
Widely Held Partnerships: Compliance and Administration Issues

A Report to The Congress



**Department of the Treasury
March 1990**



DEPARTMENT OF THE TREASURY
WASHINGTON

March 1990

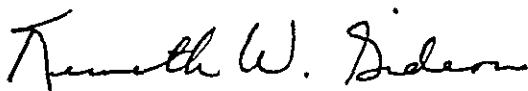
The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515


Dear Mr. Chairman:

Enclosed is a study of the compliance and administrative issues posed by publicly traded and other large partnerships. The study is required by section 10215 of P.L. 100-203, the Omnibus Budget Reconciliation Act of 1987, and has been prepared jointly by the Treasury Department and the Internal Revenue Service. The study concludes that the requirements of current law, as they apply to large partnerships, their partners and the Service, are overly complex and inefficient and that a new system to address these concerns is warranted. It is strongly believed that such a new system will significantly benefit all parties.

A copy of the study and a similar letter are being sent to Representative Bill Archer.

Sincerely,


Kenneth W. Gideon
Assistant Secretary
(Tax Policy)


Fred T. Goldberg, Jr.
Commissioner
Internal Revenue Service



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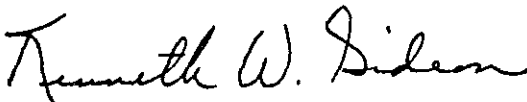
The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510


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A copy of the study and a similar letter are being sent to Senator Bob Packwood.

Sincerely,


Kenneth W. Gideon
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CONTENTS

	<u>Page</u>
I. INTRODUCTION.....	1
II. THE GROWTH OF WIDELY HELD PARTNERSHIPS.....	5
III. CURRENT SYSTEM AND REASONS FOR CHANGE.....	9
A. Reporting Compliance.....	9
B. Administration of Widely Held Partnerships.	12
1. Description of TEFRA Partnership Audit Rules.....	12
2. Description of Service Audit Procedures with Respect to Widely Held Partnerships.....	13
3. Problems Faced by the Service in Administering Widely Held Partnerships.....	21
IV. PROPOSED SIMPLIFIED REPORTING SYSTEM FOR WIDELY HELD PARTNERSHIPS.....	27
A. Introduction.....	27
B. Determination of Partnership Items at the Widely Held Partnership Level.....	28
1. In General.....	28
2. Income and Deductions.....	28
3. Allocations.....	31
4. Credits.....	32
a. Consolidated Tax Credit.....	32
b. Separately-Reportable Credits.....	33
c. Foreign Tax Credit.....	34

5.	Other Reporting Issues.....	36
6.	Reporting Form.....	37
7.	Possible Further Simplification.....	38
8.	Examples.....	39
C.	Elimination of Non-Income Items.....	41
D.	Magnetic Media Filing.....	42
E.	Treatment of Large Partners.....	42
F.	Summary of Simplified Reporting Issues.....	43
G.	Withholding.....	44
H.	Ownership Changes.....	46
1.	Fungibility.....	46
2.	Constructive Termination Under Section 708.....	48
3.	Accounting Conventions.....	49
4.	Information Reporting.....	51
V.	PROPOSALS FOR CURRENT ASSESSMENT OF DEFICIENCIES WITH RESPECT TO WIDELY HELD PARTNERSHIPS.....	53
A.	Overview.....	53
B.	House Proposal.....	54
1.	Description.....	54
2.	Examples.....	55
3.	Analysis.....	56
C.	Deficiencies with Respect to Widely Held Partnerships Should be Borne by Current Partners.....	58
D.	Partnership Collection Proposal.....	58
1.	Description.....	58

	2. Basis and Capital Accounts.....	60
	3. Overstatements and Amended Returns....	60
	4. Insolvent Partnerships.....	61
	5. Examples.....	63
	6. Discussion.....	64
E.	Alternative Proposals.....	68
	1. Partner Collection Method.....	68
	2. Non-Flowthrough Method.....	70
	3. Nonrefundable Credit.....	72
	4. Elective Payment of Deficiencies by Partnerships.....	73
F.	Comparison to Deficiency Dividend Procedures	73
G.	Audit Procedures.....	74
VI.	PENALTIES.....	77
	A. Overview.....	77
	B. Accuracy-Related Penalty.....	77
	1. Background.....	77
	2. Negligence.....	78
	3. Substantial Understatement of Income Tax.....	79
	4. Substantial Valuation Overstatement....	81
	C. Fraud Penalties.....	82
VII.	SCOPE OF THE PROPOSALS--DEFINITION OF A WIDELY HELD PARTNERSHIP.....	83
VIII.	EFFECTIVE DATE CONSIDERATIONS.....	85
	Appendix I - Proposals for Amendments to TEFRA Rules	
	Appendix II - Description of TEFRA Rules	

SECTION I. INTRODUCTION

Section 10215 of the Omnibus Budget Reconciliation Act of 1987 directs the Treasury Department to conduct a study of (1) the issues of treating publicly traded limited partnerships (and other partnerships which significantly resemble corporations) as corporations for federal income tax purposes, including disincorporation and opportunities for avoidance of the corporate tax, and (2) the issues of compliance and administration with respect to publicly traded partnerships and other large partnerships.

This report, which is the product of a joint Treasury and Internal Revenue Service study, addresses the second set of issues in the requested study. It describes the compliance by and administration of widely held partnerships under current tax law, and discusses the problems faced by the Internal Revenue Service (the "Service" or "IRS") in monitoring compliance, determining additional tax due, and collecting tax deficiencies attributable to such partnerships and their partners. It concludes that the requirements of current law, as they apply to widely held partnerships, their partners and the Service, are overly complex and inefficient and that a new system to address these concerns is warranted. It is strongly believed that such a new system will significantly benefit all parties.

The report first sets forth the Treasury's analysis of the existing situation, and the reasons to provide new procedures in order to insure collection of tax attributable to the partners who are members of widely held partnerships.¹ The report then recommends the adoption of a new administrative system, applicable only to widely held partnerships. In general, the term "widely held partnership" would include partnerships with 250 or more partners, except for service partnerships such as accounting or law partnerships. See Section VII of this report for a more complete discussion of the definition of a widely held partnership. This report also discusses matters relating to withholding at the widely held partnership level, but does not recommend such withholding at this time. In addition, the report includes as Appendix I proposed revisions to the unified partnership audit rules applicable to all partnerships with more than 10 partners.²

¹The Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 (the "1987 Revenue Act"), added section 7704 to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."). Section 7704 treats certain publicly traded partnerships as corporations for federal income tax purposes. This report discusses the administrative treatment of widely held partnerships that are not treated as corporations for federal income tax purposes.

²I.R.C. §§ 6221 et. seq. The unified partnership audit rules also apply to certain partnerships with 10 or fewer partners.

The proposed administrative system for widely held partnerships would have two principal features. First, widely held partnerships would use a simplified system for reporting income to the Service and partners. The current Schedule K-1 reporting form would be replaced by a new Form 1099-K on which widely held partnerships would report certain specified and limited information. Elections now made by partners would be made at the partnership level. Rules applicable in calculating taxable income, such as limitations on certain deductions, would be applied at the partnership level wherever possible. Transmissions to the Service would be made by magnetic media. The second principal feature of the system would be a consolidation of the tax audit and administration procedures at the partnership level, including payment of any tax deficiencies, interest and penalties at the partnership level.

Because of the administrative difficulties currently posed by widely held partnerships, it is reasonable to conclude that there may be significant loss of revenue to the government. This revenue loss is partially attributable to income reported by the partnership which is not included on a partner's return, whether through inadvertence, confusion, or conscious failure to report income. The revenue loss is also partially attributable to the underreporting of income by the partnership itself. We do not believe that clearly erroneous reporting positions are commonly taken by large partnerships. However, to a significant degree, our voluntary reporting system anticipates an adversarial relationship between taxpayers and the Service. A taxpayer may report a transaction or event as he or she deems appropriate and, if the Service disagrees with the taxpayer's analysis, the Service has the right and obligation to challenge the taxpayer's position. The unwieldy administrative rules currently applicable to widely held partnerships make it difficult for the Service to fulfill this role, and hampers the proper functioning of the voluntary reporting system.

It is reasonable to assume that the government will receive increased revenue as a result of a simplified reporting system and more efficient rules governing audits of widely held partnerships. We estimate that implementation of a new reporting system with respect to partnerships with 250 or more partners would raise between \$85 million and \$140 million over a five-year period, and implementation of a streamlined audit and assessment proposal would raise between \$100 million and \$200 million over a five-year period.

Moreover, apart from revenue considerations, there are sound tax policy reasons to alter the tax administration system with respect to widely held partnerships. Current law and procedures were developed in an era when partnerships were generally relatively small, and, to a significant degree, these procedures treat partnerships as aggregations of individual taxpayers. This

approach makes little sense in an era where partnerships may have 500, 1,000, or an even larger number of partners. An individual partner's relationship to the partnership is similar to that of a shareholder to a large corporation. We do not assert that widely held partnerships should be taxed as corporations; however, we do believe that today's large partnerships represent a new type of entity that requires a new set of rules. These rules should be grounded on the similarity between widely held partnerships and corporate entities, and the need to achieve efficient administration. Like corporations, widely held partnerships should use a simplified system for reporting to the Service and their partners, and audits and assessments of deficiencies should be conducted at the entity level.

SECTION II. THE GROWTH OF WIDELY HELD PARTNERSHIPS

In recent years, the number of widely held partnerships has significantly increased. In 1978 some 671 partnerships had 500 or more partners; by 1987 the number had grown to 1,735. The greatest portion of the increase was attributable to partnerships with over 1,000 partners, the number of which grew from 288 in 1978 to 1,224 in 1987. During this period, there was a corresponding increase in the percentage of partners who held their interests in large partnerships. In 1978 only 15.1 percent of all partners held their interests in partnerships with 500 or more partners; by 1987 this percentage was 46.9 percent. Again, most of this growth was attributable to partnerships with 1,000 partners or more, which accounted for 44.6 percent of all partners in 1987, nearly four times the figure of 10.8 percent in 1978. Although comparable 1978 numbers are not available, in 1987 there were 3,459 partnerships with 250 or more partners accounting for 50.4 percent of all partners and 6,845 partnerships with 100 or more partners accounting for 53.2 percent of all partners in 1987.³

In 1987, sales of publicly offered partnership interests reached record levels.⁴ Although sales since 1987 have declined sharply, they still are substantial in terms of dollars. Sales of partnership interests in public offerings, including traded and untraded interests, declined 44 percent from 1987 to 1989 and publicly traded interests in master limited partnerships declined a substantial 79 percent (\$2.9 to \$.6 billion). Total sales of all such partnership interests were \$13.5 billion for 1987 and \$7.6 billion for 1989.⁵ Despite the decline in the rate of growth, sales of this magnitude will continue to materially increase the growing number of large partnerships.⁶

³Internal Revenue Service, Statistics of Income--Partnership Returns: 1978 and 1980. 1987 figures from unpublished IRS data.

⁴See "Record Public Partnership Sales in 1987" The Stanger Register, February 1988, p. 13.

⁵See Table 1 "Public Partnership Sales" for 1988-1989 The Stanger Register, February 1990, p. 35.

⁶There are also substantial sales of partnership interests in private placements (so-called regulation D offerings exempt from certain Securities and Exchange Commission filing requirements). The estimated sales of such offerings for 1987, 1988 and 1989 amounted to \$1.5 billion, \$2 billion, and \$1.4 billion, respectively (Source: Robert A. Stanger & Co.). Privately offered partnerships probably have less impact on the issues discussed in this report because they are less commonly widely held partnerships as the term is used herein.

This growth in the number of widely held partnerships is not surprising. Operating a business or investment activity in partnership as opposed to corporate form offers significant tax advantages, including the avoidance of an entity-level tax and the ability of the members to deduct losses from the activity on their own tax returns (subject to certain restrictions). Despite these advantages, a number of factors traditionally hampered use of the partnership form by widely held entities. Among these factors were the administrative complexity for the entity and members of applying the partnership tax rules to a widely held entity, the reluctance of small investors to invest through the less familiar partnership form, and a relative lack of liquidity for partnership interests.

In the late 1970s and 1980s, these limiting factors began to weaken. Computer programs and other procedures were developed for applying the partnership tax rules to widely held partnerships. Investors became more familiar and comfortable with limited partnership investments. In addition, the use of tax shelters greatly expanded in the late 1970s and early 1980s and widely held partnerships became an increasingly popular investment vehicle, in part because they made shelters accessible to smaller investors. Finally, a number of widely held partnerships began to offer partners a significant degree of liquidity, either through the offering of redemption or remarketing programs or, more notably, through the listing of partnership interests on stock exchanges. Prior to 1980, no partnerships were listed on any major stock exchange; as of December 31, 1989, 126 were listed.

The forces encouraging the growth of large partnerships have not been unchecked. In particular, the desirability of these investments has been limited by a series of tax law changes culminating in the enactment of the passive loss rules which limited the deductibility of losses by partnership investors,⁷ and the enactment of section 7704 of the Code which limited the ability of publicly traded entities to qualify as partnerships for tax purposes.

Nonetheless, as long as income earned through partnerships is subject to a lower effective tax rate than income earned through corporations, we believe that the number of widely held partnerships will continue to grow. Moreover, we believe that interests in many of the widely held partnerships will experience significant levels of trading. For example, section 7704 grandfathered all existing publicly traded partnerships for a ten-year period,⁸ and does not apply to partnerships earning certain

⁷See, e.g., I.R.C. § 469.

⁸1987 Revenue Act Section 10211(c).

types of qualifying income, including natural resource and real estate related income.⁹

Administrative difficulties faced by the Service will be exacerbated by any growth in the number of widely held partnerships and by significant trading levels of interests in such partnerships. In light of the recent and anticipated future growth in widely held partnerships, and the likelihood of continued significant trading, the issue of compliance and administration with respect to large partnerships is a timely and important subject.

⁹I.R.C. § 7704(d).

SECTION III. CURRENT SYSTEM AND REASONS FOR CHANGE

A. Reporting Compliance

Under current law, a partnership must file Form 1065, partnership return of income, for each taxable year. The return is accompanied by a Schedule K-1 for each partner, reporting the partner's share of allocable items of the partnership's income and deductions, credits and other specified information. A copy of the Schedule K-1, or a substituted form, is furnished to each partner to be used in reporting such items on the partner's income tax return.¹⁰

In the case of many partnerships, such reportings to partners are voluminous and complex due to the considerable number of passthrough items. On the 1989 Schedule K-1 there are nine different categories of passthrough items with more than forty possible individual amounts to be included in the partner's return or schedules related thereto. Comments received from taxpayers during various IRS Town Meetings held around the country during the 1989 filing season invariably included references to the complexity of the Schedule K-1. Furthermore, widely held partnerships frequently send out information to partners in a format which differs from the Schedule K-1. This is permissible as long as the official Schedule K-1, or an approved substitute Schedule K-1, is filed with the Service and the required information is provided to the partner. This lack of uniformity in information reporting forms is also a frequently mentioned matter of concern expressed when Service representatives meet with practitioner groups. Illustrative of the extent of this problem is a recently issued prospectus describing the proposed merger of two partnerships (assets over \$300 million) into a corporation intended to qualify as a real estate investment trust. The prospectus states that one of the principal benefits of the merger is the ability to provide to investors a tax information form (Form 1099) which is less complex and easier to understand than the Schedule K-1 currently required to be provided.¹¹ The complexity of the Schedule K-1 as compared to

¹⁰Schedule K-1 is an information return used to furnish information to partners pursuant to section 6031(b). The form lists specific types of income (11 entries), deductions (4 entries), 7 types of credits (12 entries), tax preference items (6 entries), investment interest (3 entries), self-employment amounts (3 entries), and recapture of investment tax and low-income housing credits (2 entries).

¹¹Prospectus/Proxy Statement of CRI Liquidating REIT, Inc., and CRI Insured Mortgage Association, Inc., dated August 17, 1989, pages 1 and 11.

interest and dividend reporting on Form 1099s, may in and of itself discourage proper reporting by the partners.

The Service has insufficient data to determine the extent of underreporting of income by partners in widely held partnerships. However, statistics show a material level of noncompliance in the case of reporting of payments of interest, dividends and capital gains.¹² While an estimated 99.5 percent of wages and salaries were voluntarily reported in 1987 by individuals who filed tax returns, 94.5 percent of interest and dividends were reported¹³ and only 88.3 percent of capital gains were reported. These figures do not include the failure to report such income by persons not filing a required tax return.¹⁴ By analogy, it can be inferred that a material percentage of income from widely held partnerships is not reported by partners. Furthermore, even in cases where partners make good faith efforts to report items attributable to widely held partnerships, given the complexity of the Schedule K-1, it seems reasonable to conclude that some additional percentage of income attributable to widely held partnerships is not properly reported.

¹²A Form 1099 information return is required to be filed by any person making payments of interest or dividends above a certain amount and by brokers upon certain sales of assets. I.R.C. §§ 6042, 6045, and 6049.

¹³See Table I-2, "Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992," Publication 7285 (March 1988) ("Gross Tax Gap Estimates and Projections"). The 94.5 percent compliance figure resulted in underreported interest and dividends for 1987 of \$13.2 billion.

¹⁴The Service is concerned that partners who hold their interest through nominees may not be receiving Schedule K-1s from the partnership or the nominees. The Service has anecdotal information that in the past some brokerage houses holding partnership interests as nominees destroyed information returns received from such partnerships instead of forwarding those returns to their customers. However, such information predates the enactment of section 6031(c). Section 6031(c), which was added by the Tax Reform Act of 1986, Pub. L. No. 99-514, requires any person who holds an interest in a partnership as a nominee for another person to furnish to the partnership information concerning such other person to the extent prescribed by the Secretary. This section is effective for taxable years beginning after October 22, 1986. Section 1015(a) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, extended the section 6722 penalty to cover returns required under section 6031(c).

The Service currently has the technical capability to match information reported to the Service by partnerships with the information reported by partners on their returns. However, the application of the matching program is significantly complicated by the fact that each partner's Schedule K-1 information may consist of numerous items (over forty separate items possible) which, in many cases, are limited or modified at the partner level and are required to be reported in a variety of different places on the partner's Form 1040 and related schedules. Furthermore, in contrast to corporations that file substantial numbers of information returns,¹⁵ widely held partnerships are not required to use magnetic media filing to report Schedule K-1 information¹⁶ and in almost all cases file such information on paper returns. The Service must manually transcribe paper returns before matching can occur. These systemic barriers mean that matching partnership data is more expensive and time consuming than matching other types of reported information.¹⁷

The reporting system for widely held partnerships is thus needlessly complex and inefficient. It is important to solve these deficiencies in the compliance system, not only to protect the fisc, but also to provide a system that is workable for the public and administrable by the Service. It is also important to recognize in our tax system the changing economic and capital structure of the country and to adapt the system to changes in order to protect the interests of the public and the government.

¹⁵Notice 90-15, 1990-7 I.R.B. 23.

¹⁶Publication 1437 (Rev. 1-90).

¹⁷The difficulties in the operation of a matching program are also faced by the Information Returns Program ("IRP"). An IRP program involves the matching of data contained in information returns filed by payors and flow-through entities with the data reported on tax returns filed by payees and investors in flow-through entities. An IRP program normally results in assessment of additional tax in cases where a taxpayer agrees with the proposed adjustment to his or her reported income, and issuance of a statutory notice of deficiency in the event the partner fails to agree or respond. Under the unified partnership audit rules discussed below, the Service may be authorized to proceed directly to assessment under its authority to make a computational adjustment in a case in which a partner fails to report consistently with the partnership return and fails to disclose such inconsistency. I.R.C. § 6222. However, to institute the IRP procedure, the Service would have to locate and obtain the partners' returns for purposes of making the computational adjustment. The IRP procedure is not cost efficient under current law when applied to widely held partnerships.

A proposal for a simplified reporting system to help accomplish these objectives is discussed in Section IV below.

B. Administration of Widely Held Partnerships

1. Description of TEFRA Partnership Audit Rules

Prior to the enactment of unified partnership audit rules by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), adjustments to items of income, gain, loss, deduction and credit relating to a partnership had to be made in separate proceedings with the respective partners. Similarly, settlements and judicial determinations were only binding on those partners that were parties to the agreement or judicial proceeding. This system was not an efficient means of auditing tax shelters and other large partnerships, because each partner was entitled to separate administrative and judicial review of partnership items that were common to all partners.¹⁸ The TEFRA partnership audit rules consolidate the administrative and judicial review of all partnership items at the partnership level. Congress, noting the potential conflict between investors and tax shelter promoters, balanced the consolidated audit provisions with considerable protections for individual partners.

The TEFRA partnership audit rules apply to all partnerships, except for partnerships with ten or fewer partners in which each partner's share of any partnership item is the same as his or her share of every other item (e.g., there are no special allocations) and each partner is a natural person (other than a nonresident alien) or an estate.¹⁹ The tax treatment of all partnership items is determined at the partnership level.²⁰ Generally, all partners must treat items on their individual

¹⁸See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 267-68 (hereinafter referred to as "TEFRA General Explanation").

¹⁹I.R.C. § 6231(a)(1)(B). All partners of a partnership for the partnership taxable year under audit generally are subject to the TEFRA partnership audit rules. However, under certain circumstances, the inclusion of a partner in a unified proceeding would interfere with the efficient enforcement of the tax law. I.R.C. § 6231(c). When special enforcement considerations exist with respect to a partner, that partner's partnership items will be treated as nonpartnership items and the partner is removed from the partnership proceeding. Examples of special enforcement situations include the filing of a bankruptcy petition naming a partner as the debtor or the criminal investigation of a partner. Id.; Temp. Treas. Reg. §§ 301.6231(c)-4T through 8T.

²⁰I.R.C. § 6221.

returns consistently with the treatment of those items on the partnership return unless they notify the Service of an inconsistent treatment.²¹ If the Service challenges a reporting position of a partnership subject to the TEFRA rules, it conducts a single administrative proceeding to resolve the issue with respect to all partners. Similarly, if a partnership decides to challenge an administrative determination of the Service, a single judicial proceeding will occur.²²

The central figure in a TEFRA partnership proceeding is the tax matters partner ("TMP"). The TMP is the representative of the partnership who serves as a liaison between the partnership, the Service and the court with respect to the unified audit and litigation proceedings regarding the tax treatment of partnership items attributable to the partnership. As such, the TMP serves as the focal point for service of all notices, documents and orders on the partnership, and concomitantly has many rights and duties both at the administrative stage of the proceeding and in the course of litigation. The Code provides that the TMP is the general partner designated by the partnership to serve as the TMP or, if there is no such designation, the general partner having the largest profits interest as of the close of the taxable year involved.²³ If the Service determines that it is impracticable to apply the largest profits interest rule, the Service may select any partner to serve as the TMP.²⁴

The TEFRA partnership audit rules are described in detail in Appendix II.²⁵

2. Description of Service Audit Procedures with Respect to Widely Held Partnerships

The Service has elaborate procedures for auditing partnerships and assessing and collecting partner deficiencies after the amount of the audit adjustment has been finally determined. This section provides a detailed description of the steps that are followed in conducting an audit of a large partnership.

²¹I.R.C. § 6222(a) and (b).

²²See I.R.C. § 6226.

²³I.R.C. § 6231(a)(7); Temp. Treas. Reg. § 301.6231(a)(7)-1T.

²⁴Id.; see Rev. Proc. 88-16, 1988-1 C.B. 691.

²⁵Proposals for amendment of these rules are described in Appendix I.

There are ten Internal Revenue Service Centers ("Service Centers") located throughout the country. Each Service Center processes income tax returns of individuals and entities which reside (or have their principal place of business) within the geographical jurisdiction of the center. The Service also has 63 district offices which may have jurisdiction over a single state or a smaller geographical area in more densely populated states. The primary functions of each district office are the examination of tax returns (Examination Division), the collection of delinquent tax (Collection Division), the enforcement of criminal penalties for tax crimes (Criminal Investigation Division), and the response to taxpayer requests for assistance (Taxpayer Service Division). The Appeals Division's field function is organized by region, with branches located in some but not all district offices. The Appeals Division is responsible for settlement of disputes between the Examination Division and the taxpayer based on the merits of a given case as well as the hazards of litigation. The Appeals Division is also responsible for settlement of some collection disputes.

