New Partnership Audit Rules: Concepts and Issues, Part 2

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In this report, Brause reviews the reasons Congress enacted the new partnership audit rules, and he summarizes the core concepts and elements of the new regime. Brause also discusses various practical issues that arise under the new rules, with a particular emphasis on investment funds, so-called UPREIT and UP-C structures, acquisitions involving partnerships, and securitization transactions.

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C. Partnership-Level Tax Collection Mechanism

1. No joint and several liability of partners. Because the new audit rules make the partnership liable for the imputed underpayment and a partnership is a conduit under general principles, the question arises whether the partners are jointly and severally liable for the imputed underpayment payable by the partnership. The answer is no because nothing in the new audit rules establishes such a liability, and under general state law principles applicable to partnerships and limited liability companies, no such liability exists unless clearly established by specific contractual agreements. By contrast, both the Tax Reform Act of 2014 and the Partnership Audit Simplification Act of 2015 had provided for joint and several liability.[139]

This leaves one with the question whether that joint and several liability concept should exist. I believe that the answer is no. The key feature of modern partnerships is limited liability, regardless of how much the limited partner (LP) or the LLC member is involved in the activities of the partnership; investors have bargained for and expect that their downside from an investment in a partnership is limited to the capital they have contributed (including undistributed profits). To statutorily impose a joint and several liability for taxes would in effect pierce the limited liability shield and introduce significant uncertainty. In fact, only the absence of such a joint and several liability provides sufficient grounds for massively curtailing the participation rights of the partners.

2. Scope of partnership-level determinations. Let's turn next to the question of what kind of issues will be determined on the partnership level as required by section 6221(a).

a. Debt-equity and fee-partnership interest issues. The debt-equity issue raises the question whether a purported partner is truly a partner in the partnership or merely a creditor.[140] Because this could be viewed as either a partner- or a partnership-level item, it is not entirely clear whether this would be an item that should be determined on the partnership level. However,

[139]*See* section 6241(d)(1) (Tax Reform Act of 2014) (''The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto.''); and section 6241(d)(1) (Partnership Audit Simplification Act of 2015) (''The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto.'').

[140]*See TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006). (The district court concluded that banks were partners in a partnership. On appeal, the Second Circuit reversed by taking the position that the banks' interests did not constitute equity in the partnership. Instead, the interests were more in the nature of a secured lender's interest.).

courts have taken the position that the question whether a partner is a partner in a partnership subject to the 1982 Tax Equity and Fiscal Responsibility Act is a partnership item.[141] Also, new section 6241(8) provides that if a partnership return is filed by an entity for a tax year but it is determined that the entity is not a partnership (or that there is no entity) for that tax year, then, to the extent provided in regulations, the provisions of the new audit rules are extended for that year to that entity and its items and to the persons holding an interest in that entity. Accordingly, the new regulations should confirm the approach taken under TEFRA for purpose of the new audit rules. The same rule should apply to whether a purported partner is indeed a partner or merely a person earning a fee for services.[142]

b. Economic substance of partnership. Whether a partnership has economic substance or is merely a sham goes to the very question whether a partnership exists in the first place. Under TEFRA, in the context of partnership tax shelters, the courts have taken the view that this question is a partnership item.[143] In light of new section 6241(8), this approach should also apply to the new audit rules.

c. Constructive partnerships. Based on the foregoing, the question whether a legitimate business arrangement should be treated as a constructive partnership should also be treated as an item that should be determined on the partnership level.[144]

d. Series LLCs. Series LLCs are not uncommon in investment funds.[145] Whether a series of a series LLC is treated as a separate partnership is an issue that should be determined on the partnership level. It would be helpful if the IRS clarified in the new regulations that it will respect each series of a series LLC as a separate partnership, thereby limiting the reach of the entity-level tax rule of the new audit rules to a particular series. That would avoid the ''liability pollution'' of other series of a series LLC.

e. ECI and UBTI. Consistent with general partnership tax principles of subchapter K, the question whether a partnership is engaged in a U.S. trade or business and therefore earns effectively connected income should be determined on the partnership level.[146] The same rule should apply to unrelated business taxable income, including the application of the fractions rule.[147]

f. Trader, dealer, and investor status. Under general partnership principles, the question whether a partnership is an investor, trader, or dealer is determined on the partnership level.[148] Accordingly, those items should also be determined on the partnership level for purposes of the new audit rules.

Example 9: A is a partnership with more than 100 partners. The largest partner is B, a real estate investment trust. A invests in real estate. In year 3 A sells various properties it had acquired in year 1. A reports all the gains from those sales as capital gains. In year 5 the IRS audits A and determines that the sales resulted in ordinary income because they constituted sales of dealer property.

As discussed above, the IRS should be able to determine dealer status on the partnership level under general case law. Whether real estate constitutes dealer property under section 1221(a)(1) is a notoriously difficult issue as reflected in decades of case law.[149] To address this problem, REITs (but not other taxpayers) may rely on a prohibited transaction safe harbor.[150] Accordingly, it is unclear whether the IRS within the audit of A could (or should) consider whether B may rely on this safe harbor because it is a partner-level characteristic. A sensible approach would be to allow the IRS to ignore the prohibited transaction safe harbor in its review of the dealer property issue but to permit A and B to show (solely for purposes of reducing the imputed underpayment discussed below) that B may rely on the safe harbor.

g. Other aspects. Other aspects that, consistent with the approach taken under TEFRA, should be determined on the partnership level are (1) section

[141] *Blonien v. Commissioner*, 118 T.C. 541 (2002) (concluding that the question whether a partner is a partner in a TEFRA partnership could not be considered in a partner-level proceeding).

[142] *See* REG-115452-14 (regulations proposed in July 2015 on disguised payments for services); *see also* reg. section 301.6231(a)(3)-1(a)(4)(iii).

[143] *Petaluma FX Partners LLC v. Commissioner*, 591 F.3d 649, 654 (D.C. Cir. 2010) (holding that the determination that the partnership was a sham is a partnership item).

[144] *See* William B. Brannan, ''Constructive Partnerships,'' Tax Club (2006) (discussing the constructive partnership issue in light of recent business arrangements and authorities).

[145] *See* LTR 200803004 (discussing the special case of series LLC); *see also* prop. reg. section 301.7701-1(a)(5) (series organizations for insurance purposes); and Michael E. Mooney, ''Series LLCs: The Loaves and Fishes of Subchapter K,'' *Tax Notes*, Aug. 20, 2007, p. 663.

[146] *See Brannen v. Commissioner*, 78 T.C. 471 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984) (because a partnership is a separate entity, the character of deductions under section 162 is determined on the partnership level); *see also* FSA 200111001 (discussing whether a partnership is a trader or investor).

[147] Reg. section 301.6231(a)(3)-1(a)(1)(iv).

[148] Rev. Rul. 2008-39, 2008-32 C.B. 252.

[149] *See, e.g.*, *Malat v. Riddell*, 383 U.S. 569 (1966) (discussing whether a real estate dealer held real estate primarily for sale to customers).

[150] Section 857(b)(6)(C) (two-year safe harbor if specified additional requirements are met).

704(c) allocations; (2) section 707(c) guaranteed payments;[151] (3) partnership terminations under section 708(b)(1)(A);[152] (4) taxable distributions of marketable securities under section 731;[153] and (5) the application of section 751.[154]

3. Netting and no imputed underpayment. Let's take a look at the situation in which audit adjustments do not result in an imputed underpayment. This situation will usually arise when the audit turns out to be favorable to the taxpayer (that is, overpayment cases). But that is not always the case.

Example 10: Asset manager A manages Hedge Fund, a hedge fund using a traditional master feeder structure with quarterly liquidity. A is the designated partnership representative for the master feeder partnership. Hedge Fund invests in debt instruments using leverage. U.S. high-net-worth individuals are the investors in the domestic feeder while U.S. tax-exempt and foreign investors invest through the offshore feeder. The IRS decides to audit Hedge Fund's master feeder partnership. The IRS identifies one issue: the amount of capital gains on distressed debt instruments in light of the market discount rules. The proposed audit adjustments for the reviewed year decrease the long-term capital gain by $100 and correspondingly increase ordinary income in the form of market discount by $100. In the adjustment year, Hedge Fund has taxable income.

The proposed audit adjustments would clearly increase the overall tax burden because some partners are U.S. individuals. Long-term capital gains in the hands of individuals are taxed at a reduced rate, and a portion of those gains are recharacterized as ordinary income. However, this should be a situation in which there is no imputed underpayment because, under a strict reading, the rules regarding the calculation of the imputed underpayment require the netting of *all* income, gain, loss, or deduction *irrespective of character*.[155] Accordingly, no imputed underpayment should be shown in the final partnership administrative adjustment, and the audit adjustments should be reflected in the partnership tax return of the master partnership as a reduction of $0 (that is, $100 minus $100 per FPAA) of partnership taxable income under section 702(a)(8).

Another situation in which this netting could be useful to taxpayers is the context of a section 475(f) mark-to-market election.

