New Partnership Audit Rules—What We Know So Far (And What Still Needs to Be Clarified)

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New rules have created a new world for partnership audits and triggered an avalanche of practical, economic, business, legal, and investor relations ramifications. Although the new rules generally are effective for returns filed for partnership tax years beginning after 2017, taxpayers need to analyze the implications of the new rules and take steps now in anticipation of the changes. This article describes the new law, significant federal income tax issues it raises, and areas in which additional legislative and administrative clarification and guidance are needed from a federal income tax perspective. The article also explores key transactional and practical considerations raised by the new rules.

On November 2, 2015, legislation was enacted as part of the Bipartisan Budget Act of 2015 (the “Budget Act”)¹ that fundamentally changes the federal income tax rules applicable to audits of partnerships, generally effective for federal income tax returns filed for partnership tax years beginning after 2017.² Under the new rules, the IRS can impose liability at the partnership level if it determines, on

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² As explained in text infra, partnerships can elect to provide the rules earlier in accordance with administrative guidance. Guidance on electing to apply the rules early has not yet been issued.
audit, that a partnership incorrectly reported its income or allocations for the audited tax year—unless the partnership makes certain elections or those who were partners in the audited year take certain actions.

Although the new partnership audit rules generally will not apply for a few years, it is important for partnerships, partners, and those considering acquiring partnership interests to understand now the implications the new law could have on rights and obligations associated with partnerships and partnership interests. How a partnership responds to the enactment of the new law could affect significant issues, such as:

- Whether the partners in the year the adjustment is made or the partners in the “reviewed year” to which the adjustment relates will bear the burden of an understatement (or enjoy the benefit of an overstatement) of income or gain in an audited year
- Whether a partnership could be obligated to pay tax with respect to income or gain that it understated in the reviewed year and, if so, whether that amount might exceed the amount that the partners in the reviewed year would have been required to pay on such income or gain
- Whether reviewed-year partners might be obligated either to file amended returns or to take into account currently adjustments relating to the partnership’s understatement of income in the reviewed year
- Whether and to what extent creditors, tax-exempt investors, and other investors who may not be subject to tax on partnership income may raise concerns about a potential exposure of partnership assets to IRS claims
- Whether and to what extent partners will have input into decisions made with respect to audit and assessment matters

This article describes the new law, the significant federal income tax issues it raises, and the areas in which additional legislative and administrative clarification and guidance are needed from a federal income tax perspective. It also explores key transactional and practical considerations raised by the new law. A discussion of the significant financial accounting and state and local tax issues raised by the new law, however, is beyond the scope of this article.4

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3 This article is not intended to, and does not, provide legal advice with respect to any issue. Readers should consult their own legal advisors with respect to any legal matters raised by, or addressed in, this article.

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I. Background

In current tax years, an entity that is classified as a partnership for U.S. federal income tax purposes generally is subject to one of three audit regimes, depending on the number of its partners and whether it has made certain elections. These regimes are extremely complex. Very generally:

- A partnership with more than 10 partners or with at least one passthrough partner typically is subject to the unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). Under TEFRA, the IRS determines the tax treatment of partnership items at the partnership level (including the statute of limitations on assessment of partnership items or affected items); however, any deficiencies are collected from the partners based on their respective partnership interests in the reviewed year. The TEFRA rules require partners to be notified of, and to be able to participate in, audits. Many partnerships are subject to the TEFRA rules.

- A partnership with 100 or more partners can elect to be subject to simplified rules. As under TEFRA, the IRS determines adjustments for these Electing Large Partnerships (“ELPs”) at the partnership level; however, the adjustments flow through to the partners for the year in which the adjustments take effect and generally do not affect prior year returns of partners (unless there are changes to partners’ distributive shares). Alternatively, an ELP can determine an “imputed underpayment” for the adjustment year at the partnership level and can itself pay the underpayment and any interest and penalties. Few large partnerships have elected to be ELPs.

- Certain partnerships with 10 or fewer partners (“Small Partnerships”) are excepted from the TEFRA rules unless they elect otherwise. For Small Partnerships that do not choose to be subject to the TEFRA rules, adjustments are determined in separate proceedings for each partner. For example, the audit letter is issued to the partner, the statute of limitations for assessment is based on the partner’s return filing, and the IRS must issue a statutory notice of deficiency to the partner for any partnership adjustment.

In recent years, there has been increased focus on problems the IRS faces in auditing large partnerships. For example, according to a report issued by the U.S. Government Accountability Office (“GAO”), the number of “large” partnerships (defined for this purpose as partnerships with $100 million or more in assets and 100 or more direct and indirect partners) more than tripled from 2002 to 2011; however, the IRS currently audits few large partnerships and makes few adjustments. The GAO report indicates that the IRS faces challenges in finding the sources of income within multiple tiers of partnerships.
partnerships, complying with the TEFRA rules (including the notification requirements) within specified timeframes, and determining each partner's share of an adjustment.

Prior to the enactment of the Budget Act, both Republican and Democratic lawmakers had introduced proposals to reform the partnership audit rules by, among other things, allowing the IRS to impose a partnership-level tax if it determined that the partnership had understated income in the audited year, as opposed to limiting that approach to an option only available under the ELP rules. For example, two members of the House Ways and Means Committee, Rep. Renacci (R-OH) and Rep. Kind (D-WI), introduced H.R. 2821, Partnership Audit Simplification Act, in June of 2015. 10 H.R. 2821 would have imposed joint and several liability for tax on understated income on the partnership and all its direct and indirect partners in both the reviewed year and the current (adjustment) year.11

Some taxpayers raised concerns with aspects of H.R. 2821, particularly the joint and several liability provision. Some suggested an alternative approach under which audits would be resolved at the partnership-level and partners would be bound by partnership-level adjustments. However, the adjustments would flow through to the reviewed-year partners in the current (adjustment) year, and the IRS simply would rely on the existing self-assessment system to collect from those partners.12

Several months after H.R. 2821 was introduced, a modified version of partnership audit reform legislation was included in an agreement put together by congressional leadership and the White House to address the so-called “debt ceiling.” 13 This agreement—the Budget Act—was signed into law within one week of being unveiled. There are no committee reports associated with the Budget Act’s partnership audit reform provisions.14

Because the Budget Act moved so quickly from an agreement to law, there was no real opportunity for public comment on the modified partnership audit regime before its enactment.15 Nonetheless, some of

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10 In the previous Congress, former House Ways and Means Committee Chairman Camp (R-MI) included partnership audit reform in his tax reform bill (H.R. 1, the “Tax Reform Act of 2014”), and Sen. Levin (D-MI) introduced S. 3018, the “Partnership Auditing Fairness Act.” The partnership audit reform proposals in Chairman Camp’s bill were scored as raising approximately $13.4 billion over a 10-year period. See JCS-1-14 (Sept. 2014).


13 The partnership audit reform provisions in the Budget Act were estimated as raising approximately $9.325 billion over a 10-year period. See JCX-135-15 (Oct. 28, 2015).

14 A section-by-section summary was posted on a House of Representatives website; however, it is not clear who prepared this document. See http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf.

15 Indeed, a statement posted on Rep. Renacci’s website indicated that:

On Monday evening October 26th, Members of the House of Representatives learned that Leadership had negotiated a massive budget and debt ceiling package. . . .

After introducing H.R. 2821 in June, it was my intent to receive member and stakeholder feedback, and to incorporate that feedback into a revised bill. And since June, I have been very engaged with stakeholders regarding recommendations for revisions to the bill, and continued to work through that process in good faith towards a final
the modifications to the partnership audit rules relative to H.R. 2821 appear to respond to previous comments about H.R. 2821. For example, the modified rules do not provide for "joint and several" liability for partnership-level tax. In addition, they include an elective mechanism by which reviewed-year partners (rather than the partnership) can pay underpaid amounts in the adjustment year (without having to file amended returns for the reviewed year). 16

In December of 2015, clarifications to some of the partnership audit reform provisions were enacted as part of the Protecting Americans from Tax Hikes Act (the "PATH Act") title of the Consolidated Appropriations Act. 17 The staff of the Joint Committee on Taxation ("JCT") issued a technical explanation of the PATH Act (the "JCT PATH Explanation") that included a brief description of both the new partnership audit rules and the changes made by the PATH Act. 18

Several months later, on March 14, 2015, the staff of the JCT released a General Explanation of Tax Legislation Enacted in 2015 (the "Blue Book"). The Blue Book includes technical explanations of tax legislation enacted in 2015. It contains considerable additional information about the partnership audit reform law and clarifies some, but not all, of the issues about which questions have been raised. Although the Blue Book does not constitute official legislative history, the IRS and the Treasury Department ("Treasury") can be expected to look to the Blue Book as they draft regulations and other administrative guidance implementing the new regime.

Nonetheless, as explained throughout this article, there are still many unanswered questions about the new law and additional legislative clarification and administrative guidance are still needed. 19

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16 This elective mechanism appears similar to the approach suggested by some commentators. However, whereas the commentators had suggested that this mechanism be the default rule, the Budget Act made the imposition of a partnership-level tax the default rule, with the other mechanism being an elective alternative.

17 The PATH Act is in Division Q of the Consolidated Appropriations Act, 2016 (Pub. Law 114-113). As explained below, changes made by the PATH Act relate to (1) the computation of the partnership-level assessment, (2) the limitations period for partnership adjustments, (3) the forum for judicial review, and (4) restriction on authority to amend partner information statements.

18 “Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029,” prepared by the Staff of the Joint Committee on Taxation, JCX-144-15 (Dec. 17, 2015).

19 Note that, on April 11, 2016, the chairmen and ranking members of the House and Senate tax-writing committees introduced “technical corrections” legislation in the House and the Senate. See H.R. 4891 and S. 2775. These bills include clerical changes to the partnership audit rules; they do not address the substantive issues described in this article. It is not clear what the legislative vehicle for technical corrections legislation might be, whether Congress will act on such legislation this year, or whether additional provisions might be added. Note also that, in Notice 2016-23, I.R.B. 2016-13 (Mar. 28, 2016), the IRS requested comments on the new partnership provisions. Rochelle Hodes, attorney-adviser, Treasury Office of Tax Legislative Counsel, noted that there are “hundreds” of issues with implementation of the statute at a recent Federal Bar Association Tax Section meeting. William R. Davis, “IRS Wants Comments on Key Partnership Audit Issues,” 2016 TNT 44-3 (Mar. 7, 2016).
II. Overview of New Law

Generally effective for returns filed for partnership tax years beginning after 2017, the Budget Act repeals the TEFRA unified audit rules and the special rules for ELPs and replaces them with a single system of centralized audit, adjustment, and collection of tax that generally applies to all entities classified as partnerships that are required to file federal income tax returns (i.e., “tax partnerships”).20 Specifically, for years to which the new system applies, sections 6221 through 6255 and sections 771 through 777 are repealed and replaced with a new subchapter C of chapter 63 of the Code.21 The statutory rules of this new subchapter are referred to in this article as the “New Rules.”22 As discussed further below, given the possible assessment of a partnership-level tax, enactment of the New Rules may increase the importance of determining whether certain contractual arrangements rise to the level of tax partnerships and whether certain arrangements should be treated as one or multiple partnerships.

As explained in greater detail later in this article, the New Rules address a host of issues, including partnership adjustments and assessments, consistency between the partnership return and its partners’ returns, designation of a “partnership representative,” administrative adjustment requests, amending Schedules K-1, and statutes of limitations on assessment and refunds. With respect to partnership examinations, the New Rules generally provide for the following:

- The IRS initiates a partnership examination by issuing a notice of administrative proceeding to the partnership or its representative.23

- Once a notice of administrative proceeding with respect to a tax year has been mailed, the partnership may not file an administrative adjustment request (“AAR”) with respect to any partnership items for that tax year.24

- If, as a result of the administrative proceeding, the IRS determines that the partnership overstated income or gain (or understated losses and deductions) in the reviewed year, the partnership must adjust its non-separately stated income or loss for the year the adjustment is made (with the reduced income or increased deductions generally benefiting the adjustment-year partners).25

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20 See new Code section 6241(1), which defines “partnership” for purposes of the new rules as those partnerships required to file returns under section 6031(a). References to “new Code sections” are to sections added to the Code by the Budget Act, as amended by the PATH Act, that will become effective as of the effective date of the new law.

21 Chapter 63 is entitled “Assessments.” The new subchapter relates to the treatment of partnerships.

22 A partnership may elect to apply the New Rules for any partnership return filed for partnership tax years beginning after the date of enactment (i.e., November 2, 2015). For example, a partnership might choose to make this election to be eligible before 2018 to pay at the partnership level to obviate the need to furnish amended Schedules K-1. Nonetheless, partnerships will not know how to make this election until administrative guidance is provided. See Blue Book at page 83 for a brief discussion of “early elections.”

23 New Code section 6231(a)(1).

24 See flush language at end of new Code section 6227.

25 See new Code section 6225(a)(2) and discussion in text infra. New Code section 6225(d)(2) defines the “adjustment year” as the partnership tax year during which (1) in the case of an adjustment pursuant to a court in a proceeding brought under the New Rules’ judicial review provisions, such decision becomes final; (2) in the case of an AAR, such request is made; or (3) in
If the IRS determines that the partnership understated income or gain (or overstated losses or deductions) in the reviewed year, the IRS determines the amount of tax required to be paid—the “imputed underpayment”—and mails the partnership a notice of proposed partnership adjustment (“NOPA”).

The partnership has 270 days after the date of the NOPA to submit certain kinds of information that can be used to reduce the amount of the imputed underpayment.

After the IRS reviews this information, it issues a notice of final partnership adjustment (“FPA”).

The partnership has 45 days after the date of the FPA to decide whether to make an election to “push out” to each partner in the audited (reviewed) year the partner’s share of any adjustment to partnership items, instead of paying a partnership-level tax.

If the partnership elects to “push out” the adjustment, each reviewed-year partner must take its share of such adjustment into account on its current year tax return (using a formula to determine the amount by which to increase its current-year tax); the statute does not provide a person who is allocated a share of the adjustment the right to challenge the adjustment or the amount that is allocated to such person.

The partnership has 90 days after the date of the FPA to file a petition for a readjustment with the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. district court for a district in which the partnership has its principal place of business. The court has jurisdiction to determine not only all partnership items for the reviewed year, but also the proper allocation of such items among the partners and the applicability of penalties and other additional items.

Importantly, the new law also allows some partnerships to “elect out” of the New Rules (the “Election Out”) and to be subject to the non-TEFRA rules that currently apply to Small Partnerships. Absent administrative guidance otherwise, a partnership generally is not eligible to make the Election Out.

any other case, notice of the Final Partnership Adjustment is mailed. The Blue Book provides an example indicating that the adjustment year would be 2021 if an adjustment with respect to partnership tax year 2018 results in an imputed underpayment being asserted in 2020 but the partnership litigates the adjustment in Tax Court and the decision becomes final in 2021 and is not appealed. See Blue Book at page 62. The New Rules define the “reviewed year” as the partnership tax year to which the item being adjusted relates. See new Code section 6225(d)(1).

See new Code sections 6225 and 6231 and discussion in text infra.

See new Code section 6225(c) and discussion in text infra.

See new Code sections 6231 and 6235, as amended by the PATH Act. The FPA generally cannot be issued until 270 days after the NOPA. However, new Code section 6235, as amended by the PATH Act, provides the IRS extension periods to issue the FPA.

See new Code section 6226 and discussion in text infra.

See new Code section 6234, as amended by the PATH Act. Although the legislative language is not entirely clear, the JCT PATH Explanation indicates that a partnership can seek judicial review even in a situation in which the partnership elects to push out the adjustment to its partners. See JCT PATH Explanation at page 252. This treatment is also indicated in the Blue Book at page 76.

