# CALIFORNIA LAWYERS ASSOCIATION
# TAXATION SECTION

## 2023 DC DELEGATION

## PROPOSED CHANGES TO COMPUTATION OF THE IMPUTED UNDERPAYMENT UNDER THE BBA PARTNERSHIP AUDIT REGIME PURSUANT TO IRC SECTION 6225(b)
## (Treas. Reg. § 301.6225-1)

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[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.

[2] Although the authors, presenters and reviewers of this paper may have clients affected by the rules applicable to the subject matter of this paper and may have advised such clients on applicable law, such participants have not been engaged by a client to participate on this paper.

## EXECUTIVE SUMMARY

The Bipartisan Budget Act of 2015 (“BBA”)[3] reformed the partnership audit and tax collection procedures established by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”)[4] to create a new centralized audit regime. A key feature of the new BBA centralized audit regime is the assessment and collection of a tax at the partnership level, rather than following the traditional partnership tax principles that income and other partnership items flow through to each partner resulting in each partner paying taxes (if any) based on their individual circumstances. While perhaps compelling in form to eliminate the need for the IRS to expend resources on assessing and collecting any tax understatement from each partner, in practice, because of computational issues that arise from the BBA’s use of Imputed Underpayment (“IU”), the BBA will often yield a liability that differs materially from the tax burden that would have been imposed on the respective partners had the information been reported correctly in the first place. Thereby, the BBA audit regime departs from the fundamental principle that a partnership is solely a conduit and not a taxable entity.

This paper addresses the need for consistency in the IRS’s examination of partnerships under the BBA. Specifically, this paper will address inconsistencies inherent in the computation of the IU, as well as the lack of clear directives as to when it would be an abuse of discretion for the examination agent to include otherwise excluded non-income items to compute an IU.

The definitions under relevant Treasury Regulations treat certain non-income partnership items as if they would necessarily create an additional income tax. Examples of these non-income items include basis adjustments, recharacterizing the partnership’s liabilities, changes in characterization of partnership income as subject to self-employment, and adjustments in capital accounts. Adjustments to these items could create an IU under the applicable Regulations, even though in some cases these items may not have directly changed any partner’s tax liability if they were reported correctly by the partnership in the first place.

The IU is determined by grouping partnership-related items and netting all adjustments within each grouping and subgrouping, as described in IRC Section 6225(b)(1)[5] and Treas. Reg. § 301.6225-1(b) and (e), resulting in the Total Netted Partnership Adjustment ("TNPA"). The TNPA is multiplied by the highest tax rate applicable, resulting in the IU.

For the netting process, all partnership-related adjusted items are classified as either positive or negative adjustments. Positive and negative adjustments are defined in Treas. Reg. § 301.6225-1(d)(2). Negative adjustments are the decrease of an item of gain or income, or an

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[3] Pub. L. No. 114-74, 129 Stat. 584.

[4] Pub. L. No. 97-248, 96 Stat. 324.

[5] Unless otherwise indicated, all “IRC” references are to the Internal Revenue Code of 1986, as amended by the BBA.

increase of an item of loss or deduction. Positive adjustments are conversely defined as any adjustment that is not a negative adjustment.

By default, all adjustments that are not a decrease of an item of income or gain or an increase of an item of loss or deduction are positive adjustments. This includes non-income items or items that, if properly reported on the original return, may not have resulted in any increase in tax owed by any partner.

On December 9, 2022, the IRS, recognizing this issue, published final Treas. Reg. § 301.6225-1(b)(4) in the Federal Register.[6] Under this Regulation if any positive adjustment, including a non-income item, is related to, or results from, a second positive adjustment, one of the positive adjustments may be treated as zero. However, the examiner retains discretion to include the non-income item in the computed IU. This provision allowing for treatment of non-income items as zero does not sufficiently alleviate the concern, since the Regulations do not specify the appropriate standard for the exercise of the IRS's discretion.

