# BBA Indemnities May Result in Double Taxation

by Kate Kraus

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In this article, Kraus explains how typical indemnity provisions may result in double taxation for some, an a windfall for others under the Bipartisan Budget Act of 2015.



One of the most noteworthy features of the partnership audit rules enacted by the Bipartisan Budget Act of 2015 (BBA) is that a partnership may itself be required to pay tax if it makes a mistake on its tax return. Partnerships are generally viewed as flow-through entities that don't pay tax on their own income, and the possibility that a partnership might have to pay tax on adjusted items has resulted in much angst.[1]

The BBA doesn't always require a partnership to pay tax on its adjusted items. It offers many ways in which an adjustment may be taken into account, and some alternatives allow the adjustment to be taken into account (and for any additional tax to be paid) by the partners rather than the partnership. For example, the partnership might make a section 6226 push-out election or avail itself of one of the modification procedures under section 6225(c)(2). However, those solutions might not always be available.[2] Thus, it has become common for a partner to agree to indemnify the partnership for its share of an imputed underpayment, with this obligation surviving the sale of the partnership interest to a new partner.[3]

Typical indemnity provisions focus on the economic loss that results when a partnership pays an imputed underpayment. For example, if a partnership pays an imputed underpayment that resulted from omitting $10 of income that should have been allocated to one of its partners

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[1]Before the BBA, it was possible for a partnership to pay tax on its adjusted items under the former electing large partnership rules of sections 771-777 and 6240-6255, but those rules did not apply unless a partnership elected to be subject to them, and few partnerships made that election.

[2]For example, a partnership cannot avail itself of the section 6225(c)(2) modification rules without the cooperation of its partners. Also, a section 6226 push-out election might be unavailable if the partnership cannot satisfy the criteria for a valid election. *See* Kate Kraus, "The Push-Out Election and AARs Might Not Get You Back to Kansas," *Tax Notes Federal*, Dec. 2, 2019, p. 1429.

[3]Sometimes the selling partner also agrees to indemnify the new partner.

(Stella), Stella should have to make the partnership whole, for she is the partner who paid too little tax. The other partners shouldn't have to bear the economic cost of that tax payment. However, when a partner leaves the partnership, it is important to look at the bigger picture. Otherwise, the indemnity could require the former partner to pay tax on income that she has already paid tax on and provide the adjustment-year partners with a windfall.

**Outside Basis and Double Taxation**

One factor that a partner should consider is outside basis. Partnerships are ordinarily treated as passthrough entities, with partners paying tax on the partnership's income. A critical part of the passthrough regime is section 705, which provides that a partner's outside basis is increased by the partner's share of partnership income. Otherwise, a partner would pay tax on that income twice – once when it includes its share of income under section 704, and then a second time when it sells or liquidates its partnership interest.

For example, consider a partnership that issues a profits interest (with $0 basis) to Stella. In year 1, the partnership recognizes $10 of income that it allocates to Stella, and on the first day of year 2, Stella sells her partnership interest for $10. Stella therefore starts with property (a profits interest) with $0 basis and ends up with $10 of cash. She should therefore recognize $10 of taxable income. And that is what subchapter K provides. First, Stella reports her $10 share of partnership income on her return for year 1. Then, in year 2, when she sells her partnership interest for $10, her outside basis has increased by the $10 of year 1 income, so she has no gain or loss from the sale.

In contrast, C corporations are taxed at the entity level, with no outside basis adjustments to reflect corporate income. Therefore, their income is generally taxed twice. For example, if a C corporation recognizes $10 of income, it pays tax on that $10 of income. When it distributes its income as a dividend, the income is taxed again as dividend income.[4]

The BBA has a default rule that determines how adjustments are taken into account if no special elections are made or special procedures followed. Under this default rule, a partnership is generally treated as a taxable entity if the IRS increases the partnership's income; it is the

[4] The amount distributed as a dividend (and hence the amount subject to double taxation) would generally be less than $10, for the corporation must use some of its earnings to pay its own tax liability. Therefore, if it pays $2.10 of tax, $2.10 of its taxable income will be taxed once, and the $7.90 of taxable income that is distributed as a dividend is taxed twice (once at the corporate level and once at the shareholder level).

partnership itself – not the reviewed-year partners – that pays tax on that additional income.[5] For example, if a partnership omitted $10 of year 1 income that it should have allocated to Stella and the IRS corrects this error, the partnership will pay tax on that $10 of income. In that sense, the partnership is no longer being treated as a passthrough. But the fact that the partnership is paying tax on its own income doesn't mean that the partnership's income must be double-taxed; it is possible for that $10 of income to be taxed only once if outside basis is increased by the additional $10 of income that the partnership pays tax on.

