MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

August 14, 2017

Via Electronic Filing:

Internal Revenue Service
CC:PA:LPD:PR (REG- 136118–15)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Managed Funds Association Comments on Proposed Rules -- Centralized Partnership Audit Regime

Dear Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] would like to provide comments to the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS" or the "Service")) on proposed rules REG–136118–15 to implement the centralized partnership audit regime (the "Proposed Rules") that was enacted as part of the Bipartisan Budget Act of 2015. As Treasury and the IRS are aware, the new partnership audit regime is applicable to partnership tax returns filed for tax years beginning after December 31, 2017, which underscores the importance of finalizing a regulatory framework to provide clear and administrable rules for taxpayers. In that regard, we appreciate that Treasury and the IRS have issued the Proposed Rules and that they anticipate issuing additional proposed rules on certain key issues not addressed in the Proposed Rules, including proposals on the reporting option for tiered partnership structures and basis adjustments for payments made under Section 6225 of the Internal Revenue Code of 1986, as amended, (the "Code").[2]

When implementing the partnership audit framework, we believe that Treasury and the Service should focus on implementing the partnership audit legislation in a manner that

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] All "Section" references in the letter refer to the Code, as amended by the Bipartisan Budget Act, unless otherwise indicated.

establishes an efficient, administrable regime that best ensures that the government collects the correct amount of tax from the correct taxpayers. This approach is consistent with the statutory intent and the policy goal set out in President Trump's Executive Order 13789, Identifying and Reducing Tax Regulatory Burdens (the "Tax Executive Order").[3] As a matter of fundamental tax policy and basic tax fairness, the partnership audit rules should not force taxpayers to bear liability for other taxpayers' obligations, to pay taxes that they do not rightfully owe to the government, or to pay taxes twice on the same income. While we support several aspects of the Proposed Rules, we are concerned that the Proposed Rules fail to accomplish this goal fully, as they do not address a number of the issues raised by MFA and other industry participants in response to Treasury and the IRS' 2016 request for comments.[4]

MFA supports the goal underlying the changes to partnership audit rules in Subchapter C of Chapter 63 of the Code that Congress enacted as part of the Bipartisan Budget Act of 2015. Congress intended these changes to ensure that the Service would be able to effectively audit and assess partners in partnerships. Ensuring that all aspects of the new partnership audit legislation are workable in practice is critical to achieve the intended objectives of the legislation, as noted in the report, *General Explanation of Tax Legislation Enacted in 2015*, by the staff of Joint Committee on Tax (the "Bluebook"). As the Bluebook notes[5] the statute provides the Secretary with authority to issue rules or guidance that are designed to:

> determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.

To best achieve this outcome, we believe it is critical for Treasury and the Service to implement Sections 6225 and 6226 in a way that imposes post-audit tax liabilities as closely as possible to partners' tax liabilities outside of the audit context. In that regard, Treasury and the IRS should provide additional clarification regarding how the modification rules

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[3] Section 1 of the Tax Executive Order provides –

> The Federal tax system should be simple, fair, efficient, and pro-growth. The purposes of tax regulations should be to bring clarity to the already complex Internal Revenue Code (title 26, United States Code) and to provide useful guidance to taxpayers. Contrary to these purposes, numerous tax regulations issued over the last several years have effectively increased tax burdens, impeded economic growth, and saddled American businesses with onerous fines, complicated forms, and frustration. Immediate action is necessary to reduce the burden existing tax regulations impose on American taxpayers and thereby to provide tax relief and useful, simplified tax guidance.

Available at: https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-executive-order-identifying-and-reducing-tax-regulatory.

[4] *See,* MFA's April 15, 2016 comment letter, available at: https://www.managedfunds.org/wp-content/uploads/2016/04/MFA-Comment-Letter-on-Partnership-Audit-Release.pdf.

[5] *See,* pages 65 and 66 of the Bluebook.

under Section 6225 apply in respect of upper-tier partnerships (or other passthrough entities). Moreover, the Section 6226 reporting alternative to the default rules is a critical mechanism to help ensure that partners can correctly calculate their taxes, and partnerships can equitably allocate taxes to upper-tier partners that are themselves partnerships. For the new partnership audit framework to achieve the objectives Congress intended, in particular with respect to the investment fund industry, we believe that rules need to be adopted that make the reporting option of Section 6226 a feasible and realistic alternative to the default rules under Section 6225.

To the extent Sections 6225 and 6226 impose additional tax liabilities on investors that they do not rightfully owe to the government, impose double taxation, or shift tax liabilities from investors to other investors, we believe that the new partnership audit regime will distort investment activity among different types of asset management structures. Some investors, for example, may expect managers to provide separate account structures, rather than pooled funds, which eliminates many of the efficiencies that pooled vehicles provide investors. Moreover, some managers may not have sufficient resources to effectively provide separate accounts, which may preclude those managers from providing their investment services to investors who request separate accounts. Some investors may choose to invest through passive foreign investment company structures to avoid domestic investment funds structured as entities treated as partnerships.

To help accomplish the goal of having the regulatory framework reflect the congressional intent underlying the partnership audit legislation, we believe that Treasury and the IRS should propose rules that take into account the relevant provisions of the Tax Technical Corrections Act of 2016 (the "Technical Corrections Bill").[6] While Congress did not enact the Technical Corrections Bill into law last year, we believe the bill provides relevant guidance as to Congress's intent in enacting the partnership audit framework established in the Bipartisan Budget Act of 2015, particularly in light of the fact that the proposed statutory changes in the Technical Corrections Bill were determined to be technical, rather than substantive in nature. Accordingly, we encourage Treasury and the IRS to consider the Technical Corrections Bill as relevant guidance in drafting regulations to enact the statutory partnership audit framework. We also encourage Treasury and the IRS to continue working to help Congress enact technical corrections to the partnership audit provisions in the Bipartisan Budget Act of 2015.

