NEW FINAL AND PROPOSED REGULATIONS ON THE CENTRALIZED PARTNERSHIP AUDIT REGIME

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The regulations provide guidance on elections-out, tax attribute adjustments, and multi-tiered partnerships.

Over two years ago, Congress enacted into law as part of the Bipartisan Budget Act of 2015 (the "BBA"),[1] as amended by the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"),[2] a new set of tax procedural rules with respect to partnership audits, moving from a two-dimensional set of rules and limitations with respect to auditing partnerships and their partners to a centralized or consolidated partnership regime. Subject to a two-year phase-in, which recently ended for tax years commencing on or before December 31, 2017, the BBA repealed the "two-tier" partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),[3] as well as the electing large partnership regimes.[4] While the new rules may have had a specific purpose in mind—i.e., dramatically improving the administration of the tax law with respect to auditing partnerships and collecting tax revenues from resulting understatements of partnership income tax—the statutory language to the new rules as well as some of its essential core principles reflected not only ambiguities in how the law was to be applied, but revealed problems that some commentators felt requires further congressional action.[5]

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Ensuing Wave of Proposed Regulations and Guidance

After the repeal of the TEFRA entity audit rules and its replacement with the centralized partnership audit rules, the Service had two years to issue definitive guidance under the new regime.[6] This was and continues to be a daunting task for our tax administrators, corroborated not only by a remarkable shift in standard audit rules and principles for auditing partnerships to address in the rule-making procedure, but also by the complex and potentially inequitable outcomes that are generated by the new rules.

The first rule-making under the BBA pertained to the ability of a partnership to "elect-into" the new centralized partnership audit rules (in lieu of applying the TEFRA entity audit rules) for tax years beginning after November 2, 2015, and before January 1, 2018.[7] The ability to make an "early" election into the new centralized audit rules is authorized under section 1101(g)(4) of the BBA. Under Temp. Reg. 301.9100-22T, which was issued on August 5, 2016, partnerships were instructed on the time, form, and manner for a partnership to make an early election-in.[8]

On June 14, 2017, a notice of proposed rulemaking[9] ("June 14 NPRM") implemented the new centralized partnership audit regime. The

Author's Note:

After submission of this Article, Congress, as part of the Bipartisan Consolidated Appropriations Act (BCCA) (P.L. 115-141, March 23, 2018), made long-awaited technical corrections to the partnership audit rules. The technical corrections made to the partnership audit rules included several provisions that were awaiting congressional action for some time.

The BCCA eliminated references to adjustments to items of partnership income, gain, loss, deduction, or credit and replaced them with a more generic "partnership-related items." Partnership-related items are any item or amount used in determining the income tax liability of any partner. Included are an imputed underpayment or an item or amount relating to any transaction with, basis in, or liability of the partnership. This is much broader than the partnership item and affected item concepts under TEFRA. As a second item, while the BBA audit rules do not apply to withholding taxes unless specifically provided, partnership income tax adjustments must be taken into account when assessing withholding taxes. A major new reform in the BCCA is a "pull-in" procedure which permits the modification of an imputed underpayment without requiring the filing by individual partners of an amended return. This is indeed good news. The pull-in procedure results in partner payments and information that may be collected by the IRS. The procedure permits the partnership representative or third-party accounting or law firm to collect the required data and forward it to the IRS. New Section 6232(f) permits the IRS to pursue collections against both a partnership and its partners for the same liability, subject to a ceiling of 100% of the applicable taxes, interest, and penalties. Section 6232(f) is triggered if any amount of an imputed underpayment is not paid within ten days of the agency demanding payment. The new collection provision may prove to be difficult to apply where there is a multi-tiered partnership structure and one or more lower tier partnerships fail to make the required payments of tax. While the BCCA puts some additional language in the BBA, most noteworthy presumably will be the "pull-in" and collection provisions.

June 14 NPRM contained rules pertaining to (1) the scope and election out of the new regime, (2) consistency in reporting by partners, (3) the powers and duties of the partnership representative, (4) partnership adjustments made by the IRS and determinations of the amount of the partnership's liability (referred to as the imputed underpayment), (5) the filing of administrative adjustment requests, and (6) the election for partners to take the partnership adjustments into account (Sections 6221 through 6227 and Section 6241). The June 14 NPRM reserved comment on a number of items, including how pass-through partners take into account adjustments under the push-out election in Section 6226 and similar rules under Section 6227 with respect to administrative adjustment requests ("AARs"). Included in the items reserved in the June 14 NPRM were (1) rules pertaining to partners that are foreign entities;[10] (2) adjustments to partners' outside bases and capital accounts and a partnership's basis and book value in property;[11] and (3) rules coordinating the AAR rules in Section 6227 with creditable foreign taxes incurred by a partnership.[12]

On December 19, 2017, proposed regulations were issued with respect to rules governing push-out elections under Sections 6226 and 6227, including rules for tiered partnership structures, and administrative and procedural provisions.[13] Final regulations with respect to elections out of the centralized partnership audit rules were issued on January 2, 2018, which was one day after the statutory provisions became operative for calendar year partnerships. Then, on February 2, 2018, proposed regulations were issued with respect to adjusting tax attributes, including basis and property inside the partnership, as well as capital accounts.[14]

This article examines three of the four most recent sets of rule-making that were published by the Service and Treasury under the centralized partnership audit rules. There are an extensive number of technical rules and provisions contained in the regulations.

Final Regulations on Eligibility of Partnerships and Partners to Elect Out

On January 2, 2018, the Service and Treasury issued final regulations under Section 6221(b) pertaining to the ability of a partnership to elect-out of the BBA. Since the general effective date of the new rules commenced for tax years beginning after 2017, the government was pressed to release final regulations on the election-out. The final regulations cover three general areas: (1) determining the number of partners of the partnership for purposes of determining whether the partnership has 100 or fewer partners under Section 6221(b); (2) determining who is an eligible partner in determining whether the partnership is an eligible partnership under Section 6221(b); and (3) the election-out mechanical rules and disclosure requirements under Section 6221(b).

Section 6221(b) provides that certain partnerships with 100 or fewer partners may elect for a particular partnership tax year to avoid application of the centralized audit rules. The election-out of the centralized partnership audit regime must be made on a timely filed return of the partnership for such tax year that, in the manner prescribed by the regulations or other guidance, discloses the name and taxpayer identification number of each partner, and the partnership must notify each such partner of the election as provided for in the regulations. The

election-out must be elected by the partnership representative. Special rules apply with respect to S corporation partners and foreign partners with respect to shareholder identification and addresses and nonresident identification and addresses respectively.[15]

Under Section 6221(b)(1)(C), in order for a partnership to elect-out for a particular tax year, it must prove that each of its partners is an individual, C corporation, foreign entity that would be treated as a C corporation, S corporation, or estate of a deceased partner, i.e., an "eligible partner."[16] The Preamble to the June 14 NPRM noted that the IRS had received comments suggesting that it should exercise its authority under Section 6221(b)(2)(C) to expand the types of persons who are "eligible partners" for the election-out rule in Section 6221(b). The government responded that allowing partnerships, single member limited liability companies, and grantors of grantor trusts to be eligible partners would pose additional tax administration and collection problems for the Service. Obviously, the Service may have been stunned by Congress's unexplained expansion of the TEFRA "10 or fewer" eligible election-out rule to the new "100 or fewer K-1 rule."[17] In contrast to new Section 6221(b)'s annual election requirement to "elect out," the "10 or fewer" eligible partner election-out under TEFRA was a permanent election. It is obvious that both Treasury and the Service wanted to avoid liberalizing the types of partners that would qualify under Section 6221(b) in further broadening of the election-out rule. Further expansion of the ten-fold increase in the number of partners allowed to be subject to individual audits, deficiency and assessment, and collection and refund procedures and rights would run the risk of providing an unintended work-around of the new centralized audit rules.[18]

After considering the criticisms it received on the election-out eligibility described in the June 14 NPRM, the final regulations once again decided not to expand the set of "eligible partners" for purposes of Section 6221(b). The Preamble to the final regulations provided a lengthy explanation of the reasons behind this conclusion. In particular, the following statement capsulizes the government's thinking:

> As noted in the preamble to the June 14 NPRM, the number of partnerships has grown substantially in recent years and is likely to continue to grow, compounding the audit and collection inefficiencies extant outside of the new regime for the IRS with each expansion of the eligible partner list. It would undermine the benefits of the new regime to expand the group of partnerships that are eligible to elect out

[1] P.L. 114-74. Act § 1101.

[2] P.L. 114-113.

[3] For a criticism of the TEFRA audit rules, see Prescott, "Jumping the Shark: The Case for Repealing the TEFRA Partnership Audit Rules," 11 Fla. Tax Rev. 503 (2011); Spellmann, "Taxation Without Notice: Due Process and Other Notice Shortcomings with the Partnership Audit Rules," 52 Tax Law. 133, 162 (1998).

[4] See, in general, August and Cuff, "The New Partnership Audit Rules: Guidance Needed, 44 Corp. Tax'n 3 (Jan/Feb 2017); August, "Drafting Partnership Agreements: The New Partnership Representative and the Outgoing Tax Matters Partner," 44 Corp. Tax'n 3 (Sep/Oct 2017); August and Cuff, "The TEFRA Partnership Audit Rules Repeal: Partnership and Partner Impacts," ALI-CLE Video Webcast (July 17, 2016); August, "The Good, the Bad, and Possibly the Ugly in the New Audit Rules: Congress Rescues the IRS from Its Inability to Audit Large Partnerships," 18 Business Entities 4 (May/June 2016); August, "Entity-Level Audit Rules Continue to Pose Challenges for Partners," Parts 1 and 2, 16 Business Entities 4 (Nov/Dec 2014), 17 Business Entities 4 (July/Aug 2015). Budget Act section 1101 repeals the current rules governing partnership audits and replaces them with a new centralized partnership audit regime that, in general, assesses and collects tax at the partnership level. On the new audit provisions generally, see NYS Bar Ass'n, Tax Section, "Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015," Report No. 1347 (May 25, 2016).

[5] See Susswein, "New Partnership Audits Under the Proposed Technical Corrections Bill," Tax Notes Apr. 4, 2017.

[6] The BBA, section 1101(c), replaced the TEFRA rules with a centralized partnership audit regime. Section 1101(c) of the BBA added a new subchapter C to chapter 63 reflected in Sections 6221 through 6241 of the Code. Related and conforming amendments were made to other Code provisions.

[7] BBA section 1104(g)(4).

[8] The temporary regulations were set forth in TD 9780, 81 Fed. Reg. 51795, and proposed rulemaking in REG-105005-16, 81 Fed. Reg. 51835.

[9] REG-136118-15, 82 Fed. Reg. 27334-01.

[10] Prop. Reg. 301.6226-3(c)(f) (2014 NPRM).

[11] Prop. Reg. 301.6226-4 (2014 NPRM).

[12] Prop. Reg. 301.6227-1(b); Section 905. For proposed rules regarding international provisions under the centralized partnership audit regime, see (REG-119337-17) published in the Federal Register on November 30, 2017 (82 Fed. Reg. 56765) (November 30 NPRM). Due to space limitations, this article will not address the recent proposed rule-making on special rules, including withholding, applicable to foreign partners under the BBA. Mr. August will be submitting an article to this Journal on this subject.

[13] 82 Fed. Reg. 60144-01.

[14] 83 Fed. Reg. 4868-01.

[15] Sections 6221(b)(2)(A), (B).

[16] Prop. Reg. 301.6221(b)-1(b)(3).

[17] Under TEFRA, only partnerships with more than ten partners or partnerships with at least one partner that is not a U.S. individual, a C corporation, or an estate of a deceased partner are automatically subject to the TEFRA audit rules. See Section 6231(a)(1)(B).

