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Unexpected Coordination: Partnership Audit Rules and Specific IRS Forms

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In this article, the authors examine income tax form instructions for partnerships and demonstrate how taking into account prior-year adjustments under the Bipartisan Budget Act of 2015 in accordance with those instructions can lead to surprising outcomes.

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The partnership audit rules enacted by the Bipartisan Budget Act of 2015 have significantly altered how partners report and pay tax on both IRS-initiated and partnership-initiated adjustments to prior-year partnership-related items. Under the BBA, partners generally take into account prior-year adjustments by determining the chapter 1 tax increase or decrease that results from those adjustments and by reporting that increase or decrease on the partner's current-year income tax return. The instructions to various income tax forms prescribe how partners should reflect this tax increase or use the tax decrease, as applicable, when determining the income tax for the current year.

This article explores the form instructions to demonstrate how taking into account prior-year BBA adjustments in accordance with the instructions can lead to surprising outcomes. It provides a background for the BBA rules, examines the statutory and regulatory requirements for making BBA adjustments, and then focuses on the alternative minimum tax and explains how the instructions for computing AMT interact with the BBA reporting rules. It also explores the rules for using income tax credits and explains how the form instructions establish an ordering framework for applying amounts determined under the BBA when using those credits.

I. Background

To understand the interaction between the BBA rules and general income tax principles, it is necessary to first understand how partnerships and partners take adjustments into account under the BBA regime. The BBA fundamentally changes how tax related to partnership adjustments is assessed and collected by the IRS. In general, any tax attributable to an adjustment to a partnership-related item must be assessed and collected at the partnership level, unless the partnership elects for its partners to take into account the adjustments and pay any resulting tax or obtain any resulting benefit. A partnership that elects to push out the adjustments to its reviewed-year partners (that is, the persons who were partners during the tax year subject to adjustment), must furnish a Form 8986, "Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Required Under Sections 6226 and 6227)," to each reviewed-year partner.[1] Similar to an amended Schedule K-1, the Form

[1] Reg. sections 301.6226-3(a), 301.6227-3(a). The reviewed-year partners are the persons who were partners during the tax year subject to adjustment. *See* reg. section 301.6241-1(a)(9).

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8986 reflects the partner's share of the adjustments for the reviewed year. A partner other than a passthrough partner[2] (a non-passthrough partner) that receives a Form 8986 must "take into account" the Form 8986 adjustments on the partner's income tax return for the reporting year.[3]

Section 6226(b) sets forth rules for how the Form 8986 adjustments are taken into account by partners. Section 6226(b)(1) provides in the case of a non-passthrough partner "each partner's tax imposed by chapter 1" (generally "chapter 1 tax") for the reporting year "shall be adjusted by the aggregate of the correction amounts." The "aggregate of the correction amounts" effectively is the sum of the increases and decreases to a partner's income tax for each of tax years affected by the adjustments. The regulations refer to this amount as the "additional reporting year tax." Under the regulations, a partner's chapter 1 tax for the reporting year "is increased by the additional reporting year tax, or if the additional reporting year tax is less than zero, decreased by such amount."[4]

As described below, the instructions to various IRS forms provide more specificity regarding how a partner reflects the additional reporting-year tax on their reporting-year return, including how the additional reporting-year tax factors into the computation of AMT for individuals and affects the application of credits that are applied against tax imposed by chapter 1. We take a look at those instructions, first those to Form 6251, "Alternative Minimum Tax — Individuals," for calculating AMT, then the credit ordering rules in Form 3800, "General Business Credit," and Form 1116, "Foreign Tax Credit."

II. AMT Statutory Provisions

Individual partners may be liable for the AMT imposed by section 55 depending on their AMT preference items and the amount of their AMT income. Section 55(a) provides that in the case of an individual taxpayer, "there is hereby imposed (in addition to any other tax imposed by [subtitle A]) a tax equal to the excess (if any) of (1) the tentative minimum tax for the taxable year, over (2) the regular tax for the taxable year."

Section 55(b) provides a specific formula for determining "tentative minimum tax." First, alternative minimum taxable income (AMTI) is calculated by eliminating or reducing certain exclusions and deductions from taxable income and taking into account differences regarding when certain items are used to compute regular taxable income and AMTI (that is, certain items with differences between taxable income and AMTI, commonly referred to as "AMT preference items"). Second, specified AMT tax rates are applied against a certain amount of AMTI depending on how much of the AMTI exceeds a certain threshold. The result of that computation may then be reduced by any AMT foreign tax credit. The net result is tentative minimum tax (TMT).

