

**New York State Bar Association
Tax Section**

**Report on the Partnership Audit Rules
of the Bipartisan Budget Act of 2015**

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Report On The New Partnership Audit Rules of the Bipartisan Budget Act of 2015

I. INTRODUCTION

This report¹ discusses the new partnership audit rules enacted in November 2015 as part of the Bipartisan Budget Act of 2015 (the “**BBA**”).² These rules constitute a “big bang” for partnership audits: they both completely overhaul the way partnerships are audited and introduce new methods for collecting additional taxes due as a result of a partnership audit. The existing rules, enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982³ (“**TEFRA**”), were repealed in their entirety for partnership tax returns for tax years beginning after December 31, 2017.⁴

The enactment of the BBA was a direct response to significant problems encountered by the IRS under the existing TEFRA regime when auditing partnerships and collecting additional taxes. Numerous reports written by governmental agencies, bar associations, journalists and scholars had made a compelling case that the rules were not working properly and that something needed to be done. At the same time, the solution was far from clear in light of the proliferation of complex partnership structures and arrangements, the increasing complexity of the substantive partnership (and other) tax rules, and the need for the system to be fair, administrable, and consistent with the other principles of good tax administration. We commend Congress, Treasury and the IRS on tackling these important and difficult topics, and we are pleased to offer our assistance as you take on the work of implementing these new rules.

¹ The principal drafters of this report were Meyer Fedida and Diana Wollman, with substantial assistance from Kylie Barza and Tiffany Tam. Helpful suggestions, input and comments were received from Kimberly Blanchard, Andrew Braiterman, Jason Factor, Michael Farber, Patrick Gallagher, Katherine Gregor, Robert Kantowitz, Adele Karig, Stephen Land, Stephen Millman, Deborah Paul, Elliot Pisem, Yaron Reich, Richard Reinhold, Leslie Samuels, Joel Scharfstein, Michael Schler, David Schnabel, David Sicular, Bryan Skarlatos, Eric Sloan, and Andrew Solomon. This report reflects solely the views of the Tax Section of the New York State Bar Association (“**NYSBA**”) and not those of the NYSBA Executive Committee or the House of Delegates.

² Pub. L. No. 114-74, § 1101, 129 Stat. 584, 625–38 (Nov. 2, 2015)

³ Pub. L. No. 97-248, §§ 401–405, 96 Stat. 324 (Sept. 3, 1982).

⁴ The rules also allow partnerships to elect to apply the BBA to returns for earlier years (that begin after November 2, 2015).

Implementing the BBA rules will be a wide-ranging project that will include, among other things, issuing extensive regulatory guidance, updating numerous forms for tax returns and reporting (including Form 1065, Form 1120, Form 1120S, and Form 1040), adopting entirely new internal IRS procedures, training IRS personnel and making necessary changes to IRS computer systems. Each of these “workstreams” will raise difficult issues; however, to our mind the hardest ones will come in the first stage, when the fundamental design decisions need to be made. There is still a lot to do on this front because the statute is quite complex and leaves many issues to be resolved by Treasury and the IRS (either by not addressing them in the statutory text or by an explicit statutory mandate to the Secretary to address them through guidance).

The goal of this report is to assist Treasury and the IRS in making these first stage decisions. Accordingly, we address issues that we believe are fundamental design issues (including some of the questions on which the IRS asked for comments in Notice 2016-23).⁵ These issues are complex and in many cases interconnected. Once these first stage decisions have been made, many other issues (some of great importance) will need to be addressed. We look forward to addressing these additional issues in subsequent reports.

Our approach throughout this report is to explain each issue (illustrating it with examples where we think that is helpful), describe the various options for addressing the issue (again with illustrative examples where we think it is helpful), evaluate those options and provide our recommendations. In evaluating the options, we have taken into account the history to the enactment of the statute and our understanding of its goals, the intended meaning of the statute, and the principles of good tax administration. We note where we think statutory technical corrections or other changes should be considered, although we have endeavored to limit these legislative suggestions because we recognize the urgency to commence the administrative guidance process.

Part II of this report provides an executive summary of this report and our recommendations. In order to provide background, Part III then provides a brief summary of the current partnership audit regime. Part IV briefly outlines the BBA regime and some of the history leading to its enactment. Parts V through XII delve into the issues addressed in this report.

II. EXECUTIVE SUMMARY

*This Part II summarizes our key recommendations. We have generally tried to propose solutions that can be implemented through the regulatory process, but have recommended in a few instances statutory corrections or modifications which we see as critical.*⁶

⁵ Notice 2016-23, 2016-12 I.R.B. (Mar. 4, 2016).

⁶ See Recommendations in Parts II.A, II.B, II.C(1)(c), II.H, as well as potentially Parts II.D and II.I.

The last major overhaul of the partnership rules took place more than 30 years ago, as part of the Tax Equity and Fiscal Responsibility Act of 1982. It is not an exaggeration to say that the TEFRA rules were written for a completely different time: since their enactment both the use and complexity of partnerships have increased exponentially. Given this new environment, we share the assessment made by various Congressional and governmental reports that the TEFRA regime does not allow the IRS to audit partnerships efficiently and creates a strong incentive for the IRS to focus limited audit resources on corporate taxpayers. This raises significant horizontal equity concerns.

The issue is a difficult one, however, because multiple substantive and procedural issues combine to make the conduct of a partnership audit, as well as the collection of the tax resulting from that audit, very difficult. By necessity, the rules require therefore that a balance be struck between the administrability and fairness of the regime. We applaud Congress's willingness to tackle this complex issue.

A. The Coordination of the Three Payment Methods with Subchapter K and the Interpretation of Section 6225⁷ as a Withholding Tax – Part V, page 31

We believe that the BBA is an important procedural reform, intended to increase the effectiveness, efficiency and fairness of partnership audits and of the resulting collections. Consistent with the reasons for its enactment and goals, the new BBA regime should not materially affect the substantive tax liabilities resulting from items derived through partnerships. Under the BBA, if a partnership audit determines that the partnership should have reported additional income or gain (or less credits) on its Form 1065 and the Schedule K-1s it issued to its partners, the audited partnership is required to pay to the IRS an “imputed underpayment” (which is basically an approximation of how much tax would have been paid if that additional income or gain were taxed at the partner level at the highest possible rate under the Code for the year under audit). This is the main method set out in the BBA for the collection of the additional taxes resulting from a partnership audit.

Thus, the statute moves the tax collection point from many partners to one centralized point (the partnership); this is clearly a response to some of the difficulties encountered under TEFRA. However, for the reasons detailed in this report, the way in which the imputed underpayment is computed and the fact that the computations do not take into account the interaction of the partnership-level adjustments with the individual partners' other tax attributes means that the

⁷ Unless otherwise indicated, all references to sections herein are to the United States Internal Revenue Code of 1986 (as amended) and to Treasury regulations promulgated thereunder.

For convenience, we refer to the sections of the Code *as amended by the BBA* (and thus refer to the pre-BBA provisions of the Code, as Pre-BBA sections).

amount collected may be materially different from the tax that the partners would have paid if they had taken the adjustments into account under the normal substantive tax rules. Depending upon the facts, there could therefore be over-collection or under-collection, and the amounts could be significant. We believe that this difference in total tax collected is not necessary to respond to the problems raised under TEFRA.

In addition, the imputed underpayment rules (which are set out in section 6225) are subject to two exceptions which, if available and elected into by the partners or the partnership, move the tax collection point back to the partner level. Partners and partnerships can be expected to try to use whichever of the three payment methods results in the smallest payments under their particular facts.

To understand and illustrate how these rules work and their implications, the report uses a hypothetical simple fact pattern, traces through the results for each partner and the IRS under all three payment methods and compares their results to each other and to the results that would have occurred if the partnership had prepared its return initially identically to the outcome of the audit (what we call the “**Correct Return Position**”).⁸ The report also addresses the implication of the audit adjustments on the partners’ basis, capital accounts and other Subchapter K attributes as well as the consequences of indemnity payments made between current and former partners. We recommend approaches to these matters that we believe are most consistent with Subchapter K and minimize distortion.

Our detailed analysis of the consequences of the three payment methods shows that the amount collected under the imputed underpayment method may differ significantly from the amount collected under Correct Return Position (as well as from the amount collected under the other two payment methods). If this is indeed how these rules work, we find this result very troubling. We are concerned about the possibility for manipulation and even abuse by taxpayers, and the likelihood that such an application of the BBA rules would further erode taxpayers’ belief in the integrity and fairness of the tax system. The BBA regime, and in particular section 6225, will need to be fair, workable, and consistent with the tax law outside of the BBA in order for it to succeed.

We believe that section 6225 can be implemented in a way that achieves these goals by treating section 6225 as a withholding tax mechanism, similar to the regime that currently exists under section 1446 with respect to effectively connected taxable income of a partnership that is allocable to foreign partners. We refer to this approach as the **Withholding Tax Approach**. Under this approach, the payment by the partnership would ensure that the IRS collected an initial amount that approximates the total tax due; after the IRS had collected this initial amount, each

⁸ We assume that all taxes due at the partner level would be paid to the IRS.

partner would then properly take into account its share of the audit adjustments along with a credit for the corresponding amount of initial taxes paid by the partnership and settle up with the IRS by paying any additional taxes due or claiming a refund of any amount overpaid.⁹ Under this approach, the BBA's solution to the TEFRA collection difficulties should be addressed, and the fairness problems outlined above should be minimized. Indeed, the results of proceeding under section 6225 would essentially match the Correct Return Position.

We believe that the Withholding Tax Approach is the *only* way to read section 6225 in a way that is consistent with the other, existing rules of the Code. If this is not what section 6225 means, then this procedural rule will frequently result in tax obligations that differ significantly from those provided for by the substantive rules of the Code. For the additional reasons detailed in this report, we believe that because the meaning of the statute in this regard is not clear, the Withholding Tax Approach is a reasonable interpretation. As seen throughout this report, many of the difficult issues addressed in this report would be solved if the Withholding Tax Approach is followed. The fact that so many potential issues with the statute are resolved if the Withholding Tax Approach is followed supports our view that this is the correct meaning of section 6225. This being said, we are cognizant of the risk that this interpretation would be challenged and of the negative consequences of adopting an interpretation that is challenged (whether or not it is upheld). Accordingly, we encourage Congress and Treasury to consider a statutory clarification that confirms the Withholding Tax Approach.

If the Withholding Tax Approach is not adopted, then we recommend that the audit adjustments be reflected in the outside bases and capital accounts of the adjustment year partners as an imperfect but "second best" option.

B. Section 6221 and The Scope of the BBA Regime – Part IV, page 21

A threshold question and one of great importance (for reasons we discuss in detail in this report) is what "items" are subject to audit at the partnership level under the BBA (as opposed to subject to audit at the partner level). TEFRA handled this issue by defining the items subject to partnership-level audit as "*any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations...provide that...such item is more*

⁹ In order to collect these additional taxes, the Withholding Tax Approach relies upon voluntary compliance by the partners or collection efforts by the IRS. We are mindful of not wanting to reintroduce the collection difficulties the IRS faced under TEFRA, and we think the imputed underpayment mechanism was intended to prevent that. We recommend therefore that the imputed underpayment computation err (within reason) on the side of over-collection in order to minimize the risks to the IRS. In addition, relying upon voluntary compliance and collection for any additional taxes due is preferable to having a collection regime that has the inadvertent impact of making those additional taxes not due at all.

appropriately determined at the partnership level than at the partner level” and left it to the Secretary to issue regulations detailing these items. The Secretary’s regulations followed the statute’s lead with an extensive list of items “more appropriately determined at the partnership level.” TEFRA also had another term, “affected item” which was defined as “*any item to the extent such item is affected by a partnership item.*” This term, together with a special rule that extended the partner-level statute of limitations, was used to enable partnership item adjustments (resulting from a TEFRA audit) to be taken into account at the partner level in order to determine the tax (or refund) due based upon how the partnership items interacted with the partner’s affected items. Notwithstanding the broad language in the statute and the resulting regulations, there has been extensive litigation over whether a particular item was a partnership item, affected item or neither.

The BBA dispenses with these terms and concepts and instead describes the items subject to partnership-level audit in section 6221(a) as “items of income, gain, loss, deduction, or credit of a partnership.” There is no corollary to affected items and no explicit extension of the partner-level statute of limitations.

Looking at the text of the BBA and comparing it to the existing “partnership item” regulations, it is possible to interpret the scope of the BBA audit regime as very limited. We do not believe that such a reading was intended. We believe that the lawmakers were likely reacting to the controversies over the term “partnership item” and “affected item” and believed that eliminating those concepts and using the broad wording in section 6221 would reduce the challenges, not reduce IRS’s jurisdiction. We believe that in order for the BBA regime to achieve its goals, the IRS needs to be able to adjust in a BBA audit all the items that are more properly audited and determined at the partnership level than the partner level, and that this likely includes all the items defined as “partnership items” in the existing regulations promulgated under TEFRA. *However*, if the adjustment of some of those items will have *no consequences* because those adjustments cannot be reflected in the “imputed underpayment” computation (since that computation takes into account only adjustments to items of income, gain, loss, deduction and credits of the partnership), then requiring those items to be adjusted only at the partnership level in a BBA audit means that adjustments to those items will never result in additional taxes being due (or refunds) if the partnership pays under section 6225 (instead of the partners utilizing one of the BBA’s two alternative payment).¹⁰

¹⁰ We illustrate this in this report with three examples: (i) an audit adjustment to the value and character of an asset distributed by a partnership to a partner, (ii) an audit adjustment to the allocation of partnership liabilities among the partners for purposes of section 752, and (iii) an audit adjustments that changes at the partnership level attributes relevant to the section 199 deduction (which attributes flow through to a partner who has computed the section 199 deduction at the partner level based upon the aggregation of the partner’s attributes from all sources). *See* Part VI.D (page 59).

The Withholding Tax Approach would prevent this inappropriate result (because the results of the audits would flow-through to the partners) and would still permit partnership-level audits of items that are more appropriately audited and adjusted at the partnership level. Therefore, if the Withholding Tax Approach is adopted, we recommend that the scope of BBA audits be the same as that of “partnership items” under TEFRA. If the Withholding Tax Approach is not adopted, then we recommend that the scope of BBA audits be limited to those items which can be taken into account in computing an “imputed underpayment,” leaving all the other items for separate partner-level adjustment. However, this will severely affect the IRS’s ability to collect taxes and eventually the IRS (and possibly Congress) will need to develop a new regime to address how to adjust all the other types of items that are not adjustable in a BBA audit but which emanate from, or are impacted by items emanating from, a partnership subject to the BBA.

A separate but related question is whether the statute of limitations of the partners should be extended when a BBA audit starts, to ensure that the audit impacts the partners’ tax positions in the way the “affected item” rules worked under TEFRA. We strongly favor an approach that facilitates getting as close as possible to Correct Return Position and leaving open the partners’ statute of limitations similar to what was done under TEFRA (Pre-BBA section 6229(d)). However, we recognize that the BBA statute does not currently provide for this, so in the absence of a statutory technical correction this could only be achieved through IRS procedures and taxpayer consent.

C. Computing the Imputed Underpayment – *Part VII, page 65*

The computation of the imputed underpayment raises many complicated issues, including how to reconcile the significant difference between the amount of the imputed underpayment and the amount of taxes that would have been under the Correct Return Position. Resolving these issues in a way that is fair and minimizes distortion is particularly important to seeing the BBA achieve its goals. If the Withholding Tax Approach is adopted, this difference is reconcilable and we believe that a reasonable over-collection at the stage of the imputed underpayment is justified (however the imputed underpayment needs to be close enough to the actual amount due that partnerships are not incentivized to turn to section 6226). If the Withholding Tax Approach is not adopted, this difference (and all the complications raised in determining how the computations are done) take on even more significance; and the imputed underpayment needs to be such that the partnerships are not incentivized to almost always elect section 6226.

1. Netting Issues

(a) Netting Items of Different Characters (e.g., FPA which recharacterizes previously reported capital gain as ordinary income) – Part VII.B.2, page 68

We believe that Treasury and the IRS should use their authority under section 6225(c) to provide that when the adjustments include positive and negative items of different character (which do not offset under the normal tax rules because they are of different character), the negative items can be taken into account in computing the imputed underpayment, provided that the partnership can establish that the reviewed-year partners would have been able to utilize the negative items in computing their respective taxes (and then capital losses should only reduce the amount of the imputed underpayment based on the tax rate applicable to capital gains).

(b) Netting Items When the FPA Changes Their Timing – Part VII.B.3, page 71

This situation raises similar issues and we believe the same approach should be used. The situation also raises the additional issue of whether section 6225 (and section 6226) are to be applied to each year covered by an FPA separately or all the years taken together, and we respectfully reserve on this issue until some of the other issues we discuss are resolved.

(c) Adjustments That Move Allocations From One Partner to Another – Part VII.B.4, page 72

Another netting issue arises when an audit results in the reallocation of an item of income from one partner to another. Section 6225(b)(2) provides that in that case the imputed underpayment is computed by taking into account only the increased income or decreased deduction and by ignoring the decreased income or increased deduction. It is not entirely clear why this rule is in the statute, but we strongly believe that this result is unfair, and has the potential to result in permanent double taxation. We believe there are several ways to address this issue. If the Withholding Tax Approach is adopted, the partner who overpaid taxes in the past should be able to get a refund and thus the regime should collect the right amount. Another approach would be for Treasury and the IRS to use their authority under section 6225(c) to reduce the imputed underpayment to reflect the taxes (proven to have been) paid by the partner who was initially allocated the income. A third approach, which we do not favor, would be to interpret the decrease as a separate “adjustment” and apply to it the rules for adjustments that do not create imputed underpayments. We recognize that there may be other approaches as well. If Treasury and the IRS believe that they do not have authority to implement an approach that resolves this issue, we recommend that a statutory change be sought.

2. Tax Credits – Part VII.C, page 74

Section 6225(b)(1)(C) computes the imputed underpayment “by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount [of the imputed underpayment] determined under [6225(b)(1)A].” Read literally, this means that additional credits reduce the section 6225(a) imputed underpayment dollar for dollar and a reduction in credits increases the section 6225(a) imputed underpayment dollar for dollar. The Code provides for a number of different credits, with complex (and differing) regimes that often take into account multiple components in computing the allowable credit (or required recapture). Some of these computations are done at the partnership level, others at the partner level, and some at either or both levels. It is not clear how the statutory formula is intended to interact with these regimes.

This is a significant issue because the tax credit regimes reflect policy choices and play a significant role in our tax system. The imputed underpayment mechanism should not supplant them. Moreover, the applicability of these policies should not depend on whether amount of credits were reported correctly on the initial return or determined in an IRS examination. We investigate in detail the application of these rules to the foreign tax credit regime and we also touch on two other credit regimes as illustrations of some of the issues raised

If the Withholding Tax Approach is adopted, the credit issue is far less problematic because the appropriate result can be achieved in the subsequent partner-level proceedings and a literal reading of the statute could be workable. If the Withholding Tax Approach is not adopted, we recommend two options (which may be applied for different credits). First, Treasury and the IRS can use their authority under section 6225(c) to take into account an adjustment to credits but only to the extent that the adjustment would have affected the tax due at the partner level. Second, the imputed underpayment can ignore the credit adjustments and have them tier up to the partners (even if the partnership otherwise is subject to the imputed underpayment).

D. Section 6226(b)(2)(B)—Decreases in Taxes Not Taken Into Account – Part VIII, page 86

Section 6226 requires the reviewed-year partners to include in their adjustment year taxes an amount equal to the additional taxes they would owe for the reviewed year *and* all years between the reviewed year and the adjustment year if the FPA adjustments were taken into account by them in the reviewed year (and all corresponding adjustments were made in subsequent years). The statutory formula provides however, that for each of those years, the partner can take into account the impact on the taxes due in that year only if it results in an *increase* in the taxes due by the partner, not a decrease. This can lead to significant permanent double taxation and we illustrate this in examples. Once Treasury and the IRS have developed the conceptual approach to section 6225, we recommend they consider carefully whether it is appropriate for section 6226 to operate

in this way. In particular, we believe that a statutory correction should result in a much more accurate tax collection, but we recognize that there may be policy reasons to keep section 6226 as is in order to encourage taxpayers to use the section 6225 mechanism. If it is determined that this aspect of section 6226 is to stay in place (and not be statutorily corrected), then it is even more important that the rules implementing section 6225 be as fair as possible and get all the partners as close as possible to the tax liability they should have had if they had paid their taxes correctly. In addition, this also means that the IRS and Treasury should consider how, if at all, they can add in protections for partners who may be seriously disadvantaged if a partnership representative selects section 6226 rather than proceeding under section 6225.

E. Section 6241(7) – Part IX, page 92

Section 6241(7) provides that, if a partnership “ceases to exist” before a BBA adjustment takes effect, the adjustment shall be “taken into account” by “the former partners.” There is no guidance on the meaning of these three terms. In deciding how to interpret these terms and how to implement section 6241(7), it will be important to ensure that the result is both fair and does not create inappropriate incentives for partners to leave partnerships in existence or to cause them to cease to exist.¹¹ For instance, the amount of the tax payable should not change because the partnership has ceased to exist. Since a partnership that has ceased to exist cannot serve as a “collection point” for the tax liability (which is the paradigm for section 6225), we believe that section 6241(7) should be applied by treating the parties as if the partnership had made a section 6226 election. We also consider whether a partnership and its former partners should have access to the other payment regimes.

F. Partnerships with Insufficient Assets – Part IX, page 92

If the Withholding Tax Approach is not adopted and section 6225 is the final payment for the tax due, then the IRS will not be able to collect the tax due if the partnership is insolvent or does not have sufficient assets to pay the imputed underpayment. This would create a significant risk of abuse. We believe that the IRS could interpret section 6241(7) so that a partnership that does not have sufficient assets to pay the imputed underpayment (and does not make a section 6226 election) will be deemed to have “ceased to exist.” Thus, the IRS will be able to rely on section 6241(7) to collect from the reviewed year partners (per Recommendation E immediately above). However, this is an important issue and we believe that it would be better if the statute were clarified.

¹¹ The IRS may have access to certain state law remedies if a partnership liquidates with the intent of avoiding a BBA tax liability, for example after a BBA audit has started, but it would be preferable if these rules did not create an incentive for partnerships to take such an action.

G. Tiered Partnership Issues and Section 6226 – Part X, page 103

Tiered partnership structures are very common and often involve many tiers, many indirect partners and complex allocations. The difficulties the IRS encountered under TEFRA in auditing and collecting from tiered structures were significant and were one of the main reasons for the enactment of new BBA rules. Under the BBA, if the audited partnership proceeds under section 6225 by paying the imputed underpayment, the existence of complex tiers above that entity should not complicate the IRS's ability to compute and collect that amount (other than with respect to the possible attempt by the partnership to reduce the imputed underpayment using section 6225(c)).¹² If instead the audited partnership wants to make a section 6226 election, then the tiers above the partnership become relevant. The text of section 6226 gives no indications as to what should happen in such a case: it merely indicates that the recipient of the section 6226 statement must increase its taxes payable under "chapter 1" to account for the adjustment. We believe that the Secretary has regulatory authority to implement a broad range of different approaches. The BBA Bluebook however has interpreted section 6226 to mean that the push-out stops at the source partnership's direct partners (*i.e.*, it goes up one tier only) and that partners that are themselves partnerships should then pay the tax due with respect to the FPA as if they were an individual. We find this approach problematic, and question if it is authorized by the statute (including because partnerships are not subject to chapter 1 taxes). We discuss these issues in detail, consider a variety and options, and ultimately recommend that the section 6226 election not stop at the first tier above the audited partnership, and that instead each partnership in the chain be permitted to elect to either (i) pay the portion of the audited partnership's imputed underpayment allocated to it (and have the ability to reduce that amount using section 6225(c)) *or* (ii) elect to apply section 6226 to push the obligation up another tier. We also strongly recommend safeguards to reduce the collection risk for the IRS. First, we recommend that any partnership in the chain that elects to proceed under section 6226 to push out the liability must provide to the audited partnership (or the IRS examination team) either (x) the section 6226(a)(2) data with respect to its partners or (y) an affidavit attesting that its partners have filed the required tax returns and paid the taxes due with respect to their shares of the adjustment. Second, we recommend that there be a maximum period for all the push-outs to occur. We believe that this approach is authorized by the statute. We would be pleased to provide further suggestions on the implementation of this system.

¹² If the Withholding Tax Approach is adopted, the second-stage partner-level refunds and collections would be complicated, but this is why the imputed underpayment should come as close as possible to Correct Return Position, while erring on the side of over-collection rather than under-collection.

H. Timing and Procedures

The statute raises a series of timing and procedural issues, some of which require technical corrections and others which may be addressed in regulations.

1. Statute of Limitations for IRS Issuance of an Adjustment – Part XI.A, page 121

There seems to be an inadvertent flaw in the rules governing the last day that the IRS can issue a final partnership adjustment. Specifically, there is no time limit for the issuance of a notice of proposed partnership adjustment, and once a notice of proposed adjustment has been issued, the IRS automatically has additional time to issue the notice of final partnership adjustment. We believe that this should be corrected by requiring that the document finalizing the audit adjustments (but before the application of section 6225(c)) be issued before expiration of the standard 3-year statute of limitations.

2. Providing Documentation Under Section 6225(c) – Part XI.B, page 125

The partnership should not be required to provide documentation under section 6225(c) before the final, substantive, position of the IRS has been determined and the audit adjustments have been determined. Accordingly, we recommend that the regulations establish that the 270-day period to provide the section 6225(c) information only start *after* the document finalizing the audit adjustments referenced in recommendation H.1. (immediately above) is issued.

3. Section 6225(c)(2) and Section 6226 – Part XI.D, page 128

Partners should not be required to file amended tax returns under section 6225(c)(2) until the IRS has issued the document finalizing the audit adjustments described in recommendation H.1. above. In addition, because the section 6226 election is only made after the final partnership adjustment is issued, we recommend that partners that want to avail themselves of section 6225(c)(2) file their amended returns (and deposit the tax due) in escrow with the IRS exam team until the partnership makes a section 6226 election (or the statutory period for making such election lapses).

4. Standards for and Review of IRS Decisions In Response to Documentation To Reduce the Imputed Underpayment – Part XI.E, page 130

We think that the IRS will be best served by specifying what standards will apply to its section 6225(c) evaluations and decisions, providing partnerships with explanation of any denial, and implementing procedures for taxpayers to elevate a denial within exam and then to IRS Appeals.

5. IRS Appeal Process and the BBA – Part XI.F, page 132

Procedures are needed to establish when the partnership is able to protest the proposed adjustments and the section 6225(c)(2) decisions to IRS Appeals. We consider the options in this report and recommend: (i) that in a first stage, all the proposed adjustments (but not any disagreements over the section 6225(c) decisions) be heard by Appeals and (ii) then, that the case go back to the exam team to review and respond to the section 6225(c) documentation, after which the partnership could go back to Appeals to address those section 6225(c) decisions. The initial imputed underpayment computation (*i.e.*, the application of the section 6225 formula to the adjustments) could be heard in the first Appeals hearing or deferred until the second Appeals hearing (under a policy that applies in all cases or under a flexible policy that allows for either approach in any given case).

6. Section 6226 and Petitioning to Court – Part XI.G, page 135

Section 6234 needs to be clarified to establish how the partnership's right to go to court interacts with the various payment rules.

7. Timing For IRS Collection Proceedings With Respect to the Imputed Underpayment – Part XI.H, page 136

The statute is internally inconsistent. Section 6232(b)(1) should be corrected to provide that an assessment of a deficiency and collection proceeding may not commence before the 90th day after the due date for the imputed underpayment under section 6232(a) (instead of 90 days after the issuance of the final partnership adjustment).

I. Section 6221 and Electing Out of the BBA – Part XII, page 137

The 100-partner threshold that shuts off a partnership's ability to elect out of the BBA is far higher than the 10-partner threshold that determined the applicability of TEFRA. We recognize that the BBA rules differ from TEFRA, but we have focused on the fact that, if a partnership elects out, the IRS will be able to adjust items arising from the partnership only pursuant to individual partner-level proceedings. To understand what this might be like we have revisited the historic reports of the problems that the IRS (and taxpayers) faced pre-TEFRA (which led Congress to enact TEFRA). We note that the same problems, as well as new problems, may well arise under the BBA's election out, that the problems are likely to be more troubling and that the number of taxpayers and the amount of revenue affected will be significantly larger because the 100 partner number is so high.

While we are troubled by this rule, we hesitate to recommend reducing the number at this time. Instead, we recommend that a reduction be taken up once the BBA has been implemented in a way that irons out the issues and the BBA is operating in a way that is fair and effective.

III. CURRENT REGIME

This Part III describes in broad strokes the current regimes applicable to partnership audits. Part III.A discusses the TEFRA audit rules which apply to the large majority of partnerships, and Part III.B outlines the main features of an elective system for large partnerships (the electing large partnership or “ELP” rules).

A. TEFRA¹³

Until the enactment of TEFRA (in 1982), when dealing with partnership items the IRS was required to separately audit each partner (taking into account its specific statute of limitations) and compute its individual adjustments. Settlements or judicial determinations with respect to one partner were not binding in proceedings against any other partner. Not surprisingly, this fragmented framework placed significant administrative burdens on the IRS, resulted in an extremely inefficient audit process and ultimately put the IRS at a significant disadvantage when auditing partnerships.¹⁴ TEFRA was Congress’s attempt to address these issues:¹⁵ it introduced streamlined entity-level proceedings both for audits and litigation for all partnerships (except certain small partnerships with 10 or fewer partners).¹⁶ We discuss the scope of TEFRA, the conduct of a TEFRA audit and the collection process in Part III.A.1, Part III.A.2 and Part III.A.3, below. We then analyze the issues raised by TEFRA in Part III.A.4.

¹³ As noted, this discussion provides a very brief summary of the TEFRA rules. For a fuller discussion, see WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶¶ 10.01–10.08 (2007); WILLIS & POSTLEWAITE: *PARTNERSHIP TAXATION* (WG&L) ¶¶ 20.01–20.11; SALTZMAN & BOOK, *IRS PRACTICE AND PROCEDURE* (WG&L), ¶¶ 8.17–8.21; Barbara T. Kaplan, *Unified Reporting, Audit, and Litigation Procedures for partnerships, LLC’s and Joint Ventures*, in PRACTICING LAW INSTITUTE, *THE PARTNERSHIP TAX PRACTICE SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES* 320–21 (2010 ed. Vol. 16).

¹⁴ STAFF OF THE JOINT COMM. ON TAX’N, *GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982* (1982) (JCS-38-82) (the “**TEFRA Bluebook**”).

¹⁵ TEFRA Bluebook, at 268.

¹⁶ Pre-BBA § 301.6231(a)(1)-1. A small partnership would only qualify if it had fewer than 10 partners, but only if all the partners in the small partnership were natural persons or estates and if each partner’s share of any partnership item was identical to its distributive share of every other partnership item. *Id.*

1. Scope

As noted, TEFRA applies to all partnerships with more than 10 partners. It enables the IRS to examine all “partnership items” in a single partnership-level proceeding.¹⁷ Items that are not partnership items are classified as either “affected items” or “nonpartnership items.”¹⁸

The classification of any particular item is critical in the TEFRA regime because it will determine (i) whether the item can (and must) be adjusted in a partnership-level proceeding (only partnership items can be adjusted through TEFRA proceedings), and (ii) whether any tax resulting from an adjustment to the item can be assessed against partners without the need for an additional partner-level deficiency proceeding.¹⁹ Not surprisingly, there has been substantial litigation over whether specific items are partnership items.²⁰

2. Conduct of the Audit: The Tax Matters Partner

Under TEFRA, the tax matters partner (the “TMP”) is the primary liaison between the partnership and the IRS during a TEFRA audit. It functions primarily as a point of contact for the IRS and information source for the partners in the partnership.²¹ Generally, the partnership may designate a general partner to act as the TMP (provided that it is a United States person within the meaning of section 7701(a)(30)),²² however, if the partnership fails to make a designation, or the

¹⁷ Pre-BBA § 6221; H.R. Rep. No. 760, 97th Cong., 2d Sess. § 600 (1982).

¹⁸ Pre-BBA § 6231(a)(4) (defining a nonpartnership item) and Pre-BBA § 6231(a)(5) (defining an affected item).

¹⁹ Before assessing a tax related to certain affected items and nonpartnership items of any given partner, the IRS must initiate a separate audit process with respect to that partner. Thus, in order to assess the tax, the IRS must send the partner an individual notice of deficiency giving the partner the right to petition the Tax Court for judicial review of its affected and nonpartnership items. Pre-BBA § 6230(a)(2)(A)(i). *See Saso v. Comm’r*, 93 T.C. 730, 734–35 (1989) (holding that the court could not adjust affected and nonpartnership items for a year in which the partner did not receive a notice of deficiency).

²⁰ The partnership item/affected item dichotomy (and corresponding litigation) is discussed in further detail in Part VI (page 53).

²¹ Pre-BBA § 6231(a)(7) and Pre-BBA § 6223(g).

²² In the case of partnerships that are organized as limited liability companies, the TMP must be a managing member. Pre-BBA Treas. Reg. § 301.6231(a)(7)-2 (addressing the designation of the TMP for a limited liability company).

designated TMP is ineligible, the IRS may select a TMP pursuant to the procedures established in the regulations.²³

While the TMP represents the partnership in its interactions with the IRS, the other partners are generally entitled to receive individual notice of significant audit-related events from the IRS and have the right to fully participate in the partnership's administrative and judicial proceedings.²⁴ Additionally, under certain circumstances, individual partners can initiate judicial proceedings to challenge the determinations made by the IRS in a TEFRA audit²⁵ as well as make their own administrative adjustment requests to claim different treatment of their share of partnership items (and request refunds with respect to their individual tax liabilities).²⁶ Even settlements entered into by the TMP will not necessarily bind all of the partners.²⁷

3. Collection

Once the audit concludes, the IRS issues a final partnership administrative adjustment (“FPAA”) to the TMP.²⁸ The TMP may then seek judicial review of the FPAA within ninety days after the date on which the IRS mailed the FPAA to the TMP, after which any “notice partner” (or 5% group) may do so within sixty days of the close of the ninety-day period.²⁹ If an FPAA is challenged, the reviewing court has the jurisdiction to determine all partnership items for the taxable year in question as well as the allocation of such items among partners.³⁰

If neither the TMP nor any other partner petitions for judicial review of the FPAA, or any such judicial proceeding is finalized, any adjustments to partnership items are flowed through to

²³ Pre-BBA § 6231(a)(7) and Pre-BBA Treas. Reg. § 301.6231(a)(7)-1. If the partnership does not designate a TMP, the TMP is determined by a number of default rules which generally look to the general partner with the largest profits interest.

²⁴ Pre-BBA § 6223(a) and Pre-BBA § 6224.

²⁵ Pre-BBA § 6226(b).

²⁶ Pre-BBA §§ 6227(d) and 6228(b).

²⁷ Pre-BBA § 6224(c)(3). See United States Government Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Efficiency*, GAO-14-732, at 27 n. 32 (Sept. 14, 2014) (the “GAO Report”).

²⁸ Generally, the FPAA must also be sent to other partners (so long as the name and address of the partner has been provided to the IRS) within 60 days of the date on which the IRS mailed the FPAA to the TMP. Pre-BBA § 6223(a)(2) and Pre-BBA § 6223(d)(2). If the IRS fails to send the FPAA to these “notice partners,” they have several options available to them outlined in Pre-BBA § 6223(e).

²⁹ Pre-BBA § 6226(b).

³⁰ Pre-BBA § 6226(f); Pre-BBA Treas. Reg. § 301.6226(f)-1.

the partners and the IRS computes and assesses their resulting tax liabilities as if the partners' returns for the audited year were amended to reflect the adjustments (although there are no amended K-1s or amended returns sent to the partners or filed with the IRS). Although not explicitly stated in the statute, it is understood that partners then make corollary adjustments to going-forward tax attributes to reflect the results of the partnership-level audit (*e.g.*, adjusting outside basis, accumulated earnings and profits, net operating loss carryforwards and foreign tax credit pools). Because this "tiering up" of the consequences of the FPAA must be done by the IRS, TEFRA extends each partner's statute of limitation by one additional year to give the IRS additional time to compute and prepare the assessment for each of the partners.³¹

4. Issues with TEFRA

The rise in popularity of partnerships as well as the rise in the complexity of modern partnership structures have put significant stress on TEFRA. By way of illustration, based on a report from the U.S. Government Accountability Office ("GAO"), between 2002 and 2011, the number of large partnerships with 1,000 or more direct or indirect partners and at least \$100 million in assets more than tripled to over 10,000. Of these large partnerships, about two-thirds had six or more tiers and 1,000 or more partners, and several hundred had more than 100,000 partners.³²

The TEFRA framework struggled to cope with these numbers and complexity. Recent governmental reports (from the GAO, and from the Treasury Inspector General for Tax Administration ("TIGTA"))³³ provide a detailed and sobering account of the IRS's difficulties and highlight three main difficulties: (i) identifying the correct TMP, (ii) flowing adjustments through to the ultimate taxpayers after the FPAA was issued, and (iii) complying with the burdensome notice and participation requirements with respect to the partners. The combination of

³¹ Pre-BBA § 6229(d) and (g).

³² GAO Report, at 15–16. According to an IRS official, the largest of these large partnerships had over 50 tiers and a million partners. *Id.*

³³ GAO Report; United States Government Accountability Office, *Large Partnerships: Characteristics of Population of IRS Audits*, GAO-14-379R (2014) ("**Preliminary GAO Report**"); United States Government Accountability Office, *Large Partnerships: Growing population and Complexity Hinder Effective IRS Audits*, GAO-14-746T (2014); United States Government Accountability Office, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, GAO-14-453 (2014); Treasury Inspector General for Tax Administration 2015-30-004, *Additional Improvements are Needed to Measure the Success and Productivity of the Partnership Audit Process*, at 17, 22 (2015) ("**TIGTA Report**").

these issues ultimately led to the perception that—to quote Amy Elliott—large partnerships had become effectively “audit proof.”³⁴ We discuss these issues below.

