act (CARES Act) to fix the so-called “retail glitch” in the 2017 Tax Cuts and Jobs Act (TCJA). Under the TCJA, residential real property was intended to be depreciable over a 15-year period and be eligible for 100% bonus depreciation. Due to a drafting error, however, such property was given a recovery period of 39 years and was not eligible for bonus depreciation. This error may have affected a taxpayer’s decision whether to make an election under §163(j) to be treated as a real property trade or business.

The CARES Act corrected this retail glitch, with retroactive effect. In addition, Rev. Proc. 2020-22 allowed taxpayers to make a late election under §163(j) to be treated as a real property trade or business, or to revoke such an election.

To enable partnerships and their partners to benefit from such retroactive relief without being subject to the AAR rules, Rev. Proc. 2020-23 temporarily allowed certain partnerships to file amended returns. Under Rev. Proc. 2020-23, a partnership could amend a return for a tax year that began in 2018 or 2019 if the return was filed before April 8, 2020 (the date that Rev. Proc. 2020-23 was issued). The amended return had to be filed before September 30, 2020.

A partnership was eligible to file an amended return even if it was not availing itself of the retroactive provisions.⁶⁰⁷

2. Rev. Proc. 2021-29

Section 202 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), enacted as part of Title II of Division EE of the Consolidated Appropriations Act, 2021 (Pub. L. No. 116-260), retroactively allows a recovery period of 30 years under the alternative depreciation system (ADS) in §168(g) for certain residential rental property that was placed in service before January 1, 2018, held by an electing real property trade or business under §163(j)(7)(B), and not previously subject to the ADS. Rev. Proc. 2021-28 allowed taxpayers to make the associated change in method of accounting by filing amended tax returns, but that revenue procedure did not authorize partnerships subject to the BBA to file amended returns. Rev. Proc. 2021-29 extended the relief provided by Rev. Proc. 2021-28 to partnerships that are subject to the BBA. Under Rev. Proc. 2021-29, a partnership could file an amended return for a tax year that began in 2018, 2019, or 2020 if the original return was filed before June 17, 2021 (the date that Rev. Proc. 2021-29 was issued). The amended return had to be filed before October 15, 2021. An amended return was allowed in only two situations: (1) when the partnership had residential rental property within the scope of §3 of Rev. Proc. 2021-28 and was changing its method of depreciation or general asset account treatment for such property, or (2) when the partnership was within the scope of §3.01(1) of Rev. Proc. 2020-22 and was choosing to make a late §163(j) election.

3. Rev. Proc. 2021-50

In response to the COVID-19 pandemic, Congress created the Paycheck Protection Program (PPP) loan program under which part or all of the loan could be forgiven. Such loan forgiveness could result in tax-exempt income. Rev. Proc. 2021-48 addressed the timing of when such tax-exempt income

is received or accrued. Rev. Proc. 2021-49 addressed associated allocations under §704 and adjustments to outside basis under §705.

Under Rev. Proc. 2021-50, a partnership subject to the BBA could implement the guidance provided by Rev. Proc. 2021-48 and Rev. Proc. 2021-49 by filing an amended return. The amended return procedures were available if the return was for a tax year that ended after March 27, 2020 but before November 18, 2021 (the date that Rev. Proc. 2021-48 and Rev. Proc. 2021-49 were issued), and if the original return was filed before November 18, 2021 (the date that Rev. Proc. 2021-50 was issued). The amended return had to be filed before December 31, 2021.

An amended return was not allowed unless the partnership was implementing the guidance provided in Rev. Proc. 2021-48 or Rev. Proc. 2021-49. To implement Rev. Proc. 2021-48, the partnership must treat tax-exempt income resulting from the forgiveness of a PPP loan, at a time described in §3.01(1), (2) or (3) of Rev. Proc. 2021-48, by filing an amended return in accordance with §3.02 of Rev. Proc. 2021-48. To implement Rev. Proc. 2021-49, the partnership must be within the scope of §3 of that revenue procedure and meet the requirements of §4.02(1), 4.02(2), 4.02(3), or 4.02(4) of Rev. Proc. 2021-49 by filing an amended return in accordance with §6 of Rev. Proc. 2021-49.

