Tennessee Law Review

Volume 88
Issue 1 *Fall 2020*

Article 5

2020

SIMPLE AUDITS FOR SIMPLE TAX PARTNERSHIPS

Andrew L. Lawson

Follow this and additional works at: https://ir.law.utk.edu/tennesseelawreview

Part of the Courts Commons, and the Legal Profession Commons

Recommended Citation

Lawson, Andrew L. (2020) "SIMPLE AUDITS FOR SIMPLE TAX PARTNERSHIPS," *Tennessee Law Review*: Vol. 88: Iss. 1, Article 5.
Available at: https://ir.law.utk.edu/tennesseelawreview/vol88/iss1/5

This Article is brought to you for free and open access by Legal Scholarship Repository: A Service of the Joel A. Katz Law Library. It has been accepted for inclusion in Tennessee Law Review by an authorized editor of Legal Scholarship Repository: A Service of the Joel A. Katz Law Library. For more information, please contact eliza.boles@utk.edu.

SIMPLE AUDITS FOR SIMPLE TAX PARTNERSHIPS

ANDREW L. LAWSON*

I. INTRODUCTION 118
II. FROM DECENTRALIZATION TO CENTRALIZATION 120
A. A Hypothetical 122
B. Decentralization and Its Shortcomings 122
C. Navigating the BBA 126
1. The Scope of the BBA 126
a. Eligibility for the Election Out 127
b. Applicable Items 128
2. The PR Component 130
3. The Adjustment Component 132
a. General Treatment of Adjustments 133
b. An Exception: AARs that Do Not Give Rise to Imputed Underpayments 136
4. Applying the BBA to Super Subs 138
III. AUDITING THE AUDIT RULES 142
A. Efficiency 143
B. Simplicity and Enforceability 145
C. Equity 152
IV. CLOSING LOOPHOLES, AVOIDING PITFALLS 155
A. Bifurcating the Election Out 156
B. Narrowing the Election-out Criteria by Reducing the Threshold Number of Partners 159
C. Broadening the Election Out by Creating an Automatic Exemption for Certain Small Partnerships 160
1. The First Alternative: The Income-and-assets Test... 161
2. The Second Alternative: The Partner-focused Test ... 164
3. The Policy Benefits of the Automatic Exemption 165
a. Promoting Fairness 165
b. Simplifying the Tax Law and Maintaining its Enforceability 167
c. Improving Efficiency 169
V. CONCLUSION 170

New rules targeting sophisticated tax partnerships unnecessarily burden small, unsophisticated taxpayers. This is a familiar narrative in partnership tax. This time, the story takes place in the rules that prescribe the process by which the IRS audits and collects tax from partnerships and partners. Designed to limit abuse, the rules are highly complex and needlessly saddle small, simple

businesses with increased compliance costs and potentially excessive tax liability. Ironically, at the same time, the rules leave loopholes for sophisticated organizations able to exploit them. This Article explains these disparate consequences and suggests solutions to both limit the loopholes for large taxpayers and simplify the rules for small businesses.

I. INTRODUCTION

Complicated partnership tax rules designed to limit abuse by sophisticated organizations have once again unnecessarily burdened small, unsophisticated partnerships.[1] This time, the rules at issue prescribe the process by which the IRS audits and collects tax from partnerships, adding even more layers to the labyrinth of subchapter K.[2] Ironically, at the same time that they needlessly burden small, simple businesses, they leave loopholes for larger, more sophisticated ones.

This Article suggests a two-part legislative solution to both relieve unnecessary burdens and close remaining loopholes.[3] The

---

* Visiting Assistant Professor, University of Arkansas School of Law. I would like to thank Will Foster, Lonnie Beard, Laurent Sacharoff, Carol Goforth, Amanda Hurst, and Son Nguyen for their valuable input on various drafts of this Article.

1. Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 232 (1998) (stating that the partnership tax system intended to limit abuse by sophisticated taxpayers instead "plagues many unincorporated small businesses utilizing relatively simple arrangements. These enterprises must incur the time and expense of navigating this complex system of rules in order to comply with its requirements. Worse yet, the elaborate system has failed to curb abuse."); Kristen A. Parillo, *Early BBA Audits Reveal Lack of Familiarity with New Rules*, 166 TAX NOTES FED. 1837, 1837 (2020) (stating that, in early audits under the BBA, IRS agents have noticed "a lack of familiarity, a lack of understanding of the regime").

2. Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101(a), 129 Stat. 584, 625 (2015) (codified in scattered sections of 26 U.S.C.), *amended by* Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 411, 129 Stat. 2242, 2576–77 (2015) (codified in scattered titles of U.S.C.).

3. This Article joins primarily practitioner-driven literature. It fills a void by focusing in depth on small businesses and suggests a novel solution to insulate them from unnecessary complexity. *See, e.g.*, Todd J. Gluth, *Behind the BBA: A History of Partnership Audit and Collection Rules*, TAXES, Mar. 2017, at 201, 218. *See generally* Carol Kulish Harvey et al., *New Partnership Audit Rules—What We Know So Far, Part 1*, 152 TAX NOTES FED. 829 (2016); Carol Kulish Harvey et al., *New Partnership Audit Rules—What We Know So Far, Part 2*, 152 TAX NOTES FED. 991 (2016); Jerald David August, *Repeal of the TEFRA Entity Level Audit Rules Under the Bipartisan Budget Act of 2015: The Adoption of a New Paradigm for Assessing and Collecting Income Taxes from Partnerships*, J. TAX PRAC. & PROC., Aug.–Sept. 2016, at 55; Monica Gianni, *Partnership Audit Rules: After the Final Regulations*, J. TAX'N, June 2019, at 9; Todd J. Gluth & Diana L. Wollman, *A Better BBA: A Proposal for*

solution would first limit the extent to which large partnerships can opt out of the centralized partnership audit regime (commonly called the "BBA," after the regime's inclusion in the Bipartisan Budget Act of 2015), furthering the policy goals underlying the rules by limiting the potential for abuse by large organizations.[4] Then the solution would create an automatic exemption for small businesses having either few owners or a low level of income and assets. This automatic exemption would limit the unintended casualties of a regulatory regime targeted toward sophisticated taxpayers.

To delve deeper into this Article's proposed solution, one must first understand the two basic components of the BBA. Think of the BBA as involving two distinct components. The first is the procedures by which the IRS interacts with the partnership (e.g., during an audit) which require the partnership to appoint an all-powerful "partnership representative" (the "PR") to represent the partnership.[5] I refer to this component as the "PR component." The second component is the procedures for processing adjustments arising from those interactions (e.g., an increase or decrease in income arising from an audit). I refer to this component as the "adjustment component." Currently, certain partnerships with one hundred or fewer direct and indirect partners can elect out of both components, in which case a different system that is less burdensome for small businesses applies.[6] This Article identifies the second component—the adjustment component—as the primary source of complexity in the rules but finds that the PR component is relatively easy to navigate even for unsophisticated taxpayers.

Building on these findings, the first part of the solution suggests that Congress should remove partnerships' ability to elect out of the PR component. If adopted, this would require all partnerships to appoint an all-powerful PR but would still allow certain smaller

---

Improving the BBA Partnership Audit and Collection Rules, TAXES, Mar. 2017, at 235; Kathryn Keneally & Michael Scarduzio, *The Repeal of the TEFRA Audit Regime and the Shift from an Aggregate to an Entity-level Approach to Partnership Taxation*, J. TAX PRAC. & PROC., Feb.–Mar. 2016, at 37; James R. Malone, Jr., *All Partners are Small Partners: The Due Process Implications of the New Partnership Audit Regime*, J. TAX PRAC. & PROC., Feb.–Mar. 2017, at 17; Fred F. Murray, *New Partnership Audit Rules Affect Oil and Gas and Other Investment Partnerships*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2016, at 9.

4. Gluth & Wollman, *supra* note 3, at 201–02.

5. *Id.* at 213.

6. I.R.C. § 6221(b). Technically, the partnership is eligible only if it "is required to furnish [one hundred] or fewer" Schedule K-1s to its partners for the taxable year, including each statement that an S-corporation partner must furnish to its shareholders under § 6037(b). Treas. Reg. § 301.6221(b)-1(b)(2) (2018).

partnerships to escape the adjustment component either by opting out or satisfying an automatic exemption.

The second part of the solution turns to the process by which these smaller partnerships may avoid the BBA's adjustment component. This part of the solution would itself have two pieces. First, Congress should require partners with more than ten direct and indirect partners to follow the adjustment component. This is a significant departure from current law, which allows partnerships with up to one hundred direct and indirect partners to opt out of the BBA.[7] Second, Congress should create an automatic exemption from the adjustment component for small partnerships that satisfy one of two alternative tests: (1) a test that exempts partnerships with less than a certain level of gross income and total assets, and (2) a test that exempts partnerships with ten or fewer direct and indirect partners, each of which is an individual, C corporation, or an entity that is disregarded for tax purposes and owned solely by an individual or C corporation.

This Article begins by explaining the rules and examining how they create loopholes for sophisticated taxpayers and burdens for small businesses. It then analyzes the rules through a policy framework, focusing on whether the rules are fair, efficient, simple, and enforceable. After identifying the rules' shortcomings, it concludes by further describing the two-part solution and its potential to both close loopholes and protect vulnerable small businesses.

II. FROM DECENTRALIZATION TO CENTRALIZATION

Partnership tax is a tale of two theories. For some purposes, partnerships are entities distinct from their partners much like a corporation is separate from its shareholders.[8] But for other purposes, they are merely an aggregate of their partners, with each partner treated as owning a proportionate share of the partnership's assets.[9]

For example, a partnership generally does not pay tax and instead passes through to its partners any tax liability arising from

---

7. I.R.C. § 6221(b).

8. WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02[2] (2019).

9. This oversimplifies matters. Even provisions viewing the partnership as a conduit may cause different results than if the partners directly owned their proportionate shares of the assets. *See* Emily Cauble, *Taxing Selling Partners*, 94 WASH. L. REV. 1, 8 (2019).

its operations.[10] Thus, if Partnership AB had two equal partners and $100 in taxable income for 2020, each partner would account for $50 in taxable income.[11] But Partnership AB would adopt its own taxable year and accounting method and make elections such as selecting a method of depreciating its assets.[12]

These aggregate-entity questions extend beyond the substantive partnership tax provisions into the depths of the tax code: the enforcement provisions governing how audits are conducted, how decisions are appealed, how tax is assessed, and, eventually, how tax is collected.[13] Does the aggregate theory control, resulting in a *decentralized* system in which the IRS must audit and pursue each partner separately for any tax due? Or does entity treatment prevail, giving rise to a *centralized* system in which the IRS may audit the partnership and collect any increased tax from it alone? Or some combination of both?

Historically, full decentralization prevailed.[14] Beginning in 1982, however, policymakers increasingly centralized the audit process while also retaining exceptions in which the decentralized process applied.[15] This shift toward centralization accelerated in 2015 when Congress further consolidated the audit process and introduced a new assessment and collection system.[16] But it still retained and even expanded the exceptions in which the decentralized system applies.[17]

To provide a foundational understanding for the remainder of this Article, Sections A, B, and C explore the differences between a centralized and decentralized enforcement system. Section A introduces a fact pattern that the Article later uses to illustrate the differences between each system. Section B illustrates the operation and shortcomings of a completely decentralized system. Section C turns to the BBA, first describing its approach to centralization and then providing an example of its operation.

---

10. I.R.C. § 701.

11. *Id.* § 702.

12. *Id.* § 703(b); Treas. Reg. § 1.703-1(b)(1) (as amended in 1991).

13. *See* Gluth & Wollman, *supra* note 3, at 236 (describing various proposed systems for auditing and collecting tax from partnerships and their partners).

14. Keneally & Scarduzio, *supra* note 3, at 38.

15. McKEE ET AL., *supra* note 8, ¶ 10.01.

16. August, *supra* note 3, at 55–56. The BBA's adjustment system is new in the sense that it is mandatory for all BBA partnerships. An entity-level payment system existed under prior law for electing large partnerships under former I.R.C. §§ 6240–6255, which allowed electing large partnerships to elect to pay the tax at the partnership level. I.R.C. § 6242(a)(2).

17. I.R.C. § 6221(b).

A. A Hypothetical

In 2018, Adam and Cleo started a sandwich shop. After consulting a local attorney, they formed a limited liability company, calling it Super Subs, LLC ("Super Subs"). The LLC is taxed as a partnership under federal law. With aims to expand into surrounding cities, they each invested $50,000 and also convinced Adam's cousin John, a nurse practitioner in a nearby town, to contribute $25,000 in exchange for a 20% stake. John is a passive partner and does not participate in the business.

B. Decentralization and Its Shortcomings

Under a fully decentralized system, an audit of Super Subs would proceed as follows. The IRS would separately audit each partner's individual return though perhaps with some coordination by IRS representatives.[18] Each partner could correspond separately with auditors and would maintain full control over his or her audit with the discretion to take actions without affecting the other partners.[19] For example, a partner might choose to extend the statute of limitations for the IRS to assess a tax deficiency, but that decision would not affect the other partners' statutes of limitation.[20]

After completing the audit of a partner, if the IRS determined that he or she owed additional tax, that partner could accept or reject the examiner's findings.[21] Again, that partner's decision would not bind the other partners.[22] If a partner rejected the IRS's findings, he or she could eventually file an administrative appeal, petition the U.S. Tax Court, or, after paying the tax, file a refund claim in a federal district court or the Court of Federal Claims.[23]

---

18. IRM 4.31.5.1.1(4) (Apr. 5, 2019) (describing procedures for linking pass-through entities and their investors); AM. L. INST., FEDERAL INCOME TAX PROJECT 10 (Tentative Draft No. 7, 1981). To be clear, the IRS is not required to audit all three partners. It could audit one or more of them.

19. GERALD A. KAFKA & RITA A. CAVANAUGH, LITIGATION OF FEDERAL CIVIL TAX CONTROVERSIES ¶ 9.01[1] (2020).

20. *Id.*

21. MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 8.01[2] (2020).

22. KAFKA & CAVANAUGH, *supra* note 19.

23. This oversimplifies the actual process, which technically involves several steps including a thirty-day letter and a notice of deficiency (also known as a ninety-day letter). SALTZMAN & BOOK, *supra* note 21. The notice of deficiency is the document that permits a taxpayer to file a Tax Court petition. I.R.C. § 6213(a).

And each partner could navigate this process differently.[24] One may refuse to pay the tax deficiency and petition the Tax Court.[25] Another might pay the tax and file a refund claim with a federal district court.[26] Yet another might file a refund claim with the Court of Federal Claims.[27] If the partners resided in different judicial districts, they could even file refund claims in courts with potentially different applicable precedent.[28] Importantly, no judicial decision with respect to one partner would bind another partner who was not a party to the litigation.[29]

After the IRS completed the audit, it would then have to separately assess the increased tax liability against each partner[30] and send each a separate "notice and demand" for payment of the increased tax.[31] If the partner then failed to pay the amount due, the IRS could initiate collection remedies—but, again, only against each separate partner.[32] It generally could not, for example, collect Adam's tax liability from Super Subs, Cleo, or John; it could only collect it from Adam himself.[33]

Under these circumstances—a three-person partnership with relatively simple operations and with each partner residing in the same state—this decentralized process probably poses very few issues.[34] The IRS could easily identify Adam, Cleo, and John as the

---

24. *See* Malone, *supra* note 3, at 18.

25. *See* Peter A. Prescott, *Jumping the Shark: The Case for Repealing the Partnership Audit Rules*, 11 FLA. TAX REV. 503, 508–10 (2011).

26. 28 U.S.C. § 1346(a)(1) (2018); Prescott, *supra* note 25, at 510. To file a refund suit, a taxpayer must satisfy additional requirements such as filing a prior administrative claim with the IRS and filing the refund suit before the statute of limitations expires. I.R.C. §§ 6511(a), 7422(a).

