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Building a Better BBA: A History of, and Proposal for, Partnership Audit and Collection Rules

By Todd J. Gluth[1]

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I. Introduction

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II. TEFRA

Prior to the enactment of the Taxpayer Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),[2] any adjustment in respect of a partnership's items of income, gain, loss, deduction or credit had to be resolved in separate proceedings for each partner, notwithstanding that the tax treatment of such items generally depended on characteristics of the partnership. Partner-level administrative and judicial proceedings were required because the partners (and not the partnership) would be liable for any additional tax that results. The necessity of multiple proceedings to resolve the same substantive partnership determinations produced two "generally undesirable consequences":

> First, in order to audit a partnership, the Service must separately control each tax return which includes an item attributable to that partnership. Second, even if the Service successfully initiates and manages a partnership audit, each partner may separately determine where and when his partnership matter will be determined.[3]

These problems compounded throughout the 1970s due to the proliferation of tax shelters. The tax shelters took the form of syndicated partnerships, each of which featured large numbers of widely dispersed partners, and in many circumstances multiple tiers of "pyramided" partnerships.[4] The increasing size and complexity of partnerships had a predictable impact on tax controversies – "[d]isputes rage on endlessly, reconciliation of different views is virtually impossible, backlogs and frustrations build up, judicial calendars are clogged, and an important part of the tax administration system is threatened."[5]

The challenges of combatting tax shelters prompted Treasury to propose to treat newly formed limited partnerships with more than 15 limited partners as corporations for tax purposes (at that time, 15 was also the maximum number of shareholders in a subchapter S corporation).[6]

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[2] Pub. L. No. 97-248, §§ 401-406, 96 Stat. 324, 648-671.
[3] Dep't of Treasury, *The President's 1978 Tax Program*, at 123 (1978) (the "1978 Tax Program").
[4] *See* 1978 Tax Program, at 123-129.
[5] ABA Section of Tax'n, *Proposal as to Audit of Partnerships,* 32 TAX LAW. 551, 551 (1979).
[6] *See* 1978 Tax Program, at 69, 117-120. Regarding the appropriateness of classifying such limited partnerships as corporations, Treasury asserted:

> [A] syndicated partnership is, to all intents and purposes, the equivalent of a corporation. The limited partners are not responsible for the debts of the partnership and have no voice in its day-to-day management. As a practical matter, moreover, the syndicated partnership has the same ability to maintain its existence as a corporation, and a limited partner has the same ability to transfer his partnership interest as he would stock in a comparably sized corporation. Were it not for the long-standing bias in the existing

In addition to, or in lieu of, the more blunt measure of reclassifying limited partnerships with a threshold number of limited partners as corporations, Treasury proposed to authorize the Service to audit and make binding tax determinations at the partnership level.[7] Such authorization was expected to result in more effective policing of partnerships, and in turn improved voluntary compliance by taxpayers.[8] Congress eventually endorsed the second measure, enacting in TEFRA mechanics for the administrative and judicial resolution of partnership items in a unified partnership proceeding.

The principal policy justifications proffered for the enactment of TEFRA included: (1) administrative problems from the fragmented determination of tax liabilities on a partner-by-partner basis (including inconsistent settlements and judicial determinations), which problems were exacerbated by the development and growth of partnership syndications, (2) even in the absence of inconsistent determinations, inability to collect tax from all partners within the statute of limitations because partners span many audit jurisdictions and/or tiered partnerships make it difficult to identify the ultimate beneficial owners, (3) duplication of manpower and administrative and judicial effort to determine the aggregate tax liability attributable to a single partnership item (which duplicative efforts may result in inconsistent results for different partners with respect to the same item), and (4) difficulty reaching settlements because the IRS had little incentive to settle with one partner where the issue had to be litigated with other partners.[9] In addressing these infirmities TEFRA was "designed to promote increased compliance and more efficient administration of the tax laws."[10]

> regulations, these partnerships would be classified as corporations under the criteria enunciated by the Supreme Court in the Morrissey decision. Because substantive differences between a syndicated partnership and a corporation are minimal, the same tax rules should apply to both.

Id., at 118.

[7] 1978 Tax Program, at 69, 121-131.

[8] *See* 1978 Tax Program, at 129 ("It has become increasingly clear that tax shelters have proliferated in significant part because promoters and investors believe that there is little risk that the Service can muster an effective audit against the investors in the shelter. Thus, highly creative and ingenious tax positions which are often taken by a tax shelter limited partnership and which are questionable under the law can go unchallenged because of the necessity to audit separately each and every member of the partnership within the requisite limitations periods. If, however, partnerships were audited at the partnership level, potential investors in tax shelters would have to take into account the very high probability that their investments will be subject to close scrutiny by the Service. Given the fact that under current law, most shelter investors do not take the possibility of extensive IRS audit seriously, it may be expected that the full implementation of this proposal will have a significant impact on shelter activity.").

[9] Jt. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, JCS-38-82, at 268 (1982) ("TEFRA Bluebook"). For additional background regarding how partnership audits were conducted prior to TEFRA, the challenges presented by such audits, and contemporary proposals to address these infirmities, see TEFRA Bluebook, at 267-268; Am. Law Inst., *Federal Income Tax Project*, at Part N (Council Draft No. 7, Nov. 24, 1980) ("1980 ALI Project"); ABA Section of Tax'n, *Proposal as to Audit of Partnerships* 32 Tax Law. 551 (1979); H.R. REP. NO. 95-1445, at 74-78 (1978); 1978 Tax Program, at 121-131. *See also* ABA Section of Tax'n, *Partnership Tax Audit and Litigation Regime Revisions*, at 3-5 (Nov. 2, 2015), *available at* 2015 TNT 212-19; Noel P. Brock, *Audits of Partnerships, TEFRA and Partnership Noncompliance: Where We Are and Where We Are Going*, 93 TAXES 193, 195-198 (2015); Peter A. Prescott, *Jumping the Shark: The Case for Repealing the TEFRA Partnership Audit Rules*, 11 FLA. TAX REV. 503, 507-512 (2011); Mortimer M. Caplin & Stuart L. Brown, *Partnership Tax Audits and Litigation after TEFRA*, 61 TAXES 75, 75-77 (Feb. 1983); Jay Rosen, *TEFRA's New Partnership Auditing Procedures: Was the Small Partner Left Out?*, 38 Tax L. Rev. 479, 479-483 (1983); Jerome Kurtz, *Auditing Partnerships*, 6 TAX NOTES 581 (1978), *reprinted in* 134 TAX NOTES 977 (2012).

[10] *See* H.R. REP. NO. 97-760, at 600 (1982).

While a tremendous body of law has developed around TEFRA,[11] the backbone consists of the following rules summarized below.

- *Consistency.* Unless a partner notifies the Service of inconsistent treatment, (i) the partner must report partnership items consistently with the partnership's reporting, (ii) the Service can make "computational adjustments" to conform the partner's return to the partnership return and assess any resulting additional taxes without commencing a partnership (or partner-level) proceeding, and (iii) the Service may impose an understatement penalty.[12]

- *Entity-Level Proceedings for Partnership Items.* "Partnership items" are addressed in a single unified partnership-level proceeding in the case of any audit, administrative appeal, administrative adjustment request, and/or judicial review.[13] Items that are not partnership items continue to be determined under general audit, appeal, refund, and judicial review provisions of the Code.[14]

- *Tax Matters Partner*. The partnership is primarily represented by a "tax matters partner" ("TMP") throughout the administrative and judicial phases of the proceeding. The TMP is the general partner designated by the partnership to serve as TMP or, in the absence of such designation, the general partner with the largest profits interest at the close of the taxable year.[15] The TMP is authorized to take certain actions on behalf of all the partners, including seeking judicial review of administrative adjustments,[16] initiating refund proceedings,[17] seeking judicial review of the denial of refunds,[18] and extending the statute

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[11] For a more extensive discussion of the intricacies of TEFRA, see, e.g., Jerald David August, *Entity-Level Audit Rules Continue to Pose Challenges for Partners*, 16 BUS. ENTITIES 4 (Nov./Dec. 2014); Jerald David August, *Entity-Level Audit Rules Continue to Pose Challenges for Partners—Part 2*, 17 BUS. ENTITIES 4 (July/Aug. 2015); Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 112.2 (2d/3d ed. 1993-2016 & 2016 Cum. Supp. No. 2); Sheri A. Dillon & Sam B. Guthrie, *The TEFRA Swamp: Managing the Complexities Of a Partnership Audit*, 31 TAX MGMT. REAL ESTATE J. 146 (May 6, 2015); Barbara T. Kaplan, *Unified Reporting, Audit, and Litigation Procedures for Partnerships, LLC's and Joint Ventures*, 16 PARTNERSHIP TAX PRACTICE SERIES 320-1 (PLI 2016); Steven R. Mather, 624-3rd T.M., *Audit Procedures for Pass-Through Entities*; William S. McKee et al., FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶¶ 10.01-10.07 (4th ed. 2007 & Supp. 2016-3); Michael I. Saltzman & Leslie Book, IRS PRACTICE AND PROCEDURE ¶¶ 8.17-8.21 (2nd ed. 2002 & Supp. 2016-2); [Arthur B. Willis et al., PARTNERSHIP TAXATION ¶¶ 20.01-20.11 (7th ed. 2011 & Supp _____)].
[12] Pre-BBA §§ 6222, 6230(a)(1).
[13] *See* Pre-BBA §§ 6221, 6226, 6227, 6228. A "partnership item" is an item that is more appropriately determined at the partnership level than at the partner level, as provided by regulations. *See* Pre-BBA § 6231(a)(3); Treas. Reg. § 301.6231(a)(3)-1. In certain circumstances, a partnership item may cease to be treated as such. *See* Pre-BBA § 6231(b).
[14] Items that are not partnership items are classified as either "nonpartnership items" or "affected items." *See* Pre-BBA §§ 6231(a)(4), 6231(a)(5); Treas. Reg. §§ 301.6231(a)(5)-1, 301.6231(a)(6)-1.
[15] Pre-BBA § 6231(a)(7). The regulations additionally require that the TMP be a "United States person" within the meaning of Section 7701(a)(30) of Code. Treas. Reg. § 301.6231(a)(7)-1(b)(2). In the case of partnerships that are organized as limited liability companies, the regulations require that the TMP be a "member-manager." Treas. Reg. § 301.6231(a)(7)-2.
[16] Pre-BBA § 6226(a).
[17] Pre-BBA § 6227(c).
[18] Pre-BBA § 6228(a).

of limitations for assessing tax attributable to partnership items and affected items.[19] The TMP can also enter into settlement agreements that bind direct and indirect partners who are neither "notice partners" nor members of a "notice group" (unless the partner files a statement with the Service revoking this authority).[20] Finally, the TMP has an obligation to keep the partners informed of proceedings,[21] but failure of the TMP to fulfill any of its responsibilities does not affect the applicability of any proceeding or adjustment to the partners.[22]

- *Notice and Participation*. Every direct and indirect partner has the right to participate in partnership-level administrative proceedings.[23] The Service ordinarily must give all partners notice of the commencement of such proceedings (as well as any resulting final partnership administrative adjustment ("FPAA")).[24] If the partnership has more than 100 partners, however, a partner must have at least a one percent interest in the profits of the partnership to qualify as a "notice partner" who is entitled to notice from the Service (although a group of partners having in the aggregate at least a five percent interest in partnership profits can designate one of their members to receive notice).[25] As a practical matter, the partners' participation rights may be limited by the fact that the Service and the TMP determine the time and place for the proceedings (which arrangements will generally not be changed merely for the convenience of another partner),[26] and the TMP's responsibility to keep other partners informed is generally limited to major events in the proceedings.[27]

- *Settlement*. Each partner may enter into his, her or its own settlement agreement with the government, and having done so the government must then offer every other partner who so requests consistent settlement terms.[28] Generally no partner can be bound to a settlement agreement by the actions of others (including the TMP), subject to limited exceptions in the case of non-notice partners and indirect partners.[29]

- *Judicial Review*. If the administrative proceeding concludes without a settlement agreement and the Service finds that changes are appropriate, the Service issues the

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[19] Pre-BBA § 6229(b)(1)(B); Chief Counsel Notice 2009-027 (Aug. 21, 2009).
[20] Pre-BBA § 6224(c)(3); *see also* Treas. Reg. § 301.6224(c)-1.
[21] Pre-BBA § 6223(g); *see also* Treas. Reg. § 301.6223(g)-1.
[22] Pre-BBA § 6230(f).
[23] Pre-BBA § 6224(a); Treas. Reg. § 301.6224(a)-1. TEFRA defines the term "partner" to include indirect partners who hold partnership interests through pass-thru partners. *See* Pre-BBA § 6231(a)(2)(B), 6231(a)(9), 6231(a)(10).
[24] *See* Pre-BBA §§ 6223(a), 6223(d). Notice must be given to all the partners identified on the partnership return and any other direct or indirect partners otherwise identified to the Service. Pre-BBA § 6223(c).
[25] Pre-BBA §§ 6223(b), 6231(a)(8), 6231(d); *see also* Treas. Reg. § 301.6223(b)-1, 301.6223(e)-1(a). If the Service is provided the requisite information, notice requirements can be pushed out from "pass-thru partners" to "indirect partners" who hold interests in the audited partnership through one or more such pass-thru partners. *See* Pre-BBA, §§ 6223(c)(3), 6223(h), 6231(a)(9), 6231(a)(10); Treas. Reg. §§ 301.6223(b)-1(b), 301.6223(e)-1(b), 301.6223(h)-1.
[26] *See* Pre-BBA § 6223(g); TEFRA Bluebook, at 270; Treas. Reg. § 301.6224(a)-1.
[27] *See* TEFRA Bluebook, at 270; Treas. Reg. § 301.6223(g)-1.
[28] *See* Pre-BBA § 6224(c); Treas. Reg. § 301.6224(c)-3(c).
[29] A settlement agreement entered into by the TMP (and, in the case of indirect partners, the pass-thru partner) will bind partners and indirect partners who (i) are not entitled to notice and (ii) do not file a statement with the Service electing not be bound *See* Pre-BBA §§ 6224(c)(1), 6224(c)(3); Treas. Reg. § 301.6224(c)-1.

