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The New Partnership Audit Rules

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Partnership audit rules

Background

The IRS historically has struggled in auditing partnerships under the procedures provided.

— Prior to TEFRA, the IRS had to undertake separate examinations for each partner, following deficiency procedures separately to adjust items from a partnership and determine the resulting tax for each partner.

— In 1982, Congress enacted the TEFRA audit procedures establishing unified rules allowing the IRS to make adjustments to "partnership items" at the partnership level in one proceeding, with such adjustments then being reflected through computational adjustments to the partner's returns.

— In 1997, Congress enacted a centralized audit regime that large partnerships (i.e., 100 or more partners) could elect into, but few made the election.

— In 2013, Congress requested that the GAO investigate partnerships and the IRS's audit rate with respect to partnerships.

— In 2014, the GAO issued the report indicating a significant growth in large partnerships (100 or more direct or indirect partners and $100 million or more in assets), but showing an audit rate of only .8% for large partnerships as compared to a 27.1% rate for large corporations.

Overview

The Bipartisan Budget Act of 2015 (the "BBA") establishes new rules for partnership audits and assessment of tax.

— Change the way partnerships are assessed tax and, for the first time, make a partnership liable for U.S. federal income tax.

— Generally effective for partnership returns filed for tax years beginning after December 31, 2017.

  – Early election into regime is possible under Reg. §301.9100-22T.

— TEFRA and electing large partnership rules repealed.

— The Protecting Americans From Tax Hikes Act of 2015 (the "PATH Act"), enacted on December 18, 2015, contained certain changes to the rules.

— The Tax Technical Corrections Act of 2016 (H.R. 6439 and S. 3506) introduced on December 6, 2016 ("Technical Corrections"), would clarify the new rules in a number of important ways.

— Proposed regulations were released online and through tax media on January 18, 2017 but were "pulled" from the Federal Register as a result of the new administration's regulatory freeze on January 20, 2017.

— New proposed regulations were issued on June 14, 2017.

Why are the new rules important?

— Fundamentally change how tax related to partnerships is assessed and collected upon audit.

— May change the risk analysis in evaluating uncertain tax positions.

— Should be considered in connection with due diligence.

— Raise structuring considerations.

— Require changes to new and existing partnership agreements and related documents (e.g., purchase agreements).

— May affect financial statement reporting.

— Will have state tax implications.

What are the key considerations under the new rules?

— How is return filing impacted?
— Who has authority to communicate with the IRS and make decisions on behalf of the partnership in the context of an audit?
— How is a deficiency calculated and assessed under the new rules?
— How does a partnership voluntarily adjust amounts reported on a return in light of the new rules?
— How do the logistics of a partnership audit change as a result of the new rules?
— How do partners protect themselves in the context of a partnership audit (e.g., role in decision-making and economic responsibility for deficiency amounts)?
— How do parties who acquire a direct or indirect interest in a partnership after a taxable year that produces an adjustment protect themselves from responsibility for such adjustments?

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Items That Are Subject to the Partnership Audit Rules

What Adjustments are Subject to the New Audit Rules

The proposed regulations define the scope of adjustments that are the subject of the rules very broadly, including not just changes in timing, character, source, existence, or allocation of income, gain, loss, or deductions, but also certain items that typically would be reported on a partner's return, such as disguised sale gain.

What Adjustments are Subject to the New Audit Rules

More specifically, under Prop. Reg. §301.6221(a)-1(b)(1), the phrase "items of income, gain, loss, deduction, or credit" that are the subject of the rules means all items and information required to be shown, or reflected, on a return of the partnership under section 6031, the regulations thereunder, and the forms and instructions prescribed by the IRS for the partnership's taxable year, and any information in the partnership's books and records for the taxable year. This phrase includes --

— the character, timing, source, and amount of the partnership's income, gain, loss, deductions, and credits, including whether an item is deductible, tax-exempt, or a tax-preference item;
— the character, timing, and source of the partnership's activities, including whether the partnership's activities are passive or active;
— contributions to, and distributions from, the partnership, including the value, amount, and character of those contributions and distributions (for example, for purposes of section 704(c)), 721(b), 721(c), 737, and 751(b));
— the partnership's basis in its assets, the character and type of the assets, and the value (or revaluation such as under section 1.704-1(b)(2)(iv)(f) or (s) of this chapter) of the assets; including any effect the character or value of the partnership's assets has on the sale or exchange of an interest in the partnership (for example, for purposes of section 751(a));
— the amount and character of partnership liabilities, including whether a liability is recourse or nonrecourse and any changes to those liabilities from the preceding tax year;
— the separate category, timing, and amount of the partnership's creditable foreign tax expenditures described in section 1.704-1(b)(4)(viii)(b) of this chapter;

What Adjustments are Subject to the New Audit Rules

Under the proposed regulations, the phrase "items of income, gain, loss, deduction, or credit" means all items and information required to be shown, or reflected, on a return of the partnership under section 6031, the regulations thereunder, and the forms and instructions prescribed by the IRS for the partnership's taxable year, and any information in the partnership's books and records for the taxable year. This phrase includes -- (cont'd)

— any elections made by the partnership and the consequences or effects of those elections, including a section 754 election, any election referenced in section 703(b), a section 761 election, and an election under section 6221(b) or 6226(a);
— ***items related to transactions between a partnership and any person including disguised sales***, guaranteed payments, section 704(c) allocations, and transactions to which section 707 applies;
— any item resulting from a partnership terminating under section 708(b)(1)(A) (including as a result of a transaction under Rev. Rul. 99-6);
— items and any effects from a technical termination under section 708(b)(1)(B); and
— partner capital accounts, including the release of a partner from a deficit restoration obligation.

Technical Corrections contain a provision that is consistent with the proposed regulations. Technical Corrections §201 (amending I.R.C. §6241(2)).

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Return Filing

Binding Nature of Partnership Reporting

Partners generally are required to report consistently with the partnership. I.R.C. §6222(a); Prop. Reg. §301.6222-1(a).

— A partner may take an inconsistent position in some circumstances if the partner provides notification of the inconsistency in accordance with forms, instructions, and other guidance provided by the IRS. I.R.C. §6222(c); Prop. Reg. §301.6222-1(c)(1).

  – Under no circumstances may a partner take a position that is inconsistent with the partnership with respect to items reflected on an administrative adjustment request under section 6227 (discussed at slides 50 - 54) or a "push-out" statement filed by the partnership under section 6226 (discussed at slides 39 - 49). Prop. Reg. §301.6222-1(c)(2).

— If a partner impermissibly reports inconsistently with the partnership, the IRS may adjust the inconsistently reported item to make it consistent, and the IRS may assess and collect the underpayment under expedited procedures as if the amount was due to a mathematical or clerical error. I.R.C. §6222(b); Prop. Reg. §301.6222-1(b).

The Audit: The Partnership Representative

Authority of the Partnership Representative

The Partnership Representative is the only party who the IRS is required to communicate with in an audit and is the only person who may bind the partnership in an audit. I.R.C. §6223(a).

— The actions of the Partnership Representative bind the partnership, partners, and any person whose tax liability is determined by reference to audit adjustments (e.g., indirect partners). Prop. Reg. §301.6223-2(a).

— The Partnership Representative has sole authority to act on behalf of the partnership. Prop. Reg. §301.6223-2(c)(1).

— No person other than the Partnership Representative may participate in an audit without the permission of the IRS. *Id.*

— The Partnership Representative has authority to bind the partnership by virtue of designation, without regard to any limitations on authority by virtue of contract or state or local law. Prop. Reg. §301.6223-2(c)(1) and (2).

Issues for Other Partners

Partners do not have rights to:

— Participate in the partnership level examination or litigation;

— Receive notice of partnership proceedings;

— Challenge the Partnership Representative's actions (e.g., settling partnership adjustment issues or extending the period of limitations on assessment of partnership items); or

— Challenge the merits of an adjustment that is pushed out to them by the partnership.

Partnership agreement should consider notification rights and recourse among partners, but partnership agreement will not affect authority of the Partnership Representative nor validity of actions taken by the Partnership Representative.