See new Code section 6234(c).
unless it (1) is required to furnish 100 or fewer Schedules K-1 and (2) meets other requirements, including that it has no partners that are partnerships. Although the Election Out likely will not be available for most funds and other partnerships with numerous partners or complex ownership structures, it may be available for many corporate joint ventures and relatively simple business arrangements. Further, some partnerships that do not qualify for the current Small Partnership exception to the TEFRA rules might qualify to make the Election Out. Importantly, however, the Election Out must be made with the timely filed partnership return for each year to which it is to apply; the partnership cannot wait to make the election until the year is examined.

III. New Rules

Although some aspects of the New Rules are procedural in nature, others may have substantial economic, legal, investor relations, and other ramifications; these include the potential imposition of a partnership-level tax, the ability to choose to “push out” understated income to reviewed-year partners, and the treatment of past overstatements of income. The discussion below first focuses on how the New Rules relating to adjustments and assessments affect the economic rights and burdens of the partnership and different groups of partners. Then, it addresses other significant aspects of the New Rules.

A. Adjustments and Assessments

1. Overview

As a threshold matter, new section 6221 provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year (and any partner’s distributive share thereof) will be determined at the partnership level under the New Rules. In addition, it provides that any adjustment to items of income, gain, loss, deduction, or credit of a partner for a partnership tax year (and any partner’s distributive share thereof) will be determined at the level of the partner.

32 For questions regarding how the New Rules would, or ought to, apply in the case of issues that are substantively determined at the partner level, in whole or in part, such as whether a transfer of property by a partner to a partnership is a contribution or a disguised sale, see the letter by Monte Jackel to the editor of Tax Notes, “Partnership Audit Rules: Taxing at the Partnership Level,” Tax Notes, May 2, 2016 (Doc. 2016-3684); the response by Donald B. Susswein, “Should the Partnership Audit Rules Be Broader in Scope?” Tax Notes, May 10, 2016 (2016 TNT 94-14); and Jackel’s response to that letter, “Simplify the Partnership Audit Rules,” Tax Notes, May 23, 2016 (Doc. 2016-10127). In the most recent letter, Jackel wrote:

This state of affairs is a strong argument for a consolidated proceeding under the new partnership audit law in which the tax liability for both the imputed underpayment and the tax at the partner level, if any, is determined. The next question, if one determines that a consolidated proceeding is desirable, is whether the IRS and Treasury have the regulatory power under the statute as written to enact one or whether a change to the statute is first required. The IRS has broad discretion to write regulations under the statute as written but it remains to be seen whether Treasury and the IRS believe that this grant of authority is broad enough to cover consolidated proceedings (if they first determine that consolidated proceedings are preferable to separate proceedings).

At the end of the day, it is apparent that the statute as enacted has flaws. That rightfully raises the question, which I have heard at least one notable and respected practitioner express, that perhaps the government is better off not rushing to push out regulations under the statute as written but, rather, seek legislative clarification of the statutory flaws as a first priority item.
any tax attributable to such an adjustment will be assessed and collected, and the applicability of any penalty or addition to tax relating to such adjustment will be determined, at the partnership level.

As explained in more detail below, new section 6225 sets forth general rules that apply to audit adjustments that result in either (1) underpayments or (2) reallocations of items among partners (the “General Rules for Underpayments” and the “Rules for Reallocations,” respectively). Under the General Rules for Underpayments, the IRS can assess and collect tax attributable to adjustments, as well as associated penalties and additions to tax, at the partnership level. Partnership-level tax, however, can be eliminated in some situations, including if all the reviewed-year partners (or all the partners affected by a reallocation) file amended returns for the reviewed year and pay the associated tax due with interest and penalties.

Notwithstanding the General Rules for Underpayments, new section 6226 allows a partnership to elect to apply special rules (the “Alternative Method”) under which the partnership “pushes out” to its reviewed-year partners their shares of adjustments to partnership items resulting from net understatements of income using a process similar to the current Schedule K-1 process. Under the Alternative Method, the partnership does not pay tax itself; instead, the reviewed-year partners adjust their income tax liabilities in the current year. Although the reviewed-year partners do not need to file amended returns, they must pay a higher interest rate on their shares of the underpayment than the typical underpayment rate and must perform potentially complex calculations to determine how to adjust their current-year tax liabilities.

Different rules apply to adjustments from IRS examinations that do not result in underpayments (such as adjustments resulting from net overstatements of partnership income or net understatements of partnership loss). The statutory rules indicate that these adjustments are taken into account by the partnership in the year of the adjustment as changes in the partnership’s non-separately stated income or loss (or as separately-stated credits); however, the Blue Book suggests that separately stated treatment may be appropriate in some situations. Regardless of whether the adjustment is to separately stated or non-separately stated items, however, adjustment-year partners may benefit from additional deductions resulting from past overstatements of income. It is not currently clear what procedures a partnership will need to follow to take these favorable adjustments into account on its adjustment-year return, or what procedures or rights it will have if the IRS does not fully allow all the favorable adjustments presented during the examination. As noted above, the partnership is precluded from filing an AAR after the notice of partnership examination has been issued.

2. General Rules for Underpayments

Under the General Rules for Underpayments, an audited partnership is required to pay an “imputed underpayment” (described in greater detail below) with respect to an adjustment for the reviewed year by the due date of the partnership’s tax return (without regard to extensions of time to file) for the


33 As indicated in text at note 24 supra, the partnership is precluded from filing an AAR after the notice of partnership examination has been issued.
adjustment year.\textsuperscript{34} The partnership also must pay any interest and penalties.\textsuperscript{35} For this purpose, interest is determined using the section 6621(a)(2) underpayment rate (i.e., the federal short-term rate plus three percentage points). No deduction is allowed for any payment required to be made by the partnership under the New Rules.\textsuperscript{36} As a result, a partnership apparently may not deduct its payment of an imputed underpayment or any associated interest or penalties.

\textbf{a. Application of Subchapter K Rules to Partnership-Level Payment}

If an imputed underpayment is paid at the partnership level, consideration will need to be given as to how some basic subchapter K rules principles apply to the payment of partnership-level tax. Consider the following example (which, like all the examples in this article, is based on highly simplified assumptions):\textsuperscript{37}

\textbf{Example One}

In 2020, the IRS asserts (and Partnership X pays) an imputed underpayment with respect to Partnership X’s 2018 tax year. That tax liability relates to a $1 million understatement of income that would have been allocated to Y and Z, each of which owned a 50 percent interest in Partnership X in 2018 and continues to do so in 2020.

In the example, it seems relatively clear that the nondeductible tax payment by the partnership should reduce each partner’s basis in its partnership interest by its share of the payment under section 705(a)(2)(B). Indeed, the Blue Book indicates that a partner’s basis in its partnership interest is reduced to reflect the nondeductible payment by the partnership.\textsuperscript{38} Likewise, the Blue Book indicates that the partnership’s total adjusted basis in its assets is reduced by the cash payment of the tax. That is, the Blue Book indicates that both inside and outside basis would be adjusted.\textsuperscript{39} This makes sense given that the partnership’s payment of tax reduces the assets available for distribution to the partners as well as the fair market value of their partnership interests.

However, as discussed below, neither the statute nor the Blue Book indicates whether each partner in the example above should be allocated its share of the $1 million understatement of income (which would increase each partner’s basis in its partnership interest by $500,000) or whether adjustments should be made to take into account the underlying adjustments that gave rise to the imputed underpayment itself. Moreover, there is uncertainty regarding how the subchapter K rules may apply to some arrangements for funding the partnership’s payment of tax. Thus, legislative or administrative

\textsuperscript{34} See new Code sections 6225(a)(1), 6232(a), and 6241(3).
\textsuperscript{35} See new Code section 6233(a). Any penalty is determined at the partnership level as if the partnership had been an individual subject to tax under chapter 1 for the reviewed year and the imputed underpayment were an actual underpayment (or understatement) for such year.
\textsuperscript{36} See new Code section 6241(4). In contrast, a C corporation in the same situation may be able to deduct interest.
\textsuperscript{37} For simplicity, all the examples (1) exclude interest or penalties from the amount of the assessment; (2) assume that future section 1 and section 11 rates are the same as under current law; and (3) assume that no partnerships make Elections Out (even though making the Election Out may be available and may make sense in some of the examples).
\textsuperscript{38} See Blue Book at page 79.
\textsuperscript{39} Id.
guidance may be needed regarding the application of some subchapter K principles to a partnership’s payment of an imputed underpayment.

i. **Basis Impact of Underlying Adjustments**

In the above example, each partner theoretically should be entitled to a basis increase for its share of the understated income that gave rise to the partnership-level tax. The activities that gave rise to underreported income in 2018 presumably increased the fair market value of the partnership. Assuming a dollar-for-dollar increase in value, a failure to increase each partner’s basis by its share of the understated income will eventually result in gain (or a reduction in loss) to the partners. Thus, a failure to provide a basis increase with respect to the understated income could result in “double-tax” on the same income and would ultimately penalize the partners in an amount over and above any interest and penalties already assessed.40

Similar issues arise with respect to how the underlying adjustments that gave rise to the imputed underpayment are taken into account. For instance, if a partnership audit results in the determination that the partnership took too much of a depreciation deduction with respect to an asset in the reviewed year, should the partnership increase the basis in its asset for the amount of the adjustment? Should a partner increase the basis of the partner’s interest in the partnership for the amount of the adjustment? Failure to do so may result in double-taxation upon sale of the asset or the interest.

Clarification of these “adjustment” issues would be helpful. Uncertainty regarding these issues may discourage some partnerships that might otherwise be inclined to use the General Rules for Underpayments from using that approach as opposed to electing the Alternative Method.

ii. **Payment Funded by Partners**

As explained above, the New Rules treat the partnership’s payment of the imputed underpayment as a nondeductible payment of the partnership. This seemingly reflects that the imputed underpayment amount is a liability of the partnership (rather than the partners).

In some instances, the partners might agree that, in the event of a payment of an imputed underpayment amount by the partnership, partners will be required to transfer funds to the partnership for each partner’s share of the imputed underpayment amount. This agreement may be drafted so that only current partners fund the payment or, as more likely will be the case, so that only reviewed-year partners fund the payment. The agreement might also be contained in an indemnification agreement entered into at the time a partnership interest is sold. The Blue Book indicates that any payments under indemnification agreements would be nondeductible, but does not otherwise address how such payments would be treated.41

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40 Additional complexities could arise if there were changes in the composition of the partners in the partnership or in the partners’ respective shares of partnership income between the reviewed year and the adjustment year.

41 See Blue Book at page 79.
In the case of a current partner, it would seem reasonable to treat such a transfer of funds as a contribution by the partner to the partnership, with the “outside” basis and capital account consequences of the contribution likely being offset by the partner’s share of the nondeductible payment. However, in the case of a former partner, it is unclear how the transfer of cash and the allocation of the nondeductible payment should be treated. One possibility is that the former partner might still be considered a partner for federal tax purposes such that the former partner might be considered to contribute the funds and to be allocated its share of the nondeductible payment. This, however, could raise other issues, including to what extent the former partner might still be considered a partner for purposes other than accounting for the partnership-level payment. Alternatively, query whether a former partner’s transfer of cash to the partnership could potentially result in income to the partnership to be allocated among the current partners. If so, the partnership and its past and former partners potentially could be required to pay the IRS an aggregate amount with respect to an understatement of income in excess of the imputed underpayment, interest, and penalties. Such a result would appear to be inconsistent with the apparent intent of the legislation.

b. Initial Computation of Amount of Imputed Underpayment

As explained below, the amount of the imputed underpayment initially is determined using a formula that serves as a simplified proxy for what the IRS might be owed as a result of an understatement of partnership income, without getting into the complexity associated with determining how much actual tax the reviewed-year partners should have paid on understated income based on the particular facts. However, the initial computation can be adjusted in some circumstances, reducing or even eliminating the partnership-level assessment.

The formula for determining the imputed underpayment, in effect, assumes that all income or gain that was understated at the partnership level (on a net basis) would have been fully taxable in the reviewed year at the highest statutory income tax rate. Specifically, the amount of the imputed underpayment for a reviewed year initially is determined by:

- Netting the partnership-level adjustments of items of income, gain, loss, or deduction for the reviewed year (treating any net increase or decrease in loss as a decrease or increase, respectively, in income); and

- Multiplying this net amount by the “highest rate of tax in effect for the reviewed year under section 1 or 11” (i.e., the highest individual or corporate statutory income tax rate).

The imputed underpayment formula assumes that all net underpaid income would have been subject to tax at the highest possible income tax rate under section 1 or 11, regardless of the character of the

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42 Consistent with the simplified nature of the approach, the imputed underpayment calculation does not take into account taxes under sections of the Code other than section 1 or 11 that might apply in particular fact situations (such as the section 1411 net investment income tax rate and the section 1401 tax on self-employment income).

43 Adjustments in items of credit are also taken into account in the calculation. See new Code section 6225(b)(1).
income or the characteristics of the partners. As a result, under the current rate structure, the imputed underpayment generally would be determined by multiplying the net amount of an understatement by 39.6 percent.44

Note that the statutory language of the new law suggests that, in computing the imputed underpayment, all items of income, gain, loss, and deduction might be netted, even if such items would not ordinarily be netted when determining net taxable income.45 Nonetheless, both the JCT PATH Explanation and the Blue Book indicate that “netting is done taking into account applicable limitations, restrictions, and special rules under present law.”46 Further, the Blue Book includes the following general example of how the netting provisions might work:

**Example Two**

For its 2019 tax year, a partnership reports (1) ordinary income of $300,000, (2) long-term capital gain (from asset sales) of $125,000, (3) long-term capital loss (from asset sales) of $75,000 (resulting in a net long-term capital gain of $50,000); (4) depreciation deductions of $100,000, and (5) a tax credit of $5,000. On examination, the IRS determines that: (1) ordinary income was understated by $200,000 and should have been $500,000; (2) long-term capital gain was understated and should have been $200,000; (3) long-term capital loss was overstated and should have been $25,000 (resulting in net long-term capital gain of $175,000, rather than $50,000); (4) depreciation deductions were overstated by $30,000 and should have been $70,000; and (5) the tax credit was overstated by $2,000 and should have been $3,000.

The Blue Book concludes that: (1) the adjustments to ordinary income and to depreciation deduction net to $230,000, while (2) the adjustments to long-term capital gain and loss net to $125,000. Thus, the adjustments total to $355,000. Assuming that the rate structure in 2019 is the same as today, this amount is multiplied by 39.6 percent, yielding $140,580. The $2,000 adjustment to the credit is added to this amount, resulting in an imputed underpayment amount of $142,580 (not taking into account the possible modifications to the imputed underpayment amount described below).47

In limited situations, the initial calculation of the imputed underpayment might result in the partnership paying the same amount as would have been paid on the understated income by the reviewed-year partners. Consider the following example:48
Example Three

In 2020, the IRS determines that Partnership X understated $1 million of ordinary income on its 2018 tax return. This income would have been allocated to A and B, two individuals who are taxed at the highest marginal tax rate. A and B each owned a 50 percent interest in Partnership X in 2018 and continue to do so in 2020. Computing the imputed underpayment using a 39.6 percent rate results in Partnership X paying the same amount ($396,000) that A and B together would have paid on their shares of the understatement in 2018 (i.e., $198,000 plus $198,000). Moreover, A and B each share the economic burden of Partnership X’s tax payment in the same proportions as each would have if the income had been reported in 2018.

