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August 1, 2017

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Internal Revenue Service
CC:PA:LPD:PR (REG-136118-15)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments on Proposed Regulations Regarding Implementing Centralized Partnership Audit Regime

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "IRS" or "Service") in the Notice of Proposed Rulemaking (REG-136118-15) issued on June 13, 2017 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the implementation of the new centralized partnership audit regime (the "Centralized Audit Regime") enacted by section 1101 of the Bipartisan Budget Act of 2015, as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL

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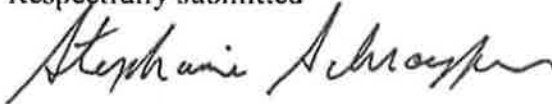
We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted



Stephanie S. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosures

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COMMENTS ON PROPOSED REGULATIONS IMPLEMENTING CENTRALIZED PARTNERSHIP AUDIT REGIME

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Richard L. Hunn, Co-Chair of the Tax Controversy Committee, Leonora S. Meyercord, Vice Chair of the Partnership and Real Estate Tax Committee, and Crawford Moorefield, Chair of the Energy and Natural Resources Tax Committee. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Jeffry M. Blair, Co-Chair of COGS, reviewed these Comments. Mary A. McNulty, Past Chair of the Tax Section and member of the Past Chair Advisory Board, reviewed the Comments and made substantive suggestions on behalf of COGS.

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

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I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's request for comments regarding the Proposed Regulations, proposed rules concerning the implementation of the new Centralized Audit Regime which was enacted into law on November 2, 2015 by section 1101 of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (the "BBA"), as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, div. Q (the "PATH Act"). The BBA repeals the current rules governing partnership audits, including those enacted under the Tax Equity and Fiscal Responsibility Act ("TEFRA"), for tax years beginning

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after December 31, 2017. The BBA replaces those rules with a centralized audit regime that generally provides for assessment and collection of tax at the partnership level rather than the partner level. We appreciate the opportunity to comment on the Proposed Regulations.

II. ELECTION OUT FROM CENTRALIZED AUDIT REGIME AND DISREGARDED ENTITIES

Section 6221(b)[1] provides that partnerships with 100 or fewer partners may elect out of the Centralized Audit Regime ("Election Out"). For purposes of determining whether a partnership has 100 or fewer partners, partners that are individuals, domestic C corporations, foreign entities that would be treated as C corporations if they were domestic, and estates of deceased partners are counted as partners.[2] S corporations are looked through with each shareholder of an S corporation treated as a partner for purposes of meeting the 100 or fewer partners test.[3]

Section 6221(b) does not specifically address whether an entity that is disregarded as separate from its owner for federal tax purposes under existing regulations (a "DRE") would be treated as an ineligible type of partner that would cause the partnership automatically to be ineligible for the Election Out, or separately counted as an additional partner for purposes of the Election Out's 100 partner limit. However, Section 6221(b)(2)(C) provides flexibility to Treasury and the IRS to prescribe regulations allowing for additional kinds of partners not described in Section 6221(b)(1)(C) and to create rules for counting the number of partners in a manner similar to the rules for S corporations.

Under the Proposed Regulations, a partnership, a trust, a foreign entity that would not be treated as a C corporation if it were a domestic entity, "a disregarded entity described in §301.7701-2(c)(2)(i) [DRE]," a nominee or other similar person, or an estate of an individual other than a deceased partner would not be treated as an "eligible partner" for purposes of qualifying for the Election Out.[4] This would result in any partnership with one or more such ineligible partner being unable to make an Election Out. The preamble to the Proposed Regulations states that Treasury and the IRS "have declined in these proposed regulations to exercise the authority under section 6221(b)(2)(C) to expand the types of entities that are eligible partners for purposes of the election out rules or to create separate election out provisions for specific partnership structures." Treasury and the IRS gave the following reasons for this decision:

> . . . When a partnership elects out of the centralized partnership audit regime, the IRS must examine and assess tax with respect to each ultimate partner under the deficiency procedures under subchapter B of chapter 63. Enactment of TEFRA was a reaction to the complexity and burden of these deficiency procedures with respect to partnerships. The

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[1] Unless otherwise indicated, all "Section" or "§" references are to the Internal Revenue Code of 1986, as amended (including amendments enacted under the BBA and the PATH Act).