Example 11: Asset manager A manages Hedge Fund, a hedge fund using a traditional master feeder structure with quarterly liquidity. A is the designated partnership representative for the master feeder partnership. Hedge Fund invests in debt instruments using leverage. U.S. high-net-worth individuals are the investors in the domestic feeder, while U.S. tax-exempt and foreign investors invest through the offshore feeder. Hedge Fund makes a mark-to-market election under section 475(f) for the master partnership, which also establishes and identifies separately specific positions held for investment purposes.[156] In year 2 Hedge Fund reports a $200 long-term capital gain from its investment assets and $500 of ordinary income from its trading assets. In year 3 the IRS audits the master partnership for year 2 and denies the separate identification of investment assets, arguing that they are really part of the trading assets.

The denial of the investment asset treatment will result in a reduction of the long-term capital gain of $200 to zero, offset by a corresponding increase of ordinary income by $200, resulting, under the netting approach, in a zero net adjustment amount.[157] Accordingly, the IRS will not be able to collect an imputed underpayment.

4. Netting and imputed underpayment. The netting *without regard to character* is a core feature of the new audit rules even if there is an imputed underpayment.

Example 12: Asset manager A manages Hedge Fund, a hedge fund using a traditional master feeder structure with quarterly liquidity. A is the designated partnership representative for the master feeder partnership. Hedge Fund invests in debt instruments using leverage. U.S. high-net-worth individuals are the investors in the domestic feeder, while U.S. tax-exempt and foreign investors invest through the offshore feeder. The IRS decides to audit Hedge Fund's master feeder partnership. The IRS makes the following adjustments: (1) increase of long-term capital loss by $100; (2) increase of interest income by $150; and (3) increase of dividend income by $10. Accordingly, as a result of the netting approach, the underpayment is calculated based on $60, thereby allowing a full offset of

[151]Reg. section 301.6231(a)(3)-1(a)(2).

[152]*Harbor Cove Marina Partners Partnership v. Commissioner*, 123 T.C. 64 (2004).

[153]Reg. section 301.6231(a)(3)-1(a)(4)(ii).

[154]Reg. section 301.6231(a)(3)-1(a)(1)(vi)(E).

[155]Section 6225(b)(1)(A) (Bipartisan Budget Act of 2015 (BBA)). *But see* Bluebook, Part 1, at 63-64 ("Netting is done taking into account applicable limitations, restrictions, and special rules under present law.").

[156]Section 475(f)(1)(B).

[157]*But see* Bluebook, Part 1, at 63-64 ("Netting is done taking into account applicable limitations, restrictions, and special rules under present law.").

capital losses against ordinary income, which is otherwise subject to limitations.[158]

5. Allocations of adjustments and tax liability: Capital accounts, basis, and avoidance of double taxation. The next conceptual question associated with the entity-level tax collection mechanism is: What are the ancillary consequences of this mechanism? Let's break this down into smaller pieces.

First, once an audit adjustment regarding items of income, loss, or credit for a reviewed year has been established, the question arises of what happens to these audit adjustments apart from serving as the basis for calculating the imputed underpayment. One approach would be that these audit adjustments disappear because the imputed underpayment has been made. That would be a drastic implementation of the entity theory approach. Because there is nothing in the language of the new audit rules that would suggest that the audit adjustments simply disappear, I believe that this is not what Congress intended and contemplated. Accordingly, the audit adjustments do not disappear solely as the result of the imputed underpayment.

Second, how should an audit adjustment of an item of income, loss, or credit be allocated among the partners in the adjustment year? The new audit rules are silent on this issue. If there are no shifts in the percentage interests of the partners between the reviewed year and the adjustment year, this is straightforward: The adjustments should be allocated the same way the adjusted items of income, loss, or credit are allocated under the partnership's otherwise applicable general allocation regime. If, however, there are changes in the percentage interests, the question arises whether there should be special allocations of the audit adjustments to reflect those changes using in essence section 704(c) principles, and whether those special allocations should be mandatory or voluntary.

Example 13: ABCD LLC is a Delaware LLC with four equal partners in year 1. Each partner has contributed $25. ABCD LLC is treated as a partnership. Except as specifically stated, ABCD LLC has no liabilities and no assets. Assume no small partnership opt-out election and no section 6226 pushout election. In year 1 ABCD LLC acquired stock of Corp. X for $100. In year 2 ABCD LLC exchanged the stock in X for stock in Corp. Y worth $400, in a transaction intended to be a tax-free reorganization. In year 3 D made an additional capital contribution of $200, thereby becoming a 50 percent partner in ABCD LLC (and each of A, B, and C is diluted from 25 percent to 16.667 percent). In year 4 the IRS determines that the reorganization in the reviewed year (year 2) was fully taxable, resulting in a taxable gain of $300 in the adjustment year. The question is whether the gain of $300 should be allocated 25 percent to each of A, B, C, and D (based on the percentage interests in the reviewed year) or 50 percent to D and 16.667 percent to each of A, B, and C (based on the percentage interests in the adjustment year).

Example 14: An LP is a master limited partnership owned by a group of private equity partnerships. In year 1 A LP engages in a complex transaction that was intended to be tax free. In year 2 A LP undertakes an initial public offering by offering new units in exchange for cash capital contributions. The IPO is successful and has the effect that approximately 40 percent of A LP's units are free float. In year 3 the IRS determines that A LP's transaction in year 1 (the reviewed year) was taxable, thereby resulting in an additional gain of $100 in year 3 (the adjustment year). Again, the question is how the additional gain of $100 in year 3 should be allocated: based on the percentage interests in year 1 or on the percentage interests in year 3?

I believe the new regulations should adopt a default rule such that the percentage interests of the adjustment year are determinative unless the partnership agreement provides otherwise by mandating or permitting special allocations.[159] Given the potential accounting complexities in very large partnerships, I don't think that any special allocations should be made mandatory. Taxpayers should generally be entitled to determine whether it is worth the costs and efforts to achieve the correct economic result because allowing that choice does not undermine any tax policy considerations. Indeed, the very existence of the section 6226 pushout election seems to support that view. However, new regulations should provide for an antiabuse override by the IRS in cases in which there seems to be a potential for abuse.

Example 15: ABCD LLC is a Delaware LLC with four equal partners in year 1. Each partner has contributed $25. A, B, and C are profitable U.S.

[158] *Id.*

[159] Another issue arises if the percentage interests during the adjustment year fluctuate because of sale, redemptions, and contributions during the adjustment year. There appear to be at least three conceptual approaches to address this problem. First, one determines the average percentage interests for the entire adjustment year and uses those average percentage interests. For this purpose, one could use a monthly or quarterly convention (*i.e.*, one uses the percentage interests in effect as of the end of each month or quarter, as the case may be, for calculating the annual average). Second, one looks simply to the percentage interests in effect on the last day of the adjustment year. Third, one looks to the percentage interests in effect on the first day of the adjustment year.

corporations with no net operating losses, and D is a foreign bank with no U.S. trade or business. ABCD LLC is treated as a partnership. Except as specifically stated, ABCD LLC has no liabilities. Assume no small partnership opt-out election and no section 6226 push-out election. In year 1 ABCD LLC acquired stock of Corp. X for $100, and it has no other assets. In year 2 ABCD LLC exchanged the stock in X for stock in Corp. Y worth $400 in a transaction intended to be a tax-free reorganization. ABCD LLC receives only a ''reasonable basis'' assurance that the transaction is tax free. In year 3, as intended and agreed by all the partners at the end of year 1, D made an additional capital contribution of $800, thereby becoming a 75 percent partner in ABCD LLC (and each of A, B, and C is diluted from 25 percent to 8.33 percent) for all future investments. At the end of year 3, ABCD sells the Y stock for $400, distributes $400 equally to A, B, C, and D, and acquires stock of Corp. Z for $800. In year 4 the IRS determines that the reorganization in the reviewed year (year 2) was fully taxable, resulting in a taxable gain of $300 in the adjustment year. The question is whether the gain should be allocated 25 percent to each of A, B, C, and D (based on the percentage interests in the reviewed year) or 75 percent to D and 8.33 percent to each of A, B, and C (based on the percentage interests in the adjustment year). In this case, the IRS should, based on an antiabuse provision, have the right to demand an allocation based on the percentage interests in the reviewed year.

Third, because in Example 13 the exchange of X stock for Y stock is taxable, there should be an inside basis step-up in the Y stock in the adjustment year. How is that inside basis allocated among the partners? The new audit rules provide no guidance. The inside basis allocation should, I believe, follow the allocation of the audit adjustments.

Fourth, once a tax liability of the partnership has been established and paid by the partnership, how should the economic burden of that liability be allocated among the partners? The new audit rules are silent on this point, too. The most sensible approach appears to be that the tax liability should generally be allocated the same way the audit adjustments for items of income, loss, or credit are allocated.

Fifth, if the tax liability is paid by the partnership, how does this payment affect the capital accounts and the outside basis? The new audit rules provide no guidance. Two conceptual approaches seem possible. First, similar to the payment of a third-party damage claim, the payment of the tax liability is treated as a loss in an amount equal to the tax payment. Upon payment, the loss is reflected as a downward adjustment in the capital accounts and reduces income allocable to the partners, which is in turn reflected in the outside basis as required by section 705(a)(2)(B). In allocating the loss among the partners of the adjustment year, one would use the percentage interests used for the audit adjustments described above. The alternative approach would be to treat the payment of the tax liability as a deemed cash distribution in an aggregate amount equal to the amount of the tax payment to the current partners of the adjustment year immediately followed by the partners' deemed payment of the tax to the IRS. The deemed cash distribution would use the percentage interests used to allocate the adjustments and the tax liability among the current partners.[160]

Sixth, the next mechanical issue, is how to avoid double taxation for audit adjustments for which the partnership has already paid the tax.