When a Service Center receives a partnership return, certain return information is entered into a Service Center computer system²⁶ and transmitted to the Martinsburg Computing Center.²⁷ Partnership returns with high audit potential scores are then screened by classifiers at the Service Center in order to determine which returns should be audited.²⁸ Lists of returns with high audit potential are transmitted to their assigned district offices.²⁹ The district office then obtains the

²⁶After a period of time, depending on the return in question and on the available space at the Service Center, the tax returns are transported to one of several Federal Record Centers for further storage and ultimate destruction.

²⁷The Martinsburg Computing Center is responsible for various data processing functions within the IRS.

²⁸Partnership returns are assigned a "Discriminate Function" or DIF score at the Martinsburg Computing Center based on the values of various line items and the interrelationships of certain line items. DIF scores on partnership returns, just as on individual returns, are a numerical rating of the potential of significant errors being present on a particular return. If a return has a DIF score above a certain level, it goes into the DIF inventory and is ordered out by the Examination function as work is needed. It is then screened for audit potential by the Classification Branch at the Service Center where the return was filed.

²⁹Partnership audits are generally assigned to the district in which the partnership has its principal place of business.

original partnership return (with any associated files), and the case is assigned to a revenue agent of the Examination Division.

The revenue agent sends the TMP a Notice of the Beginning of the Administrative Proceeding (which is required to be issued at least 120 days before a notice of Final Partnership Administrative Adjustment is mailed to the TMP).³⁰ The revenue agent then has 45 days to determine whether the items of the partnership are correctly reported.³¹ If the revenue agent determines that there should be no changes to items as reported, the Notice of the Beginning of the Administrative Proceeding must be withdrawn within 45 days of its issuance (otherwise, a notice of Final Partnership Administrative Adjustment must eventually be issued).³²

If the revenue agent determines that an audit is warranted, he or she reconciles all of the Schedule K-1s with the partnership return.³³ The information drawn from the Schedule K-1s regarding individual partners is forwarded from the district office to the Examination Support Unit³⁴ of the Service Center with jurisdiction over the partnership return (the "partnership's Service Center"). The Examination Support Unit then enters this information into the Partnership Control System computer programs, which automatically generates requests for all partner returns in the Federal Records Centers which are then transferred to the various Service Centers with jurisdiction over each partner's return (the "partner's Service Center").³⁵ It takes

³⁰I.R.C. § 6223(d)(1).

³¹Temp. Treas. Reg. § 301.6223(a)-2T(a).

³²Id.

³³Copies of the Schedule K-1s are filed with the original partnership return and continue to be associated with the original partnership return throughout the audit process. The reconciliation process involves adding the partner profits percentage indicated on each Schedule K-1 to determine whether the percentages total 100 percent (in order to ensure that all partners have been accounted for).

³⁴An Examination Support Unit is located in each of the ten Service Centers. The units, which are part of the Examination Division, are principally responsible for coordinating the notice and assessment procedures with respect to individual partners of partnerships subject to the TEFRA partnership audit rules.

³⁵If a partner's return is not currently under examination, the Examination Support Unit of that partner's Service Center may review this return for possible audit.

an average of two to three months from the date a return is ordered to locate and forward the return to the appropriate Service Center.³⁶ The Partnership Control System of the partnership's Service Center generates Notices of the Beginning of the Administrative Proceeding to each notice partner.³⁷

When the examination of a partnership return is completed, the revenue agent arranges a conference with the TMP and any other partner who wishes to attend.³⁸ Prior to the conference, the revenue agent issues a preliminary report to the TMP summarizing the revenue agent's initial conclusions, which are subject to change as a result of legal or factual arguments presented at the conference.

At the conference, the revenue agent and the TMP (and any other partners present) discuss the issues raised in the audit. Even if the revenue agent and the TMP reach an agreement regarding a proposed adjustment, by statute the TMP is only authorized to bind non-notice partners,³⁹ and in practice will rarely exercise that authority. If, as is typically the case in an audit of a widely held partnership, the revenue agent does not obtain an agreement regarding a proposed adjustment that covers all of the partners of the partnership, the agent prepares a final report containing facts, analysis of law, statement of taxpayer's position, and the agent's conclusions on each issue.

³⁶If a partner is itself a pass-through entity, the procedure must be repeated with respect to its members. It takes approximately four to six months to locate all partner returns for each tier in a multi-tier partnership.

³⁷All partners whose names and addresses have been furnished to the Service are entitled to receive such notice from the Service in partnerships having 100 partners or less. I.R.C. § 6223(a)(1). For partnerships having more than 100 partners, only partners having a one-percent or greater profits interest or the designated member of a group of partners who form a five-percent "notice group" are entitled to receive notice from the Service. I.R.C. § 6223(b). The TMP is under an obligation to forward such notices to non-notice partners (with certain exceptions including indirect partners who have not been identified to the TMP). Temp. Treas. Reg. § 301.6223(g)-1T(a).

³⁸The burden of notifying all partners of the conference is placed on the TMP. Temp. Treas. Reg. § 301.6223(2)-1T(b)(1)(i).

³⁹I.R.C. § 6224(c)(3)(A). However, under section 6224(c)(3)(B), a non-notice partner may file a statement with the Service providing that the TMP is not authorized to enter into a settlement on such partner's behalf.

This report may be reviewed by the Quality Review Staff⁴⁰ in the district office responsible for the partnership audit.

The Quality Review Staff then prepares a "60-day letter package" and forwards it to the Examination Support Unit of the partnership's Service Center. The Examination Support Unit then mails a copy of the package to the TMP.⁴¹ The 60-day letter package contains a letter notifying the partners of the time period to protest the proposed adjustments to the Appeals Division. The package also contains a copy of the revenue agent's report and an agreement form for use by the partner in the event he or she decides to accept the proposed adjustments.⁴² The TMP files his or her protest with the Quality Review Staff of the district responsible for the partnership audit. Other partners must file their protests with the Examination Support Unit of the partnership's Service Center. The Examination Support Unit forwards any protests it receives to the Quality Review Staff, which in turn forwards all protests to the Appeals Division office with jurisdiction over the partnership's district.

If no protest is received, the Quality Review Staff of the partnership's district office prepares a notice of Final Partnership Administrative Adjustment, which is reviewed by the District Counsel office for the district. Copies of the notice are mailed to the TMP and each notice partner or the designated member of each notice group by the partnership's Service Center. The TMP is required to forward copies of the notice to each non-notice partner within 60 days after the mailing by the Service.⁴³

If a protest is received, an Appeals Division settlement conference is held at which any partner is entitled to participate. If a settlement covering all of the partners is not reached at the conference, the Appeals Officer prepares a settlement package which the Examination Support Unit of the partnership's Service Center mails to all partners who have not

⁴⁰The Quality Review Staff is a branch of the Examination Division with responsibility for review of completed audit reports in order to determine whether proper procedures have been followed and to review revenue agents' determinations.

⁴¹The TMP would then be responsible for notifying non-notice partners. Temp. Treas. Reg. § 301.6223(g)-1T(b)(1)(ii).

⁴²A copy of the 60-day letter and the agreement form (Form 870-P or 870-L) is sent to all notice partners.

⁴³Temp. Treas. Reg. § 301.6223(g)-1T(a)(2).

yet settled.⁴⁴ If not all partners accept the proposed settlement, the Appeals Division office prepares a notice of Final Partnership Administrative Adjustment, which is reviewed by District Counsel and sent to the TMP. Copies of the notice of Final Partnership Administrative Adjustment are mailed to each notice partner or the designated member of each notice group by the Examination Support Unit of the partnership's Service Center.⁴⁵ Although the Appeals Division may have developed a settlement position (under the above-described procedure), the notice of Final Partnership Administrative Adjustment generally will reflect the litigation position of the Service (rather than the settlement position).⁴⁶

The TMP has 90 days from the date of mailing of the notice of Final Partnership Administrative Adjustment to file a petition with the Tax Court, the Claims Court, or a federal district court.⁴⁷ If the TMP fails to file a petition within the 90-day period, any notice partner or any group having in the aggregate a five-percent interest in profits may file a petition during the 60 days following the end of the 90-day period.⁴⁸ Every partner of the partnership is treated as a party to an action brought by the TMP or notice partner (or five-percent group), and is entitled to participate in the action, unless the partner's partnership items have been converted to nonpartnership items or the statute of limitations has expired with respect to that partner.

After a final determination has been made with respect to a partnership level adjustment, the Examination Support Units located in the partners' Service Centers are responsible for assessing deficiencies against the partners. The tax must be assessed with respect to each partner within one year of the date

⁴⁴The Appeals Division may determine in certain situations that it is not efficient to mail settlement packages to non-notice partners.

⁴⁵I.R.C. § 6223(a)(2).

⁴⁶If any settlement was entered into between a partner and the Service, any other partner may still obtain consistent terms by making a request within a prescribed time period. See I.R.C. § 6224(c)(2).

⁴⁷I.R.C. § 6226(a).

⁴⁸I.R.C. § 6226(b)(1). The "five-percent group" for purposes of filing a petition need not be the same partners that were members of a five-percent "notice group." Temp. Treas. Reg. § 301.6223(b)-1T(e).

on which the adjustment became final as to that partner.⁴⁹ Each of these Service Centers reviews the returns of the partners within their jurisdiction, computes the deficiency, and mails a notice of computational adjustment to the partners. A computer generated notice of assessment and demand for payment is then mailed to each partner from the various partners' Service Centers within 60 days of the date of assessment of that partner. Payment is due within 10 days of the mailing of the first notice and demand for payment. If a partner fails to make payment within that time period, a tax lien is created by operation of law at the end of the 10 day period. The lien relates back to the date of assessment.⁵⁰ Shortly after the 10 day period, computer generated notices are transmitted to the partners who have not yet paid. Two to five notices (including the above-mentioned notice of assessment and demand for payment) are transmitted depending on the amount of money involved. The last notice, identified as "Final Demand and Notice of Intent to Levy," must be issued before enforced collection by levy can occur and must either be sent by certified mail to the partner's last known address, hand-delivered to the partner, or left at the partner's home or place of employment.⁵¹ Absent exigent circumstances which would support the making of a jeopardy levy (usually the same circumstances that would support a termination or jeopardy assessment), the Service cannot levy for 30 days from the date of the final notice.

After the notices have been transmitted, if the amount of the deficiency is below a set tolerance level, no action is taken by Service personnel; however, any potential levy sources (such

⁴⁹The one-year assessment period must be calculated on a partner-by-partner basis, because some partners may settle their cases separately on different dates while other partners may choose to await the outcome of the litigation.

⁵⁰If any person fails to pay the tax (including any related interest or penalty) after notice and demand, a statutory lien is created in favor of the United States upon all property and rights to property of that person. I.R.C. § 6321. The lien imposed by section 6321 arises as of the date of assessment and continues until the liability is paid or becomes unenforceable by reason of lapse of time (usually due to the running of the statute of limitation on collection six years after assessment). I.R.C. §§ 6322 and 6502.

⁵¹At this stage, the debt is classified as a "taxpayer delinquent account." The average cost to the Service to close such accounts during 1986, 1987 and 1988 was \$196.04, \$198.48 and \$234.00, respectively. The amount of tax owed thus must be relatively substantial for collection of these accounts to be cost effective.

as refunds due) are identified by computer, and the amount of any such refund will be offset by the outstanding liability. A delinquent account with a balance due above the tolerance level is then entered into the Automated Collection System computer, which sets collection priorities based on potential yield (the amount of the liability is only one of several factors considered). After priorities have been set, revenue representatives of the Collection Division located at 21 locations throughout the country commence efforts to collect the liability. The revenue representatives telephone, and in some cases correspond with, the partners. Any information obtained from the partner or third party sources is entered into the Automated Collection System computer for future reference. If a revenue representative identifies a levy source, he or she may issue a notice of levy or file a notice of federal tax lien.

If the partner still has an outstanding liability at the conclusion of the above-described process, the account is placed into an automated queuing system. The automated queuing system is a computerized listing of outstanding accounts with priorities based on expected amounts of collection. If the amount of expected collection is high enough, the case is automatically transferred to the district where the partner resides and assigned to a revenue officer. Even if the amount of expected collection is not high enough to be immediately transferred to the district, the amount may be transferred and assigned later if circumstances warrant. However, many smaller accounts (even though above the set tolerance level) are never assigned to a revenue officer and therefore the amount due generally would not be collected.

After an account has been assigned to a revenue officer, the officer contacts the partner in an effort to collect the amount due. If this contact does not lead to payment of the liability, the revenue officer is empowered to take various collection actions, including seizure of the partner's property. If all efforts to collect are unsuccessful, a determination may be made that the debt is currently uncollectible.

The Service has similar, although less well developed procedures, for handling Requests for Administrative Adjustment ("RAA"), which are the TEFRA equivalent of a refund claim or an amended return. An RAA could be filed in the many situations in which a partnership level deficiency flowed through to partners in a TEFRA proceeding and leads to a related overpayment in another year for all such partners.⁵² Many of the steps discussed above would essentially have to be repeated in such a case.

⁵² See section III(B)(3)(6).

3. Problems Faced by the Service in Administering Widely Held Partnerships

The present audit and assessment system applies to all partnerships with more than ten partners (and in certain cases to even smaller partnerships). Because of the breadth of its coverage, the system provides procedural protections and rules that are generally desirable for partnership administration, but that may not be appropriate when applied to the type of widely held partnerships that are becoming common today. The sheer number of partners in a large partnership (one for instance had more than 90,000 partners in its first year of operation) may cause a myriad of problems in the areas of filing, audit, settlement, litigation, assessment and subsequent proceedings. The following is a summary of these problems.

(1) Partners may take filing positions inconsistent with the partnership return. Although in widely held partnerships this right may not be frequently exercised because the partner does not have adequate information to take such a position, the possibility does exist. If the Service is not notified by the partner as required, the inconsistent treatment in most cases will never be detected. If notified, the Service may challenge the inconsistency and conduct a partnership audit or deal with the items as nonpartnership items. In either case, there is a significant potential burden in trying to monitor inconsistent positions of partners in widely held partnerships absent a mandatory magnetic media filing requirement with a fully implemented matching procedure.

(2) To conduct an audit of a widely held partnership, the Service must obtain and monitor information concerning each individual partner. The actual audit of a large partnership's books and records ordinarily proceeds in a manner similar to an audit of a large corporation; however, in a corporate audit, the Service is not required to develop and track information concerning each shareholder.⁵³ In a partnership audit, the Service must first identify each partner. To do so, the Service must reconcile individual Schedule K-1s to determine that it has accounted for 100 percent of the interests in profits and losses in the partnership. This process is especially difficult in a publicly traded partnership because there may be numerous transfers of partnership interests during any taxable year. Furthermore, information provided by the partnership regarding

⁵³Generally, jurisdiction of the Service Centers is based on the residence of the partners (or principal place of business in the case of corporate partners). Several (and possibly all) Service Centers would necessarily become involved in auditing, assessing and collecting deficiencies from the partners of a widely held partnership.

individual partners is often incomplete or incorrect, thus requiring the Examination Division to expend considerable resources (particularly in the case of larger partnerships) in order to determine the proper identity of the partners and to develop sufficient information to make assessment possible.

The Service must then obtain the individual returns of all partners. It takes an average of two to three months to obtain the return of a partner once it is ordered from the appropriate Federal Records Center. If a partner is itself a passthrough entity, the process must be repeated. It takes approximately four to six months to obtain all partner returns for each tier of a multi-tier partnership. The Service also must keep track of the statute of limitations for every partner, because, for a variety of reasons, partners may have differing statutes of limitation. Thus, the Service is required to obtain and monitor a significant amount of information concerning each partner. In the audit of a large partnership, the cumulative effect of these monitoring and information-gathering activities offsets the efficiencies afforded the Service by the TEFRA rules.

(3) The TMP is authorized to extend the statute of limitations on behalf of all partners.⁵⁴ However, if the Service is unable to obtain a consent from the TMP which binds all partners to an extension of the statute of limitations for assessment, the Service must solicit a consent from each partner.⁵⁵ If one partner fails or refuses to extend the statute of limitations for assessment, the Service is forced to issue a premature notice of Final Partnership Administrative Adjustment (applicable to all partners) or else allow the statute of limitations to expire as to the nonconsenting partner.

(4) A settlement agreement entered into with the TMP will not be binding on notice partners and will only bind non-notice partners if the TMP expressly makes the settlement binding on such partners. Since the TMP of a widely held partnership will rarely, if ever, elect to bind other partners, the Service generally must deal with the individual partners if it desires to settle the entire case. As a result, as the size of the partnership increases, there is less incentive on the part of the Service to actively attempt to settle the case. This is because the Service cannot realistically expect to reach an agreement with all of the partners in a widely held partnership, even if the TMP agrees to the settlement offer. Since the refusal of just one partner to settle could force the Service to litigate the case, it would be in the Service's best interests to take a hard-line position in settlement negotiations. Consequently, in

⁵⁴I.R.C. § 6229(b)(1)(B).

⁵⁵See I.R.C. § 6229(b)(1)(A).

the context of a widely held partnership, the existing rules are an impediment to resolving the dispute through settlement and increase the likelihood of litigation.

If the Service does enter into a settlement agreement with any partner with respect to partnership items, any other partner may request consistent settlement terms within (1) 150 days of the mailing of the notice of Final Partnership Administrative Adjustment ("FPAA") to the TMP or, (2) if later, within 60 days after the settlement agreement was reached.⁵⁶ This right continues even if all settlement offers have subsequently been withdrawn. In widely held partnerships, if the Service follows a de minimis approach by not pursuing small adjustments, those with greater tax deficiencies may contend they are entitled to the same treatment of no adjustment. Thus, the consistent settlement rules add to the administrative complexity of dealing with widely held partnerships.

(5) Because each partner has the right to participate in both administrative and judicial proceedings, the Service may be faced with numerous representatives in a single partnership proceeding. This may result in considerable complexity and cause confusion both to the Service and the taxpayers' representatives.

(6) Once adjustments are finalized at the partnership level, the Service must compute the tax for each partner, including indirect partners, i.e., those holding an interest through a passthrough entity or nominee. After the notices are issued, a partner who disagrees with the computational adjustment must pay the tax, and then may file a claim for refund followed by a refund suit if the claim is disallowed. This again raises the potential for multiple actions resulting from a single partnership adjustment, although such actions are limited to the computational aspects of the adjustment.⁵⁷

(7) Deficiencies in one year will frequently give rise to refund claims in subsequent years. This can result, for example, from timing differences or basis adjustments. The claims may be filed by each partner for the overpayment years, thus again opening up the possibility of handling large numbers of

⁵⁶I.R.C. § 6224(c)(2); Temp. Treas. Reg. § 301.6224-3T(c)(3)(ii). The TMP is required to forward a copy of the notice of FPAA to all non-notice partners within 60 days of the date the notice of FPAA was mailed to the TMP. The TMP is also required to provide non-notice partners with information regarding the Service's acceptance of any settlement offer within 30 days of receiving information of such acceptance. Temp. Treas. Reg. § 301.6223(g)-1T(b).

⁵⁷I.R.C. § 6230(c).

individual cases that relate to a single or a few partnership adjustments.

(8) Penalties attributable to a taxpayer's investment in a TEFRA partnership must be asserted in separate proceedings with the respective partners following the conclusion of the partnership-level proceeding.⁵⁸ The assertion of penalties against the investors in a widely held partnership is administratively burdensome and significantly increases the inventory of cases both under audit and in the Tax Court. Moreover, since these penalty proceedings are generally duplicative, conducting a separate proceeding with each partner is an inefficient use of resources at both the administrative and judicial level and seriously undermines one of the principal objectives of having a unified, partnership-level proceeding to determine the tax treatment of items flowing from the partnership.

In summary, the audit and administrative procedures were not designed for nor do they effectively accommodate widely held partnerships. These procedures reflect a balancing between certain entity concepts and individual partner protections. This balancing is appropriate when applied to small to medium size partnerships, in which the number of partners is manageable from an administrative standpoint and where there is a substantial likelihood that most partners will have a significant investment in the partnership. However, when applied to widely held partnerships, the individual partner protections seem disproportionate to the rights in need of protection, and present significant administrative obstacles.

Widely held partnerships resemble large corporations in their method of operation and capitalization, *i.e.*, a large number of partners contributing capital to a centralized operating organization. Each partner of a widely held partnership generally has an investment comparable to that of a shareholder in a comparably sized corporation in terms of dollars invested, role in management and rights under state law. In auditing a corporation, the Service does not need to deal with shareholders directly, but in auditing a widely held partnership, the Service must deal directly with hundreds or thousands of partners in order to complete an examination that results in even the simplest adjustment. Moreover, adjustments to the income of a widely held partnership that in the aggregate are substantial are relatively small when applied to the individual partners.⁵⁹

⁵⁸I.R.C. § 6230(a)(2)(A)(i); N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987).

⁵⁹The relative cost of making an adjustment with respect to a widely held partnership is likely to increase under the present system. In past years, partnership audits were mainly directed

The present system, when applied to widely held partnerships, creates a burden on and results in an inefficient use of the valuable and limited resources of the Service. Partners in these partnerships should be treated for administrative purposes in a manner similar to that of shareholders in a corporation (which is subject to entity-level audit), rather than receiving the same procedural protections accorded partners in small to medium size partnerships. Accordingly, a proposal for a new administrative system applicable to widely held partnerships is discussed in Section V.

at tax shelters in which the average annual deficiency per partner was substantial (the average deficiencies for tax shelters audited from 1983-87 ranged from approximately \$18,500-\$22,000). As post-1986 years become subject to audit, due in large measure to the enactment of the passive loss rules of section 469, tax shelter audits will be reduced and should be replaced by audits of partnerships generating income, including widely held partnerships. In that setting, although overall partnership deficiencies may be substantial, the average deficiency on a per partner basis is likely to be relatively small. The average size of deficiencies may be further reduced with respect to partners in widely held partnerships that are actively traded in that interests are often held for short periods of time.

SECTION IV. PROPOSED SIMPLIFIED REPORTING SYSTEM FOR WIDELY HELD PARTNERSHIPS

A. Introduction

In order to simplify reporting for widely held partnerships, encourage correct reporting by partners and aid the Service in its compliance monitoring, a simplified system of reporting by widely held partnerships is recommended. Such reporting to the partners and Service would be accomplished by use of a Form 1099-K designed for use by widely held partnerships in lieu of the current Schedule K-1.⁶⁰

The present Schedule K-1 is used by all partnerships to report their partners' distributive shares of partnership income, gain, loss, deduction or credit. The Schedule K-1 form and instructions are complex and result in voluminous amounts of paperwork being filed with the Service and sent to partners by widely held partnerships. While magnetic media filing of information returns is permissible, and generally required for corporations, few widely held partnerships use magnetic media to file with the Service. The volume of Schedule K-1 information and the manner in which it is reported on each partner's Form 1040 does not lend itself to efficient integration into the matching programs presently maintained by the Service. The use of a Form 1099-K with limited categories of information, as described in detail below, would encourage compliance due to its simplicity. In addition, reporting limited information would ease the reporting burden on widely held partnerships and requiring magnetic media filing would provide the Service with a more efficient means of matching partnership data with partner returns.⁶¹

⁶⁰Section 6031(b) currently requires that partners be furnished with either a Schedule K-1 or substituted form by the due date of the partnership return (April 15 for a calendar year partnership unless extended). If the proposal for the Form 1099-K is adopted, it is recommended that the due date for furnishing the Form 1099-Ks to partners be the same as provided in section 6031(b), rather than the January 31 due date applicable to other information returns.

⁶¹Although only the term "magnetic media" is used, it is meant to encompass any future improvements to include information transferred in machine readable form by other means, such as electronic filing.

B. Determination of Partnership Items at the Widely Held Partnership Level

1. In General

The key to simplification of the reporting of partnership income is reduction of the number of items that must be separately reported to partners. Under current law, the Code and regulations specifically enumerate many items that must be passed through separately to partners⁶², and under regulations, any item not enumerated must also be passed through if separate treatment would affect the calculation of the partner's income tax liability.⁶³

In the simplest of passthrough systems, an entity such as a widely held partnership could in theory pass through a single item of income or loss. In such a system, information reporting would be as simple as the reporting of interest and dividends under current law. For a number of reasons, this level of simplicity is not realistically achievable (and may not be desirable) at the present time for widely held partnerships. However, we believe it would be possible and desirable to significantly reduce the number of items to be separately passed through to partners of widely held partnerships.