Nonetheless, in many cases, the initial computation of the imputed underpayment could lead to the partnership being assessed more tax than the reviewed-year partners would have owed with respect to understated income in the reviewed year. Consider the following example: 49

Example Four

Assume the same facts as in Example Three except that A had passive activity losses in the reviewed year that could have been used to completely offset his $500,000 share of the understated income. Thus, the total tax that A and B together would have owed on the understatement would have been $198,000. Under the General Rules for Underpayments, the initial computation of the imputed underpayment still would be $396,000. This amount exceeds the amount of tax that would have been paid by the partners in 2018 if Partnership X had reported the understated income on its 2018 return; however, Partner A still has his $200,000 passive activity loss.

c. Modifications to Initial Computation

As explained in greater detail below, the new law directs Treasury and the IRS to establish procedures that “shall” provide for modification of the amount of the imputed underpayment in the following situations:

- The partners include certain tax-exempt entities that would not have been subject to tax on their shares of understated income or gain (the “Tax-Exempt Partner Rule”),
- The adjustment relates to income and gain allocable to C corporation partners or to capital gains and qualified dividends of individuals and S corporations (the “Rate Reduction Rule”),
- The partnership is a publicly traded partnership (“PTP”) and there is a net decrease in certain passive activity losses allocable to certain partners (the “PTP Rule”), or
- The reviewed-year partners file amended returns and pay additional tax due with respect to understated income or gain (the “Amended Return Rule”). 50

49 See note 37 for simplifying assumptions that apply to all the examples in this article.
50 The JCT Explanation of the PATH Act describes the rules for modifying the imputed underpayment by stating that: “If a partnership disagrees with the computation of the imputed underpayment during an administrative proceeding, it may seek
Treasury and the IRS also have broad authority to provide additional procedures for modifying the amount of the imputed underpayment based on other factors, as appropriate (the "Administrative Discretion Rule"). According to the Blue Book, these procedures:

- may modify imputed underpayment amounts on the basis of factors that the Secretary determines are necessary or appropriate to carry out the function of the modification provisions, that is, to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.

Note, however, that anything required to be submitted to the IRS in determining the amount of an imputed underpayment may need to be submitted not later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed ("the "270-Day Period"), unless the period is extended with the consent of the Secretary. Thus, partnerships that seek to reduce the initial computation of the imputed underpayment may need to be cognizant of the 270-Day Period in providing information to support such reduction. Further, according to the Blue Book, any modification of the imputed underpayment is made only if such modification is approved by the Secretary.

### i. Tax-Exempt Partner Rule

The new law directs the IRS and Treasury to provide for determining the amount of the imputed underpayment without regard to the portion that "the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity" (as defined in section 168(h)(2)). This guidance could allow the partnership-level tax to be reduced (or even eliminated) for some modification of the computation.” It then states that modification procedures “permit” redetermination of the imputed underpayment in the four situations described above. See JCT PATH Explanation at pages 249-250.

51 See new Code section 6225(b)(5).
52 See Blue Book at page 65. (Emphasis added.)
53 See new Code section 6225(b)(6). The JCT PATH Explanation indicates that the 270-Day Period is intended to allow the partnership time to seek modifications to an imputed underpayment. See JCT PATH Explanation at page 250. See also Blue Book at page 75.
54 See Blue Book at page 66.
55 See new Code section 6225(b)(3). Under section 168(h)(2), a “tax-exempt entity” includes a governmental entity (including agencies and instrumentalities thereof), an organization (other than a certain kind of cooperative) that is exempt from income tax under chapter 1 of the Code (i.e., sections 1 through 1400L), certain foreign persons or entities, and certain tribal governments. Section 168(h)(2)(B) provides that a foreign person or entity is not treated as a tax-exempt entity with respect to any property if more than 50 percent of the gross income for the tax year derived by the foreign person or entity from the use of such property is (1) subject to tax under chapter 1 of the Code, or (2) included under section 951 in the gross income of a U.S. shareholder for the tax year with or within which ends the tax year of the controlled foreign corporation in which such income was derived.
partnerships with tax-exempt partners, without those partners having to file amended returns. Consider the following example: 56

**Example Five**

In 2020, the IRS determines that Partnership X understated $1 million of ordinary income in its 2018 tax year. This income would have been allocated to A and B, two tax-exempt entities that would not have been subject to federal tax with respect to their distributive shares of such income. A and B each owned a 50 percent interest in Partnership X in 2018. The imputed underpayment should be reduced to zero, provided Partnership X can adequately demonstrate that the income at issue would not have been subject to unrelated business income tax (“UBIT”) to either A or B and that, as a result, neither partner would have owed tax with respect to its share of the understated income.

Query, however, what the IRS will require from the partnership (and possibly its partners) to demonstrate that tax-exempt partners would not have been subject to federal tax on their shares of understated income. Partnerships also will need to consider how to ensure that tax-exempt partners cooperate with efforts to satisfy this “Demonstration Requirement”—including in situations in which tax-exempt partners may have disposed of their partnership interests between the reviewed year and the adjustment year and, therefore, may have little concern about the partnership bearing a tax liability in the adjustment year. In addition, administrative guidance will be needed to address how the Tax-Exempt Partner Rule and the Demonstration Requirement might apply to audited partnerships that are owned indirectly by tax-exempt entities through upper-tier partnerships.

In addition, from the partnership’s and the partners’ perspective, the Tax-Exempt Partner Rule may raise significant practical issues if some—but not all—of the partners in the partnership in the reviewed year are tax-exempt entities. Consider the following example: 57

**Example Six:**

In 2020, the IRS determines that, in its 2018 tax year, Partnership X understated $1 million of ordinary income that would have been allocated to A (an individual) and B (a tax-exempt entity that would not have been subject to federal tax on its distributive share of Partnership X’s income). A and B each owned a 50 percent interest in Partnership X in 2018 and each continues to do so in 2020. Under the Tax-Exempt Partner Rule, the imputed underpayment should be reduced by half (from $396,000 to $169,800). However, absent contractual agreements to the contrary, B would still bear half of the economic burden of a payment by Partnership X to the IRS of $169,800. Thus, B might raise “investor relations” issues unless it is satisfied that it will not bear any economic burden associated with the partnership’s payment of the residual imputed underpayment amount.

Generally speaking, if a partner is allocated an item of deduction or loss, such allocation reduces the partner’s capital account and economic entitlement. In the example above, the parties might consider

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56 See note 37 for simplifying assumptions that apply to all the examples in this article.

57 Id.
amending the partnership agreement to provide for a special allocation of any nondeductible payment solely to A in the event the partnership pays the amount of any imputed underpayment so as to have A bear the economic burden of the payment rather than B. Nonetheless, if the partnership has to borrow funds to make the payment, keep in mind that the partnership tax rules potentially could require all or part of the nondeductible payment to be allocated to B. That is, if the payment of the imputed underpayment amount by the partnership results in partnership or partner nonrecourse deductions, the section 704(b) rules generally require such deductions to be allocated based upon the “partners interest in the partnership” or, alternatively, to those partners that bear the economic risk of loss on the debt if such partners (or persons related to such partners) make the loan or otherwise agree to bear the risk of loss on the loan through arrangements such as guarantees. Thus, it might be difficult to eliminate the possibility that the tax-exempt partner will end up bearing some of the economic burden of the partnership’s payment of the imputed underpayment amount. Consider the following example:

**Example Seven**
Assume the same facts as Example Six, except that the partnership borrows funds from a bank to pay the imputed underpayment amount. The debt is secured by all the partnership assets. However, the bank requires B to guarantee the debt. At the end of the year, the debt exceeds the basis of the partnership’s assets by $169,800, resulting in partnership nonrecourse deductions of $169,800. The regulations under section 704(b) would require the partnership to allocate the nondeductible payment of the imputed underpayment to B as a partner nonrecourse deduction, even if the partnership has revised its agreement to provide for a special allocation of any nondeductible payment solely to A in the event the partnership pays the amount of any imputed underpayment.

Finally, keep in mind that the Tax-Exempt Partner Rule might not reduce a tax-exempt entity’s economic burden of a partnership-level tax if the entity acquires its interest in the partnership between the reviewed year and the adjustment year. Consider the following example:

**Example Eight**
In 2020, the IRS determines that Partnership X understated $1 million of ordinary income in its 2018 tax year. In 2018, Partnership X was owned by two individuals. However, in 2019, two tax-exempt entities purchased the interests owned by those individuals. The initial computation of the imputed underpayment would be $396,000. The two tax-exempt entities could end up bearing the economic burden of Partnership X’s payment of tax with respect to the 2018 understatement.61

As explained later in this article, tax-exempt entities and others considering acquiring partnership interests may want to consider how particular partnerships respond to the new law as part of their due diligence.

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58 See generally section 1.704-2.
59 See note 37 for simplifying assumptions that apply to all the examples in this article.
60 Id.
61 As explained below, the partnership-level tax can be eliminated if the reviewed-year partners file amended returns for the reviewed year and pay taxes due or if the partnership elects the Alternative Method.
diligence efforts, so as to minimize the risk of bearing the economic burden of liabilities associated with prior year understatements of partnership income.

ii. **Rate Reduction Rule**

The IRS and Treasury are also directed to provide for situations that involve a rate of tax lower than the highest rate in effect under section 1 or 11 with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to (1) a C corporation partner or (2) in the case of capital gain or a qualified dividend, an individual. For this purpose, an S corporation is treated as an individual. However, the law provides that "in no event shall the lower rate . . . be less than the highest rate in effect with respect to the income and taxpayer described." The following examples illustrate how the Rate Reduction Rule might apply.

**Example Nine**

In 2020, the IRS assesses an imputed underpayment attributable to an understatement by Partnership X of long-term capital gain recognized on a sale of stock in 2018. In 2018, all the partners in Partnership X were individuals. Under IRS guidance, the imputed understatement presumably would be calculated by applying the highest capital gains rate applicable to individuals (20 percent) for the reviewed year, as opposed to the higher rate applicable to the ordinary income (39.6 percent).

**Example Ten**

In 2020, the IRS determines that Partnership X understated its ordinary income in 2018. In 2018, some of the partners in Partnership X were C corporations and others were individuals. Under IRS guidance, the imputed understatement presumably would be calculated by applying the highest rate applicable to corporations (35 percent) to the portion of the understatement allocable to the C corporation partners.

Under the Rate Reduction Rule, the portion of an imputed underpayment subject to a lower rate generally is determined by reference to the partners’ distributive shares of items to which the imputed underpayment relates. If the imputed underpayment is attributable to more than one item, and any partner’s share of those items is not the same with respect to all such items, then the portion of the imputed underpayment to which the lower rate applies is determined by reference to the amount that would have been the partner’s distributive share of net gain or loss if the partnership had sold all its assets at their fair market value as of the close of the reviewed year. This use of a “fair market value sale” approach may have been intended as a simplifying assumption; however, having to determine fair

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62 See new Code section 6225(b)(4), as modified by the PATH Act. Prior to amendment by the PATH Act, the rules for reducing the imputed underpayment allocable to C corporation partners were limited to situations involving ordinary income. Limiting this provision in this manner made no sense given that C corporations are subject to tax at a maximum 35 percent rate on both capital gain and ordinary income.

63 See note 37 for simplifying assumptions that apply to all the examples in this article.

64 See new Code section 6225(b)(4)(B)(ii).

market value at the close of the reviewed year might make this approach burdensome for some partnerships. The Blue Book provides the following example\(^{66}\) of this approach:

**Example Eleven**

Assume that, on audit of a partnership, adjustments are made to the partnership’s rental income from property A and its depreciation deductions with respect to property B. A corporate partner has a 20 percent share of rental income from property A, a 15 percent distributive share of depreciation deductions from property B, and a 20 percent share of any gain in the reviewed year. If the partnership had sold its assets at fair market value as of the close of the reviewed year, the gain would have been $100 and, based on its capital account, the corporate partner’s share would have been $20. The Blue Book concludes that the portion of the imputed underpayment to which the lower rate applies with respect to the corporate partner is 20 percent.\(^{67}\)

Consistent with other aspects of the new law, the Rate Reduction Rule does not explicitly address tiering situations—i.e., situations in which C corporations, S corporations, trusts, and individuals indirectly own interests in an audited partnership through other partnerships. Nonetheless, given the broad authority granted to the IRS and Treasury by the new law, guidance could extend the Rate Reduction Rule to tiered situations. Query, however, whether many audited partnerships would have sufficient information about indirect ownership and allocations to upper-tier partners to demonstrate to the satisfaction of the IRS that underreported items ultimately would have been allocated to C corporations, S corporations, or individuals. Query also how the “fair market value sale” approach to determining the portion of an imputed underpayment eligible for a lower rate would apply in a tiered context.

Finally, as a practical matter, note that the same kind of “economic burden” issues raised by the Tax-Exempt Partner Rule could arise under the Rate Reduction Rule if a partnership is able to compute its imputed underpayment amount at a reduced rate because of the characteristics of some, but not all, of its reviewed-year partners. Consider the following example: \(^{68}\)

**Example Twelve**

In 2020, the IRS determines that Partnership X understated its ordinary income by $2 million in 2018. In 2018, a C corporation and an individual were 50-50 partners. Partnership X’s owners are the same in 2020. Under IRS guidance, the imputed underpayment presumably would be $746,000 (i.e., (1) 35 percent of $1 million plus (2) 39.6 percent of $1 million), rather than $792,000 (i.e., 39.6 percent of $2 million). Absent legal agreements to the contrary, each of the partners would share the economic burden of Partnership X’s tax liability equally, even though the fact that one of the partners was a C corporation contributed to part of the imputed underpayment being computed at a reduced rate.

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\(^{66}\) See note 37 for simplifying assumptions that apply to all the examples in this article.

\(^{67}\) See Blue Book at page 67.

\(^{68}\) See note 37 for simplifying assumptions that apply to all the examples in this article.
iii. **PTP Rule**

The PATH Act added a special rule for modifying the imputed adjustment in the case of a PTP in light of the special passive activity loss rules for PTPs in section 469(k). Under section 469(k), passive activity losses are carried forward and applied against other income from the PTP, rather than against other income of the PTP’s partners. The JCT PATH Explanation describes the PTP Rule as follows:

The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to (i.e., would be offset by) specified passive activity losses attributable to a specified partner. The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the decrease into account in the adjustment year with respect to the specified partners to which the decrease relates.

A specified passive activity loss for any specified partner of a publicly traded partnership means the lesser of the section 469(k) passive activity loss of that partner (1) for the partner’s taxable year in which or with which the reviewed year of the partnership ends, or (2) for the partner’s taxable year in which or with which the adjustment year of the partnership ends. A specified partner is a person who continuously meets each of three requirements for the period starting with the partner’s taxable year in which or with which the partnership reviewed year ends through the partner’s taxable year in which or with which the partnership adjustment year ends. These three requirements are that the person is a partner of the publicly traded partnership; that 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.

iv. **Amended Return Rule**

Even when the IRS issues guidance implementing the Tax-Exempt Partner Rule, the Reduced Rate Rule, and the PTP Rule, there still are likely to be situations in which a partnership’s imputed underpayment could exceed the total amount of tax the reviewed-year partners would have paid if understated income had been taken into account in the reviewed year. Further, the Administrative Discretion Rule (described in more detail below) may not completely eliminate the imputed underpayment in all situations. In those situations, the Amended Return Rule can contribute to equating the total amount the IRS is paid with respect to understated income with the total amount the reviewed-year partners would have paid in the reviewed year. However, as explained below, the Amended Return Rule is far from a perfect solution. Not only does it raise a number of practical issues, but legislative clarification also may be in order regarding how it applies in tiered situations.

The Amended Return Rule requires the IRS and Treasury to issue procedures providing that, if a partner files an amended return for its tax year that includes the end of the partnership’s reviewed year and pays any associated tax due in accordance with the IRS proposed adjustment, the partnership’s  

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69 See new Code section 6225(c)(6), as added by the PATH Act.  
70 See JCT PATH Explanation at pages 251-252. See also Blue Book at page 65, note 207. Note that the PTP Rule does not apply to partnerships other than PTPs.
imputed underpayment is determined without regard to the portion of the adjustment taken into account on that amended return.\textsuperscript{71} Thus, if \textit{all} the reviewed-year partners file amended returns and pay the tax due, the imputed underpayment should become zero, thereby eliminating the partnership-level tax. Consider the following example: \textsuperscript{72}

\textit{Example Thirteen}

In 2020, the IRS determines that, in 2018, Partnership X understated $1 million of ordinary income that would have been allocated equally to A (an individual) and B (a C corporation). Both A and B file amended returns for the reviewed year. A pays $183,000 of tax on his share of the understatement; however, B is able to completely offset its income with a net operating loss ("NOL"). Because all reviewed-year partners took their shares of the income into account and paid any tax due, Partnership X’s imputed underpayment is reduced to zero.