It is also important for Treasury and the IRS to prioritize issuing the proposal and ultimate implementation of the regulatory framework as soon as reasonably practicable. As Treasury and the IRS are aware, the new partnership audit rules will be applicable to tax years beginning in 2018. Further, investors facing the potential tax risks associated with the new framework already have begun seeking assurances from private fund managers that the investors will not bear tax liabilities of other investors in the fund or otherwise pay tax liabilities that those investors would not have owed outside the context of an audit adjustment. The lack of rulemaking and guidance to date creates significant uncertainty for investors making investment decisions and for managers, who are being asked to make contractual representations about how they will implement the yet to be determined rules. Given these concerns and the current status of rulemaking to implement the partnership audit framework, we encourage Treasury and the IRS

[6] H.R. 6439, 114th Cong. (2016).

to work with Congress on including a delay in the effective date of the partnership audit framework as part of any technical corrections legislation.

Executive Summary

To accomplish the intended goals of the legislation, and avoid adverse consequences that may deter investment in private investment funds, we believe that the following issues need to be addressed:

Application of Reporting Option Available to Upper-Tier Partnerships – It is critical that the mechanism implementing the Section 6226 reporting option provides a feasible and realistic alternative to the default rules under Section 6225 for all partnerships, including tiered partnerships, as intended by Congress. For the reporting option in Section 6226 to work in practice, it is important to provide a mechanism for upper-tier partnerships (or other passthrough entities) to make a reporting election similar to the partnership under audit, consistent with the approach taken in Section 204 of the Technical Corrections Bill.

Modifications Under Section 6225 for Upper-Tier Partnerships – Partnerships that choose to pay any underpayment under Section 6225 are permitted to make certain modifications in determining the amount of any underpayment. However, Treasury and the Service should provide guidance clarifying how a partnership can make modifications when it has upper-tier partnerships (or other passthrough entities) as partners. Such guidance should develop a framework that enables lower-tier partnerships to make modifications to imputed underpayments in light of the tax characteristics of the ultimate partners of those upper-tier partnerships. In that regard, we appreciate and support the language in the Proposed Rules that provides the ability of a partnership to make permitted modifications for indirect partners as well as direct partners.

Basis Adjustments Under Section 6225 – When a partnership decides to pay an imputed underpayment under Section 6225, partners should receive a basis adjustment that reflects the adjustment to income that gave rise to the tax payment as well as an adjustment to reflect the non-deductible payment made by the partnership. Absent such basis adjustments, partners would be subject to double tax on the same income, once when the partnership pays the tax and again when the partner receives a distribution reflecting the income that gave rise to the tax payment by the partnership. In that regard, we appreciate the statement in the preamble to the Proposed Rules that Treasury and the IRS intend to issue additional rules regarding basis adjustments when a partnership makes an imputed underpayment under Section 6225.

Symmetrical Adjustments for Overpayments and Underpayments – Sections 6225 and 6226 have specific provisions that provide for adjustments to be made for underpayments, but do not clearly provide that similar adjustments should be made for overpayments. Taxpayers should receive symmetrical treatment with respect to

adjustments under Sections 6225 and 6226, including adjustments for overpayments or other adjustments that would serve to reduce the taxpayer's tax liability, consistent with the approach taken in Section 206(e) of the Technical Corrections Bill.

Accounting Treatment of Partnerships – The statutory language in Section 6225 is unclear whether the partnership is paying taxes on behalf of its partners, or whether Section 6225 deems the partnership to be the taxpayer itself, which would create a conflict with the language in Section 701 of the Code. We agree with the statement in the Bluebook that the flowthrough nature of partnerships is not changed by Section 6225, and encourage Treasury to provide explicit guidance confirming this interpretation.

Good Faith Efforts to Report to Partners – Consistent with other provisions in the Code, and consistent with the Proposed Rules, Treasury and the Service should confirm that a partnership will be deemed to have made a valid election under Section 6226 if it makes good faith efforts to provide adjusted tax statements to all of its partners (along with providing adjusted tax information to the IRS).

Partnership Representative – Section 6223 requires a partnership to designate a person with a substantial presence in the United States as the partnership representative to act on behalf of the partnership under the legislation. For many investment funds, the current tax matters partner often is a general partner entity affiliated with the fund's investment manager. That entity, while often formed under U.S. law, typically does not have its own employees. Consistent with the Proposed Rules, Treasury and the IRS should confirm that such an entity may be designated as the partnership representative under Section 6223, provided that Treasury and the IRS have sufficient ability to contact that entity and its control persons, as necessary.

Small Partnership Election Under Section 6221 – MFA believes that small partnerships that have passthrough partners should not automatically be excluded from making an opt-out election under Section 6221. We believe Treasury and the IRS should issue rules or guidance that would permit a partnership to look through upper-tier partnerships, as appropriate, to permit partnerships required to provide 100 or fewer tax statements to make the opt-out election.

Also, consistent with the general treatment of grantor trusts under the Code, Treasury and the IRS should reconsider the Proposed Rules and adopt rules under Section 6221 to provide that grantor trusts may be disregarded, and that the partnership should look at each grantor for purposes of determining the type of partner under Section 6221(b)(1)(C) and the number of statements the partnership is required to furnish under Section 6221(b)(1)(B).

Reporting Option Should Permit Partnerships to Challenge IRS Audits – Section 6226 requires a partnership to make the election to provide adjusted tax statements within 45 days of the Service sending a final audit determination to the partnership. We believe that a partnership should not be required to decide whether

to make an election under Section 6226 until final resolution of an audit, including any taxpayer right to challenge the final audit determination through an administrative or judicial proceeding. At a minimum, Treasury and the Service should provide guidance that a partnership will not be required to provide adjusted tax statements until after the partnership has exhausted its rights to challenge a final audit determination through an administrative or judicial proceeding, and that any partnership's decision to revoke its election under Section 6226 upon the completion of an administrative or judicial proceeding will be approved by the Secretary of the Treasury.

Permitting Modifications Under Section 6225 for Taxes Actually Paid by Partners – Section 6225(c) permits partnerships to make modifications to an imputed underpayment for amended returns filed by partners that meet the requirements of the statute. We believe Treasury and the Service should interpret Section 6225(c) to permit modifications to imputed underpayments for any tax return filed by a partner that has already reported that partner's allocable share of the adjustment amount and paid that partner's tax liability with respect to such income.