- *Identifying the Correct TMP.* Under TEFRA, a partnership may, but is not required to, designate a TMP on its return (or otherwise notify the IRS of its TMP designation).³⁵ As a result, IRS auditors can spend months requesting that the partnership identify the TMP and, in the alternative, designating a qualified TMP. Because the TEFRA audit cannot start without the TMP, the IRS can lose precious time and thus run into statute of limitations issues.³⁶
- *Flowing Adjustments Through to the Ultimate Taxpayers.* In modern partnerships with very complex structures, the identity of the ultimate taxpayer can often be very difficult to ascertain. Further, even if the ultimate taxpaying partners are identified, there are very

³⁴ Amy S. Elliot, *News Analysis: Why it Matters that the IRS Has Trouble Auditing Partnerships*, Tax Analysts (April 7, 2015), available at <http://www.taxanalysts.com/www/features.nsf/Articles/B92306DD25FB663B85257CB300466DE4?OpenDocument>.

Less than one percent of large partnerships were audited in 2012 (compared to over 27 percent for C corporations) and about two-thirds of these audits resulted in no overall change to the taxpayer’s position (compared to just 21 percent for C corporations). Even when there was a change, the aggregate additional taxes owed were minimal compared to those owed by audited C corporations and, in some years, this number was even negative. GAO Report, at 19-21. In 2013, for example, audits of C corporations resulted in a total of \$14.9 billion in additional tax liabilities, with an average of \$2.4 billion per corporation. In contrast, audits of large partnerships resulted in a \$370 million net decrease in taxpayer liabilities, with an average reduction in tax liability of \$3.9 million per partnership.

A research paper circulated after the BBA was enacted further corroborates this data. See Richard Prisinzano & Danny Yagan, *Business in the United States: Who Owns It and How Much Tax do They Pay?*, NEW YORK UNIVERSITY SCHOOL OF LAW COLLOQUIUM ON TAX POLICY AND PUBLIC FINANCE (April 5, 2016), available at http://www.law.nyu.edu/sites/default/files/upload_documents/Danny%20Yagan.pdf; Lee A. Sheppard, *News Analysis: Partnerships and Inequality*, Tax Analysts (April 11, 2016), available at <http://www.taxnotes.com/tax-notes/partnerships-and-other-passthrough-entities/news-analysis-partnerships-and-inequality/2016/04/11/18453161>.

³⁵ See Pre-BBA Treas. Reg. § 301.6231(a)(7)-1(c) (“The partnership *may* designate a tax matters partner for a partnership taxable year on the partnership return for that taxable year in accordance with the instructions for that form.”) (emphasis added); GAO Report, at 27 (noting that the burden of identifying the correct TMP falls largely on the IRS in part because “TEFRA does not require partnerships to designate a TMP on their returns”).

³⁶ GAO Report, at 27–28. In focus groups conducted by the GAO, IRS personnel reported running out of time before they were able to find partner information needed for an assessment and as a result had to simply close audits as no change. *Id.*

significant costs associated with actually collecting the tax from each such partner (both in terms of “tiering up” the adjustment from the FPAA and in terms of collecting small amounts of taxes from a very large number of partners).³⁷ This problem is exacerbated by TEFRA’s one-year statute of limitations for passing through assessments to partners.³⁸

- *Notice and Participation Rights Muddy the Waters.* As noted above, under TEFRA, most partners are entitled to notice of the proceedings. Even minor technical infractions of the notice rules may be grounds for partners to challenge the substantive results of an audit. In addition, because most partners are also entitled to participate in administrative and judicial proceedings (and potentially dissent from the partnership’s position and take a different position) the proceedings themselves can also be cumbersome and contentious.³⁹

B. The Electing Large Partnership Regime

Before turning to the BBA, it is interesting to review the electing large partnership regime since the BBA borrowed some of its features: In 1997 already, Congress recognized that the TEFRA audit procedures were complex, inefficient and ineffective when applied to large partnerships.⁴⁰ Accordingly, it established streamlined audit procedures which would apply to any eligible partnership that elected into the regime: an electing large partnership (“**ELP**”).⁴¹

Generally, an ELP is any partnership with 100 or more direct partners that elects to be treated as an ELP on its return.⁴² This is a purely elective regime, and so a large partnership that does not elect into the regime will by default be subject to the TEFRA rules described in Part III.A. This Part III.B provides an overview of the ELP regime.

³⁷ GAO Report, at 29–30; JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2016 BUDGET PROPOSAL (JCS-2-15), at 265 (2012).

³⁸ GAO Report, at 26.

³⁹ JCS-2-15, at 265.

⁴⁰ STAFF OF THE JOINT COMM. ON TAX’N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 (JCS-23-97) (the “**1997 Bluebook**”), at 363 (1997).

⁴¹ The Taxpayer Relief Act of 1997, §§ 1221–1243, Pub. L. No. 105-34, 111 Stat. 788 (1997) (the “**1997 Act**”).

⁴² Pre-BBA § 775(a)(1). *See* 1997 Bluebook, at 359 (noting that indirect partners do not count towards the 100-partner requirement).

1. Conduct of an ELP Audit

ELPs, like TEFRA partnerships, are subject to unified audit procedures whereby the IRS determines the tax treatment of “partnership items” in a single partnership-level proceeding.⁴³ However, the conduct of the audit is significantly simplified and streamlined:

- *Notice for ELP partners.* The IRS is not generally required to provide individual partners in an ELP with notice of audit-related events.⁴⁴
- *Partnership Representative.* There is no TMP in an ELP, instead an ELP must designate a partner *or other person* to act as its “partnership representative.”⁴⁵ When initiating or conducting the audit, the IRS liaises only with the partnership representative. The partnership representative has the sole authority to act on behalf of the ELP in connection with (i) settlement negotiations, (ii) refund requests, (iii) judicial review of proposed and final administrative adjustments, and (iv) requests for administrative adjustments.⁴⁶ Despite these limited participation rights, both former and current partners of the ELP are bound by the actions (or inaction) of the partnership representative.⁴⁷

2. Collection

Perhaps the most significant difference between the ELP regime and TEFRA is the manner in which partnership adjustments affect current and former partners. The ELP rules provide that any adjustments of partnership items flow through to partners *for the year in which the adjustment takes effect*.⁴⁸ Thus, the partners for the year under audit and their returns for that year are not relevant in determining the tax consequences of the adjustments.⁴⁹

⁴³ Pre-BBA § 6245(a). The corresponding section under TEFRA is § 6221. The term “partnership item” has the same definition under both the ELP and TEFRA rules. 1997 Bluebook, at 363.

⁴⁴ Pre-BBA § 6245(b)(1). The IRS is only required to send notice to the ELP directly. Even if a partnership has terminated, the IRS may satisfy the notice requirements by mailing such notice to the partnership at its last known address. *Id.*

⁴⁵ If the ELP fails to designate a partnership representative, the IRS may appoint any partner to assume the role. Pre-BBA § 6255(b)(1). *Id.*

⁴⁶ 1997 Bluebook, at 364–65. In contrast, individual partners in TEFRA partnerships are entitled to participate in all proceedings related to partnership items adjustments. *See* Pre-BBA § 6224(a) (stating that all partners may participate in administrative proceedings); Pre-BBA § 6226(c) (stating that all partners that are parties to a judicial action are entitled to participate in the action).

⁴⁷ Pre-BBA § 6255(b)(2).

⁴⁸ Pre-BBA § 6242; 1997 Bluebook, at 363. Accordingly, current-year partners’ shares of current-year partnership items of income, gains, losses, deductions and credits are adjusted to take into account any

footnote continued

In addition, the ELP may choose to (and in certain cases may be required to) assume any tax liability related to the audit by paying an “imputed underpayment.”⁵⁰

3. Limited Use

The ELP regime raised many significant policy and practical questions. However, its main weakness stems from its elective nature: very few partnerships elected to become ELPs. Based on information from the GAO, in 2011, only 105 (out of thousands of eligible large partnerships) elected to be treated as ELPs,⁵¹ of which only 15 had \$100 million or more in assets.⁵² Furthermore, from 2007 to 2013, the IRS did not complete a single audit of an ELP.⁵³

IV. THE BIPARTISAN BUDGET ACT OF 2015

The BBA repealed and replaced both TEFRA and the ELP regime. This Part IV provides an overview of the new audit rules introduced by the BBA. Part IV.A starts with the legislative history of these rules, then Part IV.B discusses the entities to which the BBA applies. Finally, Part IV.C and Part IV.D address the two main innovations of the BBA rules: (a) the introduction of a “partnership representative” role (and elimination of the tax matters partner), and (b) the addition of new processes for how the tax due as a result of an audit or litigation is determined and collected.

A. Legislative History

The legislative history of TEFRA’s overhaul can be traced back to the design and enactment in 1997 of the ELP regime. More recent legislative proposals began with the Obama

partnership adjustments that take effect in that year. *Id.* While it is not entirely clear how partnership adjustments should be allocated to the partners under the ELP regime, Pre-BBA § 6242(a) makes clear that in flowing the adjustments through to the partners, appropriate correlative adjustments are permitted. *See* NYSBA Tax Section Report No. 812, *Report on the Large Partnership Provisions of the Tax Simplification Bill*, at 38–43 (December 16, 1994); Linda Z. Swartz, *The Elective Large Partnership Rules*, in PRACTICING LAW INSTITUTE – THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, 653, 675–78 (2009 ed. Vol. 7) (discussing the open issues related to the allocation of an ELP partnership adjustment).

⁴⁹ *Id.* The exception to this general rule is cases involving adjustments to a partner’s distributive share.

⁵⁰ *Id.*

⁵¹ Preliminary GAO Report, at 6.

⁵² GAO Report, at n. 31.

⁵³ Preliminary GAO Report, at 12.

administration's budget proposal for the 2013 fiscal year. The proposal would have mandated the ELP rules apply to any partnership with more than 1,000 direct or indirect partners.⁵⁴

The following year, Representative Camp, the House Ways and Means Committee Chairman, included in his tax reform proposal an expansive revision of the partnership audit rules.⁵⁵ The Camp proposal built on some of the concepts introduced by the Obama 2013 budget proposal, but went further by proposing to completely repeal TEFRA and the ELP regime. The proposal envisioned replacing these rules with a single set of rules for auditing partnerships and partners at the partnership level that would apply to all partnerships with more than 100 partners (or any partnership with any partner which was a pass-through entity, including S corporations and RICs and REITs). Under the proposal, any additional tax resulting from a partnership audit, termed the "imputed underpayment" under the proposal, would be paid by the partnership based on a formula (although the amount could be modified if reviewed-year partners submitted amended tax returns incorporating any adjustments, along with the corresponding tax payment).⁵⁶ Importantly, the partners and the partnership would be held jointly and severally liable for any such imputed underpayment. Similar proposals were introduced by Senator Levin in 2014⁵⁷ and subsequently by the Obama administration as part of its 2016 budget proposal.⁵⁸

The first iteration of the bill that became the BBA was introduced in March of 2015 without any provisions addressing TEFRA reform. The original bill underwent several

⁵⁴ DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 155 (2013). JOINT COMM. ON TAX'N, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSAL (JCS-2-12), at 622–26 (2012).

⁵⁵ Tax Reform Act of 2014, H.R. 1, 113th Cong., 2nd Sess. § 3622 (2014).

In 2013, Representative Camp had introduced a discussion draft of a Tax Reform Act, which did not specifically address partnership audit procedures but put forth two high-level approaches to reforming the treatment of pass-through entities: (a) revisions to subchapter K and subchapter S to eliminate perceived abuses and to clarify and align the two regimes or (b) a new unified pass-through regime. *See* Tax Reform Act of 2013, Ways and Means Discussion Draft, 113th Cong., 1st Sess. (2013).

⁵⁶ These two payment approaches under Camp's proposal correspond to the payments options provided under sections 6225(a) and 6225(c) of the BBA; the BBA's payment options are discussed in greater detail below in Part IV.D (page 28).

⁵⁷ The Partnership Auditing Fairness Act, S. 3018, 113th Cong., 2nd Sess. (2014).

⁵⁸ DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 235 (2015); JOINT COMM. ON TAX'N, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2016 BUDGET PROPOSAL (JCS-2-15), at 262–70 (2012).

amendments from March to October:⁵⁹ the partnership audit provisions first appeared in the version introduced on October 27, 2015.

These provisions were substantially similar to a bill proposed by Representative Renacci (a member of the House Ways and Means Committee) in June of 2015 (titled the Partnership Audit Simplification Act of 2015),⁶⁰ which was itself a revised version of the Camp proposal.⁶¹

The provisions included in the October 27th version of the BBA differed from Renacci's proposal in four important ways: (i) the joint and several liability between the partners and the partnership for imputed underpayments was removed, (ii) an alternative payment method (now section 6226, described below⁶²) was added, (iii) the requirement that the partnership representative maintain a "substantial presence" in the United States was added, and (iv) the effective date was moved to tax returns starting on or after January 1, 2018 (as opposed to January 1, 2019). There was no floor discussion or any other indication of the background to these changes.⁶³

These provisions were not changed after their introduction and the bill went on to be enacted by Congress on November 1, 2015 and signed by the President on November 2, 2015. On

⁵⁹ See, e.g., H.R. 1314, 114th Cong., 1st Sess. (2015) (the BBA as introduced in the House of Representatives on March 4, 2015) (available at <https://www.congress.gov/bill/114th-congress/house-bill/1314/text/ih>); Ensuring Tax Exempt Organizations the Right to Appeal Act, H.R. Rep. No. 114-67 (April 3, 2015) (as reported by the Committee on Ways and Means); H.R. 1314, 114th Cong., 1st Sess. (2015) Cong. Rec. 2235 (as passed in the House on April 15, 2015); Trade Act of 2015 (as passed in the Senate, with amendment, on May 22, 2015); The Bipartisan Budget Act of 2015, H.R. 1314, 114th Cong., 1st Sess. (2015) (passed in the House, with amendment to the Senate's amendment, on October 28, 2015; the Senate agreed to amendments and passed the bill on October 30, 2015) (note that this is the first version of the bill that includes the partnership audit rules); The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101, 129 Stat. 584, 625–38 (Nov. 2, 2015).

⁶⁰ Partnership Simplification Act of 2015, H.R. 2821, 114th Cong., 1st Sess. (2015) (the "**Renacci Proposal**").

⁶¹ Notably, Renacci's provisions regarding the imputed underpayment formula, joint and several liability, and the partnership representative, appeared exactly as they did in Camp's bill. Some material differences between Renacci's and Camp's proposals are that: (i) Renacci gave individual partners 270 days following the mailing of the proposed adjustment to submit an amended return justifying modifications to the imputed underpayment, as opposed to the 180 days provided in Camp's proposal; (ii) Renacci granted the Secretary authority to issue regulations to address the way in formers partners of a partnership "that ceased to exist" would take into account adjustments resulting from an audit (now section 6241(7)); and (iii) Renacci's bill would be effective only for tax returns filed after December 31, 2018 instead of December 31, 2014 in Camp's proposal.

⁶² See Part IV.D.3 (page 30).

⁶³ The only discussion of which we are aware is found in Donald B. Susswein & Ryan P. McCormick, *Understanding the New Partnership Audit Rules*, TAX NOTES 1171–78 (Nov. 30, 2015).

December 18, 2015, the PATH Act was enacted, making a handful of technical corrections to the newly-enacted rules.⁶⁴

Given the depth of concerns about the state of the TEFRA regime, Congress acted swiftly in adding the partnership audit rules to the BBA; it is therefore not surprising that the statute includes ambiguities. While there are no Congressional or Committee reports discussing the provisions, the Joint Committee on Taxation has published two explanations, one in connection with the enactment of the PATH Act and a subsequent one addressing the Bipartisan Budget Bill and the BBA provisions in detail.⁶⁵ The release of these two Bluebooks provides a welcomed explanation of the rules (particularly, in light of the lack of legislative history and the differences between the BBA and the prior proposals). However, there are some statements in the Bluebooks which may not match a plain reading of the statute and, while the Joint Committee Explanations carry weight, they do not have the weight of Congressional reports and the IRS and taxpayers are not required to follow them if their approach is not persuasive.⁶⁶ Finally, the GAO and TIGTA reports (discussed above)⁶⁷ and the Obama 2016 budget proposal's explanation provide a great deal of context and background as to why Congress was eager to revise the TEFRA and ELP rules.

B. Partnerships Subject to the BBA

Before discussing the details of the BBA it is helpful to understand its scope. The new partnership audit and collection procedures of the BBA will apply, by default, to all items of “income, gain, loss, deduction and credit” of partnerships.⁶⁸ For this purpose, a partnership is any entity that is required to file a tax return under section 6031(a).⁶⁹

⁶⁴ Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment To H.R. 2029, 114th Cong., 1st Sess. § 411 (2015) (the “**PATH Act**”). The technical corrections included allowing an imputed underpayment to be modified to account for certain passive losses of publicly traded partnerships and both capital gains and ordinary income attributable to a C corporation partner.

⁶⁵ STAFF OF THE JOINT COMM. ON TAX’N, GENERAL EXPLANATION OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015 (JCS-144-15) (2015) (the “**PATH Bluebook**”). STAFF OF THE JOINT COMM. ON TAX’N, GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN 2015 (JCS-1-16) (2016) (the “**BBA Bluebook**”).

⁶⁶ The Supreme Court has held that a Bluebook issued by the Joint Committee on Taxation is neither legislative history nor a binding interpretation of the law. *See, e.g.*, *United States v. Wood*, 134 S. Ct. 557, 568 (2013).

⁶⁷ *See* Part III.A.4 (page 17).

⁶⁸ § 6221.

⁶⁹ § 6241(1). In other words, all U.S. partnerships and most foreign partnerships that derive effectively connected income or U.S. source income would be subject to the rules. Foreign partnerships with U.S.

footnote continued

A partnership has the option to elect out of the BBA for a particular year if it issues no more than 100 K-1s in that year and each of its partners is an individual, C corporation, S corporation, estate of a deceased partner, or a foreign entity that would be a C corporation if it were domestic.⁷⁰ The election is made on the partnership's Form 1065 for the year. Thus, while under TEFRA, a partnership was excluded from the required unified audit regime only if it had less than 10 partners; under the BBA, a partnership could have up to 100 partners and be outside of the centralized audit regime. The main implication is that the BBA expands the scope of the partnerships that can completely avoid the application of "centralized audit" rules from partnerships with less than 10 partners (as was the case under TEFRA) to partnerships with less than 100 partners.

As a general matter, therefore, in a post-BBA world, there are two categories of partnerships: (1) those subject to the BBA and (2) those that validly elect out.

- *A Partnership that Elects Out.* In the case of a partnership which elects out, the partners are presumably subject to the pre-TEFRA rules:⁷¹ this would imply that (1) adjustments must be made at the level of each partner, (2) in order to make those adjustments, the IRS will

partners and no U.S. source income may be required to file a return (for instance, if the partnership has capital gain since capital gains are generally sourced under section 865 by reference to the residency of the partner).

In addition, if an entity or legal arrangement files a partnership return by mistake (*i.e.*, it is determined that the entity was not a partnership or that there was no entity), then, to the extent provided in the regulations, it is subject to the BBA rules. § 6241(8). Presumably the intent of this provision is to avoid having to open a different audit once a BBA audit has already started. The expansive application of these rules will need to be carefully thought through: For instance, if the entity at issue is a corporation for U.S. federal income tax purpose, it may make sense for the "partnership representative" to remain as an interlocutor, but presumably § 6221(b) and § 6226 elections will not be available.

⁷⁰ § 6221(b). The BBA Bluebook helpfully clarifies certain procedural aspects related to counting the number of Schedules K-1 for purposes of "electing out," including (i) with respect to S Corporations, each statement that the S Corporation is required to furnish to its shareholders, is treated as a Schedule K-1 furnished by the partnership (in addition to the Schedule K-1 actually furnished to the S Corporation partner); (ii) administrative guidance may expand the list of permissible partners to whom rules similar to that described above for S corporation partners would apply to include, for example, disregarded entities; (iii) to the extent consistent with the "prompt and efficient collection of tax," guidance may provide rules allowing for partnerships with other partnerships as partners to elect out, assuming the sum of all direct and indirect partners does not exceed 100 persons to which a Schedule K-1 must be provided; and (iv) RIC and REIT-partners will not preclude a partnership from electing out. BBA Bluebook, at 58–59.

⁷¹ BBA Bluebook, at 57 ("Electing out of the [BBA] leaves applicable the present law rules for deficiency proceedings.").

need to open an audit of each partner separately,⁷² and (3) any audit determination, settlement or court decision as to one partner would not be binding on or required to be made available to the other partners. We discuss these issues further below.⁷³

- *A Partnership that is Subject to the BBA.* If the BBA rules apply, the partnership and its partners are subject to what the BBA Bluebook has termed a “centralized” process. All items of income, gain, loss, deduction and credit of the partnership must be adjusted pursuant to a centralized partnership-level proceeding.⁷⁴ A partner may not take a position on its return that is inconsistent with the partnership’s treatment of the relevant item (unless the partner discloses that inconsistency in its return).⁷⁵ If a partner does take such an inconsistent position without disclosure, the IRS is permitted to assess any underpayment attributable to the inconsistency as if it were a mathematical error.⁷⁶

C. Conduct of the Audit: the Partnership Representative

Consistent with the desire to address the problems described above (including the difficulties the IRS experienced in finding the TMP and providing the required notifications to the other partners), the new regime replaces the tax matters partner (TMP) with the “partnership representative” found in the ELP regime. The partnership representative has significantly more power and authority to bind the partnership, and the individual partners have almost no statutory rights to notice of, or to participate in, the audit process.⁷⁷

1. Function

Under the BBA, the partnership representative has the broad and in many instances, exclusive, power to bind the partnership with respect to the audit. Notably, the partnership representative (acting on behalf of the partnership) is given the exclusive authority to (i) interact

⁷² The IRS could “audit” at the partnership level as well in order to gather information, but it would need to both open an audit and make any actual adjustments at the partner level.

⁷³ See Part XII (page 137).

⁷⁴ § 6221(a).

⁷⁵ § 6222(a).

⁷⁶ § 6222(b). The partner may only avoid mathematical error-treatment by (i) providing notice to the IRS of the inconsistency prior to any such assessment, or (ii) proving that the partner’s return is consistent with the K-1 it received from the partnership. § 6222(c). While the rules are generally similar under TEFRA, the ELP regime does not allow a partner to avoid mathematical error-treatment after filing an inconsistent return by providing notice to the IRS.

⁷⁷ § 6223(a).

with the IRS on behalf of the partnership, (ii) accept an IRS adjustment or seek judicial review, (iii) decide which court to proceed in if judicial review is sought and represent the partnership in that proceeding and (iv) submit requests for administrative adjustments (which function like amended partnership returns).⁷⁸

At the same time, partners are no longer required to be notified by either the IRS or the TMP of the start of the audit or of significant events during the audit (the partnership and the partnership representative are notified) and do not seem to have a right to separate their audits from the general partnership-level audits. Nonetheless, the partnership representative's actions (or inaction) will bind the partnership and any current or former partners, possibly *even if* these actions are taken without proper authority under the partnership's constitutive documents.⁷⁹

2. Selection

The TEFRA rules required the “general partner” to serve as the TMP (or, for LLCs, the managing member).⁸⁰ By contrast, the partnership representative can be *any* person (partner or non-partner) with a “substantial presence in the United States,” a concept that is not defined in the statute.⁸¹

⁷⁸ While unclear, it may also be the person that makes the election under section 6226 or demonstrates to the IRS that a lower imputed underpayment should be paid by the partnership under section 6225(c). See Part IV.D (page 28).

⁷⁹ § 6255(b)(2). There may be significant constitutional issues implicated by the sweeping and binding authority given to the partnership representative under the BBA, however, an in-depth discussion of those issues is beyond the scope of this report. Note that under TEFRA, several courts have held that the regime does not present constitutional concerns because the notice and participation rights granted partners (other than the TMP) satisfy constitutional due process requirements. *Walthall v. Comm'r*, 131 F.3d 1289, 1291 (9th Cir. 1997) (holding that TEFRA complies with the constitutional requirements of due process); *Kaplan v. United States*, 133 F.3d 469, 475 (7th Cir. 1998) (same) (*citing* *Brookes v. Comm'r*, 108 T.C. 1, 8 (1997); *Energy Resources, Ltd. v. Comm'r*, 91 T.C. 913, 916 (1988)).

While there is no case law regarding the constitutionality of the centralization in the ELP regime, commentators have noted that the ELP regime is unlikely to raise significant due process concerns because it is a purely elective regime. See Don R. Spellman, *Taxation Without Notice: Due Process and Other Notice Shortcomings with the Partnership Audit Rules*, 52 TAX LAW. 133, 161 (1999).

⁸⁰ Pre-BBA Treas. Reg. § 301.6231(a)(7)-1(b)(1) (addressing the designation of the TMP for a partnership). Pre-BBA Treas. Reg. § 301.6231(a)(7)-2 (addressing the designation of the TMP for a limited liability company).

⁸¹ See § 6223(a). By contrast, the ELP regime required that the partnership representative be a U.S. person. Note that under Camp's and Renacci's proposals, the partnership representative could be any person, but if the IRS was making the designation, it would only be permitted to select a partner to act as the partnership

footnote continued

In order to avoid the need to “track down” the partnership representative (an issue which plagued TEFRA audits),⁸² the IRS can name a partnership representative if a designation is not in effect and can choose any person for that purpose.⁸³ Thus, there is no guarantee that the partnership representative (whether designated by the partnership or the IRS) will have any fiduciary obligations under the applicable state law to the partnership or the partners.

D. Collection: Overview of the BBA’s Three Payment Methods

As discussed above,⁸⁴ the TEFRA rules which are eliminated by the BBA provided a set of procedural rules that governed examination and assessment, but not collections. Under TEFRA, once an examination adjustment was determined and any appeal to IRS Appeals was resolved, an FPAA was issued and the IRS computed the assessments at the level of the ultimate (*i.e.*, top-tier) taxpaying partners by determining the total taxes each partner would have paid if the relevant returns for the audited year(s) (for the partnership that had been audited and each partner) were completed using the corrected items (we refer to this result as the “**Correct Return Position**”). The total taxes each partner paid were then compared to the taxes the partner would have paid under the Correct Return Position (for the year under audit and all subsequent years): any taxes due were assessed and any overpayment of taxes were processed as a refund.

Under the BBA, once a “final partnership adjustment” or “**FPA**” (instead of TEFRA’s FPAA) is issued, new specific payment rules apply.⁸⁵ The inclusion of rules that compute the amount of tax due and provide for how it is to be paid are the biggest differences from the TEFRA regime. These rules provide three ways of computing the resulting tax liabilities and satisfying those liabilities: (i) a payment by the partnership of the full amount of the “imputed underpayment” pursuant to section 6225(a); (ii) a payment by one or more of the partners (by way of an amendment to their own tax returns for the year corresponding to the partnership tax year

representative. As discussed above in Part IV.A (page 21), neither proposal contained the requirement that the partnership representative maintain a substantial presence in the United States. The BBA Bluebook also notes, “A substantial presence in the United States enables the partnership representative to meet with the Secretary in the United States as is necessary or appropriate, and facilitates communication during the audit process and during any other proceedings in which the partnership is involved.” BBA Bluebook, at 62.

⁸² See Part III.A.4 (page 17).

⁸³ *Id.* Presumably, to the extent not materially disruptive to the process, the IRS should provide the partnership with an opportunity to replace the designated representative.

⁸⁴ See Part III.A (page 14).

⁸⁵ This assumes that no court petition is filed and the liabilities are paid.

under audit (the “**reviewed year**”)⁸⁶ pursuant to section 6225(c)(2); and finally (iii) a payment by all the reviewed year partners pursuant to an election to “push out” the adjustment resulting from the FPA to those partners under section 6226. These three methods are summarized below and discussed in detail in Parts V, VII and VIII of this report.

An FPA (or, in certain cases, an adjustment included in an FPA) that does not result in an imputed underpayment is taken into account by the partnership in the so-called “**adjustment year**” (generally, the year the FPA is mailed unless the partnership disputes the FPA in court)⁸⁷ as a decrease in non-separately stated income, or increase in non-separately stated loss; if the item is a credit, it is taken into account by the partnership in the adjustment year as a separately stated item.⁸⁸ There does not appear to be a right for the partners to file amended returns or for the partnership to select the push-out method if the FPA does not result in an imputed underpayment.

1. Method 1 – Default Rule: Partnership Tax Liability

Under the default rule found in section 6225(a), the partnership—not the partners—pays the tax.⁸⁹ Following the Camp proposal, the statute refers to the amount payable as the “imputed underpayment.” This payment is due with the partnership’s Form 1065 filed for the adjustment year.

The imputed underpayment is computed based on a formula, which we discuss in detail in Parts V.A.4 and VII, below. At a high level, however, the imputed underpayment is calculated by netting the adjustments made during the audit and multiplying the net amount by the highest tax

⁸⁶ Section 6225(d) defines the reviewed year as the partnership taxable year to which the item being adjusted relates.

⁸⁷ Section 6225(d) defines the adjustment year as the partnership tax year in which (i) the FPA is mailed, (ii) in the case of an adjustment pursuant to the decision of a court in a proceeding under section 6234, such decision becomes final or (iii) in the case of an administrative adjustment request under section 6227, such administrative adjustment request is made.

⁸⁸ § 6225(a)(2).

⁸⁹ An interesting question arises with respect to legal arrangements that are treated as partnerships for U.S. federal income tax purposes: in that case, is there a person that is liable for the tax (*i.e.*, is section 6225(a) turned off)? Are the partners jointly and severally liable for the tax? Or should the IRS look at the legal arrangement to determine how the partners allocate the liability and expenses of the venture among themselves?

It would seem consistent with the removal of the “joint and several” liability concept from the statute that section 6225(a) not apply in that case (and thus the partners should pay their share of the tax), but guidance will be needed in this respect.

rate in effect (for any type of taxpayer) for the reviewed year.⁹⁰ Any adjustments to items of credit are taken into account as an increase or decrease, as the case may be, in the resulting number. The formula also provides that where an adjustment reallocates the distributive share of any item from one partner to another, the computation of the imputed underpayment should disregard decreases in income or gain, and increases in deductions, losses or credits.⁹¹

The partnership may seek to modify the imputed underpayment by demonstrating that a lower tax rate applies to portions that are allocable to certain partners (specifically, individuals and C corporations),⁹² or that income was allocable to a partner that would not owe taxes by reason of its status as a tax exempt entity (within the meaning of section 168(h)(2)).⁹³ The statute authorizes the IRS to issue regulations providing for additional factors to be taken into account in adjusting the imputed underpayment.⁹⁴

2. Method 2 – Section 6225(c)(2): Partners Amend their Tax Returns

The second payment method is found under section 6225(c)(2) and modifies the default rule described above. Under the second method, if within the prescribed period, a reviewed-year partner files an amended return for the reviewed year that takes into account the partner's allocable share of the adjustments made pursuant to the audit *and* pays the tax (and interest) due as a result, the amount of the imputed underpayment for which the partnership is otherwise liable is reduced by the amount corresponding to the partner's allocable adjustments.⁹⁵

If all reviewed-year partners file amended returns for the reviewed year and pay the taxes due, the partnership has no liability.

3. Method 3 – Section 6226: “Push Out” the Liability

The third payment method enables the partnership to avoid paying the imputed underpayment and to pass the liability for the additional taxes resulting from the FPA to the reviewed-year partners.⁹⁶ As noted above,⁹⁷ this method appeared for the first time in the October

⁹⁰ § 6225(a)–(b).

⁹¹ § 6225(b)(2).

⁹² § 6225(c)(4). Note that the Camp proposal and the Renacci bill did not include these modifications.

⁹³ § 6225(c)(3). This is another innovation of the BBA, as compared to the Camp and Renacci proposals.

⁹⁴ § 6225(c)(6).

⁹⁵ § 6225(c)(2). In the case of an adjustment which reallocates the distributive share of any item from one partner to another, all partners affected by such adjustment must file an amended return for this option to be available.

⁹⁶ § 6226.

27th version of the BBA, and there is thus little background or legislative history on it. At its core however, it is similar to the TEFRA regime, *except* that it relieves the IRS from having to carry through the complicated computations and adjustments resulting from an FPA and places this burden on the electing partnership and its partners. In order to make this election the partnership must elect the application of this rule within 45 days of receiving the FPA. The partnership is then required to send each reviewed-year partner and the IRS a statement (the “**Section 6226 Statement**”) with that partner’s share of the relevant adjustments for the reviewed year. Contrary to section 6225(c)(2), the partners do not file an amended return for the reviewed year but instead take into account, in the year in which they receive the Section 6226 Statement, the increased taxes resulting from the adjustment (for the reviewed year and the intervening years between the reviewed year and the adjustment year) plus interest (computed at a rate that is higher by 2% than the usual interest rate applicable under section 6225(a) and section 6225(c)(2)).

This mechanism is deceptively simple. While it does eliminate certain complexities associated with sections 6225(a) and 6225(c), section 6226 raises difficult policy and implementation issues, some of which are discussed in this report.

V. THE THREE PAYMENT METHODS: A REGIME IN NEED OF A CONCEPTUAL APPROACH

As discussed immediately above, the BBA provides three methods to satisfy the tax liabilities resulting from an FPA. In order to implement these methods through a regulatory framework, there needs to be an understanding of the role of each method and how each is supposed to interact with Subchapter K. This issue is not addressed directly by the statute or in either of the Bluebooks. We believe there are two key issues that need to be addressed first:⁹⁸

- Setting aside the “interest surcharge” that results from a section 6226 election, are the three collection regimes intended to lead to Correct Return Position for all the partners and the IRS or is one (or more) of them a completely different regime which may ultimately result in a different aggregate tax liability (over time)? This is a particularly significant issue with respect to the imputed underpayment method of section 6225(a) and will be especially relevant for situations in which the reviewed-year partners and the adjustment year partners are not the same (a situation that we expect will be quite common).
- How is each payment regime intended to interact with Subchapter K (*i.e.*, how will it impact the tax attributes of the partnership and the partners going forward)?

⁹⁷ See Part IV.A (page 21).

⁹⁸ Once these two key issues have been decided upon, there will be many important (and difficult) secondary-level issues to be addressed. We believe however, that it is critical to have first a conceptual framework as to the goal and intent of the three regimes before addressing the secondary-level questions.

These are important policy issues, because there is no indication that the statute was designed to change the substantive tax law. Indeed, the legislative history that is available indicates that the intent was to enable the more efficient and effective collection of taxes due under pre-existing substantive law. If these new *procedural* rules also alter the total taxes due in any way other than substituting the imputed underpayment for what would have been due for the reviewed year, then the manner in which they do that needs to be very clear.

As a matter of policy, we believe that a regime that provides for different aggregate tax liabilities as a result of an FPA depending on the payment method that is chosen (or used, if there are no choices) or that is “disconnected” from Subchapter K creates significant risks of results that are unfair (to both the government and the taxpayers) and opportunities for abuse. We recognize that the statute as drafted may limit the ability to adopt regulations that result in Correct Return Position (or even consistent results) under all three methods. Nevertheless, we believe that getting this new regime to work correctly is essential to the integrity of the system, and so we have investigated options that may require statutory changes or clarifications. In doing so, we have tried to adhere closely to what we believe is the core of the BBA and the goals behind it (of solving the problems experienced with TEFRA).

A. Example

These issues are complex but we think they can be illustrated through a simple example: Partnership P is a Delaware limited liability company classified as a partnership for U.S. Federal income tax purposes. All partners (A, B and C) are Delaware C corporations with no items of income, gain, loss, deduction or credit, other than those from P, all items recognized by P are stated below, and the highest rate of tax under Sections 1 and 11 in each year is 35%. There are no special allocations and no section 754 election; liquidations are in accordance with capital account balances. Each of P and A, B and C is a calendar year taxpayer. P does not elect out under section 6221(b) in any year.

Each of A and B starts out with \$1,070 of cash and C starts out with \$1,200 of cash.

2018

- In 2018, P is formed; A and B each contribute \$1,000 of cash; all profits and losses are split 50/50.⁹⁹

⁹⁹ Bolded items in the tables are new or changed items.

2018: Formation	Outside Basis	Inside Basis (Partnership Assets)
Partnership		Cash \$2,000
A	\$1,000	
B	\$1,000	

- During 2018, P provides services to a third party and as compensation receives Asset, which P values at \$200. Accordingly, P recognizes \$200 of income, A and B each take into account \$100 of income, and therefore A and B each pay tax of \$35.

2018 Year End Results	Outside Basis	Inside Basis (Partnership Assets)	Taxes Paid for Year	Cumulative Taxes Paid
Partnership		Cash \$2,000 Asset \$200		
A	\$1,100		\$35	\$35
B	\$1,100		\$35	\$35

At this stage, there is no inside/outside basis discrepancy.

2019

- On January 1, 2019, A sells its partnership interest to C. C values Asset at \$400 and thus buys A's interest for \$1,200 (50% of \$2,400).
- A recognizes \$100 of section 741 gain (\$1,200 - \$1,100 basis) and pays \$35 of tax.

2019: A sells to C	Outside Basis	Inside Basis (Partnership Assets)	Taxes Paid for Year	Cumulative Taxes Paid
Partnership		Cash \$2,000 Asset \$200		
A	\$1,100		\$35	\$70
B	\$1,100			\$35
C	\$1,200			

A has thus paid \$70 of taxes (which is all the taxes due on the \$200 of value that A economically realized from its investment in P).

2020

- In 2020, the IRS audits P’s 2018 return and determines that Asset was already worth \$400 when received by P in 2018 (which increases P’s 2018 income by \$200). An FPA is issued showing \$200 of additional income for 2018.

Under the BBA, there are three possible ways to satisfy the resulting underpayment: (i) section 6225(c)(2),¹⁰⁰ (ii) section 6226, and (iii) section 6225(a). It is helpful to compare the results of the three methods with the amount of taxes that would have been paid if P’s 2018 return had reflected the Correct Return Position so we start with that.

1. Correct Return Position

- If P had correctly valued the Asset at \$400, then in 2018 each of A and B would have been allocated \$200 (instead of \$100) of income and paid \$70 of taxes.
- At the end of 2018, P would have a \$400 basis in Asset and each of A and B would have had an outside basis in P of \$1,200 (*i.e.*, there would be no inside/outside basis discrepancy).¹⁰¹ P also would have reflected the \$200 in each of A’s and B’s capital accounts, resulting in each having a capital account of \$1,200.
- In 2019, when A sold its interest to C for \$1,200, A would have had no taxable gain and thus no tax would have been due. C would have inherited A’s \$1,200 capital account.