[2] § 6221(b)(1)(C).

[3] *Id.* The S corporation is also required to furnish additional information with respect to each such S corporation shareholder.

[4] *See* Prop. Reg. §§ 301.6221(b)-1(b)(3)(ii) and (iii).

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increasing number and complexity of partnerships since TEFRA was enacted revealed that the TEFRA procedures were inadequate for the IRS to effectively audit partnerships. The centralized partnership audit regime is intended to enhance the IRS's ability to examine partnerships, particularly large and highly tiered partnerships. If the proposed regulations broaden the scope of the election out provisions to include additional types of partners or partnership structures, the IRS will face additional administrative burden in examining those structures and partners under the deficiency rules. Comments on any potential expansion of the election out rules are particularly helpful if they address the additional burdens any such expansion would impose on the IRS and not just the decreased burden on taxpayers resulting from the suggested change.

Generally, we understand Treasury's and the IRS's concerns insofar as they relate to expansion of the Election Out to include as eligible partners entities such as partnerships and nominees. We believe the concerns regarding those entities are potentially significant and that expansion of the Election Out to include them could result in a substantial increase in the IRS's administrative burdens.

However, we respectfully disagree that allowing the Election Out for DREs would pose substantial administrative burdens for the IRS. Under existing law, DREs are generally disregarded as separate from their owners for federal tax purposes.[5] We respectfully recommend that the IRS simply look through the DRE and look at the sole owner to determine whether that owner is an eligible partner for the Election Out. As a legal matter, treatment of DREs as not separate from their owners for purposes of the Election Out would not represent an expansion of partnerships eligible for the Election Out. As a practical matter, the IRS could require a DRE to supply the applicable information with respect to the DRE's sole owner, similar to an S corporation. Any additional burden from allowing a partnership with DREs to elect out would fall on taxpayers and not on the IRS.

The IRS had previously relied on Congress's definition of the term "pass-thru partner" at former Section 6231(a)(9) in ruling that a DRE's separate existence was taken into account for purposes of determining whether a partnership was eligible for the small partnership exception under TEFRA.[6] These rules also prevented partnerships with an S corporation as a partner from qualifying for the small partnership exception.[7] Former Section 6231(a)(9) has been repealed, and S corporations are now allowed to be partners of partnerships that may make an Election Out. We respectfully recommend that Treasury and the IRS further consider whether it would be appropriate to permit partnerships with S corporation partners to be eligible for the Election Out while denying that same option to partnerships with DREs as partners. Although an S corporation may not have a partnership as a shareholder, whereas a DRE may be wholly-owned by a partnership, this difference would not result in any additional administrative burden on the

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[5] *See* Treas. Reg. § 301.7701-2(c)(2)(i).

[6] *See* Rev. Rul. 2004-88, 2004-2 C.B. 165.

[7] § 6231(a)(9).

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IRS. A partnership with a DRE partner that is wholly-owned by a partnership would not be eligible to make the Election Out.[8]

If partnerships with DREs as partners are categorically excluded from eligibility, the adverse effect on taxpayers would be very substantial. For more than two decades, taxpayers have relied on the check-the-box regulations for purposes of their tax planning, creating entities that they understood would be disregarded as separate from their owners for virtually all federal tax purposes. Taxpayers have relied on this treatment to provide state law liability protection while understanding that DREs would be ignored for federal income tax purposes and their owners would remain fully responsible for the federal income taxes for their portions of partnership income. If Proposed Regulations section 301.6221(b)-1(b)(3)(ii)(D) is adopted as proposed, the burden on taxpayers to reorder their affairs would likely be very substantial, resulting in a new wave of tax planning by taxpayers to undo unintended and unanticipated consequences of elections they made years ago. Moreover, the provision, as proposed, creates a potential trap for the unwary. Those who relied on the promise of Treasury Regulations section 301.7701-2(c)(2)(i) that their entity will be disregarded for federal tax purposes may be terribly surprised to find that their entity would not be disregarded under the partnership audit rules as described in an entirely separate set of regulations. This would create a difficult choice for taxpayers in having to choose between a structure that is beneficial for non-federal income tax purposes and one that would be best for federal partnership income tax audit purposes. It could also result in some partnerships refusing to admit partners who own their interests through DREs.