Determination of Penalties at the Partnership Level – Section 6226(c)(1) provides that penalties shall be determined at the partnership level, which has raised questions whether partners may be assessed penalties under Section 6226, even if no partner had any underpayment. We encourage Treasury and the Service to clarify that the language in Section 6226(c)(1) will be interpreted consistently with prior regulation §301.6221-1(c), including that partnerships will be able to avail themselves of partner-level defenses under §301.6221-1(d), and will not be interpreted to mean that penalties are measured by reference to the imputed underpayment amount at the partnership level.

Definition of Items of Income, Gain, Loss, Deduction, or Credit – The Proposed Rules create a broad definition of items of income, gain, loss, deduction, or credit, including items related to transactions between a partnership and a partner. We encourage Treasury and the IRS to clarify that the final determination of a transaction between a partnership and a partner (when not acting in its capacity as a partner in the partnership) following an audit of the partnership is not binding on the partner who is not a party to the audit.

Overview of Investment Fund Partnerships

Many private investment funds are structured as partnerships (or other passthrough entities) in order to pool money from investors in a manner that preserves, to the extent practicable, tax neutrality for those investors when compared to investing directly in capital markets. Investors in private investment funds include tax-exempt investors (*e.g.*, public and private pension plans and charitable endowments and foundations) and other institutional and sophisticated investors. These institutional investors, along with others, have invested trillions of dollars in private investment funds, seeking the professional risk management, portfolio diversification, and other benefits provided by managers of private investment funds.

Private investment funds are one type of asset management structure, along with separate accounts and mutual funds, that sophisticated investors can utilize to obtain professional asset management services. Unlike operating partnerships, which compete for investment with operating corporations that have two levels of tax (at the corporate level and at the investor level) and potential tax liabilities that pre-date an investment into the corporation, investment fund partnerships compete with other asset management structures that impose one level of tax on the investor, and only with respect to that investor's investments.[7]

Further, the investor base for many private investment funds changes regularly, as new investors come into the fund and earlier investors leave the fund.[8] As a result, a partnership level tax on private investment funds creates disadvantages for investors in those funds compared to investors in other asset management structures because investors would face the potential to indirectly bear tax obligations from a period prior to their investment in the fund. Not only does bearing the risk of paying tax obligations of other investors create a disincentive to invest in fund partnerships, many institutional investors (such as pension funds subject to the Employee Retirement Security Income Act of 1974) owe fiduciary obligations to their underlying beneficiaries that could preclude them from making an investment under those circumstances. As such, with a partnership level tax, these institutional investors face the risk of over-taxation on their investments (if permitted to invest) or the risk of losing the investment benefits that they achieve by investing in private investment fund partnerships.

To avoid creating distortions in how investors allocate money to asset managers and to avoid imposing additional tax liabilities that they do not rightfully owe to the government, imposing double taxation on investors, or shifting tax liabilities from former investors to current investors, we encourage Treasury and the Service to implement rules and guidance to address the issues set out below. To the extent that Treasury or the Service believe that they lack authority under the legislation to address any of these issues, we encourage them to identify those issues so that Congress can determine how best to address those concerns about regulatory authority.

1. Application of Reporting Option Available to Upper-Tier Partnerships

The reporting option provided by Section 6226 requires a partnership to report adjusted tax statements to its partners and the Service within a specified time period, to be determined in regulations or regulatory guidance. The language in the statute, including the 45-day period within which a partnership must elect Section 6226, does not address how upper-tier partnerships, or other passthrough entities, would be able to make a similar election to provide adjusted tax information statements to their partners and to the Service, once they have received adjusted tax statements from a lower-tier partnership. Section 204 of the Technical Corrections Bill does, however, clearly provide for the application of Section 6226 to upper-tier passthrough entities.

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[7] U.S. mutual funds technically are subject to an entity-level tax. However, mutual funds generally operate in a manner to avoid the entity-level tax, in accordance with the requirements set out in Subchapter M of the Code.

[8] While liquidity terms for investment fund partnerships vary, typically in relation to the liquidity of the fund's portfolio of investments, many funds offer monthly or quarterly redemption rights to investors, typically with some period of advance notice.

We are hopeful that the language in the Technical Corrections Bill is ultimately enacted by Congress, but at a minimum, we believe the language provides useful guidance as to the appropriate interpretation of Section 6226. Treasury and the IRS determined to reserve rulemaking on this issue in the Proposed Rules, though they announced their intention to propose additional rules on this issue. The implementation of Section 6226 is a critical component of the partnership audit framework for many partnerships. As such, we strongly encourage Treasury and the IRS to propose rules to provide a framework for upper-tier passthrough entities to use the reporting option set out in Section 6226, consistent with the clear intent of Congress, as indicated in the Technical Corrections Bill.

Many partnerships, including investment funds, have partnerships as investors (such as feeder funds,[9] funds of funds,[10] and family partnerships). For the reporting option to be a meaningful alternative for partnerships, it is important for the reporting option to be available to upper-tier partnerships and other passthrough entities. Allowing such upper-tier entities to elect the Section 6226 reporting option should not significantly increase the Service's enforcement burden as it has the authority to create forms that would enable it to track the adjusted tax information statements through multiple tiers, as well as authority to establish the time periods for information to be reported to partners and the IRS.

If upper-tier partnerships and passthrough entities are not able to make a similar reporting election, then that upper-tier entity must pay tax at the entity level. It is not clear from the statute exactly how such entities would determine the appropriate tax to be paid. If an upper-tier partnership is deemed to owe tax under Section 6225, then the lower-tier partnership's election not to be subject to the default rule has been made ineffective for upper-tier partnerships.[11] If the upper-tier partnership is required to pay tax as if it were an individual under Section 703 of the Code, as suggested by the Bluebook, then the lower-tier partnership's election under Section 6226 would seem to turn an upper-tier partnership into a taxable entity, inconsistent with Section 701 of the Code.