E. Form 1065-X

For taxpayers not filing electronically, Form 1065-X is used to (i) correct items on a previously filed Form 1065, *U.S. Partnership Return of Income*, Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*, or Form 1066, *U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return*; or (ii) to make an Administrative Adjustment Request (AAR) for a previously filed Form 1065, Form 1065-B, or Form 1066.

The correct version of form to use depends on the tax year, as described below:

- For tax years beginning before 2020, taxpayers should use the September 2018 version of Form 1065-X.
- For tax years beginning after 2020 and before 2023, taxpayers should use the December 2021 version of Form 1065-X, which added instructions for including amended Schedules K-2 and K-3 (Form 1065).
- For tax years beginning after 2022 and before 2025, taxpayers should use the August 2023 version of Form 1065-X.
- For tax years beginning after 2024, taxpayers should use the October 2025 version of Form 1065-X, which removed references to TEFRA and added instructions regarding domestic R&E expenditures.

F. Amendments to Schedules K-1

Under §6031(b), a partnership cannot amend the Schedules K-1 it sends to its partners after the due date for filing its return, including extensions, unless:

- The partnership has made a valid election out of the BBA rules for that tax year under §6221(b);

⁶⁰⁷ Rev. Proc. 2020-23, §3.02.

- The amendment is made pursuant to the modification procedures of §6225(c);
- The amendment is with respect to statements provided under §6226; or
- The amendment is otherwise allowed by the Secretary.

If a partnership files its tax return by its unextended due date, it would ordinarily not request an extension, in which case it would generally be prohibited from revising its Schedules K-1 after the unextended due date. A partnership that requests an extension, however, would be allowed to revise its Schedules K-1 until the extended due date, even if it files its return before that date.⁶⁰⁸

Planning Point: A partnership should consider requesting an extension for filing its tax return even if it will file by the unextended due date. Otherwise, the partnership might have to file an AAR in order to revise a Schedule K-1.

⁶⁰⁸ Rev. Proc. 2019-32 allowed an eligible partnership that had filed its return by its unextended due date to be treated as having filed a timely and appropriate request for a six-month extension so that the partnership may could revise its Schedules K-1 by filing a superseding Form 1065 and associated Schedules K-1. This extension was only available for partnership tax years that ended before July 25, 2019, and for which the extended due date was after July 25, 2019.

VII. Taxes, Withholding and Reporting Obligations Not Imposed Under Chapter 1

A. Scope of BBA Limited to Chapter 1 Taxes

The scope of the BBA is generally limited to taxes imposed under Chapter 1, which does not include self-employment taxes (SECA) imposed under Chapter 2; net investment income taxes imposed under Chapter 2A; or Chapter 3 and Chapter 4 taxes, withholding, and reporting obligations.⁶⁰⁹ The BBA and associated regulations, however, include provisions that coordinate the BBA with these other rules.⁶¹⁰

B. BBA Adjustments Taken into Account in Other Proceedings

Although the BBA is limited to adjustments to items reported under Chapter 1, the determinations made in a BBA proceeding will be taken into account in subsequent proceedings that address taxes imposed under other chapters.⁶¹¹

Example: A partnership omits \$10 million of income in Year 1. This income should have been allocated to Stella, and Stella should have taken this \$10 million of income into account for purposes of the Chapter 1 income tax and the Chapter 2A net investment income tax. In Year 3, the IRS audits the partnership in a BBA proceeding and the partnership agrees to increase the income it should have allocated to Stella in Year 1 by \$10 million. The partnership representative decides to apply the default rule for this adjustment. If the highest individual or corporate tax rate is 37%, that is the applicable tax rate and the partnership pays \$3.7 million of tax (the imputed underpayment). This tax does not take into account the Chapter 2A tax on net investment income. The IRS may, however, open an audit of Stella with respect to the net investment income tax she was required to pay for Year 1, and in this audit, the IRS may take into account the \$10 million adjustment made in the BBA proceeding. Therefore, that additional \$10 million of income might affect whether Stella's income is over the threshold amount specified by §1411(b), and that \$10 million of income might be subject to net investment income tax. The partnership would not be liable for this tax or any associated interest or penalties.