The Joint Committee on Taxation (the "Joint Committee") explained that Treasury and the IRS could prescribe regulations allowing partnerships with certain types of partners, including DREs, to remain eligible for the Election Out.[9] The Joint Committee included a specific example for DREs, as follows:

> For example, assume that a partner of a partnership is a disregarded entity such as a State-law limited liability company ("LLC") with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole shareholder, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer statements criterion is met.[10]

We agree with the Joint Committee's suggestion that DREs be disregarded for purposes of determining who is the applicable partner of the partnership with respect to the Election Out. Consequently, we respectfully recommend that Treasury and the IRS follow the approach set out by the Joint Committee and ignore a DRE's separate existence from its owner for purposes of determining whether the partnership in which it is a partner is eligible for the Election Out.

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[8] Under I.R.C. § 6221(b)(1)(C), a partnership with a partnership as a partner is not eligible to make the Election Out.

[9] Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in 2015 59-60 (Comm. Print 2016).

[10] *Id.* at 60.

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However, we believe that, with regard to the 100 partner limit, it would more appropriate if the separate existence of the DRE were disregarded and only the owner of the DRE were counted for purposes of the limit. We believe this approach is appropriate because the 100 partner limit is ordinarily determined based on the number of Schedule K-1s (or equivalent) issued by the partnership and its partners.[11] There does not appear to be any federal income tax authority that would require a partnership with a DRE partner to issue separate Schedule K-1s to both the DRE and its owner.[12] Because only one Schedule K-1 is appropriately issued with respect to a DRE partner, it seems appropriate to count as only one partner for purposes of the 100 partner limit.

Although we believe that not counting a DRE is the better approach, we understand that Treasury and the IRS may feel constrained to follow the approach recommended by the Joint Committee to count both the DRE and its owner for purposes of the 100 partner limit. In that case, we believe that such an approach would still be more appropriate than the current Proposed Regulation approach of not allowing a partnership with a DRE to be eligible for the Election Out.

III. PARTNERSHIP REPRESENTATIVE

A. Partnership Representative Designation

Under the Centralized Audit Regime, a partnership designates a partnership representative (the "Partnership Representative") who is the only person that has the authority to act on behalf of the Partnership in connection with partnership audits, adjustments, assessments, and collection.[13] The Partnership Representative's authority is expansive, and the Partnership Representative's actions are binding on all former and current partners.[14] The Proposed Regulations provide that a partnership may designate as the Partnership Representative any person (including an entity) that has a substantial presence in the United States and the capacity to act.[15]

However, there is currently no provision in the Proposed Regulations or statute requiring that the designated person accept the designation as Partnership Representative. Given the importance of communication between the IRS and the Partnership Representative for an efficient and effective administrative proceeding and the expansive authority of the Partnership Representative,[16] we think it is critical that the Partnership Representative agree to serve. We recommend that the Proposed Regulations, as finalized, require the Partnership Representative to be named in the operative documents or to accept the designation. Such acceptance could be evidenced on the tax return by adding a box that the Partnership would check to confirm the

[11] §§ 6221(b)(1)(B) and 6221(b)(2)(A)(ii).

[12] By contrast, an S corporation is respected as a partner of a partnership, and the partnership is required to issue a Schedule K-1 to the S corporation. Therefore, the Proposed Regulations appropriately require that both the Schedule K-1 issued to the S corporation by the partnership and the Schedule K-1s issued by the S corporation to its shareholders be counted. Prop. Reg. §§ 301.6221(b)-1(b)(2)(iii), Ex. 4.

