Partnership Administrative Adjustment Requests (AARs) Are Dangerous

by Kate Kraus

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In this article, Kraus explores the dangers of a partnership filing an administrative adjustment request to adjust a prior return under the Bipartisan Budget Act rules.

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Not all adjustments are bad. Sometimes a taxpayer would like to adjust a previously filed return to take a more favorable position. When the adjustment involves a partnership, however, it is risky. If the partners for the affected year have net losses (or little income) in the year that the partnership submits its request for the adjustment to be made, and if the request relates to a partnership return that is subject to the partnership audit rules enacted by the Bipartisan Budget Act of 2015 (BBA), the adjustment may actually *increase* the amount of tax that the partners must pay. In fact, taxes might increase even if the adjustment is being made to take advantage of retroactive legislation that is intended to provide a benefit for for taxpayers.

The IRS has sometimes issued revenue procedures to provide relief from these rules, but the scope of this relief has been limited.[1] Proper procedures must be followed; the relief is only temporary; and sometimes it is only available to to certain taxpayers.

Example — The Retail Glitch

The dangers of requesting an apparently favorable adjustment can be illustrated with the correction that Congress made to the so-called retail glitch. Under the Tax Cuts and Jobs Act, qualified improvement property (QIP) was intended to be depreciable over a 15-year period and be eligible for 100 percent bonus depreciation. Because of a drafting error, however, QIP was given a recovery period of 39 years and was not eligible for bonus depreciation. The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), enacted March 27, 2020, has fixed this mistake. QIP now has a 15-year recovery period and is eligible for 100 percent bonus depreciation, and these amendments have retroactive effect.[2] As a result, QIP that was placed in service in 2018 or 2019 may be eligible for 100 percent bonus depreciation.

This means that an owner of QIP who had already filed its returns for 2018 and 2019 might have paid too much tax, for the owner would have calculated the amount of tax due using a 39-year recovery period, not 100 percent bonus depreciation. One might think that the owner could simply amend its tax returns to claim the benefits of bonus depreciation, and be entitled to an

[1] See, e.g., Rev. Proc. 2021-50; Rev. Proc. 2021-29; and Rev. Proc. 2020-23.
[2] *See* CARES Act section 2307(b).

associated refund. Unfortunately, when a partnership is involved, such an adjustment to the partnership's 2018 or 2019 tax return could make the partners worse off.

AARs Under the BBA

Under the BBA, a partnership does not ordinarily revise a previously filed tax return by filing an amended return. Instead, the partnership must generally file an administrative adjustment request (AAR).[3] This is not a new procedural rule; partnerships that were subject to the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) were also required to file AARs instead of amended returns.[4] What is different, however, is that under TEFRA, if a historic partner had paid too much tax, the partner could receive a refund as a result of an adjustment requested through an AAR. With an AAR filed under the BBA, the historic partners *cannot* receive refunds.[5] Instead, they receive a nonrefundable credit for the year in which the AAR is filed.[6]

Therefore, if an AAR is filed in 2020 to report bonus depreciation for QIP in 2018 or 2019, a partner who paid too much tax for 2018 or 2019 would receive a nonrefundable credit for 2020. This credit will not be useful if the partner has net losses for 2020 — a situation in which many taxpayers found themselves.[7]

For example, consider a partnership that paid $100 million to purchase QIP in 2019. When it filed its return for 2019, it reported $2.56 million of depreciation for that QIP because it adopted a 39-year recovery period. If the partnership had instead reported $100 million of bonus depreciation, it would have reported an additional $97.44 million of depreciation for 2019, and its partners from 2019 would have paid $36.05 million less tax (37 percent of $97.44 million).

If this partnership files an AAR in 2020 to claim bonus depreciation for its QIP in 2019, the partners from 2019 would receive a nonrefundable credit of $36.05 million. This credit can reduce the amount of tax they owe for 2020, but if they have net losses for 2020, they have no tax in 2020 to reduce. Moreover, that $36.05 million credit cannot be refunded, and it cannot be applied to reduce the amount of tax owed for some other year (for example, 2019 or 2021).[8]

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[3] See Section 6227.

[4] See section 6227, as in effect for a return filed for a partnership tax year beginning on or before December 31, 2017, unless the partnership has made a valid election for the BBA to apply to that return.

[5] There is generally only one situation in which a refund may be available under the BBA: when an adjustment is made pursuant to an IRS audit and the partnership avails itself of certain modification rules under section 6225(c). For example, refunds are available under the amended-return modification rules of section 6225(c)(2)(A). *See* section 6225(c)(2)(D). (Refunds, however, are not available under the "pull in" or "alternative procedure" modification rules of section 6225(c)(2)(B). *See* reg. section 301.6225-2(d)(2)(x)(A).)