Once TMT is determined, it is necessary to determine the individual's regular tax. For purposes of section 55, the term "regular tax" means the "regular tax liability for the taxable year (as defined in section 26(b))" reduced by the FTC allowable under section 27(a).[5] Section 26(b) defines "regular tax liability" as "the tax imposed by [chapter 1]" for the tax year. Section 26(b)(2) excludes certain taxes from the definition of regular tax liability and provides that such taxes "shall not be treated as tax imposed by [chapter 1]."

III. Form 6251 Instructions

Form 6251 is used by an individual taxpayer to figure the individual's amount, if any, of AMT. The individual first computes AMTI on Part I of the form, and that AMTI is then used in Part II to

[2] A passthrough partner includes partnerships, S corporations, estates, and certain trusts but not wholly owned entities that are disregarded as separate from their owners for federal income tax purposes.

[3] Section 6226(a); reg. section 301.6227-2(b)(3)(ii). The partner's reporting year is the tax year that includes the date on which the Form 8986 is furnished by the partnership that files the administrative adjustment request or by the audited partnership to its direct partners. The date is reported on Form 8986, Part II, item G. For example, if a partnership filed an AAR and furnished to its direct partners Forms 8986 on Dec. 31, 2023, any direct or indirect non-passthrough calendar-year partner must take the adjustments into account on their 2023 tax return.

[4] Reg. section 301.6226-3(a).

[5] Section 55(c) also provides that the term "regular tax" will not include any increase in tax under sections 45(e)(11)(C), 49(b), or 50(a), or subsection (j) or (k) of section 42.

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calculate TMT, which is then compared with regular tax liability to determine if the individual is liable for AMT.

On line 10 of the form, the individual reports regular tax liability by entering the amount of tax reported on Form 1040, line 16.[6] The line 10 instructions on the face of the form indicate that the Form 1040, line 16 amount should be reduced by any FTC and by any net decrease in tax reported on Form 8978, line 14 (treating that negative amount as a positive number).[7]

Form 8978, "Partner's Additional Reporting Year Tax," is used by a partner to report the partner's additional reporting-year tax. The partner computes correction amounts for each affected year and totals the additional reporting-year tax on Form 8978, line 14. Despite its name, the "additional" reporting-year tax may be a positive or negative amount depending on whether the overall change in income tax is an increase or a decrease.

When the additional reporting-year tax is negative, the Form 6251 instructions say to reduce regular tax liability by that amount. The instructions do not require a similar reduction to TMT. By adjusting only the regular tax downward and leaving TMT as originally calculated, the instructions to Form 6251 effectively create a preference item for the additional reporting-year tax.

Example 1: Net decrease in tax. Assume that an individual taxpayer has $200 million of taxable income, $50 million net decrease in tax from Form 8978, and AMTI equal to taxable income (that is, no AMT preference items).

Table 1. Example 1: Computation of AMT Under Form 6251 Instructions

Regular tax before applying decrease in tax:	$74 million ($200 million * 37% highest marginal tax rate)
Form 8978 net decrease in tax:	($50 million)
Adjusted regular tax:	$24 million
Note: For simplicity, examples 1 and 2 assume the highest marginal tax rate applies.	

The taxpayer's TMT is $56 million (that is, $200 million * 28 percent, the specified statutory rate).[8] If we follow the Form 6251 instructions, the taxpayer's TMT is not decreased by the Form 8978 net decrease in tax. As a result, because the taxpayer's TMT ($56 million) is greater than her "adjusted" regular tax ($24 million), the taxpayer now has an AMT liability of $32 million. The taxpayer's new total chapter 1 tax is $106 million (that is, $74 million regular tax + $32 million AMT). This chapter 1 tax is then reduced by the Form 8978 net decrease in tax of $50 million, resulting in total tax of $56 million (that is, $106 million - $50 million). This results in a net tax reduction of $18 million ($74 million original regular tax - $56 million new total tax).