	Taxes Paid: as Reported	Taxes Paid: Correct Return Position	Fair Market Value of Partnership Interest	Outside Basis: as Reported	Outside Basis: Correct Return Position
	2018				
A	\$35	\$70	\$1,200	\$1,100	\$1,200

¹⁰⁰ The amended return method pursuant to § 6225(c)(2) can be combined with the partnership paying the imputed underpayment (§ 6225(a)) because not all partners are required to file an amended return. (It cannot be combined with the push-out election of § 6226.) For purposes of the illustrations and discussion in this section, we analyze the results of the amended-return method as if all the partners filed amended returns.

¹⁰¹ We note that under TEFRA, the results would be identical to this in that P, A and B would all have adjusted their respective bases to reflect the adjustments made by the audit even though there is no specific statutory provision in TEFRA or other parts of the Code that specifies, authorizes or requires this. *See* Parts III.A.3 and IV.D.

	Taxes Paid: as Reported	Taxes Paid: Correct Return Position	Fair Market Value of Partnership Interest	Outside Basis: as Reported	Outside Basis: Correct Return Position
B	\$35	\$70	\$1,200	\$1,100	\$1,200
Total	\$70	\$140	\$2,400	\$2,200	\$2,400
	2019				
A	\$35	0		–	–
B	0	0	\$1,200	\$1,100	\$1,200
C	0	0	\$1,200	\$1,200	\$1,200
Total	\$35	0	\$2,400	\$2,300	\$2,400

To summarize, under the Correct Return Position at the end of 2019:

- A has \$1,200 of cash (\$1,200 received from C plus \$70 of cash on hand less \$70 of taxes paid).
- B's net assets are \$1,200 (a partnership interest worth \$1,200 plus \$70 of cash on hand less \$70 of taxes paid).
- C has a partnership interest worth \$1,200.
- The IRS has collected \$140 of tax payments.

2. Section 6225(c)(2): Amended Reviewed Year Returns

A and B, as reviewed year partners, file amended returns to reflect the adjustment from the FPA and pay the taxes due in accordance therewith. C is not implicated.

(a) Treatment of B

- **Income:** B files an amended tax return for 2018 and includes an additional \$100 of income resulting in an additional tax liability of \$35 (plus interest).¹⁰²
- **Basis Adjustments:** Since B has amended its tax return to recognize the additional income, and B still holds the P interest, presumably, B should increase its basis in its P interest by \$100, resulting in an outside basis of \$1,200.¹⁰³

¹⁰² At the federal short term rate plus 3%.

Ignoring the time value of money (and the interest charge), B's position (and the amount the IRS has collected with respect to B) matches the Correct Return Position.

(b) Treatment of A

- **Income:** A files an amended return for 2018. Like B, A includes an additional \$100 of income, which results in a payment of \$35 of tax (plus interest).
- **Implication for the 2019 Sale of A's Interest to C:** If P had filed a correct return for 2018, A would have had a \$1,200 basis in its P interest when that interest was sold in 2019 to C for \$1,200. However, when the sale occurred, A reported a basis of \$1,100 in its P interest and thus paid the tax on the \$100 of section 741 gain.

We believe that the statutory language should allow A to take into account the impact of the adjustment to its outside basis, such that A should be able to claim a refund for the \$35 of taxes A paid for 2019 regardless of whether the statute of limitations for that year has otherwise expired.¹⁰⁴

Assuming this is correct, then again, setting aside the interest charge and time value of money, A's position (and the IRS's collections with respect to A) also matches the Correct Return Position.

¹⁰³ This is an important point that needs to be confirmed in the guidance because the statute does not specify that this occurs, although it implies it by referring in § 6225(c)(2)(A)(ii) to "any tax attribute [which] is affected by reason of such adjustments."

¹⁰⁴ § 6225(c)(2)(A)(ii) requires A to file an amended 2018 return that "*take[s] into account all adjustments [from the FPA] properly allocable to [A] (and for any other taxable year in respect to which any tax attribute is affected by reason of such adjustments).*" There are two issues, however:

- **Subsequent Years:** It is not entirely clear from § 6225(c)(2)(A)(ii) whether these conforming adjustments are reflected in the amended 2018 return or handled otherwise. It would seem appropriate to either allow A to include the consequences of the 2019 adjustment in its 2018 tax return (similar in a way to what is done under § 6226 in the adjustment year return), or to allow A to file an amended return with respect to 2019 (regardless of whether the time to do so has run). We note that the special rule in § 6225(c)(2)(A)(i) that authorizes A to file the amended 2018 return even if the time to do so has already run applies, by its terms, only to the return for the reviewed year.
- **Interest Payments:** Similarly it is not entirely clear if A receives overpayment interest to offset the underpayment interest. We note that § 6225(c)(2)(A)(iii) requires A to pay "any tax due" with the amended return.

(c) Treatment of P

Presumably, P is obligated to adjust the inside basis of Asset to \$400 and to adjust the capital accounts of B and C to bring them up to \$1,200. As noted above,¹⁰⁵ the TEFRA statute never articulated that this was required, but it was always understood to be one of the consequences of accepting the audit adjustment. We believe that BBA should be interpreted as making no changes in this regard, at least when the partners all file amended returns under section 6225(c)(2). (We discuss below how these conforming adjustments should operate under the other two payment methods.)

3. Section 6226 Election

In 2020, P timely provides Section 6226 Statements to A and B, the reviewed-year partners. Under section 6226, each partner computes and then pays, together with its tax liability for 2020, an amount equal to the following:

- for 2018, the amount by which the tax imposed under chapter 1 would increase if the partner's share of the adjustment provided in the Section 6226 Statements were taken into account in 2018,
- for 2019, the amount by which the tax imposed under chapter 1 would *increase*¹⁰⁶ by reason of the adjustment made in the 2018 return,¹⁰⁷ and
- interest on those two amounts from the date they would have been due (computed at an increased rate (short-term rate plus 5%, instead of plus 3%)).

Each partner prepares its 2020 (and subsequent year returns) reflecting all conforming adjustment to its tax attributes. While the statute is silent as to whether P also conforms its tax attributes (such as inside basis and capital accounts), we presume that this would also occur.

(a) Treatment of B

For B, this mechanism results in the same additional tax payment as occurred under the section 6225(c)(2) payment method,¹⁰⁸ *except that* B does not file an amended 2018 return and

¹⁰⁵ See Part III.A.3 (page 16).

¹⁰⁶ This is not a typo but rather precisely what the statute provides. § 6226(b)(2)(B). See Part VIII (page 86) for a discussion of this issue.

¹⁰⁷ The partners also take into account the effect of the adjustment for the current year (2020), but this is part of their ordinary tax liability, not the tax due under § 6226 (and as such no interest is due in respect of any additional tax due for 2020).

¹⁰⁸ See Part V.A.2(a) (page 35).

interest is paid at federal short term rate plus 5% (instead of plus 3%). Presumably, B's outside basis in P is increased to \$1,200.¹⁰⁹

In other words, ignoring the interest charge, B is (and the IRS is) again put in a position that matches the Correct Return Position.

(b) Treatment of A

For A, the answer is unclear. As a result of the sale to C in 2019, A has already paid the additional \$35 of taxes due with respect to its allocable share of Asset's correct value. Nonetheless, based on the formula set out above (which comes directly from the statute), it would seem that A's 2020 tax return should include an additional \$100 of income (and thus \$35 of tax liability) to reflect the 2018 adjustment, *but* that A's income should *not* be decreased to reflect the fact that, if the adjustment had been reflected in 2018, A would not have recognized \$100 of capital gain in 2019.

The statute thus seems to result in A paying \$105 of taxes (plus interest) in the aggregate (\$35 in 2018, \$35 in 2019 and \$35 as part of the section 6226 election) and A never being compensated for the \$35 overpayment (solely because A had already sold its P interest).¹¹⁰ In other words, A would be permanently taxed twice on the \$100 that was missing from the 2018 K-1 provided to A. We discuss this issue further below.¹¹¹

(c) Treatment of P

Presumably, P is required to adjust its basis in Asset (to \$400) and to adjust capital accounts. For B's capital account, this seems relatively straightforward: P should adjust it to \$1,200. Presumably, the same is true for C.¹¹²

¹⁰⁹ § 6226(b)(3) provides that “*any tax attribute which would have been affected if the adjustments...were taken into account for the [reviewed year] shall...be appropriately adjusted,*” but it is not entirely clear whether these are the partnership tax attributes (*e.g.*, inside basis), the partners' attributes or both. We believe that the latter (*i.e.*, all tax attributes of the partnership and the partners) is the correct answer, but this will need to be addressed in the guidance.

¹¹⁰ Since A has sold its interest to C, A cannot increase its basis in its P interest in 2020 (as B can do).

¹¹¹ See Part VIII (page 86).

¹¹² Under the section 704 rules, A's capital account carries over to C. Presumably the adjustment of attributes would include adjusting the capital accounts of the *reviewed year partners* to match what they would have been if the FPA adjustment had been reflected in the partnership's capital accounts.

4. Section 6225(a) Payment by the Partnership

Under section 6225(a), P pays the \$70 imputed underpayment (plus interest)¹¹³ with its 2020 Form 1065.

Under section 6241(4), this results in a nondeductible partnership expense in 2020. That expense (presumably allocated 50/50 as between B and C) then results in a decrease of \$35 in each partner's outside basis.¹¹⁴ As a result of this payment, the fair market value of each of B and C's interests in P has also decreased from \$1,200 to \$1,165.

2020: 6225(a)	Outside Basis	Inside Basis (Partnership Assets)	Taxes Paid for Year	Cumulative Taxes Paid
Partnership		Cash \$1,930 Asset \$400*	\$70	\$70
A	–	–	–	\$70
B	\$1,100 – \$35 = \$1,065			\$35
C	\$1,200 – \$35 = \$1,165			

Section 6225(a) is silent on how the FPA items are allocated and whether there are collateral adjustments to outside bases and capital accounts.¹¹⁵ If the \$200 additional income from the FPA is not allocated for section 705 outside basis purposes, then the tax on the \$200 (that is, A's \$100 and B's \$100) will be collected twice:

- *A's \$100.* Each of A and P have *both* already paid the taxes due on the incremental \$100 of income allocated to A (A paid in connection with the 2019 sale and P paid in connection with receipt of the FPA in 2020). Intuitively, one would think that the double taxation of this \$100 would be fixed if A indemnified C (or P) for the portion of the imputed underpayment attributable to A's \$100, but this is not the case. The indemnity does not

¹¹³ For simplicity, the remainder of this Part V ignores the payment of interest since it does not affect the issues that are discussed here.

¹¹⁴ § 705(a)(2)(B).

¹¹⁵ As discussed above, TEFRA was also silent in this regard.

reduce the amount of income subject to double taxation (but only reallocates the incidence of this double taxation between A and C).¹¹⁶

¹¹⁶ If A indemnified C for the tax, then, in 2020, A would make a payment of \$35 (plus interest, which as noted in note 113 we ignore for purposes of this illustration) to C. The BBA Bluebook provides that this indemnity payment would not be a deductible expense to A, although presumably it could generate a loss. BBA Bluebook, at 70 (“Because the payment of the tax by the partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible.”) and 79 (language repeated). So, what would happen to each of A, C and P for tax purposes? We believe there are *two alternative approaches*, both of which result from applying the “relation back” doctrine of *Arrowsmith v. Comm’r*, 344 U.S. 6 (1952) to characterize the results to each party.

The *first* approach applies *Arrowsmith* by looking back to the sale by A to C. This was a taxable sale giving rise to section 741 gain for A and a purchase price basis to C. Applying *Arrowsmith* with respect to that sale, the \$35 indemnity would be an adjustment to the sale price and the resulting tax and economic consequences would be as follows:

- A: the \$35 of indemnity payment would provide A with a \$35 capital loss (as an adjustment to the § 741 capital gain A recognized in the 2019 sale). A’s tax savings from a \$35 capital loss (assuming it is usable at all) would equal \$12.25 ($\$35 \times 35\%$) so that A would have paid cumulative taxes of \$57.75 (\$70 less \$12.25) plus a tax indemnity payment of \$35, so A’s total costs resulting from the transactions (*i.e.*, P’s receipt of Asset, P’s incorrect valuation of Asset, and A’s sale of its P interest) is \$92.75. Compare this to the total costs A would have had of \$70 under the Correct Return Position (*i.e.*, the same set of transactions but without the incorrect valuation). So, A has paid \$22.75 over what A would have paid under Correct Return Position. The IRS has collected an additional \$35 from P and refunded only \$12.25 of that amount at that stage.
- C: the \$35 of indemnity payment would provide C with (i) \$35 in cash (which simply reimburses C for the \$35 that P used to pay the imputed underpayment on A’s \$100) and (ii) a purchase price adjustment on the 2019 purchase from A and thus a reduced basis in C’s P interest. Thus, C would have two downward adjustments to its initial purchase price basis in P: (a) a \$35 downward adjustment pursuant to § 705 to reflect P’s payment of \$35 of imputed underpayment and (b) a \$35 downward adjustment to reflect receipt of the indemnity payment, leaving C with a basis of \$1,130. Since that P interest is worth \$1,165, C would as a result have a taxable built-in gain of \$35, which would eventually result in additional taxes. Assuming for simplicity that the additional \$35 of gain is eventually taxed at the same 35% rate, the additional tax to C would be \$12.25 ($\$35 \times 35\%$). So, the IRS would re-collect the \$12.25 and A’s \$100 is indeed taxed at 35% twice, with A bearing \$22.75 of it and C bearing \$12.25 of it.

Under this approach, the indemnity payment does nothing to fix the problem that the IRS has collected tax on the \$100 twice; its only effect is to reallocate a portion of the \$35 tax from C to A, although C is not made whole.

The *second* approach applies principles of *Arrowsmith* by looking back to the expenditure that is being indemnified for (although we are not aware of authorities which have applied this approach). That expenditure is P’s payment of the \$35 imputed underpayment, which the statute tells us is a nondeductible expense. Under this approach, the payment to compensate C for that expenditure must also be nondeductible

footnote continued

- *B's \$100.* Similarly, if B cannot reflect the \$100 of FPA income in its outside basis in P, B will be taxed twice on this \$100. To illustrate this, assume that after the audit, B sells its interest to D (or has it redeemed by P) for \$1,165 (its fair market value). B would recognize \$100 of taxable gain and pay \$35 of tax (even though there has been no additional increase in value).

Thus, if nothing further happens to the FPA adjustments and no outside basis adjustments are made, the entire \$200 shown in the FPA is taxed twice. This cannot be the correct result.

B. Options for Section 6225 Payment

In this Part V.B, we discuss five options to account for the FPA adjustments and the section 6225 payment.¹¹⁷

to A, and the result for the payee (C) must also be characterized by relation back to the imputed underpayment which is being compensated for. Accordingly, because the expense is not deductible, the receipt of the indemnity should not create includible income, nor should it be capitalized into the sales price as an adjustment because doing so would be the equivalent of creating includible income (as is demonstrated by what happens to C under the first approach).

Applying this approach, the resulting tax and economic consequences would be as follows:

- A: the \$35 of indemnity payment would have no tax impact on A. A's total tax plus tax indemnity costs would be \$105 (\$70 of taxes paid to date plus \$35 of indemnity), which is \$35 more for A than Correct Return Position and \$35 more for the IRS than Correct Return Position.
- C: the \$35 indemnity payment would have no tax impact on C. C's total tax plus tax indemnity costs would be zero (\$35 of imputed underpayment compensated for fully by \$35 of cash; outside basis in P matches value of P interest).

How does this compare to the first approach? Under both approaches, the IRS collects tax on the \$100 of income twice. Under the first approach, the indemnity shifts some, but not all, of that tax from C to A, but C still ends up bearing some of the tax. (A and C could negotiate a "gross up" on the indemnity payment so A bears the full \$35 and C's after-tax indemnity cost is zero although this would result in additional taxes.) Under the second approach, the cost is shifted entirely from A to C with less difficulty, less room for slippage (because of differences in the tax rates applicable to A, C and P (with respect to the computation of the imputed underpayment and because of timing differences) and less wear-and-tear on the system because A does not need to claim the offset and C does not need to adjust C's basis.

We recommend that the guidance clarify which approach the IRS is adopting: we recommend that the second approach be chosen unless the Withholding Tax Approach discussed in Part V.B.5 (page 46) is adopted. Below we address the correction of the double tax result.

¹¹⁷ Regardless of the option chosen to implement section 6225(a), at least two additional adjustments will be needed. First, the capital accounts of P will need to be adjusted to reflect the nondeductible imputed

footnote continued

1. Option 1.A: Double Taxation

A possible reading of section 6225(a) is that (i) section 6225(a) is a final payment by the partnership, and (ii) no basis adjustments should be made. In other words, when section 6225(a) applies, the FPA items are taxed twice.

We do not think that this reading is correct. We do not read section 6225(a) as providing for, or implying, such a complete departure from the principles of good tax administration and the basic substantive rules and principles of partnership taxation. First, as a matter of fairness, the fact that the partnership's returns were incorrect does not mean that the income not reported should be subject to tax twice. There is no reason or need to interpret section 6225 in a way that makes the results punitive when a non-punitive interpretation is possible. Second, the cornerstone of partnership taxation is that a partnership's income is taxed once, and only once, and this reading of section 6225(a) would create two taxes by imposing one at the partner level and a second at the partnership level. Such a drastic departure from key principles of our tax system should be done by the statute explicitly not implicitly. Nothing in the BBA indicates that subchapter K ceases to apply when adjustments are made as a result of an audit.¹¹⁸ Finally, reading section 6225(a) in this way would essentially ensure that partnerships never use the section 6225 payment mechanism and instead always use section 6226 (or potentially section 6225(c)(2)). An interpretation of the section 6225 imputed underpayment mechanism that creates such a significant disincentive cannot be the right interpretation.

2. Option 1.B: Reviewed-Year Partners

In order to avoid the double taxation result, the partners need to obtain outside basis for the income resulting from the FPA. Under this Option 1.B, because A and B were partners in P when

underpayment expense (which matches the decline in the value of P's assets and the section 705 allocation to the partners).

Second, the inside basis of the Asset needs to be adjusted to reflect the \$200 adjustment. Section 6225 does not explicitly provide for this (whereas § 6226(b)(3) specifically provides for conforming adjustments to tax attributes (although it is itself unclear as to whether it applies only to partner-level attributes) and § 6225(c)(2)(A)(ii) directly addresses conforming adjustments). However, if the basis is not adjusted, then the \$200 is potentially taxed twice (temporarily, with the offsetting loss not allowed until A and C exit P). We believe that the implementing regulations should confirm this.

¹¹⁸ The BBA Bluebook helpfully notes in this respect that: "Under the centralized system, the flow-through nature of the partnership under Subchapter K of the Code is unchanged, but the partnership is treated as a *point of collection* of underpayments that would otherwise be the responsibility of the partners." BBA Bluebook, at 79.

the income was earned, each of A and B would get the additional \$100 of outside basis. This adjustment would be retroactive and effective as of the end of the reviewed year (2018).

For A, since A has sold its partnership interest, this would mean that A would have to amend its tax return for 2019 (assuming the statute of limitations has not expired for that year either by virtue of the normal rules or a special rule that is put into place as part of the adoption of this Option 1.B)¹¹⁹ to claim a refund for the \$35 of taxes paid in connection with the sale of its partnership interest to C.

Each of B and C, as adjustment-year partners, would also take an outside basis reduction to reflect the nondeductible payment of the imputed underpayment by P in the adjustment year. Therefore, each of B and C would have a \$1,165 basis in its partnership interest (such that there would be no built-in gain or loss).

Looking now at the net assets of A, B and C under this Option 1.B:

- A's net assets are \$1,235 (\$1,200 received from C plus \$70 of cash on hand less \$35 of taxes paid in 2018), as compared to \$1,200 in the Correct Return Position;¹²⁰
- B's net assets are \$1,200 (a partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid in 2018), as was the case in the Correct Return Position.
- C's net assets are \$1,165 (*i.e.*, the value of its partnership interest) as opposed to \$1,200 in the Correct Return Position.¹²¹

As a result, the system would collect only once the tax on the \$200 of additional income resulting from FPA *but* the tax burden has shifted from A to C: (i) A would be richer by \$35 (because the \$35 of imputed underpayment with respect to the \$100 of additional income was paid

¹¹⁹ Though we recognize that the mitigation provisions in §§ 1311–1314 may mitigate concerns under certain circumstances, we believe that it would be unwise to rely on these provisions as the exclusive means for rectifying this issue (or any of the adjustment issues discussed in this report). Specifically, the mitigation provisions have been interpreted to apply only to a very narrow set of circumstances. *See O'Brien v. United States*, 766 F.2d 1038, 1042 (7th Cir. 1985) (noting that the mitigation rules should be narrowly construed and apply only to some situations). For instance, in the context of the BBA, it is unclear whether an FPA will satisfy the “determination” requirement of § 1311(a) or whether basis adjustments will be permitted under § 1312(7) where the FPA and subsequent challenges do not specifically determine the basis of a partner's partnership interest. For a detailed discussion of the mitigation provisions, *see SALTZMAN & BOOK, supra* note 13, at ¶ 5.05.

¹²⁰ A has \$35 more than Correct Return Position because P paid the \$35 tax instead of A paying it.

¹²¹ C has \$35 less than Correct Return Position because C bore \$35 of the imputed underpayment paid by P.

by P), and (ii) C would be poorer by that same amount (for the same reason). It is not entirely clear whether an indemnity would fix this imbalance.¹²²

3. Option 1.C: Adjustment-Year Partners

Option 1.C allocates the basis to the adjustment year partners under the theory that they bear the cost of the section 6225(a) tax.¹²³

- At the end of the adjustment year, B and C each get an additional \$100 of basis (resulting in \$1,165 of total outside basis for B and \$1,265 of total outside basis for C).
- C's adjusted tax basis in P exceeds the fair market value of its interest (\$1,165) by \$100, so, while at this stage too much tax has been collected (\$175 of taxes instead of \$140), C will be able to get a refund of the \$35 if and when it disposes of its partnership interest (or otherwise uses the basis to obtain a tax-free distribution under section 731).

Looking at the partners' net assets after the payment:

¹²² As discussed in note 116, under the second approach described in that footnote, a \$35 indemnity payment by A to C would cure the imbalance (because A would pay over \$35 to C and there would be no loss or adjustment to purchase price).

Under the first approach described in that footnote, the indemnity would instead shift only part of the burden but not the entire burden. To illustrate what would happen under the first approach:

- A would (i) pay the \$35 to C and (ii) get a \$35 capital loss (reflecting the fact that it would have had a capital loss if it had sold a partnership interest with a \$1,200 basis to C for \$1,165). Assuming the capital loss is usable, this means that A's net assets are \$1,212.25 (1,200 plus \$70 of cash on hand less \$35 of taxes in 2018 less \$35 of taxes in 2019 less \$35 of indemnity plus \$35 for the refund of the 2019 tax plus \$12.25 resulting from the use of the capital loss).
- C would have (i) \$35 of cash (and a partnership interest worth \$1,165), and (ii) an adjustment in its basis interest such that taking into account the reduction for the indemnity, and the reduction for the nondeductible § 6225(a) payment by P, C would have a basis of \$1,130 and thus a built-in gain of \$35 in its partnership interest. Assuming that C is ultimately taxed on that built-in gain (and ignoring time value of money), this means that C's net assets would be \$1,187.75 (\$1,165 for the value of its partnership interest plus \$35 of indemnity less \$12.25 of tax from its built-in gain in the partnership interest).

A would have borne only \$22.75 of the \$35, and C would have borne \$12.25 (although presumably this imbalance could be narrowed in many cases with a grossed-up indemnity).

¹²³ This is consistent with the ELP regime, although in that case the statute is explicit. Pre-BBA § 6242. *See* Part III.B.2 (page 20).

- A would have \$1,200 (*i.e.*, \$1,200 of cash received from C plus \$70 of cash on hand less the \$70 of taxes it paid in 2018 and 2019), which is consistent with the Correct Return Position;
- B would have \$1,200 of assets (a partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid), which is consistent with the Correct Return Position; and
- C would have \$1,165 of assets as compared to \$1,200 in the Correct Return Position but will be able to eventually realize a \$35 tax savings or refund, giving C a result which is consistent with the Correct Return Position.

Under this option, if A and C wanted an indemnity to make C whole, this could be very complicated to negotiate and execute (even under our simple fact pattern where everyone is subject to the same tax rate on all income and gain) because C's tax cost is a temporary one and precisely when C will recoup its \$35 depends upon many factors.

Furthermore, this result is somewhat deceptive: the basis increase granted to C allows C to obtain a tax benefit for the \$100 of income reassessed by the FPA as opposed to correcting the amount of taxes that should have been paid by A. All parties end up in Correct Return Position in this example because we have assumed, for simplicity sake, that (i) A, B and C all have the same tax profile and (ii) that there are no character mismatch issues. If these assumptions are not correct, the aggregate amount of tax collected under Option 1.C (and the aggregate net assets of the partners) may vary significantly from the Correct Return Position.

- **Tax Profile of the Partners:** The section 6225(a) imputed underpayment amount is calculated based on the tax attributes of the reviewed year partners but Option 1.C allocates the corresponding basis increase to the adjustment year partners. If C has a different effective tax rate than A (or C is tax-exempt), then the basis adjustment may result in permanent under-collection or over-collection of taxes. Thus, if C is a tax-exempt entity, for instance (and the income from the partnership is not "unrelated business taxable income" to C), then C will not receive any tax benefit from its additional \$100 of basis and the system will have collected \$105 of taxes (instead of \$70) on the \$200 of income resulting from the FPA.¹²⁴

¹²⁴ To illustrate this point further, if A was a corporation and C is an individual subject to the highest marginal tax rate as well as to the § 1411 tax with respect to its income from P, under § 6225(c)(4), P would be able to pay the § 6225(a) payment based on the highest corporate income tax rate (*i.e.*, 35%). C however, would be subject to a tax rate of 43.4% in respect of distributions from the partnership or sale of the partnership. Thus, C will have economically paid \$35 instead of \$43.40 for \$100 of basis and thus \$100 of value received from, or from the sale of, P.

- **Character Mismatch Issues:** The correct amount of aggregate tax has also been preserved in the example because A, P and C are indifferent as to the character of the income. To illustrate, if A is an individual, she may have paid less than \$35 in taxes in 2019 when she sold her interest in P to C; assume the \$100 was capital gain subject to a 20% tax rate. Thus, in Option 1.C, A would be better off than in the Correct Return Position: in the Correct Return Position, A would have paid \$70 of taxes,¹²⁵ whereas under Option 1.C, A would pay \$35 of taxes in 2018 and \$20 in 2019 (assuming no section 751 assets) thereby resulting in an aggregate tax of \$55 instead of \$70. In addition, if C is a corporation, it would be able to monetize or obtain a refund of \$35 from the \$100 of basis it received (see above), such that ignoring the time value of money, the IRS would have collected only \$55 instead of \$70 on the \$200 of income resulting from the FPA.

4. Option 1.D: Optional Allocation of The Adjustment to a Notional Partnership Interest

Part V.B.3, immediately above, identifies two downsides to Option 1.C: the timing differs from Correct Return Position and the aggregate tax may differ from Correct Return Position (in favor of the government in some cases and the taxpayers in others). At the same time, Option 1.B depends on the ability of A to amend its past returns to reflect the basis adjustment.¹²⁶

A possible alternative would be to allocate the basis to A, as if A still held an interest in P in the adjustment year. Since A is not a partner anymore, this mechanism (which could either be elective or mandatory) would allocate basis to a notional interest in P in the year of the adjustment, and that interest would be deemed disposed of immediately thereafter for no consideration, thereby resulting in A recognizing a \$100 loss.¹²⁷ Importantly, A would not be a partner for any other purposes (*e.g.*, allocation of income, attribution of activities under section 875, etc.).

¹²⁵ See Part V.A.1 (page 34).

¹²⁶ A statutory change could eliminate the need for A to file an amended return to get the benefit of the increased basis by using a section 6226-like mechanism.

¹²⁷ In a more complicated scenario, for instance, where the partnership has § 751 assets, this may not result in a completely neutral result as there could be differences in the character of the gain and the loss recognized by A in 2019 and 2020 if P's assets or the built-in gain in these assets has changed. Similarly, if A is an individual it may be limited in its ability to carryback the loss. However, conceptually, at least, A has received a loss which offsets the gain it recognized when it disposed of its interest in 2019.

We considered also whether the allocation of the basis to A could depend on A remaining as a “small” partner holding a “stub” interest in P for this purpose, but we believe that this approach would not be desirable. First, because remaining as a partner in P would have material U.S. federal tax and other legal consequences. Second, because the availability of a loss should not depend on A's modifying its legitimate business goals (*i.e.*, terminate its partnership interest).

footnote continued

5. Option 1.E: Withholding Tax Approach

As we discussed above, none of Options 1.A, 1.B, 1.C or 1.D truly place the government and the partners in the Correct Return Position (and the extent of the difference will depend upon the facts of each case).¹²⁸ An approach that would achieve this result would be to interpret the section 6225(a) payment as a collection mechanism only: *i.e.*, while the partnership pays the tax, it is essentially acting as an agent for the partners with respect to the tax they owe as a result of the FPA. The system is therefore equivalent to current law in terms of all the impacts of an IRS audit adjustment at the partnership level other than (i) how the *initial* payment due is computed and (ii) who is obligated to pay it. It is very similar to the existing section 1446 withholding tax regime for effectively connected taxable income allocated to partners who are non-U.S. residents.¹²⁹

Under this approach, the reviewed year partners take into account the FPA adjustments and receive a credit for the imputed underpayment paid by the partnership. Applied to our example, \$100 of additional income resulting from the FPA is allocated to each of A and B, as the reviewed year partners, and they each get a \$35 credit for the imputed underpayment paid on that income by P. Thus,

- B recognizes the additional \$100 of taxable income allocated to it but gets a credit for its allocable share of the taxes paid by P (\$35). Because B would owe \$35 (plus interest) on the additional \$100 of taxable income, this credit mechanism means that B owes no additional tax. B's outside basis in P is then increased to \$1,200 to reflect this additional income, and decreased by \$35 to reflect the payment by the partnership of B's share of the imputed underpayment.¹³⁰ B's basis in its partnership interest would thus be \$1,165, which is equal to its value. B's net assets would be \$1,200 (*i.e.*, partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid) which is consistent with the Correct Return Position.

Similarly, we considered whether the allocation of basis to A should depend on whether A had agreed to indemnify P or C (and thus had agreed to economically bear the tax), but we believe that a system which would require the IRS to determine whether an indemnity existed (in light of possible baskets, caps and floors) would not be administrable.

¹²⁸ Moreover, the extent of difference will not be a result of how aggressive or weak the partnership's return position was.

¹²⁹ Under § 1446, a domestic partnership that derives effectively connected taxable income (or "ECTI") is required to withhold the U.S. federal income taxes due by its foreign partners with respect to that ECTI based on several conservative assumptions (*e.g.*, assuming that the highest tax rate applies, etc.), and the foreign partners can adjust the tax due or obtain a refund through their tax returns.

¹³⁰ § 705(a)(2)(B).

- A also recognizes the \$100 of taxable income resulting in pre-credit tax liability of \$35.
 - **Credit:** As between A and C, A should be the one allocated the \$35 credit. While C economically bears the burden of the \$35 of imputed underpayment paid by P, this was paid with respect to income allocable for U.S. federal income tax purposes to A, and A should therefore get the credit. This follows the section 1446 rules (and the foreign tax credit rules, which treat the recipient of interest income as if it paid the foreign taxes economically borne by the interest payor (under a gross-up) because those taxes are imposed by law on the interest income recognized for tax purposes as income by the interest recipient).¹³¹
 - **A's Adjusted Basis:** A gets a basis increase of \$100 to reflect the allocation of income. However, because the tax was paid by P with respect to income allocable to A, then following the section 1446 model, there is an allocation of the tax expenditure to A (under either section 6241(4) or principles similar to section 731) which results in a reduction in outside basis, such that A is treated as if it had a \$1,165 basis in its partnership interest (either at the end of 2018 or at the time of the sale to C).¹³²
 - **Impact on 2019 Return:** A would be able to recognize the effect of this basis adjustment with respect to the sale of its partnership interest in 2019 (through an amended return for 2019 or in A's adjustment year return, whichever approach the regulations adopt). Thus, A would have a \$35 gain in 2019 with respect to the sale of its partnership interest to C (as opposed to the \$100 it reported), thereby resulting in a refund of \$22.75 of the taxes it paid in 2019 (plus interest).
 - **Net Assets:** A's net assets would be \$1,222.75 (*i.e.*, \$1,200 plus \$70 of cash on hand less \$35 of taxes paid in 2018, and less \$35 paid in 2019 plus a \$22.75 refund). This is more than the \$1,200 in the Correct Return Position, but this reflects the fact that the

¹³¹ § 1446(d); Treas. Reg. §§ 1.1446-3(d)(2)(v) and 1.901-2(f).

¹³² § 1446(d); Treas. Reg. § 1.1446-3(d)(2)(v) (“... a partnership’s payment of 1446 tax on behalf of a foreign partner is treated under section 1446(d) and this section as a deemed distribution of money to the partner on the earliest of the day on which the partnership paid the tax, the last day of the partnership’s taxable year for which the amount was paid, or the last day on which the partner owned an interest in the partnership during the taxable year for which the tax was paid.”).

It is possible to take a different approach and allocate the basis reduction to C instead of A, in which case A would get a full \$100 of basis increase (resulting in a full refund of the tax paid in 2019) and C would get a basis reduction of \$35 (for a basis of \$1,165). This is the same result as in Option 1.B. *See* discussion in Part V.B.2 (page 42).

Note that in any case, C's capital account would be decreased by the tax (either because C succeeded to A's capital account or because C was allocated the tax).

section 6225(a) underpayment mechanism inherently creates a benefit for A since P pays the tax. *If A indemnifies C for the tax, then A (and C) could be put into Correct Return Position.*¹³³

- **Partner C:** Because A's basis was affected by the section 6225 payment, C's basis should not be decreased by the amount of the tax paid by P. In other words, C would have an adjusted basis of \$1,200 in its partnership interest reflecting a built-in loss of \$35 (for the tax paid by P). Its net assets are worth \$1,165 (plus the ability to receive a refund of \$12.25 in taxes, *i.e.*, \$1,177.25), as opposed to \$1,200 in the Correct Return Position. This reflects the economic loss C incurred because P paid the tax. Again, C could be put in the Correct Return Position if A indemnifies C by paying C \$35.¹³⁴

C. Recommendation

As this simple fact pattern illustrates, there is no perfect solution to account for the impact of the section 6225(a) underpayment.

1. Withholding Tax Approach

(a) A Better Approach

We strongly believe that Option 1.E. (the “**Withholding Tax Approach**”) is by far the best approach to implementing section 6225. This approach will both protect the fisc and be more fair to taxpayers. We recognize that it has some complexity, but not more than the BBA's two other payment methods, and with the significant benefit for the government of an upfront payment of tax by a single person (the partnership) that is before the IRS in the audit. The section 1446 withholding rules could be used as a precedent to implement this approach.

The Withholding Tax Approach's other important benefits include:

First, it will allow the aggregate tax collection results to be as close as possible to the Correct Return Position. There is some discrepancy with respect to which taxpayers have borne some of the tax collected because the initial payment is by P and thus the cost is economically

¹³³ Here, the way to get to Correct Return Position is to allow the \$35 indemnity payment to offset the \$35 nondeductible expense that reduces A's basis in the P interest, so that A's basis in the P interest is equal to \$1,200 at the time of the sale. In other words, the way to arrive at Correct Return Position under Option 1.E is to adopt the first approach set out in note 116 for the tax treatment of indemnity payments.

¹³⁴ Again, this assumes that the first approach of note 116 is used (where the \$35 is a purchase price adjustment to C and therefore nontaxable but reflected as a decrease in C's outside basis in P).

borne by B and C (instead of B and A), but this can be solved as between B and C with an indemnity.

Second, if the taxes resulting from the adjustments of the items described in section 6221(a) are paid at the partnership level without any second step connecting those adjustments to the tax attributes of the partners and allowing those adjustments to effect the taxes due from the partners, this will create results (we believe in many cases) that are deeply unfair and prone to manipulation. The example above has illustrated the double tax result. *Under-taxation* is also a very significant risk. The section 6225(a) payment will often fail to capture the full amount of tax that a partnership adjustment generates (under Correct Return Position) and well-advised taxpayers will use the section 6225(a) payment mechanism when section 6226 or 6225(c)(2) would increase their liabilities. A few possible examples of why section 6225 could result in under-collection include the absence of the section 1401 and 1411 tax from the section 6225 formula, the spillover effects of having effectively connected income (and thus a U.S. trade or business), the adverse effects of income resourcing for foreign tax credit purposes or the recapture of a dual consolidated loss, overall domestic loss or overall foreign loss. We explore these issues and provide additional examples in the following parts of this report.¹³⁵

Third, even setting aside the interaction of the section 6221(a) adjustments with partner-level attributes, the computation of the imputed underpayment under the rules in section 6225 will often not accurately arrive at the amount of tax the partners would pay if they were taking those adjustments into account directly. The Withholding Tax Approach has the benefit of reducing the pressure on getting the amount accurately, as over-collecting or under-collecting at the partnership level can be corrected at the partner level. A reasonable amount of over-collecting under section 6225 will be more tolerable if it can be recouped by the partners.

Fourth, as discussed in Parts VI and VII, below, if the section 6225(a) payment is the final payment, then there are a whole host of complex issues that are very difficult to resolve in a way that ensures that the correct amount of tax is collected. Indeed, most of the thorny issues we address in this report would be mitigated and perhaps even fully resolved if the Withholding Tax Approach is followed.

¹³⁵ In order to collect these additional taxes, the Withholding Tax Approach relies upon voluntary compliance by the partners or collection efforts by the IRS. We are mindful of not wanting to reintroduce the collection difficulties the IRS faced under TEFRA, and we think the imputed underpayment mechanism was intended to prevent that. What the Withholding Tax Approach does is prevent that mechanism from resulting in significant distortion. It should operate like a withholding tax and thereby minimize the collection risks for the IRS. Relying upon voluntary compliance and collection for any additional taxes due is preferable to having a collection regime that has the inadvertent impact of making those additional taxes not due at all.