27. 28 U.S.C. § 1346(a)(1).

28. *Id.* § 1402(a). Even if each partner petitioned the Tax Court, different judicial precedent could apply if they were residents of different judicial districts. *See* Golsen v. Comm'r, 54 T.C. 742, 757 (1970). The Tax Court applies the precedent of the United States Court of Appeals to which the taxpayer may appeal the Tax Court's decision. *Id.* Individuals may appeal the Tax Court's decision to the court of appeals for the judicial district in which he or she resides. I.R.C. § 7482(b)(1)(A).

29. KAFKA & CAVANAUGH, *supra* note 19; Prescott, *supra* note 25, at 509.

30. "Assessment" is simply the "formal recording" of the partner's tax liability on the IRS's books, fixing the amount that he or she is required to pay. I.R.C. §§ 6201(a), 6203; SALTZMAN & BOOK, *supra* note 21, ¶ 10.01[1].

31. I.R.C. §§ 6213(c), 6215(a).

32. *See id.* §§ 701, 6213(c), 6215(a).

33. *See* Keneally & Scarduzio, *supra* note 3, at 38.

34. *See* N.Y. STATE BAR ASS'N, TAX SECTION, REPORT NO. 1347, REPORT ON THE PARTNERSHIP AUDIT RULES OF THE BIPARTISAN BUDGET ACT OF 2015, at 137 (2016) [hereinafter NYSBA 2016 Report] (stating that the arguments for centralizing the

partners, separately audit them with little difficulty in coordinating strategy, and assess and collect tax from each of them with relatively few obstacles.[35] Even if the three partners took inconsistent tax positions, the IRS's administrative burden would be quite easy to bear.[36]

But the complexity of the audit quickly multiplies if more partners join, especially if some of those partners are entities themselves (such as partnerships, S corporations, or complex trusts).[37] Indeed, partnerships commonly have hundreds or thousands of partners—many of which may in turn be partnerships themselves with their own partner and own assets worth more than $100 million.[38] And many of these partnerships have more-complicated operations and engage in far more-sophisticated transactions than selling sandwiches.[39]

With these factual changes, the IRS's administrative burden under a decentralized system mushrooms.[40] More partners means more time and resources required to conduct an audit.[41] Even assuming that all the partners are individuals, the IRS still must separately audit hundreds or thousands of different partners who may reside in different states and different judicial districts.[42]

The IRS's task becomes even more difficult if one or more partners are themselves partnerships.[43] This forces the IRS to not

---

audit and collection process "are less compelling in the context of relatively small and simple (i.e., single-tier) partnerships").

35. *See id.* at 140.

36. *See id.* at 137–38.

37. 26 C.F.R. § 301.6221(b)-1 (2018).

38. U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-732, LARGE PARTNERSHIPS: WITH GROWING NUMBER OF PARTNERSHIPS, IRS NEEDS TO IMPROVE AUDIT EFFICIENCY 17 (2014) [hereinafter 2014 GAO Report] ("In 2011, [seventeen] large partnerships had more than a million partners," and "several large partnerships ha[d] more than [fifty] tiers.").

39. Amy S. Elliot, *Why It Matters that the IRS Has Trouble Auditing Partnerships*, 143 TAX NOTES FED. 7, 7 (2014) ("Many private equity firms, oil and gas partnerships, and hedge funds are set up as widely held partnerships.").

40. *Section of Taxation Proposal as to Audit of Partnerships*, 32 TAX LAW. 551, 551 (1979).

41. *See* 2014 GAO Report, *supra* note 38, at 24–25.

42. *See* Prati v. United States, 81 Fed. Cl. 422, 427 (2008) ("Prior to TEFRA's enactment, the examination of a partnership for federal tax purposes was an exceedingly tedious process. . . . [I]f the IRS deemed it necessary to adjust an item listed on a Form 1065, the IRS was essentially forced to audit each individual partner in a partnership. As a consequence, the IRS could not guarantee consistent treatment of a partnership item for each partner in a partnership.").

43. Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 TAX POL'Y & ECON. 91, 117–18 (2016) ("[T]he extent of

only identify and audit *direct* partners—Adam, Cleo, and John—but also *indirect* partners, that is, persons who hold their interests in the partnership through another entity.[44] To illustrate, imagine Adam and Cleo formed another partnership ("AC Partnership") to hold their interests in Super Subs. AC Partnership would be the direct partner in Super Subs, and Adam and Cleo would be indirect partners. While the IRS would likely face few problems identifying Adam and Cleo, this is not always the case with larger partnerships, especially those with numerous tiers of partners. In these "tiered" partnerships, it can be quite difficult to identify the indirect partners, much less collect tax from them.[45]

In addition to auditing each partner, the IRS must contend with administrative appeals and judicial proceedings arising from the audit.[46] The IRS may face numerous separate actions, with potentially different outcomes, in potentially different forums, and with potentially different precedent.[47] Although there are avenues for consolidating cases, this nevertheless strains the IRS's limited resources as well as the efficiency of the judicial system.[48]

These problems prompted Congress to increasingly centralize the partnership audit and collection process.[49] First, Congress passed the Tax Equity and Financial Responsibility Act ("TEFRA") in 1982.[50] Adopted largely in response to the proliferation of partnership tax shelters, TEFRA partially consolidated the audit process and the procedures for appealing any proposed increase in tax liability but still generally retained decentralized collection procedures.[51] Then, after the IRS's struggles with large partnerships continued, Congress replaced TEFRA in 2015 with the BBA.[52]

---

partnership tiering presents major challenges from a tax administration perspective.").

44. 2014 GAO Report, *supra* note 38, at 2.

45. Cooper et al., *supra* note 43, at 117.

46. *See* Malone, *supra* note 3, at 17.

47. AM. L. INST., *supra* note 18, at 15–18.

48. The Tax Court's rules allow for consolidation of cases, and the Multidistrict Panel on Litigation may consolidate cases across different federal judicial circuits. 28 U.S.C. §§ 1404, 1407; TAX CT. R. 141; *In re* Tax Refund Litig., 723 F. Supp. 922, 923–25 (E.D.N.Y. 1989) (consolidating cases for refund of tax penalties); KAFKA & CAVANAUGH, *supra* note 19, ¶ 7.05.

49. Gianni, *supra* note 3, at 9.

50. I.R.C. §§ 6221–6324.

51. *See id.* §§ 6221–6234.

52. Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101(a), 129 Stat. 584, 625 (2015) (codified in scattered sections of 26 U.S.C.), *amended by* Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, div. Q, § 411, 129 Stat. 3040, 3121–3122 (2015) (codified at 26 U.S.C. § 6225).

C. Navigating the BBA

To understand the BBA, one must first see the forest and then the trees. Viewed broadly, the BBA has two basic components.[53] The first is the centralized audit and appeals system (the "PR component"), which streamlines the process of auditing partnerships and navigating related judicial proceedings.[54] It aims to assist the IRS in determining whether the partnership owes more tax and in responding when taxpayers disagree with that determination.[55]

The second component is the entity-level adjustment system.[56] (the "adjustment component."). This allows the IRS to assess and collect tax from the partnership itself rather than pursuing each individual partner.[57] It is meant to reduce the time and effort required for the IRS to collect the tax determined under the first component.[58]

The remainder of this Part explores the trees. It first addresses a threshold matter: When does the BBA apply, and when does it not? It then separately examines the first and second components of the system described above, noting the differences between each component versus a decentralized system or TEFRA. Finally, it applies the BBA to the Super Subs example and compares the results against what would occur under a decentralized system.

1. The Scope of the BBA

To determine whether the BBA applies to a particular scenario, one must ask two questions. First, does the BBA apply to the partnership at all (as certain partnerships can elect out of the BBA)?[59] Second, assuming the BBA applies generally to the partnership, does it cover the particular tax item at issue (e.g., an item of income or loss)?[60] While the BBA covers many items related to the partnership, other items fall outside its scope.[61] To adjust

---

53. NYSBA 2016 Report, *supra* note 34, at 21.

54. *See* I.R.C. §§ 6221–6223, 6231, 6234.

55. Centralized Partnership Audit Regime, 82 Fed. Reg. 27,334, 27,338–27,339 (June 14, 2017) (to be codified at 26 C.F.R. pt. 301) (describing the "concept of the partnership representative" as "intended to address the shortcomings" of prior law).

56. I.R.C. §§ 6221, 6225–6226, 6232–6233.

57. *Id.* § 6221(a).

58. Letter from George C. Howell, Chair, Am. Bar Ass'n, Section of Tax'n, to Internal Revenue Service (June 6, 2016) [hereinafter ABA Letter].

59. I.R.C. § 6221(b).

60. *Id.* § 6221(a).

61. *Id.*

these items, the IRS must still separately audit each partner even if the BBA applies generally to the partnership.[62]

a. Eligibility for the Election Out

If a partnership elects out of the BBA,[63] the decentralized audit system applies and the IRS must separately audit and assess and collect tax deficiencies from each partner.[64]

To elect out, a partnership must satisfy an eligibility test and must make an affirmative election out.[65] A partnership is eligible to elect out if: (1) it has one hundred or fewer direct and indirect partners,[66] and (2) each of its direct partners is an individual, a C corporation, an S corporation, or a deceased partner's estate.[67] Assuming the partnership meets this criteria, it must then make an affirmative election out for each taxable year in which it wishes to be exempt from the BBA.[68] This requires several actions, including an affirmative election on the partnership's "timely filed" tax return and disclosure of certain information about its partners.[69]

---

62. *Id.*

63. *Id.* § 6221(b).

64. Keneally & Scarduzio, *supra* note 3, at 40. TEFRA is eliminated entirely for 2018 and future years but will continue to be relevant for years before 2018. *See* Jerald David August, *Drafting Partnership Agreements: The New Partnership Representative and the Outgoing Tax Matters Partner*, CORP. TAX'N, Sept.–Oct. 2017, at 3, 7.

65. I.R.C. § 6221(b).

66. Technically the partnership is eligible only if it "is required to furnish [one hundred] or fewer" Schedule K-1s to its partners for the taxable year, including each statement that an S-corporation partner must furnish to its shareholders under § 6037(b). Treas. Reg. § 301.6221(b)-1(b)(2) (2018). For example, a partnership could not elect out if it had fifty-one direct partners, fifty of which are individuals and one of which is an S corporation with fifty shareholders. *Id.* § 301.6221(b)-1(b)(2)(iii) (example 4). This is a significant departure from TEFRA, which automatically exempted a partnership unless it had: (1) more than ten partners, or (2) a partner other than an individual, C corporation, or a deceased partner's estate. I.R.C. § 6231(a)(1)(B).

67. Permissible partners also include a foreign entity that would be treated as a C corporation if it were a U.S. entity. I.R.C. § 6221(b)(1)(C). Prohibited partners include a person that holds partnership interest on behalf of another person. Treas. Reg. § 301.6221(b)-1(b)(3)(ii)(F).

68. Treas. Reg. § 301.6221(b)-1(c).

69. *Id.* This information includes, among other items, each partner's name, taxpayer identification number, and tax classification (e.g., partnership, S corporation, or C corporation). *Id.* § 301.6221(b)-1(c)(2). "If a partner is an S corporation, the partnership must also disclose to the IRS information about each shareholder of the S corporation[,]" including each shareholder's name, taxpayer identification number, and tax classification.

For example, for Super Subs to be exempt from the BBA for 2020, it must make an election out on its timely-filed 2020 return and provide information to the IRS about Adam, Cleo, and John. It would have to repeat this process to be exempt for 2021; otherwise, it would be exempt for 2020 but not for 2021.[70] Likewise, if John transferred his interest to, say, a revocable trust, Super Subs would be ineligible to elect out even if he was the sole settlor and sole trustee of the trust.[71]

b. Applicable Items

Assuming the BBA applies as a general matter, one must still identify the specific instances to which it applies. Partners' returns may reflect income, deductions, and other tax items both related to and unrelated to the partnership.[72] For example, John's return may include both losses passed through from Super Subs and income from wages that he earned as a nurse practitioner. Certainly, the BBA should not apply to his wages, but how do the rules resolve less-obvious circumstances?

The statute answers this question by applying the BBA only when the IRS is adjusting "a partnership-related item,"[73] which is an item that is "with respect to the partnership" and is "relevant" in determining any person's income tax liability.[74] Fortunately, the regulations clarify this amorphous standard and provide some examples. Under the regulations, an item is "with respect to the partnership" if it: (1) must be included in the partnership's return, or (2) must be maintained in the partnership's books or records.[75] Examples include the character or amount of the partnership's income or loss (e.g., Super Subs recognized $1,000 in ordinary income from sandwich sales), the allocation of partnership income or loss among partners (e.g., Super Subs allocated $100 of that sales income to John), and contributions and distributions from the partnership (e.g., John contributed $25,000 to Super Subs).[76]

---

70. *Id.* § 301.6221(b)-1.

71. *Id.* § 301.6221(b)-1(b)(3)(ii)(B).

72. *See* I.R.C. § 702.

73. *Id.* § 6221(a).

74. "Partnership-related item" also includes "any partner's distributive share" of an item that is "with respect to the partnership" and is "relevant" in determining any person's income tax liability. *Id.* § 6241(2)(B).

75. Treas. Reg. § 301.6241-1(a)(6)(iii) (2019).

76. *Id.* § 301.6241-1(a)(6)(v). Other examples include the "character, timing, and source of the partnership's activities," the basis and value of the partnership's assets, the "amount and character of partnership liabilities," items of the partnership

To illustrate this concept, consider the following examples:

> Example 1: In 2020, Super Subs paid Landlord $1,000 in rent. Super Subs deducted this $1,000 payment on its 2020 return. (To simplify this example, assume that this $1,000 deduction is the only item for Super Subs in 2020.) Landlord included the $1,000 payment in income in 2020. Super Subs's $1,000 deduction is a "partnership-related item" with respect to Super Subs.[77] Landlord's income is not.[78]
>
> Example 2: Super Subs allocates the $1,000 deduction $400 to Adam, $400 to Cleo, and $200 to John, which they include on their personal returns. The partners' shares of the deduction are partnership-related items.[79]
>
> Example 3: To account for their shares of the $1,000 deduction, Adam and Cleo each reduce their adjusted basis in their Super Subs partnership interest by $400, and John reduces his by $200.[80] The amount of each partner's adjusted basis in his or her partnership interest is not a partnership-related item.[81]
>
> Example 4: Super Subs allocates $200 of the deduction to John who, contrary to the passive activity loss limitations under § 469, improperly deducts it against his nurse-practitioner wages from 2020. (Section 469 prohibits individuals from deducting losses from "passive" activities against income from activities in which they materially participate (e.g., John's wages.))[82] Although the allocation of the $200 deduction to John is a

---

relating to a [§] 754 election, and the "identity of a person as a partner in the partnership." *Id.*

77. *Id.* § 301.6241-1(a)(6)(vi)(A).
78. *Id.*
79. *Id.* § 301.6241-1(a)(6)(vi)(C).
80. I.R.C. § 705(a)(2).
81. Treas. Reg. § 301.6241-1(a)(6)(iii).
82. I.R.C. § 469(a).

> partnership-related item, John's improper $200 deduction taken on his personal return is not.[83]

Distinguishing whether an item is a "partnership-related item" is the gateway to the BBA. If it is not, the IRS must adjust it in a partner-level audit. But if it is a "partnership-related item," the BBA applies (assuming no election out) with important implications for the IRS, the partnership, and its partners. It is these implications and the specific rules giving rise to them that we turn to next.

