REPORT #812

TAX SECTION

New York State Bar Association

REPORT ON THE LARGE PARTNERSHIP PROVISIONS
OF THE 1993 TAX SIMPLIFICATION
AND TECHNICAL CORRECTIONS BILL

December 16, 1994

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TAX SECTION
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MEMORANDUM

Large Partnership Provisions of the Tax Simplification Bill

Enclosed is a Report by the New York State Bar Association Tax Section concerning the large partnership provisions of H.R. 3419, the Tax Simplification and Technical Corrections Bill of 1993. The relevant provisions of the Bill are intended to simplify the pass-through treatment, tax reporting and audit procedures for partnerships with at least 250 partners. The Bill passed the House of Representatives in May of 1994 but was not acted on by the Senate.

The Report takes the following positions, among others:

1. We generally support a simplified tax regime for large partnerships. However, we believe a number of modifications to the Bill are necessary.

2. While we generally support the simplified flow-through treatment of partnership items, we recommend an expansion of the items that specifically flow through to partners, as under current law, to include investment expenses, dividend income and short-term capital gains.

3. We strongly oppose the provision in the Bill imposing liability for tax for partnership audit adjustments on persons who are partners in the year the audit is concluded, as

opposed to persons who were partners in the year under audit. We believe the proposed rule is fundamentally inconsistent with the nature of partnerships, will create new and complex issues, will complicate trading anddiscourage investment in large partnerships, and will create new (and in many cases abusive) tax planning opportunities for partners.

4. We believe the Bill goes too far in reducing notice and participation rights of partners in partnership audits.

5. Guidance should be provided on a number of issues prior to the effective date of the new rules, and a delayed effective date should be provided to allow for adjustment to the new rules.

The Report also makes a number of more technical comments on the Bill, and comments on certain technical corrections to the existing partnership audit rules that are also contained in the Bill.

The Tax Section, as always, strongly supports simplification of the partnership and other provisions of the Code. Please let me know if we can be of further help in the development of simplified rules for large partnerships or in any other efforts at simplification.

Sincerely yours,

Michael L. Schler
Chair, Tax Section

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Tax Report #812

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON THE LARGE PARTNERSHIP PROVISIONS OF THE 1993 TAX SIMPLIFICATION AND TECHNICAL CORRECTIONS BILL

December 16, 1994

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on the Large Partnership Provisions ofthe 1993 Tax Simplification and Technical Corrections Bill[*]

December 16, 1994

I. Introduction

This report considers the provisions contained in Sections 301 through 306 of H.R. 3419, the Tax Simplification and Technical Corrections Bill of 1993 (the "Tax Simplification Bill"). These provisions would create new statutory rules governing the pass-through treatment, reporting requirements, audit procedures and other administrative matters of large partnerships (the "Proposed Rules"). The report also briefly comments on certain of the technical corrections to existing partnership audit rules contained in Sections 311 through 323 of the Tax Simplification Bill. The Tax Simplification Bill was passed by the House of Representatives on May 17, 1994. TheSenate did not act on the Tax Simplification Bill before adjourning.

II. Overview of the Proposed Rules

A. Background

[*] This report was prepared by Linda Z. Swartz, co-chair of the Real Property Committee. Significant contributions were made by Simon Friedman, Stephen L. Millman and Michael L. Schler, and helpful comments were received from Andrew N. Berg, John A. Corry, Robert A. Jacobs, Carolyn Lee, Richard O.Loengard, Jr., Andrew S. Mason, Richard L. Reinhold and Lary Wolf.

The genesis of the Proposed Rules was section 10126 of the Tax Simplification Bill of 1987, which first addressed the tax treatment of large partnerships. Although the provisions contained in that section were not enacted as part of the Omnibus Budget Reconciliation Act of 1987, the Act required the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") to prepare a joint report on the compliance and administrative issues posed by large partnerships (the "Treasury Report"). That report, which was delivered to the House Ways and Means Committee in March 1990, contains a lengthy discussion of the administrative burdens the rules enacted in 1982 for larger partnerships (the "TEFRA Rules") impose on the IRS and Treasury. The principal burdens include (i) the administrative complexity involved in negotiating settlements with individual partners, who are each entitled to participate in audits and other IRS proceedings concerning partnership items, (ii) administering refund claims separately filed by those partners, (iii) the IRS difficulty in locating former partners and collecting deficiencies from those partners, and (iv) the inability of the IRS to detect undisclosed inconsistent reporting by partners and the resulting significant revenue loss to the fisc. The Proposed Rules are intended to address each of these concerns.

B. Definition of Large Partnerships

The Proposed Rules define large partnerships as partnerships with 250 or more partners during the year. Proposed I.R.C. § 775(a)(1). In the case of partnership interest transfers during a taxable year, both the transferors and transferees of the interests are counted as partners for purposes of determining whether a partnership is subject to the Proposed Rules. See H.R. Rep. No. 353, 103d Cong., 1st Sess. 55 n.9 (1993) (the "House Report"). Any partnership treated as a large partnership for a

taxable year generally will be treated as a large partnership for all succeeding years, even if the number of its partners subsequently falls below 250, although to the extent provided in regulations a partnership would cease to be treated as a large partnership if the number of partners falls below 100 in any taxable year. Proposed I.R.C. § 775(a)(1). In addition, a partnership with at least 100 partners can elect to be treated as a large partnership. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent. Proposed I.R.C. § 775(a)(2). Partnerships principally engaged in the commodities business are excluded from the definition of a large partnership. Proposed I.R.C. § 775(c).

A partnership with 250 or more partners is not a large partnership if substantially all of the partners of the partnership (or the owner-employees of personal service corporation partners) (i) perform substantial services in connection with the partnership's activities, (ii) performed suchsubstantial services prior to retirement, or (iii) are spouses of partners who are performing (or previously performed) such substantial services. Proposed I.R.C. § 775(b)(2). In addition, for purposes of determining whether a service partnership that does not satisfy the “substantially all” test is considered a large partnership, individuals holding partnership interests and performing substantial services in connection with the partnership's activities, and individuals who previously performed substantial services while holding a partnership interest, are not considered partners. Proposed I.R.C.§ 775(b)(1).

C. Simplified Reporting and Flow-Through Treatment of Partnership Items

The Proposed Rules reduce to ten the items that a partner in a large partnership takes into account on a flow-through basis, and the items that a large partnership must therefore separately report to its partners. These items are:(1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities; (3) net capital gain or loss, separately computed to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment, separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credits; (8) rehabilitation credits; (9) foreign income taxes; and (10) credit for producing fuel from a nonconventional source. Proposed I.R.C. § 772(a). Income orloss from passive loss limitation activities means income or loss from any activity involving the conduct of a trade or business and any rental activity. Proposed I.R.C. § 772(d)(1). Income or loss from “other activities” is always treated as investment income or loss. Proposed I.R.C. § 772(c)(3)(A). The IRS has the authority to specify additional items that must be separately reported. Proposed I.R.C. § 772(a)(11).

A large partnership computes its income and loss in the same manner as an individual, except that flow-through items are separately stated. Generally, limitations and elections affecting the taxable income or any credit of a large partnership (including, for example, section 1231 calculations) will be applied or made at the partnership level. Proposed I.R.C.§§ 773(a)(2) and (3); House Report at 52. However, certain modifications are made to the calculation of taxable income. For example, miscellaneous itemized deductions, such as section 212 expenses incurred for the production of income, are subject to a 70% disallowance intended to approximate the amount of deductions

that would be denied to an individual partner under the section 67(a) two-percent floor. Proposed I.R.C. § 773(b)(3); House Report at 53 n.7. Moreover, the at-risk, passive loss and section 68 overall itemized deduction limitations will be applied at the partner level. Proposed I.R.C. § 773(a)(3). In addition, the election to claim foreign tax credits will continue to be made at the partner level, and the applicability of the section 108 rules will continue to be determined at the partner level. Proposed I.R.C. § 773(a)(2).

The Proposed Rules require netting capital gains and losses at the partnership level, except that any excess of partnership net short-term capital gain over net long-term capital loss is consolidated with the partnership's ordinary income and is not separately reported to partners. Proposed I.R.C. S 772(a)(3); House Report at 52. A partner's allocable share of a large partnership's net capital gain or loss is treated as long-term capital gain or loss and is allocated between passive loss limitation activities and other activities. Proposed I.R.C. § 772(c)((4) and (d)(4). Under current law, a partner's share of a partnership's net short-term capital gain or loss and its net long-term capital gain or loss are separately reported to the partner. I.R.C. § 702(a).

D. Consistent Reporting by Partners

Under the Proposed Rules, a partner may not report a partnership item inconsistently with the partnership's tax return. Proposed I.R.C. § 6241(a). Any underpayment attributable to an inconsistently reported partnership item would be immediately assessed and collected as if it were a mathematical or clerical error on the partner's return. Proposed I.R.C. § 6241(b). Under current law, a partner may report partnership

items inconsistently with the partnership's position if the inconsistency of the positions is disclosed on the partner's tax return. I.R.C. § 6222(b).

E.Liability for Large Partnership Audit Adjustments

The Proposed Rules generally treat adjustments topartnership items of income or loss (“Partnership Adjustments”)as giving rise to additional taxable income or loss of the partnership for the year the adjustments take effect, thus flowing through to the partners in such year rather than to the partners for the prior year to which the Partnership Adjustments relate. Proposed I.R.C. § 6242(a)(1). However, the partnership, rather than current partners, is liable for any interest and penalties imposed in connection with Partnership Adjustments. Proposed I.R.C. § 6242(b).

Thus, a current year partner's share of partnership income and loss items will be adjusted to reflect Partnership Adjustments that take effect in the current year, regardless of the year or years under audit. Each partner's tax liability attributable to the adjustments will depend on the marginal tax rate of that partner. Partnership Adjustments that relate to the primary adjustment and are attributable to taxable years subsequent to the year under audit and prior to the current year will be taken into account in the current year and will be netted against the primary adjustment to determine a Partnership Adjustment. Proposed I.R.C. § 6242(a)(3).

To satisfy the tax liability resulting from Partnership Adjustments that would otherwise be borne by the partners (a “Partnership Assessment”), a partnership may elect to pay an “imputed underpayment” rather than pass through personal

liability for the Partnership Assessment to current partners. Proposed I.R.C. § 6242(a)(2)(A) and (b)(4). The imputed underpayment associated with a Partnership Adjustment is calculated by multiplying the Partnership Adjustments by thehigher of the individual or corporate tax rates for the partnership taxable year to which the Partnership Adjustments relate. Proposed I.R.C. § 6242(b)(4) and (d)(3). A partner may not file a credit or refund claim for its share of the partnership's imputed underpayment, even if the partner's marginal tax rate is less than the tax rate used to compute the imputed underpayment. House Report at 60.

The only exception to the liability of current year partners for Partnership Assessments (in the absence of a partnership imputed underpayment) is for Partnership Adjustments that change the distributive shares of partnership income or loss of the partners. In these cases, former partners whose distributive shares of income or loss are reallocated will remain personally liable for any assessment of tax attributable to the reallocation (and interest and penalties thereon), and the partnership and the current partners will have no liability for these Partnership Assessments. Proposed I.R.C. § 6241(c)(2).

If a partnership ceases to exist before an adjustment takes effect, the former partners of the partnership are required to take Partnership Adjustments into account. Forthcoming regulations will define “former partners” and will provide rules governing the collection of Partnership Assessments from former partners. Proposed I.R.C. § 6255(d).

F. Authority to Issue Regulations

The Proposed Rules provide that regulations will make appropriate adjustments to the Proposed Rules to take into account partnership adjustments that involve a change in thecharacter of any item of income, gain, loss or deduction.Proposed I.R.C. § 6242(d)(5). More generally, the Secretary is also granted the authority to prescribe "such regulations as may be appropriate to carry out the purposes of this part [§§ 771-777]." Proposed I.R.C. § 777. The legislative history to the Proposed Rules provides that these regulations may include rules governing partnership interest transfers to tax-favored persons or entities in anticipation of adjustments, e.g., to corporations with net operating losses, tax-exempt organizations, shell corporations and foreign persons. The regulations may provide, among other things, that partnership adjustments are treated as taking effect before a transfer was completed, or that the former partner is treated as a current partner for purposes of the Proposed Rules. Where partnership interests are transferred to foreign persons, the regulations may provide that partnership adjustments are treated as effectively connected income. House Report at 62.

G. Large Partnership Audit Procedures

1.Partner Notice and Participation in Partnership Audits

Each large partnership must designate a partner, or other person, who will have the sole authority to act on behalf of the partnership in all proceedings brought under the Proposed Rules. Proposed I.R.C. § 6255(b)(1). The partnership and its partners will be bound by the decisions and actions taken by the partnership representative in proceedings under the Proposed Rules. Proposed I.R.C. § 6255(b)(2). Individual partners willhave no right to participate in settlement negotiations or request

refunds under the Proposed Rules. If a large partnership fails to designate a representative, the IRS may designate any one of the partners as the partnership's representative.Proposed I.R.C. § 6255(b)(1). By contrast, under current law, each partner has the right to participate in any partnership proceedings relating to the determination of partnership items. I.R.C. § 6224(a).

The IRS will no longer be required to give notice to individual partners of the commencement of a partnership administrative proceeding or a final partnership adjustment. Rather, the IRS need only mail notice (by certified or registered mail) of such a proceeding to the Partnership's last known address, even if the partnership has terminated its existence. Proposed I.R.C. § 6245(b)(1). Under current law, the IRS is generally required to give notice of the commencement of a partnership administrative proceeding and any resulting adjustments to all partners whose names and addresses are furnished to the IRS. I.R.C. § 6223(a). For partnerships with more than 100 partners, however, the IRS currently is not required to give notice to any partner with less than a 1% profits interest. I.R.C. § 6223(b).

2. Statute of Limitations for Partnership Items

The Proposed Rules provide that absent an agreement extending the statute of limitations, the IRS cannot adjust a partnership item more than three years after the later of (i) the filing of the relevant partnership return, or (ii) the last dayfor filing the relevant partnership return. Proposed I.R.C.§ 6248(a). The partnership, acting through its representative, has the sole authority to extend the statute of limitations for all partnership items, and any extension by the partnership binds all partners. Proposed I.R.C. §§ 6248(1.) and 6255(b). If a

partnership omits an amount in excess of 25% of its stated gross income from its taxable income in any taxable year, the statute of limitations for that taxable year automatically would be extended to 6 years, and in the case of a fraudulent or false partnership return with intent to evade tax or a failure to file a return for a taxable year, the statute of limitations for that year would remain open indefinitely. Proposed I.R.C. § 6248(c).

3. IRS Proceedings Involving Large Partnerships

The Proposed Rules allow an IRS notice of partnership adjustment to be challenged within 90 days after notice is mailed to the partnership. Only the partnership, acting through its representative, can petition for a readjustment of partnership items. Proposed I.R.C. §§ 6247(a) and 6255(b)(1). The petition can be filed in the Tax Court, the United States district court for the district in which the partnership's principal place of business is located, or the Claims Court, assuming the rules of the relevant court are satisfied. Proposed I.R.C. § 6247(a).The court with which a petition is filed would have jurisdiction to determine the tax treatment of all partnership items and the proper allocation of the items among the partners, in addition to those items listed in the IRS notice. Proposed I.R.C. § 6247(c). Once a petition is filed, the IRS cannot collect any part of adeficiency from either the partnership or its partners until the relevant court's decision is final. Proposed I.R.C. § 6246(a).

4. Partnership Administrative Adjustment Requests

Under current law, a partnership or any partner may separately file a request for an administrative adjustment of a

partnership item (an “RAA”). I.R.C. §§ 6227(a) and (b). The Proposed Rules permit only a partnership, acting only through its representative, to file an RAA. The Proposed Rules require theRAA to be filed before a notice of partnership adjustment ismailed to the partnership and within three years of the later of (i) the date the partnership return was filed, or (ii) the last day for filing the partnership return (determined without regard to extensions). Proposed I.R.C. § 6251(a). If the IRS disallows any part of an RAA, only the partnership, acting through its representative, is permitted to file a petition for an RAA adjustment with the Tax Court, the United States district court for the district in which the partnership's principal place of business is located, or the Claims Court. Proposed I.R.C.§ 6252(a). The petition must be filed within two years of the filing of the RAA, but may not be filed earlier than six months after the date the RAA is filed. Proposed I.R.C. § 6252(b).