Fifth, and perhaps most importantly, we believe that this approach is consistent with what Congress intended when it enacted BBA and is consistent with the actual changes that BBA made to the Code. The BBA was intended to change how the IRS audits partnership returns and collects the additional taxes due; it was not intended to create new substantive tax rules or new substantive taxes. The BBA Bluebook articulated this very point: “Under the centralized system, the flow-through nature of the partnership under Subchapter K of the Code is unchanged, but the partnership is treated as a point of collection of underpayments that would otherwise be the responsibility of the partners.”¹³⁶

(b) Statutory Authority

There is a question as to whether the statute, as currently drafted, allows for this approach. For the reasons outlined below, we believe that the better view is that it does, but we also believe that implementing regulations that are criticized, and challenged in court, as being beyond the Secretary’s authority would create undesirable uncertainty which could last for years while the challenges work their way through the courts. Thus, we would strongly support any technical correction that would clarify this.

The reasons why we think the better view is that the statute does allow for this interpretation of section 6225 are as follows.

Section 6225 (and the remainder of the BBA) is silent in this respect. It does not indicate that the imputed underpayment is the final payment or what happens to partners in a partnership that makes a section 6225 payment. But TEFRA was also silent as to these matters. There was no statutory provision under TEFRA saying that the FPAA adjustments flowed up to the partners, that the partners owed more tax or got refunds based upon those adjustments, outlining whether the partnership was required to provide the adjustment information to the partners or the IRS would instead issue assessments to the partners, or saying that conforming adjustments to attributes occurred at the partnership and partner level.¹³⁷ Notwithstanding this statutory silence, there was no question that the FPAA adjustments were supposed to flow up to the reviewed year returns and to be reflected in the partners’ and the partnership’s tax attributes and future tax returns.¹³⁸ The BBA’s silence therefore may reflect the same approach, which is to leave it to administrative guidance and procedures to fill in the gaps.

¹³⁶ BBA Bluebook, at 79.

¹³⁷ We recognize that TEFRA did keep the statute of limitations at the partner level open for an additional year after the partnership level adjustment was final, but that was all that it did.

¹³⁸ See Part III.A.3 (page 16).

The authority under TEFRA for all the results not specified in the TEFRA provisions was in fact section 702, which requires each partner to take into account its distributive share of the partnership's items. Section 702 was not modified by the BBA, and there is no reason to think it does not have the same reach it had before the BBA was enacted.

If the Withholding Tax Approach is not authorized under the BBA, then the BBA created an enormous set of complex changes to the substantive tax rules, including shutting off all kinds of rules that normally apply to taxpayers (as discussed in detail elsewhere in this report). For example, an adjustment to the source of a partnership's income would otherwise potentially trigger the re-application of the foreign tax credit computations (including the income-recapture rules and potentially the interest allocation rules), but under the BBA without the Withholding Tax Approach, if the partnership pays under section 6225 those rules simply are made irrelevant—the adjustment escapes the application of those rules entirely.

The BBA would also usher in a whole new world of manipulation and incentives for taxpayers who are interested in exploiting the possibilities. Congress could not have intended the statute to be implemented in a way that facilitated this.

We believe that if the section 6225 rules are not interpreted in this way, the BBA is very likely to be so troubled in implementation that it will need to be revised by Congress and only after years of difficulties for all involved.

We recognize that provisions that establish a withholding tax regime are generally much clearer in that respect, and provide for a clear crediting mechanism (*cf.* section 1446(d)). In addition, we recognize that viewing the section 6225 payment as a withholding tax with subsequent adjustments at the reviewed partner level may not be fully consistent with section 6225(a)(2), which provides that adjustments that do not result in an imputed underpayment (*e.g.*, additional losses) are taken into account by the partnership in the adjustment year. However, we do not think that either of these counter-points comes close to outweighing the overwhelming problems that would arise if section 6225 is interpreted as not being a withholding tax. We think that when a statute has gaps, as the BBA does, it cannot be a reasonable interpretation to fill those gaps with an approach that makes the results of the statute so contrary to principles of good tax administration and existing substantive law. By contrast, we believe that an interpretation that fills the gaps in a way that makes the statute fully consistent with existing substantive law is, under the existing judicial authorities, a reasonable interpretation of the statute and therefore within the Secretary's power to implement. Unfortunately, we do not think that this precludes the possibility of litigation over whether it is indeed within the Secretary's power.

2. Other Options

If you believe that Option 1.E is not advisable or achievable, the “second best” alternative would be Option 1.C (“**Adjustment Year Partners**”), as it puts the partners more closely in line

with the Correct Return Position. For the reasons discussed above,¹³⁹ however, this option still creates significant risk of under-collection and over-collection.

D. Introduction to Next Three Parts

Having discussed the broad framework of the payment regimes in this Part V, we now address in the next three Parts various other issues which we believe are key to the development of the BBA guidance. Many of these issues are inter-related: Part VI addresses the scope of a BBA partnership-level audit. Part VII then addresses the computation of the imputed underpayment under section 6225. Finally, Part VIII addresses the section 6226 rules that prevent partners from taking into account decreases in taxes resulting from the FPA.

Throughout these Parts, we note where we believe the issues will be resolved more effectively if the Withholding Tax Approach is used. Following our approach in Part V, we have chosen to provide various options to address the issues raised by the BBA regime, even if the options may not be squarely within the regulatory authority under the current statute but instead may need statutory corrections to be implemented. We are mindful of the rules in *Chevron*¹⁴⁰ and *Mayo*,¹⁴¹ and that regulations are to be either dictated by the statute or a reasonable interpretation of an ambiguous statute. Because our focus is on making the BBA regime fair and efficient and because we are hopeful that statutory corrections that are necessary will be made, we have addressed options that may not be authorized under the current statute.

VI. SCOPE OF THE REGIME: SECTION 6221

Section 6221(a) establishes the scope of the BBA regime. It provides:

Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined, 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 or share shall be determined, at the partnership level pursuant to this subchapter.

The meaning of this statutory language is an important question, particularly for the government, because it determines the jurisdiction that the IRS has during a BBA partnership audit

¹³⁹ See Part V.B.3 (page 44).

¹⁴⁰ *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

¹⁴¹ *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011).

(and similarly determines the jurisdiction of a court which has been petitioned to resolve a disagreement over an audit adjustment). Jurisdiction is important in two ways:

First, the items which the IRS is permitted to adjust in a partnership-level audit will impact how effective partnership audits are at addressing noncompliance in the context of partnerships. For many items that the IRS might want to adjust, the logical locus for the audit will be at the partnership level since the items arise in, are generated within, or in connection to, the partnership and all or most of the necessary information is at the partnership level. Once a partnership audit has been opened, the more items the IRS can audit and adjust in that audit, the greater the impact of the audit on compliance. Whatever items are not within the scope of section 6221(a) will be required to be audited and adjusted through a partner-level audit. For various reasons, partner-level audits of items that arise at the partnership level will be difficult. As discussed above,¹⁴² this is one of the reasons why TEFRA was initially enacted and why the BBA continues the concept of auditing and determining adjustments at the partnership level.

Second, if the scope of section 6221(a) is not clear, then the IRS is exposed to the risk of erroneously pursuing an issue at the partnership level in a BBA audit, believing that section 6221(a) provides the requisite jurisdiction, and then, when subsequently it is determined that section 6221(a) does not provide the requisite jurisdiction (*i.e.*, does not permit this issue to be adjusted in a BBA audit), being foreclosed from auditing the issue and making adjustments at the partner level because the statute of limitations on (some or all of) the partners has closed. Moreover, if the rules are sufficiently ambiguous that these types of jurisdictional disputes are frequent, this may incentivize partnerships to assert such jurisdictional challenges late in the game after the partners' statutes of limitations have closed.

A. TEFRA's Approach to the Scope of Items Subject to Partnership-Level Audit and Adjustment

Under TEFRA, the jurisdiction of a partnership-level TEFRA audit is determined by the definition of the term "partnership item": once the IRS commences a partnership-level TEFRA audit, the IRS can propose adjustments to any partnership item.¹⁴³ The TEFRA rules protect the IRS's ability to collect the tax due from the partners by providing that, if an FPAA is issued during the 3-year period following the date the return was filed (or, if later, the last day it could have been filed), each partner's own statute of limitation for the years corresponding to the partnership years

¹⁴² See Part III.A (page 14).

¹⁴³ Pre-BBA § 6221: "Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level." See also Part III.A.1 (page 14).

under audit is extended [for one year]¹⁴⁴ so that the IRS may collect the taxes due from the partners as a result of the audit adjustments to partnership items. TEFRA also addresses how a partnership item might interact, at the partner level in determining the tax due from the partner, with items that are maintained or generated at the partner level. TEFRA does this through the rules defining and addressing IRS and court jurisdiction over “partnership items” and “affected items.”¹⁴⁵

Thus, TEFRA defines a partnership item, in Pre-BBA section 6231(a)(3) as follows:

The term “partnership item” means, with respect to a partnership, any item required to be taken into account for the partnership’s taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Affected item is defined, in turn, in Pre-BBA section 6231(a)(5) as follows:

The term “affected item” means any item to the extent such item is affected by a partnership item.

The Treasury Regulations called for by Pre-BBA section 6231(a)(3) defined partnership item by providing a laundry list of items that are “more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items,”¹⁴⁶ and the Treasury

¹⁴⁴ Pre-BBA § 6229(d).

¹⁴⁵ Pre-BBA § 6226(f) (providing that a court in a partnership-level proceeding has jurisdiction over partnership items). Courts have consistently interpreted Pre-BBA § 6226(f) to preclude a court from adjusting *affected* items in a partnership-level proceeding. *See, e.g.,* Petaluma FC Partners v. Comm’r, 131 T.C. 84, 90 (2008) (“In partnership-level proceedings such as the case before us, the Court’s jurisdiction is limited by § 6226(f).”); *Jade Trading, LLC v. United States*, 598 F.3d 1372, 1379 (Fed. Cir. 2010) (holding that under § 6226(f), a court in a partnership-level proceeding only has jurisdiction over partnership items, not affected items).

Similarly, it is clear that a court in a partner-level proceeding does not have jurisdiction to adjust partnership items. Pre-BBA § 6221. *See, e.g.,* David E. Kohn, 77 T.C.Memo 1957, at 2 (1999) (“This Court does not have jurisdiction in a partner’s personal tax case to redetermine any portion of a deficiency attributable to partnership items.”); *W. Robert Curtis*, 72 T.C. Memo 369, at n. 4 (1996).

¹⁴⁶ Pre-BBA Treas. Reg. § 301.6231(a)(3)-1:

“(a) *In general.* For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items:

- (1) The partnership aggregate and each partner’s share of each of the following:
 - (i) Items of income, gain loss, deduction, or credit of the partnership;

footnote continued

Regulations implementing the definition of affected item have been written so as to protect the IRS's ability to make adjustments to the tax due from the partners following a change in a partnership item by defining affected item expansively so as to include various items "to the extent [they] are not a partnership item."¹⁴⁷

- (ii) Expenditures by the partnership not deductible in computing its taxable income (for example, charitable contributions);
 - (iii) Items of the partnership which may be tax preference items under section 57(a) for any partner;
 - (iv) Income of the partnership exempt from tax;
 - (v) Partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year); and
 - (vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine—
 - (A) The investment credit determined under section 46(a);
 - (B) Recapture under section 47 of the investment credit;
 - (C) Amounts at risk in any activity to which section 465 applies;
 - (D) The depletion allowance under section 613A with respect to oil and gas wells; and
 - (E) The application of section 751 (a) and (b);
- (2) Guaranteed payments;
 - (3) Optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest); and
 - (4) Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:
 - (i) Contributions to the partnership;
 - (ii) Distributions from the partnership; and
 - (iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

(b) *Factors that affect the determination of partnership items.* The term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. Examples of these determinations are: The partnership's method of accounting, taxable year, and inventory method; whether an election was made by the partnership; whether partnership property is a capital asset, section 1231 property, or inventory; whether an item is currently deductible or must be capitalized; whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183; and whether the partnership qualifies for the research and development credit under section 30."

¹⁴⁷ Pre-BBA Treas. Reg. § 301.6231(a)(5)-1. "Definition of affected item.

(a) *In general.* The term "affected item" means any item to the extent such item is affected by a partnership item. It includes items unrelated to the items reflected on the partnership return (for example, an item, such

footnote continued

Despite these very broad definitions, there has been a significant amount of litigation over the meaning of “partnership item” and “affected item” under TEFRA and over whether certain items are partnership items or affected items that must be addressed in a partner-level audit.¹⁴⁸ Ideally, the BBA rules will benefit from this history and not simply introduce a new set of concepts and a new saga of litigation over what they mean. While no set of rules is beyond some amount of disputes, the goal here should be a set of rules that is as clear as possible and that reflects the lessons learned from the battles over the meaning of “partnership item” and “affected item.”

B. BBA’s Approach to Scope of Partnership-Level Audit and Adjustment

The BBA does not by its terms adopt any of the TEFRA nomenclature or history. Instead, as noted above, the scope of jurisdiction of a BBA partnership level audit is defined as: “*any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner’s distributive share thereof).*”

Comparing this language to the definition of partnership items under the TEFRA rules, one sees that section 6221(a) uses the very same words as the *first* item in the TEFRA regulation’s list of partnership items. Pre-BBA Treasury regulations section 301.6231(a)-1(a)(1)(i) reads: “*Items of income, gain loss, deduction, or credit of the partnership.*”¹⁴⁹ But, as noted, those Regulations follow this one provision with a long list of many other items that were determined to be more properly determined at the partnership level. This juxtaposition may suggest that section 6221(a) is authorizing the IRS to audit and adjust only those items stated in Pre-BBA Treasury regulations section 301.6231-1(a)(1)(i) and none of the items identified in the remainder

as the threshold for the medical expense deduction under section 213, that varies if there is a change in an individual partner’s adjusted gross income).

(b) *Basis in a partner’s partnership interest.* The basis of a partner’s partnership interest is an affected item to the extent it is not a partnership item.

(c) *At-risk limitation.* The application of the at-risk limitation under section 465 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(d) *Passive losses.* The application of the passive loss rules under section 469 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.”

¹⁴⁸ See, e.g., *Petaluma FC Partners v. Comm’r*, 131 T.C. 84 (2008) (holding that whether (i) a partnership is a sham, lacks economic substance, or should be disregarded for tax purposes, and (ii) a partner’s outside basis, are partnership items), *rev’d*, 591 F3d 649, 654–55 (D.C. Cir. 2010) (holding that the partner’s outside basis is not a partnership item, but an affected item over which the court did not have jurisdiction); *Tiger’s Eye Trading, LLC v. Comm’r*, 138 T.C. No. 6 (2012) (holding that a partner’s outside basis is a partnership item), *aff’d in part, rev’d sub nom.*, *Logan Trust v. Comm’r*, 616 Fed. Appx. 426, 429 (2015) (partner’s outside basis is not a partnership item).

¹⁴⁹ See footnote 146 above, quoting Pre-BBA Treas. Reg. § 301.6231-1(a) and (b).

of that Regulation (*e.g.*, section 731 distributions, section 752 allocations of debt, guaranteed payment, etc.).¹⁵⁰

It is possible to look at BBA as a whole and say that this is a correct reading of the scope of the BBA. For example, section 6225(a) computes the amount due by taking into account only the FPA “adjustments of items of income, gain, loss, or deduction...and items of credit” and ignores any partner-level consequences of an FPA’s adjustments (including consequences that occur only as the FPA adjustments interact with partner-level attributes).

We do not believe that such a reading is correct or desirable. The intent of BBA was to make IRS audits of partnership-generated tax items (as well as the resulting collection) more effective and efficient. It would be inconsistent with this intent to reduce (especially so significantly) the scope of items that could be audited and adjusted in a partnership audit. In addition, we think that Congress and the President in enacting the BBA intended to respond to the problems raised by TEFRA while retaining those aspects of TEFRA that were generally believed to be working well. The breadth of the IRS’s authority under TEFRA was not one of TEFRA’s problems. Rather, the problem in this respect was that the IRS’s jurisdiction was subject to such frequent challenges. We believe that the lawmakers believed that eliminating the “partnership item” construct and using the broad wording in section 6221 would achieve the better result of giving the IRS more clearly broad authority and thereby eliminate (or minimize) challenges. In other words, we believe their goal was to reduce the challenges, not to reduce the IRS’s jurisdiction.

C. Affected Items and Statute of Limitations Concerns

A second concern we have about the scope of section 6221(a) and the jurisdiction of the IRS in a BBA partnership audit relates to the elimination of the “affected item” concept and the one year suspension of the statute of limitations for collecting from partners that existed under TEFRA.¹⁵¹ As explained above, under TEFRA, if a partnership-level adjustment would interact with a partner-level attribute in determining the ultimate tax due, that partner-level attribute was called an “affected item,” and the IRS had authority to compute the bottom line due from the partner taking into account the affected item and to collect that tax for one year following the conclusion of the TEFRA audit.

¹⁵⁰ In addition, the numerous controversies under TEFRA defining and refining the scope of partnership items will be irrelevant (except to the extent they are clear that they are applying either § 301.6231-1(a)(1)(i) or another section of the Regulation).

¹⁵¹ This second concern overlaps with the issue discussed in Part VII (page 64) (how the § 6225(a) “imputed underpayment” is computed).

The BBA has no corollary to this (unless a section 6226 election is made or amended, or returns are filed pursuant to section 6225(c)(2)). If the partnership pays under section 6225, the statute does not address whether anything else occurs that would enable the IRS (or the partners) to take into account the audit adjustments at the partner level for any purpose (including for purposes of collecting additional taxes or obtaining a refund or credit of previously paid taxes). While some adjustments will clearly give rise to increases or reductions in items of income, gain, loss, deduction or credit that can be translated into an imputed underpayment (albeit imperfectly in many cases, as discussed below),¹⁵² other adjustments only translate into an additional tax due when taken into account at the partner level in combination with partner-level attributes (either pursuant to a provision in subchapter K or elsewhere in the Code).

This is another circumstance where the precise role of section 6225 becomes a key issue. If the payment by the partnership of the section 6225(a) amount is understood as the end of the story, this may argue in favor of a narrow scope for section 6221(a). This would leave the other issues for (potentially inefficient) auditing at the partner level. Any additional taxes that would be due as a result of the intersection of partnership-level and partner-level attributes may essentially be out of the IRS's reach if the partnership chooses to resolve the partnership level by making a section 6225 payment. (Whereas, if the intersection of partnership-level and partner-level attributes would result in a reduction of a partner's taxes, the partner could realize that saving by proceeding under section 6225(c)(2) or in some cases under section 6226.)

If section 6225 is not the final payment with respect to a BBA audit, and instead the results of the audit are taken into account at the partner level (even following a section 6225 payment), then there is still a statute of limitations issue since the partners' relevant years may be closed. This may result in certain types of tax adjustments being effectively immune from being made except in limited circumstances.

D. Examples Relating to the Scope of Section 6221(a)

In this section, we attempt to illustrate some of the concerns described above using examples. The first three examples are adjustments that could not be translated into an imputed underpayment. The last example is an adjustment that conceivably could be translated into an imputed underpayment, but very imperfectly. Each one of these involves items that we believe are more suitably investigated by the IRS and determined at the partnership level because the relevant information will be maintained at the partnership level.¹⁵³

¹⁵² See Part VII (page 64).

¹⁵³ We have limited ourselves to four examples, but many other (common) situations will raise this issue.

1. Example 1: Value and Character of Distributed Asset

During 2018, Partnership P distributed Asset to partner A and assigned Asset a value of \$x. Immediately prior to the distribution, A had a basis in its partnership interest of \$x. The IRS conducts a BBA audit of P and during the audit determines that Asset's value at the time of the distribution was \$x + \$100 and that Asset was a marketable security (*i.e.*, a section 731(c) asset that is treated as cash for section 731(a)(1) purposes).

Neither the change in the value nor the change in the character of Asset gives rise to an imputed underpayment (at least not as imputed underpayment is currently defined in section 6225). However, if the IRS's determination were given effect, A would have recognized taxable gain of \$100 under section 731(a) in 2018. (If the determination were given effect, A would also have a different basis in its interest in P and a different basis in Asset than A has under the "as-filed" position.)

Under TEFRA, the value and character of Asset for purposes of the distribution would have been a "partnership item" by virtue of Pre-BBA Treasury Regulation section 301.6231-1(a)(4)(ii).¹⁵⁴ Accordingly, the TEFRA audit of P would have adjusted the value and character of Asset, the statute of limitations for A would still be open, and the IRS could have assessed the additional tax due from A (and the changes to the bases would be given effect going forward).

Under the BBA, what should happen? Should issues like this not be subject to audit and adjustment at the partnership level? Should the fact that a change in the value and character of Asset does not give rise to an imputed underpayment drive whether the value and character of Asset should be subject to audit and adjustment in a partnership-level audit? The TEFRA rules defined the value and character of distribution assets as a partnership item for the very appropriate reason that the value and character is, in most cases, better determined in a partnership-level audit than in a partner-level audit. We believe that the BBA was not intended to alter what types of items are audited in partnership level audits, or at least not so drastically. That aspect of the system was not one of the problems.

Nonetheless, if the item is determined to be a BBA item, then unless the Withholding Tax Approach to section 6225 is followed, if P chooses to pay any imputed underpayment resulting from this audit, then there would be no additional tax due. If instead P and the partners proceed under section 6226 (or section 6225(c)(2)), there would be additional tax due. This illustrates that given different facts a partnership or the partners may derive a tax savings from selecting section 6225(a) and also demonstrates that the section 6225(a) mechanism may not make the IRS

¹⁵⁴ See also Pre-BBA Treasury Regulation section 301.6231-1(c)(3).

whole even if the jurisdiction of the IRS under section 6221(a) is very broad.¹⁵⁵ If the Withholding Tax Approach is adopted, then even if the partnership proceeds under section 6225(a), the IRS could make an assessment against A for the additional tax, provided that the statute of limitations for A for the reviewed year was still open.¹⁵⁶

2. Example 2: Allocation of Partnership Liabilities

In a BBA audit of P, the IRS determines that partner A did not provide a true guarantee of a partnership's recourse debt for purpose of Treasury regulation section 1.752-2 and thus that a smaller amount of the debt should have been allocated to A for section 752 purposes. A has availed itself of the additional section 752 basis to utilize losses on its 2018 return which would otherwise have been limited under section 704(d).

The TEFRA way of handling this is essentially the same as Example 1: the amount of liabilities allocated to the partners for section 752 purposes was a partnership item,¹⁵⁷ and the additional tax due from A could be assessed for up to one year following the conclusion of the partnership audit.

Under the BBA, this adjustment would not give rise to an imputed underpayment (as the statute is currently written). As with Example 1, this adjustment seems more appropriately determined at the partnership level.¹⁵⁸ Again, if the Withholding Tax Approach were adopted, the IRS would be able to collect the tax from A (and provide other affected partners with any refunds due), provided the relevant statutes of limitations were open.

¹⁵⁵ To add to complications, assume A subsequently sold Asset and reported gain based upon the lower basis it reported. In that case, if the IRS were to collect additional tax in respect of this distribution, then the IRS would essentially be collecting twice. These issues are addressed to some extent in Part V.

¹⁵⁶ If the Withholding Tax Approach were used, the results would be as follows: P would not owe a tax under § 6225, but A would still be required to amend its tax return and take into account the impact of the audit and thus recognize the § 731(a) gain. (In addition, A would take an increased basis of $\$x + \100 in Asset.)

¹⁵⁷ Pre-BBA Treas. Reg. § 301.6231-(a)(1)(v).

¹⁵⁸ Similar examples arise when a partnership interest is sold, and there is a question of how section 751, 1239 or 453 might apply. All these were partnership items under TEFRA. Adjustments relating to all of these would not generate an "imputed underpayment" under BBA.

3. Example 3: Change in Attributes That Only Have Impact at Partner Level and Under a Non-Subchapter K Provision

The section 199 deduction is a deduction that is claimed at the partner level, but certain items of the partnership are taken into account in computing the partner's entitlement to the deduction and its amount.¹⁵⁹

Under TEFRA, those items could be adjusted in a partnership-level audit.¹⁶⁰ If those items of the partnership are adjusted in a BBA audit, how is the partner's section 199 deduction recomputed and taken into account? If the partnership proceeds to pay the imputed underpayment under 6225(a), then when does the partner take into account the modified attributes and adjust its Section 199 deduction for the reviewed year?¹⁶¹

4. Example 4: Change in Character of Partnership Income Which Has an Impact at the Partner Level

A BBA audit of P determines that its income was effectively connected income under section 864 or that P had a permanent establishment (for purposes of a treaty applicable to A) to which that income was attributable. Under TEFRA, these issues would be determined at the partnership level,¹⁶² and this seems likely to be the right locus because all the relevant information is likely to be at the partnership level.

Under section 6225, this change in character could presumably be translated into an imputed underpayment by creating a positive adjustment of the income (as effectively connected income attributable to a permanent establishment) and a negative adjustment of the income as reported. For the reasons discussed in detail in Part VII, this "imputed underpayment" may not result in the same aggregate taxes as the Correct Return Position. Moreover, in this case, the fact of there being a U.S. trade or business (or permanent establishment) at the partnership level could result in additional taxes being owed on other income of the partner (not from this partnership).¹⁶³

¹⁵⁹ These include the partnership's "domestic production gross receipts," "cost of goods" and other expenses, losses and deductions properly allocable to such receipts, and "W-2 wages."

¹⁶⁰ Pre-BBA Treasury Reg. § 301.6231-1(b).

¹⁶¹ Another example that could have significant impact for a partner is the change in the source of an item of income or deduction.

¹⁶² Pre-BBA Treas. Reg. § 301.6231-1(b).

¹⁶³ As an aside, this example also raises the issue of the interaction of section 6225 with the withholding tax rules that may apply at the partnership level. The adjustment here would also trigger a section 1446 withholding obligation at the partnership level, and rules will be needed to coordinate the section 6225 rules with the section 1446 and sections 1441, 1442 and 1445 rules, all of which may be triggered by a BBA FPA.

footnote continued

E. Options

With the foregoing in mind, we now discuss the possible options for what the scope of section 6221(a) should be.

1. Option 2.A: Literal Reading

Limit the scope of section 6221(a) to items listed in section 6221(a); the other items listed in Pre-BBA Treasury regulation section 301.6231-1(a) and (b) would not be subject to a BBA partnership level adjustment.

A variation on this approach would be to include the other items listed in the current regulations (a) to the extent they are duplicative of the items of “income, gain, loss, deductions or credits” (for instance, whether income is exempt, the amount of guaranteed payments, and the determination of whether income is attributable to a permanent establishment), and (b) their consequences can be adequately handled through the imputed underpayment mechanism.

2. Option 2.B: TEFRA Partnership Item

The scope of section 6221(a) is the same as “partnership item” under TEFRA, and all the guidance and case law interpreting that definition applies.

3. Option 2.C: Partial Expansion

The scope of section 6221(a) is the same as Option 2.A, plus some subset of the remaining things listed in Pre-BBA Treasury regulations section 301.6231(a) and (b) (which are not already incorporated into “income, gain, loss, deductions or credits.”). In which case, the questions will be which ones and what principles should guide the choice?

4. Option 2.D: Swing Items

The scope of section 6221(a) is the same as Option 2.A, plus all other items currently found in Pre-BBA Treasury regulations section 301.6231-1(a) and (b) may, at the IRS’s option, be determined at either the partnership or partner level.

These rules will need to address, among other things, (i) whether the withholding rules trump the section 6225 rule (or vice versa), (ii) if the two result in different amounts due whether both apply with one being reduced by the amount paid under the other, and (iii) how (if at all) a partner can claim a refund of an amount over-withheld. It would be particularly unfair if a section 6225 payment that exceeds a U.S. partner’s Correct Return Position liability could not be the subject of a refund claim by the partner but a section 1441, 1442, 1445 or 1445 liability triggered by a BBA FPA with respect to a non-U.S. partner (and that otherwise could have been satisfied via a section 6225(a) payment) could be the subject of a refund claim.

To prevent “double jeopardy,” if the IRS commences an audit of a partnership or any partner, it must select the items it is auditing, and those items may not be re-audited at the other level, even if the audit is of only one of the multiple partners in the partnership.

5. Option 2.E: TEFRA Partnership Items Plus TEFRA Affected Items

Address the failure of the section 6225(a) collection mechanism to impact partner-level attributes (both in terms of computing the section 6225(a) imputed underpayment and in terms of collecting any additional amounts that would be due from any partner as a result of the partnership-level adjustments) by expanding BBA audits to include all items that were “affected items” under TEFRA.

This option has numerous weaknesses: There would be significant practical problems (in terms of gathering information) and fairness problems (because requiring the partnership to pay taxes due with respect to “affected items” of a partner could be very unfair), unless the IRS opens a simultaneous audit of the partners’ returns and combined those audits with the BBA audit. This approach would be extremely difficult in the case of tiered partnership structures. More significantly, it would be an entirely different regime from the BBA (and from TEFRA).

A benefit of Option 2.E though, is that it ensures that all affected items are taken into account as part of a BBA audit.

F. Recommendation

The question of which option is best is intrinsically linked to the role of the imputed underpayment and how the questions in Part V are resolved.

If the Withholding Tax Approach is adopted, then the problems identified in the foregoing discussion are in large part resolved. Whatever is not determined at the partnership level can be determined in the subsequent partner-level collection or refund proceeding.

If the Withholding Tax Approach is adopted, then we believe that Option 2.B (*TEFRA Partnership Items*) is the most appropriate. If the Withholding Tax Approach is not adopted, then Option 2.A (*the Literal Reading*) is probably better, because any broader reading would mean that certain items would be potentially un-adjustable (because they would be adjustable only at the partnership level, but the adjustment may not be able to be translated into additional taxes or a reduction in taxes because of the limits of the section 6225 regime). However, if the Literal Reading is adopted, the IRS (and possibly Congress) will eventually need to develop a new regime to address how to adjust all the other types of items that are not adjustable in a BBA audit but which emanate from, or are impacted by items which emanate from, a BBA partnership.

A separate but related question is whether the statute of limitations of the partners should be extended when a BBA audit starts, to ensure that the audit impacts the partners’ tax positions

(both positively and negatively) and thus puts them as close as possible to the Correct Return Position. The narrower the approach chosen to the scope of the BBA audits, the less important this will be. Similarly, if the Withholding Tax Approach is adopted, this issue could be addressed as part of that. We strongly favor an approach that facilitates getting as close as possible to Correct Return Position, and leaving open the partners' statute of limitations is similar to what was done under TEFRA.¹⁶⁴ However, we recognize that the BBA statute does not currently provide for this, so in the absence of a statutory technical correction this could only be achieved through IRS procedures and taxpayer consent.¹⁶⁵

VII. COMPUTING THE SECTION 6225(a) PAYMENT

This Part VII addresses difficulties we see in determining how the section 6225(a) imputed underpayment is computed. These difficulties include two different but related problems. The first is the practical question of how the calculation is made when the adjustments include certain types of items, and the second is the more policy-focused question of whether the imputed underpayment should be able to be different from the additional tax the partners would have paid under the Correct Return Position (and if a difference is acceptable whether there should be any limit on how much difference is acceptable).

A. The Statutory Language

Section 6225(b) governs the computation of the imputed underpayment. It reads as follows:

(b) DETERMINATION OF IMPUTED UNDERPAYMENTS.—For purposes of this subchapter

—

(1) IN GENERAL.—Except as provided in subsection (c), any imputed underpayment with respect to any partnership adjustment for any reviewed year shall be determined—

(A) by netting all adjustments of items of income, gain, loss, or deduction and multiplying such net amount by the highest rate of tax in effect for the reviewed year under section 1 or 11,

(B) by treating any net increase or decrease in loss under subparagraph (A) as a decrease or increase, respectively, in income, and

¹⁶⁴ Pre-BBA § 6229(d).

¹⁶⁵ We do not mean to minimize the importance of this issue by addressing it so briefly.

(C) by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount determined under subparagraph (A).

(2) ADJUSTMENTS TO DISTRIBUTIVE SHARES OF PARTNERS NOT NETTED.—In the case of any adjustment which reallocates the distributive share of any item from one partner to another, such adjustment shall be taken into account under paragraph (1) by disregarding—

(A) any decrease in any item of income or gain, and

(B) any increase in any item of deduction, loss, or credit.

If this computation results in an imputed underpayment, section 6225(a)(1) provides that the partnership must pay that amount to the IRS. Section 6225(a)(2) then provides:

(2) any adjustment that does not result in an imputed underpayment shall be taken into account by the partnership in the adjustment year—

(A) except as provided in subparagraph (B), as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8), or

(B) in the case of an item of credit, as a separately stated item.

B. Netting of Positive and Negative Items

1. Overview

Section 6225(b)(1) indicates that all negative items are netted against all positive items. A full and complete netting of all negative items against all positive items may not accurately reflect the impact the adjustments would ordinarily have had on how much tax was due from each of the partners. Indeed, it may result in an imputed underpayment that is very different from the taxes that would be due under Correct Return Position. We note that if the Withholding Tax Approach is adopted, this discrepancy is less problematic because it can be corrected after the imputed underpayment has been paid through subsequent action taken by the IRS and the partners. Yet, even if the Withholding Tax Approach is adopted, the initial computation of the section 6225(a) imputed underpayment still must be made and it will still have a significant impact.¹⁶⁶

¹⁶⁶ One example of this is that there may be partners who are entitled to a refund but do not actually request it from the IRS, and, if there are partners who owe additional amounts, the IRS may have difficulty collecting those amounts.

In both the BBA Bluebook and the PATH Bluebook, the Joint Committee on Taxation indicated that the statutory formula of section 6225(a) did not mean unfettered netting:

*Netting is done taking into account applicable limitations, restrictions, and special rules under present law.*¹⁶⁷

The BBA Bluebook then provides two examples to illustrate this point. In the first example, the FPA results in an additional \$5,000 of ordinary income and an increased depreciation deduction of \$10,000. The Bluebook then notes that because these items are “ordinary in character and not subject to differing limitations or restrictions,” the two items are netted and result in a \$5,000 loss. As a result, there is no imputed underpayment payable, and, pursuant to section 6225(b)(2), the partnership has a non-separately stated loss (or a reduction of \$5,000 in non-separately stated income) for the adjustment year.¹⁶⁸

In the second example, the FPA results in an increase in ordinary income and capital gain and a disallowance of previously-claimed ordinary deductions, capital losses and credits. The BBA Bluebook first groups the items by character: (a) it increases the additional, reassessed, ordinary income by the amount of disallowed ordinary deductions and (b) it increases the additional, reassessed, long-term capital gain by the amount of disallowed capital loss. The result is additional ordinary income and additional capital gain. Under the example, the two numbers are then added together, and the sum is multiplied by 39.6% (the highest taxable rate for individuals and corporations). Finally, the resulting amount is increased by the amount of credits disallowed.¹⁶⁹

While the examples are helpful, their facts do not confront what happens if, after grouping the items by character, there remain positive and negative items of different character (*e.g.*, ordinary income and a capital loss). In fact, there are several contexts in which netting is raised and, as we explain in the discussion below the problems raised in these different contexts overlap. Below we discuss the netting for items with different character (Part VII.B.2); FPAs that change the timing of an item (Part VII.B.3); and FPAs that move allocations from one partner to another (Part VII.B.4).

¹⁶⁷ BBA Bluebook, at 63; PATH Bluebook, at 249.

¹⁶⁸ BBA Bluebook, at 63–64.

¹⁶⁹ BBA Bluebook, at 64.

2. Netting Items of Different Character

Items of different character that offset (in whole or in part) can arise because the FPA changes the character of an item or because the FPA includes items of different character that just happen to offset.

(a) Example 5: Adjustment Changes the Character of Income

All of partnership P's partners are individuals that are U.S. residents. In 2018, P reported \$100 of long-term capital gain. In 2020, the IRS audits P's 2018 return and issues an FPA, which does not affect the quantum or timing of P's 2018 income, but re-characterizes the \$100 as ordinary income.

The adjustment in the FPA reduces capital gain by \$100 and increases ordinary income by \$100. True netting would therefore create additional taxable income of zero and an imputed underpayment of zero.

Following the BBA Bluebook, would the imputed underpayment be computed by taking into account that capital losses ordinarily cannot offset ordinary income, and if so what would the result be?

Separating the income from the deduction does not help. Under section 6225(b)(1), the imputed underpayment is calculated by multiplying all adjustments to items by the single highest rate of tax in effect for the reviewed year, so even if the capital loss and the ordinary income were entered into the calculation separately, the result would seem to be a deduction of \$100 multiplied by the highest rate of tax and an income item of \$100 multiplied by the highest rate of tax, resulting in a zero imputed underpayment.¹⁷⁰

Another alternative would be to read the BBA Bluebook as saying that, because the capital loss cannot offset ordinary income, only the income item would be taken into account (and multiplied by the applicable tax rate) while the loss would be completely ignored (and lost to the partnership and the partners). In Example 5, this would mean a section 6225(a) imputed underpayment of \$39.60 (assuming that the reviewed-year partners are individuals). This seems to be inconsistent with the language of section 6225(b)(1) and it certainly seems to contradict section 6225(b)(2), which provides a very specific exception to the netting rule (*i.e.*, when the FPA re-allocates items from one partner to another). In addition, it would create (or be perceived to create) an unfair result to taxpayers and an inappropriate incentive for IRS agents: any adjustment that changed the character of an item would result in a collection of tax on the gross amount of that adjustment (potentially at the highest applicable rate). If the Withholding Tax Approach is

¹⁷⁰ The BBA Bluebook's second example, described in Part VII.B above (page 66) shows how this is done.

adopted, this unfair result could eventually be corrected by the affected partners filing refund claims.

Given this, we see three main options for handling netting of items of different character in computing the imputed underpayment.

(b) Option 3.A: Full and Complete Netting

Follow the text of section 6225(b) literally and net all negative items against all positive items. In Example 5, there would therefore be no imputed underpayment.

There are at least three issues with this approach. First, it results in a tax due that is far off from the Correct Return Position. Second, unless the Withholding Tax Approach is adopted (and the consequences of the FPA tier up to the partners), it would mean that FPA adjustments to the character of items would be pointless unless the partnership elects to proceed under section 6226 or the partners elect to proceed under section 6225(c)(2) (which presumably would happen only if the FPA adjustments as a whole, together with partner-level items, meant that one of those two methods resulted in less taxes paid in the aggregate). This would create unfair and arbitrary results. Finally, it appears to contradict the two Bluebooks.¹⁷¹

(c) Option 3.B: Two Separate Adjustments

Take the positive and negative adjustments into account separately such that there is (i) one adjustment that creates an imputed underpayment (*i.e.*, the ordinary income times the highest tax rate) and (ii) one adjustment (the \$100 capital loss) “that does not result in an imputed underpayment” and so is taken into account in accordance with section 6225(b)(2) (the rule for adjustments that do not result in an imputed underpayment).