2. The PR Component

The PR component consolidates the partnership audit process and related judicial proceedings.[84] When applicable, the IRS can avoid separately auditing each partner and instead conduct one consolidated audit.[85]

To facilitate the audit process, the partnership must annually designate a PR on its tax return.[86] This individual may be a partner or non-partner.[87] If the partnership fails to appoint a PR for a particular year, the IRS may appoint one for it.[88]

Appointing a competent and trustworthy person as PR is critical because of that individual's broad power.[89] Once designated, the PR has the sole authority to file administrative adjustment requests ("AARs" in tax shorthand, which are roughly the BBA equivalent of an amended return),[90] bind the partnership and its partners during

---

83. Treas. Reg. § 301.6241-1(a)(6)(vi)(C).

84. I.R.C. §§ 6221, 6234.

85. *Id.* § 6221(a).

86. *Id.*

87. The partnership may designate an entity as the PR, but if it does so, the entity-PR must designate an individual who essentially functions as the PR. *See* Treas. Reg. § 301.6223-1(b)(ii) (as amended in 2019).

88. I.R.C. § 6223(a). The PR designated continues to serve until he or she resigns, the partnership revokes the designation, or the IRS determines "that the designation is not in effect"—for example, because the PR is dead, incarcerated, or otherwise incapacitated and unable to meet with auditors. *See* Treas. Reg. §§ 301.6223-1(a), (f)(2) (as amended in 2019); Partnership Representative Under the Centralized Partnership Audit Regime and Election to Apply the Centralized Partnership Audit Regime, 83 Fed. Reg. 39,331, 39,335 (Aug. 9, 2018) (to be codified at 26 C.F.R. pt. 301).

89. I.R.C. § 6223(a)–(b).

90. *Id.* §§ 6223, 6227; Treas. Reg. § 301.6227-1(a) (2019); Centralized Partnership Audit Regime, 84 Fed. Reg. 6468, 6519 (Feb. 27, 2019) (to be codified at 26 C.F.R. pt. 301) ("[O]nly the partnership representative has the authority to file an AAR under [§] 6227 . . . .").

the audit,[91] and appeal adverse determinations to the Tax Court, appropriate federal district court, or Court of Federal Claims.[92] No partner (other than the PR, if he or she is a partner) may file an AAR or participate in an audit or any judicial proceeding arising from it.[93] Indeed, the IRS need not give notice of the audit or any final determination in the audit to any partner who is not the PR.[94] The PR's authority and the lack of rights for other partners remain in effect regardless of any state law or contractual agreement otherwise.[95] Even if the partnership agreement requires the PR to consult with each partner prior to making a decision, this does not bind the IRS, which may rely on the PR's actions even if he or she ignored the agreement.[96]

The PR's authority eases several aspects of the audit process. For the IRS, the settlement process is much simpler: If the PR enters into a settlement agreement, that settlement binds all partners, even if they do not agree to it.[97] Likewise, the IRS need not obtain extensions of the statute of limitations from each partner or respond to different judicial proceedings with different applicable precedent.[98] Instead, the PR's decision to extend the statute of limitations binds the partnership and its partners.[99] If the PR petitions (or decides not to petition) a court, again that decision binds the partnership and its partners, enabling the IRS to avoid contending with and potentially being whipsawed by inconsistent judicial decisions.[100]

When applicable, this centralized audit process is a significant improvement over a fully decentralized system and even over

---

91. I.R.C. § 6223(b).

92. *Id.* § 6234(a). To petition a U.S. district court or the Court of Federal Claims, the partnership must first deposit with the IRS the amount of tax alleged to be due (including penalties and interest). *Id.* § 6234(b)(1).

93. Treas. Reg. § 301.6227-3(a) (2019).

94. I.R.C. § 6231(a) (requiring the IRS to "mail to the partnership and the partnership representative" certain notices relating to the audit).

95. Treas. Reg. § 301.6223-2(d)(1) (as amended in 2019).

96. *Id.*

97. Treas. Reg. § 301.6223-2(a) (as amended in 2019).

98. *Id.*

99. *Id.*

100. I.R.C. § 6234. The applicable precedent is that of the circuit court to which the partnership may appeal the court's decision. *See* Golsen v. Comm'r, 54 T.C. 742, 757 (1970). District courts apply the precedent of the circuit in which the district court is located. If the lower court is the Tax Court, the relevant precedent is that of the circuit in which the partnership has its principal place of business. I.R.C. § 7482(b)(1)(E). TEFRA included a similar rule but suffered from other defects. *Id.* § 6226(a)(1)–(b)(1).

TEFRA, which did not require partnerships to annually designate a representative on their return[101] and gave partners broad participation, approval, and notice rights.[102] But the BBA does not end there. To facilitate the collection of tax deficiencies established during the audit, it incorporates a novel concept: an entity-level adjustment system.

3. The Adjustment Component

Without special rules, all adjustments to partnership-related items (e.g., an increase or decrease in income) would have to be passed through to the partners.[103] For example, once the IRS audited each partner, it would also have to separately pass the adjustments from the audit through to each partner and assess and collect the tax from each partner, which can be particularly problematic with respect to large partnerships with many partners.[104] With few exceptions, the BBA (when it applies) now centralizes the adjustment process as a default rule by requiring the partnership itself to take adjustments into account.[105] For instance, if the IRS audits the partnership and disallows a deduction, the partnership must pay the tax arising from that adjustment unless it (through the PR) elects otherwise.[106] But when the rules do not apply, the decentralized system remains in place.[107]

In principle, this concept sounds straightforward enough: consolidate the adjustment system just as the law consolidated the

---

101. Treas. Reg. § 301.6231(a)(7)-1(c) (as amended in 2001) ("The partnership *may* designate a tax matters partner for a partnership taxable year on the partnership return for that taxable year . . . ." (emphasis added)). Some IRS agents even reported that larger partnerships were "purposely unclear" about the identity of the tax matters partner "as an audit-delay strategy." 2014 GAO Report, *supra* note 38, at 27.

102. *See, e.g.*, I.R.C. §§ 6223(a), 6224(a), 6226(b). There were limited exceptions to these participation, approval, and notice rights for certain partners with less than a 1% interest in the profits of a partnership with more than one hundred partners. *See id.* §§ 6223(b)(1), 6224(c).

103. 2014 GAO Report, *supra* note 38, at 30.

104. Governmental reports pre-dating the rules detailed the cumbersome nature of passing through adjustments to partners. *See, e.g.*, *id.* at 29–30 ("[T]he process for passing audit adjustments through to partners is costly and very time consuming. This limits the number of large partnerships that IRS can audit."). Even though TEFRA partly consolidated the audit process, it retained this decentralized collection system. I.R.C. § 6225.

105. I.R.C. § 6221(a).

106. *Id.*

107. *See id.* § 6221(b).

audit process. But creating the regulatory scheme necessary to implement it is a Herculean task and quickly generates a lengthy maze of statutes and regulations.

a. General Treatment of Adjustments

When a partnership reports too little income or overstates a deduction for a prior year, one can approach the labyrinth of the BBA's adjustment system by asking two questions. First, what is the default amount of tax that the IRS would assess against and collect from the partnership under the BBA if either the IRS adjusted the partnership's income in an audit or the partnership self-reported the understatement in income on an AAR?[108] Second, what actions may taxpayers take to reduce that liability so that it more closely approximates what the partners would pay if they took the adjustment into account individually?[109] As we will see, this second question is quite important as the first question can lead to an answer that far exceeds the parties' correct tax liability under substantive law.

Let us start with the first question. To determine the amount that the partnership owes, the IRS first calculates the underpayment of tax from the year audited (the "reviewed year").[110] For example, if the IRS contacted Super Subs in 2022 to notify it that the IRS is examining its 2020 taxable year, then 2020 would be the "reviewed year."[111] Broadly speaking, but with important qualifications that we will explore, the underpayment is the difference between the amount of tax the partners paid and what they should have paid (i.e., the "correct" tax liability).[112] To calculate the underpayment, the IRS first determines the necessary adjustments for the reviewed year (e.g., a $5,000 increase in income) and then multiplies the adjustment by the highest rate in effect under the tax code for individuals (37%) or corporations (21%).[113] For example, if Super Subs omitted $5,000 in income from sandwich

108. *Id.* § 6225(a).

109. *Id.* §§ 6225(b), 6226.

110. *Id.* § 6225(a); Treas. Reg. § 301.6225-1(a) (2019).

111. I.R.C. § 6225(a); Treas. Reg. § 301.6225-1(a).

112. Centralized Partnership Audit Regime, 84 Fed. Reg. 6468, 6479 (Feb. 27, 2019) (to be codified at 26 C.F.R. pt. 301).

113. I.R.C. §§ 1, 11, 6225(b)(1); Treas. Reg. § 301.6225-1(b). There can be both positive adjustments (i.e., adjustments that increase taxable income) and negative adjustments (i.e., adjustments that decrease taxable income). Treas. Reg. § 301.6226-1(d)(2).

sales for 2020, the underpayment would be $1,850 ($5,000 * 37%). Then the IRS "imputes" that underpayment to the partnership in the current year (the "adjustment year"), which is 2022 in the Super Subs example above.[114] This imputed underpayment is treated as a tax imposed on the partnership in the adjustment year, which the PR may accept, attempt to reduce, or eventually contest by petitioning a court.[115]

Now to the second question: Why would taxpayers need to chip away at this imputed underpayment and how do they do so? Though administratively convenient, the adjustment component can create several problems. For one, using the highest marginal rate to determine the imputed underpayment can produce an excessive amount of tax if the partners are in lower tax brackets.[116] And, as we will see in the Super Subs example, positive and negative adjustments to a partnership's taxable income may not offset one another, generating tax liability where none would exist under a decentralized system.[117]

In an attempt to mitigate these issues, Congress included two procedures for shifting or reducing the tax burden of an imputed underpayment.[118] One procedure allows the PR to request "modifications" (usually reductions) of the imputed underpayment if, for example, a partner is tax exempt or a partner files an amended return.[119] If a partner files an amended return (or uses a "quasi"

---

114. I.R.C. § 6225(a); Treas. Reg. § 301.6225-1(a).

115. I.R.C. §§ 6225, 6234(a); Treas. Reg. § 301.6225-1(a)(2). The adjustment-year partners are held directly liable for their "proportionate share" of the imputed underpayment if the partnership fails to pay the imputed underpayment within ten days after the date on which the IRS "provides notice and demand for such payment." I.R.C. § 6232(f)(1).

116. *See* Dinh Tran et al., *BBA Audit Regime Affects Buyers and Sellers of Partnership Interests*, 50 TAX ADVISER 511, 511 (2019).

117. Another source of concern is the potential difference between reviewed-year and adjustment-year partners. The adjustment-year partners bear the economic burden of the tax even though the tax arose from events in a prior year, when those persons may not have been partners. Certainly, this creates new considerations for those buying or selling partnership interests. *See id.* (discussing factors to consider in selling or buying partnership interests).

118. I.R.C. §§ 6225(c), 6226.

119. *Id.* § 6225(c). To obtain a modification based on a partner's tax-exempt status, the partnership must demonstrate that the partner is in fact tax-exempt and identify which adjustments are allocable to that partner. Treas. Reg. § 301.6225-2(d)(3). A partnership can also obtain a modification if it shows that the adjustment would be allocable to a C corporation or, in the case of a capital gain, an individual or S corporation. I.R.C. § 6225(c)(4)(A). For individuals, this only reduces the applicable rate to the highest rate for long-term capital gains, regardless of the individual's actual tax bracket. *Id.*; Treas. Reg. § 301.6225-2(d)(4).

amended return procedure that does not require the partner to actually file an amended return but provides similar results)[120] for the reviewed year accounting for and paying his or her share of the increased tax, the imputed underpayment is reduced by the adjustments for which the partner accounted.[121] This shifts the economic burden of that portion of the tax liability to the reviewed-year partner and allows him or her to take into account any specific attributes that might reduce the tax, such as a lower tax rate or the ability to offset positive and negative adjustments.[122]

Under the second procedure, the partnership can elect to shift—"push out"—the imputed underpayment to the reviewed-year partners.[123] To qualify, the partnership must make a "push-out" election within forty-five days after the final determination of the imputed underpayment amount.[124] The partnership must also furnish statements to each partner and the IRS setting forth "the partner's share of any adjustment to a partnership-related item" within sixty days after: (1) the ninety-day period during which it may petition a court, or (2) if the partnership petitions a court, the date that the court makes a final decision.[125] If it meets those requirements, the partnership itself is no longer liable for the

---

120. The "quasi" amended return procedure requires the partnership to submit, on the partner's behalf, the information and payments that would be required to qualify for a modification if the partner was filing an amended return. Treas. Reg. § 301.6225-2(d)(2)(x). Unlike amended returns, however, a partner cannot receive a refund via the alternative procedure. Centralized Partnership Audit Regime, 84 Fed. Reg. 6468, 6496 (Feb. 27, 2019) (to be codified at 26 C.F.R. pt. 301) ("Partners that have been allocated negative adjustments . . . may take those adjustments into account using the alternative procedure but by doing so will forego any claim for refund of any amounts related to taking those adjustments into account. . . . If the partner would be entitled to a refund as a result of its allocated adjustments, the partner must use the amended return procedures to obtain that refund.").

121. I.R.C. § 6225(c)(2)(A); Treas. Reg. § 301.6225-2(b)(2). The PR must provide the IRS with a signed affidavit from each partner who filed an amended return stating "under penalties of perjury" that he or she filed an amended return and paid the tax due. Treas. Reg. § 301.6225-2(d)(2)(iii).

122. Centralized Partnership Audit Regime, 84 Fed. Reg. at 6487 (stating that the tax amount on a partner's amended return "is the correct amount of tax for that partner after taking into account the partnership adjustments and includes any allowable reductions that may offset any additional income determined at the partnership level").

123. I.R.C. § 6226.

124. *Id.* § 6226(a).

125. *Id.*

increased tax and the reviewed-year partners must report and pay the tax.[126]

Similar to the modification procedure, the push-out election transfers the economic burden to the reviewed-year partners and permits those partners to reduce (or requires them to increase) the tax due by reason of their individual tax attributes.[127] But it does have several drawbacks, not the least of which is a 2% increase in the interest rate applied to the underpayment.[128]

b. An Exception: AARs that Do Not Give Rise to Imputed Underpayments

If a partnership omits income or overstates a deduction, the partnership takes into account the adjustments from that improper reporting position, at least as a default rule.[129] This is true regardless of whether the adjustment arises from an audit or the partnership filing an AAR (i.e., voluntarily reporting the unfavorable adjustment).[130] In addition, if the IRS makes an adjustment on audit that does not give rise to an imputed underpayment (i.e., a favorable adjustment such as an increased deduction or a decrease in income), the partnership typically takes that adjustment into account as well.[131]

One exception to this entity-driven adjustment system is when a partnership files an AAR claiming a favorable adjustment (i.e., an AAR that does not give rise to an imputed underpayment).[132] Unlike non-BBA partnerships, which "can revise a previous partnership return by filing an amended Form 1065 and Schedules K-1," BBA partnerships must revise prior returns by filing an AAR.[133] The

---

126. *Id.* § 6226. The reviewed-year partners must account for the increased tax in the year in which they receive the statements from the partnership, but the tax is calculated based on those partners' attributes from the reviewed year. *Id.* § 6226(b)(1)–(2); Treas. Reg. § 301.6226-3(a)–(b).

127. Treas. Reg. § 301.6226-3(a)–(b).

128. I.R.C. § 6226(c)(2)(C). Another drawback is that the taxpayer is not entitled to overpayment interest. Treas. Reg. § 301.6226-3(c). This may create excessive tax compared to a decentralized system if the partnership reports the correct amount of income but in the incorrect year (e.g., in 2020 rather than 2019). *See* Kate Kraus, *The Push-out Election and AARs Might Not Get You Back to Kansas*, 165 TAX NOTES FED. 1429, 1433–34 (2019).