This paper proposes the implementation of clear directives as to what would be an appropriate exercise of discretion for consistency to include or exclude non-income items in calculating the IU. Adopting this proposal would result in the consistent treatment of taxpayers, which is a key component of a fair and just tax system and thus, important to an equitable and effective tax administration.

[6] 87 Fed. Reg. 75473 (Dec. 9, 2022).

## DISCUSSION

### I. Background

Signed into law on November 2, 2015, the BBA created a new partnership audit regime. It replaced the existing audit regime, known as the TEFRA regime—the Tax Equity and Fiscal Responsibility Act of 1982—for taxable years beginning on or after January 1, 2018.[7]

Under both the BBA and TEFRA, adjustments are made at the partnership level. The difference is that under TEFRA any tax is assessed against and collected from the individual partners while under the BBA, absent a "push-out" election, the partnership is liable for the IU resulting from the adjustments. Thereby, the BBA deviates from the traditional partnership tax principles, which require that partnership items flow through to each partner resulting in partners paying taxes based on their individual circumstances.[8]

In addition, the BBA does not permit amendment to partnership returns or Schedules K-1. Instead, the partnership representative files an Administrative Adjustment Request ("AAR").

Adjustments determined under a BBA audit and in consequence of an AAR can result in a liability—the IU—that would be paid by the partnership in the year the adjustments become final. This IU can be modified or the adjustments can be pushed out to the partners for the reviewed year.

The BBA allows an IU determination, even if the IU is based on non-income items that are adjusted or where no partner would have owed any additional tax if the item had been properly reported by the partnership on its original return.

This paper comments on the current method of calculating IU and proposes a change in Treasury Regulations (Treas. Reg.) to limit the instances where discretion would permit the inclusion of non-income items in calculating the IU if these items had no impact on any partners' tax liability.

### II. Current Law

Except for certain partnerships that elect out of the BBA audit regime under IRC Section 6221(b), all partnerships filing Form 1065 for tax years beginning after 2017 are, by default, subject to the BBA partnership audit regime. If the IRS audits and determines that partnership-related items should be adjusted, it will issue a Notice of Proposed Partnership

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[7] Unless partnerships "early elect-in" to have the BBA centralized partnership audit regime apply to partnership returns filed for tax periods beginning after November 2, 2015 and before January 1, 2018. BBA *supra* n.3 § 1101(g)(4).

[8] *See, e.g.*, IRC § 701.

Adjustments. This notice, among other things, reflects the proposed adjustments and the IU resulting from these adjustments. IRC Section 6231(a)(2).

The IU is determined by grouping the partnership items and netting all partnership adjustments of return items within each grouping and subgrouping, as described in IRC Section 6225(b)(1) and Treas. Reg. § 301.6225-1(b), (e), resulting in the TNPA.

The TNPA is multiplied by the highest tax rate under IRC Section 1 (individuals) or IRC Section 11 (corporations) for the reviewed year (currently 37%). An IU results if the final amount is a net-positive adjustment. IU payments made in furtherance of the partnership audit are not deductible, according to IRC Section 6241(4).

The partnership adjustments are thus the relevant inputs for the IU. IRC Section 6241(2)(A) defines partnership adjustments as any adjustment to a partnership-related item. "Partnership-related item" is defined broadly in IRC Section 6241(2)(B) as any item or amount related to the partnership that is relevant in determining any person's tax liability under chapter 1 of the Code and any partner's distributive share thereof. IRC Section 6241(2)(B). Treas. Reg. § 301-6241-1(a)(6)(iii) clarifies that items or amounts relating to partnership transactions are items or amounts with respect to the partnership only if they are shown or required to be shown on the partnership return or are required to be maintained in the partnership's books and records. The Regulation also clarifies that items or amounts shown, or required to be shown, on a return of a person other than the partnership (or in that person's books and records), as a result of applying the Code to a partnership-related item and taking into account facts and circumstances unique to that person, are not partnership-related items.