If the Form 8978 net decrease in tax were instead excluded from the calculation of regular tax, the taxpayer's regular tax would remain $74 million. Because the taxpayer's TMT is $56 million, the taxpayer would not be subject to AMT as the TMT would be less than the regular tax. The taxpayer's total chapter 1 tax would be $74 million. This chapter 1 tax would then reduced by the Form 8978 net decrease in tax of $50 million, resulting in total tax of $24 million.

Thus, by including the Form 8978 net decrease in tax in the calculation of regular tax, the form instructions subject the taxpayer to AMT and a higher overall chapter 1 tax liability than would otherwise result had the Form 8978 net decrease in tax been excluded from the calculation. Put differently, if, for purposes of computing AMT, the additional reporting-year tax is excluded from the regular tax calculation, the taxpayer in this example would not be subject to an AMT liability.

[6] All references to line numbers relate to the 2023 tax year forms and could change in later tax years.

[7] A net increase in tax from Form 8978 is included in regular tax liability by virtue of the additional reporting-year tax being included on Form 1040, line 16 ("Tax"), in the case of an individual, and Form 1120, "U.S. Corporation Income Tax Return," Schedule J ("Tax Computation and Payment"), line 2 ("Income Tax") for a C corporation.

[8] Once AMTI has been computed, the taxpayer generally determines TMT by taking the excess of AMTI over the appropriate exemption amount, applying the AMT tax rates, and subtracting any applicable tax credits. For simplicity, examples 1 and 2 assume the highest specified statutory rate and assume the exemption amount has not been taken into account.

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Example 2: Net increase in tax. Assume that an individual taxpayer has $200 million of taxable income, a $50 million increase in tax from Form 8978, and AMTI equal to taxable income.

Table 2. Example 2: Computation of AMT Under Form 6251 Instructions

Regular tax before applying increase in tax:	$74 million ($200 million * 37% highest marginal tax rate)
Form 8978 increase in tax:	$50 million
Adjusted regular tax:	$124 million
Note: For simplicity, examples 1 and 2 assume the highest marginal tax rate applies.	

The taxpayer's total chapter 1 tax of $74 million is adjusted by the $50 million increase in tax, resulting in total tax of $124 million (that is, $74 million + $50 million).

The taxpayer's TMT is $56 million (that is, $200 million * 28 percent). If we follow the Form 6251 instructions, the Form 8978 net increase in tax does not affect the taxpayer's TMT. As a result, the taxpayer is not subject to AMT because her regular tax ($124 million) exceeds her TMT ($56 million).

Including the Form 8978 increase in tax, however, potentially could cause a taxpayer to not be subject to the AMT to the extent the taxpayer has AMT preference items. For example, if the taxpayer had an AMT preference item that increased her AMTI by $60 million, the taxpayer's TMT would increase by $19.6 million (that is, $60 million * 28 percent) to $75.6 million (that is, $56 million + $19.6 million). In that case, TMT would exceed regular tax (that is, $74 million, without regard to the Form 8978 net increase), and the individual would be subject to AMT in the amount of $1.6 million for a total chapter 1 tax of $125.6 million ($74 million + $1.6 million + $50 million). However, if we adjust regular tax by the Form 8978 net increase, the individual's regular tax increases to an amount greater than TMT and no AMT liability results. In that case, the individual's total chapter 1 tax is $124 million ($74 million + $50 million).

IV. Discussion

In the case in which an individual's regular tax is reduced by a negative additional reporting-year tax (that is, a net decrease in tax), it may cause regular tax to fall below TMT. If that occurs, the individual partner will become subject to AMT, as AMT is the excess of TMT over regular tax. This may occur despite the fact that if the Form 8978 negative amount had not been applied to reduce regular tax, regular tax would have exceeded TMT, and there would be no AMT. Conversely, when an individual's regular tax is increased by a positive additional reporting-year tax (that is, a net increase in tax), it may reduce an individual's AMT liability, or it may take the individual out of AMT all together by causing the individual's regular tax to exceed TMT.

Section 55(c) provides that the term "regular tax" means the regular tax liability reduced by any FTC. Consistent with section 55(c), the Form 6251, line 10 instructions on the face of the form allow for a reduction to "regular tax liability" by the amount of the individual's FTC for the year. Going beyond the statutory language of section 55(c), however, the line 10 instructions then provide for a further reduction by any Form 8978 negative amount.