FPAA.[30] During the first 90 days after the FPAA is issued, the TMP alone is authorized file a petition for judicial review in the Tax Court, a federal district court, or the Court of Federal Claims.[31] If the TMP files a petition, no other partner may do so thereafter (and thus the TMP can dictate the forum in which the proceeding will be adjudicated).[32] If the TMP does not file within the 90-day period, any notice partner or "5-percent group" (i.e., a group of partners who for the taxable year involved had at least 5% of the profit interests) may do so within the next 60 days; a non-notice partner may not seek judicial review alone.[33] If more than one partner petitions, only one of the petitions goes forward.[34] All partners who have not settled with the Service and have an interest in the outcome are automatically parties to the litigation, and the court must allow them to participate.[35] The reviewing court has jurisdiction to determine all partnership items for the taxable year in question, the proper allocation of such items, and the applicability of any penalties that relate to an adjustment to a partnership item.[36] Any partner may appeal the decision of the reviewing court, except that a non-notice partner can do so only by joining with other partners to form a 5% group.[37]

- *Computational Adjustments and Collection*. After a final partnership-level determination of one or more partnership items has been made through the issuance of a FPAA or a final Tax Court decision, the burden is on the Service to compute the additional taxes (and interest and penalties) due and make assessments against the partners. The Service may make its computational adjustments and issue these assessments without the need for deficiency proceedings,[38] unless the computations require a partner-level determination, in which case the Service must initiate a partner-level proceeding.[39] A partner wishing to contest a computational adjustment must pay the tax and claim a refund, and is generally limited to challenging the computation itself (and not the merits of any partnership-level adjustment).[40]

- *Statute of Limitations*. The period for assessing tax "attributable to any partnership item (or affected item)" for a partnership taxable year does not expire before three years after the partnership return was filed or due (whichever is later).[41] This period may be extended by agreement on behalf of all partners by the TMP (or other person authorized

[30] Pre-BBA § 6223(a).
[31] Pre-BBA § 6226(a).
[32] *See* Pre-BBA § 6226(b)(1). In order to bring an action in federal district court or the Court of Federal Claims, the petitioning partner or 5-percent group must make a deposit. *See* Pre-BBA § 6226(e); Treas. Reg. § 301.6226(e)-1.
[33] *See* Pre-BBA §§ 6226(b), 6231(a)(11); Treas. Reg. § 301.6226(b)-1. In addition, while the filing of a petition in Tax Court precludes the Service from assessing a deficiency attributable to partnership items on the basis of the FPAA, a proceeding in federal district court or the Court of Federal Claims does not. *See* Pre-BBA § 6225(a).
[34] Pre-BBA § 6226(b)(4). If any of the petitions is to the Tax Court, the first Tax Court petition survives. Pre-BBA § 6226(b)(2). If none of the petitions is to the Tax Court, the earliest in time supersedes the others. Pre-BBA § 6226(b)(3). The TMP can intervene in the action that goes forward. Pre-BBA § 6626(b)(6).
[35] Pre-BBA §§ 6226(c), 6226(d)(1).
[36] Pre-BBA § 6226(f).
[37] Pre-BBA § 6226(g).
[38] *See* Pre-BBA §§ 6230(a)(1), 6231(a)(6).
[39] *See* Pre-BBA §§ 6230(a)(2), 6231(a)(4), 6231(a)(5); Treas. Reg. §§ 301.6231(a)(5)-1, 301.6231(a)(6)-1.
[40] *See* Pre-BBA § 6230(c).
[41] Pre-BBA § 6229(a).

by the partnership in writing), or on behalf of a particular partner by such partner.[42] The three-year period is also extended in the case of fraud, a substantial omission of income by the partnership, or failure to file a partnership return.[43] It may additionally be extended as to a particular a partner if the partner is not identified on the partnership return,[44] partnership items convert to nonpartnership items,[45] or the partner is in bankruptcy.[46] Finally, if an FPAA is mailed to the TMP, the period of limitations is suspended for the period during which judicial review may be sought (and, if judicial review is sought, until the decision of the court becomes final) and for one year thereafter.[47]

- *Administrative Adjustment Requests*. An administrative adjustment request ("AAR") is the TEFRA version of an amended tax return or claim for refund. An AAR must be filed within three years after the original partnership return was filed or due (whichever is later), and before the conclusion of any partnership-level administrative proceedings for such taxable year (as evidenced by the mailing of an FPAA the TMP).[48] Any partner may file an AAR. An AAR filed by the TMP on behalf of the partnership may, if the TMP so requests and the Service agrees, serve as a substituted partnership return (in which case the Service treats the changes as corrections of clerical or mathematical errors on the original return).[49] In other cases, an AAR generally serves as a claim for refund.[50] Whether filed by the TMP or an individual partner, the Service may (but is not required to) respond to an AAR by initiating a partnership proceeding.[51] Partners may seek judicial review if the AAR is not allowed in full, subject to different procedures depending on whether the AAR was filed by the TMP on behalf of the partnership[52] or an individual partner.[53]

- *Small Partnerships*. Absent an election into TEFRA, the unified partnership-level procedures of TEFRA do not apply to any "small partnership" that has 10 or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.[54] If a small partnership elects into TEFRA, the election cannot be revoked without the consent of the Service.[55]

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[42] Pre-BBA § 6229(b); Treas. Reg. § 301.6229(b)-1.
[43] Pre-BBA § 6229(c).
[44] Pre-BBA § 6229(e).
[45] Pre-BBA § 6229(f)(1).
[46] Pre-BBA § 6229(h).
[47] Pre-BBA § 6229(d).
[48] Pre-BBA § 6227(a). The three-year period is subject to extension in limited circumstances. *See* Pre-BBA §§ 6227(b), 6227(e).
[49] *See* Pre-BBA §§ 6227(c)(1), 6230(b).
[50] *See* TEFRA Bluebook, at 273.
[51] *See* Pre-BBA §§ 6227(c)(2)(A)(ii), 6227(d)(4).
[52] *See* Pre-BBA § 6228(a).
[53] *See* Pre-BBA § 6228(b).
[54] Pre-BBA § 6231(a)(1); Treas. Reg. § 301.6231(a)(1)-1(a). The current small partner exception reflects the liberalization of the original exception in two important respects. In 1997 Congress expanded the exception to no longer exclude partnerships with C corporation partners or partnerships that use special allocations. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1234(a), 111 Stat. 788, 1024; Jt. Comm. on Tax'n, *General Explanation of the Tax Legislation Enacted in 1997*, JCS-23-97, at 374 (1997).
[55] Pre-BBA § 6231(a)(1)(B)(ii); Treas. Reg. § 301.6231(a)(1)-1(b).

III. 1990 Reform Proposals for Widely Held Partnerships

Not long after its enactment, Congress grew concerned that that TEFRA did not go far enough in enabling the Service to audit widely held partnerships effectively. In the Omnibus Budget Reconciliation Act of 1987,[56] Congress directed the Treasury Department to conduct a study of "the administrative and compliance issues related to the tax treatment of publicly traded partnerships and other large partnerships."[57] The Treasury Department and the Service jointly prepared the study, which they delivered to the House Ways and Means Committee in March 1990 (the "1990 Treasury Report"). [58] The 1990 Treasury Report contained a lengthy discussion of TEFRA's requirements, the procedures followed by the Service to audit widely held partnerships, the administrative burdens imposed thereby, and proposals for the assessment of deficiencies with respect to such partnerships.[59]

A. Problems under TEFRA

The 1990 Treasury Report identified various problems "in the areas of filing, audit, settlement, litigation, assessment and subsequent proceedings" that arise when administering TEFRA in the context of widely held partnerships.[60] These problems include:

- *Inconsistent Filing Positions*. While partners are subject to computational adjustments and penalties if they fail to notify the Service of their inconsistent treatment of partnership items,[61] the Service has limited ability to police the matter because it is unlikely to detect inconsistent reporting that partners do not disclose.

- *Identification of Partners*. The Service must obtain and monitor information concerning each individual partner, reconciling all the Schedules K-1 to determine that 100% of partnership items have been accounted for, and then proceeding against each partner individually to collect deficiencies. Merely identifying partners can consume significant resources, particularly if there are numerous transfers of partnership interests during the taxable year, or information provided by the partnership regarding individual partners is incomplete or incorrect.

- *Statutes of Limitations*. Although the TMP is authorized to extend the statute of limitations on behalf of all partners,[62] if the TMP declines to do so the Service must solicit consent from each partner. If one partner fails or refuses to extend the statute of limitations, the Service is forced to issue a premature FPAA (applicable to all partners) or else allow the statute of limitations to expire as to the nonconsenting partner.

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[56] Pub. Law No. 100-203, § 10215, 101 Stat. 1330, 1330-408.
[57] *Id.*, § 10215, 101 Stat. 1330-408.
[58] The report is available at 90 TNT 71-30.
[59] 1990 Treasury Report, §§ III.B, V.A, Appendix A.
[60] 1990 Treasury Report, § III.B.3.
[61] Pre-BBA § 6222.
[62] Pre-BBA § 6229(b)(1)(B).

- *Obstacles to Settlement*. Even if the Service and the TMP reach a settlement agreement, that agreement does not bind notice partners, and it binds non-notice partners only if (1) the TMP expressly makes it binding on non-notice partners, (2) the non-notice partner has not joined a notice group, and (3) the non-notice partner has not filed a statement with the Service restricting the TMP's authority to settle on the partner's behalf.[63] As the size of the partnership increases, the prospect of reaching agreement with all the partners decreases. Consequently, the Service has little reason to actively attempt to settle; it might as well take a hardline position in settlement negotiations because it will ultimately have to litigate the case regardless. Moreover, when the Service enters into a settlement agreement with any partner with respect to partnership items, other partners may request consistent settlement terms.[64] If the Service follows a de minimis approach by not pursuing small adjustments, those with greater tax deficiencies may contend that they are entitled to the same treatment of no adjustment.

- *Partner Participation in Partnership Proceedings*. Each partner has the right to participate in both administrative and judicial proceedings.[65] Forcing the Service to deal with numerous representatives in a single partnership proceeding can result in considerable complexity and cause confusion to both the Service and the taxpayers' representatives.

- *Partner Actions on Computational Adjustments.* Once adjustments are finalized at the partnership level, the Service must compute tax for each partner (including indirect partners). Any partner who disagrees with the computational adjustment can pay the tax and then file a claim for refund, and if the claim is disallowed bring suit.[66] Thus there can be multiple actions resulting from a single partnership adjustment, even if such actions are limited to the computational aspects of the adjustment.

- *Partner Refund Claims for Corollary Adjustments*. Deficiencies in one year frequently give rise to refund claims in subsequent years (e.g., by reason of timing differences or basis adjustments). Refund claims may be filed by each partner for the overpayment years, saddling the Service with many individual cases that relate to only a single or a few partnership adjustments.

- *Penalties Asserted at Partner Level*. As originally enacted, TEFRA required the Service to assert penalties attributable to a partner's investment in a partnership in separate proceedings with the partners following the conclusion of the partnership-level proceeding.[67] These duplicative penalty proceedings burdened both the Service and the Tax Court.

[63] Pre-BBA § 6224(c)(3).
[64] Pre-BBA, § 6224(c)(2).
[65] *See* Pre-BBA §§ 6224(a), 6226(c).
[66] *See* Pre-BBA § 6230(c).
[67] In the Taxpayer Relief Act of 1997, Congress amended §§ 6221 and 6230(c)(4) (and made conforming amendments elsewhere) to provide for penalty determinations in the partnership-level proceedings (while preserving rights of partners to raise partner-level defenses in a refund forum). *See* Pub. L. No. 105-34, § 1238, 111 Stat. 788, 1026-1027; Jt. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97, at 337 (1997).

- *Multiplicity of Small Partner Adjustments.* Adjustments to the income of a widely held partnership that in the aggregate are substantial may nevertheless be relatively small as to the individual partners, making the cost of the audit, assessment and collection too large relative to the amount collected.

The 1990 Treasury Report concludes that TEFRA's "audit and administrative procedures were not designed for nor do they effectively accommodate widely held partnerships."[68] In particular, TEFRA strikes a balance "between certain entity concepts and individual partner protections" that is "appropriate when applied to small to medium size partnerships, in which the number of partners is manageable from an administrative standpoint and there is a substantial likelihood that most partners will have a significant investment in the partnership"; as applied to widely held partnerships, by contrast, "the individual partner protections seem disproportionate to the rights in need of protection, and present significant administrative obstacles."[69] The 1990 Treasury Report also suggests that TEFRA's solicitude for rights of partners was in part a byproduct of fear that concentrating too much power in one partnership representative could hurt less culpable partners in the tax shelter era that engendered TEFRA: "Congress, noting the potential conflict between investors and tax shelter promoters, balanced the consolidated audit provisions with considerable protections for individual partners." [70]

The 1990 Treasury Report argues that partners in widely held 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."[71] In this respect, it recommends "current assessment" of deficiencies that are borne by partners in the year the adjustment takes effect, as contrasted with the TEFRA's requirement "that a deficiency must be assessed against taxpayers who were partners in the year in which the understatement of tax liability arose."[72] While acknowledging this proposal "would involve a significant departure from traditional subchapter K principles,"[73] it concludes that lesser changes would not adequately address the administrative burdens imposed by the current system. The following discussion summarizes the proposals considered by the 1990 Treasury Report.

B. Modest Proposal: Underpayments Collected from Reviewed-Year Partners, but Partnership Responsible for Reporting

A more modest proposal to address the burden on Service to locate and monitor partners for the tax year under review would be to retain the principle that adjustments flow through to the partners for such year, but require the partnership "to perform many of the tasks required to convert a partnership level adjustment into assessments with respect to individual partners."[74] For example, "[t]he partnership could be required to file amended returns for the years to which

[68] 1990 Treasury Report, at § III.B.3.
[69] *Id.*
[70] 1990 Treasury Report, § III.B.1, Appendix A.
[71] 1990 Treasury Report, § III.B.3.
[72] 1990 Treasury Report, § V.A.
[73] 1990 Treasury Report, §V.C.
[74] 1990 Treasury Report, § V.A.

the adjustment relates, and issue amended Form 1099-Ks, including penalties and interest, to the partners in those years."[75] As under current law, however, "taxpayers who had related adjustments in subsequent years would be entitled to file refund claims based on their overpayments in those years." The 1990 Treasury Report concludes that such an approach would not satisfactorily improve the administration of widely held partnerships because "the Service would still face the prospect of handling claims for refund from thousands of partners upon an adjustment with respect to any sizeable partnership, and would be responsible for monitoring compliance by both partnerships and partners."[76]

C. 1987 House Proposal: Underpayments Collected from Partnership, and Reviewed-Year Partners Responsible for Adjustments

During the formulation of the Omnibus Budget Reconciliation Act of 1987, the House of Representatives originally passed a bill that would have allowed the Service to collect tax deficiencies from certain partnerships rather than the reviewed-year partners (the "1987 House Proposal").[77] Under the 1987 House Proposal, any "partnership shortfall" 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.[78] The partnership shortfall would be determined by reference to any understatement of taxable income, overstatement of taxable loss, overstatement of credits, or any combination thereof for a given partnership taxable year.[79] The partnership would pay tax at the highest rate (individual or corporate) applicable for the taxable year of the shortfall.[80] The amount of the shortfall would have been reduced to the extent the partnership could have proven to the satisfaction of the Secretary that a partner reported consistently with the adjustment in the partner's original or amended return.[81]

Payment of tax by the partnership would have been treated as payment of tax by the partners of their allocable shares of the payment determined in accordance with their interests in the partnership in the reviewed year to which the adjustment related.[82] To the extent that 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.[83] The partnership would have had a statutory right to recover the amount of payment made on behalf of a partner from the partner.[84]

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[75] *Id.*
[76] *Id.*
[77] *See* Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong. § 10126 (as received by Senate, Nov. 4, 1987); H.R. REP. NO. 100-391, at 1077-1078 (1987). The 1987 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. Prop. § 6234(b).
[78] Prop. §§ 6234(a), 6234(f)(3).
[79] *See* Prop. § 6234(c).
[80] Prop. § 6234(d)(2).
[81] Prop. § 6234(d)(3)(B).
[82] Prop. § 6234(f)(1).
[83] *See* H.R. REP. NO. 100-391, at 1078 (1987).
[84] Prop. § 6234(f)(2).

Neither the bill nor the legislative history specified the capital account or basis adjustments to be made in connection with a partnership payment under the 1987 House Proposal. The 1990 Treasury Report presumes that the partners' capital accounts would have been adjusted for the redetermined amounts of income, deductions, or credits in the year of the shortfall, and that payment of tax by the partnership would have been treated as a partnership distribution (with the reviewed-year partners receiving a credit for the amount of tax paid). The 1987 House Proposal treated adjustments on a year-by-year basis, with no reference to related offsetting adjustments in other years, and did not include any provision for the payment of interest and penalties with respect to a partnership deficiency.