Fortunately, proposed regulations provide for such adjustments to outside basis. Under the proposed regulations, when the IRS increases a partnership's income and the partnership pays the resulting imputed underpayment, outside basis will be increased by the amount of additional income that has been taxed.[6] Therefore, if a partnership pays tax on the $10 of income that it omitted on its return for the reviewed year, outside basis would be increased by $10. Moreover, if the omitted income should have been allocated to Stella, the $10 increase in outside basis is given to Stella, not the other partners.[7]

These adjustments to outside basis don't have retroactive effect. They are made in the adjustment year (roughly, the year in which the audit is resolved) and don't affect any earlier years.[8] This approach is not unreasonable. The BBA's default rule is designed so that the IRS can generally conduct an audit, make an adjustment, and implement the adjustment (for example, collect any additional tax) as if the partnership were a box, without needing to pay attention to anything outside the box. That is, under the default rule, the IRS can conduct a BBA audit by looking at the partnership's books and records, without involving the partners.[9] There is no need

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[5]A reviewed-year partner is a person who was a partner in the tax year that is being adjusted. For example, if the IRS adjusts a partnership's return for 2020, the reviewed-year partners are those who were partners in 2020.

[6]Prop. reg. section 301.6225-4(b)(6)(iii). Under an antiabuse rule, basis adjustments are not allowed in some situations involving tax-exempt partners or related-party transactions. Prop. reg. section 301.6225-4(b)(6)(iii)(B).

[7]Prop. reg. section 1.704-1(b)(4)(xi); prop. reg. section 301.6225-4(b)(5).

[8]Prop. reg. section 301.6225-4(a)(3). The BBA generally defines the adjustment year as the partnership's tax year in which the IRS mails the notice of final partnership adjustment, or, if the dispute is litigated, the tax year in which a final decision has been made by the Tax Court, a federal district court, or the Court of Federal Claims. Reg. section 301.6241-1(a)(1).

[9]There are, however, limited situations in which partner-level information or involvement is unavoidable, for example, in determining the partnership's basis in an asset that was contributed in a transaction governed by section 721.

to locate the reviewed-year partners, obtain information from them, take their tax attributes into account, run the resulting adjustment through their returns, or collect tax from them.

This core principle of treating partnerships as boxes would be violated if adjustments to outside basis took effect in the reviewed year. A partner's outside basis may affect whether gain is recognized under section 731 or whether losses are limited under section 704(d), among other things. This means that if the basis adjustment took effect retroactively, in the reviewed year, the adjustment could affect the amount of tax that the reviewed-year partner owed for the reviewed year or perhaps some other year that precedes the adjustment year. However, the default rule provides no way for a partner to take outside basis adjustments into account before the adjustment year, and there is no easy way to modify the default rule to handle such basis adjustments without sacrificing the simplicity and administrability of the partnerships-as-boxes model.

The proposed regulations also address the treatment of outside basis adjustments when a reviewed-year partner is no longer a partner in the adjustment year, either because the partner has transferred her partnership interest or has been redeemed out of the partnership. In keeping with the partnerships-as-boxes model, the proposed regulations provide that the outside basis bump goes to the successor.[10]

Let us revisit the above example, in which a partnership omitted $10 of year 1 income that should have been allocated to Stella, and then on the first day of year 2 Stella sold her partnership interest to Bryan for $10. In that situation, Stella included $10 too little income in year 1, but $10 too much gain in year 2. When the IRS audits the partnership's year 1 return and increases the income allocated to Stella by $10, the partnership takes the adjustment into account under the default rule and pays the resulting imputed underpayment of $3.70 (assuming that the applicable tax rate is 37 percent). When Stella became a partner in year 1, however, she agreed to indemnify the partnership for her share of an imputed underpayment and that obligation survives the sale of her partnership interest to Bryan. She is therefore required to indemnify the partnership for that $3.70 imputed underpayment, so she effectively pays tax on the $10 of partnership income that was omitted.

The year 1 adjustment does not, however, change the amount of gain she recognized in year 2 from her sale to Bryan. The payment of the imputed underpayment increases Bryan's outside basis by $10, not Stella's outside basis. Therefore, if the partnership had properly reported that $10 of year 1 income, Stella would have included $10 of income in year 1 and $0 gain in year 2, for a total of $10 of taxable income. But due to the error and the application of the BBA default rule, she instead ends up paying tax on the $10 of income in year 1 (that is, the

[10]Prop. reg. section 1.704-1(b)(4)(xi).

imputed underpayment), and the $10 of gain from the sale in year 2 – a total of $20 of taxable income.[11] The net result is that she pays tax twice on that $10 of year 1 income.