Set forth in this section is an outline of a proposed simplified system for determining and reporting the distributive items of widely held partnerships. We recognize that legislation amending many sections of the Internal Revenue Code would be necessary to implement such a system and that the proposed changes would have a substantive impact on the calculation of a partner's tax liability. We also recognize that this outline does not address all questions that would arise in developing the system and in identifying legislative changes that will be required to allow for the simplified system. However, we believe that implementation of the general approach articulated below would represent a significant step towards rationalizing the reporting system for widely held partnerships.

2. Income and Deductions

Under the proposed approach, all income and expense, including capital gains and losses, would be netted at the partnership level. In calculating a partnership's net income, the application of any limitation with respect to a deduction would be determined at the partnership level. For example, under current law an election may be made under section 194 to amortize

⁶²See I.R.C. § 702(a) and Treas. Reg. § 1.702-1.

⁶³Treas. Reg. § 1.702-1(a)(8)(ii).

certain reforestation expenditures over a seven year period. The maximum amount eligible for the election in any taxable year is \$10,000.⁶⁴ In the case of a partnership, this maximum is applicable at both the partnership and the partner level.⁶⁵ Consequently, a partnership must separately report amortization deductions under section 194 to permit partners to calculate their individual limitations. Under the simplified reporting approach, the section 194 limitation would apply solely at the widely held partnership level. Thus, amortization deductions under section 194 would be reflected in the widely held partnership's net income reported to partners, and would not be separately reported.

Any elections relevant to deductible items would be made by the widely held partnership. For example, section 617 allows a taxpayer to elect to deduct certain mining exploration expenses. If the election is made and the mine eventually reaches the producing stage, the expenses must be "recaptured" by inclusion in income or by denial of depletion deductions.⁶⁶ Under current law, each partner independently decides whether to make the election under section 617.⁶⁷ Under the simplified reporting approach, the section 617 election would be made by the widely held partnership, and recapture of section 617 expenses would be determined at the partnership level. Thus, any deduction or recapture of section 617 expenses would be reflected in the widely held partnership's net income.

Where a limitation on a deduction results in a carryover of a deduction, the amount would be carried over at the widely held partnership level. For example, under section 175 a taxpayer is permitted to deduct soil and water conservation expenses. However, the deduction may not exceed 25 percent of the taxpayer's gross income from farming; any excess is carried over until the taxpayer has sufficient gross income from farming.⁶⁸ Therefore, a partnership is required to separately report its gross income from farming.⁶⁹ Under the simplified reporting approach the 25 percent limitation and any resulting carryover would be determined at the widely held partnership level.

⁶⁴I.R.C. § 194(b)(1).

⁶⁵I.R.C. § 194(b)(2)(B).

⁶⁶I.R.C. § 617(b).

⁶⁷I.R.C. § 617(b)(2).

⁶⁸I.R.C. § 175(b).

⁶⁹See Treas. Reg. § 1.702-1(c)(1)(iv).

Most interests in widely held partnerships are held by limited partners who are subject to the passive loss rules of section 469 because they do not materially participate in any of the partnership's activities.⁷⁰ Under current law, a widely held partnership's operations may be multiple activities for purposes of the passive loss rules. In that case, the partnership must separately report items of income and deduction from each of its activities. One reason separate reporting is necessary is that a partner who holds both passive and nonpassive activities through a partnership takes only the items from the passive activities into account in applying the passive loss rules.⁷¹ In addition, a partner cannot compute the suspended loss allowed on the fully taxable disposition of the partner's entire interest in a passive activity conducted through the partnership unless the partnership has separately reported items from the activity.⁷²

Under the simplified system, a limited partner's interest in a widely held partnership would be treated as a single activity for purposes of section 469. For passive limited partners, all items of income and deduction from widely held partnerships will be either passive or portfolio.⁷³ Thus, the only information the limited partner would need to apply section 469 would be the net passive income or net passive loss for the partnership as a whole, and the partnership would report this information rather than separately reporting items from multiple activities.

Portfolio income (e.g., interest and dividends) would be reported separately from other income, and would be reduced by

⁷⁰Temp. Treas. Reg. § 1.469-5T provides that a limited partner's participation in an activity is material only if it exceeds 500 hours during the taxable year or satisfies one of two other tests that consider multi-year participation. It may be appropriate to provide that a limited partner's interest in a widely held partnership is always passive.

⁷¹This is a minor consideration in the case of limited partners because, as noted above, they typically do not materially participate in any of the partnership's activities.

⁷²This is a concern only if the partnership is not publicly traded. Under section 469(k), the activities of a publicly traded partnership are treated as a single activity for purposes of this rule.

⁷³Expenses that are not treated as passive activity deductions under Temp. Treas. Reg. § 1.469-2T(d)(2) and are not portfolio items under section 469(e)(1) would be treated as passive deductions for this purpose. For example, charitable deductions of a widely held partnership would be treated as passive.

portfolio deductions and allocable investment interest expense. Further, to reflect the 2 percent floor limitation imposed on miscellaneous itemized deductions at the individual level, it will be necessary to reduce such deductions by an arbitrary amount (e.g., 50 percent). To the extent there is excess investment interest, it would be carried over at the partnership level.

Netting of capital gains and losses would occur at the widely held partnership level. Thus, capital gains would be consolidated with other reported income, and an individual partner would not be able to net partnership capital gains and losses on his or her individual income tax return. Any excess of capital losses over capital gains would be carried over at the widely held partnership level. Therefore, an individual partner would not receive the benefit of the limited annual offset of capital loss against ordinary income allowed under current law. If a capital gains preference is enacted, a widely held partnership should be able to take advantage of a preferential rate without reporting its capital gains separately. If a deduction (or exclusion) is permitted for long term capital gains, as under pre-1987 law, the partnership would determine its long term capital gains, compute the appropriate deduction, and reduce net income to be flowed through to partners.

Alternative minimum tax adjustments and preferences would be combined and allocated to partners. To apply the passive loss rules, it will be necessary to report portfolio income minimum tax items separately from other minimum tax items. Tax-exempt interest would be shown as a passthrough information item because of its significance in the taxation of social security benefits.

3. Allocations

Under the simplified reporting system, a single amount of net taxable income or loss would be reported to each partner. Therefore, widely held partnerships would not be able to report to partners specially allocated items of income or deduction. This does not mean, however, that widely held partnerships would be required to allocate all items on a pro rata basis. Pro rata allocations would deprive partnerships of any flexibility in income allocations, and would cause serious transitional difficulties for existing partnerships.

A degree of flexibility could be achieved by allowing special allocations of those items which are separately reported on the Form 1099-K.⁷⁴ Taxable income would therefore be

⁷⁴Allocations would, of course, be required to satisfy the rules of section 704(b) and the regulations thereunder (e.g., the substantial economic effect test).

allocable on a bottom line basis. For example, assume Partnership X has \$10 million of rental income, \$3 million of depreciation deductions attributable to its rental activities, and no other items. On a bottom line basis, it would allocate \$7 million of passive income among its partners. Portfolio income could similarly be allocated on a bottom line basis. Alternative minimum tax adjustments would be allocated in accordance with the allocation of passive and portfolio taxable income. Tax exempt interest and credits would be reported separately, so that separate allocation of these items should be feasible under the simplified reporting system.

Further flexibility could be achieved by allowing widely held partnerships to allocate gross income (whether portfolio or passive) and total allowable deductions as determined at the partnership level. Partnership X could therefore allocate the \$10 million rental income and the \$3 million depreciation deductions independently, although each partner would still be reported a single item of passive income or loss. Where a limitation on a deduction applies at the partnership level, it would reduce the total allowable deductions. This approach would permit a particular deduction to be effectively allocated to a particular class of partners, without requiring reporting of the deduction separately from the partners' share of other income or deductions reported on the Form 1099-K.

4. Credits

a. Consolidated Tax Credit

Under the proposed simplified approach, credits would generally be determined at the partnership level and would be passed through to partners as a single combined item on the Form 1099-K. Each credit typically has its own set of special rules (e.g., carryover provisions); these rules would have to be examined and altered where necessary to apply at the partnership level. We believe that in most cases it will be possible to restructure credit limitations to permit consolidation. In the case of credits which are consolidated for reporting purposes, recapture would necessarily occur solely at the partnership level, as a partner would not be able to determine his or her recapturable amount upon disposition of a partnership interest. Thus, recapture of any type of nonseparately-reported investment credit might occur if the partnership disposed of the property, but would not occur upon disposition of any partner's interest. It would also be possible to deem the transfer of a specified percentage of interests in a partnership to be a recapture event, although this approach would not be consistent with entity-level treatment of widely-held partnerships. The partnership could either offset credit recapture against current credits, satisfy any recapture liability itself, or could increase taxable income

in the year of recapture by the amount necessary to recapture the credit assuming a partner-level tax rate.

It should be possible to consolidate many credits for reporting as a single item. However, at least three credits (low income housing credit, rehabilitation credit, and credit for withheld taxes) may require separate reporting. The foreign tax credit also poses a number of particular issues. These credits are discussed below.

b. Separately-Reportable Credits

The low income housing credit and the rehabilitation credit are subject to special favorable treatment under the passive loss rules.⁷⁵ It would be impossible for partners to take advantage of these rules without separate reporting of each credit. On the other hand, most widely held partnerships will not generate these credits. To keep the Form 1099-K as simple as possible in most cases, only partnerships which are significantly engaged in activities anticipated to generate these particular credits should be permitted to report them as separate items. For example, unless a partnership's assets are substantially comprised (e.g., at least 50 percent) of low income housing, it would not be permitted to separately report the low income housing credit. Similarly, unless a partnership's assets are substantially comprised of real property, it would not be permitted to separately report the rehabilitation credit. If a partnership not substantially engaged in the relevant activity were to generate one of these two credits, it would report the credit together with any other credits as part of the general tax credit (line 5) reported on the Form 1099-K.

Under the Partnership Collection Proposal, a partner may be entitled to a credit for partnership payments which would be refundable to the extent it creates an overpayment.⁷⁶ The refundability feature would distinguish this credit from other credits, and would require the credit for partnership payments to

⁷⁵Section 469(i) exempts these credits from the passive credit limitations to the extent they are equivalent in their effect on tax liability to a specified amount of deductions. The deduction equivalent of the credits allowed under this rule is generally \$25,000, but the \$25,000 amount is reduced by the amount of losses and the deduction equivalent of other credits allowed under section 469(i) and, in the case of the rehabilitation credit, by 50 percent of the amount by which adjusted gross income (computed with certain modifications) exceeds \$200,000.

⁷⁶See Section V (D) of this report.

be reported separately.⁷⁷ Since it will not be common for partnerships to have such a credit, the Form 1099-K will report this item only for partnerships that have had a final determination during the taxable year.

c. Foreign Tax Credit

Under current law, taxpayers have the option of choosing to deduct or claim a credit against U.S. tax for certain foreign taxes paid or accrued by the partnership.⁷⁸ Most taxpayers choose to credit their foreign income taxes against U.S. income tax. The credit option is subject to a complex set of limitations. Under section 904, creditable foreign taxes must be allocated to a specific basket or category of income, and within each basket the foreign tax credit is subject to a ceiling that is determined by reference to the amount of income in that basket. In determining the amount of income in each basket and the amount of foreign taxes paid or accrued with respect to that income, a partner of a partnership is treated as directly earning his or her distributive share of the partnership's income and directly paying the foreign tax, *i.e.*, a partnership generally is treated as an "aggregate" rather than as an "entity" for this purpose. Under current law, each partner's distributive share of foreign taxes paid or accrued by the partnership is separately stated on Schedule K-1, in order to provide the partner with the information necessary to combine foreign taxes paid or accrued by the partnership with other foreign taxes paid or accrued by the partner in computing his or her foreign tax credit limitation.

Partnership Level Credit. In order to avoid the complexity associated with a separate listing of foreign taxes and income on Form 1099-K, the foreign tax credit limitations should be applied at the widely held partnership level. All elections and computations concerning foreign tax credits would then be determined at the partnership level, as are other elections and computations under the simplified reporting system. A widely held partnership would have an annual election to deduct or credit foreign taxes paid or accrued; any carryovers of such items would be at the partnership level. In order to apply this concept, the credit for foreign taxes paid or accrued would be determined by using an assumed U.S. tax rate for the partnership. The amount of foreign taxes paid or accrued by the partnership which could be claimed as a credit against U.S. tax on the income in a particular foreign tax credit limitation basket would be limited to an amount equal to U.S. taxes (calculated at the

⁷⁷The same issue would arise if in the future partnership withholding were to be instituted. See Section IV (G) of this report.

⁷⁸I.R.C. §§ 901 and 903; I.R.C. § 164(a)(3).

assumed rate) on the foreign source income in that basket. All partnership income would be reported at the partner level as having a U.S. source.

This approach could be applied by using all of the limitations and separate baskets provided under current law. The foreign tax credit passed through to the partners would be the sum of all the separate foreign tax credit limitations. This sum would be included as part of the consolidated tax credit on the partners' Form 1099-Ks, and reported by partners directly on their tax returns.⁷⁹ The choice of an assumed tax rate for the partnership in making the foreign tax credit calculation would have a substantial effect on the partners. A low assumed rate would reduce the amount of foreign tax credits available to offset U.S. income tax liability of the partners and would be detrimental to those partners whose marginal rate is higher than the assumed rate. Conversely, if a higher assumed rate were used by the partnership, those partners who actually are subject to a lower marginal rate would receive the benefit of foreign tax credits to which they would otherwise not be entitled.

Partner Level Credit. As an alternative method, foreign income and foreign taxes paid could be reported separately to partners on the Form 1099-K. An additional line on the Form 1099-K would show the foreign source portion of any income item, and another line would show the amount of foreign tax paid or accrued (the amount which results from netting lines 17(e) and 17(f) of the current Schedule K-1).

As stated above, foreign taxes paid or accrued generally are creditable only against U. S. income tax on the specific baskets of income to which the foreign taxes relate. Special rules apply to limited partners (and corporate general partners) who own less than 10 percent of the value of the partnership (based on profits or capital interests). These partners must treat their distributive shares entirely as passive income for foreign tax credit purposes, regardless of the type of income earned by the partnership.⁸⁰ There are two exceptions under current law to passive income treatment which it may be possible to eliminate in order to facilitate simplified partner level reporting. Under the first exception, the distributive portion of each partner's interest income which is "high withholding tax interest" continues to be treated as such for foreign tax credit purposes. Under this rule, interest income which would otherwise be in the passive basket is placed in a separate basket if such income is subject to a foreign withholding tax of 5 percent or more. The

⁷⁹With respect to the treatment of foreign partners of a widely held partnership, see footnote 104.

⁸⁰Treas. Reg. § 1.904-5(h).

effect of the high withholding tax basket is generally unfavorable to taxpayers, because tax credits associated with such income cannot be used to offset U.S. tax on low-taxed or untaxed income in the passive basket. While some revenue loss would result from eliminating this exception, the effect would not be large if the proposal were applied only to a limited class of partnerships. Under the second exception to passive income treatment under current law, a distributive share from a partnership interest held in the ordinary course of the partner's active trade or business receives look-through treatment for purposes of section 904. This exception generally applies to small corporate general partners in the oil and gas industry, and is a special relief provision for those taxpayers. Eliminating this exception would adversely affect a small number of taxpayers. If these exceptions were eliminated for partners owning less than 10 percent of the partnership interests, reporting of foreign source income and foreign taxes would require no more than two additional lines on the Form 1099-K.⁸¹

5. Other Reporting Issues

As proposed, the Form 1099-K would not require the separate reporting of unrelated business taxable income ("UBTI"). Under current law, all income of a publicly traded partnership is UBTI,⁸² but this is not the case for other widely held partnerships. To prevent evasion of the UBTI rules, it might be necessary to require separate reporting of income that would be UBTI to tax exempt partners or treat all income of any widely held partnership as UBTI.

Oil and gas issues present special concerns, in large part because of the unique treatment of oil and gas properties held by partnerships. Under the Code, percentage depletion is disallowed to certain taxpayers, and is significantly restricted for all other taxpayers.⁸³ Partnerships must allocate basis in and

⁸¹These exceptions should probably not be eliminated for partners holding 10 percent or more of the interests in a widely held partnership. Thus, the treatment of the foreign tax credit may have an impact on whether large partners should be excluded from the simplified reporting system. See Section IV (E).

⁸²I.R.C. § 512(c)(2).

⁸³Retailers and refiners are prohibited from claiming percentage depletion with respect to oil and gas properties. I.R.C. § 613A(d). Other taxpayers are permitted to claim percentage depletion on production not in excess of the taxpayer's depletable oil quantity of 1,000 barrels of production per day, subject to a number of other restrictions. I.R.C. § 613A(c).

production from oil and gas properties to partners.⁸⁴ In addition, partnerships must report a significant amount of information on a property-by-property basis to each partner to permit the partner to calculate his or her depletion limitation.⁸⁵ These allocation rules are inconsistent with the basic goals of the simplified reporting proposal.

Detailed reporting of oil and gas items could be avoided by prohibiting the use of percentage depletion by widely held partnerships, and instead require cost recovery of their properties to occur through the generally less favorable cost depletion method. Alternatively, partnerships could be permitted to claim the amount of percentage depletion permitted a single taxpayer, with any remaining depletion calculated under the cost method. This alternative would allow the benefit of percentage depletion to partners who would not otherwise be eligible with respect to the partnership's properties, either because, for example, a partner is ineligible for percentage depletion or the partner's share of production from other properties exceeded the maximum allowable depletable production. This effect would, however, be relatively minor with respect to any partner, as a widely held partnership's percentage depletion deductions would be spread among its many partners. Under either method, items relating to depletion would not be reported separately. However, this would not allow depletion to be calculated by each partner, as under current law.

To permit partners in widely held partnerships to calculate percentage depletion separately as under current law, it would be necessary to design a special reporting form for widely held partnerships engaged in oil and gas exploration and production. Standards would have to be established to determine eligibility for this special reporting. The unique tax treatment of oil and gas properties held by partnerships may justify a more complex reporting form.

6. Reporting Form

To summarize, the following categories or spaces would appear on the simplified reporting Form 1099-K:

- (1) Passive income (loss)
- (2) Portfolio income (loss)
- (3) Passive AMT adjustments and tax preferences
(one amount)
- (4) Portfolio AMT adjustments and tax preferences
(one amount)

⁸⁴I.R.C. § 613A(c)(7)(D).

⁸⁵Id. See Prop. Treas. Reg. § 1.613A-3(j).

- (5) Tax credit
- (6) Tax-exempt interest

All widely held partnerships would be required to provide a standard Form 1099-K to their partners. No substitute or alternative versions of the form would be permitted. Thus, partners in widely held partnerships would receive uniform information documents.

7. Possible Further Simplification

The simplified system discussed above represents a general approach to determining and reporting partnership income for widely held partnerships that would substantially reduce the reporting burdens of partnerships and their partners and the administrative burden of the Service. The particular items listed on the proposed Form 1099-K are illustrative of the suggested simplification. The list of separately reported items could of course be expanded, although at the cost of additional complexity. On the other hand, the number of items on the 1099-K could be further reduced. For example, the "Tax credit" line could be eliminated by converting the credit amounts into deductions. The net credit amount would be "grossed up" into a deduction at the partnership level by using an assumed tax rate. Thus, if a partnership had credits of \$5,000, the grossed-up deduction would equal \$22,727 if 22 percent were used as the assumed tax rate for this purpose (midway between the 15 percent and the 28 percent brackets).⁸⁶ This amount would be treated the same as any other partnership deduction and would be reflected as an adjustment to taxable income reported to partners on the Form 1099-K.

The "Tax-exempt Interest" item could also be eliminated, but only by treating such interest as taxable. If interest is tax-exempt, separate reporting is essential in order to provide individual taxpayers receiving social security benefits with the data necessary to calculate their separate tax liability.⁸⁷ Hence, the "Tax-exempt Interest" item could only be eliminated by removing the tax exemption on such interest for partners of these partnerships and by treating interest that is currently tax exempt in the same manner as other taxable interest includible in portfolio income. Separate reporting of the low income housing credit and the rehabilitation credit could also be prohibited for widely held partnerships, even those substantially engaged in

⁸⁶A higher assumed tax rate would result in a larger grossed-up deduction and a lower rate would result in a smaller deduction.

⁸⁷Social security benefits become taxable when certain income levels are reached.

these activities. This would prevent partners from taking advantage of the special treatment afforded these credits under the passive loss rules. The resulting inability of partners to take advantage of the current law favorable treatment of tax-exempt interest and the low income housing and rehabilitation credits illustrates that there may be adverse consequences to further simplification of the reporting form.

8. Examples

The following examples illustrate the operation of the simplified reporting system in a number of fact patterns.

EXAMPLE 1 Assume the individual taxpayer receives a Schedule K-1 under present law which indicates the following items:

Ordinary income	\$ 400	Investment interest expense	\$90
Net rental loss	300	Charitable contribution	5
Dividends	55	Misc. portfolio deductions	20
Interest	125		
Net short-term capital losses	500		
Net long-term capital gains	400		

The individual is a limited partner and the ordinary income and rental loss result from passive activities. The capital losses and gains result from assets held for investment purposes and the miscellaneous deductions are subject to the 2 percent limitation. Assuming the net capital loss, charitable contributions and miscellaneous deductions can be fully deducted on the individual's return, taxable income of \$65 would result under current law.⁸⁸ Under the proposal, the only reportable items would be passive income of \$95, and portfolio income of \$80, for a total taxable income of \$175.⁸⁹

The difference of \$110 (\$175-65) in the calculation of taxable income under current law and the proposal is due to the net capital loss of \$100, which under the proposal carries over at the partnership level and can be used in a later year, and \$10 representing the 50 percent adjustment to the miscellaneous deductions not allowed under the proposed treatment.⁹⁰ Both of

⁸⁸Current law: $\$400 - 300 + (55 + 125) - (500 - 400) \text{ less } (90 + 5 + 20) = \65 .

⁸⁹Proposal: $\$400 - 300 - 5 = \95 Passive.
 $\$55 + 125 - 90 - 10(20 \times 50\%) = \80 Portfolio.

⁹⁰This represents an adjustment to reflect the 2 percent floor limitation on miscellaneous itemized deductions.

these items, the capital loss and the miscellaneous deduction, may or may not be deductible at the taxpayer level due to various limitations. In this example, two items would be reported on Form 1099-K versus nine on the present Schedule K-1.

EXAMPLE 2 The individual is a partner in a publicly traded partnership and the Schedule K-1 under present law indicates the following items:

Ordinary loss	\$ 200	Misc. portfolio deductions	\$100
Net rental loss	500	Investment interest	
Dividends	400	expense	800
Interest	300		

The losses are passive and taxable income or loss under both the current and proposed system would be zero. There would be a passive activity loss carryover of \$700 in both cases and an investment interest expense carryover of \$200 under current law to the individual partner assuming no other interest to offset the expense.⁹¹ Under the proposal there would be a carryover of \$150 to the partnership due to the excess investment interest (because of the 50 percent allowance for miscellaneous deductions).⁹² In this example, two items would be reported on Form 1099-K versus six on the present Schedule K-1.

EXAMPLE 3 The individual is a partner in a publicly traded partnership and the Schedule K-1 under present law indicates the following items:

Ordinary loss	\$ 700	Foreign taxes paid	\$ 5
Net rental loss	100	Foreign source income	150
Sec. 179 expense	70	(included in ordinary	
Targeted job credit	20	loss)	
Recapture of low-income housing credit	10		

The losses are passive and under current law the partner would report a passive activity loss of \$870 (including the \$70 section 179 deduction) and a disallowed passive activity credit of \$20. The foreign tax credit is not subject to the passive loss rules.

⁹¹Current law: $\$200 + \$500 = \$700$ Passive loss.
 $\$400 + \$300 - 100 - (800 - 200 \text{ carryover}) = \0 Portfolio.

⁹²Proposal: $\$200 + \$500 = \$700$ Passive loss.
 $\$400 + \$300 - 50(100 \times 50\%) - (800 - 150 \text{ carryover}) = \0 Portfolio.

The partner would incur a current recapture tax of \$10.⁹³ Under the proposed system, the reportable items would include a disallowed passive loss of \$875 and a disallowed passive activity credit of \$10 (assuming the recaptured credit was offset against the jobs credit).⁹⁴ In this example, two items would be reported on Form 1099-K versus seven on the present Schedule K-1.