In this case, the first adjustment would cause the partnership to owe the imputed underpayment (the ordinary income times the highest rate), and the second adjustment would create a deduction in the partnership’s adjustment year Form 1065 of non-separately stated income under section 702(a)(8) (as section 6225(b)(2) requires) that must be allocated to the *adjustment-year* partners.

In Example 5, P would pay \$39.60 (plus interest) as a section 6225(a) payment with respect to the 2020 FPA and would include in the K-1s provided to partners for the 2020 year a \$100 section 702(a)(8) “non-separately stated” item of deduction, which would be an *ordinary* deduction.

¹⁷¹ As stated in note 66, the Bluebook statements should not be viewed as being as authoritative as reports issued by Congress that are part of the legislative history.

Oddly, this Option 3.B converts the character of the offsetting deduction from capital loss to ordinary loss. The actual net tax collected (taking into account the payment of the imputed underpayment) would depend upon the adjustment year partners' other income, their respective rates of tax on ordinary income in that year and how the 2020 deduction is allocated among the partners under the partnership's allocation provisions. Ultimately, whether the net result is close to or far different from the Correct Return Position would depend upon many factors unconnected with the 2018 year and the tax situation of the 2018 partners.

Another downside to this approach is that, in situations where reviewed-year partners differ from adjustment year partners, it would add an additional layer of complexity for partners who try to negotiate contractual indemnities to ensure that the tax impact of a BBA audit falls as closely as possible to where the Correct Return Position liabilities would have fallen.

Finally, as discussed in detail below (in the context of the netting issues associated with allocations that are moved from one partner to another),¹⁷² the statutory text of section 6225 conflicts with the concept of disaggregating an FPA's adjustments in this way.

(d) Option 3.C: Netting Based Upon Partner-Level Usability (3.C-1: Not Limited By Character; 3.C-2: Limited By Character)

Utilize the concept found in section 6225(c) and the IRS's authority under section 6225(c)(6) and provide that items that are of different character do not offset, but that the negative items will be taken into account in computing the imputed underpayment if the partnership can establish that the reviewed-year partners would have been able to utilize those items in computing their respective taxes (in light of their respective circumstances). This mechanism is similar to section 6225(c)(3) and section 6225(c)(4), which allow a partnership to prove that the imputed underpayment should be reduced because one or more partners are tax-exempt or subject to a lower rate of tax.

In Example 5, this means that the imputed underpayment computation would take into account the \$100 of capital loss only to the extent the partnership establishes that the reviewed-year partners to whom the capital loss was allocated would have been able to use that loss to offset income. These computations could be difficult because there may be many different numbers on many different years of returns that are affected. For example, if the reviewed-year partner may have offset the 2018 capital gain from P with losses from other sources and once this has been proven, then it would seem appropriate to require each partner to adjust its going-forward attributes to reflect the "as-if" scenario that had been used in reducing the imputed underpayment.

¹⁷² See Part VII.B.4 (page 72).

If P does prove that \$50 of the capital loss would have been usable by a reviewed-year partner, there are then two options for how to take that \$50 deduction into account.

- **Option 3.C-1:** the amount of the “usable deduction” could be netted against the positive item (so \$100-\$50, multiplied by 39.6%, or \$19.80), even if they are of different character.
- **Option 3.C-2.:** the usable deduction could be multiplied by the highest rate (or possibly the lowest rate) of tax applicable to items of that character in the reviewed year (for each using 2018 tax rates). For example, if the highest rate applicable to capital gains is used, this means that the imputed underpayment would be \$29.60 ($\$100 \times 39.6\% - 50 \times 20\%$).

Clearly, the result may be fairly different from the Correct Return Position, and partnerships may have great difficulty obtaining the needed information from their partners (particularly in the case of tiered partnerships). Accordingly, this option may be very difficult to administer and apply and may lead to results that are perceived as unfair.

(e) **Recommendation**

This netting issue illustrates further that the imputed underpayment may vastly differ from the Correct Return Position. If the Withholding Tax Approach is adopted, the impact of these differentials may be narrowed through subsequent collections and refunds. As between subsequent collections and subsequent refunds, we believe the computations should be done in a manner that favors subsequent refunds. Thus, we believe the computations should err on the side of (reasonably) collecting too much rather than too little and putting the onus on taxpayers to seek refunds. We recognize that this also burdens the IRS, may result in over-collection, and may be perceived as unfair and inappropriate by taxpayers. In fact, we suspect that in practice, some taxpayers may not, as a cost/benefit matter, file for refunds. So, while we favor the Withholding Tax Approach, we think it is important that the rules and procedures are designed so as to permit the imputed underpayment to come as close to the Correct Return Position as possible.

While it is by no means perfect, we believe that Option 3.BC (*Netting Based Upon Partner Level Usability Limited by Character*) is the fairer option to the government and the taxpayer.

3. Netting Items When the FPA Changes the Timing of an Item

A second netting issue is how the imputed underpayment rules operate when the adjustment changes the timing of an item (moves it from one year to another). This situation raises the same issues as discussed directly above, and we believe that the same approach should apply.

In addition however, this fact pattern raises the question of whether the imputed underpayment is computed year by year or FPA by FPA.¹⁷³

If the computation is done on a year-by-year basis (or if each FPA addresses only one year), then moving an item would create one year with an imputed underpayment and one year without. To illustrate, if the audit moves \$100 of ordinary income from Year 2 to Year 1, this would mean that there is a Year 1 adjustment of \$100 of additional income and a Year 2 adjustment of \$100 of additional ordinary loss. If these two items are reflected in the same FPA, then presumably the partnership must use section 6226 or section 6225 for both adjustments. If they are in two separate FPAs, the partnership could presumably use section 6226 for one and section 6225 for the other unless the regulations require consistency when items are moved.

We reserve further comments on this issue until the other issues are resolved (which resolution may dispense with this issue).

4. Adjustments That Move Allocations From One Partner to Another

A third netting issue is raised when an audit adjustment moves an allocation from one partner to another partner. Section 6225(b)(2) provides that in that case the imputed underpayment is computed by taking into account *only* the increased income or decreased deduction and by ignoring the decreased income or increased deduction.¹⁷⁴

The BBA Bluebook restates the rule and illustrates its operation with an example. In the example, a partnership has allocated \$70 of depreciation and interest deductions to partner M and the IRS in the audit reallocates those deductions to partner L. The imputed underpayment is \$70 multiplied by the 39.6% tax rate. The Bluebook then states: “However, the partnership may implement procedures for modifying the imputed underpayment as so determined.”¹⁷⁵

The reason for this statutory rule is unclear and not explained by the BBA Bluebook. One possible explanation is that the drafters of the statute realized that if the decrease in income/increase in deductions item is taken into account in computing the imputed underpayment, it will always offset the increase in income/decrease in deduction item, so that the only way consistent with the simple math of the statute to turn a reallocation of items into an imputed

¹⁷³ A third question, which we discuss in Part VII.B.4, immediately below, arises if the consequence of the timing change is to reallocate the income from one partner to another (*e.g.*, because of the allocations in the particular partnership at issue, or because a partner transferred its interest).

¹⁷⁴ This is not one of the situations enumerated in section 6225(c) that would allow the partnership to reduce the imputed underpayment. We discuss later on in this Part VII.B.4 whether the Secretary could rely on its authority under section 6225(c)(6) to address the issue.

¹⁷⁵ BBA Bluebook, at 64–65.

underpayment is to ignore the “decrease.” If that is the reason, then we believe that the imputed underpayment computations should be fixed to accommodate offsetting items, rather than having such a punitive result.

Such a fix may be what the BBA Bluebook was referring to in the sentence quoted above. The sentence could be suggesting that the IRS may permit the partnership (under its section 6225(c)(6) authority) to try to prove that tax was paid on the initial allocation, but that is unclear from its reference to the *partnership* putting in place procedures. Alternatively, it may simply be suggesting that the partnership is permitted to try to prove that the partner to whom the allocation was moved is “tax-exempt” within the meaning of section 6225(c)(3) or that a lower tax rate may be applicable under section 6225(c)(4).

A second possible explanation of the statutory rule is that it was intended to be punitive. We find that very unlikely since a mistake (or disagreement with the IRS) over allocations is not something that should result in an automatic penalty, especially not in the form of double taxation of the amount erroneously allocated.¹⁷⁶

The important question here is whether this approach should be followed or should be changed and, if it is to be changed, whether it can be done by regulation or instead needs a statutory correction. We strongly believe that the current rule is unfair and will result in, among other things, an incentive for partnerships to elect to push out such adjustments under section 6226 or to litigate the results of the FPA (or both). Accordingly, we believe there should be an approach that prevents the permanent second tax on moved allocations.

If the Withholding Tax Approach is used, it could solve the permanent double collection issue because reviewed-year partners could file for refunds. If *Option 3.C (Netting Based Upon Partner Level Usability)*, discussed above,¹⁷⁷ is used, then partnerships could use the payment by the reviewed-year partner to establish a reduction in the imputed underpayment, but we recognize the difficulties that this approach raises (which is again why we favor the Withholding Tax Approach).

Another approach would be similar to Option 3.B¹⁷⁸ – that is, to interpret the “decrease” item as a separate “adjustment” from the increase item, and the decrease item would then be an “adjustment that does not result in an imputed underpayment” which would be taken into account

¹⁷⁶ As discussed in Part VIII (page 86), the statute has a similar rule under the § 6226 regime whereby a partner who receives a Section 6226 Statement is to aggregate the change in tax in all years from the reviewed year through the year prior to the adjustment year, but to take into account in the adjustment year only those years where the taxes would have been increased (and not those years where taxes would have decreased).

¹⁷⁷ See Part VII.B.2(d) (page 70).

¹⁷⁸ See Part VII.B.2(c) (page 69).

(pursuant to section 6225(a)(2)(A)) in the partnership's adjustment year return as a section 702(a)(8) separately stated deduction.¹⁷⁹ We believe that this interpretation would likely be within the Secretary's authority, although it conflicts somewhat with the statutory text of section 6225(b)(2) which suggests that there is a single adjustment,¹⁸⁰ and also conflicts with the rule in section 6225(b)(1) that "all adjustments" are netted for purposes of determining if the "adjustment...results in an imputed underpayment" (indicating that all adjustments made in an FPA are one "adjustment"). We also do not favor this approach because, although it prevents the decrease item from being "lost," it creates significant distortion by moving the decrease away from the reviewed year partner to whom it is attributable to the adjustment year partners. We note that the Withholding Tax Approach would put the decrease where it properly belongs.

These are three possible approaches, and we recognize that there are probably others as well.

If the IRS and Treasury do not believe they have regulatory authority to implement an approach that resolves this unfairness or believe that a more effective approach than they currently have the regulatory authority to implement requires a statutory change, then we believe a statutory change should be sought.

C. Section 6225(a) and Adjustments to Credits

We now turn to the treatment of tax credits under section 6225: Section 6225(b)(1)(C) computes the imputed underpayment "by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount [of the imputed underpayment] determined under [6225(b)(1)A]." Read literally, this means that additional credits reduce the section 6225(a) imputed underpayment dollar for dollar and a reduction in credits increases the section 6225(a) imputed underpayment dollar for dollar. The BBA Bluebook seems to confirm this reading.¹⁸¹

¹⁷⁹ One commentator has suggested that this is actually what the statute provides for (WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.08[5], n.345 (2016)) as opposed to a reasonable interpretation that could be adopted and implemented through regulations.

¹⁸⁰ Section 6225(b)(2) refers to "any adjustment which reallocates the distributive share" and provides that "such adjustment shall be taken into account under paragraph (1) by..."

¹⁸¹ See example in BBA Bluebook, at 64 (discussed in text at note 170), as well as BBA Bluebook, at 63, which notes:

"An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and

footnote continued

The Code provides for a number of different credits (approximately 30 business-related credits are found in sections 38 through 50). These credits have complex (and differing) regimes that often take into account multiple components in computing the allowable credit and often require recapture under certain circumstances. Some of these credits are computed at the partnership level, others at the partner level, and some can be computed at either level. Some of these computations are based upon attributes that are measured and adjusted each year, and this also can occur at the partnership level, the partner level or both depending upon the credit. Some of these credit regimes include carryforwards and carrybacks that are maintained at the partner level and others include carryforwards and carrybacks that are maintained at the partnership level.

It is not clear how the statutory formula is intended to interact with these regimes. In this Part VII.C we focus primarily on how the statutory rule might work in the case of the foreign tax credit and investigate various options. We then touch briefly on some issues raised in the context of two other credits, as illustrations of the complexity of the Code's credit regimes and the difficulty raised by trying to coordinate them with the imputed underpayment regime. If the Withholding Tax Approach is adopted, the credit issue is far less problematic because the appropriate result can be achieved in the subsequent partner-level proceedings. If the Withholding Tax Approach is not adopted, then the credit issue will need to be solved in a way that does not result in a section 6225 tax liability that is drastically different from the Correct Return Position and which creates incentives and opportunities for manipulation and abuse.

1. Foreign Tax Credit

The foreign tax credit regime has many different components that raise questions regarding how (if at all) section 6225(a) would be applied to foreign tax credits.

First, the credit is claimed only if the taxpayer elects to treat its eligible expenditures on foreign taxes as credits (instead of deductions, which is the default rule), and that election is made at the partner level.¹⁸² The partnership has expenditures that it allocates to the partners, but does not actually have "credits". The section 704 allocation rules, however, assume that the

multiplying the net amount by the highest rate of Federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year. Any adjustments to items of credit are taken into account as an increase or decrease of the product of this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law."

The last sentence (which references limitations and restrictions on netting) seems to apply to the increase or decrease in losses, not to the adjustments to items of credits.

¹⁸² § 703(b)(3).

expenditures will be claimed by the partners as credits and therefore treats the tax expenditures as a credit for substantial economic effect purposes. So, the partners are allocated the partnership's expenditures, which the partners then claim as credits.

Second, the ability to use a foreign tax credit is subject to a complex limitation formula that is calculated and applied at the partner level pursuant to section 904.¹⁸³ The components of that computation are maintained year-after-year and adjusted each year, again at the partner level. The partner is also permitted to carry back and carry forward credits from the year they are generated to other years. The "excess credit" pool is maintained at the partner level, not the partnership level.

Given the above, it is possible to view creditable foreign tax payments made at the partnership level as not a "credit" at all for purposes of section 6225(a). If that is the case, then one possibility is that they are items of deduction because they would be deductible under the general rule in section 164 unless the taxpayer turns that rule off by making the election to claim them as a credit, and the partner is the only person eligible to do that. Another possibility is that they are a nondeductible expenditure that is ignored in the section 6225(a) computations, but that is within the scope of section 6221(a) because it is an item of expense. If that is the case, then an FPA adjustment to foreign tax credits has no impact if the partnership proceeds to pay under section 6225(a) (unless the Withholding Tax Approach applies).

We think the better view is that creditable foreign tax expenditures made by a partnership are a "credit" for purposes of section 6225(a), but that there are several different ways that "credit" could be taken into account in computing the imputed underpayment.

Theoretically, it could be possible to perform the section 904 foreign tax credit calculations entirely at the partnership level as if the partnership were the taxpayer, but doing so would likely result in a tax liability that is drastically different from the Correct Return Position. We consider this option (Option 4.E.) and others below, followed by examples that illustrate how the options would work.

2. Options for Foreign Tax Credits

(a) Option 4.A: Literal Reading

- Reduction in foreign tax credits results in additional imputed underpayment (regardless of whether any partner actually claimed the benefits of these credits on their tax returns).
- Similarly, additional foreign tax credits reduce the amount of the imputed underpayment on a dollar-for-dollar basis (regardless of whether these credits would be actually usable by a partner).

¹⁸³ Treas. Reg. § 1.904-5(h)(1).

As discussed above, this will result in a tax liability that is very different from the Correct Return Position and it may incentivize partnerships to elect section 6226 whenever foreign tax credits are reduced (unless that would otherwise result in more aggregate tax due).

(b) Option 4.B: Foreign Tax Credits Are Excluded from Section 6225(a) and Instead Tier Up to Reviewed Year or Adjustment Year Partners

- Reduction in foreign tax credits are ignored in making the section 6225(a) computation and instead, they must be taken into account by the reviewed-year partners under a section 6226-like mechanism.¹⁸⁴
- Additional foreign tax credits are treated similarly.

This approach forces foreign tax credits into a section 6226-type mechanism even if the partnership otherwise pays under section 6225. The credits that are taken into account in this way would be adjusted to account for the credits taken into account on an amended return under section 6225(c)(2).

(c) Option 4.C: Partners' Involvement (Section 6225(c)(2)-Like)

- For a reduction in foreign tax credits, the amount of the decreases results in an underpayment unless the partnership proves under a mechanism similar to section 6225(c) that the partner did not use those credits. These partners then undertake not to use the credits going forward.
- Additional foreign tax credits are taken into account only to the extent the partnership proves that partners could have used those credits on their own returns in the reviewed year: (a) in fact, (b) only if they considered the partnership items quarantined (and without having to prove those items were not used by partners already), or (c) only if they considered the FPA items.

(d) Option 4.D: Foreign Tax Credits Treated as Deductible and As If Deducted

- Reduction in foreign tax credits results in additional income.

¹⁸⁴ The alternative (reflecting them in the partnership's current Form 1065 and requiring them to be taken into account by adjustment year partners in the adjustment year) becomes extremely distortive unless the partnership has other current year foreign tax credit expenditures which it can reduce by this "reduction" in foreign tax credits.

- Conversely, additional foreign tax credits are taken into account but only as a deduction against the partnership income regardless of whether partners elected to deduct their foreign taxes under section 164 or use the foreign tax credit mechanism.¹⁸⁵

(e) Option 4.E: Partnership Applies the Foreign Tax Credit (or Section 164 Deduction) Based Upon its FPA Items Only

In keeping with the concept of section 6225(a) as a final payment, this approach treats the partnership as the taxpayer (so, for instance, it will determine the source of the income by reference to the partnership not its partners). If the section 904 computations were to be performed at the partnership level there would be two primary choices. One option is to apply them based solely upon the items adjusted and appearing in the FPA and to prohibit partners from taking these items into account in computing their own section 904 computations (unless the section 6226 or 6225(c)(2) approach is used). Another option is to apply them based solely upon what appeared in the partnership's Form 1065 for the year as adjusted by the FPA (however, since the partners have already taken into account the items reported on the Form 1065 in computing their available credits, this approach could result in double counting to the benefit of taxpayers or the government, depending upon the facts). A variation ("**Option 4.E(i)**") would be to allow the partnership to elect to treat the foreign tax as a credit or section 164 deduction.

We believe that this approach is flawed and difficult to justify as a policy matter as it would result in a tax liability which has no substantive connection to the Correct Return Position. It would also provide significant incentives to taxpayers that have limitations on the use of foreign tax credits (*e.g.*, partners with significant partner-level deductions allocable under section 861 to foreign source income or with overall foreign losses) to cause the partnership to under-report its income and credits.

(f) Option 4.F: Mix and Match

Finally, it is theoretically possible to adopt a different approach for the reductions in credit and the increases in credit (*e.g.*, Option 4.A for the reduction in credit but Option 4.D for additional credits). However, we believe that this mixing and matching would be unfair to the taxpayers and produce results that would be hard to justify as a policy matter and accordingly do not discuss it further.

¹⁸⁵ This is similar to the rules of § 901 which, in some cases, treats disallowed tax credits as deductions under § 164.

3. Illustrations of Foreign Tax Credit Options

(a) Example 6: Reduction in Credit

Partnership AB has two equal partners, A and B, each of which is a domestic corporation. A is in an excess foreign tax credit position without considering P items. B has no other foreign source income or foreign tax credits. In 2018, AB operated in Country X. It earned \$100 of “general category income”¹⁸⁶ and paid \$15 of foreign taxes on this income. AB believes that the foreign tax paid is an income tax within the meaning of section 901 and thus reported to the partners the income and the credit (each K-1 reported \$50 of income and \$7.50 of tax credit each). In 2020, the IRS audits the 2018 tax year and determines that the tax was not a tax within the meaning of section 901 (and section 164).

Correct Return Position

If the Correct Return Position had been adopted in 2018, A’s tax liability would not have varied (but its foreign tax credit carryforward pool would be reduced by \$7.50), and B’s tax liability would have been increased by \$7.50 (its share of the foreign tax credits).

How should this reduction in credit be taken into account under section 6225(a)?¹⁸⁷

Options

- *Option 4.A (Literal Reading)*. The denial of the credit means that AB has to pay \$15 (plus interest), even though A has not used the foreign tax credits that it was allocated.
- *Option 4.B (Credits are Excluded from Section 6225(a))*. AB is not liable for an imputed underpayment. Each of A and B amends its tax return for 2018 or takes into account the 2018 changes in its 2020 return. Since A did not use the credits, it has no additional liability, but it adjusts its foreign tax credit carryforward downward by \$7.50. In 2018, B claimed the benefit of the \$7.50 of foreign tax credit to reduce its U.S. federal tax liability, so it must pay \$7.50 (plus interest).
- *Option 4.C (Partners’ Involvement)*. Assuming A satisfies the relevant documentation requirement, AB must only pay \$7.50 of imputed underpayment, plus interest (*i.e.*, the foreign tax credits that were allocable to B), and A reduces its foreign tax credit carryforward by \$7.50.

¹⁸⁶ Within the meaning of § 904(d).

¹⁸⁷ Assume, for this purpose, that AB proves to the IRS that the applicable tax rate should be the corporate tax rate under § 6225(c)(4).

- *Option 4.D (Deduction)*. The credits are denied and instead a section 164 deduction applies, such that the imputed underpayment is \$5.25 ($\$15 \times 35\%$), plus interest.
- *Option 4.E (Computations Based only on FPA)*:
 - Because the FPA does not carry with it income, solely a reduction of foreign taxes previously reported as foreign taxes, the disallowance results in an imputed underpayment of \$15 (plus interest), *i.e.*, the same result as Option 4.A
 - *Option 4.E(i)*: AB elects to treat the 2018 foreign “tax” as a section 164 deduction, such that the disallowance leads to the same result as Option 4.D

	Correct Return Position	Option 4.A Literal Reading	Option 4.B Credits are Excluded from Section 6225(a)	Option 4.C Partners' Involvement	Option 4.D Forced Deduction/Income	Option 4.E Computations Based on FPA Only
Additional Tax Collected (ignoring interest)	\$7.50 <i>A's FTC carryforward reduced by \$7.50</i>	\$15 <i>A's FTC pool is not affected</i>	\$7.50 <i>A's FTC carryforward reduced by \$7.50</i>	\$7.50 <i>A's FTC carryforward reduced by \$7.50</i>	\$5.25 <i>A's FTC pool is not affected</i>	Same as Option 4.A (Option 4.E(i): same as Option 4.D)

(b) Example 7: Additional Credits

Partnership CD has two equal partners, C and D, each of which is a domestic corporation. In 2018, partnership CD reported \$100 of income (\$50 to each of C and D). Assume that C has a very large overall foreign loss such that it is not able to use foreign tax credits against its foreign source income. D has no income, gain, deduction, loss or credit other than with respect to its investment in CD.

CD operates in country X through an affiliate (FC), which generated in 2018 \$100 of pre-tax foreign source income and was subject to foreign tax at a 15% rate, so \$15. In 2020, the IRS audits the 2018 tax year and determines that FC was merely an agent of CD, and that the income earned (and taxes paid) by FC is properly taken into account by CD.

How should this increase in credit be taken into account under section 6225(a)?

Correct Return Position:

If a Correct Return had been filed in 2018, C would have paid additional taxes of \$17.50 ($\50 of income $\times 35\%$, its overall foreign loss would have been reduced by \$50 and its \$7.50 of foreign tax credits would have carried forward). D would have been able to claim a foreign tax credit for its share of the tax (\$7.50), and thus would have paid \$10 of tax ($\$50 \times 35\% - \7.50 of foreign tax credit). This would have resulted in an aggregate liability of \$27.50.

Options:

- *Option 4.A (Literal Reading)*. The imputed underpayment is reduced by the amount of credits, such that CD pays \$20 ($\$100 \times 35\% - \15), plus interest. C’s overall foreign loss is not affected.
- *Option 4.B (Credits Are Excluded From Section 6225(a))*. CD pays the imputed underpayment on \$100 of income, so \$35 (plus interest). The foreign tax credits for the \$15 of taxes tier up to C and D. Since C is in an overall foreign loss position, it cannot use the foreign tax credit in that year. Similarly, D has no use for the credit. The foreign tax credits carry forward for C and D and may (or may not) be of value in the future.
- *Option 4.C (Partners’ Involvement)*. Assuming D satisfies the relevant documentation requirement, it can prove that it would have been able to claim a foreign tax credit for its share of the tax. Thus, the imputed underpayment is reduced by \$7.50 from \$35 to \$27.50. (In addition, interest applies.) The unused credit (\$7.50) carries forward to 2020 and is allocated to C and D as adjustment year partners under section 6225(a)(2)(B).
- *Option 4.D (Deduction)*. The credits are denied and instead a section 164 deduction applies, such that the imputed underpayment is \$29.75 ($(\$100 - \$15) \times 35\%$), plus interest.
- *Option 4.E (Computations Based Only on FPA)*. Looking at the FPA on a stand-alone basis, CD elects the application of section 901. Accordingly, looking at the FPA items on a stand-alone basis, the imputed underpayment is \$20, plus interest (same as Option 4.A). C’s overall foreign loss is not affected.

	Correct Return Position	Option 4.A Literal Reading	Option 4.B Credits are Excluded from Section 6225(a)	Option 4.C Partners’ Involvement	Option 4.D Forced Deduction/ Income	Option 4.E Computations Based on FPA Only
Additional Tax Collected (ignoring interest)	\$27.50 <i>(C’s OFL is reduced and it has a \$7.50 FTC carryover)</i>	\$20 <i>(C’s OFL is not affected; no FTC for C and D)</i>	\$35 <i>(C’s OFL is not affected; each of C and D have a FTC carryover of \$7.50)</i>	\$27.50 <i>(C’s OFL is not affected; no FTC for C and D)</i>	\$29.75 <i>(C’s OFL is not affected; no FTC for C and D)</i>	Same as Option 4.A

(c) Example 8: Additional Credits Not Usable by Partnership

Assume the same facts as Example 7, *except* that (i) C has no overall foreign loss and in 2018 had \$20 of additional foreign source income (from another source) but no foreign tax credit (and paid \$7 of U.S. taxes in respect of that income in 2018), and (ii) as part of the 2020 audit, the IRS determines that FC’s income should be taxed as U.S. sourced.

What should be the imputed underpayment?

Correct Return Position

If a Correct Return had been filed, then in 2018:

- C would have been subject to \$17.50 of taxes with respect to the income allocated from CD, but would have been able to use the additional \$7 out of the \$7.50 of foreign tax credit to offset its tax liability with respect to its foreign source income from its other investments. In other words, its net tax liability for 2018 would have been higher by \$10.50 and it would have had a foreign tax credit carryover of \$0.50.
- D would have paid \$17.50 of additional taxes (\$50 of income*35%) and obtained a foreign tax credit carryover of \$7.50.

Options

- *Option 4.A (Literal Reading)*. The imputed underpayment is reduced by the amount of credits, even though the income is U.S. sourced, such that CD pays \$20 ($\$100 \times 35\% - \15), plus interest.
- *Option 4.B (Credits are Excluded From Section 6225(a))*. CD pays the imputed underpayment on \$100 of income, so \$35 (plus interest). The foreign tax credits for the \$15 of taxes tier up to C and D. C amends its tax return for 2018 or takes into account the 2018 changes in its 2020 return: C obtains a refund for \$7 of taxes paid in 2018. C and D have a foreign tax credit carryforward of \$0.50 and \$7.50, respectively.
- *Option 4.C (Partners' Involvement)*. The pre-credit imputed underpayment is \$35 ($\$100 \times 35\%$), plus interest. D's share of the additional tax credit (\$7.50) cannot be used to reduce the imputed underpayment. C's ability to reduce the underpayment depends on whether it can look at all of its 2018 income or just the partnership items.¹⁸⁸ In the former case, it can reduce the imputed underpayment by \$7 in light of the benefit it would have derived in 2018. Any excess unused credit (*i.e.*, \$8) carries forward to 2020 and is allocated to C and D.
- *Option 4.D (Deduction)*. The credits are denied and instead a section 164 deduction applies, such that the imputed underpayment is \$29.75 ($(\$100 - \$15) \times 35\%$), plus interest.
- *Option 4.E (Computations based only on FPA)*:
 - Looking at the FPA on a stand-alone basis, CD cannot elect the application of section 901 (since all of the FPA's additional income is U.S. sourced). The imputed

¹⁸⁸ See Part VII.C.2(c) (page 77).

underpayment is \$35, plus interest. The foreign tax credits carry forward to 2020 and are allocated to C and D.

- Option 4.E(i): CD uses the section 164 deduction. Same result as Option 4.D

	Correct Return Position	Option 4.A Literal Reading	Option 4.B Credits are Excluded from Section 6225(a)	Option 4.C Partners' Involvement	Option 4.D Forced Deduction/ Income	Option 4.E Computations Based on FPA Only
Additional Tax Collected (ignoring interest)	\$28 <i>(C has \$0.50 of FTC carryover; D has \$7.50)</i>	\$20 <i>(no FTC carryover)</i>	\$28 <i>(C has \$0.50 of FTC carryover; D has \$7.50)</i>	\$28 <i>(no FTC carryover)</i>	\$29.75 <i>(no FTC carryovers for C and D)</i>	\$35 (Option 4.E(i): same as Option 4.D)

(d) Example 9: Adjustment of Amount of Foreign Source Income

Partnership FG has two equal partners, F and G, each of which is a domestic corporation. Assume that F is in an overall foreign loss position of \$100 such that it is not able to use foreign tax credits against its first \$100 of foreign source income. G has no income, gain, deduction, loss or credit other than with respect to its investment in FG.

In 2018, partnership FG reported \$200 of pre-tax foreign source income and paid foreign taxes at a 40% tax rate, so \$80. Each of F and G was allocated \$100 of income and \$40 of foreign tax credits. F paid \$35 of taxes, eliminated its overall foreign loss and carried forward \$40 of foreign tax credits. G claimed a foreign tax credit and paid no U.S. federal income tax (and carried forward \$5 of foreign tax credit).

In 2020, the IRS audits the 2018 tax year and determines that for U.S. federal income tax purposes, FG's income was not \$200 but \$240. Neither F nor G has used the foreign tax credits it carried forward from 2018.

How should the imputed underpayment be computed? Should FG be able to use the excess credit that was paid in 2018?

Correct Return Position

If FG had correctly reported its income in 2018, each of F and G would have been allocated \$120 of foreign source income and \$40 of foreign tax credit.

- F would have been subject to U.S. federal income tax on the first \$100 (in light of its overall foreign loss of \$100) and claimed foreign tax credit against the additional \$20 of income (so a \$7 credit). As a result, F would have earned out of its overall foreign loss, paid \$35 of taxes ($\$120 \times 35\% - \7) and carried forward \$33 of foreign tax credits.

- G would have been subject to tax on the \$120 of income (so a pre-credit liability of \$42), claimed a foreign tax credit of \$40 and paid \$2 of taxes. It would have no foreign tax credit carryover.

Options

- Since the FPA does not carry with it additional foreign tax credits, Option 4.A (*Literal Reading*), Option 4.B (*Credits are Excluded from Section 6225(a)*), Option 4.D (*Deduction*) and Option 4.E (*Computations Based Only On FPA*) have the same result: the imputed underpayment is \$14 (\$40 of additional income*35%) (plus interest). Neither F nor G can use its foreign tax credits to offset the amount of the underpayment.
- *Option 4.C (Partners' Involvement)*. Assuming F and G satisfy the relevant documentation requirement, they can prove that they have not used their excess foreign tax credits and would have been able to claim a (partial) foreign tax credit for the additional income. Thus, the additional \$20 of income allocable to F is not subject to an imputed underpayment and F reduces its foreign tax credit carryover by \$7. With respect to the \$20 of income allocable to G, G has only \$5 of foreign tax credit carryover, such that the partnership pays an imputed underpayment of \$2, plus interest (pre-credit tax of \$20*35% or \$7, reduced by a \$5 foreign tax credit) and eliminates its foreign tax credit carryover.

	Correct Return Position	Option 4.A Literal Reading	Option 4.B Credits are Excluded from Section 6225(a)	Option 4.C Partners' Involvement	Option 4.D Forced Deduction/Income	Option 4.E Computations Based on FPA Only
Additional Tax Collected (ignoring interest)	\$2 <i>(F's FTC carryover is \$33; G has no FTC carryover)</i>	\$14 <i>(F's FTC carryover is \$35; G has \$2 of FTC carryover)</i>	Same as Option 4.A	\$2 <i>(F's FTC carryover is \$33; G has no FTC carryover)</i>	Same as Option 4.A	Same as Option 4.A

4. Other Credits: the Section 41 Research Expenditure Credit and the Section 52 Low-Income Housing Credit

We considered, for illustration purposes, two other credit regimes: the research expenditures credit and the low-income housing credit.

(a) Section 41 Research Expenditure Credit

The section 41 research expenditure credit can be computed at the partnership level based upon the partnership's conduct of a trade or business and the expenditures made by the partnership in connection with that trade or business; alternatively, if the partnership is not engaged in a trade or business but has research expenditures, one or more of the partners may be able to take those

expenditures into account and compute the credit at the partner level.¹⁸⁹ Thus, in a BBA audit of a partnership that previously claimed a section 41 credit, the IRS may determine that the partnership was not engaged in a trade or business and therefore was not eligible to claim (and allocate to its partners) the section 41 credit. Under the literal reading of section 6225, the FPA could result in an imputed underpayment equal to the amount of the credit claimed by the partnership. However, this ignores the fact that one or more of the partners may have been entitled to claim, at their own level, a credit for these expenditures. Would this possibly be taken into account under section 6225(c) or would it only be taken into account if the partners filed amended returns in 6225(c)(2) or the adjustment was pushed out under 6226?

(b) Section 42 Low-Income Housing Credit

The low-income housing credit under section 42 is computed and claimed at the partnership level. Section 42(j) requires recapture of a previously claimed credit under certain conditions but the amount of recapture is limited to the amount of credits actually used by the taxpayer to reduce the taxpayer tax liability. Thus, the recapture amount must be computed at the partner level.¹⁹⁰ So imagine a partnership that has allocated a low-income housing credit to its partners and in a BBA audit the IRS determines that the conditions are met for recapture. Would section 6225 treat this as a reduction in credits or would it need to be ignored since section 42 makes it clear that the amount of recapture is determined at the partner level once the conditions for recapture are met at the partnership level?

Our point here is to illustrate that each credit regime has its own unique rules and fitting them into the BBA, particularly section 6225(a) of the BBA, is going to require special attention.

5. Recommendation

These three examples demonstrate that in the case of tax credits, it is often necessary to look both at the partners and at partnership level in order to determine the liability under the Correct Return Position. Accordingly, if the Withholding Tax Approach is not adopted, it is going to be difficult to apply the BBA to adjustments in tax credits, as well as to adjustments to the attributes used to compute the availability of credits. Any imputed underpayment mechanism will in many cases arrive at a tax liability that is completely different from the Correct Return Position. This is a significant issue because the tax credit regimes reflect policy choices and play a

¹⁸⁹ Treas. Reg. § 1.41-2(a)(4)(ii).

¹⁹⁰ There is a special rule (in § 42(j)) pursuant to which recapture is computed at the partnership level and allocated to the partners on their K-1 (this rule applies whenever the partnership has 35 or more partners and has not elected out of the rule). If this rule applied, the section 6225 liability would be significantly simpler to compute.

significant role in our tax system. The imputed underpayment mechanism should not supplant them. Moreover, the applicability of these policies should not depend on whether amount of credits were reported correctly on the initial return or determined in an IRS examination. The more disconnected the imputed underpayment is from the Correct Return Position when tax credits are involved, the greater the incentives for manipulation, strategizing and potential abuse.

The Withholding Tax Approach we recommend in this report would mitigate the impact of this disconnect since the impact of the FPA would tier up to the partners, thereby ensuring that the correct amount of tax is ultimately levied. With this in mind, we believe that if the Withholding Tax Approach is adopted, Option 4.A (*the Literal Reading of the Statute*) may be workable for the foreign tax credit and many other credits as it is easy to administer. It will not collect the correct amount, but it will result in some payment to the IRS (which may be too much or too little) and the tax returns filed by the partners will ultimately adjust this amount.

If the Withholding Tax Approach is not adopted, we believe that in order to safeguard the integrity of the tax credit systems, Option 4.C (*Partners' Involvement*) might be the best approach (in spite of its complexity) for the foreign tax credit and many other credits (although Option 4.B (*Credits are Excluded from Section 6225(a)*) may also be appropriate for some tax credits).

Our recommendations may change when decisions are made on the other key issues.

VIII. SECTION 6226(b)(2)(B): DECREASES IN TAXES NOT TAKEN INTO ACCOUNT

As discussed above,¹⁹¹ section 6226 requires the reviewed-year partners to include in their adjustment year taxes¹⁹² an amount equal to the additional taxes they would owe for the reviewed year and all years between the reviewed year and the adjustment year if the FPA adjustments were taken into account by them in the reviewed year (and all corresponding adjustments were made in subsequent years). The statutory formula provides however, that for each of those years, the partner can take into account the impact on the taxes due in that year only if the impact is an *increase* in the taxes due by the partner.

This formula can therefore result in significant double taxation of items affected by an FPA if, for example, (i) the FPA reallocates an item of income, deduction, gain, loss or credit between partners, (ii) the FPA reallocates such items across years or (iii) between the reviewed year and the adjustment year, the reviewed-year partner has disposed of its interest (see our example in Part V)

¹⁹¹ See Parts IV.D.3 (page 30) and V.A.3 (page 37).

¹⁹² To be precise, the relevant year for the partner is the year during which the partner receives the Section 6226 Statement from the partnership, which may under the regulatory guidance be a year after the actual “adjustment year”. We use “adjustment year” throughout this section for simplicity.

or receives a distribution from the partnership taxable under section 731 (because the distribution exceeds the partner's outside basis). The result is all the more anomalous because section 6226 allows the reviewed-year partners to take into account the full effects of the adjustments resulting from the FPA (both increases and *decreases* to taxes) starting in the adjustment year.

