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June 6, 2016

The Honorable John A. Koskinen
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The Honorable William J. Wilkins
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The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Comments on Bipartisan Budget Act of 2015 Partnership Audit Procedures

Dear Messrs. Koskinen, Wilkins, and Mazur:

Enclosed please find comments on the new 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 would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: Hon. Orrin G. Hatch, Chairman, U.S. Senate Committee on Finance
Hon. Ron Wyden, Ranking Member, U.S. Senate Committee on Finance
Hon. Kevin Brady, Chairman, U.S. House Committee on Ways & Means
Hon. Sander M. Levin, Ranking Member, U.S. House Committee on Ways & Means

Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

NEW PARTNERSHIP AUDIT PROCEDURES ENACTED AS PART OF THE BIPARTISAN BUDGET ACT OF 2015

These comments ("Comments") are submitted on behalf of the Section of Taxation of the American Bar Association ("ABA") and represent the position of the ABA Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the ABA. These comments accordingly, should not be construed as representing the policy of the ABA. These comments concern proposals for reforming the administration of tax law affecting partnerships.

Principal responsibility for preparing and reviewing these Comments was exercised by George Hani and Jennifer Breen of the Section's Administrative Practice Committee (the "Committee"). Substantive comments were provided by Jeremiah Coder, Sheri Dillon, Tom Greenaway, Kathleen Gregor, Andrew Howlett, Kevin Johnson, Clint Massengill, James Malone, Michael Mendelevich, Mary McNulty, Lee Meyercord, Ariella Mutchler, Jennifer O'Leary, Andrew Penman, Mary Slonina, Fred Witt, and Daniel Zuckerman of the Committee, by Noel Brock, Sarah Ritchey, and Jennifer Alexander of the Partnerships & LLCs Committee, and by Charles Ruchelman and Elizabeth Stevens of the Section's Court Procedure and Practice Committee. These Comments were reviewed by Megan L. Brackney, the Section's Council Director for the Committee, Mary McNulty, on behalf of the Committee on Government Submissions, and Peter H. Blessing, the Section's Vice Chair (Government Relations).

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 herein or who 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: June 6, 2016

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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")) makes fundamental changes in how the Internal Revenue Service ("Service") will conduct audits of partnerships. The BBA repeals the partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982[3] ("TEFRA") and electing large partnership ("ELP") regimes and replaces them with a new set of rules for partnership audits and judicial review of partnership audit adjustments, which we refer to herein as the "new centralized partnership audit regime."

Section 6621(a) provides that "[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."[4] Under TEFRA, the additional tax due as the result of adjustments to the partnership's return was assessed and collected from the partners. Observers often cited the administrative and computational complexity of assessing and collecting from the individual partners under TEFRA as a reason for the low audit rates of partnerships.[5] The BBA establishes

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[1] Pub. L. No. 114-74, 129 Stat. 584.

[2] Pub. L. No. 114-113, § 411, __ Stat. __.

[3] Pub. L. No. 97-248, 96 Stat. 324.

[4] Section 6221(a). Unless otherwise indicated, all section references are to the Internal Revenue Code as amended by the BBA and the PATH Act (the "Code" or "I.R.C."). Pursuant to § 1101(g)(1), 129 Stat. at 638, of the BBA, the changes generally apply to partnership taxable years beginning after December 31, 2017.

[5] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure That Procedures Are Followed During Partnership Audits Subject to the Tax Equity and Fiscal Responsibility Act of 1982*, Reference Number 2014-30-082 (Sept. 26, 2014), https://www.treasury.gov/tigta/auditreports/2014reports/201430082fr.html; United States Government Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732 (Sept. 2014).

the new default rule that the Service can assess and collect from the partnership: "any tax attributable [to such adjustment] shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to [such adjustment] . . . at the partnership level."[6]

Under the BBA, the amount that can be assessed and collected from the partnership is defined as the "imputed underpayment," which is the net amount derived from all adjustments multiplied by the highest rate from section 1 (tax rates for individuals) or section 11 (tax rates for corporations). The partnership's liability for the imputed underpayment is in the "adjustment year," which generally is the year in which any adjustments are finalized.[7] The BBA instructs the Treasury to establish procedures to allow a partnership to reduce the amount of the imputed underpayment.[8]

In addition, the partnership may elect to eliminate its own liability by issuing information statements to its "reviewed year" partners, which were the partners during the year under audit.[9] Certain partnerships with 100 or fewer partners may elect out entirely of this new audit regime, and instead be subject to the non-TEFRA audit rules currently in place.

The new centralized audit regime is generally effective for audits of partnership returns for tax years beginning after December 31, 2017, although partnerships may elect to have certain

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[6] I.R.C. § 6221(a).

[7] I.R.C. § 6225(a)(1).

[8] I.R.C. § 6225(c).

[9] I.R.C. § 6226(a).

aspects of the new rules apply to audits of returns for tax years beginning after November 2, 2015.[10]

The new centralized partnership audit regime is a significant change from the TEFRA regime. Never before has a federal income tax been assessed and collected at the partnership level, and determining how that will happen requires the Service and the Treasury to issue extensive guidance. The BBA itself identifies particular areas for which guidance is needed, such as procedures for the time and manner of various elections and procedures for a partnership to request reductions to the imputed underpayment amount based on the tax posture of its partners. In Notice 2016-23,[11] the Service requested comments on many issues, including those specifically referenced in the BBA as well as others, such as the parameters of the Service's ability to designate a representative of the partnership when the partnership itself fails to do so.

We recognize that promulgating guidance with respect to these new partnership audit rules is an enormous undertaking for the Service. We further appreciate the Service and Treasury's awareness of the need for guidance and their outreach to tax practitioners for comments on the implementation of the new partnership audit regime. We believe such a cooperative effort will further the effective and efficient administration of the new centralized partnership audit regime.

We provide the comments below in response to the items in the BBA and Notice 2016-23.[12] In providing these comments, we are mindful of the motivation behind the legislation,

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[10] BBA § 1101(g)(4).

[11] 2016-12 I.R.B. 490 (Mar. 28, 2016).

[12] These Comments address the uncertainties that could be addressed through regulations or other guidance issued by Treasury and the Service. We expect to communicate directly with Congressional staff regarding clarifications or changes that would need to be addressed through legislation.

namely to assist the Service in the assessment and collection of tax due stemming from adjustments to partnership returns. The complex rules designed to ensure that the precise amount of tax due from each partner was computed properly made TEFRA difficult to administer. The new audit rules keep partnership-level audits and adjustments but institute a new assessment and collection regime reflective of a desire for administrative practicability (or "rough justice"). The imputed underpayment is inherently overstated, as it is calculated using the highest rates, but the new regime affords partnerships the ability to ameliorate the unfairness of the overstated amount through various means. Thus, for example and as reflected in the comments below, we view the potential for modifications of the imputed amount to be only reductions to that amount. The dynamic we envision under the new centralized partnership audit regime is that, once the Service proposes its audit adjustments, the partnership must decide whether the additional burden to seek the amelioration is worth the tax savings that will result.

In these comments, we also embrace the notion of practical administration so long as it is balanced such that, to the extent precision is sacrificed, it will not cause "rough justice" always to favor one side or the other. Furthermore, the TEFRA regime introduced complexity in an effort to achieve "fairness" with precision. That complexity made the TEFRA rules difficult to administer and ultimately led to their repeal. Accordingly, our comments encourage rules that are simple for taxpayers to follow and for the Service to administer.

II. **EXECUTIVE SUMMARY**

The following is a brief summary of our comments and recommendations:

A. Election into Early Application of New Centralized Partnership Audit Regime

- Adopt flexible rules, given the newness of the BBA and the issuance of forthcoming guidance in multiple stages.
- Permit the election in to be made with the original return or later.

- For partnerships that would not otherwise be subject to TEFRA, permit the election in to be made before any of the partners are notified of an audit for the applicable tax year.
- For partnerships that would otherwise be subject to TEFRA, permit the election in to be made up to 45 days after the partnership has been selected for audit.
- Permit the election in to be made by filing a simple statement with the Service that includes the partnership's name, the Partnership Representative's name, a reference to the election in allowed by section 1101(g)(4) of the BBA, and the tax year involved.
- If the election is made other than with the filing of the original return, require the statement to include a copy of the first page of the return and confirmation of electronic filing or some other documentation to correlate the election with the return to be audited.
- Clarify whether the section 6226 election is available to partnerships that elect into the early application of the new centralized partnership audit regime.

B. <u>Election to Opt Out of New Centralized Partnership Audit Regime</u>

- In the case of a partner that is a disregarded entity, look through the disregarded entity for purposes of determining the number of Schedules K-1 issued and the type of partner.
- Allow first-tier partnerships that satisfy the S Corporation ownership limitations found in section 1361(b)(1)(B) to be treated as eligible partners for purposes of the election; all other partnerships should be treated as ineligible partners.
- Count the Schedules K-1 issued by any partnership determined to be an eligible partner in the total number of Schedules K-1 used for purposes of determining the 100-partner limitation in section 6221(b)(1)(B).
- Treat a grantor trust that is owned by a single person who is otherwise an eligible partner as an eligible partner.
- Address issues that arise when an eligible partner dies, in a manner similar to the S corporation rules.
- Use section 1361(c)(6) as a model so that tax-exempt organizations described in sections 401(a) and 501(c)(3) that are exempt from taxation under section 501(a) (which may be shareholders of an S corporation) are treated as eligible partners.
- In the case of a nominee owner, look through the nominee to the beneficial owner to determine whether the partner is eligible.
- Reference the entity classification regulations under section 7701 with respect to foreign entities so that entities treated as corporations under those rules are treated as eligible partners.
- In the case of a partner that is an S corporation, ignore the Schedule K-1 issued to the S corporation and count only the Schedules K-1 issued to the S corporation

owners for purposes of the limit of 100 or fewer Schedules K-1 in section 6221(b)(1)(B).

- Require the election to be made with the original return (timely filed, including extensions).
- Require notice of the election to be included with the Schedule K-1 that is delivered to the partners.
- Aggregate multiple Schedules K-1 issued to same person for purposes of the limit of 100 or fewer Schedules K-1.
- Do not count spouses in community property states as two partners by virtue of the community property laws for purposes of the limit of 100 or fewer Schedules K-1.
- Allow revocation of an election out of the centralized audit rules, when all the adjustment year partners and the Service agree.
- Allow a partnership to correct minor, inadvertent compliance errors at any time before an audit of the partners or the partnership begins.
- Disregard transfers to ineligible partners when rescinded or corrected by the transfer to an eligible partner within a specified, short period of time (*e.g.*, 60 days) and within the same taxable year.

C. Partnership Representative

- Require a designation each year when the partnership's return is filed. The same Partnership Representative could be named in successive years. If the partnership names a new Partnership Representative, that Partnership Representative would serve in that capacity for all open years.
- Adopt rules similar to the existing rules concerning resignation of a tax matters partner and revocation of a designation.
- Require the partnership to notify the Service if its designation of a Partnership Representative has terminated by operation of law.
- Adopt standards similar to those governing who may sign a tax return for determining who may act on behalf of an entity designated as a Partnership Representative (*i.e.*, that any person authorized to sign the return of the entity may take whatever actions are required of the Partnership Representative on behalf of that entity).

- Do not adopt the definition of "substantial presence" in Treasury Regulations section 301.7701(b)-1(c)(1) for purposes of the "substantial presence" requirement to be a Partnership Representative. Instead, provide that the "substantial presence" test will be met if the Partnership Representative either designates a location in the United States to which notices may be directed and at which a summons could be served or has appointed an agent duly authorized to receive a notice or summons on its behalf. Alternatively, provide that the substantial-presence test can be met only by domestic entities and individuals that are U.S. citizens or resident aliens in the tax year(s) under examination.
- Provide that the Partnership Representative designation terminates by operation of law in the case of bankruptcy or receivership.
- Provide that the status as Partnership Representative ceases if the Partnership Representative no longer meets the substantial presence test.
- When the Service selects the Partnership Representative, require the Service first to attempt to appoint a current partner of the partnership. If no current partner is eligible to serve as the Partnership Representative (due to failure of the substantial presence test or other disqualifying event), require the Service to consider a current employee, former partner, or former employee (in that order).
- If the Service selects a person or entity other than a current partner or member to be the Partnership Representative, require that person or entity to consent to the appointment as the Partnership Representative.
- For purposes of the Service appointing a Partnership Representative, adopt with some modifications the standards for the Service to appoint a partner as the tax matters partner under TEFRA, but eliminate the preference given to general partners and to managing members in the existing regulations.
- Similar to the existing regulations, provide that the partnership be notified of the Service's intent to appoint a Partnership Representative and allow the partnership a limited time period to designate a different Partnership Representative.
- Also similar to the existing regulations, permit a partnership to designate a new Partnership Representative after the Service has designated one.

D. Consistent Reporting Requirement

- Adopt with some modifications the framework under TEFRA for notification of an inconsistent position and treatment of a partner who has provided notice.
- Provide that prior inconsistent positions of which the Service was properly notified that later prove to be consistent with the Service's adjustments in an examination of the partnership be allowed to modify the imputed underpayment owed by the partnership.

E. Default Determination of Imputed Underpayment

- With respect to the netting of adjustments and character implications, provide that when a partnership enters into a transaction or arrangement that by itself results in an adjustment that increases ordinary income and decreases capital gain, the

netting rule is adjusted to recapture the rate differential, *e.g.*, by separating the items and applying the tax rates to each of them to derive the underpayment amount as to those items. Outside of this narrow rule, character changes should be disregarded.

- With respect to character restrictions and limitations, the pre-existing rules should govern, using the following guidelines:
  - If the character of the item should be determined at the partnership level but the restriction or limitation applies at the partner level under current rules, the restrictions or limitation should be disregarded for purposes of calculating the imputed underpayment.
  - If the restriction or limitation should be applied at the partnership level under the current rules, it should be applied in calculating the imputed underpayment.
- When a partnership pays the imputed underpayment:
  - require that any adjustments to items of income, gain, loss, and deduction give rise to an item of income, gain, loss, and deduction in the adjustment year that is allocated to the partners in the adjustment year;
  - provide that any such item of income, gain, loss, and deduction is not taxable to or deductible by the partner under sections 705(a)(1)(B) or (2)(B);
  - provide that the partnership's payment of the imputed underpayment reduces the basis of a partner's interest in the partnership under section 705(a)(2)(B); and
  - clarify that both the allocation of the adjustment and the imputed underpayment should be made in accordance with the partnership agreement and subject to the existing "substantial economic effect" requirements under section 704.

F. Options to Reduce Imputed Underpayment Amount

- Require the examination team to respond to a requested reduction to the imputed underpayment amount within 270 days of receipt. To the extent the examination team disagrees with the proposed reduction, require it to provide the partnership with the equivalent of a 30-day letter and the ability of the partnership to pursue review by the Appeals office of any disputes, prior to the issuance of an FPA.
- Require the request for reduction to be made on a either a published form available to taxpayers (with instructions) or a template, similar to a protest letter, with the requisite information explicitly required by the Service At a minimum, the form shill include information allocating the adjustment(s) to specific partners. The form should be drafted in a manner that permits a partnership to allocate income to identified partners seeking a reduction of their share of imputed underpayment, versus the "remaining" partners who may not seek a reduction (and therefore, need not be named directly).

- Verify requested reductions based on taxpayer status on expanded versions of the existing Forms W-8 and W-9. This would include verification of reductions or exemptions based on the following: corporate versus individual tax rates (including long-term capital gain for individuals), tax-exempt status (including certification that income from the partnership is not subject to the section 514 debt-financed unrelated business taxable income ("UBTI") rules as a result of borrowing by the tax-exempt entity), tax-exemption based on foreign status (including, without limitation, certification, if applicable, of the application of the portfolio interest exception for certain partners and including reduction of imputed underpayment on U.S.-source dividends from 39.6% to 30%, even in the absence of reduced treaty rates), tax-exemption based on section 892, and reduction in taxes based on eligibility for reduced rates of withholding under a tax treaty.
- Depending on the resolution of issues involving tiered partnerships, provide special forms transmitting information regarding tiered partnerships and other intermediaries (*i.e.*, Form W-9IMY).
- Provide that the verification of requested reductions based on the filing of amended returns be documented based on a certification under penalties of perjury by a partner that an amended return has been filed and such return has included the allocable share of the adjustment.
- Do not require individual partners who file amended returns to provide the partnership with copies of the amended returns for the partnership to be allowed to request a reduction under section 6225(c)(2).
- In the case of a tiered partnership structure, allow the reviewed partnership the option of providing information to the Service verifying the allocation of the adjustment through other partnerships until the ultimate taxpayer provides an amended return certification, a Form W-8 or a Form W-9. If a pass-through partner is unable to provide a Form W-9IMY (or only includes amended return certifications, Forms W-9 or W-8 for a subset of its respective partners), then the portion of the adjustments that is ultimately attributable to indirect partners without verification would default to the statutory calculation.
- Provide that one or more alternative procedures may be implemented by the partnership if some, but not all, partners file amended returns.
- Section 6225 Reductions Based on Rates
    - Clarify whether reductions based on partner status or tax rates are determined based on reviewed-year partners, adjustment-year partners, or both.
    - With respect to UBTI of a tax-exempt partner, require partnerships claiming the benefit of a reduced imputed underpayment resulting from the tax-exempt status of a partner to submit certifications on behalf of each of the partnership and the relevant partner of the amount, if any, of the adjustment that is UBTI to such tax-exempt partner.