Under the Amended Return Rule, it appears that amended returns might need to be filed by partners, and any tax due might need to be paid, within the 270-Day Period for submitting anything required to be submitted with respect to determining the amount of the imputed underpayment. All the amended returns filed by partners then would have to be taken into account in adjusting the amount of the imputed underpayment—a task that could be complicated when there are many partners. Further, in some situations, taking into account additional income or gain on amended returns could affect tax attributes, such as NOLs and basis, relevant to other tax year returns. Query also whether the IRS would review each amended return prior to adjusting the imputed underpayment (which could be burdensome and time-consuming).

Moreover, keep in mind that many partners may be reluctant to file amended returns for a variety of reasons.\textsuperscript{73} As a result, attempting to contractually obligate partners to file amended returns could raise business and investor relations concerns. Further, if \textit{all} reviewed-year partners were not contractually obligated to file amended returns, and only \textit{some} of those partners ultimately agreed to file amended returns, a partner who files an amended return could end up bearing more than its proper share of the burden of an understatement. Consider the following example: \textsuperscript{74}

\textit{Example Fourteen}

In 2020, the IRS proposes an adjustment to Partnership X’s 2018 tax year of $1 million for an understatement of ordinary income that would have been allocated equally to individuals A and B. A and B continue to be equal owners in 2020. The assessment of tax to Partnership X would be $396,000, without taking into account any permissible modifications. However, if B files an amended return for her tax year that includes the partnership’s 2018 year and pays $50,000 of tax on her $500,000 share of understated income (using passive activity losses to offset some

\textsuperscript{71} See new Code section 6225(c)(2).

\textsuperscript{72} See note 37 for simplifying assumptions that apply to all the examples in this article.

\textsuperscript{73} Taxpayers are often reluctant to file amended returns for a variety of reasons, including that amending returns may raise concerns that an examination may be more likely; can be costly and time consuming; may require amending one or more state tax returns (which may extend the state statute of limitations on assessments); and requires correcting other known errors.

\textsuperscript{74} See note 37 for simplifying assumptions that apply to all the examples in this article.

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of her share of such income) but A does not file an amended return, the partnership’s imputed understatement will be $183,000 (i.e., 39.6 percent of $500,000). Unless the partnership agreement provides otherwise, B may share in the economic burden of Partnership X’s $183,000 tax payment, even though the partnership-level tax is attributable to A’s share of the understated income. As a result, if B is aware of how the new law works, B might not be willing to file an amended return unless she knows that A does so as well.

In addition, different groups of partners may have very different views as to the benefits and burdens of filing amended returns if there have been changes in the partnership’s ownership or allocations between the reviewed year and the adjustment year. For example, partners who have left the partnership completely may have little or no incentive to amend their tax returns for the reviewed year and to pay tax due given that, if they do not file such returns, the current partners will bear the economic burden of paying tax on understated income from the reviewed year. As a result, existing partnerships may find it difficult to secure the agreement of partners who have reduced, or who anticipate reducing, their interests to file amended returns.

Given the practical issues associated with the Amended Return Rule, many partnerships may want to instead consider using the Alternative Method to ensure both that the burden of an underpayment falls on reviewed-year partners and that the amount of the underpayment reflects the total amount that would have been paid by those partners.

As described in the discussion of the Alternative Method later in this article, there is an issue as to how and whether the Alternative Method applies in tiered contexts. However, there similarly is uncertainty as to how the Amended Return Rule applies in tiered situations. That is, the new law requires “the partner” to file the amended return and pay any tax due. Would this mean that an “upper-tier partnership” that owns an interest in an audited partnership would have to file an amended return and pay any “tax due” itself? Would the tax due be zero given that a partnership generally does not pay tax or would the “lower-tier partnership’s” imputed underpayment be reduced only if the reviewed-year partners of the upper-tier partnership filed amended returns and paid the tax due? Given the likely intent that the upper-tier partnership not be able to satisfy the Amended Return Rule by asserting that it owes zero tax on the underpayment because of its status as a tax partnership, legislative clarification may be in order.

Guidance also is needed with respect to administrative issues associated with the application of the Amended Return Rule to tiered situations. For example, if the partners of an upper-tier partnership would be the persons responsible for filing amended returns and paying tax due, would the audited partnership have 270 days to try to get all direct and indirect partners to file amended returns and pay the tax due? Would extensions of the 270-Day Period be available in the case of multi-tiered structures where the lower-tier partnership might not know who the ultimate indirect owners are? How difficult would it be for the IRS to associate numerous returns with the audited partnership and re-compute the imputed underpayment?
v. The Administrative Discretion Rule

As indicated above, the new law also provides the IRS with broad discretion to establish additional procedures to modify the imputed underpayment amount “on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes” of the imputed underpayment rules. The Blue Book suggests that the IRS is expected to allow partnerships to reduce the underpayment to the extent those partnerships can demonstrate that modification is supported by the particular facts in the reviewed year. In particular, the Blue Book states:

Additional procedures to modify the amount of an imputed underpayment may be provided by the Secretary on the basis of factors the Secretary determines are necessary or appropriate to carry out the purposes of the provision. These procedures allow partnerships to demonstrate tax attributes or information with respect to the reviewed year and with respect to reviewed year partners that could permit modification of the imputed underpayment to more closely approximate the amount of tax due with respect to the reviewed year if the partnership and partners had correctly reported and paid the tax due.

In the absence of regulations or guidance specifically addressing the manner in which these modifications or calculations are made, it is anticipated that partnerships will furnish to the Secretary the necessary documentation, data, and calculations to determine the amount of the reduction of the imputed underpayment with a reasonably high degree of accuracy.

Nonetheless, as indicated above, the Blue Book also indicates that the Secretary must approve any modification to the imputed underpayment amount. Thus, it appears that the IRS ultimately would have to agree with the manner in which a partnership determined the amount by which the imputed underpayment should be reduced.

3. Rules for Reallocations among Partners

Under the New Rules, the IRS can make adjustments to the allocations of partnership items among the partners in the partnership. In the case of any adjustment that reallocates the distributive share of an item from one partner to another, however, the Rules for Reallocations provide that the amount of the partnership’s imputed underpayment is increased to reflect the component of the reallocation that increases income to one partner, but the amount of the partnership’s imputed underpayment is not decreased to take into account the component that decreases income to another partner, unless all the partners that are affected by the reallocation file amended returns for the reviewed year and pay any associated tax due. The need for all affected partners to file amended returns to prevent a reallocation

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75 New Code section 6225(c)(6).
76 Blue Book at page 68.
77 Blue Book at page 66.
78 See new Code section 6225(a).
79 See new Code sections 6225(b)(2) and 6225(c)(2)(B).
of items from contributing to an imputed underpayment may come as a surprise to some partners and partnerships. Consider the following example: 80

Example Fifteen

In 2020, the IRS determines that $1 million of Partnership X’s income in 2018 that was allocated to Partner Y should instead have been allocated to Partner Z. Unless both partners file amended returns for 2018 and pay any tax due, the $1 million increase in income that should have been allocated to Partner Z, but not the $1 million decrease in income allocated to Partner Y, is included in the imputed underpayment amount. In other words, unless both partners file amended returns, the partnership would be assessed tax on the increase in income allocated to one partner, even though that increase was offset by a corresponding decrease in income allocated to the other partner.

The Blue Book also includes an example in which one partner (L) is allocated $100 of a partnership’s rental income, while another partner (M) is allocated $70 of depreciation. On audit of the partnership, the IRS determines that the $70 of depreciation should be reallocated from M to L. The Blue Book concludes that, assuming the current rate structure is still in effect, the imputed underpayment amount is $27.72 (i.e., $70 multiplied by 39.6 percent), but that the partnership “may implement procedures for modifying the imputed underpayment as so determined.”

4. Alternative Method for Underpayments

New section 6226 provides an Alternative Method that a partnership can elect after it receives an FPA with respect to an imputed underpayment. Under the Alternative Method, the General Rules for Underpayments (and the Rules for Reallocations) do not apply and the audited partnership does not pay a partnership-level tax on an imputed underpayment. 81 Instead, the reviewed-year partners generally pay tax with respect to their shares of the understatement in the current year.

The discussion below explains how a partnership elects to use the Alternative Method and how the reviewed-year partners determine the amounts they must pay if the partnership uses that method. Then, it describes significant questions regarding how the Alternative Method applies in tiered situations and notes Blue Book language regarding deficiency dividend procedures when a partnership that elects the Alternative Method has as a partner a real estate investment trust (“REIT”) or a regulated investment company (“RIC”).

a. Electing the Alternative Method

New section 6226 indicates that a partnership must do two things to use the Alternative Method: (1) file an election with respect to an underpayment (the “Alternative Method Election”) and (2) furnish certain statements to the reviewed-year partners and the IRS (the “Furnishing Requirement”).

80 See note 37 for simplifying assumptions that apply to all the examples in this article.
81 New Code section 6626(a) provides, in part, that if the partnership elects the application of the Alternative Method with respect to an underpayment, new Code section 6225 “shall not apply with respect to such understatement.”
i. Filing the Alternative Method Election

The Alternative Method Election must be made not later than 45 days after the date of the notice of the FPA (i.e., it must be made within the “45-Day Period”). Once an election is made with respect to an FPA, that election can be revoked only with the consent of the IRS.

The Blue Book indicates that the election may be made regardless of whether or not the partnership files a petition for judicial review of the FPA. However, according to the Blue Book, the election is not implemented until the final court decision. Specifically, the Blue Book states:

The partnership may make the election within 45 days from the notice of final partnership adjustment, and within 90 days from the notice of final partnership adjustment may file a petition for readjustment with the Tax Court, district court, or Court of Federal Claims. Upon the final court decision, dismissal of the case, or settlement, the partnership is to implement the election by furnishing statements (at the time and manner prescribed by the Secretary) to the reviewed year partners showing each partner’s share of the adjustments as finally determined. As part of any settlement, for example, it is contemplated that the Secretary may permit revocation of a previously made election, and the partnership may pay at the partnership level.

The new law is silent as to whether the partnership will be able to make a “late” election if it fails to make the Alternative Method Election within the 45-Day Period. Further, “section 9100” late election relief would not appear to be available currently because the election is a statutory election. Hopefully, the statutory rules will be amended to provide a relief mechanism for situations in which there is reasonable cause for a late election.

ii. Meeting the Furnishing Requirement

The partnership is required to furnish, at such time and in such manner as the IRS may require, each reviewed-year partner and the IRS a statement of the partner’s share of any adjustment to items or income, gain, loss, deduction, or credit, as determined in the FPA (an “Adjusted Schedule K-1”). According to the JCT PATH Explanation, this statement would be similar to a Schedule K-1. The Blue Book adds that the statement should include the amounts and the “tax attributes of” the adjustments allocable to the recipient partner.

Note, however, that the statutory language of the new law does not specify what it means for a partnership to “furnish” a schedule to a reviewed-year partner. Administrative guidance will be needed.

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82 New Code section 6226(a)(1).
83 See new Code section 6226(a), flush language at end.
84 See Blue Book at page 69, citing new Code section 6226(d).
85 Blue Book at page 69. Furnishing statements to the reviewed-year partners showing adjustments after the judicial decision becomes final would be similar to the current TEFRA rules that provide that the IRS cannot assess a partner once a proceeding has begun in the Tax Court until the decision becomes final.
86 See JCT PATH Explanation at page 249.
87 Blue Book at pages 69-70.
in this regard, particularly with respect to reviewed-year partners that no longer hold partnership interests. Consider the following example: 88

**Example Sixteen**

Partner A is a partner in Partnership X in 2018. Partner A, however, terminates his interest in 2019 and is no longer a partner after that time. Several months after retiring, Partner A decides to sell his residence and travel around the world for the next several years. In 2020, Partnership X is audited. After receiving the FPA in 2021, Partnership X elects the Alternative Method and sends an Adjusted Schedule K-1 to the last known address it has on file for Partner A (Partner A’s former house). Will the IRS consider Partnership X to have met the Furnishing Requirement? Might the IRS require Partnership X to establish that it exercised due diligence in trying to track down Partner A? If so, what internal procedures might Partnership X need to establish to locate former partners?

b. **Amounts “Billed” to Reviewed-Year Partners**

i. **In General**

If the Alternative Method applies, partnership-level tax is not assessed under the General Rules for Underpayments. Instead, each reviewed-year partner increases the tax imposed by chapter 1 of the Code (i.e., the “normal” income taxes imposed by sections 1 through 1400) for the tax year that includes the date the statement is furnished (i.e., the current tax year) to reflect the sum of the following:

- In the case of the tax year of the partner that includes the end of the reviewed year, the amount by which the tax imposed under chapter 1 would increase if the partner’s share of the adjustments were taken into account for such year, plus

- In the case of a tax year after the tax year described above and before the current tax year, the amount by which the tax imposed under chapter 1 would increase by reason of “tax attributes” that would have been affected by certain adjustments to tax attributes. 89

Thus, it appears that each reviewed-year partner would need to calculate the hypothetical increase in its chapter 1 tax liability for each tax year between the reviewed year and the current tax year in a manner that takes into account the adjustment in the reviewed year (the “As-If Calculation”). This computation could be complex in some cases and could be burdensome for some partners that do not pay for sophisticated tax return preparation advice. Nonetheless, at least the As-If Calculation is simplified insofar as it ignores the impact of an adjustment on “non-normal” taxes, much like the

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88 See note 37 for simplifying assumptions that apply to all the examples in this article.
89 The Blue Book indicates that tax attributes in any subsequent year are to be appropriately adjusted.
General Rules for Underpayments simplify the computation of the imputed underpayment by assuming that all partners would have paid tax on understated income at the highest statutory income tax rate. Consider the following example:  

**Example Seventeen**

In 2020, the IRS determines that Partnership X understated $1 million of ordinary income on its 2018 return. This income would have been allocated equally to A (an individual) and B (a C corporation). In 2018, B had an NOL of $650,000 that B could have used to offset its $500,000 share of understated income if Partnership X had reported such income in 2018. However, B used the full amount of the NOL to offset other income earned in 2019. Both Partnership X and B use the calendar year. Partnership X elects to use the Alternative Method for the imputed underpayment and sends B a statement in 2020 showing B’s $500,000 share of the adjustment. For B’s 2020 tax return, B presumably must include the sum of (1) the amount by which its tax liability for 2018 would be increased by virtue of the adjustment (i.e., zero, because of the NOL), and (2) the amount by which its tax liability for 2019 would increase given that none of the NOL would have been available to offset B’s income in that year.

Similar to the General Rules for Underpayments, the Alternative Method rules do not specifically address the impact of an adjustment on other items, such as the partners’ bases in their partnership interests. Although the Alternative Method provides that any “tax attribute” that would have been affected should be appropriately adjusted, it is unclear what is meant by a tax attribute for this purpose (particularly in light of the use of the term “tax attribute” to describe the characteristic of the adjustment itself). Moreover, the As-If Computation looks only to how much the tax imposed under chapter 1 for the reviewed year and any “intervening” years would increase if the partner’s share of the adjustments were taken into account; it does not take into account potential decreases in tax liability in any of those years. As a result, depending upon future guidance, in some cases a partner could end up paying more tax under the Alternative Method than it would have paid if the partnership had not understated income in the reviewed year. Indeed, in some cases, a partner could even end up paying “double tax” on some income or gain. Consider the following example:  

**Example Eighteen**

In 2020, the IRS determines that Partnership X understated $1 million of ordinary income on its 2018 return. This income would have been allocated equally to A (an individual) and B (a C corporation). Partnership X elects to use the Alternative Method for the imputed underpayment and sends B a statement in 2020 showing B’s $500,000 share of the adjustment. B sold its interest in Partnership X in 2019.

