EXAMPLE ILLUSTRATING BBA & MTC MODEL APPLICATION TO NEGATIVE PARTNERSHIP AUDIT ADJUSTMENTS

In reviewing the example below, keep in mind the following:

- “Negative adjustment” refers to an adjustment that, by itself, reflects overpaid tax—even if it is related to a separate positive adjustment.
- “Taken into account by the partnership,” as used in IRC Sec. 6225 and applicable regulations, means that the negative adjustment is reported in the partnership’s adjustment year Form 1065, offsetting other positive tax items in the same category reported that year, and allocated to partners on adjustment year Schedule K-1s.
- “Adjustments that do not result in an imputed underpayment” generally refers to audit adjustments that cannot be fully netted against positive adjustments in the same category or group in computing an imputed underpayment under applicable federal rules. See IRC §6225(a)(2) and applicable regulations.
- The example, like the model, assumes states begin their calculation of tax with the federal 1065 and Schedule K-1s so that negative adjustments taken into account by the partnership will flow through and to the state return without any additional filing by the partnership or partners.
- The term “federal adjustments report” includes methods or forms required for reporting any final federal adjustment, including an amended state tax return. See Model Section A(7).

The simple example set out below focuses on negative federal adjustments resulting from an IRS audit, and not an Administrative Adjustments Report (AAR). Treatment of negative adjustments resulting from an AAR will be simpler:

- Negative AAR adjustments will generally not be taken into account by the partnership in the adjustment year partnership return.
    - If negative adjustments can be fully netted against positive adjustments in the same category in computing any amount of imputed underpayment as a result of an AAR, then they will be netted.
    - If negative adjustments cannot be netted fully then, they will be pushed out to the partners (regardless of whether the partnership pays any AAR imputed underpayment).
- The Model does not permit a partnership to elect the partnership pays method at the state level for reporting adjustments from an AAR. Therefore, negative adjustments that are netted for federal purposes will be reported by the partnership and all direct and indirect partners through the filing of federal adjustments reports (e.g. amended state returns) under Section C. If the negative adjustment reflects overpaid state tax, the filing of federal adjustments reports will also be the basis for claiming a refund of state tax under the Model Section G.