129. I.R.C. §§ 6225(a), 6227(b)(1).

130. *Id.*

131. *Id.* § 6225(a)(2).

132. *Id.* § 6227(b); Treas. Reg. § 301.6227-1(a).

133. *See* I.R.C. § 6031(b); James Usseglio, *A Guide to Changing Previously Filed Partnership Returns*, 51 TAX ADVISER 394, 396–99 (2020).

difference is not simply semantic; while partners of non-BBA partnerships filing an amended return can receive refunds of overpayments made with respect to a prior year, BBA partnerships filing AARs cannot.[134]

Here's how it happens. When a partnership files an AAR reporting a favorable adjustment, the reviewed-year partners take the adjustment into account as if the partnership had made a push-out election.[135] The partnership must furnish a statement to each reviewed-year partner setting forth, among other things, that partner's share of the adjustment.[136] The partner must then calculate the extent to which the favorable adjustment would have reduced his or her tax liability in the reviewed year.[137] After making that calculation, the partner uses that amount to reduce the amount of tax that he or she would otherwise owe in the year in which he or she received the statement from the partnership (the "reporting year").[138] Thus, while the change in tax liability from the adjustment is calculated based on the partner's reviewed-year circumstances, it is applied to the partner's tax liability in the reporting year.[139] In essence, the decrease in tax liability operates as a "tax credit" applied to the partner's reporting year tax liability.[140] Importantly, however, this "credit" is nonrefundable—if the credit "exceeds the amount of tax the partner otherwise would have had to pay for the reporting year, the excess amount cannot be refunded or carried forward."[141] In other words, you use it or you lose it.[142] This is a

---

134. *See* Kate Kraus, *Partnership Administrative Adjustment Requests are Dangerous*, 167 TAX NOTES FED. 435, 436 (2019); Kraus, *supra* note 128, at 1434–35.

135. I.R.C. § 6227(b).

136. Treas. Reg. § 301.6227-1(d)–(e).

137. *Id.* §§ 301.6226-3(b)(2)(i), 301.6227-3(a).

138. *Id.* § 301.6227-3(a)–(b).

139. *Id.* §§ 301.6226-3(b)(2)(i), 301.6227-3(a).

140. KATHERINE KRAUS, BLOOMBERG LAW PORTFOLIO 629-1ST: THE PARTNERSHIP AUDIT RULES UNDER THE BIPARTISAN BUDGET ACT VI.B.2 (2020).

141. Treas. Reg. §§ 301.6226-3(b)(1), 301.6227-3(b)(1); *see also* Kraus, *supra* note 128. The partner may, however, receive a refund if he or she has made overpayments for the reporting year, such as through payments of estimated taxes. *See* Treas. Reg. § 301.6227-3(b)(2)(ii).

142. This can become problematic in a recessionary environment—for example, the U.S. economy in 2020 after the onset of COVID-19—in which policymakers adopt retroactive tax benefits. This is because if the partnership had to file an AAR, the partners would not be able to receive the benefits of the favorable adjustments until they filed their current year return. *See* Rev. Proc. 2020-23, 2020-18 I.R.B. 749. In addition, many taxpayers are likely to be in a loss position for years of economic distress, further diluting the benefit of AARs. To address these issues in the context of the COVID-19 pandemic, Revenue Procedure 2020-23 allows certain BBA partnerships to file amended returns for taxable years beginning in 2018 and 2019 to

substantial departure from the amended-return process for non-BBA partnerships, under which the partners can simply receive a refund for overpayments with respect to the reviewed year.[143]

4. Applying the BBA to Super Subs

To gain a better sense of how the BBA operates, consider an example based on the Super Subs hypothetical that involves both favorable and unfavorable adjustments that the IRS makes in an audit. In the example, we will consider the results if Super Subs elects out of the BBA or does not elect out. For sake of simplicity, assume that John's top marginal tax rate is 22% in all years and that, other than John's nurse practitioner wages, no partner has any income or loss outside of Super Subs.

Imagine that it is 2022. Having navigated the COVID-19 pandemic, Super Subs is growing and nearly generating a profit, though it had a small loss in 2022. Later that year, a letter arrives stating that the IRS is auditing the business for the 2020 tax year. In 2020, Super Subs reported $0 in taxable income because its expenses fully offset its income from sandwich sales. During the audit, the IRS determines that Super Subs improperly deducted $5,000 of employee wages that it paid using the proceeds of a loan under the Paycheck Protection Program which was later fully forgiven.[144] But the auditors also discover that, under § 1231, Super Subs should have claimed a $5,000 ordinary loss on the sale of a refrigerator that it had owned for more than one year.[145] The IRS sends a notice of final partnership adjustment in 2022, and the partnership does not petition a court for readjustment.

> Scenario One (election out): On its 2020 return, Super Subs elects out of the BBA. In 2022, the IRS separately audits each partner for the 2020 tax year. Because each partner's shares of the $5,000

---

take advantage of "tax changes brought about by the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") as well as any other tax attributes to which the partnership is entitled by law."

143. *See supra* note 136 and accompanying text.

144. As of the date of this Article, the IRS takes the position that § 265(a)(1) disallows any deduction for payments of expenses—including payroll costs—to the extent that those payments result in forgiveness of the loan under § 1106(b) of the CARES Act. I.R.S. Notice 2020-32, 2020-21 I.R.B. 837.

145. Section 1231 provides that losses on the sale of depreciable assets used in a trade or business and held for more than one year are treated as ordinary if those losses exceed the gains from such assets during the year. I.R.C. § 1231(a).

disallowed deduction and the $5,000 increased loss net to zero, no party owes additional tax.[146]

Scenario Two (no election out):[147] Same facts, but Super Subs does not elect out. The auditors correspond solely with the PR.[148] The IRS proposes a $1,850 imputed underpayment,[149] calculated by multiplying the $5,000 disallowed deduction by 37%.

Assuming Super Subs neither requests any modifications nor makes a push-out election, John, as a partner in 2022, would economically bear 20% ($370) of the $1,850 imputed underpayment.[150] Unlike scenario one, the $5,000 increased loss would not net against the imputed underpayment because the increased loss under § 1231 would be a separately stated item under § 702(a).[151] Instead, Super Subs would have a $5,000 reduction in 1231 gains (i.e., an increased 1231 loss) in 2022, the

146. *Id.* § 6211(a); Treas. Reg. § 301.6211-1 (as amended in 1995) (defining "deficiency" as the difference between the tax owed and the sum of: (1) the tax that the taxpayer previously reported plus, (2) amounts previously assessed or collected, but reducing the sum of (1) and (2) by rebates).

147. A partnership may fail to make an election out for several reasons. It may intentionally refrain from electing out, or it may simply be ineligible, such as if John had invested through a revocable trust. Treas. Reg. § 301.6221(b)-1(b)(3)(ii) (2018). The partnership's tax preparer may neglect to make the election or fail to follow the requirements for doing so, such as disclosing required information about each partner and notifying each partner of the election within thirty days. *Id.* § 301.6221(b)-1(c). Or the partnership may file a late return. *Id.*

148. Some notices are sent to the partnership as well. *See, e.g.*, I.R.C. § 6231(a) ("The Secretary shall mail to the partnership and the partnership representative [certain notices].").

149. This would be set forth in a "notice of proposed partnership adjustment." Treas. Reg. § 301.6225-1(a)(3) (2019).

150. This sum does not include penalties and interest.

151. *See* I.R.C. § 702(a) ("In determining his income tax, each partner shall take into account separately his distributive share of the partnership's . . . (3) gains and losses from sales or exchanges of property described in [§] 1231 . . . and (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection."); Treas. Reg. § 301.6225-1(d)(2)(D), (3)(i) (2019) ("[A]n adjustment is subgrouped according to how the adjustment would be required to be taken into account separately under [§] 702(a) . . . . A negative adjustment must be placed in the same subgrouping as another adjustment if the negative adjustment and the other adjustment would have been properly netted at the partnership level and such netted amount would have been required to be allocated to the partners of the partnership as a single partnership-related item for purposes of [§] 702(a) . . . .").

> adjustment year. This reduction would net against any 1231 gains that the partnership has in 2022 with the net amount flowing to the adjustment-year partners.[152] If Super Subs had no 1231 gains for 2022, this $5,000 loss would pass through to Adam, Cleo, and John to use on their 2022 personal returns.[153]
>
> John, having no other income in 2022 other than his nurse practitioner wages, cannot take his $1,000 share of the loss in 2022 because of the passive activity loss limitations under § 469.[154] John cannot use the $1,000 loss until he disposes of his interest in Super Subs, Super Subs allocates net income to him for a year, or he receives income from another "passive" activity (e.g., another passive investment in a business).[155]

Analyzed without any modifications or push-out election, the discrepancies between these two scenarios are striking. In the first scenario, John's total tax liability from Super Subs is zero. In the second, his economic share of the partnership's tax liability is $370, which he will bear in full until he can use the $1,000 loss. Even when he uses the $1,000 loss, he will only recoup $220 in tax ($1,000 * 22%) because that deduction is applied to his 22% personal rate rather than the higher 37% rate used to calculate the imputed underpayment. Thus, even if John could immediately use the $1,000 loss in 2022, he would still bear an extra $150 in tax under scenario two.[156]

---

152. *See* Treas. Reg. § 1.702-1(a)(3) (1960) ("Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in [§] 1231 . . . his distributive share of the combined net amount of such gains and losses of the partnership."); Treas. Reg. § 301.6225-3(b)(2), (d)(1) (2019).

153. I.R.C. § 702(a)(2); Treas. Reg. § 301.6225-3(b)(2) (2019).

154. *See* I.R.C. § 469(a)–(b), (d).

155. *Id.* § 469(g).

156. This amount could further increase due to penalties and interest. The partnership would be required to pay interest on the $1,850 imputed underpayment. *See id.* § 6233(a). Penalties could also apply depending on the circumstances. *Id.* Whether a penalty applies is determined at the partnership level, and the partnership is the taxpayer for purposes of determining, for example, whether the reasonable cause and good faith defense applies under I.R.C. § 6664(c)–(d). Treas. Reg. § 301.6233(a)-1(c)(2)(iv)(D) (2019).

To be sure, procedures exist to mitigate this excessive tax depending on John's (or Super Subs's tax advisor's) familiarity with the BBA. For example, the PR might request a "modification" decreasing the imputed underpayment by proving that a partner filed an amended return.[157] If Super Subs received a modification because John filed an amended return for 2020 reflecting the $1,000 disallowed deduction and $1,000 increased loss, then it could recalculate the imputed underpayment without those items.[158] John would not pay any tax with this amended return because those items would net to zero. This would reduce the imputed underpayment to $1,480[159] and more closely approximate the parties' correct tax liability. If Adam and Cleo also filed amended returns and received modifications, the imputed underpayment would be reduced to zero as in scenario one.[160] But, as we will see, filing amended returns (or using the quasi-amended-return procedure) is not a panacea.[161]

The second possible procedure is the push-out election, which allows Super Subs to shift the adjustments to Adam, Cleo, and John (the reviewed-year partners).[162] (This would be unnecessary if they each filed an amended return and paid their share of the tax due.) Each partner could net the disallowed deduction against the increased loss, eliminating the discrepancy between the two scenarios.[163] But, like modifications, the push-out election is not a flawless solution as it depends on the taxpayer knowing the imputed underpayment is an excessive amount of tax, knowing how to reduce that amount, and complying with the procedural hurdles for doing so.[164] These procedural hurdles can be difficult to satisfy depending on the familiarity and level of cooperation among partners.

Building on this illustration, the next Part closely examines the BBA from a policy perspective, focusing on efficiency, enforceability, simplicity, and equity as guiding principles. Ultimately, it concludes that the rules fall short of their potential and turns to measures to improve them while retaining their basic framework.

---

157. I.R.C. § 6225(c)(2)(A); Treas. Reg. § 301.6225-2(b)(2) (2019).

158. I.R.C. § 6225(c)(2)(A); Treas. Reg. § 301.6225-2(b)(2).

159. ($5,000 – $1,000) * 37% = $1,480.

160. I.R.C. § 6225(c)(2)(A); Treas. Reg. § 301.6225-2(b)(2).

161. *See infra* Part III.

162. This would be unnecessary if they each filed an amended return and paid their share of the tax due. *See* I.R.C. § 6225(c)(2)(A); Treas. Reg. § 301.6225-2(b)(2).

163. Treas. Reg. § 301.6226-3(b)(2)(ii).

164. *Id.*

III. AUDITING THE AUDIT RULES

Evaluating a tax system requires a proper set of criteria. Most commonly, these criteria take the following forms: Is the system efficient?[165] Is it sufficiently simple and enforceable?[166] And does it raise revenue in an equitable (fair) manner?[167]

Together, these principles provide a guide to whether a particular provision or group of provisions is a positive or negative addition to the tax law. This is not to say that a provision must enhance each principle to be a net positive for the tax law; indeed, trade-offs between principles are common.[168] A provision may enhance the fairness of the tax law but also make the law less efficient or more complicated.[169] Making a rule simpler may also make the tax system less fair if it reduces the relevance of a taxpayer's individual circumstances in determining his or her tax liability.[170] In the end, the question is whether an improvement in one or more principles justifies a corresponding decline in one or more others.

Applying this framework to the BBA reveals a regulatory scheme that fails to live up to its potential. Though intended to increase the efficiency and enforceability of partnership tax law by raising more revenue with less effort,[171] it leaves loopholes and also creates significant complexity and fairness concerns for taxpayers—especially those with fewer resources.

---

165. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 3.2.1 (3d ed. 2019).

166. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 229 (5th ed. 2017).

167. Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 ALA. L. REV. 289, 293 (2012) (identifying "four competing values" in partnership tax: "flexibility, efficiency, equity, and simplicity").

168. Laurence N. Woodworth, *Tax Simplification and the Tax Reform Act of 1969*, 34 LAW & CONTEMP. PROBS. 711, 719–20 (1969).

169. *Id.* at 719 ("Often Congress gives objectives of equity and economic or fiscal effects priority over tax simplification.").

170. For example, a head tax (i.e., an equal tax on each citizen) is simple and efficient but largely viewed as unfair because the poorest citizens bear the same tax burden as the wealthiest. SLEMROD & BAKIJA, *supra* note 166, at 85, 179–80.

171. Steven Toscher & Jonathan Kalinski, *New Partnership Examination Procedures Designed to Simplify Will Cause Complications and Additional IRS Scrutiny of Large Partnerships*, J. TAX PRAC. & PROC., Dec. 2015–Jan. 2016, at 23, 24.

A. Efficiency

Efficiency focuses on market distortions.[172] A tax is efficient if it avoids distorting taxpayers' behavior, allowing taxpayers instead to make choices for non-tax reasons.[173]

To illustrate a distortionary (or inefficient) tax, imagine that citizens typically consume an equal amount of coffee and tea. The government later imposes a tax on the sale of tea, but coffee remains tax-free. After the government passes the tax, citizens consume 75% coffee and 25% tea. This is an inefficient tax because it has (apparently)[174] changed taxpayer behavior: While many consumers would prefer to drink tea, some have either switched to coffee or stopped consuming coffee and tea altogether.[175] If the former tea drinkers simply stopped consuming tea without switching to coffee, this decreases overall economic consumption and reduces the revenue that the government intended the tax to collect (a "deadweight loss" for the economy).[176] And the government may collect less revenue than needed even if many consumers switched to coffee, the non-taxed beverage.[177]

Distortionary taxes may also affect the choice of business entity. If the regulatory scheme governing one business entity is more complex and administratively onerous than that governing another, some businesses may tend toward the simpler entity form.[178] Others may be unaware of the comparative complexity between entity choices and end up spending valuable resources navigating the complexity.[179] Still others may favor the more complicated entity if their owners see opportunities to decrease the flow of money from their pockets to the Department of Treasury—for instance, by

---

172. Paul Burnham & Larry Ozanne, *Distortions from Partial Tax Reform Revealed Through Effective Tax Rates*, 59 NAT'L TAX J. 611, 611 (2006).