[18] Comments made in response to Notice 2016-23, 2016-13 IRB 490, suggested that partnerships, disregarded entities, trusts (including tax-exempt trusts, revocable trusts, charitable remainder trusts, grantor trusts, and non-grantor trusts), individual retirement accounts, nominees, qualified pension plans, profit-sharing plans, and stock bonus plans should be considered eligible partners for purposes of making an election under Section 6221(b). Another comment suggested that all tiered partnerships should be eligible to make the election under rules similar to the S corporation rules, which would require counting the number of statements required to be furnished to each pass-through partner in meeting the 100-or-fewer requirement under Prop. Reg. 301.6221(b)-1(b)(2).

of the new regime. Moreover, it would be unwise to do so at a time before the first returns for taxable years subject to the new regime have been filed.[19]

The final regulations parrot the language in Section 6221(b) in terms of who is an "eligible partner" and in describing the limitation of 100 or fewer partners rule.[20] Reg. 301.6221(b)-1(b)(3)(ii) identifies persons who are not eligible partners, including (1) a partnership; (2) a trust; (3) an ineligible foreign entity; (4) a disregarded entity under Reg. 301.7701-2(c)(2)(i); (5) an estate of an individual other than a deceased partner; or (6) any person that holds an interest in the partnership on behalf of another person. Examples provided in the final regulations provide clarity to these limitations.[21]

A significant development in the proposed regulations allows multi-tiered partnerships to be part of the push-out election process, with each level of the partnership tiers having the right to pay the resulting assessment or timely push-out the required tax payment to its partners.

Example 1 [Partnership as an ineligible partner]. During the 2020 tax year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, D, is a partnership. Because D is a partnership, D is not an eligible partner.... Accordingly, Partnership is not an eligible partnership ... and, therefore, cannot make the election [out] ... for its 2020 taxable year.

Example 2 [Disregarded entity S shareholder does not disqualify S Corporation-partner]. During its 2020 tax year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, S, is an S corporation. S has ten shareholders. One of S's shareholders is a disregarded entity, and one is a qualified small business trust. S is an eligible partner ... even though S's shareholders would not be considered eligible partners if those shareholders held direct interests in Partnership.

Example 3 [Disregarded entity ineligible direct partner]. During its 2020 tax year, Partnership has two equal partners, A, an individual, and C, a disregarded entity, wholly owned by B, an individual. C is not an eligible partner.... Accordingly, Partnership is not an eligible partnership ... and, therefore, is ineligible to make the election [out] ... for its 2020 taxable year.

The election-out mechanics are in Reg. 301.6221(b)-1(c). As previously set forth in the 2014 NRPM, an election-out must be made on the eligible partnership's timely filed return—including extensions—for the taxpayer year to which the election applies and must include all information required by the IRS.[22] All information required by the regulations must be disclosed or the election will be invalid. A partnership that makes an election under this section must notify each of its partners of the election within 30 days of making the election in the form and manner determined by the partnership.[23] In general, an election-out is binding on the partnership and all partners unless the IRS determines the election is invalid.[24] Were the IRS to claim an invalid election-out was made or the partner notification required was not satisfied, it is unclear whether the partnership would have recourse to an administrative appeal or judicial review.[25] The language in the regulations does not specifically grant a right of judicial review to the partnership or the partners who presumed that the BBA did not apply for one such year.[26]

[19] Preamble to 83 Fed. Reg. 24-01.

[20] This is based on the actual number of Forms K-1 issued. See Section 6031(b).

[21] Reg. 301.6221(b)-1(b)(3)(iv).

[22] Such partner information that must be disclosed includes (1) each partner's name and correct U.S. tax ID number (or alternative form of identification required); (2) each partner's federal tax classification; (3) an affirmative statement that the partner is an eligible partner; and (4) any other information requested by the IRS in forms, instructions, or other guidance; (5) as to any S corporation partner, each shareholder's name and TIN (or alternative form of identification as required), each shareholder's federal tax classification and any other information as is required by the Service. See Reg. 301.6222(b)-1(c)(2).

[23] Reg. 301.6221(b)-1(c)(3).

[24] Reg. 301.6221(b)-1(e).

[25] See Regs. 301.6221(b)-1(e)(1), 301.6221(b)-1(e)(2).

[26] See Reg. 301.6221(b)-1(e)(2). The Preamble to the rulemaking notes that the Tax Court is a court of limited jurisdiction and that Treasury and the Service do not have authority to confer jurisdiction on the Tax Court.

[27] Reg. 1.6221(b)-1(d)(2), Example 1.

[28] Reg. 1.6221(b)-1(d)(2), Example 2.

[29] Compare, e.g., *Bergford*, 12 F.3d 166 (CA-9, 1993); *Irvin J. Bussing*, 88 TC 449 (1987) with Rev. Rul. 75-374, 1975-2 CB 261 (co-ownership of apartment building not a partnership); See, e.g., Rev. Rul. 77-220, 1977-1 CB 263 (three separate corporations treated as single corporation for determining whether it had an excessive number of shareholders under Subchapter S), revoked by Rev. Rul. 94-43, 1994-2 CB 198.

[30] REG-136118-15 (June 14, 2017). See also Reg. 1.761-2(b) (qualified election out of Subchapter K).

[31] 82 Fed. Reg. 50144-01.

[32] The new proposed regulations made corresponding changes to the June 14 NRPM on the subject, although the prior notice reserved treatment of tiered partnerships.

An interesting aspect of the final regulations is set forth in Reg. 301.6221(b)-1(d), which pertains to an election-out by a partnership that is itself a partner. While the upper-tier partnership, if eligible, may elect-out, a lower-tier partnership that does not make the election out for a tax year still results in application of the BBA rules to the upper-tier partner despite it having elected-out. Several examples drive home the applicable rules.

Example 1 [Election-out by eligible partnership-partner]. During its 2020 tax year, Partnership, a calendar year taxpayer, has two partners. One partner, A, is also a calendar year partnership. A files a valid election [out] … with its timely filed partnership return for its 2020 tax year. The [lower tier] Partnership does not file an election-out. Notwithstanding A's valid election-[out] under … section 6221(b), with respect to A's interest in the lower-tier Partnership, A is subject to the rules applicable to partners in a partnership subject to the rules under subchapter C of chapter 63, including the consistency requirements of section 6222 and the regulations thereunder.[27]

Example 2. Same facts as in Example 1…. The IRS mails to the [lower-tier or operating] Partnership a notice of final partnership adjustment under section 6231 with respect to Partnership's 2020 taxable year. The [lower-tier] Partnership timely elects the alternative to payment of imputed underpayment under section 6226 [the push-out election] and the regulations thereunder. Partnership must provide Partner A with a statement under section 6226 reflecting A's share of the adjustments for Partnership's 2020 taxable year. A is subject to the rules applicable to partners in a partnership subject to the rules under subchapter C of chapter 63 with respect to A's interest in Partnership [despite the fact that it has elected out for other items of income, deduction, loss, and credit].[28]

De facto partnership issues. A difficult question that surfaced in 2017, as reflected in the June 14 NRPM, was whether two or more partnerships should be treated or recast as having formed one or more constructive or de facto partnerships for federal income tax purposes.[29] The Service announced that it would carefully review situations where, for example, the profits or losses of partners are determined, in whole or in part, by the profits or losses of partners in another partnership, as well as those arrangements that purport to be something other than a partnership, such as co-ownership of property. More specifically, the Service stated:

> If it is determined that two or more partnerships that have elected out of the centralized partnership audit regime have formed a constructive or de facto partnership for a particular partnership taxable year and are recast as such by the IRS, that constructive or de facto partnership will be subject to the centralized partnership audit regime because that constructive or de facto partnership will not have filed a partnership return and, therefore, will not have made a timely election out as required under section 6221(b)(1)(D)(i) and these proposed regulations. The constructive or de facto partnership may also have more than 100 partners or an ineligible partner, making it ineligible to elect out.[30]

The Preamble to the election-out final regulations provide that nothing in either the June 14 NPRM or the final regulations alters existing judicial doctrines governing whether a partnership is in existence. It further provides that the IRS's application of existing judicial doctrines to two or more partnerships "would require the IRS to follow all applicable due process requirements, including those under the centralized partnership audit regime." Again, it is important to note that an "election out" under Section 6221(b) is required to be made on a timely filed return. This raises the question of whether co-owners who believe that their ownership arrangement is not a partnership should nevertheless decide to file a protective election-out under Section 6221(b).

Rules for Election (Including Tiered-Partnership Structures)

The Service and Treasury issued a proposed rulemaking on December 19, 2017[31] ("December 19 NPRM") with respect to the push-out election rules. The much-awaited proposed regulations set forth applicable rules for how pass-through partners take into account adjustments under the push-out election rules under Section 6226 and under rules similar to the push-out election with respect to AARs under Section 6227.[32] The proposed regulations further contain rules with respect to the assessment and collection of tax, penalties, and interest, and periods of limitation under the centralized partnership audit. Judicial review provisions are also set forth. The most prominent development in this proposed rulemaking is the Service's adoption of rules which allow multi-tiered partnerships to be part of the push-out election process, with each level of the partnership tiers having the right to pay the resulting assessment or to timely push-out the required tax payment to its partners.

Before addressing the December 19 NPRM in depth, the core principles announced in the BBA with respect to the payment of tax at the partnership level under Section 6225 or at the partner level under Section 6226, as amplified by the June 14 NPRM, are summarized. Also summarized are the applicable rules under Section 6227.

Section 6225: Imputed underpayment rule. As a cardinal tenet of the BBA, Section 6225(a)(1) provides that in the case of any adjustment made by the Service in the amount of any item of income, gain, loss, deduction, or credit of the partnership—or any partner's distributive share thereof—the partnership is legally obligated to pay any imputed underpayment with respect to such adjustment in the adjustment year as provided in Section 6232.[33] Any adjustment that does not result in an imputed underpayment must be taken into account by the partnership in the adjustment year.[34] Except for an adjustment to an item of credit, which is taken into account as a separately stated item, an adjustment not resulting in an imputed underpayment must be taken into account as a reduction in non-separately stated income or as an increase in non-separately stated loss (whichever is appropriate) in accordance with Section 702(a)(8).[35]

Section 6225(c) sets forth modification rules whereby a partnership may modify (reduce) an imputed underpayment amount. Per Section 6231, information required to be submitted (to the IRS) must be received within 270 days following the date the notice of proposed partnership adjustment (NOPPA) is mailed by the Service unless the period is extended by consent of the Secretary.[36] Any modification of the imputed underpayment amount must receive IRS approval.[37]

Section 6225(c)(2) contains the "amended return and payment" modification rule. In particular, it provides that where (1) one or more partners file amended returns (without regard to whether the statute of limitations on refunds under Section 6511 has expired) that include the end of the reviewed year(s) of the partnership; (2) such partners filing amended returns take into account all adjustments to partnership items made by the IRS properly allocable to such partners (and for any other "intervening" tax year with respect to which a tax attribute is affected by reason of the adjustments made by the Secretary); and (3) payment of any tax due is included with the amended returns, the imputed underpayment will be reduced to the extent such amended returns are filed and payments made. Where an item of adjustment reallocates the distributive share of any item from one partner to another, the amended return modification rule applies only where amended returns are filed by all partners affected by such adjustments.

Under Section 6225(c)(3), where a reviewed year partner is a tax-exempt organization, modification (reduction) of the partnership's imputed underpayment may be made by proffer by the partnership that the tax-exempt partner's share of the adjustment reflecting an increase to income for the reviewed year would not result in any tax due by virtue of its tax-exempt status.

Another modification rule, Section 6225(c)(4), allows the partnership to take into account a tax rate lower than the rate of tax described in Section 6225(b)(1)(A) (that is, the highest rate under Section 1 or Section 11) with respect to any portion of an imputed underpayment that the partnership demonstrates is allocable to a partner that is a C corporation or, in the case of a capital gain or qualified dividend, an individual. Thus, with the new tax rate reductions on C corporations, i.e., a flat 21% on net taxable income, modification of an imputed underpayment allocable to a corporate partner will be important.[38] In no event can the lower rate allowed under Section 6225(c)(4) be lower than the highest rate in effect for the reviewed year with respect to the type of income and taxpayer (that is, a C corporation or an individual). For purposes of the lower rate for capital gains and qualified dividends, an S corporation will be treated as an individual. If an imputed underpayment is attributable to the adjustment of more than one item and any partner's distributive share of such items is not the same with respect to all such items, the portion of the imputed underpayment to which the lower rate applies with respect to a partner is to be determined using the amount which would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership.[39]

Computation of imputed underpayment amount. Prop. Reg. 301.6225-1(c)(1) (2014 NPRM) provides that the imputed underpayment is calculated by multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year (per Prop. Reg. 301.6241-1(a)(8)) under Section 1 or Section 11.

