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

April 15, 2016

Via E-Mail: Notice.Comments@irscounsel.treas.gov

Internal Revenue Service
CC:PA:LPD:PR (Notice 2016-23)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Managed Funds Association Comments on Notice 2016-23

Dear Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to Notice 2016-23, Request for Comments Regarding Implementation of the New Partnership Audit Regime Enacted as Part of the Bipartisan Budget Act of 2015 (the "Notice"). We believe the Notice identifies a number of issues that will require rulemaking or guidance from the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS" or the "Service"). In addition to the issues identified in the Notice, we believe there other issues that will require additional guidance from Treasury and the Service. In considering the various issues requiring clarification or guidance, we encourage Treasury and the Service to identify those issues which may need technical legislative changes to ensure that all areas of ambiguity or uncertainty can be addressed through regulatory guidance or legislative fixes in advance of the effective date of the legislation.

MFA supports the goal underlying the changes to partnership audit rules in Subchapter C of Chapter 63 of the Internal Revenue Code of 1986, as amended, (the "Code") that were enacted as part of the Bipartisan Budget Act of 2015, which were intended to ensure that the Service is 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

[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.

the staff of Joint Committee on Tax (the "Bluebook"), namely, "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."

As a matter of fundamental tax policy and basic tax fairness, the new 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. In implementing the new partnership audit legislation, we believe that Treasury and the Service should focus on implementing the legislation in a manner that establishes an efficient, administrable regime that best ensures that the government collects the correct amount of tax from the correct taxpayers.

In that regard, Treasury and the Service should clarify how the default rules apply in respect of upper-tier partnerships (or other passthrough entities), as they relate to modifications for tax characteristics of the upper-tier partners. Moreover, the section 6226 reporting alternative to the default rules is a critical mechanism to help ensure that taxes are correctly calculated and equitably allocated, including with respect to tiered partnerships.[2] 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 accomplish the intended goals of the legislation, we believe that the following issues need to be addressed, through regulation, regulatory guidance, or legislative amendments:

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.

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.

[2] All section references in the letter refer to the Code, as amended by the Bipartisan Budget Act.

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.

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.

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 guidance confirming this interpretation.

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).

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 designated 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 employees. 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 confirm 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).

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.

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.[3]

Further, the investor base for many private investment funds changes regularly, as new investors come into the fund and earlier investors leave the fund.[4] 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) 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.

We understand that investors facing this tax risk 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. 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. 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 investment activity is likely to be distorted as 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 (and which some managers may not have sufficient resources to provide and which may preclude some managers from implementing their investment strategies across multiple accounts). Some investors may choose to invest through passive foreign investment company structures to avoid investment funds structured as entities treated as partnerships.

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[3] 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.

[4] 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.

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, and the 45-day period within which a partnership must elect section 6226, do 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. Many partnerships, including investment funds, have partnerships as investors (such as feeder funds,[5] funds of funds,[6] 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 the Service 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 Service.

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.[7] 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.

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

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

[7] 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.

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 the 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. 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 owners of those upper-tier entities. We encourage Treasury and the Service to issue guidance that permits upper-tier passthrough entities to provide information regarding the tax characteristics of their owners either to the lower-tier partnership or to the Service, which could take those characteristics into account in determining the imputed underpayment for the lower-tier partnership, so as to permit modifications that would otherwise be permitted under section 6225 if those ultimate owners were direct partners in the lower-tier partnership under audit. In addition, in the context of a tiered structure, we believe that the guidance should allow a partnership to modify its imputed underpayment amount under section 6225(c)(2) to the extent that the adjustments are reported on amended returns, and appropriate taxes are paid, by either: (1) the upper-tier partnership or other passthrough entity; or (2) the ultimate tax paying persons in the upper-tier entity, to the extent that information regarding the amended return(s) is provided either to the lower-tier partnership or to the Service.

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.

Example:

An investment fund partnership has a fund-of-funds as one of its partners. The fund-of-funds itself is a partnership and has as all of its partners institutions that 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 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 would 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.

Example:

Two individuals, A and B, form a partnership and each invest $55,000 and the partnership uses those investments to purchase an asset for $100,000 in Year 1 (leaving $10,000 in excess cash). At the end of Year 1, 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.[8] The partnership has no gain, income,

[8] For 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.

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, ($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 distribution amount above that net basis, or $5,000 each.

This clearly results in over taxation on the partners. 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,[9] meaning the government would collect more 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 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.

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. 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

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

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 receive 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. (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.)

After taking into account all tax payments with respect to B's interest in the partnership through Year 4, an aggregate tax amount of $7,920 has been collected with respect to aggregate income of $10,000. B has not recovered his/her Year 2 overpayment; rather B now has loss which it 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.[10]

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 make 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 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.

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

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 have 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. They therefore 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).

5. 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. To the extent section 6225 is deemed to create a partnership level liability, partnerships could be required to place reserves on their financial statements 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 financial statements. Many investors are understandably reluctant to invest in funds that have such reserves on their financial statements, 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 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 such as 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. In order to minimize the risk that a former partner cannot be located, we believe that it would be reasonable to require as a condition of making a section 6226 election that a partnership make a good faith effort to maintain contact information for former partners until the closing of the statute of limitations for the latest year in which such person was a partner.

We note in this regard that the Notice asks for comment on the consequences when a partner fails to account for adjustments as required under section 6226(b), including how tax attributable to those adjustments is assessed and collected. We believe that, once the partnership has sent out adjusted tax information statements, the responsibility to properly pay any tax liability belongs to the partner, the same as the responsibility to properly pay any tax liability reported by a partnership to a partner outside of the context of section 6226. We do not believe that there should be any further consequence to the partnership in these circumstances as the statute clearly requires a partnership to provide adjusted tax information statements to partners and to the government; it does not require a partnership to guarantee that partners pay tax liabilities that they owe. 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.

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 designated partner 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 employees. 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.

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 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 does not require the partnership, for purposes of determining whether the partnership is required to furnish 100 or fewer tax statements, 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 treated as disregarded entities under the Code, 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 under the Code,[11] Treasury and the IRS should confirm 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).

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.

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

[11] See sections 671-673.

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 not be limited only 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 (*e.g.*, when partners file tax returns with inconsistent positions that reflect the income being adjusted in the audit, when two or more people are deemed by the IRS to have formed a partnership and they have individually reported the income being ascribed to the deemed partnership, when a foreign partnership has an unknown, remote U.S. partner who has reported its 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:

The final audit determines that a partnership had additional income in each of Year 1 and Year 2 of $5,000, creating an imputed underpayment of $3,960 in the adjustment year. A and B are each 50% partners in the partnership. 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 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. 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 owe 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 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.

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 suggested amendments to the Notice, 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 Director, General Counsel