Bryan, on the other hand, has a windfall. There is only one way in which he is affected by the adjustment: It increases his outside basis by $10. The value of his partnership interest is not reduced, for Stella has indemnified the partnership. If there have been no other changes to the value or basis of Bryan's partnership interest, his basis would be increased to $20 while the value would remain at $10, giving Bryan a free built-in loss of $10 that he might be able to harvest.

The indemnity would therefore ultimately result in Stella's including $10 too much income and Bryan including $10 too little.

**Grouping Two-Legged Adjustments**

There is a second way in which an indemnity may result in double taxation for a partner who leaves a partnership. This stems from the grouping rules and the asymmetry between positive and negative adjustments. These grouping rules make it possible for the IRS to treat the partnership like a box without losing any tax revenue. Outside the BBA context, we typically consider only the net effect of an adjustment, but that is possible because the taxpayer's characteristics and other tax items may be taken into account. If a partnership is treated like a box and no partner-specific information may be taken into account, adjustments must be evaluated as gross items, not net items.

[11]The tax consequences of Stella's indemnity might reduce, but will not eliminate, this double taxation. If she is allowed to report a loss of $3.70 (*e.g.*, under *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952)), then she includes $20 of income and has a loss of $3.70, resulting in a total of $16.30 of taxable income. In that case, from her perspective it would be as if the partnership were a C corporation, if corporations were subject to a 37 percent tax rate. The after-tax income of $6.30 would be taxed twice, but the $3.70 of income that is used to pay the entity-level tax would be taxed only once. The treatment of the indemnity payment may therefore mitigate the double taxation, but it does not eliminate it.

Note, however, that there is some uncertainty in whether Stella would be allowed to report a loss of $3.70. The blue book suggests that the loss would be nondeductible because it is a tax payment. *See* Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 2015," JCS-1-16, at 79 (Mar. 2016). It isn't clear that this is correct – it is the partnership, not Stella, who is paying its own tax obligation, so the imputed underpayment results in a partnership expense that is not deductible. Section 6241(4); reg. section 301.6241-4. Therefore, it might be overkill to say that both the partnership's payment of the imputed underpayment as well as Stella's satisfaction of her obligation to indemnify the partnership constitute nondeductible expenses. If the blue book is correct and the indemnity payment isn't deductible, the indemnity wouldn't reduce the amount of tax Stella must pay, and Stella would effectively be paying tax on $20 of income.

Consider an adjustment that recharacterizes income. If a partnership reports $10 of long-term capital gain and the IRS determines that the income was ordinary, it is possible that the partners paid the correct amount of tax, notwithstanding the mischaracterization. For example, the partners might all be C corporations that didn't have any capital loss carryforwards or carrybacks to offset that $10 of gain. In that case, the corporations would have paid tax on $10 of income in the reviewed year, and the applicable tax rate wouldn't have been affected by the mischaracterization. But under the default rule, the partnership is treated like a box, so the IRS and the partnership must take into account the possibility that the partners had capital loss carryforwards or carrybacks, or that a partner was an individual and therefore eligible for a preferential tax rate on capital gain.

The default rule handles this issue with a line-by-line approach. Each adjustment to a line on the tax return is treated as a separate adjustment, and then grouping rules determine whether one adjustment might offset another. Before discussing the grouping rules, it may help to review how a single adjustment is treated when it is the only adjustment made. Under the default rule, if the IRS's only adjustment is to increase a partnership's income by $10, the partnership pays tax on $10 of income (that is, it pays the imputed underpayment). If instead the only adjustment is to decrease the partnership's income by $10, the partnership makes a "true-up adjustment" on its return for the adjustment year, by omitting $10 of income (or reporting an additional $10 of loss).[12]

The complexity increases dramatically when more than one adjustment is made (that is, more than one line on a tax return is adjusted). If there are two adjustments that would both increase partnership income (or decrease partnership loss), they are added together and taxed at the highest tax rate that might apply to an individual or to a corporation.[13] But if instead one of the adjustments is negative (that is, it is a favorable adjustment that reduces partnership income

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[12]Reg. section 301.6225-3(b)(1) and (2). The term "true-up adjustment" is mine and not in the regulations.