The product is then increased or decreased by any tax credit adjustments. If the result is a net positive adjustment, the resulting amount is the imputed underpayment, and if it results in a net non-positive amount, the result is an adjustment that does not result in an imputed underpayment.[40]

There are three types of adjustment groupings: (1) the reallocation grouping, i.e., adjustments that reallocate items among the partners; (2) the credit grouping, i.e., adjustments to the partnership's credits are grouped together; and (3) the residual grouping, i.e., all remaining adjustments are grouped together according to the character, preferences, restrictions, and other limitations of the item adjusted.[41] Within each grouping, there might be more than one subgrouping based on a partnership's particular adjustments. For instance, within the residual grouping, there might be an ordinary income or loss subgrouping as well as a capital gain or loss subgrouping. Net items will be netting within the same grouping or subgrouping. For example, all ordinary adjustments are netted against each other but none of the ordinary adjustments are netted against the capital subgrouping adjustments.[42] Adjustments from one tax year may not be netted against adjustments from another tax year even if part of the same subgrouping.[43] After each grouping or subgrouping has been netted, there will then either be a net positive adjustment or a net non-positive adjustment.[44] Any net non-positive adjustment is disregarded for purposes of calculating the imputed underpayment.[45] There is an exception to disregarding a net non-positive adjustment for credit groupings because adjustments to credits are applied to the total netted partnership adjustment after the rate is applied in Prop. Reg. 301.6225-1(c)(1). Where the net credits reduce the imputed underpayment amount on net positive adjustments to zero or less, the partnership adjustments to the total netted partnership adjustment and to credits do not result in an imputed underpayment under Prop. Reg. 301.6225-1(c)(2).

Multiple imputed underpayment concept. Last year's NPRM on Section 6225 allowed for multiple imputed underpayments in the interest of tax administration despite the fact that the statute does not so provide.[46] A centralized partnership audit that results in net positive adjustments will, in general, result in a general imputed underpayment. The June 14 NRPM noted that each administrative proceeding that ends with the determination by the IRS of an imputed underpayment will result in a general imputed underpayment. The IRS may determine, in its discretion, a specific imputed underpayment on the basis of certain adjustments allocated to one partner or a group of partners based on the items or adjustments having the same or similar characteristics, based on the group of partners sharing similar characteristics, or based on the partners having participated in the same or similar transactions.[47] In other words, there may be multiple specific imputed underpayments depending on the adjustments. For instance, some transactions may not involve all partners, and there may be a reason to place certain adjustments or even entire groupings into a specific imputed underpayment while other adjustments remain as part of the general imputed underpayment.[48] Then, the partnership could elect to push-out the specific imputed underpayment to the affected partners while the partnership could pay the general imputed underpayment. The stated rationale given by the Service for allowing multiple imputed underpayments was administrative flexibility.

Section 6226 and the "push-out election." Section 6226 provides an alternative to the partner-

[33] Under Section 6225(c), a partnership may modify an imputed underpayment under procedures for modification of the imputed underpayment, which information must be submitted within 270 days following the date the notice of proposed partnership adjustment (NOPPA) is mailed under Section 6231 by the IRS, unless that period is extended with the consent of the Secretary. Section 6225(c)(7). Any modification of the imputed underpayment amount must be approved by the Service. Section 6225(c)(8).

[34] Except for the adjustment of an item of credit, which is accounted for as a separately stated item, an adjustment not resulting in an imputed underpayment must be taken into account as a reduction in non-separately stated income or as an increase in non-separately stated loss under Section 702(a)(8). See Sections 6225(a)(2)(A)-(B).

[35] Sections 6225(a)(2)(A)-(B). Prop. Reg. 301.6225-1(c)(1) (2014 NPRM) provides that the imputed underpayment is calculated by multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year (per Prop. Reg. 301.6241-1(a)(8)) under Section 1 or Section 11.

[36] Section 6225(c)(7).

[37] Section 6225(c)(8).

[38] Section 6225(c)(4).

[39] Section 6225(c)(4)(B)(ii).

[40] Prop. Reg. 301.6225-1(c)(2).

[41] Prop. Reg. 301.6225-1(d)(2)(i).

[42] Prop. Reg. 301.6225-2(d)(3).

[43] Prop. Reg. 301.6225-1(c)(4).

[44] Prop. Reg. 301.6225-1(d)(3)(ii)(C).

[45] See Prop. Reg. 301.6225-1(c)(2).

[46] Prop. Reg. 301.6225-1(e).

[47] In response to a NOPPA with more than one imputed underpayment, the partnership may request that further modifications or changes be made among the multiple imputed underpayments. See Prop. Reg. 301.6225-2(d)(6).

[48] Prop. Regs. 301.6225-1(e)(2)(iii), 301.6225-1(e)(2)(ii).

ship's obligation to be assessed and pay any resulting imputed underpayment. It allows the partnership to elect under Section 6226(a) to push-out the adjustments, i.e., the aggregate imputed underpayment amount, including additions to tax in the form of penalties, to the reviewed year partners.

In order to elect application of Section 6226, a partnership must meet two requirements. First, the partnership must make an election in the manner provided by the Secretary no later than 45 days after the date the final partnership adjustment ("FPA") is mailed by the IRS under Section 6231.[49] Second, the partnership must furnish—at such time and in such manner as provided by the Secretary—a statement of each partner's share of any and all required adjustments as determined in the FPA to its reviewed year partners.[50] More specifically, Section 6226(a) provides that, when a push out election is made, the reviewed year partners "shall take such adjustments into account" as provided in Section 6226(b).[51]

Prop. Reg. 301.6226-2(a) further provides that the push-out statements furnished to the reviewed year partners are in addition to, and must be filed and furnished separate from, any other statements required to be filed with the IRS and furnished to the partners for the tax year, including any Schedules K-1, partner's share of income, deductions, credits, etc. Therefore, the partnership may not include the partnership adjustments that are to be taken into account by the reviewed year partners under Section 6226 in any Schedule K-1 required to be furnished to the partner under Section 6031(b). Similarly, the partnership must furnish separate statements for each reviewed year at issue and cannot combine multiple reviewed years (if any) into a single statement.[52]

The push-out statements must be furnished by the partnership to the reviewed year partners no later than 60 days after the date that the partnership adjustments become final. Final determination of partnership adjustments is the later of the expiration of the time to file a judicial petition under Section 6234 or, if a petition has been filed under Section 6234, the date when the court's decision becomes final. Where, for example, an FPA is mailed on June 30, 2020, and no petition is filed by the partnership, the partnership adjustments reflected in the FPA become "finally determined" on September 28, 2020 (at the conclusion of the 90-day petition period under Section 6234).[53]

The earlier rule-making under Section 6226 addressed the issue of erroneous push-out

[49] Section 6226(a)(1).

[50] Section 6226(a)(2).

[51] In order to elect push-out treatment under Section 6226(b), the partnership must (1) file an election in the manner provided by the Secretary no later than 45 days after the date the FPA is mailed by the IRS under Section 6231; and (2) furnish, at such time and in such manner as provided by the Secretary, a statement of each partner's share of any adjustment as determined in the FPA to its reviewed year partners. If the partnership takes these two steps in the time and manner prescribed by the statute and by the Secretary, Section 6225 does not apply with respect to the imputed underpayment and each partner must take its share of the adjustments into account as provided in Section 6226(b). An election under Section 6226 is revocable only with the consent of the Secretary. See Prop. Reg. 301.6226-1 (June 14 NPRM).

[52] The proposed regulations set forth rules as to the proper transmission of the push-out statements and required electronic filing of the same with the IRS, along with a transmittal that includes a summary of the statements and any other information required in the forms and instructions, by the date on which the partnership is required to furnish the statements to the reviewed year partners. See Prop. Reg. 301.6226-2(c).

[53] See Prop. Reg. 301.6226-2(b)(3).

[54] The contents of the push-out statements issued to the reviewed year partners must include (1) the name and correct TIN of the reviewed year partner; (2) the current or last address of the reviewed year partner that is known to the partnership; (3) the reviewed year partner's share of items originally reported to the partner (taking into account any adjustments made under Section 6227); (4) the reviewed year partner's share of the partnership adjustments and any penalties, additions to tax, or additional amounts; (5) modifications, i.e., Section 6225(c)-type modifications, attributable to the reviewed year partner; (6) the reviewed year partner's share of any amounts attributable to adjustments to the partnership's tax attributes in any intervening year (as defined in Prop. Reg. 301.6226-3) resulting from the partnership adjustments allocable to the partner; (7) the reviewed year partner's safe harbor amount and interest safe harbor amount (if applicable) per Prop. Reg. 301.6226-2(g); (8) the date the statement is furnished to the partner; (9) the partnership tax year to which the adjustments relate; and (10) any other information required by the forms, instructions, or other guidance prescribed by the IRS. See Prop. Reg. 301.6226-2(e).

[55] Under Prop. Reg. 301.6226-3(c), a reviewed year partner furnishing a push-out statement may elect to pay the "safe harbor amount" and/or the "interest safe harbor amount" for individuals shown on the statement in lieu of the additional tax for the reporting year as calculated by the partner. The election is made on the reviewed year partner's return. Where a partner is furnished multiple push-out statements, the partner may elect to pay the safe harbor amount as to some or all of the statements. A reviewed year partner could elect to pay the safe harbor amount for one tax year, but not the other tax year. If a partner elects to pay the safe harbor amount, the partner must report the safe harbor amount on the partner's timely filed return (excluding extensions) for the partner's reporting year. If the partner fails to do so, the partner may not utilize the safe harbor amount, but instead must compute the additional reporting year tax under Prop. Reg. 301.6226-3(b) as if no election was made. Note that, as to safe harbor interest election, interest is determined at the partner level based on the underpayment rate plus five percentage points.

[56] As previously discussed, reviewed year partners filing amended returns (or entering into closing agreements) and remitting required payments under Section 6225(c)(2) during the modification phase of the audit can avoid the computation under Section 6226(b).

[57] Prop. Reg. 301.6226-1(c)(2).

[58] See Sections 6226(b)(2)(A), (B).

[59] Section 6226(b)(3)(A).

[60] Section 6226(b)(3)(B).

statements and incomplete or invalid notices issued to one or more reviewed year partners. For example, Prop. Reg. 301.6226-2(d) (June 14 NPRM) provides that, where a partnership discovers an error on a push-out, K-1-type statement filed with the IRS, the partnership must correct the error within 60 days of the due date for furnishing the statements to partners and filing the statements with the IRS. Moreover, where the partnership discovers an error after this 60-day period, the partnership may only correct the statements with the permission of the IRS in accordance with the forms, instructions, or other guidance prescribed by the IRS.

Where the IRS discovers an error in the statements, the IRS may require the partnership to correct the errors. If a partnership fails to correct an error as required by the IRS, the IRS may treat this as a failure to properly furnish statements to partners and file the statements with the IRS, thereby allowing the IRS to determine that the election under Prop. Reg. 301.6226-1 is invalid, with the result that the partnership is liable for the imputed underpayment to which the election related. A partnership can undertake to correct an error in a statement by electronically filing the corrected statement with the IRS and furnishing the corrected statement to the affected reviewed year partner in accordance with the forms, instructions, and other guidance prescribed by the IRS. The adjustments contained on a corrected statement are taken into account by the reviewed year partner in accordance with Prop. Reg. 301.6226-3 for the reporting year. Because reviewed year partners cannot file inconsistently with any statements furnished by the partnership under Prop. Reg. 301.6226-2, this provision provides a partner with a period during which the partner may notify the partnership of any errors in a statement, have the partnership furnish a corrected statement to the partner, and file the corrected statement with the IRS.[54] A reviewed year partner's share of the adjustments must be taken into account and tax paid in the year in which the push-out election is received. Any penalties, additions to tax, or additional amounts are reported to the reviewed year partners in the same proportion as each partner's share of the adjustments to which the penalties relate, unless the penalty, addition to tax, or additional amount is specifically allocated to a specific partner(s) or in a specific manner by a final court decision or in the FPA, if no petition is filed. Where a penalty is determined with respect to a specific item or items, that penalty is reported to the reviewed year partners in the same manner as the adjustments to that specific item or items, unless otherwise provided in the FPA or a final court decision.[55]

Where the push-out election is made, the partnership is not required to pay the imputed underpayment. Its liability with respect to all or part of the imputed underpayment is extinguished.[56] There are also rules whereby certain imputed underpayment amounts could be the subject of a push-out election, but a general imputed underpayment amount would still be assessed and paid by the partnership. The Service may also reject the push-out election as to one or more imputed underpayments.[57]

The proposed regulations allow multiple imputed underpayments in the interest of tax administration despite the fact that the statute does not so provide.