As discussed in V.B.1.b., above, the amount of self-employment earnings reported on the Schedule K-1 is a partnership-related item, and an adjustment to that amount may result in an imputed underpayment. The payment of that imputed underpayment is not a payment of self-employment tax under Chapter 2, and the partner's liability for self-employment tax is not reduced by the partnership's payment of the imputed underpayment.

C. The Statute of Limitations for Self-Employment Taxes and the Net Investment Income Tax

Adjustments relating to self-employment taxes or the net investment income tax are generally subject to the partner's statute of limitations under §6501, but partnership adjustments under the BBA are generally subject to the statute of limitations provided by the BBA. Therefore, a partnership adjustment might be made under the BBA after the partner's general statute of limitations under §6501 has expired. To enable the IRS to collect self-employment taxes and net investment income tax that relate to items adjusted in a BBA audit, §6501(c)(12) provides that when an adjustment to self-employment tax or net investment income tax is attributable to a partnership adjustment under the BBA, the period of limitations will not expire until one year after the partnership adjustment becomes final.

D. Coordination with Chapter 3 and Chapter 4 (FDAP, ECI, FIRPTA, and FATCA)

Chapter 3 and Chapter 4 withholding (i.e., withholding relating to FDAP, ECI, FIRPTA and FATCA) are generally outside the scope of the BBA, so such withholding and reporting obligations are not generally enforced in a BBA proceeding. These withholding and reporting rules are applied when a partnership makes a §6226 election, however.⁶¹²

In addition, the BBA coordinates the withholding rules with the BBA default rule so that income is not taxed more than once.⁶¹³ Payments of tax made under the BBA should satisfy the obligation to pay tax (or withhold) under Chapters 3 and 4, and vice versa. Interest and penalties might nevertheless apply.

Example — BBA Proceeding Resolved Before the Withholding Proceeding: A partnership omits \$100 of income that is subject to withholding. The IRS conducts two audits: a BBA proceeding that addresses Chapter 1 income tax, and an examination of withholding under Chapters 3 and 4. The BBA proceeding is resolved first and the partnership pays the associated imputed underpayment. As that imputed underpayment is tax that is paid with respect to the \$100 of omitted income, the partnership is deemed to have satisfied its associated withholding obligations under Chapters 3 and 4.⁶¹⁴ The partnership may, however be required to pay interest and penalties under Chapters 3 and 4.

Example — Withholding Proceeding Resolved Before the BBA Proceeding: A partnership omits \$100 of income that is subject to withholding, and the IRS conducts a BBA audit and a withholding audit. The withholding examination is resolved first and the IRS collects the amount required

⁶⁰⁹ §6241(9). Also see the discussion in V.B.1.b., above, regarding why an adjustment to self-employment earnings on the Schedule K-1 may be a "partnership related item" that is within the scope of the BBA.

⁶¹⁰ Reg. §301.6241-6.

⁶¹¹ §6241(9). It is also possible for a PRI to be adjusted at the partner level, solely for purposes of chapters other than Chapter 1. See Reg. §301.6241-6(a); CCA 202440007.

⁶¹² Reg. §301.6241-6(b)(4). See V.D.4., above.

⁶¹³ The regulations do not address withholding under §1443(b), relating to foreign tax-exempt organizations, because such withholding relates in part to tax owed under §4948, which is not a Chapter 1 tax. Reg. §301.6241-6(b)(2); REG-119337-17, 82 Fed. Reg. 56,765 (Nov. 30, 2017) (preamble to proposed regulations).

⁶¹⁴ Reg. §301.6241-6(b)(3).

to be withheld with respect to that \$100. When an adjustment is then made under the BBA, the additional \$100 of income is disregarded for purposes of calculating the imputed underpayment.⁶¹⁵ It is not clear, however, whether the partnership would be required to pay interest and penalties under the BBA. Interest and penalties are im-

posed on partnerships that owe an imputed underpayment; if there is no imputed underpayment, there might be no basis for imposing penalties and interest.

⁶¹⁵ Reg. §301.6225-1(b)(3), §301.6241-6(a)(2)(ii).

VIII. Partners that Are Foreign Corporations

A. CFC Partners

Under §6241(12), when a partner is a controlled foreign corporation (CFC), each U.S. shareholder (as defined in §951(b) or §953(c)(1)) with respect to that CFC is treated as a partner in the partnership, except as otherwise provided by the Secretary.