Identifying the Partnership Representative

Partnership Representative must have "Substantial Presence in US" and "Authority to Act for Partnership." I.R.C. §6223(a); Prop. Reg. §301.6223-1(b)(1) and (2).

— Substantial Presence—1) ability to meet in person with IRS at reasonable time and place; 2) a US street address and US phone number reachable during business hours; 3) a US TIN. Prop. Reg. §301.6223-1(b)(2).

— Capacity to Act—1) not dead; 2) not incarcerated; 3) not judicially incapacitated; 4) not dissolved if an entity; 5) IRS has not determined PR unable to act. Prop. Reg. §301.6223-1(b)(4).

An entity may serve as the Partnership Representative so long as an individual who meets the substantial presence and capacity to act requirements is appointed by the partnership through which the "Entity Partnership Representative" will act. Prop. Reg. §301.6223-1(b)(3).

The IRS may designate a Partnership Representative if the Partnership fails to do so or the designated Partnership Representative is ineligible. Prop. Reg. §301.6223-1(f).

— The IRS will notify the partnership and the most recent Partnership Representative and provide an opportunity for the partnership to designate a successor Partnership Representative before itself designating a Partnership Representative. *Id.*

Identifying the Partnership Representative

The Partnership must designate a Partnership Representative for each taxable year. I.R.C. §6223(a); Prop. Reg. §301.6223-1(c)(1).

— The Partnership Representative generally is designated on the partnership return for the taxable year to which the designation applies. Prop. Reg. §301.6223-1(c)(2).

The Audit: Setting the Stage

Key Definitions

NOAP

— Notice of administrative proceeding (i.e., notice of audit). I.R.C. §6231(a)(1).

NOPPA

— Notice of proposed partnership adjustment. I.R.C. §6231(a)(2).

FPA

— Notice of final partnership adjustment. I.R.C. §6231(a)(3).

Reviewed year

— Partnership taxable year to which the partnership item being adjusted relates. Prop. Reg. §301.6241-1(a)(8).

Adjustment year. Prop. Reg. §301.6241-1(a)(1).

— Generally, partnership taxable year which includes the date that is 90 days after the FPA is mailed. I.R.C. §6234.

– If, however, the partnership petitions to dispute the partnership adjustment in court, the relevant date is the date when the court's decision becomes final.

General Framework

Election Out of New Rules

— General "non-TEFRA" rules that were not modified by BBA apply

— BUT, partnership must satisfy certain eligibility requirements

- 100 or fewer Schedules K-1
- Eligible partners (excludes partnerships, trusts, and disregarded entities)

— Election made each year on partnership's timely filed return

General Rule – Partnership "Pays"

— Partnership taxed at highest section 1 or 11 rate in current year

— Adjustment year partners bear economic burden

— Consider possibility of reducing "imputed underpayment amount" (which, in some cases, may require reviewed year partners to file amended returns)

— Adjustments resulting in "overpayments" taken into account and allocated by partnership in adjustment year

— Interest and penalties determined at partnership level

Alternative Rule – Partnership "Pushes"

— Reviewed year partners increase chapter 1 taxes in "current year" based on "as if amended" formula for the reviewed year through the current year

— Partners pay interest at increased rate and penalties

The Audit: Opting Out of the New Partnership Audit Rules

Opting Out of the New Audit Rules

Under certain circumstances, a partnership may elect for the new partnership audit rules to not apply.

— If this election is made, the audit rules pre-TEFRA would apply, so that the audit and assessment process essentially is undertaken on a partner-by-partner basis.

Eligibility to Opt Out of the New Audit Rules

In order to opt out, a partnership must

— Have 100 or fewer partners. I.R.C. §6221(b)(1)(B); Prop. Reg. §301.6221(b)-1(b)(1).

– Determined by number of statements (e.g., Form K-1s) the partnership is required to file.

– Look through S corporations and treat shareholders as partners.

— Each statement for the entire taxable year must be provided to an "eligible partner." I.R.C. §6221(b)(1)(C); Prop. Reg. §301.6221(b)-1(b)(1).

– An eligible partner does *not* include

— a partnership,

— a trust,

— a eligible foreign entity that would not be treated as a C corporation if it were a domestic entity,

— a disregarded entity,

— a nominee or other similar person that holds an interest on behalf of another person, or

— an estate of an individual other than a deceased person. Prop. Reg. §301.6221(b)-1(b)(3)(ii).

Election to Opt Out of the New Audit Rules

The election to opt out must be made each taxable year on the partnership's timely filed return and must include all information required by the IRS, including information regarding partners (and shareholders of S corporation partners). Prop. Reg. §301.6221(b)-1(c).

— The partnership must notify its partners within 30 days of making the election. Prop. Reg. §301.6221(b)-1(c)(3).

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The Audit: Determining the Partnership-Level Adjustment

What Adjustments are Subject to the New Audit Rules

Under section 6225, the partnership is directly liable for any "imputed underpayment," and the imputed underpayment must be paid in the "adjustment year." Prop. Reg. §301.6225-1(a).

How Are Adjustments Assessed Under the New Audit Rules?

Under section 6225, the partnership must pay any "imputed underpayment" with respect any "partnership adjustment" for any taxable year in the same manner as if the imputed underpayment was a tax imposed for the adjustment year. Prop. Reg. §301.6225-1(a).

— An imputed underpayment is calculated by multiplying the "total netted partnership adjustments" by the highest Federal income tax rate in effect for the reviewed year under section 1 or 11 (and increasing or decreasing such amount by increases or decreases in credits). Prop. Reg. §301.6225-1(c).
  – This amount is subject to modification, as described in slides 35 -36.

What Adjustments are Subject to the New Audit Rules

In calculating the imputed underpayment, adjustments are first divided into four groups:

— Reallocations of a distributive share of items (taking into account only allocations of increased income or gain or reduced deductions or loss);

— Adjustments to credits;

— Adjustments to creditable expenditures; and

— Remaining adjustments taken into account in a residual grouping. Prop. Reg. §301.6225-1(d)(2).

Adjustments in Groups 1 and 4 above are considered together in determining the "total netted partnership adjustment," which is multiplied by the highest tax rate. Prop. Reg. §301.6225-1(c)(1).

— Adjusted credits then are considered in arriving at the imputed underpayment. *Id.*

What Adjustments are Subject to the New Audit Rules

Within each grouping, adjustments are further grouped into subgroupings based on preferences, limitations, restrictions and conventions, such as source, character, holding period, or restrictions applicable to such items. Prop. Reg. §301.6225-1(d)(1).

Items are netted within each grouping or subgrouping, but items cannot be netted among groupings or subgroupings. Prop. Reg. §301.6225-1(d)(3)(i).

— For example, adjustments increasing ordinary income and reducing capital gain will fall into separate subgroupings and hence cannot be netted.

Only adjustments resulting in a net positive adjustment for a grouping or subgrouping are taken into account in calculating the "total netted partnership adjustment." Prop. Reg. §301.6225-1(d)(3)(ii).

— That is, you add together all net positive adjustments (i.e., generally taxpayer-unfavorable adjustments) to determine the "total netted partnership adjustment" that forms the basis for the imputed underpayment.

How Are Adjustments Assessed Under the New Audit Rules?

While adjustments that result in an imputed underpayment create a partnership level tax liability under section 6225, if a partnership adjustment does not result in an "imputed underpayment," there is no refund to the partnership.

— Instead, the adjustment must be taken into account by the partnership in the adjustment year and allocated to the partners in that year. Prop. Reg. §301.6225-3.

— Allocation of such adjustments among the partners generally is left to determination under the partnership agreement. REG-136118-15 (preamble).

  – Special rules are provided, however, for reallocations that do not result in an underpayment, and those rules are intended to ensure that the reviewed year partners who are the subject of the adjustment (or their transferees) are allocated the adjustment. Prop. Reg. §301.6225-3(b)(4).

How Are Adjustments Assessed Under the New Audit Rules?

An adjustment does not result in an imputed underpayment if

— The adjustment relates to a reallocation of increased deduction or loss or decreased income or gain to a partner;

— The result of netting within a grouping or subgrouping is a "net non-positive adjustment" (i.e., generally a taxpayer favorable adjustment like increased deductions or loss or reduced gain or income); or

— There would be no imputed underpayment by reference to total netted partnership adjustments because of an increase in credits resulting from adjustments. Prop. Reg. §301.6225-1(c)(2).