Audited Partnership Structure

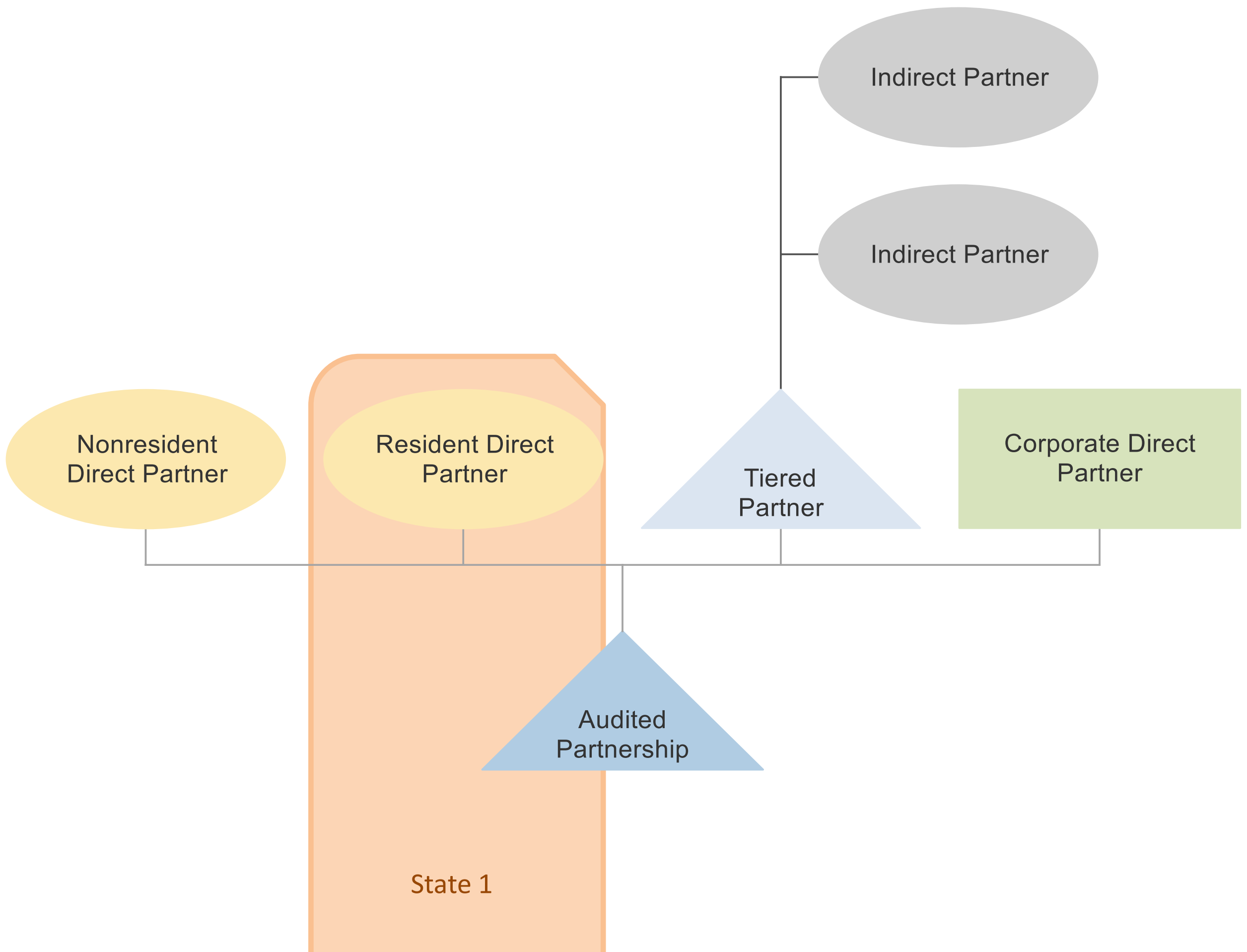
Assume the IRS audits a partnership, operating partly in State 1, with the following structure:

Audited Partnership – 4 Partners

- Tiered Partner
- Resident Direct Partner
- Nonresident Direct Partner
- Corporate Direct Partner

Tiered Partner – 2 Partners

- Indirect Partner 1
- Indirect Partner 2



IRS Audit Adjustments and Calculation of Imputed Underpayment

Assume, the IRS audits the 2019 tax year and adjusts the following items. Note, the IRS has discretion to issue multiple imputed underpayments, grouping audit adjustments for that purpose (Reg. §301.6225-1(g)). Assume the IRS groups the audit adjustments as shown. Also note, there are two negative adjustments that do not result in an imputed underpayment.

	Amount/Effect of Adjustment that -	
Nature of Audit Adjustment	**Results in Imputed Underpayment**	**Does not Result in Imputed Underpayment**
Items Grouped for Imputed Underpayment No. 1		
Increase operating income underreported	$12 Million	
Increase in COGS underreported (can be netted)	($4 Million)	
Recharacterization of gain from capital to ordinary -		
Increase in ordinary income	$8 Million	
Decrease in capital gain (cannot be netted)		($8 Million)
Total	$16 Million	($8 Million)
Items Grouped for Imputed Underpayment No. 2		
Reallocate capital loss from Tiered Partner to Resident Direct Partner -		
Amount of loss reallocated from Tiered Partner	$4 Million	
Amount of loss reallocated to Resident Direct Partner		($4 Million)
Total	$4 Million	($4 Million)

This example assumes that the increase in cost of goods sold (COGS) can be netted against the increase in operating income because those adjustments fall into the same category under IRC §702. But it the decrease in capital gain resulting from the recharacterization of that amount cannot be netted against ordinary income. The example assumes it also cannot be netted against the positive reallocation adjustment. So this adjustment results in two separate adjustments, one of which is a negative adjustment. The negative adjustment reallocating capital loss to Resident Direct Partner also cannot be netted against the reallocation to Tiered Partner, or any other adjustment in this case. See IRC §6225(b)(2).

