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Nichols Patrick CPE a Division of the Loscalzo Institute

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CONTENTS

IRS Issues, Then Pulls Back, Proposed Regulations for BBA Partnership Audit Regime 3

REG-136118-15, 1/20/16.....3

Scope of the Regime 3

Penalty Defenses 5

Election Out of the BBA Audit Regime 6

Consistent Treatment of Items by Partners 11

Partnership Representative 17

Binding Effect of Actions of Partnership Representative.....23

Partnership Adjustment by the IRS.....25

Modification of the Imputed Underpayment 32

Modifications that Affect Partnership Adjustments.....33

Modification Based on a Lower Tax Rate 37

Examples of the Adjustments 38

Adjustments to Partners' Outside Bases and Capital Account and a Partnership's Basis and Book Value in Property 40

Election for an Alternative to the Payment of the Imputed Adjustment (the "Push Out" Option) 41

Statements Furnished to the IRS and Partners for a Push Out Election.....42

Adjustments Taken Into Account by Partners.....48

Adjustments to Partners Outside Bases and Capital Accounts and a Partnership's Basis and Book Value in Property 54

Administrative Adjustment Requests (AARs) by a Partnership.....54

Determining and Accounting for Adjustments Request in AAR 57

Partner Taking AAR Adjustments Into Account 58

Bankruptcy of the Pratnership 59

Partnership Ceases to Exist 60

Payments are Not Tax Deductible 64
Dealing with "Nonpartnership Partnerships" 64

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IRS ISSUES, THEN PULLS BACK, PROPOSED REGULATIONS FOR BBA PARTNERSHIP AUDIT REGIME

REG-136118-15, 1/20/16

The IRS had released proposed regulations (REG-136118-15) that explain how the IRS proposes to implement the centralized partnership audit regime adopted as part of the Bipartisan Budget Act of 2015. The provisions contained in that bill created a new audit arrangement for partnerships which, by default, will have a tax imposed at the end of an audit on the partnership to take into account any adjustments that would have increased partners' taxes had the items been reported on the original return as is being proposed in the audit.

The new centralized regime takes effect for tax years beginning on or after January 1, 2017, though partnerships under exam for years beginning after November 2, 2015 and before January 1, 2018 may elect to have these provisions apply.

While the proposed regulations were made available on January 18, they were later taken back by the IRS before publication in the *Federal Register* due to the change of administrations on January 20. Shortly after the inauguration, President Trump issued an order that stopped publication of new regulations pending the new administration's ability to review the work in progress—a step that has taken place in the past following a change of administrations.

Given the nature of these regulations and the law that demands they be issued, it's likely that these proposed regulations will be later released either virtually or completely as is. The real final regulations would come after comments are received on these regulations. As well, there is likely to be a technical corrections bill passed eventually this year by Congress that will also clarify some of these issues.

Scope of the Regime

The IRS in the preamble to the proposed regulations defends taking a broad view of the applicability of the provisions, explaining that the agency does not believe that Congress intended for the items to be covered to be less comprehensive than found under prior TEFRA audits, but rather to be broader in scope.

Thus, per Proposed Reg. §301.6221(a)-1(a), all items relating to the partnership (items of income, gain, loss, deduction, or credit) are to be determined at the partnership level. Any chapter 1 tax (that is, income tax) arising from such adjustments are to be collected at the partnership level. [Temporary Reg. §301.6221(a)-1(b)(3)]

Taxes outside of chapter 1 are not covered by this regulation, but rather the IRS can institute other proceedings against the partners for such taxes. As the preamble to the proposed regulations notes:

> In some circumstances, adjustments made under the centralized partnership audit regime may have an effect on the determination of taxes imposed by provisions of the Code outside of chapter 1. For example, if it is determined in a proceeding under the centralized partnership audit regime that a partnership has additional unreported ordinary income, that determination could form the basis for a separate determination that one or more of the partners in that partnership owe additional self-employment tax under chapter 2 of the Code. Additionally, as clarified in proposed § 301.6221(a)-1(d), determinations regarding items covered by the centralized partnership audit regime may be relied upon by the IRS when making determinations of taxes not covered by chapter 1 to the extent they are relevant in making such determinations. For instance, if the IRS determines as part of the centralized partnership audit regime that an individual who is treated as a partner in the partnership has received additional unreported ordinary income from the partnership, the IRS is not precluded from separately examining the partnership or that individual for purposes of determining whether that individual is an employee and not a partner of the partnership for purposes of imposing subtitle C employment taxes

with regard to that income or examining the individual for purposes of determining whether the individual owes additional self-employment tax on the income. Any such determinations made in a separate examination outside the centralized partnership audit regime will be solely for purposes of the taxes not covered by chapter 1, will not constitute determinations for purposes of chapter 1, and will not constitute an administrative proceeding with respect to the partnership for purposes of subchapter C of chapter 63. The IRS may use all procedures available, such as obtaining the books and records of the partnership, to make determinations of items covered by the centralized partnership audit regime solely for purposes of taxes not covered by chapter 1. Any determinations for taxes other than chapter 1 taxes are not covered by the centralized partnership audit regime under subchapter C of chapter 63.

Proposed Reg. §1.301.6221(a)-1(b) provides that the phrase "items of income, gain, loss, deduction, or credit" means:

- All items and information required to be shown, or reflected, on a return of the partnership
    - Under section 6031,

  Regulations, and
    - The forms and instructions prescribed by the Internal Revenue Service (IRS) for the partnership's taxable year, and
- Any information in the partnership's books and records for the taxable year.

Specifically, the regulation goes on to note the phrase would include a long list of items related to the partnership including:

- The character, timing, source, and amount of the partnership's income, gain, loss, deductions, and credits, including whether an item is deductible, tax-exempt, or a tax-preference item;
- The character, timing, and source of the partnership's activities, including whether the partnership's activities are passive or active;
- Contributions to, and distributions from, the partnership, including the value, amount, and character of those contributions and distributions;
- The partnership's basis in its assets, the character and type of the assets, and the value (or revaluation such as under § 1.704-1(b)(2)(iv)(f) or (s)) of the assets; including any effect the character or value of the partnership's assets has on the sale or exchange of an interest in the partnership;
- The amount and character of partnership liabilities, including whether a liability is recourse or nonrecourse and any changes to those liabilities from the preceding tax year;
- The separate category, timing, and amount of the partnership's creditable foreign tax expenditures described in § 1.704-1(b)(4)(viii)(b);
- Any elections made by the partnership and the consequences or effects of those elections, including a section 754 election, any election referenced in section 703(b), a section 761 election, and an election under sections 6221(b) or 6226(a);
- Items related to transactions between a partnership and any person including disguised sales, guaranteed payments, section 704(c) allocations, and transactions to which section 707 applies;
- Any item resulting from a partnership terminating under section 708(b)(1)(A), including as a result of a transaction under Rev. Rul. 99-6 (1999-1 C.B. 432) (see § 601.601(d)(2) of this chapter);
- Items and any effects from a technical termination under section 708(b)(1)(B); and
- Partner capital accounts, including the release of a partner from a deficit restoration obligation.

Factors that are to be taken into account to determine items of income, gain, loss, deduction or credit include, per Proposed Reg. §301.6621(a)-1(b)(1)(ii):

- The legal and factual determinations that underlie the determination of items of income, gain, loss, deduction, or credit;
- The partnership's accounting practices and methods;
- Whether any person is a partner in the partnership;
- Whether a partnership exists for tax purposes, including whether multiple partnerships should be treated as a single partnership;
- Whether any items or transactions of the partnership, the adjustments to which are determined under the BBA centralized audit regime, lack economic substance or should otherwise be disregarded, collapsed, recharacterized, or attributed to other persons (for example, under the step transaction doctrine), including whether the partnership is a sham or should otherwise be disregarded for tax purposes (including under § 1.701-2 of this chapter and any applicable judicial doctrines);
- The period of limitations on making adjustments under the BBA exam regime;
- The period of limitations on the assessment of amounts attributable to adjustments determined under the BBA centralized audit regime, except for the period of limitations under section 6501 with regard to assessments of tax attributable to adjustments taken into account by partners as a result of an election under the BBA alternative to the payment of the imputed underpayment under section 6226;
- Partners' outside bases, but only to the extent the partners' outside bases relate to an adjustment determined under the BBA centralized audit regime; and
- Any determinations necessary to calculate the imputed underpayment (as defined in § 301.6241-1(a)(3)) under section 6225, including whether items adjusted under the BBA centralized audit regime are limited (or subject to limitations) under the Internal Revenue Code (or a treaty), and the facts and circumstances specific to any partner(s) that might affect the calculation of an imputed underpayment or modification requested by the partnership with respect to an imputed underpayment.

A partner's distributive share is defined as:

- The partner's share of items adjusted under the BBA centralized audit regime, including the type of partnership interest(s) the partner holds and the percentage interest of a partner in the partnership;
- The allocation of any item determined under the BBA centralized audit regime;
- Any special allocations applicable to any partner;
- The character, source, and timing of any item or activity required to be taken into account by the partner which is related to any item adjusted under the BBA centralized audit regime; and
- Any amount required to be taken into account by any person under the section 6226 election for an alternative to the payment of the imputed underpayment by the partnership.

Penalty Defenses

As part of Proposed Reg. §301.6221(a)-1 the IRS outlined its position that penalty issues are to be resolved as part of the audit of the partnership under the BBA provisions. Proposed Reg. §301.6221(a)-1(c)(1) provides:

> Any defense to any penalty, addition to tax, or additional amount must be raised by the partnership in a partnership-level proceeding under subchapter C of chapter 63, regardless of whether the defense relates to facts and circumstances relating to a person other than the partnership. After the adjustments determined in a partnership proceeding under subchapter C of chapter 63 become final, no defense to any penalty determined may be raised or taken into account in determining the applicable penalties, additions to tax, or additional amounts under subchapter C of chapter 63 with respect to any person.

Note that this position would require the partnership to obtain information from each partner regarding any potential partner level defense to a penalty as part of the examination or forgo the possibility of reducing penalty exposure by walking away from partner level defenses.

The IRS provides a pair of examples in Proposed Reg. §301.6221(a)-1(c)(2):

EXAMPLE 1

The IRS initiates an administrative proceeding with respect to Partnership's taxable year under subchapter C of chapter 63. During the proceeding, the IRS mails to Partnership a notice of proposed partnership adjustment under section 6231 that imposes a section 6662 accuracy-related penalty with respect to an imputed underpayment on the grounds that the imputed underpayment is attributable to negligence or disregard of rules or regulations. Partnership believes that the actions of A, a partner in the partnership for the taxable year subject to the administrative proceeding, demonstrate that A had reasonable cause and acted in good faith with respect to how A reported on A's Federal income tax return the items that were adjusted and gave rise to the imputed underpayment subject to the penalty. Partnership provides this information to the IRS during the administrative proceeding in response to the notice of proposed partnership adjustment. The IRS will take this penalty defense into account when determining whether the portion of the penalty that relates to the adjustments attributable to A applies at the partnership level.

EXAMPLE 2

Same facts as in Example 1 of this paragraph (c)(2), except Partnership does not provide A's information to the IRS during the administrative proceeding. The IRS mails Partnership a notice of final partnership adjustment (FPA) under section 6231. Partnership does not challenge the FPA in court. Partnership makes a timely election under section 6226 (regarding the alternative to payment of the imputed underpayment) and furnishes each reviewed year partner (as defined in § 301.6241-1(a)(9)) a statement including the reviewed year partner's share of the section 6662 accuracy-related penalty determined in the FPA. In taking the section 6662 accuracy-related penalty into account, A raises with the IRS a reasonable cause defense based on A's actions, asserting that A had reasonable cause and acted in good faith. Because all defenses against a penalty imposed under subchapter C of chapter 63 may only be raised by Partnership, A may not raise a defense to his share of the section 6662 penalty determined under section 6226. Therefore, the IRS will not take the penalty defense into account.

Election Out of the BBA Audit Regime

Proposed Reg. §301.6221(b)-1 contains provisions related to option to elect out of the BBA audit regime for certain partnerships that issue fewer than 100 K-1s pursuant to IRC §6221(b).

The preamble to the proposed regulations indicates that the IRS plans to strictly limit the ability of partnerships to opt out and, in fact, contains warnings that the IRS plans to review such elections to insure they are not being made to "frustrate IRS compliance efforts."

The IRS specifically announces its intention to increase examination of partnerships opting out, rather than limiting the increase to those that are subject to the new regime:

> …[T]he IRS intends to increase the number of partnership audits for both partnerships that are subject to the centralized partnership audit regime and partnerships that have elected out of the partnership audit regime.

As well, the IRS goes on to note in the preamble the specific concerns they will be looking at for partnerships that attempt to elect out of the new regime:

> …[T]o ensure that the election out rules are not used solely to frustrate IRS compliance efforts, the IRS intends to carefully review a partnership's decision to elect out of the centralized partnership audit regime. This review will include analyzing whether the partnership has correctly identified all of its partners for federal income tax purposes notwithstanding who the partnership reports as its partners. For instance, the IRS will be reviewing the partnership's partners to confirm that the partners are not nominees or agents for the beneficial owner.
>
> In addition, the IRS intends to carefully scrutinize whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for federal income tax purposes. The types of arrangements that the IRS will carefully review include those where the profits or losses of partners are determined in whole or in part by the profits or losses of partners in another partnership, and those that purport to be something other than a partnership, such as the co-ownership of property. If it is determined that two or more partnerships that have elected out of the centralized partnership audit regime have formed a constructive or de facto partnership for a particular partnership taxable year and are recast as such by the IRS, that constructive or de facto partnership will be subject to the centralized partnership audit regime because that constructive or de facto partnership will not have filed a partnership return and, therefore, will not have made a timely election out as required under section 6221(b)(1)(D)(i) and these proposed regulations. The constructive or de facto partnership may also have more than 100 partners or an ineligible partner, making it ineligible to elect out.

To be eligible to make the election, the following conditions must be met:

- The partnership has 100 or fewer partners, and
- Each statement the partnership is required to furnish the opt-out rules for the partnership taxable year is furnished to a partner that was an eligible partner for the partnership's entire taxable year. [Proposed Reg. §301.6221(b)-1(b)(1)]

As well, all partners must be "eligible partners."

100 or Fewer Partners Test

A partnership is treated as having 100 or fewer partners if it issues 100 or fewer Schedule K-1s for the tax year. [Proposed Reg. §301.6221(b)-1(b)(2)] However, if any of those partners are S corporations, the partnership must treat each K-1 issued by the S corporation as a "partner" for purposes of meeting the 100 or fewer partner test.

The IRS provides five examples of applying the 100 or fewer partners test at Proposed Reg. §301.6221(b)-1(b)(2)(iii):

EXAMPLE 1

During its 2020 partnership taxable year, Partnership has four partners each owning an interest in Partnership. Two of the partners are Spouse 1 and Spouse 2 who are married to each other during all of 2020. Spouse 1 and Spouse 2 each own a separate interest in Partnership. The two other partners are unmarried individuals. Under section 6031(b), Partnership is required to furnish a separate statement (that is, Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.) to each individual partner, including separate statements to Spouse 1 and Spouse 2. Therefore, for purposes of paragraph (b)(2) of this section, Partnership has four partners during its 2020 taxable year.

EXAMPLE 2

The facts are the same as in Example 1 of this paragraph (b)(2)(iii), except Spouse 2 does not separately own an interest in Partnership during 2020 and Spouse 1 and Spouse 2 live in a community property state. Spouse 1 and Spouse 2 have lived in the community property state for the entire taxable year and at all times since they were married. Spouse 1 acquired Spouse 1's interest in Partnership while married to Spouse 2. Because Spouse 2's community property interest in Spouse 1's partnership interest is not taken into account for purposes of determining the number of statements Partnership is required to furnish under section 6031(b), Partnership is required to furnish a statement to Spouse 1, but not to Spouse 2. Therefore, for purposes of paragraph (b)(2) of this section, Partnership has three partners during its 2020 taxable year.

EXAMPLE 3

At the beginning of 2020, Partnership, which has a taxable year ending December 31, 2020, has three partners -- individuals A, B, and C. Each individual owns an interest in Partnership. On June 30, 2020, Individual A dies, and A's interest in Partnership becomes an asset of A's estate. A's estate owns the interest for the remainder of 2020. On September 1, 2020, B sells his interest in Partnership to Individual D, who holds the interest for the remainder of the year. Under section 6031(b), Partnership is required to furnish five statements for its 2020 taxable year -- one each to Individual A, the estate of Individual A, Individual B, Individual D, and Individual C. Therefore, for purposes of paragraph (b)(2) of this section, Partnership has five partners during its 2020 taxable year.

EXAMPLE 4

During its 2020 taxable year, Partnership has 51 partners -- 50 partners who are individuals and S, an S corporation. S and Partnership are both calendar year taxpayers. S has 50 shareholders during the 2020 taxable year. Under section 6031(b), Partnership is required to furnish 51 statements for the 2020 taxable year -- one to S and one to each of Partnership's 50 partners who are individuals. Under section 6037(b), S is required to furnish a statement (that is, Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc.) to each of its 50 shareholders. Under paragraph (b)(2)(ii) of this section, the number of statements required to be furnished by S under section 6037(b), which is 50, is taken into account to determine whether partnership has 100 or fewer partners. Accordingly, for purposes of paragraph (b)(2) of this section, Partnership has a total of 101 partners (51 statements furnished by Partnership to its partners plus 50 statements furnished by S to its shareholders) and is therefore not an eligible partnership under paragraph (b)(1) of this section. Because Partnership is not an eligible partnership, it cannot make the election under paragraph (a) of this section.

The above example resolves the "S corporation partner" count in a way that may surprise some advisers. The rule provides that the S corporation's K-1 from the partnership counts an issued K-1 plus each of the K-1s issued by the S corporation is counted. The alternative view would have been that the S corporation K-1 would have been removed from the count, with the K-1s issued by the S corporation then substituted. In that case, the above example would have had 50 K-1s issued directly to partners plus 50 issued indirectly to the shareholders of the S corporation—or 100 total K-1s.

EXAMPLE 5

During its 2020 taxable year, Partnership has two partners, A, an individual, and E, an estate of a deceased partner. E has 10 beneficiaries. Under section 6031(b), Partnership is required to furnish

two statements, one to A and one to E. Any statements that E may be required to furnish to its beneficiaries are not taken into account for purposes of paragraph (b)(2) of this section. Therefore, Partnership has two partners under paragraph (b)(2) of this section.

In this case the IRS notes that the law does not requiring counting the K-1s issued by an estate in applying the 100 or fewer partner test.

Eligible Partners

To make the election out of the BBA audit regime, all partners of the partnership during the year must be eligible partners. Proposed Reg. §301.6621(b)-1(b)(3) provides that an eligible partner is:

> …a partner that is an individual, a C corporation (as defined by section 1361(a)(2)), an eligible foreign entity described in paragraph (b)(3)(iii) of this section, an S corporation, or an estate of a deceased partner. An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not an eligible partner.

Proposed Reg. §301.6221(b)-1(b)(3)(iii) provides the definition of an "eligible foreign entity":

> For purposes of this paragraph (b)(3), a foreign entity is an eligible partner if the foreign entity would be treated as a C corporation if it were a domestic entity. For purposes of the preceding sentence, a foreign entity would be treated as a C corporation if it were a domestic entity if the entity is classified as a per se corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), is classified by default as an association taxable as a corporation under § 301.7701-3(b)(2)(i)(B), or is classified as an association taxable as a corporation in accordance with an election under the provisions of § 301.7701-3(c).

A list of entities that are not eligible entities is also provided. If any partner is one of these entities, under the proposed regulations the partnership would not be eligible to opt out of the BBA audit regime regardless of how many partners the partnership has.

The ineligible entities specifically enumerated are:

- A partnership,
- A trust,
- A foreign entity that is not an eligible foreign described above
- a disregarded entity (see the discussion below)
- a nominee or other similar person that holds an interest on behalf of another person, or
- an estate of an individual other than a deceased partner.

Note that the last item makes clear that if an estate were, for some reason, to acquire an interest in a partnership that had not been held by the decedent, that partnership would not be eligible to make the election out.

The "disregarded entity" is defined by reference to Reg. §301.7701-2(c)(2)(i) which is a business entity which is not treated as a corporation that has a single owner. Thus an LLC, unless it had elected to be taxed as a corporation (either C or S), would always be an ineligible entity.

Of some interest is the fact that the regulation does not directly mention a grantor trust as an ineligible entity, nor does it clarify that the grantor trust is not part of the trust ineligible entity.

The IRS provides three examples to illustrate eligible and ineligible partners.

EXAMPLE 1

During the 2020 taxable year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, D, is a partnership. Because D is a partnership, D is not an eligible partner under paragraph (b)(3)(i) of this section. Accordingly, Partnership is not an eligible partnership under paragraph (b)(1) of this section and, therefore, cannot make the election under paragraph (a) of this section for its 2020 taxable year.

EXAMPLE 2

During its 2020 taxable year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, S, is an S corporation. S has ten shareholders. One of S's shareholders is a disregarded entity and one is a qualified small business trust. S is an eligible partner under paragraph (b)(3)(i) of this section even though S's shareholders would not be considered eligible partners if those shareholders held direct interests in Partnership. See § 301.6221(b)-1(b)(3)(i). Accordingly, Partnership meets the requirements under paragraph (b)(3) of this section for its 2020 taxable year.

EXAMPLE 3

During its 2020 taxable year, Partnership has two equal partners, A, an individual, and C, a disregarded entity, wholly owned by B, an individual. C is not an eligible partner under paragraph (b)(3)(i) of this section. Accordingly, Partnership is not an eligible partnership under paragraph (b)(1)(ii) of this section and, therefore, is ineligible to make the election under paragraph (a) of this section for its 2020 taxable year.