We recognize that Treasury and the IRS want to ensure that the reporting framework under Section 6226 allows the IRS to be able to identify tax returns or other tax filings by upper-tier partners as related to the original partnership audit. We also recognize that Treasury and the IRS want to develop a reporting system that enables them to ultimately determine whether they have collected taxes from the ultimate partners. In determining the appropriate framework under Section 6226, we believe it is important for Treasury and the IRS to focus on how to implement Section 6226 in a manner that provides the appropriate information to the government and not in a manner that would effectively require a guarantee of tax payments by partners for a partnership to make the election.

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[9] Feeder funds are investment funds that invest all, or nearly all, of their capital into a single investment fund, typically called a master fund.

[10] Funds of funds are investment funds that invest in multiple underlying investment funds.

[11] It also would seem to follow from the statute that, if the upper-tier partnership were deemed to owe tax under Section 6225, then that partnership would have the ability to choose Section 6226 itself.

We believe that Section 6226 provides Treasury and the IRS with authority to create such a framework through the development of new, or modification of existing, tax forms to provide the IRS with sufficient information to link various filings from partnerships and partners. We understand that Treasury and the IRS may be considering creating a numerical code that would identify the relevant partnership audit, which we believe would be a useful part of a reporting framework, particularly for tiered structures. Using this, or other similar approaches, the final rules could require a partnership to include the audit code on the information statement it must provide to the IRS and on the adjusted tax information statements the partnership must provide to its partners. Further, the final rules could require each upper-tier partnership that makes a Section 6226 election to include the audit code in its information statements to the IRS and in the adjusted tax information statement provided to its partners. Finally, we believe that the final rules could require a partnership making a Section 6226 to identify its partners on the information statement provided to the IRS. We believe that collection of this information would provide the IRS with the information it needs to tie the tax payments it ultimately receives back to the original audit, and also would provide the information about all of the partners through a tiered structure to allow the IRS to identify any non-payments or underpayments by ultimate partners (we note that such non-payment or underpayment may be the appropriate tax result based on the individual circumstances of those partners).

We also encourage Treasury and the IRS to modify the definition of "former partners" in §301.6241–3(d) of the Proposed Rules with respect to partnerships that have ceased to exist, when the partnership representative has elected the reporting option under Section 6226. We believe that former partners in this context should include reviewed year partners of the partnership that has ceased to exist, to the extent that such partners can be identified and contacted by the partnership representative.

Example:

Many private funds are organized into tiered structures. A master fund, which engages in the trading activity, often is owned by multiple feeder funds (which invest only in the master fund), which accommodate different types of investors (such as U.S. taxable investors, U.S. tax-exempt investors, and non-U.S. investors). Master funds and feeder funds for U.S. taxable investors typically are structured as partnerships. Investors in feeder funds may themselves be partnerships (including family partnerships or funds of funds).

To the extent a master fund is the partnership under audit and elects to report to its partners under Section 6226, unless the feeder fund could make its own election under Section 6226, it would be forced to pay tax, pursuant to the rules under Section 6225 or as if it were an individual under Section 703. Under either scenario, the partnership level tax at the feeder fund level would effectively block the master fund's Section 6226 election, as the tax adjustments would not be passed through to taxpayers. This result is inconsistent with the intent underlying Section 6226, to the extent that it denies investment fund partnerships any practical ability to avail themselves of the Section 6226 election.

Administrative Adjustment Request Alternative

We have heard suggestions that upper-tier partnerships for which administrative adjustment requests ("AARs") are available, could make AARs to pass through tax information statements to their partners when a lower-tier partnership has made a Section 6226 election, in lieu of guidelines for upper-tier partnerships to make an election under Section 6226. We believe the better approach would be for Treasury and the Service to implement Section 6226 in a way that would avoid the need for upper-tier partnerships or other passthrough entities to rely solely on the AAR process. To the extent that Treasury and the Service believe that the AAR process is an appropriate mechanism available for upper-tier entities to pass through tax information statements, we believe that the following issues would need to be addressed through rules or guidance.

Section 6227(c) establishes a three-year period of limitations on when a partnership may file an AAR. An audit on a lower-tier partnership may not be concluded until after the three-year period set out in the statute has expired (for example, if the lower-tier partnership extended the statute of limitations on the underlying issue giving rise to the audit). As such, for Section 6227 to provide an opportunity for an upper-tier partnership to make an AAR, we believe Treasury and the Service would need to issue guidance that an upper-tier partnership would be permitted to make an AAR within an appropriate period of time following the upper-tier partnership's receiving a final adjusted tax information statement from a lower-tier partnership.

Section 6227(c) also provides that a partnership may not make an AAR after a notice of an administrative proceeding is mailed under Section 6231. An upper-tier partnership that receives an adjusted tax information statement from a lower-tier partnership has not itself had a notice of an administrative proceeding mailed to it. However, there is uncertainty whether Treasury and the Service might interpret the statute to preclude an upper-tier partnership from making an AAR with respect to an adjustment resulting from an audit at a lower-tier partnership. As such, we encourage Treasury and the Service to confirm in guidance that an upper-tier partnership may make an AAR following receipt of an adjusted tax information statement from a lower-tier partnership pursuant to Section 6226.

Some upper-tier partnerships may have chosen to elect out of Subchapter C, pursuant to Section 6221. It is unclear whether and how these partnerships can make an AAR under Section 6227. We encourage Treasury and the Service to provide guidance that an upper-tier partnership that has otherwise elected out of Subchapter C under Section 6221 would be permitted to make an AAR following its receiving an adjusted tax information statement from a lower-tier partnership pursuant to Section 6226, and to provide guidance on how such partnerships may make an AAR. We also encourage Treasury and the Service to confirm in its guidance that a partnership making an AAR under these circumstances will still be deemed to have opted out of Subchapter C for all other purposes.

Finally, we encourage Treasury and the Service to provide guidance regarding these issues with respect to upper-tier passthrough entities other than partnerships, which are not

covered by Subchapter C, that receive adjusted tax information statements from a lower-tier partnership pursuant to Section 6226.

