The Curious Case of Debt Allocation Miscommunication and the BBA

by Eric Yauch

Treasury's latest proposal on the partnership audit regime offers a solution on how to deal with issues in reporting liabilities, but some claim it may not be a solution at all.

Under proposed rules (REG-123652-18) released November 24, a partnership that failed to report liabilities on the partners' Schedules K-1 would simply report the correct amount of liabilities for the adjustment year.

But according to Kate Kraus of Allen Matkins Leck Gamble Mallory & Natsis LLP, that essentially means there might not be a remedy available for a partner who has paid too much tax.

For example, say a partnership accidentally omitted a liability from its Schedules K-1 (or misallocated its liability), so partner 1 thought she had a distribution in excess of basis and therefore reported gain. If the IRS adjusts the liability — or the allocation of it — and determines that additional liability should have been allocated to partner 1, partner 1 generally won't be able to obtain a refund or have any other remedy for its overpayment of tax, Kraus said.

The latest proposed regulations provide that under the default rule, the remedy would be that the partnership reports the correct amount of liabilities in its adjustment year. That is, the partnership reports the liabilities that it should be reporting anyway, regardless of the adjustment.

> ***If a taxpayer-favorable adjustment is made to the partnership's liabilities, the only way a partner could be sure to obtain a refund is by using the amended return modification, Kraus said.***

No partner gets a refund of the tax that partner 1 overpaid, and in the adjustment year no income is omitted, nor is extra loss reported. However, if the partnership had reported $10 million too much income in the reviewed year, the remedy under the default rule would be for the partnership to omit $10 million of income, or report an additional $10 million of loss, in the adjustment year — regardless of whether the

error actually affected the amount of tax that any partner owed.

For example, if the partners in the reviewed year were tax exempt, the extra income reported might not have increased the tax owed by any person. Kraus said that under the new proposed regulations, if a taxpayer-favorable adjustment is made to the partnership's liabilities, the only way a partner could be sure to obtain a refund is by using the amended return modification. The push-out election or the pull-in modification do not allow for refunds.

Kraus said the proposal is another example of "heads I win, tails you lose" under the partnership audit regime.

Something New

The partnership audit regime was created under the Bipartisan Budget Act (BBA) of 2015 and allows the IRS to audit partnerships at the entity level. The regime — which was effective beginning in the 2018 tax year — changed the audit landscape in several ways. Under the BBA, the IRS doesn't have to engage in drawn-out battles over who can bind the partnership. Instead, it only has to deal with one person named on the return.

Partnerships subject to the BBA can't simply amend prior-year returns to make changes to partnership items. Instead, they must file administrative adjustment requests, which in some cases can result in a partnership, or the partners, losing out on a refund or any other remedy.

Several rounds of regulations have been released to implement the audit regime. As both the government and practitioners navigate the new landscape, issues continue to pop up. One of them is the government's approach to partnership debt allocations.

Partnerships are unique in that partners receive an increase in the basis of their partnership interests for their share of debt allocated to them. The partners' basis increase boosts their ability to receive losses from the partnership and increases the amount of distributions they can receive tax free.

For years many return preparers didn't worry about the numbers listed in the liability section of a partnership Schedule K-1, according to practitioners, but that changed when final rules (T.D. 9844) released in 2018 said mischaracterizing debt could create an entity-level tax.

In Example 7 of reg. section 301.6225-1(h) of the 2018 final rules, if a partnership mischaracterizes its $100 nonrecourse liability as a recourse liability, that is an error within the scope of the audit regime, and the partnership must pay tax on $100 of income — the imputed underpayment — under the default rules.

The example is complex, and it's unclear if it works both ways. That is, if the liability were a recourse liability but was reported as a nonrecourse liability, and if the nature of the liability as recourse versus nonrecourse didn't affect the allocation of the liability, it's unclear whether there would be an imputed underpayment for the partnership to pay.

Practitioners have also noted that there are procedural routes to take to avoid getting hit with a tax bill in that case, but that navigating the new and complex rules may be lost on many. Under the new proposed rules, the IRS has tried to fill in some gaps on debt allocation issues under the BBA.

If a partnership failed to report $10 million of liabilities on its Schedules K-1 and the IRS makes an adjustment to correct that amount, it's unclear if the existing final regs addressed that situation, Kraus said. Under the new proposed rules, the IRS said the partnership would report the correct amount of liabilities in the adjustment year, she added.

"I can understand why the government would want to take this position — otherwise partnerships could generate artificial tax benefits by omitting information about their liabilities on their returns," Kraus said. "But I'm not sure whether this approach is entirely consistent with [section] 6225(a)(2), which says that the adjustment will be taken into account in the adjustment year." It might be possible to argue that the proposed regs don't actually have anyone take the adjustment into account in the adjustment year, she added.

If the partnership underreported, misallocated, or mischaracterized its liabilities, it could be required to pay an imputed underpayment under existing regulations, Kraus said.

"So an error in one direction results in tax being paid, but an error in the other direction has no remedy," Kraus said, adding that it's difficult to say what the right approach should be — the statutory language isn't helpful, and it's difficult to try to spell out a reasonable set of tax rules that treat a partnership as a taxpaying entity for years in which an adjustment is made.

It might be that the approach taken by the new proposed regulations is the best one to take, despite the cost it may impose on taxpayers, some practitioners have noted.

It's not entirely clear whether the latest proposed regulations are consistent with the current final and earlier proposed regulations that have examples about liabilities, so those examples might need to be revised to conform with the government's new approach, Kraus said.

Brave New World

The November 24 proposed rules were released to put regulatory meat on the statutory bones of changes made to the BBA in the Consolidated Appropriations Act, 2018, which added section 6241(11). That code section says that in the case of partnership-related items involving special enforcement matters, the IRS may issue regulations stating that the audit regime doesn't apply and the items are subject to special rules necessary for the effective enforcement of the tax code.

Jerald David August of Fox Rothschild LLP said that by enacting section 6241(11), Congress was acknowledging that the BBA wouldn't always work, nor would it necessarily want it to in some circumstances, such as in a criminal investigation or an audit requiring application of an indirect method of proving a taxpayer's income.

August said Treasury essentially said in the proposed regulations that when it decided a case was outside the BBA's reach because of its special enforcement issues, the IRS can pursue only that partner and apply the normal deficiency procedures.

In some instances, a rule mandating the IRS to adjust certain partnership-related items only as part of a BBA audit would hinder the efficient enforcement of the tax code. That may happen when the partnership's treatment of a partnership-related item was based on information provided by a partner or person other than the partnership.

The partnership may lack the required detailed records for that information that would be readily more obtainable by audit of the partner or other person, August said.

"So the IRS tells you whether you're in or out of the BBA, and it's a new world we're living in," August said. "I think they're trying to add depth and analysis to the instances and the rationale behind this section." ■