173. LAURIE L. MALMAN ET AL., THE INDIVIDUAL TAX BASE: CASES, PROBLEMS, AND POLICIES IN FEDERAL TAXATION 15–16 (3d ed. 2019).

174. This simple scenario ignores outside factors that might have influenced people to consume more coffee.

175. MALMAN ET AL., *supra* note 173, at 16.

176. *Id.* at 19–21.

177. Woodworth, *supra* note 168, at 721.

178. MCKEE ET AL., *supra* note 8, ¶ 10A.01 (stating that the BBA's bias against taxpayers and the substantial "complexity of the new provisions [are] factor[s] that should be taken into account in selecting a form of organization for many new and existing businesses . . . .").

179. *Id.*

structuring their affairs to fall within the election-out criteria and leveraging the IRS's difficulty in separately auditing partners.[180]

Turning this lens to how the BBA may affect entity choice first requires an acknowledgement of the lack of data given that the BBA did not fully apply until 2018.[181] This data scarcity requires a large degree of prediction in analyzing the rules. But, acknowledging this uncertainty, the rules portend potentially offsetting implications for efficiency such that any benefits or drawbacks may largely net out.

In some respects, the BBA will likely enhance the role of non-tax motivations in entity choices. Under prior law, taxpayers often formed partnerships to mask abusive tax positions and decrease their tax liability, taking advantage of the difficulty that the IRS encountered in auditing partnerships and their partners.[182] To the extent the BBA decreases this practice by helping to close an avenue for abusive tax avoidance, they may make the tax system more efficient by refocusing taxpayer attention on economic factors.[183] Rather than choosing an entity to mask tax shelters, taxpayers may now concentrate more of their energy on economically beneficial activities or on non-tax reasons for choosing an entity, though a cynic might suggest that they will simply search for other methods of disguise.[184]

Other features of the rules appear likely to reverse these potential efficiency gains, however. Some businesses may spend time and money configuring (or reconfiguring) their holding structure to qualify for the election out.[185] For businesses left subject to the rules,

---

180. *See* Crystal Christenson, *Electing Out of the New Centralized Partnership Audit Rules*, WIPFLI (Jan. 30, 2019), https://www.wipfli.com/insights/articles/tax_electing-out-of-the-new-centralized-partnership-audit-rules.

181. This Article analyzes whether the BBA increased the tax system's marginal efficiency rather than its absolute efficiency. Answering the latter question requires first knowing the level of efficiency in the existing tax system (i.e., is any increase or decrease in efficiency a departure from a neutral system or does it merely affect an already inefficient one?).

182. Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 26 n.123 (2004) ("Practitioners have frequently told us of the complexity of tax shelter structures where several layers of partnerships and other entities are used to obfuscate the transaction."); Andrea Monroe, *What's in a Name: Can the Partnership Anti-abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RSRV. L. REV. 401, 403 (2010) ("Subchapter K nonetheless remains appealing to many taxpayers because the enforcement resources dedicated to partnership taxation have been woefully insufficient.").

183. *See* Monroe, *supra* note 182, at 465.

184. *Id.*

185. *Id.* at 423 n.103 ("It is the cautious and conservative businessman who will struggle with these rules, and, in some cases, in an effort to reduce risk choose less

efforts to navigate the sea of regulations will divert resources away from economically productive activities.[186] Certainly, this will mean more trips to the tax lawyer and CPA and fewer dollars for new equipment and employees. The intricacy of the BBA—and the compliance costs and excessive tax liability that it entails—are especially concerning for the most vulnerable businesses that are already struggling to continue operating.

B. Simplicity and Enforceability

As tax systems go, simpler is generally thought to be better.[187] To many, the tax code and its regulations are too long and too convoluted with too many loopholes for sophisticated taxpayers and too many pitfalls for unsuspecting ones.[188] But complexity is not always bad. Used properly, it can engender greater certainty in the tax law, providing corresponding gains in compliance and enforceability.[189] A lengthy, complicated statute or regulation that provides certainty and is easier to comply with and enforce is often better than a shorter, more ambiguous one.[190]

But how do we distinguish good complexity from bad? Although there are many possible points of distinction, this Article focuses on two in particular.

One point is whether the law actually increases certainty.[191] If a law is riddled with uncertainty, it is both more difficult for the tax authorities to enforce and more onerous for taxpayers to comply with.[192] For sophisticated taxpayers, this uncertainty may provide opportunity—opportunity to take aggressive tax positions and

---

desirable operating structures or abandon legitimate business opportunities altogether.").

186. *Id.*

187. T.R. REID, A FINE MESS: A GLOBAL QUEST FOR A SIMPLER, FAIRER, AND MORE EFFICIENT TAX SYSTEM 250–52 (2017) (suggesting reforms to simplify the U.S. tax code).

188. NAT'L TAXPAYER ADVOC., 2012 ANNUAL REPORT TO CONGRESS 3 (2012) ("The most serious problem facing taxpayers—and the IRS—is the complexity of the Internal Revenue Code . . . .").

189. Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIA. L. REV. 1, 2 (1974) ("[S]tatutory intricacies may in fact be of minor importance, if they are addressed to tax experts concerned with transactions that rarely occur; and they may even clarify the law, despite their initially baffling phraseology.").

190. BITTKER & LOKKEN, *supra* note 165, ¶ 3.8.

191. Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 327 (1972) (addressing "two elements" of complexity).

192. *Id.* at 374.

reduce their tax liability.[193] But for others, uncertainty may simply mean higher compliance costs or a higher likelihood of incurring penalties for inadvertent missteps.[194]

A second point is whether the law, even if ultimately certain, takes significant time to understand or imposes onerous requirements on taxpayers or the government.[195] Even rules which ultimately provide a certain answer may make the system more complex if they are difficult to understand, enforce, or follow.[196] If the tax system is simpler and easier to comply with, businesses spend fewer resources on tasks such as recordkeeping, reporting, and determining the proper tax position.[197] Likewise, if the system is easier to enforce but still imposes the same level of tax liability, the IRS can collect the same revenue with less effort.[198]

Observers have long criticized partnership tax law for its crippling complexity.[199] To these commentators, subchapter K represents the worst kind of complexity: a Byzantine mix of rules

---

193. Cunningham & Repetti, *supra* note 182.

194. NAT'L TAXPAYER ADVOC., *supra* note 188, at 3 ("[T]he tax code: [m]akes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns; [r]equires the significant majority of taxpayers to bear monetary costs to comply, as most taxpayers hire preparers and many other taxpayers purchase tax preparation software; [and] [o]bscures comprehension, leaving many taxpayers unaware how their taxes are computed and what rate of tax they pay . . . ."); James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 9 (1989) ("Perhaps the trouble with the tax law is that it is written and interpreted by so many 'experts'; that it has lost sight of the fact that there are real people out there someplace that have to function under this system.").

195. Peter E. Boos, *Decoding the Code*, 156 TAX NOTES FED. 323, 324 (2017).

196. Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 166 (1989).

197. *See id.* at 128 ("For many taxpayers, the tax return and instruction present a bewildering morass of rules which cannot be mastered easily. One consequence is that many low income taxpayers either turn to professional preparers or fail to comply with the law.").

198. *See, e.g.*, Roberts et al., *supra* note 191, at 336 (describing one benefit of simplifying the Tax Code as "sav[ing] substantial compliance cost for the government and taxpayers alike").

199. Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964) ("The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field."); MALMAN ET AL., *supra* note 173, at 21 ("Taxpayers have difficulty understanding [the partnership tax] rules (most do not!). As a result, taxpayers must hire accountants and tax attorneys to handle these issues (and many of those experts do not understand the rules either!)").

that nonetheless leaves swaths of gray areas.[200] For many taxpayers, partnership tax is a perplexing, mazelike regulatory scheme that saddles them with substantial compliance costs and forces them to retain advisors well-versed in its intricacies.[201] For other, more sophisticated taxpayers and their expert advisors, this uncertainty creates openings for aggressively lowering their tax liability.[202] Indeed, partnership tax often befuddles even IRS auditors.[203]

Whether the BBA improved this status quo depends on the two points previously described. Did it make the law applicable to auditing partnerships more certain? And even if it did, does it nonetheless overburden taxpayers or regulators?

First, the question of certainty: Given sufficient time and resources, can a knowledgeable individual find a reasonably clear answer in the BBA for most fact patterns? For questions relating to the audit and appeals process, the answer is largely yes.[204] The process for appointing the PR, navigating the audit, and petitioning a court is largely straightforward.[205] The partners clearly do not

---

200. Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 451 (2001) (noting the existence of a "plethora of studies" in which "Subchapter K . . . is vilified for its complexity and, where comprehensible, the difficulty in complying with its dictates").

201. Indeed, certain provisions such as § 751(b) are so complex that they are "reputedly . . . widely ignored." Karen C. Burke, *Origins and Evolution of Section 751(b)*, 60 TAX LAW. 247, 247 (2007); *see also* Monroe, *supra* note 167, at 311–12 (stating that for non-tax shelter partnerships, the complexity of subchapter K "has made it virtually impossible to navigate subchapter K without the expenditure of significant resources.").

202. *See* Southgate Master Fund, L.L.C. *ex rel.* Montgomery Cap. Advisors, L.L.C. v. United States, 659 F.3d 466, 483 (5th Cir. 2011) ("[S]o many abusive tax-avoidance schemes are designed to exploit the Code's partnership provisions.").

203. In 2014, IRS auditors reported that they "had limited knowledge of the technical tax issues for partnerships and they may work on a partnership audit once every few years." 2014 GAO Report, *supra* note 38, at 32; *see also* Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 252 (1999) ("[M]any tax practitioners believe that very few IRS auditors of partnership returns understand enough of subchapter K to challenge partnership accounting for items subject to the more complicated aspects of subchapter K . . . .").

204. *See supra* Part II.C.2. *But see* Nathan J. Richman et al., *Partnership Audit Transition Potentially is 'Tax Procedure Hell'*, 155 TAX NOTES FED. 1813, 1813 (2017) (quoting a Tax Court judge as stating that "[t]he potential for court cases involving new and old partnership audit rules along with early opt-ins to the new rules and partnerships opting out 'is my idea of tax procedure hell.'"); Eric Yauch, *Audit Regime Creates Confusion for Extension Relief Seekers*, 166 TAX NOTES FED. 1333, 1333 (2020) (describing uncertainties faced by partnerships seeking to file amended returns to make late elections involving basis adjustments).

205. *See supra* Part II.C.2.

have notice or participation rights.[206] And, though flawed, the criteria for electing out are quite certain.[207]

This certainty generally extends to the adjustment component. The regulations are detailed and provide answers for many common circumstances. But despite this impressive level of detail, it is difficult to predict and provide answers for every situation in which the entity-focused adjustment rules interact with the substantive partnership tax rules, which often treat the partnership as an aggregate of its partners.[208] As the BBA ages and is applied to more and more fact patterns, we can expect to see taxpayers, the IRS, and the judiciary struggle to resolve more and more novel issues.[209]

Now to the second question: Disregarding certainty, is the BBA overly difficult to understand, enforce, or follow? It depends on whose perspective is relevant.

From the IRS's perspective, the BBA—when it applies—almost certainly made it easier to audit and collect tax related to partnerships.[210] They streamline the audit process by providing auditors with a single contact point (the PR).[211] The PR's broad authority saves the IRS valuable time and resources otherwise spent

---

206. *See supra* Part II.C.2.

207. I.R.C. § 6221(b); Treas. Reg. § 301.6221(b)-1 (2020).

208. MARTIN J. MCMAHON ET AL., FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 4 (5th ed. 2014).

209. Take, for example, the application of the rules when a partnership "ceases to exist" under the BBA to transactions such as partnership mergers or divisions. I.R.C. § 6241(7). If a partnership "ceases to exist" before it pays an amount due under the BBA in full, the IRS can collect from the former partners. *Id.*; Treas. Reg. § 301.6241-3(a), (c), (e) (2019). Under the BBA regulations, a partnership only ceases to exist if the IRS determines either that the partnership: (1) has terminated "within the meaning of [§] 708(b)(1)[,]" or (2) lacks the "ability to pay, in full," an amount for which the partnership is liable under the BBA. Treas. Reg. § 301.6241-3(b)(1)-(2) (2019). This gives the IRS discretion to determine that a partnership has not ceased to exist even if it has terminated within the meaning of § 708(b)(1). *See* Centralized Partnership Audit Regime, 84 Fed. Reg. 6468, 6528 (Feb. 27, 2019) (to be codified at 26 C.F.R. pt. 301) (stating that the IRS has "discretion as to whether to determine that a partnership has ceased to exist, even if the facts would indicate that the partnership" has terminated under § 708(b)(1)). This also leaves out the rules for when a partnership terminates in a merger or division under § 708(b)(2). Thus, it is unclear how the IRS would apply the BBA in the context of a merger, which can give rise to a single partnership that is a continuation of two or more prior partnerships, or a division, which can give rise to two or more partnerships that are continuations of a single prior partnership. *See* Andrew L. Lawson, *When Does a BBA Partnership Terminate?*, TAX LAW. (forthcoming 2021).

210. MCKEE ET AL., *supra* note 8, ¶ 10A.01 ("The statute is clearly intended and designed to make life easier for the tax collector . . . .").

211. *See* I.R.C. §§ 6223, 6231(a) (requiring each partnership to designate a PR and listing instances where the partnership would be contacted through their PR).

notifying the partners and allowing them to participate.[212] Agents need not coordinate settlements or litigation responses at the partner level across different audits or proceedings, in possibly different states or judicial apparatuses.[213]

These improvements also extend to the adjustment component, which limits the need for the IRS to chase down each partner.[214] The onus is on the partnership and its partners to mitigate the entity-level tax by either requesting modifications or making a push-out election.[215] For instance, to obtain a modification, the partnership must demonstrate compliance with multiple requirements, and the IRS can condition approval on the partnership providing various documents and information.[216] Likewise, a partnership making a push-out election must furnish to each reviewed-year partner and the IRS a statement setting forth numerous items that assist the IRS in ensuring that the partners actually pay the tax "pushed out" to them.[217]

Yet these positive effects quickly evaporate if a partnership elects out of the BBA. The single contact point disappears and the tax authorities must separately audit, interact with, and collect tax from each partner.[218] They must, for example, obtain extensions of the statute of limitations from each partner, negotiate separate settlements, and navigate separate judicial proceedings in different forums.[219] And more partnerships have the opportunity to opt out than under prior law.[220] Partnerships were exempt from TEFRA only if they had ten or fewer partners, none of which could be an S corporation.[221] Now, partnerships can elect out even if they have one hundred partners, some of which may be S corporations.[222] These expanded criteria extend the opportunity to elect out to many large partnerships, which are likely to have access to sophisticated tax advice. Even though tiered partnerships with partnerships as partners—arguably the most problematic audit subjects—are subject to the BBA without exception,[223] this does not exclude all

212. *Id.* § 6223.
213. *Id.* § 6234.
214. *Id.* § 6221(a).
215. *Id.* §§ 6225(c), 6226.
216. Treas. Reg. § 301.6225-2(c)(1)–(2) (2019).
217. I.R.C. § 6226(a)(2); Treas. Reg. § 301.6226-2(a), (e).
218. Christenson, *supra* note 180.
219. *Id.*
220. I.R.C. § 6221(b).
221. *Id.* § 6231(a)(1)(B).
222. *Id.* § 6221(b).
223. Treas. Reg. § 301.6221(b)-1(b)(3)(ii)(A) (2018).

partnerships with relatively complex holding structures.[224] Even if a partnership has only individual partners, separately auditing and collecting tax from one hundred different individual partners is an intimidating task for already overburdened IRS personnel.[225]

For many taxpayers, on the other hand, the rules almost certainly increased compliance costs and further obfuscated partnership taxation, with the primary culprit being the rules by which the IRS adjusts items relating to partnerships.[226] The PR

---

224. For example, S corporations, whose shareholders are limited to individuals (including disregarded entities), estates, and certain trusts, are eligible partners. I.R.C. § 1361(c)(2). Though not rising to the level of many-tiered partnerships, S corporations can still have intricate ownership structures (at least temporarily). N.Y. STATE BAR ASS'N, TAX SECTION, REPORT NO. 1378, REPORT ON PROPOSED REGULATIONS IMPLEMENTING THE CENTRALIZED PARTNERSHIP AUDIT AND COLLECTION REGIME 43–44 (2017) [hereinafter NYSBA 2017 Report] (illustrating a partnership with an S-corporation partner whose shareholders include a complex trust with "numerous beneficiaries" whose tax liability may depend on the partnership's income).