For B’s 2020 tax return, B must include the sum of (1) the amount by which its chapter 1 tax liability for 2018 would increase by virtue of the adjustment, and (2) the amount by which its chapter 1 tax liability for each of 2019 and 2020 would increase as a result of the adjustment. To prevent the same economic gain being taxed twice, the adjustment with respect to 2018

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90 See note 37 for simplifying assumptions that apply to all the examples in this article.
91 Id.
ought to increase the basis of B’s partnership interest and decrease the amount of gain recognized by B on the sale of such interest in 2019. However, there is currently no specific rule providing for B to adjust the basis of its partnership interest to reflect the additional income allocated to it for 2018. Moreover, even if B’s basis in its interest were increased, in determining the amount that B must increase its tax liability for the 2020 adjustment year, the As-If Computation only takes into account increases in B’s chapter 1 tax liability for 2018 and 2019—not decreases. Thus, it might be the case that B must increase its chapter 1 tax liability for 2020 by the increase in its 2018 tax liability, without regard for the fact that B should have paid less tax on the sale of its interest in 2019. Further, B might not be able to file an amended return to claim a refund with respect to 2019.\(^92\)

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**ii. Interest and Penalties**

Under the Alternative Method, interest is determined at the partner level.\(^93\) Significantly, however, interest is determined by adding five percentage points, rather than three percentage points, to the federal short-term rate.\(^94\) Thus, there is a “toll charge” associated with the use of the Alternative Method.\(^95\) Given the lack of legislative history, it is not clear why the drafters of the legislation chose to impose such a charge; however, it is possible that some may have wanted to make “pushing” adjustments out to reviewed-year partners less attractive than paying tax at the partnership level.

By contrast, penalties or additions to tax are determined at the partnership level,\(^96\) but the reviewed-year partners are liable for payment of such amounts.\(^97\) The Blue Book indicates that the amount of penalties or additions to tax are “determined at the partnership level as if the partnership were an individual who was subject to Federal income tax for the reviewed year, and the imputed underpayment were an actual underpayment or understatement for the reviewed year.”\(^98\)

Significantly, although the statutory language indicates that the reviewed-year partners are liable for payment of penalties, it does not specify that such partners are “jointly and severally” liable. As a result, it appears that each partner might only be liable for its “share” of the penalties. The statute, however, does not state how each partner’s share of the penalty is determined or to what extent a partner might be able to raise defenses based on its own reasonable cause or lack of negligence. In addition, query whether a reviewed-year tax-exempt partner that would not be subject to tax on its share of understated

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\(^92\) In the interest of fairness and tax economy, when a share of the IRS’s upward adjustment is passed out to a partner via an Adjusted Schedule K-1, the partner should be able to make correlative downward adjustments on the current year return. Moreover, without further guidance from Treasury and the IRS, it is unclear how partnership items or affected items a partner could file a claim for refund and pursue in court. Further, even if B could pursue the item in court, it is possible that the statute of limitations to seek a refund could have expired prior to the resolution of the partnership audit.

\(^93\) See new Code section 6226(c).

\(^94\) See new Code section 6226(c)(2)(C).

\(^95\) As indicated in text supra, under the General Rules for Underpayments, interest on the imputed underpayment is determined using the federal short-term rate plus three percentage points under Code section 6621.

\(^96\) See new Code sections 6226(c)(1) and 6221.

\(^97\) See new Code section 6226(c)(1).

\(^98\) Blue Book at page 74.
income might have to pay a share of any penalties determined at the partnership-level (and would have an associated filing obligation notwithstanding its tax-exempt status). Hopefully, this will not be the case; however, these are issues on which administrative guidance is needed.

### iii. Rights of Persons Receiving Adjusted Schedules K-1

The reviewed-year partners who receive Adjusted Schedules K-1 do not appear to be able to challenge the substantive merits of the adjustments in the FPA. This result may have been intended given that multiple litigation of substantive issues could undercut the purpose of the legislation. However, the New Rules do not even provide rules allowing a person who is allocated a share of an adjustment to establish that it was not a partner in the reviewed year or that its share of an adjustment is incorrect. Moreover, it is not clear that such a person could pay the allocated adjustment and then seek a refund. Providing a mechanism for partners who receive Adjusted Schedule K-1’s to challenge the amount of their liability in at least these kinds of cases would seem to appropriately balance tax policy fairness objectives with the government’s interest in efficiently and promptly collecting tax. Consider the following example: 99

**Example Nineteen**

In exchange for services, an individual was granted a partnership interest that was subject to a substantial risk of forfeiture. Assume the partnership is audited, has an imputed underpayment amount, elects to use the Alternative Method, and provides an Adjusted Schedule K-1 to the individual. Does the individual have the ability to challenge the provision of the Adjusted Schedule K-1? Does it matter whether or not the individual made an election under section 83(b) or whether or not the partnership previously treated the individual as a partner under Revenue Ruling 2001-43?100

### c. Tiered Partnership Issues

The statutory rules do not make clear how the Alternative Mechanism works in the case of partnerships that have other flowthrough entities as partners. In particular, legislation clarifying how an “upper-tier” partnership that receives an Adjusted Schedule K-1 from another partnership takes into account its share of an adjustment from a lower-tier partnership is needed. Consider the following example.101

**Example Twenty**

In 2020, the IRS asserts an imputed underpayment with respect to Partnership X’s 2018 tax year and issues an FPA. Partnership X elects to use the Alternative Method and sends its partners Adjusted Schedules K-1 for the 2018 tax year. One of its partners, Partnership Y, is itself a partnership. Partnership Y’s partners changed significantly between 2018 and 2020. Partnership Y did not make an Election Out for 2018.102 Can Partnership Y use the Alternative

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99 See note 37 for simplifying assumptions that apply to all the examples in this article.

100 2001-2 C.B. 191.

101 See note 37 for simplifying assumptions that apply to all the examples in this article.

102 Even if a partnership is able to use the Alternative Method in taking into account its share of an adjustment from a lower-tier partnership that uses the Alternative Method as a general matter, query whether Partnership Y would be able to elect the Alternative Method to flow adjustments through to its 2018 partners if it had made an Election Out of the New Rules with
Method to pass the adjustment through to its 2018 partners, notwithstanding that Partnership Y itself did not receive an FPA? If Partnership Y instead performs the As-If Calculation, would it report no additional tax due given that it is not itself an audited partnership and is not subject to tax under chapter 1? Is there a statutory basis for imposing a partnership-level tax on Partnership Y?

i. Policy Support for Use of Alternative Method in Tiered Structures

Allowing Partnership Y to use the Alternative Method in the example above would be consistent with the policy objectives underlying the new law insofar as it would allow the IRS to collect payments of tax with respect to underpayments from Partnership Y’s past-year partners using a system similar to the current Schedule K-1 process, but would not impede the IRS’s ability to find sources of income within tiers or to determine the amount of income that was understated. Moreover, allowing adjustments to “flow up through the tiers” would allow the ultimate economic burden of adjustments to fall on those who were indirectly partners of the audited partnership in the past, rather than potentially being borne by the current indirect owners of the audited partnership. 103

ii. Blue Book Discussion

Notwithstanding the above policy argument, in the Blue Book, the JCT staff seems to indicate that the upper-tier partnership might not be able to use the Alternative Method but instead might have to pay tax on its share of the adjustment at the entity-level as if it were an individual (citing the statutory rule that generally requires a partnership to compute its income using the rules applicable to individuals). The Blue Book also appears to contemplate that the upper-tier partnership might use indemnification agreements to ensure that past-year partners, rather than the current partners, bear the economic burden of the upper-tier partnership’s tax on its share of the adjustment. Specifically, the Blue Book provides, in relevant part:

In the case of tiered partnerships, a partnership that receives a statement from the audited partnership is treated similarly to an individual who receives a statement from the audited partnership. That is, the recipient partnership takes into account the aggregate of the adjustment amounts determined for the partner’s taxable year including the end of the reviewed year, plus the adjustments to tax attributes in the following taxable years of the recipient partnership. The recipient partnership pays the tax attributable to adjustments with respect to the reviewed year and the intervening years, calculated as if it were an individual (consistently with section 703), for the taxable year that includes the date of the statement. The recipient partnership, its partners in the taxable year that is the reviewed year of the audited partnership, and its partners in the year that includes the date of the statement, may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax respect to 2018. (The Alternative Method is part of the New Rules.) Legislation clarification may be needed with respect to this issue.

103 See also Susswein and McCormick, “Understanding the New Partnership Audit Rules,” Tax Notes, Doc. 2015-25227 (Nov. 17, 2015), for a brief discussion of how the statute “evidently anticipates” the ability of upper-tier partnerships to use the Alternative Method.
liability of reviewed year partners being borne economically by partners in the year that includes the date of the statement. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible.104

Although the policy rationale is understandable for concluding that the As-If Calculation should not always yield a result of zero when an adjustment is passed through to an upper-tier partnership, the statutory predicate for the Blue Book’s apparent conclusion that an upper-tier partnership is taxed at the entity-level appears unclear. The fact that a partnership generally computes its income using the rules applicable to individuals does not make a partnership liable for the payment of an entity-level tax. Indeed, the subchapter K rules make clear that a partnership is a “flowthrough” entity that does not itself pay income tax; the income computation rules only relate to how the partnership computes the income that flows through to its partners.105

Could the Blue Book’s apparent conclusion be predicated on reading the general rules in new section 6221 as applying not only to the partnership that was examined by the IRS but also to any partnership in a tiered-partnership arrangement? As discussed above, however, there are specific statutory rules in new section 6226 governing how a partner that receives an Adjusted Schedule K-1 computes its associated tax liability—and these rules look to such partner’s chapter 1 tax liability. Given this specific language and the lack of chapter 1 liability for a partnership, Congress may want to consider clarifying this issue legislatively.

Moreover, although the use of indemnification procedures to shift the economic burden of the receipt of an Adjusted Schedule K-1 from current partners to past partners may be feasible for some upper-tier partnerships, indemnification provisions may be less helpful for other upper-tier partnerships. For example, consider a situation in which the partners in an upper-tier partnership are all tax-exempt entities that are not subject to UBIT on their shares of the adjustment and there have been no changes in the partnership’s ownership structure. Is the Blue Book suggesting that the upper-tier partnership would be subject to tax in the year it receives the Adjusted Schedule K-1 as if it were an individual, even though its partners would not have been subject to tax on the income on the Adjusted Schedule K-1 if such income had been reported by the lower-tier partnership in the reviewed year? Or, is the Blue Book envisioning that the upper-tier partnership would somehow be able to reduce the current tax liability resulting from the receipt of the Adjusted Schedule K-1 to reflect that its partners would not have been subject to tax on the amount that would have flowed up from the lower-tier partnership if such partnership had not understated income in its reviewed year?

104 See Blue Book at page 70. (Emphasis added.)
105 See, e.g., Code section 701, which provides that a partnership as such is not subject to income tax imposed under chapter 1.
iii. Possible Use of AAR Mechanism

Some have suggested that an upper-tier partnership might be able to use the AAR provisions in the New Rules to push out to its past-year partners its share of an adjustment from a lower-tier partnership that elected the Alternative Method. As explained further later in this article, the AAR provisions generally allow an adjustment to be determined and taken into account for a partnership that has not received a notice of administrative proceeding for the tax year for which the AAR is made either (1) by the partnership, under rules similar to the General Rules for Underpayments, or (2) by the partnership and its partners under rules similar to the Alternative Method. 106

Absent administrative guidance, however, it is not clear how this approach would work. For example, would an upper-tier partnership file an AAR to adjust items for the year in which it receives an Adjusted Schedule K-1, even though it has not yet filed a current return for such year? If so, how would the adjustment relate back to past-year partners? Or, would the partnership file an AAR with respect to the past year in which it would have taken into account the additional income items from the lower-tier partnership if the lower-tier partnership had not underreported such items, even though the Adjusted Schedule K-1 is supposed to generate a current-year tax liability? If the AAR is filed with respect to the past year, would the upper-tier partnership be able to use the AAR mechanism if it had previously made an Election Out of the New Rules for that tax year or would it be precluded from filing an AAR given that the AAR provisions are part of the New Rules?

The Blue Book does not directly address the possible use of the AAR Mechanism in such a situation, but can be read as leaving open the possibility of such an approach. The Blue Book includes general language explaining how an upper-tier partnership may choose to file an AAR with respect to its share of an adjustment from a lower-tier partnership. Although this language might be focused on situations in which a lower-tier partnership files an AAR and pushes an adjustment through to an upper-tier partnership, it also might be intended to address situations in which a lower-tier partnership that is audited uses the Alternative Method to push an adjustment through to an upper-tier partnership. The Blue Book states, in relevant part:

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for a partnership taxable year. Following the filing of the administrative adjustment request, the partnership may apply most of the procedures for modification in a manner similar to modification of an imputed underpayment under new section 6225(c). Like the partnership audit, tax resulting from the adjustment may be paid by the partners in the manner in which a partnership pays an imputed underpayment in the adjustment year under new section 6225. Alternatively, the adjustment may be taken into account by the partnership and partners, and the tax paid by reviewed year partners upon receipt of statements showing the adjustments, similar to new section 6226. . .

In the case of tiered partnerships, a partnership’s partners that are themselves partnerships may choose to file an administrative adjustment request with respect to their distributive shares

106 See new Code sections 6227(b) and 6232(a).
of an adjustment. The partners and indirect partners that are themselves partnerships may choose to coordinate the filing of administrative adjustment requests as a group to the extent permitted by the Secretary.

Nonetheless, even if upper-tier partnerships that receive Adjusted Schedules K-1 from audited lower-tier partnerships might be able to use the AAR mechanism to pass adjustments through to past-year partners as a general matter, a number of questions and issues could be raised depending upon how administrative guidance implements the use of such a mechanism. For example:

- The New Rules only allow a partnership to file an AAR for a tax year within three years of the date on which it filed its partnership return for such year (or three years of the date on which such return was due, excluding extensions, whichever is later) and, in no event, can a partnership file an AAR after it has received a notice of administrative proceeding. Given that the exam process for a lower-tier partnership may take significant time, it might be difficult for an upper-tier partnership to satisfy the timing requirements for filing an AAR with respect to the year to which the adjustment relates. In addition, as indicated above, a partnership that has filed an Election Out or that is itself being audited might not be able to file an AAR. Thus, query whether there could be some situations in which an upper-tier partnership might be precluded from using an AAR as a mechanism to push an adjustment from a lower-tier partnership out to past-year partners.

- The filing of an AAR by a partnership seemingly extends the statute of limitations for assessment of partnership items for three years after the date of the filing of the AAR. For many partnerships, extending the statute of limitations could raise investor relations, partner conflict, and other issues. Thus, using the AAR process to achieve a “push out” of adjustments to past-year partners may not be feasible in some cases, unless the statute is extended only with respect to the adjusted items. Clarification of the scope of the statute of limitations provisions would be helpful.

- If an upper-tier partnership pushes its share of an adjustment resulting from the audit of a lower-tier partnership to its past-year partners under the AAR procedures, those partners might not be subject to the increased interest rate that applies under the Alternative Method. Thus, depending on what guidance ultimately is issued, those who own interests in an audited partnership directly and who are allocated amounts under the Alternative Method might pay a higher interest rate than would those who hold their interests indirectly through an upper-tier partnership that uses the AAR mechanism. If so, the potential different treatment of direct and indirect partners could raise concerns for different partner groups.

- An AAR is intended to allow a partnership to inform the IRS of adjustments of the partnership for a tax year so that the IRS either (1) can collect additional tax from the partnership or partners or (2) can allow, in effect, a refund for the year in question. If the IRS already has issued a notice of FPA to a lower-tier partnership and the lower-tier partnership already has passed out an allocable share of the adjustment to the upper-tier partnership, the IRS is already on notice of the adjustment and filing an AAR appears to be redundant or a nullity.
iv. Need for Clarification

Hopefully, Congress and the IRS will provide additional clarity on how the Alternative Method applies in tiered situations, as well as other tiered partnership issues, before the new law begins to apply. As explained above, allowing upper-tier partnerships to use the Alternative Method would appear to be consistent with the policy objectives of the new law. As also indicated above, legislative clarification may be needed as to what options are available when an upper-tier partnership that has made an Election Out of the New Rules receives an Adjusted Schedule K-1 from a lower-tier partnership that has been audited.