Example 16: ABCD LLC is a Delaware LLC with four equal partners in year 1. A, B, C, and D are U.S. corporations. Each partner has contributed $25. ABCD LLC is treated as a partnership. Except as specifically stated, ABCD LLC has no liabilities and no other assets. Assume no small partnership opt-out election and no section 6226 push-out election. In year 1 ABCD LLC acquired stock of Corp. X for $100. In year 2 ABCD LLC exchanged the stock in X for stock in Corp. Y worth $400 in a transaction intended to be a tax-free reorganization. In year 4 the IRS determines that the reorganization in the reviewed year (year 2) was fully taxable, resulting in a long-term capital gain of $300 in the adjustment year. The IRS calculates an imputed underpayment of $105 ($300 x 35 percent), and ABCD LLC immediately pays the imputed underpayment.

Here the question is what happens to the $300 of additional gain in the adjustment year on which the tax is paid by the partnership. In my view, the $300 gain should be reflected in the partnership tax return and the Schedules K-1 for the adjustment year. If that is correct, how is it that the new audit rules avoid that the partners are taxed again on the partner level for that additional $300 of gain allocated to them? It seems that there should be an additional statement as part of the Schedules K-1 to the effect that the tax has already been paid by the partnership on the $300 (but not on the other income), and the partners should be entitled to rely on this statement in excluding the $300 from the calculations of their respective corporate taxes.[161]

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[160]*See* Bluebook at 79 (arguing for an outside basis adjustment under section 705(a)(2)(B)).

[161]This is essentially the nontaxable income approach of section 705(a)(1)(B).

Seventh, how should the allocations of audit adjustments interact with the netting approach?

Example 17: Asset manager A manages Hedge Fund, a hedge fund using a traditional master feeder structure with quarterly liquidity. A is the partnership representative for the master partnership. Hedge Fund invests in debt instruments using leverage. U.S. high-net-worth individuals are the investors in the domestic feeder, while U.S. tax-exempt and foreign investors invest through the offshore feeder. The IRS decides to audit Hedge Fund's master partnership. The IRS identifies one issue: the amount of capital gains on distressed debt instruments in light of the market discount rules. The proposed audit adjustments for the reviewed year decrease the long-term capital gain by $100 and correspondingly increase ordinary income in the form of market discount by $100. In the adjustment year, Hedge Fund has taxable income.

As noted above, the netting concept results in a net adjustment amount of zero. Accordingly, no imputed underpayment will be payable. So what happens to the audit adjustments? As described above, the adjustments should flow through the Schedules K-1 in the adjustment year to the current partners under section 702(a)(8) using the percentage interests in the adjustment year. Because there has been no tax payable by the partnership, the question is whether the adjustments should result in tax on the partner level in the adjustment year. The flow-through regime for cases in which there is no imputed underpayment based on section 702(a)(8) clearly suggests this outcome. However, this would overlook that some partners in the reviewed year actually paid tax on the relevant items of income, just at the wrong rate because of the character issue. Accordingly, it appears that the current partners should be on the hook only for the rate differential, but there seems to be no rule in the new audit rules to ensure that outcome. Maybe this is intended given that the new audit rules are intended to be revenue raisers, but I think this is a technical issue left by Congress to be figured out in new regulations. An alternative approach would be to modify the netting approach such that the IRS would be allowed in these kinds of cases to impose an imputed underpayment equal to the capital gain/ordinary income rate differential. That, however, would likely require a technical correction of the statute itself.

6. Reductions of imputed underpayment.

a. Self-executing rule or inoperative without regulations? Because section 6225(c) provides that "the Secretary shall establish procedures under which the imputed under payment amount may be modified" based on the principles described in section 6225(c), the question arises whether section 6225(c) in its entirety is self-executing or whether it is inoperative without enabling regulations. The question of self-executing statutes is generally a murky one,[162] but on balance I believe the better view is that the rules of section 6225(c) are not self-executing because section 6225(c) is drafted as giving the IRS merely a clear task to address a particular issue — namely, that the imputed underpayment amount could be wildly overstated under the general rule in absence of the principles set forth in section 6225(c).[163] Accordingly, I hope that the IRS will provide guidance on section 6225(c) before the new audit rules become effective.

b. Partner-level information. As noted above, the imputed underpayment may be reduced before that payment amount is finalized in the FPAA if the partnership can provide the necessary partner-level documentation showing that lower rates should be applied for the allocable shares of income attributable to specific partners. This reduction of the imputed underpayment will apply to tax-exempt partners as defined in section 168(h)(2), which includes (1) the United States, any state or political subdivision thereof (including any agency or instrumentality of any of the foregoing); (2) any organization (other than a cooperative described in section 521) that is tax exempt under chapter 1 of the code; (3) any foreign person or entity; and (4) any Indian tribal government described in section 7701(a)(40).[164] Accordingly, if a private equity or hedge fund partnership has U.S. state and private pension plans[165] or section 892 investors, foreign pension plans, or other foreign institutional investors (such as foreign insurance companies or foreign funds of funds) as partners, the partnership may be able to reduce the imputed underpayment by showing a reduced rate of 0 percent for various items of income (for example, interest and capital gains from sales of financial instruments). However, this reduction of the imputed underpayment for tax-exempt partners raises some interesting questions that should be addressed in the new regulations.

Example 18: A is a publicly traded REIT organized as an UPREIT. OP, the operating partnership, has 89 partners other than A. A's percentage interest in OP

[162]*See* Philip Gall, "Phantom Tax Regulations: The Curse of Spurned Delegations," 56 *Tax Law*. 413 (2002-2003) (discussing case law on the problem of self-execution in the absence of regulations).

[163]Section 6225(b)(1)(A) (BBA).

[164]Section 6225(c)(3) (BBA); section 168(h)(2).

[165]Private pension plans should be treated as exempt under clause (2) above even though they could be subject to UBTI under section 511, but only if UBTI is not the relevant issue at stake in the partnership audit.

in has been 80 percent in year 1 and 85 percent in years 2 and 3, respectively. A is the partnership representative of OP, and in each year, A has distributed cash equal to 105 percent of its taxable income.[166] OP owns through disregarded entities numerous office buildings in the United States. In year 3 the IRS begins an audit of OP under the new audit rules, and the IRS, in its notice of proposed audit adjustments, proposes two adjustments. First, a transaction reported by OP in year 1 as a good section 1031 exchange was a fully taxable transaction, resulting in an additional long-term capital gain of $100 for that year. Second, the depreciation deductions taken by OP for its office buildings are adjusted so that OP's depreciation deductions will be reduced by $20 for each of years 1 through 10. There are no other adjustments. Accordingly, the IRS proposes an imputed underpayment of $63.36 ($47.52 for year 1 ($120 x 39.6 percent), $7.92 for year 2 ($20 x 39.6 percent), and $7.92 for year 3 ($20 x 39.6 percent)). A as the partnership representative agrees with the adjustments as a matter of substantive law but nonetheless wishes to reduce the imputed underpayment so that the FPAA will show a much lower imputed underpayment.

This example raises the question whether A can make the argument that it is in essence exempt from corporate tax and that the portion of the imputed underpayment properly allocable to A should therefore be reduced to $0. The answer, in my view, should generally be yes because REIT status is central to the tax burden ultimately imposed on the imputed underpayment, and there seems to be no argument grounded in tax policy or administrative ease that would speak clearly against that treatment. The adjustments should instead be routed up to A through the mechanism for adjustments that do not result in an imputed underpayment.[167] At the REIT level, the reported additional taxable income should be addressed through the normal deficiency dividend mechanism because that is exactly the type of situation for which that mechanism was enacted.[168] This approach would put REITs and UPREITs on equal footing. The new audit rules, however, are not entirely clear on this point. The practical question faced by REIT practitioners is whether — at least until this question is clarified favorably for REITs — REIT offering documents should include a risk factor related to the new audit rules.[169]

One critical open issue is the kind of documentation (and form — paper or electronic) that will be required by the partnership to avail itself of the right to reduce the imputed underpayment: Will the subscription documents be sufficient? Will forms W-8 and W-9 otherwise on file with the general partner be sufficient? Will there be a need to obtain new forms W-8 or W-9? Will there be a need to obtain new or special representations by the partners? Will there be a need to get affidavits from partners? It appears that the most sensible approach would be one based on otherwise available forms W-8 and W-9, and the future regulations should clarify this point. Until that clarification is obtained, fund sponsors — under the applicable fund documents — will likely require their limited partners to provide whatever documentation is reasonably necessary to comply with the (future) documentation requirements for the reduction of the imputed underpayment.

c. Special case: Section 469(k) passive activity losses of master limited partnerships. For a publicly traded partnership (as defined in section 469(k)(2)), the PATH Act amends the new audit rules by mandating that new regulations provide that (1) the imputed underpayment will be determined without regard to the portion thereof that the partnership demonstrates is attributable to (that is, would be offset by) a "specified passive activity loss" that is allocable to a "specified partner"; and (2) the partnership will take that net decrease of the imputed underpayment into account as an adjustment in the adjustment year for the specified partners to which that net decrease relates.[170] For this

[166]Cash may exceed taxable income because of depreciation deductions.