Modification Period and Filing of Amended Returns

During the 270-day modification period, one or more partners can file amended returns for the reviewed year (or the partnership may provide similar information for the partners) allowing the IRS to assess the partners for their share of the tax. If a partner properly reports all audit adjustments allocated to her, including negative adjustments that do not result in an imputed underpayment, and pays the tax, the related adjustments and imputed underpayment will be reduced accordingly. In the case of a reallocation adjustment, the adjustment and imputed underpayment will be reduced only if all partners affected file and pay any related tax. See IRC §6225(c).

Assume here that during the modification period in 2022, Nonresident Direct Partner files an amended return and includes adjustments that affect him (Imputed Underpayment No. 1), properly paying the related tax. The following summarizes the remaining adjustments:

	Amount/Effect of Audit Adjustment that -		Amount/Effect of Audit Adjustment that is -	
Nature of Audit Adjustment	**Results in Imputed Underpayment**	**Does not Result in Imputed Underpayment**	**Included in Nonresident Direct Partner Amended Return**	**Remaining after Modification Period**
Items Grouped for Imputed Underpayment No. 1				
Increase operating income	$12 Million		$3 Million	$9 Million
Increase in COGS (can be netted)	($4 Million)		($1Million)	($3 Million)
Recharacterization of capital gain to ordinary income -				
Increase in ordinary income	$8 Million		$2 Million	$6 Million
Decrease in capital gain (cannot be netted)		($8 Million)	($2 Million)	($6 Million)
Total	$16 Million	($8 Million)	$2 Million	
Items Grouped for Imputed Underpayment No. 2				
Reallocate capital loss from Tiered Partner to Resident Direct Partner -				
Amount of loss reallocated from Tiered Partner	$4 Million			
Amount of loss reallocated to Resident Direct Partner		($4 Million)		
Total	$4 Million	($4 Million)		

Federal Treatment & Treatment Under the Model – State 1

Assume that for federal purposes:

- Imputed Underpayment No. 1 – Audited Partnership pays the remaining imputed underpayment (highest marginal tax rate) and then contests the audit adjustment recharacterizing ordinary income, which is finally resolved in favor of the IRS in 2024.
- Imputed Underpayment No. 2 – Audited Partnership pushes out the adjustment related to Imputed Underpayment No. 2.
- As a result:
  - The negative federal adjustment reducing capital gains is required to be taken into account in Audited Partnership's partnership adjustment year return. See Reg. § 301.6225-3(b)(2).
  - The negative federal adjustment reallocating capital loss to Resident Direct Partner is pushed out to Resident Direct Partner. See Reg. § 301.6225-3(b)(6).

Scenario No. 1

Assume that for State 1, neither Audited Partnership nor Tiered Partner elects to pay the state tax under the Model. Treatment of the negative adjustments is as follows:

- Share of negative adjustments reported by Nonresident Direct Partner during Modification Period - Because Nonresident Direct Partner filed an amended federal return in 2022 reporting his share of the adjustments that affect him, he must also report that share of adjustments to State 1 in a federal adjustments report and the final determination date for that purpose will be the date that amended federal return is filed. See the definition of the "final determination date" in the Model Section A(9). Both the shares of the negative adjustment to COGS (netted) and the negative adjustment decreasing capital gains (not netted) must be included in that partner's state amended returns.
- Remainder of negative adjustment decreasing capital gains – The remainder of the negative adjustment decreasing capital gains, after subtracting the amount reported by Nonresident Direct Partner, will be reported by Audited Partnership in its adjustment year partnership return and will flow through to direct and indirect partners (other than Nonresident Direct Partner) in that year. Therefore,

that remaining negative adjustment to capital gains will not be included in the adjustments required to be reported under the Model Section C (netted against positive adjustments) and no refund can be separately claimed for that adjustment under Section G.