[13] § 6223(a).

[14] § 6223(b).

[15] Prop. Reg. § 301.6223-1(b)(2), (b)(3) and (b)(4).

[16] *See* Proposed Regulations, Preamble at Explanation of Provisions, Section 4.A (recognizing that communication between the IRS and the Partnership Representative is fundamental to an efficient administrative proceeding).

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named Partnership Representative agreed to serve as the Partnership Representative. If this box were not checked, the Proposed Regulations, as finalized, could allow the IRS to designate the Partnership Representative.

Having the Partnership Representative agree to serve would help avoid delays on the initiation of an audit. If the Partnership Representative has not agreed to serve, the Partnership Representative—when faced with the significant responsibilities of representing the partnership in an IRS audit that will bind both current and former partners—may be more likely to promptly resign. This could delay the audit while the partnership or IRS designates a successor.

B. Multiple Partnership Representatives in a Multi-Year Audit

The Proposed Regulations provide that the partnership must designate the Partnership Representative on the partnership's return each year, and the partnership must designate a Partnership Representative separately for each taxable year.[17] Consequently, in a multi-year audit, the partnership may have a different Partnership Representative for each year under audit, which may lead to confusion, a duplication of resources and a lack of coordination in the administrative proceeding. To improve the efficiency of a multi-year audit involving multiple Partnership Representatives, we recommend that the Proposed Regulations, as finalized, permit the IRS to require the partnership to designate one Partnership Representative to act as the Partnership Representative for all of the years under audit.[18] If the partnership fails to make such a designation following an IRS request, the IRS would be permitted to designate the Partnership Representative from those named by the partnership for the different years under audit.

C. Factors for IRS Designation of Partnership Representative

The Proposed Regulations provide that when the IRS determines that the designation of a Partnership Representative is not in effect and the partnership fails to designate a successor, the IRS may designate a Partnership Representative. Proposed Regulations section 301.6223-1(f)(5)(ii) provides that the IRS may designate any person as the Partnership Representative and indicates that in addition to other factors, the IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year (as defined in Proposed Regulations section 301.6241-1(a)(8)) or at the time the partnership representation designation is made. In addition, the IRS may consider the following factors when designating a person as the partnership representative:

- The views of the partners having a majority interest in the partnership regarding the designation;
- The general knowledge of the person in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership; and

[17] Prop. Reg. § 301.6223-1(c).

[18] The recommendation that the Partnership Representative be named in the operative documents or accept the designation on the return may also reduce the likelihood that the partnership will designate a different Partnership Representative each year.

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- Whether the person is a United States person (within the meaning of Section 7701(a)(30)).[19]

In the absence of a suitable partner from the reviewed year or at the time of the designation, this provision does not provide any real constraints on the exercise of the IRS's discretion. It does not require that the IRS ordinarily consider any specific factors, but instead provides only that the IRS **may** consider the four enumerated factors. To provide some reasonable limits on the IRS's discretion, we respectfully recommend that Proposed Regulations section 301.6223-1(f)(5)(ii) be revised as follows:

> (ii) *Factors considered when partnership representative designated by the IRS.* The IRS may designate any person to be the partnership representative. In addition to other relevant factors, the IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year (as defined in §301.6241-1(a)(8)) or at the time the partnership representative designation is made. The IRS ~~may~~ will ordinarily consider one or more of the following factors when designating a person as the partnership representative:
>
> (A) The views of the partners having a majority interest in the partnership regarding the designation;
>
> (B) The general knowledge of the person in tax matters and the administrative operation of the partnership;
>
> (C) The person's access to the books and records of the partnership;
>
> (D) Whether the person is a United States person (within the meaning of section 7701(a)(30)).