There are two categories of Section 6226(b)(2) adjustments. The first category is the tax year of the partner that includes the end of the partnership's reviewed year. This is referred to as the "first affected year." The adjustment amount is the amount by which the reviewed year partner's income tax (chapter 1) would increase for the partner's first affected year if the partner's share of the adjustments were taken into account in that year. The second category is for each tax year after the first affected year and before the reporting year, i.e., the "intervening year(s)." The adjustment amount for the intervening years is the amount by which the reviewed year partner's income tax would increase by reason of the adjustment to tax attributes determined under Section 6226(b)(3) in each of the intervening years.[58] The tax liabilities under each category are added together in determining the aggregate tax liability of the partner for push-out purposes.

As to adjustments to tax attributes, with respect to an intervening year, any tax attribute must be appropriately adjusted for purposes of determining the adjustment amount for that intervening year.[59] In addition, with respect to any subsequent year, including the adjustment year, any tax attribute must also be appropriately adjusted.[60] Further, in the case of any subsequent tax year (that is, a year, including the reporting year, that is subsequent to the intervening years referenced in Section 6226(b)(3)(A)), any tax attribute must be appropriately adjusted.

Penalties, additions to tax, or additional amounts are required to be determined at the partnership level; reviewed year partners are liable with respect to such amounts.[61] Interest is determined at the partner level commencing from the due date of the partner's return for the tax year to which the increase in tax is attributable, taking into account any increases related to a change in tax attributes for an intervening year.[62] Interest is computed at the underpayment rate under Section 6621(a)(2), but adding three percentage points for purposes of Section 6621(a)(2)(B).

Section 6227 AARs. Section 6227 permits a partnership to file an AAR to correct one or more errors in a partnership return for a prior year.[63] An AAR is taken into account for the partnership tax year in which the AAR is filed.[64] Unlike TEFRA, under the new centralized audit rules only the partnership may file an AAR. A further limitation is that only the partnership representative, acting on behalf of the partnership, may file an AAR. The partnership has a period of three years from the later of the filing of the partnership return or the due date of the partnership return, excluding extensions, to file an AAR for a tax year. Importantly, an AAR may not be filed after the IRS has mailed a notice of an administrative proceeding (audit) per Section 6231 for that tax year.

Where the adjustment under the AAR results in an imputed underpayment, the partnership may approach the payment issue in the same manner as it does under Sections 6225 and 6226.[65] Under Section 6227(b), the partnership may determine and take the adjustment into account for the partnership tax year in which the AAR is filed under rules similar to the rules under Section 6225. In this context, however, the modification provisions related to amended returns by partners, the time for submitting information to the Secretary for purposes of modification, and approval by the Secretary of any modification do not apply.[66] Penalties and interest are added to an AAR that results in an imputed underpayment.[67] As with Section 6225, the partnership's payment of the imputed underpayment with respect to an AAR is treated as a nondeductible expenditure under Section 705(a)(2)(B).[68]

Alternatively, the partnership and the partners may determine and take the adjustment into account under "push-out" rules similar to those under Section 6226 relating to the alternative to the partnership payment of the imputed underpayment, except that the additional two percentage points of interest imposed under Section 6226 do not apply.[69]

Where the AAR adjustment does not result in an imputed underpayment, Section 6227(b) requires the partnership and the reviewed year partners to take the adjustment into account under rules similar to the rules under Section 6226—with appropriate adjustments. This allows the reviewed year partners to benefit from any resulting refund attributable to a prior overpayment in tax.

In the June 2014 NPRM, the government noted it would issue further guidance under Prop. Reg. 301.6225-4 for rules pertaining to both partners' outside bases and capital accounts and a partnership's basis and book value in property as to an AAR imputed underpayment where no election to push-out is made under Prop. Reg. 301.6227-2(c).

December 19 NPRM on Sections 6226 and 6227. The June 14 NPRM addressed the impact of a push-out election under Section 6226(b) to a "direct partner" but did not address how the adjustments are taken into account for tiered-partnership structures where direct partners and upper-tier partners are also partnerships. While a literal interpretation of Section 6226(b) might support the view that the push-out election could only move up one level, the June 14 NPRM acknowledged that consideration was being given to allow partnerships to push-out beyond the first-tier partners.[70] Subsequent proposed regulations addressed this important subject.

These proposed regulations, i.e., December 19 NPRM, allow adjustments pushed out to partners under Section 6226(b), if properly elected, to be pushed through the partnership tiers to the ultimate tax-paying owners. Under Prop. Reg. 301.6241-(a)(5) (June 14 NPRM), a "pass-through partner" is defined as a partnership—regardless of whether the partnership has made an election-out under Section 6221(b)—an S corporation, certain trusts, or a decedents estate.

As a corollary, the proposed regulations allow each pass-through partner in an ownership chain of a tiered-partnership structure the ability to elect whether to push the adjustments it received (e.g., as a direct partner) up to its partners, shareholders, or beneficiaries as to the adjustments. Alternatively, a pass-through partner has the choice of paying the imputed underpayment amount allocated to it. In other words, each pass-through partner in an ownership chain has the choice to either

push the adjustments to its partners, shareholders, or beneficiaries or pay the tax with respect to the adjustments. The same rules will apply with respect to a push-out election that is part of an AAR that involves a tiered-partnership structure.

Prop. Reg. 301.6226-3(e)(1) provides that, if a pass-through partner is furnished a statement described in Prop. Reg. 301.6226-2 (June 14 NPRM) (including a statement described in Prop. Reg. 301.6226-3(e)(3)(i)), the pass-through partner must take into account the adjustments reflected on that statement by either furnishing statements to its partners that held an interest in the pass-through partner at any time during the tax year to which the adjustments relate or by paying an amount calculated like an imputed underpayment on the adjustments reflected in the statement plus any applicable penalties and interest. This process continues up the tiers if the push-out partnership decides to further push-up the adjustments.

As mentioned, under Prop. Reg. 301.6226-3(e)(2), if a pass-through partner fails to timely take into account the adjustments in accordance with Prop. Reg. 301.6226-3(e)(3) or (e)(4), the pass-through partner must take into account the adjustments and pay an amount calculated like an imputed underpayment—plus any applicable penalties and interest—in accordance with the rules provided under Prop. Reg. 301.6226-3(e)(4). Where a partnership makes a push-out election, the penalties, additions to tax, and additional amounts related to a partnership adjustment are determined at the partnership level. The reviewed year partners are liable for such penalties, additions to tax, and additional amounts.[71] However, the December 19 NPRM allows for partner-level defenses to penalties, additions to tax, or additional amounts related to an adjustment reflected on a push-out statement—provided, however, that the partner seeking penalty abatement first pays the penalty and files a claim for refund. The proposed regulations state that "partner-level defenses are limited to those that are personal to the partner such as reasonable cause and good faith for purposes of section 6664(c) as specifically related to the facts applicable to the partner."

Push-out election statements to partners, as per Prop. Reg. 301.6226-3(e)(3)(ii), must be furnished no later than the extended due date for the return for the adjustment year of the partnership that made the election under Prop. Reg. 301.6226-1 (June 14 NPRM). For purposes of determining the due date for the statements, the extended due date for the return for the adjustment year of the partnership that made the election under Prop. Reg. 301.6226-1 (June 14 NPRM) is the extended due date under Section 6081, regardless of whether the partnership that made the election under Prop. Reg. 301.6226-1 (June 14 NPRM) is required to file a return for the adjustment year and regardless of whether an extension was actually requested. For example, if the adjustment year of the partnership that made the election under Prop. Reg. 301.6226-1 (June 14 NPRM) ended on December 31, 2020, the pass-through partner would be required to furnish statements to its affected partners no later than September 15, 2021, the due date, including extensions, of a partnership return for a tax year ending December 31, 2020. If a pass-through partner fails to issue statements by the due date under Prop. Reg. 301.6226-3(e)(3)(ii), the pass-through partner has failed to take into account the adjustments as described in Prop. Reg. 301.6226-3(e)(3). There is no provision that allows for an extension of time for filing, even where, for ex-

61 Section 6226(c)(1).

62 Sections 6226(c)(2), 6226(b)(2).

63 Section 6227(a).

64 Section 6227(b).

65 See Prop. Reg. 301.6227-2(b)(1) (partnership payment of imputed underpayment, as adjusted for permitted modifications).

66 Section 6227(b)(1). Prop. Reg. 301.6227-2(a)(2) provides that, with respect to an AAR, the partnership may reduce the imputed underpayment as a result of certain modifications permitted under Prop. Reg. 301.6225-2. The permitted modifications in this context are those which relate to tax-exempt partners, rate modification of certain passive losses of publicly traded partnerships, qualified investment entities described in Section 860, and other modifications to the extent permitted under future IRS guidance. The modifications described in Prop. Reg. 301.6227-2 are the only modifications a partnership can use in an AAR context. Other types of modifications, such as modifications under Prop. Reg. 301.6225-2 with respect to amended returns and closing agreements, are not available in the case of an AAR.

67 Section 6233(a)(3); Prop. Reg. 301.6227-2(b)(2).

68 Prop. Reg. 301.6241-4.

69 Section 6227(b)(2); Prop. Reg. 301.6227-2(c) (push-out election approach).

70 As noted in the Preamble to the June 14 NPRM, Section 6226(b) could be interpreted as treating direct pass-through partners like individuals who would be directly liable for their allocable share of the imputed underpayment. See Joint Comm. on Tax'n, JCS-1-16, General Explanations of Tax Legislation Enacted in 2015 (2016). On the other hand, a tiered-partnership approach could be taken until the ultimate designated "individuals" subject to tax under chapter 1 of the Code are determined.

71 See Prop. Reg. 301.6226-3(i)(2).

ample, an upper-tier partnership has not received its push-out "adjusted" K-1s with sufficient time to make the required payment or otherwise elect to push-out to the next tier to avoid the entity-level tax.

The statements issued to the affected partners are required to contain all information required in Prop. Reg. 301.61226-3(e)(3)(iii) and any other information required by the forms, instructions, or other guidance prescribed by the IRS.

Where a pass-through partner decides to pay its share of the imputed underpayment, including additions to tax, it is required to treat the amount owed under Section 6225 as additional tax for the adjustment year. The amount required to be paid by the pass-through partner must be paid no later than the extended due date for the return for the adjustment year of the partnership that made the push-out election per Prop. Reg. 301.6226-1 (June 14 NPRM).[72]

The December 19 NPRM outlines, in Prop. Reg. 301.6226-3(e)(3)(v), special rules for adjustments subject to income tax and FACTA withholding per chapters 3 and 4 of the Code. This area was the subject of a proposed rulemaking on November 30, 2017 (November 30 NPRM), which will be addressed in a later article. The guiding principle in this area is that, where a pass-through partner takes the adjustments into account by furnishing statements under Prop. Reg. 301.6226-3(e)(3), the pass-through partner must comply with Prop. Reg. 301.6226-2(h)(3) (November 30 NPRM) (providing rules for the payment of tax under chapters 3 and 4 when adjustments are pushed out) as if the pass-through partner were the partnership that made the election under Prop. Reg. 301.6226-1 (June 14 NPRM) and an affected partner must comply with Prop. Reg. 301.6226-3(f) (November 30 NPRM) (providing rules for partners subject to withholding under chapters 3 and 4) as if it were the reviewed year partner.

Penalties, additions to tax, and additional amounts under a push-out election. The general rule is that a partner who is subject to a push-out election made by the partnership is responsible for the payment of penalties, additions to tax, and additional amounts resulting from its share of an imputed underpayment under Section 6221(a).[73] As mentioned, the revised proposed regulations, Prop. Reg. 301.6226-3(i)(3), provide that a partner may assert a defense against a penalty based on a defense that is personal to the partner (partner-level defense), such as reasonable cause or good faith, by first paying the tax and penalty due and then filing a claim for refund that asserts the partner's specific penalty defense.[74] Interest on the push-out statement (assessment) is determined at the partner level.[75] Interest is assessed from the due date of the partner's return for the tax year to which the increase in tax is attributable, taking into account any increases attributable to a change in tax attributes for an intervening year. The interest is the rate of deficiency interest plus five percentage points instead of three percentage points set forth in Section 6621(a)(2)(B).

