

Section 6221.—Tax Treatment Determined at Partnership Level

26 CFR 6221–1T: Tax treatment determined at partnership level (Temporary)

T.D. 8808

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301**

Modifications and Additions to the Unified Partnership Audit Procedures

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the unified partnership audit procedures added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The unified partnership audit procedures generally provide administrative rules for the auditing of partnership items at the partnership level. These regulations modify the existing unified partnership audit procedures to comply with the Taxpayer Relief Act of 1997 (1997 Act) and the Internal Revenue Service Restructuring and Reform Act of 1998 (1998 Act), and add new regulations to administer the new unified partnership audit provisions added by the 1997 Act. In general, the text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–106564–98, on page 53.

DATES: *Effective Date:* These regulations are effective January 26, 1999.

FOR FURTHER INFORMATION CONTACT: Robert G. Honigman, (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary amendments to the Procedure and Administration Regulations (26 CFR Part 301) relating to the unified partnership audit procedures found in sections 6221 through 6233 of the Internal Revenue Code (Code) and final regulations pertaining to the applicable dates of §301.6231(a)(7)–1T(p)(2) and §301.6231(a)(7)–1T(r)(1). Sections 1231 through 1243 of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788, modified some of the existing procedures and added certain new rules. Section 3507 of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206, 112 Stat. 685, modified section 6231. This document modifies existing regulations that, because of the 1997 Act or the 1998 Act, no longer reflect current law.

Explanation of Provisions

Penalties Determined At The Partnership Level

Before the 1997 Act, the Internal Revenue Service (Service) could impose penalties on a partner only through the application of the deficiency procedures after the completion of a partnership level proceeding. Forcing the Service to open deficiency proceedings against the individual partners was inconsistent with the efficiency goal of the unified partnership audit rules. The 1997 Act cured this problem by providing that, for partnerships under audit for taxable years ending after August 5, 1997, partnership level proceedings include the determination of applicable penalties at the partnership level. Partners now may raise any partner level defenses to the imposition of penalties only in a subsequent refund action.

Consistent with these statutory changes, the temporary regulations mandate that the partnership's penalty defenses are to be resolved during the partnership proceeding. Nevertheless, any individual defenses that a partner may have to the imposition of a penalty may

be brought by the partner in a refund action subsequent to the partnership level determination. In order to minimize the burden on individual partners to defend themselves by bringing their own refund suits, the temporary regulations incorporate a large number of defenses at the partnership level. The majority of a partner's defenses to the imposition of penalties are not specific to a particular partner, but can be determined by reference to the activities of the partnership. The applicability of these defenses may be resolved at the partnership level during the partnership proceeding. In addition, the temporary regulations modify the computational adjustment rules to allow the Service to assess penalties under those procedures.

Partial Settlements

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is one year after the date that the items became nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the Service with respect to such items. In some audits, however, the taxpayer and the Service will enter into a settlement agreement regarding some, but not all, of the taxpayer's partnership items. The 1997 Act added a special rule for these partial settlement agreements in section 6229(f)(2), providing that the period for assessing any tax attributable to the settled items is determined as if the partial settlement had not been executed. Thus, the limitations period applicable to the last partnership item to be resolved for the partnership's taxable year under audit is controlling with respect to all disputed partnership items (including settled items) for such partnership taxable year.

The temporary regulations state that the one year period for assessing partnership items that convert to nonpartnership items applicable to settlement agreements under section 6231(b)(1)(C) does not apply to partial settlement agreements under sec-

tion 6229(f)(2). Moreover, the temporary regulations clarify that the partner remains subject to the unified audit procedures regarding the nonsettled items.

Tax Matters Partner As A Debtor In Bankruptcy

Section 6229(b)(1)(B) provides that the statute of limitations under section 6229 is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the Service. Treas. Reg. §301.6231(a)(7)–1(l)(1)(iv) (1996) and Temp. Treas. Reg. §301.6231(c)–7T(a) (1987), however, provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, the partner/debtor's partnership items convert to nonpartnership items, and if the partner/debtor was the TMP, that status terminates. These rules were promulgated to avoid the complications that the automatic stay provision contained in 11 U.S.C. 362(a)(8) would have on a unified partnership audit. As a result, if a TMP executed a consent to extend the statute of limitations during a period when the TMP was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners. Under the regulations, the person signing the agreement was ineligible to act as the TMP and extend the statute as to all partners.