C. Elimination of Non-Income Items

The present Schedule K-1 reports a substantial amount of non-income information. Items A through J of Schedule K-1 report information concerning each partner, including whether the partner is general or limited, a domestic or foreign person, the type of entity, the partner's share of liabilities, the partner's percentage interest and acquisition date. In addition, the form requests the following information about the partnership: where the return was filed, Tax Shelter Registration Number, if any, whether publicly traded, foreign countries to which taxes were paid, and whether the current Schedule K-1 is an amended one. As proposed, none of these items would be reported on the Form 1099-K. The only non-income information reported on the Form 1099-K would be the taxpayer's name, address and taxpayer identification number and the same information for the partnership.⁹⁵ Any additional relevant information could be furnished upon examination or on separate schedules with the partnership return of income.

Item K on the present Schedule K-1 records the partner's capital account activity for the year. The amounts in the capital account analysis reflect various additions and deductions to the account during the taxable period, including contributions of capital and distributions to the partner, as well as taxable income or loss and other amounts reflected on the return. The capital account information is probably not necessary for an individual partner's computation of his or her separate tax liability. In contrast, it is necessary for partners to maintain information as to the bases of their partnership interests. Although neither basis nor capital account information is included on the Form 1099-K, partnerships

⁹³Current law: $\$800 + 70 = \870 Passive loss. This assumes the section 179 deduction is not limited by section 179(b) at the partner level.

⁹⁴Proposal: $\$700 + 100 + 70 + 5 = \875 Passive loss.
 $\$20 - 10 = \10 Disallowed credit. The result in the example assumes that the partnership has elected to deduct foreign taxes paid.

⁹⁵We recognize that in implementing this proposal certain other non-income items may be determined necessary for inclusion on the Form 1099-K.

should be required to separately provide basis information. Similarly, partnerships should be required to reflect any section 743(b) adjustments in computing the partners' shares of taxable income. Even without a specific requirement, however, we assume that partnerships would generally provide the information necessary for partners to compute and substantiate their tax bases in their partnership interests.⁹⁶

D. Magnetic Media Filing

Each widely held partnership would be required to provide Form 1099-K data to the Service by magnetic media. Partnerships are now permitted, but not required, to use such means for filing.⁹⁷ Once a partnership is required to file using magnetic media under this provision the requirement would continue indefinitely, as a partnership that meets the definition of a widely held partnership will continue to be treated as such until the Commissioner grants permission for a change in status.⁹⁸

The instructions for the Form 1099-K would cover the items mentioned above and key each item, where appropriate, to a specific line on Form 1040 and its schedules or to a special schedule which would be used to accumulate Form 1099-K information from partnerships and thus facilitate the matching of information from widely held partnerships to the partner's return.

E. Treatment of Large Partners

It is not clear whether partners holding significant percentage interests in a widely held partnership should participate in the simplified reporting system. Interests held by such partners are excluded from the current assessment system proposed by this report,⁹⁹ but the considerations are somewhat different under the reporting system. The calculation of taxable

⁹⁶Currently, no complete basis information is provided to the partners. The capital account information included on the Schedule K-1 may correspond to a partner's tax basis (excluding the partner's share of liabilities) in his or her partnership interest.

⁹⁷Although this recommendation of mandatory filing by magnetic media would apply only to widely held partnerships, no inference should be drawn with respect to whether such filing may be required of other partnerships in the future.

⁹⁸See Section VII of this report.

⁹⁹See discussion at Section V (D) (1) and V (D) (5) of this report.

income may become substantially more complex if the income reported to partners with at least a five or ten percent interest is determined separately from the income reported to the remainder of the partners. On the other hand, if large partners were allowed to use the simplified reporting system, they might in some cases be able to use widely held partnerships to avoid various restrictions. For example, depending on the manner in which the foreign tax credit is calculated by widely held partnerships, taxpayers may derive a material advantage from generating certain income through such a partnership. Until the precise rules of the simplified reporting system have been formulated, it is difficult to predict the extent to which simplified reporting for large partners would present opportunities for tax abuse. Accordingly, this report makes no recommendation with respect to the treatment under the simplified reporting system of partners holding significant interests in widely held partnerships.

F. Summary of Simplified Reporting Issues

The potential advantages of a simplified reporting system are threefold:

(1) The widely held partnership would experience a significant reduction in the number of forms and correspondence sent to the Service and to partners with a corresponding reduction in associated costs.

(2) The partner would receive a one page form, similar to other information forms such as a Form W-2 for wages or the Form 1099 used for interest, which would be familiar and relatively simple. Such a system would be more understandable than the present system and would thus encourage compliance.

(3) The Service would receive data by magnetic media which would be used to provide a more efficient matching of data to the information reported by partners on their returns and would thereby enhance compliance with reporting requirements.

By implementing a simplified reporting system, the calculation of income and related items would be altered with respect to widely held partnerships. The goal of these proposed changes is not to increase or decrease the overall tax due with respect to such partnerships. Rather, the goal is to produce a simplified system that, within the constraints of a radically simplified Schedule K-1, approximates the current law calculation of taxable income and related items as closely as possible. Nonetheless, we recognize that the total income tax attributable to a partnership subject to the simplified reporting system would almost certainly vary to some degree from the total income tax under the current rules. This raises two principal concerns.

The first concern is that, given the recent history of tax law changes that have adversely affected investment partnerships, the redefinition of the calculation of a widely held partnership's income will be structured to increase the overall tax due. That is not the intent of the proposed simplified reporting system. The goal of the proposal is to simplify the reporting system rather than to raise revenue, other than revenue attributable to improved compliance.

The second concern is that certain partnerships will be able to take advantage of any variations in income calculation by selecting the most beneficial system. For example, a partnership with 200 partners might restrict entry of new partners if it feared that the simplified reporting system would significantly increase overall taxable income. If the system is properly designed, any income calculation advantage or disadvantage to a partnership will be minimal, thus reducing this incentive to target growth for a marginal tax advantage.¹⁰⁰ Furthermore, once a partnership becomes subject to the simplified reporting system as a widely held partnership, it will not be able to withdraw from the system without permission of the Commissioner.¹⁰¹ Therefore, partnerships will not have the ability to move in and out of the simplified system at will. These factors should minimize the impact of any variations in income calculation that may arise under the simplified reporting system.

G. Withholding

As a general matter, in tax administration, it is axiomatic that if third parties report to the Service the income they pay to individuals, compliance in reporting that income markedly improves. Withholding of tax at the source has generally proven to be an even more effective means of assuring compliance. At present, withholding is mainly imposed on certain limited categories of items, including wages, tips, supplemental unemployment benefits, and gambling and lottery winnings. Dividends and interest are subject to information reporting, but not withholding unless the backup withholding provisions apply.¹⁰² Not

¹⁰⁰Nonetheless, as noted above, the possibility of differences in income calculation may necessitate the exclusion of large partners from simplified reporting.

¹⁰¹See Section VII of this report.

¹⁰²I.R.C. § 3406. In certain instances, withholding is voluntary (e.g., pension distributions, annuity payments, sick pay). I.R.C. §§ 3402 and 3405.

surprisingly, Service studies indicate that compliance levels are highest in areas in which withholding is imposed.¹⁰³

Partnership distributions are different from wages, interest or dividends, in that partnership distributions may consist not only of current income, but also advances on estimated income (drawings), or return of capital. Under current law, neither income nor distributions of a domestic partnership are subject to withholding, except as to nonresident alien partners.¹⁰⁴

¹⁰³Gross Tax Gap Estimates and Projections, at 5-6.

¹⁰⁴"Inbound transactions," that is transactions giving rise to income from U.S. sources paid to foreign persons, are subject to a reporting and payment system which operates in addition to and independently of the reporting system applicable to partners generally. The reporting and withholding system applicable to foreign partners is beyond the scope of this report and will not be affected by the proposals made herein.

Section 1446, as amended in 1988, currently requires a U.S. or foreign partnership with effectively connected taxable income allocable to a foreign partner to pay a U.S. withholding tax with respect to that partner's allocable share of that income in the time and manner prescribed by the Service. Rev. Proc. 89-31, 1989-20 I.R.B. 136 (May 15, 1989), implements this section and provides that affected partnerships must generally pay a withholding tax, without regard to distributions, on a quarterly basis based upon 28 or 34 percent of the effectively connected taxable income allocable to foreign noncorporate and corporate partners, respectively. The Revenue and Reconciliation Act of 1989 amended section 1446 to clarify that the Service is authorized to apply the corporate estimated tax rules and penalties to partnerships to compute and enforce the quarterly payment requirement. Publicly traded partnerships are allowed to withhold on distributions at a flat 28 percent rate, but these partnerships may elect to make quarterly payments without regard to distributions.

Section 1446 withholding overrides section 1445(e)(1) withholding. Under section 1445(e)(1), a domestic partnership is required to withhold 34 percent of a foreign partner's net gain attributable to the partnership's disposition of a U.S. real property interest. Generally, section 1445(e)(1) withholding is to be made by the partnership within 20 days of the disposition of U.S. real property, but publicly traded partnerships and any other partnerships with more than 100 partners generally defer the payment of the section 1445(e)(1) withholding tax until a distribution attributable to the sale proceeds is made.

We do not recommend withholding for widely held partnerships at this time. Under the proposed reporting system with required magnetic media filings, it is expected that the Service will be able to include the Form 1099-K information in its document matching program and the Information Returns Program procedures. Moreover, the ability of partnerships and the Service to determine the identity of persons holding interests has been significantly improved through the enactment of the nominee reporting system of section 6031(c).¹⁰⁵ Thus, the Service should be able to more efficiently match Form 1099-K information with that reported on the partner's return.

The Service continues to evaluate the level of compliance by partners of widely held partnerships and the possibility of recommending the institution of withholding, if necessary, to ensure that adequate standards of reporting and collection are maintained.

H. Ownership Changes

The issues arising under subchapter K of the Code that have particular relevance to widely held partnerships generally relate to the tax impact of ownership changes of interests in these partnerships. The ownership change issues are especially important to publicly traded partnerships because interests may be frequently traded and must remain fungible in the marketplace. This section will briefly discuss the subchapter K issues with respect to (1) fungibility, (2) constructive terminations, (3) accounting conventions for allocations of income, and (4) information reporting.

1. Fungibility

For partnership interests to be fungible, any interest purchased must possess the same tax characteristics to the buyer, regardless of the tax characteristics that interest had in the hands of the seller. Under current law, application of certain technical rules of subchapter K can result in buyers holding

¹⁰⁵Under I.R.C. § 6031(c)(1), any person who holds an interest in a partnership as nominee for another person is required to furnish to the partnership the name and address of such other person, and any other information for such taxable year as may be prescribed by form and regulation. The nominee is also required to furnish such other person with the information provided by the partnership on the Schedule K-1.

partnership interests that are identical, as an economic matter, but that possess substantially differing tax characteristics depending on the identity of the seller of each interest.

In general, under subchapter K, the purchaser of a partnership interest takes a basis in partnership assets equal to his or her pro rata share of the partnership's basis in those assets. If an election is made under section 754, however, the purchaser's basis in partnership assets will be adjusted under section 743(b) to reflect the purchase price of his or her partnership interest. The basis adjustment is made with respect to the purchaser only, and does not affect any other partner's proportionate share of basis in partnership assets. Under the regulations for section 743(b), the purchaser partner's share of basis in partnership assets prior to adjustment is determined by reference to the transferor partner's share of basis in those assets. Publicly traded partnerships typically make a section 754 election so that purchasers will not inherit tax attributes (e.g., unrealized appreciation) unrelated to the purchase price of their units. Moreover, under current law, a section 754 election may be necessary to prevent different units in a publicly traded partnership from having different tax attributes, i.e., to make the units fungible.

Under section 704(c), income, gain, loss, and deduction with respect to contributed property must be shared among partners so as to take account of the variation between the basis of the contributed property in the partnership and its fair market value at the time of contribution. The object of that section is to prevent gain or loss inherent in property at the time of contribution from being shifted from the contributing partner to noncontributing partners.¹⁰⁶ As a result of section 704(c), partnership units may have different tax attributes because they are subject to different allocations under section 704(c). A basis adjustment under section 743(b), however, generally will eliminate any difference between partnership units caused by section 704(c) unless the "ceiling rule" has affected the application of section 704(c).

The "ceiling rule" of section 1.704-1(c)(2) of the regulations may prevent section 704(c) allocations from eliminating the disparity between adjusted basis and fair market value

¹⁰⁶The principles of section 704(c) are also to be applied when a partnership revalues its property for purposes of section 704(b) upon the occurrence of certain events, including the admission of a new partner. Treas. Reg. § 1.704(b)-1(b)(4)(i). See also Treas. Reg. §§ 1.704(b)-1(b)(2)(iv)(f) and (g). Allocations made pursuant to such a revaluation are frequently referred to as "reverse section 704(c) allocations," and the discussion herein applies equally to such allocations.

of contributed property over time. Under the ceiling rule, the total depreciation, depletion, or gain or loss allocated to the partners cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to the partnership. If the ceiling rule applies, allocations under section 704(c) cannot prevent gain or loss inherent in contributed property from being shifted to noncontributing partners. Moreover, a basis adjustment under section 743(b) cannot eliminate differences between partnership units caused by the application of the ceiling rule. Accordingly, if the ceiling rule limits the allocations that may be made under section 704(c), different units carry different tax characteristics even after section 743(b) adjustments have been made, and the units thus are not fungible.

Regulations under section 704(c) may address the problems caused by application of the ceiling rule.

2. Constructive Termination Under Section 708

Section 708(b)(1)(B) provides that a partnership will be considered as terminated¹⁰⁷ if within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits. The regulations¹⁰⁸ clarify that multiple sales of the same interest during the 12-month period are treated as the sale of a single interest for purposes of applying the 50 percent rule. In addition, a disposition of a partnership interest by gift, bequest or inheritance, or the liquidation of a partnership interest is not a sale or exchange for purposes of section 708(b)(1)(B).

Because it is generally impractical for publicly traded partnerships to match transferors and transferees of particular units traded on the securities market, publicly traded partnerships in many cases will be unable to determine whether a termination under section 708 has occurred during a given year.¹⁰⁹ Moreover, the administrative proposals recommended

¹⁰⁷Treas. Reg. § 1.708-1(b)(1)(iv) provides that in a constructive termination under section 708(b)(1)(B) there is a deemed distribution of all partnership property and a deemed contribution of such property to a "new" partnership.

¹⁰⁸Treas. Reg. § 1.708-1(b)(1)(i).

¹⁰⁹Publicly traded partnerships generally will be unable to determine whether a particular unit has been transferred more than once during a year, or whether a transfer was made by gift, bequest or inheritance. In certain situations, however, publicly traded partnerships will be able to determine whether a termination under section 708(b)(1)(B) has taken place (e.g., if

herein disregard terminations under section 708(b)(1)(B) for audit and collection purposes. Accordingly, consideration should be given to narrowing or eliminating the application of section 708 to widely held partnerships.

3. Accounting Conventions

Under section 706(c)(2), the taxable year of a partnership closes with respect to a partner who disposes of his or her entire interest in the partnership. Section 1.706-1(c)(2)(ii) of the regulations provides that the distributive share of a partner whose entire interest is sold may be computed either through an interim closing of the books¹¹⁰ or, by agreement among the partners, through a proration method.¹¹¹ Under section 706(d), added by the Tax Reform Act of 1984, each partner's share of income, gain, loss, deduction or credit must be determined by taking into account his or her varying interests in the

there was a large block transfer of over 50 percent of the interests during the year, or if less than 50 percent of the interests were transferred during the year).

¹¹⁰Under the interim closing of the books method, the partnership traces all partnership items to the particular segment of the partnership taxable year in which such item arose.

¹¹¹Under the proration method, partnership items are allocated to portions of the taxable year (e.g., days, months) by prorating the entire year's items regardless of when the item arose. The regulation provides that the proration may be based on the portion of the taxable year that has elapsed prior to the sale (i.e., a daily convention) or "under any other method that is reasonable."

partnership during the partnership taxable year.¹¹² Certain items are required to be allocated on a daily basis.¹¹³

It appears that most widely held partnerships have adopted a monthly convention for determining when a purchaser of a unit becomes a partner both in the case of partial and complete dispositions of partnership interests. Thus, widely held partnerships typically treat transfers of interests occurring at any time within a month-long period as if all such transfers had occurred on a specified day within that period.¹¹⁴ An interim closing of the books or use of a daily convention is probably impractical in the context of publicly traded partnerships.

Because publicly traded partnership interests are normally transferred in anonymous transactions over a securities market, there does not appear to be significant potential tax avoidance resulting from the use of a monthly convention as long as the convention is uniformly applied. Partnerships that are not publicly traded within the meaning of section 7704(b) typically will not have sufficient trading activity to create material distortion. To provide for the unusual case where tax avoidance is of concern, the Conference Committee Report to the 1984 Act states that the Service "may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that use of a convention could result in significant tax avoidance." Regulations might also prevent the application of a convention to large block transfers

¹¹²The Conference Committee Report to the 1984 Act expresses an expectation that regulations under section 706(d) will provide for a monthly convention, apparently only with respect to dispositions of less than an entire partnership interest. H.R. Rep. No. 861, 98th Cong., 2d Sess. 858 (1984). In News Release IR 84-129, the Service permitted the use of a semi-monthly convention in the case of a partial disposition of a partnership interest for partnerships using the interim closing of the books method. The news release did not change the general requirement of a daily convention for partnerships using the proration method. The Blue Book to the 1984 Act, referring to dispositions of less than an entire partnership interest, stated that the use of any "reasonable convention" would be permitted until regulations are issued under section 706(d). Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 221-222 (1984).

¹¹³I.R.C. § 706(d)(2).

¹¹⁴The specific methods vary among partnerships. For example, some partnerships treat all transfers during a month as occurring on the first day of that month or the first day of the following month.

(e.g., transfers in excess of 5 percent of outstanding interests) where the potential for tax avoidance may exist in connection with an extraordinary transaction.

4. Information Reporting

It is difficult or impossible for widely held partnerships, and especially publicly traded partnerships, to comply with a number of information reporting and gathering requirements applicable to partnerships generally. Under section 6050K and the regulations thereunder, upon certain transfers of partnership interests subject to section 751, a partnership is required to file Form 8308 reporting both the transferor and transferee of the interest.¹¹⁵ This requirement cannot be satisfied for transactions occurring on an exchange because the buyer and seller of any given interest cannot be matched. Similarly, widely held partnerships may be unable to comply with certain requirements imposed under the tax shelter registration rules. For example, the seller of an interest in any partnership which is classified as a tax shelter under section 6111 must furnish a document containing specified information to the purchaser of the interest; this requirement cannot be satisfied for a transfer on a securities exchange.¹¹⁶ Additionally, any partnership subject to registration under section 6111 is required to maintain a list of all investors in the partnership which must be available for inspection within 10 days of a request by the Service.¹¹⁷ The 10-day requirement cannot be satisfied by any partnership in which interests are owned through nominees. To the extent these provisions continue to be imposed by the Code,¹¹⁸ consideration

¹¹⁵Treas. Reg. § 6050K-1(b)(1). Under Treas. Reg. § 1.605K-1(a)(2), a partnership need not file a Form 8038 with respect to any transfer which must be reported under Code section 6045 (reporting by brokers, etc.). However, many types of transfers are exempted from reporting under section 6045. See Treas. Reg. § 5f.6045-1(c)(3).

¹¹⁶Temp. Treas. Reg. § 301.6111-1T, Q & A 51 et. seq. In addition, the required tax shelter list must specify the transferor of any interest held by a transferee partner. Temp. Treas. Reg. § 301.6112-1T, Q & A 17. Again, this type of matching of buyers and sellers is not possible for a publicly traded entity.

¹¹⁷Temp. Treas. Reg. § 301.6112-1T, Q & A 21.

¹¹⁸The recently completed study of civil tax penalties made no recommendation with respect to the tax shelter registration rules, concluding that the "area should continue to be monitored to assure that the registration requirement continues to be needed." Report on Civil Tax Penalties by Executive Task Force,

should be given to amending the regulations so that widely held partnerships will be able to comply.

SECTION V. PROPOSALS FOR CURRENT ASSESSMENT OF DEFICIENCIES WITH RESPECT TO WIDELY HELD PARTNERSHIPS

A. Overview

Much of the administrative inefficiency and complexity facing the Service in the administration of widely held partnerships stems from the fact that a deficiency must be assessed against taxpayers who were partners in the year in which the understatement of tax liability arose. This requires the Service to locate and monitor the returns of all taxpayers who were partners in that year, and eventually assess each former partner's share of the deficiency. If an adjustment covers several years, the complexity of the task is compounded.

These administrative burdens could be partially alleviated, from the point of view of the Service, by requiring the partnership to perform many of the tasks required to convert a partnership level adjustment into assessments with respect to individual partners. The partnership could be required to file amended returns for the years to which the adjustment relates, and issue amended Form 1099-Ks, including penalties and interest, to the partners in those years. The filing of amended returns and the issuance of amended Form 1099-Ks would be required within a reasonable period from the date of the final determination. As under current law, taxpayers who had related adjustments in subsequent years would be entitled to file refund claims based on their overpayments of tax in those years.

This approach cannot be viewed as a satisfactory means of improving the administration of widely held partnerships. Although part of the burden of tax administration would be shifted to partnerships and partners under this approach, the Service would still face the prospect of handling claims for refund from thousands of partners upon an adjustment with respect to any sizable partnership, and would be responsible for monitoring compliance by both partnerships and partners. Furthermore, there would be no net reduction in the overall effort necessary to achieve assessment and collection of deficiencies with respect to widely held partnerships.

The key to streamlining the assessment of deficiencies with respect to widely held partnerships is to devise an assessment system that significantly reduces this overall effort. This section of the report reviews proposals for achieving this goal. The first proposal discussed was considered in connection with the formulation of the 1987 Revenue Act; this report concludes that this proposal would not materially reduce complexity and thus should not be enacted. Other proposals, the Partnership Collection Proposal and the alternative current assessment proposals, have been developed in the preparation of this report. While this report concludes that the Partnership Collection

Proposal is the preferred approach, it is believed that the enactment of any of these current assessment proposals would produce a system under which it would be feasible to conduct audits of widely held partnerships.

B. House Proposal

1. Description

The bill originally passed by the House of Representatives¹¹⁹ during formulation of the Revenue Act of 1987 contained a proposal for collecting deficiencies from certain partnerships (the "House Proposal"). Under the House Proposal, underpayments of tax resulting from "applicable return adjustments" with respect to certain partnerships would have been collected either from the partnership or from each partner. For this purpose, an "applicable return adjustment" meant a final partnership administrative adjustment (if no court proceeding had been timely commenced), a court decision that had become final, an amended return filed by the partnership, or a settlement agreement binding on the partners. Any "shortfall" (*i.e.*, any understatement of taxable income, overstatement of taxable loss, overstatement of credits, or any combination thereof for a given partnership taxable year) resulting from an applicable return adjustment would have been subject to notice and demand by the Service in the same manner as if the tax were originally imposed on the partnership. The partnership would have been required to pay tax at the highest rate (individual or corporate) applicable for the taxable year of the shortfall. The amount of the shortfall would have been reduced to the extent the partnership could have proven that a partner had reported consistently with the applicable return adjustment in the partner's original or amended return.

Under the House Proposal, the payment of tax by the partnership would have been treated as payment of tax by each partner of his or her allocable share of the payment determined in accordance with his or her interest in the partnership in the year to which the adjustment related. To the extent the payment by the partnership created an overpayment with respect to any partner (*e.g.*, where the partner's marginal tax rate was lower than the rate paid by the partnership), that partner would have been entitled to file a claim for credit or refund of the overpayment. The partnership would have had the right to recover the amount of payment made on behalf of a partner from that partner.

Neither the House Bill nor the House Ways and Means Committee Report specified the capital account or basis

¹¹⁹H.R. Rep. No. 3545, 100th Cong., 1st Sess. (1987).

adjustments to be made in connection with a partnership payment. Presumably, the partners' capital accounts would have been adjusted for the redetermined amounts of income, deductions, or credits in the year of the shortfall. The payment of tax by the partnership presumably would have been treated as a partnership distribution, with the partners in the year to which the adjustment related receiving a credit for the amount of tax paid. The House Proposal treated adjustments on a year-by-year basis, with no reference to related offsetting adjustments in other years. The House Proposal did not include any provision for the payment of interest and penalties with respect to a partnership deficiency.

The House Proposal would have applied to any partnership with interests required to be registered under federal or state laws regulating securities, or sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.¹²⁰

2. Examples

The following examples illustrate the application of the House Proposal.

