The Honorable John A. Koskinen  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20024  

Re: Comments Regarding Capital Accounts and Basis with Respect to Proposed Regulations Implementing the Partnership Audit Procedures Enacted as Part of the Bipartisan Budget Act of 2015  

Dear Commissioner Koskinen:  

Enclosed please find comments concerning capital accounts and basis with respect to the proposed regulations implementing the partnership audit procedures enacted as part of the Bipartisan Budget Act of 2015 (“Comments”). These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.  

The Section of Taxation will be pleased to discuss the Comments with you or your staff if that would be helpful.  

Sincerely,  

Karen L. Hawkins  
Chair, Section of Taxation  

Enclosure  

cc: William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service  
Drita Tonuzi, Deputy Chief Counsel (Operations), Internal Revenue Service  
Kathryn Zuba, Associate Chief Counsel (Procedure & Administration), Internal Revenue Service  
John Moriarty, Acting Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service  
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Dana L. Trier, Deputy Assistant Secretary (Tax Policy), Department of the Treasury  
Thomas West, Tax Legislative Counsel, Department of the Treasury
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Terence Floyd Cuff and Michael Hirschfeld of the Section’s Partnerships & LLCs Committee (the “Committee”). Substantive comments were provided by Lynn Fowler, Monica Gianni, Laura Luko, Hannah Smith, Kristen Hazel, Kathleen Saunders Gregor, Maurice Holloway, and Noel P. Brock. These Comments were reviewed by Noel P. Brock, Committee Chair, Adam M. Cohen, the Section’s Council Director for the Committee, Michael J. Desmond, on behalf of the Section’s Committee on Government Submissions, and William H. Caudill, the Section’s Immediate Past Chair.

Although many of the members of the Section who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 20, 2017
COMMENTS REGARDING CAPITAL ACCOUNTS AND BASIS WITH RESPECT TO PROPOSED REGULATIONS IMPLEMENTING THE PARTNERSHIP AUDIT PROCEDURES ENACTED AS PART OF THE BIPARTISAN BUDGET ACT OF 2015

I. INTRODUCTION

The Bipartisan Budget Act of 2015\(^1\) (the “BBA”) (as modified by the Protecting Americans from Tax Hikes Act of 2015\(^2\) (the “PATH Act”) adopted a new centralized regime through which the Internal Revenue Service (the “Service”) will audit partnerships. The BBA repeals the partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982\(^3\) (“TEFRA”) and the electing large partnership regimes of subchapter D\(^4\) and replaces them with a new set of rules for partnership audits and judicial review of partnership and audit adjustments, which we refer to herein as the “BBA Regime.”

Under the BBA Regime, “[a]ny adjustment to items of income, gain, loss, deduction, or credit of a partnership . . . (and any partner’s distributive share thereof) shall be determined . . . at the partnership level.”\(^5\) Pursuant to the BBA, the changes generally apply to partnership taxable years beginning after December 31, 2017.\(^6\) The BBA establishes a new default rule under which the Service assesses and collects certain taxes from the partnership.\(^7\) The BBA allows a partnership and its partners to take various steps to alter the outcome under the default rule, which can include modifying the amount due from the partnership or utilizing alternative procedures to collect the tax due from the partners.\(^8\) In this regard, the BBA instructs the Department of the Treasury (the “Treasury”) to establish procedures to implement these modifications and alternatives.

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\(^4\) Unless otherwise stated herein, all “section,” “subchapter,” “chapter” or “subtitle” references are to the Internal Revenue Code of 1986, as amended, including as amended by the BBA and the PATH Act (the “Code” or “I.R.C.”).
\(^5\) I.R.C. § 6221(a).
\(^7\) I.R.C. § 6221(a).
\(^8\) I.R.C. §§ 6225 and 6226.
The BBA includes several provisions that instruct the Treasury and the Service to provide further guidance. In Notice 2016-23, the Service requested comments on many issues, including those identified in the BBA. We previously submitted comments ("Prior Comments") on the statutory provisions and items referenced in Notice 2016-23.9