How Are Adjustments Assessed Under the New Audit Rules?

Note that, by separating adjustments that result in an imputed underpayment from those that don't, it is possible that, with respect to any reviewed year, a partnership may have both

— an imputed underpayment payable by the partnership attributable to the total netted partnership adjustment (i.e., positive adjustments in groupings or subgroupings); and

— other adjustments not taken into account as part of total netted partnership adjustments (i.e., generally taxpayer-favorable adjustments), which will the allocated to partners in the adjustment year.

For example, if the IRS recharacterizes capital gain items as ordinary income items, an imputed underpayment will be calculated based upon the increase in ordinary income (i.e., a net positive adjustment), and the corresponding reduction in capital gain (i.e., a net non-positive adjustment) will be allocated to partners in the adjustment year.

Example Under Section 6225

Consider a situation where, with respect to a two-person 50-50 partnership (A and B), the IRS re-classifies for the 2018 taxable year $100 of capital gain to ordinary income and separately reallocates $100 of ordinary rental income from A to B.

— The partnership must consider adjustments that will combine to determine the total netted partnership adjustment that result in the imputed underpayment.

  – The reallocation of $100 of rent to B will represent a "group 1" adjustment in arriving at the total netted partnership adjustment.

  – The $100 increase in ordinary income will represent a "group 4" residual adjustment in arriving at the total netted partnership adjustment.

— The partnership must separately consider adjustments that would not result in an imputed underpayment.

  – The reallocation of $100 of rent from A cannot be netted with the adjustments above.

  – The $100 reduction in capital gain will be reflected as a reduction in such gain - this will result in a net non-positive adjustment that cannot offset adjustments set forth above (since the capital loss is a different character than the other items).

— The total netted partnership adjustment that determines the imputed underpayment would equal $200.

— The $100 reallocation from A and $100 reduction in capital gain would be allocated by the partnership in the adjustment year.

Permitted Modifications to Partnership Adjustments

The Partnership Representative may request modification of a proposed imputed underpayment by reference to reviewed year partners. Prop. Reg. §301.6225-2(a).

— A partner may file an amended returns for all affected years taking the proposed adjustments into account, and if this is done, such partner's share of the adjustment will be excluded from the calculation of the imputed underpayment.

  – The partner must file such returns for all affected years and pay the related tax within the 270-day modification period (*see* slide 60).

  – The partnership must provide affidavits from such partners as to the filing and payment.

  – If a partnership adjustment reallocates the distributive share of income from one partner to another, the modification will be approved only if all partners affected by the adjustment file amended returns.

— The partnership can request modification with respect to tax-exempt partners (as defined under section 168(h)(2)(A), (C), and (D)) to the extent such partners would not be subject to tax on the adjusted income.

  – A tax-exempt partner can include a non-U.S. partner who would not owe tax with respect to such income.

— The partnership can request modification for rate differences (i.e., rates below 39.6% highest rate) for corporations (35% highest applicable rate), or individuals (with respect to capital gain or qualified dividend income).

— If a REIT pays a deficiency dividend in accordance with section 860, the IRS will take the dividends paid deduction into account in determining the imputed underpayment attributable to the REIT partner.

Permitted Modifications to Partnership Adjustments

The Partnership Representative may request modification of a proposed imputed underpayment by reference to reviewed year partners. Prop. Reg. §301.6225-2(a).

— A partnership may request modification based on a closing agreement entered into by the IRS and any partner (or indirect partner) pursuant to section 7121, and, if approved by the IRS, the IRS will allow modification with respect to a partnership adjustment that is fully taken into account by such partner (or indirect partner) under a closing agreement and for which the required payment under the closing agreement is made.

  – The preamble to the proposed regulations states: "Commentators requested that an alternative modification be available to partners that involved a summary or schedule of adjustments that reflect what would happen if an amended return were filed, rather than requiring the partners to file amended returns. The IRS will take into account closing agreements entered into as partners to the degree they affect the imputed underpayment, and the partners could use this modification option to accomplish the goal of avoiding amended returns." REG-136118-15 (preamble).

    — Technical Corrections would provide for an alternative "pull-in" procedure that could accomplish the same goal. Technical Corrections §203 (adding a new I.R.C. §6225(c)(2)(B)).

  – A partnership may request a modification not otherwise described, and the IRS will determine whether such modification is accurate and appropriate.

Modifications may be requested with respect to indirect partners holding interests through a pass-through entity.

Permitted Modifications to Partnership Adjustments

After the IRS makes a determination as to whether a requested modification is accurate and appropriate, the IRS will notify the Partnership Representative of the approval or denial, in whole or in part, of any request for modification. Prop. Reg. §301.6225-2(c)(4).

Basis and Capital Account Adjustments

The proposed regulations reserve on the adjustments to adjusted basis and capital account determinations resulting from adjustments under section 6225. Prop. Reg. §301-6225-4.

— According to the preamble, future regulations will provide that, if the partnership pays an imputed underpayment attributable to an item of income, gain, loss, or deduction, the partnership will allocate that item in the adjustment year to the adjustment year partners treating such items as items of income, gain, loss, or deduction as non-taxable or non-deductible under section 705(a)(1)(B) or 705(a)(2)(B). REG-136118-15 (preamble).
  – Future regulations also will provide rules for adjustments to inside basis and book value of partnership property if the adjusted items are basis derivative.

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The Audit: Election to "Push Out" a Partnership Adjustment

Section 6226 Push-Out Election

With respect to "reviewed year" audits, section 6226 allows the partnership to provide information to "reviewed-year" partners to pay the relevant tax with respect to the partnership adjustments.

— Under the proposed regulations, if a partnership makes a valid election under section 6226, the reviewed year partners must take into account their share of the partnership adjustments that relate to the imputed underpayment as well as penalties and interest. Prop. Reg. §301.6226-1(b)(1).
  – The additional tax imposed with respect to the adjustments is reported by each partner in the partner's taxable year that includes the date when the statement reporting the adjustments under section 6226 is furnished to the partner. Prop. Reg. §301.6226-3(a).

— Under the proposed regulations, adjustments that do not result in an imputed underpayment will not be taken into account by the partnership in the adjustment year, as is the case under section 6225, but instead such amounts will be included in the reviewed year partners' share of the partnership adjustments reported to the reviewed year partners of the partnership. Prop. Reg. §301.6226-1(b)(2).
  – Under the proposed regulations, taxpayer favorable adjustments may be netted against other adjustments in a year under section 6226, but the adjustment cannot result in a refund taken into account for a year.
  – Technical corrections would allow such adjustments reported under section 6226 to result in a refund. Technical Corrections §206 (amending I.R.C. §6226(b)).

Section 6226 and Tiered Partnerships

The proposed regulations reserve on the application of section 6226 to tiered partnership arrangements.

— Technical Corrections would allow an adjustment to be "pushed out" through tiers of partnerships. Technical Corrections §204 (amending I.R.C. §6226(b)(4)).
  – Under the Technical Corrections, if a partner that is a pass-through entity in a tiered arrangement receives a statement under section 6226, that partnership must file a "tracking report" providing such information as is required by the IRS not later than the due date for the return (including extensions) for the taxable year of the *audited partnership* which includes the date the final determination was made with respect to such partnership.
    — A tracking report may require information identifying the partner's own partners or shareholders (if an S corporation), describing an quantifying adjustments necessary to determine partnership-related items or the equivalent in the hands of those partners or shareholders, or other information necessary or appropriate to assessment and collection from tiers of partners.
  – Statements under section 6226 also must be provided to the ultimate partners not later than the due date for the return (including extensions) for the taxable year of the *audited partnership* which includes the date the final determination was made with respect to such partnership.

Calculation of Partner Tax Liability

Under the proposed regulations, the tax due from a partner who is the subject of an election under section 6226 is equal to the "additional reporting year tax." Prop. Reg. §301.6226-3(a).

— Unless a safe harbor election is made, the "additional reporting year tax" is equal to the aggregate of the "correction amount" calculated for each taxable year beginning with the reviewed year and ending with the taxable year immediately before the reporting year. Prop. Reg. §301.6226-3(b)(1).