To resolve the uncertainty under prior law in the situation where a TMP executes an agreement extending the statute of limitations as to all partners while, unknown to the Service, the TMP is a debtor in a bankruptcy proceeding, the 1997 Act provides that the Service may rely on the executed statute extension agreement unless it is notified of the TMP's bankruptcy proceeding. If the Service is not notified of the TMP's bankruptcy proceeding, statute extensions granted by the TMP are binding on all partners in the partnership.

The temporary regulations provide a mechanism for the TMP, or other partners, to provide notice to the Service that the TMP is a debtor in a bankruptcy proceeding and therefore is ineligible to serve as TMP and extend the statute under section 6229. This mechanism is derived from existing regulations that provide guidance on how to notify the Service of information concerning a partnership's partners.

Small Partnership Exception

The 1997 Act amended the small partnership exception to the unified partnership audit procedures found in section 6231. Formerly, in order to qualify for the small partnership exception, the partnership had to have 10 or fewer partners at all times during the tax year, each of whom was a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item was the same as that partner's share of every other partnership item. The 1997 Act amended the small partnership exception by allowing partnerships to qualify for the exception even if they have a C corporation for a partner or specially allocate some partnership items. The temporary regulations modify the existing regulations interpreting the small partnership exception to take account of this change in the law.

Effective Date

These final and temporary regulations are applicable January 26, 1999. In accordance with section 7805(e)(2), the temporary regulations contained herein shall expire January 25, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross reference notice of proposed rule-making published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these final and temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these temporary regulations are Robert G. Honigman, Office of the Assistant Chief Counsel

(Passthroughs & Special Industries), and William A. Heard, Office of the Assistant Chief Counsel (Field Service). However, other personnel from the Service and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Amend §301.6221-1T by:

1. Redesignating paragraph (c) as paragraph (e).
2. Adding new paragraphs (c) and (d).
The additions read as follows:

§301.6221-1T Tax treatment determined at partnership level (temporary).

* * * * *

(c) *Penalties determined at partnership level (partnership taxable years ending after August 5, 1997)*. Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, shall be determined at the partnership level. Partner level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership level determinations. Partnership level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner level defenses specified in paragraph (d) of this section.

(d) *Partner level defenses*. Partner level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, may not be asserted in the partnership level proceeding, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4).

Partner level defenses are limited to those that are personal to the partner or are dependant upon the partner's separate return, and cannot be determined at the partnership level. Examples of these determinations are: whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b)(penalties applicable only where return is filed), or section 6664(c)(1)(reasonable cause exception) subject to partnership level determinations as to the applicability of section 6664(c)(2).

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Par. 3. Amend §301.6223(c)-1T by adding a sentence to the end of paragraph (c) to read as follows:

§301.6223(c)-1T Additional information regarding partners furnished to the Service (temporary).

* * * * *

(c) * * * Furthermore, reference to a prior general notification to the Service that a partner who would otherwise be the tax matters partner is a debtor in a bankruptcy proceeding or has had a receiver appointed for him in a receivership proceeding is not sufficient unless a copy of the notification document referred to is attached to the statement.

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Par. 4. Amend §301.6224(c)-3T by:

1. Revising the section heading.
2. Revising paragraphs (b), (c)(3)(ii), and (d), *Example (1)*.

The revisions read as follows:

§301.6224(c)-3T Consistent settlement terms (temporary).

* * * * *

(b) *Requirements for consistent settlement term s--(1) In general*. Consistent settlement terms are those based on the same determinations with respect to partnership items. However, consistent settlement terms also may include partnership level determinations of any penalty, addition to tax, or additional amount that relates to partnership items. Settlements with respect to partnership items shall be self-contained; thus, a concession by one party with respect to a partnership item

may not be based upon a concession by another party with respect to any item that is not a partnership item other than any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item. Consistent agreements, whether comprehensive or partial, must be identical to the original settlement (that is, the settlement upon which the offered settlement terms are based). A consistent agreement must mirror the original settlement and may not be limited to selected items from the original settlement. Once a partner has settled a partnership item, or penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, that partner may not subsequently request settlement terms consistent with a settlement that contains the previously settled item. The requirement for consistent settlement terms applies only if—

(i) The items were partnership items (and any related penalty, addition to tax, or additional amount) for the partner entering into the original settlement immediately before the original settlement; and

(ii) The items are partnership items (and any related penalty, addition to tax, or additional amount) for the partner requesting the consistent settlement at the time the partner files the request.