EXAMPLE 1 In its return for the 1992 taxable year, partnership X understates its income by \$1 million, with no offsetting adjustments in later years. In 1998, a final assessment is made. X would pay tax at the highest applicable rate for 1992 (assume 34 percent for purposes of these examples). The applicable return adjustment would be allocated among X's 1992 partners in accordance with their interests in the partnership. The 1992 partners would be entitled to file a claim for refund for any excess tax paid on their behalf (e.g., amounts attributable to marginal tax rate differentials). X would have a right to seek reimbursement from partners, including former partners, of tax paid on their behalf by X. The partners' bases and capital accounts would presumably be adjusted to reflect the allocation of additional income. Presumably, the payment of tax by X would be treated as a deemed distribution to the partners. The net effect of these adjustments would be to increase the adjusted bases of the partnership interests as of the end of 1992. Consequently, any 1992 partner who sold an interest in the partnership between 1992 and 1998 presumably would be entitled to file a claim for refund of tax for the year of sale to reflect reduced gain or increased loss from the sale.

EXAMPLE 2 In 1992, Partnership Y reports a deduction of \$1 million that should have been reported in its 1993 taxable year. In 1998, a final assessment is made. Because the House Proposal

¹²⁰Id.

applies on a year-by-year basis, it would not permit an offset of underpayments and related overpayments occurring in different years. Thus, the results would be identical to those described in Example 1 above, with Y paying tax on the deficiency for 1992 at the highest rate in effect for that year (34 percent). Y's 1993 partners would be entitled to file claims for refund for their overpayments in that year.

EXAMPLE 3 In 1992, Partnership Z deducts \$1 million that should have been amortized on a straight-line basis over ten years. In 1998, a final adjustment is made. The result would generally be the same as in Example 2 above. The applicable return adjustment to be paid by Z for 1992 would equal \$900,000 (\$1 million minus \$100,000 allowable amortization). Z's partners from 1993 through 1997 would be entitled to file claims for refund for their overpayments (attributable to Z's \$100,000 deduction understatement in each year) in those years.

3. Analysis

The House Proposal attempted to address problems that exist under current law in assessing and collecting deficiencies from partners of widely held partnerships by collecting the deficiency directly from the partnership. Under the House Proposal, the tax paid by the partnership would have been treated as paid by persons who were partners during the year to which the adjustment related, and any partners who had a marginal tax rate that was less than the maximum tax rate applicable under sections 1 or 11 would have been entitled to file claims for refund. Since the maximum corporate rate currently exceeds the maximum individual rate, apparently all individual partners would have been due such refunds. In addition, the proposal would not have offset understatements of income with directly related overstatements of income, resulting in refunds due to partners who had a directly related negative adjustment to income in a different taxable year. Thus, thousands of potential refund claims would have been created with respect to partnerships with substantial numbers of partners. A significant paperwork burden would have been imposed on the Service and taxpayers to the extent these refund claims were pursued; to the extent the refund claims were not pursued, the proposal would have resulted in the collection of more tax than the government was due. The House Proposal would have imposed further record maintenance responsibilities on the Service by permitting a reduction of a shortfall to the extent the partnership could have demonstrated that its partners reported the matter on their own returns consistently with the applicable return adjustment. Thus, while the House Proposal provided greater assurance of collection of partnership deficiencies, it might have actually increased the Service's paperwork burden. Furthermore, because it involved collection of deficiencies directly from the partnership, the House Proposal would have created the same partnership liquidity problem

discussed below in connection with the Partnership Collection Proposal.

The House Proposal endeavored to continue to impose the burden of payment of the tax deficiency on the partners who originally benefited from the understatement of income. This was accomplished by providing that the partnership would be entitled to recover from those persons who were partners in the year to which the adjustment related any amounts paid on their behalf. We do not believe it appropriate for the Internal Revenue Code to grant a private right of action. Furthermore, it often would have been difficult or impossible for a widely held partnership to obtain reimbursement from former partners for tax payments. The difficulty and expense of locating these partners, combined with the partners' probable unwillingness to reimburse the partnership voluntarily, would have likely rendered the right of reimbursement merely theoretical in most cases. Thus, notwithstanding the reimbursement provisions under the House Proposal, the tax on deficiencies would have been borne chiefly by the persons who held partnership interests during the year in which the final partnership adjustment occurred, and not those who held interests during the year to which the shortfall related. Yet the House Proposal did not provide the partners in the year in which a final adjustment occurred with any credit for tax paid or with any increase in the bases of their partnership interests. Thus, the House Proposal would have had the effect of attributing income to current partners without providing the adjustment to basis normally afforded partners who recognize income.

Furthermore, the House Proposal did not eliminate the administrative difficulties of assessing and collecting tax deficiencies of partners in partnerships covered by the proposal--it merely shifted the initial burden of dealing with these difficulties to the partnership. In cases where the amount of the deficiency for the average partner was small, partnerships would have been unlikely to have sought reimbursement from former partners, and partners with potential refund claims would have been unlikely to have filed them. Just as the Service may avoid the administrative problems of current law by not attempting to assess deficiencies with respect to widely held partnerships, such partnerships and their partners would have been expected to avoid them under the House Proposal by acquiescing in the collection of excessive amounts of tax. In cases where partnerships and partners would have decided to pursue refund claims, the Service would have continued to be faced with a paperwork burden that is similar to that existing under current law. For these reasons, we do not recommend that Congress adopt the House Proposal.

C. Deficiencies with Respect to Widely Held Partnerships
Should be Borne by Current Partners

The House Proposal would not have materially reduced complexity because it retained the current law approach of looking back to prior-year partners as ultimately responsible for adjustments. This approach may be logical with respect to smaller partnerships, which correspond to the traditional view of partnerships as aggregations of individual taxpayers; however, widely held partnerships are best viewed as entities in this context and it is not necessary to treat the adjustments as personal to prior partners. The present system has the effect of isolating current partners from the impact of adjustments made with respect to the business of the partnership. Contrast this with the treatment of a shareholder in a large corporation. Assume that a shareholder owns stock from 1990 through 1992 in a corporation which substantially understates its taxable income for 1990. In 1993, a deficiency is assessed, and causes the value of the corporation's stock to drop materially. Meanwhile, the original shareholder has sold his stock. The cost of the deficiency is borne by the stockholder who purchased in 1992.

This report proposes an assessment structure for widely held partnerships which treats partners in a manner roughly comparable to the treatment of current and former shareholders in corporations. A current partner would bear the risk of tax adjustments relating to prior years; if a partnership interest is purchased without knowledge of the possibility of a substantial tax adjustment, the purchaser may pay too much for the partnership interest. It is important to note, however, that the basis adjustment rules of section 705 would mitigate both the "windfall" to the former partner and the unanticipated burden to the purchasing partner. Any deficiency to be collected from current partners would be adjusted to take into account offsetting adjustments in years other than the year of the shortfall. Offsetting related adjustments would greatly simplify the administration of widely held partnerships.

This proposal would involve a significant departure from traditional subchapter K principles. However, we believe that such a departure is warranted in view of the substantial costs and difficulties faced by both the Service and partnerships in applying these subchapter K principles to widely held partnerships.

D. Partnership Collection Proposal

1. Description

The central features of the Partnership Collection Proposal are: (1) the treatment of a partnership shortfall in a prior year as a current item of income in the year in which a final

determination of the adjustment is made; (2) the collection of tax, interest, and penalties with respect to the shortfall directly from the partnership; and (3) the netting of related adjustments in other years. As under the House Proposal, a shortfall is defined as any understatement of taxable income, overstatement of taxable loss, overstatement of credits, or any combination thereof for a given taxable year.

Under the Partnership Collection Proposal, a widely held partnership would be treated as the taxpayer with respect to any partnership shortfall. The partnership would pay tax and interest as if it were a corporate taxpayer subject to tax at the highest rate applicable under section 1 or 11 for the year of the final determination. In computing the tax, interest, and penalties that would be paid by the partnership with respect to a partnership shortfall, the Partnership Collection Proposal would allow an offsetting adjustment for any directly related overstatement of taxable income, understatement of taxable loss, or understatement of credits for any other taxable year intervening between the taxable year to which the shortfall relates and the year in which the final partnership adjustment is made.¹²¹ The offsetting adjustment would be computed by treating the partnership as if it were a corporate taxpayer that had paid tax on the related overstatement at the maximum rate applicable under section 1 or 11 of the Code for the year of the final determination.

The Partnership Collection Proposal would treat a partnership shortfall attributable to an understatement of taxable income or an overstatement of taxable loss (less any offsetting adjustment) as a positive adjustment to the taxable income of the partnership for the taxable year in which the final partnership adjustment is made. Each partner's share of the adjustment would be reported on the partner's Form 1099-K and included in the partner's income for such year. The income would be deemed to have arisen pro rata throughout the year, so that all partners during the year of the final determination would share the income. Any tax paid by the partnership with respect to such shortfall would be treated as tax paid by such partners, effectively treating the tax paid by the partnership as a credit allowable to the partners which would be refundable to the extent an overpayment can be established. Thus, although tax would be withheld at the maximum rate (and interest would be calculated on such basis), the tax would actually be imposed at the marginal rates of the partners in the year the final adjustment is made. The partnership would also pay interest and penalties with respect to the shortfall based on tax calculated at the maximum rate. Interest and penalties would not be refundable and would be nondeductible by the partners.

¹²¹See I.R.C. § 6601(f).

A constructive termination of a partnership under section 708(b)(1)(B) would not affect the Service's right to make an entity-level assessment against the partnership for a taxable year preceding the year of termination. In addition, regulations would be authorized to govern the application of these rules to partnerships that have been liquidated, and exclude partnerships or their partners from the operation of these rules in appropriate or abusive situations. Partners holding a significant percentage of interests (e.g., at least five percent or ten percent) in a partnership in the year of the understatement would be excluded from the current assessment system. Thus, such partners would continue to be responsible for their allocable share of deficiencies even if they sold their interests prior to the final determination. The remainder of the deficiency would be allocated among all other current partners.

2. Basis and Capital Accounts

For purposes of maintaining the partners' capital accounts and determining the bases of their partnership interests, a partnership shortfall would usually be treated as a positive adjustment to the partners' capital accounts and bases,¹²² any tax paid by the partnership would be treated as a distribution of cash to the partners, any interest or penalty paid by the partnership would be treated as a nondeductible partnership expense.

3. Overstatements and Amended Returns

If an audit determines that an overstatement was made in reporting a prior year's taxable income, the adjustment could also be treated as a current item by allowing a deduction in the year of the final determination. Related understatements would be offset against overstatements to produce a single adjustment. Interest due on such an overpayment (determined after application of section 6601(f)) would be calculated on the basis of an assumed rate and paid directly to the partnership. Appropriate basis and capital account adjustments would be made.

¹²²Partners' bases and capital accounts would not be adjusted where a final determination relates to an item that has already been reflected in their bases and capital accounts. For example, when a partnership reports tax exempt interest, a partner's basis and capital account are increased by his or her share of the interest. See I.R.C. § 705(a)(1)(B). Therefore, upon a determination that the interest was not tax exempt, no further basis or capital account adjustment would be appropriate.

Amended partnership returns¹²³ would pose a number of issues under the Partnership Collection Proposal, regardless of whether the amended returns sought to increase or decrease previously reported income. If a partnership were allowed to treat an adjustment resulting from an amended return as a current item, partnerships arguably would have a measure of flexibility in determining when to claim a deduction or to report income. For example, if it were known that tax rates would increase in the next year, a partnership might fail to claim a deduction in the current year and then amend its return the next year to claim the deduction when it was worth more to its partners. This tactic would probably be successful only where there existed some legitimate uncertainty concerning the allowance of the deduction in the initial year, as the initial return might otherwise be found to contain a false statement. However, it is not improbable that in certain situations partnerships would be able to manipulate the system to use amended returns to their advantage if such returns were to produce a current adjustment. On the other hand, if adjustments arising from amended returns were to relate back to prior year partners, management of a partnership might be faced with a conflict of interest if it were aware at the commencement of an audit that a reporting position in a prior year is likely to result in an adjustment, regardless of whether the adjustment were an increase or decrease in taxable income. If management were to file an amended return, the adjustment would accrue to prior owners, while if the audit were allowed to run its course the adjustment would accrue to current owners. One possible solution would provide that amended returns would relate back to prior years, but that no such return could be filed after an audit has commenced. This would, however, place a great deal of significance on the commencement date of the audit. If the Partnership Collection Proposal is enacted, specific rules would be needed to deal with amended returns.

4. Insolvent Partnerships

A mechanism for collection from partners is necessary for situations in which a widely held partnership is unable to satisfy a deficiency. Our recommended approach would permit the Service to proceed against both current and former partners to collect the amount owed, but would also take into account the partners' tax status in determining ultimate liability. Under this approach, current partners would be required to pay amounts of tax liability not collected from the partnership, in effect requiring them to pay tax on the deficiency at a 34 percent rate. The amounts could be collected either by sending the current partners notices of deficiency or by reporting the liability as

¹²³As noted above, an RAA is the procedure applied under the unified partnership audit rules for filing an amended return or refund claim.

an amount owed on the Form 1099-K. This flat percentage liability would be collected from all current partners, including tax exempt partners, regardless of their personal tax rates. A procedure should also be established to take into account the partners' individual tax status. This might be accomplished, for example, by having the partners add their share of the deficiency to their income for the year of the final determination or a subsequent year, and allowing a refund to the extent their payment exceeded the amount of tax owed on that income computed at their actual marginal tax rate.

If within a specified time period the amount of tax collected from the partnership and current partners was less than the amount owed by the partnership using the 34 percent rate, taxpayers who were partners in the year of the understatement (and who had since sold their interests) would be liable for their share of the amount owed (again applying a 34 percent tax rate).¹²⁴ In addition, a rule could be provided under which a former partner who was neither a partner in the year of the understatement or in the year of the final determination would be liable if his or her interest was transferred to a dummy or in any other transfer designed to reduce the overall tax liability or to avoid payment of the deficiency. The procedure would be similar to that described for current partners. Tax would be collected at the flat percentage tax rate based on their interests in the partnership, and a mechanism would be provided to take into account their actual tax status. While the collection approach described above would be somewhat cumbersome, it would permit collection of deficiencies with respect to insolvent partnerships even when interests are held at the time of determination by dummy or sham partners.¹²⁵

Under the proposed collection approach, a general partner would essentially be treated the same as the other partners. Thus, the general partner would not be liable for more than the share of the underpayment attributable to his or her interest in

¹²⁴This would apply to partners other than those holding a significant percentage interest in the year of the shortfall. As discussed above, those partners would be excluded from the current assessment system.

¹²⁵There are, of course, alternative approaches for proceeding against partners directly. If the Service is unable to fully collect a deficiency from the partnership, the current partners could be responsible for payment of any additional amounts owed under rules similar to the partner collection method discussed below. The current partners' tax liability would then be entirely determined by their individual tax status. Under this approach, collection against former partners probably would only be pursued in cases involving abusive transfers.

the partnership¹²⁶ and would not be liable for unpaid taxes on behalf of all current partners.¹²⁷

5. Examples

The following examples illustrate the application of the Partnership Collection Proposal.

EXAMPLE 1 In its return for the 1992 taxable year, partnership X understates its income by \$1 million, with no offsetting adjustment in a later year. In 1998, a final assessment is made. X would pay a tax at the highest applicable rate for 1998 (assume for purposes of these examples that the maximum tax rate is 34 percent), plus interest from 1992. In X's partnership return in 1998, \$1 million would be added to partnership income, and the partners would be treated as having received a distribution of cash equal to the amount of tax paid (\$340,000). The partners' bases and capital accounts would be adjusted to reflect the allocation of additional income and interest expense and the deemed distribution. The partners also would be given a refundable credit for the tax paid on their behalf. Thus, a partner whose marginal tax rate is less than 34 percent would use this credit to satisfy his or her tax liability on other income or would claim a refund.

EXAMPLE 2 In its return for the 1992 taxable year, partnership Y reports a deduction of \$1 million that should have been reported in its 1993 taxable year. In 1998, a final assessment is made. No additional liability for tax would be imposed in 1998. However, Y would pay the interest imposed on the underpayment of tax in 1992 under section 6601, taking into account any credit against the underpayment under section 6601(f) as a result of the overpayment of tax in 1993. Any interest on

¹²⁶Of course, in certain cases, the rules described above regarding transferee liability would apply to general partners following a transfer of partnership assets out of partnership solution.

¹²⁷Even though not personally liable for an underpayment of a deficiency, a general partner could have increased exposure to personal liability for partnership business obligations as a result of collecting the tax from the partnership. For example, partnership funds used to satisfy the deficiency would not be available to satisfy other debts of the partnership for which the general partners might be personally liable. Analogously, the collection of deficiencies from the partnership may have a disproportionate impact as between classes of limited partners with different interests in partnership allocations and distributions.

the 1992 underpayment would be treated as a nondeductible partnership expense.

EXAMPLE 3 In its return for the 1992 taxable year, partnership Z reports a deduction of \$1 million for an expenditure that should have been amortized on a straight-line basis over 10 years. In 1998, a final assessment is made. The understatement of taxable income by Z for 1992 would be offset in part by Z's overstatement of taxable income for the taxable years 1993 through 1997. The adjustment in tax would equal 34 percent of the amounts previously expensed and not yet properly amortized (\$400,000). In addition, Z would pay the interest imposed on the underpayment of tax in 1992 under section 6601, taking into account any credit against the underpayment under section 6601(f) as a result of the overpayment of tax in 1993 through 1997. In Z's partnership return for 1998, \$400,000 would be added to partnership income, and the partners would be treated as having received a distribution equal to the amount of tax paid (\$136,000). The partners' bases and capital accounts would be adjusted to reflect the allocation of additional income and interest expense and the deemed distribution. The partners also would receive a refundable credit for the tax paid. Any interest on the 1992 underpayment would be nondeductible.

6. Discussion

In General. The Partnership Collection Proposal would simplify the administrative process by treating a prior year deficiency and any related overstatements as an adjustment for the year of the final determination of the deficiency. The Partnership Collection Proposal may also offer the Service greater assurance than under current law that a tax deficiency attributable to a widely held partnership will in fact be paid. As in the case of full withholding, partner-level noncompliance would be avoided by collecting tax directly from the partnership. In addition, the Partnership Collection Proposal may be preferred by some partnerships to the "partner collection" method discussed below because of the fact that tax attributable to prior years would not be imposed directly on current partners.

Shifting of Tax Liabilities and Manipulation Concerns. Under the Partnership Collection Proposal, tax liabilities would follow ownership of a partnership interest and would not, as under current law, be personal to the owner of the interest in the year of the understatement. This approach would represent a divergence from normal partnership tax principles. The most significant consequence of this divergence is the potential shifting of tax liability among taxpayers. This raises two principal concerns.

The first concern is that such a rule appears to give a windfall to a partner who held a partnership interest in the year

income was understated and to impose an unfair burden on a partner buying into the tax liability. Although this is a valid concern, the windfall and burden are less than initially appear. Because the failure to report income generally will result in an understated basis, the windfall to the selling partner is limited to a change in the character of income and deferral of the tax from the year of the understatement to the year of the sale of his or her interest.¹²⁸ Similarly, the burden to the purchasing partner generally will be limited to the interest and any penalties imposed on the understatement, the delay in utilizing the tax benefit represented by the positive basis adjustment produced by the allocation of income, and possible character differences. This burden is not fundamentally different from that resulting from other liabilities that are assumed by a partner purchasing a partnership interest (including unaccrued tax liabilities on items such as built-in gains of a partnership that has not made a section 754 election). As a result of these basis adjustments, the detriment to a partner who buys into a tax liability of a widely held partnership under the current assessment approach would be less than the detriment to a shareholder who buys into a corporation with a similar tax liability.

The second concern is that taxpayers may be able to manipulate the rules to avoid payment of tax. As an initial matter, it should be noted that it would not be possible to avoid taxes by simply distributing partnership assets. Since widely held partnerships would be treated comparably to corporate taxpayers for this purpose, the partnership level deficiencies should have the same status as deficiencies with respect to corporate taxpayers. Thus, for example, in order to collect a deficiency from a widely held partnership, the Service could apply the summary assessment, levy and seizure procedures of section 6331. In addition, section 6901 would be amended to provide that transferees of partnership assets (including partners) would be subject to transferee liability. Hence, distribution of partnership assets would not prevent the government from collecting taxes due.¹²⁹

¹²⁸Under section 705, a partner's basis in his partnership interest is increased by the allocation of both taxable and tax-exempt income. Consequently, if a partnership, rather than underreporting income, mischaracterizes taxable income as tax-exempt, the selling basis will not be understated and his or her windfall will not be so limited.

¹²⁹As discussed in section V(D)(4) above, we recommend that procedures be adopted to collect from current and former partners when the partnership is unable to satisfy a deficiency.

Since in general the amount of liability under the Partnership Collection Proposal is ultimately dependent on the tax status of the partners in the year of the final determination, the central manipulation concern would be the potential for shifting of tax liabilities from high bracket taxpayers to low bracket taxpayers. To achieve a material reduction in a widely held partnership's tax liability, a significant portion of the interests would have to be transferred to lower bracket taxpayers (including tax exempts). The likelihood of such transfers would be reduced by the exclusion from the current assessment approach of any partner holding a significant percentage of interests (e.g., at least five percent or ten percent) in a widely held partnership in the year of the understatement. As under current law, such a significant owner would be liable for his or her allocable share of a deficiency even if the interest were sold prior to the year of final determination. The remainder of the deficiency would be allocated among the current partners. The Service would be able to administer adjustments with respect to the large partners covered by this exclusion. Because these partners will be more likely to know of an impending adjustment and to arrange transfers to lower bracket taxpayers, opportunities for manipulation will be reduced if these partners are not permitted to shift tax liability by transferring their interests.

Even though adjustments with respect to interests held by large partners will be excluded from the current assessment system, a problem would arise if a significant portion of interests were transferred to lower-bracket taxpayers, and in particular tax-exempt entities, through normal market transactions. Existing constraints reduce the likelihood that tax-exempt entities would acquire a significant percentage of interests in a widely held partnership through such transactions. If the partnership is publicly traded (within the meaning of section 7704), tax-exempt investment would be discouraged by section 512(c)(2), which characterizes all income from a publicly traded partnership as unrelated business taxable income. If a widely held partnership is not publicly traded, section 7704 in many cases would discourage the transfer of a significant percentage of partnership interests in any given year.¹³⁰

Even with the adoption of anti-manipulation rules such as those discussed above, it is possible that the collective tax rate of partners in the year of final determination would be

¹³⁰ See Notice 88-75, 1988-27 I.R.B. 29. However, under section 7704, partnerships which derive substantially all of their income from certain types of investment activity (e.g., real estate, oil and gas) will not be taxed as a corporation even if they are publicly traded.

somewhat lower than that in the year of an understatement. Collection of interest on deficiencies at the partnership level, calculated on the assumption of a high effective rate of tax, would reduce the impact of such a rate shift. It would also be possible to impose a punitive interest rate on deficiencies, as is done under the Regulated Investment Company ("RIC") and Real Estate Investment Trust ("REIT") deficiency dividend rules, to further minimize the effect of a rate shift.¹³¹

Section 704(b). Adjustments under section 704(b) may present difficulties under the Partnership Collection Proposal; while certain partners would effectively have their distributive shares of income increased, the corresponding decrease in other partners' distributive shares would result in no overall partnership level deficiency (except as to any differential in interest rates on deficiencies and overpayments). One answer would be to simply conclude that section 704(b) adjustments would have to be handled under current law. However, if enforcement of section 704(b) with respect to widely held partnerships must proceed under an extremely unwieldy system while other adjustments that arise under audit can be processed through a simplified system, the government might be essentially forfeiting enforcement of section 704(b) in these cases. If the Partnership Collection Proposal were to be enacted, further consideration will need to be devoted to the treatment of section 704(b) adjustments under the system.

Liquidity Issues. Because it involves entity-level collection, the Partnership Collection Proposal might create liquidity problems for certain partnerships. Liquidity problems are of particular concern to rental real estate partnerships, many of which experience deficits in the early years of operation, are highly leveraged, and have insufficient cash reserves to finance tax liabilities without selling off partnership assets. Some partnerships would presumably be able to borrow against assets; in some cases, however, a partnership could be forced to sell assets to satisfy a deficiency. A forced sale of assets at an inopportune time could result in significant losses to the partnership. While this may be a significant concern for partners in existing partnerships, partnerships formed after the effective date could presumably establish reserves for possible tax liabilities.¹³²

¹³¹See I.R.C. § 860(c)(1). Under these rules, interest is calculated based on the amount of the deficiency, rather than based on the amount of tax owed.