The 1990 Treasury Report observes that while the 1987 House Proposal "provided greater assurance of collection of partnership deficiencies, it might have actually increased the Service's paperwork burden."[85] For example, because reviewed-year partners are entitled to refunds for overpayments by the partnership, and the partnership pays tax at the highest applicable rate for corporations or individuals, a significant number of partners would be due refunds. Moreover, the year-by-year adjustment mechanism would not accommodate the offsetting of understatements of income with directly related overstatements of income in later years (e.g., where an item that the partnership expensed was required to be depreciated), thereby resulting in refund claims for the taxable years between the reviewed year and the finalization of the adjustment. Thus the audit of a single widely held partnership could potentially trigger thousands of potential refund claims from numerous partners across multiple taxable years.[86]

The 1990 Treasury Report also objects the 1987 House Proposal's attempt to continue to impose the burden of the tax deficiency on the reviewed-year partners by entitling the partnership to recover amounts it pays from such partners.[87] First, it questions whether it is appropriate for the Code to grant a private right of action. Second, it observes that it will often be difficult or impossible for a widely held partnership to recover from former partners, and thus tax deficiencies satisfied by the partnership are likely to be borne chiefly by the partners in the year the adjustment occurs (not partners in the reviewed year to which the adjustment relates). Because the 1987 House Proposal tries to flow everything through to the reviewed-year partners, however, it would not provide the current year partners who end up bearing the tax any credit for tax paid or any increase in the bases of their partnership interests. The 1990 Treasury Report therefore advises against the 1987 House Proposal, concluding that it "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."[88]

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[85] 1990 Treasury Report, § V.B.3.
[86] In addition to the burden of refund claims, the 1990 Treasury Report notes that the 1987 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.
[87] 1990 Treasury Report, § V.B.
[88] 1990 Treasury Report, § V.C.

D. 1990 Treasury Report Proposal: Underpayments Collected from Partnership, and Current Partners Responsible for Adjustments

Departing from the 1987 House Proposal's attempt to make the reviewed-year partners ultimately responsible for deficiencies, the 1990 Treasury Report offers a proposal (the "Partnership Collection Method") that is guided by the belief that partners in widely held partnership should be treated "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."[89]

Like the 1987 House Proposal, the Partnership Collection Method would have (1) collected deficiencies from the partnership, (2) similarly defined the applicable "shortfall" as any understatement of taxable income, overstatement of taxable loss, or any combination thereof in for a given taxable year, and (3) similarly calculated the tax payable by the partnership by reference to the maximum rate applicable to individuals or corporations. Unlike the 1987 House Proposal, however, the Partnership Collection Method would have (1) treated 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 (with each partner's share of the adjustment reported by the partnership and included in income by the current partners), (2) collected tax based on the maximum rate in effect for the year of the final determination (rather than the reviewed year), (3) not permitted any reduction in tax based on consistent reporting by the reviewed-year partners (but by reason of treating tax paid by the partnership as tax paid by the current partners, would entitle the current partners to a credit that results in the imposition of tax at the marginal rates of the current partners), (4) netted related adjustments in other years (i.e., any deficiency would be adjusted to take into account offsetting adjustments in years other than the reviewed year), and (5) would have collected interest and penalties with respect to the shortfall directly from the partnership (calculated at the maximum rate, and neither refundable or deductible by the partners).[90]

1. *Potential for Shifting Tax Liabilities to Insolvent Partnerships*

The 1990 Treasury Report acknowledged that a partnership's insolvency could preclude entity-level collection. To police distributions of partnership assets that could render the partnership insolvent prior to collection, the Partnership Collection Method would have entitled the Service to use the summary assessment, levy and seizure procedures of Section 6331 of the Code, and also imposed liability on transferees of partnership assets (including partners) pursuant to Section 6901 of the Code.[91] The Partnership Collection Method would have additionally permitted the Service to collect from current and former partners whenever the partnership is unable to satisfy the deficiency. If the partnership cannot pay, the deficiency would first be collected from the current partners (including tax-exempt partners, with the full amount

[89] 1990 Treasury Report, § V.C. The 1990 Treasury Report notes that basis adjustments would "mitigate both the 'windfall' to the former partner and the unanticipated burden to the purchasing partner." In a report dated May 15, 1991, the Congressional Research Service analyzed the 1990 Treasury Report and suggested "[s]ome policymakers may ask why larger partnerships should be treated more like partnerships for administrative and compliance purposes while they continue to be treated like partnerships for income tax purposes."

[90] 1990 Treasury Report, § V.D.1.

[91] 1990 Treasury Report, § V.D.6.

collected regardless of the current partners' personal tax rates), and then to the extent the full amount of tax was not collected from the current partners the reviewed-year partners would be liable for their shares of the remaining amount owed.[92] Procedures would be put in place to take into account each partner's individual tax status (e.g., by having the partners add their shares of the deficiency to their income for the year of the final determination or a subsequent year, and allowing a refund to the extent the payment exceeded the amount of tax owed on that income computed at their actual marginal tax rates).[93]

2. *Potential for Shifting Tax Liabilities from Reviewed-Year Partners to Current Partners*

The 1990 Treasury Report also recognized that having tax liabilities follow ownership of the partnership interests (as opposed to being personal to the owners of the interests in the year of the understatement) created potential for unfairness as well as manipulation and abuse.

The first concern is that the Partnership Collection Method appears to give a windfall to a former partner who held the partnership interest in the year the income was understated, and to impose an unfair burden on a partner buying into the tax liability. The 1990 Treasury Report calls this "a valid concern," but argues that the "windfall and burden are less than initially appear."[94] From the perspective of the selling partner, failure to report income would generally result in understated basis, which limits the windfall "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 the interest." From the perspective of the purchasing partner, the burden "generally will be limited to the interest and any penalties imposed on the underpayment, the delay in utilizing the tax benefit representing by the positive basis adjustment produced by the allocation of income, and possible character differences." The 1990 Treasury Report argues that these burdens are no worse, and in fact may be less severe, than the burdens our current tax system already imposes on purchasers in analogous contexts:

> 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.[95]

The 1990 Treasury Report additionally contends that the federal income tax laws already apply a current assessment approach to certain passthrough entities. In particular, under the deficiency

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[92] 1990 Treasury Report, § V.D.4. The 1990 Treasury Report recognizes that the possibility exists that an understatement of income for an earlier year could result in a tax liability for current partners that exceeds the value of their partnership interests in the case of an insolvent partnership, but contends that this possibility is remote in the case of widely held partnerships, and that a special rule could be provided for such a situation. *Id.*, § V.D.E.1, n.134.
[93] 1990 Treasury Report, § V.D.4.
[94] 1990 Treasury Report, § V.D.6.
[95] *Id.*

dividend procedures in Section 860 of the Code, investors in RICs and REITs bear the tax cost of a prior year deficiency.[96]

The more troubling concern for the drafters of the 1990 Treasury Report relates to the shifting of tax liabilities from high-bracket reviewed-year partners to low-bracket (or tax-exempt) current partners. To help address this risk, the Partnership Collection Method would provide that any person holding a significant percentage of the partnership interests (e.g., at least 5% or 10%) in the reviewed year would be liable for his or her allocable share of a deficiency even if the interest were sold prior to the year in which the adjustment is made. The remainder of the deficiency would be allocated among the current partners. It was presumed that significant owners would be more likely to know of an impending adjustment and arrange transfers to lower bracket taxpayers, and therefore restricting their ability to shift the tax liability by transferring their interests would reduce opportunities for manipulation.[97]

The 1990 Treasury Report also assumed that publicly traded partnership ("PTP") rules would limit the likelihood that there could be a transfer of a significant percentage of partnership interests to lower-bracket taxpayers (especially tax-exempt entities) in normal market transactions. For example, at the time of the 1990 Treasury Report all income from a PTP was automatically classified as unrelated business taxable income ("UBTI"), which was expected to discourage tax-exempt investment in widely-held partnerships classified as PTPs.[98] In addition, Treasury anticipated that for partnerships that were not classified as PTPs, the risk of becoming a PTP under Section 7704(b) of the Code would discourage inordinate transfers of partnership interests in any given year.[99]

Finally, recognizing that preceding anti-manipulation proposals and assumptions would not prevent scenarios in which the collective tax rate of the current partners is lower than the collective tax rate of the reviewed-year partners, the Partnership Collection Method would have collected interest on deficiencies on the assumption of a high effective rate of tax (and perhaps even impose a punitive interest rate on deficiencies).[100]

3. *Section 704(b) Adjustments*

The 1990 Treasury Report observed that adjustments under Section 704(b) of the Code would present difficulties because increases in the distributive shares of partnership income by

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[96] *See* 1990 Treasury Report, § V.F.
[97] *See* 1990 Treasury Report, §§ V.D.1, V.D.6.
[98] Former § 512(c)(2) (1987); H.R. REP. NO. 100-495, at 953 (1987) (Conf. Rep.). Congress repealed this "automatic UBTI" rule in the Omnibus Budget Reconciliation Act of 1993. Pub. L. No. 103-66, § 13145, 107 Stat. 312, 443; H.R. REP. NO. 103-111, at 617 (1993). Commentators have noted that notwithstanding the repeal of this "automatic UBTI" rule, PTPs still tend to present UBTI risks for tax-exempt organizations because most traditional PTPs generate active-business UBTI, and even the newer financial services and investment PTPs may use leverage (especially with respect to real estate investments) and thereby generate debt-financed UBTI. *See* Matthew W. Lay et al., 723 T.M., *Publicly Traded Partnerships*, § III.D.2.a.
[99] 1990 Treasury Report, § V.D.6.
[100] 1990 Treasury Report, § V.D.6. For the interest calculation, the 1990 Treasury Report suggests analogous authority can be found in the deficiency dividend rules for regulated investment companies (RICs) and real estate investment trusts (REITs), which calculate interest based on the gross amount of the dividend rather than on the additional tax that would be imposed on receipt of the dividend. *See* § 860(c)(1); Treas. Reg. § 1.860-3.

some partners would be offset by decreases in the distributive shares of partnership income for other partners, resulting in no overall partnership level deficiency (except as to any differential in interest rates on deficiencies and overpayments).[101] While one answer would be to provide that such adjustments would continue to be handled under current law, the 1990 Treasury Report warned that "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."[102] The 1990 Treasury Report ultimately recommended "further consideration" without proposing any solutions.

4. *Liquidity Issues*

The 1990 Treasury Report noted that one potential objection to entity-level collection is liquidity problems for certain partnerships, especially for "rental real estate partnerships, many of which experience deficits in early years of operation, are highly leveraged and have insufficient cash reserves to finance tax liabilities without selling off partnership assets."[103] Some partnerships could borrow against their assets to satisfy tax liabilities, but others may be forced to sell assets (perhaps at an inopportune time that results in significant losses to the partnership). The 1990 Treasury Report concludes that "[w]hile 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."[104]

5. *Overstatements and Amended Returns*

Under the Partnership Collection Method, related understatements would be offset against overstatements to produce a single adjustment. If the audit resulted in a net overstatement, the adjustment could be treated as a current item by allowing the partnership a deduction in the year of the final determination. Interest due on the overpayment would be calculated on the basis of an assumed rate and paid directly to the partnership.[105]

The 1990 Treasury Report highlighted that amended partnership returns would present a number of issues that require specific rules, but did not make a specific recommendation in the Partnership Collection Method. First, it noted that "[i]f 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. The 1990 Treasury Report asserts 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," but concedes that "it is not improbable that in certain situations

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[101] 1990 Treasury Report, § V.D.6.
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] 1990 Treasury Report, § V.D.3.

partnerships would be able to manipulate the system." If, instead, adjustments arising from amended returns were to relate back to the reviewed-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 prior year is likely to result in an adjustment" – the partnership could file an amended return to put the liability on the reviewed-year partners, or it could allow the audit to run its course and have the liability borne by the current partners. The one possible solution proposed in the 1990 Treasury Report would be to have amended returns relate back to prior years, but preclude the filing of an amended return after an audit has commenced.

6. *Audit Procedures*

The Partnership Collection Method contemplates a new audit system that would be separate and independent from TEFRA, and would apply only to widely held partnerships that are subject to current assessment. Working from the premise that "a widely held partnership should be treated as a single entity for purposes of deficiencies," this audit system would greatly expand the authority of the TMP to act as the partnership's representative and largely eliminate the rights afforded each partner under TEFRA.[106]

First, the Partnership Collection Method would impose a more extreme consistency requirement than that under TEFRA. Under the Partnership Collection Method, the only basis for partners to report inconsistently with the partnership return would be "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)."[107] This "clearly erroneous" 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."

Second, notice and participation would generally be limited to the TMP. The Service would be required to provide notice of commencement of an administrative proceeding and of final adjustment to the TMP only, who would no longer be required to keep partners informed of proceedings. Partners would have no right to participate in administrative hearings, no right to file suit independently or otherwise participate in court proceedings, and no right to seek a refund independently with respect to a partnership item. The TMP would control any administrative or judicial proceedings with respect to partnership items, and the TMP's settlement decisions would be binding on all partners. Only the TMP would be permitted to participate in the decision to extend the statute of limitations.

The 1990 Treasury Report recognizes that "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."[108] In general, however, the 1990 Treasury Report argues that "it is unlikely that the removal of these statutory rights and protections would render individual partners powerless in the determination of deficiencies" because (1) the TMP would have a fiduciary duty to "treat other partners reasonably and fairly," and (2) in response to the new audit system partnership agreements

[106] 1990 Treasury Report, § V.G.
[107] 1990 Treasury Report, § V.G. n.142.
[108] 1990 Treasury Report, § V.G.

would likely "replace these statutory rights with comparable contract rights." For example, the partnership agreement might require the TMP to keep all partners informed of administrative and judicial proceedings, and it could establish a committee to advise or control settlement actions of the TMP. While such contractual provisions would complicate the task of the TMP, they put the burden on the partnership and the TMP rather than the Service.[109]

The 1990 Treasury Report also notes that expanding the power and responsibility of the TMP would exacerbate certain concerns that already arise under TEFRA, namely confusion as to which partner is the TMP, situations where a partner refuses to serve as the TMP, and conflict of interest issues that face the Service when it appoints a TMP.[110]

E. Alternative Current-Assessment Proposals

The 1990 Treasury Report considers a few alternative methods for current assessment – collecting deficiencies directly from current partners (the "Partner Collection Method"), collecting deficiencies from the partnership but not treating the adjustment as current income (the "Non-Flowthrough Method"), providing a nonrefundable partner-level credit for taxes paid by the partnership, and giving the partnership flexibility to elect into or out of current assessment.

1. *Partner Collection Method*

Under the Partner Collection Method, understatements from prior reviewed years (less any offsetting adjustments) would, for the year in which the final adjustment is made, be included as income on the partnership's return, and the partnership would report (and the partners would include) the partners' distributive shares of such income. Tax on prior year partnership deficiencies would be paid by the partners in the year of the final adjustment at the marginal tax rates in effect in that year. Thus changes in tax rates (and the identity and tax positions of the partners) could result in collection of a different tax liability than if the income had been properly reported in the reviewed year.