There is also a question concerning imposition of income tax if an S corporation is a partner in the partnership under examination and the partnership elects to push out the adjustment to its partners. Neither the New Rules nor the Blue Book explicitly addresses this situation, but it would appear that the S corporation, which generally is not subject to income tax, would not be required to pay the tax at the S corporation level. Presumably, the adjustment is intended to be passed out to the S corporation’s shareholders. If the adjustment is to be pushed out to the shareholders of the S corporation, clarification is needed concerning whether the shareholders would be required to file amended returns to include the adjustment in the reviewed year or whether the shareholders would report the adjustment on the return for the adjustment year, similar to the rules of section 6226.

d. RIC and REIT Partners

The Blue Book indicates that the IRS should provide guidance with respect to the deficiency dividend procedures when an audited partnership that elects the Alternative Method has as a partner a REIT or a RIC. Specifically, the Blue Book states:

A recipient partner that is a RIC or REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend with respect to the reviewed year. Guidance coordinating the receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary.

5. Audit Adjustments Not Resulting in Underpayments

Different rules from those described above apply in the case of audit adjustments that do not result in imputed underpayments, such as adjustments that decrease the net amount of partnership income and gain, or increase the net amount of losses and deductions, in a reviewed year. In such a case, the New Rules indicate that the partnership would take the adjustment into account in the adjustment year as a

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107 Section 1363 provides that an S corporation is not liable for chapter 1 tax except as provided in section 1374 (relating to certain built-in gain) and section 1375 (relating to certain passive investment income).

108 Indeed, even Code section 6221 would not appear to apply to an S corporation partner.

109 Blue Book at page 70.
reduction in non-separately stated income or an increase in non-separately stated loss (or, in the case of a credit, as a separately stated item) under section 702(a)(8). \(^\text{110}\)

Notwithstanding that the statutory language provides for non-separately stated treatment, the Blue Book indicates that “it may also be appropriate to treat the amount of an adjustment as a reduction (or increase) in a separately stated amount of income, gain, loss, or deduction.” \(^\text{111}\) A footnote in the Blue Book suggests that the conclusion that separately stated treatment may be appropriate is based on the broad grant of authority the statutory rules provide for the IRS to modify the imputed underpayment amount. \(^\text{112}\) Given that the statutory rules cited related to imputed underpayments, rather than to adjustments that do not relate in imputed underpayments, however, query whether a statutory amendment ought to be provided to support guidance providing for separately stated treatment.

In addition, note that an adjustment that does not result in an imputed underpayment generally would increase losses or reduce income allocable to adjustment-year partners—even though it may relate to reviewed-year partners having been allocated too much income, or too little loss, in the past. Further, the partnership apparently would not be able to amend Schedules K-1 for the reviewed year to reflect the adjustment. \(^\text{113}\) Consider the following example. \(^\text{114}\)

**Example Twenty-One**

In 2020, the IRS audits Partnership X and determines that Partnership X overstated its ordinary income for the 2018 tax year by $1 million. During Partnership X’s 2018 tax year, A and B each owned a 50 percent interest in Partnership X. A and B are individuals who paid tax at the highest marginal rate on their shares of Partnership X’s income. In 2019, A sold his interest in Partnership X to C, an individual. The overstatement of income in 2018 reduces the amount of ordinary income allocated to B and C in 2020 by a total of $1 million. This reduction benefits C, even though A paid tax on the overstated ordinary income to which the reduction relates. A, however, may have paid less capital gains tax on the sale of his interest than he would have if his basis in his interest had not been increased by the overstated income.

As explained later in this article, selling partners may want to enter into legal agreements with buying partners to contractually obligate the buyer to return any benefit associated with adjustments other than underpayments. Note, however, that structuring such agreements could be complex when tax-exempt

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\(^{110}\) New Code section 6225(a)(2). Section 702(a)(8) is a catch-all provision that includes all partnership items that are not specifically required to be separately stated under section 702(a) or that are required to be separately stated by regulations. Section 702(a)(8) taxable income or loss is typically considered to be ordinary income or ordinary loss.

\(^{111}\) Blue Book at page 63.

\(^{112}\) Blue Book at page 63, note 203.

\(^{113}\) See JCT PATH Explanation at page 251. See also flush language of new Code section 6227 (which provides that a partnership cannot file an AAR after the mailing of a notice of administrative proceeding), and new Code section 6241(e) (which provides that, except as provided by procedures by the Secretary, a partnership cannot amend Schedules K-1 after the due date of the return).

\(^{114}\) See note 37 for simplifying assumptions that apply to all the examples in this article.
entities purchase partnership interests from taxable persons, given that the tax-exempt buyer may not receive any tax benefit from the adjustment.

B. Other Significant Aspects of New Rules

The New Rules also include other significant aspects, including new requirements for a “partnership representative,” a duty of consistency, new rules for AARs, and new statute of limitations provisions. These aspects of the New Rules generally apply to all tax partnerships other than those that make valid Elections Out.

1. Partnership Representative

Under the New Rules, a partnership must designate a partner, or other person,115 with a substantial presence in the United States as the partnership representative (“Partnership Representative”). This designation must be made “in the manner prescribed by the Secretary.”116 If the partnership does not designate a Partnership Representative, the IRS can select “any person” as the Partnership Representative.

The New Rules provide that the Partnership Representative has the sole authority to act on behalf of the partnership for purposes of the new regime.117 Further, the partnership and all its partners are bound by actions taken under the new regime by the partnership and by any final decision in a proceeding brought under the new regime with respect to the partnership.118 Thus, it appears that the Partnership Representative’s responsibilities would include the following:

- Binding the partnership and the partners with respect to an adjustment or settlement,
- Deciding whether the partnership can and should make the Election Out,
- Communicating with partners to gather information for purposes of reducing the imputed underpayment amount,
- Determining whether to elect to use the Alternative Method with respect to an underpayment and making any such election with the 45-Day Period,
- Providing Adjusted Schedules K-1 (and information regarding penalties) to the reviewed-year partners if the Alternative Method is elected,

115 Although not stated in the statute, presumably the definition of “person” should be read to be consistent with section 7701(a)(1), which includes an individual, trust, estate, partnership, association, company, or corporation. Query whether a disregarded entity that is a partner can be a Partnership Representative given that it does not appear to be a “person” under section 7701. Hopefully, administrative guidance will address this issue.

116 See new Code section 6223(a).

117 Id.

118 See new Code section 6223.
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- Extending the statute of limitations, and
- Pursuing a court resolution with respect to an FPA.

Notwithstanding these broad responsibilities, it does not appear that a Partnership Representative may sign the partnership’s tax return unless other requirements are met. Under current IRS guidance, only a general partner or member-manager of a limited liability company (“LLC”) can sign the partnership return.

The Partnership Representative rules likely were viewed as essential to the new law, given the difficulties the IRS has faced auditing complex tiered partnership structures under the TEFRA rules. In addition, the fact that a partnership may designate any partner or other person to serve as the Partnership Representative could be very helpful because it often has been difficult to get the IRS to approve the designated tax matters partner for settlement purposes or extension of the statute for assessment of partnership items. Nonetheless, the substantial power accorded the Partnership Representative could deprive some partners of rights in audit matters and could set up potential conflicts if a partner is designated as the Partnership Representative, given that the partner’s interests may not align with those of other partners.119

In this regard, note that the Blue Book recognizes that, under the TEFRA rules, partners had certain rights of notification of the proceedings from either the IRS or the tax matters partner, while under the new centralized system, the partnership acts through its Partnership Representative, who has the sole authority to act on behalf of the partnership. Under the centralized system, the partnership and all partners are bound by actions taken by the partnership and partners may not participate or contest results of an examination of a partnership.120

The Blue Book also makes it clear that a partner has almost no rights with respect to the new audit regime. In an example, the Blue Book describes a situation in which the IRS asserts in an FPA that a partnership had an imputed underpayment of $1,000, but the partnership chooses not to seek judicial review. The partnership elects to push out the imputed underpayment to reviewed-year partners under the Alternative Method and sends Partner A a statement that his allocable share of the adjustment is $100, which would result in an increase of $35 in taxes for Partner A. Partner A does not include this adjustment on his current year return as required. The Blue Book indicates that, prior to a levy on Partner A’s property, Partner A is entitled to a collection due process hearing, but Partner A is precluded from raising whether the issue of whether $1,000 (or A’s $100 share of such amount) was properly includible in determining partnership taxable income.121

Partnerships may want to confer with counsel about building as many decisions as possible into the partnership agreement regarding the designation and replacement of a Partnership Representative, the

119 In the event of an audit, conflicts of interest may also exist if the person responsible for the tax compliance of the partnership is designated as the Partnership Representative.
120 The New Rules do not require notification of the partners of a partnership audit. Thus, it will be important to incorporate any rights of notification into the partnership agreement.
121 See Blue Book at pages 81-82.
powers accorded the Partnership Representative, and the various elections the partnership can make under the new regime. Partnerships also may want to discuss with counsel the possibility of designating persons as their Partnership Representatives who have adequate liability protection (such as a corporation or LLC). Issues associated with designating a Partnership Representative are discussed in more detail later in this article.

2. Settlement Prior to FPA

As indicated above, a partnership and all its partners are bound by actions taken by the partnership under the New Rules. In this regard, the Blue Book specifically provides that a settlement entered into by the partnership binds the partnership and all the partners of the partnership. However, neither the statute nor the Blue Book provides any guidance on how payment is to be made if the settlement results in the partnership having an imputed underpayment.

Of course, there is no issue if the partnership chooses to pay the tax given that a settlement agreement generally includes a waiver of restriction that allows immediate assessment. However, there does not appear to be a statutory mechanism for the partnership to push out the payment to the reviewed-year partners. New section 6226 allows the partnership to pass out the imputed underpayment after receiving an FPA, but that would not seem to encompass a settlement. The partnership could ask the IRS to send it an FPA in the amount of the settlement, allowing the partnership to obtain the benefit of section 6226. However, it would seem more efficient for the IRS to provide specific guidance allowing the partnership to pass out the settlement amount to the reviewed-year partners without the issuance of an unnecessary FPA.

3. Duty of Consistency

Under the New Rules, a partner’s return must treat each item of income, gain, loss, deduction, or credit attributable to a partnership in a manner that is consistent with the treatment of that item on the partnership return, unless the partner files a statement identifying the inconsistency or demonstrates that it received incorrect information on the Schedule K-1 it received from the partnership. Any final decision with respect to a disclosed inconsistent position in a proceeding in which partnership is not a party is not binding on the partnership. Further, if a partner fails to comply with the consistency requirement, any resulting underpayment generally is assessed and collected as if it were on account of a mathematical or clerical error on the partner’s return, except that the abatement procedures of section 6213(b)(2) do not apply, and an accuracy-related penalty under section 6662 may be asserted.

Under the currently applicable TEFRA rules, if a partner files inconsistently but makes a proper disclosure, the IRS cannot make an assessment against that partner with respect to that partnership item unless the IRS conducts a partnership-level proceeding or notifies the partner that all partnership items will be treated as nonpartnership items. If the IRS converts the partnership items to

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122 See Blue Book at page 62.
123 See new Code section 6222.
124 If a taxpayer makes a “math or clerical error” rather than a substantive error, section 6213 allows the IRS to “correct” the error and recompute the tax and assess the tax immediately without issuing a statutory notice of deficiency.
nonpartnership items, the IRS cannot assess any tax against the partner without issuing a statutory notice of deficiency. The TEFRA provisions contain detailed rules on the manner and timing of converting a partner’s items from partnership to nonpartnership items.

The new partnership provisions do not provide any rules with respect to a properly disclosed inconsistent position except that the IRS cannot treat it as a “math error” and make an immediate assessment. Thus, it appears that the IRS must issue a statutory notice of deficiency to the partner for this adjustment before it can assess any deficiency unless the IRS examines the partnership. However, there is no guidance on either (1) whether all the partner’s partnership items are converted to nonpartnership items or just the partnership items disclosed or (2) the procedures and timing for these matters.

4. Restrictions on Amending Schedules K-1

The new law generally restricts a partnership from issuing amended Schedule K-1s to its partners after the “due date” of the return to which the Schedule K-1 relates.\footnote{See new Code section 6241, amending section 6031(b).} The Blue Book explains that:

The due date takes into account the permitted extension period. For example, the Schedules K–1 furnished by a partnership with respect to its taxable year 2020 may not be amended after the due date for the partnership 2020 return. If the partnership has a calendar taxable year, the due date for its partnership 2020 return is September 15, 2021 (taking into account the permitted 6-month extension following the due date of March 15, 2021), after which date the Schedules K–1 for 2020 may no longer be amended. The partnership may, however, file an administrative adjustment request pursuant to new section 6227, and the partnership may pay any resulting imputed underpayment at the partnership level.

5. Administrative Adjustment Requests

As mentioned above, effective for requests with respect to returns filed for partnership tax years beginning after December 31, 2017, a partnership may be able to file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit for any partnership tax year (subject to the statute of limitations provisions described below). If the partnership files such an AAR, any adjustment is taken into account for the partnership tax year in which the AAR is made (i.e., the year of the filing, not the prior year). Further, any adjustment that would result in an imputed underpayment is taken into account either (1) by the partnership, under rules similar to the General Rules for Underpayments or (2) by the partnership and the partners, under rules similar to those described for the Alternative Method.

If the adjustment is taken into account by the partnership under the General Rules for Underpayments contained in new section 6225, the partnership pays the imputed underpayment when the AAR is filed.\footnote{New Code section 6232(a)} New section 6227(b)(1) provides that, in this case, the adjustment is determined under the rules of section 6225, “other than paragraphs (2),(6), and (7) thereof.” As initially enacted, this language...
would have allowed the imputed underpayment to be reduced under the Tax-Exempt Partner Rule, the Rate Reduction Rule, and the Administrative Discretion Rule (which was in section 6225(c)(5) prior to amendment by the PATH Act), but not the Amended Return Rule. However, when the PATH Act added the PTP Rule, the paragraphs of section 6225(c) were renumbered such that the Administrative Discretion Rule is now in section 6225(c)(6). As a result, as a technical matter, the statute now allows the imputed underpayment in the case of an AAR to be reduced under the Tax-Exempt Partner Rule, the Rate Reduction Rule, or the PTP Rule, but not the Amended Return Rule or the Administrative Discretion Rule. It is hoped that technical corrections legislation will modify the cross reference in the AAR rules to make clear that the Administrative Discretion Rule can apply in the case of an AAR.

In addition, in the case of an adjustment with respect to an AAR that would not result in an imputed underpayment, the new law states that the partnership must use rules similar to those described for the Alternative Method. This is confusing given that the Alternative Method is not available for adjustments that do not result in underpayments. Nonetheless, the Blue Book seemingly attempts to clarify the meaning of the statutory language by explaining that:

In the case of an adjustment (pursuant to a partnership’s administrative adjustment request) that would not result in an imputed underpayment, any refund is not paid to the partnership; rather, procedures similar to the procedure for furnishing reviewed year partners with statements reflecting the requested adjustment apply, with appropriate adjustments.

Thus, it appears that, in the case of an AAR, an adjustment that reflects an overstatement of income or gain in a past year may be able to be pushed out to those who were partners in the past year.