H. Section 708 Constructive Terminations

Under current law, a partnership terminates if all partners cease carrying on the business, financial operation or venture of the partnership, or if 50% or more of the total partnership interests are sold or exchanged within a twelve monthperiod. I.R.C. § 708(b). Under the Proposed Rules, a large partnership will not terminate for tax purposes solely because 50% of its interests are sold or exchanged within a twelve month period. Proposed I.R.C. § 774(c).

I. Effective Dates

The Proposed Rules generally apply to partnership taxable years ending on or after December 31, 1994. Section 306

of the Tax Simplification Bill. By analogy, Proposed Rules eventually enacted presumably would apply to partnership taxable years ending on or after December 31 of the year the rules are enacted.

J. Technical Corrections to the TEFRA Rules

1. Expanded Definition of Small Partnerships

Normal deficiency procedures, rather than the TEFRA Rules or the Proposed Rules, apply to “small partnerships.”Under current law, “small partnerships” are defined as partnerships with ten or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, if each partner's share of each partnership item is the same as that partner's share of every other partnership item. I.R.C.§ 6231(a)(1)(B). The Proposed Rules expand the definition of small partnerships to include partnerships with no more than 10 partners that have C corporations and nonresident aliens as partners, and that specially allocate partnership items among partners. Proposed I.R.C. § 6231(a)(1)(B).

2. IRS Reliance on Partnership Returns to Determine Correct Audit Procedures

In determining whether to apply the TEFRA Rules or regular deficiency procedures to a partnership and to its partners, the Proposed Rules allow the IRS to apply the TEFRA Rules if the IRS reasonably determines on the basis of the partnership's tax return for the year at issue that the TEFRA Rules should apply. Proposed I.R.C. § 6231(g)(1). The Proposed Rules also allow the IRS to apply normal deficiency procedures if the IRS reasonably believes on the basis of the partnership's tax

return that a partnership is a small partnership. Proposed I.R.C. § 6231(g)(2).

3. Determination of TEFRA Partnership Penalties at the Partnership Level

Under current law, the IRS may only assert penalties against a partner through a separate deficiency proceeding after the completion of the partnership level audit proceeding. The Proposed Rules provide that partnership level proceedings may include the determination of applicable penalties at the partnership level. Proposed I.R.C. § 6221. Partners will be allowed to assert any partner level defenses to penalties imposed in the context of the partnership level proceeding. Proposed I.R.C. § 6230(c)(4).

III. Summary of Comments on the Proposed Rules

1. We generally support a simplified tax regime for the largest partnerships, although we believe certain modifications to the Proposed Rules are necessary.

2. The determination of large partnership status for a taxable year should be based on the number of partners in the partnership's immediately preceding taxable year.

3. We generally support the proposed simplified reporting and flow-through treatment of partnership items. However, we recommend that investment expenses, dividends, and net short-term capital gain that exceeds net long-term capital loss, each be separately reported to partners.

4. We strongly oppose the provision in the Proposed Rules imposing liability for tax on partnership adjustments on persons who are partners in the year of the audit (sometimes referred to herein as “current partners”). We strongly support retention of the present rule imposing liability only on the persons who were partners in the year to which the adjustment relates (sometimes referred to as “former partners”). Moreover, if our position is rejected, we believe only the partnership, and not current partners, should be liable for tax on partnership adjustments. Similar rules should apply to refunds.

5. We agree that penalties attributable to the incorrect reporting of partnership items to partners should be imposed on partnerships. However, if former partners are liable for the tax (as we suggest in 4. above), we believe they should also be liable for all interest and any other penalties. If current partners or the partnership are liable for the tax, we believe the Proposed Rules correctly impose all interest and any other penalties on the partnership.

6. We oppose provisions of the Proposed Rules that greatly reduce notice and participation rights of partners in partnership audits. If current partners are personally liable (as in the Proposed Rules), or if the existing partner liability rule is retained (as we recommend), notice and participation rights for all but the smallest partners for the appropriate year should be preserved. If all partner liability is eliminated in favor of partnership liability, participation rights for partners could be substantially curtailed.

7. In the case of a liquidated partnership, regulations should define former partners of a partnership as the partners at the time of the partnership's liquidation.

8. If the provisions in the Proposed Rules relating to current partner liability are adopted, guidance should be provided before the Proposed Rules are effective regarding (i) the calculation of Partnership Adjustments attributable to a change in the character of a partnership item; (ii) permissible allocations of Partnership Adjustments and partnership payments of Partnership Assessments; and (iii) proper adjustments to partners' partnership interest bases and capital accounts and to partnership asset bases as a result of Partnership Adjustments and payment of Partnership Assessments.

9. The Proposed Rules should be effective only for taxable years of large partnerships (and audits of those years) that begin more than 12 months after the Proposed Rules are enacted, but in any event only for taxable years that begin afterthe guidance requested above is published.

IV. Evaluation of the Proposed Rules

A. In General

The Proposed Rules depart significantly from the historical tax treatment of partnerships as pass-through entitiesand from the TEFRA Rules. The fundamental nature of the changes the Proposed Rules would enact raises the important threshold question of whether the reasons for adopting the Proposed Rules justify the imposition of a new taxregime on large partnerships.[1]

[1] As a procedural matter, we suggest consideration be given to incorporating the Proposed Rules as separate subsections in existing sections of the Internal Revenue Code to the extent possible. Integrating the Proposed Rules into existing sections of the Code would prevent confusion, particularly where numerous cross-references would otherwise be required for separate, largely duplicative statutes. A single set of partnership provisions would also help to clarify more

We support, in general, the adoption of a simplified tax regime for large partnerships. However, if some or all of the Proposed Rules are adopted (either in their current form or in a modified form), we believe therules should beappliedtoonly the largest partnerships. As discussed below,theapplication of the Proposed Rules concerning the flow-through treatment and reporting of partnership income, and the rules that alter liability for Partnership Adjustments, will each require broad, necessarily arbitrary rules. We believe it would be inappropriate to extend these arbitrary rules to smaller partnerships where they would displace individual partner determinations. As a result, we recommend limiting theapplication of any Proposed Rules that are enacted to only the largest partnerships. We would retain both the TEFRA Rules and the small partnership rules, even though we acknowledge the inherent complexity of three audit schemes for partnerships of different sizes.

B. Definition of Large Partnerships

We generally support defining large partnerships on the basis of the number of direct partners in a partnership, consistent with our belief that all but the largest partnerships should be entitled to rely on the appropriate existing rules for pass-through entities.[2] However, we believe determining large partnership status on the basis of number of partners at any time during the year may have unintended consequences.

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generally the applicability of other partnership and general tax provisions to large partnerships.

[2] We do not believe partnership interests held by relatedparties should be aggregated and treated as held by a single partner for purposes of determining the number of partners in a partnership, since this would vastly complicate the determination of whether a partnership was a large partnership.

First, a partnership may not know whether it is a large partnership until the end of its taxable year if transfers of partnership interests may cause the partnership to qualify as a large partnership for the first time that year. Since this delayed determination may make it difficult for partnerships to comply with the Proposed Rules, it appears to be advisable to base large partnership determinations for a given taxable year on the number of partners during the partnership's immediately preceding taxable year.

Second, because all partners during a taxable year are counted, multiple transfers of partnership interests could subject even relatively small partnerships to the Proposed Rules. This is exacerbated by the fact that while partnership agreements frequently prohibit transfers of partnership interests without the consent of a general partner, assignments of interests are generally freely permitted (because they do not create “free transferability of interests”); since assignees are treated as partners for tax purposes, partnership interest assignments may increase the likelihood that a partnership is a large partnership.

Moreover, a disenchanted partner of a relatively small partnership might threaten to transfer (or assign) subdivided portions of its partnership interest, perhaps to numerous affiliates, as a means of subjecting the partnership to the Proposed Rules. This could be a significant threat in some situations because the consequences of large partnership status may be significantly detrimental. For example, corporate partners would receive only 30% of their otherwise allowable deductions for investment expenses, as discussed below. It might be possible for a partnership to avoid this risk by having the partnership agreement treat as void any assignments of interests without

consent, although a partnership with only a few current partners would probably not realize the need for such a provision. We have no solution to this problem, but we believe it deserves serious consideration.

As a separate matter, we recommend that the rules governing the large partnership status of service partnerships clarify the meaning of "substantially all the partners." As an illustration, the rules could provide that substantially all means partners with a 90% share in capital and profits. In addition, we believe partnership interests held by children, grandchildren, and trusts for the benefit of spouses, children and grandchildren, as well as by spouses (and former spouses) of current or former substantial service providers, should be treated as held by such service providers for purposes of the "substantially all" test. Further, we suggest consideration be given to excluding these same individuals and trusts from the definition of partners under Proposed I.R.C. § 775(b)(1).

Finally, we recognize that defining large partnerships by reference to direct partners creates the opportunity for taxpayers to use tiered partnerships to avoid the Proposed Rules, possibly to their benefit. Consequently, we would support an anti-abuse rule that allows the IRS to look through partnership tiers to determine whether it is appropriate to apply the Proposed Rules to partnerships that employ multiple tiering arrangements to intentionally avoid the Proposed Rules. Evidence of avoidance could include, for example, an operating partnership where some or all partners are partnerships whose only assets arethe lower tier partnership interests, if the partners of the upper tier partnerships total 250 or more.[3]

[3] An exception should apply if tiering results in only a deminimis number of partners not covered by the large partnership rules, such as where

C. Simplified Reporting and Flow-Through Treatment of Partnership Items

We generally support simplified flow-through treatment of income and loss and simplified reporting by large partnerships. We agree that under these rules the IRS should be much better able to match partnership and partner tax returns and so collect additional tax revenue. As discussed below, we believe several aspects of simplified flow-through treatment should be modified to provide for separately stating certain types of income and deductions.

1. Reporting Issues for Investment Partnerships

We do not favor disallowing 70% of partners' deductions for partnership expenses that would be treated as miscellaneous itemized deductions in the hands of an individual. While this rule may approximate the portion of deductions allowed for some or many individuals, it represents a 70% reduction of such deductions otherwise fully available to corporate partners. We do not view administrative convenience as an appropriate reason to disallow these deductions. Corporations will be reluctant to invest in large partnerships if 70% of these types of deductions are not passed through to them, and we know of no reason the TaxSimplification Bill should seek to discourage corporate participation in large partnerships making investments that are not considered a trade or business. By contrast, we note that section 7704 affirmatively permits publicly traded investment partnerships with corporate partners to be taxed as partnerships.

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the only asset of a large partnership is an interest in a joint venture, and the joint venture has a relatively small number of other individual partners.

To address this concern, we recommend that each partner's allocable share of partnership miscellaneous itemized deductions be passed through as a separate item to the partner, with the character of those expenses being determined at the partner level. This treatment would be consistent with the separate reporting of income or loss from passive loss limitation activities, and the determination of the character of that income or loss by each partner. See Proposed I.R.C.§ 773(a)(3)(B)(iii). Alternatively, the general rule could be that 70% of miscellaneous itemized deductions would be disallowed at the partnership level, but partnerships could be required to flow through as a separate item the disallowed 70% to each corporation that notifies the partnership (on a designated form) of its status as a corporation that is a U.S. taxpayer. This rule should enable the IRS to match partnership and partner reporting of the expense items, while not arbitrarily disallowing otherwise available deductions to corporate partners.

Similarly, we believe dividend income received by large partnerships should be reported to the partners as a separately stated item of partnership income. We do not believe dividend income should be included in the definition of taxable income or loss from “other activities,” because doing so would denycorporate partners the ability to claim an otherwise available dividends received deduction. For the reasons discussed above, we do not believe the disallowance of corporate partners' otherwise available dividend received deductions is justifiableunder the Proposed Rules. Consequently, we recommend separate reporting of dividend income.

2. Net Short-Term Capital Gain

We do not favor combining net short-term capital gain in excess of net long-term capital loss with the partnership's income from other activities under the Proposed Rules. If such short-term capital gain is not separately stated, partners cannot use other capital losses to offset that capital gain. We do not believe partners should be prevented from using nonpartnership capital losses to offset net short-term capital gain from large partnerships, particularly in view of the significant existing limitations on the use of capital losses. We therefore recommend that large partnerships' net short-term capital gain in excess of net long-term capital loss be reported to partners as a separate item of income.

3. Foreign Withholding Taxes

We suggest confirmation be provided that simplified flow-through treatment and reporting of partnership items will not affect the characterization of income for purposes of determining whether foreign partners qualify for specific treaty-based withholding rates on interest and dividends paid to the partnership, and that foreign partners who comply with applicabletax reporting requirements are exempt from withholding tax on portfolio interest paid to the partnership.

4. Foreign Income Taxes Paid by Partnership

We recommend the legislative history to the Proposed Rules clarify that the amount of foreign income taxes paid by a partnership and separately reported to partners is fully useable under section 901 for foreign tax credit purposes, and that foreign taxes paid by a partnership are not subject to further limitation at the partner level under section 904. We believe

this result is appropriate, given the extreme complexity of the calculations of foreign tax credit limitations. It appears to be clearly the rule under Proposed I.R.C. § 773(a)(3)(A), which provides that limitations affecting the computation of any credit of a large partnership (with certain specified exceptions) are applied at the partnership level. However, clarification is necessary because of the apparently conflicting statement in the House Report at 53 that elections, computations and limitations concerning foreign taxes are made by the partner.

D. Consistent Reporting by Partners

We are concerned that requiring partners to report partnership items consistently with the partnership's treatment of those items may require taxpayers to sign a tax return that they believe contains incorrect information. On the other hand, consistent reporting satisfies Treasury's legitimate goal of reducing the time and effort involved in matching each partnership return with over 250 individual tax returns to uncover inconsistent reporting by partners. On balance, we agreethat preserving a partner's right to inconsistently report partnership items with disclosure is not essential, as long as partners in large partnerships are not liable for interest and penalties occasioned by the incorrect reporting of partnership items to partners.[4] We also agree that the IRS should be permitted to immediately assess any underpayment associated with an inconsistent position as a deemed computational filing error.

[4] We suggest below that under a regime where former partnersare liable for tax on audit adjustments, they should also be liable for interest on all tax deficiencies. We believe mandatory consistent reporting is still appropriate in that situation because the partners have had the use of the money during the interim period regardless of the cause.

However, we remain troubled that a partner believing that the partnership incorrectly reported information could not sign a consistently filed tax return under penalty of perjury. Consequently, we suggest an appropriate exception be made to the penalty of perjury requirement for information reported to partners by large partnerships.

E. Large Partnership Audit Adjustments

1. Recommended Retention of Existing Liability Rule

We strongly oppose the provision in the Proposed Rules imposing liability for tax on partnership adjustments on the current partners of the partnership (or on the partnership if it elects to pay). We strongly believe that liability should remain on those who were partners in the year to which the adjustment relates, as under current law. For the reasons discussed below, we do not believe the proposed change to current law isappropriate despite the difficulties of audits and collections under current law. Certainly this proposal is much more than mere “simplification”.

First, we believe the Proposed Rules are fundamentally inconsistent with the pass-through nature of partnerships. The bedrock principle of partnership taxation is that a partner is subject to tax on current income of the partnership. While other aspects of the Proposed Rules cut back on the pass-through nature of partnerships, none goes nearly so far as this. We do not believe that taxpayers should be required to forfeit the ability to apply classic pass-through treatment for the imposition of tax liability solely because a partnership has 250 or more partners.

Second, even if the Proposed Rules concerning liability result in simplification of the existing audit and tax collection procedures, they at the same time create new and complex issues whether it is the current partners or the partnership that pay the tax. For example, we discuss below at length the new complexities created by the need to allocate Partnership Adjustments among the current partners to determine basis, book capital accounts, and tax capital accounts. These complexities, including the possible need to apply section 704(c) principles to reduce resulting differences between book and tax capital accounts, are extremely significant.