    - Because the adjustment-year partners will bear the economic burden of any imputed underpayment paid by the partnership, allow a partnership to request a reduction to the imputed underpayment based on the status or tax attributes of the current-year partners (who would likely also be the adjustment-year partners once the FPA is issued).
- Permit the reduction to the imputed underpayment if the partner(s) with additional income or a smaller deduction files an amended return, even if the partner(s) with less income or a larger deduction does not file amended returns.
- Need for Dispute Resolution Procedures
    - Provide that the Service will not issue the FPA until it has acted upon any timely filed request for reductions submitted under section 6225 and that the FPA reflect whatever decision was made with respect to that request for reduction. In this manner, disputes with respect to both the underlying substantive issue(s) and the reduction request can be addressed in the same proceeding.
    - Establish procedures to allow the decision with respect to the reduction request to be considered by Appeals in conjunction with any substantive issue to avoid creating parallel proceedings for the substantive issues and the reduction issue.
- Reduction for Publicly Traded Partnerships with Certain Passive Losses
    - Expand to all partnerships the special rule for publicly traded partnerships that allows a reduction of the imputed underpayment resulting from a net decrease in passive losses in the reviewed year to the extent the partnership can instead decrease passive losses in the adjustment year, with respect to a specific partner.
    - Because adjustment-year passive losses cannot be determined until the tax year has ended, allow such a reduction request to be submitted within 105 days following the end of the adjustment year.
    - Allow the adjustments for passive losses even if there is an intervening year with no passive loss.
- For adjustments other than to the amount of income, gain, loss, deduction, or credit, make available the section 6226 (or similar) procedure to allow partners to reflect those adjustments on their individual returns.
- Address partnership-favorable adjustments that do not result in an imputed underpayment.
- Clarify that any audit adjustments do not cause any corresponding adjustment to the gain or loss on the sale of the partnership interest that occurs between the reviewed year and the audit year.
- Clarify that allocations under section 6225(c)(3) are based on the reviewed year, not the adjustment year, to ensure that amounts may be fully allocated based on reviewed-year sharing percentages.

- Clarify that when a partner's allocable share is determined based on the adjustment year, then the tax status of such partner is irrelevant to any further reductions or calculations of the imputed underpayment.

G. Alternative to Payment of the Imputed Underpayment Amount

- Require that the election under section 6226 (the "Push-Out Election") be made in writing to the person who issued the FPA and that it contain certain identifying information, including the name of the taxpayer, the affected tax year(s), the amount of the adjustments and the FPA date. Generally, the amended statements provided to partners pursuant to a Push-Out Election ("Amended Statements") should be in the same format as a Schedule K-1, with an additional line item for the reviewed year partner's share of the penalties imposed by the Service.
- The timing of the issuance of the Amended Statements can be complicated if the partnership files an action in court. In the PATH Act, § 411(b)(1), Congress added section 6226(d), which cross-references section 6234(a) for "the time period within which a partnership may file a petition for readjustment." This reference confirms that a partnership may both elect to apply the Push-Out Election and contest the FPA in court, and we recommend that the regulations make this clear.
- Require a partnership to furnish the Amended Statements by the later of (1) the timely issuance of the Schedule K-1 for the year in which the FPA was issued, (2) 120 days after the date of the election to issue Amended Statements, and, if applicable, (3) 90 days after the date upon which a Tax Court decision entered in a proceeding initiated under section 6234 becomes final, or the date upon which a final decision is entered by a district court of the United States or the Court of Federal Claims in such a proceeding (the "Decision Date").
- To avoid penalizing prevailing parties for having made a protective Push-Out Election, and for administrative convenience, allow automatic consent to revocation of the election, if such revocation is requested (*e.g.*, on an analog to Form 3115) within a reasonable time (*e.g.*, 45 days) after the Decision Date.
- Require notice of the Push-Out Election be provided to partners within 30 days of the partnership making the election.
- Allow the notice to the partners to be delivered by any means permitted for the issuance of a Schedule K-1 or any additional delivery methods provided in the partnership's partnership agreement, including email or other electronic delivery.
- Provide that, if such notice and the Amended Statements are delivered to the last known address or other applicable contact information of the partners, the partnership has fulfilled its duty to deliver such notice and Amended Statement.
- Provide that any tax due as a result of the issuance of the Amended Statements should not affect the determination of penalties for underwithholding or deposit obligations of the taxpayer who receives an Amended Statement.

- Provide that any calculation of the tax increases in the intervening years take into account any decreases in tax.
- Provide that, if the partnership complies with the requirements to make the election under section 6226(b) and appropriately provides the Amended Statements to the partners, then the partnership has done all that it needs to do to eliminate its own liability for the imputed underpayment. To achieve that end, provide that: (i) the Amended Statement, when issued, shall be treated as a component of the partnership's return for the partnership taxable year in which the Amended Statement is issued; and (ii) the consistency rule and procedure for filing a notice of inconsistent treatment set forth in section 6222 shall apply with respect to the partner's return for the partner's taxable year in which such partnership taxable year ends.
- Provide that, to the extent that an Amended Statement would be issued to a partner that has declared bankruptcy or ceases to exist, the Amended Statements issued to all other partners are still effective.
- Allow first-tier partnerships to request modifications under section 6225(c)(3)-(5) of their shares of the imputed underpayment amount.
- Allow all upper-tier partnerships to make the Push-Out Election under section 6226.

H. Administrative Adjustment Requests and Taxpayer Favorable Adjustments

- Allow a partnership to file a taxpayer-favorable administrative adjustment request ("AAR") at any time (subject to the statute of limitations) and require the partnership to attach a copy of that AAR with the Form 1065 for the year the AAR is initially submitted and reflect the adjustment as a decrease in non-separately stated income, or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8).
- Allow partners to file notices of inconsistent positions on amended tax returns, which would then be subject to traditional administrative and judicial review to the extent the amended return claims a refund that the Service denies. For government-favorable AARs when the partnership is under audit, allow the partnership the option to defer implementation of a government-favorable AAR until the adjustment year when the resolution of all other audited issues is implemented.
- For partnerships that are not under audit when the AAR is made, allow the partnership to reflect the impact of a government-favorable AAR on the return in the same manner as a taxpayer-favorable AAR.
- In taking into account due process, consider establishing certain rights for and notice to the partners.
- Allow a partnership that files an AAR to utilize procedures similar to those under section 6225(c) for reducing the imputed underpayment amount (other than the option for partners to file amended returns).

- Adopt procedures to prevent the strategic filing of an AAR with the intent to convert the character of an item.
- Provide that the increase in partnership income from an audit adjustment should be treated as tax-exempt income for purposes of section 704(b) and as tax-exempt income for purposes of section 705(a)(2)(B).

I. Statutes of Limitation

- Provide examples to illustrate the interaction of sections 6235(a)(2) and (3) with section 6235(a)(1), particularly to illustrate the statute of limitations' impact to a partnership that submits a reduction request under section 6225 as compared to one that does not.
- Clarify that the parenthetical in section 6235(a)(3) ("(plus the number of days of any extension consented to by the Secretary under section 6225(c)(7)") is only applicable if the partnership requests additional time to submit a reduction request but then fails to do so.
- Illustrate how the submission of a reduction request extends the statute of limitations for adjustments for up to 540 days.
- Because of the impact of the extension of time granted by the Secretary under section 6225(c)(7) on the computation of the period of limitations on making adjustments, prescribe a form that must be used to consent to an extension of the 270-day period under section 6225(c)(7) to avoid confusion and disputes over when the period of limitations expires.
- Provide that, to the extent that the issuance of a notice of proposed partnership adjustment ("NOPPA") extends the statute of limitations (under section 6225(a)(3)) beyond the date that would be applicable under section 6235(a)(1), such extension is effective only with respect to issues raised in the NOPPA.
- Confirm that if a partner files an amended return under section 6225(c)(2) at a time when the limitations period for assessments has already otherwise closed, the Service may only make offsets that reduce any refund.
- Confirm that a partner's filing of an amended return under section 6225(c)(2) does not impact the limitations period for the Service to make adjustments that are unrelated to the adjustments included in the amended return.
- When an amended return is filed to take into account audit adjustments that increase the partner's income, confirm that the partner is allowed to offset such adjustments by previously unclaimed deductions, consistent with Service guidance outside of the partnership area.

J. Notices

- Clarify that the 270-day period referenced in the first sentence of the flush language in section 6231(a) includes the number of days of any extension consented to by the Secretary under section 6225(c)(7).

III. DISCUSSION

We respectfully submit the following comments. In each section below, we briefly summarize particular provisions of the new legislation, the request for comment, and then provide our comments. Our comments first address items specified in the BBA and in Notice 2016-23, and are followed by additional comments.

A. Election into Early Application of New Centralized Partnership Audit Regime

1. Overview of New Rules

As noted above, the new centralized partnership audit regime is generally effective for audits of partnership tax returns for tax years beginning after December 31, 2017. Section 1101(g)(4) of the BBA allows a partnership to elect into the new centralized partnership audit regime (other than the election under section 6221(b) (discussed below) to opt out of the new audit regime) for any partnership return filed for partnership taxable years beginning after November 2, 2015 (the date of enactment of the BBA) and before January 1, 2018.[13] The Secretary is authorized to prescribe the time and manner of making this election.[14]

2. Comments

Given the newness of these rules and the expected multiple stages of guidance, we recommend that the Service adopt rules that allow taxpayers flexibility to elect into the new centralized partnership audit regime. While we believe other elections in the new audit regime should be made only with the original return (timely filed, with extension), we recommend that the Service permit the election in to be made with the original return or later. For partnerships that would not otherwise be subject to TEFRA, we recommend that the election be allowed at any time before any of the partners are notified of an audit for the applicable tax year. For

[13] BBA § 1101(g)(4), 129 Stat. at 638.

[14] *Id.*

partnerships that would otherwise be subject to TEFRA, we recommend that this election be allowed up to 45 days after the partnership has been selected for audit. The substantive issues will be addressed at the partnership level under either TEFRA or the BBA; the election to apply the BBA primarily affects the assessment and collection once the Service has concluded an adjustment is necessary.

We believe flexibility is appropriate because a taxpayer's understanding of how the new audit regime will operate will evolve as guidance is released by the Service. We expect multiple stages of guidance. Thus, it will be difficult for partnerships to make informed decisions about whether to make this election until some guidance is issued. So long as the election is made before the Service commences an audit of an individual partner or within a short time after it commences a TEFRA proceeding, no prejudice should result to the Service. While there is some potential for logistical issues if the Service has begun preparing for an audit before it receives notice of the election being made, we believe the newness of this program should tolerate some degree of inefficiency so taxpayers can make informed decisions. Otherwise, we expect few (if any) partnerships to make this election due to the uncertainty of what lies ahead.

We recommend that the election be made by filing a simple statement with the Service. The statement needs to include only the partnership's name, the name of the Partnership Representative (discussed below), a reference to the election in allowed by section 1101(g)(4) of the BBA, and the tax year involved. We also recommend that the statement include a copy of the first page of the partnership's tax return and confirmation of electronic filing or some other documentation to correlate the election with the return that will be subject to the audit. If the election is made when the original return is filed, a copy of the statement should accompany the original return.

We also recommend that the Service clarify that, if this election is made, the partnership will have the ability to make the election under section 6226 to issue amended statements to partners reflecting the audit adjustments. The BBA contains a special effective date providing that "[i]n the case of a partnership electing the application of section 6226 of such Code, the amendments made by [section 1101 of the BBA] shall apply to elections with respect to returns filed for partnership taxable years beginning after December 31, 2017."[15] It is unclear whether this special effective date means that partnerships electing into the early application of the new centralized partnership audit regime cannot issue amended statements under section 6226. We believe the election to issue amended statements under section 6226 is an important part of the new audit regime and should be available to any partnership that elects into that regime. In any event, whether the section 6226 election is available or not is a critical factor for those considering whether to make the election into the early application of this new audit regime. Thus, we recommend that the Service clarify whether the section 6226 election is available to those who elect into the early application of the new audit regime.

B. Election to Opt-Out of New Centralized Partnership Audit Regime

1. Overview of New Rules

Certain partnerships with limited types of partners and a limited number of partners may make an annual election out of the new centralized partnership audit regime for that tax year (the "Opt-Out Election").[16] The Opt-Out Election must be made on the timely filed return for such taxable year and must include, in a manner prescribed by the Secretary, a disclosure of the name

[15] BBA § 1101(g)(3).

[16] I.R.C. § 6221(b).

and taxpayer identification number of each partner of such partnership.[17] The Secretary is authorized to allow "alternative identification of any foreign partners."[18]

First, to be eligible for this election, each partner in the partnership must be "an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner" (collectively, "eligible partners").[19] In addition, the Secretary may prescribe rules similar to these rules to provide for additional types of eligible partners.[20] Second, to be eligible for this election, the partnership cannot have more than 100 partners, with the number of partners determined based on the number of statements the partnership is required to issue under section 6031(b) (the Schedule K-1) for such taxable year.[21] If the partnership has an S corporation as a partner, the Schedules K-1 issued by the S corporation are counted for purposes of meeting the 100-or-fewer-partner requirement.

The partnership must also notify each of its partners, in a manner prescribed by the Secretary, when it makes an Opt-Out Election.[22]

2. Requested Comments

Notice 2016-23 (Item (1)) specifically requests comments on "whether any type of partner, other than those types of partners specifically identified in section 6221(b)(1)(C), should be treated under the rules similar to the special rules applicable to S corporations."[23]

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[17] I.R.C. § 6221(b)(1)(D).

[18] I.R.C. § 6221(b)(2)(B).

[19] I.R.C. § 6221(b)(1)(C).

[20] I.R.C. § 6221(b)(2)(C).

[21] I.R.C. § 6221(b)(1)(B).

[22] I.R.C. § 6221(b)(1)(E).

When a partnership opts out of the new centralized partnership audit regime, the Service can no longer collect underpayments from the partnership and must audit each partner. Congress has therefore expressed an intent that partnerships imposing a greater administrative burden on the Service not be allowed to opt out of the new centralized partnership audit regime.

We believe that, when Congress provided that C corporations and S corporations could be eligible partners, it signaled the limits on the administrative burden it was willing to place on the Service in pursuing audit adjustments against partners. Because S corporations cannot be owned by pass-throughs, except certain trusts, S corporations cannot have multi-tiers of ownership. C corporations, of course, are not pass-throughs at all. We believe that limitations on tiered ownership should be a guiding principle in determining what other types of entities should be allowed as eligible partners for purposes of the Opt-Out Election.

With those principles in mind, we offer the following comments on the types of partners that should be treated as eligible partners for purposes of the Opt-Out Election.

a. **Disregarded entities: look through to owner for purposes of the Opt-Out Election**

A business entity that is not classified as a corporation is a "domestic eligible entity" and, in the absence of an election, the domestic eligible entity is "[d]isregarded as an entity separate from its owner if it has a single owner."[24] If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.[25]

In the case of a disregarded entity, we recommend that the regulations provide that the entity would be disregarded both for purposes of determining the number of Schedules K-1

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[23] 2016-13 I.R.B. 490, 491 (Mar. 28, 2016).

[24] Reg. § 301.7701-3(b)(1)(ii).

[25] Reg. § 301.7701-2(a).

issued and the type of partner. Thus, the owner of the disregarded entity, rather than the disregarded entity itself, would be examined for purposes of determining whether it is an eligible partner and counting the number of Schedules K-1 issued. For example, if a disregarded entity is owned by an individual, a partnership interest held by that disregarded entity should be viewed as owned by that individual for purposes of determining if the partnership is eligible to make the Opt-Out Election and counting to the 100 partners.

We recognize that the Service determined in Rev. Rul. 2004-88[26] that, when a disregarded entity held a partnership interest, the partnership could not qualify as a small partnership for purposes of TEFRA. The small partnership exception was significantly different from the Opt-Out Election rules, however, as the former section 6231(a)(1)(B)(i) prohibited partnerships with partners other than individuals (other than nonresident aliens), C corporations, or an estate of a deceased partner to be treated as a small partnership.[27] Because the Opt-Out Election rules permit partnerships with S corporations or nonresident aliens as partners to opt out of the new centralized partnership audit rules, the rationale for the holding in Rev. Rul. 2004-88 no longer exists.