2. Modifications to Imputed Underpayments under Section 6225 for Upper-Tier Partnerships

Partnerships that choose to pay any underpayment under Section 6225 are permitted to make certain modifications to the imputed underpayment. However, Treasury and the Service should provide guidance clarifying how a partnership can make modifications when it has upper-tier partnerships (or other passthrough entities) as partners. We appreciate and support the language in the Proposed Rules that provides the ability of a partnership to make permitted modifications for indirect partners as well as direct partners.

It is important for the regulatory framework to enable lower-tier partnerships to make modifications to imputed underpayments in light of the tax characteristics of the ultimate owners of those upper-tier entities. One of the disincentives for partnerships to use the default rules under Section 6225 is the application of the highest tax rate in effect for the reviewed year under Section 6225(b)(1)(A). The modifications permitted under Section 6225 help mitigate this provision; however, to the extent that a partnership cannot modify its imputed underpayment with respect to indirect partners investing through upper-tier passthrough entities, then the applicable tax rate imposed by Section 6225(b)(1)(A) will continue to provide a disincentive to partnerships. This disincentive is particularly strong for partnerships with U.S. tax-exempt indirect partners, such as pension plans. Permitting partnerships to modify their imputed underpayment for direct and indirect partners is consistent with the policy objective of having the new partnership audit rules "determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid" and will reduce one of the disincentives for partnerships to pay imputed underpayments under Section 6225. Accordingly, we encourage Treasury and the IRS to adopt rules that permit modifications for indirect partners, consistent with the Proposed Rules.

Example:

An investment fund partnership has a fund-of-funds as one of its partners. The fund-of-funds itself is a partnership, and all of its partners are U.S. tax-exempt entities. All of the investment fund's other partners are individuals subject to the highest income tax rate. If the investment fund partnership is not able to make modifications to its imputed income to reflect the tax-exempt investors that are indirect partners in the investment fund, the partnership will effectively impose an excessive tax payment on its partners in the amount that the imputed underpayment otherwise would have been reduced had the tax-exempt investors been direct partners. This excess tax liability provides a strong disincentive for the investment fund partnership to use Section 6225, as the excess tax is the type of liability that tax-exempt investors expect investment fund partnerships to avoid.

3. Basis Adjustments under Section 6225

When partnerships decide to pay an imputed tax underpayment under Section 6225, the adjustment year partners should receive a basis adjustment that reflects the adjustment to income that gave rise to the tax payment as well as an adjustment to reflect the non-deductible payment made by the partnership. Absent such basis adjustments, partners could be subject to being taxed twice on the same income, once when the partnership pays the tax and again when the partner receives a distribution reflecting the income that gave rise to the tax payment by the partnership. The possibility of partners being subjected to double taxation on an investment in a passthrough entity is another strong disincentive for partnerships to use Section 6225. Ensuring that partners receive appropriate basis adjustments under that Section would remove that disincentive.

In that regard, we appreciate the statement in the preamble to the Proposed Rules that Treasury and the IRS intend to issue additional rules regarding basis adjustments when a partnership makes an imputed underpayment under Section 6225. We look forward to reviewing and providing constructive comments on those proposals.

Example:

Two individuals, A and B, form a partnership, and each invests $55,000. The partnership uses those investments to purchase an asset for $100,000 in Year 1 (leaving $10,000 in excess cash). The partnership reports no taxable income for Year 1. In Year 2, an audit of the partnership determines that the asset increased in value in Year 1, generating $10,000 of taxable income for Year 1. Under Section 6225, the partnership pays an imputed tax of $3,960 in Year 2.[12] The partnership has no gain, income, or loss in Year 2. In Year 3, the partnership sells the asset for $110,000, and the partnership is liquidated. Each of the partners receives $58,020 upon liquidation ($55,000 from the sale of the asset, and $3,020 in remaining cash - *i.e.*, $5,000 less the $1,980 in taxes paid by the partnership under Section 6225).

If there is no basis adjustment to reflect the adjustment to income that gave rise to the partnership paying tax under Section 6225, then each partner would have an original basis of $55,000, less $1,980 to reflect the nondeductible tax paid by the partnership, for a net basis of $53,020. Upon liquidation of the partnership, each partner would owe tax on the distributed amount in excess of net basis (*i.e.*, tax on $5,000 each).

This clearly results in double taxation of the partners on the same economic income. Over the life of the partnership, there is only $10,000 of taxable income. On that $10,000 of income, the partnership would have paid $3,960 in taxes, and each partner would pay an additional amount in taxes upon liquidation,[13] meaning the government would collect more

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[12] For the sake of clarity and simplicity, the example assumes that the highest marginal income tax rate applies, that no interest or penalties were applied, and that there are no other adjustments under Section 6225.

[13] Depending on the nature of the income, the rate and character of the income could vary.

than $3,960 in taxes on $10,000 in income. As such, absent a basis adjustment, the partners would pay a tax rate higher than the top marginal rate on that $10,000 of income.

4. Symmetrical Adjustments for Overpayments and Underpayments

Sections 6225 and 6226 have specific provisions for adjustments to be made for underpayments, but do not clearly provide that similar adjustments should be made for overpayments. Taxpayers should receive symmetrical treatment with respect to adjustments under Sections 6225 and 6226, including adjustments for overpayments or other adjustments that would serve to reduce the taxpayer's tax liability. In that regard, we note that Section 206(e) of the Technical Corrections Bill, which permits adjustments for increases and decreases in tax, clearly indicates Congress's intent to provide adjustments for overpayments as well as underpayments.

Providing symmetrical adjustments is consistent with basic principles of tax fairness. Permitting adjustments only for underpayments will result in taxpayers being subject to excess tax payments and will result in taxpayers paying liabilities of other taxpayers. Neither of these outcomes is consistent with the intent of the statute or the policy goals underlying the statute. We encourage Treasury and the Service to provide certainty that adjustments under both Sections include adjustments for overpayments as well as underpayments.