On June 14, 2017, the Treasury and the Service published in the Federal Register proposed regulations (REG-136118-15) providing detail on the implementation of the BBA Regime (the “Proposed Regulations”).10 The American Bar Association Section of Taxation, Administrative Practice Committee submitted comments addressing certain provisions of the Proposed Regulations ("2017 Administrative Practice Comments").11 The Proposed Regulations reserved Regulation sections 301.6225-4 and 301.6226-4 to address adjustments to partners’ outside bases and capital accounts and the partnership’s bases and book values in property. The Treasury and the Service requested comments with respect to these issues. These Comments address those substantive portions of the Proposed Regulations and offer recommendations for the proposed regulations that will be drafted for those reserved issues.

II. EXECUTIVE SUMMARY

A. Section 6225 Issues

The preamble to the Proposed Regulations states that the Treasury and the Service intend to adopt rules that provide that a partnership that pays an imputed underpayment attributable to an adjustment to an item must allocate such item in the adjustment year to the adjustment-year partners as either exempt income under section 705(a)(1)(B) or a nondeductible expense under section 705(a)(2)(B), as applicable. The preamble requests

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comment on how such adjustments should be allocated. It is our view that the partnership and its partners should be able to decide among themselves how audit adjustments and payment of an imputed underpayment should be allocated, subject to the rules under subchapter K of chapter 1 of subtitle A (“Subchapter K”) that would appropriately prevent any potential abuse.

We believe that the existing rules of Subchapter K can appropriately determine reallocations among partners and address situations where a partner is no longer a partner for determinations of outside basis and capital accounts. Adjustments with respect to an imputed underpayment should be allocated consistently with Proposed Regulation section 301.6225-3(b)(4), which specifies to which partners reallocation adjustments are made where the adjustment does not result in an imputed underpayment. However, flexibility should be provided in both situations, with the overriding principles of Subchapter K determining the proper allocation of adjustments so as to appropriately determine outside basis and capital accounts.

We agree that the Treasury and the Service should provide appropriate rules for adjustments of inside basis and book value of partnership property if the adjustment is “basis derivative.”

B. Section 6226 Issues

The preamble to the Proposed Regulations indicate that the Treasury and the Service have determined that it is appropriate to adjust the adjustment year partners’ outside bases and capital accounts and a partnership’s basis and book value in property when one of those tax attributes is affected by reason of a partnership adjustment. However, the Treasury and the Service acknowledge that a different approach is appropriate because the tax imposed under section 6226 includes the amount by which the tax imposed under chapter 1 would increase attributable to any intervening year. Further, the preamble indicates that the purpose of the partnership adjustments is to create a new, accurate starting point for later taxable years and that a myriad of technical issues arise if adjustments are made to adjustment year partners’ outside bases and capital accounts where the reviewed year partners pay the additional tax under section 6226.
We believe that section 704(b) requires that allocations of partnership income, gain, loss, deduction and credit be made in accordance with that section and the regulations promulgated under that section. We also believe that all adjustments to a partnership’s basis in its property, to capital accounts, to partners’ bases in their partnership interests and to book values of partnership assets need to be made in the reviewed year to ensure that the operative provisions of Subchapter K and the remainder of the Code apply appropriately in the reviewed year and all intervening years.

III. Discussion

A. Section 6225 Issues

The Treasury and the Service have stated an intention to adopt rules that will provide that, when a partnership pays an imputed underpayment, the partnership must allocate that item in the adjustment year to the adjustment-year partners.\(^{12}\) The item would be treated as exempt income under section 705(a)(1)(B) or as a nondeductible expense under section 705(a)(2)(B), as applicable, and would result in changes to outside basis and capital accounts.\(^{13}\) The Treasury and the Service also intend to provide rules for adjustments of inside basis and book value of partnership property if the adjustment is “basis derivative.”\(^{14}\) Proposed Regulation section 301.6225-4 reserves on adjustments to partners’ outside bases and capital accounts, as well as on a partnership’s basis and book value in property.