6. Statute of Limitations

The New Rules generally allow the IRS to adjust an item on a partnership return for a tax year at any time within three years from the latest of (1) the date on which the partnership return for the tax year was filed, (2) the return due date for the tax year, or (3) the date on which the partnership filed an AAR with respect to the year. In addition to the expected extensions caused by extensions by agreement, false returns, substantial omission of income and no return, the period also remains open for adjustment: (1) in the case of any modification of the imputed underpayment, to a date that is 270 days (plus the number of days of any extension granted by the Secretary) after the date everything required to be submitted is submitted to the IRS; and (2) in the case of any notice of proposed partnership

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127 See discussion of PTP Rule in text supra.
128 Consideration should also be given to whether the Amended Return Rule should apply in the case of an AAR.
129 Blue Book at page 71.
130 Note that this result is different in a non-AAR situation. As explained above, under the General Rules, an adjustment that results in “other than an imputed underpayment” potentially may benefit the partners in the adjustment year (rather than the reviewed-year partners).
131 New Code section 6235.
adjustment, to a date that is 330 days (plus the number of days of any extension granted by the Secretary) after the date of the notice.132

As suggested above, allowing the statute to stay open for three years following the filing of an AAR could discourage taxpayers from filing AARs in order to report additional income or fewer tax benefits. Query further why the IRS needs three years to make an adjustment resulting from the filing of an AAR, especially if the partnership pays the tax.

7. Partnership Terminations

The New Rules provide that, if a partnership ceases to exist before a partnership adjustment takes effect, the adjustment must be taken into account by the former partners of the partnership under regulations to be issued by the IRS and Treasury.133

The Blue Book elaborates on the termination rules. As a threshold matter, it indicates that a notice of administrative proceeding, proposed adjustment, or FPA is sufficient if mailed to the last known address of the Partnership Representative or partnership, even if the partnership has terminated.134 Thus, terminated partnerships and their representatives would be well advised to keep the IRS apprised of their contact information so that they are aware of any such notices and can act within required timeframes.

In addition, the Blue Book indicates that a partnership that terminates within the meaning of section 708(b)(1)(A) is treated as ceasing to exist.135 Regulations also may provide that a partnership that has no significant income, revenue, assets, or activity at the time the adjustment takes effect may be treated as having ceased to exist. Further, the successor partnership in a “technical termination” under section 708(b)(1)(B) succeeds to the adjustment or imputed underpayment, absent regulations to the contrary.136

Note that, although the Blue Book indicates that a technical termination under section 708(b)(1)(B) is not taken into account in determining whether a partnership has ceased to exist, there remain many unanswered questions involving the new partnership audit provisions and a technical termination. For example, when there is a technical termination, a partnership is required to file a short-year return. If the IRS examines the short-year return of the partnership, does the “old” partnership or the “succeeding” partnership have the right to designate the Partnership Representative? This is an important matter

132   New Code section 6235(a)(2) and (3), as modified by the Path Act.
133   See new Code section 6241(7).
134   Blue Book at page 72.
135   Presumably, if a partnership is considered to continue under section 708(b)(1)(A), which is common in certain conversions and mergers, it will also be considered as continuing under the New Rules.
136   Section 708 generally provides that, for purposes of subchapter K, an existing partnership is considered to continue if it is not terminated. Section 708(b)(1)(A) addresses “actual” terminations of partnerships; section 708(b)(1)(A) generally provides that a partnership terminates if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. By contrast, section 708(b)(1)(B) addresses “technical” terminations; section 708(b)(1)(B) provides that a partnership will be considered to have terminated if, within a 12-month period, there has been a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.
because, if the IRS asserts an imputed underpayment for the short-year return, the Partnership Representative has the option of (1) seeking judicial review, (2) having the partnership pay the tax under new section 6225, which would burden the owners of the succeeding partnership, or (3) having the adjustment pushed out under new section 6226 to the partners of the old partnership.

Hopefully, future guidance will address these issues. Further, buyers and sellers of partnership interests will want to take these matters into consideration during negotiations and due diligence.

IV. Election Out

Generally effective for returns filed for partnership tax years beginning after 2017, partnerships that meet certain eligibility requirements will be able to elect out of the New Rules for a tax year.137 If a valid Election Out is made for a tax year, the partnership and its partners are subject to the assessment and collection rules that currently apply to Small Partnerships that are not subject to TEFRA rules. Thus, for example:

- The IRS could still audit the partnership at the partnership level; however, the partnership could not extend the statute of limitations for assessment for partnership items for the partners. Instead, each partner’s period for assessment for partnership items would correspond to the partner’s limitation period for other items under section 6501, and the IRS would need to enter into a separate agreement to extend the period with each partner.

- The partnership could not settle partnership items on behalf of any partners. Instead, the IRS would need to enter into a separate settlement with each partner.

- The IRS would issue statutory notices of deficiency to a partner within the partner’s limitation period under section 6501. The partner then would have an option to petition the deficiency to the U.S. Tax Court or to pay the deficiency and seek a refund in the appropriate federal district court for that partner or the U.S. Court of Federal Claims. Thus, more than one case on the same issue or issues from the partnership could occur at the same time.

Keep in mind that, based on the current statutory language, the Election Out applies to all the New Rules. Thus, for example, absent further guidance to the contrary, a partnership that makes an Election Out for a tax year might not be able to file an AAR with respect to that year or to elect the Alternative Method (even if it is not itself audited but receives an Adjusted Schedule K-1 from an audited partnership in which it holds an interest). Also, if a partnership that has made an Election Out is issued an Adjusted Schedule K-1, could it be liable for any partnership-level tax as a result of the issuance of the Adjusted Schedule K-1 given that the New Rules do not apply to it?

Given that additional clarification and guidance are needed with respect to many aspects of the New Rules, it is impossible to know at this time when a partnership that can qualify to make an Election Out for a tax year might consider the election to be advantageous. Nonetheless, the partnership may need

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137 See new Code section 6221(b).
to consider not only how it might be affected by the New Rules if it is audited by the IRS but also how it might be affected if it receives an Adjusted Schedule K-1 from a lower-tier partnership that is audited.

The discussion below describes the requirements a partnership must meet to make an Election Out and the mechanics of such an election.

A. Eligibility to Make the Election Out

The new law generally provides that a partnership can make the Election Out for a tax year only if it meets both the following requirements:

- Each of its partners is an individual, a deceased partner’s estate, a C corporation, an S corporation, or a foreign entity that would be treated as a C corporation if it were domestic (the “Partner Eligibility Requirement”)

- It is required to furnish 100 or fewer statements under section 6031(b) (i.e., Schedules K-1) with respect to its partners for the tax year (the “100-or-Fewer Requirement”)

As explained further below, the new law provides special counting and disclosure rules in the case of partners that are S corporations. Further, it indicates that administrative guidance can provide similar rules in the case of partners that are themselves partnerships.¹³⁸ Thus, depending on such guidance, it is possible that some partnerships that have other partnerships as partners may be able to make the Election Out.

Note that some partnerships that currently do not qualify as Small Partnerships under the TEFRA rules likely will be able to satisfy both the Partner Eligibility Requirement and the 100-or-Fewer Requirement. Indeed, a partnership with up to 100 partners may be able to make the Election Out, while a TEFRA Small Partnership can have no more than 10 partners. Thus, the universe of partnerships that make the Election Out could end up being larger than the universe of partnerships that were not subject to the TEFRA rules.

1. Partner Eligibility Requirement

A partnership considering making the Election Out will have to determine if it meets the Partner Eligibility Requirement. In making this determination, it is not clear at this time to what extent a partnership will be able to rely on legal records regarding who owns its interests or will have to perform due diligence to determine if the beneficial ownership of an interest differs from the legal ownership.

Further, pending additional guidance, different issues may be raised with respect to different kinds of shareholders. For example:

¹³⁸ See new Code section 6221(b)(2)(C). The Blue Book further indicates that such guidance could apply to partners that are themselves partnerships “to the extent that such rules are consistent with prompt and efficient collection of tax attributable to the income of partnerships and partners.” Blue Book at page 60.
• The Partner Eligibility Requirement does not specifically mention REITs or RICs. However, the Code refers to both RICs and REITs as "corporations"139 and section 1362 defines a "C corporation" for purposes of the income tax title of the Code as any corporation that is not an S corporation. Further, although H.R. 2821 had specifically provided that REITs or RICs were not C corporations for purposes of the Election Out, the enacted partnership audit reform legislation omitted this language. Likewise, the Blue Book indicates that the fact that a partnership has a C corporation that is a REIT or a RIC as a partner does not prevent the partnership from making the Election Out.140 Thus, it appears that the mere presence of REIT or RIC partners would not disqualify a partnership from making an Election Out.

• Given the definition of a C corporation in section 1362, it appears that any foreign entity that is treated as an association taxable as a corporation for federal income tax purposes would be an eligible partner for purposes of the Partner Eligibility Requirement.141 Although it is not clear what the statutory reference to "foreign entities that would be treated as C corporations if domestic" means,142 the Blue Book suggests that foreign entities that have elected to be, or that are, treated as per se corporations under the entity classification rules are "eligible" partners for purposes of determining if the partnership can make the Election Out.143

• A partnership with tax-exempt partners may need to determine whether those partners are classified as trusts or C corporations for federal income tax purposes.

• If the partnership has an S corporation partner, the statute indicates that Schedules K-1 required to be furnished by the S corporation are treated as statements of the partnership for purposes of the 100-or-Fewer Requirement,144 but does not state that the shareholders of the S corporation are treated as partners for purposes of the Partner Eligibility Requirement. Thus, pending administrative guidance, it does not appear that a partnership has to "look through" an S corporation for purposes of the Partner Eligibility Requirement.

• In the case of partnership interests that are owned by nominees, disregarded entities ("DREs"), trusts, or individual retirement accounts, the statute does not specify who is treated as the partner for purposes of the Partner Eligibility Rule—the tax owner, the nominee, the trustee, the beneficial owner, or some other person. Note that, although a DRE typically is disregarded for federal income tax purposes, in a similar context, the IRS concluded that a DRE, and not its owner, was treated as the owner of a partnership interest for purposes of the Small Partnership

139 See sections 851 and 856.
140 Blue Book at page 58.
141 See section 1361(a)(2) for the definition of a C corporation. Because S corporations must be domestic entities, a foreign entity that is treated as a corporation for U.S. federal income tax purposes would be a C corporation.
142 Under the entity classification rules, the only domestic eligible entities that must be classified as corporations for federal tax purposes are those that are either per se corporations (such as incorporated entities or certain special taxpayers such as insurance companies and REITs) or those that elect to be classified as corporations.
143 Id.
144 See new Code section 6221(b)(2)(A).
exception from TEFRA.145 Further, although the Blue Book provides examples illustrating how DREs and trusts might be treated for purposes of the 100-or-Fewer Requirement, it does not directly address who is treated as the partner for purposes of the Partner Eligibility Requirement.146 Administrative guidance on how the Partner Eligibility Rule should be implemented in these situations would be helpful.

2. 100-or-Fewer Requirement

Although the 100-or-Fewer Requirement in the statute may seem straightforward, it may raise some surprising practical issues, depending upon how it is implemented.

As a threshold matter, it is important to note that the 100-or-Fewer Requirement is based on the number of Schedules K-1 required to be furnished, rather than the number actually furnished, during the tax year. Thus, a partnership may want to pay close attention to transactions that could cause it to be required to issue more than the threshold number of Schedules K-1 in a year. For example, a partnership that never has more than 100 partners at any given time during the year might nevertheless fail the 100-or-Fewer Requirement if several transfers of interests occur during the year (even as a result of nonrecognition events), so that more than one Schedule K-1 is issued for an interest in the partnership. Further, absent guidance as to what it means to be “required” to issue more than 100 Schedule K-1s, a partnership that routinely provides a separate Schedule K-1 for each class of interest held by a single partner might want to consider whether issuing the additional Schedules K-1 could affect the partnership’s ability to make the Election Out.

Moreover, the Blue Book suggests that partnerships with certain kinds of partners—such as S corporations, DREs, trusts, and other partnerships (to the extent permissible under administrative guidance)—might need to employ a counting rule that could cause the number of Schedules K-1 treated as required to be furnished to add up quickly. Specifically, the Blue Book suggests that a partnership with S corporation shareholders must count both the Schedule K-1 that the partnership is required to furnish the S corporation, as well as the Schedules K-1 that the S corporation is required to furnish its shareholders, for purposes of the 100-or-Fewer Requirement. The Blue Book includes an example147 that generally provides as follows:

Example Twenty-Two

A partnership has as partners 49 individuals as well as one S corporation. The S corporation has 30 shareholders (all individuals). For purposes of the 100-or-Fewer Requirement, the partnership is treated as required to furnish 80 Schedules K-1 (i.e., the 49 individuals, plus the S corporation, plus the 30 S corporation shareholders).148

In addition, the Blue Book indicates that administrative guidance that applies rules similar to those for S corporation partners to other kinds of partners for purposes of the 100-or-Fewer Requirement “shall

146 See discussion infra.
147 See note 37 for simplifying assumptions that apply to all the examples in this article.
148 Blue Book at page 59.
take into account” both direct and indirect owners of the partnership. Further, in an example, the Blue Book suggests that a partnership that has a single-member LLC classified as a DRE as a partner might be treated as furnishing Schedules K-1 to both the LLC itself and the owner, even though only one Schedule K-1 is required to be issued. It is not clear why the Blue Book suggests this treatment.

The Blue Book provides the following examples of its interpretation of the 100-or-Fewer Requirement:

**Example Twenty-Three**
One of a partnership’s partners is an LLC with a single owner that is classified as a DRE for federal income tax purposes. According to the Blue Book, administrative guidance may provide that the partnership may be able to make the Election Out if (1) it discloses the names and taxpayer identification numbers of the DRE and its owner and (2) both the DRE and its owner are taken into account “as if each were a statement recipient” in determining if the 100-or-Fewer Requirement is met.

**Example Twenty-Four**
One of a partnership’s partners is a trust. According to the Blue Book, administrative guidance may provide that the partnership may be able to make the Election Out if (1) it discloses the names and taxpayer identification numbers of the trustee, each person who is deemed to be the owner of the trust, and any other person the Secretary considers appropriate; and (2) each of those persons is taken into account “as if each were a statement recipient” in determining if the 100-or-Fewer Requirement is met.

**Example Twenty-Five**
One of a partnership’s partners is another partnership. According to the Blue Book, administrative guidance regarding tiered partnerships may provide that, to make the Election Out, the “lower-tier” partnership (1) must disclose the name and taxpayer identification number of all its direct partners as well as all its indirect partners (in every tier), and (2) must take into account all such direct and indirect partners in determining if the 100-or-Fewer Requirement is met.

**B. Election Timing and Mechanics**

To make an Election Out for a tax year, the partnership must file an election with its timely filed return for the tax year and include (in the manner prescribed by Treasury) the name and taxpayer identification number of each partner in the partnership (unless the Treasury provides alternative identification for foreign partners). The partnership also must notify each such partner of the Election

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149. See Blue Book at pages 59-60.
150. See Instructions to Form 1065, which provide that, if a single-member LLC classified as a DRE is the owner of the partnership interest, the partnership should enter the name, address, and taxpayer identification number of the owner of the DRE on the Schedule K-1 rather than the name, address, and TIN of the DRE.
151. See note 37 for simplifying assumptions that apply to all the examples in this article.
152. Blue Book at pages 60-61.
Out. 154 Administrative guidance is needed regarding the procedures for notifying partners of an Election Out.

As explained above, if a partner is an S corporation, the partnership also must provide the IRS with the name and taxpayer identification number of each of the S corporation’s shareholders with respect to which a Schedule K-1 is required to be furnished (in accordance with procedures prescribed by Treasury). Likewise, administrative guidance allowing a partnership with other partnerships as partners to make the Election Out may require the partnership to disclose the names and identification numbers of all its direct and indirect partners and to notify all those partners of the election.155

Because the Election Out must be filed with the timely filed tax return for the tax year, a partnership cannot wait until the return for the year is audited to make the Election Out. Thus, a partnership may want to make the determination of whether to make the Election Out part of its standard return preparation filing process for each tax year. Further, because an affirmative Election Out may need to be made for each tax year with respect to which the partnership wants to make such an election,156 it appears that an eligible partnership could make an Election Out for some tax years, but not for others.

V. Practical Implications Today

As the discussion above highlights, the New Rules represent a whole new world for partnership audits. Although the New Rules are generally effective with respect to tax years beginning after December 1, 2017, the New Rules need to be considered today and have many practical, economic, business, legal, and investor relations implications.