Furthermore, simplicity should be one of the overall goals of any set of regulations. When entities are disregarded for some purposes and not others, complexity results. In this case, the goals of the new centralized partnership audit regime can be satisfied without that unneeded complexity by looking to the owner of one or more disregarded entities for purposes of determining if an eligible partner ultimately owns the partnership interest. Because there will ultimately will be only one owner, such a rule should not inject unnecessary complexity.

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[26] 2004-2 C.B. 165.

[27] *See* Reg. § 301.6231(a)(1)-1(a)(2).

b. **Allow certain partnerships to be eligible partners**

As noted above, S corporations are eligible partners for purposes of the Opt-Out Election. To be eligible to make an S election under section 1361(b)(1)(B), a corporation must have certain types of shareholders: (1) an individual (other than a nonresident alien); (2) an estate; (3) an organization exempt from tax under section 501(a); or (4) certain trusts.

Although the BBA does not expressly include partnerships as eligible entities for purposes of the Opt-Out Election, Congress provided that "[t]he Secretary may by regulation or other guidance prescribe rules similar to the rules [regarding the information a partnership must provide about the shareholders of an S corporation partner] with respect to any partners not described in such subparagraph or paragraph (1)(C)."[28] This provision strongly implies that Congress expected other types of "persons,"[29] including pass-through entities, to be included among the types of eligible partners for purposes of the Opt-Out Election.

We recommend that regulations provide that a first-tier partnership that satisfies the S Corporation ownership limitations found in section 1361(b)(1)(B) be treated as an eligible partner for purposes of the Opt-Out Election.[30] While allowing some partnerships to be eligible partners introduces some degree of complexity, we believe restricting the eligibility to first-tier partnerships limits the complexity while allowing some flexibility. Thus, the Opt-Out election would be available only if all second-tier owners are eligible entities. Further, because the ownership limitations for S corporations are already in place, complexity will be reduced. All

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[28] I.R.C. § 6221(b)(2)(C).

[29] "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation." I.R.C. § 7701(a)(1).

[30] Certain types of trusts that are eligible to own interests in S corporations would not be eligible partners for purposes of the Opt-Out Election. *See* I.R.C. § 1361(c)(2)(A)(v), (vi).

other partnerships should be treated as ineligible partners.[31] The regulations should also provide that the Schedules K-1 issued by any partnership determined to be an eligible partner would be included in the total number of Schedules K-1 used for purposes of determining the 100-partner limitation in section 6221(b)(1)(B).

Additionally, we believe there is a significant benefit to providing some level of uniform treatment between S corporations and partnerships. These investment vehicles are similar for tax purposes. Both are pass-through entities that file tax returns and issue information statements to their owners on Schedules K-1.[32] Partnerships that have a partnership as a partner and are otherwise eligible to make an Opt-Out Election may believe it worthwhile to convert that entity to an S corporation. And, in the case of newly formed business arrangements, investors may feel incentivized to use an S corporation where, in the absence of these rules, a partnership arrangement would better suit their business needs because, for instance, they desire more than one type of ownership interest in the new entity.

c. **Certain trusts should be eligible partners**

As noted previously, section 6221(b)(2)(C) authorizes the inclusion of other types of "persons" as eligible partners. The statute says nothing about trusts, a common form of ownership. We recommend that any grantor trust that is treated as owned by a single person who is otherwise an eligible partner (*e.g.*, an individual or a C corporation) be treated as an eligible

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[31] Because S corporations were the only pass-through entity included in the list of eligible entities, we do not think it is consistent with Congressional intent to allow more flexibility to partnerships than to S corporations. Incorporating into the regulations similar limitations on partnerships as those that are in place for S corporations accomplishes that goal.

[32] S corporations, however, allow only one class of stock. I.R.C. § 1361(b)(1)(D).

partner.[33] In the case of a grantor trust owned entirely by a single person, the administrative burden associated with making partnership-related adjustments to the trust's taxable income are relatively slight, as the procedures are generally straightforward and unambiguous. Furthermore, because the grantor is treated as the owner of the trust's assets for federal income tax purposes (like the owner of a disregarded entity), including grantor trusts as eligible partners is consistent with the purposes of section 6221(b).

We also recommend that the regulations address issues that arise when an eligible partner dies, similar to the S corporation rules. For example, a trust that was a grantor trust immediately before the death of the grantor can be a shareholder of an S corporation for two years after the grantor's death.[34] And a trust that receives S corporation stock pursuant to the terms of a will can be a shareholder in an S corporation for two years.[35] We recommend that similar rules be included in the regulations for purposes of determining eligible partners for the Opt-Out Election.

We recognize that there are an infinite number of trust arrangements possible. Consequently, there is the potential for significant administrative burden in pursuing partnership adjustments against trusts and their beneficiaries. Thus, outside of the limited circumstances described above, we do not recommend that trusts be included as eligible partners for purposes of the Opt-Out Election.

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[33] Under section 1361(c)(2)(A)(i), grantor trusts all of which are treated as owned by an individual are eligible to be shareholders in an S corporation.

[34] I.R.C. § 1361(c)(2)(A)(ii).

[35] I.R.C. § 1361(c)(2)(A)(iii).

d. **Tax-exempt organizations as eligible partners**

There are numerous types of tax-exempt organizations, including 29 under Section 501(c) alone. Because the process of weighing which, if any, of the many types of tax-exempt organizations should be included as eligible partners would be resource intensive, the easy answer would be to exclude them all. However, we instead recommend using section 1361(c)(6) as a model. That section provides that organizations described in sections 401(a) (qualified pension, profit-sharing, and stock bonus plans) and 501(c)(3) (tax-exempt corporations) that are exempt from taxation under section 501(a) may be shareholders of an S corporation.

Those types of tax-exempt entities are popular, familiar, and useful. We believe the Service should be cautious about creating any disincentives to their being part of a business arrangement. Congress's inclusion of those organizations as eligible shareholders of S corporations provides a useful analog. These types of organizations should not present any unusual administrative burden for the Service with respect to either audits or collections in the case of adjustments attributable to a partnership. For those reasons, we recommend providing that those organizations are eligible partners for purposes of the Opt-Out Election.

With respect to other types of tax-exempt entities, we recommend that, at least initially, they not be included as eligible partners for purposes of the Opt-Out Election.

e. **In the case of a nominee owner, the determination of whether the partner is eligible should be made by looking through the nominee to the beneficial owner**

A person who holds an interest in a partnership as a nominee is required to furnish information about the beneficial owner to the partnership.[36] We recommend that, in determining whether the partner is an eligible partner, the nominee be disregarded. This approach is

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[36] *See* I.R.C. § 6031(c); Temp. Reg. §1.6031(c)-1T(a).

consistent with the reporting regime in place for nominee owners and incorporates that regime. It is also consistent with the S corporation regulations.[37] Leaving the question of nominee ownership unaddressed might invite efforts to skirt the rules. At the same time, a rule that makes the outcome turn on the type of nominee disregards the substance of the arrangement and potentially interferes with the established regime for nominee reporting by creating incentives for taxpayers to restructure arrangements that are already in place.

f. **Incorporate the entity classification regulations under section 7701 with respect to foreign entities**

Section 6221(b)(1)(C) includes "any foreign entity that would be treated as a C corporation were it domestic" as an eligible partner for purposes of the Opt-Out Election. For the sake of clarity, the regulations should reference the regulations under section 7701 to make that determination.[38] Entities that are treated as corporations under those rules should be treated as eligible partners.

g. **An eligible pass-through entity should be disregarded for purposes of determining the number of Schedules K-1 issued**

Section 6221(b)(2)(A)(ii) provides that "the statements such S corporation is required to furnish shall be treated as statements furnished by the partnership for purposes of paragraph (1)(B)." Thus, the Schedules K-1 the S corporation provides to its shareholders count for purposes of determining whether the partnership furnishes 100 or fewer Schedules K-1 to its partners.

Under this circumstance, and any similar circumstances that might be adopted by the regulations, the pass-through entity, *e.g.,* the S corporation, should be disregarded. For example,

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[37] *See* Reg. §1.1361-1(e)(1).

[38] *See* Reg. §§ 301.7701-2(b)(8); -3(b)(2), (3).

if an S corporation with five shareholders is a partner, the regulations should provide that the number of Schedules K-1 is five, not six. Doing so treats the S corporation as a pass-through and acknowledges that the S corporation's shareholders will bear the burden of the adjustments. To do otherwise would be inconsistent with that principle by including in the 100-partner count entities that do not bear any of the economic burdens resulting from the audit adjustments.

3. Additional Comments

The new centralized partnership audit regime raises various procedural and compliance issues as well. We offer the following comments regarding some of those issues.

a. **Opt-Out Election should be made with the original return**

Section 6221(b)(1)(D)(i) provides that the election should be made "with a timely filed return." We recommend that the regulations clarify that the election should be made with the original return (timely filed, including extensions). An amended return that is filed within the applicable statute of limitations is still "timely filed," but allowing an election on an amended return can create the type of administrative complexity and confusion that the new centralized partnership audit regime is designed to reduce. For example, if one office within the Service begins preparing to audit a partnership but in the meantime the partnership files an amended return electing out of the new centralized partnership audit regime, there would be significant confusion and wasted resources while determining the proper taxpayer to audit. For the sake of simplicity and ease of administration, the election should be filed with the timely filed (including extensions) original return.

b. **Notice of the election should be included with the Schedule K-1 that is delivered to the partners**

The regulations should specify how the partners are informed that the partnership has elected out of the centralized partnership audit regime. The partnership's delivery of Schedules

K-1 to the partners is the best time to provide that notice. Amending the Schedule K-1 to add a box indicating that the election out has been made would simplify this process.

c. **Multiple Schedules K-1 to same person should be aggregated for purposes of the limit to 100 or fewer Schedules K-1**

Section 6221(b)(1)(B) provides that only partnerships issuing 100 or fewer statements under section 6031(b) (*i.e.*, Schedule K-1) may elect out of the new centralized partnership audit regime. Under some circumstances partnerships may issue multiple Schedules K-1 to the same person – for example, when the same person owns both a preferred and a common interest; when the person transfers an interest and then buys another interest; and when the person holds an interest directly and through a disregarded entity.

We believe that simply counting Schedules K-1 without taking into account the fact that there is ultimately only one partner is arbitrary and not in the spirit of the new centralized partnership audit regime, which Congress designed to place certain limits on the expenditure of resources with respect to auditing multiple partners instead of the partnership. We therefore recommend that the rules clarify that a partner who receives more than one Schedule K-1 is treated as receiving a single Schedule K-1 for purposes of the limitation in section 6221(b)(1)(B).

d. **Spouses in community property states should not be counted as two partners by virtue of the community property laws**

Under the laws of some states, both spouses own property accumulated during marriage.[39] We recommend that the regulations clarify that a partnership interest owned by a married couple will be treated as owned by a single person for purposes of the 100-partner limit

[39] *See, e.g.*, Tex. Fam. Code Ann. § 3.002 ("Community property consists of the property, other than separate property, acquired by either spouse during marriage.").

in section 6221(b)(1)(B).[40] Otherwise, differences would result in counting to 100 for partnership with married couples who reside in different states.

e. **Partnerships should be allowed to revoke the Opt-Out Election**

There may be situations in which a partnership elects out of the centralized audit rules but both the partners and the Service later conclude that they would benefit from having the audit conducted at the partnership level. For example, at the conclusion of an audit of a partner, it might become clear that an adjustment is required, but it is not an efficient use of the partners' and the Service's resources to go through the administrative process of allocating the adjustment to all the partners. Alternatively, there might be an active partner with a majority interest and many other minority, passive partners with little at stake. In those circumstances, it may save resources to make the adjustments at the partnership level. Therefore, we recommend that the regulations provide that the Secretary can revoke an election out of the centralized audit rules when all the adjustment year partners and the Service agree.

f. **Mechanism needed for correcting minor compliance errors**

Partnerships making the election out of the centralized partnership audit regime must provide certain information about their partners with their return. Inevitably, there will be errors. For example, the partnership might identify the wrong taxpayer as a shareholder of an S corporation partner, provide the wrong taxpayer identification number for a partner, or overlook the fact that a partnership interest has been transferred.

If minor, inadvertent compliance errors foreclose the ability to make the Opt-Out Election, the consequences to the partners can be significant. We recommend that the

[40] Such an approach was taken by Congress for purposes of the S Corporation owner limitation. I.R.C. § 1361(c)(1)(a)(i).

regulations allow a partnership to correct inadvertent compliance errors at any time before the commencement of an audit of the partnership or any of its partners.

In addition, partners may transfer partnership interests to partners who are ineligible partners for purposes of this rule, thereby inadvertently causing the partnership to be ineligible for the Opt-Out Election. We recommend that the regulations disregard transfers to ineligible partners when such transfers are rescinded or corrected by transfer to an eligible partner within a specified, short period of time (*e.g.*, 60 days) and within the same taxable year.

C. Partnership Representative

1. Overview of New Rules

As part of the BBA, Congress created a replacement for the TEFRA "tax matters partner" called the "Partnership Representative." Each partnership must designate, in the manner prescribed by the Secretary, a partner or other person with substantial presence in the United States as the Partnership Representative.[41] The Partnership Representative has the sole authority to act on behalf of the partnership for purposes of the new partnership audit regime. Where no designation is in effect, the Secretary may select any person as the Partnership Representative.

The partnership and all of its partners are bound by actions taken by the Partnership Representative on behalf of the partnership and by any final decision in a proceeding brought under the new centralized partnership audit regime with respect to the partnership.[42]

The new centralized partnership audit regime significantly changes the tax matters partner rules of TEFRA. First, the partnership can identify a non-partner to serve as its representative. Second, if the Service appoints a representative, the statute does not require that

[41] I.R.C. § 6223(a).

[42] I.R.C. § 6223(b).

it appoint someone who is (or was) a partner; instead, the Service may appoint "any person." Third and most significantly, the Partnership Representative has greater power to bind the other partners, as it is vested with "sole authority" to act on the partnership's behalf, and all partners are bound by actions taken by the partnership.

2. <u>Comments</u>

The Partnership Representative will play a central role in the audit process, and because the Partnership Representative will bind the partnership, its role will be even more important than the role of the tax matters partner. In light of that enhanced role, as well as some of the concerns with the existing TEFRA regime that led to its repeal, we submit the following comments.

a. **Qualifications of the Partnership Representative**

Subchapter K is designed to afford flexibility to individuals and entities to structure their legal relationship in a manner that fits their business plans. In light of that flexibility, allowing a partnership to authorize "a partner (or other person)" to serve as the Partnership Representative is an improvement over the TEFRA regime.

Notice 2016-23 specifically requested comment on whether there should be any limitation on who may be designated as a Partnership Representative. We recommend that there be no limitation on the ability of a *partnership* to select an individual or entity as its representative, other than the "substantial presence" test mandated by the BBA.

This flexibility means that LLCs will be able to designate a non-managing member or a non-member manager as the Partnership Representative, even though neither was permitted as a

tax matters partner under TEFRA.[43] We believe that this is a favorable development. Given modern LLC structures, the profits and capital interests of non-managing members often dwarf those of the managing member(s).

b. **The formal designation process for a Partnership Representative**

We understand the Service's difficulty in identifying the tax matters partner was one problem that led to the development of the BBA. We also note that section 6223(a) contemplates a mandatory designation, as it provides that "[e]ach partnership shall designate" a representative. By contrast, the TEFRA regulations provide for a permissive designation, as they state that a partnership "may designate" its tax matters partner either on the return or in a subsequent statement.[44]

We recommend that the regulations be structured to assure that the Service has a clear record to identify the current Partnership Representative. We recommend that the regulations describe, in detail, the time for the initial designation, along with the procedure for changing that designation to ensure that the Service can communicate easily with the Partnership Representative. We think the best approach is to require designation each year when the partnership's return is filed. The same Partnership Representative could be named in successive years. If the partnership names a new Partnership Representative, that Partnership Representative would serve in that capacity for all open years.

Once a formal requirement for designation is in place, the existing rules concerning resignation of a tax matters partner and revocation of a designation appear to be workable and

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[43] *See* Reg. § 301.6231(a)(7)-2(a) ("Solely for purposes of applying section 6231(a)(7) and § 301.6231(a)(7)-1 to an LLC, only a member-manager of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner.").