Making the Election

Proposed Reg. §301.6221(b)-1(c)(1) provides the general rules for making the election out of the BBA audit regime. The election must be made on a timely filed return (including extensions) for the year in question—thus the election is a year-by-year election and must be attached to each return to which it will apply. The partnership must make specific disclosures to the IRS about its partners (including S corporation shareholders if there is an S corporation partner. The election may not be revoked without the consent of the IRS. [Proposed Reg. §301.6221(b)-1(c)(1)]

The information to be provided to the IRS is described as follows:

> A partnership making an election under this section must disclose to the IRS information about each person that was a partner at any time during the taxable year of the partnership to which the election applies, including each partner's name, correct U.S. taxpayer identification number (TIN), and Federal tax classification, an affirmative statement that the partner is an eligible partner under paragraph (b)(3) of this section, and any other information required by the IRS in forms, instructions, or other guidance. If a partner is an S corporation, the partnership must also disclose to the IRS the name, correct TIN, and Federal tax classification of each shareholder of the S corporation as well as any other information required by the IRS in forms, instructions, or other guidance. [Proposed Reg. §301.6221(b)-1(c)(2)]

Each partner of the partnership must be notified of the election within 30 days of when the election is made. [Proposed Reg. §301.6221(b)-1(c)(3)]

The fact that a partnership makes this election has no impact on a partnership of which it is a partner. [Proposed Reg. §301.6221(b)-1(c)(4)] In fact, any partnership that has interests held by an electing

partnership would not be eligible to make the election since it would have an ineligible partner. But there could be a pushout of an adjustment that would make its way out to an electing partnership if the partnership it held an interest in was examined.

The IRS outlines this in two examples.

EXAMPLE 1

During its 2020 taxable year, Partnership, a calendar year taxpayer, has two partners. One partner, A, is also a calendar year partnership. A files a valid election out of the centralized partnership audit regime with its timely filed partnership return for its 2020 taxable year. Notwithstanding A's valid election out of the centralized partnership audit regime, A is subject to the same rules as any partner in a partnership subject to the rules under subchapter C of chapter 63, including the consistency requirements of section 6222 and the regulations thereunder.

EXAMPLE 2

The IRS mails to Partnership, a calendar year taxpayer, a notice of final partnership adjustment under section 6231 with respect to Partnership's 2020 taxable year. Partnership timely elects the alternative to payment of imputed underpayment under section 6226 and the regulations thereunder. One of Partnership's partners is A, a calendar year partnership. A made a valid election out of the centralized partnership audit regime with its timely filed partnership return for its 2020 taxable year. Partnership must provide A with a statement under section 6226 containing A's share of the adjustments for Partnership's 2020 taxable year. A is subject to the same rules as any partner in a partnership subject to the rules under subchapter C of chapter 63.

An election made under this provision is binding on the partnership until and unless the IRS notifies the partnership that the election is invalid. [Proposed Reg. §301.6621(b)-1(e)(1)] If the IRS determines the election is invalid, the IRS will notify the partnership in writing of that fact. [Proposed Reg. §301.6621(b)-1(e)(2)]

Consistent Treatment of Items by Partners

Similar to the provisions under the TEFRA partnership audit regime that will be replaced by the BBA regime, a partner generally is bound to report an item on his/her return consistent with the partnership's treatment. [IRC §6222] Proposed Reg. §301.6222-1(a)(1) provides that to meet this requirement the "treatment on a partner's return of each item of income, gain, loss, deduction, or credit (as defined in § 301.6221(a)-1(b)(1)) attributable to a partnership must be consistent with the treatment of those items on the partnership return in all respects, including the amount, timing, and characterization of those items."

The IRS emphasizes that the reporting must be consistent with the return actually filed, even if the partnership provided other information. As Proposed Reg. §301.6222-1(a)(1) continues:

> A partner has not satisfied the requirement of this paragraph (a) if the treatment of the item on the partner's return is consistent with how the item was treated on a schedule or other information furnished to the partner by the partnership but inconsistent with the treatment of the item on the partnership return actually filed. For rules relating to the election to be treated as having reported the inconsistency where the partner treats an item consistently with an incorrect schedule or other information furnished by the partnership, see paragraph (d) of this section.

The rules apply to all partners, including partners that are themselves partnerships and have filed a valid election out of the BBA partnership audit regime. [Proposed Reg. §301.6222-1(a)(2)]

If a partnership does not file a tax return, a partner will be required to file a notice of inconsistent treatment as described below. Otherwise the partner will be deemed to have reported in a manner not consistent with the partnership's reporting. [Proposed Reg. §301.6222-1(a)(3)]

The proposed regulations define the treatment of an item by the partnership in the following manner:

- The treatment of an item on the partnership's return of partnership income filed with the IRS under section 6031, and any amendment or supplement thereto, including an administrative adjustment request (AAR) filed pursuant to section 6227 and the regulations thereunder; and
- The treatment of an item on any statement, schedule or list, and any amendment or supplement thereto, filed by the partnership with the Internal Revenue Service (IRS), including any statements filed pursuant to section 6226 and the regulations thereunder. [Proposed Reg. §301.6222-1(a)(4)]

The IRS provides the following examples at Proposed Reg. §301.6222-1(a)(5):

EXAMPLE 1

B is a partner in Partnership during 2018 and 2019. Both B and Partnership are calendar year taxpayers. In December 2018, Partnership receives an advance payment for services to be performed in 2019 and reports this amount as income on its partnership return for 2018. B includes its distributive share of income from the advance payment on B's income tax return for 2019 and not on B's income tax return for 2018. B did not file a notice of inconsistent treatment with respect to the advanced payment. B's treatment of the income attributable to Partnership is inconsistent with the treatment of that item by Partnership on its partnership return.

EXAMPLE 2

C is a partner in Partnership during 2018. Partnership incurred start-up costs before it was actively engaged in its business. Partnership capitalized these costs on its 2018 partnership return. C deducted his distributive share of the start-up costs on C's 2018 income tax return. C's treatment of the start-up costs is inconsistent with the treatment of that item by Partnership on its partnership return.

EXAMPLE 3

D is a partner in Partnership during 2018. Partnership reports a loss of $100,000 on its partnership return for 2018. On the 2018 Schedule K-1 attached to the partnership return, Partnership reports $5,000 as D's distributive share of that loss. On the 2018 Schedule K-1 furnished to D, however, Partnership reports $15,000 as D's distributive share of the loss. D reports the $15,000 loss on D's 2018 income tax return. D has not satisfied the requirements of paragraph (a) of this section because D reported D's distributive share of the loss in a manner that is inconsistent with how D's distributive share of the loss was reported on the 2018 partnership return actually filed. See, however, paragraph (d) of this section for the election to be treated as having reported the inconsistency where the partner treats an item consistently with an incorrect schedule.

EXAMPLE 4

D was a partner in Partnership during 2018. Partnership reports a loss of $100,000 on its partnership return for 2018. In 2020, Partnership files an AAR under section 6227 reporting that the amount of the loss on its 2018 partnership return is $90,000, rather than $100,000 as originally

reported. Pursuant to section 6227 and the regulations thereunder, Partnership elects to have its partners take the adjustment into account, and furnishes D a statement showing D's share of the reduced loss for 2018. D fails to take his share of the reduced loss for 2018 into account in accordance with section 6227 and the regulations thereunder. D has not satisfied the requirements of paragraph (a) of this section because D has not taken into account his share of the loss in a manner consistent with how Partnership treated such items on the partnership return actually filed.

EXAMPLE 5

E was a partner in Partnership during 2018. In 2021, Partnership receives a notice of final partnership adjustment in an administrative proceeding under subchapter C of chapter 63 with respect to Partnership's 2018 taxable year.

Partnership properly elects the application of section 6226 and furnishes to E a statement of E's share of adjustments with respect to Partnership's 2018 taxable year.

E fails to take his share of the adjustments into account in accordance with section 6226 and the regulations thereunder. E has not satisfied the requirements of paragraph (a) of this section because E has not taken into account his share of adjustments with respect to Partnership's 2018 taxable year in a manner consistent with how Partnership treated such items on the partnership return actually filed.

EXAMPLE 6

In 2018, E is a partner in Partnership. E is a partnership-partner with a 2018 taxable year that ends on the same day as Partnership's 2018 taxable year.

E has filed a valid election under section 6221(b) in effect with respect to E's 2018 partnership taxable year. Notwithstanding E's election under section 6221(b) for its 2018 taxable year, E is subject to section 6222 for taxable year 2018. E must treat, on its 2018 partnership return, any items attributable to E's interest in Partnership in a manner that is consistent with the treatment of those items on the 2018 partnership return actually filed by Partnership.

Underpayment Resulting from Inconsistent Treatment

Proposed Reg. §301.6222-1(b)(1) provides the following for determination of the underpayment of tax resulting from an inconsistent treatment:

> If a partner fails to satisfy the requirements of paragraph (a) of this section, unless the partner provides notice in accordance with paragraph (c) of this section, the IRS may adjust the inconsistently reported item on the partner's return to make it consistent with the treatment of such item on the partnership return and determine the underpayment of tax that results from that adjustment. For purposes of this section, the underpayment of tax is the amount by which the correct tax, as determined by making the partner's return consistent with the partnership return, exceeds the tax shown on the partner's return.

Collection of Tax from Inconsistent Treatment

As Proposed Reg. §301.6222-1(b)(2) notes, the law allows for the IRS to collect that tax under a math error treatment that provides fewer options than a normal math error collection:

> The IRS may assess and collect any underpayment of tax resulting from an adjustment described in paragraph (b)(1) of this section in the same manner as if the underpayment of tax was on account of a

> mathematical or clerical error appearing on the partner's return, except that the procedures under section 6213(b)(2) for requesting abatement of an assessment do not apply.

The IRS provides the follow examples of dealing with the underpayment of tax resulting from an inconsistent treatment:

EXAMPLE 1

D, an individual, is a partner in Partnership. D and Partnership are both calendar year taxpayers and Partnership does not have an election under section 6221(b) in effect for its 2018 taxable year. On its partnership return for taxable year 2018, Partnership reports $100,000 in ordinary income. On the Schedule K-1 attached to the partnership return, as well as on the Schedule K-1 furnished to D, Partnership reports $15,000 as D's distributive share of the $100,000 in ordinary income. D reports only $5,000 of the $15,000 of ordinary income on his 2018 income tax return. The IRS may determine the amount of tax that results from adjusting the ordinary income attributable to D's interest in Partnership reported on D's 2018 income tax return from $5,000 to $15,000 and assess that resulting underpayment in tax as if it was on account of a mathematical or clerical error appearing on D's return. D may not request an abatement of that assessment under section 6213(b).

EXAMPLE 2

F was a partner in Partnership during 2018. In 2021, Partnership receives a notice of final partnership adjustment in an administrative proceeding under subchapter C of chapter 63 with respect to Partnership's 2018 taxable year.

Partnership properly elects the application of section 6226 and files with the IRS a statement of F's share of adjustments with respect to Partnership's 2018 taxable year. F fails to report one adjustment, F's share of a decrease in the amount of losses for 2018, on F's return as required by section 6226 and the regulations thereunder. The IRS may determine the amount of tax that results from adjusting the decrease in the amount of losses on F's return to be consistent with the amount included on the section 6226 statement filed with the IRS and may assess the resulting underpayment in tax as if it was on account of a mathematical or clerical error appearing on F's return. F may not request an abatement of that assessment under section 6213(b).

Partner's Notice of Inconsistent Treatment

The law does provide a partner an option to report inconsistently—but the partner has to report that inconsistent treatment to the IRS. [Proposed Reg. §301.6222-1(c)(1)]

The protection provided is described by Proposed Reg. §301.6222-1(c)(3):

> A partner who reports the inconsistent treatment of an item is not subject to paragraphs (a) and (b) of this section only with respect to those items identified in the statement described in paragraph (c)(1) of this section. Thus, if a partner notifying the IRS with respect to one item does not report the inconsistent treatment of another item, the IRS may determine the amount of tax that results from adjusting the unidentified, inconsistently reported item on the partner's return to make it consistent with the treatment of the item on the partnership return, and assess the resulting underpayment of tax in accordance with paragraph (b)(2) of this section.

If such a notice is provided, the IRS can make adjustments via a partner level proceeding. As Proposed Reg. §301.6222-1(c)(4)(i) notes:

> If a partner notifies the IRS of the inconsistent treatment of an item in accordance with paragraph (c)(1) of this section, and the IRS disagrees with the inconsistent treatment, the IRS may adjust the identified, inconsistently reported item in a proceeding with respect to the partner. Nothing in this paragraph (c)(4)(i) precludes the IRS from also conducting a proceeding with respect to the partnership.

The nature of that partner level proceeding is described in Proposed Reg. §301.6222-1(c)(4)(ii):

> In a proceeding with respect to a partner described in paragraph (c)(4)(i) of this section, the IRS may adjust any identified, inconsistently reported item to make the item consistent with the treatment of that item on the partnership return or determine that the correct treatment of such item differs from the treatment on the partnership return and instead adjust the item to reflect the correct treatment, notwithstanding the treatment of that item on the partnership return. The IRS may also adjust any item on the partner's return, including items that are not attributable to the partnership. Any final decision with respect to an inconsistent position in a proceeding to which the partnership is not a party is not binding on the partnership.

The IRS gives the following two examples of applying the notification of inconsistent treatment provisions at Proposed Reg. §301.6222-1(c)(5):

<u>EXAMPLE 1</u>

B is a partner in Partnership during 2018. B treats a deduction and a capital gain attributable to Partnership on B's 2018 income tax return in a manner that is inconsistent with the treatment of those items by Partnership on its 2018 partnership return. B reports the inconsistent treatment of the deduction in accordance with paragraph (c)(1) of this section, but not the inconsistent treatment of the gain. Because B did not notify the IRS of the inconsistent treatment of the gain in accordance with paragraph (c)(1) of this section, the IRS may determine the amount of tax that results from adjusting the gain reported on B's 2018 income tax return in order to make the treatment of that gain consistent with how the gain was treated on Partnership's partnership return. Pursuant to paragraph (c)(3) of this section, the IRS may assess and collect the underpayment of tax resulting from the adjustment to the gain as if it was on account of a mathematical or clerical error appearing on B's return.

<u>EXAMPLE 2</u>

On its 2018 partnership return, Partnership treats partner E's distributive share of ordinary loss attributable to Partnership as $8,000. E, however, claims an ordinary loss of $9,000 as attributable to Partnership on its 2018 income tax return and notifies the IRS of the inconsistent treatment in accordance with paragraph (c)(1) of this section. As a result of the notice of inconsistent treatment, the IRS conducts a separate proceeding under subchapter B of chapter 63 of the Internal Revenue Code with respect to E's 2018 income tax return, a proceeding to which Partnership is not a party. During the proceeding, the IRS determines that the proper amount of E's distributive share of the ordinary loss from Partnership is $3,000. During the same proceeding, the IRS also determines that E overstated a charitable contribution deduction in the amount of $2,500 on its 2018 income tax return. The determination of the adjustment of E's share of ordinary loss is not binding on Partnership. The charitable contribution deduction is not attributable to Partnership or to another partnership subject to the provisions of subchapter C of chapter 63. The IRS may determine the amount of tax that results from adjusting the $9,000 ordinary loss deduction to $3,000 and from

adjusting the charitable contribution deduction. Pursuant to paragraph (c)(4)(ii) of this section, the IRS is not limited to only adjusting the ordinary loss of $9,000, as originally reported on E's partner return, to $8,000, as originally reported by Partnership on its partnership return, nor is the IRS prohibited from adjusting the charitable contribution deduction in the proceeding with respect to E.

Partner's Receipt of Incorrect Information

The law provides an option for a partner to make a late election of inconsistent treatment if the partnership provides the partner a K-1 that is not consistent with what the partnership files with its tax return. Per Proposed Reg. §301.6222-1(d)(1) the partner can take advantage of this rule if the partner:

- Demonstrates that the treatment of the item on the partner's return is consistent with the treatment of that item on the statement, schedule, or other form prescribed by the IRS and furnished to the partner by the partnership, and
- The partner makes an election in accordance with paragraph (d)(2) of this section.

The taxpayer must file the election within 60 days of being notified by the IRS of inconsistent treatment. [Proposed Reg. §301.6222-1(d)(2)(i)] The election must be:

- Clearly identified as an election under section 6222(c)(2)(B);
- Signed by the partner making the election;
- Accompanied by a copy of the statement, schedule, or other form furnished to the partner by the partnership and a copy of the IRS notice that notified the partner of the inconsistency; and
- Include any other information required in forms, instructions, or other guidance prescribed by the IRS. [Proposed Reg. §301.6222-1(d)(2)(ii)

If it is not clear exactly how the taxpayer's reporting on his/her return is consistent with the K-1 received, additional information is required. Proposed Reg. §301.6222-1(d)(2)(iii) provides:

> …[I]f it is not clear from the statement, schedule, or other form furnished by the partnership that the partner's treatment of such item on the partner's return is consistent, the election must also include an explanation of how the treatment of such item on the statement, schedule, or other form furnished by the partnership is consistent with the treatment of the item on the partner's return, including with respect to the characterization, timing, and amount of such item.

The IRS provides the following example related to the election after receipt of inconsistent information [Proposed Reg. §301.6222-1(d)(3)]:

EXAMPLE

E is a partner in Partnership for 2018. On its 2018 partnership return, Partnership reports that E's distributive share of ordinary income attributable to Partnership is $1,000. Partnership furnishes to E a Schedule K-1 for 2018 showing $500 as E's distributive share of ordinary income. E reports $500 of ordinary income attributable to Partnership on its 2018 income tax return consistent with the Schedule K-1 furnished to E. The IRS notifies E that E's treatment of the ordinary income attributable to Partnership on its 2018 income tax return is inconsistent with how Partnership treated the ordinary income allocated to E on its 2018 partnership return. Within 60 days of receiving the notice from the IRS of the inconsistency, E files an election with the IRS in accordance with paragraph (d)(2) of this section. Because E made a valid election under section 6222(c)(2)(B) and paragraph (d)(1) of this section, E is treated as having notified the IRS of the inconsistency with respect to the ordinary income attributable to Partnership under paragraph (c)(1) of this section.

Application of Provisions in the Case of Early Election of BBA Provisions

If a partnership elects early application of the BBA audit regime for a tax year beginning after November 2, 2015 and before January 1, 2018, the rules of this provision would apply to that examination.

Partnership Representative

Under the BBA regime the partnership representative fills a role that is similar to that of the tax matters partner under the TEFRA regime—but there are significant differences.

Definition of the Partnership Representative

Under Proposed Reg. §301.6223-1(a) the basic provisions governing the partnership representative are outlined. Every partner subject to the BBA regime must designate a partnership representative and the partnership can only have a single partnership representative at a time.

Once appointed the partnership representative will remain in that position until:

- A valid resignation takes place under the regulations;
- A valid revocation takes place under the regulations; or
- The IRS makes a determination that the designation is no longer in effect. [Proposed Reg. §301.6223-1(a)]

The representative must update his/her contact information as required by forms, instructions or other guidance the IRS may issue.

Eligibility to Serve as Partnership Representative

Any person (not just a partner) who meets the requirements may serve as a partnership representative. [Proposed Reg. §301.6223-1(b)]

- To serve as a partnership representative, the individual must have a substantial presence in the United States. A substantial presence exists if:
- The person is available to meet in person with the IRS in the United States at a reasonable time and place, as is necessary and appropriate, as determined by the IRS;
- The person has a street address that is in the United States and a telephone number with a United States area code where the person can be reached during normal business hours; and
- The person has a United States taxpayer identification number. [Proposed Reg. §301.6223-1(b)(2)]

In addition to an individual, the partnership can designate an entity to be its partnership representative. In that case, there must be appointed a "designated individual." The designated individual must be an individual who meets the requirements to have been the partnership representative. [Proposed Reg. §301.6223-1(b)(3)]

If a person loses the capacity to act, he/she is no longer eligible to serve as the partnership representative. The person loses the capacity to act in the event of:

- Death;
- A court order adjudicating that the person does not have the capacity to manage his or her person or estate;
- A court order enjoining the person from acting on behalf of the partnership or the entity partnership representative;
- Incarceration;
- Liquidation or dissolution under state law in the case of an entity partnership representative; or

- Any similar situation where the IRS reasonably determines the person may no longer have the capacity to act. [Proposed Reg. §301.6223-1(b)(4)]

Designation of the Partnership Representative

A separate designation must be made each year of the partnership representative and the designation is only effective for that year. [Proposed Reg. §301.6223-1(c)(1)]

The actual designation process is defined at Proposed Reg. §301.6223-1(c)(2):

> Except in the case of designation of a partnership representative after an event described in paragraph (d) of this section (regarding resignation), paragraph (e) of this section (regarding revocation by the partnership), or paragraph (f) of this section (regarding designation made by the IRS), or as prescribed in forms, instructions, and other guidance, designation of a partnership representative must be made on the partnership return for the partnership taxable year to which the designation applies and must include all of the information required by forms, instructions, and other guidance, including information about the designated individual if the provisions of paragraph (b)(3) of this section apply. The designation of the partnership representative (and the appointment of the designated individual, if applicable) is effective on the date that the partnership return is filed.

The IRS provides the following example of designating a partnership representative in Proposed Reg. §301.6223-1(c)(3).