¹³²See Section VIII of this Report concerning effective date issues.

Summary. The Partnership Collection Proposal would eliminate several fundamental problems that severely hamper the Service's ability under current law to audit and collect deficiencies attributable to widely held partnerships. The proposal would eliminate the need to obtain and monitor the individual returns of partners for the year to which the audit relates and to assess and attempt to collect deficiencies for that year. It would also avoid creating offsetting refund claims in later years. Collection of deficiencies would be greatly simplified. Adoption of the proposal would dramatically reduce the Service's burden in auditing widely held partnerships.

E. Alternative Proposals

Much of the simplification offered by the Partnership Collection Proposal could be achieved under a number of alternative current assessment approaches. The adoption of any of the approaches discussed below would significantly improve the administration of widely held partnerships.

1. Partner Collection Method

The treatment of deficiencies with respect to widely held partnerships as current income items could also be implemented by collecting deficiencies directly from current partners. This approach is referred to in this report as the "partner collection" method. In most respects, these rules would parallel those discussed above in connection with the Partnership Collection Proposal. The following discussion focuses on areas where the two approaches would differ.

Under the partner collection approach, understatements arising from erroneous reporting positions taken by a partnership in prior years (less any offsetting adjustments) would be: (1) included as an income item on the partnership's return (Form 1065) in the year a final adjustment is made; (2) included on the Form 1099-Ks sent to the partners in that year; and (3) reflected as an item of income on the partners' income tax returns (Form 1040 or 1120) in that year. Thus, under the partner collection approach, tax on prior year partnership deficiencies would be paid by the partners in the year of the final determination at the marginal tax rates in effect in that year. To the extent tax rates changed between the year of the understatement and the year of the final determination, the tax owed with respect to a deficiency would likewise vary from that which would have been due had the income been properly reported in the year of understatement. A shortfall reflecting an overstatement of credits in a given year (less any related understatement of credits in a different year) would be included as a separate item on the partnership's return in the year a final determination is made and would be similarly included in the partners' Form

1099-Ks in that year. Thus, the partners in the year of the final determination would be responsible for the repayment of credits as part of their separate tax liability.

Interest and penalties with respect to a deficiency could either be passed through to partners or paid directly by the partnership. If interest and penalties were to be passed through to partners along with the underlying deficiency, a system could be devised under which each partner's interest and penalties were calculated with respect to the partner's actual tax on the deficiency. However, this would require the partnership to provide the partner with an interest rate and a penalty rate to be applied to the partner's tax. While this approach would tailor each partner's interest and penalties to his or her actual tax, deficiency income would need to be reported to partners separately from other income and guidance would be required to determine the amount of each partner's total tax liability that would be treated as attributable to the deficiency income. Only then could the partner use the special interest rate and penalty rate to determine his or her interest and penalties. It is not clear that this approach could be efficiently administered within the partnership's normal reporting system. Furthermore, it would not be possible to apply computer matching to these amounts since the Service would not be independently reported the amount of any partner's interest and penalties. The alternative approach to passing interest and penalties through to the partners would be to calculate the amount of interest and penalties by assuming a partner-level tax rate and showing the resulting interest and penalties as tax due on the partners' Form 1099-Ks. The Service would be able to match these amounts. However, while partners would be likely to properly report additional income shown on a Form 1099-K, they are more likely to be confused by and object to a Form 1099-K that reports additional tax attributable to interest and penalties attributable to a prior year deficiency. Thus, this approach could result in new compliance problems. It would also require partners not otherwise subject to tax to pay penalties and interest on a deficiency.

The passthrough of interest and penalties to partners is perhaps the most significant barrier to designing a pure passthrough of partnership deficiencies and related items. An alternative would be to have partnerships pay interest and penalties, while deficiencies were flowed through to partners. This would lessen the administrative savings from passing deficiencies through to partners as part of the normal deficiency process, and would require the use of an assumed tax rate. Assuming partners were not permitted to seek refunds of penalties and interest, this approach would be relatively simple. Therefore, if the partner collection method were to be adopted, it would be preferable to have partnerships pay interest and penalties.

For purposes of maintaining the partners' capital accounts and determining the bases of their partnership interests, an increase in taxable income would be treated as a positive adjustment to the partners' capital accounts and bases of their interests, and any interest or penalty paid by the partnership would be treated as a nondeductible partnership expense.¹³³ Interest or penalties paid by a partner would be treated as any other interest or penalties paid by a taxpayer with respect to a tax deficiency.

Like the Partnership Collection Proposal, the partner collection method would simplify the administration of widely held partnerships by providing for a single entity level determination that would eliminate the need for the Service to obtain and monitor returns of each prior year partner, and by combining related adjustments as a single current item. The partner collection approach would not offer the Service the opportunity to satisfy a deficiency from a single source. It would also raise a number of the same concerns as the Partnership Collection Proposal, including questions of transferring tax liability and fairness to incoming partners.¹³⁴ On the other hand, the partner collection method would not pose the concerns raised by illiquid partnerships under the Partnership Collection Proposal, although payment of interest and penalties by the partnership would raise such issues to a lesser degree. Furthermore, it is arguable that the partner collection method would represent less of a shift from current law as the collection of deficiencies could be entirely subsumed within the normal reporting procedure.

2. Non-Flowthrough Method

The current assessment system could also be implemented by collecting deficiencies from the partnership without treating the adjustment as current income. The partnership would pay tax at a fixed rate (e.g., the maximum individual rate). Income would not flow through to partners, no partner-level credit would be

¹³³See I.R.C. § 162(f); Treas. Reg. § 1.162-21(b)(1)(ii).

¹³⁴Under the partner collection method, the possibility exists that an understatement of income for an earlier year could result in a tax liability for the current partners that exceeds the value of their partnership interests. This could also occur under the Partnership Collection Proposal in the case of an insolvent partnership. In the case of widely held partnerships, we believe this possibility is remote. Partners in these partnerships are unlikely to incur a tax liability that is disproportionate to the size of their investment (particularly where related amounts are offset). Moreover, a special rule could be provided for such a situation.

allowed for taxes paid by the partnership, and no adjustments would be made to the bases of partners in their partnership interests (although capital accounts would be adjusted).

This non-flowthrough approach would be relatively simple to administer, because partnerships would need to make few adjustments as a result of a partnership deficiency. As a consequence of the absence of basis adjustments, however, the approach could cause partnership income with respect to a deficiency to be taxed twice. Conversely, allowing a partnership to claim a refund under this method for an overstatement of partnership income could result in a double benefit to the partners.

Double taxation of a deficiency could be avoided by using the non-flowthrough method with basis adjustments. Deficiency income would not flow through to partners, and partners would not receive a credit for their allocable share of taxes paid by the partnership. However, partners would receive a basis adjustment for their share of the deficiency income, less tax paid by the partnership. Although at first glance it might appear anomalous to adjust a partner's basis even though the partner was not allocated taxable income, similar adjustments are made under current law for certain items that are not reflected in a partnership's taxable income (e.g., tax-exempt interest income).¹³⁵ Basis adjustments would also prevent a double benefit to partners if refund claims are treated as giving rise to current adjustments.

Whether or not basis adjustments are made, the non-flowthrough approach would tax a partnership's deficiency income at a single rate, regardless of the rates of its partners. By not taking the varying tax rates of its partners into account, this approach would not seek to place the partnership and its partners in approximately the same position they would have been in had the income been properly reported initially. As a result, unlike the Partnership Collection Proposal, it would not permit the reduction of tax due by a shift in the composition of the partners toward tax exempt entities or other lower bracket taxpayers. In addition, the non-flowthrough method would establish a fixed amount of tax due (independent of partner tax rates) which could be collected first from the partnership, second from the current partners, and third from former partners.¹³⁶

¹³⁵ See I.R.C. § 705(a)(1)(B) and (C).

¹³⁶ Unlike the Partnership Collection Proposal, no adjustment procedure would be required to reflect the partners' actual marginal tax rates.

By taxing deficiency income at a single rate, the non-flowthrough approach would, to a certain degree, reflect an entity treatment of widely held partnerships. If basis adjustments were permitted, the approach would recognize the flowthrough nature of a partnership and would not tax deficiency income twice, nor provide a double benefit for a refund on an overstatement. On the other hand, basis adjustments would add a measure of complexity to an otherwise extremely simple entity-oriented system.

On balance, we believe an assessment method that taxes a deficiency at the rates of the partners is the preferable approach, and have therefore recommended the Partnership Collection Proposal. However, as discussed above, taxing a deficiency at the partners' rates opens up the possibility that deficiency income may escape taxation through a shift in the composition of the partners. If it is concluded that the anti-manipulation rules discussed in connection with the Partnership Collection Proposal will not act as sufficient deterrent, serious consideration should be given to the non-flowthrough approach to taxing deficiencies of widely held partnerships, either with or without basis adjustments.¹³⁷

3. Nonrefundable Credit

The current assessment approach could also be implemented with a nonrefundable partner-level credit for taxes paid by the partnership with respect to a deficiency, in contrast to the refundable credit under the Partnership Collection Proposal. Under the nonrefundable credit approach, taxes would be collected from the partnership at a single rate. Income attributable to a deficiency would flow through to partners and would be reported on their Form 1099-Ks, along with a nonrefundable credit for the partner's share of tax paid by the partnership with respect to the deficiency. Partners would have their bases and capital accounts adjusted to reflect the additional income (less tax paid by the partnership).

This method is similar in effect to the non-flowthrough method discussed above, except that taxable investors with a rate lower than the rate at which the partnership paid tax would be able to use the nonrefundable credit to offset tax on other income during the year, and, if the credit could be carried to other years, to offset tax on income in other years. Thus, under a system using a nonrefundable credit, depending on their individual circumstances and whether the credit could be carried

¹³⁷A rule could be provided that basis adjustments would only be made with respect to deficiencies exceeding a certain size.

over, taxable partners might be able to achieve full use of the credit (at least over time). Fully tax-exempt partners would never be able to benefit from the credit. Thus, a partnership's deficiency income would be taxed at a rate which might exceed the collective tax rate of its partners.

4. Elective Payment of Deficiencies by Partnerships

It might also be possible to combine the Partnership Collection Proposal and the partner collection method by making payment of deficiencies by the partnership optional. Thus, if a partnership were determined to have a relatively small deficiency, management might prefer to pay the deficiency directly rather than allocate it as income to the partners. In cases where management determined that this was not a viable alternative, such as in the case of an illiquid partnership, the deficiency could be flowed through to partners as additional income. This approach might, however, create conflict of interest issues for the management of a partnership. If an election approach were adopted, it would be necessary to determine whether the election could be made on a case-by-case or year-by-year basis or whether it would be a more general (perhaps binding) election. It would also be necessary to provide specific rules for making the election and notifying the Service.

F. Comparison to Deficiency Dividend Procedures

While the treatment of adjustments as current items would represent a departure from subchapter K principles, the Code does provide analogous treatment of other widely held passthrough entities. This section discusses the deficiency dividend rules of section 860 of the Code under which the tax attributable to a prior year's deficiency is borne by current investors. Under these rules, a RIC or a REIT may declare a dividend in the year in which a deficiency is finally determined with respect to a prior year.¹³⁸ A deficiency dividend is treated as if it had been paid in the prior year for purposes of determining the dividends-paid deduction of the RIC or REIT for the prior year.¹³⁹ This permits the RIC or REIT to ensure it has satisfied the applicable minimum distribution requirements with respect to the prior year and to avoid any corporate level tax for that year.¹⁴⁰ This procedure places the cost of the prior-year deficiency on current RIC or REIT shareholders. For example, assume that a RIC determines that for 1984 its ordinary income prior to allowance of a deduction for dividends paid is \$900. The RIC distributes \$900

¹³⁸I.R.C. § 860(f).

¹³⁹I.R.C. § 860(a).

¹⁴⁰I.R.C. § 852(a)(1).

to shareholders, thus apparently reducing its taxable income to zero. X, who owns 1 percent of the stock in the RIC, sells his stock to Y on December 31, 1985. In 1986, when Y still owns the stock, the RIC is determined to have understated its income for 1984 by \$100. The RIC declares in 1986 a deficiency dividend of \$100, which is taken into account in determining the RIC's dividends-paid deduction for 1984 and allows the RIC to satisfy the distribution requirement and to reduce its taxable income to zero. If the RIC's 1984 income had been properly reported, X would have received a distribution of \$1 more than he actually received, and the value of X's interest in the RIC would have been correspondingly reduced by \$1; therefore, the incorrect reporting position permitted X to convert \$1 of ordinary income to capital gain on the sale of the stock. Meanwhile, the distribution of the deficiency dividend causes Y to recognize \$1 of ordinary income in 1986 and creates an unrealized \$1 capital loss in Y's RIC stock (assuming no other change in asset value). Furthermore, interest and penalties with respect to the deficiency must be paid by the RIC, which further reduces the value of Y's stock.¹⁴¹

Under the deficiency dividend procedure, current shareholders in a RIC or REIT bear the tax cost of a prior year deficiency. While not providing an exact analogy to the Partnership Collection Proposal or any of the alternatives, these rules demonstrate that federal income tax already employs a current assessment approach for certain passthrough entities.

G. Audit Procedures

Under the Partnership Collection Proposal or any of the alternatives discussed above, deficiencies with respect to widely held partnerships would be determined and assessed on an entity-wide basis rather than on a partner-by-partner basis. To facilitate this process, it will be necessary to provide a new audit system which is separate from and independent of the current TEFRA partnership audit rules of Code sections 6221 through 6233. This new audit system would be applicable only to widely held partnerships which are subject to current assessment, and would not otherwise affect the application of the TEFRA audit procedures. This section briefly outlines the approach to be followed under such an audit system.

¹⁴¹A RIC or REIT utilizing the deficiency dividend procedure is subject to a penalty interest charge. Specifically, interest and penalties are charged on the gross amount of the dividend, rather than on the additional tax that would be imposed on receipt of the dividend. I.R.C. § 860(c)(1).

In general, the authority of the TMP to act as the partnership's representative in tax matters would be greatly expanded while the rights afforded each partner under the TEFRA rules generally would be eliminated. Partners would be required to report consistently with the partnership return, and a penalty would be imposed for failure to do so.¹⁴² Notification of the commencement of an administrative proceeding and of a final adjustment would be provided only to the TMP, who would no longer be required by the Code to keep partners informed of proceedings. Partners would have no right to participate in administrative proceedings. Partners would have no right to file suit independently or otherwise participate in proceedings before a court. They would have no right to seek a refund independently with respect to a partnership item.

Only the TMP would be permitted to participate in the decision to extend the statute of limitations. The TMP would control any litigation relating to partnership deficiencies and refund claims. Settlements of administrative or judicial proceedings with respect to partnership items could be made only by the TMP, and would be binding on all partners. Thus, the TMP would no longer have the option to refuse to bind other partners, and other partners would no longer have the right to prohibit the TMP from settling on their behalf. Naturally, it would be necessary to provide protections for partners and the partnership in the event a designated TMP failed to take certain actions or in the event there was a conflict of interest between the TMP and the other partners.

It is unlikely that the removal of these statutory rights and protections would render individual partners powerless in the determination of deficiencies. First, the TMP undoubtedly would have a duty to treat other partners reasonably and fairly. Second, it is likely that partnership agreements will replace these statutory rights with comparable contract rights. Thus, a partnership agreement might require the TMP to keep all partners informed of administrative or judicial proceedings. A partnership agreement might also provide for a committee to advise or control settlement actions of the TMP. All partners might have the right to have some input through the committee in settlement or litigation decisions. It is possible that such provisions would complicate the task of the TMP, but if complexity is

¹⁴²It would be necessary to provide some type of relief from the consistent reporting rule for taxpayers who receive a clearly erroneous Form 1099-K (e.g., a Form 1099-K incorrectly reflects a partner's ownership of 60 partnership units rather than his or her actual ownership of 50 units). This exception would apply only if the partner disclosed the inconsistent position, and only to items relating to a partner's personal tax position and not to items relating to overall partnership income.

inherent in the system it should burden the partnership and the TMP rather than the Service.

These proposals would invest significant power and responsibility in the TMP. This would in turn exacerbate the problems that have been caused under normal TEFRA rules where there is confusion as to which partner is the TMP,¹⁴³ or where a partner has been unwilling to serve as TMP.¹⁴⁴ Furthermore, the increased power of the TMP would add to the conflict of interest issues that face the Service when it appoints a TMP.¹⁴⁵

By limiting the authority of each partner to act independently of the partnership as to the reporting and determination of partnership items, this type of audit system would reflect the fact that a widely held partnership should be treated as a single entity for purposes of deficiencies. Such an audit system is essential to the implementation of the Partnership Collection Proposal or any of the alternative current assessment approaches.

¹⁴³See, e.g., PAE Enterprises v. Commissioner, 55 TCM 875 (1988); Sente Investment Club v. Commissioner, 55 TCM 1565 (1988).

¹⁴⁴See, e.g., Computer Programs Lamba Ltd. v. Commissioner, 90 T.C. 1124 (1988).

¹⁴⁵See I.R.C. § 6231(a)(7); Rev. Proc. 88-16, 1988-1 C.B. 691.

SECTION VI. PENALTIES

A. Overview

A significant amount of the administrative cost and logistical difficulty in performing an audit of a widely held partnership stems from the fact that penalties are not partnership items and thus are not covered by the TEFRA audit procedures.¹⁴⁶ Penalties must be applied to the partners individually, and therefore must be asserted on a partner-by-partner basis through the use of the statutory notice procedures.¹⁴⁷ Furthermore, the assertion of penalties must await the completion of the related TEFRA proceeding.¹⁴⁸ The implementation of a system for the efficient administration of widely held partnerships should include provisions to facilitate the imposition of penalties where appropriate.

An erroneous reporting position, as to a matter of either law or fact, that leads to the assertion of penalties in the widely held partnership context is realistically the position taken by the partnership. In almost all cases, a partner in a widely held partnership will not have sufficient information to reasonably take a position different from that of the partnership. The Partnership Collection Proposal and the alternative current assessment approaches each represent a shift away from an aggregate approach and towards an entity approach with respect to the administration of widely held partnerships. Consistent with this shift in focus, it is recommended both from the standpoint of fairness and efficiency that penalties related to underpayments of tax by partners of widely held partnerships generally be determined and imposed at the entity level.

B. Accuracy-Related Penalty

1. Background

The Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (the "1989 Act") consolidated into one part of the Code the major penalties relating to the accuracy of tax returns.¹⁴⁹ The penalties consolidated as the "accuracy-related penalty" were the negligence penalty, the substantial understatement penalty, and the valuation penalties. These consolidated penalties were

¹⁴⁶See I.R.C. § 6231(a)(3).

¹⁴⁷I.R.C. § 6230(a)(2)(A)(i).

¹⁴⁸N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987); Maxwell v. Commissioner, 87 T.C. 783, 792 (1986).

¹⁴⁹I.R.C. § 6662.

also coordinated with the fraud penalty.¹⁵⁰ The accuracy-related penalty is imposed at a rate of 20 percent and, as relevant to widely held partnerships, applies to the portion of any underpayment that is attributable to (1) negligence, (2) substantial understatement of income tax, or (3) substantial valuation overstatement.

This section will discuss the accuracy-related penalty as related to widely held partnerships. In general, it is recommended that the penalty be determined at the partnership level and imposed against the partnership. The amount of the addition to tax would be determined by applying the 20 percent penalty against the partnership underpayment attributable either to negligence, substantial understatement or substantial valuation overstatement. The amount of the partnership underpayment would be deemed to equal the product of the net adjustment to partnership income or deductions multiplied by the maximum tax rate (either individual or corporate) for the year of the final determination.

2. Negligence

If part of an underpayment is due to negligence or disregard of rules or regulations, a penalty is imposed on the portion of the underpayment attributable to negligence.¹⁵¹ Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.¹⁵² In addition, the 1989 Act repeals the presumption under prior law that an underpayment is attributable to negligence if the underpayment is due to a failure to include on an income tax return an amount shown on an information return.¹⁵³

Under current law, even following the enactment of the 1989 Act, the penalty for negligence is determined at the partner level. This treatment seems inappropriate when applied to partners of widely held partnerships who report their income consistently with the partnership return. In that case, the penalty relates to the position taken or course of conduct of the partnership, and should be assessed at the partnership level and collected from the partnership. In certain instances, however, the penalty for negligence should continue to be imposed on the

¹⁵⁰I.R.C. § 6663.

¹⁵¹I.R.C. § 6662(b)(1).

¹⁵²I.R.C. § 6662(c).

¹⁵³Such presumption was formerly included in I.R.C. § 6653(g).

partners directly. A partner of a widely held partnership generally should be subject to a negligence penalty (and possibly a fraud penalty in some cases) if he or she fails to report partnership income on a return or takes a position on a return that is inconsistent with that taken by the partnership.¹⁵⁴

3. Substantial Understatement of Income Tax

The accuracy-related penalty also applies to underpayments attributable to a "substantial understatement" of income tax.¹⁵⁵ An understatement generally means the excess of the amount of tax required to be shown on a return over the amount of tax which is shown on the return.¹⁵⁶ A "substantial understatement" is defined as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000. In the case of a corporation (other than an S corporation or a personal holding company), the test is applied by substituting \$10,000 for \$5,000.¹⁵⁷ As applied to a partner in a partnership, the determination of whether an understatement exists and whether that understatement is substantial is based on the partner's individual or corporate overall tax liability, rather than on the taxable income generated by the partnership.

The amount of the understatement is reduced by the portion thereof attributable to (1) the tax treatment of an item as to which there is or was substantial authority, or (2) any item with respect to which there was adequate disclosure of the relevant facts on the return or in a statement attached to the return.¹⁵⁸ For this purpose, disclosure of the tax treatment of partnership items is generally made on the partnership's return.¹⁵⁹ The test relating to adequate disclosure does not apply to a tax shelter investment. The term "tax shelter" includes a partnership or other entity whose principal purpose is the avoidance or evasion

¹⁵⁴As discussed above, it would be necessary to provide some type of relief to a partner who receives an erroneous 1099-K in certain cases.

¹⁵⁵I.R.C. § 6662(b)(2).

¹⁵⁶I.R.C. § 6662(d)(2).

¹⁵⁷I.R.C. § 6662(d)(1).

¹⁵⁸I.R.C. § 6662(d)(2)(B).

¹⁵⁹Treas. Reg. § 1.6661-4(e). Because the statute has not been changed on this point, the regulation probably reflects current law. A partner may also make adequate disclosure with respect to a partnership item by attaching a statement to his or her return.

of federal income tax. In the tax shelter context, the taxpayer must demonstrate that (1) substantial authority exists or existed for the position taken on the return, and (2) the taxpayer reasonably believed that the position taken on his or her return was more likely than not the correct position.¹⁶⁰ The determination of whether a partnership item is related to a tax shelter is based on the principal purpose of the partnership, not the partner.¹⁶¹ With respect to tax shelters, the actions taken by the partnership will be deemed to have been taken by the partner and will be considered in deciding whether the partner reasonably believes that the tax treatment of an item is more likely than not the proper tax treatment.¹⁶²

Under section 6664(c)(1), no accuracy-related penalty will be imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith. In the case of an understatement related to a partnership item, the good faith (or lack thereof) of the partnership generally will be imputed to the partner.¹⁶³

Most of the issues relating to the imposition of the accuracy-related penalty related to substantial understatements are resolved at the partnership level. In particular, the partnership makes the determination as to whether a reporting position is supported by substantial authority. Nevertheless, the penalty currently is applied separately with respect to each partner. In view of the administrative difficulties this treatment creates with respect to widely held partnerships, the penalty for substantial understatements (like the other relevant parts of the accuracy-related penalty) should be treated as a

¹⁶⁰I.R.C. § 6662(d)(2)(C).

¹⁶¹Treas. Reg. § 1.6661-5(a)(1) and (2).

¹⁶²Treas. Reg. § 1.6661-5(e). In general, a taxpayer may establish reasonable belief if (1) the taxpayer analyzes the relevant facts and authorities and reasonably concludes that there is a greater than 50 percent likelihood that the tax treatment will be upheld in litigation if challenged; or (2) the taxpayer in good faith relies on the opinion of a professional tax advisor, provided the opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that the tax treatment of an item will be upheld if challenged. Treas. Reg. § 1.6661-5(d).