[167]Section 6225(a)(2) (BBA).

[168]*See* section 860; and section 316(b)(3); *see also* James S. Halpern, "Real Estate Investment Trusts and the Tax Reform Act of 1976," 31 *Tax Law*. 329, 343 (1977). A REIT's bona fide determination of its REIT taxable income and its net capital gain for a tax year is the basis for its calculation of the minimum current distribution required for that year. So, what happens if upon an IRS audit it turns out that the REIT's income was understated on a bona fide basis? This is problematic because in the absence of any special rule, the REIT may not have distributed enough earnings for that past year subject to IRS audit to satisfy the minimum distribution requirement for that year (assuming the subsequent upward adjustment upon IRS audit is significant enough), and the REIT cannot simply make an additional "true up" distribution for that past year after the IRS audit because the minimum distribution rule requires a current distribution of earnings (and not a distribution years later). Since 1976, the REIT rules have addressed this technical problem in connection with the "current distribution" principle sensibly through the concept of a so-called deficiency dividend. The effect of the deficiency dividend concept is to allow a REIT to avoid the loss of REIT status as a result of a subsequent IRS audit adjustment at the price of an interest charge (determined on the amount of the deficiency dividend) on the REIT level.

[169]*See also* Bluebook at 70 (arguing for coordination of section 6226 push-out election and REIT deficiency dividend mechanism).

[170]Section 6225(c)(5)(A) (BBA), as amended by section 411(a) of the PATH Act.

purpose, specified passive activity loss means, for any specified partner of the publicly traded partnership, the lesser of (1) the passive activity loss of that partner that is separately determined for the partnership under section 469(k) for the partner's tax year in which or with which the reviewed year of the partnership ends; or (2) the passive activity loss so determined for that partner's tax year in which or with which the adjustment year of the partnership ends.[171]

The term ''specified partner'' means any person if that person (1) is partner of the publicly traded partnership; (2) is described in section 469(k)(2); and (3) has a specified passive activity loss regarding that partnership. The flush language specifies that the above qualifications be ''with respect to each taxable year of such person which is during the period beginning with the taxable year of such person in which or with which the reviewed year of such publicly traded partnership ends and ending with the taxable year of such person in which or with which the adjustment year of such publicly traded partnership ends.''[172]

d. Amended partner tax returns. As noted above, the amended partner tax return relief[173] is the other major way to reduce the imputed underpayment. This mechanism may be of particular interest in smaller partnerships.

Example 19: ABCD LLC is a Delaware LLC with four equal partners in year 1. A, B, C, and D are U.S. high-net-worth individuals. Each partner has contributed $25. ABCD LLC is treated as a partnership. Except as specifically stated, ABCD LLC has no liabilities and no other assets. Assume no small partnership opt-out election and no section 6226 push-out election. In year 1 ABCD LLC acquired stock of Corp. X for $100. In addition and at the same time, ABCD LLC invests in debt funded by a $100 bank loan. The taxable income attributable to the debt investments is allocated solely to D, who has NOL carryforwards even though cash from those debt investments is allocated in accordance with percentage interests (based on relative capital commitments). In year 2 ABCD LLC exchanged the stock in X for stock in Corp. Y worth $400 in a transaction intended to be a tax-free reorganization. In year 4 the IRS determines that the reorganization in the reviewed year (year 2) was fully taxable, resulting in a long-term capital gain of $300 in the adjustment year. Also, the IRS determines that the taxable income from debt investments was misallocated among the partners. Accordingly, it reduces the income allocation to D by $100 for year 2. After application of the one-way upward adjustment rule, the IRS computes an imputed underpayment of $158.40 ($400 x 39.6 percent).

In this example, the amended partner tax return relief may come in handy. It is worth noting at the outset that the amended partner tax return relief does not require an election by the partnership and therefore by the partnership representative. If A and B (but not C and D) decide that they are willing to amend their own returns and actually pay their share of the imputed underpayment, one would think they could do so. However, that is not the case. Because there is also a misallocation of income (that is, income from the debt instruments), the amended partner tax return relief would be available only if *all* partners file amended partner tax returns.[174] This feature may significantly limit the use of this mechanism in practice. Also note that the reduction of the imputed underpayment in the amended partner tax return relief is expressly tied to the actual payment of the tax by the partner.[175] This shows, I believe, that this mechanism is designed to give partnerships and partners more flexibility — as long as this grant of additional flexibility does not increase the collection risk or the administrative burden for the IRS. Accordingly, the amended partner tax return relief is unlikely to be of practical use for lower-tier partnerships in tiered partnership structures because it will be difficult to show to the IRS that tax has been paid by the partners in the upper-tier partnerships.

e. Contractual considerations. Given that the reduction of the imputed underpayment is economically important, partnership agreements should arguably provide for a broad cooperation covenant for any such mechanisms available for those reductions (for example, delivery of information or willingness to file amended tax returns). Because the precise workings of the procedures for the reduction will depend on new regulations, the wording of the covenant has to be broad and a bit vague at this point. It is likely, however, that sophisticated investors will reject any open-ended, upfront obligation to file amended tax returns.

7. Effect on calculation of carried interest. Another issue of great significance for investment partnerships and their asset managers is how the tax payment by the partnership under the new audit rules affects the calculation of the carried interest. The typical business deal is that the carried interest

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[171] Section 6225(c)(5)(B) (BBA), as amended by section 411(a) of the PATH Act.

[172] Section 6225(c)(5)(C) (BBA), as amended by section 411(a) of the PATH Act.

[173] Section 6225(c)(2) (BBA).

[174] Section 6225(c)(2)(B) (BBA).

[175] Section 6225(c)(2)(A)(iii) (BBA).

is calculated on a pretax basis.[176] If the tax payment by the partnership is conceptualized as a payment of a third-party damage claim, the tax payment would be taken into account for purposes of the carry calculation: The investment result is worth less than expected. If, however, the tax payment is conceptualized as a payment of tax on behalf of the partners, the tax payment would not affect the carry calculation. It would instead be treated like any other withholding tax that the partnership pays on behalf of its partners. Given that both views are not entirely correct, it appears that partnership agreements should expressly clarify this point.

8. The 3.8 percent Medicare tax. Interestingly, the 3.8 percent Medicare tax imposed by section 1411 is not addressed in the new audit rules because the imputed underpayment is calculated by ignoring it.

Example 20: ABCD LLC is a Delaware LLC with four equal partners in year 1. A, B, C, and D are U.S. high-net-worth individuals. Each partner has contributed $25. ABCD LLC is treated as a partnership. Except as specifically stated, ABCD LLC has no liabilities and no other assets. Assume no small partnership opt-out election and no section 6226 push-out election. In year 1 ABCD LLC acquired stock of Corp. X for $100. In year 2 ABCD LLC exchanged the stock in X for stock in Corp. Y worth $400 in a transaction intended to be a tax-free reorganization. In year 4 the IRS determines that the reorganization in the reviewed year (year 2) was fully taxable, resulting in a long-term capital gain of $300 in the adjustment year.

Example 21: The same as Example 20, except that ABCD LLC is a very large investment partnership that has hundreds of investors other than A, B, C, and D.

In Example 20, the IRS would calculate an imputed underpayment of $118.80 ($300 x 39.6 percent). However, because the gain is a long-term capital gain and the partners are U.S. individuals, the partnership should be able to show to the IRS that the imputed underpayment should only be $60 ($300 x 20 percent). This would leave the Medicare tax imposed on the capital gain out of the equation. So how does the Medicare tax get collected on the $300 of long-term capital gain? One approach would be to allow a reduction of the imputed underpayment only after taking into account the Medicare tax (that is, using 23.8 percent rather than 20 percent).[177] However, it is not clear to me that the IRS would have the authority to do so under the new audit rules. Maybe a technical correction of the new audit rules is needed. It would seem inconsistent with the general concepts of the new audit rules to rely on the collection of the Medicare tax on the partner level, particularly in the context of publicly traded investment partnerships.

A real-world explanation for this situation may be that the new audit rules are modeled on the electing large partnership (ELP) rules, which were enacted in 1997, long before the Medicare tax was enacted. And because the ELP rules were essentially not used in practice, neither the IRS nor taxpayers paid much attention to this academic issue after the introduction of the Medicare tax.

9. Inversions and corporate tax reform: Looking ahead. Inversions have triggered an intense debate about the structure of U.S. corporate taxation, including a debate about the proper rate structure. Consensus appears to be that because the U.S. corporate tax rate is essentially the highest in the world (after taking into account state and local taxes), it should be lowered to 25 percent or perhaps 20 percent.[178] The critical issue from a tax policy perspective will be whether this would be matched with a corresponding reduction of individual tax rates. Because a corresponding reduction would massively reduce tax revenues, such a move would be doable only if any comprehensive tax reform adopted a VAT to make up for the lost tax revenues.[179] Accordingly, it appears more likely in today's political climate that we will be heading toward a regime in which corporate-level taxes are significantly lower than individual tax rates.[180] This is a type of income tax regime that we already have in parts of Western Europe.