Neither the statute nor the Regulation defines a "partnership-related item" as an income item. Treas. Reg. § 301-6241-1(a)(6)(v)(D), for example, specifies that the partnership's basis in its assets is also considered a partnership-related item.

All partnership-related adjusted items are classified as either positive or negative adjustments.

Positive and negative adjustments are defined in the Treas. Reg. § 301.6225-1(d)(2). Negative adjustments are the decrease of an item of gain or income, or an increase of an item of loss or deduction. The positive adjustment is conversely defined as any adjustment that is not a negative adjustment.

By default, all adjustments that do not decrease an item of income or gain, or do not increase an item of loss or deduction, are positive adjustments. This includes non-income items, items that would not have resulted in any increase in tax if declared correctly or adjusted under the TEFRA regime. For example, an increase to an asset’s tax basis changes neither income or gain

nor loss or deductions of the partnership.[9] By default, it would be categorized as a positive deduction because it neither decreases an item of income or gain nor increases an item of loss or deduction.

The Treasury Department and IRS recognized the concern that non-income items could result in an IU. On December 9, 2022, the IRS released final Treas. Reg. § 301.6225-1(b)(4), under which non-income items (and other positive adjustments) that are related to, or result from, a positive adjustment to another item, will generally be treated as zero for the purpose of calculating IU.

Furthermore, the final Treasury Regulation ("Regulation") gives the IRS discretion to include the non-income adjustment in computing the IU. Moreover, the Regulation does not provide an example of when it would be appropriate to exercise such discretion nor does it specify the appropriate standard for the exercise of the IRS's discretion. Thus, the Regulation does not adequately address the concern raised by this paper.

In addition, the rule is silent to the extent that a non-income item is the only item changed. In the event the change of the non-income item does not relate to or result from another positive adjustment, this change would cause an IU despite no additional tax being owed if the item were declared correctly on the initial return. The second sentence of Treas. Reg. § 301.6225-1(b)(4), therefore, should include stand-alone adjustments of non-income items.

## III. **Rationale for the Proposal**

Non-income items can be still included in the IU determination under current Regulations. The wide range of examples (see III. A.) shown below illustrates that there is only one set of cases where the inclusion would be appropriate. Exercise of discretion should be limited to this set of cases. Further granting of discretion to the examiner results in an unjustified imbalance between taxpayers and the IRS (see III.B.) by giving the examiner unguided discretion and – aside from administrative appeal rights through a burdensome modification process – leaving the taxpayer with the option of judicial review only under the abuse of discretion standard. Given the lack of statutory or regulatory guidance for the exercise of discretion, abuse of discretion becomes arguably unchecked and yet, almost impossible to challenge. Without a meaningful standard to determine the proper exercise of discretion, the ability to successfully challenge and obtain a finding of an abuse becomes virtually unattainable. Treasury's recent omission of the term "tax liability" in describing the IU, instead using the term "an entity-level liability of the partnership",[10] is likely to further exacerbate the concerns here as this omission, if intended to nullify the tax

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[9] Typically, the change of non-income items is accompanied by a second adjustment, but not in all cases. These second adjustments can impact the tax burden. For example, a change in an asset's tax basis is often accompanied in a change of taken depreciation deductions. A disallowance of the depreciation deductions would impact the tax burden, as deductions are an income item.

[10] Centralized Partnership Audit Regime, Final regulations on treatment of special enforcement matters (TD 9969), released December 9, 2022; see https://www.federalregister.gov/documents/2022/12/09/2022-26783/treatment-of-special-enforcement-matters.

classification of the IU, would remove the last meaningful goalpost for interpreting the proper exercise of discretion. For instance, if an examiner added a non-income item to the IU computation to penalize taxpayers simply for providing an untimely response to an Information Document Request (IDR), the examiner could suggest that the imposition of an IU is being done as an administrative convenience to collect taxes when it was truly intended to be punitive, thus, rendering a challenge futile absent some guidance as to an appropriate exercise of discretion.