¹⁶³Treas. Reg. § 1.6661-6(b). Any good faith imputed to a partner as described above may be refuted by other factors showing the partner's lack of good faith. Id.

partnership item for partners of widely held partnerships, and the partnership should in effect be treated as a taxpaying entity.

Under either the Partnership Collection Proposal or the other approaches, the penalty would be collected from the partnership and treated as a nondeductible expense by the partners.¹⁶⁴ Determinations with respect to the reasonable cause exception (and imposition of the penalty with respect to tax shelters) would be made at the partnership level. For purposes of applying the penalty to widely held partnerships, an "understatement" would be defined as the net adjustment to partnership income or deductions, multiplied by the highest marginal rate under section 1 or section 11. The test applied with respect to corporations in section 6662(d)(1)(B) (substituting \$10,000 for \$5,000 as the threshold level for an understatement to be deemed substantial) would be used to determine whether the partnership would be subject to the penalty.¹⁶⁵

4. Substantial Valuation Overstatement

The accuracy-related penalty includes an addition to tax for underpayments of tax attributable to valuation overstatements.¹⁶⁶ A valuation overstatement is deemed to occur if the value of any property or its adjusted basis claimed on any return is 200 percent or more of the amount determined to be the correct amount.¹⁶⁷ The valuation overstatement penalty does not apply unless the underpayment of tax attributable to the valuation overstatement exceeds \$5,000 (\$10,000 in the case of a

¹⁶⁴Alternatively, under the partner collection method, the penalty could continue to be payable by partners, although the applicability of the penalty would be determined at the partnership level.

¹⁶⁵Because the penalty would be imposed at the partnership level, income and deductions from a widely held partnership would not be taken into account in determining a partner's separate liability for the penalty based on other investments.

¹⁶⁶Like other portions of the accuracy-related penalty, the addition to tax for substantial valuation overstatements equals 20 percent of the underpayment.

¹⁶⁷Under section 6662(h), the rate of the general accuracy penalty is doubled (to 40 percent) in the case of gross valuation misstatements. As relevant to widely held partnerships, a gross valuation misstatement is a valuation overstatement claimed on a return that is 400 percent or more of the amount determined to be the correct amount.

corporation other than an S corporation or a personal holding company).¹⁶⁸ A valuation overstatement by a partnership flows through to the returns of the individual partners. Thus, an underpayment of tax on an individual partner's return resulting from a valuation overstatement by a partnership is treated as an underpayment of tax attributable to a valuation overstatement. As is generally the case with respect to the accuracy-related penalty, no penalty will be imposed if it is shown that there was a reasonable cause for the underpayment attributable to the valuation or adjusted basis claimed on the return and that such claim was made in good faith.¹⁶⁹

The applicability of the accuracy-related penalty with respect to valuation overstatements should be determined at the partnership level with respect to widely held partnerships and the penalty imposed on the partnership. Individual partners are unlikely to have had any involvement in valuing partnership property. Therefore, the valuation penalty should be a partnership item. Under this approach, for purposes of applying the penalty to a widely held partnership, the term "underpayment" would be defined to include the net adjustment to partnership income and deduction attributable to a substantial valuation overstatement by the partnership multiplied by the maximum tax rate (either the individual or corporate rate). The underpayment of tax attributable to substantial valuation overstatements would be subject to the \$10,000 threshold generally applicable to corporations under section 6662(e)(2). The partnership would be treated as the taxpayer for purposes of determining whether the reasonable cause exception of section 6664(c) should apply.

C. Fraud Penalty

Under section 6663, if any portion of an underpayment is due to fraud, a penalty is imposed equal to 75 percent of such portion. The accuracy-related penalty is not to apply to any portion of an underpayment on which the fraud penalty is imposed. Like the accuracy-related penalty, the fraud penalty should be assessed at the partnership level and collected from the partnership.

¹⁶⁸I.R.C. § 6662(e).

¹⁶⁹I.R.C. § 6664(c).

SECTION VII. SCOPE OF THE PROPOSALS--DEFINITION OF A WIDELY HELD PARTNERSHIP

The definition of a widely held partnership should satisfy three criteria. First, it should cover partnerships with numerous partners, because it is these partnerships that present the most serious administrative difficulties under current law. Second, it should provide a bright line, so that partnerships and the Service will be able to determine with certainty whether any given partnership is subject to the simplified reporting and current assessment system. Third, the definition of a widely held partnership should exclude service partnerships such as accounting or law firms. In a service partnership, each partner is likely to be an active member of the business, making full entity treatment less appropriate.¹⁷⁰

The following definition should satisfy these criteria. A widely held partnership is any partnership (i) with 250 or more partners during a taxable year¹⁷¹, and (ii) in which interests are required to be registered under federal or state laws regulating securities or have been sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.¹⁷²

In determining the number of its partners during a taxable year, a partnership will be entitled to rely on the number of partners properly reported to the partnership by nominees under

¹⁷⁰Although all publicly traded partnerships will presumably be treated as widely held partnerships, the uncertainty inherent in the definition of a publicly traded partnership under section 7704 makes it unsuitable as a threshold test for application of the proposals made herein. Moreover, there is a sizable population of partnerships that have numerous partners but are not publicly traded partnerships under section 7704.

¹⁷¹Pursuant to section 6011(e) of the Code, the Service may not require the filing of information returns by electronic or magnetic media unless the filer is required to file at least 250 of the particular information return. Therefore, this appears to be an appropriate bench mark for required participation in the simplified reporting system.

¹⁷²This definition is similar to that under the House Proposal, except that it is restricted to relatively large partnerships. We believe the scope of the definition under the House proposal was considerably broader than necessary.

section 6031(c).¹⁷³ Any partnership that actually has 250 or more partners in a taxable year will be subject to audit under the current assessment procedure, as well as any partnership that reports under the simplified system.¹⁷⁴

Partnerships with less than 250 partners may wish to enter the simplified system. This would be acceptable as long as the system is restricted to partnerships that have a relatively large number of partners. The fewer the number of partners, the easier it would be to take advantage of any variations in the calculation of taxable income resulting from the simplified system. Therefore, partnerships with at least 100 partners should be allowed to elect into the system.

A partnership that becomes subject to the simplified system, either because it is a widely held partnership or because it elects in, will be required to remain in the system unless it receives permission of the Commissioner to be removed. It is expected that such permission would be granted only in rare cases, such as where a partnership suffered a severe diminution in size. It may also be necessary to consider aggregation rules for situations where series of partnerships are structured to avoid the 250 partner limitation.

¹⁷³A nominee holding a partnership interest on behalf of another person during a partnership's taxable year is required to furnish the partnership with the name, address, and taxpayer identification number of the owner within one month of the close of the taxable year. Temp. Treas. Reg. § 1.6031(c)-1T.

¹⁷⁴A partnership might be subject to the widely held partnership audit system and not the simplified reporting system for a given year. This would occur if, for example, at the time a partnership mailed Form 1099-Ks to its partners, it did not have information indicating that it had at least 250 partners due to lapses in nominee reporting. If it is subsequently determined that the partnership had 250 or more partners in that year, the partnership would be subject to the widely held partnership audit system, but would not be required to file an amended return and transmit Form 1099-Ks to its partners. It might be necessary to provide a rule for situations in which the Service inadvertently applies the wrong audit and assessment procedure under these circumstances. Consideration should be given to whether any other problems would result from a partnership being subject in a single taxable year to the widely held partnership audit system and not to the simplified reporting system.

SECTION VIII. EFFECTIVE DATE CONSIDERATIONS

Effective date considerations differ somewhat for the current assessment system and the simplified reporting system. The simplified reporting system should probably apply to all widely held partnerships as soon as practicable after the passage of implementing legislation, taking into account the time necessary for partnerships to develop new accounting and reporting procedures.

There are a number of possible approaches to implementing the proposed audit and assessment system for widely held partnerships. First, the new rules could be made effective only for partnerships formed after a certain date. This would permit partnerships to take the new rules into account in structuring their partnership agreements. However, it would delay the true effective date of the provision for many years. Such a delay may be unacceptable in view of the Service's current difficulties in administering widely held partnerships. Alternatively, the audit and assessment system could be made applicable to audits commenced after a given date. While this would make the rules quickly applicable, it would place significant pressure on determining the exact date an audit is commenced. It also might be viewed as unfair to impose a new system on partnerships that have not had any time to prepare for it. Therefore, the best approach would be to make the proposal effective for taxable years ending after a given date.¹⁷⁵ The date selected should allow partnerships enough lead time to amend their partnership agreements should they choose to do so.

The simplified reporting system and the revised audit procedures could be effective in differing taxable years, as the implementation of either is not dependent on the other. However, if the necessary lead time for the simplified reporting system is comparable to that needed under the audit and assessment system, both should be made applicable in the same taxable year.

¹⁷⁵The reference to taxable years ending after rather than before a given date is preferred due to occasional uncertainty concerning the date a partnership's taxable year commences.

APPENDIX I

Proposals for Amendments to TEFRA Rules

The unified audit and litigation provisions that were enacted with respect to partnerships as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and extended to S corporations by the Subchapter S Revision Act of 1982, represented a radical change in the way that audits and litigation relating to these entities and their investors were conducted. As can be expected with respect to any change of this magnitude, the transition has been difficult and the procedures have not always worked in practice the way that they were envisioned. However, we are in favor of retaining these provisions, at least with respect to partnerships that would not be subject to the new procedures recommended by this study. On the other hand, based upon our experience in administering these provisions, we recommend that certain changes be made. A summary of the TEFRA rules is provided in Appendix II.

1. Boundary Issues

A substantial problem area exists with respect to whether the TEFRA partnership procedures or the regular deficiency procedures apply to a particular taxable year, a particular taxpayer, or a particular adjustment. This determination can be very technical and difficult to make, and the consequences of an incorrect choice can be severe because if the Service applies the wrong procedure, the statute of limitations applicable to the correct procedure may have expired by the time that the problem is discovered. The situations giving rise to this problem are generally described as presenting "boundary issues."

One example of a boundary issue arises in the context of the small partnership exception contained in section 6231(a)(1)(B). Pursuant to that section, the partnership audit provisions do not apply to a partnership that has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as that partner's share of every other partnership item. Several pitfalls exist in applying this provision. Specifically, if an incorrect determination is made regarding whether there were ever more than 10 partners in the partnership at any one time during the year, or whether a person is a nonresident alien, or whether any special allocations were made during the year, the Service may inadvertently apply the wrong procedures.

Similarly, boundary issues may be encountered as a result of the operation of the special enforcement provisions of section 6231(c). For example, Temp. Treas. Reg. §§ 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items are converted to nonpartnership items, and if the debtor was the tax

matters partner (TMP), such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. § 362. However, problems arise because the Service is not automatically notified of every bankruptcy filing. When the Service is unaware that a partner is in bankruptcy, the Service may mistakenly treat the debtor as a party to a partnership proceeding and allow the statute of limitations with respect to the partner's nonpartnership items to expire. In such a case, a statutory notice of deficiency adjusting the converted partnership items will be barred, even though the Service could have timely issued such a notice if the Service had been aware of the bankruptcy filing. Likewise, if unbeknownst to the Service the TMP goes into bankruptcy, the Service may issue a notice of final partnership administrative adjustment (FPAA) to the bankrupt TMP, which may be determined to be invalid because the debtor's status as TMP was automatically terminated by the filing of the bankruptcy petition.

Another boundary issue arises in the context of tiered partnerships. In particular, if the source (operating) partnership is non-TEFRA and the tier (investor) partnership is TEFRA, or vice versa, it is unclear whether the TEFRA procedures or the deficiency procedures should be applied. The Service has taken the position that it is the source partnership's status that controls with respect to any adjustments relating to items flowing from the source partnership. However, to the extent that the tier partnership generates income or expense items attributable to its own activities, any adjustment to those items must be made at the tier level. When dealing with multiple tier situations, such determinations are very difficult and mistakes are bound to be made. As a result, many of these adjustments may be in jeopardy if it is subsequently determined that the wrong procedures were applied. To alleviate this problem, the interplay between the TEFRA and deficiency procedures in the context of tiered partnerships should be clarified.

As the above discussion illustrates, boundary issues present hidden traps and create substantial administrative difficulties for the Service, which must frequently decide at its peril whether to apply the TEFRA procedures or the deficiency procedures and run the risk that if it chooses incorrectly, the adjustments may be barred. Since the revenue loss may be substantial, we recommend that legislation be enacted which would mitigate the effect of boundary issues. One approach would be to resolve each boundary issue separately. If that is not feasible, another approach would be to provide that if the Service erroneously makes a determination regarding the proper procedure to apply and timely issues the appropriate notice in accordance with that determination, i.e., a statutory notice or a notice of FPAA, then the statute of limitations for assessment will not expire before 1 year after a court determines that the wrong procedure was followed and that determination becomes final. A legislative

proposal along these lines is attached. One potential benefit to this latter approach is that it will cover all boundary issues, even those that have not yet been identified. As a result, this approach should eliminate the need to seek additional legislation concerning boundary issues in the future, if new boundary issues are identified.

Additionally, we have two proposals concerning the small partnership exception that should reduce the number of partnerships that are subject to the unified, entity-level procedures and eliminate some of the boundary issues discussed above:

A. The "natural person (other than a nonresident alien) or an estate" requirement should be eliminated from section 6231(a)(1)(B)(i)(I) and replaced with a "no pass-thru entity" requirement. Under this proposal, a partnership with 10 or fewer partners that has a subchapter C corporation as a partner would still qualify for the small partnership exception, but a partnership having an S corporation, a trust, another partnership (tier), or a nominee as a partner would not be eligible for the exception.

B. The same share requirement contained in section 6231(a)(1)(B)(i)(II) should be eliminated. When dealing with a partnership that has 10 or fewer partners, we do not believe that the mere existence of a special allocation causes sufficient problems to warrant subjecting the entire partnership to the TEFRA procedures. It should be recognized, however, that if this proposal is adopted, a potential for inconsistent treatment of partners may be created if a reallocation of items becomes necessary.

2. Treatment of Partnership Items in Deficiency Proceedings

In Munro v. Commissioner, 92 T.C. 71 (1989), the Tax Court upheld the validity of a statutory notice that disallowed net losses from TEFRA partnerships before computing the deficiency amount, but ruled that it was impermissible for the Service to disallow the partnership losses in the statutory notice even if this was done solely for computational purposes and was not intended to be a substitute for issuing a notice of final partnership administrative adjustment (FPAA) as required by section 6225. The court held that the partnership items (whether income, loss, deduction or credits) included on a taxpayer's return should be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items. Hence, under Munro, the Service may not assume the correctness of its proposed adjustments to partnership items for computational purposes in determining a deficiency, and taxpayers may not offset net partnership losses against their taxable income for purposes of deficiency proceedings.

Prior to the Munro case, it was the Service's practice to treat all partnership items as if they were correctly reported for purposes of the deficiency proceeding; under Munro, the partnership items are eliminated from the taxpayer's return. However, in Munro situations, where the taxpayer is over-sheltered, i.e., losses entirely offset the taxpayer's income, this procedure would not have permitted any adjustment to the nonpartnership items. It was these unusual facts that led to the Munro opinion.

In most of the cases that are either currently in litigation or under audit, net losses from TEFRA entities are claimed and used to only partially offset income from non-TEFRA sources. Since under normal circumstances the TEFRA proceeding progresses more slowly than the deficiency proceeding, computing the deficiency under Munro will result in a greater deficiency being asserted in the deficiency proceeding than would have been asserted under the Service's practice prior to the Munro opinion. Consequently, under Munro, the taxpayer will not get the benefit of the partnership losses until the losses are determined to be allowable in a TEFRA proceeding, even though the factual scenario that gave rise to the Munro opinion is relatively unusual.

While we believe that the Tax Court's opinion is technically correct in that the deficiency procedures and the TEFRA procedures were intended to be totally separate, the solution proposed by the Tax Court is unworkable as a practical matter. In the typical case, computing the tax liability without reference to partnership items will have the same effect as though those partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the partner is ultimately allowed any part of the losses, the partner will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the partner will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, implementation of Munro in the typical case means loss of a prepayment forum for TEFRA partnership adjustments. As a policy matter, we view this result as an inappropriate and unintended consequence of implementing Munro.

In light of the above, and other problems which have been identified with respect to the implementation of Munro, we strongly endorse the legislative proposal that has been worked out with the staffs of the Joint Committee and House Legislative Counsel. In essence, this proposal would enable the Service to continue using its prior practice for most cases but provides a special rule covering oversheltered situations such as existed in Munro. With respect to the oversheltered cases, the proposal provides that partnership items shall be disregarded in determining whether a deficiency exists for purposes of the deficiency

proceeding and any adjustment in that proceeding shall be taken into account in determining the amount of any computational adjustment following the completion of the partnership proceeding. A copy of this proposal is attached.

3. Relationship Between the Limitations Periods Provided By Sections 6229 and 6501

Section 6501 provides a limitations period with respect to any tax imposed by title 26. This period is determined with reference to the filing of the taxpayer's return. Section 6229 provides a limitations period with respect to any tax imposed by subtitle A that is attributable to any partnership item or affected item. This period is determined with reference to the filing of the partnership's return. Under the existing statutory scheme, it is unclear whether these two sections create separate statutes of limitations, i.e., section 6501 applies with respect to nonpartnership items and section 6229 applies with respect to partnership and affected items, or whether section 6229 simply extends the limitations period with respect to partnership and affected items in situations where the section 6501 period has otherwise expired. Since both of these interpretations are supportable under current law but each approach presents conceptual difficulties, legislation clarifying this area should be enacted. In addition, the issue of whether an extension of the statute of limitations that is obtained pursuant to section 6501(c)(4) and does not make specific reference to partnership items applies to partnership items that subsequently convert to nonpartnership items, should also be addressed.

4. Suspension of the Statute of Limitations During the Pendency of Bankruptcy Proceedings

As discussed with respect to the boundary issues, a partner's partnership items convert to nonpartnership items upon the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. Section 6229(f) provides that the period for assessing tax with respect to items that convert to nonpartnership items shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(i) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502. Since the limitations period pertaining to converted items is governed by section 6229(f) rather than section 6501, the suspension of the limitations period provided by section 6503(i) will not apply with respect to partnership items that convert to nonpartnership items by reason of the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. As a result, the limitations period will continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the Service is prohibited from making an

assessment against the debtor because of the automatic stay imposed by section 362(a) of the Bankruptcy Code. Moreover, under certain circumstances it is possible for the normal 3 year limitations period to be shortened to 1 year or for the limitations period to arguably expire prior to the filing of the return for a given year. Consequently, either a provision similar to section 6503(i) should be enacted to cover the limitations period provided in section 6229(f) or section 6503(i) should be amended to extend the suspension provision to the section 6229(f) period. The suspension provision should also be extended to the limitations period provided in sections 6229(a) and 6229(d) relating to the time for making a computational adjustment following default or judicial review of a notice of final partnership administrative adjustment (FPAA).

5. Exclusion of Partial Settlements From the 1 Year Assessment Period

Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date the Service enters into a settlement agreement with the partner with respect to such items. As discussed previously, under section 6229(f), the limitations period for assessing any tax attributable to converted items shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. This rule creates a problem in situations where a settlement agreement is entered into with respect to some but not all of the issues in the case. The reason for this is that a 1 year assessment period will apply with respect to the settled items whereas the remaining items will be governed by the normal assessment period under section 6229(a). If issues are settled at several different stages of the proceeding, the problem can become severe.

The fractured statute problem can be illustrated by the following example:

Assume that five issues are raised in connection with the examination of the 1984 return for the ABC Partnership. While the case is still being handled by the Examination function, the Service and all partners enter into a specific matters closing agreement whereby all parties agree that a deduction was erroneously claimed. The case then goes to Appeals where the Service concedes the second issue. After the case is docketed but before the trial, the parties settle the third adjustment. Pursuant to a court order, the parties file a Stipulation of Settled Issues with the court evidencing their agreement with respect to the third adjustment. The remaining two issues are tried but the partnership concedes the fourth issue on brief. The last issue is decided by the court.

Under the above scenario, the partners in the ABC Partnership will be subject to five different limitations periods for assessment with respect to their investment in the ABC partnership for the 1984 taxable year. Making five separate computations with respect to each partner for a single taxable year is extremely burdensome and creates a drain on the Service's limited resources. Moreover, the fractured statute poses a significant tracking problem for the Service, which may result in many, if not most, of the assessments not being made within the relevant time period. On the other hand, if the assessments are timely made, the partners in the ABC Partnership may become angered or confused when they receive multiple notices of assessment with respect to the same taxable year.

In light of the above, it is recommended that even though partnership items covered by a settlement agreement will convert to nonpartnership items, if the agreement constitutes only a partial settlement, it should not trigger a 1 year assessment period. Instead, legislation should be enacted to provide that the 1 year assessment period will not begin to run until all issues in the case are disposed of. As applied to the above example, this would not occur until the decision of the court became final. One possible way to accomplish this may be to provide that for purposes of the statute of limitations on assessment, a settlement must be comprehensive, i.e., if a settlement is limited to selected items, it will not be treated as a settlement, and hence, it will not commence a 1 year assessment period with respect to those settled items. On the contrary, the assessment period with respect to the settled items will be governed by section 6229(a). Thus, the assessment period with respect to the settled items will be the same as the assessment period for the items that have not been settled.

6. Forum For Contesting the Applicability of the Increased Rate of Interest Under Section 6621(c)

Section 6621(c) provides for an increased rate of interest with respect to any substantial underpayment attributable to tax motivated transactions. Jurisdiction to determine the applicability of section 6621(c) was granted to the Tax Court in section 6621(c)(4), but said jurisdiction is limited to those proceedings in which the Tax Court also has jurisdiction over the deficiency to which the increased rate of interest relates. When the issue arises in connection with an investment in a TEFRA partnership, the applicability of section 6621(c) is treated as an affected item that requires partner-level determinations. As a result, under section 6230(a)(2), the application of section 6621(c) must be determined in separate proceedings at the partner level following the completion of the partnership-level proceeding. Unfortunately, since in an affected item proceeding the Tax Court does not have jurisdiction over the underlying deficiency, the Tax Court similarly lacks jurisdiction to

determine the applicability of section 6621(c) in such a proceeding. Likewise, a partner cannot contest the applicability of section 6621(c) in a section 6230(c) refund suit because such actions are essentially limited to computational disputes. Consequently, it is recommended that a judicial forum be provided for partners to challenge the imposition of the increased rate of interest under section 6621(c) relating to deficiencies attributable to their investment in a TEFRA partnership. It is noted, however, that if proposal 13 regarding the determination of penalties and the increased rate of interest at the partnership level is adopted, no further action with respect to this proposal will be necessary since a forum under section 6230(c) will be provided.

7. Forum For Raising Innocent Spouse Defense

Under section 6013(e), an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met. However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership. Since the innocent spouse defense requires substantive determinations, a refund suit under section 6230(c) would not be permissible. Similarly, since innocent spouse is an affirmative defense that will only be raised by a taxpayer, the taxpayer will only be able to assert the defense in the Tax Court if the Service issues an affected items statutory notice to the taxpayer. If such a notice is not issued to the taxpayer, there does not appear to be a judicial forum available in which to raise the innocent spouse defense. Accordingly, it is recommended that a judicial forum be provided for a spouse of a partner in a TEFRA partnership to raise the innocent spouse defense insofar as it relates to a liability that is attributable to an investment in the TEFRA partnership.

8. Suspension of the Statute of Limitations Upon the Filing of an Untimely Petition

In a deficiency case, section 6503(a) provides in pertinent part that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection shall be suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides in pertinent part that the period of limitations shall be suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the

filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely. Consequently, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court. To prevent this from occurring, the Service must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. Hence, the statute creates a trap for the unwary and necessitates an inefficient use of resources on the part of the Service. Accordingly, section 6229(d) should be amended to make the suspension provision concerning the filing of petitions in TEFRA cases consistent with the rule under section 6503(a) pertaining to deficiency cases.

9. Administrative Adjustment Requests (RAA)

A. Refund Suits Under Section 6228

Section 6230(a)(2)(A)(ii) provides that deficiency procedures apply to items which have become nonpartnership items. An exception to this rule is provided with respect to items that convert by reason of a settlement agreement. Pursuant to section 6231(b)(1)(B), a partner's partnership items become nonpartnership items upon the filing of a suit under section 6228(b). Since items that convert pursuant to section 6231(b)(1)(B) will already be the subject of a judicial proceeding, the deficiency procedures should not apply. Accordingly, this situation should be excluded from the rule under section 6230(a)(2)(A)(ii).