EXAMPLE

Partnership properly designates A as its partnership representative for taxable year 2018 on its 2018 partnership return. Partnership designates B as its partnership representative for taxable year 2021 on its 2021 partnership return. In 2022, the IRS mails Partnership a notice of administrative proceeding under section 6231 with respect to Partnership's 2018 taxable year. A is the partnership representative for the 2018 partnership taxable year, notwithstanding the designation of B as partnership representative for the 2021 partnership taxable year.

Resignation of the Partnership Representative

A partnership representative may resign his/her position by following the provisions in Proposed Reg. §301.6223-1(d) to notify the partnership and the IRS. The notification to the IRS is to be made in accordance with forms and instructions to be provided by the IRS. The resignation may also include a designation of a successor partnership representative. The resignation and, if applicable, designation of a successor partnership representative takes effect 30 days from the date the IRS receives the notice. [Proposed Reg. §301.6223-1(d)(1)].

The proposed regulations outline the steps that will take place in either the case where a successor is appointed or where one is not.

> If the resigning partnership representative designates a successor, the IRS will notify the partnership, the resigning partnership representative, and the newly designated partnership representative when the IRS receives the written notification. If the resigning partnership representative does not designate a successor, the IRS will determine there is no designation in effect in accordance with paragraph (f) of this section, and the partnership will have the opportunity to designate a successor partnership representative, or the IRS will designate a successor, as described in paragraph (f)(1) of this section.

If the provisions of Proposed Reg. §301.6223-1(d) for resignation are not properly followed, the regulation provides:

> Failure to satisfy the requirements of this paragraph (d) is treated as if no resignation has occurred and the partnership representative designation remains in effect until the designation is terminated either by valid resignation (as described in this paragraph (d)), a valid revocation of the designation by the partnership (as described in paragraph (e) of this section), or a determination by the IRS that the designation is not in effect (as described in paragraph (f) of this section).

Since the partnership representative is the sole party that can act for the partnership in a BBA audit, this could easily create a situation where the representative, believing he/she has removed him/herself from the role, simply doesn't participate in the exam. So, clearly, it's important that resignations and the designation of a new partnership representative take place strictly following the regulation.

The IRS allows the resignation to coincide with the filing of an administrative adjustment request (AAR), upon receipt of a notice of an administrative proceeding (the BBA audit) or at other times the IRS may designate. If the resignation comes in connection with filing an AAR, the partnership representative must designate a successor. [Proposed Reg. §301.6223-1(d)(2)]

The resignation of the designated individual of an entity that was designated partnership representative is handled under similar provisions. Such a resignation would take place for many reasons, including if the designated individual ceased to be associated with the entity that was designated the partnership representative. The resignation would be submitted using the same methods and at the same allowed times noted above, and the individual would be allowed, but not required, to appoint a successor designated individual. The resignation and, if applicable, designation would take effect 30 days after the IRS received the notice of resignation. [Proposed Reg. §301.6223-1(d)(3)]

The proposed regulations go on as follows:

> If the resigning designated individual appoints a successor, the IRS will notify the partnership, the partnership representative, the resigning designated individual, and any newly appointed designated individual when the IRS receives the written notification. If the resigning designated individual does not appoint a successor, the IRS will determine there is no designation in effect in accordance with paragraph (f) of this section, and the partnership will have the opportunity to designate a partnership representative, including the appointment of a designated individual, or the IRS will designate a partnership representative, as described in paragraph (f)(1) of this section. [Proposed Reg. §301.6223-1(d)(3)]

Note that if a designated individual resigns without appointing a successor designated individual, the entity is at least temporarily removed as partnership representative. The entity would need to be designated again as the partnership representative by the partnership along with naming an appropriate designated individual.

Revocation of a Partnership Representative

The partnership itself can remove a partnership representative by following the procedures found in Proposed Reg. §301.6223-1(e). The partnership must submit the revocation as provided for by the IRS in forms and instructions and must designate a successor partnership representative at the same time. The revocation will take place 30 days after the IRS receives the notice, and the service will notify the partnership and the representative whose status is being revoked upon receipt of the revocation. [Proposed Reg. §301.6223-1(e)(1)]

More detailed rules on timing are provided for revocation than for resignation, but again the regulations provide for revocation either during an administrative proceeding or with an administrative adjustment request (AAR).

The regulations also provide that the IRS may provide other times during which the agency will allow a revocation to be made.

The general rule provides that a revocation cannot take place before the IRS mails a notice of administrative proceeding to the partnership. When the notice is received the partnership is allowed to revoke the partnership representative designation. [Proposed Reg. §301.6223-1(e)(2)(i)]

If the partnership is submitting an AAR the designation may be revoked at that time. However an AAR may not be submitted solely to revoke the designation of a partnership representative. [Proposed Reg. §301.6223-1(e)(2)(ii)]

The IRS appears to be attempting to reduce the correspondence the agency will receive with regard to either resignations or revocations by limiting the times when the actions may be taken. For partnerships this creates some problems, since the partnership would likely become aware the representative no longer is willing to serve or the partnership may not wish the representative to serve at a time other than one when the action can be taken. The partnership and/or representative will need to insure the proper actions are taken when the opportunity first arises to make the submission.

Revocation has one additional problem—who can sign the revocation on behalf of the partnership? Under the general rules applicable to BBA exams only the partnership representative may act on behalf of the partnership but presumably a partnership is revoking the status because the partnership representative is not willing to resign. Proposed Reg. §301.6223-1(e)(3) provides the rules for who may sign a designation.

The revocation must be signed by:

- A general partner of the partnership at the close of tax year for which the designation is in effect; or
- A partner at the close of the year for which the designation is in effect who was not a general partner if there exists no general partner described above currently has a capacity to act (using the same test of capacity to act as described above for the partnership representative).

If the entity is LLC taxed as a partnership, a member-manager is treated as a general partner and a member who is not a manger is treated as a partner other than a general partner for purposes of the revocation rules. [Proposed Reg. §301.6223-1(e)(3)]

A valid revocation must contain each of the following elements:

- A certification under penalties of perjury that the person signing the form --
    - Is a person with a status described above who is also authorized by the partnership to revoke the designation of the partnership representative; and
    - Has provided a copy of the revocation to the partnership and to the partnership representative whose designation is being revoked;
- A statement that the person signing the form is revoking the designation of the partnership representative; and
- A subsequent designation of a partnership representative in accordance with forms and instructions prescribed by the IRS. [Proposed Reg. §301.6223-1(e)(3)(iii)]

If the partnership representative is one designated by the IRS under the regulations, the partnership can revoke the designation only with the consent of the IRS. [Proposed Reg. §301.6223-1(e)(4)]

If the IRS receives more than one revocation of designation of a partnership representative signed by different persons within a 90 day period, the IRS may determine that no designation is in effect. [Proposed Reg. §301.6223-1(e)(5)] Presumably the IRS feels that such a circumstance indicates there exists some sort of dispute within the partnership that would make it imprudent for the agency to accept either revocation's designation of a new partnership representative. Not surprisingly, Proposed Reg. §301.6223-1(f)(4) provides

that in a case of multiple revocations the IRS will appoint the representative and will not give the partnership the right to appoint one. Since the partnership also cannot revoke an IRS designation without permission, the partnership will be "stuck" with the IRS choice.

The IRS provides two examples of the revocation process in Proposed Reg. §301.6223-1(d)(5), both of which deal with invalid revocations.

<u>EXAMPLE 1</u>

Partnership properly designates B as partnership representative for its 2018 taxable year on its 2018 partnership return. In 2020, Partnership mails written notification to the IRS to revoke designation of B as its partnership representative for Partnership's 2018 taxable year. The revocation is not made in connection with an AAR for Partnership's 2018 taxable year, and the IRS has not mailed Partnership a notice of administrative proceeding under section 6231 with respect to Partnership's 2018 taxable year. Because the revocation was not made during a time permitted under paragraph (e)(2) of this section, the revocation is not effective and B remains the partnership representative for Partnership's 2018 taxable year.

<u>EXAMPLE 2</u>

During an administrative proceeding with respect to Partnership's 2018 taxable year, Partnership provides IRS with written notification to revoke its designation of B as its partnership representative for the 2018 taxable year. The written notification does not include a designation of a new partnership representative for Partnership's 2018 taxable year. Because the revocation does not include a designation of a new partnership representative as required under paragraph (e)(1) of this section, the revocation is not effective and B remains the partnership representative for Partnership's 2018 taxable year.

Designation of the Partnership Representative by the IRS

The law provides that if no partnership representative is properly designated by the partnership, the IRS is given the power to select the partnership representative. [IRC 6223(a)]

The IRS must first determine that no partnership representative designation is in effect for the year. If the IRS determines that:

> …the IRS will notify the partnership and the most recent partnership representative for that partnership taxable year that a partnership designation is not in effect and provide the partnership with the opportunity to designate a successor partnership representative that is eligible… The determination that a designation is not in effect is effective on the date the IRS mails the notification.

Except in a case where the IRS has received multiple revocations within a 90 day period, the IRS gives the partnership a right to designate a successor before the agency does so. The regulations provides in that case:

> …the partnership may designate a successor partnership representative within 30 days of the date of notification. If the partnership does not designate a successor within 30 days from the date of notification, the IRS will designate a partnership representative in accordance with paragraph (f)(5) of this section.

Proposed Reg. §301.6223-1(f)(2) provides a list of situations in which the IRS will determine that no partnership representative designation is in effect:

- The partnership failed to make a valid designation on its tax return for the year in question;

- the partnership representative or the designated individual does not have substantial presence or does not have capacity to act;
- the partnership failed to appoint a designated individual if the partnership appointed an entity as the partnership representative; or
- no successor designation or appointment was made in the case of a resignation without a designation or appointment of a successor.

As well, as was noted above, the IRS will also find no partnership representative designation is in effect if it receives multiple revocations signed by different individuals within a 90-day period.

If the IRS designates a partnership representative, the proposed regulations describe the notification process as follows:

> The IRS designates a partnership representative by notifying the partnership of the name, address, and telephone number of the new partnership representative. The designation of a partnership representative by the IRS is effective on the date on which the IRS mails the notice of the designation to the partnership. The IRS will also mail a copy of the notice to the new partnership representative. [Proposed Reg. §301.6223-1(f)(5)(i)]

Proposed Reg. §301.6223-1(f)(5)(ii)] provides information on how the IRS is to go about designating a partnership representative in this case. The proposed regulation notes that the IRS may actually appoint any person to be the partnership representative. However, the regulation immediately goes on to note "[i]n addition to other relevant factors, the IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year (as defined in § 301.6241-1(a)(8)) or at the time the partnership representative designation is made."

Specific factors outlined in the regulation that the IRS will consider are:

- The views of the partners having a majority interest in the partnership regarding the designation;
- The general knowledge of the person in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership;
- Whether the person is a United States person (within the meaning of section 7701(a)(30)).

The IRS provides four examples of situations involving the IRS designation of a representative at Proposed Reg. §301.6223-1(f)(6).

EXAMPLE 1

The IRS determines that Partnership has designated a partnership representative that does not have substantial presence in the United States as defined in paragraph (b)(2) of this section. The IRS may determine that the designation is not in effect and designate a new partnership representative after following the procedures in paragraph (f) of this section.

EXAMPLE 2

Partnership designates as its partnership representative a corporation but fails to appoint a designated individual to act on behalf of the corporation as required under paragraph (b)(3) of this section. The IRS may determine that the partnership representative designation is not in effect and may designate a new partnership representative after following the procedures in paragraph (f) of this section.

EXAMPLE 3

The partnership representative resigns pursuant to paragraph (d) of this section without designating a new partnership representative. The IRS mails Partnership a notification informing Partnership that no designation is in effect and that the IRS plans to designate a new partnership representative. Partnership fails to respond within 30 days of the IRS's notification. The IRS will designate a partnership representative pursuant to paragraph (f) of this section.

EXAMPLE 4

Partnership designated on its partnership return a partnership representative, PR1. After Partnership received a notice of administrative proceeding, general partner, GP1, signs and submits to the IRS the form described in paragraph (e)(3) of this section requesting the revocation of the current partnership representative PR1 and the designation of a successor partnership representative, PR2. Sixty days later, general partner, GP2, signs and submits a form described in paragraph (e)(3) of this section requesting the revocation of the newly appointed PR2 and the designation of PR3 as the new partnership representative. The IRS may accept GP2's revocation and subsequent designation of PR3 or, because GP2's revocation was within 90 days of GP1's revocation, the IRS may determine, pursuant to paragraphs (e)(5) and (f)(2) of this section that there is no designation in effect due to multiple revocations. The IRS may then designate a new partnership representative pursuant to paragraph (f) of this section without allowing the partnership an opportunity for additional, possibly conflicting, designations.

Binding Effect of Actions of Partnership Representative

Proposed Reg. §301.6223-2 outlines the powers of the partnership representative. The new BBA exam regime gives the partnership representative complete powers to represent the partnership in most circumstances and the actions of the partnership representative are binding on the partnership and the partners for any matter covered by the BBA exam regime. [Proposed Reg. §301.6223-2(c)(2)]

Proposed Reg. §301.6223-2(a) provides:

> The actions of the partnership and the partnership representative taken under subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) and any final decision in a proceeding brought under subchapter C of chapter 63 with respect to the partnership bind the partnership, all partners of the partnership (including partnership-partners as defined in § 301.6241-1(a)(7) that have a valid election under section 6221(b) in effect for any taxable year that overlaps with the taxable year of the partnership), and any other person whose tax liability is determined in whole or in part by taking into account directly or indirectly adjustments determined under subchapter C of chapter 63 (for example, indirect partners as defined in § 301.6241-1(a)(4)). For instance, a settlement agreement entered into by the partnership representative on behalf of the partnership, a notice of final partnership adjustment with respect to the partnership that is not contested by the partnership or the partnership representative, or the final decision of the court with respect to the partnership if the notice of final partnership adjustment is contested, binds all persons described in the preceding sentence.

Even if the representative's designated is terminated, any actions taken before the termination date remain binding on the partnership. The regulation gives, as an example, a representative who consented to extend the statute of limitations for assessments pursuant to IRC §6235(b). Even if the partners, perhaps upset over that extension, were to move to terminate the partnership representative's status and appoint a new one, the extension would remain valid. [Proposed Reg. §301.6223-2(b)]

The regulation notes that the power to act on behalf of the partnership rests exclusively with the partnership representative. If an entity is appointed as the partnership representative, the power to act effectively resides with the designated individual. The proposed regulations provide specifically:

> Except for a partner that is the partnership representative or the designated individual, no partner, or any other person, may participate in an examination or other proceeding involving the partnership under subchapter C of chapter 63 without the permission of the IRS. No state law, partnership agreement, or other document or agreement may limit the authority of the partnership representative or the designated individual as described in section 6223 and this section.

That last sentence is important for all parties to understand—you can't directly limit the authority of the partnership representative via the partnership agreement. At best it would appear you could only hold the representative liable for taking actions with regard to the exam that go beyond what the partners had agreed the representative could do.

The IRS provides the following five examples of the actions of a partnership representative.

EXAMPLE 1

Partnership designates a partnership representative, PR, on its partnership return for 2020. PR is a partner in Partnership. The partnership agreement for Partnership includes a clause that requires PR to consult with an identified management group of partners in Partnership before taking any action with respect to an administrative proceeding before the IRS. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year. During the course of the administrative proceeding, PR consents to an extension of the period for adjustments under section 6235(b) allowing additional time for the IRS to mail a final notice of partnership adjustment. PR failed to consult with the management group of partners prior to agreeing to this extension of time. PR's consent provided to the IRS to extend the time period is valid and binding on Partnership because, pursuant to section 6223, PR, as the designated partnership representative, has authority to bind Partnership and all its partners.

EXAMPLE 2

Partnership designates a partnership representative, PR, on its partnership return for 2020. PR is not a partner in Partnership. During an administrative proceeding with respect to Partnership's 2020 taxable year, PR agrees to certain IRS adjustments and within 45 days after the issuance of the notice of final partnership adjustment (FPA), elects the alternative to payment of the imputed underpayment under section 6226 and the regulations thereunder. Certain partners in Partnership challenge the actions taken by PR during the administrative proceeding and the validity of the section 6226 statements furnished to those partners, alleging that PR was never authorized to act on behalf of Partnership under state law or the partnership agreement. Because PR was designated by Partnership as the partnership representative, under section 6223 and this section, PR was authorized to act on behalf of Partnership for all purposes under subchapter C of chapter 63, and the IRS may rely on that designation as conclusive evidence of PR's authority to act on behalf of Partnership.

EXAMPLE 3

Partnership designates an entity partnership representative, EPR, and appoints an individual A, as the designated individual, on its partnership return for 2020. EPR is a C corporation. A is unaffiliated with EPR and is not an officer, director, or employee of EPR. During an administrative proceeding with respect to Partnership's 2020 taxable year, A, acting for EPR, agrees to an

extension of the period for adjustments under section 6235(b). The IRS mails an FPA within the extended period for adjustments as agreed to by EPR, but after the expiration of the period had no agreement been entered into. Partnership challenges the FPA as untimely, alleging that A was not authorized under state law to act on behalf of EPR and thus the extension agreement was invalid. Because A was appointed by the partnership as the designated individual to act on behalf of EPR, A was authorized to act on behalf of EPR for all purposes under subchapter C of chapter 63, and the IRS may rely on that identification as conclusive evidence of A's authority to act on behalf of EPR and Partnership.

EXAMPLE 4

The partnership representative, PR, consents to an extension of the period for adjustment under section 6235(b) for Partnership for the partnership taxable year. After signing the consent, PR resigns as partnership representative in accordance with § 301.6223-1. The extension of the period under section 6235(b) remains valid even after PR resigns.

EXAMPLE 5

Partnership designates a partnership representative who is unable to meet with the IRS in person in the United States as required by § 301.6223-1(b). Although the partnership representative does not have substantial presence in the United States within the meaning of § 301.6223-1(b)(2), until a termination occurs under § 301.6223-1(d) or (e) or the IRS determines the partnership representative is ineligible under § 301.6223-1(b) and terminates the designation under § 301.6223-1(f), the partnership representative designation remains in effect, and Partnership and all its partners are bound by the actions of the partnership representative.

Partnership Adjustment by the IRS

The IRS's computation of the imputed adjustment is the fundamental change from the TEFRA examination regime in place prior to the new BBA regime. Proposed Reg. §301.6225-1 outlines how the process of the IRS coming to the imputed underpayment will work.

The imputed adjustment is treated as a tax imposed in the adjustment year. [Proposed Reg. §301.6225-1(a)] The adjustment year is:

- In the case of an adjustment pursuant to the decision of a court in a proceeding, such decision becomes final;
- In the case of an administrative adjustment request (AAR), such AAR is made; or
- In any other case, a notice of final partnership adjustment is mailed under section 6231 or, if the partnership waives the restrictions under section 6232(b) (regarding limitations on assessment), the date the waiver is executed by the IRS. [Proposed Reg. §301.6241-1(a)(1)]

The notice of final partnership adjustment will contain the amount of the imputed underpayment unless the partnership waives its right to such notice. [Proposed Reg. §301.6225-1(a)]

If the partnership pays an imputed underpayment, the amount is treated as a nondeductible expenditure. That includes not only the tax and penalties, but also any interest paid by the partnership. [Proposed Reg. §§301.6225-1(a), 301.6241-4(a)]

The IRS will apply all preferences, limitations, restrictions, and conventions in computing the imputed underpayment. As Proposed Reg. §301.6225-1(a)(2) provides:

> For purposes of determining the imputed underpayment, adjustments, netting of adjustments, and calculations or determinations of any amounts under this section, unless the Internal Revenue Service (IRS) in its discretion determines otherwise, all applicable preferences, restrictions, limitations, and conventions will be taken into account to disallow netting of adjustments, where applicable, or to disallow or limit, as applicable, any adjustment that potentially results in an increase of loss, deduction or credit, or decrease of income or gain, and as if the adjusted item was originally taken into account by the partnership or the partners, as applicable, in the manner most beneficial to the partnership or partners. For instance, if the adjustment is a reduction of qualified research expenses, the amount of the imputed underpayment is determined as if all partners claimed a credit with respect to their allocable portion of such expenses under section 41, rather than a deduction under section 174. See § 301.6225-2 for modifications of the imputed underpayment that may be requested by the partnership.

The imputed adjustment contained in the notice of partnership adjustment is the adjustment prior to any modifications requested by the partnership. [Proposed Reg. §301.6225-1(a)(3)] This amount may be reduced if the partnership determines it wishes to follow the procedures for reducing the imputed underpayment as provided for in the proposed regulations.

Adjustments That Do Not Result in an Imputed Underpayment

If an adjustment does not result in an imputed underpayment (for instance, the exam determines the partnership reported income in excess of what should have been reported or a specific sub-grouping does not result in an underpayment) the adjustment is taken into account by the partnership in the adjustment year. [Proposed Reg. §301.6225-3(a)] as follows:

- To the extent the adjustment involves separately stated items under IRC §702, the adjusted is taken into account to increase/decrease the related separately stated item in the adjustment year;
- Other adjustments of income/deductions are taken account by increasing/decreasing non-separately income/loss for the adjustment year; and
- Adjustments to credits are separately stated items in the adjustment year [Proposed Reg. 301.6225-3(b)(1)-(3)]

The allocation of the adjustments in this case is complicated by the fact that individuals/entities that were partners in the year under exam (the reviewed year) quite often will not be the same as those that are partners in the adjustment year (roughly the year the exam becomes final). Proposed Reg. §301.6225-3(b)(4) provides the method for handling the allocation problem:

> A partnership adjustment that does not result in an imputed underpayment pursuant to § 301.6225-1(c)(2)(i) is taken into account by the partnership in the adjustment year as a separately stated item or a non-separately stated item, as required by section 702. The portion of an adjustment allocated under this paragraph (b)(4) is allocated to adjustment year partners (as defined in § 301.6241-1(a)(2)) who are also reviewed year partners (as defined in § 301.6241-1(a)(9)) with respect to whom the amount was reallocated. If any reviewed year partner with respect to whom an amount was reallocated is not also an adjustment year partner, the portion of the adjustment that would otherwise be allocated to such reviewed year partner is allocated instead to the adjustment year partner or partners who are the successor or successors to the reviewed year partner. If the partnership cannot identify an adjustment year partner that is a successor to the reviewed year partner described in the previous sentence or if a successor does not exist, the portion of the adjustment that would otherwise be allocated to that reviewed year partner is allocated among the adjustment year partners according to the adjustment year partners' distributive shares.