The preamble to the Proposed Regulations requests comments on whether adjustments should be allocated to partners in accordance with the partnership agreement and the section 704 “substantial economic effect” requirements, or whether partnership adjustments that result in an imputed underpayment should be allocated to partners who bear the expense of the imputed underpayment (i.e., adjustment-year partners that are allocated the section 705(a)(2)(B) expense related to the partnership’s payment of the imputed underpayment).\(^{15}\) As we described in our Prior Comments and for the reasons

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\(^{12}\) 82 Fed. Reg. at 27356.

\(^{13}\) Id.

\(^{14}\) Id.

\(^{15}\) 82 Fed. Reg. at 27357.
set forth in our Prior Comments, we believe that the partnership and its partners should be able to decide among themselves how audit adjustments and payment of the imputed underpayment should be shared and believe that the existing rules under Subchapter K appropriately regulate any potential abuse.\textsuperscript{16} Proposed Regulation section 301.6225-3(c) takes this general approach for the allocation of adjustments that do not result in an imputed underpayment: “The rules under [Subchapter K] with respect to the treatment of partners apply in the case of adjustments taken into account by the partnership.”\textsuperscript{17} A similar statement should be contained in Proposed Regulation section 301.6225-4. Accordingly, we recommend that the regulations clarify that both the allocation of the adjustment and the imputed underpayment should be made in accordance with the partnership agreement, subject to the existing “substantial economic effect” requirements under section 704.

The preamble to the Proposed Regulations also requests comments on whether additional rules are required for adjustments that are reallocated from one partner to another partner, such that allocations would be made only with respect to the partners from and to whom the item was reallocated, as well as rules to address successor partners or circumstances in which the reviewed year partner has received a liquidating distribution and is no longer a partner.\textsuperscript{18} For determinations of outside basis and capital accounts, we believe that the existing rules of Subchapter K can appropriately determine reallocations among partners and address situations where a partner is no longer a partner. We note that Proposed Regulation section 301.6225-3(b)(4) specifies to which partners reallocation adjustments are made where the adjustment does not result in an imputed underpayment. Adjustments that affect an imputed underpayment should be allocated consistently with that Proposed Regulation. However, flexibility should be provided in both situations, with the overriding principles of Subchapter K determining the proper allocation of adjustments, so as to appropriately determine outside basis and capital accounts.

\textsuperscript{16} Supra, note 9, at 45.
\textsuperscript{17} Prop. Reg. § 301.6225-3(c), 82 Fed. Reg. at 27391.
\textsuperscript{18} 82 Fed. Reg. at 27357.
Regarding rules for the partnership’s basis in its property and the book value of partnership property and partners’ bases in their partnership interests and partners’ capital accounts, we agree that the Treasury and the Service should provide appropriate rules. As with adjustments made and to which section 6226 is applicable and as described below, we believe that these adjustments should be made in the reviewed year (after allocating the adjustments among the partners as described above) with appropriate adjustments flowing from those adjustments in the intervening years and with the adjustments being allocated among the partners in accordance with section 704(b) for such years.

C. Section 6226 Issues

No set of Regulations is more important to partnership taxation than the substantial economic effect rules of section 704. These Regulations provide an important part of the tax superstructure for partnership taxation. These extensive rules govern the ability of a partnership agreement to control allocation of partnership income, loss, deduction, gain, and credit.

The operation of the substantial economic effect rules is fundamentally dependent on knowing the reliable book capital account of each partner at the end of each taxable year of the partnership. This requires that correct income and loss allocations for each taxable year be credited or charged to capital accounts at the end of the taxable year in which the economic income or loss occurs.

The capital accounts of the partners at the end of the reviewed year will serve as the basis for the application of substantial economic effect for the immediately following year. The capital accounts of the partners at the end of each partnership taxable year are critical for applying substantial economic effect for the immediately following year. If capital accounts for the reviewed year fail to include audit adjustments and fail properly to express partnership economics, then capital accounts at the end of the reviewed year will provide false guidance for applying substantial economic effect for the immediately following year.