Although, perhaps an extreme scenario, it serves as an illustration of the predicament faced by taxpayers and the IRS in the absence of clear guidance. It is the absence of statutory or regulatory guardrails which leaves unanswered the question of under what circumstances a non-income item may be included and opens up such examinations to both an increased potential for disparate treatment toward taxpayers, which is contrary to the overall goals of tax administration as well as a concern that unguided discretion under Treas. Reg. § 301.6225-1(b)(4) could provide, or be perceived to provide, an examiner with an improper bargaining chip.[11]

### A. Consequences of the Imputed Underpayment

Non-income items are all items that are not items of income, gain, deduction or credit, although a change in a non-income item may result in an adjustment to income, gain, deduction, or credit. In other words, a change of tax basis by itself is not a change of income, gain, deduction, or credit. The change of the tax basis, though, can have an effect on the depreciation deductions taken in the adjustment years, and thus affect an income item.

#### 1. Basis Adjustments

Adjusting an asset's basis has no impact on the tax owed by the partners, and therefore should not result in an IU. Depreciable assets usually have an adjustment that accompanies the basis adjustment, the adjustment of depreciation deductions. The adjustment of the income item of depreciation deductions are a separate adjustment and must be analyzed that way. Sometimes, however, the tax basis comes without these secondary adjustments, either because the asset is not depreciable or because the depreciation period has not started yet because the asset has not put in use.

EXAMPLE

A partnership acquires a building for $100,000 and assumes the mortgage for $50,000. The building shall be rented to other businesses. The tax basis is wrongly recorded as $100,000. Because the building has not been placed in use yet, no depreciation has been taken at the time of the audit. The building has not been sold in the reviewed year.

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[11] Similar concerns inspired Congress to implement management approval requirements for penalties in IRC § 6751(b)(1). "The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip", S. REP. 105-174, 65; see also *Chai v. Comm'r*, 851 F.3d 190, 219 (2d Cir. 2017).

The examiner determines that the mortgage is part of the tax basis and corrects the tax basis to $150,000. Under Treas. Reg. § 301.6225-1(d)(2), the $50,000 correction of the tax basis has no effect on income for the reviewed year and, as a result, it does not fall under any of the categories defined in Treas. Reg. § 301.6225-1(d)(2)(i). It is, thus, not a negative adjustment and becomes a positive item by default. As a result of the capitalization, the TNPA for calculating the IU is $50,000.

Due to the lack of another positive adjustment that the basis change related to or resulted from, Treas. Reg. § 301.6225-1(b)(4) does not require zeroing out the positive adjustment, even though the basis adjustment does not impact the tax owed by the partners. If Treas. Reg. § 301.6225-1(b)(4) is applied, the basis adjustments of $50,000 would be treated as zero for the purpose of calculating IU. Nonetheless, the Regulation as currently written, provides the examiner discretion to include the $50,000 adjustment in the IU as there are no standards or guidelines as to when and how to exercise this discretion.

### 2. Recharacterizing of Certain Partnership Liabilities

Adjusting a partnership liability from a nonrecourse liability to a recourse liability often has no direct impact on the tax owed by the partners, and therefore should not result in an IU in this event. While some recharacterizations could impact a partner's ability to claim pass-through losses, and thus have an indirect impact on the tax owed, this is not always the case.[12]

EXAMPLE

Partnerships have to report each partner's share of partnership liabilities at the end of the tax year on their Schedule K-1, which lists three categories of liabilities: nonrecourse, recourse, and qualified nonrecourse.

For example, Partnership A has two equal partners. It reports only a liability of $10,000 as being a nonrecourse liability and allocates the entire liability equally between both partners ($5,000 each to each partner) because no partner bears an economic risk of loss. Treas. Reg. § 1.752-3. Both partners have a $0 basis. The IRS determines that one partner bears the economic risk of loss. Under Treas. Reg § 1.752-2 and Publication 541, a partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss for that liability. A partner's share of a recourse liability equals his economic risk. Consequently, the IRS allocates the entire $10,000 to one partner, increasing one partner's share of liability by $5,000 and reducing the other partner's share of liability by $5,000.