IV. COMPUTATION OF THE IMPUTED UNDERPAYMENT

The Proposed Regulations provide detailed rules regarding the calculation of the imputed underpayment, and the examples illustrating these rules are very helpful. The Proposed Regulations, however, delete Example 3 that was included in section 301.6225-1(f) of the unofficial Proposed Regulations that were released in January, 2017. While we identified a math error in that example, the example was helpful in illustrating the calculation of the imputed underpayment in a situation in which an adjustment reallocates an item from one partner to another. We respectfully recommend that this example be included as corrected below.

Example 3 in the unofficial Proposed Regulations provided as follows (underline added):

> *Example 3.* Partnership has two partners, A and B. Under the partnership agreement, among other items allocated to the partners, $30 of ordinary income and $70 of depreciation are specially allocated to B for the 2019 taxable year. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines that the $30 of ordinary income and $70 of depreciation should be

[19] Prop. Reg. § 301.6223-1(f)(5)(ii)(A)-(D).

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reallocated from B to A. The partnership adjustment is a decrease of $30 of ordinary income (<$30> adjustment) and a decrease of $70 of depreciation ($70 adjustment) allocated to B and a corresponding increase of $30 ordinary income ($30 adjustment) and $70 of depreciation (<$70> adjustment) allocated to A. Pursuant to paragraph (d)(2)(ii) of this section, for purposes of determining the imputed underpayment, the adjustments to the distributive shares of A and B are grouped separately. The increases and decreases to depreciation are treated as decreases and increases, respectively, of ordinary income. As a result, the net $40 of income ($70 ordinary income plus <$30> ordinary income) allocated to B is the total netted partnership adjustment. The $40 increase is then multiplied by 40 percent, which results in an imputed underpayment of $28. The net decrease of income of $40 ($30 ordinary income plus <$70> ordinary income) reallocated to A is disregarded for purposes of determining the imputed underpayment. The $30 of ordinary income and the $70 of deductions reallocated to A are partnership adjustments that do not result in an imputed underpayment.

We believe that the underlined portion above contains the math mistake. As indicated in the first part of the sentence, the forty percent (40%) tax rate applies to the $40 netted amount.[20] Thus, we believe that based on the wording of the example, the imputed underpayment is $16, rather than $28. Once corrected, we believe this example would be helpful in illustrating the rules for calculating an imputed underpayment in a situation in which an adjustment reallocates an item from one partner to another.

Accordingly, we respectfully recommend that Proposed Regulations § 301.6225-1(f) be revised to include the example above as corrected to reflect the imputed underpayment as $16 rather than $28 or clarified to make it clear how the $28 figure was calculated.

V. MODIFICATION BY PARTNERS FILING AMENDED RETURNS

The Proposed Regulations provide that the IRS will not accept modification of the partnership's imputed underpayment under Section 6225(c) with respect to an amended return if the partner for whom the modification is sought would owe tax and the period of limitations for assessment with respect to that return has expired.[21] Specifically, Proposed Regulations section 301.6225-2(d)(v)(A) provides:

> (v) *Period of limitations must be open*—(A) *In general.* Except as described in paragraph (d)(2)(v)(B) [allowing modification if a refund is claimed] of this section, the IRS will not accept modification under paragraph (d)(2) of this section with respect to any amended return if the period of limitations on assessment under section 6501 with respect to the partner's taxable year for which the amended return is being filed has expired. For modification with respect to years for which a partner's period of limitations on assessment under section 6501 has expired, see §301.6225-2(d)(8) (regarding closing agreements).

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[20] *See* Prop. Reg. § 301.6225-1(d)(2)(ii) (allowing for items in the reallocation grouping allocable to a partner to be placed into subgroupings and netted).

[21] Prop. Reg. §301.6225-2(d)(2)(v).

As was explained in the preamble to the Proposed Regulations, Congress expressly allowed modification with respect to amended returns for which a refund is claimed, even though the period of limitations for claiming a refund under Section 6511 has expired.[22] In contrast, Congress did not similarly provide such relief when an assessment and payment of tax is involved and the period of limitations for assessment for the partner in question has expired.