Another consideration is whether interest and penalties should be passed through to partners or paid directly by the partnership. If passed through to the partners, the tax could be calculated based on the partner's actual tax on the deficiency, or it could be calculated by the partnership assuming a partner-level tax rate and reported by the partnership as tax due by the partners. The former would present administrative and monitoring challenges, while the latter might pose compliance problems from taxpayers who object to an information return that reports additional tax attributable to interest and penalties from a prior year deficiency (when the current partner may not have even been a partner). The 1990 Treasury Report therefore recommends that if the Partner Collection Method were adopted, interest and penalties should be collected from the partnership using an assumed tax rate (while flowing deficiencies through to partners). The Partner Collection Method would not allow the Service to satisfy a deficiency from a single source, plus it would raise some of the same concerns as the Partnership Collection Method

[109] *Id.*
[110] *Id.*

(including questions of transferring tax liability and fairness to income partners). On the other hand, it would alleviate issues relating to illiquid partnerships, and it might be viewed as less of a shift from current law as the collection of deficiencies could be entirely subsumed within the normal reporting procedure.[111]

2. *Non-Flowthrough Method*

Under the Non-Flowthrough Method, the partnership would pay tax at a single fixed rate regardless of the rates of its partners (e.g., the maximum individual rate), and income would not flow through to partners, no partner-level credit would be 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). To avoid double taxation of deficiencies, the Non-Flowthrough Method could give partners a basis adjustment for their shares of the deficiency income less their shares of tax paid by the partnership (and, correspondingly, basis adjustments could prevent a double benefit from refunds on overstatements). By reason of not taking the partners' varying tax rates into account, the Non-Flowthrough Method avoids a reduction in tax due to a shift in the composition of the partners toward tax-exempt entities or other lower bracket taxpayers. While the 1990 Treasury Report recommends taxing deficiencies at the rates of the current partners, it states that "serious consideration" should be given to the Non-Flowthrough Method if it is concluded that the Partnership Collection Method's anti-manipulation measures would not sufficiently deter tax avoidance through shifting the composition of partners.[112]

3. *Nonrefundable Credit*

The 1990 Treasury Report also proposes that, in lieu of a refundable credit, current assessment could be implemented with a nonrefundable partner-level credit for taxes paid by the partnership. Taxes would be collected from the partnership at a single rate, and income attributable to deficiencies would flow through to partners, along with a nonrefundable credit for the partner's share of tax paid by the partnership with respect to the deficiency. 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. Consequently, taxable partners might be able to achieve full use of the credit (at least over time if the credit can be carried forward), but fully tax-exempt partners would never be able to benefit from the credit.[113]

4. *Elective Payment of Deficiencies by Partnerships*

Finally, the 1990 Treasury Report discusses the possibility of allowing partnerships to elect between partnership collection and partner collection. For example, management might prefer to have the partnership pay a deficiency that would require relatively small allocations of income to the partners. Or if the partnership faced liquidity problems, management may prefer to flow the deficiency through to partners as additional income. The 1990 Treasury Report cautions

[111] 1990 Treasury Report, § V.E.1.
[112] 1990 Treasury Report, § V.E.2.
[113] *See* 1990 Treasury Report, § V.E.3.

that this approach might create conflict of interest issues for management, and would require specific rules regarding how and when the election is made (including whether it can be made on a case-by-case, year-by-year, or more permanent basis).

F. Scope: Definition of Widely Held Partnership

The 1990 Treasury Report recommends defining the widely held partnerships that are subject to its proposed audit procedures by reference to three criteria: (1) numerous partners (since these partnerships present the most serious administrative difficulties under current law), (2) a bright line (so that it is easy for the Service and taxpayers to determine which audit system applies), and (3) excluding service partnerships such as accounting of law firms (because "each partner is likely to be an active member of the business, making full entity treatment less appropriate").[114]

With these criteria in mind, the 1990 Treasury Report proposes to define the widely held partnerships that are subject to the proposed audit system as any partnership:

> (i) with 250 or more partners during a taxable year, 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.[115]

In addition, the 1990 Treasury Report would permit partnerships with at least 100 partners to elect into the proposed audit system. It explains that it would require 100 partners because "[t]he 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."[116] Nevertheless, once a partnership becomes subject to the proposed audit system, either because it is widely held or it elects in, it would be required to remain in the system unless the Service granted it permission to be removed (which permission would be granted only in rare cases, such as where a partnership suffered a severe diminution in size).

IV. Early 1990s Legislative Proposals for Large Partnerships

In the early 1990s, Congress introduced a number of bills (the "Early 90s Bills") that proposed new audit procedures for large partnerships, which derived in significant part from recommendations in the 1990 Treasury Report.[117] These audit procedures would have applied

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[114] 1990 Treasury Report, § VII.
[115] *Id.*. This definition is similar to the definition in the 1987 House Proposal, except that the 1987 House Proposal was not limited to partnerships with 250 or more partners. *See* Budget Reconciliation Act of 1987, H.R. 3545, § 10126 (as received by Senate, Nov. 4, 1987) (proposing § 6234(b)); H.R. REP. NO. 100-391, at 1077-1078 (1987).
[116] 1990 Treasury Report, § VII.
[117] *See* Revenue Act of 1992, H.R. 11, 102d Cong., § 4302; Tax Fairness and Economic Growth Act of 1992, H.R. 4210, 102d Cong., § 4302; Tax Fairness and Economic Growth Act of 1992, H.R. 4287, 102d Cong., § 4302; Tax Simplification Act of 1991, S. 1394, 102d Cong., § 202;Tax Simplification Act of 1991, H.R. 2777, 102d Cong., § 202; Tax Simplification Act of 1993, H.R. 13, 103rd Cong., § 302; Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103d Cong., § 302; Seven-Year Balanced Budget Reconciliation Act of 1995, H.R. 2491, 104th Cong., § 14302 (as received by Senate, Oct. 27, 1995); Seven-Year Balanced Budget Reconciliation Act of

only to "large partnerships," generally defined as partnerships with at least 250 partners, or partnerships with at least 100 partners that affirmatively elect in, but would generally not include any service partnerships. [118]

A. Overview of Early 90s Bills

Under the Early 90s Bills, large partnerships would have been subject to the following audit regime:

- *Adjustments Flow Through to Current Partners*. Partnership adjustments would generally flow through to the partners for the year in which the adjustment takes effect, generally not affecting prior year returns of partners (except in the case of changes to partners' distributive shares).[119] Treasury would have authority to prescribe regulations as necessary to prevent manipulation and abuse (e.g., transfers of partnership interests to tax-indifferent parties in anticipation of a partnership adjustment).[120] The Tax Simplification Act of 1991 would have applied special rules to any partner who owned more than a 5% partnership interest (or materially participated in the partnership's activities and held any interest that was not a limited partnership interest).[121]

- *Partnership Election to Pay Imputed Underpayment*. In lieu of flowing an adjustment through to its partners, the partnership could elect to pay an imputed underpayment (generally calculated by netting the adjustments to the income and loss items of the partnerships and multiplying the amount by the highest individual or corporate tax rate for the reviewed year).[122] Consistent with the "Non-Flowthrough Method" from the 1990 Treasury Report, apparently no income would flow through to partners in respect of

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1995, H.R. 2517, 104th Cong., § 14302; *see also* H.R. REP. NO. 102-461, at 509-513 (1992); H.R. REP. NO. 102-631, at 133-137 (1992); H.R. REP. NO. 102-1034, at 873-877 (1992); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)*, JCS-10-91, at 21-25 (1991); Jt. Comm. on Tax'n, *Description of S. 1394 (Tax Simplification Act of 1991) and Proposed Modifications*, JCX-8-92, at 8 (1992); S. PRT. 102-77, at 153-157 (1992); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)*, JCS-1-93, at 65-69 (1993); H.R. REP. NO. 103-353, at 58-62 (1993); H.R. REP. NO. 104-280, pt. 2, at 432-437 (1995).

[118] Prop. §§ 6240(a), 6255(a).

[119] Prop. §§ 6241(c), 6242(a)(1), 6242(d)(2), 6242(d)(3).

[120] Prop. § 6255(g). The legislative history offers the following example:

> [I]f prior to the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

H.R. REP. NO. 102-461, at 512-513 (1992); H.R. REP. NO. 102-631, at 137 (1992);H.R. REP. NO. 102-1034, at 877 (1992); S. PRT. 102-77, at 156-157 (1992); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)*, JCS-1-93, at 68-69; H.R. REP. NO. 103-353, at 62 (1993); H.R. REP. NO. 104-280, pt. 2, at 436 (1995).

[121] *See* S. 1394, 102d Cong., §§ 201 & 202 (defining "excluded partners" in § 775(b), whom § 6256 generally excludes from the large partnership audit rules); H.R. 2777, 102d Cong., §§ 201 & 202 (same); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)*, JCS-10-91, at 23 n.15 (1991).

[122] Prop. §§ 6242(a)(2), 6242(b)(4), 6242(c), .

deficiencies collected from the partnership, and the tax paid by the partnership would not be credited to the partners.[123]

- *Offsetting Adjustments for Intervening Years*. Regardless of whether the adjustment flows through to current partners or the partnership elects to pay the imputed underpayment, an adjustment is offset if it requires another adjustment in a year after the reviewed year and before the year the adjustment takes effect.[124]

- *Partnership Responsible for Interest and Penalties*. The partnership, rather than the partners individually, would generally be liable for any interest and penalties.[125]

- *Mandatory Consistent Reporting*. Partners could not report any partnership items inconsistently with the partnership, even if they notified the Service of the inconsistency.[126] The Service could treat a partnership item that was reported inconsistently by a partner as a math error and immediately asses any additional tax against the partner.[127]

- *Partnership Representative.* The partnership must designate a partner (or other person) who has sole authority to act on behalf of the partnership in all proceedings, and if the partnership fails to do so the Service is authorized designate any partner to serve as the representative.[128]

- *No Partner Rights to Notice or to Initiate or Participate in Proceedings.* The Service would send notice of a partnership adjustment to the partnership itself at the partnership's last known address, but would have no obligation to provide notice to individual partners.[129] Partners would have no rights individually to initiate or participate in administrative or judicial proceedings, including settlement conferences and claims for refunds.[130]

- *Statute of Limitations*. The partnership, acting through its representative, would have sole authority to extend the statute of limitations for all partnership items, and any extension by the partnership would bind all partners.[131]

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[123] *See* H.R. REP. NO. 102-461, at 511 (1992) ("A partner may not file a claim for credit or refund of his allocable share of the payment."); H.R. REP. NO. 102-631, at 135 (1992) (same); H.R. REP. NO. 102-1034, at 875 (1992); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)*, JCS-10-91, at 23 (1991) (same); S. PRT. 102-77, at 155 (1992) (same); Jt. Comm. on Tax'n, *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)*, JCS-1-93, at 67 (1993) (same); H.R. REP. NO. 103-353, at 60 (1993) (same); H.R. REP. NO. 104-280, pt. 2, at 434 (1995) (same); *Hearings Before the Subcommittee on Tax'n of the S. Comm. on Finance on S.1364, S.1394, and H.R. 2777*, S. HRG. 102-451, at 239 (1992) (statement of John J. Flavio, Jr., Chairman of the Bd., Coal. of Publicly Traded P'ships).

[124] Prop. §§ 6242(a)(3), 6242(c).

[125] Prop. § 6242(b).

[126] Prop. § 6241(a).

[127] Prop. § 6241(b).

[128] Prop. § 6255(b).

[129] Prop. § 6245(b)

[130] Prop. §§ 6247, 6251, 6252, 6255(b).

[131] Prop. §§ 6248(b), 6255(b).

In testimony and statements related to the bills, government officials uniformly endorsed the proposal, but also expressed the view that the TEFRA rules "continue to be appropriate for small and medium size partnerships."[132] They also reiterated that service partnerships should be exempt from the new audit rules,[133] explaining that partners in such partnerships "generally earn their livelihood from these partnerships" and therefore deserve to retain "significant participatory rights."[134]

The feature of the Early 90s Bills that drew the most heated criticism was the imposition of liability for reviewed-year deficiencies on current partners (or the partnership, if it elects to pay), rather than the reviewed-year partners (the "Current Partner Liability Rule").[135] The complaints generally fell into the following categories:

- *Partnership Form & Fairness*. The Current Partner Liability Rule fundamentally conflicts with the pass-through nature of partnerships and the bedrock principle that each partner pays tax on that partner's share of the partnership's income and does so based on that partner's individual tax status. Moreover, the Current Partner Liability Rule puts new partners in partnerships in a worse position than new shareholders in corporations because shareholders in corporations because new partners may have to go out-of-pocket to pay tax on their allocable shares of adjustments (which taxes could potentially exceed the amount of their investment).

- *Complexity*. Rather than simplifying the system, the Current Partner Liability Rule engenders new and complex issues for partnerships and partners. These issues range from the immediate challenge of allocating the partnership adjustment among current partners and adjusting bases and capital accounts, to negotiating and consummating business deals involving partnerships or partnership interests (which may undercut the marketability of partnerships).[136]

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[132] S. HRG. 102-451, at 280 (statement of Kenneth W. Gideon, Asst. Sec. for Tax Policy, Dep't of Treasury).
[133] *See*, *e.g.*, S. HRG. 102-451, at 330 (statement of Fred Goldberg, Commissioner, Internal Revenue Service).
[134] *See Tax Simplification Act of 1991: Hearing on H.R. 2777 Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 102d Cong. (1991) (statement of Abraham N.M. Shashy, Chief Counsel, Internal Revenue Service)*, available at* 91 TNT 159-22.
[135] *See*, *e.g.*, ABA Section of Tax'n, *Report of the Partnerships Committee on the Proposals of the "Tax Simplification Act of 1991" (H.R. 2777, S. 1394) to Simplify the Taxation of Large Partnerships* (August 28, 1991) ("1991 ABA Report"), *available at* 91 TNT 195-26; S. HRG. 102-451, at 555 (statement of Oryx Energy Co.); NYSBA Tax Section, *Report on the Large Partnership Provisions of the 1993 Tax Simplification and Technical Corrections Bill* (Dec. 16, 1994) ("1994 NYSBA Report"), *available at* 94 TNT 250-22; Letter from NYSBA Tax Section to Bill Archer, Chairman Comm. on Ways and Means (Oct. 2, 1995), *available at* 95 TNT 194-21.
[136] The 1991 ABA Report closes with a long series of questions regarding practical business implications of the shifting of the Current Partner Liability Rule:

> Would the pendency of audit proceedings need to be disclosed to prospective buyers by general partners who approve transfers, by sellers who are aware of such proceedings, and by brokers who assist in the purchase and sale of such interests? Would partnership agreements be drafted to enable partnerships to recoup tax liabilities from prior partners or to reallocate tax liability on an equitable basis, including the imposition of capital call obligations on former partners? Many existing partnerships have been structured economically without regard to the cash flow requirements and potential burdens imposed by the Legislative Proposals, and amendments of large partnership agreements to address such matters is impractical, if not impossible because of the voting procedures or consent required. Such a radical change

- *Tax Avoidance and Manipulation.* Under the Current Partner Liability Rule, the discontinuity between the reviewed-year partners who had the "real" income and the current year partners who bear the tax, as well as the discontinuity in the reflection of adjustments relating to the reviewed year in the current year, encourage tax avoidance and manipulation. Thus the Current Partner Liability Rule could hinder tax collection rather than enhance it. Moreover, the government's efforts to combat "audit" planning will require complex anti-abuse rules that further undermine simplicity, and may not suffice in any event.