Note: This rule may make it difficult for a partnership to make a valid §6226 election when it has a partner that is a CFC. To make a valid election, a partnership must send a Section 6226 Partner Statement to each partner. Therefore, if the partnership has a partner that is a CFC, the partnership might be required to send a Section 6226 Partner Statement to some of the shareholders of the CFC, but the partnership might not have any information about these shareholders. For example, the partnership might not know who the United States shareholders are.

B. PFIC Partners

When a partner is a passive foreign investment company (PFIC), a similar rule applies with respect to taxpayers that make “QEF” elections under §1295. To date, the Treasury has not made any exceptions to these rules.

Note: This rule may make it difficult for a partnership to make a valid §6226 election when it has a partner that is a PFIC. To make a valid election, a partnership must send a Section 6226 Partner Statement to each partner. Therefore, if the partnership has a partner that is a PFIC, the partnership might be required to send a Section 6226 Partner Statement to some of the shareholders of the PFIC, but the partnership might not have any information about these shareholders. For example, the partnership might not know whether any shareholder has made a QEF election.

C. Foreign Corporations that Are Not CFCs or PFICs

As discussed above, when a partner is a CFC or a PFIC, the partnership might be required to send Section 6226 Partner Statements to certain shareholders of that partner to make a valid §6226 election. There would not be any obligation to provide statements to shareholders of a partner that is a foreign corporation that is not a CFC or a PFIC. However, it is possible that the partnership might have to prove that its partner is not a CFC or a PFIC, to establish that it provided all requisite Section 6226 Partner Statements and hence made a valid §6226 election.

IX. BBA Audit Procedures

A. Notice of Selection for Examination (NOSE)

The notice of selection for examination (NOSE) is the first notice that a partnership will receive about an IRS audit.⁶¹⁶ The NOSE is sent to the partnership but not to the partnership representative.⁶¹⁷

There are three reasons why the NOSE is significant. First, once the IRS has issued the NOSE, it appears that the partnership might have no more than 30 days in which it may file an administrative adjustment request (AAR). An AAR must be filed before the IRS issues a notice of administrative proceeding (NAP),⁶¹⁸ and the IRS is apparently planning to wait 30 days after issuing a NOSE before issuing the NAP.⁶¹⁹ This 30-day period between the NOSE and the NAP is a matter of IRS internal procedures and is not guaranteed by the statute or regulations. Moreover, the NOSE itself is a matter of IRS internal procedures and does not need to be issued in order for the IRS to issue an FPA.⁶²⁰

Practice Point: When a partnership receives a NOSE, it should evaluate whether to file an AAR as quickly as possible. In some respects, the AAR rules may be more favorable than the rules that apply when an adjustment is not made pursuant to an AAR. For example, with a §6226 election, the underpayment interest rate is generally 2 percentage points higher than what ordinarily would apply, but with an AAR a partnership may avail itself of the §6226 rules without having this increased interest rate apply.⁶²¹ On the other hand, the AAR rules are more limited than the options available under §6225. For example, with an AAR, an imputed underpayment cannot be modified to take into account an amended return filed by a partner or a closing agreement entered into by a partner. Similarly, the pull-in modification is not available.⁶²² In addition, the partners may effectively receive a nonrefundable credit (but not a refund) if an adjustment is made pursuant to an AAR, but refunds are available under some of the modification rules when an AAR is not filed.

The second reason why the NOSE is significant is that it provides a partnership with an opportunity to revoke the designation of its partnership representative before the partnership representative acts on behalf of the partnership and its partners in connection with the audit. The receipt of the NOSE is generally a partnership's first opportunity to revoke the designation of its partnership representative; revocation before that date is prohibited and ineffective unless the partnership files an AAR for purposes other than to revoke the designation of

the partnership representative.⁶²³ In addition, the NOSE is not sent to the partnership representative, so if the designation is revoked when the NOSE is received, the partnership representative would never be informed about the audit.

A partnership might have no more than 30 days in which to revoke the designation before the partnership representative is informed about the audit. As discussed above, the IRS might issue a NAP 30 days after the NOSE, and the NAP is issued to both the partnership and the partnership representative.⁶²⁴

Third, if the affected tax year began after November 2, 2015 and before January 1, 2018, the partnership could elect to apply the BBA to that tax year.⁶²⁵ As discussed in I.C.2., above, a partnership had 30 days from the date of the NOSE to make this election.