Third, the Proposed Rule could significantly unsettle trading in interests in large partnerships. For example, news of a tax audit could significantly depress the trading price of partnership interests, because current partners might be requiredto bear the tax burden of many years of misreporting by the partnership and former partners. Moreover, if current partners were responsible for paying the tax, since the exact date (or at least year) of the resolution of the audit would determine which partners would bear the tax cost of the resolution,[5] there would be a premium on advance knowledge by partners as to the expected settlement date, many partners would try to sell prior to a large expected settlement, and the market value of partnership interests would fluctuate based on speculation about the timing of a significant settlement. Finally, any partner making a significant investment in a large partnership would feel obligated to conduct “due diligence” of

[5] It is not clear whether a Partnership Adjustment would apply to partners who were partners on the actual date that the audit is resolved, or to all partners who were partners at any time during the year. Presumably the income resulting from an adjustment would be treated as any other partnership income arising on the adjustment date and would be allocated under the normal rules of the partnership agreement.

the partnership's past tax reporting positions to determine if there was a hidden contingent liability, and possibly demand an indemnity from the selling partner.

Fourth, if the current partners (rather than the partnership) would be required to pay the tax, the Proposed Rule would significantly chill future investments by limited partners in large partnerships. A fundamental economic assumption of an investor in a limited partnership is that while the investor will be liable for current taxes on current partnership income, the investor will not be liable for debts of the partnership and willhave only its partnership interest at the risk of the business.This is one of the key attractions of a limited partnership investment. Imposing liability on limited partners for past misreporting by the partnership completely undercuts this assumption. Moreover, contrary to the Treasury Report-, the limited partner will receive little comfort from the basis increase resulting from a Partnership Adjustment, since that will probably provide a capital loss benefit some years in the future.[6] In fact, the Proposed Rules place a limited partner in a worse position than a purchaser of stock in a corporation, because a stock purchaser is not personally liable for debts of the corporation.

Fifth, the Proposed Rules create considerable tax planning possibilities because of (i) the discontinuity between the former partners who have the “real” income and the current

[6] This detriment to the partner will frequently be a windfall to the government. For example, if the former partner sold its interest to the current partner at a capital gain equal to the allocable share of an ordinary income Partnership Adjustment, the only tax cost to the government from the prior misreporting was the rate differential on the gain. Nevertheless, the government would collect again from the current partner at the time of the Partnership Adjustment, and the ultimate balancing of the books between thegovernment and taxpayers could be very long delayed.

partners who are liable to pay the tax, and (ii) the discontinuity arising from the fact that adjustments to prior year income are reflected in income taxed at current year rates.The encouraging of tax planning is undesirable in and of itself, but also means that complex anti-abuse rules will be required.For example, there will be a considerable incentive to transferpartnership interests from high to low bracket taxpayers shortly before an audit is settled, or from low to high bracket taxpayers shortly before a refund claim is expected to be granted. In an extreme case, a large partnership (e.g., among high bracket affiliates) could be created that would intentionally underreport income, with the idea that the partners would sell to low bracket or judgment-proof purchasers before any audit was concluded, resulting in a permanent revenue loss to the government equal to the bracket differential.[7] As another example, if tax rates were scheduled to go down in year 2, there would be a tendency to underreport income in year 1 and to file an amended return in year 2 reporting the additional year 1 income (which would now be taxable at year 2 rates even if the partners were unchanged). If tax rates were scheduled to increase in year 2, a partnership would overreport income in year 1, file an amended return in year 2 claiming less income in year 1, and permit its partners to obtain tax refunds at the year 2 tax rates even though tax on the income had been paid at the lower year 1 tax rates. None of this makes sense or promotes simplification.

For all of these reasons, we strongly believe that current law concerning partner liability should be retained. Nevertheless, if it is considered essential that prior-year partners not be the ones subject to tax, we believe thatmandatory

[7] The same result could apparently be achieved in part without taxable gain to the existing partners through the issuance of new partnership interests to low bracket partners, thereby diluting the interests of the former high bracket partners.

taxation of the partnership (with no possibility of taxing current partners) is preferable to the scheme in the Proposed Rules. We wish to emphasize that we still strongly oppose taxing the partnership, because it is economically equivalent to taxing the current partners, it may in fact be more burdensome than taxing the current partners if the highest marginal tax rates are applied to the partnership, and it does not solve many of the foregoing problems.

The reason for our preference for partnership level taxation (as opposed to (the election in the Proposed Rules) is that the election itself creates difficulties. Since the partnership would pay tax on an adjustment at one rate (the highest rates for the years being adjusted) while the partners would pay tax at their own current-year rates, a partnership electing to pay itself might face suits from disgruntled partners in tax brackets lower than the bracket at which the partnership paid the tax. Partnership managers trying to decide who should pay would frequently be placed in an impossible situation. Moreover, even if a partnership announced its intention in advance to pay deficiencies itself, this would provide little comfort to partners insisting on limited liability because they would be required to pay if the partnership had no liquid funds at the time the tax was due; only a mandatory partnership obligation would provide assurance to partners that they could never be personally subject to tax on income arising before they became partners. Finally, any election of this sort as to who should pay and at what rate gives rise to tax planningpossibilities, particularly if rates change from the audit year to the current year.

Partnership level liability would produce a simpler system than current partner liability and would avoid (with

little to no revenue loss) the necessity for the individual partner notice and participation rights we believe necessary if current partners are personally liable for tax on Partnership Adjustments. The IRS's collection rights would not be unduly restricted if current partner liability is eliminated, because Partnership Assessments could be collected from the proceeds of a forced sale of the assets of a partnership otherwise unable to pay an assessment, and the IRS would be entitled to the same protections against partnership asset distributions during contested partnership proceedings as it has in the corporate context.[8] If further protection is warranted, regulations could permit the IRS to recover distributions to partners in respect of capital after the issuance of a Partnership Adjustment to the extent necessary to satisfy a Partnership Assessment.

Consistent with our strong belief that the existing law concerning partner liability should be retained, we agree with the position in the Proposed Rules assessing former partners for reallocations of their distributive shares of partnership income and loss. This seems to be the only way to give effect toreallocation adjustments. We do suggest that the Proposed Rules clarify the fact that changes to partners' distributive shares refers to reallocations of distributive shares of the same partnership item among partners. In addition, if the proposed liability rules are enacted, we suggest the legislative history to the Proposed Rules confirm that liability associated with subsequent reallocations among partners of Partnership Adjustments and Assessments determined under the Proposed Rules will be assessed against the partners among whom the items were originally allocated.

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[8] Except in cases where a partnership is insolvent, we believe imposing only partnership level liability should allow Treasury to collect the same revenue, because we expect solvent partnerships will likely create and maintain cash reserves to pay Partnership Assessments.

We note that the special rule concerning reallocations reinforces our concern about the complexity of imposing most liability on the current partners. An audit may involve both allocation and other issues, with the result that different adjustments may be made to two groups of partners with respect to a single audit of a single taxable year. A person who was a partner in both the prior year under audit and the current year may have one adjustment for the prior year and one for the current year. Moreover, there is no apparent right of offset between the adjustments, even though they in fact both arose in a single taxable year of the partnership.

2. Calculation of Partnership Imputed Underpayments

If the provision in the Proposed Rules is retained permitting a partnership to elect to pay tax on a Partnership Adjustment in lieu of the current partners, or if mandatory tax liability is imposed on the partnership, it appears to bereasonable to calculate tax liability for Partnership Adjustments in the first instance by reference to the highest rate of tax (whether corporate or individual), recognizing that determining- the actual marginal tax rate of each partner would be burdensome. However, we do not believe tax on Partnership Adjustments should ultimately be imposed at rates that exceed the partners' actual tax rates. To ensure that excess tax is not imposed, we recommend treating the partnership as merely the paying agent for the tax. The partnership should pay tax at the highest statutory rate for the current year (rather than the year to which the adjustment relates). The partnership would then report to the partners their allocable shares of the partnership adjustment and tax paid thereon, and each partner could claim a refund from the IRS if the 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.[9] We believe partners not otherwise required to file U.S. tax returns, e.g., tax-exempt entities, should be permitted to claim refunds under an appropriate simplified procedure. We believe the additional complexity in allowing partners to claim refunds under these circumstances is justified by the equities of taxing a partnership adjustment by reference to the actual tax rates of the partners.

If the procedure recommended above is not adopted, we believe partnerships should be entitled to compute their liability for Partnership Adjustments by using a weighted average of the highest corporate and individual marginal rates for the year to which an adjustment relates based on partner status (taking into account the number of tax-exempt partners and the portion of the partnership's income that constitutes unrelated business taxable income to those partners).[10] A partnership able to demonstrate that the weighted average of its partners' highest marginal tax rates for the year to which the adjustment relates is less than the higher of the corporate or individual rates for that year should be permitted to use the lower, average tax rate.[11] Each partner's corporate, individual or tax-exempt status

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[9] A similar system currently exists under section 1446 whereby foreign partners may request refunds of tax withheld on income from U.S. partnerships engaged in a U.S. trade orbusiness, if the amount of tax withheld exceeds the foreign partner's actual U.S. federal income tax liability with, respect to the income.

[10] We note that the amount of tax withheld by partnerships under section 1446 is computed using the highest applicable tax rate, based on each foreign partner's status.

[11] For purposes of computing the weighted average, the percentage interests of the partners would be the same as the partners' allocable shares of the Partnership Adjustments determined under the principles discussed in Section IV.I. of this report.

could be demonstrated through the production of affidavits from partners attesting to their status for each year at issue.

3. Partner Liability for Interest and Penalties Calculation of Partnership Imputed Underpayments

We support imposing liability on the partnership for penalties for adjustments of partnership items incorrectly reported to partners. We believe partnership liability in connection with these adjustments is appropriate in light of the consistent reporting obligations imposed by the Proposed Rules.This is true whether former partners, current partners or the partnership are liable for the underpayments.

However, if our recommendation is accepted that former partners remain liable for the tax, they should also remain liable for all interest (since they had the use of the money during the interim period) as well as for penalties on reporting positions within their control (i.e., adjustments that do not depend on the manner in which items are reported to the partners, such as adjustments attributable to partners' at risk or passive loss limitations).

If the Proposed Rules regarding partner liability are adopted, or if the partnership is the entity solely liable for the deficiency, the partnership should be the party liable for all interest and penalties associated with adjustments. We agree with the approach of the Proposed Rules that it would be inequitable to assess interest and penalties attributable to Partnership Adjustments directly against current partners where the assessment is attributable to items reported in a prior year in which a current partner may not have been a partner. Under

those circumstances, the current partners who were not partners in the prior year had no benefit of an interim use of funds (and so should not pay interest) and had no intent to avoid taxes when filing a prior return (and so should not pay penalties).

F. Large Partnership Audit Procedures

1. Partner Notice and Participation in Partnership Level Audits

We appreciate the IRS's desire for a single, unified audit proceeding with limited participation by multiple partners, and we are not opposed to the exclusion of the smallest partners from the audit process. Nevertheless, if either current or former partners are subject to tax liability, we feel strongly that at least the five largest general and limited partners, partners with at least a 20% interest in an audit item at issue, and 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”), should be entitled to notice of, and should have the right to directly participate in, partnership audits and other proceedings.

We also recommend permitting 51% of the partners, determined on the basis of their capital interests reported on Form 1065, to replace the original representative at any time (by a vote evidenced by a writing signed by each voting partner), whether or not the representative is willing and able to continue. The partners with the largest equity interests would then choose a new partnership representative, who would continue in the role unless, and until, the partners choose a new representative. The partners could thereby retain effective, yet

indirect participation in the IRS proceedings. If a majority of the partners cannot agree on a representative, so that the IRSchooses a representative under the Proposed Rules, we propose the IRS 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. Providing partners with additional flexibility to choose and replace the representative will address often encountered problems of the Tax Matters Partner being difficult to locate, having no substantial continuing partnership interest, and being bankrupt by the time a partnership audit occurs.[12]

If partnerships, rather than current partners, are liable for Partnership Assessments, direct partner participation in audits would only be essential where a partnership audit concerns a reallocation of income between two or more former partners. It is essential in those audits that a representative of each group of partners whose allocations could be changed, and at least each former partner with a 5% interest in the reallocation, have the right to directly participate in that portion of the audit. It is simply not possible for a single partnership representative to fairly and effectively represent more than one party in connection with a reallocation that willnecessarily benefit one or more partners at the expense of other partners. In any case, notice should continue to be given to all Participating Partners, in order to increase the

[12] Seee.g., September Partners, Ltd. v. Commissioner. T.C.Memo. 1990-33 (Tax Court petition filed by TMP who had previously filed a bankruptcy petition was a nullity; court directed limited partners to appoint new TMP); Starlight Mine v. Commissioner, T.C. Memo 1991-59 (Tax Court petition filed by non-partner after death of TMP was defective; court granted partnership leave to designate a TMP to ratify the petition); AMRB Associates v. Commissioner, T.C. Memo. 1991¬450 (Tax Court petition filed by corporate TMP that had previously dissolved was invalid; court directed partnership to appoint a substitute TMP to ratify the invalid petition).

likelihood of a timely response from partnerships that may have ceased active operations.

2. Amended Partnership Returns

If the existing partner liability rule is retained, as we recommend, we believe the partnership and any Participating Partner should be permitted to file an RAA, and any partner should be permitted to request a refund of its tax paid. This rule would be consistent with existing audit rules, except that non-Participating Partners would have to rely on the partnership or Participating Partners to file an RAA. If an RAA is rejected, we recommend that the partnership and any Participating Partner be permitted to file a petition in the relevant court beginning six months after the RAA was filed, and up to two years after the RAA is rejected. Refunds should continue to belong to partners, and they should be calculated using each partner's tax rate for the year to which a refund relates, as under current law.

If the Proposed Rules concerning partner liability are enacted, we would not object to the provisions in the Proposed Rules permitting only a partnership's representative to file amended partnership returns, or to the flowing through of any resulting Partnership Adjustment to partners in the year the adjustment takes effect. We note, however, that if an amended return produces a negative Partnership Adjustment, current partners will receive the resulting benefit based on theirrespective tax rates in the year the Partnership Adjustment takes effect. Under this rule, partnerships with tax-exempt partners could overreport taxable income and then file amended returns that correctly state taxable income. If tax-exempt partners were to transfer their partnership interests to high tax bracket individuals or entities before the negative Partnership

Adjustment resulting from the amended return takes effect, the transferee partners' tax savings from the negative Partnership Adjustment would likely exceed the tax-exempt partners' tax cost for the overstated income. We recommend that general anti-abuse rules to be issued specifically address this possible abuse.

3. Testing Date for Large Partnership Status

The Proposed Rules should be clarified to provide that the large partnership audit rules apply only if the partnership was a large partnership in the year under audit. If it was not a large partnership in that year, partners in that year should be permanently subject to tax deficiencies for that year and should not receive a windfall release from such liability merely because the partnership became a large partnership in a subsequent year. The Proposed Rules should also address the consequences of an audit occurring during a “small” partnership year that relates to a prior year in which the partnership was a large partnership.Are current partners subject to audit adjustments for the prior year?

G. Definition of Former Partners of LiquidatedPartnerships

The legislative history of the Proposed Rules does not make clear whether regulations providing for the collection of Partnership Adjustments from former partners of previously liquidated partnerships will define former partners as the partners at the time of the partnership's liquidation, during the partnership's tax year to which the adjustment relates, or during other specified times. We believe the definition of former partners should be limited to partners at the time of the partnership's liquidation. For this purpose, former partners should include partners when a partnership plan of liquidation is formally or informally adopted, particularly if the plan

contemplates sequential redemptions of partnership interests.This definition would preclude any tax advantage from redemptions of all but tax-exempt partners in one year and income recognition followed by liquidation of the partnership in the next year.