The failure to take audit adjustments to capital accounts into account in the reviewed year likely will result in the improper application of substantial economic effect
in that immediately following year. This failure to take audit adjustments to capital accounts into account in the reviewed year may result in the improper application of the minimum gain chargeback, the partner minimum gain chargeback, and the qualified income offset in the immediately following year. The application of substantial economic effect will be in error until the reviewed-year audit adjustments are made to partner capital accounts. Partners’ interests in the partnership also may be difficult to apply in the absence of reliable capital accounts.

As with section 6225, a partner’s share of any adjustment, penalty, addition to tax, or additional amounts under section 6226 should be determined in accordance with the rules under section 704(b). This requires an analysis of the partnership agreement and partnership economics, and is required by this provision of the statute. Where the allocations in the partnership agreement have substantial economic effect, the allocations in the partnership agreement control a partner’s distributive share of income, gain, loss, deduction or credit. Otherwise, adjustments should be allocated in accordance with partners’ interests in the partnership or section 704(c), as the circumstances may require. We believe that there are various portions of the Proposed Regulations that should be clarified in this respect, including Proposed Regulation section 301.6226-2(f)(1)(i), (ii) and (iii), in addition to reflecting this in a newly proposed regulation under Regulation section 301.6226-4. Further, we believe that Proposed Regulation section 301.6226-3(g), Example 1 should clarify that the allocations of partnership items, including the adjustment to the charitable contributions, are made in a manner that satisfies the “substantial economic effect” rules of section 704(b).

While the preamble to the Proposed Regulations indicate that the Treasury and the Service have determined that it is appropriate to adjust the adjustment year partners’ outside bases and capital accounts and a partnership’s basis and book value in property, we recommend that audit adjustments to capital accounts and bases be made for the reviewed year. We believe that deferring adjustments to the adjustment year or the reporting year will create major disruptions in the operation of the basic tax machinery of Subchapter K. The Treasury and the Service acknowledged in the preamble to the Proposed Regulations that adjustments in the adjustment year raise a myriad of technical issues, and we believe the various issues can be better resolved by making the
adjustments in the reviewed year and making any further adjustments, as necessary, in any intervening years.

We are concerned that deferring audit adjustments to basis and capital accounts to the adjustment year or the reporting year may require substantial amendments to a number of substantive regulations under Subchapter K. In particular, we believe that revisions would be required to regulations addressing partnership allocations under section 704, defining the rules of substantial economic effect and partners’ interests in the partnership, minimum gain and capital accounts. Revisions would also be required to rules that tangentially look to partnership allocations, such as those under section 168 and section 514(c)(9)(C).

The problem is illustrated below in Example 1:

**Example 1.** At January 1, 2020, the balance sheet of Partnership AB (a partnership with a tax year ending December 31, 2020) was as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities + Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>Blackacre</td>
<td>100</td>
</tr>
<tr>
<td>Whiteacre</td>
<td>400</td>
</tr>
<tr>
<td>Total</td>
<td>600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>100</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partner A</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Partner B</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Subtotal Capital</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

The partnership agreement for Partnership AB allocates losses first 100% to A, to the extent of its capital account, and thereafter 100% to B. In 2020, Partnership AB claims a charitable contribution in the amount of $250 with respect to a contribution that purportedly occurs on December 31, 2020. Partnership AB has a $50 capital loss in 2020 but no other transactions in 2020 or 2021. For 2020, A has no capital gains and over $3,000 of capital losses. Under the capital account maintenance rules of Regulation section 1.704-1(b)(2)(ii), $83 of the charitable deduction and $17 of the capital loss claimed on the 2020 partnership return reduces A’s capital account from $100 to zero as of the end of Partnership AB’s 2020 taxable year. On June 30, 2023, the Service issues a FPA to Partnership AB that disallows the charitable contribution for the 2020 tax year on the basis that the contribution did not occur until January 2021. Partnership AB does not
dispute the adjustments. Partnership AB timely files a push-out election under section 6226, but does not receive the adjustment statement until January 2024.