[44] *See* Reg. § 301.6231(a)(7)-1(c), (e).

could be adapted readily to the Partnership Representative.[45] The one situation that the existing regulations do not fully address is when a designation terminates by operation of law. While the existing regulations identify situations in which a designation will terminate by operation of law, they impose no obligation on the partnership to notify the Service. We thus recommend that the regulations require the partnership to notify the Service if its designation of a Partnership Representative has terminated by operation of law in order to eliminate any gap in the administrative record of the Partnership Representative.

The initial regulatory guidance should also address who may act on behalf of an entity that has been designated as the Partnership Representative. We recommend that the regulations include standards similar to those governing who may sign a tax return. Thus, any person authorized to sign an entity's return can take whatever actions are required of the entity as the Partnership Representative.

c. The substantial presence requirement

Under the BBA, the only apparent constraint on a partnership's freedom to select a Partnership Representative is that the individual or entity selected by the partnership has a "substantial presence in the United States."[46] As the BBA does not define this term, it should be clarified as part of the process of providing guidance, as recognized by Notice 2016-23.

In that context, we note that the term is used in existing regulations as one of three alternative tests for determining whether an individual is a non-resident alien. The relevant regulation provides as follows:

> An alien individual is a resident alien if the individual meets the substantial presence test. An individual satisfies this test if he or she has been present in the

[45] *See* Reg. § 301.6231(a)(7)-1(*l*)(1)(i)-(iv).

[46] I.R.C. § 6223(a).

> United States on at least 183 days during a three year period that includes the current year. For purposes of this test, each day of presence in the current year is counted as a full day. Each day of presence in the first preceding year is counted as one-third of a day and each day of presence in the second preceding year is counted as one-sixth of a day.[47]

There are two problems with adopting this test for purposes of the Partnership Representative rules. First, it provides no guidance as to an entity. Second, the test is an annual one, which could lead to different results in different years. Thus, a Partnership Representative could be disqualified based upon absence from the United States in a tax year that follows the year under audit. In an extreme case, a recalcitrant partnership could potentially delay the audit process by appointing a representative who then spends less than 183 days in the United States during the year in which the audit is being conducted. A firmer standard will assure that the Partnership Representative is qualified under objective criteria that cannot be manipulated.

Given the Partnership Representative's role, we understand the need for the Partnership Representative to be accessible to the Service during an audit. A practical approach to the issue would be to provide that the "substantial presence" test will be met if the Partnership Representative either designates a location in the United States to which notices may be directed and at which a summons could be served or has appointed an agent duly authorized to receive a notice or summons on its behalf. Alternatively, the regulations could provide that the substantial-presence test can be met only by domestic entities and individuals that are U.S. citizens or resident aliens in the tax year(s) under examination.

d. **Loss of Partnership Representative status**

Under TEFRA, the designation of a tax matters partner can terminate by operation of law when certain conditions are met, such as the death or incompetency of the tax matters partner

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[47] Reg. § 301.7701(b)-1(c)(1).

and the liquidation or dissolution of an entity that is tax matters partner.[48] As these are relevant to the ability of an individual to represent the partnership and the other partners effectively, a similar standard should be applied to a Partnership Representative under the BBA. We also recommend that bankruptcy or receivership be listed as an additional reason for a designation to terminate by operation of law.[49] Finally, we recommend that the regulations provide that the status as Partnership Representative should cease if the Partnership Representative no longer meets the substantial presence test.

e. Selection of the Partnership Representative by the Commissioner

Notice 2016-23 also seeks comments on how the Service will designate a Partnership Representative when no effective designation is in place.[50] While the statute technically permits the Secretary to designate "any person," we believe that the regulations should provide standards for the exercise of the Service's discretion.

First, we recommend that the Service be required to attempt first to appoint a current partner of the partnership as the Partnership Representative. In the event that no current partner is eligible to serve as the Partnership Representative (due to failure of the substantial presence test or other disqualifying event), we recommend that the regulations require the Service to consider a current employee, former partner, or former employee (in that order). If the Service selects a person or entity other than a current partner or member to be the Partnership

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[48] *See* Reg. § 301.6231(a)(7)-1(*l*)(i)-(iv).

[49] We do not believe this addition alters current law, because a designation of a tax matters partner terminates under TEFRA if its partnership items become nonpartnership items under pre-BBA section 6231(c), which occurs when a bankruptcy petition is filed or a receiver is appointed. *See* Reg. § 301.6231(a)(7)-1(*l*)(iv) (designation terminates when partnership items become nonpartnership items); *see also* Reg. § 301.6231(c)-7 (filing of bankruptcy petition or appointment of receiver converts a partner's partnership items to nonpartnership items).

[50] 2016-13 I.R.B. 490, 491 (Mar. 28, 2016).

Representative, we recommend that the regulations require that person or entity to consent to the appointment as the Partnership Representative. Further, the regulations should include a mechanism to ensure that the Service's appointee does not have a conflict of interest if it serves as the Partnership Representative. For example, the regulations could provide that the Service is precluded from selecting an employee of the federal government as a Partnership Representative.

Second, for purposes of the Service appointing a Partnership Representative, we recommend that the regulations adopt with some modifications the standards under TEFRA for the Service to appoint a partner as the tax matters partner. Under TEFRA, the standards for appointment of a tax matters partner by the Service require that the general partner or the managing member be selected.[51] The Partnership Representative will assume a role similar to that of the tax matters partner under TEFRA, but with greater power to bind the partnership and its partners. In light of this increased authority, additional attention to the process is warranted to assure that the due process interests of partners are protected, particularly since the BBA eliminates many of the opportunities for partners to participate directly in administrative and judicial proceedings to protect their own interests.

We therefore suggest that the new regulations not adopt the preference given to general partners and to managing members in the existing regulations. While it is difficult to generalize, some partnerships subject to the Partnership Representative provision will fit into one of the following templates:

- A partnership comprised of a general partner who contributed minimal capital and received a carried profits interest that is relatively minor as a percentage of the whole, and limited partners who contributed substantially all of the invested capital and hold the bulk of the profits interests; or

[51] *See* Reg. § 301.6231(a)(7)-1(p)(1).

- An LLC with a managing member who contributed minimal capital and received a carried profits interest that is relatively minor as a percentage of the whole and non-managing members who contributed substantially all of the invested capital and hold the bulk of the profits interests.

In both of these situations, the preference for selecting the general partner or managing member with the largest interest may not match the economic reality. For example, a general partner who has a small investment and a relatively nominal profits interest in a partnership may not be motivated to vigorously defend a partnership audit or seek judicial review of adjustments, while a limited partner with a significant investment and a large profits interest might do so. Further, a partnership's failure to select a Partnership Representative may indicate some conflict between the partners that cautions against assuming that the Partnership Representative should be a general partner or a managing member.

Other than the requirement that a general partner or managing member be designated as the tax matters partner, we believe that the existing standards under Treasury Regulations section 301.6231(a)(7)-1 should be extended to the selection of a Partnership Representative. A presumption that the partner or member with the largest profits interest should be the Partnership Representative generally should assure that the Partnership Representative will act in the best interests of the partnership and the other partners in conjunction with the examination and any subsequent judicial proceedings. Similarly, the criteria listed in Treasury Regulations section 301.6231(a)(7)-1(q) are appropriate to assess whether a member or partner can properly function as the Partnership Representative.

The existing regulations include a provision requiring the Service to notify the partnership of the Commissioner's intent to appoint a tax matters partner and allow the partnership 30 days to appoint a tax matters partners, thereby avoiding a selection to be made by

the Commissioner.[52] We recommend that the regulations for the new centralized partnership audit regime provide a similar requirement for the Service to notify the partnership of its intent to appointment of a Partnership Representative with a limited time period for the partnership to name a Partnership Representative. The existing regulations also permit a partnership to designate a new tax matters partner after the Commissioner has designated one.[53] We recommend the regulations for the new centralized partnership audit regime include a similar provision.

D. Consistent Reporting Requirement

1. Overview of the new rules

Section 6222 provides that a partner's return must be filed consistently with the partnership return, including the manner in which the partnership treats each item of income, gain, loss, deduction, or credit.[54] When a partner fails to report items consistently, the Service will assess and collect any underpayment as a math error with no right to petition the Tax Court and contest the tax liability in a prepayment forum.[55] For partners that fail to comply with the consistency requirements in section 6222, an accuracy-related penalty under section 6662 is imposed.[56]

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[52] Reg. § 301.6231(a)(7)-1(r)(2)(i).

[53] Reg. § 301.6231(a)(7)-1(r)(2)(iii).

[54] I.R.C. § 6222(a).

[55] I.R.C. § 6222(b).

[56] I.R.C. § 6222(e).

2. Comments

Notice 2016-23 requests comments regarding the rules for notifying the Service of an inconsistent position and the treatment of partners that properly file such notifications.[57] For these purposes, we recommend the regulations adopt, with some modifications, the framework under TEFRA for the notification of an inconsistent position and treatment of notifying partners. With respect to notification, under TEFRA, the statement is required to be filed on Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*.[58] This form is required to be attached to and filed with a partner's original tax return.[59] We recommend that a similar form be used and that similar information be required, including information necessary to identify the partnership, the inconsistency, the amount shown on the Schedule K-1, the amount the partner is reporting, the difference and the rationale. Further, a partner reporting an inconsistent position should attach this form to the partner's original tax return that is filed with the Service.

With respect to treatment of a notifying partner, under TEFRA, the Service can initiate a partnership-level audit, take no action, or deal with the partner separately.[60] Under the new centralized partnership audit regime, we recommend that regulations take a similar approach with one modification – when the IRS has been properly notified of the inconsistency, any final decision with respect to the inconsistent position in a proceeding at the partner level should not be binding on the partnership or the Service at the partnership level.[61] We note, however, that

[57] 2016-13 I.R.B. at 492.

[58] Reg. § 301.6222(b)-1.

[59] *See Instructions for Form 8082* (Rev. Dec. 2011), Cat. No. 62051N, Jan 12, 2012.

[60] Reg. § 301.6222(b)-2(a).

[61] I.R.C. § 6222(d).

this disconnect between the inconsistent treatment at the partner level and the non-binding nature at the partnership level can produce anomalous results. We recommend that regulations address these results to the extent possible.

For example, assume partner A of the equal AB partnership believes the partnership should have deducted an item in Year 1 rather than Year 2 and files its return showing a corresponding lesser distributive share of income in Year 1. The partnership deducts the item in Year 2. If the Service successfully challenges the Year 2 deduction, it is unclear if and how the imputed underpayment would be impacted by Partner A's prior inconsistent treatment.

In this regard, we recommend that regulations allow the partnership to take into account any partner's inconsistent treatment of an item that later proves to be consistent with the Service's partnership level adjustments in a request for reduction of the imputed underpayment under section 6225(c). The legislative history supports this approach, as it provides that the function of the reduction procedures is to determine the amount of tax due "as closely as possible to the tax due if the partnership and partners had correctly reported and paid…"[62] This recommendation would address instances where a partner *had* correctly reported and paid, albeit it inconsistently with how the partnership originally reported it, in the reviewed year.

E. Default Determination of the Imputed Underpayment

1. Overview of New Rules

In the event of "any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share," the partnership must pay, subject to certain other rules described below, the "imputed

[62] 2015 Bluebook at 65-66.

underpayment."[63] The "imputed underpayment" under section 6225(b) is determined by first multiplying the net increase in income or gain (or decrease in loss or deduction) by the highest tax rate applicable in the reviewed year under section 1 or section 11 and then increasing or decreasing that amount by any adjustments to the credits claimed by the partnership. With respect to changes to any partners' distributive shares, section 6225(b)(2) requires the imputed underpayment to take into account only the increases to items of income or gain and the decreases to items of deduction, loss, or credit.

Interest on the imputed underpayment amount (determined under section 6223) or on any amount owed by partners as a result of an election by the partnership not to pay the imputed underpayment amount (section 6226(c)) is non-deductible.[64] The partnership is required to pay the imputed underpayment with its return for the adjustment year.[65] The partnership must also pay the amount of interest that would be due under Chapter 67 rules from the day after the due date of the reviewed year return to the due date of the adjustment year return (or if earlier, the date of payment of the imputed underpayment).[66] A "proper adjustment" to the computation of the interest due "shall be made for adjustments required for partnership taxable years after the reviewed year and before the adjustment year by reason of such partnership adjustment."[67]

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[63] I.R.C. § 6225(a)(1).

[64] I.R.C. § 6241(c).

[65] I.R.C. § 6225(a)(1).

[66] I.R.C. § 6225(a)(1).

[67] I.R.C. § 6233(a)(2).

2. Comments

a. **Netting of adjustments and character implications**

Notice 2016-23 (Items (3)(a) and (b)) specifically requests comments on how the "netting calculation under section 6225(b)(1) should work" and how "character changes, restrictions, and limitations under the Code are taken into account."[68]

As noted above, section 6225(b)(1) describes how the Service will determine the imputed underpayment. Section 6225(b)(1)(A) requires "netting all items of income, gain, loss, or deduction and multiplying such net amount by the highest rate of tax in effect for the reviewed year under section 1 or section 11." These provisions suggest that the character issue (capital versus ordinary) should be disregarded.

That approach introduces the possibility, if not the probability, that the imputed underpayment could be significantly more or less than the cumulative amount that the reviewed-year partners would have to pay if the adjustments were allocated to them, as required by the TEFRA rules. For example, if the only two adjustments were an increase in ordinary income of $1,000 and a decrease in capital gain of $700, the net adjustment will be $300. Assuming a 35% tax rate, the imputed underpayment will be $105. But in that scenario, the reviewed-year partners, depending on their circumstances, may have underpaid by $350 with respect to the ordinary income and overpaid by $140 with respect to the capital gain. Their net underpayment for the reviewed year would be $210 in that scenario. Shifting responsibility for the underpayment from the partners to the partnership would cost the Treasury $105 in tax.

The opposite also could occur. If the ordinary income adjustment were an increase of $700 and the decrease in capital gain were $1000, the imputed underpayment would still be

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[68] 2016-13 I.R.B. at 491.

$105, but the partners may have underpaid by $245 with respect to the ordinary income and overpaid by $200 with respect to the capital gain. In that scenario, the Treasury benefits by $60 as a result of the partnership being responsible for the underpayment. Congress has clearly chosen to accept this imprecision in exchange for administrative convenience. We believe that the benefit to either the taxpayer or the government that may result in the ordinary course of an audit should be tolerated in the name of administrative convenience.

The Code includes numerous "character changes, restrictions, and limitations" that apply to partnership taxable income. Most of these restrictions and limitations relate to the availability of deductions rather than the inclusion of income.[69] The question of whether restrictions and limitations should be applied at the partnership level can raise difficult entity/aggregate issues. In some cases, the restrictions and limitations are applied at the partnership level,[70] and in some cases at the partner level.[71] Furthermore, it remains unclear how the various restrictions and limitations should be applied. This makes it difficult to reach certainty as to those questions in a set of procedural rules.

We believe that the centralized partnership audit regulations are not the appropriate rulemaking exercise for deciding substantive rules regarding whether restrictions and limitations are applied at the partnership or partner level; the pre-existing rules should govern, using the following guidelines:

- If the character of the item should be determined at the partnership level but the restriction or limitation applies at the partner level under current rules, the restrictions

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[69] *See*, *e.g.*, I.R.C. §§ 163(d), 163(h), 465, 469, 246(c), 265, 266, and 1092.

[70] *See, e.g.*, I.R.C. § 265(a)(2); *McDonough v. Commissioner*, 36 T.C.M. (CCH) 213 (1977), *aff'd*, 577 F.2d 234 (4th Cir. 1978).

[71] *See, e.g.*, I.R.C. § 165(c)(3) (casualty and theft losses).

or limitation should be disregarded for purposes of calculating the imputed underpayment.

- If the restriction or limitation should be applied at the partnership level under the current rules, it should be applied in calculating the imputed underpayment.

We also recommend that the Service identify by regulation or published guidance those restrictions and limitations that are most significant and whether they will be included in determining the imputed underpayment.

b. **Basis adjustments as a result of the imputed underpayment**

Notice 2016-23 (Item (8)) specifically requests comments regarding the "effect of adjustments on the basis of the partners in their partnership interest and the basis of the partnership in its assets."[72]

The partnership's payment of the imputed underpayment raises certain technical questions that are left unaddressed in the statute. For example, assume an audit results in a single adjustment: a decrease in deduction of $100. That results in an imputed underpayment of $35, which the partnership pays. Is that $100 of income then allocated to any of the partners? What is the effect of the $35 payment? What are the effects on capital accounts and inside basis?