The decrease of one partner's share of partnership liabilities are adjustments that are not allocated under IRC Section 704(b) under Treas. Reg. § 301.6225–1(c)(5)(ii). Under Treas. Regs. §§ 1.752–1(c) and 1.731–1(a)(1)(i), the decrease of the partner's share is treated as a distribution

[12] For an example when the recharacterization impacts the tax owed by the partners see the exception under A(v).

of money and no gain is recognized except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Because of the cumulative effect, the decrease of the $5,000 share of liabilities, could be seen as neither the decrease of an item of gain or income, nor an increase of an item of loss or deduction[13], it would not be a negative adjustment. By default, the decrease of the share of liability by $5,000 would be a positive adjustment. The same applies to the increase in the other partner's share by $5,000.

Under Treas. Reg. § 301.6225-1(b)(4), one partner's decrease of the share of liabilities would be treated as zero for the purpose of calculating IU. Nonetheless, the Regulation as currently written, would give the examiner discretion to include the amount of either $5,000 in computing the IU, without defined standards or guidelines directing when and how this discretion should be exercised.

### 3. <u>Changes in a Partner's Net Earnings from Self-Employment,</u>

Another example is the change in a partner's net earnings from self-employment. Because the partner can deduct the employer-equivalent portion of the self-employment tax, increasing the net earnings from self-employment (NESE) reported by a partnership on a partner's K-1 can decrease the Chapter 1 tax owed by the partners, and therefore should not result in an IU.

EXAMPLE

In a 2019 Memorandum,[14] LB&I described in an example a situation where the partnership issues a K-1 to the partner, reporting $100,000 of ordinary income on line 1. On line 14 of the K-1, self-employment earnings, the partnership reported $0. After audit, the IRS determines that partnership's income was self-employment earnings, and consequently makes a $100,000 adjustment to line 14. In the 2019 Memorandum, LB&I now concludes that this results in a $37,000 IU (highest tax rate 37%).

Whether a partnership's income is reported in line 1 or line 14 of the K-1 should have no effect on the Chapter 1 income tax liability of its partners (except for the allowed deduction). The effect on the self-employment tax is not a partnership related item, because it is a Chapter 2 tax. Under IRC Section 6241(2)(B), a partnership item is:

- Any item or amount with respect to the partnership[15] which is relevant in determining the tax liability of any person under chapter 1 of subtitle A of the Code;

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13 See, (not finalized) Prop. Treas. Reg. § 301.6225-4(e) (Example 5), 83 Fed. Reg. 41954.

14 LB&I-04-1019-010, dated October 24, 2019.

15 IRM 4.31.9.6 (10-29-2021): An item or amount is with respect to the partnership if it's:
a. Shown or reflected, or required to be shown or reflected, on a return of the partnership under IRC 6031, the Regulations thereunder, or the forms and instructions prescribed by the IRS for the partnership's tax year or is required to be maintained in the partnership's books or records, or

- Any partner's distributive share of any such item or amount; and
- Any imputed underpayment determined under the BBA regime.

On the partner's level, an increase in NESE allows the partner to deduct the paid NESE for his portion of the self-employment tax, resulting in a positive tax effect on the partner's level. But again, the effect is regarding a Chapter 2 tax.

Under amended Treas. Reg. § 301.6225-1(b)(4), the increase in line 14 on the Schedule K-1 would be treated as zero for the purpose of calculating IU, but at the same time the examiner has the discretion to include this amount. Again, there are no standards or guidelines when and how to exercise this discretion.

### 4. Adjustments in Capital Accounts

Since adjusting a partner's capital account itself has no impact on the tax owed by the partners, such adjustment should not result in an IU.