If current partners must bear the tax liabilities of reviewed-year partners, commenters proposed to narrow the circumstances in which this happens. For example, one could apply the Current Partner Liability Rule only to publicly traded partnerships,[137] or to partnerships with at least 500 partners.[138] Narrowing the definition of "large partnership" to require more partners and/or transfers of partnership interests would limit the Current Partner Liability Rule to circumstances where it is more justified (because of the extra burden for the Service to collect at the individual level, and the greater likelihood that the deficiency would be spread among enough partners to be borne by current partners without undue hardship). Others proposed to exclude certain types of partnerships, such as commodity pools (which can decrease significantly in the number of investors and in the size of investment over a relatively brief period).[139] Others proposed to require that if the liability of a reviewed-year partner would have exceeded a certain threshold (e.g., $5,000) if the adjustment were passed through to the reviewed-year partners, then such reviewed-year partner would remain responsible for its share of the liability (rather than the current partners or the partnership).[140]

B. <u>1991 ABA Proposal: No Partnership Collection; Liability Allocated to Reviewed-Year Partners in Current Year</u>

The 1991 ABA Report "strenuously" disagreed with the Current Partner Liability Rule in any circumstance. It allowed that audit adjustments could be made at the partnership level, and in the year the final determination is made, so that the Service need not review the partners' reviewed-year (and intervening) returns. However, it proposed that the adjustments be reflected as direct tax liabilities or tax credits that would be allocated to the reviewed-year partners based on their interests in the partnership in the reviewed year (as opposed to partnership items that flow through to returns of the current-year partners, or a partnership liability that is indirectly borne by current-year partners).[141]

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in the imposing tax liabilities could cause some partnerships to fail, even if the tax liabilities were relatively modest. Would buyers and sellers of partnership interests insist on warranties and representations and reimbursement rights with respect to tax liabilities? Will trading problems be created in these capital markets and will business enterprises be adversely affected to satisfy the need for more expediently collecting tax deficiencies attributable to an organization that at least in theory has been recognized a pass-through entity for tax purposes[?]

[137] S. HRG. 102-451, at 84 (statement of Denis Bode, President, Ind. Petr. Ass'n of Am.).

[138] *See* S. HRG. 102-451, at 213 (statement of Philip J. Wiesner, Chairman of the P'ship Tax'n Comm. of AICPA).

[139] *See* S. HRG. 102-451, at 520 (statement of William E. Seale, Dir. Gov't Relations of the Managed Funds Ass'n).

[140] S. HRG. 102-451, at 349 (statement of William Morris, General Counsel, Inv. Program Ass'n).

[141] *See* 1991 ABA Report, §§ I.B, III.B.

Under the proposal in the 1991 ABA Report, audit adjustments would be reported by the partnership as direct tax liabilities (or credits) of the reviewed-year partners on Schedule K-1. The tax liability would be determined based on the maximum nominal marginal rates for the reviewed year (as under the imputed underpayment election in the Early 1990s Bills, but unlike the default rule in the Early 1990s Bills that would flow adjustments through to current partners based on their current rates). The tax liability reported to reviewed-year partners would be increased by interest (as opposed to being borne by the partnership under the Early 1990s Bills).[142] The partnership would also supply partners with information needed to adjust the basis for their partnership interests so that gain or loss on the disposition of partnership interests may be properly determined (and interest and penalties which would otherwise be non-deductible do not become deductible by reducing subsequent gain or increasing subsequent loss).[143]

The Service would be responsible for collecting the tax, interest, and penalties from the reviewed-year partners, which would be automatically assessable against partners like mathematical errors. If the audited partnership had partners in the reviewed year that were pass-through entities, such pass-through entity partners would be required either to absorb the notified tax liability at the entity-level or issue Schedules K-1 to pass the liability through to the beneficial owners.[144]

The 1991 ABA Report acknowledged that its proposal made it harder for the Service to collect deficiencies as compared to the Early 1990s Bills (since the Early 1990s Bills made it unnecessary to chase after reviewed-year partners that are no longer partners, that are no longer in existence, or that constitute pass-through entities). Nevertheless, the 1991 ABA Report argued that such problems are inherent in the current audit system without regard to partnership issues, and that such problems are unavoidable in any system that makes the reviewed-year partners (rather than the current year partners) bear the reviewed-year liabilities.[145]

The 1991 ABA Report also criticized special rules in the Tax Simplification Act of 1991 that required significant reviewed-year partners classified as "excluded partners" to remain liable for deficiencies, while otherwise shifting liability to the current partners. Such treatment results in "[i]nconsistent treatment of partners who have made the same investment except for relative interests," which "will inevitably breed confusion and complexity." For example, allocating the residual entity-level expense in a way that is equitable for "excluded partners" who separately and directly bear their shares of the liability presents challenges. Special allocations impact partners' capital accounts, distort subsequent allocations under Section 704(b) of the Code, and

[142] The 1991 ABA Report argued that interest deserves special attention because "the interest component of an audit adjustment usually is more significant than the underlying tax deficiency." It asserted that putting the liability for interest and penalties on the partnership rather than the reviewed-year partners could promote the avoidance in the case of financially distressed partnerships and insolvent corporate general partners. It also noted that if the partnership is liable for interest, it raises issues for preserving non-deductibility by individual and S corporation partners (if the partnership's interest expense offsets its interest income) and preserving deductibility by C corporation partners (if the partnership is required to determine income as if it were an individual taxpayer). *See* 1991 ABA Report, § III.C.
[143] *See* 1991 ABA Report, § III.B.
[144] *Id.*
[145] *Id.*

"may have grave implications with respect to partnerships having tax-exempt partners, with respect to both depreciation claimed by the partnership and the determination of unrelated business taxable income, for those partnerships trying to avoid variations in profit and loss allocations."[146] These special rules for "excluded partners" were abandoned in the later proposals put forth in the Early 1990s Bills.

Finally, the 1991 ABA Report dismissed the partnership election to absorb audit liability at the entity-level as impractical. It argued that general partners would have difficulty making such election consistent with their fiduciary responsibilities because, given that tax is imposed at the maximum marginal corporate or individual rate, a partnership election will "never decrease, but will always equal or increase, the effective tax and economic burden of the partners." Consequently, exercise of the election "may be perceived by a disgruntled investor as a ticket to sue."[147]

C. 1994 NYSBA Report: Liability Collected from Partnership, with Tax Paid Treated as a Refundable Withholding Tax (or Calculate Liability Using a Weighted Average of the Highest Marginal Rates of the Reviewed-Year Partners)

The 1994 NYSBA Report strongly recommended that reviewed-year partners be liable for adjustments as under current law. If, however, such liability must be shifted to current partners, it recommended mandatory taxation of the partnership with no possibility of pushing the liability out to current partners. The election in the Early 1990s Bills puts the managers of the partnership in the "impossible situation" of deciding whether to have the partnership pay tax on the adjustment using the highest rates for the reviewed year, or to require the partners to pay tax at their current-year rates. Like the 1991 ABA Report, the 1994 NYSBA Report feared that partnerships that elected to pay tax at the entity-level would face "suits from disgruntled partners in tax brackets lower than the bracket at which the partnership paid the tax." In addition, the 1994 NYSBA Report observed that if a partnership that had no liquid funds at the time tax was due it would have to elect to push the liability out to current partners, which could eviscerate their expectation of limited liability. It also stressed that an election invites tax planning, particularly if rates change from the reviewed year to the current year. Finally, the 1994 NYSBA Report argued that limiting liability to the partnership itself (and not extending it to current partners) avoids the need for individual partner notice and partnership rights.[148]

The 1994 NYSBA Report acknowledged that insolvent partnerships present a problem under its proposal to make the partnership, and only the partnership, liable. Like the 1990 Treasury Report, it anticipated that this concern would be addressed by (1) giving the Service the same protections against partnership asset distributions during partnership proceedings as it has in the corporate context, and (2) the creation and maintenance of reserves by partnerships. If necessary, it would also permit the Service to recover distributions to partners. But the partners' liabilities for the tax liabilities of the partnership apparently could not exceed their capital contributions. [149]

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[146] *Id.*
[147] *Id.*
[148] 1994 NYSBA Report, § IV.E.1.
[149] *Id.*

The 1994 NYSBA Report approved of the Early 1990s Bills insofar as they required collections in respect of adjustments resulting from a reallocation of distributive shares of partnership income and loss from the reviewed-year partners. But the necessity of such a special rule for reallocations reinforced concerns about the complexity of imposing liability on current partners. For example, if an audit involved both allocation and other issues, the Early 1990s Bills might result in different adjustments to two groups of partners with respect to a single audit of a single taxable year.[150]

1. *Calculation of Tax on Imputed Underpayment*

Given that the partnership would remain solely responsible for taxes on audit adjustments, with no election to shift the liability to partners, the calculation of the tax liability takes on added importance. Like the Early 1990s Bills, the 1994 NYSBA Report recommended calculating the tax liability in the first instance by reference to the highest statutory rate of tax for the current year (rather than the reviewed year). However, it recommended reporting to the partners their allocable shares of the partnership adjustment and tax paid thereon, and then allowing each partner to claim a refund from the Service to the extent a partner's allocable share of the tax paid by the partnership exceeds the partner's actual tax liability for its allocable share of the same adjustment. Such a system would be similar to the regime under Section 1446 of the Code whereby foreign partners may request refunds of tax withheld on income from partnerships engaged in a U.S. trade or business if the amount of tax withheld exceeds the foreign partners' actual U.S. federal income tax liability with respect to the income.[151] Tax-exempt partners would be permitted to claim refunds under a simplified procedure. The 1994 NYSBA Report concluded that the additional complexity of allowing partners to claim refunds was justified by fairness.[152]

If the refundable withholding tax were not adopted, the 1994 NYSBA Report recommended allowing partnerships to adjust their entity-level liability by using a weighted average of the highest corporate and individual marginal rates for the reviewed year based on each partner's corporate, individual or tax-exempt status (and taking into account tax-exempt partners' allocable shares of UBTI). Partner status could be demonstrated through the production of affidavits from partners attesting to their status for each year at issue.[153]

2. *Liability for Interest and Penalties*

The 1994 NYSBA Report recommended that if the tax liability is imposed on the partnership, then the partnership should be liable for interest and penalties. If the liability is imposed on reviewed-year partners as under current law, then the reviewed-year partners should

[150] *Id.*
[151] *See*, *e.g.*, Joel D. Kuntz & Robert J. Peroni, U.S. INTERNATIONAL TAXATION ¶ C2.05 (2016 & Supp. July 2016); William S. McKee et al., FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 9.03[4][c][iv] (4th ed. 2007 & Supp. 2016-3); Philip A. Stoffregan et al., 910-2nd T.M., *Partners and Partnerships — International Tax Aspects* § IV.E (2016).
[152] *See* 1994 NYSBA Report, § IV.E.2. The 1994 NYSBA Report did not address the potential for abuse through transfers of interests to lower-bracket (or tax-exempt) partners, each of whom would be entitled to a larger refund than the reviewed-year partners.
[153] 1994 NYSBA Report, § IV.E.2.

be liable (limited, in the case of penalties, to reporting positions within their control). In any event, it would be inequitable to assess interest and penalties for reviewed years directly against current partners who may not have been partners in the reviewed year (and therefore had neither a benefit from an interim use of funds, nor any intent to avoid taxes in filing a reviewed-year return).[154]

3. *Audit Procedures*

The 1994 NYSBA Report expressed a strong belief that significant partners deserve notice and participation in partnership-level audits if any circumstance where liability is imposed at the partner-level. Adapting TEFRA's "notice partner" and "notice group" regime, the NYSBA would have granted notice and participation rights to (1) the five largest general and limited partners, (2) any partners with at least a 20% interest in an audit item at issue, and (3) any formal group comprised of at least 25% of the partners (determined based on the partners' capital interests reported on the partnership's most recent Form 1065) (together, the "participating partners"). It also recommended permitting 51% of the partners (again determined based on the partners' capital interests reported on the partnership's Form 1065) to replace the original representative at any time, which was intended to afford partners indirect participation in proceedings. If a majority of the partners cannot agree on a representative, the IRS would be required to appoint the partner with the largest capital interest reported on the partnership's most recent Form 1065 if that partner is available and willing to undertake the position.[155]

In the case of reallocations between two or more reviewed-year partners, the 1994 NYSBA Report proposed that each reviewed-year partner with a 5% interest in the reallocation have participation rights. Reallocations justified a lower threshold because "[i]t is simply not possible for a single partnership representative to fairly and effectively represent more than one party in connection with a reallocation that will necessarily benefit one or more partners at the expense of other partners."[156]

4. *Amended Partnership Returns*

Similar to its philosophy on audit procedures, unless the partnership is solely liable for the deficiency, the 1994 NYSBA Report would permit the partnership or any "participating partner" to file an AAR, and permit any partner to request a refund of its tax paid. This rule would generally be consistent with TEFRA, except that non-participating partners would have to rely on the partnership or participating partners to file an AAR. Either the partnership or a participating partner could seek judicial review of a rejected AAR. As under TEFRA, refunds would belong to partners, calculated using each partner's tax rate for the reviewed year.[157]

If the partnership is liable for adjustments resulting from the audit, the 1994 NYSBA Report would not object to allowing only a partnership's representative to file amended partnership returns, or to flowing through any resulting adjustment to current partners.

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[154] 1994 NYSBA Report, § IV.E.3

[155] 1994 NYSBA Report, § IV.F.1.

[156] *Id.*

[157] 1994 NYSBA Report, § IV.F.2.

Nevertheless, it recommended that anti-abuse rules be enacted to combat AAR planning whereby lower-bracket (or tax-exempt) reviewed-year partners over-report income, and then the partnership files an amended return in a later year when its higher-bracket current partners can enjoy an outsized benefit from the negative partnership adjustment.[158]

5. *Adjustments that Change the Character of Partnership Items*

Calculating the tax due in respect of partnership adjustments that change the character of previously reported items entails arbitrary line drawing unless the system allows adjustments to flow through to the reviewed-year partners for the reviewed year. For example, if a partnership misreported ordinary income as capital gain, the reviewed-year partners may have underpaid tax by amounts ranging from 0% to 39.6% depending on the type of taxpayer and the presence or absence of capital or ordinary losses.[159] For purposes of calculating the incremental tax liability from the adjustment, the 1994 NYSBA Report suggested an assumption that the reviewed-year partners paid flat tax at the highest rate applicable to individuals for the item reported. The 1994 NYSBA Report noted that additional arbitrary decisions would be necessary to calculate the tax liability attributable to rechacterizations relating to a partnership's passive income or loss, or redeterminations of a partnership's alternative minimum taxable income.[160]

6. *Allocations if Partnership Pays Assessment*

If the partnership pays an assessment, the 1994 NYSBA Report would have permitted the special allocation of such assessment (and related partnership adjustments) in any manner that has substantial economic effect. Special scrutiny would be necessary, however, to police disproportionate allocations of items to partners in higher tax brackets (who could take greater advantage of the attendant basis adjustments). In the absence of special allocations that have substantial economic effect, the 1994 NYSBA Report recommended that the partnership assessment be treated as an item of partnership expense in the current year (which would be the last item of loss or deduction allocated in the current year), and the allocation of the partnership adjustment would track the allocation of the partnership assessment.[161]

When the partnership pays an assessment, the partners' tax capital accounts and outside bases would be increased (under principles similar to those applied to tax-exempt income) by their allocable shares of any partnership adjustments. However, their book capital account balances under Section 704(b) of the Code would not be affected by the allocation of partnership adjustments. Rather, the additional assets the partnership adjustment is deemed to create would be treated as having a value of zero for purposes of Section 704(b) of the Code, and the principles of Section 704(c) of the Code would apply to the resulting differences between the partners' book and tax capital accounts.[162]

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[158] *Id.*
[159] For example, under current law an individual who had no offsetting ordinary or capital losses may have underpaid tax by as little as 10% (if he or she is in the 10% or 25% tax brackets) or as much as 20% (if he or she is in the 35% bracket). *See* §§ 1(h)(1)(B), 1(h)(1)(C), 1(i)(1), 1(i)(2)(A), 1(i)(3)(A)(i). An individual who had capital but not ordinary losses may have underpaid tax by as much as 39.6%. *See* § 1(i)(3)(A)(ii).
[160] 1994 NYSBA Report, § IV.H.
[161] *Id.*, § IV.I.1.
[162] *Id.*, § IV.I.2.