Section 6225 Example:

Two individuals, A and B, form a partnership in which each owns a 50% interest in profits and losses. The partnership reports no taxable income for Year 1. In Year 2, the partnership reports taxable income of $20,000, and each of A and B make a Year 2 tax payment of $3,960 with respect to his/her share of the partnership's income. Pursuant to an audit of the partnership's Years 1 and 2 conducted in Year 4, it is determined that the partnership should have recognized $10,000 of taxable income in Year 1, and $10,000 of taxable income in Year 2 instead of no income in Year 1 and $20,000 of income in Year 2. The partnership has no gain, income, or loss in Year 3 and Year 4.

Under Section 6225(b), an imputed underpayment for a reviewed year, Year 1, is determined with respect to the $10,000 increase in income, in the amount of $3,960. The partnership pays this amount ($1,980 attributable to each partner), plus interest, at the end of Year 4, the adjustment year.

Under Section 6225(a)(2), the Year 2 decrease of $10,000 of income is reported as a taxable loss of the partnership in Year 4, the adjustment year. Each of A and B receives a K-1 from the partnership for Year 4 which reports a loss of $5,000. A individually reports Year 4 income of $5,000 from other sources. B reports no income from other sources in Year 4.[14]

After taking into account all tax payments with respect to B's interest in the partnership through Year 4, an aggregate tax amount of $5,940 has been collected with respect to aggregate

[14] Alternatively, B's interest in the partnership is an interest in a passive activity, and B reports no income from passive activities in Year 4.

income of $10,000. B has not recovered his/her Year 2 overpayment. Rather, B now has a loss which he or she may be able to carry forward for use in a subsequent year.

A can utilize the Section 6225(a)(2) loss to reduce his/her individual tax payment for Year 4 by $1,980. Although A bears a 3-year interest charge with respect to the partnership's imputed tax underpayment for Year 1, A's Year 4 tax benefit does not reflect any interest adjustment to take into account the 2-year period prior to A's recoupment of his/her Year 2 tax overpayment.

In order to mitigate these unintended consequences, we believe Treasury and the Service should issue guidance to allow adjustments that move income or expense from one year to another to be netted for purposes of computing the imputed underpayment amount.[15]

We also encourage Treasury and the IRS to reconsider the proposed grouping and sub-groupings approach in §301.6225-1(d) of the Proposed Rules. We are concerned that under the proposed approach, the inability to net certain overpayments and underpayments (for example, in a situation when the IRS recharacterizes income from one group or sub-group to another) could lead to taxpayers not receiving an appropriate adjustment for taxes previously paid.

We believe example 3 in § 301.6225-1(f) of the Proposed Rules highlights this concern. In that example, the recharacterization of $125 of long-term capital gain into ordinary income creates an imputed underpayment of $50. Though the example does not specify what happens with respect to the new $125 capital loss, presumably the partnership now has a $125 capital loss to offset capital gains, as permissible. Even with such a capital loss, however, the lack of netting across the proposed groupings creates a tax overpayment by the partnership. Under the example, the partnership previously reported net long-term capital gains of $50, which presumably would have resulted in a prior tax payment of $10 (assuming a 20% long-term capital gains rate). Under the example, the partnership and its partners would have paid $60 in taxes on $125 of ordinary income gain,[16] creating a 48% tax rate on that gain. It is unknown whether the partnership will able to use the $125 capital loss to offset gains in the future, thereby creating an adverse tax consequence for the partnership if it were to elect to pay the imputed tax under Section 6225. Permitting the partnership to net adjustments across different categories of gain or loss to reflect taxes that were previously paid would avoid this adverse consequence.

Section 6226 Example:

Two individuals, A and B, form a partnership in which each owns a 50% interest in profits and losses. The partnership reports no taxable income for Years 1 and 2. In Year 3, the partnership reports taxable income of $30,000, and each of A and B makes a Year 3 tax payment of $5,940 with respect to his/her share of the partnership's income. Pursuant to an audit of the

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[15] If the underpayment year precedes the overpayment year, the IRS could, of course, charge interest for the intervening time period.

[16] We note that the example also does not provide an adjustment for the possibility that the partnership could have used a portion of its capital loss to offset $3,000 of ordinary income gain.

partnership's Year 1, the partnership's Year 1 statute of limitations was extended. At the conclusion of the audit in Year 7, it is determined that the partnership should have reported the $30,000 of income ratably over three years, Years 1 through 3, rather than entirely in Year 3. Based on that determination, a final adjustment is made to the partnership's Year 1, reflecting an increase in income of $10,000.

Under Section 6225(b), an imputed underpayment for a reviewed year, Year 1, is determined with respect to the $10,000 increase in income, in the amount of $3,960. The partnership makes an election under Section 6226, and in Year 7 furnishes each of A and B a statement showing that each has Year 1 income from the partnership of $5,000. Each of A and B compute an adjustment to their Year 7 tax liability, by paying the individual tax otherwise due for Year 7, increased by the sum of (i) $1,980 attributable to the Year 1 adjustment, plus 6 years of enhanced interest, and (ii) pursuant to Section 6226(b)(2)(B), $1,980 attributable to an adjustment to Year 2 partnership income, plus 5 years of enhanced interest.

As a consequence of the adjustments made by A and B with respect to Years 1 and 2, they have paid tax for those years, plus enhanced interest, on $20,000 of partnership income for which they had already paid tax with their tax returns filed for Year 3. The partnership may file an Administrative Adjustment Request with respect to Year 3 (so long as the statute of limitations for Year 3 remains open), reducing the partnership's income for that year from $30,000 as originally reported to $10,000. It appears that under Section 6227(b)(2), A and B receive revised Year 3 tax information from the partnership, and use that information to file amended returns for Year 3 to each obtain a refund payment of $3,960 (along with regular interest) for the Year 3 tax overpayment.

Although only Year 1 was audited, as a condition for utilizing Section 6226, the partners are obligated to take into account, and make Year 7 tax payments for, the related Year 2 tax liability as well. However, they do not take into account the Year 3 adjustment, which is a reduction to the partnership's income. Therefore, they are obligated to make Year 7 tax payments of $3,960 plus enhanced interest, and (if the statute of limitations allows) separately file for a Year 3 refund of $3,960 plus regular interest.