H. Change of Character Partnership Adjustments

If the existing partner liability rule is retained, adjustments that change the character of a partnership item should continue to be calculated on a partner-by-partner basis, and they should take into account each partner's unique tax circumstances in the year in which the adjustment relates. The regulations the Secretary is directed to prepare applying the Proposed Rules to partnership adjustments that involve a change in the character of items of income, gain, loss or deduction would then not be necessary.If, however, the existing liability rule is not retained, these regulations are crucial. In that case we would urge the prompt preparation of the regulations, and we believe the effective date of the Proposed Rules should be postponeduntil the regulations are adopted or guidance is issued in notice form. To the extent partnerships and audit agents disagree on the treatment of these adjustments in the absence of guidance, partnerships will contest the adjustments and will litigate their proper treatment.

If the proposed liability rules are enacted, we expect forthcoming regulations would adopt broad rules governing these adjustments to avoid the complexity involved in investigating each partner's tax returns for the year an item was incorrectly reported to determine the aggregate tax paid in the year at issue. Any attempt to devise a general rule that imposes liability on either current partners or partnerships for adjustments recharacterizing items previously reported will

necessarily have an arbitrary component. As a result, these rules may impose and collect a tax liability on “innocent” errors greater than the actual revenue loss to the government while opening planning opportunities for aggressive taxpayers seeking to take advantage of the rules. For example, if a partnership misreported ordinary income as capital gain, partners to whom the capital gain was actually allocated may have underpaid tax byamounts ranging from 0 to 39.6%, based on current tax rates.[13] Nevertheless, we see no alternative to these broad rules if the proposed liability rules are enacted.

If a broad rule is to be adopted, we would suggest former partners in the partnership be treated as having paid a flat 28% tax on capital gain items recharacterized as ordinary income items. Thus, current corporate partners in the highest bracket without net operating losses and capital losses would have a liability of 7% for their allocable shares of the adjustment, and current individual partners in the highest bracket without net operating losses and capital losses similarly would have a liability of 11.6%. A partnership choosing to pay an assessment at the partnership level would have a liability of11.6% of the amount of the misstated item. These results would seem generally correct in most cases.

Arbitrary decisions also will have to be made for recharacterizations of a partnership's passive income or loss as investment income or loss (or vice versa), or the redetermination

[13] Corporations and individuals in tax brackets of 15% or 28% that did not have offsetting ordinary or capital losses would not have underpaid tax. Individuals in the highest tax bracket without offsetting ordinary or capital losses would have underpaid tax by 11.6%; corporations that had capital losses but not ordinary losses would have underpaid tax by 35%; individuals with capital but not ordinary losses would have underpaid tax by 39.6%. Taxpayers with capital losses not otherwise currently useable, but available to carry forward for use at some future time, could have underpaid tax by any amount within that range.

of a partnership's alternative minimum taxable income (though not strictly a character issue). We know of no simple yet principledway to determine the actual effects of the original characterizations. One possible, arbitrary solution is to assume that the initial, incorrect treatment of the item reduced the tax of each former partner by 50% of the highest regular or alternative minimum tax rate applicable to individuals or corporations for the initial year (had the income items been properly characterized) for purposes of computing the amount of the resulting Partnership Adjustment.

I. Allocation of Partnership Adjustments and Resulting Increases to Basis and Capital Accounts

Among the most important questions not answered by the Proposed Rules is how deemed liability for an assessment paid by a partnership may be allocated among its partners, and how liability for a Partnership Assessment paid by partners may be allocated among those partners. If the current partner liability rule is retained, these allocation issues do not arise, because each partner's tax liability as a result of an adjustment is separately determined and assessed. If the proposed liability rules are enacted, however, the lack of guidance on these issues may be expected to result in disputes between the IRS and taxpayers and state court litigation among partners. We therefore recommend guidance be issued before the Proposed Rules become effective as to (i) permissible allocations of Partnership Adjustments, and in the case of partnership payments, allocations of deemed liability for Partnership Assessments, and (ii) proper corresponding adjustments to each partner's capital accounts

andpartnership interest basis.[14] We suggest below the form such guidance could take.

1. Allocations if Partnerships Pay Partnership Assessments

If a partnership pays a Partnership Assessment, the allocation of the Partnership Assessment (and of related Partnership Adjustments) among the partners may not be immediately important, but the allocation is meaningful because it will affect ultimate cash distributions to partners in partnerships that distribute in accordance with partners' section 704(b) capital accounts. In addition, the allocation of the Partnership Assessment will affect each partner's basis in its partnership interest, and it therefore will affect eventual gain or loss on a sale of that interest. Therefore, guidance regarding these allocations is essential.[15]

If a partnership pays a Partnership Assessment, we believe the partnership's governing documents should be permitted to specially allocate the assessment (and related Partnership Adjustments) in any manner that has substantial economic effector otherwise ultimately affects cash distributions to the partners. Special scrutiny should be given to allocations shifting a greater portion of the allocated items to partners in higher tax

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[14] Guidance regarding allocations should not affect any sharingof income and liabilities agreed to by partners. If the IRSdetermines that a partnership's allocations are inconsistent with the section 704(b) Treasury Regulations, a reallocation of the inconsistent items should be subject to the provisions of Proposed I.R.C. §6241(c)(2). Partnerships may elect to provide for indemnification of partners in the event of a reallocation, and so we recommend guidance be issued addressing the tax effect of indemnity payments in this context.

[15] The discussion that follows is equally applicable if apartnership elects to pay a Partnership Assessment under the Proposed Rules or if the partnership is solely liable for assessments.

brackets than would occur under the partnership's general allocation rules (thus maximizing the tax benefits to the partners of the resulting asset basis adjustments discussed below).

If a partnership's governing documents do not specifically allocate Partnership Assessments and Partnership Adjustments, or if the IRS disallows a partnership's special allocation of these items, regulations should provide guidance as to a default allocation of the Partnership Assessments and Adjustments. To avoid inconsistent allocations when the partnership, and the partners, each pay certain assessments, we recommend the same type of default allocation be used to allocate Partnership Assessments paid by both partnerships and partners.If a partnership pays a Partnership Assessment, we recommend (i) that the Partnership Assessment be treated as an item of partnership expense in the current year for purposes of allocating items of partnership income, gain, loss and deduction among the partners, (ii) that the Partnership Assessment be treated as the last item of loss or deduction allocated in the current year, and (iii) that the Partnership Adjustment be allocated among the partners in the same manner as the Partnership Assessment was allocated (the “Default Allocation Rule”).

2. Basis and Capital Account Adjustments if Partnerships Pay Partnership Assessments

Regulations should confirm that adjustments to each partner's capital account and partnership interest basis will

conform to the chosen special allocation. The Proposed Rules provide no guidance regarding the adjustments to partners' basis and capital accounts that properly follow from a partnership's payment of Partnership Assessments. We believe each partner's tax capital account and partnership interest basis should be increased (under principles similar to those applied in the case of tax-exempt income) by that partner's allocable share of any Partnership Adjustments; partners' section 704(b) capital account balances should not be affected by the allocation of Partnership Adjustments.[16]

A partnership's elective payment of a tax assessment would be treated as a deemed distribution of cash to the partners, and the partnership's payment of a tax assessment for which it alone is liable would be treated as a section 705(a)(2)(B) nondeductible partnership expense. In either case, each partner's basis, tax capital account and section 704(b) capital account would each be decreased by the partner's allocable share of the payment. Interest and penalties paid by the partnership also would be treated as nondeductible partnership expenses (or, in the case of interest, possibly adeductible expense) that would reduce each partner's basis, tax capital account and section 704(b) capital account.

3. Allocations if Current Partners Pay Tax on Partnership Adjustments

If current partners pay a Partnership Assessment, the allocation among the partners of the Partnership Adjustments that give rise to the Partnership Assessment will determine the

[16] We recommend treating the additional asset the Partnership Adjustment is deemed to create as having a value and book basis of zero for section 704(b) capital account purposes and applying section 704(c) principles to the resulting difference between partners' book and tax capital accounts.

partners' liability for the assessment. We believe the partnership's governing documents should be permitted to specially allocate these Partnership Adjustments in any manner that is consistent with the allocation of another material item of partnership income or loss. Special scrutiny should be given to allocations shifting a greater portion of the liability for an assessment to partners in lower tax brackets, or to partners with clearly insufficientresources, than would occur under the partnership's general allocation rules.

Regulations should also specify a default allocation rule that would apply if a partnership's governing documents do not specifically allocate Partnership Adjustments among partners, or if the IRS disallows a partnership's special allocation. We recommend applying the principles of the Default Allocation Rule set forth above. We would apply the rule to the partners' payment of Partnership Assessments by determining how the Partnership Assessment would be allocated among the partners if the Partnership had paid the assessment, and then allocating the Partnership Adjustments among the partners in the same manner. This rule reflects the economic reality that a PartnershipAdjustment is in substance a current year loss for the partners that pay the tax on the Partnership Adjustment, because it has no value and carries with it a tax liability.[17]

4. Basis and Capital Account Adjustments ifCurrent Partners Pay Tax on Partnership Adjustments

[17] Alternatively, Partnership Adjustments could be allocated in the manner in which items of income are shared by the partners in the current year. We believe such an allocation would less clearly reflect the economic reality that Partnership Adjustments, being phantom income, do not have the value generally attributed to items of income.

We recommend that regulations specifically confirm thatadjustments to each partner's tax capital account and partnershipinterest basis will conform to a partnership's chosen allocation.We believe the allocation of Partnership Adjustments amongpartners should result in a positive adjustment, equal to the partner's share of the Partnership Adjustment, to each partner's tax capital account and partnership interest tax basis in the year the assessment takes effect. We assume no adjustment should be made to partners' section 704(b) capital accounts in connection with the allocation.

5. Illustration of Default Allocation Rule

These allocations, while simple in concept, may produce unexpected results, as illustrated by the following example:Assume that limited partners invest 99% of the capital in a partnership and the general partner invests 1%; the partnership's net profits[18] are allocated 99% to the limited partners and 1% tothe general partner until the limited partners have obtained a specified return, and thereafter 50% to the general partner and 50% to the limited partners; and net losses are allocated in proportion to capital account balances. At a time when the partnership had net losses, and the ratio of the capital account balances of the limited and general partners was 99 to 1, thepartnership erroneously expensed capital items. In the year the Partnership Assessment takes effect and is paid by the partnership, net profits are allocated 50% to the general partner and 50% to the limited partners. Capital account balances at year end are in the ratio of 30 for the general partner and 70 for the limited partners.

[18] Net profit and net loss would be computed for this purposewithout regard to items of income allocated pursuant to minimum gain chargebacks of partnership nonrecourse debt or of partner nonrecourse debt.

Under the Default Allocation Rule, the Partnership Assessment would be allocated to those partners that would bear the loss if the partnership payment of the assessment were treated in the same manner as the partnership's payment of other current year expenses. In the example, the Partnership Assessment would be allocated (after the allocation of all other items) 50% to the general partner and 50% to the limited partners to the extent of the partnership's net profits for the current year, if any, and then 30% to the general partner and 70% to the limited partners.[19] Solely for purposes of maintaining partners'tax capital accounts, the Partnership Adjustments would then be allocated among the partners in the same manner as the Partnership Assessment was allocated, i.e., in an appropriate ratio between 50% and 70% to the limited partners and between 50% and 30% to the general partner, depending on whether, and by how much, the Partnership Assessment exceeds the partnership's net profits in the current year.

6. Partnership Asset Basis Adjustments

Neither the Proposed Regulations nor the Treasury Report address whether a Partnership Assessment may produce additional

[19] The Partnership Assessment (and the Partnership Adjustment) in the example also could be allocated in other ways under the Proposed Rules, e.g., 99% to the limited partners and 1% to the General Partner. The Partnership Assessment would be then visited upon the partners that benefitted from the initial error, or their successors. This rule would seem particularly fair if, as will be common in many partnerships, transfers of interest in the intervening years have been minimal, and successors have obtained indemnification commitments from the selling partners.Partnerships choosing to allocate assessments in this mannerwould need to separately ensure that the allocation wouldaffect cash distributions to partners.

basis in partnership assets, or how additional basis should be allocated. However, the netting concept employed by the Proposed Rules clearly contemplates that a Partnership Adjustment requiring the 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. We believe that any additional basis remaining after the year the adjustment takes effect should continue to be depreciated or amortized (to the extent consistent with general tax principles). Moreover, we believe deductionsattributable to that depreciation or amortization should be allocated to the partners in the same manner as the partners were allocated deemed or actual liability for the assessment,[20] which allocation would be consistent with section 704(c) principles.[21]

If deductions are not allocated in this manner, partners that have been allocated actual or deemed liability for a Partnership Assessment consistent with the principles discussed above would have only decreased capital gain or an increased capital loss on a sale of their partnership interests, a benefit generally worth substantially less than the tax paid by the

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[20] We have not considered the effect of section 754 if there is a transfer of partnership interests during the period in question, although this could create additional complexities.

[21] The treatment of the correlative adjustment we recommend can be illustrated as follows: Assume a partnership deducted a100 expense it should have capitalized and amortized over ten years. Five years later, the IRS denies the deduction and effects a Partnership Assessment. Because half the asset's basis properly would have been deducted before the assessment, the net assessment is a tax on 1/2 of the expense, i.e., a tax on 50. (The partnership's interest obligation is computed as if the partnership had a deficiency of the tax of 90 in year 1 and had received a refund of the tax on 10 a year for years 2 through 5.) A 10% partner would be required to pay tax on 5 of income.The partnership would amortize its additional 50 basis over the next five years, and the 10% partner would be entitled to 10% of the additional 10 of deductions each year.

partners or the partnership.[22] We note that a partner's allocable share of additional deductions would, of course, reduce apartner's increased basis in its partnership interest created under the rules discussed above and so would reduce the partner's capital loss (or increase capital gain) on a sale of that interest.

J. Section 708 Constructive Terminations

We support the provision in the Proposed Rules that excepts large partnerships from the consequences of constructive terminations under section 708(b)(1)(B) of the Code, consistent with our belief that it is not feasible to track transfers of interests in large partnerships. We suggest Treasury also consider extending the exception to section 708 terminations to partnerships with 100 or more partners (these partnerships could elect to be subject to the Proposed Rules and so be exempt from the section 708 termination rule). Alternatively, for such partnerships, we recommend counting only transfers by partners with at least 5% equity interests for purposes of determining whether a constructive termination of a partnership has occurred.[23]

We recommend that regulations clarify the tax consequences of a more than 50% change in the ownership of interests in a large partnership, where the transfer(s) reduce the number of partners in the partnership to less than 100

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[22] The capital loss would also be less than the value of the partnership's continued deduction of an improperly expensed item (if a Partnership Adjustment requiring the item to be capitalized had been deferred), because the netting of under and over payments effectively results in an ordinary deduction for each year between the year the item was expensed and the year the adjustment takes effect.

[23] A similar rule is generally employed with respect to public debtholders for section 382(1)(5) purposes. See Treas. Reg.§ 1.382-9(d)(3).

partners. It is not clear that the partnership would be considered a large partnership for purposes of the transfers, andso would be exempt from the section 708 constructive termination rule. If this result would not obtain, large partnerships would need to more closely monitor and possibly restrict trading of their partnership interests. Consequently, guidance on thisissue would be quite useful.

K. Effective Dates

We recommend that the Proposed Rules be effective only for taxable years of large partnerships (and audits of those years) that begin more than 12 months after the Proposed Rules are enacted, but in any event only for taxable years that begin after necessary guidance is published. Partnerships will have to make extensive changes to their partnership agreements to reflect the Proposed Rules, and considerable thought and discussion may be necessary to decide on the particular changes to be made. A delayed effective date is particularly important if liability for tax, interest or penalties is to be imposed at the partnership level, because most large partnerships do not currently have significant cash reserves and it may take time to create reserve funds for this purpose. We also note that a 1997 effective date for the Proposed Rules would have the added benefit of exempting pre-1986 publicly traded partnerships without qualified passive income (whose grandfathering from the section 7704 rules expires in 1997) from the time and expense of complying with the Proposed Rules for a single year.

L. Technical Corrections to the TEFRA Rules

1. Expanded Definition of Small Partnerships

We support the inclusion of nonresident alien and corporate partners in the definition of small partnerships.However, we are concerned about including partnerships that specially allocate items of partnership income and loss among the partners in the definition of small partnerships. Although the IRS must individually audit each partner in a small partnership, the small partnership rules do not contain the same safeguards found in the TEFRA Rules, for partners in the case of a reallocation of a partner's distributive share of items of income and loss. Under the small partnership rules, the IRS could audit only the partner who would owe additional tax as a result of a reallocation, and a partner entitled to a refund as a result of the reallocation might find its refund claim time-barred by the time the partner learns of the reallocation audit results.