Consequently, modification procedures to reduce the amount of imputed tax that would be owed will not be available with respect to partners whose assessment statutes of limitation have expired. For this reason the preamble cautions, "[a]ny partner that files an amended return for modification purposes and is required to make a payment of any kind with that amended return must do so prior to the expiration of the period of limitations under section 6501 for the modification year(s)."[23] Unfortunately, partners would have little control over when they can file amended returns for modification purposes, because the timing of such filings would depend upon the timing of the IRS's determination of the imputed underpayment.

In the preamble, Treasury and the IRS suggest one way to ameliorate the problem, as follows:

> . . . Nothing in the proposed regulations prevents partners from signing an extension of the period of limitations for partnership adjustments at the time the IRS initiates the partnership administrative proceeding or at any other time prior to the expiration of the period of limitations under section 6501. The IRS recognizes that securing such extensions may not be possible in all cases, but doing so may be an option for certain partners and partnerships.[24]

This approach will prove workable only if the IRS in some manner periodically solicits consents to extend the period of limitations for assessment with respect to the partners. Taxpayers do not control the IRS's solicitation of consent forms. In fact, a search for Form 872 on the IRS website does not yield the standard IRS consent forms used for extending the period of limitations. Consequently, placing the burden on the partners to extend the period of limitations for assessment is not a workable solution.

If a partner's period of limitations for assessment has expired, the alternatives for obtaining relief seem speculative or inadequate. The preamble suggests that "[a] partner may, for example, be able to enter into a closing agreement that allows for treatment similar to an amended return and to make a payment on behalf of the partnership's liability in recognition of what the partner would have filed and paid if the partner's assessment period had not already expired."[25] It is not at all clear whether and why the IRS would agree to this procedure when a partner's period of limitations for assessment has expired. Alternatively, the preamble suggests that "partners and the partnership may choose to make other arrangements where the partner pays the imputed underpayment on behalf of the partnership outside of the modification

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[22] *See* Proposed Regulations, Preamble, Background, Section 2.E; *see also* §6225(c)(2)(A)(i) (which allows such modifications "notwithstanding section 6511").

[23] Proposed Regulations, Preamble, Explanation of Provisions, Section 5.D.i..

[24] *Id.*

[25] *Id.*

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procedures."[26] While this may provide a mechanism for a partner, rather than the partnership, to pay a share of the imputed underpayment, it seems unlikely that a partner could secure an agreement from the partnership to pay anything less than his or her share of the full amount of the imputed underpayment when the partner's assessment period of limitations has expired and made modification unavailable.

Consequently, we believe the best approach would be to try from the outset to avoid having the problem occur. We therefore respectfully recommend that the Proposed Regulations include a requirement that, at the time the IRS initiates the partnership administrative proceeding and at such times as the IRS solicits consents to extend the partnership's period of limitations pursuant to Section 6235(b), the IRS provide the Partnership Representative with the consent form for extending the period of limitations for assessment with respect to partners, together with contact information for a person to contact at the IRS regarding partner-level extensions. If the Partnership Representative provides the form and contact information to the partners, a partner seeking to extend the period of limitations could then complete the form and provide it to the contact person at the IRS.

VI. CONSEQUENCES OF FAILURE TO FURNISH STATEMENTS IN PUSH-OUT ELECTION

Under Section 6226 and Proposed Regulations section 301.6226-2, a partnership that makes a push-out election under Section 6226 must furnish statements to the reviewed year partners with each partner's share of partnership adjustments. Proposed Regulations section 301.6226-2(b) requires the partnership to mail the statement to the current or last known address of the partner and—if a statement is returned—undertake reasonable diligence to identify the reviewed year partner's correct address.

The Proposed Regulations do not, however, address the consequences of the partnership's failure to properly furnish the required statement to a partner. We respectfully recommend that the Proposed Regulations clarify that, in such a situation, the push-out election is still generally effective with respect to the other reviewed year partners, but the partnership is liable for the tax attributable to the partner to which the partnership failed to properly furnish the statement. This will protect the IRS's ability to collect with respect to the incorrectly furnished statement while preserving the push-out election with respect to the other partners. It would be administratively impractical for the failure to furnish a statement to invalidate the entire push-out election because the partners that received the statement may have already filed amended returns and paid the tax due before the mistake is realized.