— For any taxable year, the "correction amount" is equal to the amount of the tax increase for such partner for such taxable year determined by taking into account the adjustments for such year. Prop. Reg. §301.6226-3(b)(2) and (3).
  – Under proposed regulations, the "correction amount" can only result in a tax increase – an adjustment or combination of adjustments in a taxable year that would decrease a partner's tax liability for such year will be ignored. Prop. Reg. §301.6226-3(b)(1).
  – Technical Corrections would allow for the pushing out of favorable net adjustments for a year that could result in a reduction in a partner's tax liability, so presumably the approach taken in the proposed regulations will change if Technical Corrections are enacted. Technical Corrections §206(e) (amending I.R.C. §6226(b)).

Example Under Section 6226

Consider a situation where, with respect to a two-person 50-50 partnership (A and B), the IRS re-classifies for the 2018 taxable year $100 of capital gain to ordinary income and separately reallocates $100 of ordinary rental income from A to B.

- Partner A would receive a statement relating to 2018 reporting three adjustments: (1) a $50 increase in ordinary income; (2) a $50 decrease in capital gain; and (3) a $100 reduction in ordinary rental income.
  - Under the proposed regulations, A would separately determine the increase in tax liability (i.e., correction amount) resulting from the adjustments for each year between the reviewed year (2018) and reporting year (assume 2021) taking into account the adjustments to tax attributes, but A could not report a reduction in tax.
    - Assuming that A could net the $50 increase and $100 decrease in ordinary income, A would have no increase in tax liability and hence there would be no correction amount.
  - Under Technical Corrections, A could file a claim for refund based upon a negative adjustment to ordinary income or capital gain under section 6226.

Example Under Section 6226

Consider a situation where, with respect to a two-person 50-50 partnership (A and B), the IRS re-classifies for the 2018 taxable year $100 of capital gain to ordinary income and separately reallocates $100 of ordinary rental income from A to B. (cont'd)

- Partner B would receive a statement relating to 2018 reporting three adjustments: (1) a $50 increase in ordinary income; (2) a $50 decrease in capital gain; and (3) a $100 increase in ordinary rental income.
  - Under the proposed regulations, B would separately determine the increase in tax liability (i.e., correction amount) resulting from the adjustments for each year between the reviewed year (2018) and reporting year (assume 2021), but B could not report a reduction in tax.
    - B's correction amount for each year would depend on the presence of other tax attributes, such as net operating loss carryovers, etc.
    - If B had a net operating loss carryover in 2018, such that the $150 net increase in ordinary income and $50 reduction in capital gain did not create a tax liability or correction amount, the adjusted NOL (and possibly capital loss carryforward) would be carried forward to 2019, and B would determine if there was a correction amount in 2019. The same would be done for 2020. The sum of all correction amounts (plus interest and penalties) would be reported on B's return for the 2021 taxable year, the reporting year.
  - Under Technical Corrections B could have a negative correction amount in a year.
    - For example, if the reduction in capital gain resulted in a capital loss carryforward for 2018, a reduction in taxable capital gain in 2019 could result in a negative correction amount for 2019.

Safe Harbor Amount Under Section 6226

As an alternative, a reviewed year partner may elect to pay a "safe harbor amount." Prop. Reg. §301.6226-3(c).

- The safe harbor amount is calculated in the same manner as the imputed underpayment under section 6225, except that the reviewed year partner's share of the partnership adjustments on the statement is used instead of adjustments taken into account under section 6225. Prop. Reg. §301.6226-2(g)(2)(i).
  - In calculating the safe harbor amount, the only modifications that may be taken into account are with respect to amended returns and closing agreements. Prop. Reg. §301.6226-2(g)(2)(ii).

Penalties and Interest

Penalties are reported to each reviewed year partner in the same proportion as the partner's share of the adjustment to which the penalty relates. Prop. Reg. §301.6226-2(f)(3).

- If a penalty does not relate to a specific adjustment, each reviewed year partner's share of the penalty will be determined consistent with how partnership allocations with respect to such items would have been made, unless penalties are allocated differently in the final determination of adjustments. *Id*.

Interest is determined differently depending on whether the partner reports under the general rule or elects to pay the safe harbor amounts.

- Under the general rule, interest on the correction amounts is the aggregate of all interest calculated for each taxable year at the general underpayment rate under section 6221(a)(2)(B) increased by 2 percentage points (calculated from the due date of the reviewed year partner's return, without extensions). Prop. Reg. §301.6226-3(d)(1).
- Interest on the safe harbor amount is calculated at the same rate from the due date of the reviewed year partner's return (without extensions) for the first affected year (i.e., the reviewed year) *until the amount is paid*. Prop. Reg. §301.6226-3(d)(2)(i).
  - As an alternative, for partners who are individuals, interest may be paid at the same rate, but calculated from the due date (without extensions) of the reviewed year partner's return for the first affected year *until the due date (without extensions) for the reviewed year partner's return for the reporting year*. Prop. Reg. §301.6226- 2(g)(2)(iii) & 3(d)(2)(ii).

REITs, RICs, and Deficiency Dividends

A REIT or RIC may utilize the deficiency dividend procedures under section 860 if the REIT or RIC receives a statement under section 6226 that includes adjustments within the meaning of section 860(d).

- If a REIT or RIC has an adjustment (within the meaning of section 860(d)) for the first affected year or any intervening year, the REIT or RIC may make a determination (under section 860(e)(4)) and avail itself of the deficiency dividend procedures set forth in section 860. Prop. Reg. §301.6226-3(b)(4).
- Interest under section 6226 is only calculated on any correction amount determined after deducting any deficiency dividend deduction from the adjustments taken into account by the REIT or RIC. *Id*.
  - A REIT or RIC, however, is liable for interest on the deficiency dividend distribution under section 860(c)(1).

Basis and Capital Account Adjustments

The proposed regulations reserve on the adjustments to adjusted basis and capital account determinations resulting from adjustments under section 6226.

- According to the preamble, future regulations will provide that, "in the adjustment year, adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property should be adjusted to what they would have been if the adjustments were made in the reviewed year to reviewed year partners and then modified to take into account all intervening events considered in computing the amount by which the tax imposed under chapter 1 would increase for any intervening year – for example, amortization or depreciation of property." REG-136118-15 (preamble).
  - Special rules will be needed if a reviewed-year partner is not the same person as an adjustment-year partner or if property that is the subject of an adjustment has been disposed of between the reviewed year and adjustment year.

Partnership Ceases to Exist

If a partnership ceases to exist before any partnership adjustment takes effect, the partnership adjustment must be taken into account by the former partners. I.R.C. §6241(7); Prop. Reg. §301.6241-3(a).

— A former partner of a partnership that ceases to exist must take partnership adjustments into account its share of adjustments as if the partnership had made an election to push out the adjustments under section 6226. Prop. Reg. §301.6241-3(e)(1).

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The New Amendment of Partnership Return Procedure – Administrative Adjustment Request

Section 6227 Administrative Adjustment Request

A partnership no longer will be allowed to file an amended partnership return.

Instead, a partnership may file an administrative adjustment request ("AAR") with respect to items of income, gain, loss, deduction and credit of the partnership, and any partner's distributive share thereof for any taxable year. I.R.C. §6227(a); Prop. Reg. §301.6227-1(a) & -2(a).

— In filing an AAR, the partnership must determine whether the adjustments result in an "imputed underpayment" (determined in accordance with section 6225 rules) for the reviewed year. Prop. Reg. §301.6227-1(a) & -2(a).

  – If the adjustments result in an imputed underpayment, the partnership must take the adjustments into account under rules similar to section 6225, unless the partnership elects to push out the adjustments under rules similar to section 6226. Prop. Reg. §301.6227-1(a).

Section 6227 Administrative Adjustment Request

Under the general rule, the partnership will pay tax on the imputed underpayment, as calculated under section 6225, with certain differences in the permitted modifications. Prop. Reg. §301.6227-2(a).

— The partnership may not modify the imputed underpayment by having the partners file amended returns or by entering into a closing agreement with the IRS. Prop. Reg. §301.6227-2(a)(2).