In addition, unlike the TEFRA Rules, the small partnership rules do not require the IRS to offer to settle the same issue on the same terms with all partners. Consequently, even if the refund claim of a partner benefitting from a reallocation adjustment was not time-barred, there would be no assurance the partner's negative adjustment to income would equal the audited partner's positive adjustment to income from the reallocation. For these reasons, we suggest that partnerships with special allocations continue to be excluded from the definition of small partnerships.

2. IRS Reliance on Partnership Returns to Determine Correct Audit Procedures

The legislative history to the Proposed Rules sets forth as the reasons for reliance on partnership tax returns to determine correct audit procedures the IRS's inability todetermine whether a partner is a nonresident alien, or whether the partnership employed a special allocation during a particular tax year where a partnership would otherwise qualify as a small partnership. We note if the Proposed Rules amend the definition of small partnerships to include partnerships that specially allocate items of partnership income and loss or have partners whoarenonresident aliens, thereasons stated in the legislativehistoryfor the new “reasonabledetermination” rulewould nolonger exist. However, we assume an additional purpose of the rule is to prevent the running of partners' statutes of limitations during an audit or IRS proceeding brought under the wrong procedures, and so we support the rule.

3. Determination ofTEFRA Partnership Penalties at thePartnership Level

The TEFRA Rules applyonly to partnershipitems, whichare currently defined in section 6231(a)(3) as items that are required to be taken into account under the income tax subtitle. Because penalties are contained in the procedure and administration subtitle, they are not partnership items and so may only be asserted at the partner level after the conclusion ofa partnership proceeding.[24] Whether this rule should be changed to permit partnership level assessments of penalties based on partner interest in connection with partnership proceedings would depend on the circumstances under which the IRS may impose these

[24] See, e.g.,Affiliated Equipment Leasing II v. Commissioner,97 T.C. 575 (1991); Span Hansa Management Co. v. United States.91-1 U.S.T.C. (CCH) ¶50,213 (W.D. Wash. 1991);N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987);Maxwell v. Commissioner, 87 T.C. 783 (1986).

penalties. We believe the IRS should be permitted to determine penalties against partners at the partnership level only in cases where the facts indicate that the IRS could in all likelihood successfully impose those penalties separately against a partner under the existing rules. While we appreciate the reduction in administrative burdens that would result from the proposed rule, we remain concerned that partners could be forced to defend penalties in a partnership proceeding where the IRS would be unlikely to succeed in imposing penalties directly on a partner and therefore would not bring the action.

Large Partnership Provisions of H.R. 3419, the 1993 Tax Simplification and Technical Corrections Bill

TITLE III -- TREATMENT OF LARGE PARTNERSHIPS

SUBTITLE A -- GENERAL PROVISIONS

SEC. 301.SIMPLIFIED FLOW-THROUGH FOR LARGE PARTNERSHIPS.

(a) General Rule. -- Subchapter K (relating to partners and partnerships is amended toy adding at the end thereof the following new part:

“PART IV -- SPECIAL RULES FOR LARGE PARTNERSHIPS

“Sec. 771.Application of subchapter to large partnerships.

“Sec. 772.Simplified flow-through.

“Sec.773. Confutations at partnership level.

“Sec. 774.Other modifications.

“Sec. 775. Large partnership defined.

“Sec. 776.Special rules for partnerships holding oil and gas properties.

“Sec. 777.Regulations.

“SEC. 771.APPLICATION OF SUBCHAPTER TO LARGE PARTNERSHIPS.

“The preceding provisions of this subchapter to the extent inconsistent with the provisions of this part shall not apply to a large partnership and its partners.

“SEC. 772 SIMPLIFIED FLOW-THROUGH.

“(a) General Rule. -- In determining the income tax of a partner of a large partnership, such partner shall take into account separately such partner's distributive share of the partnership's “

(1) taxable income or loss from passive loss limitation activities,

“(2) taxable income or loss from other activities,

“(3) net capital gain (or net capital loss) -¬”(A) to the extent allocable to passive loss limitation activities, and

“(B) to the extent allocable to other activities,

“(4) tax-exempt interest,

“(5) applicable net AKT adjustment separately computed for--

(A) passive loss limitation activities, and “(B) other activities,

“(6) general credits,

“(7) low-income housing credit determined under section 42,

“(8) rehabilitation credit determined under section 47,

“(9) foreign income taxes,

“(10) the credit allowable under section 29, and

“(11) other items to the extent that the Secretary determines that the separate treatment of such items is appropriate.

“(b) Separate Computations. -- In determining the amounts required under subsection (a) to be separately taken into account by any partner, this section and section 773 shall be applied separately with respect to such partner bytalking into account such partner's distributive share of the items of income, gain, loss, deduction, or credit of the partnership.

“(c) Treatment at Partner Level.--

“(1) In general. -- Except as provided in this subsection, rules similar to the rules of section 702(b) shall apply to any partner's distributive share of the amounts referred to in subsection (a).

“(2) Income or loss from passive loss limitation activities. -- For purposes of this chapter, any partner's distributive share of any income or loss described in subsection (a) (1) shall be treated as an item of income or loss (as the case may be) from the conduct of a trade or business which is a single passive activity (as defined in section 469). A similar

rule shall apply to a partner's distributive share of amounts referred to in paragraphs (3)(A) and (5)(A) of subsection (a).

“(3)Income or loss from other activities.--

“(A)In general. -- For purposes of this chapter,any partner'sdistributiveshare of any income or loss described in subsection (a)(2) shall be treated as an item of income or expense (as the case may be) with respect to property held for investment.

“(B) Deductions for loss not subject to section 67. -- The deduction under section 212 for any loss described in subparagraph (A) shall not be treated as a miscellaneous itemized deduction for purposes of section 67.

“(4) Treatment of net capital gain or loss. -- For purposes of this chapter, any partner's distributive share of any gain or loss described in subsection(a)(3) shall be treated as a long-term capital gain or loss, as the case may be.

“(5) Minimum tax treatment. --In determining the alternative minimum taxable income of any partner, such partner's distributive share of any applicable net AMT adjustment shall be taken into account in lieu of making the separate adjustments provided in sections 56, 57, and SB with respect to the items of the partnership. Except as provided in regulations, the applicable net AMT adjustment shall be treated, for purposes of section 53, as an adjustment or item of tax preference not specified in section 53(d)(1)(B)(ii).

“(6)General credits. -- A partner's distributiveshare ofthe amountreferred to in paragraph (6) of subsection (a) shallbe takenintoaccountasacurrent year business credit.

“(d) Operating Rules. -- For purposes of this section --

“(1) Passive loss limitation activity. -- The term 'passive loss limitation activity' means --

“(A) any activity which involves the conduct of a trade or business, and

“(B) any rental activity.

For purposes of the preceding sentence, the term 'trade or business' includesany activity treated as a trade or business under paragraph (5) or (6) of section 469(c).

“(2) Tax-exempt interest. -- The term 'tax-exempt interest' means interest excludable from gross income under section 103.

“(3) Applicable net amt adjustment.--

“(A) In general. -- The applicable net AMT adjustment is--

“(i) with respect to taxpayers other than corporations, the net adjustment determined by using the adjustments applicable to individuals, and

“(ii) with respect to corporations, the net adjustment determined by using the adjustments applicable to corporations.

“(B) Net adjustment. -- The term 'net adjustment' means the net adjustment m the items attributable to passive loss activities or other activities (as the case may be) which would result if such items were determined with the adjustments of sections 56, 57, and 58.

“(4) Treatment of certain separately stated items.--

“(A) Exclusion for certain purposes. -- In determining the amounts referred to in paragraphs (1) and (2) of subsection (a), any net capital gain or net capital loss (as the case may be), and any item referred to in subsection(a) (11), shall be excluded.

“(B) Allocation rules. -- The net capital gain shall be treated --

“(i) as allocable to passive loss limitation activities to the extent the net capital gain does not exceed the net capital gain determined by only taking into account gains and losses from sales and exchanges of property used in connection with such activities, and

“(ii) as allocable to other activities to the extent such gain exceeds the amount allocated under clause (i).

A similar rule shall apply for purposes of allocating any net capital loss.

“(C) Net capital loss. -- The term 'net capital loss' means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchange of capital assets.

“(5) General credits. - - The term 'general credits' means any credit other than the low-income housing credit, the rehabilitation credit, the foreign tax credit,and thecredit allowableunder section 29.

“(6)Foreign income taxes. -- The term 'foreign income taxes'means taxesdescribed in section 901 which are paid or accrued to foreign countries and to possessions of the United States.

“(e)SpecialRule for Unrelated Business Tax.-- In thecaseof a partnerwhich is am organization subjectto tax under section 511,suchpartner'sdistributive share of any items shall be taken into account separately to the extent necessary to coolly with the provisions of section 512(c)(1).

“(f) Special Rules for Applying Passive Loss Limitations. -- If any person holds an interest in a large partnership other than as a limited partner --

“(1) paragraph (2) of subsection (c) shall not apply to such partner, and

“(2) such partner's distributive share of the partnership items allocable co passive loss limitation activities shall be taken into account separately to the extent necessary to comply with the provisions of section 469.

The preceding sentence shall not apply to any items allocable to an interest held as a limited partner.

“SEC. 773 COMPUTATIONS AT PARTNERSHIP LEVEL.

“(a) General Rule.--

“(1) Taxable income. -- The taxable income of a large partnership shall be computed in the same manner as in the case of an individual except that –

“(A) the items described in section 772(a) shall be separately stated, and

“(B) the modifications of subsection (b) shall apply.

“(2) Elections. -- All elections affecting the computation of the taxable income of a large partnership or the confutation of any credit of a large partnership shall be made by the partnership; except that the election under section 901, and any election under section 108, shall be made by each partner separately.

“(3) Limitations, etc.--

“(A) In general. -- Except as provided in subparagraph (B), all limitations and other provisions affecting the confutation of the taxable income of a large partnership or the confutation of any credit of a large partnership shall be applied at the partnership level (and not at the partner level).

“(B) Certain limitations applied at partner level. -- The following provisions shall be applied at the partner level (and not at the partnership level):

“(i) Section 68 (relating to overall limitation on itemized deductions)

“(ii) Sections 49 and 465 (relating to at risk limitations).

“(iii) Section 469 (relating to limitation on passive activity losses and credits).

“(iv) Any other provision specified in regulations.

“(4) Coordination with other provisions. -- Paragraphs (2) and (3) shall apply notwithstanding any other provision of this chapter other than this part

“(b) Modifications to Determination of Taxable Income.-- in determining the taxable income of a large partnership -•

“(1) Certain deductions not allowed. -- The following deductions shall not be allowed:

“(A) The deduction for personal exemptions provided in section 151.

“(B) The net operating loss deduction provided in section 172.

“(C) The additional itemized deductions for individuals provided in part VII of subchapter B (other them section 212 thereof).

“(2) Charitable deductions. --In determining the amount allowable under section 170, the limitation of section 170(b)(2) shall apply.

“(3) Coordination with section 67. -- in lieu of applying section 67, 70 percent of the amount of the miscellaneous itemized deductions shall be disallowed.

“(c) Special Rules for Income From Discharge of Indebtedness. -- If a large partnership has income from the discharge of any indebtedness --

“(l) such income shall be excluded in determining the amounts referred to in section 772(a), and

“(2) in determining the income tax of any partner of such partnership --

“(A) such income shall be treated as an item required to be separately taken into account under section 772(a), and

“(B) the provisions of section 108 shall be applied without regard to this part.

“SEC. 774.OTHER MODIFICATIONS.

“(a) Treatment of Certain Optional Adjustments, Etc. -- In the case of a large partnership --

“(1) computations under section 773 shall be made without regard to any adjustment under section 743(b) or 108(b) but

“(2) a partner's distributive share of any amount referred to in section 772(a) shall be appropriately adjusted to take into account any adjustment under section743(b) or 108(b) with respect to such partner.

“(b)Credit Recapture Determined at Partnership Level.--

“(1) In general. - - In the case of a large partnership --

“(A)any credit recapture shall be taken into accountbythe partnership,--

“(B)the amount of such recapture shall be determinedasif thecreditwith respect to which the recapture is made had been fully utilized to reduce tax.

“(2) Method of taking recapture into account. -- A large partnership shall take into account a credit recapture by reducing the amount of the appropriate current year credit to the extent thereof, and if such recapture exceeds the amount of such current year credit, the partnership shall be liable to pay such excess.

“(3) Dispositions not to trigger recapture. -- No credit recapture shall be required by reason of any transfer of an interest in a large partnership.

“(4) Credit recapture.-- For purposes of this subsection, the term ‘credit recapture' means any increase in tax under section 42(j) or 50(a).

“(c) Partnership Not Terminated by Reason of Change in Ownership. -- Subparagraph (B) of section 708(b)(1) shall not apply to a large partnership.

“(d) Partnership Entitled to Certain Credits. -- The following shall be allowed to a large partnership and shall not be taken into account by the partners of such partnership:

“(1) The credit provided by section 34.

“(2) Any credit or refund under section 852(b)(3)(D).

“(e) Treatment of REMIC Residuals. -- For purposes of applying section 860E(e)(6) to any large partnership --

“(1) all interests in such partnership shall be treated as held by disqualified organizations,

“(2) in lieu of applying subparagraph (C) of section 860E(e)(6), the amour.: subject to tax under section 860E(e)(6) shall be excluded from the gross income of such partnership, and

“(3) subparagraph (D) of section 860E(e)(6) shall not apply.

“(f) Special Rules for Applying Certain Installment Sale Rules. -- In the case of a large partnership --

“(1) the provisions of sections 453 (1) (3) and 453A shall be applied at the partnership level, and

“(2) in determining the amount of interest payable under such sections, such partnership shall be treated as subject to tax under this chapter at the highest rate of tax in effect under section l or ll.

SEC. 775.LARGE PARTNERSHIP.

“(a) General Rule. -- For purposes of this part --

“(1) In general. -- Except as otherwise provided in this section or section 776,the term 'large partnership' means, with respect to any partnership taxable year, any partnership if the number of persons who were partners in suchpartnership in such taxable year or any preceding partnership taxable year ending on or after December 31. 1994, equaled or exceeded 250. To the extent provided in regulations, a partnership shall cease to be treated as a large partnership for any partnership taxable year if in such taxable year fewer than 100 persons were partners in such partnership.

“(2) Election for partnerships with at least 100 partners. -- If a partnership makes an election under this paragraph, paragraph (l) shall be applied by substituting '100' for '250'. Such an election shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

“(b) Special Rules for Certain Service Partnerships. --

“(1) Certain partners not counted. -- For purposes of this section, the term 'partner' does not include any individual performing substantial services in connection with the activities of the partnership and holding an interest in such partnership, or an individual who formerly performed substantial services m connection with such activities and who held an interest in such partnership at the time the individual performed such services.

“(2) Exclusion. -- For purposes of this part, the term 'large partnership' does not include any partnership if substantially all the partners of such partnership --

“(A) are individuals performing substantial services in connection with the activities of such partnership or are personal service corporations (as defined m section 269A(b)) the owner-employees (as defined in section 2€9A(b)) of which perform such substantial services,

“(B) are retired partners who had performed such substantial services, or

(C)are spouses of partners who are performing (or had previously performed such substantial services.

“(3) Special rule for lower tier partnerships. -- For purposes of this subsection, the activities of a partnership shall include the activities of any other partnership in which the partnership owns directly an interest in the capital and profits of at least 80 percent.

“(c) Exclusion of Commodity Pools. -- For purposes of this part, the term 'large partnership’ does not include any partnership the principal activity of which is the buying and selling of commodities (not described in section 1221(1)), or options, futures, or forwards with respect to such commodities.

“(d) Secretary May Rely on Treatment on Return. - - If, on the partnership return of any partnership, such partnership is treated as a large partnership, such treatment shall be binding on such partnership and all partners of such partnership but not on the Secretary.