[6] Technically speaking, the tax benefit is not a nonrefundable credit, but it is helpful to view it as such when evaluating the amount of tax benefit that results under the BBA.

[7] In addition, the credit does not reduce the alternative minimum tax. The credit reduces the "regular tax" under section 55(c) but not the tentative minimum tax under section 55(b). See Instructions for IRS Form 6251 (2021).

[8] Reg. section 301.6227-3.

In other words, a partner cannot receive any tax benefit from an AAR that is filed in a year in which the partner has net losses. Moreover, the AAR might prevent the partners from ever receiving the benefit of the $97.44 million of depreciation that was not reported on the original return. The AAR could therefore *increase* the amount of tax that the partners must pay, even though the AAR is requesting what should have been a taxpayer-favorable adjustment.

This unfortunate result stems from the associated adjustments to tax attributes that might have to be made. The BBA statute and regulations do not specifically address how attributes are to be adjusted for later years as the result of an AAR,[9] but the partnership might be required to reduce its basis in the QIP to zero as of 2019.[10] In that case, the partnership would not be entitled to report any depreciation of the QIP in any later year. Similarly, the 2019 partners might be required to reduce their basis in their partnership interests by the $97.44 million of depreciation that was claimed in the AAR, even though that depreciation did not provide them with any tax benefit.

In that case, the partners might be better off if the AAR were not filed. This problem is exacerbated by the complexity of the BBA rules. It would be reasonable for a partnership to expect that its partners would be better off if it files an AAR that requests a taxpayer-favorable adjustment, and there is nothing in the AAR process that ensures that the partnership will appreciate the implications for its partners. It is too easy for a partnership to hurt its partners when trying to give them a tax benefit.

Rev. Proc. 2020-23

Rev. Proc. 2020-23 provided limited relief from these rules so that taxpayers could benefit from the retroactive provisions of the CARES Act. Under that revenue procedure, a partnership could adjust a previously filed return by filing an amended return (as opposed to an AAR). This relief applied to partnership tax years that began in 2018 or 2019, and only for tax returns filed before April 8, 2020 (the date that the revenue procedure was issued). Therefore, if a partnership did not file its return for 2019 before that date, it would generally be unable to file an amended return for 2019.[11] In addition, to qualify for this relief, a partnership was required to file its amended return before September 30, 2020. However, a partnership that had not mastered the BBA rules might have filed an AAR for 2018 or 2019 and then discovered the unfortunate consequences in the spring of 2021, when the partners are filing their returns that would take the AAR adjustment into account. By that point, it would be too late for the partnership to avail itself of the opportunity to file an amended return.

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9 However, the AAR rules for favorable adjustments are generally modeled on the rules that govern push-out elections under section 6226, and there are proposed regulations regarding attribute adjustments when a section 6226 push-out election is made. Prop. reg. section 301.6226-4.

10 In fact, it is difficult to see how the partnership could have a basis other than zero in the QIP. The partnership might not know whether its 2019 partners received any tax benefit from the AAR that was filed.

11 Additional relief for the 2019 tax year was granted by Rev. Proc. 2021-29, but that relief only applied to taxpayers that had residential real property or chose to make a late section 163(j) election.

Change in Method of Accounting

An AAR might be disadvantageous, and the relief provided by Rev. Proc. 2020-23 or other guidance might not be available, but there may be other approaches that would enable the partners to obtain the benefit of an adjustment. For example, the rules regarding changes in methods of accounting may be useful. That approach may, however, affect which partners benefit from (or are burdened by) the adjustment. An AAR would affect the reviewed-year partners, but a change in a method of accounting would generally affect those who are partners when the change is made.

Push-Out Elections Under Section 6226

The problems with AARs also arise when a push-out election is made under section 6226, as I have discussed previously in *Tax Notes*.[12] With a push-out election, however, a partnership might not have as much control over the year in which the partners must take the adjustment into account (that is, the year in which the nonrefundable credit is available).[13]

Conclusion

Ideally, refunds should be available with AARs and with push-out elections. This might not be possible without congressional action, and it might not be a high priority at the moment.

It might also help for the AAR instructions to include a prominent warning that refunds will not be available and that the most the partners will receive is a reduction in the amount of tax that they owe for the year in which the AAR is filed.

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12 *See* Kate Kraus, "The Push-Out Election and AARs Might Not Get You Back to Kansas," *Tax Notes Federal*, Dec. 2, 2019, p. 1429.

13 With a push-out election, the nonrefundable credit is available in the year that the partnership provides the partner with a statement that informs the partner that the push-out election has been made and what the partner's share of the adjusted items is. Section 6226(b)(1).