B. Notice of Administrative Proceeding (NAP)

The second notice sent by the IRS is a notice of administrative proceeding (NAP). The IRS intends to wait at least 30 days after sending the NOSE before sending the NAP.⁶²⁶

The NAP is sent to both the partnership and the partnership representative and is the first notice that the IRS sends to the partnership representative.⁶²⁷ The partnership representative is allowed to resign once a NAP has been issued.⁶²⁸

A partnership cannot file an AAR after a NAP is mailed.⁶²⁹ The IRS may withdraw a NAP, however, in which case the partnership would then be allowed to file an AAR.⁶³⁰ Withdrawal must occur within 60 days of issuance of the NAP, and is prohibited if the IRS has already inspected the partnership's records. In addition, withdrawal of the NAP is generally prohibited unless an AAR was filed before the NAP was issued or the IRS examiner and manager have reasonable cause for withdrawing the NAP. Examples of "reasonable cause" include situations where there are insufficient resources to audit the partnership or where the examination is not worth the time it would require.⁶³¹

Notwithstanding the bar on filing an AAR once a NAP has been issued, it appears that a partnership might be allowed to submit an "informal claim" within 30 days of the opening conference, when this informal claim might relate to a negative adjustment. If the claim is allowed, it would result in a negative adjustment that is then addressed under the standard BBA rules.⁶³²

The IRS has taken the position that the NAP is optional, and that it may issue an FPA even if it has failed to issue a NAP.⁶³³

⁶¹⁶ Reg. §301.9100-22(b); T.D. 9839, 83 Fed. Reg. 39,331, 39,336 (Aug. 9, 2018) (preamble to final regulations). The NOSE is IRS Letter 2205-D. See the Worksheets for a list of IRS Forms, Publications and Letters relating to the BBA audit process, and a link to the IRS descriptions.

⁶¹⁷ T.D. 9839, 83 Fed. Reg. 39,331, 39,336 (Aug. 9, 2018) (preamble to final regulations).

⁶¹⁸ §6227(c). This prohibition on filing an AAR after the NAP is issued is provided by statute and cannot be waived by the IRS. The IRS may withdraw a NAP, however, in which case the partnership would then be allowed to file an AAR. Reg. §301.6231-1(f).

⁶¹⁹ See IRM 4.31.9.8.1.; see also IRM 4.31.9.7.6.9.

⁶²⁰ CCA 202547017.

⁶²¹ Reg. §301.6227-3(b)(1).

⁶²² Reg. §301.6227-2(a)(2).

⁶²³ Reg. §301.6223-1(e)(2).

⁶²⁴ §6231(a)(1).

⁶²⁵ Pub. L. No. 114-74, §1101(g)(4).

⁶²⁶ IRM 4.31.9.8.1.; see also IRM 4.31.9.7.6.9.

⁶²⁷ §6231(a)(1). IRS Letter 5893 is mailed to the partnership; IRS Letter 5893-A is mailed to the partnership representative. If the partnership representative is an entity, the NAP is mailed to the entity (to the attention of the designated individual), using the partnership representative's last known address.

⁶²⁸ Reg. §301.6223-1(d)(2).

⁶²⁹ §6227(c).

⁶³⁰ Reg. §301.6231-1(f).

⁶³¹ IRM 4.31.9.8.1.2.

⁶³² IRM 4.31.9.8.3.

⁶³³ CCA 202547019.

C. 30-Day Letter and IRS Appeals

If the partnership representative does not agree with the adjustments that the IRS examiner would like to make, the IRS will issue a 30-Day Letter (Letter 5891).⁶³⁴ The partnership will then have 30 days in which it may file a protest and ask IRS Appeals to review the adjustments that are contemplated.⁶³⁵

The application of the modification rules cannot be addressed at this stage because no modifications will have been requested yet. Modifications can only be requested after the NOPPA has been issued, and the opportunity to have IRS Appeals review the substantive tax issues will occur before the NOPPA is issued. The partnership, however, will have a later opportunity to have IRS Appeals review the application of the modification rules.⁶³⁶