Examples of push-out elections and their consequences. *Example 1.* On its partnership return for 2020, PS reported ordinary income of $10,000x and charitable deductions of $4,000x. On June 1, 2023, a final partnership adjustment is sent to PS for 2020 disallowing the $4,000x deduction and imposed a 20% accuracy related penalty. PS timely makes a push-out election for 2020 and timely files a Tax Court petition challenging the deduction disallowance and the imposition of the penalty. The Tax Court agrees with the Service and determines no charitable contribution deduction of $4,000x is allowable and upholds the penalty. The Tax Court decision for the partnership year ending in 2020 becomes final on December 15, 2025. Per Prop. Reg. 301.6225-2(b), the partnership adjustments are finally determined on December 15, 2025. On February 2, 2026, Partnership files a push-out election and timely files the statements required under Prop. Reg. 301.6226-2 with the IRS and furnishes to partner A, a reviewed year (2020) partner, a push-out election statement. A was a 25% partner in 2020. The statement filed with the IRS and submitted to A by PS under Section 6226 shows A's share of ordinary income for the reviewed year of $2500x and A's share of the charitable contribution of $1000x. The statement also shows no adjustment to A's share of ordinary income but does show an adjustment to A's share of the charitable contribution, a reduction of $1000x resulting in $0x charitable contribution allocated to A from PS for 2020. In addition, the statement reports that a 20% percent accuracy-related penalty per Section 6662(b) applies.

Partner A must pay the additional reporting year tax in addition to A's share of the penalties and interest.

The additional reporting year tax to Partner A under the push-out election rule is determined as follows:

1. Partner A determines the correction amount for the first affected year (2020) by taking into account A's share of the partnership adjustment (<$1000x>) (reduction in charitable contribution).

2. A computes the additional income tax he or she would have owed for 2020, taking the $1000x disallowance into account.
3. Partner A is next required to take intervening year tax increases (or decreases) into account as well as tax attributes. Here there is no adjustment to tax attributes in A's intervening years as a result of the adjustment to the charitable contribution for 2020.
4. Partner A's aggregate of the adjustment amounts is the correction amount for 2020, the "first affected (reviewed) year." The additional tax that would have been owed for 2020 is determined.
5. The additional tax for 2020 is added to the income tax (chapter 1) A owes for 2026, the reporting year.
6. A must add a 20% accuracy-related penalty to the increase in tax for 2020 with respect to the disallowance of the charitable contribution.
7. A is required to add interest on the correction amount at the deficiency rate plus five percentage points from the due date of the return for the first affected tax year, April 15, 2021, until A pays such amount. Interest runs on the penalty in the same manner.
8. On his 2026 income tax return, A must report the additional reporting year tax, i.e., the correction amount for 2020, plus the accuracy related penalty amount, and the interest attributable to the correction amount and penalty.[76]

Example 2. Partnership has two equal partners for the 2020 tax year: I (an individual) and J (a partnership). For the same year the J partnership has two equal partners, K and L, both individuals. On June 1, 2023, the IRS mails a FPA for 2020 increasing the Partnership's ordinary income by $500x and asserting an imputed underpayment of $200x. Partnership timely elects to push-out the imputed underpayment for 2020 and does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023, i.e., the date the partnership adjustments are finally determined. The Partnership's adjustment year is 2023, the due date of the adjustment year return is March 15, 2024, and if requested, the extended due date for the adjustment year return is September 16, 2024. On October 12, 2023, Partnership timely files push-out statements with the IRS and to its partners reflecting their share of the partnership adjustments as finally determined in the FPA. The statements to I and J each reflect a partnership adjustment of $250x of ordinary income. I takes its share of the adjustments reflected on the statements furnished by Partnership into account on I's return for the 2023 tax year in accordance with the regulation. On April 1, 2024, J takes the adjustments and makes a push-out election as a pass-through partner with the IRS and by furnishing statements to K and L reflecting each partner's share of the adjustments reflected on the statements Partnership furnished to J. K and L must take their share of adjustments reflected on the statements furnished by J into account on their returns for the 2023 tax year by treating themselves as reviewed year partners.[77]

AARs. Section 6227 provides a mechanism for a partnership to file an AAR to correct errors on a partnership return for a prior year. A partnership may file a request for administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership tax year.[78] Any adjustment requested in an AAR is taken into account for the partnership tax year in which the AAR is made.[79] Under Section 6227, only a partnership may file an AAR. Therefore, a partner who is not also the partnership representative acting on behalf of the partnership may not file an AAR.

[72] See Prop. Reg. 301.6226-3(e)(4) (information requirements). Under the proposed regulations applicable to multi-tiered partnerships, an S corporation is treated as a partnership and its shareholders are treated as partners. Prop. Reg. 301.6224-3(e)(5)(i). Similarly, a trust and an estate and their beneficiaries are treated in the same manner as a partnership and its partners. Prop. Reg. 301.6224-3(e)(5)(ii). As to disregarded entities and grantor trusts, which have only a single member or grantor, the owner of the disregarded entity or grantor of the wholly owned trust must take into account the push-out statements as if the owner were the reviewed year partner. See Prop. Reg. 301.6227-2(j).

[73] Prop. Reg. 301.6226-3(i). Compare revised Prop. Reg. 301.6226-2(e)(7) with prior Prop. Reg. 301.6226-2(e)(7) (June 14 NPRM). Under the revised regulations, the partnership furnishes to the reviewed year partner (1) his or her share of the adjustments to which the penalties, additions to tax, and additional amounts relate, (2) other information, such as the applicable rate of any penalty, and (3) the Code section under which the penalty, addition to tax, or additional amount was imposed. The reviewed year partner calculates the penalty using the normal penalty rules applicable under the Code.

[74] Section 6226(c) provides rules for the treatment of penalties and interest determined under Section 6221 at the partnership level when an election is made under Section 6226. Notwithstanding the provisions of Sections 6226(a) and (b) (regarding the requirements for making an election and how partners take into account adjustments), any penalties, additions to tax, or additional amounts are determined under Section 6221 at the partnership level, and the reviewed year partners of the partnership are liable for any such penalty, addition to tax, or additional amount. Section 6226(c)(1).

[75] Section 6226(c)(2).

[76] Prop. Reg. 301.6226-3(g), Example 1. There are nine detailed examples set forth with respect to the partnership push-out election and tiered partnerships, etc. in Prop. Reg. 301.6226-3(g).

[77] Prop. Reg. 301.6226-3(g), Example 6.

[78] Section 6227(a).

[79] Section 6227(b).

Under Section 6227(c), a partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an AAR for that tax year. However, a partnership may not file an AAR for a partnership tax year after the IRS has mailed a notice of an administrative proceeding under Section 6231 with respect to that tax year.

Under Section 6227(b), if an adjustment results in an imputed underpayment, the adjustment may be determined and taken into account in one of two ways. The partnership may determine and take the adjustment into account for the partnership tax year in which the AAR is filed under rules similar to the rules under Section 6225, relating to payment of the imputed underpayment by the partnership, except that the provisions under Section 6225 pertaining to modification of the imputed underpayment based on amended returns by partners, the time for submitting information to the Secretary for purposes of modification, and approval by the Secretary of any modification do not apply.[80] Alternatively, the partnership and the partners may determine and take the adjustment into account under rules similar to the rules under Section 6226 relating to the alternative to the partnership payment of the imputed underpayment—except that the additional two percentage points of interest imposed under Section 6226 do not apply.[81]

In the case of an adjustment that would not result in an imputed underpayment, Section 6227(b) requires that the partnership and the reviewed year partners determine and take the adjustment into account under rules similar to the rules under Section 6226 with appropriate adjustments. This provision ensures that the partners for the year to which the adjustments relate benefit from any refund that may result from such adjustments.

Proposed Regulations on Adjusting Tax Attributes under Sections 6225 and 6226

On February 2, 2018, the IRS and Treasury issued a proposed rule-making[82] setting forth rules for how partnerships and their partners are required to adjust tax attributes under the centralized audit regime. The proposed regulations pertain to parts of the June 14 NPRM that were reserved, Prop. Regs. 301.6225-4 and 301.6226-4, as well as proposed amendments to Regs. 1.704-1, 1.705-1, and 1.706-4.[83] The purpose of the rule-making concerns how and when partnerships and their partners adjust tax attributes that are to be viewed as partnership adjustments under Sections 6225 and 6226.

In the Preamble, the IRS and Treasury state that the proposed rules are consistent with the policy described in the Bluebook issued in the spring of 2016 by the Joint Committee on Taxation, "General Explanations of Tax Legislation Enacted in 2015."[84] They intended for additional rules to be issued for adjustments to basis of partnership property and book value of any partnership property where the partnership adjustment is a charge to an item of gain, loss, amortization, or depreciation. This February 2, 2018, rule-making is intended to fill in the blanks in this area.

Tax attribute adjustments attributable to Section 6225. A "partnership adjustment," as defined in the June 14 NPRM, is any adjustment to any item of income, gain, loss, deduction, or credit of a partnership (as defined in Prop. Reg. 301.6221(a)-1(b)(1)), or any partner's distributive share thereof (per Prop. Reg. 301.6221(a)-1(b)(2)).[85]

Under Prop. Reg. 301.6225-1, each partnership adjustment is either (1) taken into account when determining the amount of the imputed underpayment, or (2) treated as a partnership adjustment that does not give rise to an imputed underpayment. With respect to a partnership adjustment that is taken into account when determining the imputed underpayment, these proposed regulations provide (1) rules for adjusting partnership asset basis and book value; (2) rules for creating notional items; (3) rules for allocating these notional items under Section 704(b); (4) successor rules for situations in which reviewed year partners (per Prop. Reg. 301.6241-1(a)(9)) are not adjustment year partners (per Prop. Reg. 301.6241-1(a)(2)); and (5) rules for determining the impact of notional items on tax attributes in certain situations. These regulations also provide rules for the allocation of any partnership expenditure related to the imputed underpayment or, alternatively, for instances where the adjustments do not give rise to an imputed underpayment.

80 Section 6227(b)(1).

81 Section 6227(b)(2).

82 REG-118067-17, 83 Fed. Reg. 4868-01.

83 This set of proposed regulations supplements the June 14 NPRM.

84 JCS-1-16 (2016).

85 See also Prop. Reg. 301.6241-1(a)(6).

Basis and asset adjustment rules prior to the centralized audit rules. Under prior law, the small partnership exception under both TEFRA and the annual election out provision in Section 6221(b)—where there is, as part of the audit of a partnership (even if the audit is technically posited at the individual partner level), an adjustment to an item of income, gain, loss, deduction, or credit—is generally taken into account with respect to the partnership year under examination. For all audits conducted under the centralized partnership audit regime, any partnership adjustment taken into account in computing the imputed underpayment is generally taken into account by the partnership in the year in which the related payment obligation (i.e., the imputed underpayment) arises. Typically, this is the adjustment year unless a push-out election is made under Section 6226(b). Discontinuities will frequently arise under the new system since not only will the adjustment year occur well after the reviewed year(s), but the partners in the reviewed year may have either terminated their interest or changed their percentage interest as well. The partnership level payment rule in Section 6225 does indeed favor former partners since (1) they can avoid tax liabilities without realizing the cancellation of indebtedness income subject to a required clawback provision in the partnership agreement, or (2) instead of paying the imputed underpayment under Section 6225, the partnership may timely make a push-out election under Section 6226(b). In the latter instance, the reviewed year partners—even if one or more have left the partnership—are still partners for the purposes of paying their allocable share of the underpayment and additions to tax in the form of penalties and interest, and making the necessary attribute and basis adjustments.