[13]Adjustments to amounts that are not items of partnership income or loss are more complicated; they are always treated as "positive adjustments" that generally result in an imputed underpayment. Reg. section 301.6225-1(d)(2)(iii). If the adjustments are duplicative, one (or more) of them may sometimes be treated as $0. Reg. section 301.6225-1(b)(4). For example, if a partnership omits $10 of income and therefore underreports its adjusted taxable income under section 163(j) by $10, the increase in income and the increase in ATI would both be positive adjustments (and a positive adjustment cannot be a negative number). This would generally result in a $20 adjustment. But as the adjustment to ATI is reflected in the other adjustment, the adjustment to ATI might be treated as $0. In that case, the imputed underpayment would equal the tax on $10 of income, not $20 of income. (This example is simplified, for an adjustment to partnership income could affect many lines on the return that relate to section 163(j).)

or increases a partnership loss), the question is whether that adjustment offsets an unfavorable one (thereby reducing the imputed underpayment), or whether it is taken into account with a true-up adjustment in the adjustment year.

For example, the IRS might increase one item of partnership income by $10 (a positive adjustment) and decrease a separate item of partnership income by $10 (a negative adjustment). Will the negative adjustment offset the positive one, in which case there is no imputed underpayment to pay? Or will the partnership pay tax on the positive adjustment and take the negative adjustment into account with a true-up allocation in the adjustment year?

It is the grouping rules that determine what the result will be.[14] Under the grouping rules, the question is whether the two adjustments would always offset each other when taken into account on the partners' returns, no matter who the partners are or what their tax attributes or other tax items are. If the two adjustments would always be able to offset each other, then they will be "grouped" together, which means that the negative adjustment will offset the positive adjustment, resulting in a net adjustment of $0 and an imputed underpayment of $0. In other words, by grouping a negative (favorable) adjustment with a positive (unfavorable) adjustment, the negative (favorable) adjustment can reduce the imputed underpayment that otherwise would have resulted from the positive (unfavorable) adjustment.

On the other hand, if the two adjustments might not offset each other, they aren't grouped together, in which case the negative one (the favorable one) will not reduce the imputed underpayment that the partnership must pay. Instead, the negative adjustment will be taken into account with a true-up adjustment in the adjustment year.

This can be illustrated with the recharacterization example. If a partnership reports $10 of capital gain and the IRS determines that the income was in fact ordinary, two adjustments are made: Capital gain is decreased by $10 (the negative adjustment), and ordinary income is increased by $10 (the positive adjustment). These two adjustments wouldn't offset each other in all situations, so the negative adjustment (the reduction in capital gain) won't reduce the imputed underpayment that the partnership must pay. Instead, the partnership would pay tax on the $10 of additional ordinary income, and it would reduce its capital gain (or increase its capital loss) by $10 on its tax return for the adjustment year.[15]

This result might be relatively reasonable if there has been no change in who the partners are. When the reviewed-year partners are also the adjustment-year partners, they bear the burden

[14]Reg. section 301.6225-1(b)-(e).
[15]It isn't entirely clear whether the partnership would underreport its capital gain (if it has any in the adjustment year), or whether it would report a capital loss.

of the positive adjustment, but they also reap the benefit of the negative adjustment.[16] However, matters are worse for a reviewed-year partner who has left the partnership but remains obligated to indemnify the partnership for her share of an imputed underpayment. Such a partner will bear the cost of the unfavorable adjustment without receiving any benefit from the favorable one.

For example, consider Stella's situation if the mischaracterized $10 of income had been allocated to her in year 1, and then in year 2 (before the IRS adjustment is made) she sold her partnership interest subject to an obligation to indemnify the partnership for her share of an imputed underpayment. When she filed her tax return for year 1, she reported the $10 of capital gain that was reported on her Schedule K-1 for that year, and she paid tax on that gain. Then, when the IRS recharacterizes that income as ordinary, the partnership pays tax (the imputed underpayment) on the $10 of ordinary income that had been omitted. Under the indemnity, this tax liability is effectively transferred to Stella, so Stella would have to pay tax on $10 of ordinary income, even though she already paid tax on that $10 of income (albeit at capital gains rates).

The recharacterization would also generate a favorable adjustment – the $10 reduction in capital gain – but Stella wouldn't benefit from that adjustment. Under the grouping rules, that adjustment wouldn't offset the imputed underpayment but would instead be resolved by the partnership making a true-up allocation (that is, by omitting $10 of capital gain or reporting an additional $10 capital loss) on its return for the adjustment year. Stella would therefore pay tax on the $10 twice – once at capital gains rates, and once at ordinary income rates. Her prior inclusion of $10 of capital gain would not reduce the amount she must pay the partnership, under the terms of a typical indemnity provision. On the other hand, the partners in the adjustment year would benefit from the favorable adjustment without bearing any of the cost of the unfavorable adjustment.