As an initial matter, we note that, but for the new partnership audit rules, an imputed underpayment would be a legal obligation of the partners in a partnership. It is only the new partnership audit rules that mandate that the partnership make the payment of tax (absent an election out or the use of another mechanism that shifts the liability to the partners, such as the Push-Out Election or the partners filing amended returns). Thus, the new partnership audit rules take us from a pure flow-through system of taxation to a hybrid system in which the entity now

[72] 2016-13 I.R.B. 490, 492 (Mar. 28, 2016).

is obligated to and makes payments of taxes that would be legally owed by its owners (the partners) in a pure flow-through regime. Whenever an entity pays an obligation of an owner of the entity, it is generally treated as if the entity made a distribution to the owner who then used the distribution to pay the amount due.[73] We believe the statute was intended to view the partnership as akin to a "collection agent" for the Service to collect from the partners, which would mean that the partnership's payment of any imputed underpayment could be treated as a payment by the partnership of a partner tax liability. However, we do not believe the statute, as drafted, makes clear that any tax payment by a partnership on an imputed underpayment is being made on behalf of the partners ultimately responsible for the tax. The statute appears to us to make the liability to pay the imputed underpayment a partnership liability.

We also note that a theme, if not a goal, of subchapter K is to keep each partner's capital account and outside basis in his, her, or its partnership interest in congruence to the extent possible.

With these initial thoughts in mind, and based on the statute as drafted, we recommend that the regulations address these issues as follows:

i. The adjustments should be allocated to the adjustment-year partners

In the situation where a partnership pays the imputed underpayment, the statute does not address what happens to the adjustments to items of income, gain, loss or deduction. That raises

[73] *See, e.g.,* Treas. Reg. § 1.83-6(d). This regulation recasts a payment by a shareholder of a corporation to an employee or independent contractor of the corporation as payment for services rendered to the corporation as a contribution to the corporation followed by a payment directly from the corporation to the employee or independent contractor. Thus, when the owner of an entity pays a legal obligation of the entity, then the owner is treated as making a capital contribution to the entity followed by the entity making a payment directly to the obligee. Here, the partnership (the entity) pays an obligation (taxes due) of the partner (owner). Under the logic of the regulation, the partnership paying an imputed underpayment ought to be treated as having made a distribution to the partner.

the question whether the adjustments should be allocated to the partners and whether it is the partners in the reviewed year or the adjustment year. To allocate the adjustments to the reviewed-year partners could be read to conflict with the goals of the new centralized partnership audit regime.[74] Further, the statute could be read to provide no clear statutory basis for allocating the adjustments to the adjustment-year partners. Given the goals of the new partnership audit regime, however, we recommend that the regulations provide that any adjustments be allocated to the adjustment-year partners. We note that this approach is consistent with the statute's treatment of adjustments that do not result in an underpayment and, instead are treated as a reduction to income or increase of loss in the adjustment year as discussed further below. If this recommendation is not adopted, the following recommendations should similarly apply to the reviewed-year partners.

(a) The adjustments are allocated to the partners for purposes of basis and capital accounts

As stated above, a goal of the flow-through regime is to keep partner's capital account (often referred to as inside basis) and outside basis in congruence to the extent possible. Where the partnership pays the imputed underpayment attributable to an adjustment, to ensure that the partner's outside basis and capital account remains congruent, we recommend that the regulations require that any adjustments to items of income, gain, loss, and deduction give rise to an item of income, gain, loss, and deduction in the adjustment year that is allocated to the partners in the partnership in the adjustment year.[75] We also recommend that the regulations

[74] For example, the election under section 6226 to have reviewed year partners take into account the adjustments would make no sense if the adjustments are allocated to the reviewed year partners when the imputed underpayment is made.

[75] *See* 2015 Bluebook at 79 (stating that no deduction is allowed under the Federal income tax for any payment required to be made by a partnership under the centralized system of partnership audit, but recognizing that a basis adjustment (reduction) to a partner's outside basis in its partnership interest is

provide that any such item of income, gain, loss, and deduction is not taxable to or deductible by the partner under sections 705(a)(1)(B) or (2)(B).[76] Such adjustments are necessary to ensure that inside and outside basis remain congruent and also to make sure the income, gain, loss, and deduction are not subject to tax twice.

(b) The payment of the imputed underpayment reduces basis under section 705(a)(2)(B)

When the partnership pays the imputed underpayment, that payment has the effect of shifting the economic burden of the tax from the reviewed-year partners to the partnership. The partnership will have expended cash to make the payment. Accordingly, and in keeping with the rules of subchapter K, we recommend that the regulations clarify that the payment results in a nondeductible expenditure under section 705(a)(2)(B) and thus reduces the basis of a partner's interest in the partnership.

(c) Allocation of adjustment and imputed underpayment

We believe that the parties should be able to decide among themselves how the tax burden should be shared and believe that the existing rules under subchapter K appropriately regulate any potential abuse. 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 and subject to the existing "substantial economic effect" requirements under section 704.

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made to reflect the nondeductible payment by the partnership of the tax and that, concomitantly, the partnership's total adjusted basis in its assets is reduced by the cash payment of the tax and that, thus, the parallel basis reductions are made to outside and inside basis to reflect the partnership's payment of the tax).

[76] *Id.*

F. Options to Reduce Imputed Underpayment Amount

1. Overview of New Rules

The BBA directs the Secretary to establish procedures under which an imputed underpayment amount can be modified, such that once an amount is calculated pursuant to the rules described above, the imputed underpayment amount can be adjusted, pursuant to the rules described under section 6225(c), to take into account certain attributes or affirmative actions of a partner or partners.

One type of adjustment to the imputed underpayment would take into account the circumstance in which one or more partners file amended returns that reflect the partnership's audit adjustments.[77] The partner(s) must file the amended return for the taxable year of the partner(s) that includes the end of the reviewed year of the partnership. The amended return must take into account all adjustments properly allocable to such partner(s), and the partner(s) are required to include a payment for any tax due with the amended return.[78] In such case, the partnership's imputed underpayment is modified to exclude the amount of the adjustments taken into account on those amended return(s).[79] A partner can file an amended return even if the applicable statute of limitations under section 6511 has expired.[80] However, the amended return option is limited as a practical matter if the income adjustment results in the reallocation of items among partners (*i.e.*, a shift from one partner to another but no overall increase of income at the

[77] I.R.C. § 6225(c)(2).

[78] I.R.C. § 6225(c)(2)(A).

[79] I.R.C. § 6225(c)(2)(A)(iii).

[80] I.R.C. § 6225(c)(2)(A)(i).

partnership level) because, in such case, all partners impacted by the reallocation must file amended returns for the partnership's imputed underpayment to be reduced.[81]

In addition, the BBA instructs the Secretary to provide procedures for modifying the imputed underpayment in certain circumstances when the tax due from the partners would be less than their share of the imputed underpayment as calculated pursuant to the default rules described above. For partnerships with tax-exempt partners, the new centralized partnership audit regime will provide that the imputed underpayment amount is calculated without regard to the portion that the partnership demonstrates is allocable to a partner that would not otherwise owe tax as a result of its status as a tax-exempt entity (as defined in section 168(h)(2)).[82] Under these rules, the partnership may take into account a lower rate of tax on any portion of the imputed underpayment that it demonstrates is allocable to a partner that is a corporation or is allocable as capital gain or qualified dividends to a partner that is an individual or S corporation.[83] In the case of publicly traded partnerships, rules will provide that the imputed underpayment is computed without regard to any portion that the partnership demonstrates is attributable to a net decrease in a specified passive activity loss allocable to a specified partner, and the partnership must take such a net decrease into account as an adjustment in the adjustment year with respect to the partners to which it relates.[84] Finally, the Secretary is permitted to issue

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[81] I.R.C. § 6225(c)(2)(B).

[82] I.R.C. § 6225(c)(3).

[83] I.R.C. § 6225(c)(4). Prior to the modifications set forth in the PATH Act, section 6225(c)(4)(i) permitted reduced rates in respect of corporate partners only "in the case of ordinary income." PATH Act, Pub. L. No. 114-13, § 411(a)(1).

[84] I.R.C. § 6225(c)(5). "Specified partner" means any person that is (i) a partner of the relevant publicly traded partnership; (ii) described in section 469(a)(2) (*i.e.*, any individual, estate, or trust; closely held C corporation; and personal service corporation); and (iii) has a specified passive activity loss with respect to such publicly traded partnership, with respect to each taxable year of such person which is during the period beginning with the taxable year of such person in which or with which the reviewed year of such

regulations or guidance to provide "additional procedures to modify the imputed underpayment on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes of this subsection."[85]

Procedurally, a partnership must submit the information necessary to modify the imputed underpayment no later than 270 days from the date when the notice of proposed partnership adjustment ("NOPPA") is mailed pursuant to section 6231 unless such period is extended with the consent of the Secretary.[86] In addition, reductions to the imputed underpayment amount can be made "only upon approval of such modification by the Secretary."

2. Comments – Section 6225 Reductions in General

a. Mechanics, documentation, and timing for requesting reductions of the imputed underpayment amount

Notice 2016-23 (Item (4)(a)) specifically requests comments on the "mechanics and timing for requesting modifications and the documentation to be provided to support the requested modification."[87] This section of our comments requests clarification of the timing of adjustments to the imputed payment calculation, mechanics for requesting a reduction, and documentation of the imputed underpayment calculation.

i. Timing

Section 6225(c)(7) provides that "[a]nything required to be submitted pursuant to the modification of the amount of an imputed underpayment must be submitted to the Secretary not later than the close of the 270-day period beginning on the date the notice of a proposed

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publicly traded partnership ends and ending with the taxable year of such person in which or with which the adjustment year of such publicly traded partnership ends. I.R.C. § 6225(c)(5)(C).

[85] I.R.C. § 6225(c)(5).

[86] I.R.C. § 6225(c)(6).

[87] 2016-13 I.R.B. at 492.

partnership adjustment is mailed, unless the 270-day period is extended with the consent of the Secretary." Further, section 6231(a) provides that "[d]uring that same period, the Secretary may not issue a notice of final partnership adjustment." To ensure a timely resolution, we recommend that the Service be required to respond to the taxpayer's proposed reduction to the imputed underpayment amount within 270 days of receipt of the reduction request from the partnership. To the extent the Service disagrees with the proposed reduction, the Service should be required to provide the partnership with the equivalent of a 30-day letter and the ability of the partnership to pursue review by the Appeals office of any disputes, prior to the issuance of a Final Partnership Adjustment ("FPA"), consistent with current law.

Once the Taxpayer's 30-day period has expired, Appeals has completed its review, or the examination team has determined that Appeals is not available (*e.g.*, precluded by the statute of limitations or an issue has been designated for litigation), the Service can issue an FPA. The issuance of the FPA begins the 90-day period during which the partnership may seek judicial review of the partnership adjustment. The issuance of the FPA also marks the beginning of the 45-day period during which the partnership may elect the alternative payment procedures.[88]

ii. **Documentation in general**

To simply the process, the request for reduction should be made on a standard form with the requisite information explicitly required by the Service. This should be either a published form available to taxpayers (with instructions), or a template, similar to a protest letter. At a minimum, the form would include information allocating the adjustment(s) to specific partners. We suggest that the form be drafted to allow a partnership to allocate income to identified

[88] I.R.C. § 6226(a)(1)

partners seeking a reduction of their share of imputed underpayment, rather than the "remaining" partners who may not seek a reduction (and therefore, need not be named directly).

We recommend that the verification of requested reductions based on taxpayer status be provided on expanded versions of the existing Forms W-8 and W-9. This would include verification of reductions or exemptions based on the following: corporate versus individual tax rates (including long-term capital gain for individuals), tax-exempt status (including certification that income from the partnership is not subject to the section 514 debt-financed unrelated business taxable income ("UBTI") rules, a tax exemption based on foreign status (including, without limitation, certification, if applicable, of the application of the portfolio interest exception for certain partners and the reduction of the imputed underpayment on U.S.-source dividends from 39.6% to 30%, even in the absence of reduced treaty rates), a tax exemption based on section 892, and reduction in taxes based on eligibility for reduced rates of withholding under a tax treaty. We note that, depending on the resolution of issues involving tiered partnerships, discussed below, special forms transmitting information regarding tiered partnerships and other intermediaries may be required (*i.e.*, perhaps a Form W-9IMY).

We recommend that the verification of requested reductions based on amended returns be certified under penalties of perjury by a partner that an amended return has been filed and such return has included the allocable share of the adjustment. We also recommend that the regulations not require individual partners that file amended returns to provide the partnership with copies of the amended returns for the partnership to be allowed to request a reduction under section 6225(c)(2). A "fact of filing" certification (under penalties of perjury) should be sufficient. Compelling partners to disclose copies of their amended returns, with all the other financial information, to the Partnership Representative (who might have an obligation to share

that information with the other partners) presents obvious confidentiality concerns and is unnecessary. The Service will have the filed amended return and should be able to confirm the filing of the amended return within whatever time frame is established for the Service to respond to a partnership's request for reduction of the imputed underpayment amount under section 6225(c) (which we recommend in section F.2.a.i above be no more than 270 days).

In the case of a tiered partnership structure, the reviewed partnership should have the option of providing information to the Service verifying the allocation of the adjustment through other partnerships until the ultimate taxpayer provides an amended return certification, a Form W-8 or a Form W-9 (*i.e.*, permit the ability to use a Form W-9IMY or a Form W-8IMY with allocation schedules and further details on indirect partners included). If a pass-through partner is unable to provide a Form W-9IMY (or only includes amended return certifications, Forms W-9, or Forms W-8 for a subset of its respective partners), then the portion of the adjustments that is ultimately attributable to indirect partners without verification would default to the statutory calculation.

b. **Clarification that multiple reduction methods are permitted**

Regulations should address the manner in which an imputed underpayment is reduced if some, but not all, partners filed amended returns. For purposes of the remainder of this Section F, we use a simple example where A and B are partners in AB partnership. In the reviewed year, A was a 10% partner and B was a 90% partner (calculated with reference to income allocations in the reviewed year). In the adjustment year, A is a 20% and B is an 80% partner (also calculated with reference to income allocations in the adjustment year). The Service has issued a notice of proposed partnership adjustment of $250 that would result in an imputed underpayment of $100 using the maximum individual tax rates for the reviewed year. A files an amended return reporting its share of the income for the reviewed year of $25.

One initial question that arises based on the plain language of the statute is to what extent the remainder of the underpayment (in our AB partnership example) after A files an amended return (*i.e.*, $90, which is $225 x 39.6%) can be modified by other rules, such as the rule allowing the partnership to modify the amount of the underpayment by taking into account the status of the partners. The Staff of the Joint Committee on Taxation noted that "[o]ne or more modifications procedures may be implemented by the partnership after the initiation of the administrative proceeding, including before any notice of proposed adjustment."[89] In our example, we now assume that B is a tax-exempt entity and the adjustment is not UBTI. If A filed an amended return, based on its reviewed year allocation, $25 of income would be excluded from the calculation of the imputed underpayment. The remaining $225 of income would have been allocable to B in the reviewed year (see discussion in section F.8.a. below regarding ambiguity of section 6225(c)(3)). The partnership should be allowed to reduce the remaining imputed underpayment to $0 because it is all allocable to a tax-exempt entity. The statute is unclear whether the partnership may provide information under section 6225(c)(3) regarding B's tax-exempt status to further reduce the imputed underpayment. While the same result may be achieved if B were to file an amended return, requiring a tax-exempt partner to file an amended return is unduly burdensome. This is particularly the case for non-U.S. partners that also are entitled to reductions under these rules; such partners may not have filed tax returns in the first instance, and filing amended, or additional, returns in order to demonstrate that no tax is due defeats the purpose of section 6225(c)(3). We recommend the regulations clarify that multiple

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[89] Staff of J. Comm. Tax'n, *General Explanation of Tax Legislation Enacted in 2015* (the "2015 Bluebook") at 65 (J. Comm. Print Mar. 2016).

reduction methods are permitted, which would be consistent with the Staff of the Joint Committee on Taxation's explanation.[90]

3. Comments - Section 6225 Reductions Based on Rates

a. **Clarify that reductions based on partner status or tax rates can be determined based on partners in reviewed year or adjustment year**

As noted above, sections 6225(c)(3) and (4) do not state whether an imputed underpayment amount is reduced based on the status of the reviewed year or the adjustment year partners. Our guiding principle regarding reductions to the imputed underpayment on account of the partners' status is the purpose of section 6225, which is to approximate the tax the partners would have paid had the partnership initially reported consistently with the notice of adjustment. Therefore, we recommend that the regulations specify that the imputed underpayment should be modified (if at all) by the status of the reviewed-year partners. We note that section 6225(c)(4)(B) refers to the partner's distributive share in the reviewed year, suggesting that Congress intended the reduction rules to be applied by reference to the reviewed year partners.

b. **Provide guidance regarding the effect of UBTI of a tax-exempt partner on the reduction procedures**

Section 6225(c)(3) provides for a reduction to the imputed underpayment by the portion that the partnership demonstrates is allocable to a tax-exempt entity within the meaning of section 168(h)(2), which includes, *inter alia*, most entities exempt from tax under section 501 as well as foreign persons. However, because certain exempt persons are subject to tax on particular types of income, such as UBTI for entities exempt under section 501, and income effectively connected with a U.S. trade or business for foreign persons, it would be appropriate

[90] *Id.*

for the reduction procedures to ensure that such income is appropriately taxed. Therefore, the rules should require documentation beyond proof of tax-exempt status.[91]

We recommend that the regulations require partnerships claiming the benefit of a reduced imputed underpayment resulting from the tax-exempt status of a partner to submit certifications on behalf of each of the partnership and the relevant partner of the amount, if any, of the adjustment that would be UBTI to the tax-exempt partner. As discussed below, this option does not work in the case of tax attributes such as offsetting losses or passive losses, because other tax years would be affected, and we recommend a different mechanism in such cases.

c. **Provide guidance on additional factors to be considered in the reduction process**

Because the purpose of section 6225 is to approximate the tax that the partners would have paid if the income were correctly reported on an original return, it follows that the regulations should take into account any tax attribute that would have impacted the tax liability of the partners, subject to administrative feasibility. With respect to tax attributes such as loss carryovers and passive activity losses, we recognize it would be impossible to track the effect of the reviewed year attributes of the partners without essentially amending the partners' reviewed year tax returns and any subsequent years that would consequently require amendment. Significantly, the option to amend reviewed year returns is already separately provided and earlier we recommended that the regulations clarify that the reductions referred to in sections 6225(c)(3) and (4) be determined with reference to the reviewed-year partners.