— The partnership is not required to seek IRS approval prior to modifying an imputed underpayment as reported on an AAR. Prop. Reg. §301.6227-2(a)(2)(i).

The imputed underpayment must be paid on the date the partnership files the AAR. Prop. Reg. §301.6227-2(b)(1).

— Interest is imposed for the period beginning on the due date of the partnership return for the reviewed year (without extensions) and ending after the earlier of the date payment of the imputed underpayment is made, or the due date of the partnership return for the adjustment year. Prop. Reg. §301.6227-2(b)(2).

— The IRS may impose penalties with respect to the imputed underpayment. *Id.*

Section 6227 Administrative Adjustment Request

The partnership may elect to push out the adjustments to reviewed-year partners under rules similar to section 6226. Prop. Reg. §301.6227-2(c) & -3.

— As under section 6226, the impact of the adjustments are determined for the reviewed year and intervening years, and the cumulative difference in tax is reported on the partner's reporting year return. Prop. Reg. §301.6227-3(b)(1).

— If adjustments do not result in an imputed underpayment, the partnership must push out the adjustments under these rules. Prop. Reg. §301.6227-2(d) & -3(a).

  – That is, unlike the current rules under section 6226 (and not the Technical Corrections), the partner can claim a refund with respect to overall favorable adjustments when in connection with an AAR. Prop. Reg. §301.6227-3(b)(2).

— Unless otherwise determined by the IRS, each partner's share of the adjustments set forth in an AAR statement is binding on the partner. Prop. Reg. §301.6227-1(f).

  – That is, a partner is not permitted to take a position inconsistent with an AAR, even if disclosure is filed.

Section 6227 Administrative Adjustment Request

An AAR may only be filed after a partnership return for the taxable year has been filed. Prop. Reg. §301.6227-1(b).

— A partnership may not file an AAR with respect to a partnership taxable year more than 3 years after the later of the date the partnership return was filed or the last day for filing such return (without extensions). *Id.*

— A partnership may not file an AAR after a notice of administrative proceeding with respect to such taxable year has been mailed by the IRS. *Id.*

The filing of an AAR will extend the statute of limitations for the partnership return to the date that is 3 years after the filing of the AAR. I.R.C. §6235(a)(1)(C).

Conducting a Partnership Audit under the New Rules

Electing Out of the New Audit Rules

In order to elect out of the new partnership audit rules, the partnership must make the election on a timely filed return, including extensions, for the taxable year to which the election applies. Prop. Reg. §301.6221(b)-1(c)(1).

— Once a partnership audit begins, it will be too late to elect out.

Initiation of the Partnership Audit

A partnership audit will begin with the receipt of a notice of administrative proceeding for a partnership taxable year. I.R.C. §6231(a)(1).

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Determining Proposed Adjustments

Following receipt of the notice of administrative proceeding, the IRS agent will communicate with the Partnership Representative in reviewing partnership reporting and potentially determining proposed partnership adjustments.

— The IRS Agent has discretion to determine that partnership adjustments for the same partnership taxable year may result in more than one imputed underpayment. Prop. Reg. §301.6225-1(e)(1).

– A partnership may request that the IRS include one or more partnership adjustments in one or more particular groupings or subgroupings and may request that the IRS determine one or more specific imputed underpayments based on such groupings. Prop. Reg. §301.6225-2(d)(6).

– There are two types of imputed underpayments – general and specific. Prop. Reg. §301.6225-1(e)(2)(i).

— A specific imputed underpayment is an imputed underpayment with respect to adjustments to an item or items that were allocated to one partner or a group of partners that had the same or similar characteristics or that participated in the same or similar transaction. Prop. Reg. §301.6225-1(e)(2)(iii).

— A general imputed underpayment is calculated based on all adjustments not taken into account in determining a specific imputed underpayment. Prop. Reg. §301.6225-2(e)(2)(ii).

— Different imputed underpayments can allow the partnership to make different decisions (section 6225 or 6226) in addressing liability for such underpayments.

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IRS Issues NOPPA

After determining the proposed adjustments, the IRS will issue to the partnership a NOPPA (i.e., notice of proposed partnership adjustment). I.R.C. §6231(a)(2).

— Upon receipt of the NOPPA, the partnership has the decision to move forward under section 6225 or 6226 with respect to each imputed underpayment.

— There is some indication that the formal appeals process generally available in connection with an audit will not be available once the NOPPA is issued.

– The preamble to the proposed regulations states: "the IRS may agree to review certain information prior to the issuance of the NOPPA in an effort to resolve issues in an expedited fashion and eliminate the need to make certain adjustments. In addition, the modification process may move faster if relevant information is provided to the IRS employees conducting the administrative proceeding prior to issuance of the NOPPA. However, once the NOPPA is issued, the modification procedures under proposed §301.6225-2 are the partnership's only formal route to request changes to an imputed underpayment set forth in the NOPPA." REG-136118-15 (preamble).

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Applying Section 6225

If the Partnership Representative determines to apply section 6225 with respect to an imputed underpayment, the partnership may request modification of the proposed imputed underpayment set forth in the NOPPA (e.g., partner amended returns, tax-exempt partners, etc.). Prop. Reg. §301.6225-2(a).

— A request for modification, together with all supporting documentation, generally must be submitted on or before 270 days after the date the NOPPA is mailed, although the IRS may consent to an extension requested by the partnership. I.R.C. §6225(c)(7); Prop. Reg. §301.6225-2(c)(3).

– In order to modify an imputed underpayment based upon a partner's filing of an amended return, the partner must have filed the amended return and paid all taxes, penalties, and interest for the first affected year and all modification years before the expiration of the 270-day period. Prop. Reg. §301.6225-2(d)(2)(ii).

— The IRS will notify the Partnership Representative in writing of its approval or denial, in whole or in part, of any request for modification. Prop. Reg. §301.6225-2(c)(4)

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Issuance of FPA

Following the 270-day period (as possibly extended) and determination of accepted modifications, the IRS will issue the FPA (i.e., notice of final partnership adjustment). I.R.C. §6231(a)(3).

— The Partnership Representative and the IRS may agree, in writing, to waive the 270-day period after the IRS mailing of the NOPPA and before the IRS issues the FPA. Prop. Reg. §301.6225-2(c)(3)(iii).

— The waiving of the 270-day period will allow the earlier issuance of an FPA, which will permit the Partnership Representative to elect earlier to push-out adjustments under section 6226 or to contest the adjustment in court.

Election to Apply Section 6226

If the Partnership Representative determines to push out adjustments under section 6226, it must file an election within 45 days of the date the FPA is mailed by the IRS. I.R.C. §6226(a)(1); Prop. Reg. §301.6226-1(c)(3).

Final Determination of Partnership Adjustments

Partnership adjustments are finally determined upon the later of:

— The expiration of the 90-day period following mailing of the FPA to file a petition in court under section 6234; or

— If a petition under section 6234 is filed, the date when the court's decision becomes final. Prop. Reg. §301.6226-2(b)(1).

Fulfilling Section 6226 Requirements

Within 60 days of when the adjustment is finally determined, the partnership must provide separate statements of adjustment to the partners for each reviewed year. Prop. Reg. §301.6226-2(b)(1).

— Under Technical Corrections, if an adjustment is "pushed out" through tiers of partnerships, the statements must be provided to the ultimate recipient by the filing date of the return for the taxable year of the audited partnership that includes the date that the adjustment is finally determined.

- Each partner that is a pass-through entity also must provide a tracking report by the same date.
- The Joint Committee report explaining the Technical Corrections indicates that the due date of the audited partnership's return includes extensions for purposes of this provision. Jt. Comm. on Tax'n, *Technical Explanation of the Tax Technical Corrections Act of 2016.*

— The statement must be mailed to a partner's current or last-known address, and if the statement is returned as undeliverable, the partnership must undertake reasonable diligence to identify a correct address. Prop. Reg. §301.6226-2(b)(2).

— A REIT that receives a statement can pay a deficiency dividend under section 860 to account for the adjustment. Prop. Reg. §301.6226-2(h)(1) & -3(b)(4).