Therefore, this problem is like the outside basis problem. If a partnership omits or mischaracterizes $10 of income that it allocates (or should have allocated) to Stella and she sells her partnership interest before the adjustment year, a typical indemnity would result in Stella paying tax on $20 of income, and the buyer would be allowed to omit $10 of income (for example, through a $10 increase in outside basis, a $10 reduction in income reported in the adjustment year, or a $10 increase in loss reported in the adjustment year) without bearing any economic expense relating to the adjustment.

Making matters worse, the scope of this problem is broad. Many adjustments will be treated as two separate adjustments, with the favorable adjustment being taken into account through a true-up adjustment, instead of offsetting the unfavorable adjustment. Consider a

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[16]Proposed regulations provide that the true-up adjustment would be allocated in the manner that it would have been allocated had it been made on the return for the reviewed year. Prop. reg. section 1.704-1(b)(4)(xiii).

partnership's sale of multiple assets. The purchase price allocation will often affect a partner's tax liability. If the IRS changes the allocation, there would generally be at least one positive adjustment and one negative adjustment, where the negative adjustment generally would not offset the positive adjustment or reduce the imputed underpayment. The positive adjustment (the unfavorable one) would generally be fully taxed, and the negative adjustment (the favorable one) would generally be taken into account through a true-up adjustment in the adjustment year.

For example, a partnership might sell land (a section 1231 asset) and a building (a section 1231 asset that would have unrecaptured section 1250 gain if it were sold at a gain). If the IRS determines that the partnership allocated $1 million too much of the proceeds to the land (thereby overstating section 1231 gain by $1 million) and $1 million too little to the building (thereby understating unrecaptured section 1250 gain by $1 million), the favorable adjustment (the reduction in section 1231 gain) won't reduce the imputed underpayment. Instead, the partnership will pay tax on the $1 million of unrecaptured section 1250 gain that was omitted and will omit $1 million of section 1231 gain (or report an additional $1 million of section 1231 loss) in the adjustment year.

The same issue may arise when a partnership reports income or loss in the wrong year. The grouping rules don't allow a favorable adjustment from one tax year to offset an unfavorable adjustment from a different tax year.[17] Therefore, if a partnership reported $10 of income in the wrong tax year, it would have to pay an imputed underpayment for the year in which $10 of income was omitted, even though it reported $10 too much income – the same type of income – in a different tax year.

One challenge in thinking through the implications of the grouping rules is that they must be applied without taking into account any partner-specific information. Thus, the grouping rules take into account any special preferences or limitations that might apply to any person, regardless of whether they apply to any of the actual partners. For example, if a partnership is engaged in what might be treated as more than one activity under the at-risk rules, an increase in income in one activity cannot be offset by a decrease in income in a different activity, even if all of the partners are publicly traded corporations that aren't subject to the at-risk rules. Similarly, the grouping rules would take into account whether a capital asset has been held for more than one but less than three years, regardless of whether it has any direct or indirect partners that hold an applicable partnership interest under section 1061.

**Mitigation Strategies**

Under the BBA's default rule, there are two ways in which a partner who leaves the partnership before the adjustment year might be double taxed if she agrees to indemnify the

[17] Reg. section 301.6225-1(e)(2).

partnership for her share of an imputed underpayment. First, if income was omitted, the former partner cannot increase her outside basis to reflect the adjustment. Second, if income was mischaracterized or otherwise part of a two-legged adjustment, the former partner bears the cost of the unfavorable adjustment without receiving any benefit from the tax she already paid on that income. There is no simple solution for this problem.

One approach that a partner might want to consider when leaving a partnership is to have her indemnity be reduced by the value of any associated tax benefit that the adjustment-year partners receive. This strategy may be difficult to apply to outside basis adjustments, because those will generally be difficult to value. This approach might, however, be viable for two-legged adjustments where the adjustment-year partners receive a tax benefit from a true-up adjustment in the adjustment year.

Another approach that a selling partner should consider is to avoid having the default rule apply to her share of partnership adjustments. The BBA provides a long menu of alternatives for how an adjustment might be taken into account, and some of these alternatives allow the reviewed-year partner to take her share of adjustments into account, instead of having the partnership pay the imputed underpayment. These alternatives include the amended-return and the pull-in modification rules of section 6225(c)(2) and the section 6226 push-out election. The partnership might not be willing to rely on these other methods and forgo an indemnity, but the partnership might be amenable to limiting a partner’s indemnity so that it applies only if the partner has first been given a reasonable opportunity to take her share of adjustments into account under one of the other methods.