Calculation of the Imputed Underpayment

The calculation of the imputed underpayment that will be part of the notice of partnership adjustment is calculated by:

- Multiplying the total netted partnership adjustment by the highest rate of Federal income tax in effect for the reviewed year, and
- Increasing or decreasing the product by the net increase or net decrease in credits resulting from partnership adjustments. [Proposed Reg. §301.6225-1(c)(1)]

The "netted partnership adjustment" is defined as:

- The sum of all net positive adjustments in the residual grouping plus
- The sum of all net positive adjustments in the reallocation grouping. [Proposed Reg. §301.6225-1(c)(3)]

There is no netting between years in computing an imputed adjustment—each year stands on its own. [Proposed Reg. §301.6225-1(c)(4)]

A partnership adjustment does not result in an imputed underpayment under any of three conditions:

- The adjustment relates to a distributive share reallocation that is disregarded rules discussed below;
- After grouping and netting the adjustments as described in paragraph (d) of this section, the result of netting any grouping or subgrouping is a net non-positive adjustment; or
- The calculation of the imputed underpayment results in an amount that is zero or less than zero. [Proposed Reg. §301.6225-1(c)(2)]

Groupings of Adjustments

Proposed Reg. §301.6225-1(d) outlines the groupings used in computing the imputed underpayment. The general rule is outlined as follows:

> For purposes of calculating an imputed underpayment under paragraph (c) of this section, partnership adjustments are grouped according to paragraph (d)(2) of this section and the partnership adjustments comprising each grouping are netted in accordance with paragraph (d)(3) of this section. Within each grouping, partnership adjustments are further grouped into subgroupings based on preferences, limitations, restrictions, and conventions, such as source, character, holding period, or restrictions under the Internal Revenue Code (Code) applicable to such items.

The regulation goes on to define an ordering of groupings as follows:

- First, each partnership adjustment that reallocates the distributive share of an item forms its own grouping which is taken into account in accordance with paragraph (d)(2)(ii) of this section (reallocation grouping);
- Second, adjustments to credits are taken into account in a grouping under paragraph (d)(2)(iii) of this section (credit grouping);
- Third, adjustments to creditable expenditures are taken into account in a grouping under paragraph (d)(2)(iv) of this section (creditable expenditure grouping); and
- Fourth, the remaining adjustments are taken into account in the residual grouping under paragraph (d)(2)(v) of this section (residual grouping). [Proposed Reg. §301.6225-1(d)(2)(i)]

The first defined group is the reallocation grouping found at Proposed Reg. §301.6225-1(d)(2)(ii). The discussion begins by noting:

> A partnership adjustment that reallocates the distributive share of an item from one or more partners to one or more other partners, or a partnership adjustment that allocates an item to a particular partner or partners, is taken into account in calculating the imputed underpayment under paragraph (c) of this section by disregarding net decreases to items of income or gain and net increases to items of deduction, loss, or credit.

The description goes on to define subgroups created as part of this process:

> Each adjustment to an item or to a distributive share of an item that allocates to or reallocates to and from a particular partner or partners is a separate subgrouping for purposes of the netting rules in paragraph (d)(3) of this section. For instance, if the reallocation adjustment reallocates an item of deduction from one partner to another partner, the decrease in the deduction with respect to the first partner is in a separate subgrouping from the increase in deduction with respect to the second partner.

The focus next moves to particular partners or groups of partners with multiple allocations:

> If a particular partner or group of partners has more than one adjustment allocable to it within the reallocation grouping, such adjustments may be combined or further divided into additional subgroupings according to the principles of paragraphs (d)(1) and (d)(2)(v) of this section and netted according to paragraph (d)(3) of this section.

Finally, we move on to the positive and negative subgroupings:

> After subgroupings are netted under paragraph (d)(3) of this section, any net non-positive adjustments (as defined in paragraph (d)(3)(ii)(C) of this section) are disregarded. Net non-positive adjustments disregarded under this paragraph (d)(2)(ii) are adjustments that do not result in an imputed underpayment under paragraph (c)(2) of this section. Net positive adjustments are included in the calculation of the total netted partnership adjustment under paragraph (c)(3) of this section if the net positive adjustments would otherwise be a part of the residual grouping described in paragraph (d)(2)(v) of this section. Net positive adjustments to credits are included in the credit grouping described in paragraph (d)(2)(iii) of this section.

The definition of a credit grouping is much more concise:

> The credit grouping includes all adjustments to items that are claimed or could be claimed by a partnership as a credit on the partnership's return. [Proposed Reg. §301.6225-1(d)(2)(iii)]

The proposed regulations do not contain a definition of the third category, the creditable expenditure grouping. Rather Proposed Reg. §301.6225-1(d)(2)(iii) marks this items as reserved. In the preamble to the proposed regulations the IRS notes:

> A paragraph is reserved in proposed § 301.6225-1(d)(2)(iv) for special rules relating to the treatment of certain creditable expenditures. This paragraph is reserved to provide rules applicable with respect to adjustments to items that are, or could be, reported by the partnership as expenditures that may be treated as a credit when taken into account by a partner. The Treasury Department and the IRS also seek comments on the appropriate treatment of items reported by the partnership as expenditures that may be treated as a credit when taken into account by a partner.

The final category is the residual grouping category which captures any adjustment not covered by the first three categories. Proposed Reg. §301.6225-1(d)(2)(v) provides:

> Any partnership adjustment not described in paragraph (d)(2)(ii), (d)(2)(iii), or (d)(2)(iv) of this section is included in the residual grouping described in this paragraph (d)(2)(v) and is further divided into subgroupings according to any limitations or restrictions imposed on the items to which the adjustment

relates under the Code. Each subgrouping in the residual grouping is created to account for limitations or restrictions such as character or holding period.

Partnership adjustments within each grouping or subgrouping are netted together to determine if there is a net positive or non-positive adjustment within each category. However, the various categories or sub-categories are not to be netted against each other. [Proposed Reg. §301.6225-1(d)(3)] The proposed regulation explains:

> For instance, under paragraph (d)(2) of this section, adjustments to ordinary income and loss items are grouped together separately from capital gain and loss items. Therefore under this paragraph (d)(3)(i), the items in the ordinary grouping are not netted against the items in the capital grouping.

Only net positive adjustments are taken into account for calculating the total netted partnership adjustment. Net non-positive adjustments are disregarded for this purpose. [Proposed Reg. §301.6225-1(d)(3)(ii)]

- A net positive adjustment results if the net amount of adjustments within a grouping or subgrouping under paragraph (d)(2) of this section (except with respect to the credit grouping described in paragraph (d)(2)(iii) of this section) is greater than zero.
- A net non-positive adjustment is any net amount within a grouping or subgrouping described in paragraph (d)(2) of this section (except for the credit grouping under paragraph (d)(2)(iii) of this section) that is not a net positive adjustment (as defined in paragraph (d)(3)(ii)(B) of this section).

Within a grouping, for purposes of netting adjustments:

- An increase in gain is treated as an increase in income;
- A decrease in gain is treated as a decrease in income;
- An increase in loss is treated as a decrease in income; and
- A decrease in a loss is treated as an increase in income.[Proposed Reg. §301.6225-1(d)(3)(iii)]

Multiple Imputed Underpayments in Same Tax Year

The IRS has reserved the right to determine multiple partnership adjustments for the same partnership taxable year. [Proposed Reg. §301.6225-1(e)(1)]

There are two types of imputed underpayments—a general imputed underpayment and a specific imputed underpayment. Each type is separately calculated. [Proposed Reg. §301.6225-1(e)(2)(i)]

The general imputed underpayment is defined as follows:

> The general imputed underpayment is calculated based on all adjustments (other than adjustments that do not result in an imputed underpayment under paragraph (c)(2) of this section) that are not taken into account to determine a specific imputed underpayment under paragraph (e)(2)(iii) of this section. There is only one general imputed underpayment in any administrative proceeding. If there is one imputed underpayment in an administrative proceeding, it is a general imputed underpayment and may take into account adjustments described in paragraph (e)(2)(iii) of this section, if any.

The specific imputed underpayment is defined as follows:

> A specific imputed underpayment is an imputed underpayment with respect to adjustments to an item or items that were allocated to one partner or a group of partners that had the same or similar characteristics or that participated in the same or similar transaction. The IRS may designate more than one specific imputed underpayment with respect to any partnership taxable year. For instance, in a single partnership taxable year there may be a specific imputed underpayment with respect to adjustments related to a transaction affecting some, but not all, partners of the partnership (such as adjustments that are specially allocated to certain partners) and a second specific imputed

> underpayment with respect to adjustments resulting from a reallocation of a distributive share of income from one partner to another partner. The IRS may, in its discretion, determine that partnership adjustments that could be taken into account to calculate one or more specific imputed underpayments under this paragraph (e)(2)(iii) for a partnership taxable year are more appropriately taken into account in determining the general imputed underpayment for such taxable year. For instance, the IRS may determine that it is more appropriate to calculate only the general imputed underpayment if when calculating the specific imputed underpayment requested by the partnership, there is an increase in the number of the partnership adjustments that after netting result in net non-positive adjustments and are disregarded in calculating the specific imputed underpayment.

The IRS gives six examples to illustrate these various issues with the imputed underpayment. The proposed regulations note that, for purposes of these examples, each partnership is assumed to be subject to the BBA partnership audit regime, all of the partners are U.S. persons, the highest rate of tax is 40% and no partnership requests a modification of the imputed underpayment.

EXAMPLE 1

Partnership reports on its 2019 partnership return $100 of ordinary income and an ordinary deduction of <$70>. The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year and determines that ordinary income was $105 instead of $100 ($5 adjustment) and that the ordinary deduction was <$80> instead of <$70> (<$10> adjustment). Neither item is subject to special restrictions or limitations. Pursuant to paragraph (d) of this section, the adjustments are both in the residual grouping. The <$10> adjustment to the ordinary deduction is netted with the $5 adjustment to ordinary income because they are both ordinary in character and neither is subject to restrictions or limitations. After netting these adjustments, the total netted partnership adjustment is <$5>, which does not result in an imputed underpayment and therefore, the underlying adjustments (that is, the <$10> adjustment to the ordinary deduction and the $5 adjustment to ordinary income) are taken into account by Partnership in the adjustment year in accordance with § 301.6225-3.

EXAMPLE 2

Partnership reports on its 2019 partnership return ordinary income of $300, long-term capital gain of $125, long-term capital loss of <$75>, a depreciation deduction of <$100>, and a tax credit that can be claimed by the partnership of $5. In an administrative proceeding with respect to the partnership's 2019 taxable year, the IRS determines ordinary income of $500 ($200 adjustment), long-term capital gain of $200 ($75 adjustment), long-term capital loss of <$25> ($50 adjustment), a depreciation deduction of <$70> ($30 adjustment), and a tax credit of $3 ($2 adjustment). Pursuant to paragraph (d) of this section, the tax credit is in the credit grouping under paragraph (d)(2)(iii) of this section. The remaining adjustments are part of the residual grouping under paragraph (d)(2)(v) of this section. The adjustment to ordinary income and the depreciation deduction are grouped together in an ordinary subgrouping within the residual grouping and netted with each other because they are both ordinary in character and neither is subject to differing restrictions or limitations. Pursuant to paragraph (d)(3)(iii) of this section, for purposes of netting, the decrease in the depreciation deduction is treated as an increase in income of $30. Thus, $200 (adjustment to ordinary income) plus $30 (depreciation adjustment treated as increase in income) yields $230 of additional income in the ordinary subgrouping within the residual grouping. For similar reasons, the adjustments to long-term capital gain and long-term capital loss are grouped together in a long-term capital subgrouping within the residual grouping and netted with each other. For purposes of netting, the decrease in capital loss is treated as an increase in income of

$50. Thus, $75 (long-term capital gain adjustment) plus $50 (long-term capital loss adjustment) yields $125 of additional income in the long-term capital subgrouping within the residual grouping. With respect to the ordinary subgrouping, the $230 adjustment to ordinary income is a net positive adjustment for that subgrouping and is added to the $125 of additional income in the long-term capital subgrouping, for a total netted partnership adjustment of $355. Under paragraph (c)(1)(i) of this section, the total netted partnership adjustment is multiplied by 40 percent (highest tax rate in effect), which results in $142. Under paragraph (c)(1)(ii) of this section, the $142 is increased by the $2 credit adjustment, resulting in an imputed underpayment of $144.

EXAMPLE 3

Partnership has two partners, A and B. Under the partnership agreement, among other items allocated to the partners, $30 of ordinary income and $70 of depreciation are specially allocated to B for the 2019 taxable year. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines that the $30 of ordinary income and $70 of deprecation should be reallocated from B to A. The partnership adjustment is a decrease of $30 of ordinary income (<$30> adjustment) and a decrease of $70 of depreciation ($70 adjustment) allocated to B and a corresponding increase of $30 ordinary income ($30 adjustment) and $70 of depreciation (<$70> adjustment) allocated to A. Pursuant to paragraph (d)(2)(ii) of this section, for purposes of determining the imputed underpayment, the adjustments to the distributive shares of A and B are grouped separately. The increases and decreases to depreciation are treated as decreases and increases, respectively, of ordinary income. As a result, the net $40 of income ($70 ordinary income plus <$30> ordinary income) allocated to B is the total netted partnership adjustment. The $40 increase is then multiplied by 40 percent, which results in an imputed underpayment of $28. The net decrease of income of $40 ($30 ordinary income plus <$70> ordinary income) reallocated to A is disregarded for purposes of determining the imputed underpayment. The $30 of ordinary income and the $70 of deductions reallocated to A are partnership adjustments that do not result in an imputed underpayment.

EXAMPLE 4

Partnership reported on its 2019 partnership return long-term capital gain of $125 and long-term capital loss of <$75>. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines the long-term capital gain should have been reported as ordinary income of $125, resulting in an increase in ordinary income of $125 ($125 adjustment) as well as a decrease of long-term capital gain of $125 (<$125> adjustment). Under paragraph (d)(2) of this section, these adjustments are part of the residual grouping, but are in a separate subgrouping because of their different character, that is, the increase in ordinary income is part of an ordinary subgrouping and the decrease in long-term capital gain is part of a long-term capital subgrouping, both within the residual grouping. There are no other adjustments for the 2019 taxable year. The $125 decrease in long-term capital gain is a net non-positive adjustment in the long-term capital subgrouping and as a result is an adjustment that does not result in an imputed underpayment. The $125 increase in ordinary income results in a net positive adjustment. Because the ordinary subgrouping is the only subgrouping resulting in a net positive adjustment, $125 is the total netted partnership adjustment. Under paragraph (c)(1)(i) of this section, $125 is multiplied by 40 percent resulting in an imputed underpayment of $50.

EXAMPLE 5

Partnership reported a $100 deduction for certain expenses on its 2019 partnership return and a $100 deduction with respect to the same expenses on its 2020 partnership return. The IRS initiates an administrative proceeding with respect to Partnership's 2019 and 2020 taxable years and determines that Partnership improperly accelerated accrual of a portion of the expenses with respect to the deduction in 2019 that should have been taken into account in 2020. Therefore, for taxable year 2019, the IRS determines that Partnership should have reported a deduction of $75 with respect to the expenses ($25 adjustment) in 2019. However, for 2020, the IRS determines that Partnership should have reported a deduction of $125 with respect to these expenses (<$25> adjustment). There are no other adjustments for the 2019 and 2020 partnership taxable years. Pursuant to paragraph (c)(4) of this section, the adjustments for 2019 and 2020 are not netted with each other. The 2019 adjustment of $25 is multiplied by 40 percent resulting in an imputed underpayment of $10 for Partnership's 2019 taxable year. The $25 increase in the deduction for 2020 is an adjustment that does not result in an imputed underpayment. Therefore, there is no imputed underpayment for 2020.

EXAMPLE 6

On its partnership return for the 2020 taxable year, Partnership reported ordinary income of $100 million and a capital gain of $50 million. Partnership had four equal partners during the 2020 tax year, all of whom were individuals. On its partnership return for the 2020 tax year, the capital gain was allocated to partner E and the ordinary income was allocated to all partners based on their interests in Partnership. In an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS determines that for 2020 the capital gain allocated to E should have been $75 million instead of $50 million and that Partnership should have recognized an additional $10 million in ordinary income. In the NOPPA mailed by the IRS, the IRS may determine pursuant to paragraph (e) of this section that there is a general imputed underpayment with respect to the increase in ordinary income and a specific imputed underpayment with respect to the increase in capital gain specially allocated to E.

Modification of the Imputed Underpayment

The law allows for the partnership to present evidence to modify the imputed underpayment. The request is to be made using any forms, instructions, or other guidance the IRS may provide. [Proposed Reg. §301.6225-2(a)]

Effect of Modification

A modification may increase or decrease the amount of an imputed underpayment by affecting the extent to which adjustments factor into the calculation of the imputed underpayment, by affecting the tax rate that is applied in computing the imputed underpayment or other adjustments that may be provided in forms, instructions or other guidance issued by the IRS. [Proposed Reg. §301.6625-2(b)(1)]

There is an order in which modifications will be applied if the partnership requests multiple modifications.

- First modifications that affect the extent to which an adjustment factors into the calculation of imputed underpayment are taken into account.
- After that, modifications that affect the tax rate are taken into account.

Modifications that Affect Partnership Adjustments

The modifications that affect partnership adjustments are:

- Amended returns (governed by Proposed Reg. §301.6625-2(d)(2)
- Tax-exempt status (governed by Proposed Reg. §301.6625-2(d)(3)
- Specified passive activity losses of publicly traded partnerships (governed by Proposed Reg. §301.6625-2(d)(5)
- Qualified investment entities (governed by Proposed Reg. §301.6625-2(d)(7)
- Closing agreements (governed by Proposed Reg. §301.6625-2(d)(8); and
- Other modifications (governed by Proposed Reg. §301.6625-2(d)(9).

Any adjustment taken into account under one of these provisions is excluded from the calculation of the total netted partnership adjustment if the adjustment or portion of the adjustment is part of the reallocation group or the residual grouping. The amount is also excluded from the credit grouping if the adjustment or a portion thereof is part of the credit grouping. [Proposed Reg. §301.6625-2(b)(2)]

Amended Returns by Partners

The partnership may request a modification of the imputed underpayment based upon a qualifying amended return filed by a review partner that takes into account all of the partnership adjustments properly allocable to that partner. In that case, the partnership may not request an additional modification of any imputed payment for the taxable year related to the amended return partner. [Proposed Reg. §301.6625-2(d)(2)(i)]

Merely filing an amended return is not enough—the partner must also make full payment of the tax due on the amended return. Per Proposed Reg. §301.6625-2(d)(2)(ii):

> A modification request under paragraph (d)(2) of this section will not be approved unless the partner (or indirect partner) filing the amended return has paid all tax, penalties, additions to tax, and interest due as a result of taking into account the adjustments in the first affected year (as defined in § 301.6226-(b)(2)) and all modification years (as described in paragraph (d)(2)(iv) of this section) before the expiration of the 270-day period described in paragraph (c)(3) of this section.

The first affected year is the taxable year of the partner that includes the end of the reviewed year. [Proposed Reg. §301.6226-1(b)(2)]

A modification year is:

> …any taxable year with respect to which any tax attribute (as defined in § 301.6241-1(a)(10)) is affected by reason of taking the partner's allocable share of all partnership adjustments into account in the first affected year. A modification year may be a taxable year before or after the first affected year, depending on the effect on tax attributes of taking the partner's (or indirect partner's) share of the partnership adjustments into account in the first affected year. [Proposed Reg. §301.6625-2(d)(2)(iv)]

The form and manner for making a qualified amended return is outlined in Proposed Reg. §301.6225-1(d)(2)(iii):

> A reviewed year partner (or indirect partner) must file all amended returns required for modification under paragraph (d)(2) of this section with the IRS. The IRS will not approve modification under paragraph (d)(2) of this section unless prior to the expiration of the 270-day period described in paragraph (c)(3) of this section, the partnership representative provides to the IRS in the form and manner prescribed by the IRS an affidavit from the partner (or indirect partner) signed under penalties of perjury by such partner that each amended return required to be filed under paragraph (d)(2) of this section has been filed (including the date on which such amended returns were filed) and that the full

> amount of tax, penalties, additions to tax, additional amounts, and interest was paid (including the date on which such amounts were paid).

A major practical limitation on the use of the amended return option is found in Proposed Reg. §301.6225-1(d)(2)(v). If a balance is due on any of the required amended returns if the period for assessment of tax under IRC §6501 has expired—rather the regulation requires that the closing agreement procedures under IRC §301.6625-2(d)(8) be used in such a case. [Proposed Reg. §301.6625-2(d)(v)(A)]

The existence of closed year for which a refund is due, however, will not foreclose the use of this option (though as a practical matter it may greatly affect the willingness of a partner to exercise this option). Proposed Reg. §301.6625-2(d)(v)(B) provides:

> An amended return filed under paragraph (d)(2) of this section claiming a refund may be filed after the expiration of period of limitations under section 6511, provided all partnership adjustments allocated to the partner (or indirect partner) filing the amended return are taken into account on such amended return, the only items reported on the amended return are items attributable to such partnership adjustments, and the partner files all required amended returns described in paragraph (d)(2)(iv) of this section.