A. Illustrations of Section 6226(b)(2)(B)

1. Example 10: Reallocating Income from One Partner to Another

Partnership P has two partners, A and B. A is an individual (subject to the highest marginal tax rate)¹⁹³ and B is a domestic corporation with significant income from other investments. Under the partnership agreement, A is allocated all of the long-term capital gains for years 2018–2020 and B is allocated all of the long-term capital gains for 2021–2022.

In 2018, P earns \$100,000 of long-term capital gain, which is allocated entirely to A. No distributions are made to A and B.

In 2019, P has no net income and no distributions are made.

In 2020, the IRS issues an FPA for 2018 which disallows the special allocations as lacking substantial economic effect and allocates all long-term capital gains 50-50. P makes a section 6226 election. What is the impact to A and B?

(a) Partners' Positions (as reported)

- A paid \$20,000 of taxes (\$100,000 LTTCG*20%) in 2018.
- B paid no taxes with respect to P in 2018.
- Total Taxes Paid: \$20,000.

(b) Correct Return Position

- In 2018, A should have paid \$10,000 (\$50,000 LTTCG*20%).
- In 2018, B should have paid \$17,500 (\$50,000 LTTCG*35%).
- Total Taxes Paid Under Correct Return Position: \$27,500.

(c) Section 6226 Election

- A: In 2020, A receives the Section 6226 Statement which reduces her 2018 taxable income by \$50,000. Since taking into account the adjustment would result in a decrease, not an

¹⁹³ For simplicity, assume that the income is not subject to the taxes under §§ 1401 or 1411.

increase, in tax, A pays no additional tax and receives no refund. A is required, however, to reduce her tax basis in her P interest by \$50,000 to account for the reallocation.¹⁹⁴

- **B:** In 2020, B is required to take into account the additional \$50,000 of LTCG it is allocated under the Section 6226 Statement resulting in a \$17,500 tax (plus interest). B increases its outside basis by the additional \$50,000 of income.
- **Total Taxes Paid:** \$37,500.

Thus, section 6226 may result in permanent double taxation of \$50,000 to A because A has reduced its outside basis by \$50,000.¹⁹⁵

As discussed above,¹⁹⁶ section 6225 will not necessarily lead to a better result (unless the Withholding Tax Approach is adopted), because the imputed underpayment will take into account the \$50,000 allocation to B and not necessarily the offsetting \$50,000 decrease in the allocation to A.

2. Example 11: Section 731 Distribution

Partnership P has two partners, A and B. Each of A and B is a domestic corporation. All allocations are done 50-50.

In 2020, each of A and B starts out the year with \$100 of outside basis in its P interest. P recognizes a \$100 loss (which is allocated \$50 to each of A and B); and A has \$50 of income from another source.

During 2021, P recognizes \$20 of income and distributes \$100 to A.

In 2023, the IRS issues an FPA which disallows the 2020 \$100 loss. P makes a section 6226 election. What are the consequences to A?

¹⁹⁴ This seems required by § 705 and § 6226(b)(3).

¹⁹⁵ For instance, since P continues to give A the economic benefit of the entire \$100,000 allocation, it may be subject to tax on \$50,000 of income when A sells its partnership interest. This permanent double taxation is not offset by a tax benefit for B. In fact, B is also disadvantaged but this is a disadvantage of timing (and character) only: B is taxed on the \$50,000 in 2020, but B's outside basis increases by that amount, and so if B does not get the economic benefit of that allocation it has a \$50,000 loss (or \$50,000 less gain) from its P investment.

¹⁹⁶ See Part VII.B.4 (page 72).

(a) A's Position (as reported)

- In 2020, A used the \$50 loss allocated from P to offset its \$50 of income, thereby resulting in no taxes payable.
- In 2021, A is taxed on its allocable share of the 2021 income (\$10). In addition, because the \$100 cash distribution it received exceeds its \$60 adjusted basis in its P's interest (\$100 – \$50 of 2020 losses + \$10 of 2021 income = \$60), it is taxed on the excess of \$40. Thus, A paid taxes in 2021 on \$50 of income (\$10 of allocable income from P and \$40 of section 731 distribution) for a tax liability of \$17.50.
- Total Taxes Paid: aggregate taxes of \$17.50 over 2020 and 2021.

(b) Correct Return Position

- In 2020, A should not have been allowed the benefit of the \$50 deduction, and thus should have paid \$17.50 of taxes on its non-P income.
- In 2021, A should have been taxed on its \$10 of allocable income from P. However, because A's adjusted basis in P (\$100 plus \$10) would have exceeded the cash distribution, A would not have been subject to tax under section 731 with respect to the distribution. In other words, A should have paid \$3.50 of taxes in 2021 ($\$10 \times 35\% = \3.50).
- A's outside basis at the end of 2021 would be \$10 ($\$100 + \10 of income less \$100 of distribution = \$10).
- Total Taxes Paid Under Correct Return Position: aggregate taxes of \$21 over 2020 and 2021.

(c) Section 6226 Election

- In 2023, A receives a Section 6226 Statement from P which disallows \$50 of losses. As a result, A takes into account the following amounts in its A's 2023 return:
- With respect to 2020, \$50 of additional taxable income, resulting in an additional \$17.50 of taxes (plus interest).
- With respect to 2021, no amounts are taken into account. This is because A actually paid \$17.50 in 2021 and, that taking into account the adjustments, A should have paid \$3.50. Under the "increases-only" rule of section 6226(b)(2)(B), A *does not* reflect this decrease in taxes due.
- A's outside basis as a result of all of this is presumably \$10 ($\$100 + \$10 - \$100 = \10).

- Total Taxes Paid: A has paid \$35 of taxes (\$17.50 as reported in 2021 plus \$17.50 paid in 2023) instead of \$21 under the Correct Return Position.

*A has paid an additional \$14 of taxes that A can never recoup.*¹⁹⁷

If, by contrast, the \$100 distribution had been made in the year A received the Section 6226 Statement (2023), then A would have been able to compute the taxes arising from the distribution taking into account A's post-Section 6226 election outside basis and would not have paid this extra \$14 of tax.

(d) Section 6225 Payment

- If, instead of making a section 6226 election, P pays the imputed underpayment under section 6225(a), its liability would be \$35 (*i.e.*, $\$100 \times 35\%$), \$17.50 of which is allocable to A.
- Assuming any of Option 1.B (*Reviewed-Year Partners*), Option 1.C (*Adjustment Year partners*), Option 1.D (*Optional Allocation of the Adjustment*) or Option 1.E (*the Withholding Tax Approach*) discussed above¹⁹⁸ is adopted, A would be able to amend its 2021 tax return (if the statute of limitations is open) to obtain a refund of the tax paid with respect to the section 731 distribution (\$14).
- Total Taxes Paid by A and P (for A's share): \$21 (same as Correct Return Position).

In this case, the section 6225 payment is therefore better for A than a section 6226 election.

B. Recommendation

This approach appears to have been intentional. The BBA Bluebook simply describes it with no commentary or explanation of the rationale.¹⁹⁹ It is possible (though unlikely) that the drafters of the statute were thinking that FPAs would only ever increase taxes.

It is also possible that the drafters intended for section 6226 to be a regime that worked well for partners in some situations but not all situations. The rationale may have been that if partners want decreases in taxes taken into account they should proceed under section 6225. This explanation is not convincing however because (1) as we see in Example 10, section 6225 does not

¹⁹⁷ As noted, A's outside basis after the section 6226 election is \$10, which is the same as the value of A's interest and the same as it would have been under Correct Return Position. So A has no embedded loss that it could recognize to offset this \$14 overpayment.

¹⁹⁸ See Part V.B (page 41).

¹⁹⁹ BBA Bluebook, at page 68.

always solve this problem, and (2) it is not entirely clear whether and how the imputed underpayment computations take into account consequences in years between the reviewed year and adjustment year.²⁰⁰

Perhaps the thinking was that if partners wanted to take into account decreases they should proceed under section 6225(c)(2) with amended returns, but there are (at least) three problems there: first, that alternative is available only if the partnership does not make the section 6226 election and individual partners who may want to take into account decrease years may not control that decision. Second, if the adjustment moves allocations from one partner to another, then section 6225(c)(2) is available only if both partners file amended returns. Third, even the section 6225(c)(2) mechanism in the statute is not entirely clear as to how it permits a partner filing an amended return to take into account decreases in taxes or refunds due for the reviewed year or years between that year and the adjustment year.²⁰¹

We note the similarity between this increases-only rule and the section 6225(b)(2) rule (discussed above)²⁰² providing that when allocations are moved between partners, the imputed underpayment is computed by taking into account only the items that increase taxable income and not those that decrease it.

This leads to two questions: could regulations ameliorate the impact of this rule and, if not, should statutory corrections be sought?

We believe that regulations that depart from the plain words of the statute would pose difficult questions regarding statutory authority and should not be pursued. We believe that a statutory correction should result in more accurate bottom line payments to the IRS (closer to Correct Return Position), but we recognize that there may be policy reasons to keep section 6226 as is to encourage taxpayers to use the section 6225 mechanism.

²⁰⁰ See Parts V (page 31) and VII (page 64).

²⁰¹ See Part V.A.2 (page 35). The statutory formula of section 6226 allows a partner otherwise subject to the section 1401 or 1411 taxes to disregard those taxes in computing the additional amount owed as a result of the section 6226 election, whereas section 6225(c)(2) would appear to require that partner to take into account those taxes. (This is because section 6226 requires the partner to take into account the additional taxes the partner would owe “under chapter 1,” and sections 1401 and 1411 are contained in chapters 2 and 2A, respectively.) The rationale for excluding the chapter 2 and 2A taxes from the section 6226 computations is not clear. It could result in the section 6226 election taxes being lower than the section 6225(c)(2) taxes would have been. One might say that this counteracts the impacts of the section 6226 increases-only rule and the interest surcharge, but we do not believe that was the intent or will be the effect.

²⁰² See Part VII.B.4 (page 72).

If it is determined that this aspect of section 6226 is to stay in place (and not be statutorily corrected), then it is even more important that the rules implementing section 6225 be as fair as possible and get all the partners as close to Correct Return Position as possible. This also means, however, that the IRS and Treasury should consider how if at all they can add in protections for partners who may be seriously disadvantaged if a partnership representative selects section 6226 rather than proceeding under section 6225. We would be happy to address this in further detail once some of the preliminary decisions about approach have been made.

IX. PARTNERSHIPS THAT CEASE TO EXIST OR THAT HAVE INSUFFICIENT ASSETS

As discussed above, under the BBA regime if an FPA results in an imputed underpayment the partnership alone is liable for that imputed underpayment *unless* (i) the partnership elects to apply section 6226, (ii) the partners elect to file amended tax returns pursuant to section 6225(c)(2), or (iii) the partnership has ceased to exist under section 6241(7).

This Part IX focuses on this last case: section 6241(7) provides that if a partnership (i) “ceases to exist” before a partnership adjustment under this subchapter takes effect, then (ii) such “adjustment shall be taken into account” by (iii) the “former partners” of such partnership “under regulations prescribed by the Secretary.”

This provision raises many questions but this Part IX focuses on the meaning of its three key elements:²⁰³ First, *who* are the former partners? Second, *what* happens when section 6241(7) applies? Finally, *when* does the provision apply (*i.e.*, when does a partnership cease to exist)? This Part IX then addresses what rules and procedures should apply to a partnership that has not ceased to exist but cannot pay the imputed underpayment in full because it has insufficient assets.

We view these questions as critical to the design and implementation of the BBA because in order to ensure the integrity of the BBA regime and to avoid creating inappropriate incentives, (i) it is essential that the regime be consistent and coherent and thus that the aggregate tax collected

²⁰³ There are many issues raised by § 6241(7) that are not addressed in this report, including: (i) whether a partnership that has become a “disregarded entity” has ceased to exist or instead is treated as “the partnership” that it used to be, (ii) in the case of the merger of two or more partnerships or the division of a partnership into two or more partnerships, which, if any, of the partnerships has ceased to exist for this purpose and what rules should apply (§ 708 and the regulations promulgated thereunder provide rules for determining which partnership is a continuation of which and which partnerships have terminated or are new, but those rules do not necessarily need to apply for purposes of § 6241(7)), (iii) if § 6241(7) applies to an audited partnership and one of that partnership’s “former partners” is itself a partnership that has ceased to exist, what rules should apply and (iv) if an audited partnership makes a section 6226 election and one of its partners for the reviewed year was a partnership that has since ceased to exist, should § 6241(7) apply in that case or should some other rules apply.

with respect to an FPA issued to a partnership that has ceased to exist be consistent with the tax that would have been paid if the partnership had not ceased to exist (and ideally consistent with the Correct Return Position), and (ii) it is important that partners not have an incentive to leave partnerships in existence (or cause them to cease to exist) in order to reduce the IRS's ability to collect the tax due with respect to an FPA.

A. Who is a Former Partner?

Section 6241(7) requires the “former partners” to take into account the adjustments resulting from the FPA but does not define that term. Similarly, the BBA Bluebook does not provide any guidance on what the term means in this context. Conceivably, the term could refer to (a) reviewed year partners, (b) the persons that were partners in the entity just before the partnership ceased to exist, or (c) any and all partners.

In thinking about this issue there are (at least) two key considerations to keep in mind.

First, section 6241(7) appeared for the first time in the Renacci Proposal for the reform of the partnership audit rules.²⁰⁴ That proposal also imposed separately “joint and several liability” on all the partners with respect to the amounts due under section 6225.²⁰⁵ (Precisely which partners were so liable was not entirely clear.)²⁰⁶ As discussed above,²⁰⁷ the joint and several liability construct was not adopted in the BBA, so this suggests that section 6241(7) was not intended to result in a joint and several liability of all of the former partners.

²⁰⁴ See note 60 and accompanying text.

²⁰⁵ In the Renacci Proposal, the “ceased to exist” provision was identical to the BBA provision.

The Renacci Proposal's joint and several provision read as follows: “The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto.” Renacci Proposal § 6241(d)(1).

²⁰⁶ The Renacci Proposal also had a definition of the term “partner” (a provision also not included in the BBA): “The term ‘partner’ means – (A) a partner in the partnership, and (B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly income, gain, deduction, or loss of the partnership.” Renacci Proposal § 6241(a)(2).

For a partnership that was still in existence, it could be read as meaning only the current partners at the time the section 6225 payment was due, or it could be read as meaning any person who was ever a partner. For a partnership that had ceased to exist, it could be read to mean any person who was ever a partner. There is no indication in the wording that it was intended to be limited to reviewed year partners.

²⁰⁷ See Part IV.A (page 21).

Second, because whether the partnership has “ceased to exist” will be an intensely factual question²⁰⁸ it will be open to uncertainty and disputes and, to a certain extent, will be subject to planning by taxpayers if the FPA results in a truly significant tax liability. Defining the term is going to require line-drawing and there are inevitably going to be some unexpected consequences. For these reasons, it would be preferable to implement section 6241(7) in a way which minimizes the consequences of it applying or not applying.

We believe that the most appropriate interpretation of section 6241(7) is that “former partners” means the reviewed year partners and that the adjustment should be allocated among them in accordance with the partnership agreement for the reviewed year. There are several reasons for this recommendation.

First, the imputed underpayment regime is a collection mechanism. The taxpayers who should have been allocated the items in the FPA, and paid taxes thereon, are the reviewed year partners. They were also (presumably) the ones in charge when the under-reporting occurred. If collecting from the partnership is not an option (in other words, if the collection mechanism is not able to be utilized) and the IRS is required to go after individual former partners, it would seem that the IRS might as well go after the “right” former partners. If those partners are difficult to find or do not have sufficient assets, reverting to other former partners seem to be reintroducing the “joint and several” liability construct that was removed (apparently deliberately). The only argument we can see for interpreting this provision to mean that the IRS should be collecting from the dissolution year partners (and not the reviewed year partners) would be that the dissolution year partners cause the partnership to cease to exist in order to escape the section 6225(a) liability. If, however, that is the situation in any particular case, there should be state law fraudulent conveyance statutes that could be called upon. The possibility of this behavior should not result in a rule for all cases that imposes the liability on the dissolution year partners instead of the reviewed year partners.

Second, this result is the closest to Correct Return Position, prevents moving the liability or benefit from the reviewed year partners to other partners, and avoids the double taxation risk we have discussed in other parts of this Report.

Third, as a fairness matter, there is no reason to impose a direct tax liability on a partner for income that was allocated to another person (which happened to own an interest in the same partnership).

Fourth, asking dissolution year partners to bear the liability for taxes on income allocable to other partners would negate the limited liability on which partners rely when they invest in most modern partnerships. (This would go significantly further than section 6225, which places the tax

²⁰⁸ See Part IX.C (page 98).

burden on the partnership, not the partners.) This risk would significantly disrupt the marketplace. In addition, it could perversely create incentives for savvy partners to “rush to the exit” when a partnership is getting closer to ceasing to exist to ensure that they are not left liable for all future adjustments resulting from on-going or future audits.

One countervailing consideration is that interpreting section 6241(7) in this way may encourage the partners in a partnership that is under audit and anticipating a material adjustment to cause that partnership to “cease to exist” to avoid having to bear the section 6225 tax (particularly if the partnership or the current partners do not have indemnity rights against the reviewed year partners). We believe that this risk is limited however. First, a partnership will not want to “cease to exist” except in the most extreme cases. Second, section 6226 already provides partnerships with the ability to push out the liability to reviewed year partners.²⁰⁹ Third, the regulations could include rules that address abusive scenarios and perhaps special rules for partnerships that cease to exist during an IRS audit. For instance, if a partnership liquidates or ceases to exist while an audit is conducted (*i.e.*, before an FPA is issued) then, unless the partnership can establish that the liquidation or termination was planned before it was notified of the audit and was motivated by nontax reasons, the IRS could have the option of collecting from the dissolution year partners up to the value of assets they received in the dissolution. The IRS would also have the ability to pursue state law remedies such as fraudulent conveyance claims. Finally, the partnership division rules of section 708 already provide safeguards to avoid liquidations that are only liquidations in form and not in substance and they could apply equally in the BBA context.²¹⁰

B. What is the Liability of the Partners?

Once we conclude that the “former partners” under section 6241(7) are the reviewed year partners, we still need to understand what the requirement that the audit “adjustment shall be taken into account by the former partners” means. The answer depends, in part, upon whether section 6241(7) is an additional collection mechanism that can be used when a partnership has ceased to exist or is instead the only available collection mechanism when a partnership has ceased to exist.

Specifically, when section 6241(7) applies, does that turn off section 6225 and thus eliminate the liability of the partnership? This is relevant for two different reasons. First, under applicable non-tax laws, there may be persons that are liable for the debts of a partnership that has ceased to exist: for instance, a general partner (if the partnership is organized as a limited or

²⁰⁹ Although, as discussed in Part XI (page 120), there may be limitations on this ability to push out the liability.

²¹⁰ Treas. Reg. § 1.708-1(d).

general partnership).²¹¹ Should those persons (if any) be relieved of their state-law liability for the partnership's debt to the IRS just because the partnership has "ceased to exist"?²¹²

Since the BBA payment regimes are a means of collecting the taxes resulting from an adjustment, once a partnership has ceased to exist it seems logical that these rules should not apply and that section 6241(7) be the only way for partners and the IRS to account for the consequences of an adjustment. Section 6225(a) states that "the partnership shall pay" and section 6241(7) applies only "where partnership ceases to exist". It is possible that the drafters of section 6241(7) assumed that either the partnership was available to pay or it was not, and did not consider the possibility that the partnership might be gone but there might be another person who would be liable under state law to pay the partnership's section 6225(a) obligation. We are not commenting on whether the IRS should try to pursue state law claims against former partners. Rather, we are trying to ascertain what the drafters and enactors of section 6241(7) intended.²¹³

Second, if section 6225(a) is not turned off, then does the ceased-to-exist partnership have the option of making a section 6226 election and, if it does not make that election, do the reviewed year partners have the option of filing section 6225(c)(2) amended returns? As we discussed above, it would be preferable if section 6241(7) were implemented in a way which minimizes the consequences of it applying or not applying. It would be contrary to the goals of the BBA if this provision gave rise to a significant number of disputes over whether it does or does not apply in specific cases. As we noted above, the determination in each case will depend upon the facts and the partners will be able to influence what the facts are.

We believe that the most appropriate interpretation of section 6241(7) is that the rules and procedures of section 6226 should apply. Once we conclude that the appropriate former partners are the reviewed year partners, requiring them to take into account the adjustments logically means taking into account the adjustments as the items would have been allocated to them under the

²¹¹ This may not be particularly helpful in practice as most general partners are organized as limited liability entities and would not own assets in excess of what they legitimately believe is necessary to fulfill their role.

²¹² The precise wording of section 6225(a) is "the partnership shall pay any imputed underpayment...in the adjustment year."

²¹³ It may well be that the IRS will have a claim both under section 6225 with respect to the general partner of the partnership and the right to seek a payment from the reviewed year partners under section 6241(7). In such a case, procedures will need to be established to coordinate the two collection processes and avoid over or under collection.

partnership agreement for the reviewed year. Doing this by applying the section 6226 regime prevents the need to create a special regime.²¹⁴

One issue, however, is that section 6226 has some adverse consequences for reviewed year partners that are not present under Correct Return Position, section 6225(a) and section 6225(c)(2) (this includes the two percent increase in underpayment interest rate as well as the various issues discussed in Parts V.A.3, VIII, and X of this report). Should these adverse aspects of section 6241(7) apply when section 6226 is being forced onto a ceased-to-exist partnership (as opposed to chosen by a partnership)? This is a difficult question. We have considered the possibility that for ceased-to-exist partnerships, the section 6226 regime apply with the following three modifications: (i) no increased interest rate, (ii) no limitation on taking into account tax reduction years in computing the aggregate additional taxes (or refund) due with the partner's return which reflect the section 6226 information, and (iii) no limitation on the number of tiers of push-out.

On the one hand, it seems hard to justify imposing these adverse consequences on the reviewed year partners in this context. In the case where a partnership is still in existence, the adverse consequences of section 6226 can be rationalized as a mean to incentivize the partnership to proceed under section 6225. That paradigm does not apply if the partnership has ceased to exist and is not permitted to (or able to) proceed under section 6225. Because the language of section 6241(7) is quite broad and specifically grant regulatory authority to implement the manner in which the FPA adjustments shall be taken into account, we believe that Treasury and the IRS have the statutory authority for this approach.

On the other hand, the more different the regime is from the ordinary BBA regime, the greater the incentive for partnerships to try and plan into (or out of) section 6241(7). It seems particularly inappropriate for a partnership to even have the choice of different collection rules and the ability to engineer into the one it believes will be benefit it. (For example, wanting to use section 6226 but for these three adverse consequences, so causing itself to “cease to exist.” Conversely, wanting to use section 6225 (and possibly section 6225(c)(2)) so stretching out its life

²¹⁴ We have considered the argument that section 6241(7) could not possibly mean a required section 6226 because the same provision was in the Renacci proposal where there was no corollary to section 6226. The Renacci proposal did, however, include section 6225(c)(2); and under that proposal, the liability was either borne by the partnership (and adjustment year partners) under 6225(a) or by the reviewed year partners pursuant to section 6225(c)(2). There were no other options (other than the joint and several liability which kicked in only if the partnership did not pay the imputed underpayment and that option was not enacted into law). Thus, if we were faced with implementing the Renacci proposal, we believe we would be recommending that it also be interpreted such that “former partners” means the reviewed year partners and that a section 6225(c)(2)-like mechanism be implemented.

and remaining in existence.) There are, however, limits on a partnership's ability to foresee all of this far enough in advance to "cease to exist" in a manner that would not backfire for the reasons discussed above. But having such rules in place could create incentives, not to mention confusion, controversies and collection problems.

C. "Cease to Exist" and Partnerships with Insufficient Assets

The next issue is the scope of section 6241(7). Section 6241(7) applies to a partnership that has "ceased to exist"—this is a new terminology that is not found in either Subchapter K or the TEFRA rules. (The term was used in the ELP regime but there is no guidance as to its meaning in that context.)²¹⁵

Under section 708, a partnership "terminates" in two cases: (a) when 50% or more of the total interests in the partnership's capital and profits are transferred within a 12-month period (a "**technical termination**"), and (b) when no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership (a "**no further activity termination**"). Are those tests relevant?

First, it seems clear that a technical termination should not justify an alteration in how the BBA rules apply. The "new" partnership is considered the successor to the prior, terminated, partnership. That reading is confirmed by the BBA Bluebook which notes that "the successor partnership in a technical termination succeeds to the adjustment or imputed underpayment, absent regulations to the contrary."²¹⁶

Second, a partnership which has no further activities, and thus has terminated under the no further activity termination rule, should be considered to have "ceased to exist"; but should "ceased to exist" be exactly the same test as the no further activity termination test under section 708(b)(1)(A)? To date, courts have followed a very literal reading of section 708(b)(1)(A) to find that even minimal activities are sufficient to cause a partnership to remain in existence. Indeed, even a bankrupt partnership is not necessarily terminated for this purpose.²¹⁷ In keeping with this analysis, the BBA Bluebook indicates:

²¹⁵ Pre-BBA § 6255(d).

²¹⁶ BBA Bluebook, at 80.

²¹⁷ See *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519 (9th Cir. 1969) (partnership still in existence because it retained a note received in exchange for its operating assets); *David A. Foxman*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965); *Harbor Cove Marina v. Comm'r*, 123 T.C. 64 (2004) (partnership which had liquidated for state law purposes and distributed most of its assets was still in existence in light of the dispute as to one of the partner's liquidation entitlement). See WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT

footnote continued

*A partnership that terminates within the meaning of section 708(b)(1)(A) is treated as ceasing to exist. In addition, a partnership also may be treated as ceasing to exist in other circumstances, based on other factors under regulations provided by the Secretary.*²¹⁸

Thus “cease to exist” likely encompasses some partnerships that have not terminated within the meaning of section 708(b)(1)(A)—however, what will be the limit? How broadly should this term be defined? What happens if a partnership has insufficient assets to pay the imputed underpayment?

There are at least three categories of partnerships that could be in that situation. We discuss them below and discuss possible ways of addressing the issue.

1. Three Categories of Partnerships

(a) Category A: Fraudulent Transfers

Category A consists of partnerships that had sufficient assets to pay the imputed underpayment but distributed those assets to their partners before the section 6225(a) liability became due in a manner that may qualify as a “fraudulent transfer” under state law (but the partnerships otherwise have not terminated under section 708(b)(1)(A)). Section 6241(7) on its face may not apply to this category of partnerships since they have not ceased to exist (and may have even retained a relatively small business).

In this case, the IRS may be able to collect the section 6225(a) payment from the transferee partners by using a state law fraudulent conveyance statute to claw back from those partners the amounts that were distributed when the partnership knew or should have known of the section 6225 liability. This however, is not an ideal solution, because these claims are by their nature extremely fact specific and will require the IRS to devote significant resources to the issue without any guarantee that it will be able to recover from the transferee partners.

(b) Category B: Partnerships With Minimal Activities or Assets

Category B consists of partnerships that have ceased most of their activity but for some reason fall short of having been “terminated” under section 708(b)(1)(A). Many partnerships with insufficient assets may fall into this category.

L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 13.02; and WILLIS & POSTLEWAITE: PARTNERSHIP TAXATION (WG&L) ¶ 16.02.

²¹⁸ BBA Bluebook, at 80. *Id.*

While the IRS may interpret section 6241(7) to apply to these partnerships (drawing on the BBA Bluebook for support), designing the regulatory test will require line-drawing and applying it could result in intensely factual controversies and significant uncertainty for all involved.

(c) Category C: Non-Fraudulent, Active Partnerships With Insufficient Assets

This category consists of partnerships that are engaged in active businesses, with no intention to terminate, but that at the time the FPA is issued have asset balances that are less than the imputed underpayment as a result of non-fraudulent factors. This may occur in many cases, for example, (i) a service partnership will commonly distribute its profits annually and retain only the assets it needs to operate its business (the net value of which may be less than the section 6225(a) liability), (ii) an investment partnership will commonly be required or expected to distribute the proceeds of every asset disposition as the dispositions occur, such that during its final years it will hold fewer and fewer assets, and (iii) a partnership's affairs may deteriorate such that, while it is active, its assets have significantly declined in value.²¹⁹

Unlike Category B partnerships, these partnerships are actively engaged in business operations with no intention to terminate. Further, the lack of assets at the partnership level in these partnerships is not due to any so-called fraudulent transfer thereby precluding any state law fraudulent conveyance avenues that might be available with respect to Category A partnerships.

2. Options

Unless section 6241(7) also applies to partnerships falling into Categories A, B and C, there currently appears to be no efficient way for the IRS to collect the imputed underpayment in these scenarios.

If the Withholding Tax Approach is adopted, the inability of the partnership to pay the full amount would be mitigated by the IRS's ability to seek the remaining tax due from the reviewed-year partners individually. However, the issue will still be relevant because there will be questions as to what to do when a partnership has some assets but not enough to pay the section 6225 imputed underpayment: should the IRS collect from the partnership first? Should it be allowed to go directly against the partners? (And if so, how should the IRS establish that the partnership truly has insufficient assets?)

²¹⁹ An important issue but one that we do not delve into here is what should be done if a partnership has valuable assets but they are not liquid assets (or assets that would be easily liquidated) or their value is not easily determined.

If the Withholding Tax Approach is not adopted, the issue is compounded because (a) rules need to be established to determine whether the IRS can and should seek to collect from the partnership, and (b) there is also a question as to whether, and how, the IRS can collect the tax liability from other persons. We recommend that the IRS bring to bear its experience in the withholding and collection area on the first question: it may not always be beneficial to try to liquidate a partnership's assets if it is not clear that there will be sufficient proceeds to satisfy the imputed underpayment. This Part IX.C.2 focuses on the second question: *i.e.*, what options are available for addressing how to collect the section 6225(a) liability when the partnership has insufficient assets?

(a) Option 5.A: Broad Interpretation of “Ceases to Exist”

Interpret “ceases to exist” broadly: For example, (1) any partnership that has stopped active business operations “ceases to exist,” and (2) any partnership whose net assets at the time of the FPA are less than some percentage of what its net assets were during the reviewed year “ceases to exist.” These definitions rely on very fact-specific inquiries and tests and may be very difficult to apply and to defend against claims that they result in similarly situated taxpayers being treated very differently.

An alternative (Option 5.A(1)) would be to view any partnership whose net assets are less than its section 6225(a) liability as insolvent and therefore having “ceased to exist.” This interpretation may create some tension with the statutory text of section 6241(7), which very explicitly states that it applies when the partnership “ceases to exist *before a partnership adjustment under this chapter takes effect.*” It is not necessarily inconsistent however. We read the italicized language as a temporal reference not a causal one: section 6241(7) applies if the partnership ceased to exist before the FPA was issued (and by contrast, if a solvent partnership decides to liquidate or to cease to exist after the FPA is issued, section 6225 and section 6226 will continue to apply). The argument for this reading would therefore be that the partnership was insolvent before the FPA was issued: the contingent section 6225 liability arose from the moment the partnership filed an incorrect Form 1065 (and the FPA merely crystallized it).

(b) Option 5.B: Partnership Liability Only

Treat the section 6225(a) payment as a partnership liability, like any other liability, and thus collect only to the extent allowed by state law.

On the one hand, if the Withholding Tax Approach is not adopted, this option would seem consistent with the general approach that the section 6225 payment is the final payment. On the other hand, this would result in an illogical discrepancy between the situation where the partnership has liquidated or otherwise meets the “ceased to exist” test (where the IRS is free to collect from the “former” partners directly) and a situation where the partnership is still in

existence. This could incentivize partners to leave partnerships “in existence” until all statute of limitations on possible tax liabilities have closed.

(c) Option 5.C: Several Liability

Treat each reviewed-year partner as severally liable for its share of the section 6225(a) imputed underpayment if the partnership does not pay it. We do not favor this option, because, for the reasons discussed above,²²⁰ we do not believe reviewed year partners should be required to pay their shares of a section 6225 payment when the parties can compute the Correct Return Position.

(d) Option 5.D: Deemed 6226 Election

Allow the IRS, when faced with a partnership that has insufficient assets to satisfy the section 6225(a) liability, to deem that partnership to have made a section 6226 election, such that the reviewed-year partners are liable.

This approach has the benefit of using the section 6226 mechanism (and thus avoiding the need to create yet another collection mechanism) and, if our other recommendations are followed, being identical to what happen if the partnership met the “ceased to exist” definition. However, there seems to be no statutory basis for the IRS to deem such an election as a result of a partnership not having sufficient assets to pay the imputed underpayment.

(e) Recommendation

We believe that the statute should not permit the imputed underpayment to go unpaid and the former partners to have no liability for the taxes due. As noted above, this will create incentives and opportunities for manipulation that could and should be avoided. Thus, we do not favor Option 5.B.

Based on the current wording of the statute, we believe that the IRS has sufficient statutory basis for Option 5.A(1) but not for the other options. If section 6241(7) is interpreted consistently with our recommendations as resulting in a deemed section 6226 election, there may not be material differences between Option 5.A(1) and Option 5.D. Accordingly, we recommend that the IRS implement Option 5.A(1). However, because this issue is a significant collection risk for the IRS, we also recommend that Congress consider clarifying further section 6241(7) to eliminate any ambiguity as to its scope.

²²⁰ See Part IX.B (page 95).

X. TIERED PARTNERSHIP STRUCTURES

This Part X addresses what is one of the most vexing technical issues raised by partnership audits and the BBA, namely how the BBA regime, and in particular section 6226, can apply efficiently and fairly in the case of tiered partnership structures.²²¹

A. The Issue

Before we delve into the discussion, some context may be helpful. This Part X.A (a) introduces some nomenclature and (b) briefly surveys how tiered partnership structures are handled in the withholding tax context.

1. Nomenclature

By “tiered partnership structure,” we mean a structure where one or more of the partners in a partnership is itself a partnership. We use the term “source partnership” to refer to the partnership that is the lowest one in the chain and that is directly generating the items of income, gain, loss, deduction or credit that are being audited by the IRS in a BBA audit. Above the source partnership there may be multiple tiers of partnerships. In other words, if one of the entities holding a partnership interest in the source partnership is itself a partnership (we refer to these as “pass-through partners” or “upper-tier partnerships”), that upper-tier partnership may have partners which are also partnerships and so on. In addition, the entity we are calling the “source partnership” may not be the only partnership in the chain directly generating items of income, gain, loss, deduction or credit: Upper-tier partnerships may have (and often do have) their own income or loss generating assets, liabilities or activities. Finally, an upper-tier partnership may allocate the items of income, gain, loss, deduction and credit arising from the source partnership differently than it allocates income, gain, loss, deduction and credits that it derives from other sources.

2. Issues Surrounding Tiered Partnership Structures

Multiple recent governmental reports²²² confirm what we knew from our experience as practitioners: the IRS faces a significant challenge in applying the TEFRA rules to tiered partnerships. The multiplication of partnerships in these structures creates a perfect storm that compounds the procedural difficulties inherent in a TEFRA audit. As discussed above,²²³ the

²²¹ Although this Part X focuses on the section 6226 election, similar issues will arise in connection with the application to tiered partnerships of section 6225(c) and in particular the section 6225(c)(2) mechanism.

²²² GAO Report, at 15–17, 24–25; Dep’t of the Treasury, *supra* n. 58, at 235–236; Staff of the Joint Comm. on Taxation, *supra* n. 58 at 265–269; TIGTA Report, at 17, 22.

²²³ See Part III.A.4 (page 17).

primary difficulties reported were finding the TMPs, finding the ultimate non-partnership partners at the top of the chains (for purposes of providing statutory-required notifications, and for purposes of computing the taxes due as a result of the resolution of the audit of the source partnership), and obtaining and applying the allocation provisions of each partnership in the chain in order to trace the items of income, gain, loss, deduction and credit as they make their way up the chain to each ultimate partner. It seems clear that all of the proposals to replace the TEFRA rules, including the BBA, were aimed in large part at addressing these problems.

In addition, if section 6226 is applied to tiered structures, as we think it should be,²²⁴ there are some other unique issues that would not come up in other structures. First, the cascading of reporting implicated by tiered partnerships mechanically creates delays in the filing of tax returns and the payment of taxes. Second, if it wanted to, the IRS must be able to review allocations made at each level in the chain.

At the same time, it is important to acknowledge that tiered partnership structures are becoming more and more common as they enable businesses and investors to achieve various goals (unrelated to U.S. taxes). By way of illustration, the GAO Report mentions that as of 2011, more than two-thirds of large partnerships had at least 100 or more pass-through entities as direct partners.²²⁵ Moreover, in the absence of regulatory relief, all tiered partnership structures will be subject to the BBA with no ability to elect out.²²⁶ Accordingly, the BBA regime needs to work for tiered partnerships, and the implementing rules with respect to tiered-partnerships need to be both fair *and* scalable.

3. Existing Chapter 3 Withholding Tax Regime

Before delving into the implementation of section 6226, it is helpful to summarize how the IRS currently addresses tiered partnerships in the context of “withholdable payments,” meaning payments made to a partnership that are potentially subject to withholding under Chapter 3 of the Code (withholding on “fixed or determinable, annual or periodical income” (or “FDAP” as it is referred to) of a non-U.S. corporation or nonresident alien individual).

In this context, if a partnership (*e.g.*, the source partnership) that receives a withholdable payment is a non-U.S. entity, the payor must withhold at the highest rate *unless* the payor receives a Form W-8IMY from the source partnership that reports either (a) that the source partnership has

²²⁴ As discussed in detail in Part X.C below (page 107), the BBA Bluebook interprets section 6226 such that the adjustment does not tier up beyond the direct partners of the source partnership. If that approach is adopted, issues would not arise.

²²⁵ GAO Report, at 16.

²²⁶ A partnership at the very top of a tier could be eligible to elect out, but all the entities below that will not be.

an agreement in place with the IRS pursuant to which the source partnership effectively agrees to act as the primary withholding agent for that payment or (b) detailed information regarding the identity and tax status of the partners of the source partnership and the allocation of the withholdable payment among them (in which case the payor determines the amounts to withhold, if any, based upon that information). If any of the partners in the source partnership is itself a non-U.S. partnership, then that pass-through partner will have its share of the source partnership's withholdable payment subject to withholding at the highest rate unless that pass-through partner provides to the source partnership documentation type (a) or type (b). If the source partnership has agreed to be the withholding agent, then it will keep this information and withhold any tax due based upon it. Otherwise, it will collate the information and include it in its own W-8IMY that is provided to the payor, which will withhold as necessary on payments made to the source partnership based upon that documentation.