On February 12, 2021, the IRS issued final instructions for the 2020 Form 1065, requiring reporting of capital accounts using the transactional approach for the tax basis method. These new instructions caused many partnerships to adjust the capital accounts. If a partnership missed this new requirement or inaccurate adjustments occurred, the IRS may determine in a later audit that the partners' beginning capital accounts must be adjusted, and consequently also the year-end capital account.

The change in the capital account is neither a decrease of an item of gain or income, nor an increase of an item of loss or deduction. Therefore, it would not be a negative adjustment. By default, the decrease of the share of liability would be a positive adjustment.

Under amended Treas. Reg. § 301.6225-1(b)(4), the adjustment of the capital account would be treated as zero for the purpose of calculating IU, but at the same time the examiner arguably still has the discretion to include this amount, based upon the lack of standards or guidelines when and how to exercise this discretion.

### 5. Exception

We are aware of only one circumstance where a change to a non-income item could have a direct impact on the tax owed by the partners, and these are cases where a non-income item decreases the partners' "at-risk" tax basis and the amount of partnership losses allocated to the partner exceeds the amount of the decreased tax basis. Because the amount of partnership losses a partner may recognize in a particular tax year is limited by his or her at-risk tax basis amount at

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b. Relating to any transaction with, liability of, or basis in the partnership but only if it's described in the preceding sentence.

the end of the partnership tax year in which the loss occurred, IRC Section 704(d)(3), Treas. Reg. § 1.704-1(d), any recognized amount of losses exceeding the correct at-risk tax basis would have to be disallowed.[16]

The at-risk basis is the partner's contributions plus his share of partnership income and recourse and qualified non-recourse liabilities, plus any liability he personally assumes responsibility for minus his share of partnership losses and minus distributions to the partner. The at-risk basis is distinguished from the outside basis, which is the total amount of his or her capital account plus his share of partnership liability.

EXAMPLE

Following the earlier example, involving the recharacterization of nonrecourse debts to recourse debts, assume the partnership reports, among others, a liability of $10,000 as being a recourse liability[17] and allocated the entire liability to Partner A because Partner A bears the economic risk of loss. Treas. Reg. § 1.752-3. Partner A has a $10,000 "at-risk" basis at the end of the partnership's tax year, and Partner B has a basis of $0. The partnership reported a loss of $12,000 equally allocated to both partners. Partner A is able to recognize the entire $6,000 as a loss, reducing the adjusted gross income by the same amount. Partner B cannot recognize the loss because it would exceed his tax basis.

The IRS disagrees with this characterization as a recourse liability in this example because it determines that no partner bears the economic risk of loss. Instead, the IRS considers the liability to be a non-qualified nonrecourse debt. Because not-qualified nonrecourse debt does not provide a tax basis under the at-risk rule, Partner A's tax basis is zero. The tax basis of Partner B remains unchanged. Both Partners are now not allowed to recognize the partnership's loss, but these losses are carried forward.

In such cases, any exercise of discretion to treat non-income item not as zero, should be limited to cases where a partner's tax basis is reduced, and the partnership losses allocated to this partner exceed his tax basis.

If the government determines further cases, where the change to non-income item causing directly an increase in the partner's tax burden, only these kinds of cases should allow the examiner to be permitted to exercise his discretion to include the non-income item. The mere unrealized risks of increasing a partner's tax basis, meaning the mere possibility inherent to a change of tax basis, should not be sufficient because no real change in the tax burden arose. The fact that a

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[16] The exception, however, is limited to the described circumstances. The tax impact recedes if after the at-risk basis reduction each partner still has sufficient at-risk basis to allow deduction of his/her share of loss for the reviewed year; if the partnership did not have a loss in the reviewed year; or the change would have no impact on any partner's liability for the reviewed year.

[17] A partnership liability is a recourse liability under Publication 541 and Treas. Reg. 1.752-2 to the extent that any partner or a related person has an economic risk of loss for that liability.

change in a tax basis may have been realized upon sale is irrelevant as long as the sale did not occur at the time the adjustments become effective. Otherwise, the taxpayer would be penalized by doubling the negative tax impact by adding the IU to the correct tax treatment.