Note that the proposed regulation does not say that the refund would be paid—and, presumably, with the statute for claiming a refund expired it would not be paid.

Special rules apply for reallocation adjustments with regard to amended returns, as detailed in Proposed Reg. §301.6225-1(d)(vi):

> Except as described in this paragraph (d)(2)(vi), in the case of a partnership adjustment that reallocates the distributive share of any item from one partner to another, a modification under paragraph (d)(2) of this section will be approved only if all partners affected by such adjustment (affected partners) file amended returns in accordance with paragraph (d)(2) of this section. The IRS may determine that the requirements of this paragraph (d)(2)(vi) are satisfied if one or more affected partners take into account their allocable share of the adjustment through other modifications approved by the IRS. For instance, if, in the case where an adjustment reallocates a loss from one partner to another, one affected partner files an amended return taking into account the adjustment, and the other affected partner signs a closing agreement taking into account the adjustment, the IRS may determine that the requirements of this paragraph (d)(2)(vi) have been satisfied.

If one or more partners are pass-through entities, the pass-through entity may file an amended return and pay a tax equal to the safe harbor tax computed under the provisions described later in the regulations for the statements issued to partners when the adjustments are passed through under Proposed Reg. §301.6226-2(g). However, instead of the rate normally used to compute the imputed adjustment, the tax rate is determined by substituting the total net income of the pass-through partner for the taxable year (as adjusted) for taxable income in IRC §1(c) (the rate table for single taxpayers) without regard to the special capital gain rates found at IRC §1(h). [Proposed Reg. §301.6225-1(d)(vii)(A)]

A partner (or indirect partner) may not file an amended return with regard to partnership adjustments except as provided for in these rules. [Proposed Reg. §301.6225-1(d)(viii)(A)] As well, if a partner files an amended return under these provisions, the partner may not file another amended return for the year(s) amended without the permission of the IRS. [Proposed Reg. §301.6225-1(d)(viii)(B)]

Tax Exempt Partners

The partnership can also request a modification to the extent that it can show the adjustment would be properly allocable to a partner that was tax exempt in the reviewed year under Proposed Reg. §301.6225-1(d)(3).

The regulation defines a "tax exempt entity" by reference to IRC §168(h)(2)(A),(C) or (D). [Proposed Reg. §301.6225-1(d)(3)(ii)] Thus the list of tax exempt partners would include:

- the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,
- an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter,
- any foreign person or entity, and
- any Indian tribal government described in section 7701(a)(40). [IRC §168(h)(2)(A)]

A "foreign person or entity" for this purpose is defined as:

- any foreign government, any international organization, or any agency or instrumentality of any of the foregoing, and
- any person who is not a United States person.

However, the term does not include any foreign partnership or other foreign pass through entity. [IRC §163(h)(2)(C)]

Excluded from the list of tax exempt entities are certain instrumentalities of a government that are taxable. An instrumentality is excluded if:

- all of the activities of such corporation are subject to tax under this chapter, and
- a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof. [IRC §168(h)(2)(D)]

The proposed regulation provides the following details with regard to a modification under this provision.

> Only the portion of the partnership adjustments properly allocated to a tax-exempt partner with respect to which the partner would not be subject to tax for the reviewed year (tax-exempt portion) may form the basis of a modification of the imputed underpayment under paragraph (d)(3) of this section. A modification under paragraph (d)(3) of this section will not be approved by the IRS unless the partnership provides documentation in accordance with paragraph (c)(2) of this section to support the tax-exempt partner's status and the tax-exempt portion of the partnership adjustment allocable to the tax-exempt partner. [Proposed Reg. §301.6225-1(d)(3)(iii)]

Specified Passive Activity Losses of Publicly Traded Partnerships

Proposed Reg. §301.6225-1(d)(5) allows for a publicly traded partnership (as defined in IRC §469(k)(2)) to remove from the calculation of the imputed underpayment amounts related to "specified passive activity losses." Per Proposed Reg. §301.6225-1(d)(5)(i) this modification "applies equally with respect to a publicly traded partnership that is subject to a proceeding under subchapter C of chapter 63[1] and where a portion of the imputed underpayment is attributable to a publicly traded partnership that is a partnership-partner (or indirect partner that is a partnership-partner)."

A specified passive activity loss is defined at Proposed Reg. §301.6225-1(d)(5)(ii):

> A specified passive activity loss carry over amount for any specified partner of a publicly traded partnership is the lesser of the section 469(k) passive activity loss of that partner which is separately determined with respect to such partnership at the end of the partner's taxable year in which or with which the reviewed year of the partnership ends (reviewed year loss) or at the end of the partner's

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[1] The BBA partnership audit regime.

> taxable year in which or with which the adjustment year (as defined in § 301.6241-1(a)(1)) of the partnership ends, reduced to the extent any such partner has utilized any portion of its reviewed year loss to offset income or gain relating to the ownership or disposition of its interest in such publicly traded partnership during either the adjustment year or any intervening year (as defined in § 301.6226-3(b)(3)).

The adjustment is limited to specified passive losses allocated to specified partners. A specified partner is a partner that has held his/her interest for the entire period from the taxable year of the partner in which the reviewed year ends through the partner's taxable year in which or with which the partnership's adjustment year ends. As well, the specified partner must meet all of the following requirements:

- The person is a partner of a publicly traded partnership;
- The person is an individual, estate, trust, closely held C corporation, or personal service corporation; and
- The person has a specified passive activity loss with respect to the publicly traded partnership. [Proposed Reg. §301.6225-1(d)(5)(iii)]

When this modification is made, a notification must be made to the partner that he/she is required to reduce his/her suspended passive loss carryover. As Proposed Reg. §301.6225-1(d)(5)(iv) notes:

> If the IRS approves a modification request under paragraph (d)(5) of this section, the partnership must report, in accordance with forms, instructions, or other guidance prescribed by the IRS, to each specified partner the amount of that specified partner's reduction of its suspended passive loss carryovers at the end of the adjustment year to take into account the amount of any passive losses applied in connection with such modification request. The reduction in suspended passive loss carryovers as reported to a specified partner under this paragraph (d)(5)(iv) is a determination of the partnership under subchapter C of chapter 63 and is binding on the specified partners under section 6223 and the regulations thereunder.

Qualified Investment Entities Adjustment

A special adjustment is available for partnerships with partners who are "qualified investment entities" as described in IRC §860(b). Per Proposed Reg. §301.6225-1(d)(7)(i):

> A partnership may request a modification of an imputed underpayment based on the partnership adjustments allocated to a reviewed year partner (or indirect partner) where the modification is based on deficiency dividends distributed as described in section 860(f), by a partner that is a qualified investment entity (QIE) under section 860(b), which includes both a regulated investment company (RIC) and a real estate investment trust (REIT). Modification is available only to the extent that the deficiency dividends take into account adjustments described in § 301.6225-1 that are also adjustments within the meaning of section 860(d)(1) or (d)(2) (whichever applies).

Proposed Reg. §301.6225-1(d)(7)(ii) provides the following requirements with regard to the documentation of the deficiency dividend:

> The partnership must provide documentation in accordance with paragraph (c) of this section of the "determination" described in section 860(e). Under section 860(e)(2), § 1.860-2(b)(1)(i) of this chapter, and paragraph (d)(8) of this section, a closing agreement entered into by the QIE partner pursuant to section 7121 and paragraph (d)(8) of this section is a determination described in section 860(e), and the date of the determination is the date in which the closing agreement is approved by the IRS. In addition, under section 860(e)(4), a determination also includes a *Form 8927, Determination Under Section 860(e)(4) by a Qualified Investment Entity*, properly completed and filed by the RIC or REIT pursuant to section 860(e)(4). To establish the date of the determination under section 860(e)(4) and

> the amount of deficiency dividends actually paid, the partnership must provide a copy of *Form 976, Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust (Form 976)*, properly completed by or on behalf of the QIE pursuant to section 860(g), together with a copy of each of the required attachments for Form 976.

Closing Agreements

Under Proposed Reg. §301.6225-1(d)(8) the partnership can request an adjustment based on a closing agreement entered into by a partner with the IRS. The regulation provides:

> A partnership may request modification based on a closing agreement entered into by the IRS and any partner (or indirect partner) pursuant to section 7121, and, if approved by the IRS, the IRS will allow modification with respect to a partnership adjustment that is fully taken into account by such partner (or indirect partner) under a closing agreement and for which the required payment under the closing agreement is made. Generally, the IRS will not approve any additional modification under this section with respect to a partner (or indirect partner) to which a modification under this paragraph (d)(8) has been approved.

Other Modifications

The regulations include a final "wildcard" category in which a partnership can request an adjustment for reasons not covered directly in the regulations. Proposed Reg. §301.6225-1(d)(9) provides:

> A partnership may request a modification not described in paragraph (d) of this section and the IRS will determine whether such modification is accurate and appropriate in accordance with paragraph (c)(4) of this section. Additional types of modifications and the documentation necessary to substantiate such modifications may be set forth in forms, instructions, or other guidance prescribed by the IRS.

Modification of the Number and Composition of Imputed Underpayments

The partnership can also make a request to modify groupings and/or subgroupings of adjustments per Proposed Reg. §301.6225-1(d)(6).

The proposed regulation provides:

> A partnership may request that the IRS include one or more partnership adjustments in one or more particular groupings or subgroupings (as described in § 301.6225-1(d)(2)) and may request that the IRS determine one or more specific imputed underpayments based on such groupings. For example, a partnership may request under this paragraph (d)(6) that one or more partnership adjustments taken into account to calculate an imputed underpayment be taken into account to calculate a different imputed underpayment.

Modification Based on a Lower Tax Rate

After the above modifications related to the amount of the adjustments are taken into account, the taxpayer can present evidence in certain cases that indicates a rate lower than the maximum tax rate should apply to some or all of the adjustments remaining.

Proposed Reg. §301.6225-1(d)(4) provides the provisions for the modification of the rate. The regulation allows two types of rate adjustments:

- Adjustments that are attributable to a reviewed year partner (or indirect partner) that is a C corporation; and

- Adjustments with respect to capital gains or qualified dividends that are attributable to a reviewed year partner (or indirect partner) who is an individual or an S corporation.

The adjustment does not look at the actual marginal rate of the taxpayer(s) in question for the income, but rather at the maximum rate of tax on such income for such taxpayers.

The adjustment is also strictly limited to the two categories of taxpayers named in the law. Specifically adjustments with respect to trusts or estates for adjustments with respect to capital gains or qualified dividends do not qualify for an adjustment to a lower rate.

Examples of the Adjustments

The IRS provides six examples in the proposed regulations of the application of the modification provisions. For purposes of the examples it is assumed that the partnership and its partners are all calendar year taxpayers, all partners are U.S. persons unless otherwise stated, the highest rate of tax in effect is 40% and the partnerships request no adjustments other than those named in the examples.

EXAMPLE 1

The IRS mails a NOPPA to Partnership for the 2019 partnership taxable year proposing a single partnership adjustment increasing ordinary income by $100, resulting in a $40 imputed underpayment ($100 multiplied by the 40 percent tax rate). Partner, A, held a 20 percent interest in Partnership during 2019. Partnership requests modification under paragraph (d)(2) of this section based on A filing an amended return for the 2019 taxable year taking into account $20 of the partnership adjustment and paying the tax and interest due attributable to A's share of the increased income and based on A's effective tax rate for 2019. No tax attribute in any other taxable year of A is affected by A taking into account A's share of the partnership adjustment for 2019. IRS approves the modification and the $20 increase in ordinary income allocable to A is therefore not included in the calculation of the total netted partnership adjustment (determined in accordance with § 301.6225-1). Partnership's total netted partnership adjustment is reduced to $80 ($100 adjustment less $20 taken into account by A), and the imputed underpayment is reduced to $32 (total netted partnership adjustment of $80 after modification multiplied by 40 percent).

EXAMPLE 2

The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year. Partnership has two equal partners during its 2019 taxable year: an individual, A, and a partnership-partner, B. For 2019, B has two equal partners: a tax-exempt entity, C, and an individual, D. The IRS mails a NOPPA to Partnership for its 2019 taxable year showing a single partnership adjustment increasing Partnership's ordinary income by $100, resulting in a $40 imputed underpayment ($100 total netted partnership adjustment multiplied by 40 percent). Partnership requests modification under paragraph (d)(3) of this section with respect to B's partner, C, a tax-exempt entity. Partnership's partnership representative provides the IRS with documentation demonstrating to the IRS's satisfaction that C holds a 25 percent indirect interest in Partnership through its interest in B and that C is a tax-exempt entity defined in paragraph (d)(3)(ii) of this section that is not subject to tax with respect to its share of the partnership adjustment allocated to B which is $25 (50 percent x 50 percent x $100). IRS approves the modification and the $25 increase in ordinary income allocable to C is not included in the calculation of the total netted partnership adjustment (determined in accordance with § 301.6225-1). Partnership's total netted partnership adjustment is reduced to $75 ($100 adjustment less C's

share of the adjustment, $25), and the imputed underpayment is reduced to $30 (total netted partnership adjustment of $75, after modification, multiplied by 40 percent).

<u>EXAMPLE 3</u>

The facts are the same as in Example 2 of this paragraph (e), except 30 percent of the $25 of the adjustment allocated to C is unrelated business taxable income (UBTI) as defined in section 512 with respect to which C would be subject to tax if taken into account by C. As a result, the modification under paragraph (d)(3) of this section with respect to C relates only to 70 percent of the $25 of ordinary income allocated to C that is not UBTI. Therefore, only a modification of $17.50 (70 percent multiplied by $25) of the total $100 partnership adjustment may be approved by the IRS and excluded when calculating the imputed underpayment for Partnership's 2019 taxable year. The total netted partnership adjustment (determined in accordance with § 301.6225-1) is reduced to $82.50 ($100 less $17.50), and the imputed underpayment is reduced to $33 (total netted partnership adjustment of $82.50, after modification, multiplied by 40 percent).

<u>EXAMPLE 4</u>

The facts are the same as in Example 2 of this paragraph (e), but assume that B filed an amended return taking its share of the partnership adjustments into account. B reports 50 percent of the partnership adjustments ($50) on its amended return, and B makes a payment pursuant to paragraph (d)(2)(ii) of this section. Partnership's total netted partnership adjustment is reduced by $50 (the amount taken into account by B). Partnership's total netted partnership adjustment (determined in accordance with § 301.6225-1) is $50, and the imputed underpayment, after modification, is $20.

<u>EXAMPLE 5</u>

The facts are the same as in Example 2 of this paragraph (e), except that in addition to the modification with respect to tax-exempt entity C which reduced the imputed underpayment by excluding from the calculation of the imputed underpayment $25 of the $100 partnership adjustment reflected in the NOPPA, individual D files an amended return for D's 2019 taxable year taking into account D's share of the partnership adjustment (50 percent of B's 50 percent interest in Partnership, or $25) and paying the additional tax and interest due in accordance with paragraph (d)(2) of this section. No tax attribute in any other taxable year of D is affected by D taking into account D's share of the partnership adjustment for 2019. IRS approves the modification and the $25 increase in ordinary income allocable to D is not included in the calculation of the total netted partnership adjustment (determined in accordance with § 301.6225-1). As a result, Partnership's total netted partnership adjustment is $50 ($100, less $25 allocable to C, less $25 taken into account by D), and the imputed underpayment, after modification, is $20.

<u>EXAMPLE 6</u>

The IRS mails a NOPPA to Partnership for the 2019 taxable year proposing two partnership adjustments based on an IRS determination that two assets, asset X and asset Y, owned by Partnership were overvalued. The partnership adjustment with respect to asset X results in increased ordinary income of $75 and the partnership adjustment with respect to asset Y results in an increase in depreciation of $25, which under § 301.6225-1(d)(3)(iii) is treated as a $25 decrease in income. The total netted partnership adjustment (determined in accordance with § 301.6225-1) is $50 ($75 - $25), resulting in an imputed underpayment of $20 ($50 multiplied by 40 percent).

Under the partnership agreement in effect for Partnership's 2019 taxable year, the adjustments attributable to both of these assets are allocated to the partners consistent with their ownership percentages in Partnership. Partnership requests a modification under paragraph (d)(6) of this section to calculate two imputed underpayments with respect to the partnership adjustments for 2019: a general imputed underpayment with respect to $50 of the increase in income related to the adjustment of the value of asset X and a specific imputed underpayment with respect to $25 of the increase in income related to the adjustment of the value of asset X and the $25 decrease in income related to the adjustment of the value of asset Y. If approved by the IRS, the general imputed underpayment, as modified, is $20 ($50 multiplied by 40 percent) and the specific imputed underpayment would result in zero (increase in income of $25 attributable to asset X offset by the decrease in income of $25 attributable to asset Y), causing those two adjustments to be disregarded and taken into account by the partnership in the adjustment year as adjustments that do not result in an imputed underpayment. The IRS may determine that the creation of the specific imputed underpayment is not appropriate in this circumstance and deny the partnership's modification request because the adjustments are not related to allocations to particular partners and also because the proposed modification results in an increase in net non-positive adjustments. See § 301.6225-1(e)(2)(iii).

Adjustments to Partners' Outside Bases and Capital Account and a Partnership's Basis and Book Value in Property

The IRS did not publish proposed regulations dealing with adjustments to partners' outside bases and capital accounts and a partnership's basis and book value in property, rather marking that area as reserved. [Proposed Reg. §301.6225-4]

In the preamble to the proposed regulations the IRS notes:

> Providing mechanical rules to govern the adjustments to adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property raise a myriad of technical issues on which the Treasury Department and the IRS request comments. As a result, the proposed regulations reserve a place for rules regarding adjustments to a partner's outside basis or capital account and a partnership's basis or book value in property when a partnership elects the application of section 6226 with respect to an imputed underpayment.

But that doesn't mean the IRS doesn't have some ideas on how to approach the problem. In the preamble the IRS first notes:

> The Treasury Department and the IRS have determined that, in the adjustment year, adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property should be adjusted to what they would have been if the adjustments were made in the reviewed year to reviewed year partners and property and then modified to take into account all intervening events considered in computing the amount by which the tax imposed under chapter 1 would increase for any intervening year -- for example, amortization or depreciation of property. In some cases, the reviewed year partner may not be an adjustment year partner, or the partnership might, in an intervening year, have disposed of property to which an adjustment relates. Accordingly, rules will also need to provide how adjustments to adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property are made when there have been: (1) sales of property, (2) distributions of property to partners, (3) contributions of property to corporations or lower-tier partnerships, (4) other nonrecognition transfers of property, (5) sales of partnership interests, (6) transfers of partnership interests in nonrecognition transactions, and (7) contributions to the partnership. In addition, the Treasury Department and the IRS are considering whether partnerships should be required to recompute basis adjustments under sections 734 and 743 that resulted from

> distributions or transfers in intervening years to take into account adjustments to partners' outside bases and a partnership's basis in property. The Treasury Department and the IRS are also considering whether and how an adjustment should be made to the basis of property distributed in an intervening year when an adjustment to the partnership's basis in that property or an adjustment to the recipient partner's outside basis would otherwise have been appropriate.
>
> It seems appropriate that any outside basis and capital account adjustments that need to be made are made with respect to the adjustment year partners who are the reviewed year partners who received a statement of the partner's share of any adjustment to income, gain, loss, deduction or credit. The Treasury Department and the IRS believe that if a reviewed year partner transfers its partnership interest in an intervening year, it is appropriate for the transferee adjustment year partner's capital account and outside basis to be adjusted in the adjustment year. Whether the interest was transferred in a recognition transaction or a nonrecognition transaction, however, is relevant to the amount of the adjustment to the transferee's outside basis, but not capital account, because the transferee in either case succeeds to the capital account of the transferor, however, in a recognition transaction, the transferee would have taken a cost basis in the interest upon a transfer in which gain was recognized. The Treasury Department and the IRS request comments regarding whether and how to adjust the outside bases and capital accounts of adjustment year partners if the reviewed year partner whose basis and capital account should have been adjusted is no longer a partner as a result of a liquidating distribution and thus no other partner has succeeded to the liquidating partner's capital account.

The IRS adds one final request in the preamble:

> Finally, comments are requested on how, or if, these regulations should address partnerships that do not maintain capital accounts.

Election for an Alternative to the Payment of the Imputed Adjustment (the "Push Out" Option)

The BBA audit regime offers an option for the partnership to avoid paying the imputed underpayment by "pushing out" the adjustments to those who were partners in the reviewed year under the provisions of IRC §6226.

The proposed regulations clarify that the election is not an "all or nothing" election. As is noted in Proposed Reg. §301.6226-1(a):

> If a notice of final partnership adjustment (FPA) mailed under section 6231 includes more than one imputed underpayment in accordance with § 301.6225-1(e), a partnership may make an election under this section with respect to one or more imputed underpayments identified in the FPA.

The effect of this election on the reviewed year partners is described in Proposed Reg. §301.6226-1(b)(1):

> If a partnership makes a valid election under this section with respect to any imputed underpayment, the reviewed year partners (as defined in § 301.6241-1(a)(9)) must take into account their share of the partnership adjustments that relate to that imputed underpayment and are liable for any tax, penalties, additions to tax, additional amounts, and interest as described in § 301.6226-3. A modification approved by the IRS under § 301.6225-2 is taken into account by the reviewed year partners in accordance with § 301.6226-2(f)(2).