Such a regime would have two consequences. First, the relative attractiveness of partnerships would be reduced significantly; instead, taxpayers would move out of partnerships and into corporations. Second, and more important for purposes of

[176]This business deal is typical in commingled funds with multiple investors. In so-called funds of one, the carry is sometimes calculated on an after-tax basis.

[177]This approach would lead naturally to the question whether and how the partnership could show to the IRS that no Medicare tax is owed by the partners.

[178]*See, e.g.*, TRA 2014 (proposing a 25 percent corporate tax rate).

[179]*See, e.g.*, Michael J. Graetz, *100 Million Unnecessary Tax Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2008) (discussing tax policy options, including adopting a VAT).

[180]The other obvious choice to make ends meet — namely, a massive reduction of national defense spending — seems to be off-limits for most Americans and therefore appears very unlikely.

this report, the regime would reinvigorate the accumulated earnings tax[181] and the personal holding company rules.[182] Accordingly, it would be, in my view, sensible if the new regulations take this (likely) development into account and provide guidance on how these regimes would affect a partnership's ability to reduce the imputed underpayment by providing specific partner-level information.

D. One-Way Upward Adjustment Rule

1. Rationale of rule. The one-way upward adjustment rule is an important and somewhat surprising feature of the new audit rules. Its main purpose, it appears, is to increase the likelihood for the IRS to collect tax deficiencies from partnership audits, thereby reducing or even eliminating the disincentive to conduct partnership audits. The issue of reallocations of tax items among taxpayers is a unique problem of partnership audits that does not exit in corporate audits. This problem is particularly apparent in very large partnerships such as publicly traded master limited partnerships. The one-way upward adjustment rule essentially relieves the IRS from a lot of administrative headache because under this rule the IRS merely needs to determine that there has been a misallocation of a particular item of income. No longer is it necessary for the IRS to worry about (and implement) all the corresponding adjustments that the misallocation will trigger.

2. Special allocations. Let's take a closer look at the one-way upward adjustment rule with the help of an example using a special allocation.[183]

Example 22: A and B, two U.S. individuals, form Delaware general partnership AB. Each partner contributes $100 in cash to AB and is entitled under all circumstances, including liquidation, to 50 percent of the cash generated by AB from AB's investment in IBM stock. AB has no other assets or liabilities. AB allocates 90 percent of the taxable income (that is, IBM dividends) to A in the first five years because A has an NOL and distributes cash on a 50-50 basis. In year 1 AB's taxable income was $10. Accordingly, A pays no tax on its $9 of taxable income, and B pays $0.40 on its $1 of taxable income. Had the partnership agreement not provided for the special allocation, B would have paid $1.98 ($5 x 39.6 percent). In year 3 the IRS audits AB under the new audit rules for year 1. Assume no small partnership opt-out election and no section 6226 push-out election. The IRS determines that A's distributive share of the taxable income of AB is 50 percent, not 90 percent. Accordingly, the IRS issues an FPAA stating that A's distributive share of income in year 1 (the reviewed year) was only $5, not $9. Thus, there is a negative adjustment of $4. Since A's distributive share is only 50 percent, B's distributive share is, by definition, 50 percent, not 10 percent. Therefore, B has a positive adjustment from $1 up to $5. After a four-year litigation in the courts, the FPAA is confirmed as being correct. A's negative adjustment of $4 and B's positive adjustment of $4 would normally offset each other, thereby resulting in a net adjustment of $0. However, that is not how it works. Instead, by operation of the one-way upward adjustment rule, A's negative adjustment is ignored. Thus, AB has a net positive adjustment of $4 on which it must pay, in year 7 (audit in year 3 plus four years of litigation) (the adjustment year), the imputed underpayment of $1.58 ($4 x 39.6 percent) plus interest and penalties, which, for purposes of simplicity, shall be assumed to be $0.50, resulting in total partnership liability of $2.08. This payment of $2.08 will not result in a tax deduction of the same amount because the payment by AB is nondeductible. Note that no amendments of any partner tax returns are necessary for the IRS to collect the $2.08. So A's NOL is still reduced by $9 (rather than by $5), and B has still paid $0.40 on $1. Accordingly, the IRS will collect a total of $2.48 ($2.08 plus $0.40).

Note that in Example 22 there is no double taxation of the $5 that should have been allocated to B. Instead, the economic double taxation occurs because A's NOL is reduced by $9 rather than $5, which corresponds to an increased future tax liability for A of $1.58 ($4 x 39.6 percent). This double taxation should be rectified by amending A's individual tax return. However, because of the four-year litigation by the partnership, which does not suspend the statute of limitations for A's tax return, it is unclear whether A could still amend his tax return for year 1.[184] It would be helpful if the IRS would clarify (1) whether A could amend his tax return for year 1 to increase his NOL; (2) whether A could reflect the change in his current-year partner tax return; or (3) whether A would simply be out of luck in this case. While at first blush (3) appears to be harsh, it may, however, function as a strong incentive to contractually avoid such a situation in

[181]*See* section 531 (corporate income is taxed at the highest tax rate under section 1, currently 39.6 percent).

[182]*See* section 541 (penalty tax of 39.6 percent imposed on personal holding company income).

[183]*See also* Bluebook at 64-65 (example concerning the one-way upward adjustment rule).

[184]After a tax return has been filed and the time for filing that return has expired, the IRS generally has discretion whether to accept amended tax returns. *See Goldstone v. Commissioner*, 65 T.C. 113 (1975) (discussing the validity of an amended tax return in the context of the investment tax credit).

the first place. In my view, (2) seems to be the most sensible approach that would be most in line with the general framework of the new audit rules.

3. Section 704(c) allocations. The one-way upward adjustment rule also applies to section 704(c) and reverse section 704(c) allocations because they affect a partner's distributive share of income items.

Example 23: A and B, two U.S. individuals, form AB LLC, a Delaware LLC. A contributes IBM stock worth $100 with a tax basis of $10, and B contributes $100 of cash. The LLC agreement provides that A and B are 50-50 partners. AB LLC has no other assets. In year 2 AB LLC sells the IBM stock for $150 and reinvests all the proceeds into stock of GM. The long-term capital gain of $140 is allocated 50-50 between A and B. In April of year 3, A and B each pay $14 of tax ($70 x 20 percent). In year 3 the IRS audits AB LLC for year 2. Assume no small partnership opt-out election and no section 6226 push-out election. The IRS determines, rightly, that A's distributive share of the gain from the sale of IBM stock is $115 ($90 of preformation gain plus $25 of post-formation gain (50 percent of $50)), not $70. Accordingly, there is a positive adjustment of $45 ($115 minus $70). B's gain is therefore only $25, representing a negative adjustment of $45. A's positive adjustment of $45 and B's negative adjustment of $45 would usually offset each other, thereby resulting in a net adjustment of $0. However, by operation of the one-way upward adjustment rule, B's negative adjustment is ignored. Thus, AB has a net positive adjustment of $45 on which it must pay in year 3 (the adjustment year) the imputed underpayment, the payment of which is nondeductible.

At first blush, this result is surprising. However, there is some logic to it. Basically, what the one-way upward adjustment rule achieves is that it allows the IRS to over-collect as a result of a partnership audit and leaves it to the partners to file for refunds to obtain the right tax outcome given the overall economic result. This mechanism might have, for instance, the (intended or unintended) effect that a partner's refund claim becomes subject to the Joint Committee on Taxation's review of income tax refund claims exceeding $2 million (or $5 million for a C corporation).[185] Thus, in Example 23, B as the overtaxed partner would have to file for a refund,[186] which he can do because, on these facts, the statute of limitations for filing a refund claim has not yet expired.[187] However, B runs quickly into a statute of limitations problem on slightly modified facts, particularly if the audit takes a long time to conclude or the partnership litigates in court about the FPAA. In some circumstances, B might be able to address this problem by voluntarily extending the IRS's right to assess taxes against him, which in turn will automatically extend his right to file a refund claim by the same period plus six months.[188]

4. Tiered partnerships. The one-way upward adjustment rule will be problematic in tiered partnerships because it will often be impossible to file the necessary refund claims to obtain the right result.

Example 24: A is a large investment partnership that invests in stocks and bonds in secondary market trading and has hundreds of partners. B is a U.S. fund of funds treated as a partnership that invests in A. A represents less than 5 percent of B's gross assets. B's investors are U.S. high-net-worth individuals. No individual owns more than 0.5 percent of B. C is a non-U.S. fund of funds treated as a partnership with foreign individuals as investors. A represents less than 5 percent of C's gross assets, and no individual owns more than 0.5 percent of C. In year 2 the IRS audits A and determines that there has been a $100 misallocation of an item of income among partners. This is the only audit adjustment. Accordingly, the IRS calculates an imputed underpayment based on the one-way upward adjustment rule.

In this fact pattern, the true advantage of the one-way upward adjustment rule becomes apparent: Under TEFRA, the IRS would have been forced to run the adjustments through the tiered partnership structure, a truly burdensome exercise. Now, however, all of this is no concern for the IRS. It's the taxpayer's problem. And if the taxpayers behave like the IRS in the past — just don't do it — the one-way upward adjustment rule will be a revenue generator for Treasury.

5. Contractual considerations. As demonstrated above, the one-way upward adjustment rule could cause economic distortions among the partners if payments of the imputed underpayment by a partnership under the new audit rules (to the extent

[185] Section 6405(a).