If a partnership elects to pay assessed tax that otherwise applies to the current partners (as under the Early 90s Bills), such payment would be treated as a deemed distribution of cash to the partners. If the partnership alone is liable for the tax assessment (as recommended in the 1994 NYSBA Report), the partnership's payment would be treated as a nondeductible partnership expense under Section 705(a)(2)(B) of the Code. In either case, each partner's outside basis and tax and book capital accounts would each by decreased by the partner's allocable share of the payment. Interest and penalties paid by the partnership would likewise be treated as nondeductible expenses (or, in the case of interest, possibly a deductible expense) that reduce each partner's outside basis and tax and book capital accounts.[163]

7. *Allocations if Current Partners Pay Assessment*

If current partners pay the assessment, the 1994 NYSBA Report would have allowed the partnership to specially allocate partnership adjustments in any manner that is consistent with the allocation of another material item of partnership income or loss.[164] Nevertheless, special scrutiny would be necessary to police the shifting of adjustments to partners in lower tax brackets (or to partners with clearly insufficient assets). If there are no special allocations (or the IRS disallows special allocations), partnership adjustments would be allocated consistent with how the assessment would have been allocated had it been paid by the partnership (using the principles described above).[165]

Similar to when the partnership pays the assessment, if the partners pay the assessment the allocation of partnership adjustments among partners should result in a positive adjustment to each partner's tax capital account and outside basis, but would not impact their book capital accounts.[166]

8. *Partnership Asset Basis Adjustments*

The netting concept in the Early 90s Bills contemplates that a partnership adjustment requiring capitalization of an improperly expensed item creates additional basis in the asset during the period between the year the asset should have been capitalized and the year the adjustment takes effect. The 1994 NYSBA Report recommended making explicit that any additional basis remaining after the year the adjustment takes effect continues to be amortized or depreciated. The deductions from such amortization or depreciation would continue to be allocated in the same manner as the partners were allocated deemed or actual liability for the assessment, which allocation would be consistent with Section 704(c) principles. Absent such a rule, the partners allocated actual or deemed liability for an assessment would have only decreased capital gain (or increased capital loss) on a sale of their partnership interests, which benefit is worth much less than the tax paid by the partners or the partnership.[167]

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[163] *Id.*

[164] *Cf.* Treas. Reg. §§ 1.704-2(e)(2) (permitting special allocation of nonrecourse deductions consistent with allocations "of some other significant partnership item"); 1.752-3(a)(2) (permitting special allocation of excess nonrecourse liabilities consistent with allocations "of some other significant item of partnership income or gain").

[165] 1994 NYSBA Report, § IV.I.3.

[166] *Id.*, § IV.I.4.

[167] *Id.*, § IV.I.6.

V. Electing Large Partnerships

The "simplified audit procedures for large partnerships" proposed in the Early 90s Bills finally found their way into law as part of the Taxpayer Relief Act of 1997,[168] albeit with one critical change. Whereas the Early 90s Bills would have made the new audit system mandatory for all partnerships with at least 250 partners (and elective only in the case of partnerships with between 100 and 249 partners), the enacted legislation made the rules applicable only to those partnerships with at least 100 partners that affirmatively elected in ("electing large partnerships," or ELPs).[169] Apparently criticism of the Early 90s Bills, particularly in respect of the Current Partner Liability Rule, spurred Congress to make the new audit regime entirely optional.

Presumably the hope was that by first introducing the new audit regime to ELPs, the government and taxpayers could work out some of the wrinkles in actual controversies, and then after it had been tested (and, just as importantly, become more familiar to taxpayers and practitioners), the conditions would be ripe to enact a mandatory audit system that featured the Current Partner Liability Rule. The intended "carrot" for electing into the ELP regime was apparently the ability to use "simplified flow-through reporting," which significantly reduced the number of items that the ELP had to separately report to its partners.[170]

Unfortunately, very few taxpayers concluded that the benefits of simplified reporting outweighed the risks presented by the new audit regime (and detailed in criticism of the Early 90s Bills).[171] In 2013, the fifteenth year after partnerships could first elect into the ELP regime,[172] less than 1% of eligible partnerships did so.[173] And few of the partnerships that elected into the ELP regime were among obvious targets for partnership audits as measured by total assets.[174] Indeed, from 2007 to 2013, the IRS did not complete a single audit of an ELP.[175] Given

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[168] Pub. L. No. 105-34, § 1222, 111 Stat. 788, 1008-1020; *see also* S. REP. NO. 105-33, at 245-249 (1997); H.R. REP NO. 105-148, at 578-582 (1997); H.R. REP. NO. 105-220, at 670-674 (1997); Jt. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97, at 361-366 (1997) ("ELP Bluebook").

[169] *See* Pre-BBA §§ 6240(a), 6255(a)(1), 775.

[170] *See* Pre-BBA §§ 771-777; *see also* S. REP. NO. 105-33, at 234-245 (1997); H.R. REP NO. 105-148, at 567-578 (1997); H.R. REP. NO. 105-220, at 659-670 (1997); ELP Bluebook, at 349-361. Like the ELP audit regime, the ELP simplified flow-through reporting regime grew out of proposals in the Early 90s Bills.

[171] *See, e.g.*, William B. Brannan, *Current Developments in Partnership Taxation*, 50 MAJOR TAX PLAN. ¶ 1301.1.E.2 (1998) ("While it is too early to tell what the practice will be under the above-described rules for large partnerships, it appears that most large partnerships will not elect to have them apply, since the benefits from simplified tax information reporting are generally not perceived as being worth the disadvantages of the new audit procedures.").

[172] The ELP regime first applied to partnership taxable years beginning after December 31, 1997. Pub. L. No. 105-206, § 6012(e), 112 Stat. 685, 819.

[173] Of the 10,948 partnerships with 100 or more partners that filed returns for 2013, only 91 filed ELP returns. *See* Ron DeCarlo & Nina Shumofsky, IRS Statistics of Income, *Partnership Returns, 2013*, at 3 & 7 (Fall 2015).

[174] For tax year 2011, of the 105 partnerships that elected into the ELP regime, only 15 had $100 million or more in assets. U.S. GOV'T ACCOUNTABILITY OFFICE, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732, at 31n.39 (2014); U.S. GOV'T ACCOUNTABILITY OFFICE, *Large Partnerships: Characteristics of Population of IRS Audits*, GAO-14-379R, at 6 (2014).

[175] According to the Government Accountability Office, no partnership that filed a return as an ELP from tax years 2002 to 2011 had its tax return audited and closed by the IRS from fiscal years 2007 to 2013. U.S. GOV'T

how few partnerships elected into the ELP regime, the Joint Committee on Taxation recommended eliminating it altogether (or giving consideration to making all or portions of ELP rules mandatory for all partnerships).[176] Consequently, very little guidance has developed around the ELP audit regime beyond the statute itself and its limited legislative history (which largely copied legislative history for the Early 90s Bills).[177]

VI. BBA

Given the failure of the ELP regime to attract volunteers, and the growth of partnerships as measured by most every metric— the number of partnerships, the number of partners, the number of tiers of partnerships, and the amount of assets held by partnerships—the challenges in auditing partnerships compounded. The government issued a number of reports that detailed the dramatic increase in partnerships (including multitier partnership structures), the infrequency of partnership audits, the high rate of no-change audits for the few partnerships that are audited, the administrative burdens arising under TEFRA, and other shortcomings in policing noncompliance by partners and partnerships.[178] These findings garnered significant attention from commentators,[179] and resulted in a series of legislative proposals that ultimately culminated in the enactment of the BBA.

ACCOUNTABILITY OFFICE, *Large Partnerships: Characteristics of Population of IRS Audits*, GAO-14-379R, at 12 (2014).

[176] Jt. Comm. on Tax'n, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, JCS-3-01, at 287-291 (2001).

[177] *See* Pre-BBA, §§ 6240-6255; S. REP. NO. 105-33, at 245-250 (1997); H.R. REP NO. 105-148, at 578-583 (1997); H.R. REP. NO. 105-220, at 670-674 (1997); ELP Bluebook, at 361-366. For commentary on the ELP audit rules, see Steven R. Mather, 624-3rd T.M., *Audit Procedures for Pass-Through Entities* § XIII; Michael I. Saltzman & Leslie Book, IRS PRACTICE AND PROCEDURE ¶ 8.21 (2nd ed. 2002 & Supp. 2016-2); Linda Z. Swartz, *The Elective Large Partnership Rules*, 16 PARTNERSHIP TAX PRACTICE SERIES 321-1 (PLI 2016).

[178] *See*, *e.g.*, U.S. General Accounting Office, *Tax Administration: IRS' Partnership Compliance Activities Could be Improved* , GGD-95-1511 (June 1995); Treasury Inspector General for Tax Admin., *Filing Characteristics and Examination Results for Partnerships and S Corporations*, 2006-30-114 (Aug. 2006); U.S. Gov't Accountability Office, *Tax Gap: IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities*, GAO-10-968 (Sept. 2010); Treasury Inspector General for Tax Admin., *Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits is a Concern*, 2012-30-060 (June 2012); U.S. Gov't Accountability Office, *Large Partnerships: Characteristics of Population and IRS Audits*, GAO-14-379R (March 2014); U.S. Gov't Accountability Office, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, GAO 14-453 (May 2014); U.S. Gov't Accountability Office, *Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits*, GAO-14-746T (July 2014); U.S. Gov't Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732 (Sept. 2014); Treasury Inspector General for Tax Admin., *Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process*, 2015-30-004 (March 2015).

[179] *See*, *e.g.*, Noel P. Brock, *Audits of Partnerships, TEFRA and Partnership Noncompliance: Where We Are and Where We Are Going*, 93 TAXES 193 (March 2015); Harvey Coustan, *Audits of Partnerships*, 17 J. TAX. PRAC. & PROC. 5 (April/May 2015); Amy S. Elliott, *Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS*, 136 TAX NOTES 351 (July 23, 2012); Sheri A. Dillon & Sam B. Guthrie, *The TEFRA Swamp: Managing the Complexities Of a Partnership Audit*, 31 TAX MGMT. REAL ESTATE J. 146 (May 6, 2015); Amy S. Elliott, *Why It Maters That the IRS Has Trouble Auditing Partnerships*, 143 TAX NOTES 7 (Apr. 7, 2014); Amy S. Elliott, *"Largely Manual and Paper Driven" System Causes Lack of Audits*, TAX NOTES TODAY, Sept. 19, 2014, 2014 TNT 182-2; Amy S. Elliott, *Koskinen: More Training on Subchapter K Won't Fix Audit Issues*, TAX NOTES TODAY, Oct. 21, 2014, 2014 TNT 203-2; John Keenan & Colleen C. Harkins, *Recent Focus on IRS Audits of Partnerships and a Proposal for Replacing the TEFRA Audit Procedures*, 16 J. TAX PRAC. & PROC. 13 (June/July 2014); John Keenan et al., *Continued Focus on IRS Audits of Partnerships and Another Proposal for Replacing the TEFRA Audit*

A. Legislative Background

In 2012, as part of the FY 2013 budget, the Obama administration proposed to make the ELP audit regime mandatory for any "required large partnership" ("RLP").[180] An RLP would have generally included any partnership that had at least 1,000 direct or indirect partners at any time during the taxable year, as well as any partnership that had at least 100 partners and affirmatively elected in. The Obama administration's budget proposals for 2014 and 2015 likewise featured the mandatory RLP regime.[181] While viewed as a positive step, the proposal was criticized on the ground that, by reason of the 1,000-partner threshold, it did nothing to address the challenges of auditing partnerships with fewer than 1,000 partners (which represent more than 99% of the partnership universe) or tiered partnerships.[182]

In 2014, Representative Dave Camp, at that time the House Ways and Means Committee Chairman, released a proposal that would have completely repealed the TEFRA and ELP regimes and replaced them with a single system of centralized audit, adjustment and collection.[183] This regime would be mandatory for all partnerships, provided that a partnership could elect out if (1) it has no more than 100 partners, and (2) each of its partners is an individual, C corporation (including a foreign entity that would be treated as a C corporation if it were domestic, but excluding a RIC or a REIT), or the estate of a deceased partner.[184] Similar to the ELP regime, audits, refund requests, and judicial review would be conducted at the partnership level without partner involvement (other than the authorized partnership representative, who need not be a partner), and partners would have no rights to notice.[185] The calculation and collection of tax, interest and penalties from the partnership would also operate

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Procedures, 17 J. TAX PRAC. & PROC. 15 (June/July 2015); John D. McKinnon, *Senators Say IRS Fails to Audit 99% of Big Partnerships*, WALL ST. J., April 17, 2014; Fred F. Murray, *The Need for New Approaches in Making Adjustments to the Tax Accounts and Tax Returns of Large Partnerships*, 18 J. PASSTHROUGH ENTITIES 13 (May/June 2015); Laura Saunders, *Investments That Elude IRS Scrutiny: Master Limited Partnerships and Hedge Funds Are Often Too Complicated to Be Audited*, WALL ST. J., April 25, 2014.

[180] *See* Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2013*, at 210 (2012); Dep't of Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, at 155-156 (2012); Jt. Comm. on Tax'n*, Description of the Revenue Provisions Contained in the Fiscal Year 2013 Budget Proposal*, JCS-2-12, at 622-626 (2012).

[181] *See* Dep't of Treasury, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals*, at 189-190 (2013); Dep't of Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, at 218-219 (2014).

[182] *See* Treasury Inspector General for Tax Admin., *Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process*, 2015-30-004, at 21-22 (March 2015).

[183] Tax Reform Act of 2014, H.R. 1, 113th Cong., § 3622; *see also* Jt. Comm. on Tax'n*, Technical Explanation on the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III—Business Tax Reform*, JCX-14-14, at 255-259 (2014). Senator Carl Levin subsequently introduced in the Senate a bill that "mirrors" the Camp proposal for partnership audits. *See* Partnership Auditing Fairness Act, S. 3018, 113th Cong. (2014); 160 CONG. REC. S6921 (daily ed. Dec. 16, 2014) (statement of Sen. Carl Levin).

[184] *See* Prop. § 6221(b).