SEC. 776.SPECIAL ROLES FOR PARTNERSHIPS HOLDING OIL AND GAS PROPERTIES.

“(a) Exception for Partnerships Holding Significant Oil and Gas Properties

“(1) In general. -- For purposes of this pare, the term ’large partnership' shall not include any partnership if the average percentage of assets (by value) held by such partnership during the taxable year which are oil or gas properties is at least 25 percent. For purposes of the preceding sentence, any interest held by a partnership in another partnership shall be disregarded, except that the partnership shall be created as holding its proportionate share of the assets of such other partnership.

“(2) Election to waive exception. -- Any partnership nay elect to have paragraph (1) not apply. Such an election shall apply to the partnership taxable year for which made and all subsequent partnership taxable years unless revoked with the consent of the Secretary.

“(b) Special Rules Where Part Applies. --

“(1) Confutation of percentage depletion. --In the case of a large partnership, except as provided in paragraph (2) –

“(A) the allowance for depletion under section 611 with respect to any partnership oil or gas property shall be confuted at the partnership level without regard to any provision of section 613A requiring such allowance to be confuted separately by each partner,

“(B) such allowance shall be determined without regard to the provisions of section 613A(c) limiting the amount of

production for which percentage depletion is allowable and without regard to paragraph (1) of section 613A(d), and

“(C) paragraph (3) of section 705(a) shall not apply.

“(2) Treatment of certain partners. --

“(A) In general. --In the case of a disqualified person, the treatment under this chapter of such person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property shall be determined without regard to this part. Such person's distributive share of any such items shall be excluded for purposes of making determinations under sections 772 and 773.

“(B) Disqualified person. -- For purposes of subparagraph (A), the term 'disqualified person' means, with respect to any partnership taxable year --

“(i) any person referred to in paragraph (2) or (4) of section 613A(d) for such person's taxable year in which such partnership taxable year ends, and

“(ii) any other person if such person's average daily production of domestic crude oil and natural gas for such person's taxable year in which such partnership taxable year ends exceeds 500 barrels.

“(C) Average daily production. -- For purposes of subparagraph (B), a person's average daily production of domestic crude oil and natural gas for any taxable year shall be confuted as provided in section 613A(c)(2) --

“(i) by taking into account all production of domestic crude oil and naturalgas (including such person's proportionate share of any production of a partnership)

“(ii) by treating 6,000 cubic feet of natural gas as a barrel of crude oil,and

“(iii) by treating as 1 person all persons treated as 1 taxpayer under section €13A(c)(8) or among whom allocations are required under such section.

“SEC.777. REGULATIONS.

“The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this part.”

(b) Clerical Amendment. -- The table of parts for subchapter Kofchapter lis amended by adding at the end thereof the following new item:

“Part IV. Special rules for large partnerships.”

SEC. 302.SIMPLIFIED AUDIT PROCEDURES FOR LARGE PARTNERSHIPS.

(a)General Rule. -- Chapter 63 is amended by adding at the end thereof thefollowing new subchapter:

“SUBCHAPTER D -- TREATMENT OF LARGE PARTNERSHIPS

“Part I. Treatment of partnership items and adjustments.

“Part II. Partnership level adjustments.

“Part III. Definitions and special rules.

“PART I -- TREATMENT OF PARTNERSHIP ITEMS AND ADJUSTMENTS

“Sec. 6240.Application of subchapter.

“Sec. 6241. Partner's return must be consistent with partnership return.

“Sec. 6242.Procedures for taking partnership adjustments into account.

“Sec. 6240 APPLICATION OF SUBCHAPTER.

“(a) General Rule. -- This subchapter shall only apply to large partnerships and partners in such partnerships. .

“(b) Coordination With Other Partnership Audit Procedures.--

“(1) In general. -- Subchapter C of this chapter shall not apply to any lax?* partnership other than in its capacity as a partner in another partnership whirr, is not a large partnership.

“(2) Treatment where partner in other partnership. -- If a large partnership is a partner in another partnership which is not a large partnership –

“(A) subchapter C of this chapter shall apply to items of such large partnership which are partnership items with respect to such other partnership, but

“(B) any adjustment under such subchapter C shall be taken into account in the manner provided by section 6242.

SEC. 6241. PARTNER'S RETURN MOST BE CONSISTENT WITH PARTNERSHIP RETURN.

“(a) General Rule. -- A partner of any large partnership shall, on the partner's return, treat each partnership item attributable to such partnership in a manner which is consistent with the treatment of such partnership item on the partnership return.

“(b) Underpayment Due to Inconsistent Treatment Assessed as Math Error.--Any underpayment of tax by a partner by reason of failing to comply with the requirements of subsection (a) shall be assessed and collected in the same manner as if such underpayment were on account of a mathematical or clerical error appearing on the partner's return. Paragraph (2) of section 6213(b) shall not apply to any assessment of an underpayment referred to in the preceding sentence.

“(c)Adjustments Not To Affect Prior Year of Partners.--

“(1)In general. -- Except as provided in paragraph (2), subsections (a) and(b) shall apply without regard to any adjustment to the partnership item under part II.

“(2) Certain changes in distributive share taken into account by partner

“(A) In general. --To the extent that any adjustment under part II involves a change under section 704 in a partner's

distributive share of the amount of any partnership item shown on the partnership return, such adjustment shall be taken into account in applying this title to such partner for the partner s taxableyear for which such item was required to be takenintoaccount.

“(B)Coordination with deficiency procedures. --

“(i) In general. -- Subchapter B shall not apply to the assessment or collection of any underpayment of tax attributable to an adjustment referred - * in subparagraph (A)

“(ii) Adjustment not precluded. -- Notwithstanding any other law or rule law, nothing in subchapter B (or in any proceeding under subchapter B) shall preclude the assessment or collection of any underpayment of tax (or the allowance of any credit or refund of any overpayment of tax) attributable tc ar. adjustment referred to in subparagraph (A) and such assessment or collection c: allowance (or any notice thereof) shall not preclude any notice, proceeding, c: determination under subchapter B.

“(C) Period of limitations. -- The period for--

“(i) assessing any underpayment of tax, or

“(ii) filing a claim for credit or refund of any overpayment of tax, attributable to an adjustment referred to in subparagraph (A) shall not expire before the close of the period prescribed by section 6248 for making adjustments with respect to the partnership taxable year involved.

“(D) Tiered structures. -- If the partner referred to in subparagraph (A) is another partnership or an S corporation, the rules of this paragraph shall also apply to persons holding interests in such partnership or S corporation (as the case may be); except that, if such partner is a large partnership, the adjustment referred to in subparagraph (A) shall be taken into account in the manner provided by section 6242.

“(d) Addition to Tax for Failure to Comply With Section.--

“For addition to tax in case of partner'sdisregard of requirements of thissection, see part II of subchapter A of chapter 68.

SEC. 6242 PROCEDURES FOR TAKING PARTNERSHIP ADJUSTMENTS INTO ACCOUNT.

“(a) Adjustments Flow Through To Partners for Year in Which Adjustment Takes Effect. --

“(l) In general. -- If any partnershipadjustment with respect to anypartnership item takes effect (within themeaning of subsection (d)(2)) duringany partnership taxable year and if an election under paragraph (2) does not apply to such adjustment, such adjustment shall be taken into account m determining the amount of such item for the partnership taxable year in which such adjustment takes effect. In applying this title to any person who is (directly or indirectly) a partner in such partnership during such partnership taxable year, such adjustment shall be treated as an item actually arising during such taxable year.

“(2) Partnership liable in certain cases. -- If --

“(A) a partnership elects under this paragraph to not take an adjustment into account under paragraph (1),

“(B) a partnership does not make such an election but in filing its return for any partnership taxable year fails to take fully into account any partnership adjustment as required under paragraph (1), or

“(C) any partnership adjustment involves a reduction in acreditwhichexceeds the amount of such credit determined for the partnership taxable year in which the adjustment takes effect, the partnership shall paytotheSecretary an amount determined by applying the rules of subsection (b)(4)totheadjustmentsnot so taken into account and any excess referred to in subparagraph (C).

“(3) Offsetting adjustments taken into account. -- If a partnership adjustment requires another adjustment in a taxable year after the adjusted year and before the partnership taxable year in which such partnership adjustment takes effect, such other adjustment shall be taken into account under this subsection for the partnership taxable year in which such partnership adjustment takes effect.

“(4) Coordination with part ii. -- Amounts taken into account under this subsection for any partnership taxable year shall continue to be treated as adjustments for the adjusted year for purposes of determining whether such amounts may be readjusted under part II.

“(b) Partnership Liable for Interest and Penalties. --

“(1) In general. -- If a partnership adjustment takes effect during any partnership taxable year and such adjustment resultsin animputedunderpayment for the adjusted year, the partnership --

“(A) shall pay to the Secretary interest confutedunderparagraph(2),and

“(B) shall be liable for any penalty, addition totax, or additionalamountas provided in paragraph (3).

“(2) Determination of amount of interest. -- The interest confuted under this paragraph with respect to any partnership adjustment is the interest which would be determined under chapter 67 - -

“(A) on the imputed underpayment determined under paragraph (4) with respect to such adjustment,

“(B) for the period beginning on the day after the return due date for the adjusted yearandendingon the return duedate for the partnership taxableyearin which suchadjustmenttakes effect (or,if earlier, in the case of anyadjustment to which subsection (a)(2) applies, the date on which the payment under subsection (a)(2) is made).

Proper adjustments in the amount determined under the preceding sentence shall be madeforadjustments required forpartnership taxable years after theadjusted yearandbeforethe year in whichthe partnership adjustment takeseffect by reason of such partnership adjustment.

“(3) Penalties. -- A partnership shall be liable for any penalty, addition to tax, or additional amount for which it would have been liable if such partnership had been an individual subject to tax under chapter 1 for the adjusted year and the imputed underpayment determined under paragraph (4) were an actual underpayment (or understatement) for such year.

“(4) Imputed underpayment. -- For purposes of this subsection, the imputed underpayment determined under this paragraph with respect to any partnership adjustment is the underpayment (if any) which would result --

“(A) by netting all adjustments to items of income, gain, loss, or deduction and by treating any net increase in income as an underpayment equal to the amount of such net increase multiplied by the highest rate of tax in effect under section 1 or 11 for the adjusted year, and

“(B) by taking adjustments to credits into account as increases or decreases (whichever is appropriate) in the amount of tax.

For purposes of the preceding sentence, any net decrease in a loss shall betreated as an increase in income and a similar rule shall apply to a net increase in a loss.

“(c) Administrative Provisions. --

“(1)In general. -- Any payment required by subsection (a)(2) or (b)(l)(A) --

“(A)shall be assessed and collected in the same manner as if it were a taximposed by subtitle C, and

“(B) shall be paid on or before the return due date for the partnership taxable year in which the partnership adjustment takes effect.

“(2) Interest. -- For purposes of determining interest, any payment required by subsection (a)(2) or (b)(1)(A) shall be treated as an underpayment of tax.

“(3) Penalties. --

“(A) In general. -- In the case of any failure by any partnership to pay on the date prescribed therefor any amount required by subsection (a)(2) or(b)(l) (A), there is hereby imposed on such partnership a penalty of 10 percent of the underpayment. For purposes of the preceding sentence, the term 'underpayment' means the excessof anypayment required under this sectionoverthe amount (if any)paid on or before the date prescribed therefor.

“(B)Accuracy-related and fraud penalties made applicable. -- For purposes ofpart IIof subchapter A of chapter 68, any payment required by subsection (a)(2) shall be treated as an underpayment of tax.

“(d) Definitionsand SpecialRules.-- For purposes of this section --

“(1) Partnershipadjustment.-- The term partnership adjustment' meansanyadjustment in the amount of any partnership item of a large partnership.

“(2) When adjustment takes effect. -- A partnership adjustment takes effect--

`”(A) in the case of an adjustment pursuant to the decision of a court in a proceeding brought under part II, when such decision becomes final,

“(B) in the case of an adjustment pursuant to any administrative adjustment request under section 6251, when such adjustment is allowed by the Secretary, or

“(C) in any other case, when such adjustment is made.

“(3) Adjusted year. -- The term 'adjusted year' means the partnership taxableyear towhich the item being adjusted relates.

“(4)Return due date. -- The term 'return due date' means, with respect toany taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

“(5) Adjustments involving changes in character.-- Under regulations, appropriate adjustments in the application of this section shall be made forpurposes of taking into account partnership adjustments which involve a change in the character of any item of income, gain, loss, or deduction.

“(e) Payments Nondeductible. -- No deduction shall be allowed under subtitle A for any payment required to be made by a large partnership under this section.

“PART II -- PARTNERSHIP LEVEL ADJUSTMENTS

“Subpart A. Adjustments by Secretary.

“Subpart B. Claims for adjustments by partnership.

“Subpart A -- Adjustments by Secretary

“Sec. 6245.Secretarial authority.

“Sec. 6246.Restrictions on partnership adjustments.

“Sec. 6247.Judicial review of partnership adjustment.

“Sec. 6248.Period of limitations for making adjustments.

“SEC. 6245 SECRETARIAL AUTHORITY.

“(a) General Rule. -- The Secretary is authorized and directed to make adjustments at the partnership level in any partnership item to the extent necessary to have such item be treated inthemanner required.

“(b) Notice of Partnership Adjustment. --

“(1) In general. -- If the Secretary determines that a partnership adjustment is required, the Secretary is authorized to send notice of such adjustment to the partnership by certified mail or registered mail. Such notice shall be sufficient if mailed to the partnership at its last known address even if the partnership has terminated its existence.

“(2) Further notices restricted. -- IftheSecretary mailsanoticeofapartnership adjustment to any partnershipforany partnershiptaxableyearandthe partnership files a petition under section 6247 with respect to such notice in the absence of a showing of fraud, malfeasance, or misrepresentation of a material

fact, the Secretary shall not mail another such notice to such partnership with respect to such taxable year.

“(3) Authority to rescind notice with partnership consent. -- The Secretary may, with the consent of the partnership, rescind any notice of a partnership adjustment mailed to such partnership. Any notice so rescinded shall not be treated as a notice of a partnership adjustment, for purposes of this section, section 6246, and section 6247, and the taxpayer shall have no right to bring a proceeding under section 6247 with respect to such notice. Nothing in this subsection shall affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding

SEC. 624E.RESTRICTIONS ON PARTNERSHIP ADJUSTMENTS.

“(a) General Rule. -- Except as otherwise provided in this chapter, no adjustment to any partnership item may be made (and no levy or proceeding m any court for the collection of any amount resulting from such adjustment may be made, begun or prosecuted) before --

“(1) the close of the 90th day after the day on which a notice of a partnership adjustment was mailed to the partnership, and

“(2) if a petition is filed under section6247 with respecttosuchnotice,the decision of thecourt has become final.

“(b) Premature Action May Be Enjoined. -- Notwithstanding section 7421(a), any action which violates subsection (a) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any

action under this subsection unless a timely petition has been filed under section 6247 and then only in respect of the adjustments that are the subject of such petition.

“(c) Exceptions to Restrictions on Adjustments. --

“(1) Adjustmentsarising out of math or clerical errors. --

“(A) In general. -- If the partnership isnotified that,onaccountofamathematical or clerical error appearing on the partnership return, an adjustment to a partnership item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.

“(B) Special rule. -- If a large partnership is a partner in another large partnership, any adjustment on account of such partnership's failure to comply with the requirements of section 6241(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph.(A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment.

“(2) Partnership may waive restrictions. -- The partnership shall at any time (whether or not a notice of partnership adjustment has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the making of any partnership adjustment.

“(d) Limit Where No Proceeding Begun. -- If no proceeding under section 6H~ is begun with respect to any notice of a partnership adjustment during the 90-day period described in subsection (a), the amount for which the partnership is liable

under section 6242 (and any increase in any partner's liability for tax under chapter 1 by reason of any adjustment under section 6242(a)) shall not exceed the amount determined in accordance with such notice.

SEC. 6247.JUDICIAL REVIEW OF PARTNERSHIP ADJUSTMENT.