B. Extension of Time Within Which to File an RAA

Section 6227(a) provides that a partner may file a request for an administrative adjustment of partnership items within 3 years after the later of the date of the filing of the partnership return or the last day for filing the partnership return (determined without regard to extensions), but before the Service mails a notice of FPAA to the TMP. Section 6511(c) provides that if an agreement is entered into under section 6501(c)(4) to extend the period for assessment, the period for filing a claim for credit or refund or for making a credit or refund if no claim is filed, shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement under section 6501(c)(4). It is recommended that a provision similar to section 6511(c) be enacted with respect to the filing of an RAA where an agreement extending the statute of limitations relating to partnership and affected items is entered into under section 6229(b).

C. Allowance of Credits or Refunds After the Expiration of the Time For Filing an RAA

The rules pertaining to credits or refunds attributable to partnership items and affected items are set forth in sections 6227, 6230(c) and 6230(d). These rules are fairly complex. As a result, there is confusion regarding the allowance of credits or refunds where no RAA has been filed and the time for doing so has expired, but the statute of limitations under section 6229 is still open or the time for filing a claim or suit under section 6230(c) has not yet expired. This situation frequently occurs when the TMP extends the statute of limitations under section 6229 and after the time for filing an RAA has expired, a partner makes an advance payment of tax to stop the running of interest. Under these circumstances, it appears as if a partner should be able to obtain a credit or refund, but it is unclear from the statute whether the making of such a credit or refund would be permissible. Consequently, it is recommended that this point be clarified.

D. RAAs Filed By the Tax Matters Partner in Overpayment Situations

Section 6227(b)(1) provides that if the TMP files an RAA on behalf of the partnership and requests substituted return treatment, the Service may treat the changes shown on the request as corrections of mathematical or clerical errors appearing on the partnership return. If an RAA filed by the TMP on behalf of the partnership is not treated as a substituted return, under section 6227(b)(2) the Service may, without conducting any proceeding, allow or make to all partners the credits or refunds arising from the requested adjustments; conduct a partnership proceeding; or take no action on the request. In light of the above, it appears as if substituted return treatment is only available where additional tax is due; if the requested adjustments would give rise to a credit or refund for the partners, the RAA must be handled under section 6227(b)(2). It is unclear, however, whether in an overpayment situation the partners' right to a credit or refund is protected by the filing of an RAA by the TMP, or whether the partners must file separate RAAs in order to preserve their respective rights to file a refund suit under section 6228. Section 6228(a)(4) seems to indicate that the partners are protected if the request is not allowed and the TMP files suit, since the partners will be treated as parties to the action and they are entitled to participate. On the other hand, it appears as if the partners will not be protected if the TMP fails to timely file a suit since only the TMP is permitted to file a petition with respect to an RAA filed under section 6227(b). Accordingly, it is recommended that the partners be provided with an additional period of time within which to file a petition regarding the RAA, in the event that the TMP fails to file such a petition. This

would be similar to the provisions under section 6226 concerning the filing of a petition with respect to a notice of FPAA. Such a rule would be beneficial both to the partners and the Service because it would eliminate the need for the partners to file separate RAAs and the Service would not have to expend its limited resources processing those requests.

10. Application of Section 6223(e) in the Context of a Tiered Partnership

If the Service fails to provide a notice of the beginning of an administrative proceeding (NBAP) or a notice of final partnership administrative adjustment (FPAA) to a partner who is entitled to such notice, section 6223(e) permits the partner to make certain elections. In a tiered partnership, the pass-thru partner (tier) will normally be a notice partner. Under current law, it is unclear whether the section 6223(e) election may be made by the pass-thru partner and would be binding on the indirect partners (the investors in the tier) or whether the indirect partners are entitled to make separate elections. Additionally, if both the tier and an indirect partner make elections, it is unclear which election should be given effect. Thus, legislation clarifying these points would be helpful. In this regard, it is noted that sections 6224(c)(1) and 6224(c)(3) provide rules concerning the effect of settlement agreements entered into by a pass-thru partner or the tax matters partner (TMP) on indirect partners and nonnotice partners, respectively. Similar rules pertaining to section 6223(e) elections may be appropriate.

11. Application of the TEFRA Partnership Provisions to a Partner Who is a Member of a Consolidated Group

When a partner in a TEFRA partnership is a member of a consolidated group, several problems arise if the partner is not the common parent of the members of the consolidated group. The primary reason for this is that Treas. Reg. § 1.1502-77 provides that the common parent is the sole agent for each subsidiary in the group with respect to all matters relating to the tax liability for the consolidated return year, and that no subsidiary shall have the authority to act for or to represent itself in any such matter. On the other hand, the TEFRA partnership provisions grant many rights to the tax matters partner (TMP), such as the authority to extend the statute of limitations on behalf of all partners and to enter into a settlement agreement that may bind certain other partners. In this regard, it is noted that the other members of the consolidated group are treated as partners under section 6231(a)(2)(B) because their income tax liability will be determined in part by taking into account indirectly partnership items of the TEFRA partnership. Hence, in light of these conflicting provisions, it is unclear whether the actions taken by the TMP will be binding

on the consolidated group. Some guidance concerning the proper application of the TEFRA partnership provisions in this context would be helpful.

12. Dismissal of Premature Petitions

Section 6226 sets forth the rules concerning judicial review of notices of final partnership administrative adjustment (FPAA). Pursuant to section 6226(a), the tax matters partner (TMP) is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of FPAA. Pursuant to section 6226(b)(1), if the TMP does not file a petition within the 90-day period, notice partners are permitted to file a petition within the 60-day period after the close of the 90-day period. If more than one petition is filed under section 6226(b), that section sets forth ordering rules for determining which action goes forward and provides in paragraph (4) for the dismissal of all other actions. Section 6226(h) provides that if an action is dismissed other than under subsection (b)(4), the dismissal shall be treated as a determination that the notice of FPAA is correct. This provision creates a problem in cases where a petition is filed within the 90-day period by a person who is not the TMP. Since such a petition is filed under section 6226(a) rather than under section 6226(b), the dismissal is technically not pursuant to section 6226(b)(4). Hence, pursuant to section 6226(h), the dismissal of the premature petition would have the effect of upholding the notice of FPAA. Such a result is inappropriate. Consequently, it is recommended that legislation be enacted to correct this inequity, which clearly was not intended.

13. Determination of Penalties at the Partnership Level

Section 6231(a)(3) limits the definition of partnership items to those items required to be taken into account under any provision of subtitle A. Since penalties are contained in subtitle F, they cannot be partnership items. Instead, penalties are treated as affected items that require partner-level determinations. As a result, under section 6230(a)(2), penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding. These penalty only cases create an undue burden for the Service and have the potential of significantly increasing the Tax Court's inventory. Moreover, the requirement of conducting a separate proceeding with each partner greatly increases the likelihood of disparate treatment. Hence, the major goals of the TEFRA partnership provisions, namely administrative and judicial economy and consistent treatment of partners, are not being accomplished with respect to penalties that are attributable to an investment in a TEFRA partnership. Accordingly, it is recommended that penalties be determined at the partnership level and imposed against the partners as a

computational adjustment. However, it is also recommended that section 6230(c) be amended to provide the partners with a refund forum to raise any partner-level defenses that they may have with respect to the imposition of the penalty. This proposal should also be made applicable to the increased rate of interest under section 6621(c).

14. Repeal of the Unified Procedures For S Corporations

The Subchapter S Revision Act of 1982 added sections 6241-6245 to the Code. These provisions generally made the unified audit and litigation procedures for partnerships applicable to S corporations. Notwithstanding the repeal of General Utilities as part of the Tax Reform Act of 1986, which has made the use of S corporations more popular, the Service is in favor of repealing the unified procedures for S corporations. Historically, S corporations have not generally been used as a vehicle to market abusive tax shelters and the Service did not experience any significant difficulties in auditing S corporations or litigating at the shareholder level. Furthermore, for S corporation taxable years the return for which is due on or after January 30, 1987 (determined without regard to extensions), Temp. Treas. Reg. § 301.6241-1T(c)(2) provides for a small S corporation exception for S corporations with five or fewer shareholders, and it is our understanding that the vast majority of both existing and newly formed S corporations qualify for that exception. Hence, it appears as if the repeal of the unified procedures for S corporations is justified.

Section 6229 PERIOD OF LIMITATIONS FOR MAKING ASSESSMENTS.

* * *

(h) **Special Rule When Secretary Erroneously Applies Deficiency Procedures.**- If the Secretary erroneously determines that subchapter C of this chapter does not apply to a partnership taxable year and consistent with that determination timely mails a notice of deficiency to a partner pursuant to sections 6212 and 6501, which includes adjustments to partnership items (or affected items) of the partnership, the period of limitations provided in this section shall not expire before the date which is 1 year after the date that the determination of a court that the incorrect procedure was followed becomes final.

Section 6501 LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

Redesignate existing subsection (o) as (p) and insert the following:

(o) **Special Rule When Secretary Erroneously Makes Administrative Adjustment.**- If the Secretary erroneously determines that subchapter C of chapter 63 applies to a partnership taxable year and consistent with that determination timely mails a notice of final partnership administrative adjustment to the tax matters partner with respect to that taxable year pursuant to sections 6223 and 6229, the period of limitations for assessing any tax which is attributable to the partnership items (or affected items) of the partnership shall not expire before the date which is 1 year after the date that the determination of a court that the incorrect procedure was followed becomes final.

Section 6230 ADDITIONAL ADMINISTRATIVE PROVISIONS.

(a) Coordination With Deficiency Proceedings.-

* * *

(3) TREATMENT OF PARTNERSHIP ITEMS IN DEFICIENCY PROCEEDINGS.--

(A) IN GENERAL.--In determining whether there is a deficiency for purposes of subchapter B, except as provided in paragraph (2)(A), adjustments to partnership items may be made only as provided in this subchapter.

(B) SPECIAL RULES.--

(i) IN GENERAL.--In any case in which the taxpayer's return shows a loss or no taxable income and shows a net loss from partnership items, solely for purposes of proceedings conducted under subchapter B, partnership items shall be disregarded in determining whether there is a deficiency. Any adjustment in such proceedings shall be taken into account in determining the amount of any computational adjustment.

(ii) EXCEPTION FOR CERTAIN ITEMS.--Clause (i) shall not apply to any partnership item the treatment of which has been finally determined under this subchapter.

EFFECTIVE DATE--This amendment shall take effect as if such amendment had been included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

APPENDIX II

Description of TEFRA Rules

Prior to the enactment of unified partnership audit rules by the Tax Equity and Fiscal Responsibility Act of 1982, adjustments to items of income, gain, loss, deduction and credits relating to a partnership had to be made in separate proceedings with the respective partners. Similarly, settlements and judicial determinations were only binding on those partners that were parties to the agreement or judicial proceeding. This system was not an efficient means of auditing tax shelters and other large partnerships, because each partner was entitled to separate administrative and judicial review of partnership items that were common to all partners.¹ The TEFRA partnership audit rules consolidate the administrative and judicial review of all partnership items at the partnership level. Congress, noting the potential conflict between investors and tax shelter promoters, balanced the consolidated audit provisions with considerable protections for individual partners.

The TEFRA partnership audit rules apply to all partnerships, except for partnerships with ten or fewer partners where each partner's share of any partnership item is the same as his share of every other item (*i.e.*, there are no special allocations) and each partner is a natural person (other than a nonresident alien) or an estate.² The tax treatment of all partnership items is determined at the partnership level.³ Generally, all partners must treat items on their individual returns consistently with the treatment of those items on the partnership return unless they notify the Service of an

¹See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 267-68 (hereinafter referred to as "TEFRA General Explanation").

²I.R.C. § 6231(a)(1)(B). All partners of a partnership for the partnership taxable year under audit generally are subject to the TEFRA partnership audit rules. However, under certain circumstances, the inclusion of a partner in a unified proceeding would interfere with efficient enforcement of the tax law. I.R.C. § 6231(c). When special enforcement considerations exist with respect to a partner, that partner's partnership items will be treated as nonpartnership items and the partner is removed from the partnership proceeding. Examples of special enforcement situations include the filing of a bankruptcy petition naming a partner as the debtor or the criminal investigation of a partner. *Id.*; Temp. Treas. Reg. §§ 301.6231(c)-4T through 8T.

³I.R.C. § 6221.

inconsistent treatment.⁴ If a partner takes an inconsistent position on his or her return and does not provide notice of the inconsistency, the Service may immediately assess any deficiency necessary to make the partner's treatment consistent with the partnership return. Such an assessment would normally also include a negligence penalty.⁵

The central figure in a TEFRA partnership proceeding is the tax matters partner ("TMP"). The TMP is a representative of the partnership who serves as a liaison between the partnership, the Service and the court, with respect to the unified audit and litigation proceedings regarding the tax treatment of partnership items attributable to the partnership. As such, the TMP serves as the focal point for service of all notices, documents and orders on the partnership, and concomitantly has many rights and duties both at the administrative stage of the proceeding and in the course of litigation. The TMP is the general partner designated by the partnership to serve as the TMP or, if there is no such designation, the general partner having the largest profits interest as of the close of the taxable year involved.⁶ If the Service determines that is impracticable to apply the largest profits interest rule, the Service may select any partner to serve as the TMP.⁷

Each partner is entitled to participate in all aspects of the administrative proceedings.⁸ If the Service decides to initiate a partnership audit, it must furnish both a notice of the Beginning of an Administrative Proceeding and a notice of Final Partnership Administrative Adjustment to all partners entitled to notice.⁹ In partnerships with more than 100 partners, only identified partners with a one percent or greater interest in partnership profits, and designated members of

⁴I.R.C. § 6222(a) and (b).

⁵I.R.C. § 6222(c) and (d). See I.R.C. § 6662(b)(1).

⁶I.R.C. § 6231(a)(7); Temp. Treas. Reg. § 301.6231(a)(7)-1T.

⁷Id.; See Rev. Proc. 88-16, 1988-1 C.B. 691.

⁸I.R.C. § 6224(a).

⁹I.R.C. § 6223(a). Those partners entitled to receive notice from the Service are generally referred to as "notice partners." The partners who are not entitled to receive notice from the Service are referred to as "non-notice partners."

"notice groups,"¹⁰ are entitled to notice from the Service.¹¹ All other partners are to be kept informed of the partnership proceedings by the TMP.¹²

The TEFRA partnership audit rules provide the TMP with the power to make certain decisions on behalf of the partnership. The period for assessing any tax with respect to any partner that is attributable to any partnership item (or any item affected by a partnership item) does not expire before the date that is three years after the later of the due date determined without extension or actual filing date of the partnership return.¹³ The TMP has the authority to extend that period with respect to all partners.¹⁴ The TMP also has the authority to enter into a settlement agreement that binds all non-notice partners, although any partner may, by notifying the Service, refuse to be bound by any agreement entered into by the TMP.¹⁵ The TMP may file an administrative adjustment request (the functional equivalent of an amended return or claim for refund) on behalf of the partnership.¹⁶ The TMP may also select the forum for litigation by filing a petition, during the first 90 days following the mailing of the notice of Final Partnership Administrative Adjustment, with either the Tax Court, the Claims Court, or the United States district court for the district in which the partnership has its principal place of business.¹⁷

Partners other than the TMP are provided with significant protections under the TEFRA partnership audit rules. Notice partners have the authority to petition for judicial review from a notice of Final Partnership Administrative Adjustment during the 60 days following the 90-day period after the mailing of a Notice of Final Partnership Administrative Adjustment to the TMP (assuming the TMP fails to file a petition during the 90-day

¹⁰A "notice group" is a group of partners having in the aggregate a five percent or more interest in partnership profits who designate one member to receive notice on behalf of the group. I.R.C. § 6223(b)(2).

¹¹I.R.C. § 6223(b).

¹²I.R.C. § 6223(g); Temp. Treas. Reg. § 301.6223(g)-1T.

¹³I.R.C. § 6229(a).

¹⁴I.R.C. § 6229(b)(1)(B).

¹⁵I.R.C. § 6224(c)(3)(B).

¹⁶I.R.C. § 6227(b).

¹⁷I.R.C. § 6226(a).

period).¹⁸ If any partner files a petition in the Tax Court, a district court or the Claims Court, any partner in the partnership may file an election to participate in the action.¹⁹ If the TMP fails to execute a consent to extend the statute of limitations, the Service must obtain a consent individually from each partner or issue a notice of Final Partnership Administrative Adjustment to the TMP in order to suspend the running of the statute of limitations.²⁰ An administrative adjustment request may be filed individually by a partner other than the TMP.²¹ In addition, any partner may reach a settlement of his or her own case individually with the Service, and may file a request not to be bound by any agreement entered into by the TMP.²² Partners may individually waive their rights under the TEFRA partnership audit rules or any restrictions placed on the Service by those rules.²³

Any settlement agreement entered into between the Service and one or more partners, is binding on the parties to the agreement in the absence of fraud, malfeasance or misrepresentation of fact.²⁴ The TMP cannot bind notice partners. As noted above, an agreement entered into by the TMP is binding on non-notice partners (*i.e.*, those partners with less than a one percent profits interest in partnerships with over 100 partners) only if the TMP expressly states in the agreement that it binds the other partners, and the agreement between the Service and the TMP will not bind any partner who has filed a statement with the Service restricting the TMP's authority to settle on his or her behalf.²⁵ If the Service enters into a settlement agreement with

¹⁸I.R.C. § 6226(b).

¹⁹I.R.C. §§ 6224(a); 6226(c)(2); Tax Court Rule 245(b).

²⁰I.R.C. § 6229(b)(1)(A) and (d).

²¹I.R.C. § 6227(c).

²²I.R.C. § 6224(c)(1) and (c)(3)(B).

²³I.R.C. § 6224(b).

²⁴A partner holding an interest through one or more pass-through partners is bound by a settlement agreement entered into by a pass-through partner, unless the indirect partner has been identified to the Service. I.R.C. § 6224(c)(1).

²⁵But see Tax Court Rule 248. Under that rule, if the case is docketed in the Tax Court and certain conditions are met, the court may enter a decision consistent with a settlement entered into with some of the partners, that would be binding on all parties to the action, notwithstanding that there may be notice

respect to partnership items for a particular taxable year, the Service generally is obligated to offer consistent terms to any other partner who so requests.²⁶ The partner's right to request consistent treatment is subject to certain time limitations.²⁷

In general, a change in tax liability of a partner to properly reflect the treatment of a partnership item²⁸ is made through a "computational adjustment." After a final determination has been reached with respect to a partnership proceeding, the Service allocates the final adjustment among the partners and computes their revised tax liability based on return information in its possession. A computational adjustment may include a change in tax liability that reflects a change in an affected item if that change is necessary to properly reflect the treatment of a partnership item.²⁹ However, changes in a partner's tax liability with respect to affected items which require partner-level determinations are not included in a computational

partners, or non-notice partners who filed statements prohibiting the TMP from entering into settlements on their behalf, who did not enter into a settlement agreement with the Service.

²⁶I.R.C. § 6224(c)(2). The Service's obligation to offer consistent terms only applies if the items subject to the original agreement were partnership items with respect to the settling partner at the time of the original agreement. Temp. Treas. Reg. § 301.6224(c)-3T(b)(1). Furthermore, the items must be partnership items of the requesting partner at the time of the request. Thus, for example, the requesting partner must not have previously settled these items with the Service or had the items converted to nonpartnership items by reason of a special enforcement situation such as the partner's bankruptcy). Temp. Treas. Reg. § 301.6224(c)-3T(b)(2).

²⁷I.R.C. § 6224(c)(2). See Temp. Treas. Reg. § 301.6224(c)-3T(c)(3).

²⁸The term "partnership item" means any item required to be taken into account with respect to a partnership taxable year under subtitle A of the Code to the extent that regulations provide it is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). See Treas. Reg. § 301.6231(a)(3)-1. Partnership income, loss, deduction, or credit are common examples of partnership items.

²⁹The term "affected item" means any item to the extent it is affected by a partnership item. I.R.C. § 6231(a)(5). A change in a partner's allowable medical expense deduction due to the effect of a partnership item on the adjusted gross income threshold is an example of an affected item.

adjustment, but rather require the issuance of a statutory notice of deficiency prior to assessment of the tax liability.³⁰

Any partner, or the TMP acting on behalf of the partnership, may file an "Administrative Adjustment Request."³¹ In general, an Administrative Adjustment Request has the same effect under the TEFRA partnership audit rules as either an amended partnership or partner return or a claim for refund with respect to the partnership or the partner. An Administrative Adjustment Request may be filed with respect to partnership items for a partnership taxable year (1) within the three year period after the later of the filing date of the partnership return for that year or the last day for filing such return (determined without regard to extensions), but must be filed before (2) the mailing to the TMP of a notice of Final Partnership Administrative Adjustment for such taxable year.³²

The TMP may file an Administrative Adjustment Request with respect to the treatment of partnership items on the original partnership return. If the TMP asks that the treatment shown on the request be substituted for the treatment of partnership items on the original partnership return, the Service may treat the changes shown on the request as corrections of mathematical or clerical errors on the partnership return.³³ If the TMP files an Administrative Adjustment Request on behalf of the partnership which is not treated as a substituted return, the Service may, with respect to all or part of the requested adjustments: (1) compute the appropriate tax as to partners and issue refunds; (2)

³⁰I.R.C. § 6230(a)(2)(A)(i). A partner-level penalty based on an erroneous partnership deduction is an example of an affected item that is asserted through a statutory notice of deficiency.

³¹I.R.C. § 6227.

³²I.R.C. § 6227(a).

³³I.R.C. § 6227(b)(1). If the Service treats the Administrative Adjustment Request as a correction of mathematical or clerical errors appearing on the partnership return, the Service may proceed to assessment of the tax against partners without carrying on a unified proceeding. See I.R.C. §§ 6230(b)(1) and 6225. However, if any partner timely objects, the correction cannot be made with respect to that partner without conducting a partnership-level proceeding. I.R.C. § 6230(b)(2).

conduct a unified partnership proceeding; or (3) not act on the request.³⁴

If any partner individually files an Administrative Adjustment Request, the Service may: (1) process the request in the same manner as a claim for refund with respect to items that are not partnership items; (2) assess any additional tax resulting from the request; (3) mail to the partner a notice that all partnership items of the partner for the partnership taxable year to which such request relates shall be treated as

³⁴If the Service fails to act on an Administrative Adjustment Request made on behalf of the partnership, the TMP may file a petition for judicial review of the request. I.R.C. § 6228(a)(1). Such a petition can be filed only after the expiration of six months from the date of the filing of the Administrative Adjustment Request and before two years have elapsed from the filing date. I.R.C. § 6228(a)(2)(A). However, no petition may be filed after the Service has issued a notice of the Beginning of an Administrative Proceeding (unless after issuance of such notice the Service fails to issue notice of a Final Partnership Administrative Adjustment, in which case the partner may file a petition within the six-month period following the expiration of the applicable statute of limitations). I.R.C. § 6228(a)(2)(B) and (C). These limitation periods may be extended by agreement of the parties. I.R.C. 6228(a)(2)(D). Generally, a court in which a petition is filed will only have jurisdiction over items covered by the Administrative Adjustment Request that were not allowed by the Service and over items raised by the Service as offsets to the requested adjustments. I.R.C. § 6228(a)(5).

nonpartnership items;³⁵ or (4) conduct a unified partnership proceeding with respect to the items covered in the request.³⁶

³⁵If the partner is mailed a notice that all of his or her partnership items for the partnership taxable year to which an administrative adjustment request relates will be treated as nonpartnership items, the Administrative Adjustment Request is treated as a claim for credit or refund of an overpayment attributable to nonpartnership items and the partner may bring a refund action under section 7422 with respect to such claim within two years of the mailing of such notice. I.R.C. § 6228(b)(1). If the Service fails to grant the request in whole or in part and does not issue a notice converting the partner's partnership items to nonpartnership items, the partner may initiate a refund action within the period starting six months following the filing of the request and ending two years after such filing. I.R.C. § 6228(b)(2)(B). Upon the commencement of such an action, the partner's partnership items are treated as nonpartnership items. I.R.C. § 6231(b)(1)(B). No refund actions may be brought in a federal district court or the Claims Court with regard to partnership items except as provided above or as provided in section 6230(c) (relating to computational adjustment disputes). I.R.C. § 7422(h).

³⁶I.R.C. § 6227(c).