- If a REIT pays the deficiency dividend, it will not owe interest under section 6226 (since it will owe no tax with respect to the adjustment), but it will owe interest determined under section 860 with respect to the deficiency dividend. Prop. Reg. §301.6226-3(b)(4).

The partnership must electronically file such statements with the IRS within the same period. Prop. Reg. §301.6226-2(c).

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Points to Consider in Deciding Between Sections 6225 and 6226

Comparison of sections 6225 and 6226

Under section 6225

— Partners do not have to be bothered with audits involving de minimis amounts.

— The imputed underpayment impacts adjustment-year partners, which may cause inequities if the interests of partners have changed between the reviewed year and adjustment year.

— Calculation of tax involves highest applicable rate unless modifications are available.

- Partnership must take steps to obtain modifications for partnership prior to issuance of FPA.
- Adjustments still are at the highest rate within the modification class.

— Calculation of tax is at the partnership level by reference to groupings according to character, preferences, restrictions, and other limitations on the item adjusted.

— Adjustments that do not result in an imputed underpayment (i.e., reductions in income or increases in loss) are allocated by the partnership in the adjustment year to the relevant reviewed year partners or their successors (or if none, among the remaining partners).

- It is possible to have certain items that result in an imputed underpayment payable by the partnership and certain items that do not result in an imputed underpayment (e.g., recharacterize capital gain as ordinary income – increase in ordinary income results in imputed underpayment for the partnership in the adjustment year, and reduction in capital gain results in allocation of capital loss to partners in adjustment year).

Comparison of sections 6225 and 6226

Under section 6226

- Reviewed-year partners must recalculate their taxable income attributable to the adjustment (including the impact on years following the reviewed year) and pay the related tax in the adjustment year (unless the partner pays the safe harbor amount).
- Partnership must issue statements of adjustment and calculate safe harbor amount.
- The interest charge is 2 percentage points higher than applies under section 6225.
- Calculation of tax is specifically by reference to the reviewed-year partner's tax attributes.
- Under Technical Corrections, it would be possible to claim a refund with respect to net favorable adjustments pushed out under section 6226.
- Under Technical Corrections, it would be possible to push out adjustments through tiers of partnerships, although coordination of information may be burdensome.

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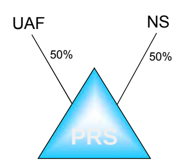
Examples

Recharacterize Capital Gain as Ordinary Income



PRS has two equal partners: (1) tax-exempt University of Alabama Foundation ("UAF"), and (2) Nick Sabin ("NS"), an individual.

In 2018, PRS reported the sale of property generating $100 of gain as capital gain, and that is PRS's only income, gain, loss, or deduction for 2018.

In 2020, the IRS audits and determines that the partnership was a "dealer" and the gain is properly taxable as ordinary income.

Recharacterize Capital Gain as Ordinary Income

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6225.

- The adjustments to be taken into account are a $100 increase in ordinary income and a $100 decrease in capital gain.
- The dealer income would be UBTI for tax-exempt UAF, so UAF's share would not qualify for modification as tax-exempt income.
- UAF would be taxable as a corporation, so a modification requesting reduction of the rate applicable to $50 of the ordinary income adjustment from 39.6% to 35% could be available.
- Assuming modification for UAF is approved, the imputed underpayment related to the positive ordinary income adjustment would equal $37.30 (($50 x 39.6% = 19.80) and ($50 x 35% = $17.50)).
  - Interest and possibly penalties also would be assessed.
- PRS would have a net non-positive adjustment of a $100 reduction in capital gain that would be allocated 50-50 to UAF and NS in the adjustment year (assume adjustment year is 2021).

Recharacterize Capital Gain as Ordinary Income

The Partnership Representative also should analyze the impact of making an election under section 6226.

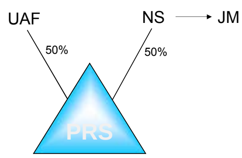
- By electing to push out the adjustments, UAF and NS would account for the $100 increased allocation of ordinary income in 2018.
  - Assuming that the final determination of partnership adjustments occurs and partner statements are provided in 2021, each partner would separately determine the impact of the increased allocation of ordinary income and reduction in capital gain on its tax liability for 2018 (the reviewed year), 2019 (an intervening year), and 2020 (an intervening year).
    - The total increased tax would be reported on each partner's 2021 tax return.
    - Assuming that the capital gain reduction can be fully utilized against net capital gain in 2018, the correction amount for 2018 would equal $9.80 (($50 x .39.6% = $19.8) – ($50 x 20% = $10)) for NS and $17.50 (($50 x .35% = $17.5) – ($50 x 0% = $0) (i.e., capital loss is not a UBTI loss).
    - The items do not affect intervening year reporting in 2019 or 2020, so the additional reporting year tax for NS would be $9.80 and for UAF would be $17.50.
    - Interest and possibly penalties also would be payable by NS and UAF, and the interest would be payable at a rate that is 2 percentage points higher than would be payable under section 6225.
  - As an alternative, NS and/or UAF could pay the safe harbor amount, which would equal the amount due under section 6225, except that the modification to the 35% rate for UAF would not be available.

Recharacterize Capital Gain as Ordinary Income

In comparing the results under section 6225 and 6226

- Under section 6225, PRS would pay $19.80 by reference to NS and $17.50 by reference to UAF.
  - Each partner also would be allocated $50 of reduced capital gain in 2021.
    - If NS otherwise has capital gain in that year, and the capital gain tax rate is still 20%, the capital gain offset would reduce NS's taxable income in that year by $10 essentially bringing the tax cost attributable to NS to $9.80, although interest would have accrued on $19.80.
    - Because the capital gain reduction would not be deductible against UBTI, UAF would obtain no benefit, and the adjustment attributable to UAF would remain $17.50.
  - Note that the tax under section 6225 is simply a tax obligation of PRS, and nothing in the tax law independently provides for the allocation of the burden between NS and UAF.
- Under section 6226, NS would recalculate prior year taxes and pay an additional $9.80 on is 2021 tax return, and UAF would go through the same exercise, paying an additional tax of $17.50 on its 2021 tax return.
  - The interest charge on amounts due would be 2 percentage points higher than under section 6225.
- Given the increased interest charge and inconvenience of requiring partners to recalculate prior year taxes, paying under section 6225 may be a rational choice.
  - If, however, NS was unable to utilize the capital loss in 2021, the dynamic changes, as the total amount payable under section 6225 becomes higher than under section 6226.

Interest Transfer and Recharacterization of Items



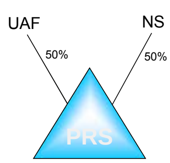
Assume the same facts as above, except NS transfers his PRS interest to Jim McElwain ("JM") in 2019.

Interest Transfer and Recharacterization of Items

In comparing the results under section 6225 and 6226

- — Under section 6225, PRS still would pay a total deficiency of $37.30 (taking into account the modification based on NS's capital gains tax rate).
  - – Note, however, that NS no longer bears any share of the liability assessed against the partnership in 2021, as NS is no longer a partner at that time.
    - — Instead, JM and UAF indirectly bear NS's share of the tax, with each taking into account the amount allocated by the PRS agreement.
    - — The PRS agreement may require NS to indemnify PRS for his share of any tax under section 6225, and, if so, NS may not claim a deduction for the payment. Jt. Comm. on Tax'n, *General Explanation of Tax Legislation in 2015* (Mar. 2016).
  - – The reduced capital gain allocation in the adjustment year will be made to JM, the transferee, and not NS.
    - — If NS contributes to PRS to fund his share of the 2018 assessment, should he seek payment from JM for the value of the capital gain reduction allocation in 2021?
- — Under section 6226, all adjustments are allocated to reviewed year partners, and PRS bears no liability directly, so the result is no different from the previous example if a PRS interest is transferred.
  - – While the interest charge is 2 percentage points higher than under section 6225, section 6226 may provide for a more equitable allocation of the adjustment liability where an interest in PRS has been transferred.

Reallocation of Partnership Income



In 2018, PRS allocated $100 of interest income (i.e., not UBTI) to UAF and $0 to NS.

In 2019, PRS allocated $100 of interest income to NS and $0 to UAF.