D. Notice of Proposed Partnership Adjustment (NOPPA)

To make an adjustment under the BBA, the IRS must issue a notice of proposed partnership adjustment (NOPPA). The NOPPA is mailed to the partnership and the partnership representative.⁶³⁷

1. Consequences of a NOPPA

To avail itself of the modification rules under §6225(c), a partnership must generally submit all supporting documentation to the IRS within 270 days of the date a NOPPA is mailed.⁶³⁸

A NOPPA also affects when a notice of final partnership adjustment (FPA) may be issued. The IRS cannot mail an FPA before that 270-day period expires unless it obtains the consent of the partnership.⁶³⁹

Also, an FPA generally must be issued within 330 days of the date of the NOPPA. This period is extended when the IRS consents to extend the partnership's period for submitting information and documentation under the modification procedures of §6225(c).⁶⁴⁰ The IRS has taken the position that the NOPPA does not limit what adjustments it may make; the IRS may issue an FPA that makes additional adjustments that were not identified on the NOPPA.⁶⁴¹

Practice Point: If the partnership agrees with the adjustments proposed by the NOPPA and signs and returns the NOPPA to the IRS, the IRS will not issue an FPA. In that case, the partnership might not be able to make a §6226 election; the IRS may view the FPA as a prerequisite for that election.

2. NOPPA Deadline

The IRS's deadline for mailing the NOPPA is generally the same as its deadline for making the adjustment, discussed in IX.F.2., below.⁶⁴² Therefore, the IRS must generally mail the

NOPPA within three years of the date the partnership files its tax return or, if later, the date the tax return was due or the date on which the partnership filed an administrative adjustment request.⁶⁴³

There are two extensions that apply to the period for making an adjustment that do not apply to the mailing of the NOPPA. One is the extension that applies when the partnership requests a modification under §6225(c);⁶⁴⁴ the other is the extension that is determined by the date of the NOPPA.⁶⁴⁵

E. The Modification Rules and IRS Appeals

If a partnership requests a modification under §6225(c) and the IRS disagrees with what modifications are allowed, the partnership may seek review of these issues from IRS Appeals.⁶⁴⁶ At this stage, the only issues that IRS Appeals will review are those relating to the modification rules. IRS Appeals will not review issues that could have been raised previously (e.g., substantive tax issues).⁶⁴⁷

F. Notice of Final Partnership Adjustment (FPA)

The notice of final partnership adjustment (FPA) is sent to both the partnership and the partnership representative.⁶⁴⁸ The partnership tax year in which the FPA is mailed is the "adjustment year" unless the partnership has waived restrictions on assessment or the adjustment is made pursuant to a court proceeding or in connection with an AAR.⁶⁴⁹

1. Consequences of the FPA

To obtain judicial review of an adjustment, a partnership must file a petition in court within 90 days of the date the IRS mails an FPA.⁶⁵⁰ If the partnership does not file a petition within that period, the IRS may assess the tax and other amounts that are due.⁶⁵¹

In addition, a partnership has 45 days from the date of the FPA to make a §6226 election.⁶⁵² The associated §6226 Partner Statements that must be sent to the partners, notifying them of the election and the adjustments that they must take into account, do not need to be sent until 60 days after the adjustments are finally determined.⁶⁵³

2. Statute of Limitations

The statute of limitations is based on the partnership's return, not the partners' returns, even when the adjustment relates

⁶⁴³ §6235(a)(1).

⁶⁴⁴ §6231(b)(1), §6235(a)(2). See, e.g., *Mammoth Cave Prop., LLC v. Commissioner*, 166 T.C. No. 4 (May 9, 2026) (following Petitioner's timely request to modify an imputed underpayment after the mailing of a NOPPA, the deadline for issuing an FPA was extended to at least 270 days from the submission of the modification request).

⁶⁴⁵ §6231(b)(1), §6235(a)(3).

⁶⁴⁶ IRM 8.19.14.2.3., IRM 8.19.14.2.6.

⁶⁴⁷ IRM 8.19.14.2.6.

⁶⁴⁸ §6231(a)(3).

⁶⁴⁹ §6225(d)(2); Reg. §301.6241-1(a)(1).

⁶⁵⁰ §6234(a).

⁶⁵¹ §6232(b)(1).

⁶⁵² §6226(a)(1).