(2) *Effect of consistent agreement.* Consistent settlement terms are reflected in a consistent agreement. A consistent agreement is not a settlement agreement which gives rise to further consistent settlement rights because it is required to be given without volitional agreement of the Secretary. Therefore, a consistent agreement required to be offered to a requesting taxpayer is not a settlement agreement under section 6224(c)(2) of the Internal Revenue Code, or paragraph (c)(3) of this section which starts a new period for requesting consistent settlement terms. For all other purposes of the Internal Revenue Code, however, (e.g., binding effect under section 6224(c)(1), and conversion to nonpartnership items under section 6231(b)(1)(C)) a consistent agreement is treated as a settlement agreement.

(c) * * *

(3) * * *

(ii) The 60th day after the day on which the settlement agreement was entered into.

(d) * * *

Example (1). The Service seeks to disallow a \$100,000 loss reported by Partnership P. The Service agrees to a settlement with X, a partner in P, in which the Service allows 60 percent of the loss, accepts the treatment of all other partnership items on the partnership return, and imposes a penalty for negligence related to the loss disallowance. Partner Y, which owns a 10 percent interest in the partnership, requests settlement terms which are consistent with the settlement made between X and the Service. The items are partnership items (and a related penalty) for X immediately before X enters into the settlement agreement and are partnership items (and a related penalty) for Y at the time of the request. The Service must offer Y settlement terms allowing a \$6,000 loss, a negligence penalty on the \$4,000 disallowance, and otherwise reflecting the treatment of partnership items on the partnership return.

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Par. 5. Add §301.6229(b)–2T to read as follows:

§301.6229(b)–2T Special rule with respect to debtors in Title 11 cases (temporary).

(a) *In general.* Notwithstanding any other law or rule of law, if an agreement is entered into under section 6229(b)(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 Title 11 of the United States Code, such agreement shall be binding on all partners in the partnership unless the Service has been notified of the bankruptcy proceeding in accordance with paragraph (b) of this section.

(b) *Procedures for notifying the Service of a partner's bankruptcy proceeding.* (1) The Service shall be notified of the bankruptcy proceeding of the tax matters partner in accordance with the procedures set forth in §301.6223(c)–1T.

(2) In addition to the information specified in §301.6223(c)–1T, notification that a person is (or was) a debtor in a bankruptcy proceeding shall include the date the bankruptcy proceeding was filed, the name and address of the court in which the bankruptcy proceeding exists (or took place), the caption of the bankruptcy proceeding (including the docket number or other identification number used by the court), and the status of the proceeding as of the date of notification.

Par. 6. Add §301.6229(f)–1T to read as follows:

§301.6229(f)–1T Special rule for partial settlement agreements (temporary).

(a) *In general.* If a partner enters into a settlement agreement with the Service 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) *Other items remaining in dispute.* Pursuant to section 6226(c), a partner is a party to a partnership level judicial proceeding with respect to partnership items. When a partner settles partnership items, the settled partnership items convert to nonpartnership items under section 6231(b)(1)(C) and will not be subject to any future or pending partnership level proceeding pursuant to section 6226(d)–(1). The remaining unsettled partnership items, however, will remain subject to termination under partnership level administrative and judicial procedures. Consequently, any remaining unsettled items will be deemed to remain in dispute. Thus, the period for assessing settled items will be governed by the period for assessing the remaining unsettled items.

Par. 7. Amend §301.6231(a)(1)–1T by:

1. Revising the first two sentences of paragraph (a)(1).

2. Removing paragraph (a)(3).

3. Redesignating paragraph (a)(4) as paragraph (a)(3).

The revision reads as follows:

§301.6231(a)(1)–1T Exception for small partnerships (temporary).