In 2020, the IRS audits and determines that PRS should have allocated the income $50 to each of UAF and NS in 2018 and 2019.

Reallocation of Partnership Income

For purposes of both section 6225 and 6226, the adjustments in 2018 and 2019 are determined and applied independently.

- — However, for purposes section 6226, changes in attributes as a result of adjustments in 2018 will affect the calculation of the correction amounts with respect to the 2019 adjustment.

Reallocation of Partnership Income

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6225.

- — In determining the total netted partnership adjustment that is used to calculate the imputed underpayment, in 2018, only the $50 increased allocation to NS will be taken into account, and in 2019, only the $50 increased allocation to UAF will be taken into account.
- — For the 2018 reallocation to NS, no modification (other than an amended return) would be available (as interest income for an individual would be taxable at a maximum rate of 39.6%).
- — For the 2019 reallocation to UAF, a modification of the rate down to 0% could be requested, as the interest income would be taxable at a 0% rate based on UAF's tax-exempt status.
- — Hence, PRS's imputed underpayment due in 2021 would be $19.80 for 2018 and $0 for 2019.
- — The reallocation of $50 away from UAF in 2018 and NS in 2019 does not result in an imputed underpayment, and thus will be allocated in 2021 (assuming this to be the adjustment year), $50 to NS and $50 to UAF, for each as a separately stated item that is a reduction in interest income.
  - – Presumably, the reduction in interest income is treated as a reduction in net investment income under section 163(d)(4) and a reduction in portfolio income under Reg. §1.469-2T(c)(3).
    - — If NS has no interest income in 2021, query whether the reduction in interest income can be carried forward as an interest deduction in future years under section 163(d)(2) (providing for carryforward of disallowed interest deductions).

Reallocation of Partnership Income

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6225.

- — As an alternative, NS and UAF each could file an amended return for 2018 and 2019 (and any other modification years) taking into account the reallocated income.
  - – By doing so, the amendments could be treated as modifications to the adjustments, so long as approved by the IRS, and there would be no imputed underpayment due with respect to PRS.
  - – In order for the amendment to be considered for purposes of determining the modification, NS and UAF each must amend for the relevant years, as each partner is affected by the reallocation.
- — By following the amendment procedure, NS would owe $19.80 (plus interest determined under sections 6601 and 6621(b)) with his amended return for 2018 and would be entitled to a $19.80 refund (plus interest determined under sections 6611 and 6621(a)) with respect to his amended return for 2019.
- — There would be no tax cost (or benefit) for the amendment procedure for UAF, as UAF would not be subject to tax (or entitled to a reduction in tax) since the interest income would not give rise to UBTI.
- — The Partnership Representative also might consider utilizing the closing agreement route to avoid requiring that NS and UAF actually file amended returns (or utilizing the "pull-in" procedure to be provided in Technical Corrections).

Reallocation of Partnership Income

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6226.

- By electing to push out the adjustments, UAF and NS would account for the reallocation of interest income income in 2018 and 2019.
  - Assuming that the final determination of partnership adjustments occurs, and partner statements are mailed, in 2021, the reallocations would be accounted for as follows:
    - In 2018, NS would determine the impact of the increased allocation of $50 of interest income on its tax liability for 2018 (the reviewed year), 2019 (an intervening year), and 2020 (an intervening year).
      - Assuming that NS had not otherwise carried over unused interest deductions from 2018, NS would have a correction amount of $19.80 ($50 x 39.6%) for 2018 and no correction amount for 2019 and 2020.
      - NS would report an additional $19.80 in tax on his 2021 tax return attributable to the 2018 adjustment (together with interest and possibly penalties).
    - In 2018, UAF would determine the impact of the reduced allocation of $50 of interest income on its tax liability for 2018 (the reviewed year), 2019 (an intervening year), and 2020 (an intervening year).
      - UAF is not subject to tax on the interest income, as that income is not UBTI.
      - As a result, the $50 reduction in interest income is 2018 would not reduce UAF's tax liability for 2018, 2019, or 2020.

Reallocation of Partnership Income

Upon receipt of the NOPPA, the Partnership Representative should separately analyze the impact of section 6226 for the reviewed year of 2019.

- Again, assuming that the final determination of partnership adjustments occurs, and partner statements are mailed, in 2021, the reallocations would be accounted for as follows:
  - In 2019, NS would determine the impact of the reduced allocation of $50 of interest income on its tax liability for 2019 (the reviewed year) and 2020 (an intervening year).
    - If NS otherwise has net investment income under section 163(d) in 2019 (i.e., interest deductions did not offset prior $50 over-allocation of interest income), the reduced allocation seemingly should offset such amount, thereby reducing taxable income for the year.
      - Under the current statute and proposed regulations, a taxpayer cannot claim a refund based upon adjustments under section 6226. The "corrected amount" for any year (i.e., the reviewed year or intervening year) cannot be less than $0.
      - Technical Corrections, however, would allow for a corrected amount that results in a refund. In this case, the refund would equal $19.80 (plus interest).
  - In 2019, UAF would determine the impact of the increased allocation of $50 of interest income on its tax liability for 2019 (the reviewed year) and 2020 (an intervening year).
    - UAF is not subject to tax on the interest income, as that income is not UBTI.
    - As a result, the $50 increase in interest income is 2019 would not increase UAF's tax for 2019 or 2020, and there would be no correction amount for those years.

Reallocation of Partnership Income

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6226.

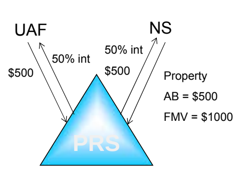
- The safe harbor amount under section 6226 would reflect each partner's share of a section 6225 adjustment, without modification for UAF's tax-exempt status.
- Accordingly, there would be a $19.80 adjustment reported to NS in 2018 and UAF in 2019.

Reallocation of Partnership Income

In comparing the results under section 6225 and 6226

- Under section 6225, PRS still would pay a total deficiency of $19.80, assuming that NS and UAF do not file amended returns, and a $50 reduction in interest income for each of 2018 and 2019 would be reported in 2021 solely to NS with respect to the 2018 adjustment and solely to UAF with respect to the 2019 adjustment.
- Under section 6225, if NS and UAF file amended returns, NS would pay a deficiency for 2018 equal to $19.80 and would receive a refund of $19.80 for 2019. UAF would have no tax liability related to the adjustments.
- Under section 6226, assuming Technical Corrections pass, NS would have a positive correction amount of $19.80 in 2018 and a $19.80 negative correction amount in 2019. Such amounts should offset so that no tax would be reported on NS's 2021 return, except that some interest attributable to the 2018 adjustment (partially offset by the refund interest for 2019) would be reported. UAF would have no tax liability related to the adjustments.
  - If Technical Corrections did not pass, NS could not take advantage of the negative correction amount in 2019, so NS would have an adjustment reported in 2021 of $19.80 attributable to the positive correction amount for 2018. UAF still would have no tax liability related to the adjustments.

Disguised Sale of Property



In 2018, UAF and NS form PRS, with UAF contributing $500 and NS contributing non-depreciable property with a $500 adjusted basis and $1,000 value. PRS distributes the $500 cash to NS, so that UAF and NS are 50-50 partners.

NS treated the property contribution as qualifying for nonrecognition under section 721 and the distribution of cash as qualifying under section 731.

In 2020, the IRS audits and determines that NS should have been treated as undertaking a disguised sale of 50% of the contributed property, recognizing $250 of capital gain which is treated as an item of gain that is a subject of the partnership audit rules.

Disguised Sale of Property

Upon receipt of the NOPPA, the Partnership Representative should analyze the impact of section 6225.

- The adjustment to be taken into account by PRS is $250 of gain.
- The $250 of gain presumably should be allocated/attributable 100% to NS (given that only NS would recognize gain upon such a disguised sale), so any modification to the proposed adjustment should be by reference to NS's tax characteristics.
- NS would be taxable on capital gain at a rate of 20%, so the modified underpayment amount assessed against PRS would be $50 ($250 x 20% = $50) (assuming acceptance of the proposed modification by the IRS).
  - Interest and possibly penalties also would be assessed.