⁶⁵³ For this purpose, an adjustment is finally determined on the date by which the partnership must file a petition in court to obtain judicial review, or, if judicial review is sought, the date the court's decision becomes final. Reg. §301.6226-2(b).

⁶³⁴ See IRM 4.31.9.10.2., IRM 8.19.14.2.4.

⁶³⁵ See IRM 8.19.14.2.5.

⁶³⁶ See X.E., below.

⁶³⁷ §6231(a)(2). IRS Letter 5892 is mailed to the partnership. IRS Letter 5892-A is mailed to the partnership representative.

⁶³⁸ §6225(c)(7).

⁶³⁹ §6231(b)(2).

⁶⁴⁰ §6235(a)(3).

⁶⁴¹ CCA 202417014.

⁶⁴² §6231(b)(1).

to income that a partner should have reported on its return (as opposed to income that the partnership should have reported on the partnership return).⁶⁵⁴

a. Three-Year or Six-Year Period

An adjustment must generally be made within three years of the date the partnership return was filed, or, if later, three years from the date the return was due.⁶⁵⁵ If a partnership has filed an AAR, the IRS has at least three years from the date the AAR was filed to make the adjustment.⁶⁵⁶

This three-year period is extended to six years when a partnership omits more than 25% of its gross income or omits gross income that should have been included under §951(a).⁶⁵⁷ The six-year period also applies when a partnership has omitted more than \$5,000 of gross income that is attributable to assets with respect to which information is required to be reported under §6038D, as applied without regard to the dollar threshold specified in §6038D(a) or the exceptions provided by §6038D(h)(1).⁶⁵⁸

b. Extension When Modification Under Section 6225(c)

Under §6235(a)(2), when a partnership requests that a modification be made to an imputed underpayment under §6225(c), the IRS's period for making an adjustment is extended to the date that is 270 days (plus the number of additional days that the IRS grants to the partnership to submit the materials to support the modification) after the date on which the partnership has submitted to the IRS everything that is required to be submitted with respect to the modification request.⁶⁵⁹ Under Reg. §301.6235-1(b)(2), this 270-day period generally does not begin until the partnership's 270-day period for requesting modification has expired, but the Tax Court has rejected that interpretation of the statute and held that the deadline is generally 270 days from the day on which the partnership has made its last submission to the IRS relating to the modification procedures.⁶⁶⁰

c. Extension Based on Date of NOPPA

The IRS's period for making an adjustment is extended until 330 days after the date of the NOPPA. If the IRS agrees to extend the period in which the partnership may request a modification under §6225, the IRS's period for making the adjustment is extended by the additional number of days given to the partners.⁶⁶¹

d. No Return or Fraudulent Return

The IRS may make an adjustment at any time when the partnership has not filed a return or has filed a fraudulent return.⁶⁶²

e. Extension by Agreement

The period for making an adjustment may be extended with the consent of the partnership.⁶⁶³

f. Failure to Notify IRS of Certain Foreign Transfers

When the partnership fails to report any information that is required to be reported under a §1295(b) election or under §1298(f), §6038, §6038A, §6038B, §6038D, §6046, §6046A, or §6048, the period for making an adjustment does not expire until three years after the IRS is furnished the requisite information, unless the failure to furnish this information is due to reasonable cause and not willful neglect.⁶⁶⁴

g. Listed Transactions

When a partnership fails to satisfy its obligation under §6011 to report information about a listed transaction (as defined in §6707A(c)(2)), the period for making an adjustment does not expire before the date that is one year after the earlier of (a) the date the requisite information is provided to the IRS, or (b) the date that a material advisor has complied with its obligation under §6112 to respond to an IRS request for information about the transaction.⁶⁶⁵

G. Assessment and Judicial Review

To obtain judicial review, a partnership must file a petition in court within 90 days of the date the FPA is mailed.⁶⁶⁶ If a petition is not filed within that period and a §6226 election is not made, the IRS may assess the partnership for the imputed underpayment and associated amounts such as interest and penalties.⁶⁶⁷

Judicial review is available in Tax Court, the Court of Federal Claims, and the United States district court for the district in which the partnership's principal place of business is located.⁶⁶⁸ No tax need be paid before filing a petition. However, to obtain review in the Court of Federal Claims or a district court, a partnership must make a deposit equal to the imputed underpayment, interest, penalties and additional amounts as provided by the FPA. This deposit must be paid even if the partnership has made a §6226 election. The deposit is not treated as a payment of tax, except for purposes of computing interest on underpayments and overpayments under Chapter 67.⁶⁶⁹ No deposit is required for adjudication by the Tax Court.