[185] *Compare* Prop. §§ 6223, 6226, 6231, 6234 *with* Pre-BBA §§ 6245(b), 6247, 6251, 6252, 6255(b). While non-partners are presumably less knowledgeable about the partnership's affairs, they may have professional expertise in managing partnership audits, and also be more likely to represent the partners' diverse interests impartially than would an interested partner. *See* Jt. Comm. on Tax'n, *Description of Certain Revenue Provisions Contained in the President's 2016 Budget Proposal*, JCS-2-15, at 269 (2015).

similarly to the rules for an ELP's elective payment of the imputed underpayment.[186] Unlike the ELP regime, however, the Camp proposal specified that adjustments to distributive shares are not netted,[187] that the imputed underpayment could be reduced to the extent reviewed-year partners submit amended tax returns incorporating any adjustments and pay any tax due,[188] and that the partnership, the reviewed-year partners, and the adjustment-year partners would be jointly and severally liable for the imputed underpayment and any interest and penalties.[189]

In February of 2015, the Obama administration similarly proposed to replace the TEFRA and ELP regimes with a single centralized audit system that would apply to any partnership that has 100 or more direct partners, or at least one partner that is a pass-through partner.[190] Similar to the Camp proposal, audits and refund requests would be conducted at the partnership level without partner involvement (other than the authorized partnership representative), and partners would not be entitled to notice. In a departure from the Camp proposal, however, there would be no partnership-level assessment and collection. Instead, adjustments would flow through to the reviewed-year partners and the deficiency would be collected from the reviewed-year partners. Unlike TEFRA, however, a direct partner that is a pass-through partner would be responsible for paying the tax on behalf of its owners.[191]

In June of 2015, Representative Jim Renacci introduced a partnership audit bill that in large part tracked the Camp proposal.[192] The Camp and Renacci proposals drew comments from many practitioners, particularly in respect of the joint and several liability provision, which "would appear to expose holders of partnership interests to a level of economic and legal risk far

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[186] *Compare* Prop. §§ 6225, 6232, 6233 *with* Pre-BBA § 6242.
[187] Prop. § 6225(b)(2).
[188] Prop. § 6225(c)(2)
[189] Prop. § 6241(d)
[190] Dep't of Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, at 235-236 (2015); Jt. Comm. on Tax'n, *Description of Certain Revenue Provisions Contained in the President's 2016 Budget Proposal*, JCS-2-15, at 262-270 (2015). A partnership that is subject to the regime because it has at least one pass-through partner could elect out if it demonstrates that the total number of direct and indirect partners in the reviewed year is less than 100. The proposal did not allow for partnerships with fewer than 100 direct partners and no indirect partners to elect in.
[191] The Joint Committee on Taxation questioned the wisdom of this departure from the Camp proposal, noting that it does not ameliorate the burden of collecting tax from numerous partners (other than partners of pass-through partners). Jt. Comm. on Tax'n, *Description of Certain Revenue Provisions Contained in the President's 2016 Budget Proposal*, JCS-2-15, at 267, 270 (2015). The Joint Committee went on to observe:

> one might question why it is appropriate to collect from passthrough partners − which may themselves be partnerships − yet not to collect from the audited partnership under the proposal. If a mechanism for collecting from partnerships is developed, arguably it could apply to the audited partnership itself. Similarly, refunds are made to the partnership rather than to partners (whether they are direct or indirect partners) under the proposal. If refunds can be made at the partnership level, the asymmetry and potential administrative difficulty of collecting tax from numerous direct partners is further highlighted.

Id., at 267.
[192] Partnership Audit Simplification Act of 2015, H.R. 2821, 114th Cong. (2015). The Renacci proposal differed from the Camp proposal in a few respects, including (i) giving partners more time to file amended returns to justify reductions to the imputed underpayment (270 days rather than 180 days), Prop. § 6225(c)(4), (ii) granting the Secretary regulatory authority to address how adjustments are taken into account by former partners if the partnership ceases to exist before the adjustment takes effect, Prop. § 6241(i), and (iii) delaying the effective date so that it applies to tax returns filed for partnership taxable years ending after December 31, 2018 (instead of December 31, 2014).

in excess of that which they would bear if they held (or acquired) corporate stock, rather than a partnerships interest."[193] Some commentators suggested an alternative approach to assessment and collection. Like the Camp and Renacci proposals, audits would be resolved at the partnership level without partner involvement (other than via the partnership's designated representative), and all direct and indirect partners would be bound by partnership-level adjustments agreed to by the partnership representative or determined in a judicial proceeding. Instead of collecting tax from the partnership (or reviewed-year partners who file amended returns), however, these commentators proposed that adjustments would flow through to the reviewed-year partners in the current year (with the audited partnership issuing adjusted Schedules K-1), and the Service would rely on the existing self-assessment system to collect from those partners.[194]

In late October of 2015, the House of Representatives amended the Bipartisan Budget Act of 2015 (a bill that had been introduced in Congress almost nine months earlier) to include partnership audit provisions.[195] The provisions were substantially similar to the Renacci proposal, but differed in some important respects, including: (i) joint and several liability for current and former partners was eliminated, (ii) in addition to having reviewed-year partners file amended returns, the partnership could reduce its imputed underpayment by establishing that reviewed-year partners were tax-exempt, corporations (in the case of ordinary income), or individuals (in the case of capital gains or qualified dividends), (iii) an alternate payment mechanism was introduced, based on the proposal described above, to allow the audited partnership to elect to require reviewed-year partners to pay deficiencies in the current year (in lieu of such partners having to file amended returns for the reviewed year), and (iv) the effective date was accelerated to apply to returns filed for partnership taxable years beginning after December 31, 2017 (rather than partnership taxable years ending after December 31, 2018).

The BBA was signed into law by President Obama on November 2, 2015, less than a week after the introduction of the partnership audit provisions.[196] Prior to its enactment, there were no committee reports, floor discussion or any other meaningful background provided regarding the addition of the partnership audit provisions to the BBA, or the changes made to the Renacci proposal, apart from an estimate that these provisions would raise approximately $9.325 billion over 10 years.[197] Representative Renacci himself was not involved in the negotiations:

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[193] Carol Kulish Harvey et al., *Potential Impact of Proposed Legislative Changes to the Partnership Audit Rules On Current and Future Partners of Partnerships*, DAILY TAX REP., July 27, 2015, 143 DTR J-1; *see also* ABA Section of Tax'n, *Partnership Tax Audit and Litigation Regime Revisions* (Nov. 2, 2015), *available at* 2015 TNT 212-19; Letter from AICPA to Representatives Renacci and Kind, *H.R. 2821—Partnership Audit Simplification Act of 2015* (July 14, 2015), *available at* 2015 TNT 136-25; Amy S. Elliott, *Renacci Aims to Revive Camp Approach to Large Partnership Audits*, TAX NOTES TODAY, July 6, 2015, 2015 TNT 128-5; Aaron Lorenzo, *New Audit Legislation Aims to Cut Complexity, Adds Burdens to Partners*, DAILY TAX REP., July 6, 2015, 128 DTR G-1; Donald B. Susswein & Ryan P. McCormack, *Fixing the Partnership Audit Process*, 149 TAX NOTES 123 (Oct. 5, 2015).

[194] *See* Donald B. Susswein & Ryan P. McCormack, *Fixing the Partnership Audit Process*, 149 TAX NOTES 123 (Oct. 5, 2015); *cf.* 1991 ABA Report, §§ I.B, III.B (making a similar proposal).

[195] Bipartisan Budget Act of 2015, H.R. 1314, 114th Cong. §1101 (as engrossed by the House of Representatives, October 28, 2015).

[196] *See* Pub. L. No. 114-74, § 1101, 129 Stat 584, 625-638 (2015).

[197] Jt. Comm. on Tax'n, *Estimated Revenue Effects of the Tax Provisions Contained in H.R. 1314, The "Bipartisan Budget Act of 2015,"* JCX-135-15 (2015). A section-by-section summary was posted on the website for the House of Representatives. *Bipartisan Budget Act of 2015*: *Section-by-Section Summary*, http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf, *available at* 2015 TNT 208-24.

> “Like most members of Congress, I was informed . . . that provisions from my partnership audit simplification bill may be included in the final package. Far too often -- this being a prime example -- Congress circumvents regular order,” he said in the statement.
>
> “Unfortunately, the latest budget and debt ceiling package has once again hijacked the legislative process. That said, due to the engagement that I have had with stakeholders over the [last] four months, the partnership audit proposal now in the budget package is a significant improvement from any prior version proposed by the administration or Congress,” Renacci said.[198]

While Congress apparently rushed the enactment of the new partnership audit rules to provide an offset for pending budget legislation, the two-year delay in the effective date was intended to provide an opportunity for public comment and corrective legislation before the rules became effective.[199]

On December 18, 2015, the PATH Act was enacted, making a handful of technical corrections to the newly enacted rules.[200] The Joint Committee on Taxation released a technical explanation of the PATH Act that included a brief description of both the new partnership audit rules and the changes made by the PATH Act.[201] In March of 2015, the Joint Committee on

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[198] Kat Lucero et al., *Bipartisan Budget Deal Would Streamline Partnership Audits*, TAX NOTES TODAY, Oct. 28, 2015, 2015 TNT 208-2. In a statement posted on his website, Representative Renacci elaborated:

> On Monday evening October 26th, Members of the House of Representatives learned that Leadership had negotiated a massive budget and debt ceiling package. This 100+ page bill was negotiated behind closed doors without any input from Members. Less than two days later, without the ability to offer any amendments, Members were forced to vote on this bill entitled the Bipartisan Budget Act of 2015.
>
> The Bipartisan Budget Act of 2015 contains some good, bipartisan compromises on important issues impacting our country, including provisions from a bipartisan bill I introduced in June entitled the Partnership Audit Simplification Act of 2015 (H.R. 2821). Despite the inclusion of these provisions, I voted against the last-minute, take-it-or-leave it budget bill, because the American people deserve legislation this impactful to go through regular order. Instead, the latest budget and debt ceiling package once again has hijacked the legislative process.
>
> After introducing H.R. 2821 in June, it was my intent to receive member and stakeholder feedback, and to incorporate that feedback into a revised bill. And since June, I have been very engaged with stakeholders regarding recommendations for revisions to the bill, and continued to work through that process in good faith towards a final product. While I was pleased that some of those stakeholder recommendations were included in the Bipartisan Budget Act of 2015, that bill stripped H.R. 2821 from the legislative process before it was able to receive a hearing or markup.

Representative Jim Renacci, *The Bipartisan Budget Act* (Nov. 3, 2015), http://renacci.house.gov/index.cfm/2015/11/the-bipartisan-budget-act.

[199] *See* 161 CONG. REC. S7636-S7637 (daily ed. Oct. 29, 2015) (statement of Sen. Orrin Hatch).

[200] Protecting Americans from Tax Hikes Act of 2015, § 411, Division Q of Consolidated Appropriations Act, 2016, P.L. 114-113, 129 Stat. 2242, 3121-3122 (2015). The technical corrections included allowing the imputed underpayment to be modified to account for certain passive losses of publicly traded partnerships and both capital gains and ordinary income attributable to a partner that is a C corporation.

[201] Jt. Comm. on Tax’n, *Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029*, JCX-144-15, at 248-252 (2015) (“PATH Act Explanation”).

Taxation released a bluebook with technical explanations of tax legislation enacted in 2015, including the partnership audit provisions in the BBA and the PATH Act.[202]

B. Overview of BBA

Effective for partnership taxable years beginning after December 31, 2017, the BBA repeals the TEFRA and ELP rules, and replaces them with a centralized system for the audit, adjustment, assessment, and collection of tax applicable to all partnerships other than eligible partnerships that elect out.[203] Many commentators have already thoughtfully analyzed the BBA in great detail, examining the statute, its legislative history and numerous practical implications.[204] This article summarizes the BBA only to situate it in the arc of the prior legislative proposals discussed above, and the proposal discussed below.

- *Mandatory Consistent Reporting Absent Notice of Inconsistent Treatment.* In general, partners must report items attributable to the partnership consistently with the partnership, and the Service can treat any such item that was reported inconsistently by a partner as a math error, immediately asses any additional tax against the partner, and impose an accuracy-related penalty.[205] As under TEFRA (but unlike the ELP regime), the BBA provides an exception in the event a partner notifies the Service of inconsistent

[202] Jt. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 2015*, JCS-1-16, at 51-83, 336-340 (2016) ("BBA Bluebook").
[203] Pub. L. No. 114-74, § 1001.
[204] *See*, *e.g.,* Jerald David August, *The Good, The Bad, and Possibly Ugly in the New Audit Rules: Congress Rescues the IRS from its Inability to Audit Large Partnerships*, 18 BUS. ENTITIES 4 (May/June 2016); Jerald David August, *Repeal of the TEFRA Entity Level Audit Rules Under the Bipartisan Budget Act of 2015: The Adoption of a New Paradigm for Assessing and Collecting Income Taxes from Partnerships*, 19 J. TAX PRAC. & PROC. 55 (Aug./Sept. 2016); Jerald David August & Terence Floyd Cuff, *The TEFRA Partnership Audit Rules Repeal: Partnership & Partner Impacts*, ALI-CLE VIDEO WEBCAST (June 7, 2016); Christian Brause, *New Partnership Audit Rules: Concepts and Issues, Part 1*, 151 TAX NOTES 621 (May 2, 2016); Christian Brause, *New Partnership Audit Rules: Concepts and Issues, Part 2*, 151 TAX NOTES 773 (May 9, 2016); Jennifer E. Breen & Sheri A. Dillon, *The Devil Is in the Details: The New "Streamlined" Partnership Procedures*," 32 TAX MGMT. REAL ESTATE J. 74 (March 2, 2016); J. Leigh Griffith, *New Partnership Audit and Collection Rules*, 94 TAXES 29 (Feb. 2016); Kate Kraus, *The Default Regime: Stranger Than Might First Appear*, 152 TAX NOTES 1395 (Sept. 5, 2016);Carol Kulish Harvey et al., *New Partnership Audit Rules – What We Know So Far, Part 1*, 152 TAX NOTES 829 (Aug. 8, 2016); Carol Kulish Harvey et al., *New Partnership Audit Rules – What We Know So Far, Part 2*, 152 TAX NOTES 991 (Aug. 15, 2016); Steven R. Mather, 624-3rd T.M., *Audit Procedures for Pass-Through Entities* § XIV; Fred F. Murray, *New Partnership Audit Rules Require Action Now in Respect to Partnership Agreements*, 19 J. PASSTHROUGH ENTITIES 9 (May/June 2016); Fred F. Murray, *New Partnership Audit Rules Affect Oil and Gas and Other Investment Partnerships*, 19 J. PASSTHROUGH ENTITIES 7 (Sept./Oct. 2016); Donald B. Susswein & Ryan P. McCormick, *Understanding the New Partnership Audit Rules*, 149 TAX NOTES 1171 (Nov. 30, 2015); Donald B. Susswein & Ryan P. McCormick, *Getting the Partnership Audit Rules Up and Running*, 151 TAX NOTES 495 (Apr. 25, 2016); Michael G. Wasserman, *A Fix Too Fast: Anomalies in the New Legislation on Partnership Tax Audits*, 124 J. TAX'N 118 (March 2016). In addition, many organizations have submitted lengthy comment letters on the BBA. *See*, *e.g.*, ABA Section of Tax'n, *Comments on Bipartisan Budget Act of 2015 Partnership Audit Procedures* (June 6, 2016) ("2016 ABA Report"), *available at* 2016 TNT 109-16; NYSBA Tax Section, *Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015* (May 25, 2016) ("2016 NYSBA Report").
[205] §§ 6222(a), 6222(b), 6222(e), 6232(d)(1)(B).

treatment.[206] Any resolution of an inconsistent position at the partner level is not binding on the partnership.[207]

- *Partnership-Level Proceedings*. As under TEFRA and ELP, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, any partner's distributive share thereof, and the applicability of any penalty, addition to tax or additional amount, are generally are determined at the partnership level.[208]

- *Partnership Representative.* The partnership must designate a partner (or other person) with a substantial presence in the United States to have sole authority to act on behalf of the partnership in all proceedings, and if the partnership fails to do so the Service is authorized designate any person to serve as the representative.[209]