A. Some Considerations for Audited Partnerships

Given the New Rules, the recent reorganization of the resources of the IRS with respect to partnerships, and the spotlight on the effectiveness of partnership audits, it is likely that taxpayers will see an increase in the number of partnership audits, the types of issues raised, and the potential for imputed underpayments.

If there is a partnership audit for a tax year beginning before December 31, 2017, the partnership might be able to adopt the New Rules early (but not to Elect Out) by making an election in the form and manner prescribed by the IRS.157 The IRS has not yet issued guidance regarding how to elect to apply the rules early. However, once such guidance is available, partnerships that are audited may want to consider whether to make an election to apply the New Rules early (assuming they are eligible). Given the many uncertainties associated with the New Rules, caution would need to be exercised before becoming an “early adopter.” However, there may be limited situations in which an audited partnership may want to apply the New Rules early (if possible). This could be the case, for example, if an audit indicates that too much income, or too few deductions, were reported for a tax year and the New Rules...
would allow the resulting adjustment to be taken into account as a current year loss by the appropriate partners.

Once the new law goes into effect more generally, partnerships will have to make a number of decisions during the course of the audit process. Some of these decisions may be affected by other decisions a partnership previously may have made, such as whether it made an Election Out with respect to a return that is audited. 158 As indicated above, if the partnership makes an Election Out on its return for a tax year, the assessment and collection rules that currently apply to Small Partnerships that have elected out of TEFRA generally would apply with respect to such year.

If a partnership has not made an Election Out and the IRS determines that there is an imputed underpayment for a reviewed year, the partnership will need to determine whether (1) to pay the imputed underpayment at the partnership level under the General Rules for Underpayments or (2) to “push out” adjustments to reviewed-year partners under the Alternative Method. Because much about the New Rules is still not clear, partnerships will need to incorporate future guidance in their decision-making process as it becomes available. Nonetheless, based on the law as it stands today, following are some of the key considerations an audited partnership that has not made an Election Out may need to address with respect to this decision:

To Pay or to Push?

- **Who has the ability to make the decision?**
  - Has a Partnership Representative been selected?
  - How does the partnership agreement provide for the Partnership Representative to make the decision?
  - Are there particular information needs or reporting responsibilities that have been or should be imposed by the partnership agreement?

- **Are there legal, financial, or other considerations that affect the decision?**
  - Has the partnership previously agreed to push the adjustment to the reviewed year partners? (Such agreement may have been required by parties interested in protecting partnership assets from exposure to federal tax liabilities, such as tax-exempt investors and creditors.)
  - Has the partnership considered the impact of paying at the partnership level on its audited financial statements?
  - Does the partnership agreement allow, or require, the partnership to pay in the case of an amount that is considered insignificant?

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158 As stated previously, a partnership cannot make an Election Out for a tax year beginning prior to January 1, 2018.
• **Is there a difference in the amount the partnership would pay under the General Rules for Underpayments relative to the amount the reviewed-year partners would pay under the Alternative Method?**
  
  - Consider the character of the adjustment items and ability to net at the partnership level.
  
  - Consider the federal tax rate the partnership would pay with respect to an underpayment as opposed to the actual federal tax rates applicable to the reviewed-year partners.
  
  - Consider that, if the partnership pays, its tax liability is calculated with respect to the reviewed year and is paid in the current year (but generally should not affect tax attributes of the partners, such as NOLs, unless the Amended Return Rule is used to reduce the imputed underpayment). If the partnership pushes, the reviewed-year partners perform the As-If Computation, which takes into account the amount a partner’s reviewed-year chapter 1 tax liability would be increased, as well as any positive impact of the adjustment on years between the reviewed year and the current year (taking into account the impact of any partner-level attributes, such as NOLs).
  
  - Consider that, if the partnership pays, the interest rate would be 2 percent less than under the Alternative Method.
  
  - Consider that, if the partnership pays, it will also pay any penalties. Under the Alternative Method, the reviewed-year partners are liable for payment of penalties, but it is not currently clear how each partner’s share of such penalties would be determined.
  
  - Are there modifications to the imputed underpayment amount that might eliminate, or significantly reduce, the amount the partnership would pay under the General Rules for Underpayments? For example:
    
    - Will the reviewed-year partners file amended returns and pay the associated tax due?
    
    - Can the partnership demonstrate to what extent a partner would not owe tax by reason of its tax-exempt status?
    
    - What was the tax-exempt partner’s allocable share of the imputed underpayment amount for the reviewed year?
    
    - Consider the possibility that the payment of the imputed underpayment may be funded by partnership debt and the allocation of the nondeductible payment as a partner or partnership non-recourse deduction.
• **Is there a difference in which partners ultimately will bear the burden of the underpayment?**
  - Have there been changes in ownership of partnership interests between the reviewed year and the adjustment year?
  - If so, investor relations and other issues may come into play in deciding whether “to pay or to push."

• **How will some of the significant uncertainties with respect to the New Rules be resolved?**
  - How will as-yet-to-be-issued guidance apply the Alternative Method to upper-tier partnerships?
    - If an acceptable mechanism is not provided for those partners to “push out” the adjustments to past-year partners, might investor relations and other business issues be raised?
  - How would a payment by the partnership (which is generally treated as a non-deductible payment) be allocated by the partnership among the partners?
  - What would be the ramifications on tax items in future years of paying at the partnership level or pushing to the partners?
  - Will future guidance provide for adjustments (under both the General Rules for Underpayments and the Alternative Method) to reflect the impact of imputed underpayments on affected items (such as the basis of the partnership property or the basis of the partner’s interest in the partnership)?

• **What other practical considerations come into play?**
  - Are there any contractual offsets to any payment by the partnership or a partner (such as required contributions, holdbacks, or indemnities)?
  - Will the partnership be able to meet various procedural requirements of the General Rules for Underpayments, such as the need to gather and provide certain information within the close of 270 days following the date on which the NOPA is mailed?
  - Will the partnership be able to meet the procedural requirements of the Alternative Method, such as electing the method within 45 days after the date of the notice of final partnership adjustment?

As the above highlights, determining the ramification of “paying versus pushing” could be complex and different partners may have conflicting interests. As a general matter, it is reasonable to expect that, in an effort to manage the consequences of a partnership audit in a manner that is considered equitable to partners (and lenders), many partnerships will require the Partnership Representative either to Elect Out of the New Rules or to elect the Alternative Method, unless the imputed underpayment amount is considered insignificant.
B. Tax Partnerships and Structural Considerations

Taxpayers may want to review today their current and future structures and arrangements in light of the New Rules. For example, as explained below, taxpayers may want to identify arrangements that potentially could be subject to the New Rules. Taxpayers also may want to consider with their legal advisors the interplay between their organizational structures and the new potential exposure of partnership assets to partnership-level tax liabilities.159

As indicated above, the new law may apply to any “partnership” that has a filing requirement under section 6031(a). The regulations under section 6031(a) generally provide that:

- Every domestic partnership must file a return. A partnership that has no income, deductions, or credits for federal income tax purposes for a tax year is not required to file a partnership return for that year.

- A foreign partnership is not required to file a partnership return, but only if the foreign partnership does not have gross income that is (or is treated as) effectively connected with the conduct of a trade or business within the United States (“ECI”) and does not have gross income (including gains) derived from sources within the United States (U.S.-source income). Said differently, if a foreign partnership has gross income that is ECI or U.S.-source income, it is required to file under section 6031(a) and could be subject to the New Rules.

As a result, increased consideration should be given to creating side or “shadow” partnership agreements for hybrid entities currently not operated according to partnership agreements in order to take into account the New Rules, including the need to designate a Partnership Representative (and the possibility of making an Election Out).160

In addition, collaboration agreements and other similar arrangements should be carefully evaluated. If these arrangements are properly classified as partnerships for federal tax purposes, provisions should be included to take into account the New Rules (or to provide for an Election Out).

Moreover, an arrangement such as a series partnership should be carefully evaluated to determine if the arrangement is properly classified as a single partnership or many partnerships in order to determine how best to take into account the new law.

C. Partnership Agreement Considerations

Partnership agreements that were in place on the date of enactment likely will need to be amended to take into account the new law. Thus, partnerships will need to work with their legal counsel in determining what modifications are appropriate in light of their particular facts and circumstances. The
discussion below highlights some of the issues that partnerships may want to discuss with their counsel.

At a minimum, partnership agreements likely will need to be amended to address the fact that TEFRA has been repealed and the designation of a Partnership Representative will need to be made. It is worth noting that this likely will involve more than merely replacing the tax matters partner (“TMP”) with a Partnership Representative. The responsibilities and obligations of the TMP are different from those of the Partnership Representative and should be given unique consideration. Issues that may need to be addressed include:

- The manner in which the Partnership Representative is selected or replaced
- The responsibilities and obligations of the Partnership Representative in the case of an audit
- The manner in which the Partnership Representative will decide which regime the partnership will pick in the event of an audit
- The ability and obligations of the Partnership Representative with respect to making an Election Out

Furthermore, TMPs often have been given responsibilities in the partnership agreement beyond what was required by TEFRA and these responsibilities may not be appropriate to assign to the Partnership Representative. For example, the partnership agreement may have charged the TMP with signing the partnership return. The partnership return must be signed by a partner in the partnership. Absent guidance issued otherwise, if the Partnership Representative is not a partner, then the Partnership Representative ought not be designated as the party responsible for signing the partnership return.

Moreover, partnership agreements will likely need to be amended beyond merely designating a Partnership Representative. Other issues that may need to be addressed include:

- The funding of any potential partnership-level tax liability (for instance, to provide for a capital call and ramifications for defaulting partners)
- Income allocations and distributions, including the manner in which the burden of any payment of a potential partnership-level tax liability will be borne by the partners
- The reporting requirements the partnership may impose on its partners (for instance, to provide information requested by the partnership within 270 days (or less))

For new partnership agreements, the same items may need to be considered.

Given that there are still many unanswered questions regarding the New Rules, if a partnership is able to easily amend its agreement in the future when more guidance has been provided, the parties may want to make minimal amendments today and delay more substantive amendments until the future. Alternatively, a partnership that has limited ability to amend may decide to wait to make revisions until after more guidance is available. Partnerships also may want to explore with counsel providing mechanisms in their agreements regarding how future guidance will be taken into account.
Unfortunately, until future guidance is issued, it will be difficult for partnerships to determine exactly what modifications to their agreements are necessary to address them. Hopefully, the IRS will issue appropriate guidance to taxpayers well in advance of the effective date of the new regime, so that partnerships may make the necessary modifications to their agreements.

D. Investor and Lender Response

The New Rules create a new risk for both investors in, and lenders to, partnerships—i.e., the risk that partnership assets may be taken to satisfy a federal income tax liability; prior to the new law becoming effective, this risk traditionally resides solely with the partners. Based on the response to date, it appears that some creditors may require partnerships to elect the Alternative Method. Some investors (particularly tax-exempt investors) may have the same request or requirement. However, some partnerships may be hesitant to limit their flexibility before the New Rules are clarified.

E. Partnership Due Diligence

The New Rules will have a significant impact on due diligence that occurs prior to an acquisition of a partnership interest, either through a purchase from an existing partner or through a direct contribution to a partnership.

Prior to the New Rules becoming effective, most partnerships have not been obligated to pay federal tax with respect to income or adjustments resulting from audits. Instead, the liability for any federal tax due with respect to an understatement or incorrect allocation of income by a partnership generally has been borne by one or more partners for the tax year at issue. Thus, the federal tax due diligence of a partnership may have been limited, for instance, to questions about the section 704(c) method used by the partnership.

For years to which the new law applies, however, a potential acquirer of a partnership interest would be wise to invest significantly more time and resources in investigating federal tax matters, given the possible imposition of a partnership-level tax with respect to prior-year tax liabilities. Consider the following example.161

Example Twenty-Six

X purchases a partnership interest from an existing partner. There is subsequently an audit of the partnership. If the partnership Elects Outs or the partnership elects the Alternative Method, the burden of an adjustment resulting in an imputed underpayment should be borne by the selling partner. However, if the partnership pays at the partnership level under the General Rules for Underpayments, X may end up bearing the burden of a portion of the liability for the underpayment, unless X takes measures to reduce its risk through indemnity agreements, holdback, escrows, or a discounted purchase price. This could be the case even if X is a tax-exempt entity. See Example Six, above.

161 See note 37 for simplifying assumptions that apply to all the examples in this article.
In addition, acquirers of partnership interests should be aware that, under the Rules for Reallocations, the IRS can find an imputed underpayment as a result of the positive adjustments from a reallocation of income among reviewed-year partners. Historically, it was generally unlikely that the IRS would examine a partnership’s allocations, particularly if all the partners were in the same tax bracket. Under the Rules for Reallocations, the IRS has a new incentive to examine and challenge the allocations in most partnerships because, even if the taxable income of the partnership is unchanged, an imputed underpayment could result from an underallocation to some reviewed-year partners. Further, the burden of the imputed underpayment could fall on the partners in the adjustment year if the partnership pays tax under the General Rules for Underpayments.

Thus, prior to the acquisition of an interest in a partnership, a potential acquirer may want to take into account the new law and the partnership’s response to that law. Relevant inquiries may address (but would not be limited to):

- The identity of the Partnership Representative
- Any restrictions or limitations on the actions of the Partnership Representative with regard to partnership tax matters
- Whether the partnership is eligible to make the Election Out and whether such election will be made for each tax year
- If the partnership is eligible to make the Election Out, whether there are any restrictions or limitations on transfers of interests in the partnership (or transfers of interests in an S corporation that owns an interest in the partnership) that could cause the partnership to fail the 100-or-Fewer Requirement
- If the partnership is not eligible to make the Election Out, whether the partnership is obligated to apply the Alternative Method with respect to any imputed underpayment or whether it might be required to pay a partnership liability with the partnership assets
- Whether the partnership has entered into indemnification or other agreements with reviewed-year partners that might affect the purchaser’s potential exposure to partnership-level tax with respect to past-year underpayments

The above questions would apply in the context of an acquisition of a partnership interest by purchase or by contribution. Depending on the answers to these questions, a potential acquirer may be well advised to devote time and resources to investigating any uncertain tax positions that could result in an imputed underpayment to the partnership in an adjustment year after the acquisition. To the extent there is any reason for concern in this regard, the potential acquirer of an interest in a partnership may want to consider requesting indemnities, holdbacks, escrows, or a reduction of purchase price.

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162 One commentator has questioned whether restrictions on the Partnership Representative will, or even may, be taken into account by the IRS when auditing a partnership. See “Practitioner Calls for Clarifying Election Out Rules,” 2015 TNT 229-9 (Nov. 30, 2015), a letter to the editor from Monte Jackel.
Note also that the dynamics of due diligence may be different if the purchaser acquires all the interests in the partnership. In such a case, the partnership should cease to exist for federal tax purposes under section 708(b)(1)(A) as a result of the acquisition. Section 6241(7) of the new law provides that, if a partnership ceases to exist before a partnership adjustment takes effect, the adjustment must be taken into account by the former partners of the partnership under regulations to be issued by the IRS and Treasury. However, care should also be taken in determining that the partnership has, in fact, ceased to exist under section 708(b)(1)(A). For example, if the acquirer is a partnership itself, its acquisition of interests may result in a continuation of the target partnership (either with or without a technical termination under section 708(b)(1)(B)) for federal tax purposes. Therefore, despite the fact that new legal entities are formed, if there is a continuation of the partnership for federal tax purposes, the purchaser may have exposure for a subsequent imputed underpayment amount.

VI. Conclusion

The new partnership audit rules can be expected to raise significant economic, business, legal, and practical considerations for partnerships, their partners, and their creditors. Although the new law generally is effective for returns filed for partnership tax years beginning after 2017, taxpayers need to consider now how the new law may affect them and what agreements they may need to put into place before the law goes into effect. Unfortunately, there are still many significant issues for which legislative clarification or administrative guidance is needed. Hopefully, such clarification and guidance will be provided soon.