The operative rules under subchapter K are well-known by tax practitioners. Under subchapter K, a partnership generally computes items of income, gain, loss, deduction, or credit under Section 703. These items are then allocated to the partners under Section 704. Under Section 705, a partner is required to increase its basis in its partnership interest (i.e., outside basis) by its distributive share of the taxable income of the partnership as determined in accordance with Section 703(a). Now comes the fun part: the interposition of Section 6225 to revise the well-known set of partnership allocation and adjustment rules. Under Section 6225, where there is a positive partnership adjustment taken into account when determining an imputed underpayment, Section 6225 does not itself allow an item of taxable income under Section 703(a) to be allocated to partners. Instead, calculations must be made at the partnership level, and the partnership pays the aggregate amount of the imputed underpayment. Payment of the imputed underpayment by the partnership must be treated as a nondeductible payment under Section 705(a)(2)(B) that reduces the outside basis (and capital accounts) of the partners.

Unlike TEFRA, under the new centralized audit rules, only the partnership may file an administrative adjustment request.

The Service and Treasury—as well as tax practitioners—have long been concerned that there is a distinction between (1) partners receiving the basis and attribute adjustments and (2) partners that have federal income tax underpayment attributable to one or more partnership adjustments for the reviewed years. This distinction has the potential to result in a partner effectively being taxed twice for the same item of income. In other words, a partner may be taxed (1) indirectly on the payment of the imputed underpayment by the partnership in lieu of having the reviewed year partners allocated the adjustment, pay the resulting deficiency and additions to tax, and then (2) again on a disposition of the partnership interest or on a distribution of cash by the partnership. This would occur when there is no corresponding basis adjustment taken into account.

The Preamble to the proposed regulations reflects the previous view of Treasury and the Service that taxing the same item of income twice is not consistent with the pass-through nature of partnerships under subchapter K. In order to prevent double taxation or other distortions, the proposed regulations have provided for an adjustment to a partner's basis in its interest, as well as other tax attributes that are deemed interdependent with basis under subchapter K.

The first operating rule, set forth in Prop. Reg. 301.6225-4(a)(1), provides that, where there is a partnership adjustment (as per Prop. Reg. 301.6241-1(a)(6)), the partnership and its adjustment year partners (per Prop. Reg. 301.6241-1(a)(2)) must adjust their specified tax attributes in the manner prescribed in Prop. Reg. 301.6225-4(a)(2). Specified tax attributes for this purpose include the tax basis and book

value of a partnership's property, amounts determined under Section 704(c), adjustment year partners' bases in their partnership interests, and adjustment year partners' capital accounts determined and maintained in accordance with Reg. 1.704-1(b)(2).

Where a partnership adjustment results in an imputed underpayment, regulations require that the adjustments to specified tax attributes be made on a partnership-adjustment-by-partnership-adjustment basis. Each adjustment is made with respect to individual positive or negative adjustments without regard to their summation as part of the determination of the total netted partnership adjustment in Prop. Reg. 301.6225-1(c)(3).

Process of adjusting specified tax attributes. The partnership must first make appropriate adjustments to the book value and basis of property to take into account any partnership adjustment.[86] Amounts determined to be adjusted under Section 704(c) must also be taken into account. The partnership does not make any adjustments to the book value or basis of partnership property for property that was held by the partnership in the reviewed year but is no longer held by the partnership in the adjustment year.

The proposed regulations introduce the concept of "notional items" to the lexicon of tax attribute rules for the centralized partnership audit regime. Prop. Reg. 301.6225-4(b)(3) provides that notional items are created with respect to a partnership adjustment, and each such notional item or items are then allocated in accordance with the proposed regulations. An item is considered to be a "notional item" when its sole purpose is to affect partner-level specified tax attributes; notional items are not considered items for purposes of adjusting other tax attributes.

Where a partnership adjustment represents an increase to income or gain, a notional item of income or gain is created in an amount equal to the partnership adjustment. Similarly, in the case of a partnership adjustment that is an increase to an expense or a loss, a notional item of expense or loss is created in an amount equal to the partnership adjustment.[87]

Where a partnership adjustment is a decrease to income or gain, however, a notional item of expense or loss is created in an amount equal to the partnership adjustment. Similarly, for a partnership adjustment that is a decrease to an expense or a loss, a notional item of income or gain is created in an amount equal to the partnership adjustment.[88] These rules have the effect of reversing out the reviewed year allocation to the extent necessary to reflect the partnership adjustment.

What do we do with these new "notional items"? Under the proposed regulations, an adjustment year partner increases its outside basis for the notional income that it is allocated. Similarly, a partnership that determines and maintains capital accounts in accordance with Reg. 1.704-1(b)(2)(iv) also adjusts capital accounts for notional items.[89] In the case of a partnership adjustment that reflects a net increase or net decrease in credits as determined under Prop. Reg. 301.6225-1(d), the partnership creates one or more notional items of income, gain, loss, or deduction that reflects the change in the item giving rise to the credit.[90]

Even though the IRS and Treasury are considering broader rules for adjusting tax attributes beyond those described in the proposed regulations, only specified tax attributes should be adjusted to conform to the proposed regulations at this time. In the June 14 NPRM, "tax attributes" were defined to include anything that can affect (1) the amount or timing of an item of income, gain, loss, deduction, or credit (as defined in Prop. Reg. 301.6221(a)-1(b)(1)) for a partnership or partner, or (2) the amount of tax due in any tax year. Examples of tax attributes include, but are not limited to, the basis and holding period, the character of items of income, gain, loss, deduction, or credit, and carry-overs and carry-backs of such items.[91]

The proposed regulations coordinate the changes to specified tax attributes made under these rules with other rules of the Code, including the rest of the centralized partnership audit regime.[92] To the extent a partner or partnership appropriately adjusted tax attributes prior to a final determination under subchapter C of chapter 63 with respect to a partnership adjustment (e.g., in the context of an amended return modification or a closing agreement), those tax attributes are not adjusted under this section. For example, when a partnership requests a modification of the imputed underpayment regarding a partner-specific tax attribute (e.g., a net operating loss) by having a partner file an amended return or by entering into a closing agreement, the partner-specific tax attribute must be reduced to the extent that it is used to modify the imputed underpayment.

Allocation of notional items. As discussed, the proposed regulations provide new items, so-called "notional items," to allocate under Section 704.

The general partnership allocation rules are well-known and—at least conceptually—understood. Under Section 704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined under the partnership agreement if the allocation under the agreement has substantial economic effect. Under the "substantial economic effect test," Reg. 1.704-1(b)(2)(i) sets forth a two-part analysis that is made at the end of the partnership year to which the allocation relates. In order for an allocation to have substantial economic effect, the allocation must have both economic effect (per Reg. 1.704-1(b)(2)(ii)) and be substantial (per Reg. 1.704-1(b)(2)(iii)). If the allocation does not have substantial economic effect—or if the partnership agreement does not provide for the allocation—the allocation must be made in accordance with the partners' interest in the partnership under Reg. 1.704-1(b)(3).

The question is, therefore, whether notional items generated under Section 6225 should be allocated under Section 704(b) and its corresponding regulations. The IRS and Treasury state that the answer is "yes, but only to some extent." More specifically, the Preamble states that, while the basic principles of Section 704(b) remain sound in the context of notional items, the unique nature of partnership adjustments under Section 6225 requires the application of these principles to be modified.[93] This limitation was included because the allocation of notional items cannot have substantial economic effect. While generally determined with respect to the reviewed year, notional items are taken into account in the adjustment year; in other words, an allocation of notional items relates to two different years. The proposed regulations dictate, therefore, that the allocation of a notional item does not have substantial economic effect, but, to address this issue, they further provide that the allocation will be deemed to be in accordance with the partners' interests in the partnership if the allocation of a notional item of (1) income or gain described in Prop. Reg. 301.6225-4(b)(3)(ii), or (2) expense or loss described in Prop. Reg. 301.6225-4(b)(3)(iii), is made in the manner in which the corresponding actual item would have been allocated in the reviewed year under the Section 704 regulations. In other words, the allocation must be pro rata as to either the partners' interest in the partnership or the items to be adjusted that resulted in the "notional items."

There is another important ground rule announced in the rule-making. The allocation of a notional item of expense or loss must be allocated to the reviewed year partners that were originally allocated that excess item in the reviewed year (or their successors).[94] As discussed further, these rules require treating successors as reviewed year partners.

Successors to review year partners. Although the audit of the partnership is with respect to the reviewed years and the reviewed year partners, the partnership adjustments under Section 704(b) are economically borne by the adjustment year partners. Outside basis adjustments must be made to avoid effectively taxing the same item of income twice. No problem of double counting is present where a reviewed year partner remains a partner in the adjustment year. However, a double tax scenario quickly comes into view where the reviewed year partner who would be allocated the adjustment and basis increase, for example, has previously transferred his interest to another by sale, gift, or redemption. Without special remedial rules, the failure to provide outside basis would result in effectively taxing the same item of income twice, just as with respect to two different taxpayers. The proposed regulations provide successor rules under Prop. Reg. 1.704-1(b)(1)(viii)(b) for purposes of adjusting specified tax attributes—including outside basis.

A reviewed year partner's successor is either a transferee that succeeds to the transferor partner's capital account or, in the case of a complete liquidation of a partner's interest, the remaining partners to the extent their interests increased as a result of the liquidated partner's departure.[95]

The June 14 NPRM stated that where a reviewed year partner to whom an amount was reallocated is not also an adjustment year partner, the portion of the adjustment that would otherwise be allocated to the reviewed year partner is allocated instead to the adjustment year partner or partners who are the successor or successors to the reviewed year partner.[96] Where the partnership cannot identify an ad-

[86] Prop. Reg. 301.6225-4(b)(2).
[87] See Prop. Regs. 301.6225-4(b)(3)(ii), (iii).
[88] See Prop. Regs. 301.6225-4(b)(3)(iv), (v).
[89] See Prop. Reg. 301.6225-4(e), Example 1.
[90] See Prop. Reg. 301.6225-4(b)(3)(vi).
[91] See Prop. Reg. 301.6241-1(a)(10).
[92] Prop. Reg. 301.6225-4(a)(4).
[93] Prop. Reg. 1.704-1(b)(1)(viii)(a).
[94] Reg. 1.704-1(b)(4)(xi).
[95] See Prop. Regs. 1.704-1(b)(1)(viii)(b), 301.6225-4(e), Example 3.
[96] Prop. Reg. 301.6225-3(b)(4) (June 14 NPRM).

EXHIBIT 1

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Cash	$2,000	$2,000	$2,000	A	$400	$1,000	$1,000
Whiteacre	$400	$1,000	$1,000	B	$1,000	$1,000	$1,000
				C	$1,000	$1,000	$1,000
Totals	$2,400	$3,000	$3,000		$2,400	$3,000	$3,000

justment year partner that is a successor to the reviewed year partner described in the previous sentence—or if a successor does not exist—the portion of the adjustment that would otherwise be allocated to that reviewed year partner is allocated among the adjustment year partners according to the adjustment year partners' distributive shares.[97]

Adjusting specified tax attributes in certain circumstances without creating notional items. For certain types of partnership adjustments, the Preamble to the proposed regulations states that notional items are not created. Specifically, notional items are not created for a partnership adjustment that does not derive from items that would have been allocated in the reviewed year under Section 704(b), such as (1) a partnership adjustment based on a partner's failure to report gains under Section 731, (2) a partnership adjustment that shifts an item of deduction to a Section 705(a)(2)(B) expenditure, or (3) a partnership adjustment to an item of tax-exempt income. In these situations, specified tax attributes are adjusted for the partnership and its reviewed year partners (or their successors) in a manner that is consistent with how the partnership adjustment would have been taken into account under the partnership agreement in effect for the reviewed year, considering all facts and circumstances.[98]

Special rules for outside basis in certain cases. As previously discussed, under the proposed regulations, partners will generally be required to adjust their outside bases in the partnership interests for notional items that are allocated to them. However, there are some exceptions. One exception pertains to a tax-exempt entity: where a tax-exempt partner transfers its interest to a partner that is not tax-exempt (i.e., a taxable partner) between the reviewed year and the adjustment year and the partnership requests a modification because of the reviewed year partner's status as a tax-exempt entity, the successor taxable partner is disallowed any basis adjustment.[99] This is to prevent a taxable successor from obtaining a tax benefit (i.e., an increase to outside basis) where there was no underlying imputed underpayment associated with the predecessor.