[186] Section 6402(a) (the IRS may refund an overpayment of taxes to the person who made the overpayment); section 6511(a) (the taxpayer must file a claim for refund of any overpayment); reg. section 301.6402-3(a) (refund claim must be made on the initial tax return filed for the year or on an amended return).

[187] Section 6511(a) (refund claim must be filed within the later of (1) three years from the date of filing the tax return to which the claimed overpayment relates; or (2) two years from the date of payment of the tax sought to be refunded); *see Allstate Ins. Co. v. United States*, 550 F.2d 629 (Ct. Cl. 1977) (discussing the interplay of the two- and three-year rules).

[188] Section 6501(c)(4) (consent to extend assessment period for taxes); section 6511(c)(1) (extension of period to file for a refund).

they are attributable to the one-way upward adjustment rule) are allocated equally among the partners in accordance with their respective percentage interests. For instance, in Example 22, AB's payment of $2.08 should be allocated entirely to B and should also result in an outside basis reduction for B because of that special allocation. Understandably, existing partnership agreements do not provide for any such special allocations of those payments under the new audit rules. I believe those special allocations should be included, and it would be helpful if the IRS expressly recognized them in new regulations. It would be particularly helpful if the IRS clarified that a special allocation would not result in a violation of the fractions rule.[189] In partnerships that are waterfall driven (for example, targeted allocations), the tax payment of $2.08 should be treated as a deemed distribution to B for waterfall purposes.

This also highlights one of the crucial benefits of both the small partnership opt-out election and the section 6226 push-out election: relief from the one-way upward adjustment rule.

E. The Section 6226 Push-Out Election

1. Rationale for election. The purpose of the section 6226 push-out election is not entirely clear. It appears that the rationale for the election is to provide the partners with a special mechanism to "specially" allocate the tax liability associated with any partnership-level adjustments for a reviewed year solely to the partners of the reviewed year using the percentage interests of those partners in that year. Such a mechanism is important when some of the partners of the reviewed year have left the partnership after the reviewed year but before the adjustment year. Under those circumstances, the partnership could not specially allocate any tax liability under the partnership allocation rules to those former partners because allocations can be made only to current partners. It is therefore noteworthy that the section 6226 push-out election does *not* push the imputed underpayment out to the *current* partners in the adjustment year. This is because that would in essence amount to something indistinguishable from a joint and several liability of current partners for taxes that are attributable to former partners in the review year, a concept that was rejected.[190]

2. Self-executing rule or inoperative without regulations? Because section 6226(a)(2) provides that the election will be made "at such time and in such manner as the Secretary may provide," the election appears to be available only when the new regulations are issued under section 6226. This is because the new regulations have to provide how and when the statutorily created tax liability of the partnership under the new audit rules ceases to exist on the ground that new corresponding tax liabilities on the level of the partners have been created, which the IRS can collect as easily as it could collect its tax liability from the partnership itself. Put differently: It is highly unlikely that Congress intended that section 6226 operate such that *it increases the collection risk or administrative burden for the IRS*. This key concept needs to be fleshed out by the regulations, since the code provides little guidance on this point and section 6226 may not, in the context of the new audit rules, work as intended without those details.

3. Eligibility requirements. There seem to be no eligibility criteria in section 6226; every domestic or foreign partnership may make the election. Neither the nature or number of a partnership's partners (for example, S corporations, REITs, RICs, foreign partners, partnerships) nor the nature of the partnership's activities (for example, investing, widget manufacturing, service business), nor the partnership's amount of assets by value, nor the use of special allocations matters. Accordingly, it appears that the election is intended to be available for lower-tier partnerships in tiered partnership settings because, unlike in the small partnership opt-out election, the section 6226 push-out election contains no express restrictions regarding tiered partnerships.[191]

4. Form of election: Election by the partnership. The section 6226 push-out election is an election by the partnership. Accordingly, under the new audit rules, the only person who may validly make that election on behalf of the partnership is the partnership representative. The authority to make the election is an integral part of the role of a partnership representative. Thus, it is impossible to designate a partnership representative without the ability to make that election. The election, once made, is irrevocable unless the secretary consents to its revocation.

[189] Section 514(c)(9)(E).

[190] *See* section 6241(d)(1) (TRA 2014) ("The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto."); and section 6241(d)(1) (Partnership Audit Simplification Act of 2015) ("The partnership and any partner of the partnership shall be jointly and severally liable for any imputed underpayment and any penalty, addition to tax, or additional amount attributable thereto."). Logically consistent, neither TRA 2014 nor the Partnership Audit Simplification Act of 2015 provided for a section 6226 push-out election.

[191] *See* Bluebook at 70 (section 6226 push-out election available in case of tiered partnerships; however, without statutory basis, arguing that the upper-tier partnership must pay the tax).

As to the form of the election, the code is silent. In my view, the IRS should create a new form for purposes of this election that must be filed electronically and include all the section 6226 statements issued to the partners.

5. Timing of election and a partnership's right to contest an FPAA. No rules regarding the timing of the election are provided in section 6226 except that the election must be made no later than ''45 days after the date of the FPAA.'' This raises an interesting interpretative question. Based on a literal reading of section 6226(a)(1), one could conclude that the partnership representative has to choose between the partnership's right to contest the FPAA in court and the partnership's right to make a section 6226 push-out election. In other words, making the section 6226 push-out election would force the partnership to give up its right to go to court regarding the relevant FPAA. This is because the 45-day period for the election is keyed off the issuance of the FPAA and is therefore not keyed off the expiration of the limitation on assessment in section 6232(b), which provides that no assessment of a deficiency may be made against the partnership before (1) the close of the 90th day after the day on which a FPAA was mailed; and (2) if a petition by the partnership is filed under section 6234 for that FPAA, the decision of the court has become final.[192] However, this was clearly a technical error because there appears to be no reason for such a draconian taxpayer-unfriendly consequence of a section 6226 push-out election. Accordingly, the PATH Act corrects this error by adding a new section 6226(d), which provides that section 6234 shall govern in determining when a partnership may file a petition for readjustment.[193] The legislative history of the PATH Act to this correction provides the following:

> The provision adds a cross reference within the alternative payment rules [section 6226] to the time period for seeking judicial review [section 6234(a)], clarifying that judicial review is available to a partnership that has made the election [section 6226(a)(1)] under the alternative payment rules.[194]

This welcome clarification itself, however, creates some challenges for the IRS to come up with sensible regulations under section 6226. The main issue presented is whether the IRS should adopt a rule such that the election is essentially postponed until after a final determination (section 1313(a)) has been made (which may require some additional changes to the statutory language), or whether it should provide for a mechanism on how any successful challenge of a FPAA (for example, a partial reduction of the imputed underpayment) should be handled after a section 6226 push-out election has been validly made (which could be years earlier for lengthy litigation in court). It seems reasonably clear that taxpayers would prefer an election mechanism that would avoid the practical challenge to make an election associated with all the required documentation and return filings and then (possibly much) later prepare and furnish corrected information to the partners. In a world of fast-changing partners in partnerships (for example, hedge funds by way of redemptions and admissions of new investors) and fund of funds, a ''subsequent correction'' approach to section 6226 push-out elections (as opposed to a ''final determination'' approach) appears to be an unduly burdensome course of action.[195]

6. Termination of partnership-level tax liability. The core issue, as described above, is when and to what extent the partnership's liability under the new audit rules terminates as the result of the section 6226 push-out election.[196]

Example 25: ABC is a Delaware LLC treated as a partnership for tax purposes. Individuals A, B, and C own 40 percent, 40 percent, and 20 percent of ABC, respectively, and are all U.S. residents. A is the partnership representative. The LLC agreement contains no tax-related covenants. No member of ABC has any valuable tax attributes and pays income tax at the highest rate. ABC owns farmland in Wyoming worth $300 with a tax basis of $100, which is its only asset. In year 2 ABC entered into a section 1031 exchange for this property. In year 4, as a result of the audit of ABC, the IRS determined in its FPAA that the section 1031 exchange was a fully taxable exchange, resulting in $200 of additional long-term capital gain (plus interest and penalties). No small partnership opt-out election is made. A makes the section 6226 push-out election 10 days after the receipt of the FPAA and at the same time furnishes the section 6226 statements to each of A, B, and C showing their respective shares of the additional liability (including tax, penalties, and interest).

[192] Section 6232(b) (BBA).

[193] Section 411(b) of the Protecting Americans From Tax Hikes (PATH) Act of 2015.

[194] JCT, ''Technical Explanation of the Revenue Provisions of the Protecting Americans From Tax Hikes Act of 2015,'' JCX-144-15 (Dec. 17, 2015), at 252 (the section reference are set forth in the footnotes); *see also* Bluebook at 69 (''The election may be made whether or not the partnership files a petition for judicial review of the notice of final partnership adjustment.'').

[195] *See* Bluebook at 69 (taking the position that the ''final determination'' approach applies).

[196] The Bluebook does not address this issue.