### B. Insufficient Fix

Treas. Reg. § 301.6225-1(b)(4) states that:

> "(…), if a positive adjustment to an item is related to, or results from, a positive adjustment to another item, one of the positive adjustments will generally be treated as zero solely for purposes of calculating any imputed underpayment unless the IRS determines that an adjustment should not be treated as zero in the calculation of the imputed underpayment."

#### 1. Silent to Stand-Alone Adjustments of Non-Income Items

The Regulation is silent to the extent that an adjustment to a non-income item is the only item changed. In the event that the change of the non-income item is not related to or resulted from another positive adjustment, Treas. Reg. § 301.6225-1(b)(4) does not apply. Consequently, this change would cause an IU despite no additional tax being owed if this were declared correctly on the initial return.

### 2. <u>Discretion to Include Non-Income Items</u>

The Regulation opens the door to include non-income items if "the IRS determines that an adjustment should not be treated as zero". There are no standards or guidelines when the IRS can determine that the adjustment should not be treated as zero.

This determination is left to the examiner's unguided discretion.

### 3. <u>Abuse of Discretion Standard</u>

In cases where the IRS exercised discretion, the taxpayer must prove that the IRS's inclusion of the non-income item was unreasonable, arbitrary, capricious, or an abuse of discretion.[18]

In determining whether there was an abuse of discretion, the Tax Court cannot simply substitute its judgement for that of the IRS. The court's jurisdiction to review discretionary decisions is limited. The Tax Court can review discretionary decisions only for a clearly erroneous assessment of the facts or an erroneous view of the law.[19]

The practical application of the lack of guidance on an examiner's exercise of discretion under the Regulation means the examiner has wide latitude to base an IU on adjustments that would not have resulted in a tax if reported correctly in the first place.

The Regulation discussed above was a clear step in the right direction for fair and just tax administration, but it remains a concern that the examiner's unfettered discretion would arbitrarily permit inconsistent treatment of taxpayers in similar situations, thus the implementation of clear guidelines defining or limiting discretion is necessary to fully effectuate a fair implementation of the finalized Regulation.

### 4. <u>Pegging Inclusion to Impact on Partners' Tax Liability</u>

Treasury recently stated that the IU "is not designed to be the exact amount of the tax liability that would have been paid by the partners, nor is it a substitute for partner tax liability."[20]

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18 See *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984) (change of accounting method); *Mailman v. Comm'r*, 91 T.C. 1079 (1988) (refusal to waive substantial understatement penalty); *Foster v. Comm'r*, 80 T.C. 34, 142–143 (1983), aff'd in part and vacated in part, 756 F.2d 1430 (9th Cir. 1985) (adjustments under IRC § 482); *Robinette v. Comm'r*, 123 T.C. 85 (2004) (where the validity of the underlying tax liability is not properly at issue, a IRC § 6330 case involves a review for abuse of discretion); *Jonson v. Comm'r*, 118 T.C. 106 (2002), and *Porter v. Comm'r*, 130 T.C. 115 (2008) (denial of innocent spouse relief under IRC § 6015(f)).

19 See *Kasper v. Comm'r*, 150 T.C. 8 (2018) (citing *Fargo v. Comm'r*, 447 F.3d 706 (9th Cir. 2006) (quoting *United States v. Morales*, 108 F.3d 1031 (9th Cir. 1977))).

20 Centralized Partnership Audit Regime, Final regulations on treatment of special enforcement matters (TD 9969), released December 9, 2022; see https://www.federalregister.gov/documents/2022/12/09/2022-26783/treatment-of-special-enforcement-matters.

Instead, Treasury describes the IU as "an entity-level liability of the partnership"[21]. Given Treasury's classification of the IU,[22] the adjustments' impact on a partner's tax liability would not be a limiting factor for the examiner's discretion.