A basis adjustment is also disallowed when a reviewed year partner transfers its interest to a related party in a transaction in which not all gain or loss is recognized during an administrative proceeding under subchapter C of chapter 63 of the Code and a principal purpose of the transfer is to shift the economic burden of the imputed underpayment among related parties.

Accounting and allocation of partnership Section 705(a)(2)(B) expenditures. As previously discussed, the payment of an imputed underpayment by the partnership is nondeductible and represents a charge to basis and capital accounts.[100] This outcome is echoed in the proposed regulations.[101]

For the allocation of the nondeductible expense to have economic effect, however, it must be consistent with the underlying economic arrangement of the partners. Generally, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides for (1) the determination and maintenance of the partners' capital accounts in accordance with Reg. 1.704-1(b)(2)(iv); (2) the liquidation of distributions to the partners in accordance with the positive capital account balances

[97] See Prop. Regs. 301.6225-3(b)(4), 1.704-1(b)(1)(viii)(b)(3).
[98] Prop. Reg. 301.6225-4(e), Example 5.
[99] Prop. Reg. 301.6225-4(b)(iii)(B).
[100] See Section 705(a)(2)(B).
[101] Prop. Reg. 301.6225-4(c).
[102] Reg. 1.704-1(b)(2)(iv)(b).
[103] See Prop. Regs. 1.704-1(b)(2)(iii)(a), (f); Prop. Regs. 301.6225-4(c), (e), Example 4.

EXHIBIT 2

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Cash	$1,880	$1,880	$1,880	A	$360	$960	$1,000
Whiteacre	$400	$1,000	$1,000	B	$960	$960	$1,000
Asset	$0	$0	$120	C	$960	$960	$1,000
Totals	$2,280	$2,880	$3,000		$2,280	$2,880	$3,000

EXHIBIT 3

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Cash	$1,832	$1,832	$1,832	A	$384	$984	$984
Whiteacre	$400	$1,000	$1,000	B	$984	$984	$984
Asset	$120	$120	$120	C	$984	$984	$984
Totals	$2,352	$2,952	$2,952		$2,352	$2,952	$2,952

of the partners; and (3) each partner to be unconditionally obligated to restore the deficit balance in the partner's capital account following the liquidation of the partner's partnership interest. In lieu of satisfying the third criterion, the partnership may satisfy the qualified income offset rules in Reg. 1.704-1(b)(2)(ii)(d).

Reg. 1.704-1(b)(2)(iv)(i) provides guidance on determining whether an allocation of a Section 705(a)(2)(B) expenditure has substantial economic effect. Specifically, it requires that a partner's capital account be decreased by allocations made to such partner of expenditures described in Section 705(a)(2)(B).[102] Further, under Section 705(a)(2)(B), the adjusted basis of a partner's interest in a partnership is decreased (but not below zero) by expenditures of the partnership that are neither deductible in computing its taxable income nor properly chargeable to capital account.

The Service has received comments on permitting the partnership agreement to control the allocation of the Section 705(a)(2)(B) expense, provided the allocation was consistent with the Section 704(b) regulations. The Preamble noted Treasury's and the Service's agreement with this approach, but the proposed regulations set forth special rules for allocating the expenditure under Section 704(b).

With respect to book capital account adjustments for the imputed underpayment, some commentators recommended that partners' capital accounts be adjusted to reflect the partnership's payment of the imputed underpayment. Treasury and the IRS agreed with this comment, but concluded that, because the expenditure is treated as an expenditure under Section 705(a)(2)(B) pursuant to the June 14 NPRM (Prop. Reg. 301.6241-4(a)), existing rules provide this result.

Treasury and the IRS have concluded, moreover, that the existing rules that determine whether the economic effect of an allocation is substantial should be modified to take into account the unique nature of these expenditures. When a partnership pays an imputed underpayment under Section 6225, it converts a nondeductible partner-level expenditure into a nondeductible partnership-level expenditure. The proposed regulations provide that an allocation of the nondeductible expenditure will be considered substantial only if the partnership allocates the expenditure in proportion to the notional item to which it relates, taking into account appropriate modifications.[103] Otherwise,

EXHIBIT 4

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Cash	$1,850	$1,850	$1,850	A	$400	$1,000	$1,000
Whiteacre	$400	$1,000	$1,000	B	$984	$984	$984
Asset	$120	$120	$120	C	$986	$986	$986
Totals	$2,370	$2,970	$2,970		$2,370	$2,970	$2,970

EXHIBIT 5

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Asset	$1,200	$1,200	$1,500	J	$400	$400	$500
				K	$400	$400	$500
				L	$400	$400	$500
Totals	$1,200	$1,200	$1,500		$1,200	$1,200	$1,500

partnerships could inappropriately allocate expenses to partners in the adjustment year in a manner inconsistent with the underlying economic arrangement of the partners. These new substantiality rules also apply to a payment made by a pass-through partner under Prop. Reg. 301.6226-3(e)(4).

In instances where partnerships do not maintain capital accounts, the allocation of the expenditure cannot be in accordance with the partners' interests in the partnership to the extent it shifts the economic burden of the payment of the imputed underpayment away from a partner (or its successor) that would have been allocated the corresponding notional income item. The proposed regulations provide, however, that an allocation of an expense that satisfies the new substantiality rule and in which the partner's distribution rights are reduced by the partner's share of the imputed underpayment is deemed to be in accordance with the partners' interests in the partnership.[104] These proposed regulations do not address the extent to which the partnership may later reverse this allocation with a special chargeback or similar provision.

The proposed regulations provide that in order for an allocation of an expenditure for interest, penalties, additions to tax, or additional amounts as determined under Section 6233 to be substantial, it must be allocated to the reviewed year partner in proportion to the allocation of the related imputed underpayment, the related payment made by a pass-through partner under Prop. Reg. 301.6226-3(e)(4), or the related notional item to which it relates (whichever is appropriate), taking into account the modifications under Prop. Reg. 301.6225-2 attributable to that partner.[105] Further, an expense arising from a substantial understatement of tax under Section 6662(d) for an imputed underpayment will generally be allocated in proportion to the notional income item to which it relates.

Partnership adjustments that do not result in an imputed underpayment. The June 14 NPRM provides that the rules under subchapter K apply in the case of a partnership adjustment that does not result in an imputed underpayment.[106] Further, Prop. Reg. 1.704-1(b)(4)(xiii) provides that an allocation of an item arising from a partnership adjustment that does not result in an imputed underpayment (as defined in Prop. Reg. 301.6225-1(c)(2))

EXHIBIT 6

	Partnership Basis	Book	Value		Outside Basis	Book	Value
Asset	$1,275	$1,275	$1,500	J	$425	$425	$500
				K	$425	$425	$500
				L	$425	$425	$500
Totals	$1,275	$1,275	$1,500		$1,275	$1,275	$1,500

does not have substantial economic effect but will be deemed to be in accordance with the partners' interests in the partnership if it is allocated in the manner in which the item would have been allocated in the reviewed year under the regulations under Section 704, taking into account the successor rules set forth in the proposed regulations.

Provisions relating to Section 6226. As discussed above, Section 6226(b) describes how partnership adjustments are taken into account by the reviewed year partners if a partnership makes an election under Section 6226(a). Under Section 6226(b)(1), each partner's tax, imposed by chapter 1 of subtitle A of the Code, is increased by the aggregate of the adjustment amounts as determined under Section 6226(b)(2). This increase in chapter 1 tax is reported on the return for the partner's tax year that includes the date on which the statement described under Section 6226(a) was furnished to the partner by the partnership (reporting year). The aggregate of the adjustment amounts is the aggregate of the correction amounts.[107]

The adjustment amounts described in Section 6226(b)(2) fall into two categories. In the case of the tax year of the partner that includes the end of the partnership's reviewed year (the so-called "first affected year") under Section 6226(b)(2)(A), the adjustment amount is the amount by which the partner's chapter 1 tax would increase for the partner's first affected year if the partner's share of the adjustments were taken into account in that year. In the case of any tax year after the first affected year and before the reporting year (that is, the intervening years) under Section 6226(b)(2)(B), the adjustment amount is the amount by which the partner's chapter 1 tax would increase by reason of the adjustment to tax attributes determined under Section 6226(b)(3) in each of the intervening years. The adjustment amounts determined under Sections 6226(b)(2)(A) and (B) are added together to determine the aggregate of the adjustment amounts for purposes of determining additional reporting year tax, which is the increase to the partner's chapter 1 tax in accordance with Section 6226(b)(1).

Section 6226(b)(3) provides two rules regarding adjustments to tax attributes that would have been affected if the partner's share of adjustments were taken into account in the first affected year. First, under Section 6226(b)(3)(A), in the case of an intervening year, any tax attribute must be appropriately adjusted for purposes of determining the adjustment amount for that intervening year in accordance with Section 6226(b)(2)(B). Second, under Section 6226(b)(3)(B), in the case of any subsequent tax year (that is, a year, including the reporting year, that is subsequent to the intervening years referred to in 6226(b)(3)(A)), any tax attribute must be appropriately adjusted.

The June 14 NPRM posited that a reviewed year partner's share of the adjustments that must be taken into account by the reviewed year partner must be reported to the reviewed year partner in the same manner as originally reported on the return filed by the partnership for the reviewed year.[108] In the event that the adjusted item was not reflected in the partnership's reviewed year return, the adjustment must be reported in accordance with the rules that apply with respect to partnership allocations—including under the partnership agreement. Prop. Reg. 301.6226-2(f)(1) provides, however, that if the adjustments, as finally de-

[104] Prop. Reg. 1.704-1(b)(4)(xii).
[105] Prop. Regs. 1.704-1(b)(2)(iii)(f)(2), (f)(3).
[106] See Prop. Reg. 301.6225-3(c).
[107] Prop. Reg. 301.6226-3(b).
[108] Prop. Reg. 301.6226-2(f).

termined, are allocated to a specific partner or in a specific manner, the partner's share of the adjustment must follow how the adjustment is allocated in that final determination.

Prop. Reg. 301.6226-4(b) provides that the reviewed year partners or affected partners (per Prop. Reg. 301.6226-3(e)(3)(i)) must take into account items of income, gain, loss, deduction, or credit with respect to their share of the partnership adjustments as contained on the statements described in Prop. Reg. 301.6226-2 (pushed-out items) in the reporting year (Prop. Reg. 301.6226-3(a)). Similarly, partnerships adjust tax attributes affected by reason of a pushed-out item in the reviewed year. In the case of a reviewed year partner that disposed of its partnership interest prior to the reporting year, that partner may take into account any outside basis adjustment under these rules in an amended return to the extent otherwise allowable under the Code.

Unlike the proposed rules under Section 6225 and subchapter K described in section 2 of the Preamble, under Section 6226, all tax attributes (as defined in Prop. Reg. 301.6241-1(a)(10)) are adjusted for pushed out items of income, gain, deduction, loss, or credit.

Allocation of push-out tax items. In accordance with Section 704(b), an allocation of a pushed-out item does not have substantial economic effect within the meaning of Section 704(b)(2). However, the allocation of such an item will be deemed to be in accordance with the partners' interests in the partnership if it is allocated in the adjustment year in the manner in which the item would have been allocated under the rules of Section 704(b), including Reg. 1.704-1(b)(1)(i) or as otherwise taken into account under subtitle A, in the reviewed year (as defined in Prop. Reg. 301.6241-1(a)(8)), followed by any subsequent tax years and concluding with the adjustment year (as defined in Prop. Reg. 301.6241-1(a)(1)).[109]

Reporting and payment issues. Under the June 14 NPRM, a reviewed year partner that is furnished a statement under Prop. Reg. 301.6226-2 is required to pay any additional chapter 1 tax (i.e., additional reporting year tax) for the partner's tax year that includes the date on which the statement was furnished to the partner in accordance with Prop. Reg. 301.6226-2 (the reporting year)—a tax that results from taking into account the adjustments reflected in the statement.[110]

While the reviewed year partners pay the tax on the push-out election, the adjustments to capital accounts and basis still apply to the partners in the adjustment year. This approach is at odds with long-standing concepts of flow-through taxation under Subchapter K. Taxing partners from prior years and giving basis increases to successors in interest? Perhaps this proposal needs one more round of criticism before the regulations are finalized.