“(a) General Rule. -- Within 90 days after the date on which a notice of a partnership adjustment is mailed to the partnership with respect to any partnership taxable year, the partnership may file a petition for a readjustment of the partnership items for such taxable year with --

“(1) the Tax Court,

“(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

“(3) the Claims Court.

“(b) Jurisdictional Requirement for Bringing Action in District Court or Claims Court. --

“(1)In general. -- A readjustment petition under this sectionmay be filedin a district court of the United States or the Claims Court onlyif thepartnership filing the petition deposits with the Secretary, on or before the date the petition is filed, the amount for which the partnership would be liable under section 6242(b) (as of the date of the filing of the petition) if the partnership items were adjusted as provided by the notice of partnership adjustment. The court may by order provide that the jurisdictional requirements of thisparagraph are

satisfied where there has been a good faithattempt tosatisfysuch requirement and any shortfall of the amount requiredto bedeposited is timely corrected.

“(2) Interest payable. -- Any amount deposited under paragraph (l), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

“(c) Scope of Judicial Review. -- A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates and the proper allocation of such items among the partners (and the applicability of any penalty, addition to tax. or additional amount for which the partnership may be liable under section 6242(b)).

“(d) Determination of Court Reviewable. -- Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision

“(e) Effect of Decision Dismissing Action. -- If an action brought under this section is dismissed other than by reason of a rescission under section 6245(b)(3), the decision of the court dismissing the action shall be considered as its decision that the notice of partnership adjustment is correct, and an appropriate order shall be entered in the records of the court.

SEC. 6248 PERIOD OF LIMITATIONS FOR MAKING ADJUSTMENTS.

“(a) General Rule. -- Except as otherwise provided in this section, noadjustment under this subpart to any partnership item for any partnership taxable year may be made after the date which is 3 years after the later of --

“(1) the date on which the partnership return for such taxable year wasfiled, or

“(2) the last day for filing such return for such year (determined withoutregard to extensions).

“(b) Extension by Agreement.-- The period described in subsection (a) (including an extension period under this subsection) may be extended by an agreement entered into by the Secretary and the partnership before the expiration of such period.

“(c) Special Rule in Case of Fraud, Etc. --

“(1) False return. -- In the case of a false or fraudulent partnership return with intent to evade tax, the adjustment may be made at any time.

“(2) Substantial omission of income. -- If any partnership omits from gross income an amount properly includibletherein which is in excessof25percent ofthe amount of gross income stated inits return, subsection (a)shallbe appliedby substituting '6 years’ for '3 years'.

“(3) No return. --In the case ofa failure by a partnershiptofile a returnfor any taxable year, the adjustmentmay be made at any time.

“(4) Return filed by secretary. -- For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

“(d) Suspension When Secretary Mails Notice of Adjustment. --If notice of a partnership adjustment with respect to any taxable year is mailed to the partnership, the running of the period specified in subsection (a) (as modified by the other provisions of this section) shall be suspended --

“(l) for the period during which an action may be brought under section 624*7 (and, if a petition is filed under section 6247 with respect to such notice, until the decision of the court becomes final), and

“(2) for 1 year thereafter.

“Subpart B -- Claims for Adjustments by Partnership

“Sec. 6251.Administrative adjustment requests.

“Sec. 6252. Judicial review where administrative adjustment request is not allowed in full.

SEC. 6251.ADMINISTRATIVE ADJUSTMENT REQUESTS.

“(a) General Rule. -- A partnership may file a request for an administrative adjustment of partnership items for any partnership taxable year at any time which is --

“(1) within 3 years after the later of --

“(A) the date on which the partnership return for such year is filed, or

“(B) the last day for filing the partnership return for such year (determinedwithout regard to extensions) and

“(2) before the mailing to the partnership of a notice of a partnership adjustment with respect to such taxable year.

“(b) Secretarial Action. -- If a partnership files an administrative adjustment request under subsection (a), the Secretary may allow any part of the requested adjustments.

“(c) Special Rule in Case of Extension Under Section 6248. -- If the period described in section 6248(a) is extended pursuant to an agreement under section 6248(b), the period prescribed by subsection (a)(X) shall not expire before the date 6 months after the expiration of the extension under section 6248(b).

SEC. 6252. JUDICIAL REVIEW WHERE ADMINISTRATIVE ADJUSTMENT REQUEST IS NOT ALLOWED IN FULL.

“(a) In General. -- If any part of an administrative adjustment request filed under section 6251 is not allowed by the Secretary, the partnership may file a petition for an adjustment with respect to the partnership items to which such part of the request relates with --

“(1) the Tax Court,

“(2) the district court of the United States for the district in which the principal place of business of the partnership is located, or

“(3)the Claims Court.

“(b)Period for FilingPetition. -- Apetition maybefiledundersubsection(a)with respect to partnership items for a partnership taxable year only --

“(1) after the expiration of 6 months from the date of filing of the request under section 6251, and

“(2) before the date which is 2 years after the date of such request.

The 2-year period set forth in paragraph (2) shall be extended for such period as may be agreed upon in writing by the partnership and the Secretary.

“(c) Coordination With Subpart A. --

“(l) Notice of partnership adjustment before filing of petition. -- No petition may be filed under this section after the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year towhich the requestunder section 6251 relates.

“(2)Notice of partnership adjustmentafter filingbutbeforehearingofpetition. -- If the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year to which the request under section 6251 relates after the filing of a petition under this subsection but

before the hearing of such petition, such petition shall be treated as an action brought under section 6247 with respect to such notice, except that subsection (b) ofsection 6247 shall not apply

“(3) Notice must be before expiration of statute of limitations. -- A notice of a partnership adjustment for the partnership taxable year shall be taken into account under paragraphs (1) and (2) only if such notice is mailed before the expiration of the period prescribed by section 6248 for making adjustments to partnership items for such taxable year.

“(d) Scope of Judicial Review. -- Except in the case described in paragraph (2) of subsection (c), a court with which a petition is filed in accordance with this section shall have jurisdiction to determine only those partnership items to which the part of the request under section 6251 not allowed by the Secretary relates and those items with respect to which the Secretary asserts adjustments as offsets to the adjustments requested by the partnership.

“(e) Determination of Court Reviewable. -- Any determination by a court under this subsection shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

“PART III -- DEFINITIONS AND SPECIAL RULES

“Sec. 6255.Definitions and special rules.

SEC. 6255.DEFINITIONS AND SPECIAL RULES.

“(a) Definitions. -- For purposes of this subchapter --

“(1) Large partnership. -- The term 'large partnership' has the meaning given to such term by section 775 without regard to section 776(a).

“(2) Partnership item. -- The term 'partnership item' has the meaning given to such term by section 6231(a)(3).

“(b) Partners Bound by Actions of Partnership, Etc.--

“(1) Designation of partner. -- Each large partnership shall designate (in the manner prescribed by the Secretary) a partner (or other person) who shall have the sole authority to act on behalf of such partnership under this subchapter. In any case in which such a designation is not in effect, the Secretary may select any partner as the partner with such authority.

“(2) Binding effect. -- A large partnership and all partners of such partnership shall be bound --

“(A) by actions taken under this subchapter by the partnership, and

“(B) by any decision in a proceeding brought under this subchapter.

“(c) Partnerships Having Principal Place of Business Outside the United States. -- For purposes of sections 6247 and 6252, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

“(d) Treatment Where Partnership Ceases To Exist. -- If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.

“(e) Date Decision Becomes Final.-- For purposes of this subchapter, the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the ClaimsCourt becomesfinal.

“(f)Partnerships in Cases Under Title 11of the UnitedStatesCode. -- Therunning of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section €501 or €502 on the assessment or collection of any amount required to be paid under section €242) shall, in a case under title 11 of the United States Code, be suspended duringtheperiodduring which the Secretary is prohibited by reason of such casefrommaking theadjustment (or assessment or collection) and --

“(1) for adjustment or assessment, 60 days thereafter, and

“(2)for collection, 6 months thereafter.

“(g)Regulations. --The Secretary shall prescribe suchregulationsasmaybenecessary to carry out the provisions of this subchapter, including regulations--

“(1) to prevent abuse through manipulation of the provisions of this subchapter, and

“(2) providing that this subchapter shall not apply to any case described in section 6231(c)(1) (or the regulations prescribed thereunder) where the application of this subchapter to such a case would interfere with the effective and efficient enforcement of this title.

In any case to which this subchapter does not apply by reason of paragraph (2), rules similar to the rules of sections. €229(f) and €255(f) shall apply.”

(b)Clerical Amendment. -- The table of subchapters for chapter €3 is amended by adding at the end thereof the following new item:

“Subchapter D. Treatment of large partnerships.”

SEC. 303.DUE DATE FOR FURNISHING INFORMATION TO PARTNERS OF LARGE PARTNERSHIPS.

(a)General Rule. -- Subsection (b) of section €031 (relating to copies to partners) is amended by adding at the end thereof the following new sentence:“In the case of a large partnership (as defined in sections 775 and 77€(a)), such information shall be furnished on or before the first March 15 following the close of such taxable year.”

(b)Treatment as Information Return. -- Section €724 is amended by adding at the end thereof the following new subsection:

“(e) Special Rule for Certain Partnership Returns. -- If any partnership return under section 6031(a) is required under section 6011(e) to be filed on magnetic media or in other machine-readable form, for purposes of this part, each schedule

required to be included with such return with respect to each partner shall be treated as a separate information return.”

SEC. 304. RETURNS MAY BE REQUIRED ON MAGNETIC MEDIA.

Paragraph (2) of section 6011(e) (relating to returns on magnetic media) is amended by adding at the end thereof the following new sentence:

“The preceding sentence shall not apply in the case of the partnership return of a large partnership (as defined in sections 775 and 776(a)) or any other partnership with 250 or more partners.”

SEC. 305.TREATMENT OF PARTNERSHIP ITEMS OF INDIVIDUAL RETIREMENT ACCOUNTS.

Subsection (b) of section 6012 is amended by adding at the end thereof the following new paragraph:

“(6) IRA share of partnership income. -- In the case of a trust which is exempt from taxation under section 408(e), for purposes of this section, the trust's distributive share of items of gross income and gain of any partnership to which subchapter C or D of chapter 63 applies shall be treated as equal to the trust's distributive share of the taxable income of such partnership.”

SEC. 306.EFFECTIVE DATE.

(a)General Rule. -- Except as otherwise provided in this section, the amendments made by this subtitle shall apply to partnership taxable years ending on or after December 31, 1994.

(b)Special Rule for Section 304. -- In the case of a partnership which is not a large partnership (as defined in sections 775 and 776(a) of the Internal Revenue Code of 1986, as added by this subtitle), the amendment made by section 304 shall only apply to partnership taxable years ending on or after December 31, 1998.

(c)Special Rule for Section 305. -- The amendment made by section 305 shall apply to taxable years beginning after December 31, 1993.

SUBTITLE B -- PROVISIONS RELATED TO TEFRA PARTNERSHIP PROCEEDINGS

SEC. 311.TREATMENT OF PARTNERSHIP ITEMS IN DEFICIENCY PROCEEDINGS.

(a) In General. -- Subchapter C of chapter 63 is amended by adding at the end thereof the following new section:

“SEC. 6234.DECLARATORY JUDGMENT RELATING TO TREATMENT OF ITEMS OTHER THAN PARTNERSHIP ITEMS WITH RESPECT TO AN OVERSHELTERED RETURN.

“(a) General Rule. -- If --

“(1) a taxpayer files an oversheltered return for a taxable year,

“(2) the Secretary makes a determination with respect to the treatment ofitems (other than partnership items) of such taxpayer for such taxable year, and

“(3) the adjustments resulting from such determination do not give rise to a deficiency (as defined in section 6211) but would give rise to a deficiency if there were no net loss from partnership items,

the Secretary is authorized to send a notice of adjustment reflecting such determination to the taxpayerbycertified or registered mail.

“(b) Oversheltered Return.--For purposes of this section,the termoversheltered return’ means an income tax return which --

“(1) shows no taxable income for the taxable year, and

“(2) shows a net loss from partnership items.

“(c) Judicial Review in the Tax Court. -- Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the day on which the notice of adjustment authorized in subsection (a) is mailed to the taxpayer, the taxpayer may file a petition with the Tax Court for redetermination of the adjustments. Upon the filing of such a petition, the Tax Court shall have jurisdictiontomake a declaration with respect to allitems(other than partnership itemsand affected items which requirepartner leveldeterminations as described in section 6230(a)(2)(A) (i)) for the taxable year which the notice of adjustment relates, in accordance with the principles of section 6214(a). Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

“(d) Failure To File Petition. --

“(1) In general. -- Except as provided in paragraph (2), if the taxpayer does not file a petition with the Tax Court within the time prescribed in subsection(c)the determination of the Secretary set forth in the notice of adjustment that was mailed to the taxpayer shall be deemed to be correct.

“(2) Exception. -- Paragraph (1) shall not apply after the date that the taxpayer --

“(A) files a petition with the Tax Court within the time prescribed in subsection (c) with respect to a subsequent notice of adjustment relating to the same taxable year, or

“(B) files a claim for refund of an overpayment of tax under section 6511 for the taxable year involved.

If a claim for refund is filed by the taxpayer, then solely for purposes of determining (for the taxable year involved) the amount of any computational adjustment in connection with a partnership proceeding under this subchapter (other than under this section) or the amount of any deficiency attributable in affected items in a proceeding under section 6230(a) (2), the items that are subject of the notice of adjustment shall be presumed to have been correctlyreported on the taxpayer's return during the pendency of the refund claim (and, if within the time prescribed by section 6532 the taxpayer commences a civil action for refund under section 7422, until the decision in the refund action becomes final).

“(e) Limitations Period. --

“(1) In general. -- Any notice to a taxpayer under subsection (a) shall be mailedbeforethe expiration ofthe period prescribedby section 6501 (relatingto theperiodoflimitations onassessment).

“(2) Suspension when secretary mails notice of adjustment. -- If the Secretary mails a notice of adjustment to the taxpayer for a taxable year, the period of limitations on the making of assessments shall be suspended for the period during which the Secretary is prohibited from making the assessment (and. in anyevent,ifa proceeding m respect of the notice ofadjustment is placedon thedocketofthe Tax Court,until the decision oftheTax Court becomesfinal), and for 60 days thereafter.

“(3) Restrictions on assessment.-- Except as otherwise provided in section 6851, 6852, or 6861, no assessment of a deficiency with respect to any tax imposed by subtitle A attributable to any item (other than a partnership item or any item affected by a partnership item) shall be made - -

“(A) until the expiration of the applicable 90-day or 150-day period sec forth in subsection (c) for filing a petition with the Tax Court, or

“(B) if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.

“(f) Further Notices of Adjustment Restricted. -- If the Secretary mails a notice of adjustment to the taxpayer for a taxable year and the taxpayer files a petition with the Tax Court within the time prescribed in subsection (c), the Secretary may not mail another such notice to the taxpayer with respect to the

same taxable year in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.

“(g) Coordination With Other Proceedings Under This Subchapter. --

“(1) In general. -- The treatment of any item that has been determined pursuant to subsection (c) or (d) shall be taken into account in determining amount of any computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section in the amount of any deficiency attributable to affected items in a proceeding under section 6230(a)(2), for the taxable year involved. Notwithstanding anyother law or rule of law pertaining to the period of limitations on the makingof assessments, for purposes of the preceding sentence, any adjustment made in accordance with this section shall be taken into account regardless of whetherany assessment has been made with respect to such adjustment.

“(2) Special rule in case of computational adjustment. -- In the case of a computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section), the provisionsof paragraph (1) shall apply only if the computational adjustment is made within the period prescribed by section 6229 for assessing any tax under subtitle A which is attributable to any partnership item or affected item for the taxable year involved.

“(3) Conversion to deficiency proceeding. -- If --

“(A) after the notice referred to in subsection (a)is mailedco a taxpayer for a taxable year but before the expiration of the period for filing a petition with the Tax Court under

subsection (c) (or, if a petition is filed with the Tax Court, before the Tax Court makes a declaration for that taxable year), the treatment of any partnership item for the taxable year is finally determined, or any such item ceases to be a partnership item pursuant to section 6231(b), and

"(B) as a result of that final determination or cessation, a deficiency can be determined with respect to the items that are the subject of the notice of adjustment, the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition filed in respect of the notice shall be treated as an action brought under section 6213.