The rules can be quite complex, but the key take-away is that (i) the source partnership and each partnership in the chain has an obligation to obtain documentation from its partners that it can give to payors or the IRS to identify who those partners are (or to suffer withholding at the highest rate if it does not obtain and, where required, turn over that documentation), and (ii) any tax due is withheld from the payment to the source partnership *unless* it, or another partnership in the chain, has assumed the withholding tax obligation.

B. Section 6226

As discussed previously, section 6226 provides a partnership that has received an FPA an alternative to paying the section 6225 imputed underpayment. Looking at the statutory text,²²⁷ it is not clear how section 6226 would apply to a source partnership in a tiered partnership structure.

Section 6226(a)(2) provides that the section 6226 election is effective only if:²²⁸

the partnership... at such time and in such manner as the Secretary may provide, furnishes to each partner of the partnership for the reviewed year and to the Secretary a statement of the partner's share of any adjustment to income, gain,

²²⁷ As discussed in note 224, the BBA Bluebook discusses the application of section 6226 in the tiered partnership context. We discuss this approach in Part IX.C (page 107).

²²⁸ The partnership needs to make the section 6226 election within 45 days of receiving the FPA, but the timing for providing the Section 6226 Statements is explicitly left to the IRS to dictate. BBA Bluebook, at 69 (“The statement is to be furnished to the Secretary and to partners within such time and in such manner as is prescribed by the Secretary. In the absence of such guidance, the statements are to be furnished to the Secretary and to all partners within a reasonable period following the last day on which to make the election under this provision.”).

loss, deduction, or credit (as determined in the notice of final partnership adjustment).

The statute then explains in section 6226(b) what “each such partner” (each recipient of a Section 6226 Statement) is obligated to do as follows (emphasis has been added):

(1) Each partner’s tax imposed by chapter 1 for the taxable year which includes the date the [Section 6226 Statement was furnished to such partner] shall be increased by the aggregate of the adjustment amounts determined under paragraph (2) for the taxable years referred to therein.

(2) The adjustment amounts determined under this paragraph are—

*(A) in the case of the taxable year of the partner which includes the end of the reviewed year, **the amount by which the tax imposed under chapter 1 would increase** if the partner's share of the adjustments described in subsection (a) [i.e., the section 6226(a)(2) text quoted above] were taken into account for such taxable year, plus*

*(B) in the case of any taxable year after the taxable year referred to in subparagraph (A) and before the taxable year referred to in paragraph (1), **the amount by which the tax imposed under chapter 1 would increase** by reason of the adjustment to tax attributes under paragraph (3).*

The term “chapter 1” refers to chapter 1 of subtitle A of the Code, which consists of sections 1 through 1400U-3. To state the obvious, entities that are partnerships are not subject to tax under chapter 1.

Thus, it is not clear from these provisions (i) what a source partnership in a tiered partnership structure needs to (or may) do, (ii) what its pass-through partners need to (or may) do and (iii) whether there are any options. For example, does section 6226(a)(2) (the first provision quoted above) mean that the source partnership provides the notice to its immediate partners?²²⁹ If

²²⁹ Notably, the BBA uses the term “partner” without defining it. By contrast, both TEFRA and the Renacci Proposal defined the term and did so in a way that included both direct and indirect partners.

TEFRA defined “partner” as “(A) a partner in the partnership, and (B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.” (Pre-BBA § 6231(2).)

The Renacci Proposal similarly defined “partner” as “(A) a partner in the partnership, and (B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly income, gain, deduction or loss of the partnership.” Renacci Proposal § 6241(a)(2).)

The BBA’s silence is a gap that regulations should be able to fill.

so, how can pass-through partners, who are not subject to tax under chapter 1, comply with what is required by section 6226(b)(1) (the second quoted provision)? Moreover, the amount section 6226(b)(1) obligates the partner to add to its chapter 1 taxes (“the amount by which the tax imposed by chapter 1 would increase” if the adjustments were taken into account by the partner) is an amount that will always be zero for a pass-through partner.

Alternatively, perhaps these provisions mean that the source partnership is supposed to give the notice directly to the ultimate partners at the top of the chain of tiered partnerships since those are the only persons who otherwise have tax “imposed by chapter 1” that “would be increased?” Or perhaps section 6226(b) is supposed to mean that the pass-through partner pays a tax under chapter 1 for the year during which the notice is received? Or is every partnership in the chain permitted to (or obligated to) send the Section 6226 Statement up the chain to its direct partners such that the notices eventually make their way up to taxpayers who otherwise pay tax under chapter 1? And if that is the case, then each partnership in the chain would need to allocate the items of income, gain, loss, deduction or credits reported on the Section 6226 Statement it received among its own partners in accordance with that partnership’s allocation provisions (so there would be some obligation to issue new statements or send out the statement received from the source partnership with a supplement indicating how much belongs to the recipient partner).

C. The BBA Bluebook

1. The BBA Bluebook’s Interpretation of Section 6226

The BBA Bluebook interprets section 6226 to mean that the push-out stops at the source partnership’s direct partners (*i.e.*, it goes up one tier only). The BBA Bluebook solves the “chapter 1” problem (which it does not explicitly acknowledge) by explaining that any pass through partner that receives a Section 6226 Statement must pay the tax attributable to the adjustments with respect to the reviewed year and the intervening years “calculated as if it were an individual (consistently with section 703), for the taxable year that includes the year of the statement.”²³⁰

The BBA Bluebook does not address how this payment will be characterized for the pass-through partner (*e.g.*, is this a section 6225 payment by that partnership?), whether the pass-through partner and its owners are authorized to make correlative adjustments (*e.g.*, outside and inside basis adjustments), and whether the payment by the pass-through partner will be the final payment of the tax resulting from the section 6226 election.

²³⁰ BBA Bluebook, at 70.

This approach strikes us as difficult to justify. First, it is not clear whether the statutory language permits such a reading because section 6226(b) refers repeatedly to the tax imposed on such partner “*under chapter 1*”, and there is no mention of treating a pass through partner as if it were an individual in order to compute that amount of tax. Second, the result seems to conflict with the BBA’s acknowledgment that the attributes of the partners (particularly, if they are tax-exempt)²³¹ should be taken into account when computing the amount due. For instance, if the source partnership has any direct tax-exempt or foreign partners, under all three BBA payment methods, their share of the FPA adjustments would not be taxed (assuming it would otherwise not be taxed under chapter 1). Under the BBA Bluebook approach, if the tax-exempt or foreign partners are indirect partners, their share of the FPA adjustment would be taxed as if those partners were U.S. taxable individuals. Third, the approach unfairly imposes an adjustment-year entity level tax on the pass through partner entity even though it did nothing “wrong” here: As required by section 6222, it reported its income consistently with the K-1 it received from the source partnership. Indeed, it may not even have a say in whether the source partnership makes a section 6226 election. This would mean that any partnership that has invested in another partnership can become subject to entity-level taxes regardless of whether its own reporting is correct. Finally, from an administrability perspective, this system could create perverse incentives if the pass-through partner is the final taxpayer because pass-through partners (*i.e.*, intermediate partnerships) could essentially become “liability blockers”: if that intermediate partnership is a limited liability entity, the ultimate partners would be able to protect their other assets from the IRS’s reach.²³²

2. Illustration Of Bluebook Approach to Tiered Structure: Example 12

(a) Facts

A source partnership (“**SP**”) has two 50-50 partners: (i) individual A (subject to the highest marginal rate of 39.6%)²³³ and (ii) a pass-through partner (“**MP**”).

MP itself has two partners, a tax-exempt entity (“**TE**”) and a pass-through partner (“**UP**”).

Finally, UP is owned 50-50 by two domestic corporations (“**DC1**” and “**DC2**”).

²³¹ § 6225(c)(3).

²³² Treas. Reg. § 1.701-2 as well as several judicial doctrines place limits on the use of partnerships, but not every situation will be clearly abusive, and we believe that it would be better not to have to resort to these doctrines in order to collect the additional taxes as a result of an audit of a tiered structure.

²³³ We ignore §§ 1401-1411 in all the examples in this section.

No partner has income or loss other than the items that are allocated to it from the partnership in which it is invested; the income allocated to TE is not unrelated business taxable income to TE.

In 2020 as part of an audit, the IRS concludes that SP had an additional \$1 million of ordinary income in 2018.

We compare below the tax that would have been paid under the Correct Return Position, the section 6225 payment mechanism, and the BBA Bluebook's interpretation of the section 6226 mechanism.

(b) Correct Return Position

- If SP had filed a correct Form 1065 in 2018, each of A and MP would have been allocated \$500,000 of additional income. A would have paid \$198,000 of additional taxes ($\$500,000 \times 39.6\%$).
- MP would have in turn, allocated \$250,000 to each of TE and UP. TE would not have paid taxes.
- UP would have allocated \$125,000 to each of DC1 and DC2, and they would have each paid \$43,750 of taxes.
- Aggregate Additional Taxes Collected in 2018: \$285,500 (\$198,000 paid by A + \$43,750 paid by DC1 + \$43,750 paid by DC2).

(c) Section 6225 Payment

- If SP does not avail itself of section 6225(c), its liability would be \$396,000 (plus interest). If the Withholding Tax Approach is adopted, the various partners in the structure will be able to file for a refund such that the aggregate additional taxes collected will be equal to the Correct Return Position.
- If (i) SP relies on section 6225(c), (ii) the implementing regulations enable SP to look-through the tiers of partnerships *and* (iii) SP can prove that DC1 and DC2 are corporations and that TE is tax-exempt, then (a) the additional income that is (indirectly) allocable to TE (\$250,000) is not subject to an imputed underpayment and (b) the additional income that is indirectly allocated to DC1 and DC2 (\$250,000) is subject to tax at a 35% tax rate instead of 39.6%. This means that the imputed underpayment would have been: $\$500,000$ (income allocable to A) $\times 39.6\%$ + $\$250,000$ (income allocable to DC1 and DC2) $\times 35\% = \$285,500$, plus interest (*i.e.*, ignoring the interest charge, the same as Correct Return Position).

(d) BBA Bluebook

- Once SP elects the application of section 6226, A will have to pay taxes on its allocable share of SP's additional income (\$500,000) and MP is subject to tax as if it were an individual. In other words, the partners together pay taxes of \$396,000 ($\$500,000 \times 39.6\% + 500,000 \times 39.6\%$), plus interest even though none of MP's partners are individuals, and half of MP's income is allocable to TE, who is tax-exempt.
- The tax collected (\$396,000) is 38.7% higher than what it would have been under section 6225 or under the Correct Return Position (\$285,500).

D. Options

Because we view the BBA Bluebook's approach as problematic, this Part X.D sets out five options for implementing the section 6226 regime in a tiered structure. Given the wording of the statute, we believe that each one of these options would be a reasonable interpretation that is within the Secretary's authority.

1. Option 6.A: No Election

A partnership that has a pass-through partner cannot make a section 6226 election. The rationale for this option is that the regime cannot work in the case of pass-through partners because a pass-through partner would technically not be liable for any tax with respect to the items shown in such Section 6226 Statement (because the pass-through partner has no tax otherwise due under chapter 1 to which this tax could be added and no way to compute its tax on these items under chapter 1 since it is not subject to tax under chapter 1).

In Example 12, this means that SP is required to proceed under section 6225.

The main benefit of this approach is that it is relatively easy to apply in most cases (although we hope that the IRS would put in place mechanisms to allow tiered partnership structures to avail themselves of section 6225(c)).

What are the drawbacks? Setting aside the obvious issue of horizontal equity, one downside is that it will discourage the use of tiered-partnership structures, and, as we discussed there are perfectly legitimate reasons for their use. We do not believe that tax procedure should have such a significant impact on economic conduct. In addition, this option may become difficult to implement because the partnership may not know whether its partners are pass-through partners (although presumably the reporting rules could be modified to require partners to provide that information to its partners). Finally, the IRS will have to deal with complicated issues when dealing with mistaken section 6226 elections in situations where the partnership wrongly thought that it did not have a pass-through partner and made a section 6226 election when it should not

have. What should happen then if the partners that receive the incorrect Section 6226 Statement filed their tax returns on that basis? Should the IRS refund the tax to them and then seek a section 6225 payment from the partnership? Alternatively, should the payment reduce the taxes due by the partnerships under principles similar to section 6225(c)(2)?

2. Option 6.B: Modified BBA Bluebook—Push-Out (One-Tier Only) the Section 6225 Payment Obligation

(a) Description

The partnership that received the FPA would send Section 6226 Statements out to its direct partners, who would be obligated to pay their shares of the additional taxes due to the IRS. In the case of any direct partner that is itself a partnership, the amount it would be obligated to pay would be its share of the source partnership's section 6225 imputed underpayment. Thus, each Section 6226 Statement could set out the recipient partner's share of both (i) the adjustments to the source partnership's items made by the FPA (which the partner would take into account if the partner is otherwise subject to tax under chapter 1) and (ii) the section 6225 imputed underpayment that was computed and shown in the FPA issued to the source partnership (which would be relevant to any partner that is a pass-through entity). A pass-through partner would pay that second amount. (This is different from the BBA Bluebook which suggests pushing out the adjustments only and having the tax due from the pass-through partner computed as if the pass-through partner were an individual.) For purposes of the interest rate applied, the section 6226 interest rate would apply.

The payment made by the pass-through partner would be treated as a section 6225 payment for the following three purposes:

- *Adjusting the Payment Amount:* The pass-through partner would have the option of reducing the imputed underpayment under section 6225(c). (Another option would be to require the full payment of the section 6225 amount by the pass-through partner and then to permit a section 6625(c) reduction through an AAR-like claim by the partnership.)
- *Insufficient Assets:* If the pass-through partner does not have sufficient assets to pay the tax due, the same mechanism discussed in Part IX (*Partnerships That Cease to Exist or Have Insufficient Assets*) would apply to ensure that the IRS can collect the amount due from that partner.
- *Correlative Adjustments:* The various correlative adjustments resulting from the FPA (both in terms of basis and implications on all the direct and indirect partners' attributes) would occur (and, if the Withholding Tax Approach is adopted, would facilitate achieving Correct Return Position for everyone).

We believe that this option is better than the Bluebook option, but it is not perfect. The same fairness concerns arise (why should the first tier partnership be stuck with the tax liability?). Similarly, there remains an incentive to create pass-through partners that will serve as “liability blockers” (although this would be far less of a concern if the Withholding Tax Approach is adopted). Finally, the mechanism will still be complex because the IRS will still need to implement rules and procedures that allow the first-tier pass-through partners to rely on section 6225(c) and look through the multiple tiers.

(b) Illustration of Option 6.B: Application to Example 12

SP makes the section 6226 election:

- A pays the tax on its additional share of SP’s income, so \$198,000 ($\$500,000 \times 39.6\%$).
- MP: The Section 6226 Statement that MP receives shows (i) \$500,000 of income, and (ii) that MP’s share of SP’s imputed underpayment is \$198,000 ($\$500,000 \times 39.6\%$).

Since 50% of the income is allocated to TE, a tax-exempt, MP can reduce the imputed underpayment using section 6225(c). MP can also establish that since all of UP’s partners are corporations, the 35% tax rate should be used to compute the imputed underpayment. Thus, MP pays \$87,500 ($\$250,000 \times 35\%$).

- In this case, the aggregate amount of taxes paid is \$285,500 (the Correct Return Position liability) plus interest.

3. Option 6.C: Each Tier Has Option to Pay or Push Out to Another Tier

(a) Description

Each partnership in the chain is permitted to either pay or push the liability up another tier provided that each push-out or all the push-outs are completed within a set number of days.²³⁴ (A possible variation on this option would be to limit the number of tiers that have the push-out option; once the entities in that specified tier receive the information, they must pay and cannot push-out any further).

²³⁴ A variation would be to allow the partnership to “mix and match” and thus pay an imputed underpayment allocable to certain partners while “pushing out” a Section 6226 Statement to others. This is not something that the source partnership is allowed to do under the statutory language, but this option would benefit the government (by allowing for a more efficient collection of the tax) and, assuming sufficient safeguards are in place (*cf.* § 6225(c)(2)(B)), should not result in whipsaw.

Each pass-through partner that chooses to (or is required to) pay itself would pay the portion of the source partnership's imputed underpayment allocable to that pass-through partner (under principles similar to Option 6.B).

Each pass-through partner that elects to push out the liability would have to comply with section 6226, including provide the IRS with the details of its allocation (among its partners) of the income, gain, loss, deduction or credits included in the Section 6226 Statement it received. The IRS would thus receive the push-out information from each partnership in the chain that chose to push out.

Practically speaking, this approach will require the partnership to establish a chain of reporting in a way which is quite similar to the way the withholding tax system operates for tiered partnerships:²³⁵ each partnership in the structure has the choice between (a) collecting the tax (which is similar to assuming primary withholding liability), and (b) providing identifying information to the IRS (although the information would not be collected in one document comparable to the W-8IMY provided to a payor, it could all be provided to the source partnership's examining agent or tied back to the source partnership's FPA by requiring each statement to identify the FPA by a unique FPA number assigned by the IRS).

In addition, presumably each partnership would have to be given a reasonable amount of time to decide whether to pay or push out the liability once it has received the Section 6226 Statement. Because this can have a cascading effect, one implication therefore is that the number of days between the source partnership's receipt of the FPA and the final ultimate paying-partners' receipt of the section 6226 information could mean a significant delay until all the additional tax is due to the IRS.²³⁶ This could create a collection risk. Indeed, some may worry that this approach

²³⁵ See Part X.A.3 (page 104).

²³⁶ Section 6226 gives the source partnership 45 days from the issuance of an FPA to elect the application of section 6226, but the statute leaves the timing of the Section 6226 Statement to be determined in regulations and does not require the recipient of the statement to make the payment to the IRS until the due date for its return for the year in which it receives the statement. Since the Section 6226 Statement will need to allocate the items that appear in the FPA (a process that may be as complex as preparing the annual tax return), we expect that the rules will provide a reasonable period for the source partnership to prepare its statement.

In the case of a tiered structure, if push-out by more than one tier is permitted, time frames will be needed. It would be unfair to expect a pass-through partner to decide whether it wants to pay or push-out another tier before it has received the Section 6226 Statement showing the items allocated to it and its share of the imputed underpayment; and if it elects to push-out, it will also need time to allocate the adjusted items amongst its partners.

The statutory rule that provides that the payment is due with partner's return for the year in which the statement is received by the partner could presumably be modified in the case of tiered structures, but even without accelerating that due date, it is easy to see how the payment due dates could be significantly delayed.

may result in more (rather than less) tiered partnership structures. However, the ultimate payments would presumably include interest for the additional period and the interest would be computed at the higher rate of section 6226. In addition, the use of an “outside date” or maximum number of tiers of push-out could limit the collection risk for the IRS. For example, the rule could be that all elections must be made (or all payments are due) before the later of (a) set number of months after the FPA was issued and (b) the due date for the source partnership’s Form 1065 for the year in which the FPA was issued.

(b) Illustration of Option 6.C: Application to Example 12

Once SP has made the section 6226 election, it sends a statement which (i) details the income that each of A and MP is allocated and (ii) their share of SP’s imputed underpayment. There are now three choices:

- **Only SP Pushes Out the Liability:** This is the same result as in Option 6.B (see Part X.D.2(b) immediately above). In this case SP pays no tax, A pays \$198,000 and MP pays \$87,500, for a total tax liability of \$285,500 that is equal to the liability in the Correct Return Position (plus interest).
- **SP and MP Elect to Push Out the Liability, UP Does Not:** if MP elects to push out the liability, MP has no liability.

Looking at MP’s partners: TE also has no liability. UP receives a section 6226-like statement which indicates (i) that UP is allocated \$250,000 of income, and (ii) UP’s share of MP’s section 6225 liability is \$99,000 ($\$250,000 \times 39.6\%$).

Since its partners are corporations, UP can prove that the imputed underpayment should be paid based on a 35% tax rate as opposed to 39.6%, such that UP’s tax liability can be reduced to \$87,500. In this case, the aggregate amount of taxes paid by A and UP is \$285,500 (the Correct Return Position) plus interest.

- **Push-out the Liability all the way:** If UP pushes out the liability to each of DC1 and DC2, UP is not liable for the tax. Each of DC1 and DC2 pays tax on the \$125,000 of income it is allocated or \$43,750. The aggregate amount of taxes paid by A, DC1 and DC2 is \$285,500 (the Correct Return Position liability) plus interest.
- **Conclusion:** the aggregate taxes collected are identical in each case and the same as in the Correct Return Position. The difference between the options is the identity of the payor (ultimate partners or intermediate partnerships) and presumably, the time required for the collection, since the more partnerships in the chain elect to push out the longer it will take for the relevant person to file the tax return and pay the taxes due.

4. Option 6.D: Option 6.C Plus the Source Partnership Must Report to the IRS All Push-Out Data

(a) Description

Option 6.D is the same as Option 6.C, except that if the pass-through partner elects to push-out the liability it must collect the section 6226(a)(2) data with respect to its partners and have the source partnership submit all of that information to the IRS (so that the IRS is notified by the source partnership of the precise persons who owe the taxes and how much income they have been allocated). If the pass-through partner cannot provide this information (including because its partners refuse to cooperate) then there are two options: (i) the source partnership “assumes back” the liability with respect to the unidentified partner and is required to pay the allocable imputed underpayment, or (ii) the pass-through who does not provide the relevant information is denied the ability to push out the liability and must pay the allocated imputed underpayment.

The benefit of this option is that it allows the IRS to have one document (or one set of documents) which precisely maps out the allocation of the income resulting from FPA all the way to the ultimate partners: it “flattens” the structure and largely removes the complications resulting from the tiers of partnerships. The reporting chain becomes quite similar to the Form W-8IMY that is provided to the payor in the withholding tax context. Presumably this would greatly facilitate the audit team’s ability to ensure that the tax that results from an FPA is actually paid. It would also facilitate the review of the allocation method used by the various pass-through partners in the chain.

One issue that this mechanism raises is that there are good commercial reasons for which an upper-tier partner may not want the source partnership to have access to the identity of its partners or to the detail of its allocations and therefore it would not be reasonable to ask a pass-through partner to have to choose between the confidentiality of the information of its own partners and paying the tax.²³⁷ This being said, we believe that it should be possible to design a system that allows for reasonable accommodations of this concern (*e.g.*, allowing a pass-through partner to provide the information directly to the IRS exam team in charge of the audit, or allowing the source partnership to hire a third party to collect this information confidentially from its pass-through partners so that the source partnership does not have access to it, but the IRS can receive all the information at once).

Another issue that will have to be resolved is which of the pass-through partner and the source partnership should bear the tax liability if the pass-through partner fails to provide the

²³⁷ In the withholding tax world, this can be easily addressed by organizing the upper-tier partnership as a domestic partnership (and thus assuming primary withholding tax responsibility instead of passing on the identity of the partners).

information. In our Example 12, if UP refuses to (or cannot) provide the information, should the liability be imposed on SP, MP or UP? As noted above, we believe there are two reasonable options: (a) having the liability revert to the source partnership (SP) (Option 6.D(1)) and (b) imposing the liability on the partnership who refused to provide the information (UP) (Option 6.D(2)). We do not believe that MP should be liable because it is at a procedural disadvantage: the source partnership can push out the liability to the first tier of pass-through partners like MP without requiring their cooperation; but that pass-through partner's ability to push out the tax would depend on the cooperation of its own partners that are pass-through partners, like UP. While in many situations the partnerships in the chain may be incentivized to push all the liability for taxes "all the way out" of the structure, this may not always be the case and the intermediate partnership that is not at fault should not bear the tax.

If and when the source partnership fails to provide all the information to the IRS, we have not reached a consensus on which option between Option 6.D(1) and Option 6.D(2) is the better one.²³⁸

- The benefit of Option 6.D(1) (*Liability For the Source Partnership*) is that the source partnership just underwent audit and is centralizing all the section 6226 information so collecting the tax from the source partnership will presumably simplify collection for the IRS (although there is no guarantee that the source partnership is more creditworthy than the non-cooperative partnership). The drawback is that it means that a source partnership has no control over whether it can or cannot make a section 6226 election in this context: it is also unfair to the other partners in the structure who have filed tax returns based on the Section 6226 Statements they have received and paid their taxes but may now indirectly bear a tax attributable to one of their partners (unless the partnership agreement provides for a specific allocation of that tax and an indemnity from the uncooperative partnership). (This is a concern in general with section 6225, but this scenario where some partners are required to pay taxes because of the section 6226 election and others push back the liability on the partnership exacerbates the issue).
- The comparative advantages and drawbacks of Option 6.D(2) (*Liability For the Uncooperative Partnership*) are the mirror image of those of Option 6.D(1): Option 6.D(2) allows the tax to be borne by the partnership which is truly at fault and refuses to cooperate. It may however require more work for the IRS in terms of collection since the entity was not under audit and before the IRS.

²³⁸ We discuss additional considerations relating to a person's failure to pay the amounts due under the BBA in in Part IX (page 92).

(b) Illustration of Options 6.D(1) and 6.D(2): Application to Example 12

Going back to Example 12, if we apply this approach to the section 6226 election made by SP, then the results should generally be similar to Option 6.C. (see Part X.D.3 immediately above), except that if MP, as the pass-through partner, wants to push out the liability to its partners (TE and UP) instead of paying the tax, it must provide documentation to SP identifying TE and UP and detailing the allocation of income between them.

In addition, because UP itself is a partnership, UP must provide to MP (and MP must then provide to SP) the identity of its partners DC1 and DC2 and the allocation of the income between them. As a result, SP will be able to show the IRS that: (i) \$500,000 was allocated to A, (ii) \$250,000 to TE, (iii) \$125,000 to DC1 and (iv) \$125,000 to DC2.

If UP does not timely provide the information with respect to its own partners, then MP is not liable for the tax since it identified UP and TE, rather:

- **Option 6.D(1):** SP has to pay the imputed underpayment that is allocable to UP, so $\$250,000 \times 39.6\%$ or \$99,000. This would result in a total tax paid of \$297,000 (\$99,000 paid by SP, \$198,000 paid by A). If the Withholding Tax Approach is adopted, DC1 and DC2 can recover the excess tax paid.
- **Option 6.D(2):** UP has to pay the liability, so $250,000 \times 39.6\%$, or \$99,000. This would result in a total tax paid of \$297,000 (\$99,000 paid by UP, \$198,000 paid by A), and as noted above, if the Withholding Tax Approach is adopted, DC1 and DC2 can recover the excess tax paid. In addition, perhaps, UP can establish that the applicable tax rate should be 35% and not 39.6%, such that it would pay \$87,500 for a total tax paid of \$285,500 (the Correct Return Position liability).

5. Option 6.E: Option 6.C, Plus the Source Partnership Must Provide to IRS Proof that the Entire Liability Has Been Paid

(a) Description

Option 6.E is the same as Option 6.C, except that within a prescribed period, the source partnership must provide the IRS with some documentation (as specified in administrative guidance) demonstrating that the entire liability has been paid by the upper-tier partners.

This regime would also rely on a chain of certification, except that, instead of providing the identity of its partners, each pass-through partner would have to certify to the next partnership down that the higher-tier entity's partners have filed their tax returns and reflected the consequences of the FPA as required under section 6226. To the extent a pass-through partnership could not provide the certification with respect to some or all of its partners, then it would be required to pay the amount of the imputed underpayment allocable to those partners (or similar to

Option 6.D(1), the source partnership would be liable). Subsequently, the pass-through partnership would be entitled to a refund of the tax paid if it could demonstrate to the IRS that its partners properly reflected the consequences of the section 6226-like statement they received in their tax returns.

(b) Illustration of Option 6.E: Application to Example 12

If we apply this approach to the section 6226 election made by SP, then the results should generally be similar to Option 6.C (see Part X.D.3, above), except that if MP, as the pass-through partner, wants to push out the liability to its partners (TE and UP) instead of paying the tax, it must collect certificates from its partners attesting that each has paid the taxes owed by reason of the section 6226 election and provide an affidavit to that effect to SP.

Because UP is itself a partnership, UP must collect from its own partners, DC1 and DC2, certificates that they filed their tax returns and paid the taxes due as a result of the section 6226 election. Based on these certificates, UP then issues an affidavit to MP certifying that its partners paid their taxes. Based on the documentation collected from UP and TE (for TE, presumably a certificate that it is tax-exempt and not subject to tax with respect to the income allocated as a result of the FPA), MP provides an affidavit to SP which in turn provides it to the IRS. Each of MP and UP keep all the certifications received from their partners in case the IRS requires further information.

If UP cannot provide the information with respect to its own partners, for instance, because DC1 does not timely file its tax return, then there are two options: similar to the two variations of Option 6.D, either SP or UP is liable for the tax:

- **SP is liable:** SP has to pay the imputed underpayment that is allocable to DC1, so $\$125,000 \times 35\%$, or $\$43,500$.²³⁹ This would result in a total tax paid of $\$285,500$ ($\$43,500$ paid by SP, $\$198,000$ paid by A and $\$43,500$ paid by DC2) which is identical to Correct Return Position.
- **UP is liable:** UP has to pay the imputed underpayment that is allocable to DC1, so $\$125,000 \times 35\%$, or $\$43,500$. Again, this would result in an aggregate tax paid which is identical to Correct Return Position ($\$285,500$).

In either case, if DC1 files its tax returns (paying the $\$43,500$ of taxes due) and provides an affidavit to that effect to UP, the payor (UP or SP) can then apply for a refund of the $\$43,500$ of taxes it paid.

²³⁹ This assumes that SP can prove to the IRS's satisfaction that the income is allocable to a domestic corporation.

E. Analysis

Which of these is the right way to proceed?

1. Legislative Intent

There is very little guidance on the legislative intent of the BBA in general, and section 6226 in particular.²⁴⁰ It is clear that the purpose of the BBA as a whole was to eliminate the difficulties that TEFRA posed for the IRS, which included the difficulty the IRS had at computing and collecting that tax after completing a source partnership audit in a tiered structure. Section 6226 was not in the initial legislation. The initial legislation included only the section 6225(a) payment method, together with the ability to reduce that partnership-level obligation by establishing that individual partners had filed amended returns that reflected the audit adjustments or had tax classifications that justified a reduction in the imputed underpayment. Section 6226 was added shortly before the BBA was enacted; other changes (whether related or not is not clear) during that period included the removal of the joint and several liability at the partner level for the section 6225(a) liability²⁴¹ and the removal of the definition of “partner.”²⁴² In light of this, there are several ways of understanding the role and function of section 6226.

First, section 6226 could be conceptualized as a variant on section 6225(c)(2): a way to allow the reviewed-year partners to compute and pay the additional taxes for the reviewed year (and subsequent year) without having to file amended returns for those prior years. Alternatively, section 6226 could be viewed as a way of eliminating the sharing of the economic burden of the obligation among all the adjustment year partners (which is what happens when the partnership has to pay the tax under section 6225) and instead allowing the liability to be pushed out of partnerships and back to the relevant taxpayer. In the context of tiered partnerships, both of these explanations might dictate that the adjustment needs to be pushed out all the way to the persons who were the ultimate partners during the reviewed years because stopping any earlier in the chain differs from an amended return position and risks causing a person other than the ultimate reviewed-year partner to bear the liability.

Second, another way of understanding section 6226 is to focus on the BBA as a whole and the reasons for its enactment. Viewed in that light, all of the legislation should be understood as intending to ensure that the collection portion of a partnership audit is as simple and effective as is possible (consistent with fairness to the affected taxpayers). Under this understanding of section 6226, providing the source partnership with an option to use section 6226 instead of paying the tax

²⁴⁰ See Part IV.A (page 21).

²⁴¹ See *id.*

²⁴² See note 229, above.

under section 6225 is appropriate only if that option is simple and effective and does not recreate the difficulties that the TEFRA unit has faced in having to determine (and collect) the partner-level deficiencies. When dealing with a single tier of partnerships, section 6226 does eliminate the main concern that was raised by TEFRA, since the partnership is essentially deputized to determine the amounts due by each partner (and the partners pay a higher interest rate charge, presumably to account for the fact that it will be somewhat harder to ensure collection from each and every partner). How does this translate however, to tiered-partnership structures? If the section 6226 regime obligates each partnership in the chain to do nothing more than pass the section 6226 information up to its direct partners, is the IRS sufficiently protected from having to perform the same partner-tracing scavenger hunt that it had to perform under TEFRA?

2. Recommendation

Unsurprisingly, there are no easy answers to these questions. The regime should allow the IRS to collect the tax in a relatively efficient fashion and at the same time, a section 6226 election should not result in imposing a liability on the intermediate entities in the structure that is disconnected from the Correct Return Position. This would only make the BBA collection regime even more complex than it already is and generate a significant amount of unpredictability (and unfairness) for pass-through partners.

Accordingly, as explained above, we believe that the approach discussed in the BBA Bluebook should not be followed. Instead, we suggest a combination of Options 6.D and 6.E, which we do believe is authorized by the statute. Each partnership in the chain should be permitted to either (a) pay its share of the source partnership's section 6225 payment (with the ability to reduce such payment by relying on section 6225(c)) or (b) push out the liability to its own partners. However, as a condition of "pushing out" the liability, each pass-through partner must provide to the IRS (directly or indirectly through a third party) the section 6226(a)(2) identifying data *or* an affidavit to certify that its partners have paid the tax. If the pass-through partner cannot provide that information or certification, the liability reverts back to the source partnership. In addition, there should be a maximum period for all the push-outs to occur.

XI. CERTAIN TIMING AND PROCEDURAL ISSUES

This Part XI addresses certain timing issues in the BBA. The BBA regime includes many actions, milestones and processes, but only some of these are given a precise timeline. While the administrative guidance will need to address many of these timing issues, we are focusing in this report on a set of timing and procedural issues which we think are best resolved as a package, including a few which may require or benefit from a statutory correction. Our primary recommendations in this section are that:

- the proposed partnership adjustment (or “PPA”) trigger the partnership’s right to appeal to IRS Appeals the substantive adjustments proposed in the PPA,
- if there is no such appeal or following the resolution of the appeal, the IRS issues a “preliminary FPA,” which will trigger the 270-day period for the submission of section 6225(c) documentation (and the right of partners to file amended returns pursuant to section 6225(c)(2)),
- following the expiration of that time period, the IRS issues the final FPA which reflects the section 6225(c) determinations (and any amended returns filed in response to the preliminary FPA),
- the partnership then has a right to appeal the section 6225(c) determinations to IRS Appeals, and
- finally, if there is no such appeal or following the resolution of that appeal, the obligation to make the section 6225 or section 6226 payments arises, unless a petition for court review is made at that time, in which case the court can hear the substantive issues and the section 6225(c) determinations, as requested by the court petition.

A. Last Date For Issuance of an FPA and The Relationship to the Normal Three-Year Statute of Limitations

1. The Issue

Under the BBA, the FPA is the document that the IRS uses to make an adjustment at the end of a BBA partnership level audit. The statute obligates the IRS to issue a PPA before it issues an FPA.²⁴³ The issuance of the FPA triggers the liability under section 6225. There is no specific rule limiting when the IRS may issue a PPA, but section 6235 sets out the rules for the latest date on which the IRS may issue an FPA. This is the *latest of three* dates:

- The “**3-Year Period**”: three years after the latest of (a) the filing of the partnership return, (b) the due date for the partnership return and (c) the filing by the partnership of an AAR;²⁴⁴
- The “**Section 6225(c) Period**”: if the partnership has received a PPA and chooses to submit documentation to the IRS in an attempt to reduce the imputed underpayment under section 6225(c) (the partnership has 270 days to do so), 270 days after the date

²⁴³ § 6231(a) (“any notice of a final partnership adjustment shall not be mailed earlier than 270 days after the date on which the notice of the proposed partnership adjustment is mailed.”)

²⁴⁴ § 6235(a)(1).

the partnership has submitted the documentation to the IRS;²⁴⁵ in other words, up to 540 days after the issuance of the PPA; and

- (iii) The “**330-Day Period**”: if the partnership has received a PPA and does not submit any documentation under section 6225(c), 330 days from the date of the PPA.²⁴⁶

Once an FPA is properly and timely issued, the partnership’s payment obligation under section 6225 is automatically triggered (unless a court petition is filed under section 6234, which only delays the partnership’s obligation until the court proceeding is concluded).²⁴⁷ The partner-level statute of limitations is not relevant (even if a section 6226 election is made).²⁴⁸

We are concerned that these rules do not properly respect the normal 3-year statute of limitations principles. The first of the three relevant dates (the 3-Year Period) is a straightforward application of the 3-year statute of limitations rule and raises no concerns. However, the two other dates imply that, if the IRS has issued a PPA, it will always have *at least* another 540 days (under the Section 6225(c) Period) or 330 days (the 330-Day Period) to issue an FPA, *even if* the PPA was issued more than 3 years after the latest date under the 3-year period. This oddity arises from the fact that the BBA has no rule for the latest date when a PPA may be issued, and whenever a PPA has been issued, the Section 6225(c) Period and the 330-Day Period trump the 3-Year Period.²⁴⁹

We believe (and have assumed) that this was not intentional, that it was not taken into account in scoring the provision’s revenue impact, and that there will be consensus that it should be corrected.²⁵⁰ For now, we will assume it was an error.

²⁴⁵ § 6235(a)(3). The 270-day period appears to be intended to give the IRS time to consider the documentation and make decisions regarding how, if at all, to revise the imputed underpayment.

²⁴⁶ § 6235(a)(2). This is 60 days after the expiration of the period for the submission of the documentation. This appears to be intended to give the IRS 60 days in which to prepare the FPA after the date on which the IRS knows for a certainty that the partnership will not be submitting any documentation.

²⁴⁷ See §§ 6221, 6225 and 6232.

²⁴⁸ So long as the FPA is issued within the time period provided for by § 6235, the imputed underpayment becomes due under § 6225. The partnership’s election under § 6226 does not re-introduce § 6501 because the effect of making the § 6226 election is to turn off the § 6225 obligation: there is no separate statute of limitations rule applicable to the payments due under § 6226.

²⁴⁹ See BBA Bluebook, at 75 (after describing the 3-year rule in § 6235(a)(1), “the time within which the adjustment is made by the Secretary may be later if a notice of proposed adjustment is issued, because the issuance of a notice of proposed adjustment begins the running of a period of 270 days in which the partnership may seek a modification of the imputed underpayment.”)