This is arguably the simplest fact pattern conceivable. Nonetheless, it is unclear whether, solely based on these facts, the election would have the intended effect. This is because the facts (1) do not state whether A, B, and C have actually paid their respective shares of the liability to the IRS; (2) whether A, B, and C have delivered any proof to ABC regarding their payments; and (3) whether any form of acknowledgment by the IRS is required for purposes of terminating the partnership's liability such that the IRS would legally be unable to collect from the partnership. Assuming that it is correct that Congress intended that the section 6226 push-out election not increase the collection risk or the administrative burden to the IRS, all these elements would be required to ensure that result. Accordingly, it would, in my view, be reasonable for the new regulations to provide for these elements.

Assuming all this is correct, at least two other questions arise. First, when do A, B, and C have to make their additional payment? Upon receipt of the section 6226 statement? When the next tax return is filed? Because the IRS could collect from the partnership right away, it seems reasonable to require partners to pay within the same time frame that the partnership would be required to pay its liability to the IRS. Second, will the section 6226 push-out election be invalid if one partner does not comply with the requirements of that election? That would be a harsh result and would unnecessarily expose partners to the bad behavior of their partners who they might not even know. It seems that the better approach would be that the section 6226 push-out election result in a termination of the partnership's tax liability *only to the extent* that the partners pay: If at least one partner does not pay, the IRS could continue to collect from the partnership to that extent.

7. Inclusion by partners in current year, not prior years. As noted above, if a section 6226 push-out election is validly made, the partners of the reviewed years include the adjustments in their current year.[197] Accordingly, partners do not need to amend their partner returns for prior (reviewed) years. That's a significant simplification of the process.

8. Allocation of adjustments, capital accounts, and basis adjustments. The allocation of adjustments and the corresponding adjustments to capital accounts and the basis adjustments should generally follow the principles described above, except that (1) the percentage interests of the reviewed year should be used; and (2) no capital account and outside basis adjustments on account of the payment of the imputed underpayment need to be made.

9. Costs associated with the election. The section 6226 push-out election may prove to be an expensive mechanism for two reasons. First, there is the special, statutorily imposed cost that interest for late tax payments will accrue at a rate 2 percent higher than the generally applicable interest rate for those underpayments.[198] In today's low-interest environment, however, this may not be much of a concern. Second, and more importantly, the administrative burden of handling the necessary accounting and general paperwork associated with the election may be significant, particularly if the partnership must retain the services of a large accounting firm. In other words, by way of the section 6226 push-out election, Congress has transferred the significant administrative costs of handling partnership audit adjustments from the IRS to the taxpayers. This may be good tax policy on the theory that it is not unreasonable to expect that competition in the market for tax reporting services may yield faster and more cost-efficient solutions to the administrative challenge than any attempt to optimize processes within an understaffed, underfunded, and underequipped (for example, information technology systems) agency.

10. Contractual considerations. Partners will have to consider whether it would make sense to have a broad cooperation covenant in the partnership agreement regarding the implementation of the section 6226 push-out election. In some (particularly smaller) partnerships, this might be a viable and sensible approach. Whether it will be of any use in larger investment partnerships will be an interesting question.

F. M&A Transactions

Let's turn next to questions that arise under the new audit rules in the context of buying and selling partnership interests.

1. Transfer of partnership interests after reviewed year. The transfer of partnership interests after the reviewed year is the mergers and acquisitions fact pattern that prompts the need to rethink partnership acquisition agreements, because this scenario may result in a shifting of the tax liabilities from a former partner to the buyer.

Example 26: ABC is a Delaware LLC treated as a partnership for tax purposes. A, B, and C own 40 percent, 40 percent, and 20 percent of ABC, respectively, as the result of aggregate capital contributions of $100. B is the partnership representative. At

[197]Section 6226(b)(1) (BBA).

[198]Section 6226(c)(2)(C) (BBA).

no time has ABC had any liabilities. In year 1 ABC invested the $100 in stock of TargetCo. ABC has no other assets. In year 3 TargetCo is acquired by way of a merger that is intended to be tax free. ABC receives solely stock of BuyerCo worth $200. In year 4, A sells his membership interest in ABC to Buyer D for $80 (40 percent of $200), and A pays the tax on the gain recognized. The purchase agreement has no tax-related covenants and does not provide for an indemnity. In year 5 the IRS audits ABC, and during the audit it is determined that the merger was fully taxable, resulting in an additional $100 of long-term capital gain for year 3. No small partnership opt-out election is made.

In this example, as the result of the new audit rules, Buyer D is exposed to inherit a share of the pre-acquisition tax liability attributable to the built-in gain in the TargetCo stock that economically belongs to seller A. Since A has already paid his share of tax on the built-in gain in TargetCo stock by way of the sale of his partnership interest ($80 proceeds minus $40 tax basis in A's partnership interest attributable to the capital contribution),[199] this shift of the audit-related tax liability to Buyer D would in fact result in a double taxation of the gain: once in the hands of A, and a second time in the hands of D (though a payment by the partnership).

The solution for this problem is obvious: A section 6226 push-out election should be made.[200] Since the election is made by the partnership and the partnership representative designated for the adjustment year, it appears that this election could easily be made. However, D may be unable to force B to make the election if the partnership agreement gives B discretion and B is, as an economic matter, totally indifferent to whether there is a double taxation of A's share of the economic profit — that's simply not his problem.

The main issue with the section 6226 push-out election is what happens if A does not cooperate. The first question is: Does A have to cooperate at all? In the example, no additional tax would be owed by A, but interest for late payment flow-through of gain would have occurred in year 3, and gain was recognized indirectly in year 4 by way of the sale). So even in the absence of any section 751 issues, it appears that the cooperation of A would be required, assuming that the section 6226 push-out election rules of the new regulations would fully protect the IRS against any increased collection risk and increased administrative burden. If A does not cooperate, the partnership would likely remain on the hook for A's entire stake of the tax liability, even though the tax has been collected from A, unless the partnership could, before the issuance of the FPAA, provide this very fact of A's payment as a partner-level fact that reduces the imputed underpayment. Even if the new regulations would permit this (which they should), the practical problem is this: How would the partnership know about A's payment of tax without A's cooperation? Accordingly, agreements to purchase partnership interests should contain cooperation covenants such that D could force A to cooperate regarding the section 6226 push-out election and, to the extent that A refuses to do so, D is indemnified appropriately. The agreement would also need to address how to deal with B and his possible refusal to make the section 6226 push-out election on behalf of the partnership.[201]

Finally, could the small partnership opt-out election be used to fix the problem? The answer here is likely no because ABC has not made that election in its partnership tax return for year 3. It is unclear whether ABC could file an amended partnership tax return solely for purposes of making that election. This is an issue that the new regulations should address.

2. Partnership ceases to exist. A partnership does not have to exist permanently. The question therefore arises of what happens if a partnership ceases to exist. The new audit rules provide, cryptically, that if a partnership ceases to exist before a partnership adjustment under the new audit rules takes effect, that adjustment shall be taken into account by the former partners of the partnership under regulations prescribed by Treasury (the cease-to-exist rule).[202] That is not much to work with. The attempt to learn anything from the ELP tax rules

[199]Sections 1001 and 741.

[200]The amended partner tax return relief may also be available.

[201]To address this problem, one might want to look at the amended partner tax return relief because this mechanism does *not* require an election by the partnership and therefore bypasses the partnership representative. *See* section 6225(c)(2) (BBA). Again, the problem with amended partner tax return relief is that for a misallocation of income, *all* partners need to agree to file amended partner tax returns. This limitation would not be a problem in Example 26 described above. However, it will often not be clear upfront (*i.e.*, a sale of a partnership interest before the commencement of a partnership audit) whether later audit adjustments will involve any misallocations of income. Accordingly, the commitment of a seller to file an amended partner tax return in accordance with the amended partner tax return relief may provide only limited comfort for a buyer.

[202]Section 6241(7) (BBA).

yields no insights because, although those rules contain the same cryptic language for the same issue, no regulations were ever proposed, let alone finalized.[203]

Example 27: ABC is a Delaware LLC treated as a partnership for tax purposes. A, B, and C own 40 percent, 40 percent, and 20 percent of ABC, respectively, as the result of aggregate capital contributions of $100. In year 1 ABC invested the $100 in stock of TargetCo. In year 2 TargetCo is acquired by way of a merger that is intended to be tax free. ABC receives solely stock of BuyerCo worth $300. In March of year 3, A, B, and C sell all their respective membership interests in ABC to D for $300. B's partner tax return for year 2 is subject to a six-year statute of limitations due to matters unrelated to ABC. ABC has filed partnership tax returns for all periods through to the date of the sale of all the partnership interests. A has been the partnership representative of ABC until the sale. The purchase agreement has no tax-related covenants and does not provide for an indemnity. The merger in year 2 was fully taxable. In year 5 the IRS wishes to audit ABC's year 2 partnership tax return.

This basic example, in which ABC LLC ceases to be a partnership as the result of the sale of all partnership interests to D,[204] should help to analyze the issues in more detail.[205] First, for purposes of applying the cease-to-exist rule, does it matter when ABC LLC ceases to exist? It should. If the partnership ceases after the expiration of the (three-year) statute of limitations for the assessment for the reviewed year (year 2), this should be the end of it. Former partners should not be exposed to the cease-to-exist rule, even if a partner's tax return (here that of B) for the reviewed year is still open because they would also not be exposed to liability if the partnership had continued to exist as a partnership.