The February 2, 2018 proposed regulations provide that adjustments to partnership-level tax attributes are calculated with respect to each year beginning with the reviewed year, followed by subsequent tax years, and concluding with the adjustment year.[111]

Effect of a push-out payment by pass-through partner. The February 2, 2018 NPRM provides that to the extent that a pass-through partner (per Prop. Reg. 301.6241-1(a)(5)) makes a payment in lieu of issuing statements to its owners described in Prop. Reg. 301.6226-3(e)(4), that payment will be treated similarly to the payment of an amount under subchapter C of chapter 63 for purposes of any adjustments to bases and capital accounts, and accordingly, the rules in Prop. Reg. 301.6225-4 will apply to determine any appropriate adjustments to bases and capital accounts.[112] To the extent that the pass-through partner continues to push out the partnership adjustments to its partners in accordance with Prop. Reg. 301.6226-3(e)(3), the partners receiving those adjustments will adjust their bases and capital accounts in accordance with the guidance provided in Prop. Reg. 301.6226-4.

Examples of the tax attribute adjustment rules under Section 6225. *Example 1.*[113] (i) In 2019, A, B, and C form partnership ABC. A contributes Whiteacre, which has an adjusted basis of $400 and FMV of $1000. B and C each contribute $1000 in cash. The partnership agreement provides, per Reg. 1.704-1(b)(2)(iv), that the capital account maintenance rules will be maintained and that the partners' capital accounts will provide, inter alia, that distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership per Regs. 1.704-1(b)(2)(ii)(b)(2), (3).

(ii) Upon formation, Partnership has the assets and capital accounts shown in Exhibit 1.

[109] See Prop. Reg. 1.704-1(b)(4)(xiv).
[110] See Prop. Reg. 301.6226-3.
[111] See Prop. Reg. 301.6226-4(b).
[112] Prop. Reg. 301.6226-3(e).

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(iii) In 2019, Partnership makes a $120 payment for Asset, which it treats as a deductible expense on its partnership return. See Exhibit 2.

(iv) Partnership does not file an AAR for 2020. The IRS determines in 2021 (the adjustment year) that Partnership's $120 expenditure was not allowed as a deduction in 2019 (the reviewed year), but rather was the acquisition of an asset for which cost recovery deductions are unavailable. The IRS therefore makes a partnership adjustment that disallows the entire $120 deduction, which results in an imputed underpayment of $48 ($120 x 40%). Partnership does not request modification under Prop. Reg. 301.6225-2. Partnership pays the $48 imputed underpayment.

The proposed regulations introduce the concept of "notional items" to the lexicon of tax attribute rules for the centralized partnership audit regime.

(v) Partnership next determines its tax attribute adjustments resulting from the partnership adjustment. Pursuant to Prop. Reg. 301.6225-4(b), Partnership ABC must re-state the basis and book value of Asset to $120. Further, pursuant to Prop. Reg. 301.6225-4(b)(3)(ii), a $120 notional item of income is created. The $120 item of notional income is allocated in equal shares ($40) to A, B, and C in 2021 under Prop. Reg. 1.704-1(b)(4)(xi). Accordingly, in 2021, Partnership increases the capital accounts of A, B, and C by $40 each, and increases A, B, and C's outside bases by $40 each per Prop. Regs. 301.6225-4(b)(5)(ii), (iii).

(vi) Partnership's payment of the $48 imputed underpayment is an expenditure described in Section 705(a)(2)(B) under Prop. Reg. 301.6241-4. Under Reg. 1.704-1(b)(40(xii), the Partnership determines each partner's properly allocable share of this expenditure in 2021 by allocating the expenditure in proportion to the allocations of the notional item to which the expenditure relates. Accordingly, each of A, B, and C have a properly allocable share of $16 each, which is the same proportion (one-third each) in which A, B, and C share the $120 item of notional income. Thus, A, B and C's capital accounts are each decreased by $16 in 2021 and A, B and C's outside bases are each decreased by $16 in 2021. The allocation of the expenditure under the partnership agreement has economic effect under Reg. 1.704-1(b)(2)(ii) and the effect of the allocations will be deemed substantial.[114]

(vii) The payment of the imputed underpayment by Partnership ABC is also reflected by a $48 decrease in partnership cash for book purposes under Reg. 1.704-1(b)(4)(ii). Therefore, in 2021, A's basis in Partnership is $384 and his capital account is $984. B and C each have a basis and capital account of $984. See Exhibit 3.

Example 2.[115] (i) The facts are the same as in Example 1, but the IRS approves modification under Prop. Reg. 301.6225-2(d)(3) with respect to A, since it is a tax-exempt entity, and per Prop. Reg. 301.6225-2(d)(4) with respect to C, which is a corporation subject to a 35% tax rate (actually 21% due to the new tax law). These modifications reduce Partnership's overall imputed underpayment from $48 to $30.

(ii) As in Example 1, Partnership determines its tax attribute adjustments resulting from the partnership adjustment by applying paragraph 301.6225-4(b). $120 is treated as a notional income item and is allocated in equal shares ($40) to A, B, and C in 2021 per Prop. Reg. 1.704-1(b)(4)(xi). In 2021, Partnership increases the capital accounts of A, B, and C by $40 each, and increases A, B, and C's outside bases by $40 respectively.

(iii) In Example 2, however, the modifications taken into account under Section 6225(c) affect how Partnership ABC must allocate the imputed underpayment expenditure in 2021 (the adjustment year) pursuant to Prop. Reg. 1.704-1(b)(2)(iii)(f). Partnership allocates the $30 expenditure in 2021 in proportion to the allocation of the notional item to which it relates (which is one-third each, as in Example 1), but it must also take into account modifications attributable to each partner. Accordingly, B's allocation is $16 (its share of the imputed underpayment, for which no modification occurred), and A and C have properly allocable shares of $0 and $14, respectively (their shares, taking into account modification). Thus, A's capital account is decreased by $0, B's capital account is decreased by $16, and C's capital account is decreased by $14 in 2021 and their respective outside bases are decreased by the same amounts in 2021.

(iv) The payment of the imputed underpayment made by the Partnership is also reflected by a $30 decrease in partnership cash for book purposes. Therefore, in 2021, A's basis in Partnership is $400 and his capital account is $1000, B's basis and capital account are both

$984, and C's basis and capital account are both $986. See Exhibit 4.

Example 3.[116] The facts are the same as in Example 1. However, in 2020, C transfers its entire interest in Partnership to D (an individual) for cash. Under Reg. 1.704-1(b)(2)(iv)(l), C's capital account carries over to D. In 2021, the year the IRS determines that Partnership's $120 expense is not allowed as a deduction, D is C's successor under Reg. 1.704-1(b)(1)(viii)(b)(2) with respect to specified tax attributes and the payment of the imputed underpayment is treated as an expenditure under Section 705(a)(2)(B).

Example 4.[117] (i) In 2019, Partnership AB is a 50-50 partnership with A and B each having a $0 outside basis. Partnership AB has a $200 nonrecourse liability per Reg. 1.752-1(a)(2) resulting in both being allocated one-half or $100 of the liability per Reg. 1.752-3. In 2021 (the adjustment year), the IRS determines that the liability was recourse and not non-recourse, resulting with only B having the right to be allocated the liability of $100 for outside basis purposes. No amount was allocable to A. As a result of the liability misclassification, the IRS assesses an imputed underpayment of $40 ($100 x 40%) resulting from the $100 decrease in A's share of partnership liabilities under Regs. 1.752-1(c) and 1.731-1(a)(1)(i). Partnership does not request modification under Prop. Reg. 301.6225-2. Partnership AB pays the $40 imputed underpayment.

(ii) Under the proposed regulations, notional items are not created with respect to this partnership adjustment. Instead, under Prop. Reg. 301.6225-4(b)(4)(i), specified tax attributes are adjusted in a manner that is consistent with how the partnership adjustment would have been taken into account under the partnership agreement in effect for the reviewed year taking into account all facts and circumstances. In this case, no specified tax attributes are adjusted.

(iii) However, because A would have borne the economic burden of the partnership adjustment if the partnership and its partners had originally reported in a manner consistent with the partnership adjustment, the $40 imputed underpayment Section 705(a)(2)(B) expenditure is nevertheless allocated to A under Reg. 1.704-1(b)(2)(iii)(f)(4). This outcome is bound to generate some comment. Presumably, this amount will also be charged against A's capital account, creating a deficit capital account (absent taking into account other partnership items of income, loss, deduction, and credit occurring after the formation of the Partnership).

Example of the tax attribute adjustment rules under Section 6226, the push-out election. *Example.*[118] (i) In 2021, J, K, and L form Partnership (JKL) by each contributing $500 in exchange for an equal one-third share of the partnership interests and allocation of income, loss, etc. Partnership JKL immediately purchases Asset on January 1, 2021 for $1500, which it depreciates using the straight-line method with a ten-year recovery period beginning in 2021 ($150). Each partner is allocated its $50 distributive share of the depreciation, resulting in an outside basis of $450 for each partner. At the end of 2022, J, K, and L have an outside basis and capital account of $400 each ($500 less $50 of their respective allocable shares of depreciation in 2021 and $50 in 2022). See Exhibit 5.

(ii) A notice of administrative proceeding (audit) is issued to Partnership JKL for its 2021 tax year (reviewed year) in 2023 (adjustment year). The IRS contends that the Asset had a 20-year recovery period beginning in 2021, resulting in a $75 partnership adjustment that results in an imputed underpayment. The IRS does not initiate an administrative proceeding with respect to Partnership's 2022 tax year, and Partnership does not file an administrative adjustment request for that tax year. Partnership makes a push-out election under Section 6226(b) and Prop. Reg. 301.6226-1 with respect to the imputed underpayment. J, K, and L each are timely furnished a statement described in Prop. Reg. 301.6226-2 by Partnership reflecting the $25 income adjustment for 2021. Pursuant to Prop. Reg. 301.6226-2(e)(6), the statement furnished by Partnership to J, K, and L also reflects a $25 income adjustment to the 2022 intervening year.

(iii) Tax attributes of the partners must be adjusted to reflect the $75 pushed-out item of income that is taken into account in equal shares ($25) by J, K, and L for the reviewed year, i.e., 2021. Specifically, J, K, and L's outside bases and capital accounts must be increased $25 each with respect to the 2021 tax year. Additionally, tax attributes must be adjusted with respect to 2022, as an intervening year. Specifi-

[113] Prop. Reg. 301.6225-4(e), Example 1.
[114] See Reg. 1.704-1(b)(2)(iii)(f).
[115] Prop. Reg. 301.6225-4(e), Example 2.
[116] Prop. Reg. 301.6225-4(e), Example 3.
[117] Prop. Reg. 301.6225-4(e), Example 5.
[118] Prop. Reg. 301.6226-4(c).

cally, J, K, and L must increase their outside bases and capital accounts by $25 each with respect to the 2022 tax year. As a result, J, K, and L each have an outside basis and capital account of $425 ($400 minus $25 of depreciation for 2023 plus $25 of income realized with respect to 2021 plus $25 of income realized with respect to 2022). Asset's basis and book value must also be changed in 2023. After adjusting tax attributes to take into account the election under Prop. Reg. 301.6225-1 and other activities of Partnership in 2023, accounts are stated as shown in Exhibit 6.

Conclusion

The final regulations on electing-out of the new partnership audit rules each year left intact unfortunate limitations that still deny many closely held family partnership the ability elect out of the centralized partnership audit regime. The presence of a single member limited liability company and/or one or more grantor trusts blocks that escape route. Perhaps the regulations will pivot and reverse course and provide for a single owner of a defective entity or trust to be part of Section 6622.

The proposed regulations with respect to the computation of the imputed underpayment and modification rules under Section 6225 are helpful and well done, although there still may be some "glitches," particularly with the inability to make modifications by amended returns for owners of defective entities. The new Budget Bill's "pull-in" election is indeed good news.

The proposed regulations under Section 6226 are worthy of applause since the rules accommodate multi-tier partnerships. The proposed regulations under Section 6226 further permit the owner of a defective entity to be able to participate as if the owner were the reviewed year partner.

While the recent rule-makings are well done despite their complexity and traps for the unwary or uninformed, Treasury and the Service need to rethink the basis and capital account approach taken under Section 6226. There is indeed a most unfortunate mismatch of income allocation and tax attributes. ■