The adjustments to capital accounts might be made in the reviewed year, the adjustment year, or the year in which partners reflect the adjustments on their individual returns under section 6226 (the “reporting year”). Consider each possibility:

(1) If the capital account adjustments attributable to that disallowance do not occur until the reporting year, A will have a zero capital account for Partnership AB’s 2020, 2021, 2022 and 2023 tax year. The allocation of the $83 of the charitable contribution and $17 of the loss, as reported on the return, reduced A’s capital account from $100 to zero. The remaining charitable contribution and capital loss were allocated to B. If Partnership AB had properly reported the charitable contribution in 2021, the entire $50 capital loss in 2020 would have been allocated to A and only $50 of the charitable contribution in 2021 would have been allocated to A, having a significantly different impact on the fisc.

We understand that some have proposed that adjustments to book capital accounts be deferred until the reporting year. This reporting year can be different for different partners, depending on their taxable years in which they receive the adjustment statement from the partnership. This would mean that adjustments to capital accounts for the reviewed year potentially would be made in different reporting years for different partners.

If correcting adjustments to book capital account for income and loss for the reviewed year are not made until the reporting year, the partners’ capital accounts will fail properly to account for partnership economics at the end of the reviewed year and each subsequent intervening year until the reporting year. The Service and the partnership will be applying substantial economic effect during the intervening years under the substantial economic effect rules based on incorrect capital accounts due to the failure to reflect the audit adjustments in the reviewed year. Similarly, provisions such as the minimum gain chargeback, partner minimum gain chargeback, and qualified income offset will not apply properly in the intervening years due to the failure to correct capital accounts in the reviewed year.

Additionally, it is axiomatic that this equation should be true:
Assets = Liabilities + Capital

That equation will not be true in intervening years between the reviewed year and the reporting year if capital account adjustments are not made in the reviewed year. This makes capital accounts inconsistent with correct partnership economics.

While the matter is not free from doubt on account of the applicable Regulations under section 704, it appears to us that the effect of allocation of tax items on partner capital accounts is an important element in applying partners’ interests in the partnership. The application of partners’ interests in the partnership therefore would be substantially altered if partnership adjustments for a reviewed year are not made to partner capital accounts until the reporting year.

(2) Deferring adjustments to the adjustment year would have a similarly inappropriate tax result. The adjustment in 2023 would not appropriately address the allocation of the capital loss from 2020.

(3) If (instead) the adjustment is made in the reviewed year, then partner A would be allocated the $50 capital loss in 2020 by virtue of the charitable contribution not reducing A’s capital account and the charitable contribution can be properly allocated among the partners in accordance with section 704(b) in 2021.

We recommend that audit adjustments to capital accounts and basis should be made to the reviewed-year partners in the reviewed year, even if paying tax on those adjustments is deferred until the reporting year. Audit adjustments to a partnership’s basis in its assets similarly should be made in the reviewed year. Appropriate corresponding adjustments should be made to capital account and tax basis for intervening years between the reviewed year and the adjustment year. The failure to make these adjustments to capital account and tax basis would mean that the partnership audit rules would have inappropriate substantive effects on partnership allocations and other effects under Subchapter K. There is no indication in the legislative history that the partnership audit rules were intended to disrupt or to upset the normal substantive rules of Subchapter K.
Further, it is critical that the adjustments to a partnership’s basis in its property, capital accounts, and partners’ basis in their partnership interests be made in the reviewed year so that the effects of adjustments in intervening years between the reviewed year and the adjustment year are properly implemented. These intervening year adjustments need to be carefully explained. We note that section 6226(b)(2) provides,

The adjustment amounts determined under this paragraph are – .
. . (B) in the case of any taxable year after the taxable year referred to in subparagraph (A) and before the taxable year referred to in paragraph (1), the amount by which the tax imposed under chapter 1 would increase by reason of the adjustment to tax attributes under paragraph (3).\textsuperscript{19}

As a corollary to our recommendation that adjustments to capital accounts be made in the reviewed year rather than in the reporting year, all balance sheet adjustments resulting from a partnership audit should be made for the reviewed year. We can illustrate the problem with an example:

Example 2. Partnership XY paid $30 for Asset in Year 1 and incorrectly deducted the full $30. Partnership XY should have depreciated Asset over three years. Partnership XY should have reported only $10 of depreciation in Year 1. The Service audits Partnership XY and, in Year 3, Partnership XY concedes the error.