225. AM. L. INST., *supra* note 18, at 16 (describing difficulties in "[e]ven handling cases of twenty different partners in different districts taking different positions"); August, *supra* note 3, at 42, 47 (noting the difficulties that the one-hundred-partner threshold is likely to cause the IRS and speculating that the "new and large escape route from the [assessment and collection] rules was not something the IRS wanted from Congress").

226. MCKEE ET AL., *supra* note 8, ¶ 10A.01 (stating that the BBA's bias against taxpayers and the substantial "complexity of the new provisions [are] factor[s] that should be taken into account in selecting a form of organization for many new and existing businesses . . . ."). One could argue that the risks for small partnerships are minimal because a "cottage industry" of firms will emerge willing to serve as PR and guide the partnership through the audit, driving down the costs of navigating the regulatory regime. Shamik Trivedi, *Issues and Considerations in Appointing a Partnership Representative*, 50 TAX ADVISER 72, 72–75 (2019). Indeed, there are indications that this industry has already begun to form. *Id.* at 75 ("The BBA has . . . given rise to a cottage industry of off-the-shelf PRs."); *see also Have You Appointed Your U.S. Partnership Representative? What You Need to Know*, DMS (Feb. 27, 2019), https://dmsgovernance.com/have-you-appointed-your-u-s-partnership-representative-what-you-need-to-know-2/ (offering PR services for "larger U.S. entities and foreign partners"); *Partnership Representative Frequently Asked Questions (FAQs)*, CSC (Aug. 14, 2020), https://www.cscglobal.com/service/gfm/partnership-representation-irc-6223-FAQ/. Still, many unanswered questions remain. What will these services cost? Will they be priced accessibly to smaller partnerships or targeted toward larger ones such as private equity funds? Will the quality of advisors in the industry be relatively good or inconsistent? From an economic perspective, would it cost the IRS less to collect tax from these smaller partnerships—that may have relatively few partners and relatively simple operations—under a decentralized system than it would for those partnerships to navigate the centralized system by hiring a competent advisor? If the IRS can administer a decentralized system for these smaller partnerships for less than those

component should pose relatively few problems for taxpayers as the requirements are fairly easy to comply with and many businesses should be familiar with the concept of appointing a representative from TEFRA. Also, the consequences of failing to navigate those requirements are minor—although the IRS can appoint a PR, the partnership has an opportunity to remove the IRS's designee and make its own appointment.[227]

But navigating the adjustment component takes serious effort with serious consequences if not done properly. It did not exist under prior law, creating an entirely new concept and packet of regulations filled with new jargon and procedures that taxpayers and their advisors must now digest.[228] This in turn increases the cost of compliance for small businesses with already limited resources. Further, if the partnership does not adequately digest the rules or lacks the resources to hire someone who has, it may pay more in tax than it should under substantive law.

And making the necessary determinations to mitigate the potentially excessive tax—how and when to make modifications, whether to push out, etc.—is just the beginning. After the partnership or its partners pay the tax, they must account for the adjustment (i.e., the increase in income or loss) and the payment of the tax.[229] They must determine, among other things, the effect of the adjustment and the payment on the partnership's basis in its property, the partners' bases in their partnership interests, and the partners' capital accounts.[230] These questions become even more complicated if a partner sells his or her interest between the reviewed year and the adjustment year.[231] Needless to say, billable hours are likely to accrue—at least for those who can afford them.[232]

---

taxpayers must pay advisors, it may benefit the economy to exempt them from the BBA or at least from the adjustment component.

227. Treas. Reg. § 301.6221(b)-1(c)(1); Treas. Reg. § 301.6223(c)-1 (2001).

228. The complexity of the regulations stems from the sheer difficulty of imposing an entity-level payment mechanism on a business organization that often serves as a conduit. Given this formidable task, the drafters of the regulations performed admirably.

229. *See* Prop. Treas. Reg. §§ 1.704-1(b)(1)(viii), (2)(iii), (4), 301.6225-4, 301.6226-4, 83 Fed. Reg. 4868, 4868 (Feb. 2, 2018).

230. *See* Prop. Treas. Reg. §§ 1.704-1(b)(1)(viii), (2)(iii), (4), 301.6225-4, 301.6226-4, 83 Fed. Reg. at 4869.

231. *See* Prop. Treas. Reg. §§ 1.704-1(b)(1)(viii), (2)(iii), (4), 301.6225-4, 301.6226-4, 83 Fed. Reg. at 4872.

232. Partnerships and their partners may also face difficult questions under state law. *See* Amy Hamilton, *Groups Endorse Model for Reporting IRS Partnership Adjustments*, 90 TAX NOTES ST. 369, 369 (2018); Amy Hamilton, *MTC Revisiting IRS Partnership Adjustments and State Tax Refunds*, 98 TAX NOTES ST. 528, 528–29

C. Equity

From an equity perspective, the BBA is a picture of unfulfilled potential.[233] It has the potential to make the tax system more progressive by curtailing sophisticated taxpayers' abusive strategies, providing a helping hand to the progressive substantive tax rules.[234] But the rules ultimately fall short, hampered by an election out which both enables many sophisticated taxpayers to escape and ensnares others who lack adequate tax advice. In other words, the election out is at once overly broad and overly narrow.

On the one hand, the breadth of the election out creates opportunities for well-advised taxpayers to exploit it. Despite its exclusion of tiered partnerships, the election out still extends even to quite large partnerships with complicated cap tables. Given the relatively high threshold for the number of partners, high-income and wealthy taxpayers (and, perhaps more accurately, their creative advisors) may discover novel methods of circumventing the rules.[235] For example, commentators have floated the possibility of forming multiple smaller partnerships rather than one larger partnership,

---

(2020). These questions may become even more complicated if partners reside in different states with different regimes for auditing and collecting tax from partnerships and their partners. *See* HELEN HECHT, MULTISTATE TAX COMM'N, REPORT OF THE HEARING OFFICER ON THE PROPOSED MODEL UNIFORM STATUTE FOR REPORTING ADJUSTMENTS TO FEDERAL TAXABLE INCOME AND FEDERAL PARTNERSHIP AUDIT ADJUSTMENTS 15–20 (2018) (describing a proposed approach for sourcing adjustments for resident and nonresident partners).

233. *See* Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1049 n.4 (2006) (describing rationales for fairness).

234. In a progressive tax system, those with greater means bear a greater share of the tax burden. Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CALIF. L. REV. 1905, 1906 (1987). Although there is considerable disagreement on this point, this Article assumes that a more progressive tax system is desirable. *See generally* Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952) (setting forth arguments for and against progressive taxation).

235. MARK P. KEIGHTLEY, CONG. RSCH. SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA 1–3 (2017) (finding that partnership income is concentrated among higher earners); Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 NAT'L TAX J. 397, 405–07 (2010) (finding that high-income taxpayers are more likely to underreport their income and more likely to receive income from pass-through entities such as partnerships); Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (And How the IRS Helps Them)*, 45 ARIZ. ST. L.J. 611, 614 n.12 (2013) (stating that "sophisticated tax planners" have often used subchapter K to help "corporations and high net worth individual taxpayers defer or avoid billions of dollars in tax liability").

with each smaller partnership having only eligible partners.[236] Although the IRS intends to heavily scrutinize these arrangements[237] and businesses and investment funds may ultimately find it infeasible from a business perspective, this is merely one example of a potential workaround.[238]

On the other hand, the lack of an automatic exemption and the election out's sole focus on number and type of partners could actually reduce the tax system's progressivity by disproportionately burdening lower-income individuals and fledgling businesses. Wealthy taxpayers can retain competent tax counsel to assist them in mitigating the rules' most onerous effects, or perhaps even avoiding the rules entirely through alternative structures. But taxpayers of lesser means with comparatively fewer resources may fall victim to the rules' complexity and suffer some of their most deleterious effects. Indeed, the rules' convoluted procedures may have regressive effects even when these taxpayers navigate them successfully. For lower-income taxpayers, a dollar spent traversing the rules looms larger than that same dollar to a taxpayer with far more of them. Indeed, studies have shown that small businesses generally "face larger tax compliance costs per dollar of sales" than larger firms.[239]

This inequity only increases when one examines the different treatment of a partnership that elects out versus one that does not, even if both have similar operations and ownership structures.[240] For example, a partnership cannot elect out if even one of its

---

236. Megan L. Brackney, *Tax Controversy Corner—Consider the Constructive Partnership Rules Before Reorganizing to Elect Out of the BBA*, J. PASSTHROUGH ENTITIES, May–June 2018, at 59, 61. *But see* Donald B. Susswein & Ryan P. McCormick, *Fixing the Partnership Audit Process*, 149 TAX NOTES FED. 123, 125 (2015) ("[I]nvestors in large and multitiered partnerships tend to be among the most conservative institutions and individuals in the country regarding tax compliance."). *See generally* Lee A. Sheppard, *Investment Fund Questions Raised by the New Partnership Audit Rules*, 149 TAX NOTES FED. 855 (2015).

237. Election Out of the Centralized Partnership Audit Regime, 83 Fed. Reg. 24, 26 (Jan. 2, 2018) (to be codified at 26 C.F.R. pt. 301) (stating that the IRS will carefully examine whether "two or more partnerships should be recast or be treated as having formed one or more constructive or de facto partnerships . . . .").

238. *See generally* Sheppard, *supra* note 236.

239. SLEMROD & BAKIJA, *supra* note 166, at 233.

240. A related shortcoming is that the rules subject partnerships to a more complicated enforcement regime than other pass-through entities whose holding structure may be quite similar. If Super Subs was an S corporation, the partnership audit rules would not apply, and the IRS would separately audit Adam, Cleo, and John. *See* I.R.C. § 6037(c); RICHARD D. BLAU ET AL., S CORPORATIONS: FEDERAL TAXATION § 17:36.25 (2019).

partners is a grantor trust or disregarded entity such as a single-member LLC, even though the owner of the grantor trust or disregarded entity is considered to own the partnership interest for tax purposes.[241] So if John transferred his interest in Super Subs to the John Family Revocable Trust of which he is the sole settlor and sole trustee, this simple act would render Super Subs ineligible to elect out. [242] This is true even if he made the transfer merely to facilitate the distribution of his assets to his descendants at death. This result is perhaps untroubling if John made the transfer with competent tax advice, knowing that it may make the audit process more difficult to navigate. But given that even general practitioners may create revocable trusts for their clients as a basic estate-planning strategy, this transfer may often occur without partners—or their attorneys—appreciating the tax consequences outside of the estate context.[243]

This is not to say that these instances of disparate treatment are unjustifiable. Simply because a law treats similarly situated taxpayers differently does not automatically make it undesirable. Other rationales such as efficiency or simplicity may justify the distinctions, and the tax authorities must draw the line between eligible and ineligible partners somewhere. Perhaps excluding revocable trusts, disregarded entities, and the like is an appropriate distinction to draw.

But the problem with this disparate treatment and the rules' suboptimal effects on progressivity is that it is far from clear that other rationales—such as efficiency, simplicity, and enforceability—justify these deficiencies. In fact, the BBA arguably falls short on each of these fronts, though it has promising attributes that are especially helpful for dealing with larger partnerships. And they add yet another extensive and highly complicated packet of regulations that partners and their advisors must peruse.

That said, the rules are not beyond repair. The BBA has a lot of promise; it simply needs a few tweaks to work properly. The next Part explores these possible changes, focusing on their potential to

---

241. I.R.C. § 676. A disregarded entity can be in the chain of ownership if it owns shares in an S corporation that in turn owns a partnership interest. *See, e.g.*, NYSBA 2017 Report, *supra* note 224, at 43 (illustrating this scenario).

242. I.R.C. § 6221(b); Treas. Reg. § 301.6221(b)-1(b)(3)(ii)(B) (2018).

243. Some commentators have recommended adopting a mechanism for correcting errors such as this within a period of time after the transfer. ABA Letter, *supra* note 58, at 28; *see also* NYSBA 2017 Report, *supra* note 224, at 45 ("[W]e believe that prohibiting partnerships with disregarded entities, trusts, and nominees as partners from electing out will lead to unintentional foot-faults and confusion.").

enhance each of the policy principles previously discussed. Namely, it proposes both narrowing and expanding the election out and incorporating an automatic exemption to make the system simpler, fairer, more enforceable, and more efficient.

IV. CLOSING LOOPHOLES, AVOIDING PITFALLS

The policy deficiencies of the BBA arise largely from the scope of the election out—which is at once both exceedingly broad and unnecessarily narrow—and the lack of an automatic exemption for small partnerships.[244] Though designed to limit abuse by large, sophisticated partnerships, it unnecessarily burdens low-income taxpayers and businesses with increased compliance costs and potentially excessive tax liability. At the same time, it leaves loopholes for affluent taxpayers with the resources to exploit.

To mitigate these concerns, I propose a two-part modification to the BBA. The first, which some commentators have previously raised,[245] would bifurcate the two basic components of the BBA—the PR component and the adjustment component—and remove partnerships' ability to elect out of the PR component. Thus, all partnerships—regardless of number of partners, holding structure, or any other variable—would follow the PR component, easing the IRS's burden while not significantly increasing that of taxpayers.

Building on this bifurcated structure, the second modification would revise the eligibility criteria for the narrowed election out and incorporate an automatic exemption for small partnerships. In either case, the partnership could only opt out or be exempted from the adjustment component and would remain subject to the PR component. First, it would reduce to ten the maximum number of partners that a partnership may have before it becomes ineligible to elect out.[246] Second, it would add an automatic exemption for small partnerships that satisfy one of two alternative tests: (1) a test that exempts partnerships having less than a certain level of gross

244. Recent data suggests that not everyone who is eligible to elect out is doing so, but it is unclear whether that is an intentional choice by taxpayers, unintentional oversight, or, even if it is an intentional choice, whether taxpayers understood the consequences of not electing out. Kristen A. Parillo, *Few Partnerships Opted Out of New Audit Regime*, 165 TAX NOTES FED. 1187, 1187 (2019).

245. *See, e.g.*, NYSBA 2016 Report, *supra* note 34, at 139–40; Letter from Terence Floyd Cuff, Loeb & Loeb LLP, to Internal Revenue Service (Oct. 24, 2015).

246. More specifically, the revised rule would require that the partnership issue ten or fewer Schedule K-1s to its partners for the taxable year. This would include any Schedule K-1s that a partner of the partnership (such as an S corporation) is required to issue to its own members.

income and total assets (regardless of the number or type of partners), and (2) a test that exempts partnerships with ten or fewer direct and indirect partners, but only if each of them are individuals, C corporations, or entities that are disregarded for tax purposes and owned solely by an individual or C corporation. Together, these two modifications would capture a larger number of sophisticated arrangements while protecting vulnerable small businesses.