Query whether the operation of line 10 on Form 6251 reflects the government's view of section 6226(b) and how that section interacts with sections 55(c) and 26(b). As discussed earlier, under section 6226(b) and the regulations, a partner's "tax imposed by chapter 1" may be adjusted downward by a negative additional reporting-year tax or upward by a positive additional reporting-year tax. If the operation of line 10 instructions reflects a view, it may be that the government interprets section 6226(b) to mean that, for purposes of the AMT calculation, regular tax liability — defined by section 26(b) as "tax imposed by [chapter 1]" — must be adjusted by any additional reporting-year tax before being

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compared with TMT.[9] As illustrated in Example 1, this interpretation may lead to an unexpected AMT liability when there is a negative reporting year tax to take into consideration.

AMT imposed under section 55 is by definition a "tax imposed by chapter 1" of the IRC. An alternative reading of the statute is to interpret section 6226(b), in conjunction with section 26(b), to provide that a partner's total tax imposed by chapter 1 is determined before any application of the additional reporting-year tax. Under this interpretation, a partner would first determine the total tax imposed by chapter 1, including AMT, and then adjust that total amount by any additional reporting-year tax. Under this reading, as part of calculating AMT, the partner would not account for the additional reporting-year tax when computing regular tax liability.

V. Credits Applied Against Chapter 1 Tax

The instructions to Forms 1040 and 1120 provide that a negative amount of additional reporting-year tax (a "Form 8978 net decrease") is treated and reported in a manner similar to a nonrefundable credit.[10] No statute or regulation addresses the ordering in which a Form 8978 net decrease ought to be used when a taxpayer has other nonrefundable credits to use in the reporting-year, such as FTCs, general business credits (GBCs), and prior-year AMT credits.

A. Foreign Tax Credit

Section 27 provides the amount of taxes imposed by foreign countries and U.S. possessions "shall be allowed as a credit against the tax imposed by [chapter 1]" to the extent provided in section 901. The regulations under section 901 provide that an FTC is allowed only against tax imposed by chapter 1.[11] The credit is not allowed against a tax that under section 26(b)(2) is not treated as a tax imposed by chapter 1.

A taxpayer generally includes Form 1116 in the case of an individual, and Form 1118, "Foreign Tax Credit — Corporations," in the case of a C corporation, to claim an FTC. A taxpayer's FTC cannot be more than its total U.S. tax liability multiplied by a fraction.[12]

For purposes of determining an individual taxpayer's FTC limit in computing its U.S. tax liability, Form 1116, line 20 (tentative U.S. tax liability) adjusts the tax reported on Form 1040, line 16 to take into account any Form 8978 net decrease in tax.[13] An increase in additional reporting-year tax would increase the FTC limitation, and a decrease in additional reporting-year tax would correspondingly decrease the FTC limitation. If, because of the limit on the credit, a taxpayer cannot use the full amount of qualified foreign taxes paid or accrued, it is allowed a one-year carryback and then a 10-year carryover of unused foreign taxes.[14] As a result, in the case of a decrease in additional reporting-year tax, the ordering imposed by the form instructions effectively prioritizes the use of a decrease in additional reporting-year tax and generally preserves a taxpayer's FTC. Curiously, however, the Form 1118 instructions do not appear to include a similar instruction for corporate taxpayers.

B. General Business Credit

Section 38 allows for a GBC "against the tax imposed by [chapter 1]" for the tax year.[15] Section 38(c) generally limits the allowable credit to the excess, if any, of the taxpayer's "net income tax"

[9] A recent IRS email chief counsel advice addresses the interaction between the additional reporting-year tax and the general business credit reported on Form 3800. *See* ECC 202346026. The guidance appears to reflect the government's view that any additional reporting-year tax, whether positive or negative, is itself "part of" chapter 1 tax. However, that conclusion does not address per se when the additional reporting-year tax should be applied in the calculation of current-year chapter 1 tax.

[10] A Form 8978 net decrease can be used by an individual partner to reduce the partner's reporting-year income tax liability to zero. *See* Treasury, "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals" (Mar. 2024) (2025 green book). The 2025 green book states that "any excess of [the Form 8978 net decrease] not offset with an income tax due in the reporting year at the partner level does not result in an overpayment that can be refunded. The excess amount cannot be carried forward and is permanently lost." The proposal in the 2025 green book would amend sections 6226 and 6401 to provide that the amount of the Form 8978 net decrease that exceeds the income tax liability of a partner is considered an overpayment under section 6401 and may be refunded.