(a) * * *

(1) “10 or fewer.” The “10 or fewer” limitation described in section 6231(a)–(1)(B)(i) is applied to the number of natural persons (other than nonresident aliens), C corporations, and estates of deceased partners that were partners at any one time during the partnership taxable year. Thus, for example, a partnership that at no time during the taxable year had more than 10 partners may be treated as a small partnership even if, because of transfers of interests in the partnership, 11 or more natural persons, C corporations, or estates of deceased partners owned in-

terests in the partnership for some portion of the taxable year. * * *

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- Par. 8. Amend §301.6231(a)(6)-1T by:
 1. Revising paragraph (a).
 2. Removing paragraph (c).
 The revision reads as follows:

§301.6231(a)(6)-1T Computational adjustments (temporary).

(a) *In general.* A change in the tax liability of a partner to properly reflect the treatment of a partnership item under subchapter C of chapter 63 of the Internal Revenue Code is made through a computational adjustment. A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item. However, if a change in a partner's tax liability cannot be made without making one or more partner level determinations, that portion of the change in tax liability attributable to the partner level determinations shall be made under the provisions of subchapter B of chapter 63 of the Internal Revenue Code (relating to deficiency procedures), except for any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(1) Changes in a partner's tax liability with respect to affected items that do not require partner level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Service may assume that amounts the partner reported on the partner's individual return include all amounts reported to the partner by the partnership, absent contrary notice to the Service (for example, a "Notice of Inconsistent Treatment"). Such an assumption by the Service does not constitute a partner level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not constitute a partner level determination

where the Service otherwise accepts all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(2) Changes in a partner's tax liability with respect to affected items that require partner level determinations (such as a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership) are computational adjustments subject to deficiency procedures. Nevertheless, any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may be directly assessed following a partnership proceeding, based on determinations in that proceeding, regardless of whether partner level determinations are required.

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- Par. 9. Amend §301.6231(a)(7)-1 by adding a sentence at the end of paragraphs (p)(2) and (r)(1) to read as follows:

§301.6231(a)(7)-1 Designation or selection of tax matters partner.

* * * * *

(p) * * *

(2) * * * For regulations applicable on or after January 26, 1999 (reflecting statutory changes made effective July 22, 1998) and before January 25, 2002, see §301.6231(a)(7)-1T(p)(2).

* * * * *

(r) * * * (1) * * * For regulations applicable on or after January 26, 1999 (reflecting statutory changes made effective July 22, 1998) and before January 25, 2002, see §301.6231(a)(7)-1T(r)(1).

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- Par. 10. Add §301.6231(a)(7)-1T to read as follows:

§301.6231(a)(7)-1T Designation or selection of tax matters partner (temporary).

(a) through (p)(1) [Reserved]. For further guidance, see §301.6231(a)(7)-1(a) through (p)(1).

(p)(2) *When each general partner is deemed to have no profits interest in the partnership.* If it is impracticable under §301.6231(a)(7)-1(o)(2) to apply the

largest-profits-interest rule of §301.6231(a)(7)-1(m)(2), the Commissioner will select a partner (including a general or limited partner) as the tax matters partner in accordance with the criteria set forth in §301.6231(a)(7)-1(q). The Commissioner will notify, within 30 days of the selection, the partner selected, the partnership, and all partners required to receive notice under section 6223(a), effective as of the date specified in the notice. For regulations applicable before July 22, 1998, see §301.6231(a)(7)-1(p)(2).

(p)(3) through (q) [Reserved]. For further guidance, see §301.6231(a)(7)-1(p)(3) through (q).

(r) *Notification of partnership.* (1) *In general.* If the Commissioner selects a tax matters partner under the provisions of §301.6231(a)(7)-1(p)(1) or (3)(i), the Commissioner will notify, within 30 days of the selection, the partner selected, the partnership, and all partners required to receive notice under section 6223(a), effective as of the date specified in the notice. For regulations applicable before July 22, 1998, see §301.6231(a)(7)-1(r)(1).

(r)(2) [Reserved]. For further guidance, see §301.6231(a)(7)-1(r)(2).

Robert E. Wenzel,
Deputy Commissioner of
Internal Revenue Service.

Approved December 30, 1998.

Donald C. Lubick,
Assistant Secretary of
the Treasury.

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