A. Bifurcating the Election Out

The two components of the BBA have similar goals: to enhance the enforceability of partnership tax law and reduce the IRS's administrative load.[247] As we have seen, however, each raises different policy implications. While the centralized audit procedure raises some concerns, these concerns are largely manageable even for less-sophisticated taxpayers.[248] Extending this procedure to all partnerships would significantly benefit the tax system without substantial drawbacks. It would further streamline the audit process and related judicial proceedings, expediting the judicial process and allowing the IRS to, for example, avoid separately auditing one hundred partners in a single partnership.[249] The extension could also increase the tax system's efficiency by dissuading more taxpayers from artificially structuring their affairs solely to qualify for the election out. And it may increase the progressivity of the tax system if this deterrence largely affects affluent taxpayers who might otherwise take advantage of the overbroad election criteria.

The adjustment component, on the other hand, introduces numerous complications that increase compliance costs and, if not properly navigated, can generate tax liability in excess of what the

---

247. *See* Jerry August, *Additional Final Regulations Issued Under the Centralized Partnership Audit Rules Increase the Size and Reach of the 'BBA Monster' that Congress Created*, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2019, at 7, 8 (describing the BBA's changes to tax enforcement procedure).

248. The all-powerful PR is the most obvious issue for taxpayers in the centralized audit process. That individual's broad power may allow some partners to unfairly shift tax liability to less-sophisticated peers and may create thorny issues under state fiduciary duty law. But this likely does not outweigh the enforceability benefits from further centralizing the audit process. A future article will address existing uncertainties and suggestions to ameliorate them.

249. Applying the centralized audit process without exception would largely avoid the need to navigate procedures for consolidating court cases and would conserve judicial, administrative, and taxpayer resources. *See supra* Part II.C.2.

partners should owe under substantive law.[250] The sheer complexity of the rules can make it difficult for taxpayers and even many tax advisors to mitigate any excessive tax liability. While more-sophisticated taxpayers may have the means to successfully traverse the adjustment component by, for example, filing amended returns, making a push-out election, or even avoiding the BBA entirely, other taxpayers may lack the resources to retain knowledgeable (read: expensive) tax advisors able to guide them through the rules' many pitfalls. These taxpayers and their less-sophisticated advisors may be simply unaware that the initial imputed underpayment can produce excessive tax liability or, even if they know generally that their liability should be lower, may not know how to go about adjusting it in a timely manner. Or they might file an AAR during a year when they are in a loss position, in which case they would lose the benefit of an increased deduction or decrease in income from the prior year.[251]

Continuing this thread, even if these less-affluent taxpayers are aware of the excessive tax or the unavailability of a refund, there are few if any perfect solutions. If the IRS audits a partnership and makes an unfavorable adjustment, the partnership can request modifications, such as by having partners file amended returns or using the "quasi" amended return procedure. But this costs time and money, commodities that are notoriously scarce in small businesses. In addition, the PR has the sole authority to request modifications.[252] Thus, if the PR is uncooperative, John from our Super Subs example may be stuck with his proportionate share of the excessive tax. Likewise, unless the IRS temporarily allows partnerships to file amended returns (as it did with respect to the years 2018 and 2019 for certain BBA partnerships),[253] partners may never be able to receive the benefit of prior overpayments of tax if they are always in a loss position in the adjustment year.

The IRS can also deny a modification, and the person requesting it "must substantiate the facts supporting [the] request to the satisfaction of the IRS."[254] In exercising this discretion, the IRS has broad authority to require the partnership to produce relevant documents and "any other information necessary to support the

---

250. Betty J. Boyd, *Dig into the New Partnership Tax Rules*, AM. BAR ASS'N: BUS. L. TODAY (Feb. 20, 2016), https://www.americanbar.org/groups/business_law/publications/blt/2016/02/02_boyd/.

251 *See supra* Part II.C.3.ii.

252. *See* Treas. Reg. § 301.6225-2(a) (2019).

253. Rev. Proc. 2020-23, 2020-18 I.R.B. 749.

254. Treas. Reg. § 301.6225-2(c)(2)(i).

requested modification."[255] Although the straightforward Super Subs example seems unlikely to generate much pushback from the IRS, one can imagine circumstances in which a partnership may lack access to requested information.[256] And, again, gathering this necessary information means more time, more money, and fewer economically productive activities. Finally, if we imagine a scenario in which John does owe additional tax when filing his amended return (recall that he did not, because the adjustments netted to zero), he would have to pay the tax due before Super Subs can file a Tax Court petition.[257] This undermines that court's role as a forum for taxpayers to contest the asserted tax deficiency before paying it.[258]

Nor is the push-out election a flawless solution. Again, only the PR can make the election, possibly leaving John and others like him subject to the whims of the majority stakeholders.[259] As in the modification context, the partnership must meet several procedural requirements, such as filing an election with the IRS with accompanying information and furnishing statements to all partners setting forth their shares of the adjustment.[260] Lastly, the push-out election comes at a financial cost: a higher interest rate.[261]

These payment methods—imputed underpayments, modifications, and push-out elections—are only one part of the intricate regime. Even after navigating these procedures, the business must determine how the payment affects its partners' capital accounts, outside bases, and other tax attributes, not only for the reviewed year (e.g., 2020) but often for years after (2021, 2022, and so on).[262] Unsurprisingly, this involves another deep dive into opaque regulations—competent guide required.

---

255. *Id.*

256. How flexible the tax authorities will be in that scenario remains to be seen; though, the IRS has signaled at least some willingness to work with taxpayers. Centralized Partnership Audit Regime, 84 Fed. Reg. 6468, 6488 (Feb. 27, 2019) (to be codified at 26 C.F.R. pt. 301) ("It is possible, however, that certain items may not be necessary in every case, and if such items are not necessary, or if different items are more appropriate, the IRS will describe the information required in forms, instructions, or other guidance.").

257. *Id.* at 6490.

258. I.R.C. § 6213(a).

259. Treas. Reg. § 301.6226-1(c)(3).

260. I.R.C. § 6226(a); Treas. Reg. § 301.6226-2.

261. I.R.C. § 6226(c)(2).

262. *See* Prop. Treas. Reg. §§ 1.704-1(b)(1)(viii), (2)(iii), (4), 301.6225-4, 301.6226-4, 83 Fed. Reg. 4868, 4869 (Feb. 2, 2018).

Lower-income taxpayers need an escape hatch from these convoluted procedures and potential unfairness arising from the adjustment component, at least in certain circumstances.[263] This escape hatch must be appropriately circumscribed to exclude unintended beneficiaries, but it must also extend relief to those least equipped to manage the rules' complexity. Sections B and C focus on this escape hatch, first by proposing to reduce the maximum number of partners that a partnership may have before it becomes ineligible to opt out and then by suggesting a new automatic exemption for small partnerships.

B. Narrowing the Election-out Criteria by Reducing the Threshold Number of Partners

After bifurcating the election out, I propose to lower the maximum number of partners that a partnership may have before it becomes ineligible to elect out of the adjustment component. A partnership may now elect out if it has one hundred or fewer direct and indirect partners, which may be individuals, S corporations, C corporations, certain estates, and some foreign entities.[264] As we have seen, this is a drastic expansion from prior law and raises questions about the new rules' implications for the enforcement of partnership tax law.

Although requiring every partnership to appoint a PR would likely reduce these concerns, it is not a complete cure. IRS agents must still pass through adjustments to the partners, which can be "costly and very time consuming" if there are many partners.[265] This is especially so if the partnership agreement has special allocations

---

263. The AAR process would also need to be revised with respect to partnerships that elect out of the adjustment component. I.R.C. § 6227. Ideally, the procedure would require the partnership to file the AAR but would pass through the adjustments to the reviewed-year partners in the reviewed year, allowing them to obtain refunds in a manner similar to the non-BBA amended return process. This would assist advisors not well-versed in the BBA, who may advise taxpayers to file an AAR in a year in which they are in a loss position and thus inadvertently deny them the benefit of the favorable adjustment. *See* KRAUS, *supra* note 140 (suggesting that partnerships should file AARs in years when their partners have net income rather than net losses). The statute of limitations on making adjustments to partnership-related items could remain the same—generally three years after the later of the filing of the partnership return, the due date for the partnership return, or "the date on which the partnership filed an administrative adjustment request with respect to such year." I.R.C. § 6235(a).

264. I.R.C. § 6221(b).

265. 2014 GAO Report, *supra* note 38, at 30.

that the agents must manually review.[266] And the number of partnerships electing out of the rules may increase over time as taxpayers and their advisors become more familiar with the rules and develop additional methods of avoiding them.[267]

My preference for the new maximum is to resurrect the threshold from TEFRA: ten or fewer partners.[268] But I acknowledge that a higher number—perhaps twenty or twenty-five—may be justified because the exceptionless application of the centralized audit process will already decrease the IRS's burden. Which number is appropriate will depend on a variety of factors, not the least of which are the IRS's resources and technological capacity to pass through adjustments to partners after the audit.

C. Broadening the Election Out by Creating an Automatic Exemption for Certain Small Partnerships

With the threshold number of partners lowered to ten (or some higher number, depending on policymakers' ultimate decision), we may now turn our attention to when and how a partnership with the requisite number of direct and indirect partners goes about avoiding the adjustment component. A partnership must now elect out of the BBA; no automatic exemption exists. The lack of an automatic exemption is potentially problematic for many small businesses that may not grasp (or have the funds to hire someone who has grasped) the consequences of not electing out of the adjustment component or even know what it means when Form 1065 asks whether they are "electing out of the centralized partnership audit regime under [§] 6221(b)."[269]

---

266. *Id.* ("Finding special allocations requires detailed reviews of the partnership agreements of the partnerships within the partnership structure. According to IRS officials, this step cannot be automated.").

267. Conversely, the number of partnerships electing out could decrease over time as taxpayers and their advisors become more familiar with the workings of the adjustment component.

268. I.R.C. § 6231(a)(1)(B).

269. Internal Revenue Serv., 2019 Form 1065: U.S. Return of Partnership Income [hereinafter 2019 Form 1065]. One might argue that the IRS could eliminate many issues that this Article raises by, for example, writing plain-language publications, holding seminars, making its representatives more available for consultation, or providing interactive tools for taxpayers. Indeed, the IRS recently created a webpage with links and information regarding the BBA. *See BBA Centralized Partnership Audit Regime*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime (last updated Dec. 3, 2020). While these resources, including the IRS's new webpage, are undoubtedly helpful to taxpayers and advisors, the regime's complexity

To mitigate these problems, I propose automatically exempting from the adjustment component partnerships that meet one of two alternative tests. The first test would cover partnerships with less than a certain level of gross income and total assets; this test has the intent of exempting the least-sophisticated partnerships while imposing the fewest reporting requirements possible. This test would exempt partnerships with all number and type of partners regardless of holding structure so long as the audited partnership's gross income and total assets fell below the requisite level. The second test would apply to non-tiered partnerships with ten or fewer direct and indirect partners, each of whom is an individual, C corporation, or an entity that is disregarded for tax purposes and owned solely by an individual or C corporation.

1. The First Alternative: The Income-and-assets Test

The first test would automatically exempt partnerships with gross income and total assets (unreduced by liabilities) for a year below a threshold amount.[270] If the partnership met that test, the adjustment component would not apply regardless of that

---

is still a considerable hurdle. Also, measures such as plain-language publications or online tools such as the IRS's "Interactive Tax Assistant" have sometimes given taxpayers the wrong advice and caused incorrect tax reporting (both in favor of the taxpayer and the IRS). Joshua D. Blank & Leigh Osofsky, *Simplexity: Plain Language and the Tax Law*, 66 EMORY L.J. 189, 193 (2017) ("[T]he use of plain language to describe legal rules and regulations often yields 'simplexity.' . . . [S]implexity occurs when the government presents clear and simple explanations of the law without highlighting its underlying complexity or reducing this complexity through formal legal changes."); *see also* Joshua D. Blank & Leigh Osofsky, *Legal Calculators and the Tax System*, 16 OHIO ST. TECH. L.J. 73, 75 (2020) ("[S]implexity also occurs when the government offers legal calculators to deliver guidance to taxpayers.") Barring comprehensive improvements in those tools, these issues seem likely to continue in an area as complex as the partnership audit rules.

270. Though ideal criteria would arguably also account for situations in which wealthy or high-income taxpayers invest in a partnership, many partnerships may find it very difficult or costly to provide this information. Many may not typically compile information about its partners' assets or income and may have difficulty obtaining it. *See* Qualified Business Income Deduction, 84 Fed. Reg. 2952, 2978 (Feb. 8, 2019) (to be codified at 26 C.F.R. pt. 1) (stating that partnerships and other pass-through entities "do not have sufficient information to determine an ultimate owner's taxable income"). Further, many partners may not regularly update the value of their total assets, some of which may be difficult to accurately value. These increased compliance costs could significantly dilute the simplicity benefits that the small-partnership exemption would otherwise offer.

partnership's number and type of partners.[271] This means-based test would serve as a proxy for the partnership's tolerance for complexity and the sophistication of the partnership's operations, and it would allow the least-sophisticated businesses to escape the adjustment component with minimal reporting requirements.[272]

To illustrate this test, suppose that Adam and Cleo held their interest in Super Subs via AC Partnership and that Super Subs had $140,000 in gross income and $100,000 in total assets for 2020. If policymakers set the income and asset thresholds at, say, $150,000 and $150,000, Super Subs would be automatically exempt from the adjustment component even though it has a tiered structure that would otherwise violate the election-out criteria.

Incorporating this test would impose minimal additional reporting requirements on the partnership. For example, the IRS could simply add a question to the partnership's Form 1065, which might read similar to the following question:

Does the partnership satisfy each of the following conditions?	**Yes**	**No**
(a) The partnership's gross income for the tax year was less than $150,000.		
(b) The partnership's total assets (unreduced by liabilities) at the end of the tax year were less than $150,000.		

271. This type of exception aimed at protecting lower-income taxpayers from complexity is not without precedent in the literature and the tax law. For example, I.R.C. § 448(a) requires certain taxpayers to use the accrual method of accounting but preserves a small-business exception that allows certain taxpayers to use the cash method if they have $25 million or less in average annual gross receipts for the prior three taxable years. I.R.C. § 448(b)(3), (c); *see* STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING 347–69 (2019). Commentators have also suggested exempting low-income taxpayers from certain provisions in the tax code. *See, e.g.*, Roberts et al., *supra* note 191, at 375 ("[C]ertain provisions of the present Code might be made either inapplicable or their complexity reduced in the case of taxpayers with gross receipts falling below a certain figure."). And prior partnership audit proposals have suggested exempting certain types of businesses, such as service partnerships. DEP'T OF THE TREASURY, WIDELY HELD PARTNERSHIPS: COMPLIANCE AND ADMINISTRATION ISSUES, A REPORT TO THE CONGRESS 83 (1990).

272. The test also excludes another relevant factor in determining a business's tolerance for complexity: its owners' sophistication, which is to say their level of education or experience in financial or regulatory affairs. But this is likely infeasible to account for as a practical matter, at least under the current system. There is no comprehensive system in place for the IRS to collect that information from taxpayers, and the cost of creating such a system solely for this exception would likely far outstrip its benefits. *See* 2019 Form 1065, *supra* note 269.

The implications of this income-and-assets test vary depending on how high or low the thresholds are set. Set them too high, and sophisticated taxpayers will seek to game the system. Set them too low, and they may miss many unsophisticated small businesses.