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[91] The determination of whether income related to the imputed adjustment is taxable to tax-exempt partners is made more difficult because the income could be taxable because of either the partnership's or the partner's activities. For example, income reported as non-UBTI on a partnership's return could nevertheless be UBTI if the relevant partner debt-financed its partnership interest. Similarly, income that is not ECI as a result of the partnership's activities could be ECI to a particular non-U.S. partner if such non-U.S. partner's participation in the partnership was effectively connected with the partner's conduct of a U.S. trade or business.

Because the adjustment-year partners will bear the economic burden of any imputed underpayment paid by the partnership, we recommend that the regulations also allow a partnership to request a reduction to the imputed underpayment based on the status or tax attributes of the current-year partners (who would likely also be the adjustment-year partners once the FPA is issued). This is efficient and fair because the Service still imposes and collects tax from the partnership, while allowing the partners that bear the economic burden to receive the benefit of their partner-level attributes.[92]

4. Comments – Section 6225 Reductions Based on Amended Returns

The new centralized partnership audit regime provides that if a partnership adjustment reallocates income between partners, the calculation of an imputed underpayment shall only take into account the adjustment that increases income or decreases loss, and not the offsetting adjustment. In the event, however, that a partner seeks to reduce the amount of the imputed underpayment by filing an amended return under section 6225(c)(2), all partners who are affected by the adjustments are required to file amended returns. Those partners whose tax liability would be increased by such an adjustment are unfairly prejudiced by this result. Assume that in the AB partnership described above, $100 of income is reallocated from A to B in the reviewed year. Should B choose to file an amended return, taking into account the increased income on its return, it may only do so if A also files an amended return taking into account a reduction of income. For many reasons, A may choose not to do so (for example, A may not be required to file tax returns based on its status). However, this results in an asymmetrical outcome: for calculation of an imputed underpayment, A's reduction of income is disregarded,

[92] In addition, as discussed in section D.2 above, we recommend that the regulations allow the partnership to take into account any partner's inconsistent treatment of an item that later proves to be consistent with the Service's partnership level adjustments for purposes of considering a requested reduction of the imputed underpayment under section 6225(c).

but for amended return purposes, A's reduction of income is required to be taken into account. The requirement makes sense were a partner to attempt to file an amended return to take into account the reduction in income, but it is unnecessary to prevent a partner from amending to report and increase income. We recommend that the regulations permit the reduction to the imputed underpayment if the partner(s) with additional income or a smaller deduction files an amended return even if the partner(s) with a decrease in income or a larger deduction does not file an amended return.

5. Comments – Need for Dispute Resolution Procedures

In the event the Service denies a request to modify the imputed underpayment amount, the process for disputing the Secretary's determination is unclear. As noted above, sections 6225(c)(7) and 6231(a) provide that a partnership may request reduction of an imputed underpayment amount only during the 270-day period following between the date of mailing of the NOPPA.[93] Sections 6231(a) and 6234(a) further provide that a partnership must seek judicial review of a notice of final partnership adjustment ("FPA"), if at all, within 90 days of its mailing, and such mailing can occur no less than 270 days after the mailing of the NOPPA.

The Secretary must approve any reduction of the imputed underpayment.[94] The statute does not expressly subject the Secretary's decision to approve or disapprove a proposed reduction to judicial review or define a standard against which that decision should be evaluated. Under the new provisions as written, whether such review is available depends upon when the reduction request is made and, relatedly, when the reason for the request arises.

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[93] Statutory references reflect the PATH Act's redesignation of section 6225(c)(5)-(7) as section 6225(c)(6)-(8).

[94] *See* I.R.C. § 6225(c)(8).

We recommend that the regulations provide that the Service will not issue the FPA until it has acted upon any timely filed request for reduction submitted under section 6225 and that the FPA reflect whatever decision was made with respect to that request for reduction. In this manner, disputes with respect to both the underlying substantive issue(s) and the reduction request can be addressed in the same proceeding. Further, we recommend that the Service establish procedures to allow the decision with respect to the reduction request to be considered by Appeals in conjunction with any substantive issue. Parallel proceedings for the substantive issues and the reduction issues would be inefficient. There may be questions regarding the standard of review a court would apply to the Service's decision on the reduction request, but we expect those questions to be answered by Congress or the courts and not by regulations.

If the regulations do not require the FPA and the decision with respect to the reduction to be subject to judicial review together, awkward procedural outcomes could result, which would be contrary to the BBA's goal of creating practical administrative solutions. Suppose first that a partnership timely seeks reduction of the imputed underpayment amount. If the Service issues the FPA and then within 90 days also denies the reduction request, the partnership could conceivably raise the substance of its reduction request in a petition for readjustment. Alternatively, if the 90-day period were set to expire with no decision received on the reduction request, the partnership could perhaps file a timely petition for readjustment on a protective basis or seek to enter into a tolling agreement (*e.g.*, Form 907), pending notice of the Secretary's decision. In either case, however, a court would have jurisdiction over the entire FPA by default. Neither outcome serves administrative efficiency.

6. Comments – Reductions with Respect to Publicly Traded Partnerships for Certain Specified Passive Losses

Section 6225(c)(5) outlines a structure for a reduction to the imputed underpayment for passive losses of a publicly traded partnership. The statute provides for a reduction of the imputed underpayment resulting from a net decrease in passive losses in the reviewed year to the extent the partnership can instead decrease passive losses in the adjustment year, with respect to a specific partner. We understand the rationale of this provision is that, to the extent it is possible to decrease net passive losses in the adjustment year to correspond to the incorrectly applied passive losses in the reviewed year, the tax effect on the partner would be equivalent. The same is true for any passive loss. Thus, we recommend that this procedure not be exclusive to publicly traded partnerships.

One issue we note is that the reduction would need to take place after the end of the adjustment year because the partnership will not know whether there is a passive loss during the adjustment year until then. However, the term "adjustment year" (other than in instances involving a court action or an AAR) is defined by reference to an FPA, while the reduction request under section 6225 is made in response to a NOPPA. Thus, a separate procedure may be necessary to take into account reductions of the imputed underpayment after the FPA is issued. In any event, whatever procedure is adopted, the regulations should allow the reduction request to be submitted within 105 days of the end of the adjustment year so that the partnership can determine whether it has passive losses in the adjustment year. Using 105 days roughly aligns with the original due date of the partnership tax return. As discussed above, however, any post-FPA reduction request would cause the FPA and a denial of the reduction request to be subject to judicial review separately.

We also recommend that the regulations provide that any procedure to account for passive losses also be made available to non-publicly traded partnerships with respect to ordinary or passive losses. Similar to the rationale for publicly traded partnership, any incorrect increase in losses with respect to a specific partner in the reviewed year could be economically offset by a corresponding decrease in losses in the adjustment year with respect to such partner. Similarly, any incorrect decrease in income in a reviewed year could be economically offset by a corresponding increase in income in the adjustment year. We therefore recommend extending this rule to all partnerships, and to both income and losses.

Additionally, we do not understand the statutory requirement that the partnership must have had a passive loss in each year beginning with the reviewed year and through the adjustment year. While the procedure clearly requires a passive loss in the adjustment year, it seems unnecessary to require the partnership to have had a passive loss in each of the intervening years. We recommend not extending this requirement if the special rule for publicly traded partnerships is extended to all partnerships.

7. Comments - Partnership Adjustments that do not Result in an Imputed Underpayment

There are two possible types of adjustments to partnership items that would not result in an imputed underpayment of tax: (i) adjustments that do not change the amount of any item of income, gain, loss, deduction, or credit (*e.g.*, items that affect character) and (ii) adjustments that do change the amount of items of income, gain, loss, deduction, or credit, but which, on a net basis, do not produce an imputed underpayment under section 6225(b) (*e.g.,* because such adjustments have the effect of increasing a partnership loss in the audited year).

a. **Adjustments other than to the amount of income, gain, loss, deduction, or credit**

This category includes any adjustments to the character of an item of income, gain, deduction, or loss of a partnership, the characterization of income as foreign or U.S.-source income and any other adjustment that does not impact the amount of a partnership item but would result in a TEFRA "affected item" within the meaning of Treasury Regulations section 301.6231(a)(5)-1 (*e.g.*, adjustments that might affect outside basis, at-risk limitations, and passive losses). The literal language of section 6225(a) does not reach such changes. Section 6225(c) is applicable only "[i]n the case of any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof." Despite not resulting in an imputed underpayment, such changes are almost certain to affect the overall tax liability of a partnership's partners.

Under the new centralized partnership audit regime, it is unclear how such an adjustment would be taken into account by the partnership or its partners, or even whether such adjustments may be made. While section 6221(a) broadly contemplates that adjustments to partnership items will be made at the partnership level, section 6225, as noted above, only encompasses adjustments to the *amount* of partnership items. We recommend that the regulations clarify that the section 6226 election (or a similar procedure) be available so that, even if the audit adjustments do not result in an imputed underpayment, the partners have the option to reflect those audit adjustments in their individual returns.

b. **Adjustments to the items of income, gain, loss, deduction, and credit that do not result in an imputed underpayment**

If, after netting multiple adjustments, no imputed underpayment results because the net income amount is negative, the new centralized partnership audit regime requires the partnership to take into account such reduction of income (or increase in loss or credit) in the year of the

adjustment as a separately stated item in the case of an item of credit and as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8) in all other cases. Such an adjustment would arise when the net effect of partnership adjustments shifts a partnership from an income position to a loss position or increases the partnership loss for the year under audit.

Guidance will need to address a number of issues with respect to such partnership-favorable adjustments to income. First, unlike partnership items that need to be separately stated, items reported under section 702(a)(8) are residual items that are lumped together and generally ordinary in character. Thus, partnership adjustments made under section 6225(a) would not carry through their underlying character as capital gains, dividends, interest, etc. If the amount of a capital loss was increased on audit but no imputed underpayment resulted, the loss would be taken into account by the partners in the current year as an ordinary loss, not a capital loss. It may be more appropriate if section 6225(a) were to provide that "any adjustment that does not result in an imputed underpayment shall be taken into account by the partnership in the adjustment year as a reduction in income or an increase in loss under section 702(a) and the regulations promulgated thereunder." This approach would ensure that, to the extent appropriate, the downward adjustments taken into account in the current year would retain their underlying character.[95]

Adjustments that do not result in an imputed underpayment could, nevertheless, affect partner level income, gain, or loss (and the associated partner level tax due) in a subsequent year, including tax years between the year under audit and the year in which the audit is conducted. For example, consider an audit of partnership P's tax year ended Dec. 31, Year 1, conducted in

[95] We acknowledge that the Service may not have the authority to provide for this result by regulation. If that is the case, then we would consider approaching Congressional staff for a legislative change.

Year 4 that results in an increased partnership loss for Year 1. What is the result if partner A sold its interest in P during Year 3? If the increased loss were taken into account by partner A in Year 1, A would have had a reduced basis in its partnership interest in Year 3 when A sold its interest. Under the section 6225 statutory language, the increased loss would be included as an item of loss in Year 4 under section 702(a)(8). Partner A would not take its share of the loss into account and would not adjust its gain or loss realized on its Year 3 sale of partnership interests. Given the purpose of the BBA to reduce complexity and to streamline implementation of audit adjustments for purposes of assessment and collection, we believe the tax rules should not adjust the gain or loss on the Year 3 sale of the partnership interest. Thus, we recommend that the regulations should make clear that, to the extent that partner A would not be entitled to a loss resulting from an audit conducted after A has left the partnership, A's gain or loss realized upon the sale of its partnership interest in P cannot be adjusted in a separate audit of A on the basis of the partnership audit outcome.

8. Interaction of Reductions from Amended Returns and Other Reductions

a. **Consistency in use of reviewed-year allocations**

Section 6225(c)(3) is ambiguous as to whether allocable share (for purposes of the amount allocable to a tax-exempt partner) is determined with reference to the reviewed year or the adjustment year. Take our example above in section F.2.b., where A files an amended return under section 6225(c)(2), utilizing its 10% allocation from the reviewed year, and B is a tax-exempt partner relying on a reduction under section 6225(c)(3). If the section 6225(c)(3) allocation is calculated based on the adjustment year, $25 of unallocated income will remain in the partnership, subject to the imputed underpayment calculation. This is an unwarranted economic distortion. Regulations should bring consistency to section 6225(c)(2) and (3) and make clear that allocations under section 6225(c)(3) are based on the reviewed year, not the

adjustment year, to ensure that amounts may be fully allocated based on reviewed-year sharing percentages.[96]

b. **Clarification: only one reduction per partner**

If a partner has filed an amended return under section 6225(c)(2), the statute is unclear as to whether the partner's status is taken into account to reduce the imputed underpayment on the remaining portion of an adjustment. In the event that a partner's allocable share is determined based on the adjustment year, then the tax status of such partner should be irrelevant to any further reductions or calculations of the imputed underpayment. We recommend that guidance clarify that once a partner has filed an amended return under section 6225(c)(2), the tax status of the partner may not be taken into account.

G. Alternative to Payment of Imputed Underpayment

1. Overview of New Rules

As an alternative to the partnership paying the imputed underpayment itself, section 6226(a) allows the partnership to elect to furnish its reviewed-year partners (and the Service) with statements ("Amended Statements") reflecting the partners' share of the audit adjustments. This is referred to as the "Push-Out Election." The partnership must make this election not later than 45 days after the date of the FPA and in a manner as provided by the Secretary. Once made, the election is revocable only with the consent of the Secretary.

If the Push-Out Election is made, section 6226(b)(3) provides that each reviewed-year partner must report and pay the additional tax due in the tax year it receives the statement from

[96] This is consistent with the 2015 Bluebook, which makes clear that one should calculate the portion of the underpayment that is reduced by referencing the tax-exempt status in the reviewed year and not the adjustment year ("[p]rocedures for modification provide for determining the amount of the imputed underpayment without regard to the portion of it that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity for the reviewed year."). 2015 Bluebook at 66.

the partnership. The amount of tax to be reported in the "current" year is the amount of tax that would have been due in the reviewed year had the audit adjustments been taken into account in that year plus (but not minus) any correlative adjustments that must also be made in the intervening years as a result of the original audit adjustment.

In addition, section 6226(c)(2) requires the reviewed-year partner also to include an interest charge from the due date of the reviewed-year tax return at a rate 2 percent above the normal rate (*i.e.*, "hot interest").

2. Comments

a. **Timing and mechanics of election**

Notice 2016-23 (Items (6)(a), (b), (c), and (e)) specifically requests comments regarding:

- "How to make the election, the time for providing information to the Service, the information that should be required to be included with the election, and the form or content of the statement of adjustments to be provided to the partners and the Service";
- "When the statements should be filed with the IRS and furnished to partners";
- "How the adjustments in the final notice of partnership adjustment should be reflected if the adjustments are changed as a result of a court proceeding"; and
- "How adjustments are taken into account by partners under the alternative to payment of the imputed underpayment by the partnership under section 6226."[97]

As noted above, the partnership must make this election not later than 45 days after the date of the FPA and in a manner as provided by the Secretary. We recommend that the election be made in writing addressed to the person who issued the FPA and contain certain identifying

[97] 2016-13 I.R.B. 490, 492 (Mar. 28, 2016).

information, including the name of the taxpayer, the affected tax year(s), the amount of the adjustments, and the FPA date. Generally, the Amended Statement should be in the same format as a Schedule K-1, with an additional line item for the reviewed year partner's share of the penalties imposed by the Service.