- Remainder of all other adjustments, including negative adjustment from reallocation of capital loss - Because Audited Partnership contests one of the audit adjustments, the final determination date for reporting the other remaining amounts of adjustments (positive and negative) will be 2024. They will be included in the amounts required to be reported under Section C of the model by the Audited Partnership, Tiered Partner, and the other direct and indirect partners. This includes the negative reallocation adjustment—which will be properly allocated to the Resident Direct Partner.
- Effect on Resident Direct Partner – Assume that Resident Direct Partner's share of the remaining adjustments under imputed underpayment No. 1, excluding the remaining negative adjustment decreasing capital gains, is $4 Million. Resident Direct Partner's share of the negative adjustment reallocating the capital loss under imputed underpayment No. 2 is also $4 Million. So Resident Direct Partner will simply net the negative reallocation adjustment and will not claim any refund of state tax. (See, in contrast, Scenario No. 4 below.)

Scenario No. 2

Assume that for State 1 Audited Partnership makes the partnership pays election under the Model Section C(3). In making the calculation of the partnership pays amount, Audited Partnership must include all audit adjustments (whether included in federal imputed underpayment No. 1 or No. 2), except for the remaining negative adjustment to capital gains which is, instead, included in the Audited Partnership adjustment year return. Therefore, the negative adjustment decreasing capital gains will not be included in the calculation of the partnership pays amount, but the negative reallocation adjustment (reallocating capital loss to Resident Direct Partner) will be included.

Note also that, under the model, unless Audited Partnership makes information available to State 1 on the residency the indirect partners of Tiered Partner, the shares of adjustments allocated to Tiered Partner will be treated as 100% taxable in the state. And, if Corporate Partner would properly treat the items allocated to it as unitary business income, under the model, then the share of adjustments allocated to it would be excluded from the partnership pays calculation and those adjustments would have to be separately reported by the corporation in a federal adjustments report.

Scenario No. 3

Assume that for State 1, Audited Partnership does not elect to pay tax on the remaining federal adjustments, but Tiered Partner does. As with Scenario No. 1, Audited Partnership would file a federal adjustments report, including all adjustments except for the negative adjustment to decrease capital gains, which will be included in the Audited Partnership's adjustment year return. Partners, other than Tiered Partner, will then file federal adjustments reports and include their allocated share of the adjustments reported. Tiered Partner will then include its shares of these adjustments allocated to it in its own federal adjustments report and make the election to calculate and pay the additional tax under Section C(3). Because none of the offsetting negative adjustment reallocating capital loss would be allocated to Tiered Partner (only the positive adjustment that reduces its share of the loss), none of the negative reallocation adjustment would be included in the calculation of the partnership pays amount for Tiered Partner.

Scenario No. 4

Assume that, for federal purposes, instead of paying the federal imputed underpayment No. 1, Audited Partnership pushes out all the audit adjustments and, therefore, the negative adjustment decreasing capital gains would not be included in the Audited Partnership's adjustment year return but would be allocated to the partners as part of the push-out process. See Reg. § 301.6225-3(b)(6). Also assume that in State 1, Audited Partnership does not make the partnership pays election. In this case, the federal adjustments reports for Audited Partnership and its direct and indirect partners will include the remaining amount of the negative adjustment decreasing capital gains. Assume that, as a result, Resident Direct Partner will now report overpaid state tax (due to his share of both the negative capital gains and capital loss adjustments). Resident Direct Partner will be entitled to claim a refund of tax (assuming all other state requirements are met) under Section G and the filing of a federal adjustments report will be the means for him to do so.