These anomalous results could be corrected if the partnership were allowed to make the Section 6226 election for both the underpayment and overpayment years. The Section 6226 election for all three years would result in the correct tax being paid by the partners who economically earned the income. Further, to the extent that a partner's aggregate tax for prior years is reduced as a result of its share of the adjustments on the adjusted tax information statements, such partner should be able to use its net overpayment as a credit against its tax for the year in which the adjusted tax information statements are received (the same year in which the taxpayer's liability would be increased if such adjustments resulted in an underpayment). We note that this approach is consistent with Section 206(e) of the Technical Corrections Bill, which, we believe, reflects the original intent with respect to Section 6226 of the Code.

5. Accounting Treatment of Partnerships

The statutory language in Section 6225 is unclear as to whether the partnership is paying taxes on behalf of its partners, or whether the partnership is deemed to be the taxpayer itself, which would create a conflict with the language in Section 701. To the extent Section 6225 is deemed to create a partnership level liability, partnerships could be required to place reserves on their books under applicable accounting guidance. This is a significant issue for investment fund partnerships because investors invest in, and redeem from, a fund based on the net asset value of the fund, as reflected on the fund's books. Many investors are understandably reluctant to invest in funds that have such reserves on their books, or funds that may have to record reserves prior to an investor redeeming its investment in order to protect the partnership and other investors from the possibility of future tax liabilities upon audit.

We agree with the statement in the Bluebook that the flowthrough nature of partnerships is not changed by Section 6225, and encourage Treasury and the Service to provide guidance explicitly confirming this interpretation. Guidance clarifying that the fundamental premise of Section 701 of the Code has not changed, together with the other rulemaking requested in this letter, will be helpful to the industry in avoiding unnecessary and disruptive reserves.

6. Good Faith Efforts to Report to Partners

Consistent with other provisions in the Code, we believe Treasury and the Service should confirm that a partnership will be deemed to have made a valid election under Section 6226 if it makes good faith efforts to provide adjusted tax statements to all of its partners (along with providing adjusted tax information to the Service). Partnerships are likely to encounter situations when a partner that is an entity no longer exists or when the partnership does not have current contact information for a former partner. We believe that once a partnership has sent out adjusted tax information to partners and to the Service, it has fulfilled its obligations under the statute. Imposing obligations on the partnership beyond the reporting requirements of Section 6226 would be inconsistent with the language and intent of that Section and would undermine Section 6226 as an alternative to Section 6225. In that regard, we support the approach taken in §301.6226-1 of the Proposed Rules, that a partnership which makes a valid election under Section 6226 is not liable for the imputed underpayment.

7. Partnership Representative

Section 6223 requires a partnership to designate a person with a substantial presence in the United States as the partnership representative to act on behalf of the partnership under the legislation. For many investment funds, the current tax matters partner, which logically could become the partnership representative, often is likely to be a general partner entity affiliated with the fund's investment manager. That entity, while often formed under U.S. law, typically does not have its own employees. We support the approach taken in §301.6223-1 of the Proposed Rules, which permits an entity to act as the partnership representative, provided the partnership identifies an individual with a substantial U.S. presence to act on the entity's behalf. We encourage Treasury and the IRS to confirm that a

person designated by an entity that is the partnership representative to be the "designated individual" does not have to be an employee of the partnership representative.

We further encourage Treasury and the IRS to permit a partnership to change its partnership representative, or the partnership representative's designated individual, to the extent the partnership is not under audit at the time of the proposed change. We are concerned that the proposed rules are overly rigid and do not provide flexibility for regularly occurring situations when a change in the partnership representative or the designated individual would be appropriate. For example, if the partnership representative or designated individual were to die or were no longer affiliated with the partnership, we believe the rules should provide a flexible approach that would permit the partnership to change its partnership representative or designated individual.

8. Small Partnership Election under Section 6221

MFA believes that small partnerships that have passthrough partners should not automatically be excluded from making an opt-out election under Section 6221. To the extent that tiered partnership structures ultimately have 100 or fewer partners, we believe it is consistent with the statutory intent to permit these partnerships to make an election under Section 6221, similar to the ability of partnerships with partners that are S corporations to make the election. Accordingly, we believe Treasury and the IRS should reconsider the approach set out in the Proposed Rules and issue rules or guidance that would permit a partnership to look through upper-tier partnerships, as appropriate, to permit partnerships with 100 or fewer partners to make the opt-out election.

We further encourage Treasury and the IRS to issue guidance that the partnership, for purposes of determining whether the partnership is required to furnish 100 or fewer tax statements, is not required to count a passthrough partner toward that limit, to the extent the partnership is counting the passthrough partner's ultimate owners. We note that the Bluebook suggests that the passthrough entity should be counted, along with its underlying owners. However, we do not see any policy reason to include both the entity and its owners for purposes of the numerical threshold.

We also note that the Bluebook suggests that Treasury and the Service may consider providing guidance with respect to partners that are grantor trusts. We believe that grantor trusts, which are generally disregarded for income tax purposes, should not be required to be considered similar to partnerships, or other passthrough entities for a partnership to be able to make an election under Section 6221. Consistent with the general treatment of grantor trusts for income tax purposes,[17] Treasury and the IRS should reconsider the approach set out in the Proposed Rules and adopt rules under Section 6221 to provide that grantor trusts may be disregarded, and the partnership should look to each grantor for purposes of determining the type of partner under Section 6221(b)(1)(C) and for purposes of determining the number of statements the partnership is required to furnish under Section 6221(b)(1)(B).

[17] See Sections 671-673.

9. Reporting Option Should Permit Partnerships to Challenge IRS Audits

Section 6226 requires a partnership to make the election to provide adjusted tax statements within 45 days of the Service sending a final audit determination to the partnership. We believe that a partnership should not be required to decide whether to make an election under Section 6226 until final resolution of an audit, including any rights the taxpayer has to challenge the final audit determination through an administrative or judicial proceeding. At a minimum, Treasury and the Service should provide guidance that a partnership will not be required to provide adjusted tax statements until after the partnership has exhausted its rights to challenge a final audit determination through an administrative or judicial proceeding and that any partnership's decision to revoke its election under Section 6226 upon completion of the administrative or judicial proceeding will be approved by the Secretary of the Treasury, or the Secretary's designee.