The PATH Act does not specify the timing of the issuance of the Amended Statements. The issuance of Amended Statements can be complicated if the partnership files an action in court. In the PATH Act,[98] Congress added section 6226(d), which cross-references section 6234(a) for "the time period within which a partnership may file a petition for readjustment." This reference confirms that a partnership may both elect the application of section 6226's Amended Statements procedure and contest the FPA in court.

A partnership electing the application of section 6226 must furnish Amended Statements to the partners "at such time and in such manner as the Secretary may provide."[99] We recommend that the regulations under section 6226(a) require a partnership to furnish the Amended Statements by the later of (1) the timely issuance of the Schedule K-1 for the year in which the FPA was issued, (2) 120 days after the date of the election to issue Amended Statements, or, if applicable, (3) 90 days after the date upon which a Tax Court decision entered in a proceeding initiated under section 6234 becomes final, or the date upon which a final decision is entered by a district court of the United States or the Court of Federal Claims in such a proceeding (the "Decision Date"). Such a requirement ensures that, if a court proceeding results in a change to the adjustments in the FPA, the partners will receive Amended Statements consistent with the court's decision.

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[98] PATH Act, § 411(b)(1).

[99] I.R.C. § 6226(a)(2).

The outcome of a judicial proceeding brought under section 6234 could materially change factors relevant to the partnership's decision to make the Push-Out Election under section 6226. To avoid penalizing prevailing parties for having made a protective Push-Out Election, and for administrative convenience, we recommend that the regulations provide for automatic consent to revocation of the election, if such revocation is requested (by simply filing a form, analogously to revocation of a method of accounting on Form 3115) within a reasonable time (*e.g.*, 45 days) after the Decision Date. Adoption of such a procedure would align with the Staff of the Joint Committee on Taxation's statement that "[a]s part of any settlement . . . it is contemplated that the Secretary may permit revocation of a previously made election."[100]

In addition to notice of the Push-Out Election being provided to the Service, section 6226(a)(2) requires that the partnership notify its partners that Amended Statements will be issued with respect to the reviewed year. We recommend that the regulations provide that such notice be provided within 30 days of the partnership making the Push-Out Election under section 6226(a). We also recommend that the notice to the partners be permitted to be delivered by any means permitted for the issuance of a Schedule K-1 or any additional delivery methods provided in the partnership's partnership agreement, including email or other electronic delivery. Further, we recommend that the regulations provide that if, such notice and the Amended Statements are delivered to the last known address or other applicable contact information of the partner, the partnership has fulfilled its duty to deliver such notice and Amended Statement.

We would expect an additional line to be added in tax returns (*e.g.*, Forms 1040 and 1120) to allow the partner to report the additional tax due resulting from a Push-Out Election. We recommend that the regulations provide that any tax due as a result of the issuance of

[100] *See* 2015 Bluebook at 69.

Amended Statements will not affect the determination of penalties for underwithholding or deposit obligations of the taxpayer who receives an Amended Statement. That taxpayer may well have no knowledge that such tax is due until it receives notice of the Push-Out Election having been made. Furthermore, if the partnership pursues the issue in court, the amount and impacted year will not be known until the court proceedings are completed. Therefore, we suggest that the calculation of penalties for underpayment of estimated taxes and similar penalties should not include any amount due as a result of the issuance of the Amended Statement.

b. **Impact on tax attributes**

Notice 2016-23 (Item (6)(d)) specifically requests comments regarding "how tax attributes should be taken into account for intervening years between the reviewed year and the adjustment years."[101] Section 6226(b)(2)(B) requires taxpayers to increase the amount due in the "current" year for tax increases in intervening years due to the adjustment in the reviewed year but does not appear to allow for a reduction to the amount due for decreases in tax in intervening years due to the adjustment in the reviewed year.

We recommend that the regulations provide that any calculation of the tax increases in the intervening years also take into account any decreases in tax.[102]

[101] 2016-13 I.R.B. at 492.

[102] We acknowledge that the Service may not have the authority to provide for this in a regulation. If that is the case, then we would consider approaching Congressional staff regarding a legislative change to section 6226(b) to allow for any tax decrease in an intervening year to be taken into consideration.

c. **Consequences to the partnership if a partner fails to account for adjustments as required by section 6226(b)**

Notice 2016-23 (Item (6)(f)) specifically requests comments regarding the "consequences that result when a partner fails to account for adjustments as required under section 6226(b), including how tax attributable to those adjustments is assessed and collected."[103]

We recommend that the regulations provide that if the partnership complies with the requirements to make the Push-Out Election and appropriately provides the Amended Statements to the partners, then the partnership has done all that it needs to do to eliminate its own liability for the imputed underpayment. Nothing in the BBA appears to require the partnership to ensure that the partners report what they are supposed to report. If a partner does not take into account the adjustment on her individual return, the Service should not be able to assert that the partnership is once again responsible for that amount or otherwise invalidate the Push-Out Election. In other contexts, the partnership is not responsible for ensuring that a partner report the items included on the Schedule K-1. The same should be true for the Amended Statements, as they serve the same purpose as the Schedule K-1 (and other information reporting forms)– providing information to the Service that enables the Service to determine whether a partner reported all of her items. To achieve that end, we recommend that the regulations under section 6226(a) provide that: (i) the Amended Statement, when issued, shall be treated as a component of the partnership's return for the partnership taxable year in which the Amended Statement is issued; and (ii) the consistency rule and procedure for filing a notice of inconsistent treatment set forth in section 6222 shall apply with respect to the partner's return for the partner's taxable year in which such partnership taxable year ends. We recognize that this places an administrative burden on the Service to match the information on the Amended Statements with what the

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[103] 2016-13 I.R.B. at 492.

partners report on their returns. However, this burden should be no more onerous than in any other information reporting context, including the original Schedule K-1 issued to the partners, a Form W-2 for wage withholding, or a Form 1099 for dividends or interest.

d. **Partners no longer in existence or able to pay**

Notice 2016-23 (Item (10)) specifically requests comments regarding the "effect of bankruptcy and the treatment under the new partnership audit rules where a partner ceases to exist."[104]

In this situation, the principles of fairness and efficient administration conflict. On the one hand, the situation of a tax deficiency owed by a taxpayer that no longer has the ability to pay or no longer exists is not new to tax administration. The Service could use its authority to prepare returns for those who do not file as a means to assess the liability and then use the traditional collection tools (such as filing a proof of claim in bankruptcy or asserting transferee liability). However, the purpose of the BBA was to shift the primary tax liability to the partnership to enable the efficient assessment and collection of tax, while providing various elections to somewhat ameliorate the default determinations. One such election is the Push-Out Election. The availability of this election should not be impacted by the circumstances of any particular partner. We note that the Service can pursue various options in the event a taxpayer is bankrupt or ceases to exist, such as the preference in bankruptcy and seeking transferee liability.

Thus, we recommend that, to the extent that an Amended Statement is issued to a partner that has declared bankruptcy or ceases to exist, the Amended Statements issued to all other partners should still be effective. We believe the BBA was intended to make it easier for the Service to assess and collect roughly what it would have collected from the partners, but not to

[104] 2016-13 I.R.B. at 492.

provide additional collection assistance in circumstances such as a bankruptcy. Thus, to the extent an Amended Statement is issued to a partner that is bankrupt or no longer exists, the Service should pursue its rights under the Bankruptcy Code, transferee liability, or any other legal tool at its disposal.

e. **Upper-tier partnerships**

We recommend that upper-tier partnerships be subject to similar procedures and have similar payment options as the audited partnership. Thus, we recommend that the regulations permit at least the first-tier partnership (a partner of the audited partnership) to request a modification under section 6225(c)(3)-(5) of its share of the imputed underpayment. We understand that allowing second-tier and further tier partnerships to submit modification requests could present unreasonable complexity due to the extent of the interaction with the Service for submitting and approving such a request.

We further recommend that all upper-tier partnerships have the ability to make the Push-Out Election under section 6226 and issue Amended Statements to their partners. The interaction with the Service is significantly less than a modification request under section 6225 and thus the added complexity would not be burdensome on the Service. The burden would fall on each partnership in the structure to push out the adjustments until the adjustments reach a taxpaying partner (i.e., not a flow-through). Allowing the flexibility to the partnerships to pay or push out is important to those partnerships that may not have sufficient cash to enable payment of the tax and no mechanism to force their partners to contribute funds. We also note that lenders have begun to insist that partnerships agree to make the Push-Out Election to eliminate the possibility of a partnership-level tax liability (though of course they could not require more than the regulations would permit).

H. Administrative Adjustment Requests and Taxpayer-Favorable Adjustments

1. Overview of New Rules

A partnership may file an AAR to request an adjustment to one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year.[105] The AAR may not be filed more than three years after the later of the date the return for the year in question is filed or the last due date for such return (determined without regard to extensions).[106]

The word "request" signals that Congress has given the Secretary discretion, as under prior law, as to whether to accept an AAR. Unlike prior law, however, the BBA does not include any specific provision allowing a partnership or a partner an opportunity for judicial review of the Service's decision to deny—or even to refuse to consider—an AAR under the new law.

AARs that are in effect claims for refund will presumably be taken into account under section 6225(a)(2), which provides that a partnership takes into account adjustments that do not result in an imputed underpayment ("taxpayer-favorable adjustments") as a decrease in non-separately stated income, or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8). If the item is a credit, it is taken into account by the partnership as a separately stated item. The adjustment is taken into account in the adjustment year as an adjustment to partnership income, loss, or credit that then flows through to the adjustment year partners under the existing rules of subchapter K. Section 6227(b) clarifies that the increased interest (i.e., hot-interest) does not apply to any partner that would have an underpayment with respect to the overall taxpayer-favorable AAR.

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[105] I.R.C. § 6227(a).

[106] I.R.C. § 6227(c).

A taxpayer-favorable adjustment must be taken into account in the year the AAR is made.[107] The adjustment resulting from the AAR may be taken into account either by the partnership under rules similar to those under section 6225 (with certain carve outs) or by the partnership and its partners under rules similar to those under section 6226 (with certain carve outs).[108]

AARs that will ultimately result in additional tax due will presumably be taken into account in the other provisions of section 6225 or the Push-Out Election of section 6226, each discussed above.

1. Comments

Notice 2016-23 (Items (7)(a) – (e)) specifically request comments regarding:

- "The circumstances in which a partnership may want to file an AAR";
- "The mechanics for how to file an AAR and pay any imputed under payment";
- "How partnerships should account for adjustments requested as part of an AAR";
- "What steps the IRS should take upon receipt of an AAR; and"
- "What opportunities the partnership has for review of IRS actions taken with respect to an AAR."[109]

We address each of these requests in our comments below.

As a preliminary matter, we note that partnerships file AARs for a host of reasons. Just like any other taxpayer, if a partnership identifies a taxpayer-favorable adjustment to a previously-filed return, the partnership would take all necessary steps to gain the benefit of that

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[107] I.R.C. § 6227(b).

[108] I.R.C. § 6227(b).

[109] 2016-13 I.R.B. 490, 492 (Mar. 28, 2016).

taxpayer-favorable adjustment. Partnerships may also file AARs with government-favorable adjustments. Sometimes these are filed in anticipation of an audit. In certain other cases, they are filed in the absence of an audit but with a desire to "get it right" and avoid the audit risks associated with previously-filed returns.

In addition, we note that we define "taxpayer-favorable adjustments" broadly to include any adjustment calculated by any method permitted under section 6227(b) (at the partnership's option, presumably) that does not yield an imputed underpayment. Such a broad definition is supported by the language of the statute. Many different kinds of adjustments to a partnership return would not yield an imputed underpayment. For instance, as discussed above, a change in character, source, or other attributes of an income item or a loss item may not yield an imputed underpayment under section 6225 or tax due under section 6226. Adjustments to allocations may not yield imputed underpayments, either. We consider all these sorts of partnership-level "no-change" adjustments appropriate for an AAR, as they were under prior law.[110] More commonly, partnerships often "true-up" prior year estimates on subsequent returns, or come to a better understanding of the proper tax treatment of an item after the original tax return is filed. We view all these as circumstances in which a partnership may wish to file an AAR.

In most cases, the new authority to incorporate a prior year taxpayer-favorable adjustment into a subsequent year's tax return (subject to the statute of limitations) is a welcome development that ratifies existing practice in many industries. Nevertheless, we have concerns on aspects of the potential application of the statute.

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[110] *See, e.g., Harbor Cove Marina Partners P'ship v. Commissioner*, 123 T.C. 64 (2004) (Service issued "no-change" FPAA).

a. **Due process concerns**

Whether the statute provides due process is our most significant concern. As noted above, the statute does not specify whether partnerships or partners have an opportunity for judicial review of the Service's decision to deny—or even refuse to consider—a taxpayer-favorable AAR. Moreover, a partner (the taxpayer) never has an opportunity to file a taxpayer-favorable AAR. Under the structure of the statute, if an item on the partnership return is incorrectly reported, and the partner does not file a notice of inconsistent treatment, any subsequent taxpayer-favorable adjustment is arguably subject to the unreviewable discretion of the Service. Partnership returns are sometimes prepared and filed incorrectly, and partners often have little or no notice of these errors, especially before filing the partner's original return.

In *Phillips v. Commissioner*,[111] the Supreme Court considered whether a summary administrative tax collection procedure as applied against the stockholders of a dissolved corporation violated the due process clause of the Fifth Amendment. The Court stated: "Where only property rights are involved, mere postponement of the judicial enquiry is not a denial of due process, if the opportunity given for the ultimate judicial determination of the liability is adequate."[112] It held:

> The procedure provided in § 298(a)(1) satisfies the requirements of due process because two alternative methods of eventual judicial review are available to the transferee. He may contest his liability by bringing an action, either against the United States or the collector, to recover the amount paid. . . . Or the transferee may avail himself of the provisions for immediate redetermination of the liability by the Board of Tax Appeals.[113]

[111] 283 U.S. 589 (1931).

[112] *Id*. at 596-97.

[113] *Id.* at 597-98 (citation omitted).

The principles of *Phillips* are generally understood to set a constitutional floor for due process in tax cases: the right to be able to present objections to the assessment and collection of tax in the form of a refund claim, subject to judicial review.[114] Of course, Congress may provide for higher due process standards than the constitutionally required minimums.[115]

Furthermore, in *Mullane v. Central Hanover Bank & Trust Co.*,[116] the Supreme Court observed: "An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." The TEFRA partnership proceeding provisions survived due process notice challenges,[117] but TEFRA allowed partners to intervene in partnership proceedings.

We query whether the new statutory scheme for presenting taxpayer-favorable adjustments on an AAR would survive due process review. The procedures established by the Service to process AARs will impact any due process review.

b. **Mechanics to file an AAR**

We recommend that the partnership be allowed to file a taxpayer-favorable AAR at any time (subject to the statute of limitations) and be required to attach a copy of that AAR with the Form 1065 for the year the AAR is initially submitted and reflect the adjustment as a decrease in non-separately stated income, or an increase in non-separately stated loss (whichever is

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[114] *Id. at* 596-97.

[115] For instance, since 1924, Congress has provided, as a fundamental principle of federal tax administration, that taxpayers are generally entitled to a prepayment forum to dispute income and other tax liabilities. I.R.C. § 6213(a).

[116] 339 U.S. 306, 314 (1950)

[117] *See,* e.*g. Kaplan v. United States*, 133 F.3d 469 (7th Cir. 1998); *Walthall v. United States*, 131 F.3d 1289 (9th Cir. 1997); *Blonien v. Commissioner*, 118 T.C. 541 (2002).

appropriate) under section 702(a)(8). The Service can designate one or more service centers as the location to file the AAR. The AAR can be filed on a Form 1065X. The benefit of requiring the adjustment resulting from the AAR to be reflected on the current year return is that there is now an opportunity for judicial review. The item is now subject to review on audit by the Service (along with all other items on that return) and subject to all other provisions of the new partnership audit rules in the BBA. The filing of the AAR with the service center establishes the year in which the AAR is "made" but the service center will not be required to act upon the AAR. The service center can review any submitted AAR and can flag a particular return for audit. However, partnerships should not be forced to wait for the Service to act upon an AAR before the adjustment can be taken into account on its return. If that were the case, there would be no opportunity for judicial review for an AAR that the Service never acts upon.