This change can be accomplished by adding the following new sentence to the end of Proposed Regulations section 301.6226-1(c)(2): "If a partnership fails to properly furnish a statement to a reviewed year partner in accordance with §301.6226-2, the election is invalid only with respect to the reviewed year partner to which the partnership failed to properly furnish the statement."

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[26] Proposed Regulations, Preamble, Explanation of Provisions, Section 5.F.

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VII. STATUTE OF LIMITATIONS FOR ADJUSTMENT

Section 6235(a) provides the limitations period within which the Service must make an adjustment under the Centralized Audit Regime.[27] Section 6235(a) provides as follows:

> (a) IN GENERAL.—Except as otherwise provided in this section, no adjustment under this subpart for any partnership taxable year may be made after the later of—
>
> (1) the date which is 3 years after the latest of—
>
> (A) the date on which the partnership return for such taxable year was filed,
>
> (B) the return due date for the taxable year, or
>
> (C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227, or
>
> (2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (7) thereof) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted, or
>
> (3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7) after the date of such notice.

The periods under Section 6235(a)(2) and (a)(3) are measured from the date the notice of proposed partnership adjustment ("NOPPA") is issued. The BBA, PATH Act and Proposed Regulations do not address the time period during which a NOPPA must be issued. Therefore, Section 6235(a)(2) and (a)(3) imply that the IRS could issue a NOPPA to revive an otherwise closed statute of limitations. That is, even if the NOPPA was issued more than three years after the return was due or filed, the IRS will have up to 540 days under subsection (a)(2)[28] or 330 days under subsection (a)(3) to issue an FPA. This would make the statute of limitations period virtually unlimited for partnership adjustments made under the Centralized Audit Regime.

An unlimited statute of limitations period would be contrary to the general three-year limitations period in the Code[29] and create a significant incentive for partners to reorganize partnership ownership to be eligible to elect out of the Centralized Audit Regime. This would likely reduce the partnerships subject to the Centralized Audit Regime and increase the partnerships that the IRS must audit and assess tax at the partner level pursuant to deficiency procedures under subchapter B of chapter 63. As the preamble recognizes, such procedures are complex and burdensome.

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[27] *See also* § 6232(b) (no assessment may be made before the 90th day after the notice of final partnership adjustment ("FPA") is mailed and—if a petition is filed in the Tax Court—the decision of the court has become final.)

[28] Under § 6225(c)(6), the partnership has 270 days after the date the NOPPA is issued to submit documentation to reduce the imputed underpayment. Therefore, Section 6235(a)(2) allows the Service 540 days after the NOPPA is issued to issue an FPA.

[29] *See, e.g.*, § 6501(a).

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In addition, an unlimited statute of limitations would conflict with long-standing Supreme Court case law. In *Rothensies v. Electric Storage Battery Co.*, the Supreme Court recognized that statutes of limitations are "an almost indispensable element of fairness as well as of practical administration of income tax policy" because otherwise taxpayers would be required to "stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest."[30] Congress could not have intended to depart from such a well-established principle—particularly without any legislative history explaining the reason for such a dramatic departure.

Therefore, a logical inference is that the NOPPA must be issued within the three-year period in Section 6235(a)(1). That is, the NOPPA must be issued within three years of the latest of the date the partnership return was filed, the date the return was due or the date the partnership filed an administrative adjustment request. Accordingly, we respectfully recommend that the Proposed Regulations clarify the NOPPA must be issued within the three-year period specified in Section 6235(a)(1).[31] This would protect the general three-year statute of limitations, while allowing for an extension for the partnership to submit and the Service to process documentation to reduce the imputed underpayment.