Second, how would the IRS learn about the fact that ABC LLC ceased to exist? No rules seem to require that taxpayers flag such a transaction to the IRS. In practice, however, the IRS could conclude from the fact that ABC filed a partnership tax return in year 2 but not in year 4 that it had ceased to exist as a partnership.[206] Accordingly, the IRS would know that there is currently no partnership representative for ABC LLC (based on latest partnership tax return on file — that is, the short year return for year 3). Because ABC LLC is a disregarded entity of D, the IRS might not know who D is at that time.

Third, to whom would the IRS send the notice about the beginning of an audit of ABC LLC for year 2? Logically, if it wishes to audit the year 2 partnership tax return of ABC LLC and there is no partnership representative for the adjustment year, the IRS would send the notice to A, the known partnership representative of ABC LLC for year 2.

Fourth, what would be the role of A in that partnership audit? It would make sense that A would be mandatorily deemed to be the partnership representative of ABC LLC until A, B, C, and D jointly inform the IRS in writing that they have elected someone else to act as the partnership representative for the audit of year 2.[207]

Fifth, what happens to the IRS's audit adjustment regarding the merger (that is, the additional gain of $200)? Because the cease-to-exist rule applies to ABC LLC, it should trump the general rules applicable to audit adjustments. Thus, the cease-to-exist rule should operate as a nonelective, statutory protection for buyer D against a shift of the audit tax liability to D because the rule would prevent the IRS from allocating any of the tax liability to the current owners of ABC LLC in the adjustment year. The audit adjustments need to be reflected in the tax returns of A, B, and C. Solely for this purpose, the IRS could deem ABC LLC to still exist, thereby creating the basis for deemed Schedules K-1 that would be binding for A, B, and C. The allocations of audit adjustments would use the percentage interests in effect in year 2. A key question in this case is whether within the realm of the cease-to-exist rule the audit adjustments should be reflected in the partner's amended tax returns for year 2 or whether they should be reflected in the partners' tax returns for the adjustment year. Given the spirit of procedural simplification, I believe the audit adjustments should be reflected in the adjustment year.

And finally, does it matter for purposes of the cease-to-exist rule whether, after the acquisition by D, ABC LLC is kept alive as a state law matter or whether it is actually liquidated as a state law matter? Based on the foregoing, it shouldn't.

Example 28: Same as Example 27, except that only A and B sell their partnership interests to D.

[203] Section 6255(d).

[204] Rev. Rul. 99-6, 1999-1 C.B. 432, Situation 2.

[205] This example ignores complications that arise if there are transfers of partnership interests or percentage interests among the partners during the reviewed year. In that case, the issue of who is a former partner within the meaning of the cease-to-exist rule must be addressed.

[206] Obviously, this conclusion may often (but not always) be right because there is always the possibility of noncompliance by ABC LLC.

[207] This approach may not work if A is itself an entity that has ceased to exist in the meantime. For that situation, the IRS arguably should have the right to designate either B or C as the partnership representative.

In this example, there is only a technical termination under section 708(b)(1)(A). Therefore, the question is whether the technical termination triggers the application of the cease-to-exist rule. Because the cease-to-exist rule is a significant protection mechanism for a buyer of partnership interests, it would seem that there would be good reasons to make it available in cases of mere technical terminations.[208]

G. Issues for Securitization Transactions

1. REMICs. A real estate mortgage investment conduit is treated as a partnership, and holders of residual REMIC interests (but not holders of regular interests, which are treated as debt for all purposes of the code) are treated as partners for procedural purposes.[209] Accordingly, the new audit rules apply to REMICs. This could create problems, because the avoidance of any risk of issuer-level tax is of paramount importance in securitization transactions. To avoid such an entity-level risk under the new audit rules, REMICs might be able to rely on the small partnership opt-out election because typically the residual interest is held by only one holder or by a very small number of holders. However, existing documentation typically does not prevent a partnership from holding the residual interest, and there is no grandfathering of "old and cold" transactions. Even if the small partnership opt-out election is unavailable, it appears that the entity-level tax should be avoidable by way of the section 6226 push-out election. It seems reasonable to expect that new REMIC documentations will address this issue. Alternatively, the IRS might consider granting automatic small partnership status to REMICs on the grounds that there are no significant compliance concerns regarding REMICs and the new audit rules do not really target them.

2. Grantor trusts and debt for tax transactions. Aside from REMICs, securitizations using grantor trusts may also be affected by the new audit rules.

Example 29: A and B, two domestic investment partnerships managed by C, acquire large numbers of small business loans. The investors of A and B are solely U.S. high-net-worth individuals. For purposes of a securitization program, A and B form a domestic "aggregator" partnership and contribute all their respective small business loans to it. The aggregator partnership, in turn, transfers the small business loans to a newly formed grantor trust X. X issues notes to institutional investors at a very low interest rate. For the notes, counsel provides a "should" level of opinion that the notes issued by X are debt for tax purposes.

Counsel for institutional investors in this example will be concerned with entity-level taxation. If the notes are respected as debt for tax purposes, there will be no entity-level tax on X because it is a grantor trust (or possibly a disregarded entity). If, however, the notes are recharacterized as an equity interest in X, X will not be a grantor trust but a partnership. Before the new audit rules, this recharacterization did not matter too much except for withholding tax purposes. However, because of the aggregator partnership on top of X, this would usually not be a concern for tax counsel because withholding tax rules would apply on the aggregator level, and the small business loans would typically be in registered form, even without being housed in a grantor trust. After the enactment of the BBA, however, a recast of the notes as equity could bring the entity-level tax of the new audit rules into play. While the risk of audit adjustments in Example 29 is arguably very low, tax counsel to institutional investors might insist on a structural fix for this (small) tax risk. The small partnership opt-out election would be unavailable here because of the prohibition against tiered partnerships. That leaves the section 6226 push-out election as the possible solution. However, because this section 6226 push-out election will likely work only if there is an actual tax payment by the partners for the audit adjustments, the value of that election in this context is unclear. Nonetheless, new documentations may contain covenants to use reasonable efforts to make use of the section 6226 push-out election.

V. Preliminary Conclusions

To draw conclusions at this early stage of the learning process is inherently difficult. Thus, I would like to offer only a few preliminary conclusions.

1. The new audit rules conclude an almost 60-year march from a pure aggregate approach to an almost pure entity approach to partnership audits. Interestingly, the audit problem of large and complex partnerships has not, as contemplated from time to time during this long march, resulted in a mandatory corporate treatment for large partnerships as a matter of substantive tax law.

2. While it may strike one at first blush as fundamentally unfair to have an entity-level audit tax liability that could be shifted among partners,[210]

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[208]*But see* Bluebook at 80 (arguing that technical termination under section 708(b)(1)(B) does not trigger the cease to exit rule).

[209]Section 860F(e) (REMIC is treated as a partnership, and holders of residual interests are treated as partners, for purposes of subtitle F, *i.e.*, sections 6001 through 7873).

[210]For a historic perspective, see NYSBA tax section, "Report on the Large Partnership Provisions of the Tax Simplification

(Footnote continued on next page.)

this gut reaction as a partnership tax practitioner may be misplaced, because partners in partnerships governed by the new audit rules are generally not worse off than shareholders in corporations. The one key exception in this regard appears to be the one-way upward adjustment rule.

3. New regulations are urgently needed to make the new audit rules workable and successful as intended by Congress. Finalizing those new regulations before the effective date of the new audit rules will be a major challenge for the IRS and Treasury. Given that the IRS in 18 years never issued any regulations under the ELP rules, and given that the IRS needed almost 20 years to come up with final regulations under TEFRA, the IRS and Treasury will be able to achieve this goal only if they give a "super priority" to this project. Whether they will do so remains to be seen, but it strikes me as unlikely. If that is correct, we face the question whether the effective date of the new audit rules will be postponed by Congress if the IRS cannot come up with new regulations in a timely fashion. Alternatively, if the effective date is not postponed even though no new regulations have been issued, the IRS may not step up its audit activities regarding partnerships.

4. To achieve Congress's goal of increased audit activities with increased tax collections, the IRS will also need to devote significant resources to train more specialized personnel to audit partnerships (and, equally important, retain those employees). Since Congress continues to refuse to fund the IRS properly in light of ever-increasing levels of business activities and since the G-20-driven breakdown of international tax planning by large corporations receives a large amount of attention these days, it strikes me, at this juncture, as unlikely that the IRS will undertake such a major training effort.

5. The small partnership opt-out election is flawed both in concept and design and should therefore be repealed. This repeal would simplify the new audit rules and to some extent reduce the burden of writing new regulations. REMICs should be carved out from the application of the new audit rules.

6. Partnership audits will, as a general matter, become more expensive for taxpayers because of the shift of administrative burdens from the IRS to taxpayers, which in some circumstances may affect taxpayers' choice of entity (for example, REITs or foreign corporations rather than partnerships).

7. The design of the section 6226 push-out election in the new regulations will be central for the day-to-day operation of the new audit rules. The key question that needs to be addressed is whether the termination of the partnership tax obligation requires actual payments of that tax by the partners. If the answer is yes, it will be important to flesh out how those tax payments by the partners will be verified and whether the use of partners' individual tax attributes (for example, NOLs) to reduce those tax payments will be permitted.

Bill" (Dec. 16, 1994) (strongly opposed to the entity-level tax rule in connection with the new large partnership audit rules proposed in 1994).