[11] Reg. section 1.901-1(f).

[12] Section 904(a).

[13] However, if there is a net increase in tax as a result of BBA adjustments, an adjustment is not needed because it is already added to the tax reported on Form 1040, line 16.

[14] Section 904(c).

[15] Section 38(a).

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over the greater of the TMT for the tax year, or 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000.[16] The term "net income tax" means the sum of the regular tax liability (as defined in section 26(b)) and the tax imposed by section 55 (that is, AMT), reduced by certain credits, including the FTC.[17]

Consistent with this statutory framework, the instructions to Form 3800 provide that a GBC is allowed only after any available FTCs are used (that is, after considering the FTC limitation rules under section 904). Like the instructions to Form 1116, the Form 3800 instructions effectively apply any Form 8978 net decrease in tax to reduce regular tax liability before determining the allowable amount of GBC for the tax year.[18]

The instructions to forms 1116 and 3800 create a de facto ordering framework whereby a Form 8978 net increase or decrease is applied first to adjust regular tax liability before applying any FTC or GBC. Under this framework, a Form 8978 net increase results in a taxpayer needing to use more FTC or GBC, and a Form 8978 net decrease results in a taxpayer having less capacity to use FTC or GBC (with the attendant result of having more FTC or GBC to carry back or carry forward). It is unclear from the instructions on what basis this ordering framework was determined to reflect the proper application of these various code sections.

Example 3: Ordering framework. Assume that a corporate taxpayer has $100 million of taxable income, $20 million decrease in tax from Form 8978, and $10 million GBC.

Table 3. Example 3: Applying Form 8978 Net Decrease in Tax Before GBC

Regular tax before application of Form 8978 net decrease in tax:	$21 million ($100 million * 21% highest marginal tax rate)
Form 8978 net decrease in tax:	($20 million)
Income tax before application of GBC:	$1 million
GBC:	($1 million)
Total tax:	$0
GBC carryforward:	$9 million

As noted, the Form 3800 instructions provide that the Form 8978 net decrease should be applied before the GBC. Unlike the GBC, which may be carried back and forward to the extent not used in the current year, the IRS's view is that any amount of the Form 8978 net decrease that is not used cannot be carried back or forward and therefore is permanently lost. For instance, if instead in the example above, the Form 8978 net decrease were applied after the GBC, the full amount of GBC would be used and only $11 million of the Form 8978 net decrease could be used, leaving a lost benefit of $9 million.[19]

Table 4. Example 3: Applying GBC Before Form 8978 Net Decrease in Tax

Regular tax before application of GBC:	$21 million ($100 million * 21% highest marginal tax rate)
GBC:	($10 million)
Income tax before application of Form 8978 net decrease in tax:	$11 million
Form 8978 net decrease in tax:	($11 million)
Total tax:	$0
GBC carryforward:	$0
Lost Form 8978 net decrease:	$9 million

[16] Section 38(c). The allowable amount can depend on the type of credit and the type of taxpayer claiming the credit. *See* section 38(c)(2)-(6).

[17] Section 38(c) flush language.

[18] The Form 8978 net decrease (which is taken into account in the amount on Form 1040, Schedule 3, line 7 and Form 1120, Schedule J, line 6) flows to Form 3800, line 10b, which, in turn, affects the amount of net regular tax on line 12, which, in turn, affects the determination of the GBC on Form 3800. *See also* ECC 202346026.

[19] *See* American Bar Association Tax Section, "Comments on the BBA Stranded Overpayment Problem" (Mar. 24, 2021).

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VI. Conclusion

Neither the code nor the regulations address how to coordinate the additional reporting-year tax, whether positive or negative, or as a result of a partnership audit or an AAR with the statutory provisions for calculating income tax imposed by chapter 1. However, the instructions for forms 6251, 1116, and 3800 create a reporting framework that in certain cases may produce possibly helpful results (for example, by applying a Form 8978 net decrease before other credits) and in other cases can produce unfavorable and unexpected results (for example, an AMT liability that might not otherwise exist). No matter which side of the coin one ends up on, the absence of clear rules creates uncertainty for taxpayers and tax return preparers.[20] ■

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