The effect of the election on the partnership is outlined in Proposed Reg. §301.6226-1(b)(2):

> A partnership making a valid election under this section is not liable for the imputed underpayment to which the election applies on the date such election is made. In addition, adjustments that do not result in an imputed underpayment described in § 301.6225-1(c)(2)(i) and (ii) are not taken into account by the partnership in the adjustment year (as defined in § 301.6241-1(a)(1)) and instead are

included in the reviewed year partners' share of the partnership adjustments reported to the reviewed year partners of the partnership.

For a "push out" election to be valid, all of the provisions of Proposed Regs. §§301.6626-1 and 301.6626-2 regarding statements to be provided to partners and the IRS must be satisfied. Once the election is made it can only be revoked with the consent of the IRS. [Proposed Reg. §301.6226-1(c)(1)]

The election is valid until and unless the IRS determines the election is invalid. If the IRS determines an election is invalid, the IRS will notify the partnership and partnership representative of this fact within 30 days of the date the election is determined to be invalid, along with the reason it is invalid. The regulation provides:

> If the IRS makes a final determination that an election under this section is invalid, section 6225 applies with respect to the imputed underpayment as if the election was never made and the partnership must pay the imputed underpayment under section 6225 and any penalties and interest under section 6233. [Proposed Reg. §301.6226-1(c)(2)]

The election must be filed within 45 days of the date the FPA is mailed by the IRS and there are no extension allowed. [Proposed Reg. §301.6226-1(c)(3)]

The election must be signed by the partnership representative and filed in accordance with the forms, instructions and other guidance provided by the IRS. The election must also include the following information:

- The name, address, and correct taxpayer identification number (TIN) of the partnership,
- The taxable year to which the election relates,
- A copy of the FPA to which the election relates,
- In the case of an FPA that includes more than one imputed underpayment, identification of the imputed underpayment(s) to which the election applies,
- Each reviewed year partner's name, address, and correct TIN, and
- Any other information prescribed by the IRS in forms, instructions, and other guidance. [Proposed Reg. §301.6226-1(c)(4)]

As with the partnership K-1 itself, consistent reporting rules apply to the statements provided to the partners under this election. Thus Proposed Reg. §301.6226-1(d) provides:

> The election under this section, which includes filing and furnishing statements described in § 301.6226-2, are actions of the partnership under section 6223 and the regulations thereunder and, unless determined otherwise by the IRS, the partner's share of the adjustments, the safe harbor amount and interest safe harbor amount (as described in § 301.6226-2(g)), and any penalties, additions to tax, and additional amounts as set forth in the statement are binding on the partner pursuant to section 6223. Accordingly, a partner may not treat items reflected on a statement described in § 301.6226-2 on the partner's return inconsistently with how those items are treated on the statement that is filed with the IRS. See § 301.6222-1(c)(2) (regarding items the treatment of which a partner is bound to under section 6223).

Making this election does not preclude the partnership from seeking judicial review of a partnership adjustment. [Proposed Reg. §301.6226-1(e)]

Statements Furnished to the IRS and Partners for a Push Out Election

Statements must be furnished both to partners who were partners in the reviewed year and the IRS for a partnership making the push out election. These statements are to be provided in addition to, and separate from, any other statements required to be filed with the IRS and furnished to partners including Schedules K-1 (Form 1065). As well, a separate statement must be provided for each reviewed year. [Proposed Reg. §301.6226-2(a)]

Time for Furnishing Statements

The statements are required to be furnished to review year partners no later than 60 days after the date all of the partnership adjustments for the statement are fully determined. The adjustments are considered fully determined on the later of:

- The expiration of the time to file a petition under section 6234 with the Tax Court, applicable United States District Court or Court of Federal Claims, or
- If a petition under section 6234 is filed, the date when the court's decision becomes final. [Proposed Reg. §301.6626-2(b)(1)]

The partnership must take the following steps in determining the address of each reviewed year partner for sending the notices:

> The partnership must furnish the statement described in paragraph (a) of this section to each reviewed year partner in accordance with the forms, instructions, and other guidance prescribed by the IRS. If the partnership mails the statement, it must mail the statement to the current or last address of the reviewed year partner that is known to the partnership. If a statement is returned to the partnership as undeliverable, the partnership must undertake reasonable diligence to identify a correct address for the reviewed year partner to which the statement relates..

Since complying with all of the requirements of this regulation is required for a valid push out election, a failure to exercise due diligence in determining the address could result in the partnership becoming liable for the entire imputed underpayment amount.

The IRS provides the following three examples related to the time for providing the statements.

EXAMPLE 1

During Partnership's 2020 taxable year, A, an individual, was a partner in Partnership and had an address at 123 Main St. On February 1, 2021, A sold his interest in Partnership and informed Partnership that A moved to 456 Broad St. On March 15, 2021, Partnership mails A's statement under section 6031(b) for the 2020 taxable year to 456 Broad St. On June 1, 2023, A moves again but does not inform Partnership of A's new address. In 2023, the IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year and mails a notice of final partnership adjustment (FPA) to Partnership for that year. Partnership makes a timely election under section 6226 in accordance with § 301.6226-1 and on May 31, 2024, timely mails a statement described in paragraph (a) of this section to A at 456 Broad St. Although the statement was mailed to the last address for A that was known to Partnership, it is returned to Partnership as undeliverable because unknown to Partnership, A had moved. After undertaking reasonable diligence as to the correct address of A, Partnership is unable to ascertain the correct address. Therefore, pursuant to paragraph (b)(2) of this section, Partnership has properly furnished the statement to A.

EXAMPLE 2

The facts are the same as in Example 1 of this paragraph (b)(3),except that A lives at 789 Forest Ave during all of 2024 and reasonable diligence would have revealed that 789 Forest Ave is the correct address for A, but Partnership did not undertake such diligence. Therefore, Partnership failed to properly furnish the statement with respect to A pursuant to paragraph (b)(2) of this section.

EXAMPLE 3

Partnership is a calendar year taxpayer. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year. On January 1, 2024, the IRS mails an FPA with respect to the 2020 taxable year to Partnership. Partnership makes a timely election under section 6226 in accordance with § 301.6226-1. Partnership timely files a petition for readjustment under section 6234 with the Tax Court. The IRS prevails, and the Tax Court sustains all of the adjustments in the FPA with respect to the 2020 taxable year. The time to appeal the Tax Court decision expires, and the Tax Court decision becomes final on April 10, 2025. Under paragraph (b)(1)(ii) of this section, the adjustments in the FPA are finally determined on April 10, 2025, and Partnership must furnish the statements described in paragraph (a) of this section to its reviewed year partners and electronically file the statements with the IRS no later than June 9, 2025. See paragraph (c) of this section for the rules regarding filing the statements with the IRS.

Filing Statements with IRS

Statements must be filed electronically with the IRS no later than 60 days after the date the partnership adjustments are finally determined for each reviewed year. As well, the partnership must transmit a summary of the statements filed and other information required in forms, instructions, and other IRS guidance. [Proposed Reg. §301.6226-2(c)]

Correction of Statements

If the partnership or IRS discovers an error in statements it has issued, it files corrected statements with the IRS and the affected partner(s) in accordance with IRS forms, instructions and other guidance. [Proposed Reg. §301.6626-2(d)]

If the partnership discovers the error different rules apply depending upon whether the error is found within 60 days of the due date or after that time.

If the error is found within 60 days of the due date for furnishing the statements the partnership files the statements provided for above with the IRS and the affected partner(s). The partnership does not need to seek the consent of the IRS in this situation. [Proposed Reg. §301.6226-2(d)(2)(i)]

However, if the error is discovered more than 60 days after the statement due date, the partnership can only correct the error after seeking the consent of the IRS in accordance with forms, instructions and guidance issued by the agency. [Proposed Reg. §301.6226-2(d)(2)(ii)]

If the IRS discovers an error in the statements the IRS may require the partnership to prepare corrected statements. If the partnership fails to correct an error when the IRS requires it, that can be treated by the IRS as a failure to provide the required statements under this regulation. Such a failure could invalidate the election and make the partnership again liable for the imputed understatement. [Proposed Reg. §301.6226-2(d)(3)]

The correction must be taken into account by the partner in the reporting year—that is the year the original statement was provided to the partner even that year is prior to the year in which the partner receives the correction. [Proposed Reg. §301.6226-2(d)(4)]

Content of Statements

Each statement must include the following:

- The name and correct TIN of the reviewed year partner to whom the statement is being furnished;
- The current or last address of the reviewed year partner that is known to the partnership;

- The reviewed year partner's share of items as originally reported for the reviewed year to the partner on statements furnished to the partner under section 6031(b) and, if applicable, section 6227;
- The reviewed year partner's share of partnership adjustments determined under paragraph (f)(1) of this section;
- Modifications with respect to the reviewed year partner determined under paragraph (f)(2) of this section;
- The reviewed year partner's share of any amounts attributable to adjustments to the partnership's tax attributes (as defined in § 301.6241-1(a)(10)) for any intervening year (as defined in § 301.6226-3(b)(3)) resulting from the partnership adjustments in the reviewed year;
- The reviewed year partner's share of any penalties, additions to tax, or additional amounts determined under paragraph (f)(3) of this section;
- The reviewed year partner's safe harbor amount and, if applicable, interest safe harbor amount, as described under paragraph (g) of this section;
- The date the statement is furnished to the reviewed year partner;
- The partnership taxable year to which the adjustments relate; and
- Any other information required by forms, instructions, and other guidance prescribed by the IRS. [Proposed Reg. §301.6226-2(e)]

Calculation of Partner's Share of Adjustments

In determining each partner's share of adjustments and other amounts, the adjusted are reported to the reviewed year partner in the same manner as they were allocated on the reviewed year or intervening year return as applicable. [Proposed Reg. §301.6226-2(f)(1)(i)]

If the item in question was not reported on the return in question, it is allocated to the partner in accordance with how the item would have been allocated had it been on the return based on the partnership agreement. [Proposed Reg. §301.6226-2(f)(1)(ii)]

With regard to adjustments that reallocate items, the regulation provides that "[i]f an adjustment involves an allocation of an item to a specific partner or in a specific manner, including a reallocation of an item, the reviewed year partner's share of the adjustment set forth in the statement is determined in accordance with the adjustment as finally determined…" [Proposed Reg. §301.6226-2(f)(1)(iii)]

If a partner has filed an amended return or entered into a closing agreement with those items not being used to compute the imputed underpayment, these modifications are disregarded for purposes of entering the reviewed year's partner share of adjustments. However, these modifications must be listed separately on the statement. [Proposed Reg. §301.6226-2(f)(2)]

Proposed Reg. §301.6226-2(f)(3) provides for the following allocation of penalties and interest:

> Penalties, additions to tax, and additional amounts must be reported to each reviewed year partner in the same proportion as the reviewed year partner's share of the adjustment to which the penalty, addition to tax, or additional amount relates as determined in paragraph (f)(1) of this section. If a penalty, addition to tax, or additional amount does not relate to a specific adjustment, each reviewed year partner's share of the penalty, addition to tax, or additional amount is determined in accordance with how such items would have been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement, unless it is allocated to a specific partner in a specific manner in a final determination of the adjustments, in which case it is allocated in accordance with that final determination. See paragraph (b)(1) of this section regarding when adjustments are finally determined.

Calculation of the Safe Harbor Amount

The partnership will compute a "safe harbor amount" of tax and interest for each reviewed year partner if the push out election is made. If an election is made, the partner may report this safe harbor amount in lieu of doing a detailed calculation of the pass through adjustment tax and interest.

The safe harbor amount is computed using the provisions found at Proposed Reg. §301.6626-2(g). Not surprising the safe harbor is computed using the same basic method as is used to compute the imputed underpayment.

Proposed Reg. §301.6226-2(g)(2)(i) provides:

> The safe harbor amount for each reviewed year partner is calculated in the same manner as the imputed underpayment under § 301.6225-1 except that each reviewed year partner's share of the partnership adjustments on the statement described in paragraph (a) of this section (including any amounts attributable to adjustments to partnership tax attributes) are substituted as the partnership adjustments taken into account for purposes of determining the imputed underpayment under § 301.6225-1.

Modifications of the imputed underpayment, except for an amended return or closing agreement related to the specific reviewed partner for whom the statement is being computed, have no impact on the safe harbor amount. That includes the tax rate modification. So this means the modification will be made based on the gross modification (except for the amounts on amended returns and covered by closing agreements) multiplied by the highest rate. [Proposed Reg. §301.6226-2(g)(ii)]

An interest rate safe harbor must be calculated for all calendar year individual partners. Proposed Reg. §301.6226-2(g)(2)(iii) provides:

> For partners who are individuals and who have calendar year taxable years, the partnership must also calculate an interest safe harbor amount. The interest safe harbor amount is calculated at the rate set forth in § 301.6226-3(d)(4) from the due date (without extension) of the individual reviewed year partner's return for the first affected year (as defined in paragraph § 301.6226-3(b)(2)) until the due date (without extension) of the individual reviewed year partner's return for the reporting year.

Coordination With Certain Other Tax Provisions

Two special rules are added to deal with certain special cases by Proposed Reg. §301.6226-2(h).

First, a provision is added to deal with partners who are registered investment companies (mutual funds) and real estate investment trusts (REITs). Proposed Reg. §301.6226-2(h)(1) provides:

> Statements furnished to qualified investment entities described in section 860.If a reviewed year partner is a qualified investment entity within the meaning of section 860(b) and the partner receives a statement described in paragraph (a) of this section, the partner may be able to avail itself of the deficiency dividend procedure described in § 301.6226-3(b)(4).

The second provision deals with certain publicly traded partnerships, found at Proposed Reg. §301.6226-2(h)(2):

> Liability for tax under section 7704(g)(3). An election under this section has no effect on a partnership's liability for any tax under section 7704(g)(3) (regarding the exception for electing 1987 partnerships from the general rule that certain publicly traded partnerships are treated as corporations).

The proposed regulations also have designated reserved (at Proposed Reg. §301.6226-2(h)(2)(iii)) guidance on withholding for certain foreign partners under these rules. The preamble notes:

> The proposed regulations reserve on rules that would apply when statements described in proposed § 301.6226-2 are provided to foreign partners, including foreign entities, or certain domestic partners. In general, certain amounts received by a partnership that are allocable to a foreign partner may be subject to withholding under chapter 3 of subtitle A of the Code (chapter 3), and certain amounts allocable to a foreign or domestic partner may be subject to withholding under chapter 4 of subtitle A of the Code (chapter 4). To the extent that amounts are withheld by the partnership or other withholding agent under chapter 3 or 4, and remitted to the IRS, such amounts are creditable by the foreign partner or domestic partner to offset the chapter 1 tax that the partner otherwise would owe in the absence of the withholding. The purpose of chapter 3 withholding is to ensure compliance by foreign persons with respect to income subject to tax under chapter 1, by requiring the partnership (or other withholding agent) to withhold and remit the tax that would normally be paid by the foreign person on payments or income allocated to the foreign person. The purpose of chapter 4 withholding is to ensure that information reporting about U.S. persons that use certain offshore financial accounts or passive foreign entities is available to the IRS to enhance tax compliance. The withholding imposed under chapter 4 may be imposed on certain foreign financial institutions, account holders of a financial account, or passive non-financial foreign entities with substantial U.S. owners, to incentivize the information required under chapter 4 to be reported and available to the IRS.
>
> It is the view of the Treasury Department and the IRS that, consistent with the purposes of chapters 3 and 4, if adjustments in a statement described in proposed § 301.6226-2 represent additional income allocable to a foreign or domestic partner that was not accounted for in the reviewed year, and the partnership elects under section 6226 to have the partners take into account the adjustments, such income should be subject to the rules in chapters 3 and 4 in the adjustment year to the same extent that such amounts would have been if they had been properly accounted for by the partnership in the reviewed year. Accordingly, the Treasury Department and the IRS intend to issue regulations that coordinate the application of the rules under chapters 3 and 4 to income allocable to a foreign partner or domestic partner where a partnership elects the application of section 6226. Comments are requested on how to efficiently coordinate the election under section 6226 with the withholding rules under chapters 3 and 4, while taking into account the objectives and purposes of BBA to improve the IRS's ability to effectively audit partnerships. In particular, the Treasury Department and the IRS request comments on: (1) how the partnership should satisfy its reporting obligations under chapters 3 and 4 in the reporting year with respect to income allocable to a foreign partner or domestic partner; (2) whether the partnership should be required to obtain new documentation from partners to support a lower withholding rate or whether the partnership should be able to rely on documentation obtained with respect to the reviewed year; and (3) how the rules under chapters 3 and 4 should apply when a statement described in proposed § 301.6226-2 includes additional income allocable to a foreign partner that is an intermediary or flow-through entity.
>
> Additionally, the Treasury Department and the IRS also intend to issue regulations to address situations where a direct partner in the partnership is a foreign entity, such as a trust or corporation, that may not be liable for U.S. federal income tax with respect to one or more adjustments, but an owner of the direct partner is, or could be liable for tax with respect to such amount. For example, if a direct partner in the audited partnership is a controlled foreign corporation, the foreign corporation as a direct partner may not have a U.S. tax liability with respect to a given adjustment; however, the adjustment may impact the tax liability of its U.S. shareholder(s). The tax effects on the U.S. shareholder(s) may arise in the adjustment year, an intervening year, or some subsequent year, depending on the specific facts and circumstances. Comments are requested on how the reporting

obligations concerning foreign entities should be modified to ensure that statements issued under section 6226 are timely reflected on the returns of the U.S. owners of such entities.

Adjustments Taken Into Account by Partners

Proposed Reg. §301.6226-3 has the methods to be used by the partners to compute the tax due when the partnership pushes out the adjustment. The proposed regulations define the amount to be paid as the additional reporting year tax. The additional reporting year tax is either the total of all the individual year adjustment amounts (for the reviewed years and any other affected years) or, if an election is made, the safe harbor amount reported to the partner. [Proposed Reg. §301.6226-3(a)]

The aggregate of the adjustment amounts is the total of the a) correction amount for the first affected year and the b) correction amounts for each of the intervening years. [Proposed Reg. §301.6226-3(b)(1)]

Correction Amount for the First Affected Year

The correction amount for the first affected year is defined at Proposed Reg. §301.6226-3(b)(2).The first affected year is the reviewed year—that is, a year directly under exam at the partnership level. This is the amount that the partner's tax under Chapter 1 (income taxes) would increase for the first affected year after taking into account the partner's share of the partnership adjustments reported to that partner.

The proposed regulation provides the following detailed text based definition of the amount:

> The correction amount is the amount by which the chapter 1 tax that would have been imposed for the first affected year if the items as adjusted in the statement described in § 301.6226-2 had been reported as such on the return for the first affected year exceeds the excess of --
>
> (i) The sum of --
>
> (A) The amount of chapter 1 tax shown by the partner on the return for the first affected year (which includes amounts shown on an amended return for such year, including an amended return filed under section 6225(c)(2) by the reviewed year partner or an indirect partner (as defined in § 301.6241-1(a)(4)) that holds its interest in the partnership through its interest in the reviewed year partner with respect to the first affected year of the indirect partner), plus
>
> (B) Amounts not so shown previously assessed (or collected without assessment) (as defined in § 1.6664-2(d) of this chapter), less
>
> (ii) The amount of rebates made (as defined in § 1.6664-2(e) of this chapter). [Proposed Reg. §301.6226-3(b)(2)}

The proposed regulation also expresses this calculation as a formula:

$$Correction\ amount\ for\ the\ first\ affected\ year = A - (B + C - D)$$

Where:

A = the amount of chapter 1 tax that would have been imposed had the items as adjusted been properly reported on the return for the first affected year;

B = the amount shown as chapter 1 tax on the return for the first affected year (taking into account amended returns);

C = amounts not so shown previously assessed (or collected without assessment); and

D = the amount of rebates made. [Proposed Reg. §301.6226-3(b)(2)]

Correction Amounts for the Intervening Years

The partner also is required to take into account the change in tax that would have taken place for each intervening year. This calculation is defined at Proposed Reg. §301.6226-3(b)(3). The intervening years include years before and after the first affected year (which is also the partnership's reviewed year).