For the Service and Partnership XY properly to apply section 6226(b)(2)(B), the basis in Asset needs to be determined for each year. Partnership XY should have a cost basis in Asset in Year 1 of $30. Partnership XY’s basis in Asset in Year 2 should be $30 minus $10 of depreciation from Year 1. Pursuant to section 1016, the partnership’s basis in Year 3 similarly should start with the cost basis and be adjusted by the correct tax depreciation from prior years. Further, if the partnership’s basis in Asset is not corrected in Year 1, then depreciation of Asset in Year 2 and Year 3 will be incorrect. The correct tax depreciation of Asset in Year 2 and Year 3 might be permanently lost if the partnership’s basis in Asset is not corrected in Year 1.

The correct tax depreciation of Asset in Year 2 and Year 3 may be important to other adjustments being made in the audit, capital accounts in Year 2 and Year 3 (which

\textsuperscript{19} I.R.C. §6226(b)(2).
could impact allocations in those years), or various other impacts from other items of income, gain, deduction or loss in these intervening years.

The situation with respect to a partner’s basis in his or her partnership interest is similar to the situation with respect to partners’ capital accounts. Much of the tax apparatus of partnership taxation depends on knowing a partner’s correct basis in his or her partnership interest. This requires that a partner’s basis in his or her partnership interest be maintained on a dynamic day-to-day basis. Allocation adjustments, however, flow through to a partner and affect his or her outside basis in his or her partnership interest at the end of the taxable year.

Failure to adjust a partner’s tax basis in his or her partnership interest currently for partnership adjustments to reviewed-year items will result in distorted and incorrect computation of outside basis for a number of years from the reviewed year through the year preceding the adjustment year.

Much of the machinery of Subchapter K depends on timely adjustment to a partner’s adjusted tax basis in his or her partnership interest. The failure of the partnership to take into account audit adjustments in computing a partner’s basis in his or her partnership interest in the reviewed year and thereafter creates difficult problems under a number of Code provisions. A partner’s basis in his or her partnership interest is important for calculating gain or loss on sale of a partnership interest, for determining gain on a partnership distribution of money to a partner, for determining a partner’s loss on the liquidation of the partner’s partnership interest, for determining the basis of distributed property when a partnership distributes partnership property to a partner, for determining losses of the partnership that the partner can deduct on his or her individual tax return, for determining the operation of the collapsible partnership rules of section 751, and for determining basis adjustments under section 734 and section 743.

Another example, involving a misallocation scenario, can demonstrate why adjustments to basis in the reviewed year are critical:

Example 3. Partnership MN allocated $100 too much income to Partner A for Year 1; for this purpose, assume this is all ordinary income. This is simply an error by the partnership or its tax return preparer in recording the income allocable to A and not a misallocation of income from another Partner to Partner A. As a result, Partner A pays
too much tax for Year 1 and no other Partner is affected. In Year 3, the Service discovers the error on audit and reduces Partner A's allocation for Year 1 and Partnership MN concedes the adjustment and the adjustment becomes final.

Partnership MN makes an election under section 6226. Partner A will receive no remedy under section 6226. Partner A, however, should have increased its capital account by $100 in Year 1, and Partner A also should have increased its tax basis in its partnership interest by $100 in Year 1 since that was reflected on the K-1 issued to Partner A.

In the meantime, if Partnership MN redeemed Partner A's partnership interest in Year 2, then the gain reported by Partner A is $100 less than what it should have been if there never was a misallocation in Year 1. To compound the errors, Partner A incorrectly reported $100 ordinary income in Year 1 and, in Year 2, Partner A did not report a matching $100 income (or overstated a loss on sale by $100), which would be taxable as capital gain unless the section 751 hot assets rule applies.

In this case, Partner A should file an amended return for Year 1 so as to recover the taxes paid on $100 of ordinary income and also file an amended return for Year 2 reporting an added $100 gain on sale (or a loss reduced by $100 or if the original loss was less than $100, eliminate the loss and report gain for the excess). If the Partnership did not redeem Partner A's interest, then Partner A should just file an amended return for Year 1 requesting a refund.