⁶⁵⁴ §6235.

⁶⁵⁵ §6235(a)(1)(A), §6235(a)(1)(B).

⁶⁵⁶ See, e.g., *Mammoth Cave Prop., LLC v. Commissioner*, 166 T.C. No. 4 (May 9, 2026) (holding that an FPA was timely issued within the period of limitations on making adjustments because a modification of an imputed underpayment extended the deadline to at least 270 days from the submission of the modification request).

⁶⁵⁷ §6235(c)(2).

⁶⁵⁸ §6235(c)(2).

⁶⁵⁹ §6235(a)(2).

⁶⁶⁰ *JM Assets v. Comm'r*, 165 T.C. No. 1 (2025).

⁶⁶¹ §6235(a)(3).

⁶⁶² §6235(c)(1), §6235(c)(3).

⁶⁶³ §6235(b). Form 921-M, *Consent Fixing Period of Limitation to Make Partnership Adjustments*, must be signed and dated by the Partnership Representative. If the representative is an entity, the Designated Individual must sign and date on behalf of the Partnership Representative.

⁶⁶⁴ §6235(c)(5).

⁶⁶⁵ §6235(c)(6).

⁶⁶⁶ §6234(a).

⁶⁶⁷ §6232(b).

⁶⁶⁸ §6234(a). IRS Appeals will generally work to settle the case after a Tax Court petition is filed. IRM 8.19.14.7.3.2.

⁶⁶⁹ §6234(b).

Appeals will generally continue to be involved even after a Tax Court petition is filed, but not if the case is adjudicated in a district court or the Court of Federal Claims.⁶⁷⁰

H. Mathematical or Clerical Errors

The IRS may make an adjustment with respect to mathematical or clerical errors without issuing an FPA.⁶⁷¹

I. Where Notices Are Sent

Notices to the partnership and to the partnership representative must be sent to their last known address, even if they no longer exist.⁶⁷² A person's last known address is the address that appears on the person's most recently filed and properly

processed federal tax return, unless the IRS is given clear and concise notification of a different address.⁶⁷³ As a result, the IRS is often sending notices to the partnership representative's home address.

Practice Point: To ensure that notices are sent to a business address where mail is reviewed promptly, the partnership representative may grant a power of attorney and have a copy of all notices sent to the person who holds that power. This is particularly useful for notices that are sent only to the partnership representative, not to the partnership.⁶⁷⁴

⁶⁷⁰ See IRM 8.19.14.7.3., IRM 8.19.14.7.4.

⁶⁷¹ §6232(d).

⁶⁷² §6231(a); Reg. §301.6231-1(c).

⁶⁷³ Reg. §301.6212-2(a). See CCA 202501009 (partnership representative's last known address might not be the address given when the partnership representative was designated, and Form 8822, *Change of Address*, may be used to give clear and concise notification of a different address); CCA 202417020 (address given on a Schedule K-1 does not constitute such notice).

⁶⁷⁴ These notices are the summary report, the 30-day letter, and notices regarding a modification request.

TABLE OF WORKSHEETS

Worksheet 1	Glossary.
Worksheet 2	Detailed Example of §6226 Election in a Tiered Partnership Structure.
Worksheet 3	IRS Forms, Publications and Letters Relating to the BBA.

Working Papers for this Portfolio can be found online at <https://bloombergtax.com>.

Additional Resources

- **IRS Pub. 5388 — Bipartisan Budget Act (BBA) Audit Roadmap for Taxpayers.**

This publication is available on the IRS's website at: <https://www.irs.gov/pub/irs-pdf/p5388.pdf>.

- **IRS BBA Centralized Partnership Audit Regime Website.**

The IRS provides a dedicated website that is intended to be a one-stop location for BBA-related information and developments, including regulations and other guidance and instructions related to the partnership representative electing out of the centralized audit rules, administrative adjustment requests (AARs) and what to expect during a BBA administrative proceeding. See <https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime>.