The partner must recomputed his/her Chapter 1 tax (income tax) for each year by taking into account any tax attributes that would be affected by the adjustments made to the first affected year (partnership's reviewed year). Proposed Reg. §301.6226-3(b)(3) provides the following full text definition:

> …[T]he correction amount for each intervening year is the amount by which the chapter 1 tax that would have been imposed for the intervening year if any tax attribute for the intervening year had been adjusted after taking into account the reviewed year partner's share of the adjustments for the first affected year as described in paragraph (b)(2) of this section and if any tax attribute for the intervening year had been adjusted after taking into account any adjustments to tax attributes in any prior intervening year(s) exceeds the excess of --
>
> (i) The sum of --
>
> (A) The amount of chapter 1 tax shown by the partner on the return for the intervening year (which includes amounts shown on an amended return for such year, including an amended return filed under section 6225(c)(2) by a reviewed year partner or an indirect partner that holds its interest in the partnership through its interest in the reviewed year partner), plus
>
> (B) Amounts not so shown previously assessed (or collected without assessment) (as defined in § 1.6664-2(d) of this chapter), over
>
> (ii) The amount of rebates made (as defined in § 1.6664-2(e) of this chapter). [Proposed Reg. §301.6226-3(b)(3)]

As with the correction amount for the first affected year, the regulations provide a formula for the correction amount for each intervening year.

$$Correction\ amount\ for\ an\ intervening\ year = A - (B + C - D)$$

Where:

A = the amount of chapter 1 tax that would have been imposed for the intervening year;

B = the amount shown as chapter 1 tax on the return for the intervening year (taking into account amended returns);

C = amounts not so shown previously assessed (or collected without assessment); and

D = the amount of rebates made. [Proposed Reg. §301.6226-3(b)(3)]

Qualified Investment Entity

Special rules apply for a partner that is a "qualified investment entity" (mutual fund or REIT) as are described in Proposed Reg. §301.6226-3(b)(4)]:

> If a qualified investment entity (QIE) within the meaning of section 860(b) receives a statement described in § 301.6226-2(a) and correctly makes a determination within the meaning of section 860(e)(4) that one or more of the adjustments reflected in the statement is an adjustment within the meaning of section 860(d) with respect to that QIE for a taxable year, the QIE may distribute deficiency dividends within the meaning of section 860(f) for that taxable year and avail itself of the deficiency dividend procedures set forth in section 860. If the QIE utilizes the deficiency dividend

procedures with respect to adjustments in a statement described in § 301.6226-2(a), the QIE may claim a deduction for deficiency dividends against the adjustments furnished to the QIE in the statement in calculating any correction amounts under paragraphs (b)(2) and (b)(3) of this section, and interest on that correction amount under paragraph (d) of this section, to the extent that the QIE makes deficiency dividend distributions under section 860(f) and complies with all requirements of section 860 and the regulations thereunder. A deficiency dividends deduction under this paragraph (b)(4) and section 860(a) has no effect on a QIE's liability for any penalties reflected in a statement described in § 301.6226-2(a).

Safe Harbor Election

As should be clear from the above description, a partner may be facing having to fully recalculate tax liabilities for a number of years. Depending on how long the exam has run and the nature of the partner's return that calculation may be time consuming and expensive. In lieu of doing the above calculation, the partner may elect to pay the safe harbor amount computed by the partnership and provided on the notice to the partner. [Proposed Reg. §301.6226-3(c)]

The partner makes the election to pay the safe harbor amount in lieu of the computed adjustments by making the election, in accordance with forms, instructions or other guidance provided by the IRS, on a timely filed return for the reporting year. However, if the taxpayer makes the election but fails to include the safe harbor tax, the election is effectively made invalid and the taxpayer must undertake the detailed recomputation. [Proposed Reg. §301.6226-3(c)]

Interest on the Correction Amounts

If a taxpayer does not make the election to pay the safe harbor amount, the taxpayer computes the amount of interest that must be paid with the return for the reporting year by computing interest using the underpayment rate as computed under IRC §6621(a)(2) plus 2% (that is, substituting 5% for 3% in IRC §6621(a)(2)(B)). [Proposed Reg. §§301.6226-3(d)(1), (4)]

If the taxpayer has elected to pay the safe harbor adjustment in lieu of calculating the adjustment for each year, the partner may pay interest using one of two mechanisms:

- The partner may pay interest calculate using the underpayment rate plus 2% described above from the due date (without extension) of the partner's return for first affected year until the amount is paid *or*
- If the taxpayer is a calendar year individual, elect to pay the safe harbor interest amount reported by the partnership, described above [Proposed Reg. §301.6226-3(d)(2)]

The proposed regulation contains the following information on making the safe harbor interest election:

> The election under this paragraph (d)(2)(ii) is made on the reviewed year partner's return for the reporting year (as defined in paragraph (a) of this section) in accordance with forms and instructions. If a reviewed year partner making an election under this paragraph (d)(2)(ii) fails to pay the interest safe harbor amount in full on or before the due date (without extension) for the return on which the election is made, interest on the safe harbor amount is determined under paragraph (d)(2)(i) of this section.

Interest on penalties is calculated using the underpayment rate plus 2% from the due date (without extensions) of the reviewed year's partner's return for the first affected year until the amount is paid.

Pass-through partners and Foreign Entities

The IRS has reserved guidance on how these issues would affect pass-through partners and foreign entities. Some of these issues have been addressed in a proposed technical corrections bill which has not yet, but is expected to, pass Congress.

Examples

The IRS has provided five examples applying the provisions of this proposed regulation. For purposes of the examples each partner is a calendar year partner (unless otherwise stated), no modifications are requested by the partnership under Proposed Reg. §301.6225-2 (unless otherwise stated) and the highest rate of tax is assumed to be 40%.

EXAMPLE 1

On its partnership return for the 2020 tax year, Partnership reported ordinary income of $1,000 and charitable contributions of $400. On June 1, 2023, the IRS mails a notice of final partnership adjustment (FPA) to Partnership for Partnership's 2020 year disallowing the charitable contribution in its entirety and asserting an imputed underpayment plus a penalty of $32 (a 20 percent accuracy-related penalty under section 6662(b)). Partnership makes a timely election under section 6226 in accordance with § 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and files a timely petition in the Tax Court challenging the partnership adjustments. The Tax Court determines that Partnership is not entitled to any of the claimed $400 in charitable contributions and upholds the penalty of $32. The decision regarding Partnership's 2020 tax year becomes final on December 15, 2025. Pursuant to § 301.6225-2(b)(1), the partnership adjustments are finally determined on December 15, 2025. On February 1, 2026, Partnership files the statements described under § 301.6226-2 with the IRS and furnishes to partner A, an individual who was a partner in Partnership during 2020, a statement described in § 301.6226-2. A had a 25 percent interest in Partnership during all of 2020 and was allocated 25 percent of all items from Partnership for that year. The statement shows A's share of ordinary income reported on Partnership's return for the reviewed year of $250 and A's share of the charitable contribution reported on Partnership's return for the reviewed year of $100. The statement also shows no adjustment to A's share of ordinary income, but does show an adjustment to A's share of the charitable contribution, a reduction of $100 resulting in $0 charitable contribution allocated to A from Partnership for 2020. In addition, the statement reports $8 as A's share of the penalty (25 percent of $32) related to the imputed underpayment resulting from the denial of the charitable contribution. The statement also shows A's safe harbor amount and interest safe harbor amount, as determined under § 301.6226-2(g). A does not elect to pay the safe harbor amount and therefore must pay the additional reporting year tax as determined in accordance with paragraph (b) of this section, in addition to A's share of the penalty and interest. A computes his additional reporting year tax as follows. First, A determines the correction amount for the first affected year (the 2020 taxable year) by taking into account A's share of the partnership adjustment (‹100› reduction in charitable contribution) for the 2020 taxable year. A determines the amount by which his chapter 1 tax for 2020 would have increased if the $100 adjustment to the charitable contribution from Partnership were taken into account for that year. There is no adjustment to tax attributes in A's intervening years as a result of the adjustment to the charitable contribution for 2020. Therefore, A's aggregate of the adjustment amounts is the correction amount for 2020, A's first affected year. In addition to the aggregate of the adjustment amount being added to the chapter 1 tax that A owes for 2026, the reporting year, A's tax liability for 2026 includes the $8 penalty and any interest on the correction amount for the first affected year and the penalty determined in accordance with paragraph (d) of this section. Interest on the correction amount for the first affected tax year runs from April 15, 2021, the due date of A's 2020 return (the first affected tax year) until A pays this amount. In addition, interest runs on the $8 penalty from April 15, 2021, the due date of A's 2020 return for the first affected year until A pays this amount. On his 2026 income tax return, A must report the additional reporting year tax determined in accordance with section (b) of this section, which is the correction amount for 2020, plus A's share of the accuracy-related

penalty determined at the partnership level ($8), and interest determined in accordance with paragraph (d) of this section on the correction amount for 2020 and the penalty.

EXAMPLE 2

The facts are the same as in Example 1 of this paragraph (g), except that A makes the elections under paragraphs (c) and (d)(ii) of this section to pay the safe harbor amount and interest safe harbor amount. In addition to the safe harbor amount and the interest safe harbor amount, A must also pay the $8 penalty allocated to A on the statement. Therefore, on his 2026 income tax return, A must report the additional reporting year tax (in this case, the safe harbor amount), the penalty of $8, and the interest safe harbor amount.

EXAMPLE 3

On its partnership return for the 2020 tax year, Partnership reported an ordinary loss of $500 million. On June 1, 2023, the IRS mails an FPA to Partnership for the 2020 taxable year determining that $300 million of the $500 million in ordinary loss should be recharacterized as a long-term capital loss. Partnership has no long-term capital gain for its 2020 tax year. The FPA for Partnership's 2020 tax year reflects an adjustment of an increase in ordinary income of $300 million (as a result of the disallowance of the recharacterization of $300 million from ordinary loss to long-term capital loss) and an imputed underpayment related to that adjustment, as well as an adjustment of an additional $300 million in long-term capital loss for 2020 which does not result in an imputed underpayment pursuant to under § 301.6225-1(c)(2)(ii). Partnership makes a timely election under section 6226 in accordance with § 301.6226-1 with respect to the imputed underpayment in the FPA and does not file a petition for readjustment under section 6234. Accordingly, under § 301.6226-1(b)(2) and § 301.6225-3(b)(6), the adjustment year partners (as defined in § 301.6241-1(a)(2)) do not take into account the $300 million long-term capital loss that does not result in an imputed underpayment. Rather, the reviewed year partners will take into account the $300 million long-term capital loss. The time to file a petition expires on August 30, 2023. Pursuant to § 301.6225-2(b), the partnership adjustments become finally determined on August 30, 2023. On September 30, 2023, Partnership files with the IRS statements described in § 301.6226-2 and furnishes statements to all of its reviewed year partners in accordance with § 301.6226-2. One partner of Partnership in 2020, B (an individual), had a 25 percent interest in Partnership during all of 2020 and was allocated 25 percent of all items from Partnership for that year. The statement filed with the IRS and furnished to B shows B's allocable share of the ordinary loss reported on Partnership's return for the 2020 taxable year as $125 million. The statement also shows an adjustment to B's allocable share of the ordinary loss in the amount of <$75 million>, resulting in a corrected ordinary loss allocated to B of $50 million for taxable year 2020 ($125 million originally allocated to B less $75 million which is B's share of the adjustment to the ordinary loss). In addition, the statement shows an increase to B's share of long-term capital loss in the amount of $75 million (B's share of the adjustment that did not result in the imputed underpayment with respect to Partnership). The statement also shows B's safe harbor amount and interest safe harbor amount, as determined under § 301.6226-2(g). B does not elect to pay the safe harbor amount and therefore must pay the additional reporting year tax as determined in accordance with paragraph (b) of this section. B computes his additional reporting year tax as follows. First, B determines the correction amount for the first affected year (the 2020 taxable year) by taking into account B's share of the partnership adjustments (a $75 million reduction in ordinary loss and an increase of $75 million in capital loss) for the 2020 taxable year. B determines the amount by which his chapter 1 tax for 2020 would have increased if the $75 adjustment to ordinary loss and the $75 million adjustment to capital loss from Partnership were taken into account for

that year. Second, B determines if there is any increase in chapter 1 tax for any intervening year as a result of the adjustment to the ordinary and capital losses for 2020. B's aggregate of the adjustment amounts is the correction amount for 2020, B's first affected year plus any correction amounts for any intervening years. B is also liable for any interest on the correction amount for the first affected year and for any intervening year as determined in accordance with paragraph (d) of this section.

EXAMPLE 4

On its partnership return for the 2020 tax year, Partnership reported ordinary income of $100 million and a capital gain of $40 million. Partnership had four equal partners during the 2020 tax year: E, F, G, and H, all of whom were individuals. On its partnership return for the 2020 tax year, the entire capital gain was allocated to partner E and the ordinary income was allocated to all partners based on their equal (25 percent) interest in Partnership. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year and determines that the capital gain should have been allocated equally to all four partners and that Partnership should have recognized an additional $10 million in ordinary income. No modifications were approved by the IRS and no penalties are imposed. On June 1, 2023, the IRS mails an FPA to Partnership reflecting the reallocation of the $40 million capital gain so that F, G, and H each have $10 million increase in capital gain and E has a $30 million reduction in capital gain for 2020. In addition, the FPA reflects the partnership adjustment increasing ordinary income by $10 million. The FPA reflects a general imputed underpayment with respect to the increase in ordinary income and a specific imputed underpayment with respect to the increase in capital gain allocated to F, G, and H. In addition, the FPA reflects a $30 million partnership adjustment that does not result in an imputed underpayment, that is, the reduction of $30 million in capital gain with respect to E. Partnership makes a timely election under section 6226 in accordance with § 301.6226-1 with respect to the specific imputed underpayment relating to the reallocation of capital gain. Partnership does not file a petition for readjustment under section 6234. The time to file a petition expires on August 30, 2023. Pursuant to § 301.6225-2(b), the partnership adjustments become finally determined on August 30, 2023. Partnership timely pays and reports the general imputed underpayment relating to the partnership adjustment to ordinary income. On September 30, 2023, Partnership files with the IRS statements described in § 301.6226-2 and furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA that relate to the specific imputed underpayment, that is, the reallocation of capital gain. The statements for F, G, and H each reflect a partnership adjustment of an additional $10 million of capital gain for 2020. The statements also show that each partner's safe harbor amount and interest safe harbor amount, determined under § 301.6226-2(g). F, G, and H elect to pay the safe harbor amount and interest safe harbor amount. The statement for E reflects a partnership adjustment of a reduction of $10 million of capital gain for 2020. The statement also reflects that E's safe harbor amount, as determined under § 301.6226-2(g), is $0 (<$10 million> multiplied by 40 percent but not less than zero). F elects to pay the safe harbor amount, which is zero.

EXAMPLE 5

On its partnership return for the 2020 taxable year, Partnership reported a capital loss of $5 million. During an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS mails a notice of proposed partnership adjustment (NOPPA) in which it proposes to disallow $2 million of the reported $5 million capital loss. No penalties are imposed with respect to the $2 million adjustment. F, a C corporation partner with a 50 percent interest in Partnership, received 50 percent of all capital losses for 2020. As part of the modification process described in §

301.6225-2(d)(2) F files an amended return for 2020 taking into account F's share of the partnership adjustment ($1 million reduction in capital loss) and pays the tax owed for 2020, including interest. Also as part of the modification process, F also files amended returns for 2021 and 2022 and paid additional tax (and interest) for these years because the reduction in capital loss for 2020 affected the tax due from F for 2021 and 2022. See § 301.6225-2(d)(2)(iv). The reduction of the capital loss in 2020 did not affect any other taxable year of F. The IRS approves the modification with respect to F and on June 1, 2023, mails an FPA to Partnership for Partnership's 2020 year reflecting the partnership adjustment reducing the capital loss in the amount of $2 million. The FPA also reflects the modification to the imputed underpayment based on the amended returns filed by F taking into account F's share of the reduction in the capital loss. Partnership makes a timely election under section 6226 in accordance with § 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and files a timely petition in the Tax Court challenging the partnership adjustments. The Tax Court upholds the determinations in the FPA and the decision regarding Partnership's 2020 tax year becomes final on December 15, 2025. Pursuant to § 301.6225-2(b)(1), the partnership adjustments are finally determined on December 15, 2025. On February 1, 2026, Partnership files the statements described under § 301.6226-2 with the IRS and furnishes to its partners statements reflecting their shares of the partnership adjustment. The statement issued to F reflects F's share of the partnership adjustment for Partnership's 2020 taxable year as finally determined by the Tax Court. The statement shows F's share of the capital loss reported on Partnership's return for the reviewed year of $1 million and the $1 million reduction in capital losses taken into account by F as part of the amended return modification. The statement shows that F's safe harbor amount, as determined under § 301.6226-2(g), is $0 ([$1 million adjustment less the $1 million taken into account in the amended return] multiplied by 40 percent). F elects to pay the safe harbor amount, which is zero.

Adjustments to Partners Outside Bases and Capital Accounts and a Partnership's Basis and Book Value in Property

As was true in the provisions dealing with a partnership paying the imputed adjustment, the IRS has reserved guidance at Proposed Reg. §301.6226-4 for adjustments to partners' outside bases and capital accounts and a partnership's basis and book value in property.

Administrative Adjustment Requests (AARs) by a Partnership

A partnership requesting an administrative adjustment request (the practical equivalent of an amended return) will generally apply treatments similar to those of changes made when the partnership is under examination by the IRS. Proposed Reg. §301.6227-1 outlines the rules.

As is explained at Proposed Reg. §301.6227-1(a), the partnership must first determine if the AAR will result in an imputed underpayment for the reviewed year or if it will not.

If the AAR results in an imputed underpayment the partnership must either:

- Compute and pay the imputed underpayment, taking into account any adjustments allowed under the rules described above *or*
- Elect to use the push out alternative to paying the imputed understatement, in which case each reviewed year partner takes the adjustment into account in the year the AAR is filed. [Proposed Reg. §301.6227-1(a)]

If the AAR does not result in an imputed underpayment, the reviewed year partners must take the adjustments into account in the year the AAR is filed. [Proposed Reg. §301.6227-1(a)]

The proposed regulations describe the limited cases when a partner may file an AAR as follows:

> A partner may not file an AAR except if the partner is doing so on behalf of the partnership in the partner's capacity as the partnership representative designated under section 6223 or if the partner is a partnership-partner (as defined in § 301.6241-1(a)(7)) filing an AAR under § 301.6227-3(c). In addition, a partnership may not file an AAR solely for the purpose of allowing the partnership to change the designation of a partnership representative. See § 301.6223-1 (regarding designation of the partnership representative).[Proposed Reg. §301.6227-1(a)]

Time to File an AAR

An AAR cannot be filed until after the original return is first filed with the IRS—that is, you can't use an AAR to effectively have the partnership pay everything at the entity level via an imputed adjustment.[Proposed Reg. §301.6227-1(b)]

As well, the proposed regulations note:

> A partnership may not file an AAR with respect to a partnership taxable year more than three years after the later of the date the partnership return for such partnership taxable year was filed or the last day for filing such partnership return (determined without regard to extensions). In no event may an AAR be filed for a partnership taxable year after a notice of administrative proceeding with respect to such taxable year has been mailed by the IRS under section 6231.[Proposed Reg. §301.6227-1(b)]

Filing the AAR

An AAR must be filed with the IRS in accordance with the forms, instructions and other guidance issued by the agency and signed under penalties of perjury by the partnership representative. [Proposed Reg. §301.6227-1(c)(1)]

An AAR must include:

- The adjustments requested,
- If a reviewed year partner is required to take into account the adjustments requested under § 301.6227-3, statements described in paragraph (e) of this section, including any transmittal with respect to such statements required by forms, instructions, and other guidance, and
- Other information prescribed by the IRS in forms, instructions, or other guidance.

Statements to Be Issued to Reviewed Year Partners

If the reviewed year partners are required to take the adjustment into account on their own returns, the partnership must issue statements that comply with Proposed Reg. §301.6227-1(d)

In general, the rule provides:

> If a reviewed year partner is required to take into account adjustments requested in an AAR under § 301.6227-3, the partnership must furnish a copy of the statement described in paragraph (e) of this section to the reviewed year partner to whom the statement relates in accordance with the forms, instructions and other guidance prescribed by the IRS. If the partnership mails the statement, it must mail the statement to the current or last address of the reviewed year partner that is known to the partnership. The statement must be furnished to the reviewed year partner on the date the AAR is filed with the IRS. [Proposed Reg. §301.6227-1(d)]

The statements must contain the following:

- The name and correct TIN of the reviewed year partner to whom the statement is being furnished;

- The current or last address of the partner that is known to the partnership;
- The reviewed year partner's share of items as originally reported on statements furnished to the partner under section 6031(b) and, if applicable, section 6227;
- The reviewed year partner's share of the adjustments as described under paragraph (c)(2) of this section;
- The date the statement is furnished to the partner;
- The partnership taxable year to which the adjustments relate; and
- Any other information required by forms, instructions, and other guidance prescribed by the IRS.[Proposed Reg. §301.6227-1(e)(1)]

The rules for determining the amounts to be reported on the reviewed year's partner's return are similar to the rules for determining this amount in an examination context. The basic rule provides:

> …[E]ach reviewed year partner's share of the adjustments requested in the AAR is determined in the same manner as each adjusted item was originally allocated to the reviewed year partner on the partnership return for the reviewed year. [Proposed Reg. §301.6227-1(e)(2)(i)]

For items that were not reported originally on the reviewed year return, Proposed Reg. §301.6227-1(e)(2)(ii) provides:

> Except as provided in paragraph (e)(2)(iii) of this section*[for allocation adjustments]*, if the adjusted item was not reported on the partnership return for the reviewed year, each reviewed year partner's share of the adjustments must be determined in accordance with how such items would have been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement.

Finally, Proposed Reg. §301.6227-1(e)(2)(iii) provides:

> Allocation adjustments. If an adjustment involves allocation of an item to a specific partner or in a specific manner, including a reallocation of an item, the reviewed year partner's share of the adjustment requested in the AAR is determined in accordance with the AAR.

Binding Nature of the AAR

The AAR is just as binding on the partners as the original tax return. As is stated in Proposed Reg. §301.6227-1(f):

> Filing an AAR as described in paragraph (c) of this section and furnishing statements as described in paragraph (d) of this section are actions of the partnership under section 6223 and the regulations thereunder. Accordingly, unless determined otherwise by the IRS, each partner's share of the adjustments set forth in a statement described in paragraph (e) of this section are binding on the partner pursuant to section 6223. A partner may not treat items on the partner's return inconsistently with how those items are treated on the statement that is filed with the IRS under paragraph (c) of this section. See § 301.6222-1(c)(2) (regarding items the treatment of which a partner is bound to under section 6223).