Further, it is not clear under proposed §301.6225–2 that a partnership has the ability to appeal or litigate an adjustment made by the IRS pursuant to a modification request. We believe that a partnership should not forfeit its rights to appeal or litigate a determination made by the IRS, and that any such limitation would be a significant hindrance to a partnership's determination to make an imputed underpayment under Section 6225 instead of making an election under Section 6226. We encourage Treasury and the IRS to revise §301.6225–2 to confirm that a partnership maintains its rights to appeal or litigate a determination made by the IRS in response to a modification request.

10. Permitting Modifications under Section 6225 for Taxes Actually Paid by Partners

Section 6225(c) permits partnerships to make modifications to an imputed underpayment for amended returns filed by partners that meet the requirements of the statute. We believe Treasury and the Service should interpret Section 6225(c) to permit modifications to imputed underpayments for any tax return filed by a partner that has already reported that partner's allocable share of the adjustment amount and paid that partner's tax liability with respect to such income. To the extent an adjustment amount and the imputed underpayment with respect to that adjustment amount have already been reported and tax paid, modifications should be permitted with respect to the tax amount paid and not be limited only to taxes paid in connection with an amended return.

There are a number of situations in which partners may have already reported the adjusted amount as income on a return and paid the appropriate tax on that income. For example, partners may file tax returns with inconsistent positions that reflect the income being adjusted in the audit, two or more people may be deemed by the IRS to have formed a partnership when they have individually reported the income being ascribed to the deemed partnership, or a foreign partnership may have an unknown, remote U.S. partner who has reported his or her share of the partnership's income and paid tax on that amount. In these situations, the partnership should not be subject to additional tax as there has been no underpayment. Imposing tax in these situations would simply be double taxation on the same income, which is beyond the intent of the statute.

Examples:

A and B are each 50% partners in a partnership. The final audit of the partnership determines that it had additional income of $5,000 in each of Year 1 and Year 2, creating an imputed underpayment of $3,960 in the adjustment year. In each of Years 1 and 2, partner A filed a tax return with an inconsistent position that included the $2,500 of income identified in the final audit and paid $990 of income in each year. To the extent the partnership is not able to modify its imputed underpayment to reflect the tax returns filed by partner A, the IRS would collect $5,940 in taxes on $10,000 of income.

A and B have an agreement to share income on a 50/50 basis, but made a good faith determination that their agreement did not create a partnership. In Year 1 and Year 2, they each received $5,000 pursuant to their agreement, and each paid $1,980 in taxes each year (totaling $7,920 in taxes paid by both individuals on $20,000 in income for the two years combined). The IRS determines that the agreement did create a partnership, and creates a partnership return because none was ever filed. The IRS determines that the partnership had $20,000 of combined income for Years 1 and 2 with an imputed underpayment of $7,920. To the extent the partnership is not able to modify its imputed underpayment to reflect the tax returns filed by A and B, the IRS would collect $15,840 in taxes on $20,000 of income.

11. Determination of Penalties at the Partnership Level

Section 6226(c)(1) provides that penalties shall be determined at the partnership level, which has raised questions whether partners may be assessed penalties under Section 6226, even if no partner had any underpayment. We are concerned that the language in example 1 of §301.6226–3(g) of the Proposed Rules, which seems to indicate that the partner pays a penalty based on the amount of the partnership's imputed underpayment, rather than the amount of the partner's increased tax liability, could lead to this result.

To the extent the determination of penalties is interpreted to mean determining the nature of the conduct at the partnership level (*e.g.*, negligence, intentional conduct), we believe that would be consistent with prior law and the intent of the statute. To the extent the determination of penalties is interpreted to mean determining the amount of penalty based on the imputed underpayment amount at the partnership level, we believe that would be inconsistent with the intended purpose of Section 6226 and could lead to fundamentally unfair circumstances. For example, if a partnership with all tax-exempt partners has an imputed underpayment of $1,000,000, and the determination of the penalty is based on that imputed underpayment amount, partners could be faced with paying their share of a penalty even when none of the partners owes any actual underpayment, resulting in penalties being assessed when there is no underpayment of taxes.

As such, we encourage Treasury and the Service to clarify the language in example 1 of §301.6226–3(g) of the Proposed Rules to provide that the language in Section 6226(c)(1) will be interpreted consistently with prior regulation §301.6221-1(c), including that partnerships will be able to avail themselves of partner-level defenses under §301.6221-1(d),

and will not be interpreted to mean that penalties are measured by reference to the imputed underpayment amount at the partnership level.

12. Definition of Items of Income, Gain, Loss, Deduction, or Credit

The Proposed Rules create a broad definition of items of income, gain, loss, deduction, or credit, including items related to transactions between a partnership and a partner. We understand the importance of including all relevant items within the scope of the partnership audit regime. However, it is important that the partnership audit rules do not create binding obligations on other persons who were not parties to the audit, regardless of whether those other persons are partners. We recognize, of course, that an IRS determination with respect to a partnership is indirectly binding on the partnership's partners, with respect to their status as partners in the partnership. To the extent a partner has an additional relationship with the partnership, however, (for example, as a counterparty to a transaction with the partnership in addition to being a partner in the partnership) the audit determination should not be binding on the partner with respect to its status as a counterparty to a transaction with the partnership. We encourage Treasury and the IRS to clarify that the final determination of a transaction between a partnership and a partner following an audit of the partnership is not binding on any third person, including any partner of the partnership (when not acting in its capacity as a partner in the partnership), who is not a party to the audit.

MFA appreciates the willingness of Treasury and the Service to consider the issues discussed above, and we would welcome the opportunity to further discuss the issues raised in this letter with Treasury and IRS staff. If you have any questions regarding any of MFA's comments, or if we can provide further information with respect to the issues raised in our letter, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice-President and Managing
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