Disguised Sale of Property

The Partnership Representative also should analyze the impact of making an election under section 6226.

- By electing to push out the adjustments, NS would receive a statement from PRS reporting a $250 increase in capital gain for 2018.
  - Assuming that the final determination of partnership adjustments occurs, and partner statements are mailed, in 2021, NS would determine the impact of the $250 of capital gain on his tax liability for 2018 (the reviewed year), 2019 (an intervening year), and 2020 (an intervening year).
    - The total increased tax would be reported on NS's 2021 tax return.
    - Assuming that NS has no capital loss (current year or carryforward) for 2018, the correction amount for 2018 would equal $50 ($250 x .20% = $50).
    - The items do not affect intervening year reporting in 2019 or 2020, so the additional reporting year tax for NS would be $50.
      - UAF would have no additional tax, as no portion of the gain would be allocated to UAF.
    - Interest and possibly penalties also would be payable by NS, and the interest would be payable at a rate that is 2 percentage points higher than would be payable under section 6225.
  - As an alternative, NS could pay the safe harbor amount, which would equal the amount due under section 6225, except that the modification to the 20% rate for NS would not be available, so that the safe harbor amount would be $99 ($250 x 39.6% = $99).

Disguised Sale of Property

In comparing the results under section 6225 and 6226

- Under section 6225, PRS would pay $50.
  - Note that the tax under section 6225 is simply an obligation of PRS to pay a tax, and nothing in the tax law independently provides for the allocation of the burden between NS and UAF.
- Under section 6226, NS would recalculate prior year taxes and pay an additional $50 on his 2021 tax return, and UAF would have no additional tax.
  - The interest charge on amounts due would be 2 percentage points higher than under section 6225.
- If PRS can allocate economic responsibility for the $50 payment to NS (i.e., NS pays PRS for the tax liability either through contributing such amount or reducing distributions due to NS), NS can avoid having to run calculations and reporting on his own and also may bear interest at a rate that is 2 percentage points lower than would apply under section 6226.
  - Would UAF want to be in a position where it is relying on NS to make the contribution, or would it require that the Partnership Representative will elect to push out any adjustment related to the transaction under section 6226?

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Points for Consideration in Drafting Partnership Agreements and Other Transaction Documents

Drafting Partnership Agreements

Partnership agreements will need to be changed or drafted to consider effect of new provisions:

- Designate partnership representative ("PR").
  - Consider standard PR will be held to in carrying out role (e.g., gross negligence, etc.), whether indemnification will be provided, or alternatively whether PR should obtain insurance.
- For partnership level assessments under section 6225, the General Partner should have authority (in consultation with tax advisor) to determine apportionment of responsibility for the payment among the partners.
  - Tax-exempt partners may attempt to negotiate for no share of section 6225 adjustment in all circumstances.
- The partners should be required to provide such information as is requested by the PR in order to reduce the partnership level assessment consistent with section 6225(c) (i.e., tax-exempt partners, corporations entitled to rate below 39.6%, individuals entitled to capital gains rates, affidavits relating to amended returns, or other adjustments).

Drafting Partnership Agreements

Partnership agreements will need to be changed or drafted to consider effect of new provisions:

- The partners (including partners who have transferred their interests) should be required to contribute to fund their share of taxes to the extent that such taxes are not funded with cash already held by the partnership.
  - If the taxes are funded with cash held by the partnership, such amounts should be treated as distributions to the partners based on their relative shares for purposes of applying the distribution waterfall.
  - Partnership agreements often use mechanics of withholding provisions to account for these taxes.
  - A payment of taxes by the partnership should be treated as a payment of non-deductible, non-capitalizable expenditures under section 705(a)(2)(B) for purposes of maintaining capital accounts.
  - If there are allocations that do not result in an imputed underpayment made after a transfer of a partnership interest or redemption of a partner, consideration may be given to accounting for the value of those allocated items on behalf of the transferring or redeemed partner.
- General Partner should have authority to set aside reserves from available cash for partnership level assessment.

Drafting Partnership Agreements

Partnership agreements will need to be changed or drafted to consider effect of new provisions (cont.):

- PR may be given discretion to "push out" audit adjustments to the partners under new section 6226 (and may be required to in some instances).
  - In pushing out through tiers, upper-tier partnerships may provide for timing of receipt of section 6226 statements in order to ensure that such partnerships have time to provide follow-on section 6226 statements to their partners (which also may be upper-tier partnerships).
  - With respect to possible disguised sale transactions, PR may be required to "push out" audit adjustments.
    - Party to possible disguised sale transaction may negotiate decision rights in connection with audit adjustments relating to such transaction.
- PR may be given discretion to elect out of the new audit rules under new section 6221(b).
  - If PR is given such discretion, the PR should have authority to require that partners provide such information requested by PR to determine and prove eligibility to elect out.

Drafting Partnership Agreements

Partnership agreements will need to be changed or drafted to consider effect of new provisions (cont.):

- General Partner should be indemnified by partners for any liability for tax imposed on the partnership that ultimately is collected from the General Partner.
- General Partner should have authority to amend the partnership agreement to the extent that, in consultation with tax and legal counsel, it is determined advisable so as to address the new partnership audit rules, including changes that might occur to such rules by amendment to statute or other guidance.
- Limited Partners may negotiate rights with respect to receipt from the partnership of information, notices, etc. in connection with audits as such items are received from the IRS.
- Limited Partners may negotiate rights with respect to actions that the Partnership Representative may take in connection with audits.
  - Such rights are merely contractual as between the Limited Partners and Partnership Representative and do not limit the IRS's ability to rely on actions taken by the Partnership Representative.

Purchase and Sale Agreements

Additional points must be considered in acquiring a partnership interest.

- Additional diligence may be advisable in order to understand previous tax positions taken by the target partnership and what tax exposure could result from those position.
- Consideration may be given to stronger representations and warranties in connection with the prior tax positions of the partnership given potential exposure for the Buyer with respect to taxes relating to pre-acquisition periods.
- Indemnification provisions will become more significant, as the Buyer will want to ensure that liability for pre-acquisition taxes are borne by the Seller.
  - If the Seller will be required to indemnify the Buyer, the Seller may wish to retain control of audits with respect to pre-acquisition periods.
  - The Seller might prefer that the partnership not make an election to push out the adjustment under section 6226 due to the higher interest charge.
  - In addition, other partners may control or influence the decision as to whether a section 6226 election will be made, so the Buyer (particularly of a minority interest) may not be able to cause the partnership to elect to push out adjustments under section 6226.
  - The Buyer may require that the Seller will file an amended return with respect to pre-acquisition adjustments and that the partnership will allocate any economic exposure for taxes, interest, and penalties to other partners when an amended return is filed.

Purchase and Sale Agreements

Additional points must be considered in acquiring a partnership interest. (cont'd)

- Buyers of upper-tier partnership interests will need to take into account the potential tax liabilities of lower-tier partnerships, and provisions discussed above should be considered with lower-tier partnership tax exposure in mind.
  - The inability to impact decisions for the lower-tier partnership may make it impossible to gain comfort that a push-out election under section 6226 may be made with respect to the lower-tier partnership (and until Technical Corrections pass, a push-out election may not be possible with respect to the upper-tier partnership for lower tier partnership adjustments).
- In connection with a partnership merger, it will be important to determine which partnership is "continuing," as liability for pre-merger taxes attributable to the pre-merger partnership that is the post-merger continuing partnership could be assessed against that continuing partnership unless a push-out election is made under section 6226.
  - The same could be important for acquisitive transactions that are partnership continuations.
- A Buyer will want to ensure that the partnership has not made an election to apply the partnership audit rules to taxable years beginning prior to January 1, 2018, so that the partnership cannot be directly liable for taxes attributable to such period.
- The Buyer may want to have some say in the preparation of pre-acquisition tax returns filed after closing, given the potential exposure for taxes related to positions taken.

Lender Considerations

Partnership lenders also will have a stake in partnership audit decisions.

- A tax liability imposed on the partnership will impact the collateral available to the lender for repayment of its debts.
- Some lenders may require that the partnership agree to make a push-out election under section 6226 with respect to all adjustments (or possibly all adjustments in excess of a threshold amount).

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Q&A

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