IRS Administrative Proceeding for Year for Which AAR is Filed

The IRS retains the right to review and modify the return year for which an AAR is filed by the partnership. Proposed Reg. §301.6227-1(g) provides:

> Within the period described in section 6235, the IRS may initiate an administrative proceeding with respect to the partnership for any partnership taxable year regardless of whether the partnership filed an AAR with respect to such taxable year and may adjust any item subject to adjustment under subchapter C of chapter 63 of the Internal Revenue Code, including any item adjusted in an AAR filed

by the partnership. The amount of an imputed underpayment determined by the partnership under § 301.6227-2(a)(1), including any modifications determined by the partnership under § 301.6227-1(a)(2), may be re-determined by the IRS.

Reserved Guidance for Creditable Foreign Tax Expenditures

The IRS has reserved Proposed Reg. §301.6227-1(h) for notice of change to the amount of creditable foreign tax expenditures.

Determining and Accounting for Adjustments Request in AAR

Similar rules as apply for calculating the amounts for adjustments in examinations of a partnership apply to an AAR, as outlined in Proposed Reg. §301.6227-2. The AAR will compute an imputed underpayment under the same rules as apply generally for an exam.

As well, most of the modifications that can be requested of the IRS with regard to the administrative adjustment amounts are available to the partnership in an AAR. Allowed AAR modifications are those for:

- Tax exempt partners
- Modifications of applicable tax rate
- Specified passive activity losses
- Certain qualified investment entities [Proposed Reg. §301.6227-2(a)(2)]

However in this case there is not a request to the IRS for the modification by the partnership. As is provided by Proposed Reg. §301.6227-3(a)(2):

> (i)The partnership is not required to seek the approval from the Internal Revenue Service (IRS) prior to modifying the amount of any imputed underpayment under paragraph (a)(1) of this section as reported on the AAR; and
>
> (ii) As part of the AAR filed with the IRS in accordance with forms, instructions, and other guidance, the partnership must --
>
> > (A) Notify the IRS of any modification,
> >
> > (B) Describe the effect of the modification on the imputed underpayment,
> >
> > (C) Provide an explanation of the basis for such modification, and
> >
> > (D) Provide documentation to support the partnership's eligibility for the modification.

Adjustments Related to Imputed Underpayment Taken Into Account by the Partnership

Unless the partnership elects to use the alternative to the imputed underpayment (the push out election), the partnership must pay the imputed underpayment resulting from an AAR when the partnership files the AAR. [Proposed Reg. §301.6227-2(b)(1)]

Penalties and interest for an AAR are described in Proposed Reg. §301.6227-2(b)(2):

> The IRS may impose a penalty, addition to tax, and additional amount with respect to an imputed underpayment determined under this section in accordance with section 6233(a)(3) (penalties determined from the reviewed year). In addition, the IRS may impose a penalty, addition to tax, and additional amount with respect to a failure to pay an imputed underpayment on the date an AAR is filed in accordance with section 6233(b)(3) (penalties with respect to the adjustment year return). Interest on the imputed underpayment is determined under chapter 67 for the period beginning on the date after the due date of the partnership return for the reviewed year (as defined in § 301.6241-1(a)(8)) (determined without regard to extension) and ending on the earlier of the date payment of the

> imputed underpayment is made, or the due date of the partnership return for the adjustment year (as defined in § 301.6241-1(a)(1)). See section 6233(a)(2). In the case of any failure to pay an imputed underpayment before the due date of the partnership return for the adjustment year, interest is determined in accordance with section 6233(b)(2).

Election to Have Adjustment Taken Into Account by Reviewed Year Partners

The partnership can elect to have the adjustment taken into account by the reviewed year partners. Proposed Reg. §301.6227-2(c) provides:

> A partnership makes an election under this paragraph (c) at the time the AAR is filed in accordance with the forms, instructions, and other guidance prescribed by the IRS. If the partnership makes a valid election in accordance with this paragraph (c), the partnership is not required to pay the imputed underpayment resulting from the adjustments requested in the AAR. Rather, each reviewed year partner must take into account their share of the adjustments requested in the AAR in accordance with § 301.6227-3. If an election is made under this paragraph (c), modifications requested under paragraph (a)(2) of this section are disregarded and all adjustments requested in the AAR must be taken into account by each reviewed year partner in accordance with § 301.6227-3.

As well, if there is no imputed underpayment calculated due to the AAR, the adjustments must be taken into account by the reviewed year partners:

> If the adjustments requested in an AAR do not result in an imputed underpayment (as determined under paragraph (a) of this section), the partnership must furnish statements to each reviewed year partner and file such statements with the IRS in accordance with § 301.6227-1. Each reviewed year partner must take into account its share of the adjustments requested in the AAR in accordance with § 301.6227-3. [Proposed Reg. §301.6227-3(d)]

Partner Taking AAR Adjustments Into Account

If the partnership either elects to have the adjustments taken into account by the reviewed year partners or is required to have those adjustments taken into account by the reviewed year partners, the provisions of Proposed Reg. §301.6227-3(a)

As Proposed Reg. §301.6227-3(a) provides:

> Each reviewed year partner receiving a statement furnished in accordance with § 301.6227-1(b) must take into account adjustments reflected in the statement in the taxable year that includes the date the statement is furnished (reporting year) in accordance with paragraph (b) of this section.

Unlike with an exam, with an AAR there is no safe harbor amount or election, but rather the tax must be calculated by the reviewed year partner:

> A reviewed year partner that is furnished a statement described in paragraph (a) of this section must treat the statement as if it were issued under section 6226(a)(2) and, on or before the due date for the reporting year must pay the additional reporting year tax (as defined in § 301.6226-3(a)), if any, determined after taking into account that partner's share of the adjustments requested in the AAR in accordance with § 301.6226-3. For purposes of this paragraph (b), the rules under § 301.6226-3(c) (regarding the election to pay the safe harbor amount), § 301.6226-3(d)(2) (regarding interest on the safe harbor amount), and § 301.6226-3(d)(4) (regarding the increased rate of interest) do not apply, and the last sentence in § 301.6226-3(b)(1) (regarding the prohibition on correction amounts being less than zero) is disregarded. Nothing in this section entitles any partner to a refund of tax imposed by chapter 1 of subtitle A of the Internal Revenue Code (chapter 1 tax) to which such partner is not entitled. For instance, a partnership-partner (as defined in § 301.6241-1(a)(7)) may not claim a refund with respect to its share of any adjustment. [Proposed Reg. §301.6227-3(b)(1)]

As well, the regulation provides:

> A reviewed year partner may reduce chapter 1 tax for the reporting year by the amount determined under paragraph (b)(1) of this section. [Proposed Reg. §301.6227-3(b)(2)]

Reviewed Year Pass-Through Entity Partner

The IRS has reserved Proposed Reg. §301.6227-3(c) for further guidance.

Examples

The IRS gives the following two examples [Proposed Reg. §301.6227-3(b)(3)].

EXAMPLE 1

In 2022, partner A, an individual, received a statement described in paragraph (a) of this section from Partnership with respect to Partnership's 2020 taxable year. Both A and Partnership are calendar taxpayers and A is not claiming any refundable tax credit in 2020. The only adjustment shown on the statement is an increase in ordinary losses. Taking into account the adjustment, A determines that his additional reporting year tax for 2022 (the reporting year) is <$100> (that is, a reduction of $100.) A's chapter 1 tax for 2022 (without regard to any additional reporting year tax) is $150. Applying the rules in paragraph (b)(2) of this section, A's chapter 1 tax for 2022 is reduced to $50 ($150 chapter 1 tax without regard to the additional reporting year tax plus <$100> additional reporting year tax).

EXAMPLE 2

The facts are the same as in Example 1 of this paragraph (b)(3),except A's chapter 1 tax for 2022 (without regard to any additional reporting year tax) is $75. Applying the rules in paragraph (b)(2) of this section, A's chapter 1 tax for 2022 is reduced by the <$100> of additional reporting year tax. Accordingly, A's chapter 1 tax for 2022 is $0 ($75 chapter 1 tax without regard to any additional reporting year tax plus <$100> of additional reporting year tax), A owes no chapter 1 tax for 2022, and A may make a claim for refund with respect to the overpayment of $25.

Bankruptcy of the Partnership

Special rules are provided for a partnership in bankruptcy with regard to the new BBA partnership audit regime at Proposed Reg. §301.6241-2.

The regulation provides the following general description:

> If a partnership is a debtor in a case under Title 11 of the United States Code (Title 11 case), the running of any period of limitations under section 6235 with respect to the time for making a partnership adjustment (as defined in § 301.6241-1(a)(6)) and under sections 6501 and 6502 with respect to the assessment or collection of any imputed underpayment (as defined in § 301.6241-1(a)(3)) determined under subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) is suspended during the period the Internal Revenue Service (IRS) is prohibited by reason of the Title 11 case from making the adjustment, assessment, or collection until --
>
> > (i) 60 days after the suspension ends, for adjustments or assessments, and
> >
> > (ii) 6 months after the suspension ends, for collection. [Proposed Reg. §301.6241-2(a)(1)]

The regulation also provides that:

> The filing of a proof of claim or request for payment (or the taking of any other action) in a Title 11 case is not be treated as an action prohibited by section 6232(b) (regarding limitations on assessment). [Proposed Reg. §301.6241-2(a)(2)]

As well, the regulation goes on to note:

> In a Title 11 case, the running of the period specified in section 6234 (regarding judicial review of partnership adjustments) is suspended during the period during which the partnership is prohibited by reason of the Title 11 case from filing a petition under section 6234, and for 60 days thereafter. [Proposed Reg. §301.6241-2(a)(3)]

The following actions are not prohibited due to the filing of a Chapter 11 petition:

- An administrative proceeding with respect to a partnership under subchapter C of chapter 63;
- The mailing of any notice with respect to a proceeding with respect to a partnership under subchapter C of chapter 63, including:
    - A notice of administrative proceeding,
    - A notice of proposed partnership adjustment, and
    - A notice of final partnership adjustment;
- A demand for tax returns;
- The assessment of any tax, including the assessment of any imputed underpayment with respect to a partnership; and
- The issuance of notice and demand for payment of an assessment under subchapter C of chapter 63 (but see section 362(b)(9)(D) of Title 11 of the United States Code regarding the timing of when a tax lien takes effect by reason of such assessment). [Proposed Reg. §301.6241-2(a)(4)

Partnership Ceases to Exist

One obvious issue with this change to handling the entire exam through even the payment of tax at the partnership level in the exam is what happens if the partnership has gone out of existence before the IRS is able to examine the return. This issue is dealt with in Proposed Reg. §301.6241-3.

But in addition to what would normally be viewed as "ceasing to exist" the proposed regulations also define a partnership as ceasing to exist should the partnership prove unable to pay the full imputed adjustment.

The general rule provides that if the IRS determines the partnership ceases to exist before the partnership adjustment takes effect, the partnership adjustment is taken into account by the former partners. [Proposed Reg. §301.6241-3(a)(1)] The partnership itself is no longer liable for any amounts arising from a partnership adjustment. [Proposed Reg. §301.6241-3(a)(2)]

If the partnership has in place an election out of the BBA regime under IRC §6221(b) will not be required to take a partnership adjustment into account—which makes sense since the partnership had elected to be examined under the pre-TEFRA partnership provisions that looked at each partner—in that structure the partnership's continued existence isn't really relevant. [Proposed Reg. §301.6241-3(a)(3)]

Ceasing to Exist

The proposed regulations make clear that the determination that a partnership ceases to exist is solely a determination of the IRS:

> For purposes of this section, the IRS may, in its sole discretion, make a determination that a partnership ceases to exist for purposes of this section, but the IRS is not required to do so even if the

> definition in paragraph (b)(2) of this section applies with respect to such partnership. If the IRS determines that a partnership ceases to exist, the IRS will notify the partnership and the former partners (as defined in paragraph (d) of this section), in writing, within 30 days of such determination using the last known address of the partnership and the former partners. [Proposed Reg. §301.6241-3(b)(1)]

The proposed regulations define "ceases to exist" as the existence of one of two conditions:

- The partnership terminates within the meaning of section 708(b)(1)(A), or
- Does not have the ability to pay in full the amount due. [Proposed Reg. §301.6241-3(b)(2)]

The regulation defines inability to pay as:

> For purposes of this section, a partnership does not have the ability to pay if the IRS determines that the account with respect to the partnership is not collectible based on the information the IRS has at the time of such determination. [Proposed Reg. §301.6241-3(b)(2)(i)]

As well, the regulation provides that the following are <u>not</u> considered conditions under which the partnership ceases to exist solely because:

- The partnership has a technical termination under section 708(b)(1)(B);
- A valid election under section 6226 and the regulations thereunder is in effect with respect to any imputed underpayment (as defined in § 301.6241-1(a)(3)); or
- The partnership has not paid any amount required to be paid under subchapter C of chapter 63. [Proposed Reg. §301.6241-3(b)(2)(i)]

The year in which the partnership ceases to exist depends on which of the two reasons the IRS determined the partnership ceases to exist:

- If a partnership terminates under section 708(b)(1)(A), the partnership ceases to exist on the last day of the partnership's final taxable year.
- If a partnership does not have the ability to pay, the partnership ceases to exist on the date that the IRS makes a determination under paragraph (b)(2)(i) of this section that the partnership ceases to exist. [Proposed Reg. §301.6241-3(b)(2)(i)]

The proposed regulations provide the IRS is barred from determining a partnership ceases to exist with respect to a partnership adjustment after the expiration of the statute of limitations on collections on those adjustments. [Proposed Reg. §301.6241-3(b)(2)(iii)]

Consequences Where Partnership Ceases to Exist

The regulation's provisions that allow the IRS to reach outside the partnership and go after partners for an unpaid imputed adjustment are found at Proposed Reg. §301.6241-3(c).

The regulation first defines what represents full payment of the partnership adjustment by the partnership after which the individual partners will no longer be at risk of having to pay. Proposed Reg. §301.6241-3(c)(1) provides:

> <u>Full payment of amounts resulting from a partnership adjustment</u>. For purposes of this section, a partnership adjustment under subchapter C of chapter 63 takes effect when there is full payment of amounts resulting from a partnership adjustment. For purposes of this section, full payment of amounts resulting from a partnership adjustment means all amounts due under subchapter C of chapter 63 resulting from the partnership adjustment are fully paid by the partnership.

The regulation then goes on to deal with a situation where the partnership pays part, but not all, of the adjustment in Proposed Reg. §301.6241-3(c)(2):

> If a partnership pays part, but not all, of any amount due resulting from a partnership adjustment before the partnership ceases to exist, the former partners of the partnership that has ceased to exist are not required to take into account any partnership adjustment to the extent amounts have been paid by the partnership with respect to such adjustment. The notification that the IRS has determined that the partnership has ceased to exist will include information regarding the portion of the partnership adjustments with respect to which appropriate amounts have not already been paid by the partnership and therefore must be taken into account by the former partners (described in paragraph (d) of this section) in accordance with paragraph (e) of this section.

Former Partners

Those liable are "former partners" which is a term defined at Proposed Reg. §301.6241-3(d). Initially that definition refers to any partner that held an interest in the partnership in the adjustment year (that is, generally the year when the imputed adjustment became final). [Proposed Reg. §301.6241-3(d)(i)] Note that this is a different set of partners than would have been liable for tax had the partnership elected to push out the adjustments under the alternative to the imputed adjustment. In that case, it would have been the reviewed year partners (the partners in the year(s) under exam) that would have faced liability for the tax.

If one of the partners of the partnership is itself a partnership, the tax would normally be owed by the partnership in this situation—but if that partner-partnership is deemed by the IRS to itself cease to exist, the partners of that partnership will become liable.

> If the adjustment year partner is a partnership-partner that the IRS has determined ceased to exist, the partners of such partnership-partner during the partnership-partner's taxable year that includes the end of the adjustment year (as defined in § 301.6241-1(a)(1)) of the partnership that is subject to a proceeding under subchapter C of chapter 63 are the former partners for purposes of this section. [Proposed Reg. §301.6241-3(d)((1)(ii)]

The rules also deal with the case where that partnership-partner may have terminated during the adjustment year. In that case the proposed regulation provides:

> If the partnership-partner ceased to exist before the partnership-partner's taxable year that includes the end of the adjustment year of the partnership that is subject to a proceeding under subchapter C of chapter 63, the former partners for purposes of this section are the partners of such partnership-partner during the partnership taxable year for which the final partnership return of the partnership-partner under section 6031 is filed. [Proposed Reg. §301.6241-3(d)(1)(iii)]

If there are no adjustment year partners (such as due to the fact that the partnership terminated prior to the adjustment year and has filed a final return), Proposed Reg. §301.6241-3(d)(2) provides:

> If there are no adjustment year partners of a partnership that ceases to exist, the term former partners means the partners of the partnership during the last taxable year for which a partnership return under section 6031 was filed with respect to such partnership. For instance, if a partnership terminates under section 708(b)(1)(A) (and therefore ceases to exist under paragraph (b)(2)(i) of this section) before the adjustment year and files a final partnership return for the partnership taxable year of such partnership, the former partners for purposes of this section are the partners of the partnership during the partnership taxable year for which a final partnership return is filed.

Calculation of Amounts Due from Former Partners

Although it affects different partners, the actual calculation of amounts due from former partners takes place in a similar fashion to what applies to reviewed year partners when the partnership elects to push out the

adjustments by electing the alternative the imputed underpayment. The calculation is made by use of statements required to be furnished by the partnership to the partners once the IRS determines the partnership has ceased to exist. [Proposed Reg. §301.6241-3(e)(1)]

The statements are similar to those provided to partners when the partnership elects the alternative to the imputed underpayment (the "push out" election) except:

- The adjustments are taken into account by the applicable former partner (as described in paragraph (d) of this section), rather than the reviewed year partners (as defined in § 301.6241-1(a)(9)), and
- The partnership must furnish statements to the former partners and file the statements with the IRS no later than 30 days after the date of the notification to the partnership that the IRS has determined that the partnership has ceased to exist.

The IRS has provided a way to deal with the very real possibility that, should the partnership be deemed to cease to exist, there may not be any party who will be able or willing to prepare the required statements. In that case the IRS itself can step in and send the statements.

Per Proposed Reg. §301.6241-3(e)(3):

> If any statements required by paragraph (e) of this section are not timely furnished to a former partner and filed with the IRS in accordance with paragraph (e)(2)(ii) of this section, the IRS may notify the former partner in writing of such partner's share of the partnership adjustments based on the information reasonably available to the IRS at the time such notification is provided. For purposes of paragraph (e) of this section, a notification to a former partner under this paragraph (e)(3) is treated the same as a statement required to be furnished and filed under paragraph (e)(2) of this section.

Examples

The IRS provides two examples of the application of this proposed regulation.

EXAMPLE 1

The IRS initiates a proceeding under subchapter C of chapter 63 with respect to the 2020 partnership taxable year of Partnership. During 2023, in accordance with section 6235(b), Partnership extends the period of limitations on adjustments under section 6235(a) until December 31, 2025. On February 1, 2025, the IRS mails Partnership a notice of final partnership adjustment (FPA) that determines partnership adjustments that result in a single imputed underpayment. Partnership does not timely file a petition under section 6234 and does not make a valid election under section 6226. On May 1, 2026, the IRS mails Partnership notice and demand for payment of the amount due resulting from the adjustments determined in the FPA. Partnership fails to make a payment. On September 1, 2029, IRS determines Partnership ceases to exist for purposes of this section because the IRS has determined that Partnership does not have the ability to pay under paragraph (b)(2)(i) of this section. Under § 301.6241-1(a)(1), the adjustment year is 2025 and A and B, both individuals, are the only adjustment year partners of Partnership during 2025. Accordingly, under paragraph (d)(1) of this section, A and B are former partners. Therefore, A and B are required to take their share of the partnership adjustments determined in the FPA into account under paragraph (e) of this section.

EXAMPLE 2

The IRS initiates a proceeding under subchapter C of chapter 63 with respect to the 2020 partnership taxable year of Partnership. G, a partnership, is a partner of Partnership during 2020. On February 3, 2025, the IRS mails Partnership an FPA that determines partnership adjustments

that result in a single imputed underpayment. Partnership does not timely file a petition under section 6234, but does make a timely election under section 6226. On May 31, 2025, Partnership timely files and furnishes a statement to G as required by section 6226 and the regulations thereunder. G terminated under section 708(b)(1)(A) on December 31, 2024. On June 1, 2026, the IRS determines that G ceased to exist in 2024 for purposes of this section in accordance with paragraph (b)(2)(i) of this section. J and K, individuals, were the only partners of G during 2024. Therefore, under paragraph (d)(1)(ii) of this section, J and K, the partners of G during G's 2024 partnership taxable year, are the former partners of G for purposes of this section. Therefore, J and K are required to take into account their share of the adjustments contained in the statement furnished by Partnership to G in accordance with paragraph (e) of this section.

Payments are Not Tax Deductible

Proposed Reg. §301.6241-4 provides that payments for taxes, penalties and interest by a partnership in an examination will be treated as a nondeductible expense as described in IRC §705(a)(2)(B).

Dealing with "Nonpartnership Partnerships"

A key issue that has arisen in recent years has involved a question of whether an entity was or was not actually a partnership. The IRS may wish to argue an entity was not a partnership to deny certain benefits that can only arise from a partnership structure. But even if the IRS successfully argues that the entity was not a partnership, the BBA partnership audit regime will still apply. The rules become applicable when an entity files a partnership return regardless of whether it is later found to actually be a partnership. [Proposed Reg. §301.6241-5(a)(1)]

Similarly, even if the finding is not just that there wasn't a partnership but also that the entity itself did not exist, the BBA regime will still apply to the "non-entity" return. [Proposed Reg. §301.6241-5(a)(2)]