VIII. APPLICATION TO CONSTRUCTIVE PARTNERSHIPS

The preamble to the Proposed Regulations provides that "the IRS intends to carefully scrutinize whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for federal income tax purposes."[32] In such a case, the constructive or de facto partnership would be subject to the Centralized Audit Regime. The rules do not address, however, how the tax will be collected from a constructive partnership, which does not have any assets since it is not a juridical entity for state law purposes.[33]

We respectfully recommend that the Proposed Regulations be revised to clarify that a constructive partnership will be treated as if it made a push-out election under Section 6226. This would ensure that the federal income tax resulting from an audit adjustment with respect to a constructive partnership would be assessed upon and collected from the parties that own (for state law purposes) the assets for which the tax deficiency originated.

This change can be accomplished by revising the definition of when a partnership "ceases to exist" in Proposed Regulations section 301.6241-3(b)(2) to include a constructive or de facto partnership. Under that section of the Proposed Regulations, the IRS treats a partnership that "ceases to exist" (which includes a partnership that lacks the ability to pay the tax) as if it made a

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30 329 U.S. 296, 300 (1946).

31 Comments have also suggested statutory fixes to this statute of limitations issue. For example, the New York State Bar Association suggested that the statute be amended to require a preliminary FPA or final NOPPA be issued in the three-year period in Section 6235(a)(1). *See* NYS Bar Ass'n Tax Section, "Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015," Report No. 1347 (May 25, 2016).

32 Proposed Regulations, Preamble, Explanation of Provisions, Section 2.C.

33 This is of particular relevance to the oil and gas industry because a joint operating agreement between co-owners of oil and gas properties generally creates a constructive tax partnership for federal income tax purposes unless the partnership elects out. *See* §§ 761(a) and 7701(a)(2).

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push-out election under Section 6226. This change would be a clarification rather than a substantive change because a constructive partnership would likely be treated as ceasing to exist because it does not have the ability to pay the tax (since it does not have any assets).

IX. CLARIFICATION OF DEFINITION OF PARTNERSHIP AS PASS-THROUGH PARTNER

For purposes of the Centralized Audit Regime, Section 6241(1) provides that "the term 'partnership' means any partnership required to file a return under Section 6031(a)." Section 6031(a) refers to the Section 761(a) definition of partnership which excludes certain eligible joint ventures that have elected out of subchapter K. The only circumstance in which a partnership that has elected out of subchapter K would file a partnership return is to make the election out. Proposed Regulations section 301.6241-5(c)(2) addresses this situation by providing that the Centralized Audit Regime does not apply to any partnership that files a partnership return for the sole purpose of making an election out of subchapter K. The preamble explains that "[u]nder proposed §301.6241-5(c)(2), the provisions of subchapter C of chapter 63 do not apply to taxable years for which a partnership return is filed solely to make an election described in section 761(a) (election out of subchapter K of chapter 1 for certain unincorporated organizations)."[34] Hence, it is clear that the Centralized Audit Regime does not apply to joint ventures that have elected out of subchapter K under Section 761(a).

However, Proposed Regulations section 301.6241-1(a)(5) does not exclude a partnership that has elected out of subchapter K from the definition of a "pass-through partner." Proposed Regulations section 301.6241-1(a)(5) defines a pass-through partner as including "a partnership as described in §301.7701-2(c)(1)" of the Treasury Regulations, which is arguably far broader than the definition of "partnership" in Section 6241(1). Treasury Regulations section 301.7701-2(c)(1) provides that "[t]he term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members." It does not provide an exception for a partnership that has elected out of subchapter K under Section 761(a).

This definitional issue is relevant to oil and gas, mineral, and timber joint ventures. This issue is especially important in states such as Texas that have significant oil and gas, mineral and timber industries, where joint ventures frequently elect out of subchapter K.

Accordingly, we respectfully recommend that Proposed Regulations section 301.6241-1(a)(5) be revised to be consistent with the definition of "partnership" in Section 6241(1). Specifically, we recommend that Proposed Regulations section 301.6241-1(a)(5) be revised to eliminate the reference to the regulations under Section 7701 and to instead refer to "a partnership required to file a return under section 6031(a)."

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[34] Proposed Regulations, Preamble, Explanation of Provisions, Section 8.F.