We acknowledge that the outcome of a BBA audit, meaning the IU, per design deviates from the partner's tax liability not only because of the absence of partner's tax characteristics such as capital losses available to offset additional capital gain or the tax rate. We are not advocating the removal of deviations required under the BBA but instead that the difference between the IU and the ultimate increase in tax that would be owed by the partners should remain fairly close and not otherwise be consciously widened by including non-income items into calculation of the IU based upon the unguided, and arguably unlimited, discretion of an examiner.

Therefore, the partners' tax liability should be the guiding principle on exercising the discretion on whether a non-income adjustment should be included in calculating the IU.

### C. Unwitting Consequences of Unguided Discretion

The cornerstone of a fair and effective tax system is the principles of consistency, predictability, and transparency. Taxpayers should have confidence that their tax liabilities are determined based on clear rules and regulations, rather than the subjective whims, regardless of the presence or absence of any improper intent, of individual revenue agents.

While some degree of discretion is necessary to allow revenue agents to assess complex tax situations on a case-by-case basis, unguided and unchecked discretion can lead to arbitrary and inconsistent treatment of taxpayers, negatively impacting the integrity of the audit process. This lack of clear guidelines and standards also results in uncertainty and unpredictability, eroding the trust and confidence of taxpayers in the tax system and the IRS.

Practically speaking, if the BBA audit process is viewed as unfair, then it increases the likelihood that a large number of partnership eligible to opt out would do so, undercutting the benefits of efficiency and resource savings intended by the BBA as well as a two-tier partnership audit process between those eligible to opt out and those not eligible.

## IV. Suggested Changes

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[21] Centralized Partnership Audit Regime, Final regulations on treatment of special enforcement matters (TD 9969), released December 9, 2022; see https://www.federalregister.gov/documents/2022/12/09/2022-26783/treatment-of-special-enforcement-matters.

[22] Meaning the classification as an entity-level liability but avoiding the term tax liability in their release of the Centralized Partnership Audit Regime, Final regulations on treatment of special enforcement matters (TD 9969), released December 9, 2022.

(1) This paper proposes to include stand-alone adjustments to non-income items, meaning non-income items that do not relate to or result from another positive (or negative) adjustment, in the second sentence of Treas. Reg. § 301.6225-1(b)(4).

(2) This paper proposes that the IRS set forth limiting instructions on an examiner's use of discretion under the Regulation to clarify any exercise of discretion will preclude consideration of non-income adjustments in computing IU in cases where the tax liability of the partner would not have changed if the item would have been reported correctly.

We propose that the IRS take appropriate steps to clarify that the exercise of an examiner's discretion, under Treas. Reg. § 301.6225-1, to include a non-income item, will be limited to only those instances where the examiner determines that the inclusion is required to reflect the increase in the tax liability of a particular partner if the adjusted item would have been reported correctly on the initial return.

## V. Feasibility and Authority

IRC Section 6225(c)(1) authorizes the IRS to establish procedures to modify the IU amount consistent with the requirement of the provision. Changes to the guidance under Treas. Reg. § 301.6225-1 is politically and economically feasible as it provides clearer standards to determine the IU and prevents the IRS from use of unbridled discretion in including non-income items in computing IU.

We urge that if the IRS is to retain discretion to include changes to non-income items in computing IU, such discretion should be clarified to be limited to those instances where, had the non-income item been correctly reported, it would have changed the partners' tax liability. This will ensure fair and just tax administration and limit the potential for unjustified penalties posed solely to encourage taxpayers to otherwise agree to audit results.[23]

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[23] As it inspired the managerial approval to penalties under IRC § 6751(b)(1); see *IRS Restructuring: Hearings on H.R. 2676 Before the S. Comm. on Finance*, 105th Cong. 92 (1998) (statement of Stefan F. Tucker, Chair-Elect, Section of Taxation, American Bar Association: "[T]he IRS will often say, if you don't settle, we are going to assert the penalties.").