Neither Congress nor Treasury can deny partners the constitutional right to claim a refund of overpaid taxes and have the denial of that refund claim reviewed by a court. The new centralized partnership audit regime only allows partners—through partnerships—to "request" a refund of taxes paid once the partners' original return is filed and assessed consistent with the partnership return. Requiring a partnership to reflect the impact of an AAR on the tax return for the tax year the AAR is initially submitted is a "request" because all positions on returns are subject to audit. The "request" is then acted upon when the return for that year is audited. All other taxpayers have a right to judicial review when the Service denies a timely refund claim for overpaid taxes. There is no principled reason for partners subject to the centralized audit procedures to be treated any differently.

A potential solution may be to allow partners to file notices of inconsistent positions on amended tax returns, which would then be subject to traditional administrative and judicial

review to the extent the amended return claims a refund that the Service denies. We acknowledge that our suggestions risk complicating the process, but each suggestion may help address due process concerns.

Government-favorable AARs present different logistical considerations. We note that section 6227(b) requires the impact of the AAR to be taken into account in the partnership's tax year in which the request is made. For partnerships that are under audit, the year the AAR is made may or may not be the "adjustment year." We suggest that partnerships be given the option to defer implementation of a government-favorable AAR until the adjustment year when the resolution of all other audited issues is implemented. At that point, the ability to modify the imputed underpayment amount (under section 6225) or elect to "push out" the adjustment (under section 6226) can take into account the AAR and all audit adjustments at once. For partnerships that are not under audit when the AAR is made, we recommend that the regulations provide that the impact of the AAR should be reflected on the return in the same manner as the taxpayer-favorable AARs discussed above.

In addition, aside from the initial notice of inconsistent treatment, there is no notice provision or opportunity for partners—certainly interested parties in this context—to present their own AARs or their objections regarding an overpayment of taxes. The Staff of the Joint Committee on Taxation sheds light on this point in their summary of the new provision,[118] noting that, after a final determination under these new audit rules, a partner could not raise the appropriateness of underlying tax in a collection due process hearing—not because the partner

[118] 2015 Bluebook at 81-82.

had a prior opportunity to dispute the tax liability as a matter of due process—but because the statute now says so.[119]

A fundamental premise underlying the new partnership audit provisions is that the Service and Treasury may ask partnerships and Partnership Representatives to fulfill "the notice and opportunity-to-object obligations" that the government owes partners under the due process clause of the Fifth Amendment.[120] Under prior law, courts held that the notice and opt-out provisions of TEFRA survived due process review, generally citing the fiduciary obligations partners owe each other as a matter of state law.[121]

We see problems with trying to adapt the reasoning of the old TEFRA due-process cases to the new centralized partnership audit regime. In the current environment, with multi-tier pass-through structures (only some of which are partnerships under state law), old assumptions regarding the duties and obligations partners owe each other may no longer be valid or even relevant.[122] The Service cannot rely on flawed or impractical assumptions regarding notice to establish due process. As the Ninth Circuit noted in *Walthall v. United States*, a notice provision must be judged in the light of its practical application to affairs as they are ordinarily conducted.[123] While we understand that the BBA intended to eliminate much of the complexity

[119] I.R.C. § 6330(c)(4)(C).

[120] "Due process, unlike some legal rules, is not a technical conception with a fixed content unrelated to time, place and circumstances. Due process is flexible and calls for such procedural protections as the particular situation demands." *Mathews v. Eldridge*, 424 U.S. 319, 334 (1976) (internal citations and quotations omitted).

[121] *E.g., Kaplan v. United States*, 133 F.3d 469 (7th Cir. 1998).

[122] *E.g., Blonien v. Commissioner*, 118 T.C. 541, 552-53 (2002), citing *Meinhard v. Salmon*, 164 N.E. 545, 464 (N.Y. 1928) (holding joint venturer to "the duty of finest loyalty . . . . Not honesty alone, but the punctilio of an honor the most sensitive, is . . . the standard of behavior.").

[123] 131 F.3d 1289, 1295 (9th Cir. 1997), quoting *Greene v. Lindsey*, 456 U.S. 444, 451 (1982).

under TEFRA regarding rights of and notice to partners (especially in the context of tiered partnerships), we urge that the Service take into account these due process concerns and consider establishing through the regulations certain rights for and notice to the partners.

c. **Reduction to imputed underpayment in the event of an AAR**

Under the new centralized partnership audit regime, "partner information returns (*i.e.*, Schedules K-1) required to be furnished by the partnership may not be amended after the due date of the partnership return to which the information returns relate."[124] The partnership may file an AAR pursuant to section 6227, and the partnership may pay any resulting imputed underpayment at the partnership level. The Staff of the Joint Committee on Taxation makes it clear that such imputed underpayment may also be modified generally in accordance with similar rules as the underpayment from a proposed partnership adjustment issued by the Service.[125] Further, the Staff of the Joint Committee on Taxation noted that the "partnership that files the administrative adjustment request is not precluded from furnishing under section 6227(b)(2) an adjusted statement (similar to a Schedule K-1) to each reviewed-year partner, who is then required to pay tax attributable to the partnership adjustment (as provided under guidance provided by the Secretary)."[126] In the case of an AAR for which the adjustment is determined and taken into account by the partnership in the taxable year in which the request is made, the partnership must pay the imputed underpayment when the request is filed, and it will be assessed at that time. The questions raised above regarding taking into account more than one modification to the underpayment amount are relevant here as well. Accordingly, we

[124] I.R.C. § 6031(b).

[125] 2015 Bluebook, at 70.

[126] 2015 Bluebook, at 82 n.257.

recommend that the regulations provide that when a partnership files an AAR, it may utilize procedures similar to those under section 6225(c) for reducing the imputed underpayment amount (other than the option for partners to file amended returns).

d. **AAR adjustments reflected as non-separately stated items**

As a technical matter, perhaps the most important observation about taxpayer-favorable adjustments is that section 6225(a)(2)(A) requires that they be reported out to partners in the adjustment year as non-separately-stated income or losses (or credits) under section 702(a)(8). Non-separately stated income or loss is generally ordinary in character as a technical matter and in practice. Treasury Regulations section 1.702-1(a)(8)(ii) provides a narrow exception to that rule in certain circumstances, but arguably, by mandating section 702(a)(8) non-separately-stated treatment for taxpayer-favorable AARs, Congress—perhaps inadvertently—circumscribed the general regulatory authority Congress provided to the Service and Treasury in section 702(a)(7) in this context.[127]

This provision may be one measure of the "rough justice" Congress intended by simplifying the partnership audit rules. Nevertheless, the provision has the potential to create mischief. For instance, assume a partnership generates a large loss in a given tax year. Further assume that none of the partners has any capacity to absorb a capital loss allocation. The partnership concludes that the better view is that the loss is capital in character, but there is at least a reasonable basis to conclude that the loss is ordinary. Could the partnership report a capital loss on its original return, and simply file an AAR immediately afterward claiming ordinary treatment? Taxpayers should be able to file an AAR to correct honest mistakes but should not be able to strategically file an AAR to intentionally convert the character of an item

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[127] *But see* T.D. 9008, 2002-2 C.B. 335 (noting that Reg. § 1.702-1(a)(8)(ii) was promulgated under the authority of subchapter K and subpart F and the policies underlying those provisions).

reported out. But that is the result section 6225(a)(2)(A) suggests, since the adjustment, if accepted, would not result in an imputed underpayment. Treasury Regulations section 1.702-1(a)(8)(ii), even if it applies, arguably does not guard against such a scenario. We recommend that the regulations adopt procedures to prevent the strategic filing of an AAR with the intent to convert the character of an item.

e. **Basis**

Finally, the basis implications of taxpayer-favorable adjustments must be considered. Because any decrease in income attributable to a taxpayer-favorable adjustment has no corresponding economic effect at the partnership level, it is unclear how it will be allocated among the partners. In the aggregate, the partners' bases will be reduced by the decrease. As stated above, we believe the adjustments and tax paid thereon should be allocated between and among the partners in the adjustment year under existing subchapter K rules. The Service should not seek to re-write the partners' economic deal. As such, we recommend that the regulations provide that the increase in income should be treated as tax-exempt income for purposes of section 704(b) and as tax-exempt income for purposes of section 705(a)(2)(B).

I. Statute of Limitations

1. Overview of New Rules

Section 6235(a) provides that the general period of limitations for making an adjustment under sections 6231-6235 for any partnership taxable year is the later of:

(a) three years from (i) the date the partnership return was filed; (ii) the due date of the partnership return; or (iii) the date on which the partnership filed an AAR;

(b) "in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension

consented to by the Secretary under section 6225(c)(7)) after the date on which everything required to be submitted to the Secretary" is submitted; or

(c) in the case of a NOPPA is issued, the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7)) after the date of such notice.

The statute of limitations on adjustments may be extended by agreement between the Service and the partnership. In addition, an adjustment may be made at any time if the partnership files a false or fraudulent return or no return. The limitations period in (a) above is extended from three years to six years if the partnership makes a substantial omission from gross income.

2. Comments

a. **Statute of limitations under section 6235**

Notice 2016-23 (Item (11)(e)) requested comments regarding the "period of limitations on making adjustments under section 6235."[128] We note that on March 15, 2016, IRS Chief Counsel, William J. Wilkins, said the Service will be most concerned about potential statute of limitations issues with the new audit regime because "'[t]his is the most significant risk there is in the compliance function.'"[129] We agree that paying careful attention to statute of limitations issues is critical. The BBA helpfully eliminates one of the key criticisms of the TEFRA regime: the complexity under TEFRA of determining the statute of limitations at both the partnership and

[128] 2016-13 I.R.B. 490, 492 (Mar. 28, 2016).

[129] William R. Davis, *New Partnership Rules Will Increase Enforcement, Wilkins Says*, 2016 *Tax Notes Today* 51-3 (Mar. 16, 2016).

partner levels. Under the BBA, the statute of limitations is calculated solely at the partnership level.[130]

If an FPA is mailed, the limitations period is suspended during the 90-day period in which the partnership may petition for judicial review (and, if a petition for readjustment is filed under section 6234, until the court decision becomes final), and for one year thereafter.[131] This provision coordinates well with section 6232(b), which prohibits an assessment from being made before the close of the 90th day after the day on which the FPA is mailed and, if a petition is filed under section 6234 with respect to such notice, the decision of the court has become final.[132]

The provisions in sections 6235(a)(2) and (3) effectively serve as an extension of the otherwise applicable three-year rule in section 6235(a)(1) in certain circumstances. The interrelationship between these rules can be confusing and some clarification in the regulations would be helpful along with an example. As we read the provisions, the application of one rule or the other depends upon whether the partnership submits a request to modify the imputed underpayment amount. If the partnership does not submit a reduction request, section 6235(a)(3) would apply. The Service would have 330 days from the issuance of the NOPPA to issue the FPA. The Service cannot issue the FPA within the first 270 days after the issuance of the NOPPA,[133] which effectively requires the Service to wait the 270 days to see if the partnership requests a reduction under section 6225(c). If the partnership does not submit a reduction request, the Service would then have another 60 days to issue the FPA. The parenthetical added

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[130] I.R.C. § 6229(a).

[131] I.R.C. § 6235(d).

[132] I.R.C. § 6232(b).

[133] I.R.C. § 6231(a).

to section 6235(a)(3) by the PATH Act[134]– "(plus the number of days of any extension consented to by the Secretary under section 6225(c)(7)"[135] – seemingly is only meaningful if the partnership requests additional time to submit a reduction request but then fails to do so. In other words, a partnership could not request an extra 90 days to submit a reduction request, and then when it opts not to do so, point to the original language of section 6235(a)(3) and assert that the Service was precluded from issuing the FPA. An example in the regulations illustrating the impact of the parenthetical would be helpful.

Section 6235(a)(2) is applicable if the partnership actually submits a reduction request under section 6225(c). This extends the statute for a potentially longer period than section 6235(a)(3) because the partnership would have had up to 270 days from the issuance of the NOPPA to submit the reduction request. Thus, this provision could potentially extend the statute of limitations for up to 540 days. That initial 270-day period is not readily apparent from the text of the statute, so including some explanation (and possibly an example) in the regulations will provide helpful guidance regarding the full implications of the reduction requests.

In addition, because of the impact of the extension of time granted by the Secretary under section 6225(c)(7) on the computation of the period of limitations on making adjustments, we recommend that the Service prescribe a form that must be used to consent to an extension of the 270-day period under section 6225(c)(7) to avoid confusion and disputes over when the period of limitations expires.

Furthermore, section 6225(a)(3) provides for an extension of the statute of limitations upon the issuance of a NOPPA. The Service is not limited to the issuance of just one NOPPA in

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[134] PATH Act, § 411(c)(2).

[135] We note that a closing parenthesis should be added to the statute after "6225(c)(7)".

any given audit. This raises the potential for abuse through the issuance of a series of NOPPAs purely for the purposes of extending the statute of limitations. We recommend that the regulations provide that to the extent that the issuance of a NOPPA extends the statute of limitations beyond the date that would be applicable under section 6235(a)(1), such extension is effective only with respect to issues raised in the NOPPA. This is the similar to the rule provided in Treasury Regulations section 301.6503(a)-1(a) with respect to the issuance of multiple Notices of Deficiency under section 6212.

b. Statute of limitations issues related to amended returns filed under section 6225(c)

As summarized in Section F above, under section 6225(c)(2), the imputed underpayment amount may be reduced to the extent the partners file amended returns for the reviewed year that take into account their share of the imputed underpayment and pay any tax due. Section 6225(c)(2)(A)(i) allows partners to file such returns "notwithstanding section 6511." If the limitations period for assessments is closed, the Service may only make offsets that reduce the refund.[136]

Similarly, a partner's filing of an amended return under section 6225(c)(2) should not impact the limitations period for the Service to make adjustments that are unrelated to the adjustments included in the amended return. In addition, when an amended return is filed, taking into account adjustments that increase the partner's income, the partner should be allowed to offset such adjustments by previously unclaimed deductions, consistent with Service guidance outside of the partnership area.[137] We recommend that the regulations confirm these points.

[136] *Lewis v. Reynolds*, 284 U.S. 281, 283 (1932); *Union Pac. R.R. v. United States*, 389 F.2d 437, 447 (Ct. Cl. 1968).

[137] *See, e.g.,* Rev. Rul. 81-88, 1981-1 C.B. 585 (Situation 2); Rev. Rul. 82-49, 1982-1 C.B. 5.

J. Notices

Notice 2016-23 (Item (11)(a)) specifically requests comments on the procedural rules related to "[n]otices of proceedings and adjustment."[138] Under section 6231(a), the Service must mail to the partnership and the partnership representative: (1) notice of the beginning of any administrative proceeding, (2) any NOPPA, and (3) any FPA. The FPA may not be mailed any earlier than 270 days after the date on which the NOPPA is mailed. As discussed above in Section F, a partnership has 270 days from the date when the NOPPA is mailed to the partnership to file any documents or evidence to have the imputed underpayment reduced. In addition, partners have 270 days after the NOPPA is issued to file amended returns to reduce the imputed underpayment amount. Therefore, section 6231(a) does not allow the FPA to be issued before the 270-day period expires. These provisions work well together, except that section 6225(c)(7) allows the 270-day period to be extended with the consent of the Secretary. To harmonize these provisions, we recommend that Treasury clarify in guidance that the 270-day period referenced in the first sentence of the flush language in section 6231(a) includes the number of days of any extension consented to by the Secretary under section 6225(c)(7).

The three notices described above are also required for any proceeding with respect to an AAR filed by a partnership under section 6227.[139] A notice is sufficient if mailed to the last known address of the partnership representative or the partnership (even if the partnership has terminated its existence).

If the Service mails an FPA and the partnership files a petition under section 6234 contesting the FPA, the Service may not mail another notice to the partnership with respect to

[138] 2016-13 I.R.B. 490, 492 (Mar. 28, 2016).

[139] I.R.C. § 6231(a) (last sentence of the flush language).

such taxable year absent a showing of fraud, malfeasance, or misrepresentation of material fact.[140] The Service may, with the consent of the partnership, rescind any NOPPA mailed to such partnership.

If the Service does not issue a NOPPA, the Service may not issue an FPA because it will not be able to satisfy the requirement that it wait at least 270 days after the date on which the NOPPA is mailed before issuing an FPA. If the Service fails to issue an FPA, the limitations period for making adjustments will not be tolled under section 6235(d). Most importantly, no assessments may be made if an FPA is not mailed. Section 6232(b)(1) prohibits the assessment of a deficiency before the close of the 90th day after the day on which an FPA is mailed. In addition, section 6232(e) limits the amount for which a partnership is liable to the amount set forth in the FPA. These remedies adequately protect a taxpayer if the Service fails to issue a NOPPA or FPA. Thus, no guidance is necessary as these provisions are clear on their face and adequately protect taxpayers.

[140] I.R.C. § 6231(b).