- *No Partner Rights to Notice or to Initiate or Participate in Proceedings.* The Service sends notice of proceedings and adjustments to the partnership and the partnership representative, but has no obligation to provide notice to individual partners.[210] Partners have no statutory rights individually to initiate or participate in administrative or judicial proceedings (including settlement conferences and claims for refunds), or even to be kept informed of such proceedings by the partnership representative.[211]

- *Tax Assessed and Collected from Partnership*. Any tax attributable to items of income, gain, loss, deduction, or credit of the partnership is generally assessed and collected at the partnership level (not the partner level).[212]

    - *Tax Imposed as a Tax for the Current Year (Not Reviewed Year).* Tax is assessed and collected in the same manner as if it were a tax imposed in the "adjustment year" (generally, the year the notice of the final partnership adjustment is mailed unless the partnership disputes the adjustment in court).[213]

    - *Calculation of Imputed Underpayment*. In general, one calculates the tax payable by the partnership, which is called an "imputed underpayment," by netting the

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[206] § 6222(c).
[207] § 6222(d).
[208] §§ 6221(a), 6233(a)(3). Departing from the TEFRA and ELP regimes, the BBA's scope does not turn on the defined term, "partnership item," and the BBA does not distinguish between "partnership items," "affected items," and "nonpartnership items." *See* BBA Bluebook, at 57. The BBA does not say anything about partner-level proceedings.
[209] § 6223. TEFRA required that the "tax matters partner" be a partner, Pre-BBA § 6231(a)(7), while ELP permitted the partnership to designate a non-partner as the representative (but required than any representative designated by the Service be a partner). Pre-BBA § 6255(b)(1).
[210] § 6231.
[211] §§ 6223, 6227, 6234.
[212] §§ 6221(a), 6225(a)(1), 6232(a).
[213] §§ 6232(a), 6225(d)(2). While not explicitly addressed in the statute, presumably basis and capital account adjustments would likewise be reflected by the adjustment-year partners in the adjustment year. *See*, *e.g.*, BBA Bluebook, at 79 (discussing basis adjustments); 2016 ABA Report, at 44-45; 2016 NYSBA Report, at 41-53; 1994 NYSBA Report, at § IV.I.

adjustments to the income and loss items of the partnership and multiplying the amount by the highest individual or corporate tax rate for the reviewed year.[214] In the case of any adjustment that reallocates the distributive share of an item from one partner to another, however, the calculation of the imputed underpayment disregards the decrease in income (or increase in loss) for the other partner.[215]

- *Reduction of Imputed Underpayment*. The imputed underpayment may be modified through procedures to be fleshed out in regulations, including the filing of amended returns by reviewed-year partners,[216] the determination of the imputed underpayment without regard to the portion allocable to a tax-exempt partner,[217] and modification of the applicable highest rates for certain types of income allocable to certain types of partners.[218]

- *Interest and Penalties*. Interest and penalties are determined at the partnership level, and the partnership is liable for such amounts.[219] Interest accrues at the rate applicable to underpayments.[220] Penalties are determined as if the partnership were an individual, and the imputed underpayment were an actual underpayment (or understatement) for the reviewed year.[221] Failure to pay the imputed

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[214] § 6225(b)(1). The Joint Committee on Taxation states that "[n]etting is done taking into account applicable limitations, restrictions, and special rules under present law." PATH Act Explanation, at 249; BBA Bluebook, at 63. Unfortunately, the examples of netting offered by the Joint Committee address relatively simplistic scenarios in which the items available for netting are all of the same character and "not subject to differing limitations or restrictions." *See* BBA Bluebook, at 63-64. The BBA Bluebook does not consider, for instance, a scenario where, after grouping items by character, the partnership has ordinary income and a capital loss. Nor does it address what happens if an item of deduction or loss is subject to partner-level limitations (e.g., §§ 704(d), 465, and 469), in which case netting could reduce the imputed underpayment by a nondeductible item that was underreported (i.e., by means of offsetting income included in the imputed underpayment calculation) or increase the imputed underpayment by a nondeductible item that was overreported. Even when items are of the same character and not subject to differing limitations or restrictions, netting can lead to incorrect results depending on the allocations (e.g., a partnership has overreported some income and underreported other income, but the overreported income was allocated to one partner and the omitted income should have been allocated to another partner). Note also that the statute's use of §§ 1 and 11 to determine the highest applicable tax rate may understate tax insofar as it does not take into account tax on self-employment income under § 1401 or tax on net investment income under § 1411.

[215] § 6225(b)(2); BBA Bluebook, at 64-65.

[216] § 6225(c)(2); BBA Bluebook, at 66. In the case of an adjustment that reallocates the distributive share of any item from one partner to another, a reduction in the imputed payment is available only if amended returns for the reviewed year are filed by *all* partners affected by the adjustment (even partners who are allocated less income or more loss). § 6225(c)(2)(B).

[217] § 6225(c)(3); BBA Bluebook, at 66.

[218] §6225(c)(4); BBA Bluebook, at 67-68. Section 6225(c)(6) authorizes the issuance of regulations or guidance to allow for additional factors to be taken into account in adjusting the imputed underpayment, which factors "are necessary or appropriate carry out the function of the modification provisions, that is to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income to the income of the partnership and partners." BBA Bluebook, at 65-66. The PATH Act amended the statute to add one such additional factor (relating to passive losses of a publicly traded partnership subject to § 469(k)). *See* § 6225(c)(5).

[219] § 6233(a)(1).

[220] §§ 6233(a)(2), 6621(a)(2).

[221] § 6233(a)(3).

underpayment tax in the adjustment year starts a new round of interest and penalties.[222]

- *No Deduction*. No deduction is permitted for any payment required to be made by the partnership,[223] nor is any deduction permitted for payments arising under an indemnification agreement with respect to nondeductible amounts paid by the partnership.[224]

- *Adjustments Not Resulting in Underpayments*. Any adjustment that does not result in an imputed underpayment is taken into account in the adjustment year (and is therefore allocated to adjustment-year partners) as a decrease in non-separately stated income or an increase in non-separately stated loss (or, if the item is a credit, as a separately stated item).[225]

- *Election to Flow Adjustments Through to Reviewed-Year Partners*. In lieu of the partnership paying the imputed underpayment under Section 6225, the partnership may elect to apply Section 6226, and furnish the Service and each reviewed-year partner a statement of the partner's share of any adjustment to income, gain, loss, deduction and credit as determined in the notice of final partnership adjustment.[226]

  - *Tax Imposed as a Tax for the Current Year (Not Reviewed Year).*The tax of a reviewed-year partner is increased for the partner's taxable year that includes the date of the Section 6226 statement.[227]

  - *Calculation of Reviewed-Year Partners' Tax.* The partner's increase in tax equals the aggregate of the "adjustment amounts," which include (i) the amount by which the partner's tax would increase if the partner's distributive share of the adjustments were included for the partner's taxable year that includes the end of the reviewed year, plus (ii) for each intervening year between the reviewed year and the year of the Section 6226 statement, the amount by which the partner's tax

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[222] § 6233(b).
[223] § 6241(4). Making the payment of tax and penalties nondeductible is consistent with generally applicable rules, *see* §§ 275(a)(1), 162(f), but denying interest deductions puts corporate partners in a worse position than if they had paid tax directly.
[224] BBA Bluebook, at 79.
[225] § 6225(a)(2). Without citing any statutory authority, the BBA Bluebook states that it may also be appropriate to treat the amount of an adjustment as a reduction (or increase) in a separately stated amount of income. BBA Bluebook, at 63. For a discussion of whether § 6225(a)(2) applies only if the proceeding does not result in any imputed underpayment, or whether it could apply to the extent netting results in no imputed underpayment for items of one character (but an an imputed underpayment for items of another character), see 2016 NYSBA Report, at 69-70, 73-74.
[226] § 6226(a). The BBA Bluebook provides some discussion of the time and manner of making the election, as well as the time and manner of furnishing Section 6226 statements and the substance of such statements. *See* BBA Bluebook, at 69-70.
[227] § 6226(b)(1).

would increase by reason of adjustment to tax attributes.[228] Tax attributes in any subsequent year are appropriately adjusted.[229]

- *Interest and Penalties.* Interest is determined at the partner level, computed at a rate that is 2% higher than the normal rate applicable to underpayments.[230] Penalties are still determined at the partnership level, but the reviewed-year partners are liable for such amounts.[231]

- *Treatment of Tiered Partnerships*. Application of Section 6226 in the context of tiered partnerships is uncertain. The 2015 Bluebook states that Section 6226 permits the audited partnership to push the liability up one tier, and the upper-tier partnership receiving a Section 6226 statement pays tax as if it were an individual.[232]

- *Administrative Adjustment Requests*. An administrative adjustment request ("AAR") is the BBA version of an amended tax return or claim for refund. An AAR must be filed within three years after the later of (i) the date the partnership return was filed or (ii) the last day for filing the partnership return for the year (determined with regard to extensions), but in no event can an AAR be filed after notice of an administrative proceeding with respect to a year has been mailed.[233] Whereas TEFRA permitted any partner to initiate an AAR, under the BBA only the partnership can make an AAR.[234] Any adjustment is taken into account for the partnership tax year in which the AAR is made, not the year to which the adjustments relate.[235] If an AAR would result in an imputed underpayment, it is taken into account either by the partnership (under rules similar to the general rules for imputed underpayments under Section 6225, with the

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[228] §§ 6226(b)(2), 6226(b)(3)(A). The calculation of "adjustment amounts" applies "tax imposed under chapter 1," which does not include tax on self-employment income under § 1401 (chapter 2) or tax on net investment income under § 1411 (chapter 2A). In addition, by taking into account *increases* in tax due by a reviewed-year partner in each of the intervening years, but not *decreases* in tax due in intervening years, the adjustments amounts can result in significant double taxation (e.g., if items are reallocated to different partners, if items are reallocated across taxable years, or if the partnership interest of a reviewed-year partner is disposed of prior to the year of the Section 6226 statement). *See* 2016 NYSBA Report, at 86-92.

[229] § 6226(b)(3)(B).

[230] § 6226(c)(2).

[231] § 6226(c)(1).

[232] BBA Bluebook, at 70. Commentators have identified textual and policy issues with this reading of the statute, including that § 6226(b)(2) defines adjustment amounts by reference to "the amount by which the tax imposed under chapter 1 would increase," but a partnership is not itself subject to tax under chapter 1. *See*, *e.g.*, 2016 NYSBA Report, at 105-120; Carol Kulish Harvey et al., New Partnership Audit Rules – What We Know So Far, Part 1, 152 TAX NOTES 82 , 846-847 (Aug. 8, 2016); Donald B. Susswein & Ryan P. McCormick, *Getting the Partnership Audit Rules Up and Running*, 151 TAX NOTES 495, 499-500 n.10 (April 25, 2016). Pointing to language in the BBA Bluebook, some have suggested that an upper-tier partnership may use the administrative adjustment request mechanism in § 6227 to push out to its reviewed-year partners their shares of an adjustment from a lower-tier partnership that elects into § 6226. *See generally* BBA Bluebook, at 71; Carol Kulish Harvey et al., *New Partnership Audit Rules – What We Know So Far, Part 1*, 152 TAX NOTES 82 , 847-849 (Aug. 8, 2016); Donald B. Susswein & Ryan P. McCormick, *Getting the Partnership Audit Rules Up and Running*, 151 Tax Notes 495, 499-501 (April 25, 2016).

[233] § 6227(c).

[234] § 6227(a).

[235] § 6227(b).

imputed underpayment paid by the partnership when the AAR is filed),[236] or by the partnership and the partners (under rules similar to the rules of Section 6226).[237] In the case of an adjustment regarding an AAR that would not result in an imputed underpayment, any refund is not paid to the partnership; rather it is pushed out to the reviewed-year partners pursuant to procedures similar to the furnishing of Section 6226 statements.[238]

- *Statute of Limitations*. In general, the Service may adjust an item on a partnership return at any time within three years of the later of (i) the date the partnership return was filed, (ii) the partnership return was due, or (iii) the date on which the partnership files an AAR under Section 6227 with respect to such year.[239] The partnership representative may extend this period by agreement with the Service without consent from partners.[240] It is also extended in the case of fraud, a substantial omission of income by the partnership, or failure to file a partnership return.[241] If the imputed underpayment is modified under Section 6225(c), the period remains open until the date that is 270 days after all required information is submitted to the Service.[242] If there is a notice of proposed partnership adjustment under Section 6231(a)(2), the period remains open until 330 days after the date of such notice (plus the number of days of any extension consented to by the Secretary under Section 6225(c)(7)).[243]

- *Partnership Ceases to Exist*. If a partnership "ceases to exist" before a partnership adjustment takes effect, the adjustment is taken into account by the former partners under regulations to be issued.[244]

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[236] §§ 6227(b)(1), 6232(a). The partnership can apply analogous procedures for most of the modifications of an imputed underpayment under § 6225(c), but not the modification for the filing of amended returns by reviewed-year partners under § 6225(c)(2). § 6227(b)(1).
[237] § 6227(b)(2). However, interest is computed at the underpayment rate without the extra 2% bump under § 6226(c)(2)(C). *Id.*
[238] § 6227(b) (flush language); BBA Bluebook, at 71. As described above, outside the context of an AAR, an adjustment that does not result in an imputed underpayment generally increases losses or reduces income allocable to adjustment-year partners. *See* § 6225(c)(2).
[239] § 6235(a)(1). In contrast to the BBA's treatment of an AAR for statute of limitations purposes, the filing of an amended return by a corporate or individual taxpayer generally does not extend the statute of limitations. *See Badaracco v. Comm'r*, 464 U.S. 386 (1984); *Zellerbach Paper Co. v. Helvering,* 293 U.S. 172 (1934); *but see* § 6501(c)(7) (When a taxpayer files within the sixty-day period ending with the due date of the return, a written document signed by the taxpayer showing that the taxpayer owes an additional tax for the taxable year, the period for the assessment for the additional tax does not expire until sixty days after the Service received the document reporting the additional tax from the taxpayer).
[240] §§ 6235(b), 6223(b).
[241] § 6235(c)
[242] § 6235(a)(2).
[243] §6235(a)(3).
[244] § 6241(7). The BBA Bluebook states that if a partnership terminates under § 708(b)(1)(A) it ceases to exist for this purpose, but if a partnership terminates under § 708(b)(1)(B) the successor partnership succeeds to the adjustment or imputed underpayment, absent regulations to the contrary. It also notes that regulations may treat a partnership as ceasing to exist in other circumstances or based on other factors (e.g., the partnership "has no significant income, revenue, assets, or activities at the time the partnership adjustment takes effect"). BBA Bluebook, at 80.

- *Election Out*. A partnership has the option to elect out of the BBA for a particular year if (i) it is required to issue no more than 100 Schedules K-1 in that year and (ii) each of its partners is an individual, a deceased partner's estate, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, or an S corporation (provided special rules are met that take into account indirect interests of the S corporation's shareholders in applying the 100-of-fewer requirement).[245] Administrative guidance may expand the list of permissible partners.[246]

VII. Building a Better BBA

[To be added following input from UofC panel discussion. Please see posted slides for sketch of proposal.]

[245] § 6221(b); BBA Bluebook, at 58-61.

[246] § 6221(b)(2)(C). The Joint Commitee contemplates that such other types of partners would be subject to "rules similar to the special rules in the case of a partner that is an S corporation," taking into account, *inter alia*, direct and indirect interests for purposes of the 100-or-fewer requirement. *See* BBA Bluebook, at 59-60.