With this in mind, these thresholds could perhaps be set at $150,000 in gross income and $150,000 in total assets. These numbers are certainly not set in stone, and I am mindful of the need for additional data and input.[273] Indeed, one can already identify potential flaws in those thresholds. The $150,000 gross income level is perhaps too low as many businesses with very little if any profit may still far exceed the threshold. For example, a small service business might receive well over $150,000 in gross income for the year but pay out most of that amount in employee compensation, rent, or advertising, though the business might still qualify under the second test described below.[274]

In any case, the threshold numbers may change with further data and input from experts on several factors. One factor may be the usual administrative burden in auditing partnerships with various levels of gross income and total assets. If the IRS's burden significantly increases beyond a certain income or asset level (e.g., because of the volume or complexity of the taxpayer's operations) that should be taken into account. Another factor may be the sheer number of partnerships with total assets and gross income above a certain level. Data on the intersection between these points would provide useful insight on the number of taxpayers that the exemption would benefit. In 2017, for example, there were roughly 1 million partnerships with less than or equal to zero assets and roughly 2.85 million partnerships with total assets under $1

273. To account for abnormal fluctuations from year to year, policymakers could convert this to a two- or three-year lookback model; though, this may add to the exemption's complexity.

274. Policymakers could also consider factors other than a partnership's income and assets, such as the number of employees and independent contractors that the business retains. While these factors do not directly measure a business's financial resources, they can provide general insight regarding the extent of its operations and the likelihood that it has systems in place to navigate regulatory procedures. These factors could be methods of either excluding businesses with greater than a certain number of employees (say, twenty) or allowing those with fewer employees (say, fewer than five) to qualify. If policymakers did adopt these factors for the latter purpose, however, they may need to retain other tests such as asset valuation to prevent sophisticated holding companies—which may have very few employees or independent contractors—from circumventing the rules.

million.[275] It would be quite useful to know how many of these same partnerships and partnerships with fewer assets have gross income below $500,000, or $250,000, or $150,000.

2. The Second Alternative: The Partner-focused Test

The second test would automatically exempt non-tiered partnerships with ten or fewer direct and indirect partners. This exemption would extend only to partnerships whose partners are limited to: (1) individuals, (2) C corporations,[276] (3) single-member LLCs with an individual or C corporation as its sole member, and (4) revocable trusts with a single settlor who is an individual.[277] Thus, assuming Super Subs did not satisfy the income-and-assets exemption, Super Subs would still be automatically exempt if its partners were Adam, Cleo, and John's single-member LLC, but not if Adam and Cleo held their interests via AC Partnership.

Partnerships are already required to report information to the IRS necessary to determine whether the partnership satisfies these criteria. On Items E and I1 of Schedule K-1, the partnership is required to, respectively, provide the partner's taxpayer identification number ("TIN") and specify what type of entity the partner is. If the legal owner of the partnership interest is a disregarded entity (including a grantor trust), the partnership must nevertheless specify the TIN and the type of entity of the beneficial owner of the disregarded entity.[278] For example, if a C corporation

---

275. Table, Internal Revenue Serv., All Partnerships: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Size of Total Assets (2017) (table available at https://www.irs.gov/statistics/soi-tax-stats-partnership-data-by-size-of-total-assets).

276. This would include LLCs that have elected to be taxed as a corporation but that have not made an S election.

277. I.R.C. §§ 673–677. Although irrevocable trusts can qualify as grantor trusts under certain circumstances, for simplicity purposes I have limited the permissible partners for the automatic election out to revocable trusts. Partnerships with irrevocable trusts as partners could still qualify under the income-and-assets test. Permissible partners could also include nominees holding an interest for an individual or C corporation, estates of deceased partners, and a foreign entity that would be a C corporation if it was a U.S. entity. In calculating whether a partnership has ten or fewer partners, a disregarded entity and its sole member would be counted as a single partner. The same rule would apply with respect to a grantor trust or a nominee holding an interest on another's behalf.

278. *Clarifications for Disregarded Entity Reporting and Section 743(b) Reporting*, INTERNAL REVENUE SERV., https://www.irs.gov/forms-pubs/clarifications-for-disregarded-entity-reporting-and-section-743b-reporting (last updated Mar. 26, 2020).

owned a disregarded entity that is a partner in a partnership, the partnership would report the beneficial owner's TIN and that the beneficial owner is a corporation.[279] The IRS could use this data and the number of Schedules K-1 issued for that taxable year to determine whether the partnership qualified for the non-tiered automatic exemption.[280]

To illustrate the interaction of the two tests for the automatic exemption, imagine first that Adam and Cleo directly own their interests in Super Subs and John holds his via his revocable trust. If Super Subs satisfied the income-and-assets test, it would be exempt from the adjustment component. But if it failed the income-and-assets test, it would still be automatically exempt from the adjustment component because it issued ten or fewer Schedule K-1s and has no partners other than individuals, C corporations, or disregarded entities owned by individuals or C corporations.

3. The Policy Benefits of the Automatic Exemption

Adopting the two-test automatic exemption would benefit small businesses by providing an easier exit route from the adjustment component. Unsophisticated taxpayers without the resources to hire expert advisors may be more likely to avoid unnecessary compliance costs and excessive tax liability. In this way, the automatic exemption would promote fairness, simplify the tax system while maintaining enforceability, and increase the tax system's efficiency.

a. Promoting Fairness

The automatic exemption would promote fairness in the tax system by enhancing the tax system's progressivity and reducing disparities in treatment between similarly situated taxpayers. The exemption would have significant procedural advantages over the existing election-out process. Requiring taxpayers to affirmatively elect out places a premium on quality tax advice, to which some unsophisticated small business may lack access. Providing an automatic exemption mitigates these discrepancies.

---

279. *Id.* The IRS would need to ensure that taxpayers distinguish between an S corporation and a C corporation.

280. This should not overly burden the IRS because the partnership would still have a PR, which would serve as a single contact point for auditors. Also, the IRS would not need to determine whether the partnership is exempt from the adjustment component unless the partnership filed an AAR or the IRS sought to make adjustments in an audit.

The automatic exemption would also reduce the likelihood that benign estate-planning transfers—such as John's transfer to his revocable trust—would subject the partnership to the adjustment component. Assuming Adam and Cleo still held their interests as individuals, Super Subs could automatically escape the adjustment component. This would bring the tax law more in line with most taxpayers' expectations. Few laypersons—or even practitioners not well-versed in partnership tax law—would expect such transfers to trigger a different regime for collecting tax from the entity in which they invested.

By providing a de minimis exception, the income-and-assets test solidifies these benefits for the smallest businesses. The test can also extend to very small tiered partnerships that are unlikely to present serious administrative burdens for the IRS. By setting the income-and-assets thresholds very low, policymakers can ensure that these tiered partnerships are those which have simple operations and relatively few partners and which may be less likely to engage in abusive tax avoidance on a large scale.

The automatic exemption would also make the tax system more progressive. Each test would extend largely to partnerships with low levels of income rather than larger businesses such as private equity funds or oil and gas partnerships. These smaller entities struggle to digest complex regulations, or to afford to hire advisors who have digested them, and may be frequent victims of the BBA's tendency to impose increased compliance costs or excessive tax liability. By comparison, businesses with more resources or more-established operations (and perhaps a higher likelihood of engaging in transactions to artificially lower tax liability) can better tolerate the adjustment component.[281] These businesses may have the funds to retain partnership tax experts who can walk them through the process of requesting modifications, making push-out elections, and determining the effects on partners' tax attributes. Exempting smaller partnerships can help equalize the playing field and avoid unduly subjecting less-affluent taxpayers to higher compliance costs and potentially excessive tax liability.[282]

---

281. *See* Johns & Slemrod, *supra* note 235, at 407–08 (finding that higher-income taxpayers may be more likely to misreport income from pass-through entities such as partnerships and S corporations).

282. This, in turn, may help equalize the existing discrepancy in tax compliance costs per dollar of sales between smaller and larger firms. SLEMROD & BAKIJA, *supra* note 166, at 233.

b. Simplifying the Tax Law and Maintaining its Enforceability

At first glance, one might find it doubtful that adding an automatic exemption with two tests could simplify the tax law, whether for the IRS or for taxpayers. But as with so many things in taxation, looks can be deceiving.

Let us start with the implications for taxpayers and specifically with the income-and-assets test. While calculating asset values can be a difficult task, it is ultimately a surmountable one in this context for three reasons. First, gross income is fairly easy to calculate. Indeed, partnerships must already report the items composing their gross income, generating only minimal if any new reporting.[283] Second, partnerships must also either report the value of their total assets or certify that their total yearly receipts and total assets were less than $250,000 and $1 million, respectively.[284] Even though the proposed thresholds deviate from these levels, small businesses and their advisors should already be familiar with the process or at least the concept of calculating asset value. Many businesses may either far exceed the threshold or own so few assets as to obviously fall within it. Finally, many businesses to which the exception would extend often own assets that have relatively predictable values, such as equipment and inventory rather than patents or trademarks.[285]

The non-tiered test is similarly straightforward. The partnership simply completes the requirements on Schedule K-1 for each partner. If it fulfills the requirements for the exemption, it is exempt from the adjustment component.

Perhaps more importantly, even though partnerships would have to report items such as asset value or gross income, they would escape the intricacies of the adjustment component. Gone would be opaque phrases such as reviewed years and adjustment years; "partnership adjustments" and "partnership-related items"; "imputed underpayments," "general imputed underpayments," and "specific imputed underpayments"; and push-out elections and their "correction amounts." There would be no need to decipher whether

---

283. 2019 Form 1065, *supra* note 269.

284. Internal Revenue Serv., 2020 Instructions for Form 1065: U.S. Return of Partnership Income 25 (available at https://www.irs.gov/pub/irs-pdf/i1065.pdf) [hereinafter 2020 Instructions for Form 1065].

285. DHL Corp. & Subsidiaries v. Comm'r, 285 F.3d 1210, 1220 (9th Cir. 2002) (noting that valuing an intangible asset is an "imprecise art"); JOHN A. BOGDANSKI, FEDERAL TAX VALUATION ¶¶ 2.01[4][b][iv], [vi], 3.04[1] (2020) (describing methods of valuing inventory and identifying the comparable sales method as a method of valuing equipment).

an imputed underpayment imposes excessive tax and how and when to modify it. Taxpayers and their advisors could avoid the complications surrounding how to obtain a refund with respect to a prior year, which (absent special relief) is now possible only if the partners file an amended return in the modification process arising from an audit.[286] Nor would taxpayers need to navigate the complicated rules for determining the effect of paying an imputed underpayment or making a push-out election on the tax attributes of the partnership and its partners. Fledgling businesses sensitive to regulatory costs could spend more of their limited resources on hiring employees, developing useful products, purchasing equipment, and providing services.[287]

This simplicity for taxpayers would not come at the cost of enforceability for the IRS—at least not a significant cost. Indeed, the exemption might actually reduce the IRS's administrative burden by relieving its employees of the need to explain the BBA to taxpayers.[288] The IRS would have to verify two tests, but taxpayers would bear the burden of answering the questions and providing the information. Because every partnership would have to appoint a PR, the IRS would always have a single contact point for the partnership.[289] Significantly, the IRS would not need to verify whether the partnership elected out of the adjustment component unless it sought to make adjustments in an audit of the partnership or if the partnership filed an AAR.

Likewise, although taxpayers may reorganize their affairs into several smaller partnerships seeking to satisfy one or both tests, this planning technique exists with respect to the current election-out criteria. As with many cliffs in the tax law, taxpayers may also underreport income at the periphery to qualify for the exemption. But this would have limited effects with respect to a partnership's level of total assets, and every partnership would in any case still have to appoint a PR.[290] That person could communicate with IRS agents, settle a controversy, extend a statute of limitations, and petition a court, among other things. And the low thresholds for the income-and-assets test could ward off many unintended beneficiaries

286. *See supra* notes 120–22 and Part II.C.3.ii.

287. For these partnerships, it may be more appropriate for the IRS to take on more of the burden if it can do so at a lower cost.

288. Parillo, *supra* note 1 ("Initial exams indicate the IRS will need to spend much time educating taxpayers on how the new centralized partnership audit regime works, according to an agency official.").

289. 2020 Instructions for Form 1065, *supra* note 284, at 27.

290. *Id.*

seeking to artificially satisfy that test. With lower thresholds come higher transaction costs necessary to unnaturally structure affairs to fall within the exemption.

Further, if the enforceability concerns became too great, policymakers could consider including a rule that automatically subjects even small partnerships to the adjustment component if they, for example, participated in a "reportable transaction" for a tax year.[291] Because reportable transactions include (very generally) scenarios presenting "a potential for tax avoidance and evasion," this would minimize enforceability concerns by assisting the IRS in auditing and collecting tax from the partnerships most likely to be engaged in tax avoidance.[292]

c. Improving Efficiency

The exemption is also likely to have a net positive effect on the tax system's efficiency. The decreased rigidity in the exemption criteria may decrease distortions for small-business owners' estate-planning decisions, such as transferring their interest to a revocable trust to avoid probate. Entrepreneurs may be more likely to choose entities for economic reasons rather than the comparative complexity of the tax rules underlying each entity form. And small businesses may incur fewer unnecessary compliance costs, benefitting the economy as a whole.

Although one can imagine negative implications for efficiency depending on how taxpayers respond to the exemption, these concerns seem likely to be minimal. Certainly, efficiency may suffer if taxpayers attempt to restructure their affairs solely to satisfy one or more of the tests. With restructuring efforts come costs in the form of legal fees and other expenses, which can reduce the entity's capacity to engage in economically productive activities. But, as we saw with concerns regarding enforceability, these efforts should not be widespread, especially with sufficiently low thresholds for the income-and-assets test. Lower thresholds mean higher transaction costs, which in turn reduce the benefit of tax-motivated restructuring. And partnerships would always remain subject to the PR component, further limiting incentives to engage in tax-motivated restructuring.

Ultimately, the automatic exemption and the accompanying election out will never be perfect. Some small businesses that have

---

291. I.R.C. § 6707A(c)(1).
292. *Id.*

difficulty navigating the BBA will not qualify. Some undeserving taxpayers will inevitably uncover opportunities for exploitation. But this system is at least a step in the right direction and can shield many taxpayers from the BBA's most onerous effects.

V. CONCLUSION

The BBA's imposition of unnecessary burdens on small partnerships is in many ways fitting given the prevalence in partnership taxation of complex rules designed to prevent sophisticated tax-avoidance schemes. All too often these complicated regimes fall short of that goal while also imposing onerous compliance costs on small businesses. And so it is with the BBA.

This Article takes aim at that tradition. Acknowledging the promise of the BBA, it suggests revisions designed to fulfill that potential by reducing unnecessary compliance costs for low-income taxpayers and closing loopholes for more sophisticated ones. It proposes to bifurcate the BBA into two parts, the PR component and the adjustment component, and to prohibit partnerships from electing out of the PR component. Then, it suggests revising the election-out criteria to reduce the maximum number of partners and incorporate a new automatic exemption for small partnerships that meet at least one of two alternative tests.

Given the recency of the BBA, I acknowledge that my proposals lack the benefit of experience with the law and extensive data. Future research should focus on those areas, asking, for example: How many and what type of partnerships does the IRS audit under the BBA compared to prior law? What is the success rate of those audits and the average amount of tax assessed? Are taxpayers and their advisors largely understanding the rules or struggling to digest them?[293] How did the rules affect the tax gap? How are they affecting the number of taxpayers who form partnerships versus other entities? And is the IRS properly verifying the application of the rules, such as the eligibility of a partnership to elect out? Answers to these questions (and assuredly many others I have failed to raise) will shed further light on the process of auditing and collecting tax from partnerships.

Finally, while the proposals in this Article are designed to ameliorate issues common to partnership taxation, breaking the tradition of ineffective and cumbersome complexity requires a

---

293. Early comments from IRS officials indicate that many taxpayers and their advisors have a limited understanding of the BBA. Parillo, *supra* note 1.

broader examination of substantive partnership taxation, a topic which is beyond the scope of this Article. Ultimately, problems in partnership taxation will persist until subchapter K is more difficult to abuse and easier to comply with, understand, and enforce, for taxpayers and IRS agents alike.