"(4) Finally determined. -- For purposes of this subsection, the treatment of partnership items shall be treated as finally determined if --

"(A) the Secretary enters into a settlement agreement(withinthe meaningofsection 6224) with the taxpayer regarding such items,

"(B) a notice of final partnership administrative adjustment has been issued and --

"(i) no petition has been filed under section 6226 and the time for doing sc has expired, or

"(ii) a petition has been filed under section 6226 and the decision of the court has become final, or

"(C) the period within which any tax attributable to such items may be assessed against the taxpayer has expired.

“(h) Special Rules if Secretary Incorrectly Determines Applicable Procedure

“(1) Special rule if secretary erroneously mails notice of adjustment. -- It the Secretary erroneously determines that sub chapter B does not apply co a taxable year of a taxpayer and consistent with that determination timely mails a notice of adjustment to the taxpayer pursuant to subsection (a) of this section, the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition that is filed in respect of the notice shall be created as an action brought under section 6213.

“(2) Special rule if secretary erroneously mails notice of deficiency. -- If the Secretary erroneously determines that subchapter B applies to a taxable year of a taxpayer and consistent with that determination timely mails a notice ofdeficiency to the taxpayer pursuant to section 6212, the notice of deficiency shall be treated as a notice of adjustment under subsection (a) and any petition that is filed in respect of the notice shall be treated as an action brought under subsection (c).”

(b)Treatment of Partnership Items in Deficiency Proceedings. -- Section 6211 (defining deficiency) is amended by adding at the end thereof the following new subsection:

“(c) Coordination With Subchapter C. -- In determining the amount of any deficiency for purposes of this subchapter, adjustments to partnership items shall be made only as provided in subchapter C.”

(c) Clerical Amendment. -- The table of sections for subchapterCofchapter63 is amended by adding at the end thereof thefollowing new item:

“Sec. 6234. Declaratory judgment relating to treatment of items other than partnership items with respect to an oversheltered return.”

(d)Effective Date. -- The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 312.PARTNERSHIP RETURN TO BE DETERMINATIVE OF AUDIT PROCEDURES TO BE FOLLOWED.

(a)In General. -- Section 6231 (relating to definitions and special rules is amended by adding at the end thereof the following new subsection:

“(g) Partnership Return To Be Determinativeof Whether SubchapterApplies

“(l) Determination that subchapter applies. -- If, on the basisof apartnership return for a taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such, partnership (and its items) for such taxable year and to partners of such partnership.

“(2) Determination that subchapter does not apply. -- If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not

apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership.

(b)Effective Date. -- The amendment made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 313.PROVISIONS RELATING TO STATUTE OF LIMITATIONS.

(a)Suspension of Statute Where Untimely Petition Filed. -- Paragraph (l) cf section 6229(d) (relating to suspension where Secretary makes administrative adjustment) is amended by striking all that follows “section 6226” and inserting the following: “(and, if a petition is filed under section 6226 with respect to such administrative adjustment, until the decision of the court becomes final and”.

(b) Suspension of Stature During Bankruptcy Proceeding. -- Section 6229 is amended by adding ac the end thereof the following new subsection:

“(h) Suspension During Pendency of Bankruptcy Proceeding. -- If a petition is filed naming a partner as a debtor in a bankruptcy proceeding under title 11 of the United States Code, the running of the period of limitations provided m this section with respect to such partner shall be suspended --

“(1) for the period during which the Secretary is prohibited by reason of such bankruptcy proceeding from making an assessment, and

“(2) for 60 days thereafter.”

(c)Tax Matters Partner in Bankruptcy. -- Section 6229(b) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph(1)the following new paragraph:

“(2) Special rule with respect to debtors in title 11 cases. --Notwithstanding any other law or rule of law, if an agreement is entered into under paragraph (1)(B) and the agreement is signed by a person who would be the tax matters partner but for the fact that, at the time that the agreement is executed, the person is a debtor in a bankruptcy proceeding under tide 11 of the United States Code, such agreement shall be binding on all partners in the partnership unless the Secretary has been notified of the bankruptcy proceeding in accordance with regulations prescribed by the Secretary.”

(d)Effective Dates.--

(1)Subsections (a) and (b). --The amendments made by subsections (a) and(b)shall apply to partnership taxable years with respect to which the period under section 6229 of the Internal Revenue Code of 1986 for assessing tax has not expired on or before the date of the enactment of this Act.

(2)Subsection (c). -- The amendment made by subsection (c) shall apply to agreements entered into after the date of the enactment of this Act.

SEC. 314.EXPANSION OF SMALL PARTNERSHIP EXCEPTION.

(a) In General. -- Clause (i) of section 6231 (a)(1)(B) (relating to except: cr. for small partnerships) is amended to read as follows:

“(i) In general. -- The term 'partnership' shall not include any partnership having 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. For purposes of the preceding sentence, a husband and wife (and their estates) shall be created as 1 partner.”

(b)Effective Date. -- The amendment made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act

SEC. 315.EXCLUSION OF PARTIAL SETTLEMENTS FROM 1 YEAR LIMITATION ON ASSESSMENT.

(a) In General. -- Subsection(£)ofsection6229 (relating to items becomingnonpartnerahip items! is amended--

(1)by striking “(f) Items Becoming Nonpartnership Items. -- If” andinserting the following:

“(f) Special Rules. --

“(1) Items becoming nonpartnershipitems.--If”,

(2) by moving the text of such subsection 2 ems to the right, and

(3)by adding at the end thereof the following new paragraph:

“(2) Special rule for partial settlement agreements. -- If a partner enters into a settlement agreement with the Secretary with respect to the treatment of some of the partnership items in dispute for a partnership taxable year but other partnership items for such year remain in dispute, the period of limitations for assessing any tax attributable to the settled items shall be determined as if such agreement had not been entered into.”

(b)Effective Date. -- The amendment made by this section shall apply to settlements entered into after the date of the enactment of this Act.

SEC. 316.EXTENSION OF TIME FOR FILING A REQUEST FOR ADMINISTRATIVE ADJUSTMENT.

(a)In General. - - Section 6227 (relating to administrative adjustment requests) is amended by redesignating subsections (b) and (c) as subsections to and (d), respectively, and by inserting after subsection (a) the following new subsection:

“(b) Special Rule in Case of Extension of Period of Limitations Under Section 6229. -- The period prescribed by subsection (a)(1) for filing of a request for an administrative adjustment shall be extended --

“(1) for the period within which an assessment may be made pursuant to an agreement (or any extension thereof) under section 6229(b), and

“(2) for 6 months thereafter.”

(b)Effective Date. -- The amendment made by this section shall take effectas if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC. 317.AVAILABILITY OF INNOCENT SPOUSE RELIEF ZN CONTEXT OF PARTNERSHIP PROCEEDINGS.

(a)In General. -- Subsection (a) of section 6230 is amended by adding at the end thereof the following new paragraph:

“(3) Special rule in case of assertion by partner's spouse of innocent spcus-relief.

“(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6013(e) applies with respect to a liability that is attributable to any adjustment co a partnership item, then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessmentspecified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making any such reassessment shall not expire before the expiration of 60 days after the date of such abatement

“(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6013(e) have been satisfied. For purposes of such determination, the treatment of partnership items under the settlement, the final partnership administrative

adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

“(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph.”

(b)Claims for Refund. -- Subsection (c) of section 6230 is amended by adding at the end thereof the following new paragraph:

“(5) Rules for seeking innocent spouse relief. --

“(A) In general. -- The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6013'to from a liability that is attributable to an adjustment to a partnership item

“(B) Time for filing claim. -- Any claim under subparagraph (A) shall be filed within 6 months after the day on which the Secretary mails co the spouse the notice of computational adjustment referred to in subsection (a)(3)(A)

“(C) Suit if claim not allowed. -- If the claim under subparagraph (B) is r.cc allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

“(D) Prior determinations are binding. -- For purposes of any claim or suit under this paragraph, the treatment of partnership items under the settlement, the final partnership administrative adjustment, or the decision of the court

(whichever is appropriate) that gave rise to the liability in question shall be conclusive.”

(c)Technical Amendments. --

(1)Paragraph (1) of section 6230(a) is amended by striking “paragraph (2) and inserting “paragraph (2) or (3)”.

(2)Subsection (a) of section 6503 is amended by striking “section 6230(a)(2)(A)” and inserting “paragraph (2) (A) or (3) of section 6230(a)”.

(d)Effective Date. -- The amendments made by this section shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1962.

SEC. 316.DETERMINATION OF PENALTIES AT PARTNERSHIP LEVEL.

(a)In General. -- Section 6221 (relating to tax treatment determined at partnership level) is amended by striking “item” and inserting “item (and theapplicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item)”.

(b) Conforming Amendments. --

(1)Subsection (f) of section 6226 is amended --

(A)by striking “relates and”and inserting “relates,”, and

(B)by inserting before the period “, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item”.

(2)Clause (i) of section 6230(a)(2)(A) is amended to read as follows:

“(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or”.

(3)(A) Subparagraph (A) of section 6230(a)(3), as added by section 317, isamended by inserting “(includingany liability for any penalty,addition to tax, or additional amount relating tosuch adjustment)” after “partnershipitem”.

(B)Subparagraph (B) of such section is amended by inserting “(and the applicability of any penalties, additions to tax, or additional amounts)” after “partnership items”.

(C)Subparagraph (A) of section 6230(c)(5), as added by section 317, isamended by inserting before theperiod “(includingany liability for anypenalties, additions totax, oradditional amountsrelating to suchadjustment)”.

(D)Subparagraph (D) of section 6230(c)(S), as added by section 317, is amended by inserting” (and the applicability of any penalties, additions to tax. or additional amounts)” after “partnership items”.

(4)Paragraph (1) ofsection6230(c) is amended by striking “or” attheendof subparagraph (A), bystriking the period at theend

of subparagraph(B)andinserting “, or”, and by adding at the end thereof the following new subparagraph:

“(C) the Secretary erroneously imposed any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.”

(5) So much of subparagraph (A) of section 6230(c)(2) as precedes “shall befiled” is amended co read as follows:

“(A) Under paragraph (l) (a) or (c). -- Any claim under subparagraph (A) or(C)of paragraph (1)”.

(6)Paragraph (4) of section 6230(c) is amended by adding at the end thereof the following: “In addition,the determination under the final partnership administrative adjustment or underthe decision ofthe court (whichever is appropriate) concerningthe applicability of any penalty, addition co tax, or additional amount which relates co an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.”

(c)Effective Dace. -- The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC.319. PROVISIONS RELATING TO COURT JURISDICTION, ETC.

(a)Tax Court Jurisdiction To Enjoin Premature Assessments of Deficiencies Attributable to Partnership Items. -- Subsection (b) of section 622S is amended by striking “the proper

court.” and inserting “the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action or proceeding under this subsection unless a timely petition for a readjustment of the partnership items for the taxable year has been filed and then only in respect ofthe adjustments that are the subject of such petition.”

(b)Jurisdiction To Consider Statute of Limitations With Respect to Partners -- Paragraph (1) of section 6226(d) is amended by adding at the end thereof the following new sentenced

“Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion.”

(c)Tax Court Jurisdiction To Determine Overpayments Attributable co Affected Items. --

(1)Paragraph (6) of section 6230(d) is amended by striking “(or an affected item)”.

(2)Paragraph (3) of section 6512(b) is amended by adding atthe end thereof the following new sentence:

“In the case of a credit or refund relating to an affected item (within the meaning of section 6231(a)(5)), the preceding sentence shall be applied by substituting the periods

under sections 6229 and 6230(d) for the periods under section 6511(b)(2), (c), and (d).”

(d)Venue on Appeal.--

(1) Paragraph (1) of section 7482(b) is amended by striking “or” at the end of subparagraph (D), by striking the period at the end of subparagraph (E) and inserting “, or”, and by inserting after subparagraph (E) the following new subparagraph:

“(F) in the case of a petition under section 6234(c) --

“(i) the legal residence of the petitioner if the petitioner is not a corporation, and

“(ii) the place or office applicable under subparagraph (B) if the petitioner is a corporation.”

(2)The last sentence of section 7482(b)(1) is amended by striking “or 6228(a)” and inserting “, 6228(a), or 6234(c)”.

(e) Other Provisions. --

(1)Subsection (c) of section 7459 is amended by striking “or section6228(a)” and inserting “, 6228(a), or 6234(c)”.

(2)Subsection (o) of section 6501 is amended by adding at the end thereof the following new paragraph:

“(3) For declaratory judgment relating to treatment of items other than partnership items with respect to an oversheltered return, see section 6234

(f) Effective Date. -- The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC.320. TREATMENT OF PREMATURE PETITIONS FILED BY NOTICE PARTNERS OR 5-PERCENT GROUPS.

(a)In General. -- Subsection (b) of section 6226 (relating to judicial review of final partnership administrative adjustments) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph(4)the following new paragraph:

“(5) Treatment of premature petitions. -- If --

“(A) a petition for a readjustment of partnership items for the taxable yea: involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

“(B) no action is brought under paragraph (1) during the 60-day period described therein with respect tosuch taxable year which is not dismissed such petition shall betreatedfor purposes of paragraph(l) asfiledon thelast day of such 60-day period.”

(b)Effective Date. --The amendment made by this sectionshallapplytopetitions filed after thedate ofthe enactment of this Act.SEC.321. BONDS IN CASE OF APPEALS FROM TEFRA PROCEEDING.

(a)In General. -- Subsection (b) of section 7485 (relating co bonds co stay assessment of collection) is amended --

(1)by inserting “penalties.” after “any interest,”, and

(2)by striking “aggregate of such deficiencies” and inserting “aggregate liability of the parties to the action”.

(b)Effective Dace. -- The amendment made by this section shall cake effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC.322. SUSPENSION OF INTEREST WHERE DELAY IN COMPUTATIONAL ADJUSTMENT RESULTING FROM TEFRA SETTLEMENTS.

(a)In General. -- Subsection (c) of section 6601 (relating to interest on underpayment, nonpayment, or extension of time for payment, of tax) is amended by adding at the end thereof the following new sentence: “In the case of a settlement under section 6224(c) which results in the conversion of partnership items to nonpartnership items pursuant to section 6231(b)(1)(C), the preceding sentence shall apply co a computational adjustment resulting from such settlement in the same manner as if such adjustment were a deficiency and such settlement were a waiver referred to m the preceding sentence.”

(b)Effective Dace. -- The amendment made by this section §hall apply co adjustments with respectto partnership taxable years beginning after the date of the enactment of this Act.

SEC. 323.SPECIAL RULES FOR ADMINISTRATIVE ADJUSTMENT REQUESTS WITH RESPECT TO BAD DEBTS OR WORTHLESS SECURITIES.

(a)General Rule. -- Section 6227 (relating to administrative adjustment requests) is amended by adding at the end thereof the following new subsection

“(d) Requests With Respectto Bad Debts or Worthless Securities. -- In the case of that portion of any request for an administrative adjustment which relates to the deductibility by the partnership under section 166 of a debt as 3 debt which became worthless, or under section 165(g) of a loss from worthlessness of a security, the period prescribed in subsection (a)(1) shall be 7 years from the last day for filing the partnership return for the year with respect to which such request is made (determined without regard to extensions).”

(b)Effective Date. –

(1)In general. -- The amendment made by subsection (a) shall cake effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

(2)Treatment of requests filed before dace of enactment. --In the case of that portion of any request (filed before the date of the enactment of this Act for an administrative adjustment which relates to the deductibility of a debt ASa debt which became worthless or the deductibility of a loss from the worthlessness of a security --

(A) paragraph (2) of section 6227(a) of the Internal Revenue Code of 1986 shall not apply,

(B)the period for filing a petition under section 6228 of the Internal Revenue Code of 1986 with respect to such request

shall not expire before the date 6 months afterthe date of the enactment of this Act, and

(C)such a petition may be filed without regard to whether there was a notice ofthe beginning of an administrative proceeding or a final partnership administrative adjustment.