²⁵⁰ If this is not the case, and the rules do mean that a PPA, and thus an FPA, may be issued long after the expiration of the 3-Year Period, we will address our concerns about this approach in a subsequent report.

The *first issue* that needs to be decided is whether this error can be corrected administratively or whether a statutory correction is needed. We think that failing to correct this statutorily and relying on administrative rules (even rules that purport to be binding on the IRS) would be inappropriate: the IRS and Treasury Department would risk being criticized for issuing rules that are contrary to the statute, and taxpayers would have no certainty that these administrative rules would not be changed (even retroactively). Accordingly, we proceed to the question of what the statute, as corrected, should provide. We begin by reviewing how the TEFRA time frames work.

2. Statute of Limitations under TEFRA

Under Pre-BBA section 6629(d), the issuance of the FPAA gave the IRS additional time to assess the tax from the partners, but that additional time was tacked onto the otherwise-established statute of limitations period for assessing any taxes from the partner (which is set out in section 6501 and Pre-BBA section 6229).²⁵¹

The statute of limitations rule under TEFRA did not dictate the last day for issuing the FPAA. Instead, TEFRA's section 6229(d) established that, if an FPAA was issued before the last day that a tax could be assessed from a partner (the last day determined under section 6501 or the other sections of Pre-BBA section 6229), the running of the assessment period was "suspended" for (i) first, the 150 days the partners had to petition a court for review (and any period that petitioned court took to decide the matter), and (ii) second, another year.²⁵² If that last day had already passed (*i.e.*, the statute of limitations period had already expired) when the FPAA was issued, this "suspension" of the statute of limitations would never take effect, and thus the IRS could not collect the tax. In practice, this meant that the FPAA needed to be issued before that last day (*i.e.*, before expiration of the statute of limitations which was normally three years, but longer in certain cases).

As a procedural matter, before the FPAA could be issued, the IRS would issue two other documents. At the conclusion of the audit, the IRS would send a Summary Report (which is similar to the PPA) together with a notice of closing conference. Following the closing conference (or if the conference was waived), the IRS would issue a so-called "60-day letter" setting out the adjustments that the examination team was proposing and giving the partnership and partners 60 days to take the matter to IRS Appeals. Then, following the expiration of the 60-day period or

²⁵¹ See *Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r*, 114 T.C. 533 (2000) (explaining how §§ 6501 and 6229 interact—specifically that § 6229 may extend the § 6501 statute of limitations for collection from partners of taxes when those taxes are attributable to partnership items or affected items but will never shorten that § 6501 period).

²⁵² § 6229.

the Appeals proceedings, the FPAA would be issued. Because the FPAA needed to be issued before the normal 3-year period had expired, the 60-day letter needed to be issued at least 61 days before that 3-year period had expired.²⁵³

3. Options

As discussed above, the BBA problem arises because the BBA sets no limitation on when a PPA can be issued and, if a PPA is issued, a new clock begins to run (whereas, the TEFRA rules required that the FPAA be issued before the expiration of the normal statute of limitations).

With this background, we propose below some options for how the BBA statute could be revised to address this timing issue.

(a) Option 7.A: FPA Issued Before Expiry of 3-Year Period

Option 7.A would require that the FPA be issued before the last date in the 3-Year Period. This is essentially equivalent to what TEFRA requires with respect to the issuance of the FPAA. Under the BBA, however, this would mean that the PPA must be issued when there are at least 271 days remaining on the 3-Year Period (and realistically there would need to be at least 300 days remaining).²⁵⁴ (The reason for this 271 day minimum is that the BBA requires that the IRS wait 270 days after the issuance of the PPA before issuing an FPA.) This would mean issuing the PPA when there is almost an entire year remaining on the statute, which would essentially reduce the period during which the IRS could conduct its audit to two years from the filing date (or, if later, the due date) of the partnership return.

Thus, requiring the issuance of the FPA before the expiration of the 3-Year Period does not seem like an appropriate approach.

(b) Option 7.B: “Preliminary FPA” (or “Final PPA”) Issued Before Expiry of 3-Year Period

Part of the difficulty here is that it is not clear from the statute if the PPA is essentially the resolution of the exam *other* than the section 6225(c) reductions to the imputed underpayment or is instead the exam team’s first formal communication to the partnership representative of the

²⁵³ This assumes that the IRS could require a partnership or partner who wants to go to Appeals to agree to extend the statute of limitations in order to do so.

²⁵⁴ 271 days would mean that the IRS would then have only one day to issue the FPA after the end of the period during which the partnership could submit section 6225(c) documentation. The statute was designed to give the IRS an additional 60 days to finalize the FPA if no documentation was submitted and an additional 270 days to do so if documentation was submitted. If the IRS wanted more than 1 day, say they wanted only 30 days, then they would need to issue the PPA when there are at least 301 days remaining in the 3-Year Period.

adjustments being considered. That is, it is not clear if the PPA reflects the completion of the dialogue between the exam team and the partnership representative on the adjustments being proposed or the beginning of that dialogue.

A second option would therefore be to require that the PPA be followed by a “preliminary FPA” which reflects the completion of this dialogue (*i.e.*, the final adjustments being proposed) but not the section 6225(c) reductions, and require that this preliminary FPA be issued before the end of the 3-Year Period (but not establish a required wait-time between the PPA and the preliminary FPA). The remainder of the time-periods provided for in the BBA would be left in place. Thus, the partnership would have 270 days from the mailing of the preliminary FPA to provide the IRS with the section 6225(c) documentation, and the IRS would have, after that 270-day period ended or the documentation was received, an additional 60 or 270 days to issue the “final” FPA, respectively.

This would be the closest to TEFRA and to what occurs in an audit of an individual or corporation because the IRS would need to resolve its adjustments before the end of the 3-Year Period; the additional time before the issuance of the final FPA would exist because of the partnership’s right to try to reduce that adjustment pursuant to section 6225(c).²⁵⁵

(c) Recommendation

We recommend Option 7.B (“*Preliminary FPA*” (Or “*Final PPA*”) Issued Before Expiry of 3-Year Period) and believe this could be implemented either as “preliminary FPA” or as “final PPA”. The substantive recommendation we are making is that there be a final document that establishes all the audit adjustments, that this document triggers the 270-day period for the partnership to submit section 6225(c) documentation and that the deadline for the issuance of this document be tied to the 3-Year Period. We recognize that there may be other options that would achieve this result. We believe, however, that it is important that this aspect of section 6235 be corrected.

B. Providing Documentation under Section 6225(c)

Section 6225(c) allows the partnership to demonstrate to the IRS that the imputed underpayment initially computed using the rules in section 6225(b) should be reduced because of the reviewed-year partners’ characteristics. Section 6225(c)(7) provides that this documentation

²⁵⁵ Another way of viewing (and wording) this option is to require administratively that the exam team provide the partnership representative with a “preliminary (or draft) PPA” before the “final PPA” and have the final PPA reflect the final resolution of all the audit adjustments other than the section 6225(c) reductions. This final PPA would need to be issued before the expiration of the 3-Year Period.

must be provided within 270 days after the IRS mails the PPA to the partnership (unless this period is extended by the Secretary).²⁵⁶ As discussed in Part XI.A immediately above, after the IRS receives the documentation, the statute gives the IRS up to 270 days to review and consider it before the IRS must issue the final FPA.

The question is how this timing works if any of the substantive adjustments in the FPA differ from those proposed in the PPA. As noted above, it is not clear from the statute if the PPA is essentially the resolution of the exam *other* than the section 6225(c) reductions. If the adjustments in the FPA are the same as those in the PPA and the only difference between the two is that the FPA reflects the section 6225(c) modification, then this timing should work. However, if the PPA results in a dialogue such that the substantive adjustments in the FPA differ from the PPA, then how and when can the partnership respond with the section 6225(c) documentation that matches the FPA? The 270 days is clearly intended to protect the right of the partnership to submit the documentation but it does not adequately protect this right if the FPA's substantive adjustments can differ from the PPA's.

The BBA Bluebook indicates that the procedures established by the IRS will permit partnerships to begin the dialogue regarding section 6225(c) adjustments “after the initiation of the administrative proceeding, including before any notice of proposed adjustment.”²⁵⁷ The PATH Bluebook states: “Any notice of proposed adjustment issued to the partnership must identify all adjustments and inform the partnership of the amount of the imputed underpayment.”²⁵⁸ Even if administrative practice is normally consistent with both of these statements, partnerships will still not be protected against this problem because there will be no certainty that the FPA's adjustments will match those in the PPA and no certainty that partnerships and partners will have the opportunity to submit the appropriate section 6225(c) documentation.

We believe that the regulatory guidance and the IRS internal procedural rules should encourage a dialogue with the partnership representative and an opportunity for the partnership representative to engage with the IRS about the proposed adjustments before they are in the form that begins the 270-day clock of section 6225(c)(7) running. The preliminary FPA and final FPA approach suggested in Option 7.B above would address these issues. The PPA could function as the document wherein the substantive adjustments are proposed, and the preliminary FPA would reflect the resolution of the dialogue regarding those adjustments.

²⁵⁶ §§ 6225(c)(1) and (c)(6) provide for the IRS to establish procedures for this.

²⁵⁷ BBA Bluebook, at 65.

²⁵⁸ PATH Bluebook, at 249.

C. Timing of Section 6225(c)(2) (Amended Returns)

The third timing problem relates to the rule in section 6225(c)(2) which provides for a reduction in the imputed underpayment for amounts allocable to a reviewed-year partner that amends its reviewed-year return (to take into account such amounts) and pays the tax due.

The statute is silent as to whether the partnership is required to submit anything to the IRS to establish that this was done, but, if the 270-day rule of section 6225(c)(7) applies to the section 6225(c)(2) mechanism, then the statute would effectively be asking a partner who wishes to take the section 6225(c)(2) route to file the amended return based on a *proposed* adjustment, without any guaranty that the FPA will be consistent.

If, instead, following our recommendation above,²⁵⁹ the IRS issues a preliminary FPA that signals the end of the dialogue about the quantum of the adjustments and the issuance of that document commences the running of the 270-day period, then it would be workable to ask the partner to file the amended return during that 270-day period.

A separate question relates to the content of the documentation that the partnership will be required to submit to the IRS to be able to rely on section 6225(c)(2). It will be important that the procedures ensure that the partners' confidentiality is respected. A partner should not be required to provide a copy of its amended tax return to the partnership (or the partnership representative) for submission to the IRS, nor should a partner be required to provide the partnership with proof of the payment of the additional tax (the precise amount of additional tax due from that partner will also be confidential because it will be based upon an interaction of the partnership-level adjustments with the partner's own tax attributes).

One way to address this issue would be to permit a partnership to document for the IRS a section 6225(c)(2) payment by collecting (and submitting to the IRS) an affidavit from the partner attesting to having filed an amended return reflecting the preliminary FPA adjustments allocable to the partner and to having paid the resulting tax due (without specifying what that amount due was). This leaves the partner with only 270 days to file the amended return, pay the tax and provide this affidavit to the partnership, but this seems to be what the statutory scheme contemplates and it does not seem to us unreasonable in principle.

An alternative suggested in Part XI.D, immediately below, is to have the amended returns filed with the exam team and held in escrow until the partnership has decided whether to make the section 6226 election. There would be no need for the partner to provide the partnership representative with any documentation and no need for the partnership representative to submit anything further to the IRS. For the reasons discussed in the next section, this also resolves a

²⁵⁹ See Part XI.A.3(c) (page 125).

potential conflict between an attempt to proceed under section 6225(c)(2) and a partnership decision to make a section 6226 election. Accordingly, we prefer this solution.

D. Interactions of Partners' Rights Under Section 6225(c)(2) To File Amended Returns and the Partnership's Right to Make the Section 6226 Election

The statutory scheme contemplates that the filing of an amended return under section 6225(c)(2) cannot be combined with a section 6226 election by the partnership. However, the timeline provided in the statute appears to raise practical issues. As discussed in Part XI.C immediately above, a partner apparently must file an amended return *before* the FPA is issued (so that the FPA can state the imputed underpayment due after backing out the adjustments attributable to the partner(s) which filed the section 6225(c)(2) amended return(s)). Section 6226(a)(1), on the other hand, provides that the partnership may make the section 6226 election any time within 45 days *after* the date of the FPA.²⁶⁰

If a partner has filed an amended return pursuant to section 6225(c)(2) prior to the issuance of the FPA, what happens if the partnership then makes the section 6226 election?

In considering this question, we are mindful that these two different routes (section 6225(c)(2) and section 6226) are not interchangeable. First, the aggregate additional taxes paid (or refund received) by a partner who files a section 6225(c)(2) amended return may differ materially from the aggregate additional taxes paid by a partner who proceeds pursuant to a Section 6226 Statement. There are various reasons for this possible difference, including that (i) a section 6225(c)(2) amended return may take into account the impact of the FPA adjustments on other items of the partner, (ii) it appears that the partner could include in a section 6225(c)(2) amended return modifications to items that were not included in or impacted at all by the FPA, and (iii) unlike a section 6226 return, a section 6225(c)(2) amended return can reflect decreases to taxes attributable to the partnership-level adjustments, in both the reviewed year and the interim years between the reviewed year and the adjustment year.²⁶¹ Second, partners eligible to file a section 6225(c)(2) amended return might not be the same persons required to pay additional tax in the event the partnership makes a section 6226 election. An indirect partner in a tiered partnership

²⁶⁰ § 6226 then indicates that regulatory guidance will provide when and how the partnership communicates the § 6226 information to each partner, which then triggers the partners' obligations under § 6226(b)(1) to pay the additional tax with their returns for the year during which this information was received *from the partnership*.

As an aside, we note that this payment year may not be the same year as the year in which the FPA was received by the partnership and the regulatory guidance will need to be mindful of not using the term "adjustment year" when referring to the date the partners are required to make the § 6226 payments.

²⁶¹ See Part VIII (page 86).

structure may be permitted to amend its return under section 6225(c)(2) but may not be able to take into account a Section 6226 Statement (at least under the BBA Bluebook's interpretation of the statute, since the BBA Bluebook stops the Section 6226 Statement at the first tier above the audited partnership. (See Part X.C, above.)

We believe there are four possible ways to address this issue:

1. Option 8.A: Section 6226 Election Governs

If the partnership makes the section 6226 election, the section 6225(c)(2) amended return is automatically rescinded and the IRS refunds any additional taxes paid or recoups any refunds paid.

This option is inefficient and likely to become very complicated, particularly if the amended return has not been fully processed by the IRS when the section 6226 election is made, and partners who have filed a section 6225(c)(2) amended return and paid the additional taxes may need to pay the section 6226 amount before they have received back the taxes they paid in their section 6225(c)(2) return.

A variation on this option would be to allow the partner who filed the section 6225(c)(2) amended return to claim a credit for the tax paid with that return on the return of the partner showing the section 6226 payment due and provide that this is the only means the partner has of recouping those taxes. This may greatly complicate an IRS audit of the partners' compliance with section 6226.

2. Option 8.B: Option 8.A plus File Amended Returns in Escrow

Require the amended returns to be filed with the examination team, which will hold them "in escrow" until the partnership decides whether to proceed under section 6225 or 6226. To address the partners' legitimate confidentiality concerns, each amended return would be filed by the partner directly with the exam team and the partnership representative would not have the right to see it.

A separate issue that the IRS will need to address is whether the examination team has the right or the obligation to review that amended return or whether the return would simply be held in escrow by that examination team (which would reduce the imputed underpayment by the adjustments items allocable to and reported on that amended return by that partner).

3. Option 8.C: Modify the Statute to Combine Section 6225(c)(2) and Section 6226

If the partnership makes the section 6226 election, any partner who has already filed a section 6225(c)(2) amended return is permitted to stick with the amended return route and need not

reflect the Section 6226 Statement. If the partner was an indirect partner (*i.e.*, a partner in an upper-tier partnership that received the Section 6226 Statement), the upper-tier partnership must back out from its Section 6226 Statement amounts the adjustments attributable to that indirect partner.

This option would seem to be fair, but does conflict with the current statute. The bottom-line differences between the section 6225(c)(2) route and section 6226 route are built into the statute, and if the statute were modified to allow some partners to go one route and other partners to go the other, this may be used strategically by partners to elect the route that reduces their taxes by the most. Is that necessarily a bad thing? Perhaps it is if the section 6226 route is intended to be a way for partners to get closer to Correct Return Position than the section 6225 imputed underpayment would but without the risks for the partners associated with filing an amended return under section 6225(c)(2), and the precondition to getting that section 6226 route is that everyone uses it (with its imperfections).

We continue to believe that the best outcome is the one that is the closest to Correct Return Position and that precisely how this issue is resolved will depend greatly upon how many of the issues raised above are solved (including whether the section 6225 payment is the end of the story or akin to a withholding tax, whether the statute's additional-tax-only rule for computing the section 6226 taxes is retained or changed, and whether either, both or neither of section 6225(c)(2) and section 6226 are available to indirect partners in a tiered structure).

4. Option 8.D: Modify the Statute to Change the Timing of a Section 6226 Election

Prevent this conflict from ever occurring by requiring a partnership to make a choice between sections 6225 and 6226 earlier in the process, before the partners' rights to file amended returns are triggered. This is problematic because the statute appears to be intended to give the partnership the ability to try to reduce the imputed underpayment first and then based upon how that is resolved to either pay the imputed underpayment or elect section 6226.

5. Recommendation

We believe that Option 8.B is the most consistent with the current statute and the fairest and most administrable result under the current statutory scheme. It also facilitates the ability of the examination team to modify the imputed underpayment to reflect the amended returns.

E. Standards for IRS Decision To Reduce the Imputed Underpayment

As we have noted throughout this report, from a tax administration perspective, it is important that the section 6225 payment method is palatable enough so that partnerships and their partners who have a choice between section 6225 and section 6226 will have as many incentives as

possible to follow section 6225. One very important aspect of section 6225 is the ability for the partnership to establish to the IRS that the final imputed underpayment should be lower than the initial computation on account of partner-specific characteristics.

As drafted, section 6225(c) only requires the IRS to consider a limited number of partner-level attributes. Section 6225(c)(6) gives the IRS discretion to consider other things as well. Significantly, the BBA does not (i) set out any standards or principles that should apply to the IRS's consideration of the documentation or information provided by the partnership, (ii) require the IRS to provide the partnership with any explanation for a denial, (iii) establish (or direct the IRS to establish) any mechanism for the partnership to have a denial reviewed or elevated within exam or (iv) specify if the issue can be appealed to IRS Appeals.²⁶² Finally, and quite significantly, the BBA appears to implicitly deny a partnership the right to have the issue heard by a court. Section 6234(c) provides:

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all items of income, gain, loss, deduction, or credit of the partnership for the partnership taxable year to which the notice of final partnership adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under this subchapter.

This provision for court review appears to be limited to the items listed, and therefore could be seen to exclude a review of an IRS determination regarding the application of partner-level characteristics.

The BBA Bluebook addresses this issue only tangentially. First, the BBA Bluebook explains that additional procedures set out in guidance may provide for the imputed underpayment to be modified

*on the basis of factors that the Secretary determines are necessary or appropriate to carry out the function of the modification provisions, that is, to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.*²⁶³

²⁶² As discussed in Part XI.A (page 121), if this is permitted, some mechanism needs to be put in place, because the BBA gives the partnership the response to the § 6225(c) documentation in the form of the FPA and presumably Appeals will come before that.

²⁶³ BBA Bluebook, at 65–66.

Second, the BBA Bluebook states that in the absence of guidance,

*It is anticipated that partnerships will furnish to the Secretary the necessary documentation, data, and calculations to determine the amount of the reduction of the imputed underpayment with a reasonably high degree of accuracy.*²⁶⁴

Neither of these statements elaborates on the standard the IRS must use in evaluating the documentation and deciding how, if at all, to reduce the imputed underpayment.

We note that the Administrative Procedures Act gives a court the right to review any final agency action for an abuse of discretion²⁶⁵ and we are skeptical that the IRS's reaction to section 6225(c) documentation would be immune from such review. We also note that taxpayers are guaranteed a right to an independent review of the IRS's proposed adjustments and this has been carried out through permitting taxpayers, except in unusual circumstances, to petition IRS Appeals. We think it would be inappropriate to deny any IRS Appeals review of the section 6225(c) determinations by the IRS. Finally, we think that the IRS will be best served by specifying what standards will apply to a section 6225(c) evaluation and decision, providing partnerships with explanation of any denial, and by providing specific procedures for taxpayers to elevate a denial within exam and then to Appeals. There are several precedents for this in the regulations, Revenue Procedures, and IRM which should be considered.

The Appeals-specific issue is further addressed in the following section.

F. IRS Appeals Process and the BBA

The next set of issues relates to the interaction of the IRS Appeals process and the issuances of the PPA and FPA. In this section we address when the partnership gets the opportunity to take the proposed adjustments to IRS Appeals, whether the partnership can seek Appeals' review of the IRS's section 6225(c) determination and, if so, what standard Appeals will apply to that review.

Neither the BBA²⁶⁶ nor the BBA Bluebook addresses the timing, procedures or review standards for appeals to IRS Appeals.

As explained above, under TEFRA the partnership's right to go to Appeals arose when the exam team issued a "60-day letter" setting out the final proposed adjustments and giving the

²⁶⁴ BBA Bluebook, at 68.

²⁶⁵ Administrative Procedure Act, 5 U.S.C. § 706 (2015).

²⁶⁶ These issues were also not addressed in TEFRA; nor are they addressed in the Code for corporate or individual taxpayers.

partnership 60-days to file a protest with Appeals. (This 60-day letter followed the IRS's issuance of a Summary Report (which is similar to the PPA) and the holding of (or waiver by the partnership of) a closing conference.) Appeals would review the substantive adjustments, issues relating to jurisdictional issues (such as whether the items being adjusted were "partnership items"), and the assertion of penalties.

Under the BBA, the question would appear to be whether Appeals review should come after the PPA or after the FPA. The closest match to what happened under TEFRA and what happens in audits of corporations and individuals would be for Appeals to come after what we are proposing be the "final PPA" or "preliminary FPA," because that is when the exam team has finalized its view of the appropriate substantive adjustments. This precedes, however, the exam team's consideration of the section 6225(c) documentation and its decision on section 6225(c) reductions.

Accordingly, if Appeals came at this point, then, Appeals would be considering the adjustments proposed by the exam team, any jurisdictional disputes and penalties. After the IRS Appeals decision, the case would go back to exam to address the section 6225(c) adjustments, which would then be reflected in the final FPA. We think that the partnership should also be able to have Appeals review the IRS's decisions on section 6225(c), although we recognize that this may complicate the finalization of the audit. In addition, if the computation of the imputed underpayment prior to the section 6225(c) reductions is at all complicated (which we expect it might well be), then it would be appropriate for Appeals to also review disputes over that computation. It is not clear if those disputes should be heard by Appeals at the same time as disputes over the substantive adjustments or at the same time as disputes over the section 6225(c) reductions, but we believe that it would be more efficient if they were heard at the same time as the substantive adjustments. We have considered the following options for how this could work.

1. Option 9.A: Two Appeals Proceedings

The partnership may first appeal the PPA (adjustments, jurisdiction, and penalties, without section 6225(c) reductions) and then, after that decision, the exam team receives, reviews and responds to the section 6225(c) documentation and issues an FPA, which is the partnership's ticket to go back to Appeals to address the section 6225(c) reduction decisions. The initial imputed underpayment computation could be heard in the first Appeals hearing or deferred until the second Appeals hearing (under a policy that applies in all cases or under a flexible policy that allows for either approach in any given case). After the second Appeals decision (on section 6225(c)), another (this time really final) FPA is issued.

One obvious downside of this option is that Appeals would be involved potentially twice before the audit is resolved.

2. Option 9.B: Accelerate the Section 6225(c) Process

If the partnership wants to petition Appeals to hear the substantive adjustments in the PPA, require the IRS and taxpayer to go through the section 6225(c) process before Appeals hears the PPA. The downside of this option is that if the statutory time frames are retained (270 days to get the section 6225(c) documentation to the IRS, 270 days for the IRS to review and respond to it), there could be a long period of time between the end of the substantive adjustment portion of the audit and the resolution of the Appeals consideration of those substantive adjustments and that delay would involve a lot of work by the taxpayer and the IRS that may end up being unnecessary. (It would also create issues with respect to the section 6225(c)(2) mechanism as discussed in Part XI.B above, since partners would not know what adjustments to take into account to file amended tax returns.) A benefit of this option is that it gives IRS Appeals the full picture of the consequences of the substantive adjustments when Appeals is considering them.

3. Option 9.C: No Appeals of Section 6225(c) Issues

Appeals does not hear the section 6225(c) issues at all, but the IRS provides a robust mechanism for elevation and review within the examination function. This seems to prevent a taxpayer from having Appeals hear a very key aspect of the exam decisions and may seriously conflict with taxpayers' rights to have an independent appeal mechanism within the IRS.

4. Option 9.D: Courts Review Section 6225(c) Issues

Same as Option 9.C, but let taxpayers take the section 6225(c) issue to court, which currently appears to be denied by the statute. This option has the weaknesses of Option 9.C. In addition, it is inefficient in that it eliminates a significant opportunity to try to have the issue resolved before the courts are involved.

5. Recommendation

While all the options have difficulties, we favor Option 9.A (*Two Appeals Proceedings*). We think there is a complicated question about the interplay of the BBA with the Administrative Procedures Act and that the IRS and the Treasury should attempt to minimize uncertainty and litigation by providing Appeals review, but that the inefficiencies of Option 9.B. should be avoided.

A separate question is what standard of review Appeals should use in reviewing a section 6225(c) decision: *de novo* (the standard for review of most substantive adjustments) or abuse of discretion? Similarly, should Appeals consider the hazards of litigation? We note again that if the section 6225 method is not made to work fairly, it will be utilized less than the lawmakers intended when they enacted the BBA.

G. Section 6226 and Petitioning to Court

The amendments made by the PATH Act to the BBA clarified that a partnership was not obligated to forgo the section 6226 election if it wanted to go to court.²⁶⁷ Payment-related issues arise, however, if the partnership petitions the Tax Court or the other courts.

1. Petitioning to Tax Court

The taxpayer is ordinarily not required to pay the deficiency in advance in order to petition the Tax Court. Is this still true for a partnership which makes a section 6226 election? If the partnership wants to petition the Tax Court, is it still obligated to send out the Section 6226 Statements, and are the partners still required to compute and pay the section 6226 tax, or are one or both of those obligations suspended until the court case is resolved?

This issue could be easily resolved by providing that if the partnership makes the section 6226 election and then files a timely petition with the Tax Court, the partnership should not send out the Section 6226 Statements. However, the delay in having the partners pay may make it more difficult for the IRS to collect when the case is resolved if the partnership has difficulty finding the historic partners at that time. The BBA Bluebook discusses the intersection of judicial proceedings and section 6226 by suggesting that a partnership that has made the section 6226 election at the end of the audit could rescind that election at the end of the judicial proceedings and proceed to pay under section 6225.²⁶⁸

2. Petitioning Other Courts

If the partnership wants to petition the District Court or Court of Federal Claims, section 6234(b) provides:

A readjustment petition under this section may be filed in a district court of the United States or the Court of Federal Claims only if the partnership filing the petition deposits with the Secretary, on or before the date the petition is filed, the amount of the imputed underpayment (as of the date of the filing of the petition) if the partnership adjustment was made as provided by the notice of final partnership adjustment. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy

²⁶⁷ PATH Act § 441(b); § 6226(d). The section 6226 election must be made within 45 days of the mailing of the FPA and the petition must be filed with the court within 90 days of the mailing of the FPA, so the partnership would be making both elections on or before this 90th day.

²⁶⁸ BBA Bluebook at 69.

such requirement and any shortfall of the amount required to be deposited is timely corrected.

Because the text of section 6234(b) sets this deposit *by the partnership* as a jurisdictional prerequisite (subject only to the court waiving it), it is not clear how this requirement is supposed to interact with the section 6226 election, which is supposed to push out the liability for the tax to the partners.

A technical correction may be needed. The issue could be resolved by requiring that the partners receiving the Section 6226 Statements pay with their current year return the amounts they would owe if the FPA is ultimately upheld and then providing that the statutory jurisdictional requirement of partnership payment is satisfied. The alternative would be to permit the partnership to wait to send out the statements and instead have the partnership pay the imputed underpayment, as the statute requires. At the resolution of the case, this prepayment (together with interest) could be returned to the partnership if it still wants to take the section 6226 route. This would be consistent with the approach of section 6226 (pushing out the tax liability to the partners) and consistent with the BBA Bluebook that indicated that after the court case was finalized, a partnership that had previously made a section 6226 election should be able to rescind it and instead pay under section 6225.

Whichever approach is taken, a technical correction may be necessary because, as noted, section 6234(b) sets out the payment by the partnership of the imputed underpayment as a prerequisite to the court having jurisdiction.

H. Timing For IRS Collection Proceedings With Respect to the Imputed Underpayment

The final timing issue is an apparent error in section 6232(b)(1) in that it conflicts with the rules set out, consistently, in sections 6225(a)(1) and 6232(a). The latter two sections provide that the partnership's imputed underpayment payment is due with the partnership's tax return filed for the year in which the FPA is mailed to the partnership. Section 6232(b)(1) by contrast provides that an assessment of a deficiency and collection proceeding may not commence before the close of the 90th day after the FPA is *mailed*, indicating that such assessment and proceeding may commence on the 91st day. This appears to be an error and section 6232(b)(1) should be revised to refer to the 90th day after the due date for the payment which is set out in section 6232(a).

XII. ELECTING OUT OF THE BBA

As discussed above,²⁶⁹ the BBA provides that any partnership that issues fewer than 100 Schedule K-1s in a particular tax year may elect to be excluded from the BBA for that year provided that each of its partners in such year is an individual, C corporation, S corporation, estate of a deceased partner or a foreign entity that would be a C corporation if it were domestic.²⁷⁰ For various reasons, including the difficulties with the BBA discussed in this report, the election out is likely to be utilized by a significant number of partnerships.²⁷¹ The practical consequence of the BBA both repealing TEFRA and providing an election out of the BBA is that there is now no centralized audit regime that would apply to partnerships that elect out. Electing-out-partnerships (“EOPs”) would seem to be returned to the pre-TEFRA world where the IRS may only make adjustments at the partner level.

A. Procedural Implications: Possible Return to The Problems That Led to Enactment of TEFRA

Prior to TEFRA, the IRS often would start with an examination of the partnership’s return, but would need to proceed against the individual partners in order to make any adjustments and collect any additional taxes.²⁷² In other cases, partnership items were audited directly at the partner level in the context of an audit of the individual partner.

This fragmented approach created several significant problems: (i) the IRS had difficulty ensuring that the relevant partners’ statutes of limitations remained open for assessment;²⁷³

²⁶⁹ See Part IV.B (page 24).

²⁷⁰ See *id.* for a more detailed discussion of the requirements that a partnership must meet in order to elect out under section 6221.

²⁷¹ Guidance will be needed regarding this election. While we limit our discussion here to a single issue, we note that guidance on the following questions would be helpful: (a) in counting the partners, does a mid-year transfer result in two partners for this purpose and do K-1s provided to a nominee holding in street name for more than one beneficial owner count as one or multiple K-1s; (b) whether a partnership can elect out in one year and refrain from doing so in the next. (See BBA Bluebook, at 59 (stating that election is valid only for the year for which it is made)); and (c) whether there is a way for entities or arrangements that are re-characterized as partnerships to elect out (either in advance or after they have been so re-characterized).

²⁷² See AM. LAW INST., FEDERAL INCOME TAX PROJECT, 10–14 (Council Draft No. 7, Nov. 24, 1980) (discussing the common practices with partnership and partner-level audits before TEFRA) (“**ALI Council Draft Report No. 7**”).

²⁷³ The statute of limitations applicable a partner is determined by that partner’s individual return and may only be extended with the partner’s consent. § 6501. Even if the IRS opened an audit of an individual partner while the partnership audit was taking place, if the partner was not willing to extend its statute of limitations,

footnote continued

(ii) because the adjustments and resolutions were effected through individual partner-level proceedings, there was a potential for inconsistent results across partners;²⁷⁴ (iii) multiple partner-level audits and proceedings resulted in the duplication of work for the government;²⁷⁵ and (iv) both the IRS and partners were reluctant to settle because other partners in the partnership would not be bound.²⁷⁶

It is yet to be seen whether these same issues will resurface with respect to EOPs and whether new problems may arise that were not present in the 1970's when the tax law was simpler, business and investments less global, and partnerships less popular. It would be particularly disappointing, however, if the result of the BBA election out is that partners in EOPs are rarely audited on their partnership items, or that the bulk of that audit activity takes place with respect to partners that are otherwise being audited. Even in the latter case, a partner's lack of access to partnership books, records and information may make auditing partnership items at the partner level very difficult. It is unclear whether that difficulty will ultimately benefit the IRS or the taxpayers.

B. Substantive Implications: Different Substantive Tax Results for the Partners in EOPs and BBA Partnerships

Depending on how some of the other issues discussed in this report are resolved, there may also be a significant substantive difference between the tax that the IRS is able to collect from partners in EOPs, as compared to partners in BBA partnerships.²⁷⁷

the statute could expire before the IRS was ready to make the adjustments. *See* TEFRA Bluebook, at 267; ALI Council Draft Report No. 7, at 15.

²⁷⁴ For instance, courts in different partner-level proceedings could reach inconsistent conclusions with respect to the same issue, and the IRS could take inconsistent positions on the same issue with respect to different partners. Inconsistent results meant that items could be duplicated or lost, and the unfairness and arbitrariness of this was detrimental to the integrity of the system and taxpayers' perceptions of the integrity of the system. ALI Council Draft Report No. 7, at 15.

²⁷⁵ ALI Council Draft Report No. 7, at 15–16 (“Even handling cases of *twenty* different partners in different districts taking different positions causes great administrative and ultimately judicial difficulty.”) (emphasis added).

²⁷⁶ Noel P. Brock, *Auditing Large Partnerships and TEFRA: Where We Are and Where We Are Going*, U.OF CHICAGO 67TH TAX CONF. 12 (Nov. 7, 2014) (noting that settlements were rare because the IRS had little incentive enter into settlements that were not binding on other partners, and partners did not want to settle when another partner could later obtain a better result). *See* ALI Council Draft Report No. 7, at 17.

²⁷⁷ When the IRS adjusts an item arising from an EOP, the partner-level proceeding will result in a collection of tax that equals Correct Return Position (setting aside settlement at Appeals). In contrast, when the IRS adjusts an item arising from a BBA partnership, the proceeding will result in a collection that may be quite

footnote continued

C. Options

Given what we have discussed immediately above, we believe that if are no changes made to the breadth of the election out and special rules are not put in place to adjust and collect additional taxes with respect to the items arising from EOPs, we will eventually see significant issues with EOPs and a round of reports on these problems similar to those released in the years before TEFRA and the BBA were enacted. We suspect that in response, Congress would attempt to address concerns by enacting a new regime that would apply to EOPs. With this in mind, we have identified the following options for dealing with the election out.

1. **Option 10.A: Administratively Implement Tailored Policies for Auditing EOPs and Their Partners**

The IRS could try to design and implement policies and procedures tailored to the issues that are likely to arise. For example, the IRS could adopt a policies under which it would try to open audits of an EOP and all of its partners simultaneously, get the partners to agree to handle the audits collectively and in any event promote as much consistency as possible. Indeed, this may be the best the IRS can do in the absence of a statutory change.

2. **Option 10.B: Apply TEFRA to EOPs**

Some members have suggested that reintroducing TEFRA for EOPs may solve the issues we have discussed. The rationales underlying this option are that (i) the problems with TEFRA are minimized when it is limited to single-tier partnerships with no more than 100 partners (as all EOPs would be); (ii) TEFRA is better than no centralized audits at all; and (iii) because the IRS is familiar with TEFRA, it is preferable to a regime that is completely new. The vast majority of our members, however, do not recommend this approach. We think that having two different statutory regimes, both of which are extremely complicated (and flawed), is not advisable.

3. **Option 10.C: Fix the BBA and Then Narrow the Election Out**

The third option is to leave the election out rules in place for now and instead focus on getting the BBA to work well (perhaps implementing some of Option 10.A. in the meantime). Once BBA is working well, then seek Congressional action to either narrow the election out or expand the BBA by modifying the election out rules. Indeed, there may be stronger support for

different from Correct Return Position (*see* Parts V, VII, VIII and X discussing the difference between the BBA and the Correct Return Position). This is a new problem. Prior to the BBA, both audits conducted under and outside of TEFRA could have potentially resulted in Correct Return Position collection outcomes. Thus, under the BBA, the election out may affect not only whether items are audited, but also how much additional tax will be due if they are indeed audited and adjusted. We find this troubling.

narrowing the election out once the BBA is working well, and the results of a BBA audit are fair to taxpayers. We see two variations on the subsequent modification to the election out.

(a) Option 10.C(1): Fix the BBA and then Lower the Election Out Threshold

Lower the threshold to a smaller number—such as 10 as it was under TEFRA or to another number that the experience with EOPs supports.

(b) Option 10.C(2): Fix the BBA and then Apply “BBA-lite” to EOPs

Lower the election out threshold and instead of subjecting EOPs to the entire BBA, apply a regime that includes some, but not all of the BBA. This “BBA-lite” could consist of, for example:

- the unified *procedures* of the BBA (with or without the sweeping authority granted to the partnership representative);²⁷⁸
- without the *collection* mechanisms of the BBA (sections 6225 and 6226).

D. Recommendation

Given the challenges involved in modifying the statute, we recommend Option 10.C. We believe that the focus should be on getting the BBA to work well for the IRS and taxpayers such that is perceived as a fair system overall. Once this is achieved, the IRS could approach Congress with a strong argument in favor of expanding the BBA to smaller partnerships that can currently elect out. At that time, the IRS would be in a better position to use its experience with the BBA to choose between full-BBA (Option 10.B(1)) and BBA-lite (Option 10.B(2)).

This approach would enable the IRS to address the concerns raised by EOPs, avoid the need to potentially develop a new regime for EOPs and also increase the likelihood that any partnership audit would ultimately place the partners and the IRS in Correct Return Position.

²⁷⁸ The BBA strips partners of any notice and participation rights, and gives the partnership representative unfettered discretion over the audit process. The arguments for these streamlined procedures are less compelling in the context of relatively small and simple (*i.e.*, single-tier) partnerships.